Local Governments Debt

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Local Governments Debt

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Synonyms

Borrower – debtor; Debt instruments; Golden rule; Gross debt; Lender – creditor; Net debt; Total gross debt – total debt or total debt liabilities

Definitions

- **Debt** is a liability in which a creditor has a claim on the debtor.
- **Debt instrument** is a financial claim that requires payment(s) of interest and/or principal by the debtor to the creditor at a date, or dates, in the future.
- **Total gross debt** ("total debt" or "total debt liabilities") consists of all liabilities that are debt instruments.
- **Net debt** is calculated as gross debt minus financial assets corresponding to debt instruments.
- **Domestic debts** are debt liabilities owed by residents to residents of same economy.
- **External debts** are debt liabilities owed by residents to nonresidents.
- **Interest** is the cost (expense) that the debtor incurs for the use of the **principal** outstanding.
- **"Golden rule"** of balanced budget prescribes that local authorities should never take on debt to cover current expenditure; it allows, or even promotes, prudent borrowing for capital projects.
- **Capital budget** includes capital receipts (such as revenues from municipal property, various grants received for capital purposes, and borrowed funds) which are spent on local investments or projects.
- **Current budget** includes current revenues used basically to cover operating expenditures.

Introduction

In the public sector, debt results when public organizations borrow money from an individual or another organization with the promise of repayment at a later date (Mikesell 2013). Subnational governments borrow and accumulate debt in order to finance a part of their assigned functions. In a decentralized setting, these functions are related with the provision of local public goods and services left to be accomplished when markets fail. Within some limits, the theory recommends that, in certain cases such as public investment, it is preferable to finance investment projects from borrowing rather than from current local revenues, because these are paid by tax and the benefits are future (Musgrave 1959). To a small or

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large extent, local government debt is the rule, not the exception, around the world, as depicted in Fig. 1 that presents data of the OECD countries. In general, local government debt accounts for no more than 15 % of GDP, with the exception of Japan with more than 35 %.

There is a limit to debt accumulation, however, known as the "golden rule" of the balanced budget (Musgrave 1959), which prescribes that local authorities should never take on debt to cover the current expenditure, but it allows – and according to the some more interventionist views, even recommends – sustainable borrowing for capital investment. This is the rationale behind the frequent prohibition of long-term borrowing for operating expenditure. For example, in West European countries, this is the case in Austria, Denmark, France, Germany, Italy, Norway, Spain, Switzerland, and the United Kingdom. Usually it is permissible to borrow funds for short term (not longer than one budget year), but for cash liquidity purposes only. Notwithstanding, it is important to underline that these general rules are not always very strictly followed.

Along with these benefit of creating capitals, there are also potential hazards in borrowing, both at a microeconomic and at a macroeconomic level. The microeconomic danger lies in the potential for excessive indebtedness of some local governments of a given public sector, which may lead to serious difficulties in the repayment of loans and may even end up jeopardizing the provision of vital public services (local government sustainability). At the macroeconomic level, local governments may contribute to the overall level of public debt (public sector sustainability). At this level, local government indebtedness may have a negative effect with respect to inflation and other important aggregates of the entire national economy.

This entry intends to present a brief description and implications of the main concepts related with local government debt, as presented in the next section. The section explains the functions of borrowing and the main principles regarding its management at the local level. Considering that local government borrowing is generally limited by formal rules of different types, the third section briefly reviews their nature and functions. The fourth section presents some comparative data. The conclusion ends with some recommendations.

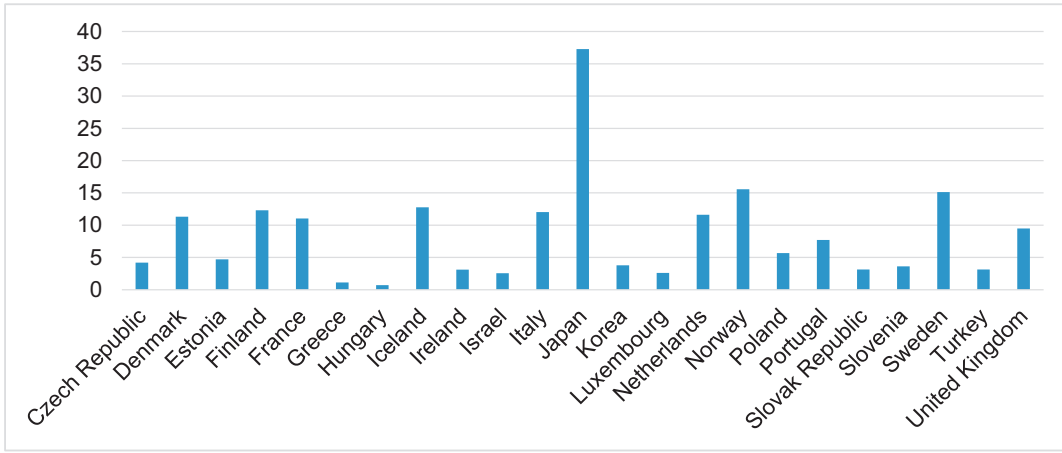
Debt and Associate Concepts

A **liability** is a **debt instrument** since is the requirement to make payments in the future, which can be made in any form, for example, cash and deposits. The **lender** forgoes purchasing power for the promise of repayment later, while the **borrower** receives purchasing power now and makes repayments later. Through the operation, the **creditor** (lender) establishes a principal liability for the **debtor** (borrower), which may change in value over time until extinguished. **Interest** is the cost of borrowing, i.e., the expense that the debtor incurs for the use of the **principal** outstanding. In formal terms, a debt contract specifies the details of the operation, typically with respect to interest, repayments, time, etc.

The debt amount – **gross debt** – is the total that includes resources originally advanced plus interest accrued to date minus any repayments, meaning that the definition of gross debt does not differentiate between principal and interest accrued.

The timing of future payments of principal and/or interest is not necessarily known. In many instances, the schedule of payments is known, such as on debt securities and loans. In other instance the exact schedule of payments may not be known. For example, the timing of payment might be at the demand of the creditor, such as for noninterest-bearing demand deposits; or when the debtor is in arrears, and it is not known whether or when the arrears will actually be paid. Periodic debt service payments can be classified as interest payments or principal payments, from a cash accounting perspective, but, for most purposes, interest is an accrual concept.

Since borrowing results in additional costs related in the form of interests, using and managing (local) government debt is a challenge to administrators under any circumstances (Shah 2008). This is even more so as decentralization



Local Governments Debt, Fig. 1 Local government debt as percentage of GDP, 2014. Note: federal countries excluded: Australia, Austria, Belgium, Switzerland, Germany, USA, Spain, Canada (Source: OECD, *Regions at Glance 2016*, Fig. 3.15)

of responsibility, fiscal stress, and pressure to privatize public services increase worldwide (Dafflon 2002). For risk management, debt liabilities and assets may be dealt with in an integrated manner, focusing on net debt (liabilities deducted by assets). For example, debt may have been incurred to fund assets that will generate income to meet liabilities.

Functions of Borrowing and Its Management

There are three main reasons explaining why local governments borrow (Fisher 2015). First and above all, borrowing is incurred to finance the realization of public capital projects or investments (schools, roads, water and sewer systems, etc.) defined in the assigned competences of local government jurisdictions. The second reason is to cover budgetary deficits whenever annual expenditures are greater than annual revenues (Mikesell 2013). The third is to provide cash flow for short-term spending. This is a particular type of debt since it is repaid in the same economic period, means that it does not add up to the amount of debt.

In some instances, local governments refinance their debt, when they borrow new funds merely to pay off old debt. This must be option when interest rates of the new debt are lower than the previous one and it is a mere substitution of one debt by another at lower cost.

The "Golden Rule" and the Current Capital Divide

The basic idea with regard to debt management was stated decades ago by Musgrave (1959), who recommended to follow the "golden rule" that long-term borrowing is allowed for capital projects but prohibited for current purposes. This approach implies and requires a clear distinction between the current and capital budgets of local governments.

A capital budget includes capital receipts (such as revenues from municipal property, various grants received for capital purposes, and borrowed funds) which are spent on local investments or projects, while the current budget includes current revenues used basically to cover operating expenditures (Dafflon 2002). The surplus in the current budget can also be used to support capital needs – typically to repay loans contracted for investment projects. This system increases the transparency of local financial management (Shah 2008). It makes it easier to assess whether current revenues are sufficient to cover operating expenditures, or what the level of operating surplus is. In addition, this information supports the planning and execution of viable capital

development programs and helps in assessing creditworthiness.

No Borrowing to Cover Operating Expenses

There is a common agreement that borrowing to cover current expenditures is either non-acceptable or only accepted in very rare and specific cases, usually to cover deficits arising from uneven cash flows within a budgetary year and for very short periods of time (Dafflon 2002). The rule of limiting current expenditures to the maximum of current revenues prevents the local government from growing beyond its optimal size, which may be seen as the fiscal burden that voters/taxpayers democratically agree to bear in order to finance the desired provision of public goods. Borrowing creates a short-term fiscal illusion and causes the demand for public services to be artificially high, since it reflects the supply financed partially by credit or bonds, rather than by local tax effort. Moreover, borrowing for operating spending would lead to an excessive debt burden and quickly lead to the rolling over of loans (financing payment of previous debt with new loans) and to very serious indebtedness problems reflecting a structurally imbalanced position (financial unsustainability). In addition, an unbalanced current budget may result in both macro- and microeconomic negative consequences, as the private investments could be crowded out, since local government borrowing draws on a pool of limited financial resources available from local creditors. Local government borrowers are more attractive to banks than private borrowers, because giving credit to public sector entities implies, in most cases, lower risk. Additionally, the competition for borrowing by local governments pressures interest rates, with a negative effect of making private investments more costly.

Borrowing to Finance Investments Makes Sense

The classic theory of fiscal federalism (Oates 1972) not only allows but recommends the option to finance investment projects with acquired funds (borrowing) instead of own-source or current revenues (Musgrave 1959). In the first place, the rationale is related with "inter-temporal equity," in terms of a balanced burden between costs and the access to benefits. The costs of an investment (expenditures) are typically incurred when the project is implemented (e.g., when a sewage treatment plant is constructed or a city bus is purchased), but the benefits from it are spread out over a longer period. When the capital project is financed with current revenues, those who financed it through their local taxes may not always benefit from it in the future, for example, if they move to another city. At the same time, those who benefit from the project may not have participated in financing it if they moved in to the city after it was completed. But with financing through bank credit or the issuing of bonds, there is an assurance that most users will pay for the benefits either through local taxes or directly through user charges. In a nutshell, borrowing over time is an effective way to overcome the problem of inequitable burden of costs among local tax payers.

Secondly, financing investments through debt is the way to ensure an optimal allocation of resources, in the sense of a tighter relationship between those who benefit and those who pay for them. Though this argument may appear somewhat abstract, virtually any text on management or economics supports it.

Thirdly, there is consensus, both in textbooks and among practitioners, that the benefits derived from an accelerated local development overshadow the costs of borrowing (Mikesell 2013). Very often the benefits of an investment (higher prices or rents, wider scope of interested investors, attraction of new projects, providing additional jobs and tax revenues) are greater than the costs resulting from interest payments to the bank or other creditors.

Fourthly, choosing debt to finance investment projects allows reducing operational costs, when replacing old and costly public equipments leads to reduction in current expenditures, often with an increased quality of services to local citizens. This costs reduction (savings) may in fact be much larger than the costs of borrowing.

In addition, since longer projects tend to cost more, financing from current revenues usually delays the completion of the project for a longer

period of time. This leads to higher constant costs and higher total volume of spent resources.

Lastly, there is the advantage in terms of stabilization of required budget resources, since the volume of local government capital spending fluctuates over the years. If capital projects are financed from current revenues, the demand for resources changes over time as well, which creates instability and uncertainty.

In sum, the best practices of debt management require a clear distinction between the current and capital budgets of local government (Shah 2008). This separation of current and capital budgets is generally followed in Western Europe (though with some exceptions) but less frequent in the case in Central and Eastern Europe and other countries.

Rules on Debt and Borrowing

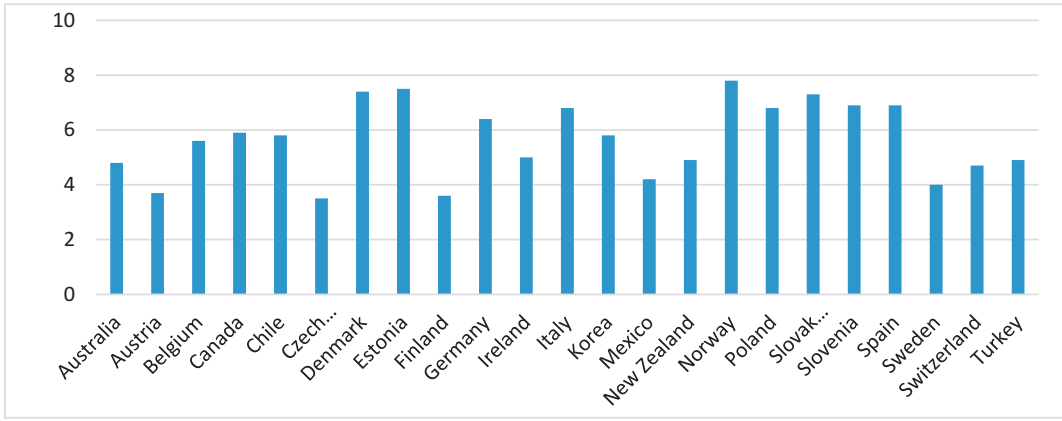
Based on the theory of fiscal federalism, laws or statutes very often limit or even prohibit the local levels of government from borrowing (Oates 1972). There are various reasons for this regulation. No regulation would be necessary if one could rely on financial market discipline in the sense that tighter credit market conditions, in the form of higher interest rates, would impose effective sanctions. The creditors would demand higher interest from those municipalities that borrow more than they can effectively bear. A similar mechanism would happen if local governments would try to issue bonds: the rating would be low and the market would refuse to buy bonds or would demand a very high interest premium. In this case, legal regulation of local government debt would also be redundant.

However, the theory suggests that the financial market discipline argument does not hold true in reality (Dafflon 2002). On the one hand, lenders do not possess adequate information on the local government financial stance while, on the other hand, local governments do not act to avoid exclusion from the credit market because they do not recognize appropriately market information. In sum, there is a consensus that external regulations and control of local borrowing plays a positive role in ensuring financial sustainability and supporting the development of the local credit market.

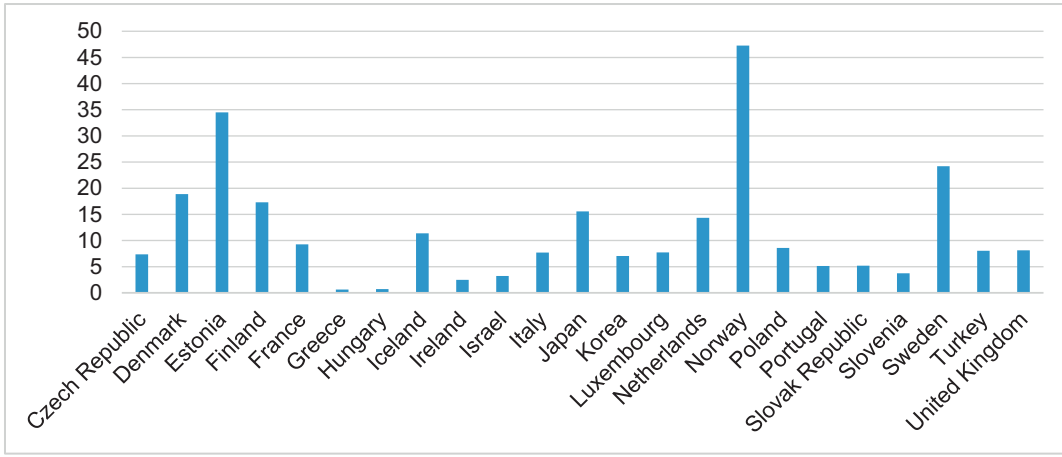
Regulation of debt and borrowing in practical terms functions in two modes. Either is based on borrowing controls, including individual borrowing limits and permissions, or is based on control of the level of indebtedness and control of the current budget, which needs to include resources for servicing debt on capital projects. Using one or other mechanism, countries do rely on regulatory systems to ensure local sustainability. Figure 2 shows that "rules are the rule," not the exception, among OECD countries. The OECD database of subcentral government fiscal rules provides a qualitative indicator on the rigidity of rules (with outcomes scaled from 0 to 10), which shows that, although some important variation, no country ignores the need of formal rules to control local government debt.

The same prescriptions also apply when it comes to regulate several levels of government in a supranational setting, with clear implications to subnational governments. As a consequence of the creation, in the European context, of what is called the "Euro zone," the recent regulations of the Maastricht stabilization pact have brought a new element into discussions of local indebtedness. The Maastricht Treaty imposes not only a limit on the overall level of public debt (which should not exceed 60 % of GDP) but also on public budgets' deficit (annually limited to 3 % of GDP). This transformation reinforces the point that, at a macroeconomic level, local government financial management should not contribute to exceed the overall level of public debt (public sector sustainability).

This issue raises the question of how much local governments contribute and to what extent they should contribute to "eating up" the overall limit of the national public debt (fiscal common framework). In some countries there have been discussions about whether the debt limit should be distributed among tiers of government. Figure 3 presents information on the contribution of local government to the overall amount of public debt. In the large majority of countries, local government debt accounts for no more than 10 % of the



Local Governments Debt, Fig. 2 Fiscal rules ensuring local debt sustainability, 2011 (Source: OECD, Fiscal Decentralization Database, Table 20 (Fiscal Rules Indicator))



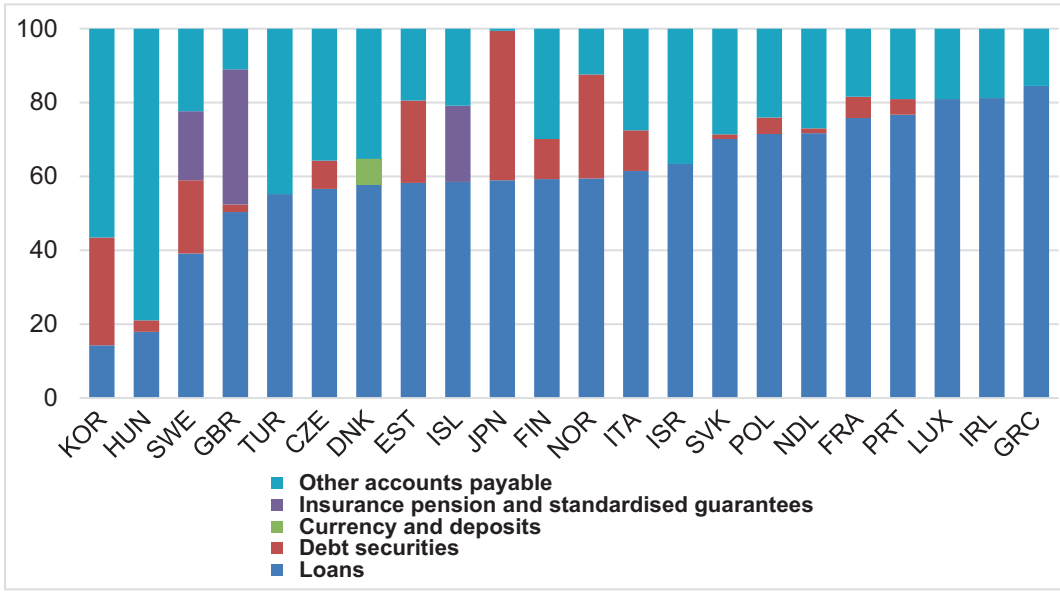
Local Governments Debt, Fig. 3 Local government debt as percentage of total public debt, 2014. Note: federal countries excluded: Australia, Austria, Belgium, Switzerland, Germany, USA, Spain, Canada (Source: OECD, *Regions at Glance 2016*, Fig. 3.15)

total public debt. The most visible exceptions are Norway (over 45 %), Estónia (35 %), and a group of countries that includes Denmark, Finland, Iceland, Japan, and Sweden (above 25 %).

From the above, it seems correct to conclude that the relatively small share of local government debt is driven by legal restrictions to local borrowing because, in a majority of countries, local governments can borrow only for the long term to finance investments.

Local Government Debt Worldwide

Figure 4 shows that the most important source in the composition of local debt in OECD countries. In 19 of the 22 countries shown, loans account for at least 50 % of local debt. In Ireland, Greece and Luxembourg, it accounts for more than 80 %. The opposite cases are Korea and Hungary with less than 20%.



Local Governments Debt, Fig. 4 Local government debt per capita (USD 2005). Note: federal countries excluded: Australia, Austria, Belgium, Switzerland, Germany, USA, Spain, Canada (Source: OECD, *Regions at Glance 2016*, Fig. 3.15)

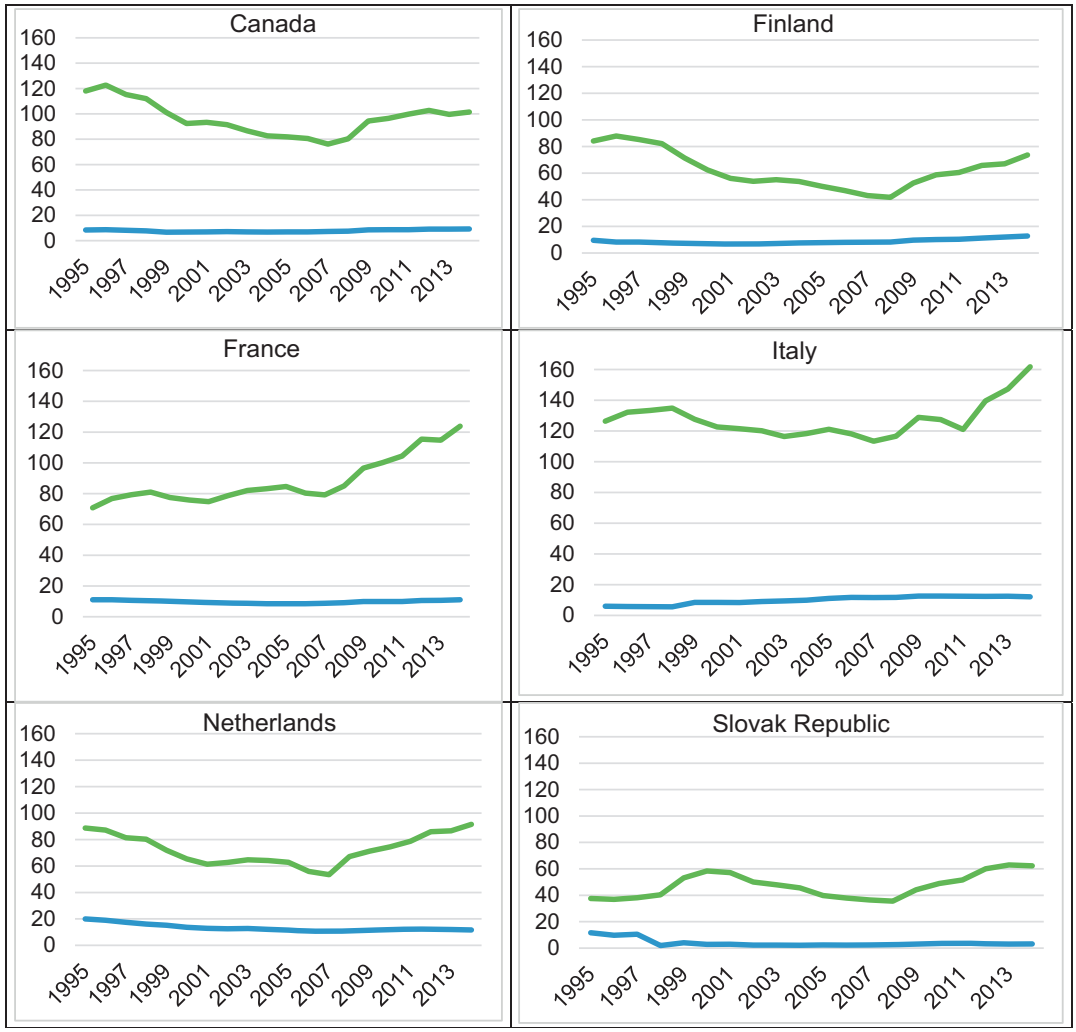
Figure 5, presenting six illustrative countries, traces how local government debt has evolved in the last two decades. This is especially important in the context of an increasing path of overall public sector debt observed in the same period. If not in the entire period (as is the case of Japan), it is clear a common and strong increase in public debt after 2006, which is certainly linked with the world financial crisis. It is also clear that, in the same period, local governments did not contribute to debt growth. The evolution shows a remarkable stability over the period, in a pattern that is common to many other countries. This fiscal discipline is likely related to the debt limitations imposed to local governments.

Conclusion

Local governments acquire capital assets to accomplish their assigned functions. In theory and practical terms, incurring in long-term debt is the recommended mechanism to finance capital investments. Given that capital investments are expenditures that benefit future generations, borrowing ensures (i) a balanced burden of cost and access to benefits – "inter-temporal equity"; and (ii) an optimal allocation of resources, in the sense of a closer relationship between those who benefit and those who pay for them.

However, financial market discipline does not ensure local financial sustainability, and there is a consensus that external regulations and control of local borrowing are necessary. This is done either through borrowing controls, including individual borrowing limits and permissions, or based on control of the level of indebtedness and control of the current budget, which needs to include resources for servicing debt on capital projects.

The conclusion is that the relatively small share of local government debt is driven by legal restrictions imposed to local borrowing because typically local governments are allowed to borrow only for the long term to finance capital investment ("golden rule").



Local Governments Debt, Fig. 5 Evolution of total and local government debt in some OECD countries, 1995–2014 (Source: OECD, *Fiscal Decentralization Database*, Table 19 (Subnational Debt as % of GDP))

Cross-References

- Budgetary Constraints
- Budgeting in the Public Sector
- Capital Budgeting
- Deficit Control
- Financial Health and Distress in Local Government
- Financial Sustainability
- New Public Financial Management

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