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Market-Oriented Subnational Debt Regimes: Empowering the Developing World to Construct Infrastructure

S. Samuel Young

Market-Oriented Subnational Debt Regimes: Empowering the Developing World to Construct Infrastructure

ABSTRACT

Globally, as national governments continue to decentralize fiscal and governmental responsibility, the sound facilitation of subnational debt markets will play a critical role in the construction of infrastructure. However, sparse scholarship exploring the optimal legal and financial frameworks for encouraging the construction of infrastructure at the subnational level has left a number of open questions. This Note primarily provides a basic overview of subnational debt trends and policies. It first reviews subnational debt regimes, comparing market-oriented regimes with regimes with varying levels of involvement by central governments. Though not always possible, the Note concludes that market-driven incentives generally produce the best subnational debt regimes. Though it has faced some struggles historically, as the largest and most liquid subnational debt market in the world, the United States' municipal bond framework can provide a useful model. The Note then presents a market-oriented proposal for U.S. policy makers. By extending tax-exempt status to the public debt instruments of select subnational entities abroad, the United States could provide a promising investment opportunity for U.S. financial institutions and citizens, facilitate the construction of infrastructure in some of the most desperate areas of the world, and encourage sound international municipal finance practices through the extension of a largely self-regulated system. This market-enabling tax exemption could prove to be far more effective than any sort of direct spending. Finally, the Note argues that a fluid and competitive subnational debt market in developing countries is in the best interest of both investors and humanitarians alike.

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I. INTRODUCTION

The world's population is not only growing,[1] but it is also urbanizing at record levels."[2] In writing the foreword for the 2005 Annual Report of the Cities Alliance, Jeffrey Sachs stated that "too many cities in the developing world are failing to thrive. . . . [C]ities in low-income and middle-income countries need to draw up bold, long-term strategies for [infrastructure] investments."[3] As national governments worldwide decentralize responsibility for infrastructure investment, the burden is largely falling on subnational governments[4] to finance and construct adequate infrastructure to keep pace with their rapidly urbanizing populations.[5]

Though, as this Note argues, a liquid, transparent, and competitive subnational debt market that matches those with savings to those with capital needs is crucial to building infrastructure, especially in the developing world, the financial and regulatory background is usually tragically absent.[6] Because there has been so little scholarship in the area, questions remain as to what the most efficient legal and financial frameworks are to facilitate a sound subnational debt market.[7] However, the burdens that local governments are facing are increasing worldwide nearly universally,[8]

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1. *World Population Growth, 1950–2050*, POPULATION REFERENCE BUREAU, http://www.prb.org/Educators/TeachersGuides/HumanPopulation/PopulationGrowth.aspx (last visited Apr. 1, 2012).

2. Press Release, United Nations, UN Report Says Urban Population of 3 Billion Today Expected to Reach 5 Billion by 2030, U.N. Press Release POP/899 (Mar. 24, 2004).

3. Jeffrey Sachs, *Foreword* to CITIES ALLIANCE, 2005 ANNUAL REPORT 1 (2005), *available at* http://www.citiesalliance.org/ca/node/585.

4. "Subnational governments" and "municipal governments" are used interchangeably throughout the Note to refer to local governmental bodies, principally cities, but also referring to provincial and regional governments and in some cases local utility providers.

5. U.N. HABITAT, GUIDE TO MUNICIPAL FINANCE 11 (2009) [hereinafter U.N. GUIDE TO MUNICIPAL FINANCE], *available at* http://www.unhabitat.org/pmss/listItemDetails.aspx?publicationID=2808 ("The growth of the urban population has created and will continue to create serious challenges for municipal governments . . . .").

6. *See* Ifzal Ali, *Foreword* to LOCAL GOVERNMENT FINANCE AND BOND MARKETS, at iii (Yun-Hwan Kim ed., 2003) ("The domestic capital market is a fertile source that has not been successfully utilized for development financing [in Asia] . . . ."). For a discussion of the decentralization challenges developing subnational governments are facing, see *infra* Part II.

7. George E. Peterson, *Banks or Bonds? Building a Municipal Credit Market*, *in* LOCAL GOVERNMENT FINANCE AND BOND MARKETS, *supra* note 6, at 1, 3 ("The frequent failure of international onlending initiatives to build sustainable local credit markets stems in part from lack of clarity as to what elements a subnational credit market should possess."); *see* examples cited *infra* Part V.

8. *See generally* U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 14 (discussing broadly applicable trends in municipal finance).

meaning that scholarship exploring these issues and adding perspectives is sorely needed.

The peculiar federal structure of the U.S. government has led it to develop one of the most decentralized and market-oriented subnational debt regimes in the world in the form of its municipal bond market.[9] The United States began with a largely decentralized system.[10] Though the U.S. subnational debt regime has endured notable scandals and market struggles,[11] it remains the largest market of its kind in the world.[12] Most applicable to the world's decentralizing governments are the peculiars of the U.S. regime that have enabled the U.S. subnational debt market to become strong, as the real risks in the U.S. system have historically been born by investors and local governments rather than by the country as a whole.[13] Though at times direct involvement by a central government is necessary and efficient, this Note argues that the market-oriented and decentralized U.S. model, with informational and antifraud regulatory oversight, is ideal in many circumstances.[14]

The primary way in which the U.S. federal government has facilitated subnational borrowing without debt guarantees or direct involvement is through an extreme "hands off" approach of merely exempting the interest payments that state and local governments pay on municipal debt from federal income taxation.[15] In other words, the purchasers of state and local debt do not have to pay federal taxes on the interest they received from their investment.[16] This tax-exemption system is largely an accident of the federalist system found in the U.S. Constitution and the expansive power given to its states under the Tenth Amendment.[17] In fact, it was not until the 1988 Supreme Court case of *South Carolina v. Baker*, that it was

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9. For an excellent review of the regulatory structure and history of the U.S. municipal bond market compiled by Paul S. Maco, the former Director of Municipal Securities for the U.S. Securities and Exchange Commission, see Paul S. Maco, *Building a Strong Subnational Debt Market: A Regulator's Perspective*, 2 RICH. J. GLOBAL L. & BUS. 1, 2 (2001).

10. *See id.* at 8 (explaining the history of American local governments in municipal financing); Paul E. Peterson, *Who Should Do What? Divided Responsibility in the Federal System*, BROOKINGS REV., Spring 2005, at 6, 7 (2005) (reviewing how this trend of decentralized financing continues into the modern era).

11. Maco, *supra* note 9, at 9–10.

12. *Id.* at 2.

13. *See infra* Parts IV, VI (reviewing the U.S. system and offering an argument as to ideal conditions for a subnational debt market, respectively).

14. *See infra* Part VI.

15. *See* 26 U.S.C. § 103(a) (2006) (exempting interest paid on certain state and local bonds from federal taxation); *see also infra* Part IV (discussing generally the history and context of the U.S. approach toward federal regulation of subnational debt).

16. 26 U.S.C. § 103(a).

17. *See* Maco, *supra* note 9, at 8–9 (discussing the federal constitutional history with regard to subnational debt in the United States).

even considered constitutional for the federal government to tax state and local debt.[18] This federal anomaly has allowed state and local governments, as well as other tax-exempt entities that the federal government lumped into the tax-exempt category for policy reasons, to have a much lower cost of capital than private entities with comparable credit ratings, as evidenced by Table 1, below.

Table 1: Typical Rates on Thirty-Year Bonds for a Tax-Exempt Nonprofit Corporation[19]

Credit Ratings	Typical Tax-Exempt Interest Rate	Typical Taxable Bond Interest Rate
AAA	5.15%	8.5%
AA	5.2%	8.6%
A	5.3%	8.75%
BBB	5.9%	9.7%
Unrated	6.5%–7.5%	10.5%–12%

As a corollary to the subnational regulatory regimes that this Note advocates, the Note also advocates for a specific market-oriented policy proposal for the United States. Encouraging private U.S. investment by selectively extending the tax-exemption given to U.S. state and local governments would not only be far more effective than direct spending, but it would also encourage long-lasting change.[20] As the Note argues in Part VII, such a policy could provide a promising investment opportunity for U.S. financial institutions and citizens, facilitate the construction of infrastructure in some of the most desperate areas of the world, and encourage sound municipal finance within the entities that were chosen to receive the exemption.

In advocating for open and competitive subnational markets, Part II of this Note discusses challenges facing local governments in modernizing cities, and Part III reviews the basics of subnational debt finance. Part IV discusses the regulatory evolution and financial innovations of the U.S. market. Part V then details varying categories of subnational debt regimes and discusses the growing pains faced by one developing nation, Mexico. Part VI makes policy

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18. *See* South Carolina v. Baker, 485 U.S. 505, 524–25 (1988) ("We see no constitutional reason for treating persons who receive interest on government bonds differently than persons who receive income from other types of contracts with the government, and no tenable rationale for distinguishing the costs imposed on States by a tax on state bond interest from the costs imposed by a tax on the income from any other state contract.").

19. ROGER L. DAVIS, ORRICK, HERRINGTON & SUTCLIFFE LLP, NONPROFIT CORPORATIONS: BORROWING WITH TAX EXEMPT BONDS (2001), *available at* http://www.orrick.com/fileupload/172.pdf.

20. *See infra* Part VII.

recommendations to facilitate efficient subnational financing in transition economies. Finally, Part VII of this Note advocates for a selective extension of the U.S. municipal bond tax exemption to facilitate U.S. private investment in developing subnational markets.

II. DEVELOPING FINANCIAL CHALLENGES FACING THE WORLD'S LOCAL GOVERNMENTS

Local governments around the world face the challenge of keeping cities economically viable by delivering a sufficient level of services while simultaneously keeping taxes low enough so as not to thwart economic growth.[21] Complicating the matter is the fact that, over the past fifty years, urban populations have been increasing at a record pace.[22] By the year 2050, the urban population in developed nations is expected to reach 1.07 billion people, or 86 percent of the total population in those nations; while in the less developed nations, urban dwellers are projected to increase to 5.3 billion people, or 67 percent of the total population.[23] Altogether, the world's urban population is expected to grow to encompass 70 percent of the world's population.[24] For example, Table 2 illustrates the urbanization of India:

Table 2: India's Urbanization Trend[25]

Year	Urban Population (million)	Urban Population to Total Population (%)	Growth over Previous Decade (%)	Contribution of Urban Sector to GDP
1981	159.5	23.3	46.1	47.0
1991	217.6	25.7	36.4	55.0
2001	285.4	27.8	31.2	60.0

The most alarming statistic in regard to infrastructure investment, however, is that the urban population is expected to

21. U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 10 ("The challenge for local governments is to keep cities economically viable by delivering a high level of services and, at the same time, keeping taxes sufficiently low so as not to discourage individuals and businesses from locating in their jurisdiction.").

22. *Id.*

23. *Id.*

24. *Id.*

25. Hemanta K. Pradhan, *India*, *in* LOCAL GOVERNMENT FINANCE AND BOND MARKETS, *supra* note 6, at 96. The data for the table was gathered from the Indian Ministry of Urban Development's website, INDIAN MINISTRY URB. DEV., http://urbanindia.nic.in (last visited Apr. 1, 2012).

triple in Africa and *double* in Asia by the year 2050.[26] Currently, 50 percent of urban residents in Asia and Africa lack adequate water and 60 percent lack adequate sanitation.[27] In Latin America and the Caribbean, 30 percent of the urban population currently lacks adequate water and 40 percent of the urban population lacks proper sanitation.[28] In total, an estimated 840 million people currently live in city slums worldwide.[29]

A. *Fiscal Decentralization and the Growing Responsibilities of Local Governments*

In response to the urban boom, over the last twenty years a number of countries have increased the powers and responsibilities of local governments.[30] The basic transfer of financial responsibilities from central governments to local governments is called fiscal decentralization.[31] Several policy rationales justify the decentralization movement, from democratic principles of local autonomy to a necessary reduction on central government spending.[32] As previously discussed, fiscal decentralization has a long history in industrialized countries like the United States, while it is much newer in developing countries.[33] Overall, more than seventy-five countries have implemented some form of a decentralization policy since 1980.[34]

Decentralization does not just entail passing responsibilities from a central government to a state or provincial entity, but more often entails a further passing of responsibilities for taxing and spending decisions from a state or provincial government to local municipalities.[35] City representatives generally have more knowledge about the efficient allocation of taxing and spending dollars and are probably able to provide services more efficiently and effectively than

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26. U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 10.

27. ILIAS DIRIE, MUNICIPAL FINANCE: INNOVATIVE RESOURCING FOR MUNICIPAL INFRASTRUCTURE AND SERVICE PROVISION: REPORT PREPARED FOR THE COMMONWEALTH LOCAL GOVERNMENT FORUM IN COOPERATION WITH COMHABITAT 257 (2006), *available at* http://www.clgf.org.uk/userfiles/1/File/Municipal_Finance_Paper.pdf.

28. *Id.* at 258.

29. *Demand for Housing Finance Is Strong*, CIVIS NOTES SERIES: SHELTER FINANCE FOR THE POOR (Cities Alliance, Washington, D.C.), Apr. 2003, at 3, *available at* http://www.citiesalliance.org/ca/sites/citiesalliance.org/files/CIVIS_April03_ShelterFinanceSynthesis.pdf.

30. U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 13.

31. See U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 14, for a detailed discussion of this topic.

32. DIRIE, *supra* note 27, at 257.

33. U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 14.

34. *Id.*

35. *Id.*

their larger governmental counterparts.[36] This concept is known as the "subsidiarity principle," which essentially holds that the provision of services is efficient when decision-making is carried out by the level of government closest to the citizens receiving the services.[37] The subsidiarity principle also helps account for local differences in tastes and costs, and for management gains.[38] In such a manner, decentralization works "to reduce large fiscal deficits among both central and local governments by raising their efficiency in mobilizing resources and generating revenues, and by helping promote subregional growth and poverty reduction."[39] However, governmental efficiency and democracy are not the only driving force behind decentralization; in some instances it may reflect an inability of a national government to provide for its citizens.[40] All too often, the revenues that central or provincial governments provide to municipalities are often not enough to match the increased level of responsibility that municipalities face in decentralizing regimes.[41]

III. SUBNATIONAL FINANCIAL MANAGEMENT AND DEBT MARKETS

Effective operational budgeting and debt management are the cornerstones that enable sound infrastructure investment.[42] Rhetoric and politics may affect many things, but they cannot change the principles of prudent financial management.

A. *The Importance of Sound Municipal Money Management Principles*

Because of the urban boom and the broad trend of decentralization, local finance has grown increasingly in importance. Already in some countries, local government expenditures account for as much as half of all public spending.[43] This number is even higher in the infrastructure context because local investments in developed countries often far exceed those of the central government.[44] For example, a recent survey by the United Nations found that almost all European countries' local investments exceeded that of the selected

36. *Id.*

37. *Id.* at 17; *see also* Robert M. Bird, *Setting the Stage: Municipal Finance and Intergovernmental Finance*, *in* THE CHALLENGE OF URBAN GOVERNMENT: POLICIES AND PRACTICES 113, 114–15 (Mila Freire & Richard Stren eds., 2001) (arguing that central governments must give further access to local governments).

38. U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 17.

39. Ali, *supra* note 6, at iii.

40. U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 14.

41. *Id.* at 13.

42. For a discussion of this principle, see *infra* Part V.

43. Bird, *supra* note 37, at 114.

44. U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 15.

countries' national investments by a central government, with the notable exception of Greece.[45] This trend is not just isolated to federalist states—in France, local governments account for more than 70 percent of public investment.[46] As previously discussed, the United Nation's *Guide to Municipal Finance* recommends that "with few exceptions (such as national defense and services that involve income redistribution), almost all public services should be provided at the local or regional level with local policy-makers making decisions about what services to provide, how much to provide, and who should pay for them."[47]

In the developed world, local governments generally pay for infrastructure by borrowing the funds and then paying it back by taxing those who use the infrastructure over a prolonged period of time. The critical question then becomes, "Is borrowing an appropriate and viable option for local government investment financing in the developing world?"[48] Subnational debt can, of course, be abused and used in an unwise manner, even in developed countries.[49]

At its core, sound finance policy in a municipality is not terribly different from that of a private corporation.[50] It entails sound management of the local balance sheet—a forecast of future revenues matched up against anticipated expenditures and debt.[51] Appropriate accounting and auditing principles are important for measuring the use and performance of municipal funds.[52] The consequences of unsound financial policies are severe: "When subnational governments follow unsustainable fiscal policy, it can jeopardize the services they manage (but for which the central government may have ultimate political responsibility), the safety of the financial system, and the country's international creditworthiness and overall macroeconomic stability."[53] Throughout much of the developing world, local fiscal reforms are underway to both ensure that local

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45. *Id.* at 15 fig.1.
46. *Id.*
47. *Id.* at 17.
48. DIRIE, *supra* note 27, at 264.
49. For a review of over-leveraged municipalities in the United States, see Omer Kimhi, *Reviving Cities: Legal Remedies to Municipal Financial Crises*, 88 B.U. L. REV. 633 (2008).
50. *Compare generally* U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 56–63 (discussing the fiscal policies of municipalities), *with* RICHARD A. BREALEY, STEWART C. MYERS & FRANKLIN ALLEN, PRINCIPLES OF CORPORATE FINANCE (9th ed. 2008) (providing background on sound corporate fiscal policy).
51. *See* U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 56–57.
52. *See id.* at 61–62.
53. Steven B. Webb, *Fiscal Responsibility Laws for Subnational Discipline: The Latin American Experience* (World Bank Policy Research, Working Paper No. 3309, 2004).

governments have a sustainable, self-generated source of revenue, as well as a transparent accounting model to facilitate sound investment decisions.[54]

Ultimately, sound debt management does not require a municipality to be debt-free, as that would generally mean that the city is not growing or appropriately investing in infrastructure.[55] It is worth emphasizing that municipalities in an appropriately regulated regime are only allowed to borrow for capital projects, and are not allowed to run a government on a deficit, as central governments so often do.[56] Instead, the operating budget is generally funded by taxes, user fees, and intergovernmental transfers.[57] Sources of other revenue may be items such as property sales or selective sales taxes such as those on fuel or alcohol.[58] Although efficient operational revenue collection is not the topic of this paper, it is worth noting that stability, predictability, accountability, and ease of administration are vital.[59]

B. *What Is a Municipal Infrastructure Investment?*

Before continuing, it is important to define exactly what is meant by "municipal infrastructure investment." Infrastructure refers to the basic physical and organizational structures needed for the operation of a society or enterprise.[60] "Municipal infrastructure is essential to the economic, social, and environmental health of cities."[61] Municipal infrastructure can be anything from an essential road or water sewage system, to a park or a library.[62] When a local government decides to build municipal infrastructure, it must make a capital expenditure.[63] "Capital expenditures generally refer to expenditures on goods that have a useful life of more than one year."[64] Generally, use of current operating revenues to finance capital spending is only desirable when the benefits of the spending benefit current users.[65]

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54. *See, e.g.*, Roberto de Vera & Yun-Hwan Kim, *Overview: Local Finance, Private Resources, and Local Credit Markets in Asia*, *in* LOCAL GOVERNMENT FINANCE AND BOND MARKETS, *supra* note 6, at 19, 22–32 (discussing local fiscal reforms in Asiatic countries).

55. *See* Peterson, *supra* note 7, at 3 (discussing Asian cities' need to access municipal credit).

56. *See* U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 65.

57. *See id.* at 21.

58. *Id.*

59. *See id.* at 22.

60. *Infrastructure*, ONLINE COMPACT OXFORD ENG. DICTIONARY, http://www.askoxford.com/concise_oed/infrastructure (last visited Apr. 1, 2012).

61. U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 41.

62. *See id.*

63. *Id.*

64. *Id.*

65. *Id.*

Operating expenditures are often used for more urgent needs, while expenditures on capital projects are often considered a secondary priority.[66] Municipalities habitually use current operating revenues for projects with a shorter life expectancy, such as police or fire equipment, or recurring expenses such as street maintenance.[67] Generally, municipalities borrow for nonrecurring expenditures with long life expectancies.[68] In developed markets, capital financing is generally used so that the municipality can later pay for capital expenditures with the increased revenues that are a result of the expenditure.[69]

C. *The Advantages, Disadvantages, and General Categories of Municipal Borrowing*

Efficient borrowing enables local governments to synchronize the cost and benefit of capital expenditures over time.[70] For example, imagine a project that, if built today, will provide a benefit for the next twenty-five years. If the funds are borrowed wisely, the benefits of the project can pay for itself over the next twenty-five years through repayments of the principal plus resulting interest.[71] Those who use the facility over the next twenty-five years can help pay for the costs through taxes and user fees.[72] This makes borrowing a more equitable and efficient alternative than paying for a project with the tax dollars of those who lived in a jurisdiction for the previous twenty-five years and may or may not enjoy the benefit of the taxation.[73]

Borrowing enables a municipality to enjoy the immediate benefits of capital improvement, which is generally not possible if a municipality relies only on current revenues on a pay-as-you-go basis.[74] Even the best financial plans will entail sporadic capital expenditures, as infrastructure needs may arise in a fashion that

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66. *Id.*
67. *Id.*
68. *Id.* at 42.
69. *See generally* Maco, *supra* note 9 (describing the U.S. municipal bond system).
70. U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 43.
71. *See id.*
72. A toll bridge is a common example of a project that is hopefully capable of paying for itself; tolls from the operation of the bridge can be pledged to retire the debt that financed the bridge's construction.
73. *See* Jia Kang, *People's Republic of China*, *in* LOCAL GOVERNMENT FINANCE AND BOND MARKETS, *supra* note 6, at 59, 72 ("Bond financing is a way to meet unexpected spending demand, in conformity with the principle of matching costs with benefits, because some benefits will last a long time, and those who enjoy them can be expected to pay for them through taxes.").
74. U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 43.

cannot be sufficiently planned.[75] An example of this is the unpredictable suburban sprawl in American cities from 1900 onward; it would have been nearly impossible for a city planner to predict which area would grow into the latest suburban boom.[76] Borrowing allows municipalities to avoid large tax fluctuations in spending when an unexpected need for a capital expenditure arises.[77] In this context, long-term borrowing spreads the cost of a capital expenditure over a number of years and allows the simultaneous completion of projects during periods of extreme growth. Long-term borrowing may also reduce the real cost of projects when there is inflation in labor and material costs without a correlative increase in technology or value.[78] As referenced above, borrowing also serves as a tool that aids in emergency situations such as a sudden increase in capital needs.[79]

The primary disadvantage of borrowing is that a municipality using it must allocate potential revenue sources to debt payments.[80] Even though the cost of debt is spread out over time, a specified and possibly significant portion of the cost can then become a fixed obligation.[81] This can restrict fiscal flexibility to respond to unforeseeable future events.[82] As discussed below, unwise borrowing can have disastrous consequences and even developed markets have undergone periods of turmoil as a result.[83] Ultimately, it is well-recognized in the developed world that responsible debt financing is a necessary component of prudent city management.[84] Local governments in developed nations are equipped to prudently manage their finances because they benefit from a deep and mature debt market that provides efficient and relatively cheap access to capital.[85]

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75. *See, e.g.*, *supra* text accompanying note 66 (discussing expenditures resulting from unexpected population growth); *infra* note 258 and accompanying text (discussing expenditures resulting from natural disasters).

76. *See, e.g.*, MEL SCOTT, AMERICAN CITY PLANNING SINCE 1890: A HISTORY COMMEMORATING THE FIFTIETH ANNIVERSARY OF THE AMERICAN INSTITUTE OF PLANNERS 508 (1969) ("[An example of unforeseen city expenditures is that] a particularly aggressive developer might announce plans for a big residential tract that could 'swamp' the local school system and call for an unforeseen expansion of the municipal sewage treatment plant and water supply.").

77. U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5, at 43.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.*

83. *See infra* Part V (discussing some of the consequences of unwise borrowing).

84. *See infra* Parts IV–V (discussing this principle in the United States and how the principle stands within the World Bank's regulatory categories).

85. *See infra* Part IV (discussing the U.S. debt market).

Sadly, the areas in developing nations that most need the benefits of advantageous financing have the most unfavorable regimes.[86]

In a broad sense, beside the monopolistic model that is discussed in Part V, developing nations may look to two market-oriented models in which subnational governments may access capital, "the bank lending model used in Western Europe, and the municipal bond model used in North America."[87] There are distinct pros and cons to each system, and "[developing l]ocal governments may start with either model but will typically end up with both models serving different segments of the local credit markets."[88] In *Banks or Bonds, Building a Municipal Credit Market*, George E. Peterson highlights some of the reason this Note is focused on bonds, given the variety of credit options available:

> There is no need to choose a single instrument as the "right" way to handle local government credit. Many countries simultaneously use bank lending to municipalities and local bond issuance. The policy rationale, however, justifies emphasizing development of local bond markets. The public monitoring and public disclosure required for efficient bond market operation are consistent with greater transparency for all public financial transactions. Financial sector deregulation has eliminated the possibility of having quasi-monopoly municipal banks draw on especially protected government allocations of low-cost, long-term savings to finance local infrastructure. In a competitive world, bonds have more ways to tap institutional and household long-term savings. Even when the ultimate credit extended to a local government continues to be a loan from a bank or other financial institution, the financial intermediary will increasingly raise its own capital for onlending from bond issues. That is the direction of change for the most successful intermediation vehicles. Even Credit Local de France, the original municipal bank, now raises the bulk of its financing on the bond market.[89]

D. *Bond Market Basics: The Cornerstone of Sound Subnational Debt*

The correlation between a robust economy and a strong public finance structure is undeniable. The world's largest economies in terms of GDP also have the world's largest domestic debt markets for use in monetary control and infrastructure investment.[90] In the same vein, as markets in places like Latin America and Asia continue to grow as economic players, their percentage of long-term domestic

86. *See* discussion of the three categories of subnational debt regimes *infra* Part V.A.

87. De Vera & Kim, *supra* note 54, at 39.

88. *Id.*

89. Peterson, *supra* note 7, at 18.

90. *See* THE WORLD BANK & THE INT'L MONETARY FUND, DEVELOPING GOVERNMENT BOND MARKETS: A HANDBOOK 3 (2001) [hereinafter DEVELOPING GOVERNMENT BOND MARKETS] (showing the composition of domestic debt markets in several countries with high GDPs).

bond debt in terms of GDP is growing while the percentage of high interest short-term debt in terms of GDP is continuously shrinking.[91] On a fundamental level, bond markets link entities that have long-term financing needs with investors who are willing to place funds in long-term, interest bearing securities.[92] A well-functioning government bond market offers a wide range of opportunities for funding the government and the private sector.[93] Bonds usually mature (are paid back) after a year or longer, and they carry coupons (periodic interest payments) at specified points during the maturity of the bond.[94] Worldwide, bond markets typically involve the same kind of actors:

> [A] number of issuers with long-term financing needs, investors with a need to place savings or other liquid funds in interest-bearing securities, intermediaries that bring together investors and issuers, and an infrastructure that provides a conducive environment for securities transactions, ensures legal title to securities and settlement of transactions, and provides price discovery information.[95]

There is a vast amount of scholarship that addresses central governments' need to issue bonds in an efficient market, but less scholarship about the need on the subnational or state level.[96] Although central governments may issue bonds for many of the same reasons that subnational entities may,[97] in actuality they often borrow for very different reasons. "Government bonds are the backbone of most fixed-income securities markets .... They provide a benchmark yield curve and help establish the overall credit curve."[98] As is discussed below, a sound macroeconomic policy by a sovereign central government is a prerequisite to a healthy subnational debt market.[99] The principal distinction between the two, however, is that a central government's securities market strengthens the transmission and implementation of monetary policy,[100] while

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91. *See id.* (showing the composition of domestic debt markets in select Latin American and Asian countries).

92. *Id.* at 2.

93. *See* general discussion of bond markets *supra* Part III.D.

94. DEVELOPING GOVERNMENT BOND MARKETS, *supra* note 90, at 2.

95. *Id.* at 4.

96. *See id.* at 1 (noting the need to develop national securities markets).

97. *See id.* at 2–5 (discussing why central governments issue bonds). Though central governments now rarely issue bonds for infrastructure investment as the decentralization trend continues. *See* discussion *supra* Part II.A.

98. DEVELOPING GOVERNMENT BOND MARKETS, *supra* note 90, at 3.

99. *See infra* Part V (discussing the debt markets of developing countries).

100. DEVELOPING GOVERNMENT BOND MARKETS, *supra* note 90, at 4 ("A government securities market can also strengthen the transmission and implementation of monetary policy, including the achievement of monetary targets or inflation objectives, and can enable the use of market-based indirect monetary policy instruments.").

subnational debt markets are chiefly concerned with infrastructure investments.[101]

As an initial requirement, a sovereign bond market is key to the formation of a subnational bond market.[102] Sovereign bonds typically serve as the backbone of the bond market, even for corporate bonds, because sovereign bonds are seen as being default-free, even though this assumption was recently called into question after the financial crises.[103] The sovereign bond market sets the rate for yield comparisons, although, over time, subnational entities develop their own independent credit history.[104] An ever-present challenge for local governments in the developing world is the fact that the major rating agencies that determine a subnational entity's creditworthiness (e.g., Moody's and Standard & Poor's) cap subnational credit ratings according to those of the sovereign.[105]

In a recent Standard & Poor's (S&P) survey of 141 subnational governments from twenty-two European countries, only one jurisdiction exceeded the credit rating of its sovereign entity.[106] This makes sense, as a subnational operates under the umbrella of its sovereign's macroeconomic policies. National governments typically have a broad range of powers granted to them by their constitutions to have first claim over a country's resources.[107] In a crisis, most national governments are able to fulfill their external or domestic debt obligations ahead of a local entity.[108] Simply put, a sovereign is unlikely to default on a loan obligation before a subnational entity does. Subnational bonds can aid the development of sovereign bonds by offering investors and savers diverse instruments in terms of risk, term, and security structure.[109] It is worth noting, however, that the

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101. *Cf.* MICHAEL NOEL, BUILDING SUB-NATIONAL DEBT MARKETS IN DEVELOPING AND TRANSITION ECONOMIES, A FRAMEWORK FOR ANALYSIS, POLICY REFORM, AND ASSISTANCE STRATEGIES, 1 (2000), *available at* http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2000/06/09/000094946_00052705305247/Rendered/PDF/multi_page.pdf (stating that decentralization has caused many countries where the World Bank is active to focus on delivering local services and improving local infrastructure).

102. *See* DEVELOPING GOVERNMENT BOND MARKETS, *supra* note 90, at 26 ("In general, the development of the sovereign bond market provides the foundation for the emergence of the other components of the domestic bond market.").

103. *Id.* at 26.

104. *See id.* at 26–27 (describing how yield curves are derived and how government bond markets become less important in deriving these curves as debt markets become more sophisticated).

105. Otaviano Canuto & Lili Liu, *Subnational Debt Finance: Make It Sustainable*, *in* THE DAY AFTER TOMORROW: A HANDBOOK ON THE FUTURE OF ECONOMIC POLICY IN THE DEVELOPING WORLD 219, 225 (Otaviano Canuto & Marcelo Giugale eds., 2010).

106. *Id.* at 225–26.

107. *Id.* at 225.

108. *Id.*

109. DEVELOPING GOVERNMENT BOND MARKETS, *supra* note 90, at 4–5.

general principle that a subnational government's creditworthiness is limited by that of its sovereign has been flipped on its head since the 2011 downgrade of the U.S. credit rating, as approximately thirteen states are now rated higher than the federal government.[110] Market conditions and a self-generated revenue stream are other important variables,[111] and Part VI of this Note will further discuss this issue as well as other hindrances to the development of local credit markets.

IV. SUBNATIONAL DEBT MARKETS IN THE UNITED STATES

Local and state governments in the United States have used capital markets to finance their funding needs for some two hundred years.[112] It not only fueled the country's industrial and westward expansion, but also helped alleviate some of the worst financial crises.[113] A thriving municipal bond market is critical to the U.S. economy—it finances schools, roads, water, and sewage of U.S. communities, as well as a myriad of other public facilities.[114] Although many blame the current state debt crisis in the U.S. on such practices,[115] such market correction is simply a consequence of operating in a competitive market[116] and could potentially be much worse in a more hierarchical regime.[117] There can be no argument that the United States has been the most innovative market through times of bust and boom.[118] What truly makes the United States different than the other jurisdictions discussed in this Note is that the United States has had the most pronounced federalist protections for its subnational entities.[119] This leads to a naturally competitive

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110. *See Slideshow: 13 states with AAA credit ratings*, DAYTON BUS. J. (Aug. 12, 2011, 2:57 PM), http://www.bizjournals.com/dayton/news/2011/08/10/slideshow-13-states-with-aaa-credit.html.

111. *See infra* Part VI.

112. *See* Maco, *supra* note 9, at 9 ("In 1751, Massachusetts became the first colony to borrow money by issuing interest-bearing transferable bonds (payable in six months) and was soon followed by Connecticut, New Hampshire, Rhode Island, and North Carolina.").

113. *Id.* at 2.

114. *Id.*

115. For a listing of the current Forbes debt rating of all fifty states, see Jon Bruner, *Is Your State a Debt Disaster?*, FORBES, http://www.forbes.com/2010/01/20/states-debt-pensions-interactive-map.html (last visited Apr. 1, 2012).

116. *See infra* Part V.

117. See discussion of market categories *infra* Part IV and discussion of the market in Mexico *infra* Part V.

118. *See infra* Part IV.

119. For a general review of federalism in the United States, see Eugene Boyd, *American Federalism, 1776 to 1997: Significant Events*, U.S. DIPLOMATIC MISSION TO GER., http://usa.usembassy.de/etexts/gov/federal.htm (last updated Jan. 6, 1997).

subnational debt market—one that can serve as an imperfect but laudable example for the developing world.[120]

However, the U.S. model is not universally applicable in every way, as sometimes central government involvement is necessary.[121] In fact, in many instances there may be absolutely no way for a subnational entity to be creditworthy without the backing of its sovereign's guaranty.[122] As Yun-Hwan Kim aptly summarized, "Country experiences and lessons in building up local government finance show that the real issue in financing local infrastructure projects is not choosing between bonds and banks but rather the ability of public policy makers to create a milieu that will encourage the private sector to build a vibrant local credit market."[123] Though the analysis must be highly contextualized, general principles still have great utility.

A. *Regulatory History of Subnational Debt in the United States*

By examining the innovations and failures of the U.S. municipal bond market, certain universal lessons emerge.[124] In the English common law, the foundation for the U.S. legal system, attempts at securities regulation can be cited as far back as 1285,[125] though securities regulation began in its modern form after the crash of the stock market in 1929.[126] The ability to issue state and local debt has played a crucial role in the development of the United States, helping build canals, turnpikes, and virtually every subnational infrastructure component.[127] The domestic subnational debt market grew slowly after the nation's founding, and by 1825, New York state

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120. *See* De Vera & Kim, *supra* note 54, at 39 ("[M]unicipal bond markets, which thrive on the principles of 'competition,' 'public monitoring,' and 'unbundled services,' can be accessed directly by local governments that have strong local financial management capabilities. The US municipal bond market is the most vibrant form of this model.").

121. *See Service Delivery,* WORLD BANK, http://www1.worldbank.org/publicsector/decentralization/service.htm (last visited Apr. 1, 2012) (giving examples of different types of traditionally governmental services and discussing the implications of decentralizing them).

122. Though there are a number of examples that can be cited, perhaps the most representative language can be found in the Asian Development's Bank summation of local government finance in Sri Lanka: "As the scope for generating local revenue is limited, the bulk of financing for local projects and local government expenditure has been provided by the central Government, particularly for development projects and social services." De Vera & Kim, *supra* note 54, at 29.

123. *Id.* at 45.

124. Paul Maco, who established and served as the first Director of the SEC's Office of Municipal Securities, provides a fantastic review of the regulatory history of the U.S. subnational debt market. Maco, *supra* note 9.

125. *Id.* at 2.

126. *Id.* at 3.

127. *Id.* at 9.

bonds were trading actively on the New York Stock & Exchange.[128] Strong revenue growth inspired the issuance of some $108 million in state debt between 1835 and 1838 alone.[129]

However, early growth was then followed by a period of default as a market panic caused the European markets (on which subnational debt was largely traded) to close.[130] Mobile, Alabama, was the first local government to default on its obligations in 1839.[131] The legacy that emerged from the first period of massive U.S. subnational default was that many state constitutions were amended to prohibit the loan or gift of state credit to aid a private enterprise or hold private stock.[132]

The next period of defaults came in the post-Reconstruction period and its accompanying depression.[133] The Fourteenth Amendment to the U.S. Constitution invalidated all debts incurred in aid of the Confederacy.[134] It is estimated that while outstanding municipal bonds totaled $850 million in 1880, bonds in default, which were primarily railroad bonds, totaled between $100 million and $150 million.[135] Because nationalized securities laws were a distant dream, bondholders had to rely on the common law for protection from these massive defaults.[136] The search for redress of defaulting railroad-aid bonds often went all the way to the Supreme Court: "During this era, 'it was not unknown for the county officials to spend their entire tenure of office in jail for failure to obey a federal court order, or to spend most of their time evading federal marshals.'"[137]

This period of great default brought about the birth of bond counsel, or legal counsel, tasked to give an opinion on the legality of a bond transaction before the subnational debt was issued.[138] Bond counsel would review the record of enabling state constitutional and legislative frameworks that enabled the issuance of the bonds and then give an approving opinion if everything was legal.[139] During the Great Depression, local governments again entered a period of

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128. *Id.* (citing THE NEW YORK STOCK EXCHANGE: THE FIRST 200 YEARS 14 (James E. Beck ed.,1992)).
129. *Id.*
130. *Id.* at 10.
131. *Id.* (citing STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION 10 (1998)).
132. *Id.* (citing Mike Willatt, *Constitutional Restrictions on Use of Public Money and Public Credit*, 38 TEX. B.J. 413, 416 (1975)).
133. *Id.*
134. *Id.*
135. *Id.* (citing A.M. HILLHOUSE, LESSONS FROM PREVIOUS ERAS OF DEFAULT 17 (1993)).
136. *Id.* (citing BANNER, *supra* note 130, at 201).
137. *Id.* (quoting HILLHOUSE, *supra* note 134, at 13)).
138. *Id.* at 11.
139. *Id.*

default, and by 1933, over 16 percent of the municipal market was in default.[140] Due to the legal reforms that took place during the 1800s, however, most of those bonds that were in default were backed by the "full faith and credit of the issuing municipalities," meaning most bonds would eventually be honored.[141] This "full faith and credit" guarantee ensures that even if a city or state temporarily defaults on its bonds, the bond will eventually be repaid so long as that city or state remains in existence.

The turmoil of the Great Depression led Congress to emphasize a system of "full and fair disclosure" in securities regulation to reinfuse investors with confidence,[142] and thus, the Securities Acts of 1933 and 1934 were born.[143] The acts generally required registration of securities and certain information disclosures.[144] Because Congress did not feel that it was appropriate to be the gatekeepers of state and local debt under a federalist system, they largely excluded the municipal market from many of the requirements of the acts.[145] However, the antifraud provisions of the acts did apply and now serve as the basis of most municipal regulation. Further, the 1933 Act established the Municipal Securities Rulemaking Board (MSRB) and granted it regulatory authority over the market, though it was initially very limited in scope.[146]

Another famous market scandal, brought about by an infamous group known as "bond daddies," in the 1970s eventually prompted further reform of the municipal markets.[147] In the 1975 amendments, Congress granted the MSRB broad rule-making and enforcement authority over municipal securities brokers and dealers.[148] The constitutional concerns about the oversight were largely alleviated because the MSRB is comprised of industry insiders, making it a self-regulating body; and, consistent with most other U.S. securities laws, its rules are focused on information disclosure and antifraud regulations.[149]

The MSRB's first and most influential rule was Broker Dealer Rule 15c2-12. This rule requires underwriters engaging in primary offerings of $1 million or more to distribute an issuer's statement to

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140. *Id.* at 12 (citing GEORGE J. MARLIN & JOE MYSAK, THE GUIDE TO MUNICIPAL BONDS 12 (1991)).

141. *Id.* (quoting MARLIN & MYSAK, *supra* note 140, at 12)).

142. *Id.* at 3.

143. Securities Act of 1933, 15 U.S.C. § 77a (2006); Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–b (2006).

144. 15 U.S.C. §§ 77a, 78a.

145. *Infra* Part IV; *see also* Maco, *supra* note 9, at 18.

146. *Id.*

147. Municipal Securities Act, Pub. L. No. 94-29, 89 Stat. 97, 131 (1975).

148. Maco, *supra* note 9, at 19 (citing Municipal Securities Act).

149. *Id.* at 22.

investors.[150] It also requires underwriters to receive assurances that the issuer will contract to provide yearly financial information statements to the Nationally Recognized Municipal Security Information Repository (NRMSIR). NRMSIR was part of the centralized municipal security information system created by the rule under the MSRB.[151] The Electronic Municipal Market Access system (EMMA) is the modern-day embodiment of NRMSIR, and has a great deal of information ranging from a bond's legality to required continuing financial disclosures by the issuing entity.[152] This online repository serves as an invaluable tool to investors and fosters a culture of online transparency.

Today, the U.S. subnational debt market is valued at over $1.5 billion and is the world's largest market for such debt.[153] Over 52,000 issuers issue over 1.5 million municipal bonds.[154] The largest holders of bonds are institutional investors, mutual funds, money market funds, closed-end funds, bank trusts accounts, banks, insurance companies, and corporations.[155] Municipal securities are not traded in a central market, but are instead traded "over the counter" by broker dealers.[156] Trading data, put out by the MSRB,[157] is available on almost immediately on EMMA.[158]

Besides the work done by private credit rating agencies and private bond insurance companies,[159] almost all of the administrative burden of enforcing regulations in the municipal market is born by bond counsel, who perform the important function of addressing the valid, binding, enforceable nature and tax exempt status of today's bond transactions in the United States.[160] Bond counsel helps provide a defense from legal recourse for violations by ensuring that bond issuances comply with disclosure and security regulations, and because reasonable reliance on the opinion of bond counsel is generally a defense for public officials.[161] In order to be marketable in today's market, every bond issuance must be accompanied by a legal

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150. *Id.*

151. *Id.* at 21.

152. *What Is an Official Statement?*, MUN. SEC. RULEMAKING BOARD, http://emma.msrb.org/EducationCenter/WhyReadOS.aspx (last visited Apr. 1, 2012).

153. Maco, *supra* note 9, at 6.

154. *Id.*

155. *Id.*

156. *Id.*

157. *Id.*

158. *See supra* note 152 and accompanying text.

159. Credit rating agencies, public disclosure of information, and private bond insurance are listed as the primary vehicles for limiting credit risk in the United States in a 2003 Asian Development Bank Report. De Vera & Kim, *supra* note 54, at 40.

160. Maco, *supra* note 9, at 11.

161. NAT'L ASS'N OF BOND LAWYERS, THE SELECTION AND EVALUATION OF BOND COUNSEL 1 (1998), *available at* http://www.michigan.gov/documents/treasury/Selection_Evaluation_Bond_Counsel_NABL_1998_351576_7.pdf.

opinion.[162] Because bond counsel bears much of the administrative burden in the U.S. system, applying the U.S. tax exemption and municipal regulatory system to foreign bonds would entail little transaction costs for the federal government.

B. *Notable Subnational Finance Innovations in the United States*

There have been two notable financial innovations in the U.S. bond markets that can have wide implications for developing markets: the revenue bond and bond banks.

1. The Revenue Bond

There has been no financing structure of greater importance to the growth of the subnational debt market in the United States than the revenue bond.[163] "Of the $226.6 billion in long-term bonds issued in the United States in 1999, $156.4 billion were revenue bonds and $70.2 billion were general obligation bonds" (bonds with the backing of the "full faith and credit" of the issuing municipality).[164] Revenue bonds are debt issuances in which both the principal and the interest are paid exclusively from a project's earnings.[165] It was first born from the "double-barreled" revenue bonds, which were backed both by the resulting earning of a project, as well as the full faith and credit of the issuing government.[166] The first "pure" revenue bond was issued in West Virginia in 1885 to finance a water and gas plant.[167] Scholars refer to the 1921 Act of the New York and New Jersey legislatures, which created the Port Authority of New York and New Jersey, as "the most important development in the history of the revenue bond."[168] The New York and New Jersey Port Authority were independent entities and had the power to finance multiple projects.[169] "By the 1950s, almost every state had enabling legislation for revenue bond financing."[170]

Today, there are three types of revenue bonds commonly employed worldwide: standalone enterprises, supplement-supported enterprises, and government guaranteed enterprise revenue bonds.[171]

162. Maco, *supra* note 9, at 11.
163. *Id.*
164. *Id.* at 13 (citing THE BOND BUYER/SEC. DATA CO., 2000 YEARBOOK 5 (2000)).
165. *Id.*
166. *Id.*
167. *Id.* (citing MARLIN & MYSAK, *supra* note 140, at 18).
168. *Id.* (citing MARLIN & MYSAK, *supra* note 140, at 19).
169. *Id.*
170. *Id.* (citing ROBERT LAMB & STEVEN RAPPAPORT, MUNICIPAL BONDS 15 (1980)).
171. *Id.* at 14.

If a project or enterprise cannot collect sufficient revenues to cover the costs of construction and operations and repay a bond, the pure revenue bond may be enhanced by adding a second source of revenue.[172] This second source of revenue may be a subsidy or grant from a local or national government[173] that is entirely independent of the project—a supplement-supported enterprise bond.[174] If circumstances do not allow for a second revenue stream, a local government may guarantee a bond with its general obligation, creating a "double-barreled bond."[175] Some local governments with a strong credit rating may choose to offer their guarantee, despite a project having sufficient revenue to cover the cost of debt, simply to enhance the credit of the bond and lower its cost.[176]

2. The Bond Bank

The second major U.S. innovation that could have wide-ranging implications for developing nations is the bond bank. One of the principal problems that local governments with modest needs faced in the United States was the financial disadvantage associated with the enormous fixed cost of placing securities on a public market and only having the high interest rates of local banks as a financing alternative.[177] Sometimes the cost of putting a bond issuance on the public market would exceed the cost of a bank loan.[178] For small, first-time issuers with little credit history, this was especially true.[179]

It was against this backdrop that bond banks were formed. States created banks or agencies capable of pooling together the resources of several municipalities in order to help them acquire capital at a lower rate.[180] The cost savings came through economies of scale achieved by combining the local municipalities' fixed costs of capital, and additional savings came through the lower interest rates that came with the diversified risk and additional credit-worthiness not available to the small, first-time issuer.[181] Today, bond banks issue their own debt securities and then re-loan the proceeds to

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172. *Id.*

173. Though a national government should never guarantee a subnational bond, see discussion *infra* Part V.

174. Maco, *supra* note 9, at 14.

175. *Id.*

176. *Id.*

177. *Id.* at 15.

178. *Id.*

179. *Id.*

180. *Id.*

181. *Id.*

municipalities with smaller needs.[182] Local governments can then negotiate their debt needs directly with the bond banks.[183]

Table 3, below, evidences the partial results of a survey of seventeen government finance leaders as to the greatest advantages of using a bond bank.

Table 3: Survey of Seventeen Government Finance Officers on the Benefits of Bond Bank Issuance[184]

Reason	Average Ranking	Mentioned in Top 3 Reasons	Not Mentioned or in Bottom 3 Reasons
Lower Interest Cost	1.2	16	0
Lower Issuance Cost	2.9	15	0
Improved Market Access	3.4	9	0
Borrower Too Small for Direct Sale	4.9	5	3
Administrative Burden Less	7.4	8	1
No Credit Rating Required	7.5	1	6
Lessens Disclosure Burdens	8.4	1	16

There are two primary disadvantages to utilizing bond banks: a lack of flexibility by the borrower in selecting financing teams and consultants, and that borrowers with good credit ratings may be better off issuing bonds on their own right.[185] However, overall they are a valuable tool that assist governmental entities in accessing capital markets.

V. SUBNATIONAL BORROWING IN THE DEVELOPING WORLD

As noted in the introduction, an operative question is whether "[subnational] borrowing [is] an appropriate and viable option for local government investment financing in the developing world?"[186] As noted in Part II, the developing world faces numerous challenges

182. *Id.*
183. *Id.*
184. De Vera & Kim, *supra* note 54, at 42 (quoting GOV'T FIN. GRP., INC., AN ANALYSIS OF STATE BOND BANKS (1997), *available at* http://www.cifanet.org/newsPDF/bb97report.pdf).
185. *Id.* at 42–43.
186. DIRIE, *supra* note 27, at 264.

in forming an efficient subnational debt market.[187] Yet, in 1996, an urban authority in India became the first entity of its kind to prove that such subnational debt markets are possible.[188] The Indian urban authority requested and received a credit rating and issued a bond for water and sewage projects.[189] The effort began two years earlier, when the urban authority launched a major effort, in partnership with the United States Agency of International Development (USAID), to improve the transparency and efficiency of its revenue expenditure and tax collection processes.[190] This focus on fiscal responsibility within the city eventually enabled it to make the bond issue and infrastructure investment, bringing clean water and sanitation to its inhabitants.[191] In a much broader sense, India has made astounding progress in facilitating a municipal credit market, which should lend hope to other developing countries.[192] In short, subnational governments can use responsible debt financing to their advantage, but the reforms necessary to facilitate optimal borrowing conditions may take work and time.[193]

A. *The Spectrum of Broad Control Regimes for Subnational Debt Markets*

World Bank scholarship generally divides the differing subnational debt regimes into one of three categories: (1) monopolistic subnational debt markets, (2) competitive subnational debt markets, and (3) mixed subnational debt markets.[194] It is important to analyze each regime within the framework of both financial and agency rationales. Each regime has a set of well-documented strengths and weaknesses, and there are many useful case studies.

1. Monopolistic Subnational Debt Markets

At the furthest end of the regulatory spectrum are countries with monopolistic subnational debt markets. In a monopolistic market, the central government is the sole principal and effectively combines the

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187. *See supra* Part II.
188. DIRIE, *supra* note 27, at 264.
189. *Id.*
190. *Id.*
191. *Id.*
192. *See generally* LOCAL GOVERNMENT FINANCE AND BOND MARKETS, *supra* note 6 (discussing the progress of Asian countries in developing municipal credit markets).
193. DIRIE, *supra* note 27, at 264; *see also* de Vera & Kim, *supra* note 54, at 43 (discussing the reality that lasting reforms are incremental rather than dramatic).
194. Noel, *supra* note 101, at 3.

functions of capital grant allocations and lending amongst its subnational entities.[195]

There are a number of problems which are inherent in monopolistic regimes. The first is that monopolistic regimes often exercise poor oversight over funds after they are disbursed, presenting classic moral hazard and agency problems. Another set of problems that may arise are ex post efficiency risks, which are a product of the lack of incentives that subnational entities have to deliver their best good faith efforts to undertake projects without the threat of non-refinancing.[196] Additionally, there is an ex ante allocation risk, which entails the danger of a central government inefficiently allocating resources due to political pressures or other influences.[197]

In this same vein, there are several other nonmonetary costs associated with a monopolistic system. Chief among these is the local government's loss of control and autonomy over its borrowing and investment decisions.[198] This violates the heart of the subsidiarity principle.[199] Additionally, there is danger that the central government will not be able to match the needs of municipalities in terms of speed, volume, expertise, and flexibility.[200] Monopolistic systems divorce domestic savers and local governments and remove the efficiencies of market pricing mechanisms.[201] In monopolistic regimes, the central government must bear the credit risks of all of its municipalities.[202]

The example of the potential detriments of a monopolistic regime can be seen in Latvia, a country that chose to revert to a centralized system of credit allocation to municipalities after a market based regime began to emerge.[203] Until the latter part of the 1990s, local governments in Latvia had wide powers to borrow from either domestic or foreign sources under a regulatory system that supported transparent and efficient borrowing.[204] There were no reported cases of defaults or related municipal finance litigations.[205] However, in 1997, the country effectively banned commercial borrowing from domestic banks due to a pervasive political attitude that distrusted banks and was inclined toward direct control by the central

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195. *Id.*
196. *Id.*
197. *Id.* at 4.
198. *Id.*
199. *See supra* Part II.
200. Noel, *supra* note 101, at 4.
201. *Id.*
202. *Id.*
203. *Id.* at 3.
204. *Id.*
205. *Id.*

government over local government finances.[206] Now, the Latvian subnational debt market is suffering from many of the problems associated with monopolistic systems.[207] Like many other central government regimes, the Latvian approach "does not involve a commercial assessment of credit risks, relies on its right to intercept transfers to local governments in case of payment default, and devotes limited time and human resources to loan applications."[208] The Latvian government may be correct in recognizing that a private system would be too much for the limited financial management capacities of its municipalities.[209] However, the inefficiencies associated with a monopolistic system may be enough to overcome such fears.

In the 1980s, Australia prohibited subnational governments from accessing capital markets and exerted direct control over all subnational loans by requiring them to go through a "Loan Council."[210] This direct control system was not effective, and subnational governments are now free to access capital markets directly.[211]

2. Mixed Subnational Debt Markets

Mixed debt markets present varying degrees of state control and private financing. They generally present varying channels of finance from central government, state-owned financial intermediaries, private financial intermediaries and investors, and state-owned agencies within the central government.[212] Multiple avenues for funding present numerous agency, moral-hazard, and accountability problems.[213] Foremost among these problems are implicit or explicit sovereign guarantees of municipal debt.[214] As discussed at length throughout this Note, such guarantees can encourage poor fiscal management on the part of subnational governments.[215] Additional agency problems arise where state-owned financial intermediaries

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206. *Id.*
207. *Id.*
208. *Id.* at 4.
209. *Id.*
210. Marcelo Giugale et al., *Subnational Borrowing and Debt Management*, *in* ACHIEVEMENTS AND CHALLENGES OF FISCAL DECENTRALIZATION: LESSONS FROM MEXICO 237, 254 (Marcelo M. Giugale & Steven B. Webb eds., 2000) [hereinafter LESSONS FROM MEXICO], *available at* http://www-wds.worldbank.org/external/default/WDSContentServer/WDSP/IB/2000/08/14/000094946_0007210532052/Rendered/PDF/multi_page.pdf.
211. *Id.*
212. Noel, *supra* note 101, at 5.
213. *Id.* at 6.
214. *Id.* at 5.
215. *See infra* Part IV.A–B.

are protected by regulatory provisions, resulting in a non-level playing field for private lenders in the market.[216] As is discussed in detail in Part V, the effectiveness of a regulatory regime is often dependent on the regime's reliance on market discipline.[217]

3. Competitive Subnational Debt Markets

In a fully competitive market, the central government creates no implicit or explicit guarantee on subnational debt.[218] The central government and private financial intermediaries compete on a level playing field for subnational lending business.[219] This decentralized system lessens agency problems and moral hazards by making the threat of non-refinance, or the potential denial of lending, more tangible.[220] Although there are currently no developing markets that employ a competitive subnational debt market structure, France provides an example of a country that switched from a mixed market to a fully competitive regime.[221] Over recent modern history, the French government adopted a simple and transparent method of capital allocation amongst its subnational entities.[222] Municipalities now do not have to get their loans preapproved by the central government and may borrow from domestic or international sources.[223] However, open and competitive does not mean "rule-free,"[224] and the French keep several checks in place ensuring that budgets are balanced and that local governments are not using debt to pay for other debt, much like in the United States.[225]

While reliance on market discipline is certainly the most desirable system, it cannot be immediately implemented in every jurisdiction for a number of reasons. The first is that a reliance on a financial market that may not be entirely free or open may not produce optimal results.[226] Liquidity is a prerequisite to an efficient

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216. *Id.*

217. For a definition of market discipline, see *Market Discipline*, INVESTOPEDIA, http://www.investopedia.com/terms/m/market-discipline.asp (last visited Apr. 1, 2012) ("The onus on the banks, financial institutions and sovereigns to conduct business while considering the risks to their stakeholders. Market discipline is a market-based promotion of the transparency and disclosure of the risks associated with a business or entity. It works in concert with regulatory systems to increase the safety and soundness of the market.").

218. Noel, *supra* note 101, at 4.

219. *Id.*

220. *Id.*

221. *Id.* at 5.

222. *Id.*

223. *Id.*

224. *See infra* Part V.

225. Noel, *supra* note 101, at 5.

226. Giugale et al., *supra* note 210, at 252.

market.[227] Second, if transparent plans of accounting are not readily available, then a uniform credit assessment is not possible.[228] Some sort of standardized system must be in place for credit agencies to be able to compare apples to apples. Further, local governments may not be incentivized to act with care if there is any form of de facto guarantee that a sovereign government will bail out the municipality.[229]

Even in Canada, a highly developed economy that relied on market discipline and private rating companies to evaluate subnational debt, Canadian provinces did not act with financial prudence.[230] By the mid-1990s subnational debt had reached 23 percent of GDP.[231] When Brazil switched to an open, competitive subnational debt market in the 1970s, subnational debt rose from 1 percent of GDP in the early 1970s to 20 percent in the mid-1990s, causing the federal government to issue three bailouts.[232] The inherent risk of relying on market discipline is that some actors will not fear market consequences. Central governments must draw a hardline, no-bailout policy to maintain the integrity of the market. As Winston Churchill once said in a broader context: "The inherent vice of capitalism is the unequal sharing of blessings. The inherent virtue of socialism is the equal sharing of miseries."[233] When subnational governments follow irresponsible fiscal policy, these governments can jeopardize not only their own services, but also the safety of the country's financial system and macroeconomic stability.[234] Notwithstanding the failures of market discipline, one could argue that the risks lie with those who take them. Central governments must continue to wrestle with the right balance between preventing bailouts and letting market forces play out, even if this comes at a social and economic cost to subnational governments.

B. *Growing Pains in Mexico*

An example of a developing country's growing pains with subnational fiscal management is that of Mexico, a country that has been locked in a struggle for sustainable subnational financial

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227. For a detailed background on the concept of liquidity in markets, see generally Sanford J. Grossman & Merton H. Miller, *Liquidity and Market Structure*, 43 J. FIN. 617 (1988).

228. Giugale et al., *supra* note 210, at 252.

229. *See id.* at 253 (arguing that sovereign bailouts in a mixed system creates moral hazard and irresponsible fiscal behavior).

230. *Id.*

231. *Id.*

232. *Id.*

233. CHURCHILL 13 (Richard Langworth ed., 2008)

234. Webb, *supra* note 53, at 2.

policies.[235] In Mexico's recent past, subnational governments could solely borrow from development and commercial banks, as explained below, and could rarely issue bonds.[236] The borrowing ability of state and local governments is regulated by the Mexican Constitution, which requires that subnational governments borrow only in pesos, only from Mexicans, and only for productive investments.[237] As often happens with government regulations, financial institutions found a way around the requirements by founding government development banks that take money from foreign investors and then lend to subnational entities in pesos, thus satisfying the "protections" of the Mexican Constitution.[238]

Most limiting was that the main source of revenue for subnational governments came from a mandatory federal transfer of funds.[239] These transfers accounted for about 85 percent of municipalities' income.[240] Prior to reform in 1997, these transfer payments could be used as collateral to secure subnational debt.[241] One of the side-effects of the mandatory transfer was then an implicit sovereign guarantee for local debt.[242] This legislative scheme had two implications for the behavior of suppliers and debtors: "First, banks had incentives to make loans to subnational borrowers, because the credit risk was virtually nil, being guaranteed by the federal government. Second, states had incentives to borrow because the federal government would always bail them out."[243] Until reform was passed in 1999, lending institutions rarely even conducted credit evaluations because lending was virtually risk free.[244]

In 1997, the Mexican government amended its Constitution to restrict banks from corresponding with the Treasury Department to automatically withdraw the funds from the federal transfers.[245] In essence, subnational governments then had to arrange their own payment plans with banks.[246] This was designed to force subnational governments to regulate themselves and reduce the likelihood of a bailout as the federal government was removed from the market. Unfortunately, the reform stymied banks' willingness to lend to

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235. *See generally* LESSONS FROM MEXICO, *supra* note 210 (describing the evolution of Mexico's subnational debt regimes).
236. *Id.* at 247.
237. *Id.*
238. *Id.*
239. *Id.*
240. *Id.*
241. *Id.* at 248.
242. *Id.*
243. *Id.*
244. *Id.*
245. *Id.* at 249.
246. *Id.*

subnational entities, forcing the Mexican Congress to once again pass an effectual guarantee by the central government.[247]

Finally, in 2000, pervasive market-oriented reforms were enacted.[248] Though the reforms are much lauded and are generally perceived by the financial community as getting Mexico back on track to fiscal responsibility,[249] it is too soon to gauge the reforms' effect on the market.[250] However, the reaction thus far has been positive,[251] with cautious optimism as to how creditors in the market will interact with the states' new autonomy.[252]

VI. SUGGESTED GUIDELINES OF SOUND SUBNATIONAL FINANCE

As discussed above, many issues presented in municipal finance differentiate it from those of, for example, corporate finance.[253] However, the principles of sound financial management should be true across the public and private sectors. Politics in local governments should not serve as an excuse to refuse to abide by the same principles of finance that govern the private sector. That is not to say that political considerations do not play a large role in the financial decisions of subnational entities,[254] but instead that political considerations should not take precedence over sound financial reasoning. Although perhaps more pronounced in the public sector, agency problems are also replete in corporate finance.[255] The biggest difference between public and corporate finance is that corporations have more immediate consequences for poor fiscal decisions and real rewards for sound fiscal management. In the public finance world, the carrots and sticks are measured by only one real metric: votes. In the private sector, there is usually no parent company to pay an

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247. *Id.* at 250.

248. *Id.*

249. *See id.* at 259 ("Mexico's new regulatory arrangement for subnational borrowing is a novel and promising start in putting local finances on a sustainable path.").

250. Steven B. Webb, *Fiscal Responsibility Laws for Subnational Discipline: The Latin American Experience* 15 (World Bank Policy Research, Working Paper No. 3309, 2004), *available at* http://elibrary.worldbank.org/docserver/download/3309.pdf?expires=1335185410&id=id&accname=guest&checksum=8FA1F28EE5C718AAB0BD17B711A679F7.

251. Giugale et al., *supra* note 210, at 259

252. *Id.*

253. *See supra* Part II.

254. *See* Webb, *supra* note 53, at 6–17.

255. Indraneel Chakraborty, Agency Problems in Corporate Finance (Dec. 22, 2010) (unpublished Ph.D. dissertation, University of Pennsylvania), *available at* http://repository.upenn.edu/cgi/viewcontent.cgi?article=1330&context=edissertations (assessing agency theory issues such as risk shifting, excessive debt, and executive compensation as applied to corporate finance).

insolvent's debts when the situation becomes too dire. The same should hold true in public finance. Sound subnational debt regulation should help to align public sector and nonprofit policies to be congruent with private sector realities. For the purposes of the present analysis, subnational debt regulation can be divided into three categories: (1) regulations by national governments, (2) internal fiscal policy within subnational entities, and (3) the relationship between subnational governments and their lenders.

A. *National Regulation*

At the national level, a central government should do everything it can to facilitate a competitive subnational debt market.[256] Market discipline is consistent and is arguably less susceptible to public pressure.[257] Though not always possible, at the heart of a competitive market is a central government's absolute per se refusal to guarantee subnational debt, absent a *force majeure*.[258] In a competitive market, the national government should not put itself in the position of universal auditor. Securities laws in the United States can serve as an important point of comparison, which, as discussed, are centered on disclosure and antifraud protections.[259]

Sound central government policies that rely on market discipline are necessary. Such policies motivate fiscal sustainability and discourage irresponsible subnational entities from free-riding on the sound fiscal management of other governments in its jurisdiction.[260] Mexico's subnational regulation, as discussed above, provides an example of what can go wrong when there is even an implicit sovereign guarantee of a subnational's debt.[261] Detractors will be quick to point out that many developing countries do not have the autonomy or expertise to properly function in a market-oriented system.[262] However, fiscal positions can be changed once sound policy

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256. *See supra* Part III.

257. For a review of market discipline, see *supra* note 217.

258. An example of an applicable *force majeure* (act of God) that should trigger insolvency assistance by a central government could be the recent tsunami in Japan. *Cf.* Chester Dawson & Kazuhiro Shimamura, *Death Toll Surpasses 1,800 as Rescue Workers Scramble*, WALL ST. J. (Mar. 23, 2012), http://online.wsj.com/article/SB10001424052748704893604576199952635789540.html?mod=WSJ_hp_mostpop_read.

259. The '33 and '34 Acts serve as the backbone of U.S. Securities regulation, and both primarily concern registration and disclosure requirements in issuing and selling securities. *See* 15 U.S.C. §§ 77a, 78a (2006). Neither includes anything like an investment appraisal nor forms of investor-guarantee provisions.

260. Webb, *supra* note 53, at 2–3.

261. *See supra* notes 235–52 and accompanying text.

262. For an example of a paper that advocates for top-down fiscal control of the subnational debt market, see Teresa Ter-Minassian & Jon Craig, *Control of Subnational Government Borrowing*, *in* FISCAL FEDERALISM: THEORY AND PRACTICE 156 (Teresa Ter-Minassian ed., 1997).

is enacted at the subnational level.[263] While top-down control over subnational finances through mechanisms like debt ceilings and budgetary discipline may be appropriate for a time, the end goal should always be to reach a system of complete market discipline.[264]

As is the case in France,[265] reliance on market discipline does not mean that there should be a complete absence of rules.[266] Having basic securities disclosure requirements, as in the United States,[267] can reduce fraud and increase investor confidence. Regulations designed to decrease fraud could also only increase true competition. National governments should create a centralized informational depository, similar to the NRMSIR in the United States. Having a centralized information system that includes the financial data of subnational entities should lead to a more transparent and informationally efficient market. Generally, the following information should be disclosed upon the subnational issuance of a debt instrument: (1) the interest rate or, if the interest rate is variable, the manner in which such rate is determined; (2) the timing and manner of payment of the interest on and the principal of the bonds; (3) the minimum denomination in which the bonds may be sold; (4) whether the bonds can be redeemed by the issuer prior to maturity and, if so, on what terms; (5) whether the investor has the right to require the issuer to repurchase the bonds at face value; (6) the sources from which the issuer has promised to make payment on the bonds (e.g., from its general taxing power, from a specific tax or revenue source, etc.); (7) whether any bond insurance, letter of credit, or other guarantees have been provided for repayment; (8) the consequences of a payment or nonpayment default by the issuer; (9) current financial and operating data; (10) revenue bond, additional financial and operating information (e.g., feasibility studies, engineering reports); and (11) a legal opinion approving the legality of the bond.[268]

Finally, subnational debt markets are just as susceptible to fraud as any other market. A regulatory body, similar to the MSRB, is needed to ensure that actors within the market play fair. Such an organization would be responsible for promulgating relevant informational requirements, antifraud provisions, and keeping

263. See *supra* notes 235–52 and accompanying text for an example.

264. The argument for an initial implementation of a top-down system and a gradual shift toward self-autonomy can be found in Jonathan Rodden & Gunnar Eskeland, *Lessons and Conclusions*, *in* FISCAL DECENTRALIZATION AND THE CHALLENGE OF HARD-BUDGET CONSTRAINTS 431 (Jonathan A. Rodden et al. eds., 2003).

265. *See supra* Part V.A.3.

266. *See supra* Part III.A.3.

267. *See supra* Part IV.A.

268. In the United States, these items are generally included in a bond's official statement that is filed with NRMSIR; for a layman's explanation, see *What Is an Official Statement?*, *supra* note 152.

possible "pay to play" and other political corruptions out of the market.

B. *Sound Internal Fiscal Policies Within Subnational Entities and Debt Instruments*

One of the consequences of operating in an open, competitive market is that governments are free to make either positive or detrimental fiscal decisions. In the discussed example of the Indian municipality that successfully issued a bond to build a water system,[269] efforts to raise the capital began with the implementation of sound internal policy.[270] Taxing and operational spending decisions are outside of the discussion of this Note, and there is already much scholarship on the topic.[271] Once a consistent and principled operational budget is in place, many municipalities may still not be viewed as creditworthy. It is crucial that developing countries take advantage of two U.S. innovations: bond banks and revenue bonds.

Bond banks may play an important role in the credit building process of the developing world. As was previously discussed, bond banks can pool the credit of several subnational entities to lower default risk.[272] It may be best to organize such entities at the state or provincial level, as was done in the United States. In emerging markets, policy makers should give particular attention to the entry requirements of bond banks to avoid free-rider problems. Standardized requirements should be developed ex ante to avoid the potential for political manipulation.

Subnational entities in emerging markets should heavily consider using revenue bonds as discussed in Part IV, if the vehicle is available.[273] Considering the need for revenue-generating projects, such as water treatment in emerging markets,[274] there are certainly a number of eligible projects. Exclusively dedicating the revenue from the resulting public works project to the bonds' coupon and principal repayment should additionally help aid credit-worthiness and lower interest rates. As discussed in Part IV, additional guarantees should also factor into the analysis, such as a dedicated tax contribution or "a full faith and credit" clause.[275]

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269. *See supra* Part IV.
270. *See supra* Part IV.
271. *See, e.g.*, U.N. GUIDE TO MUNICIPAL FINANCE, *supra* note 5.
272. *See supra* Part IV.B.2.
273. *See supra* Part IV.B.1.
274. *See Statistics of the Water Crisis*, WATER PROJECT, http://thewaterproject.org/water_stats.asp (last visited Apr. 1, 2012) (detailing the problem of worldwide sanitation and water shortage).
275. *See supra* Part IV.B.1.

C. *The Borrower–Lender Relationship in Case of Default*

In addition to information disclosures as discussed in Part V.A, it is also important to establish ordering, in case of default. Steven Schwarcz thoroughly addressed the topic in *Global Decentralization and the Subnational Debt Problem.*[276] Just as market discipline must be used to impose private sector-like discipline on subnational entities ex ante, a bankruptcy regime somewhat analogous to the private sector should be used ex post upon default. Schwarcz explains:

> The genius of bankruptcy reorganization law is that it provides incentives for debtors and their creditors, notwithstanding their disparate interests, to reach a voluntary agreement on the terms of the restructuring. Agreement on a plan of reorganization is rewarded; failure to agree is penalized. As a result, most corporate restructurings are consensual. "The basis of corporate reorganization law's efficiency rests in the underlying theory of freedom of contract: voluntary contracting maximizes value."[277]

Schwarcz's model law[278] is thus meant to model the bankruptcy procedures that creditors have against an insolvent corporation.[279] In emerging markets that are sure to be replete with high return and high risk municipal investments, such restructuring programs could go a long way toward improving creditors' collections upon default. The services that local governments provide are too important to be totally subject to events such as cyclical economic downturns. Especially when collateralized debt obligations are at issue, restructuring could be extremely useful not only to creditors' bottom line, but also to the public interest.

VII. A MARKET-ORIENTED FOREIGN AID PROPOSAL: EXTENDING THE U.S. MUNICIPAL BOND EXEMPTION

The United States is currently undergoing a budgetary crisis that necessitates budgetary efficiency.[280] At the same time, subnational governments in developing countries lack the basic

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276. Steven L. Schwarcz, *Global Decentralization and the Subnational Debt Problem*, 51 DUKE L.J. 1179 (2001).

277. *Id.* at 1192–93 (citations omitted).

278. *Id.* at 1247–50.

279. *Id.*

280. For a review of the events that led to the downgrade of the federal government's credit, see Zachary A. Goldfarb, *S&P Downgrades U.S. Credit Rating for First Time*, WASH. POST (Aug. 5, 2011), http://www.washingtonpost.com/business/economy/sandp-considering-first-downgrade-of-us-credit-rating/2011/08/05/gIQAqKeIxI_story.html.

infrastructure necessary to care for their people.[281] As was discussed in Part II, there are two primary reasons why developing subnational governments struggle to raise capital to construct infrastructure: (1) the riskiness of potential investments make borrowing costs astronomically high for developing cities, and (2) there is an insufficient regulatory structure in place to provide the necessary informational and credit-worthiness safeguards that cities in developed countries enjoy.[282] Without solid financial records and a system of information disclosure, no entity can expect to borrow money at a reasonable rate.[283]

In theory, extending the U.S. municipal bond exemption to certain developing cities could be a win–win both for the developing cities and the United States. Every potential developing issuer would have to comport with the same U.S. standards and regulations that U.S. cities must follow when issuing tax-exempt debt. This would primarily require offering documents that list basic financial history (such as tax revenues and expenditures), informational disclosures detailing the nature of the project and the developing city's plan to pay back the bonds, and an approving opinion by a U.S. bond lawyer stating that the bonds are legal and exempt from taxation.[284] The exemption would thus provide work for the U.S. public finance sector, a helpful and hopefully profitable venture for U.S. investors, and capital where it is needed most in the world. The U.S. Federal government would also win in that it would be able to maximize the efficiency of its foreign aid spending by incentivizing private investors to engage the market rather than simply pouring funds directly into a project.

To understand the advantages that this exemption would provide over direct spending, imagine that Ethiopia's second largest city, Dire Dawa, needs a new water system.[285] In 2004, the United States gave about $160 million in foreign aid to the country of Ethiopia.[286] Although the work of organizations like WaterAid have been extremely helpful in alleviating the sanitary water shortage in the country, there remains serious water access issues in Ethiopia.[287]

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281. *See supra* Part II.

282. *See supra* Part II.

283. *See* Noel, *supra* note 101, at 18 (discussing developing subnational entities' struggle with keeping accurate records).

284. For an example of what a typical U.S. offering statement contains, see *What Is an Official Statement?*, *supra* note 152.

285. *Dire Dawa*, U. CAPACITY BUILDING PROGRAM, http://www.ucbp-ethiopia.com/e548/e569 (last visited Apr. 1, 2012).

286. CURT TARNOFF & LARRY NOWELS, CONG. RESEARCH SERV., 98-916, FOREIGN AID: AN INTRODUCTORY OVERVIEW OF U.S. PROGRAMS AND POLICY 13 (2004).

287. *See Water and Sanitation Improvements in Select Localities of Three Cities*, UN HABITAT, http://www.unchs.org/content.asp?cid=2176&catid=195&typeid=13 (last

Overall, access to capital is the single largest impediment keeping Ethiopians from accessing reliable drinking water.[288] In Dire Dawa, water coverage is only estimated to extend to about 68 percent of the population.[289]

Suppose the city of Dire Dawa was interested in building a new water supply system to permanently serve its residents at a cost of $1 billion. The $160 million in foreign aid that the United States gave to Ethiopia in 2004[290] is not nearly enough to finance such a large capital investment. Tax-exempt bonds could bridge the gap by allowing private U.S. investors to make the capital investment that they might not have made outside of the enabling power of the U.S. government—an enabling that does not require the United States to do any substantive spending. Further, Dire Dawa would have to comport, and may be incentivized to pursue, a high standard of financial accounting and disclosure to be eligible for the exemption.

Tax exempt bond financing is as simple as it is useful. Suppose that Dire Dawa is ready to borrow at a rate proportional to its credit rating with the added bonus of tax exemption.[291] The city of Dire Dawa would work with a U.S. underwriter to prepare offering documents for their planned water system. If the offering documents are accurate and legal, bond counsel would write an approving opinion stating that the bonds are a valid tax-exempt investment. The underwriter would then sell Dire Dawa's bonds to investors who consider the project investment worthy, and the underwriter would then send the proceeds to the city for construction. After the project is constructed, Dire Dawa would charge the citizens who use the water system a fee for its use and place the proceeds available after operating costs into a debt repayment account, which would then be used to pay off the bonds. If the fees were not enough to service interest payments on the bonds, then Dire Dawa would probably have to dedicate other sources of tax revenue to the project.

Some might argue that a tax exemption is equal to spending because it guarantees lost revenue, but such a statement does not provide a complete picture. In a worst case scenario, imagine that the purchasers of Dire Dawa's bonds were all in the top U.S. tax bracket of 35 percent and that all of the gain that the investors otherwise

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visited Apr. 1, 2012) (noting that in 2003 only 34 percent of the total population had access to potable water).

288. *See* THE FED. DEMOCRATIC REPUBLIC OF ETH., MINISTRY OF FIN. & ECON. DEV., GROWTH AND TRANSFORMATION PLAN (GTP) 18 (2010), *available at* http://www.ethiopians.com/Ethiopia_GTP_2015.pdf (discussing the water program's struggle to raise capital).

289. *Water and Sanitation Improvements in Select Localities of Three Cities*, *supra* note 287.

290. TARNOFF & NOWELLS, *supra* note 286, at 13.

291. For the benefits of the tax exemption, see *supra* Table 1.

would have enjoyed had they not purchased the bonds would be taxed as ordinary income at the 35 percent bracket (and not in the 15 percent capital gains rate) in equal proportion. If the bonds had an interest rate of 7 percent, even in the most extreme hypothetical, the United States is only out $70 million in lost tax revenue, or roughly 44 percent of its foreign aid budget to Ethiopia in 2004.[292] However, even this is an overly grim picture, as it is impossible to model how much tax revenue the United States would "lose" in such a scenario because there is no way to predict what investors would do with their money if the Dire Dawa opportunity were not available, and if the alternative investment would be as rewarding. If the investors instead decide to put the money they would have invested in the bonds of Dire Dawa under their mattress, or worse, realize a loss on their alternative investment, then the United States would indeed lose nothing.

Such a tax exemption enables capital markets to work, utilizing more money from private investors and less from taxpayers. The U.S. government would in effect not act as a charity, but would enable the marketplace to address some of the most serious issues in the world today. The United States does this quite often domestically through its § 501(c)(3) and religious organization tax policies.[293] Some might argue that allowing international cities the opportunity to borrow at a tax-exempt rate would raise the borrowing costs of domestic cities, but this Note does not propose allowing every city in the world an exemption, as not every subnational entity in the world would be able or desire to utilize U.S. capital. If it were implemented on a large scale, the access to capital concern could largely be alleviated by allowing banks to realize the full benefit of the tax exemption, something they are not now allowed to do.[294]

Most assuredly, high disclosure and financial accounting standards, coupled with lowered borrowing costs from U.S. tax exemptions, would not be enough to allow every struggling city in the world to construct the infrastructure that it needs. It is not an appropriate tool for every situation, and high standards and a tax exemption would not prevent defaults. USAID and charitable financial NGOs, such as the World Bank, may need to provide credit guarantees in many cases just to make borrowing a realistic option for some cities. This Note does not attempt to discuss potential

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292. TARNOFF & NOWELLS, *supra* note 286, at 13.

293. *See generally* Paul H.K. Hageman, *An Examination of Religious Tax Exemption Policy Under Section 501(c)(3) Internal Revenue Code*, 17 VAL. U. L. REV. 405 (1983) (analyzing the past, present, and future policy implications of § 501(c)(3) for religious organizations).

294. *See Bank Qualified Bonds,* WM FIN. STRATEGIES, http://www.munibondadvisor.com/BQBonds.htm (last visited Apr. 1, 2012) (describing banks' limited ability to enjoy the tax-exempt status of municipal securities).

comprehensive solutions, but simply aims to present a starting point for a much needed conversation.

VIII. CONCLUSION

In many cases, an ideal subnational debt market is open, competitive, and transparent. Efforts should be made to enable market discipline to be the primary carrot and stick, and a central government agency must ensure that there is sufficient information diffusion and antifraud protection for an efficient market to operate. Subnational entities in emerging markets must first use operational fiscal discipline before they can utilize the subnational debt market effectively. The extension of the municipal bond tax exemption by the United States to select developing entities could prove to be an effective market enabler; and at minimum, it is an effective spending conversation that we should be having. This Note in no way portends to be exhaustive or definitive. However, given the proper framework, developing subnational debt markets could potentially provide both a promising investment arena for U.S. citizens and an important tool for combating urban poverty.

*S. Samuel Young**

* S. Samuel Young is a third-year law student at Vanderbilt University Law School. He is planning to work in public finance law after his expected graduation in May, 2012. He would like to thank his beautiful wife, Laura Young, his family, and Professor Yesha Yadav for her advice and feedback. *S.D.G.*