Local Debts, International Authority: Rating Agencies' Emergence in Regulating Subnational Debt

by

Ommeed S. Sathe

B.A., Urban Studies & Planning and Neuroscience (double major) (2000)
Columbia University

J.D., Harvard Law School (2006)
Harvard University

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Signature of author..
Ommeed Sathe
Department of Urban Studies & Planning
May 17, 2006

Certified by..
Balakrishnan Rajagopal, SJD
Associate Professor of Law and Development
Thesis Supervisor

Accepted by..
Langley C. Keyes, PhD
Ford Professor and Chair of M.C.P Committee,

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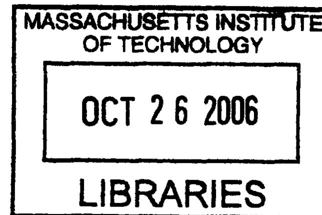
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ABSTRACT

This thesis explores the growth of subnational debt ("SND") and the different regulatory responses to this debt. It focuses on the recent emergence of credit rating agencies (e.g. Standard & Poor's, Moody's and Fitch) as an alternative regulatory mechanism, which has the potential to stabilize these markets, improve risk pricing, and alter traditional conceptions of local governance.

The first chapter traces SND's long legacy of debt defaults, federal bailouts, and improperly priced risk; as well as the profound benefits that SND can provide to local governments, particularly as a means of resisting the siren song of privatization. Unfortunately, it finds that conventional strategies for regulating SND - including federal oversight, financial rules and market discipline – have not properly balanced these trade offs and have left lingering moral hazards, overly restricted debt markets, and a legacy of mispricing.

The second chapter examines the emergence of debt rating agencies in Mexico as a possible alternative. It traces their growth, particularly the role of domestic and international agreements, their methodology, and their historic accuracy. It finds that they should improve debt pricing and obviate moral hazards when compared to existing regulatory interventions. However, these significant benefits come with profound implications on local governance and decentralization.

The third chapter investigates rating agencies infringement on traditional local autonomy as well as the more subtle ways in which these bodies can actually improve local deliberation by enhancing transparency and formality. The thesis argues further that any restrictions are outweighed by the benefits from stabilizing SND markets and replacing more onerous regimes. The thesis also suggests that the agencies' view of governance actually fits in with broader international approaches and is part of a broader movement towards international local government law. The paper concludes by considering potential regulation to improve agencies' performance further.

Thesis Supervisor: Balakrishnan Rajagopal, SJD
Title: MIT Associate Professor of Law and Development
Reader: Gerald Frug, J.D.
Title: Louis D. Brandeis Professor of Law, Harvard University

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Local Debts, International Authority: Rating Agencies' Emergence in Regulating Subnational Debt: A Mexican Case Study

Introduction

Currently, there are over $2 trillion dollars in outstanding subnational government debt ("SND") obligations[1] circulating around the globe.[2] Historically, the vast majority of this indebtedness was incurred by American and Canadian municipalities; however the last five years have seen dramatic expansions across both Europe and the developing world.[3] Although still small by Western standards, subnational borrowing in many developing countries represents an increasingly important source of domestic capital. For example, Mexico owes over $11 Billion in outstanding

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[1] SND refers to obligations incurred by states, municipalities, and public agencies. It is more often used in international contexts, rather than the American term municipal debt, since it is independent of a country's distribution of power amongst levels of government.

[2] Given the magnitude of these markets, and the wide-variety of instruments traded, arriving at a single precise figure is extremely difficult. Nevertheless, according to Bond Market Association (www.bondmarkets.com), the US municipal bond market contained over $1.3 trillion of indebtedness. Significant bond debts are also held by Canada, Western Europe, and Latin America. When added to estimates of private bank borrowing, this suggests a market well over two billion dollars. *See generally,* Dexia Credit Presentation, *Developing Private Subnational Credit Markets in Mexico and Brazil*, Cities Alliance Forum, (2003).

[3] Fitch Ratings, *Globalization Tide Reaches Subsovereign Markets*, Sept. 24 2003 available at www.fitchmexico.com/ReportesEspeciales/RW_18.pdf (finding that approximately $50 billion of the over $400 billion in annual US dollar bond market offerings came from outside the US, nearly double the figure from two year earlier. In addition, the $50 billion represents only a small fraction of overall global subnational indebtedness since many countries only issue subnational instruments in local currency and/or borrow from banks as opposed to bond markets. *See generally* www.bondmarkets.com for additional data.

SND obligations, of which approximately 15% were incurred in 2004.[4] By comparison, in 2004, Mexico received $10.8 billion in Foreign Direct Investment ("FDI") for the country as a whole.[5] Despite their similar magnitudes, SND has received a fraction of the scholarly and political attention devoted to FDI, particularly in legal circles where only six articles mention the phenomenon.[6]

The lack of attention devoted to SND belies its vital role in facilitating infrastructure investments, supporting health and education initiatives, and insuring against catastrophic events.[7] Moreover, it is one of the few vehicles that can allow localities to pursue large-scale projects without having to rely on privatization and FDI for capital. The extent of subnational borrowing authority therefore serves as an important component in measuring the depth of national commitment to true decentralization, rather than the historic "expectation that lower level government means less government."[8] At the same time, subnational governments have often recklessly borrowed and wastefully spent.[9] Excess indebtedness, and resulting loan defaults, have bankrupted lenders, forced draconian cuts in local services, and precipitated federal bailouts that threatened national fiscal stability. These bailouts in turn have created

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[4]Alfredo Gomez Garcia, *Presentation on Issuer Credit Ratings of Subnational Entities, Mexico's Experience*, 2004 Conference for North American Local Government Lawyers, available in powerpoint by contacting Fitch Ratings.

[5]*Foreign Direct Investment in Mexico Falls,* Financial Times of London, Feb. 23, 2005

[6]Although hardly an absolute indicator, only six articles appear in the JLR database that includes the word "subnational debt." "Foreign direct investment" has over 2300 matches.

[7]See generally Marco Magressi, *Subnational Investment Needs and Financial Markets's Response*, Inter-American Development Bank, (2000) at www.iadb.org.

[8]Richard Musgrave & Peggy Musgrave, Public Finance in Theory and Practice,, 112 (McGraw-Hill International Editions 1989). Not surprisingly, Canada, Mexico and the US are among the most deeply federated countries and among the largest consumers of SND.

[9]See generally Jennie Litvack, *Should Borrowing by the Public Sector be Decentralized*, World Bank Issues in Program Design Group, available at www.worldbank.org (1997).

continuing moral hazards that plague SND.[10] Alternatively, excess restrictions on borrowing have raised the cost of capital and made it inaccessible to many jurisdictions.[11] This conflict, between opportunity and crisis, has only been exacerbated by the dramatic expansion in domestic and international capital willing to invest in these instruments.

The proper regulation of SND is therefore a crucial topic. Historically there have been four primary strategies: strict limitations on debt's purpose, fiscal rules limiting borrowing by fixed metrics like debt service ratio, federal administrative control, and reliance on free-markets.[12] Unfortunately, all these strategies have failed to appropriately price risk and obviate moral hazards.[13] They have also eliminated numerous useful loans, and inconsistently treated municipalities of different sizes.[14] Recently, changes in capital markets, international law, and domestic regulatory reforms have combined to promote private bond rating agencies, such as Standard & Poor's and Moody's, as an alternative regulatory mechanism.[15] The mechanics are relatively complex, but at least in theory, this approach holds great promise to overcome SND's history of moral hazard and mispriced risk, while simultaneously expanding the range of permitted borrowings.

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[10] *See* Juergen Von Hagen, et al, ***Subnational Government Bailouts in OECD countries: Four Case Studies***, Inter American Development Bank, Working Paper 399 at www.iadb.org/res/publications/pubfiles/pubR-399.pdf

[11] *See* Raju Singh & Alexander Plekhanov, *How Should Subnational Government Borrowing be Regulated: Some Cross-County Empirical Evidence,* IMF working paper 05/54 (2001).

[12] Teresa Ter-Minassian, *Brazil,* in *Fiscal Federalism in Theory and Practice.* Washington, DC: International Monetary Fund 1997.

[13] See generally, Fausto Hernandez, Alberto Diaz, & Rafael Gamboa, *Fiscal Decentralization in Mexico: The Bailout Problem*, IADB Research Network, 2002. Section 1.3 provides a more complete analysis of this topic.

[14] Id at 10-13.

[15] See Edward Altman & Sreedhar T. Bharath, *Credit Ratings and the BIS Capital Adequacy Reform Agenda*, Conference on Banks and Systemic Risk (2001). This topic is treated in Chapter 2 in far greater detail.

However, in the course of regulating debt, these agencies penetrate deep into local choices and promote a particular vision of proper governance. Although still incipient, I believe their vision is actually less reliant on markets than competing World Bank and IMF good governance proposals, although still far more limited than UN and community governance initiatives.[16] Beyond their overt agenda, their presence will also indirectly alter the contours of decentralization by enhancing local transparency and formalizing intergovernmental relations. Finally, I argue that their powerful, unregulated position suggests lingering holes in conventional regulatory approaches, particularly public and private international law.

This paper focuses on the course of these reforms in Mexico because they have suffered through numerous bailouts and initiated many of the new roles for rating agencies.[17] In addition, Mexico has an established federal structure that is in the midst of decentralization, making these issues a pressing concern.[18] However, for the most part the paper's analysis is neither country-specific nor suggested as a definitive set of policies. Rather, my goal is to explore the diverse legal ramifications of capital markets interactions with local governments, and local government law particularly. In so doing, I hope to add legal nuance to a field that has been historically ignored by lawyers and political scientists and only shaped by economists' limited vision of regulation.[19]

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[16]This topic is treated in greater depth in chapter three. Citations are provided *supra*.

[17]See generally Marcelo Giugale & Steven Webb, *Subnational Borrowing and Debt Management,* in Achievements and Challenges of Fiscal Decentralization: Lessons from Mexico, World Bank Publications, May 2000.

[18]Id.

[19]The few papers recognizing the phenomenon of rating agency expansion have not examined any of its governance or legal dimensions but rather subjected into econometric and game theory analysis, all in the name of showing that public debt is an important component in ratings. *See*, Marcelo Giugale, et al, *A New Model for Market Based Regulation of Subnational Borrowing*, World Bank Policy Research Working Paper Series 2370, (2003).

Chapter 1: The Subnational Vise

Subnational debt[20] is more complex and has a greater potential impact, both negative and positive, than nearly any form of borrowing.[21] Unlike conventional debtor-creditor relationships, SND involves three diverse entities - borrowers (local governments that differ widely in size and capacity), lenders (private banks, bond investors, and international and domestic development agencies), and the federal government – all of whom have intricate agendas and differing goals. Municipalities want credit at the cheapest price with the greatest autonomy. Lenders, of course, want high levels of repayments and high rates; however, individual lenders will vary dramatically in their tolerance for trade-offs between these terms. Their actual terms will also be influenced by the level of market competition and capital availability. The federal government's primary interest is usually as a guarantor –either formally or informally. It wants to ensure that local borrowing is conducted responsibly and does not impose defaults on the

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[20] Debt instruments differ widely in maturity, size, source and purpose. One especially critical distinction is between long-term obligations (maturities over a year) and short term obligations (maturities of often a few months). This paper is primarily concerned with long-term instruments since they alone offer significant expansions of government financial capacity and likewise contain the majority of risks. Short-term debt, by contrast, is generally used to smooth discrepancies between the receipt of annual revenues, such as taxes and transfers, and day-to-day expenditures. For the most part short-term instruments are paid in full every few months and incur minimal interest rates. Since most localities depend on this basic line of credit being re-extended they are also among the instruments that receive priority in any period of financial instability. However, in considering the ramifications of long-term holdings it is worth remembering that they occur on top of a base of these existing shorter obligations. In addition, in many locations the traditional lenders for both instruments are the same, which thereby heightens the leverage of long-term instruments.

[21] See Miguel Braun and Mariano Tommasi, *Fiscal Rules for Subnational Governments: Some Organizing Principles and Latin American Experiences*, IMF/World Bank Conference "Rules-Based Fiscal Policy in Emerging Market Economies" available at http://econ.worldbank.org (2001) (providing examples of these awful consequences throughout Latin America, including billion dollar bailouts of municipalities in Mexico, Columbia, Brazil and Argentina), for examples of all of these dangers.

central government. Depending on its view towards decentralization it may also have active interests in restricting, or expanding, localities access to capital.

Historically, debt crises have arisen in large part from the misalignment of incentives among these differing participants. This pernicious challenge has primarily arisen from federal governments' inability to provide a credible commitment to not bailout municipalities in financial distress.[22] Without that commitment, neither lenders nor local governments have any reason to exercise caution since they will rarely have to internalize the consequences of reckless borrowing/lending.[23] In addition, once in a condition of over-indebtedness, localities will not willingly take painful steps such as raising taxes or cutting services that might reduce their fiscal instability.[24] The first section of this chapter explores why federal governments, historically, could not resist bailouts despite these deleterious consequences.

Assuming the implicit federal guarantee is removed, all three parties involved in SND still face a second challenge of accurately pricing subnational risk.[25] Although often ignored by theorists, accurate risk pricing is vital to ensure economic efficiency.[26] If subnational risk is priced too cheaply, (i.e. interest rates are set too low relative to the risk of default) lenders will be inadequately compensated for their exposure to defaults,

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[22] Undoubtedly, as with all tools capable of leveraging large amounts of capital, there are numerous opportunities for corruption, mismanagement and fraud within subnational borrowings. Nevertheless, widespread subnational debt crises have rarely been initiated by these openly venal motives. See Ehtisham Ahmad and Raju Singh, ***Subnational Public Financial Management: Institutions and Macroeconomic Considerations***, IMF Working Paper, WP/05/108.

[23] See Hernandez, *supra* Note 13 at 23.

[24] Id.

[25] According to standard economics, higher risk investments should require higher returns, and this "risk premium" should be consistent across product types. For the purpose of investors, the risk in question is borrower's intrinsic risk that can not be diversified, which is known as beta.

[26] See, *e.g.*, Braun & Tommasi, supr*a* note 22. The majority of prior analysts have largely neglected the latter of these problems and primarily concentrated on the former.

and may eventually default themselves if reserve levels are inadequate. If these lenders are funded by domestic capital, these losses will also harm ordinary citizens and possibly macro-economic stability. If risk is priced too expensively, localities will not be able to undertake as many projects and will pay more for those that they do initiate. SND markets may also dry up, leaving little choice but to return to federal borrowing or deficit spending.[27] Individual local governments whose risk is priced too high will also suffer competitively vis-à-vis other jurisdictions. This can be particularly problematic when the mis-pricing is associated with an obvious public variable and therefore creates the wrong systematic incentives. At a broader level, systematically mispriced risk within a single sector, such as subnational governments, will encourage inefficient allocations of capital within the economy, and may crowd out investment in alternative sectors. The magnitude of government spending, and the inadequate availability of capital in developing countries, dramatically increases these dangers of crowding out alternative investments.[28]

Pricing risk, in comparison to preventing moral hazards, is more of a technical rather than political or structural challenge. According to most economists, in a world of perfect information there is an objective rate, which corresponds to a borrowers' default rate vis a vis other entities, that an individual borrower should be charged.[29] Unfortunately, the world lacks perfect information, and the sheer complexity of local governments' political, financial and social obligations makes gathering information

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[27] See Hernandez, *supra* note 13.

[28] See FitchRatings Local Government, *supra* note 28.

[29] Lecture by David Geltner, Professor at MIT Center for Real Estate; see also Edward Altman & Sreedhar T. Bharath, *Credit Ratings and the BIS Capital Adequacy Reform Agenda*, Conference on Banks and Systemic Risk (2001).

particularly difficult. Among the key challenges, addressed in the second section of this chapter, are the volatility of local cash flows and the opacity and uncertainty of local government authority.[30] Both of these factors are heightened in the current environment of decentralization, since it has thrown many traditional models into flux.

These historic misalignments of incentives and difficulty pricing risk have also been exaggerated by the limited availability of capital, and the subsequent cabalistic behavior of lenders.[31] The third section of this chapter examines how the growth and increasing internationalization of capital markets is shifting traditional dynamics between the three parties to SND, as well as adding pressure for accurate risk pricing. Greater liquidity also increases all the stakes surrounding SND.

Given all these challenges, regulating subnational debt ("SND") is both crucial and extraordinarily complex. Without a means to protect themselves from extensive moral hazards, federal governments will have little choice but to heavily limit or entirely remove subnational borrowing authority. Likewise, without effect risk pricing widespread economic distortions are likely. Currently there are four primary regulatory approaches to SND – categorical prohibitions, fiscal rules, federal administrative oversight, and reliance on market discipline – that address these challenges.[32] Unfortunately, as I examine in the fourth section of this chapter, each of them is inadequate to the task and unduly limits borrowing without solving the moral hazard

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[30] Fitch Ratings, *International Rating Methodology for Regional and Local Governments* (2002), available at www.fitchratings.com.

[31] See, generally, Michel Noel, *Building Subnational Debt Markets in Developing and Transition Economies: A Framework for Analysis, Policy Reform, and Assistance Strategy*, World Bank Policy Research Working Paper Series 2239, at http://econ.worldbank.org (2000).

[32] Teresa Ter-Minassian, Intergovernmental fiscal relations in a macroeconomic perspective: An overview, in Ter-Minassian, T. (ed.) Fiscal Federalism in theory and practice, IMF, 1997

problem. They are also increasingly inappropriate vehicles to handle the changes to the capital markets. In chapter two, I argue that rating agencies may be a much needed alternative to handle these challenges. In the meantime, it is vital to understand the aforementioned issues in greater depth.

Section A: Moral Hazards & Bailouts

Federal governments provide bailouts to indebted municipalities for three primary reasons: 1) to maintain their own, and other jurisdictions', access to credit, 2) to prevent the spread of a financial panic, and 3) to avoid bearing the political costs of allowing a municipality to go bankrupt.[33] Perversely, these motives are usually the strongest for larger and more indebted municipalities, since they will then be "too large to fail." In contrast, the magnitude of these incentives is reduced when the perceived fiscal independence of localities grows, which often coincides with decentralization.[34] On the other hand, as decentralization grows in prominence, the number of municipalities that are "too large to fail" may also grow. The section below examines each of these pressures and incentives in greater detail.

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[33]See Noel supra note 23 at 14-16 . In theory, lenders can also attempt to garnish subnational asset through a domestic or international debt collection proceeding. However, broadly speaking, asset seizure requires a judicial finding of expropriation, and then either a waiver of domestic sovereign immunity or the presence of foreign assets that can be seized in other countries. Moreover, at the end of all these permutations creditors must join pari pasu with all the other creditors fighting for these crumbs. Until recently these hassles deterred nearly all creditors from pursuing such remedies and even now only a few specialized vulture funds operate in this space. Given the additional complexities of attaching subnational assets this threat is generally insignificant in practice. However, at least in theory a national government might abrogate subnational immunity to provide lenders a direct means of seeking relief from local governments. See, generally, Matthew C. Porterfield, *International Expropriation Rules and Federalism*, 23 Stan. Envtl. L.J. 3, (2004).

[34]Id.

Historically, lenders to municipal entities have been the same as lenders to the federal government. This enables them to exert exaggerated leverage. Formally, this leverage arises from cross-default provisions in loan documents that permit lenders to accelerate obligations incurred by the federal government if there are defaults by any "lower" entity.[35] Absent such agreements, large creditors can still exert significant leverage by threatening to withhold future credit or charge onerous rates for such credit.[36] Since federal obligations are usually far more significant than local ones, federal governments often have no choice but to redeem local obligations if they find these threats credible.

In addition, even when federal and municipal lenders differ, federal governments are still vulnerable to future reputation sanctions within the lending community.[37] On its face, this is odd since refusing bailouts is a sensible long-term fiscal policy. However, lenders often view this refusal as a tacit indicator that governments are willing to default themselves and as a sign that they are not willing to kowtow to their needs.[38] As a result, even this responsible behavior is often punished by lenders. Finally, when domestic banks are the primary lenders they may not be able to internalize a subnational default and can threaten the federal with their own bankruptcies and resulting possibility of widespread financial panic.

Even when federal governments are sufficiently isolated from these threats, they still face the dilemma of lenders raising the cost of future credit to other municipalities

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[35] See Ter-Minassian *supra* note 12.

[36] Id. Large lenders could also exert leverage through more corrupt channels by withdrawing political contributions and or directly bribing relevant officials.

[37] See Noel Supra note 23.

[38] Id.

within the country.[39] Besides impairing numerous innocent actors, these increased credit costs and accelerated obligations can extend fiscal instability from one municipality to the entire country, thereby precipitating fiscal crises.[40] The magnitude of these threats will turn on the extent of consolidation (informal and formal) among lenders, as well as the availability of alternatives sources of capital such as interim federal funding. However, since most developing countries themselves are maxed out, they rarely have the ability to obviate these lender threats through deployment of federal capital.[41]

Finally, federal governments bailout municipalities to avoid the political costs of a local government bankruptcy.[42] Political costs arise both from disenchanted citizens and disenchanted investors. The magnitude of these costs are a function of the importance of the locality, and here again bigger jurisdictions are more likely to be saved, as well as the structure of federalism within a country. In highly centralized regimes, voters and lenders alike will associate municipal consequences more closely with the federal governments. This is particularly true in regimes like Mexico, in which local jurisdictions have little fiscal control.[43] These local regimes have no way to raise taxes and no discretionary expenditures to cut, and, naturally, they and lenders will besiege the federal

[39] Magressi *supra* note 4. As with federal arm twisting, these measure could often be little more than a form of negotiation by lenders. However, they also represented the fact that municipal debt was often priced artificially low to begin with in anticipation of federal bailouts. If a country did indeed resist bailout future lenders would have to raise the cost of credit accordingly. See the next section for further details.

[40] Id.

[41] See Michael DeAngelis, Ronald W. Johnson et al, Building the *Municipal Credit Market for Infrastructure Finance: The Legal Framework in Bulgaria*, USAID Local Government Initiative (2002).

[42] See Hernandez, *supra* note 13.

[43]FitchRatings International Special Report, *Financing of Mexican States, Municipalities, and Agencies*: Alternatives and Strategies, Jan. 31, 2002, at www.fitchratings.com. In most Mexican States only 5% of funds are generated from revenues over which these governments have direct control. Municipalities hardly better and on average only control 7% of their own funds. Municipal tax policy is also more vulnerable to the pressures of a race to the bottom and inter-jurisdiction mobility.

treasury. In addition, if the overall fiscal framework between localities and the federal government is in flux, as it is in most decentralizing countries, local governments can perversely "signal that they are in particular need of increased federal assistance by running large budget deficits."[44]

In contrast, in highly decentralized countries there will often be a high stakes game of chicken between local and federal actors.[45] Localities will insist that they can not cut spending or raise taxes and the federal government will insist that there are no further resources to be transferred. At least historically, federal governments have caved in this battle.[46] Often they have fallen on their own swords, as prior federal spending mandates and limits on the types of taxes and fees that localities can raise have enhanced local arguments that they cannot take corrective action.[47] In addition, since local expenditures tend to directly affect vital services such as health and education, localities are more recalcitrant to make these cuts due to their high political cost. As a result, even in relatively decentralized regimes, it is still hard for the federal government to resist bailout pressure.

These dangers are exacerbated by the political pressures exerted on local officials in charge of making borrowing decisions. First, most local officials have limited tenures, whether as a result of broader political ambitions, general political instability or term limits. In all but a few cases, the officials who initiate borrowing will not last through the tenure of the instrument. As such there is a natural tendency to ignore future long term

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[44] See Hernandez, *supra* note 13 (finding that size of unit, dependence on fiscal transfers, and extent of deficit all correlated with likelihood of a municipality receiving a bailout).

[45] Id.

[46] Id.

[47] Id.

consequences or, more benignly, simply make unduly optimistic assumptions about future cash flows.[48] And ultimately, like local governments, the actual employees of lenders have a short horizon with limited incentives to restrict marginal borrowers.

Given these difficulties it is not surprising that federal governments have consistently bailed out localities. However, the eventual result of this pattern will be for national governments to remove borrowing capacity from localities, as for instance India has done.[49] It is therefore vital that regulatory mechanisms control this risk. Unfortunately, as section 3 describes, few regulatory measures have eliminated this risk.

Section B: Pricing Risk

For subnational entities, proper risk pricing is complicated by two elements: 1) the volatility of local cash flows and 2) the opacity of local government's finances and responsibilities. Volatility arises principally from economic factors but is also influenced by macro-economic changes and the political climate.[50] In terms of economics, local governments are more vulnerable to economic contractions since their tax bases are generally less diversified than higher-level entities and they have less ability to insure against disruptions.[51] This volatility is heightened when the local economy derives a significant amount of revenue from activities related to commodities, which are

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[48] See, Ter-Minassian *supra* note 13.

[49] Guigale *supra* note 7.

[50] Id.

[51] Id. The exact extent of a local government's vulnerability depends on the nature of the economy and the structure of fiscal federalism within the country. For regions whose revenues are mostly collected at the local level, they will be more vulnerable to local economic conditions. Likewise, those jurisdictions whose revenues are primarily derived from revenue sharing by higher entities will be vulnerable to national economic contraction and at the same time insured against local instabilities. In general, localities with significant federal dependence will be less volatile than those with more decentralized funding streams.

themselves highly volatile.[52] For example, in Mexico, a decline in the price of a few key agriculture products, the so-called "tequila crisis," triggered a number of municipal debt defaults.

Fluctuations in cash flow can also arise from the uncertainty of local spending commitments. Generally speaking, dramatic escalations in the costs of health care or primary goods are the most salient concerns for local governments since these areas are among the most volatile and locally controlled sectors.[53] Local burdens can also be increased due to macro-economic changes, most acutely increases in interest rates on variable rate debt. In a few cases, local governments have also issued foreign currency obligations with their concomitant risk of currency fluctuations.[54] Finally, volatility arises from the political process. Federal governments can unexpectedly reduce intergovernmental transfers without providing localities any alternative avenues through which to raise capital, such as increasing local taxes. This is particularly problematic since many localities, including those in Mexico, are beholden to federal government transfers.[55] More subtly, federal governments have passed a number of unfunded mandates that have imposed new obligations on subnational governments without providing additional resources, thereby imposing significant additional unpredictable costs.[56]

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[52]Id.

[53] See Hernandez, *supra* note 13. Again the scope of local responsibilities will dictate which items are most relevant.

[54]See Noel *supra* note 23

[55]Id.

[56] This is particularly problematic in Germany and the United States. See generally Charles B. Blankart and Achim Klaiber, *Institutional Choice of Alternative Liability Regimes for Subnational Government Debt: Two Cases*, Humbolt University, (2001)

Opacity is a function of limited local government expertise and the flux created by decentralization. According to many analysts of developing countries "local governments have weak accounting procedures, and few multi-year budgeting processes."[57] Likewise procedures for expenditures and revenue raising measures are often highly irregular. In addition, there are few laws requiring transparent local disclosures or even any capacity to audit these disclosures where they do exist. [58] These information issues are complicated further by the shifts in local government law due to decentralization, or in some cases recentralization.[59]

The heightened unpredictability of cash flows and local government capacity, coupled with the limited information disclosure, makes accurate assessments of borrowing capacity extremely difficult. In particular, observing a borrower in a single period will provide little guidance as to its overall capacity; likewise, even well covered debt service payments may go under water unexpectedly. In addition, there are numerous local variables that must be separately evaluated by each potential lender, making the process cumbersome and costly. As a result credit for subnational entities has generally been mispriced, or restricted to simple endeavors such as toll road projects that are self-servicing, as opposed to depending on general obligations of the local government.[60] Unfortunately, this chronic mispricing hinders local government initiatives and autonomy and concentrates their expenditures solely on infrastructure projects.

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[57]Noel *supra* note 23 at 17.

[58]Id.

[59] See Kent Eaton and J. Tyler Dickovick, *The Politics of Re-Centralization in Argentina and Brazil*, Latin American Research Review, Vol. 39, No. 1, February 2004.

[60]Noel *supra*, note 23.

It is important to recognize that, at least in theory, appropriate risk pricing is independent of policy choices. A worthy policy aim, whether it be investing in schools or job training, may have a high degree of risk associated with it. If a municipality or the federal government is committed to this policy, it still retains the discretion to subsidize it from general fund resources. However, the subsidy choice is independent of the risk pricing decision. The goal of pricing risk accurately is to allocate capital efficiently across the economy, as well as to encourage fiscally prudent behavior among parties. It is not meant to end the debate over what programs to pursue. With that said, pricing risk is not a purely reductive or mechanical endeavor. Borrowers are dynamic creatures making countless choices that may drastically influence their borrowing capacity. Likewise evaluations of different instruments are guided by a vision of what investment produce growth.

Given these problems with pricing and obviating moral hazards, it is no surprise that SND is a subject of considerable regulatory efforts. Unfortunately none of the conventional strategies have proved effective. Section 3 tackles these initiatives in greater detail; however, before turning to these questions, it is useful to understand the capital markets' ability to ameliorate these traditional hazards and create their own.

Section C: Capital Markets Alterations

Capital markets, both domestically and abroad, are growing dramatically in their size, risk tolerance, diversity, and willingness to invest in developing countries.[61] Whereas lending in developing countries was once the sole provenance of World Bank

[61] Alan Greenspan, submission of comments to Federal Reserve, available at www.treasury.gov.

and IMF largess, these bodies are now seeking countries to utilize their funds and even expanding membership to encourage them.[62] These changes are altering the historic narrative presented in the previous section in three significant ways. First, the broadening of capital providers reduces creditor's ability to maintain cabalistic threats over the federal government and increases the likelihood of at least a few lenders ignoring prior transgressions.[63] Secondly, the decline in global risk premiums[64] reduces the distortions produced by incorrect risk pricing and increases the competition to lend, and therefore evaluate, local government capacity. The final impact of the internationalization of capital is that it demands alternative regulatory vehicles. In the words of one commentator, "as global capital markets deepen and rely on investors, operating through disclosure and fiduciary mechanisms such as mutual, pension and insurance funds... [regulation] with similar concerns will need to grow."[65] In the next chapter, I will consider whether rating agencies can serve that function. In this section, I begin by tracing the evolution of capital sources in greater detail.

Generally speaking, localities can borrow from five different sources: public banks (either subnational or national), private banks, multilateral bodies, domestic capital markets, and international capital markets. Each of these lenders contains a series of trade-offs between the cost of capital, flexibility of terms and availability. They also

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[62]Celia Dugger, *Donor Nations to Focus on Growing States*, N.Y. Times, April 24, 2006.

[63] In this regard, the recent emergence in an America of entire industry devoted to lending to consumers coming out of bankruptcy on account of their "taste for credit" and absence of other debts is a striking hint of the extent to which broadening capital can change received wisdom. (This insight was taken from a lecture by Bankruptcy Professor Elizabeth Warren at Harvard Law School, October 2004).

[64] Risk premiums are the amount of increased yield over a risk free investment that lenders require to bear certain securities. Generally this risk is partially a function of the underlying securities own risk and secondly its correlation with other investments (beta). Definition provided by MIT professor David Geltner's Real Estate Capital Markets Course.

[65] Patrick Del Duca, *The Rule of Law: Mexico's approach to Expropriation Disputes in the Face of Investment Globalization*, 51 UCLA L. Rev. 35, 39.

vastly differ in their ability to exert pressure on federal governments and correctly price risk. Historically, the only options available to localities were domestic private banks and internal development banks.[66] In Mexico until 2000, 67% of funds received by subnational units were from private banks and the remainder from Banorobas, the Mexican development bank.[67] Besides capital, these banks often provided financial training and were actively involved in crafting repayment strategies. On the other hand, they charged high interest rates and were able to generally use their near monopoly position to exercise considerable leverage over central governments.[68]

During the late nineties, however, all the major international development banks became far more involved in subnational development as part of their increasing emphasis on decentralization. Besides lobbying for increased federal decentralizations, these institutions also began to disburse funds to localities. In the World Bank's case, all these loans required direct federal guarantees; however, the actual functional extent of federal oversight varied significantly by locale. Other institutions, such as the Inter-American and Asian Development Banks, lent directly to localities without any federal involvement.[69] These funds were generally issued at far lower rates than traditional sources and often included more sophisticated (at least in theory) technical assistance than local sources.[70] The downside of these loans was the often-restrictive formal and informal conditionalities that limited the sectors in which these funds could be used and

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[66] See Von Hagen, *supra* note 10.

[67]SNCP supra note 39.

[68]See Von Hagen, *supra* note 10.

[69]See Magressi supra note 7. Besides differing organizational cultures these regional banks are also exempt from restrictions within the World Bank Charter that force it to deal only with the national governments. As such these banks have utilized far more transparent instruments than the nominally federal backed World Bank loans.

[70]Id.

sometimes added explicit cross-default language that permitted lenders to accelerate all obligations upon any single default.[71] In addition, these entities had privileged access to central governments, which further enabled them to compel subnational bailouts if these loans faced default. They also lacked traditional market incentives to fully price risks due to federal guarantees and international monetary support.

Rapidly these traditional sources of capital have been augmented, at least in middle-income countries, by the increased presence of private capital markets.[72] Domestic capital markets have been spurred by a significant expansion in remittances, stable currencies, financial sector consolidation, and increased economic development.[73] Perhaps more importantly, many developing countries, including Mexico, have undertaken sweeping regulatory reforms that have improved the transparency of investment procedures and consolidated pension assets. These domestic capital markets tend to offer cheaper capital than domestic banks and fewer restrictions on purpose than development agency funds. However, they offer little technical assistance and are more difficult to restructure, since bonds are held by numerous disaggregated creditors. In addition, since the majority of pension assets are consolidated, these domestic lenders will continue to exert considerable leverage over central and local governments. On the other hand, the mandate of these funds is generally cautious and therefore extremely sensitive to pricing risk correctly.

[71] Carlos Santiso, Governance Conditionality and *The reform of multilateral Development Finance: The Role of the Group of Eight*, Governance 7, (1999).

[72] For the most part subnational bond debt is still largely confined in the developing world to middle income countries like India, Brazil, Mexico, et al. See The future of the World Bank a CGD Symposium. Panel on "Who Needs the World Bank: The Future of China, India and Middle Income Countries.

[73]Guigale supra note 12.

Finally, international capital markets have also begun to target localities. They offer many of the same benefits and flaws as domestic markets, but with a greater intensity. For example, they provide even lower costs of capital than domestic markets and are even harder to restructure. These markets also require higher fixed transactions costs and therefore can only be sensibly accessed for borrowings greater than $20 million.[74] On the other hand, in well-developed markets such as China, they can provide much greater access to capital than any traditional form. According to one commentator, capital markets provide over 100 times the funds that development agencies provide in China.[75] Even more importantly, international capital is now highly disaggregated both amongst nations and within them. Significant capital is now available from China, Latin America and the Middle East. Likewise, investors range from hedge funds to private or state-run banks, all with differing policies and preferences. As such, the threat of any individual lender to withhold credit is increasingly insignificant.[76]

These changes are perfectly illustrated by Argentina's recent experiences. Unlike past sovereign debtors, Argentina adopted an extremely harsh stance with international creditors and essentially devalued their obligations by 95%, despite huge pressure from the IMF and international financial community not to do so. Since the default, Argentina has had only marginal difficulty accessing capital, in part due to large inflows from other Latin American countries and China.[77] Obviously, subnational dynamics are different, as

[74] Moody's Investor Service "Sub-national Governments: A Rating Agency Perspective" New York July 1998.

[75] Comments by Adam Lerrick, The future of the World Bank a CGD Symposium. Panel on "Who Needs the World Bank: The Future of China, India and Middle Income Countries.

[76] Richard Euliss, *The Feasability of the IMF's Sovereign Debt Restructuring Mechanism: An Alternative Statutory Approach to Mollify American Reservations,* 19 Am. U. Int'l Rev. 107 (2003).

[77] *Argentine Bondholders Meet to Plan Recovery of Losses*, Financial Times of London, February 22, 2004.

they are more highly regulated than nations and they may lack the diversity of options that their national counterparts possess. Nevertheless, given these emerging changes to capital markets a strong case can be made for calling lenders' bluff in certain contexts, and certainly taking a harder line during bailout negotiations.[78] In addition, the greater diversity of capital may also militate against undue restrictions on subnationals that were developed for different liquidity conditions.

Section D: Existing Regulatory Responses

As the preceding sections made clear, SND requires careful regulation in order to balance local autonomy with macro-economic stability. This section examines the common regulatory responses to SND and their inadequacy in terms of solving traditional problems, such as moral hazard and inaccurate risk pricing, as well as handling the recent alterations in global capital markets. These conventional measures are over- and under-inclusive on their face and generally bereft of attention to local conditions. In addition, they are animated by a limited worldview, which misses the transformative power that SND may have through investments in health and education. Finally, their lack of flexibility tends to exaggerate inequalities between stronger and weaker municipalities.

Traditionally, analysts have divided the regulatory responses to SND into four categories: 1) categorical prohibitions based on loan characteristics; 2) fiscal rules; 3) imposition of national control on borrowing and, 4) market discipline.[79] In some Scandinavian countries there is also the use of a structured bargaining protocol; however

[78] Conversations with Sovereign Debt Personnel from Cleary Gottlieb Steen and Hamilton.

[79] See, Ter-Minassian *supra* note 13. (providing the original classifications that has been reiterated in nearly all IMF and World Bank work on the subject).

it has been fairly circumscribed and is unlikely to be appropriate for most developing countries.[80] Each of these responses differs in the level of federal scrutiny, the flexibility in responding to changing circumstances and their utility in decentralizing contexts. In theory, market discipline is supposed to offer the most promises, and yet in practice, it has tended to be the least effective outside of already developed countries.[81] All of these mechanisms err on the side of restricting municipalities and none provide local governments a role in managing these frameworks. They also inadequately consider the vital role of local context and specific intergovernmental policy choices. In the next chapter, I argue that many of their flaws may be alleviated by the more sophisticated use of rating agencies.

1. Blanket Prohibitions

The least sophisticated forms of regulation are federal prohibitions on defined categories of borrowings. These prohibitions emerge from a variety of legal sources ranging from constitutions, such as in Mexico, to executive fiats. As with all bright-line rules, these measures trade efficiency and predictability for nuanced evaluation. Generally speaking these rules restrict borrowing based on either its 1) purpose/function 2) financial terms or 3) lender.[82] Of these three approaches, the first is the most prevalent, and in my mind the most problematic, whereas the latter two are draconian examples of fiscal rules that less frequently restrict borrowing choices.

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[80] Id.

[81] See Guigale, *supra note 12* at p.253 ("the necessary regulation should mimic desirable market discipline to the extent possible").

[82] See, Ter-Minassian *supra* note 13.

In assessing purposes, there are three broad categories: 1) large-scale capital expenditures in infrastructure, 2) deficit spending and 3) ex post insurance.[83] The most common form of regulation limits local borrowing to the first category, the supposed "golden rule" of subnational debt according to many theorists.[84] An even tighter set of restrictions sometimes permits only those borrowings, which are largely securitized by a dedicated cash flow.[85] More rarely, these regulations may even limit borrowing to specific infrastructure tasks such as road construction. Theorists have also praised the potential of subnational debt by smoothing cash flows via its insurance function.[86] In nearly all cases, deficit spending has been heavily criticized and restricted.[87] Although brief, my analysis is designed to suggest that capital projects have more flaws and deficit spending more potential than most studies suggest, whereas insurance is in almost all cases a less than ideal function of borrowing.

Large Scale Capital Projects

The quintessential opportunity for utilizing long term SND is the development of large infrastructure projects. These endeavors, which range from road construction to utility expansion and housing development projects, require huge initial capital outlays that extend far beyond most local governments' resources. According to one recent estimate, sub-national units need hundreds of billions of U.S. dollars in these immediate

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[83]Id.

[84]See DeAngelis, *supra* note 45 at 34 ("Long term debt shall be issued solely for the purposes of financing long-term public purpose investments").

[85]Standard & Poor's, *Mexico's Subnational Securitization Market Entering Second Stage of Development*, November 3rd, 2004, reprinted from ratingsdirect.com.

[86]See, Ter-Minassian *supra* note 13.

[87] See DeAngelis, *supra* note 45.

capital investments in order to just maintain basic governmental services.[88] Moreover, this figure is likely to grow as an increasing number of countries devolve responsibilities for capital-intensive sectors, such as water provision and road construction, to local units. Utilizing long-term debt instruments to generate this capital allows localities to match the benefits of these projects, which tend to accrue steadily over time, with the costs for providing these services. In addition, by spreading the cost over time, these borrowings foster intergenerational equity. Moreover, despite their high costs, these projects can often produce immediate tangible returns that can fully repay debt service. The classic examples of such an immediate return are the tolls from highway construction.[89]

Debt issued for these purposes also has significant advantages over alternative financing arrangements such as federal borrowing and subsequent inter-governmental transfers. First, it eliminates federal intermediaries, which reduces costs and bureaucracy. Second, if local governments face repayment obligations, they will have greater incentives to fully collect the user fees and taxes that repay the debt services. Devolving financing authority also matches the general tenets of decentralization[90], which suggest that lower level officials will make more responsible and effective decisions concerning the fate of their communities. In particular, local control over infrastructure can reduce the nasty battles and rampant unfairness that often attaches to the decision on where to locate these projects. That said, as with all decentralization

[88] See Magressi *supra* note 7.

[89] Id.

[90] Although not within the scope of this paper, there is considerable debate both over what metrics – i.e. improved cost, speed, increased local participation, levels of corruption – reflect improved performance and in which direction local governments influence these metrics' performance. See generally Musgrave. Nevertheless, most theorists concur that the trend toward increasing decentralization is a fact of life. Moreover, in a given country the factors that actually determine the efficacy of any decentralization program will be highly context specific, regardless of the broad philosophical debates over the effects of these programs more generally.

efforts, particular care has to be taken that local control doesn't lead to unfair exactions on oppressed minorities.

Despite these benefits, these projects may also produce a number of drawbacks. First, like all projects, infrastructure projects may be mismanaged and unsustainable. In particular, these loans are highly dependent on projections of revenue from the slated project. Therefore, simple blanket permission for these borrowings, without a means to evaluate individual borrowings, will leave municipalities in danger. Devolving infrastructure financing responsibility to localities can also unduly increase the frequency of these projects and lead to inefficient economies of scale for projects that would be better managed by bodies with larger jurisdictions. There are also numerous opportunities for heightened political patronage and waste embedded within these projects, including paying unnecessarily high interest rates. Finally, these brightline rules also encourage projects to be gerrymandered within their confines, even when the projects would be better designed otherwise.[91]

As such, despite their promising potential, they are hardly a simple good, or an example of a so-called "golden rule." In reality, adequately differentiating the significant from the wasteful will require nuance on the ground understanding and careful budgetary calibration.

Operating Deficits

The converse of utilizing debt for capital infrastructure project occurs when long-term debt instruments are utilized to overcome structural budget deficits. Unlike infrastructure investments, these borrowings have no dedicated repayment stream and can

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[91]See Noel *supra* note 23.

exaggerate intergenerational inequity since they exaggerate current discrepancy between local governments' revenues and spending. [92] Critics have frowned on utilizing long term debt for these purposes since it removes hard budget constraints, corrodes local management incentives, leads to excessive local spending and distorts municipal decisions away from efficient policies.[93] In addition, lenders will also often require the ability to call these debt obligations prior to their completion, increasing the likelihood of future capital instability crises if obligations become bunched and lenders refuse to rollover obligations.[94] Given these numerous dangers, it is no surprise that most theorists have heavily frowned on this form of local borrowing and have suggested that national governments curtail this practice.

This common critique, however, ignores the fact that targeted deficit spending can often act as a prod to higher growth. This growth in turn can enable a locality to mature into its inflated debt service. Countless studies have shown that among the primary determinants of future growth, particularly in developing countries, are investments in childhood health and educational institutions. Nevertheless, in most jurisdictions, user fees (or other similar short term repayment strategies) have proved insufficient to recoup the requisite costs and unduly restrictive of access by the poorest members of society.[95] In addition, many local governments will not have alternative sources of funds that can sufficiently subsidize these investments without unduly restricting other vital

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[92] Id.

[93] William Dillinger, *Developing Hard Budget Constraints in Decentralized Democracies,* World Banl (2001).

[94] Hal S. Scott, *A Bankruptcy Procedure for Sovereign Debtors*, 37 Int'l Law. 103, (2003 In almost every National fiscal crisis a precipitating event was the refusal of lenders to roll-over obligations generally in response to some factor that was at least partially "irrational."

[95] John Toye, *Fiscal Crisis and Fisacl Reform in Developing Countries*, Cambridge Journal of Economics 24, (2000).

expenditures. Therefore, if national governments or other regulatory bodies restrict municipalities from acquiring debt to support these ends, they will be condemning localities to slower or non-existent growth. In addition, since the benefits of growth accrue and multiply with time, debt incurred for these purposes will not necessarily impair inter-generational equity.

It is also important to recognize that the critics of operating deficits are primarily ensconced in the World Bank and IMF, and their critiques sounds alarmingly similar to the arguments that were mounted in favor of structural adjustments programs. Like their predecessors, their fear of budget deficits represents a fear of governance and a worldview more concerned with financial outcomes than social outcomes. [96] It also misses the fact that SND maybe one of the few tools available to subnational governments to resist privatization and actually make these social investments.

SND for these purposes is also likely to perform more effectively than a number of alternative fiscal federalism arrangements, such as direct federal spending or inter-governmental transfers. For example, federal spending on basic services like health care and education contradicts most tenets of decentralization, which suggest localities are best suited to the provision and control of these services since they require a careful consideration of local circumstances and community nuances. In addition, they are sectors in which creative approaches and more efficient procedures can save dramatically on cost. Therefore, it makes sense to ensure that the units most able to implement and develop these innovative practices have the proper financial incentives to actually pursue them. Moreover, in some jurisdictions, control over these types of services may be

[96] See all footnotes for numerous examples.

constitutionally delegated to localities, further limiting the possibility of a federal role. Likewise, SND has advantages over federal borrowing and subsequent intergovernmental transfers ("IGT"). First, effective IGTs require a mechanism to evaluate the legitimacy of local spending initiatives and the differing needs of local communities. Creating this mechanism is by no means a simple task. IGTs also again disconnect direct financial responsibility from service provision responsibilities, which may lead to significant moral hazards and wasteful overspending, as well as diminish the incentives for local creativity.

Given the weaknesses of these alternative funding approaches, SND in theory may prove to be the most effective mechanisms to support these growth-fueling expenditures, so long as there is some means to differentiate fiscal mismanagement from prudent investments. I will argue later that rating agencies have a huge role to play in facilitating this distinction and can do so far better than blanket prohibitions or even more nuanced fiscal rules.[97] In either event, the important point remains that, at least in theory, deficit spending remains a viable justification for borrowing in the proper contexts.

Smooth Budgetary Flows

The third common case for SND is the utilization of debt to smooth budgetary flows in regions following one-time or reoccurring shocks – natural disasters, currency adjustments, or commodity price collapses. These types of borrowings serve as an ex post analog of insurance in which debt service payments distribute the cost of a realized harm. While superficially appealing as a way of providing added local autonomy in the face of trying circumstances, the case for debt in these purposes is actually the weakest. First, many of these potential shocks are more likely to be prevented or mitigated by

[97] See *infra* next two sections.

federal action than any local action.[98] This will certainly be true for macro-economic shocks, but even commodities prices can be influenced through international trade and tariff negotiations. In addition, many nations have devised comprehensive national agriculture policies in which localities may have little say in determining what crops are planted.[99] Therefore, making the federal government responsible for the costs of relief will ensure that they have the proper incentives to prevent these shocks.

Secondly, localized ex post insurance is far more costly than ex ante insurance.[100] In the former, the disaster has occurred and debt instrument serves to spread the cost as broadly as possible in time and amongst the whole population of the local unit. Nevertheless, when done at the local or state level, costs can only be spread over a relatively small pool. In addition, costs can only be spread over the length of the debt instrument. In contrast, ex ante insurance, if well developed, would charge small premiums to the citizens of all jurisdictions over longer horizons and then provide coverage to whichever units were injured. Similarly, even federally provided ex post debt funding can be broadly spread through incremental increases in nationwide taxes (or cuts in nationwide spending) and longer repayment schedules. Nevertheless, in circumstances where the disaster harms all municipalities at the same time, the distinction between these various options fades, and the crisis is particularly likely to be precipitated by a federally governed sector and alleviated by federal action.

The second problem with utilizing debt as an ex post insurance mechanism is that it fosters intergenerational inequity, since the users whose harm is relieved will rarely

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[98]See Noel *supra,* note 23.

[99]Id.

[100]This analysis is taken from Professor Rosenberg's Mass Tort's class at Harvard Law School.

have to pay their share of the imputed insurance premium. Likewise, those making the payments are not being protected against future harms. Ex post mechanisms also foster inter-local inequities since if all localities are equally at risk, it makes little sense for the losers of these unlucky lotteries to be solely responsible for relieving their own burden. It is therefore more desirable to encourage governments at all levels to purchase and develop insurance ex ante, and, where emergency funds are required, to solicit those funds from federal coffers. The reliance on federal entities also comports with the widely held political vision of the nation state as the ultimate source of accountability and relief.[101]

The one caveat to the preceding analysis occurs in situations in which risks are localized by regions. In such cases, a homogenized insurance mechanism or federal implicit guarantee will prevent these localities from internalizing the risks associated with their location. However, to the degree these variations are predictable ex ante and beyond the localities' control, they can be factored into insurance premiums and corresponding federal alternatives such as mandatory set-asides on intergovernmental transfers. In cases in which local action can obviate catastrophic risks, a stronger case for requiring local borrowing to compensate for harm can be made. However, I suspect these will be in the minority of cases and can be fairly easily separated from the general principles enumerated above.

In summary, there exists a strong theoretical case that SND is a desirable resource for large-scale infrastructure and potentially for growth-fueling investments in health and education. On the other hand, it should only be used as a last resort mechanism to cover

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[101]See Dillinger *Supra*

periodic budget shocks when federal or national entities abdicate their responsibilities. In all cases, the efficacy of SND as a systematic choice will depend on improved measures for differentiating sensible investments from frivolous and wasteful borrowing.

*2. **Fiscal Rules & Financial Prohibitions***

Equally blunt are most attempts to restrict local borrowing based on blanket financial attributes such as total size or maturity. These measures are particularly inept when there are wide variations in the size of local units and their financial capacities. In those contexts any single financial limit will unduly burden or insufficiently restrict different jurisdictions. These measures are also inflexible. For example, if a restriction is phrased in terms of overall size, it will ignore the actual change in debt service created by a reduction in interest rates. The one set of defensible restrictions are prohibitions on localities directly borrowing in foreign currency.[102] Subnational governments, unlike financial intermediaries or corporations, lack the ability to hedge against this currency risk. In addition, they are at the national government's mercy regarding overall macroeconomic stability and exchange rates. On the other hand, loans issued in U.S. dollars or euros do tend to offer the widest pool of potential investors and can be especially attractive if domestic bank and bond capital is limited and the overall macro-economic picture is stable.[103] Nevertheless, given the rarity of this confluence, a blanket prohibition on these instruments is reasonable.

A related set of prohibition dictates which sources can provide capital. Generally speaking, localities can potentially borrow from five different sources: public banks (either subnational or national), private banks, multilateral bodies and domestic

[102] Articles 115, 117 of Mexican Constitution

[103]See Fitch Ratings Note 28

and international capital markets. Regulation tends to prohibit accessing these latter forms, although the rationale is quite unclear. As discussed earlier, there are good reasons to believe that international capital markets may hold great promise for obviating lender's historic excess leverage. Likewise, domestic capital markets should be expected to be more sophisticated evaluators of risk. Eliminating these forms restricts the menu available to individual localities and generally increases the overall cost of capital by reducing competition. It also further impinges on local autonomy and increases the likelihood of a federal bailout being required. In explaining these restrictions, it is worth noting that they are often imposed by international measures rather than by the federal government. For example, until this decade, few of the major international development banks permitted direct lending to municipalities, and the World Bank continues to prohibit such borrowing.[104] Likewise, western pension laws often restricted their ability to invest in oversees markets.

A more sophisticated and flexible form of regulation is the deployment of fiscal rules. A fiscal rule is a "permanent (or long lasting) constraint on fiscal policy, expressed in terms of a summary indicator of fiscal performance, such as the government budget deficit, borrowing or debt."[105] Most commonly, these rules are based on numerical targets related to specified measures of local capacity to repay - GDP, free cash flow, or overall discretionary revenue. They provide localities with increased autonomy when compared to direct federal control and derive from often sensible gages of local capacity to repay. They are also fairly cheap to implement. This has led a number of critics to call

[104] See Litvack *supra note 6*

[105] See Tommasi supra at 1

for their widespread deployment and spurred a wealth of inconclusive research on their optimal forms.[106]

Nevertheless, despite these benefits, they do little to account for the instability inherent to most fiscal measures in developing countries. In particular, fiscal rules have no mechanism to consider the economic vulnerability of cash flows or the potential for local growth in local tax bases. They also ignore the danger of outstanding liabilities such as pensions and an aging population. There absolute nature impairs the ability to evaluate differently situated localities, as well as give credit to truly viable projects in excess of current capacity limits.

These mechanisms also insufficiently consider the dominant role that federal transfers and policies may play in influencing local cash flow. Most acutely, the inherently discretionary nature of inter-government transfers and their dominant role in most local government finances means that any fiscal predictions are highly tenuous. Similarly, unfunded federal mandates can rapidly and unexpectedly diminish local repayment capacity. Likewise, these measures ignore the potential implications of devolution and decentralization. Lastly, to be effective, these mechanisms presume a certain degree of government fiscal transparency and capacity that is often lacking.

3. Administrative Oversight

The simplest response to potential local profligacy is to heavily restrict municipal governments' autonomy through federal administrative agency control. In India, for example, all municipal debt instruments must be approved by a specific body appointed by the executive branch. Similarly, in Indonesia, all local lending must be done with

[106] See Tommasi supra (finding evidence inconclusive on improving performance through fiscal rules); but see Marco Magressi, *Subnational Investment Needs and Financial Markets' Response*, Inter-American Development Bank, (2000) at www.iadb.org.

federal permission and guarantees. In theory, administrative agencies should develop broad expertise in evaluating local capacity and be able to differentiate subtly amongst jurisdictions and competing candidates. However, centralizing authority over local borrowing in a federal agency is an inefficient form of regulation. Federal agencies are costly and vulnerable to political pressure. They are often biased either towards excessive caution, since they receive no direct benefits from projects, or towards unnecessary profligacy, since they receive little direct consequences of excessive borrowing. They are also prone to political manipulations and undue delays, further biasing their judgments. On a deeper level, they contradict the entire impetus towards decentralization and can obviate the devolutions of power. In addition, rather than develop actual capacity, they tend to often rely on a limited set of indicators to assess local capacity and therefore can quickly devolve into a more costly version of other regulatory alternatives such as fiscal rules. [107]

4. Market Discipline

The last regulatory mechanism is to rely on market discipline to restrict local governments. Historically, the United States and Canada have been among the few nations that relied primarily on market discipline.[108] In theory, private lenders who face both the full downside of loan default and the full upside of successful loans will have the most incentives to separate good loans from bad. Moreover, as a multitude of entities compete, rates should be reduced to their lowest sensible levels and a variety of different loan products with varying terms should be created. But sadly life doesn't work like markets.

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[107]Analysis taken from Noel supra note 23

[108]See Hernandez, *supra* note 7

Firstly, this theoretical account underestimates the difficulty for lenders to actually evaluate local governments in developing countries. Most big lenders have little familiarity with these areas and small lenders often lack the capacity to target these sectors or weather the inherent volatility of local debt.[109] In addition, these municipalities are often quite opaque and unsophisticated making evaluations even harder. A particularly challenge is to understand the relative distribution of fiscal and legal powers within a municipality, which will crucially influence its repayment capacity. Domestic legal issues can also distort market forces. Tax and bankruptcy procedures can place municipal borrowing in privileged positions that distort market incentives.[110] Moreover, in many developing countries, the overall paucity of financial sector and debt collection regulation diminish lender confidence in investment.[111]

The most important weakness to market discipline, however, is the presence of federal guarantees, particularly implicit guarantees. So long as a loan is guaranteed, lenders have little incentive to evaluate the issuer's creditworthiness and instead will compete to issue as much debt as possible, up to the levels which would be lent to the federal government, which themselves are subject to repeated bailout by the international community.[112] Nevertheless, explicit federal guarantees can at least maintain a semblance of discipline so long as a federal entity controls the amount of borrowing issued. However, borrowing authority has often been devolved, thereby allowing localities and lenders to initiate loans in which neither has much interest in whether the

[109] See generally Fitch Ratings supra note 28

[110] See DeAngleis supra at FN 6(discussing tax law neutrality, flexible forms of collateral, municipal credit market developments)

[111] Id.

[112] See Scott at note 89

borrower is able to repay the borrowing. In addition, maintaining federal control replicates the problems discussed in the prior section. Implicit guarantees - which, as discussed extensively above, arise from a past history of bailouts, political pressure and lender leverage – are even more dangerous. Unlike formal guarantees, which usually include some mechanism of federal oversight, the tacit nature of these guarantees usually means that there is no federal oversight. As such, the incentives to excess local borrowing and lending tend to spiral out of control in these situations.

Conclusion

Clearly, each of these mechanisms individually seems inadequate to the challenge of SND. Combinations of these restrictions can fare better if well designed, or, alternatively, exacerbate the flaws within the individual mechanisms if designed poorly. The appropriate design of these restrictions is therefore the source of significant research; nevertheless, in most cases this research has tended to ignore the role of rating agencies. At least tentatively, they offer a corrective to the lack of capacity, flexibility and accuracy that has limited the efficacy of the aforementioned forms of potential regulation. At the same time, rating agencies are also independent institutions with secondary effects on decentralization and governance. The next chapter traces these various considerations.

Chapter II: The Role of Rating Agencies

As the preceding section demonstrated, none of the conventional regulatory approaches (blanket prohibitions, fiscal rules, administrative control and market regulation) have effectively managed SND, and they have all reflected a limited view of local governments. At the same time, the trend towards decentralization has continued to grow, local capital needs have increased, and funding alternatives have declined, all of which have made SND capacity even more vital. This growing chasm has led nations and international policy makers to search for alternative institutions to regulate SND. A recent and largely ignored strategy has been the increased reliance on private rating agencies, the most prominent of which are Moody's, Standard & Poor's ("S&P") and Fitch (formerly Fitch/IDCA), to regulate SND.

This chapter begins by examining how rating agencies grew in prominence due to both regulatory and economic drivers. It then explores how these bodies operate, the criteria by which they rate local governments and how these ratings in turn affect SND markets. Its analysis suggests that the deployment of rating agencies should reduce the prevalence of moral hazards, provide more nuanced evaluations, and more accurately price the cost of capital when compared to any of the existing alternatives. However, the increased efficiency gains associated with their deployment are also accompanied by a particular vision of proper urban governance. In the sections that follow, the paper turns to general issues regarding the accuracy of ratings, their ability to price risk and their governance implications, including the appropriate regulatory interventions in light of these origins.

Section A: The Spread & History of Rating Agencies

Although a long standing fixture in private markets,[113]rating agencies' involvement in SND in developing countries is relatively novel.[114] As recently as 1998, Moody's boasted of rating 95 such instruments, the vast majority of which were confined to western jurisdictions or "global cities." [115] By contrast, in Mexico alone, there are now more than 95 separate subnational entities that have received ratings, usually by each of the major agencies.[116] The growth of these agencies is in part an organic response to global trends such as the increasing globalization of capital markets, deepening decentralization, and the need for specialized agencies to evaluate increasingly complex instruments.[117] Less appreciated is the role of domestic legislation, such as Mexico's recent Fiscal Coordination Laws ("FCL")[118], and international measures, specifically the Bank on International Settlements ("BIS") Basel II Capital Adequacy Requirements ("Basel-II").[119] This section examines the interactions amongst these factors and their ability to ameliorate the moral hazards traditionally endemic to SND. It also traces the

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[113] All three major bodies have existed in America since the beginning of the 20th century. Historically, these agencies evaluated private issuance of long and short term debt, however they now also rate numerous sovereign, mortgage backed, and public agency placements. They employ thousands of people, and operate on every major and most minor private indices around the world. See generally Lawrence J White, *The Credit Rating Industry: An Organization Analysis,* 2001Conference on Rating Agencies in the Global System, (2001).

[114] See FitchRatings, Subsovereign Tide note 8.

[115] Moody's Investors Service, Regional and Local Governments: The Mexican Case, July 2000.

[116] Id; Fitch note 8.

[117] See White note 112.

[118] I am using FCL to refer to a number of measures that were passed in the last few years as part of regulations aimed at ameliorating a number of financial and regulatory challenges. Technically the FCL refers to only the initial pieces of these legislation, however since they have generally been thought of as a package it is simpler to discuss them in that way in this paper.

[119]A New Capital Adequacy Framework, Basel Committee on Banking Supervision, Basel, June 2001

dialectic relationship between these changes and the shift towards bond rather than bank debt. Lastly, it examines the limited measures that target borrowers.

1. Global Economic Forces

Rating agencies arose in private markets because they provide a number of efficiency advantages over traditional evaluation frameworks.[120] First, they reduce aggregate transaction costs by permitting a single entity to evaluate a borrower, rather than each potential lender.[121] Even in circumstances where lenders insist on separate due diligence, these ratings still provide reassurance as a cheap second opinion.[122] Second, rating a borrower's capacity is often complex and benefits from specialized expertise. Third, rating agencies allow borrowers to limit the disclosure of privileged information regarding their repayment capacity. Fourth, ratings serve an advertising function and can draw lenders' attention to instruments with desirable risk profiles. Significantly, each of these aforementioned factors grows in importance as the sources of capital fragment, debtors become more complex, and lenders are attenuated from the original borrower.

Many of these motivations are especially strong for subnational debtors. Localities in the developing world are highly opaque entities nested in a complex tangle of inter-governmental fiscal policy, local government laws, and emerging patterns of decentralization. This makes them ideal candidates for being rated by specialized agencies. These entities are also relatively novel participants in the capital markets and

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[120] See Steven L. Schwarcz, *Private Ordering of Public Markets: The Rating Agnecy paradox,* 2002 U. Ill. L. Rev. 1, (2002).

[121] Id. The danger with such a model is that it encourages free ridership among later lenders. Agencies avoided this problem by actually charging borrowers for the rating and forcing them to either internalize or pass on these costs.

[122] See White note 112. According to recent estimates these organization earned between $300-500 million for their ratings, and charge between $20,000 and $125,000 per individual security ratings

therefore receive added value from the assurance a rating provides. High ratings serve as proxy signals for a municipality's transparency, management quality and overall investment climate, and can therefore also be an easy way to draw non-debt financing.[123]

However, until recently, the sources of capital for many municipalities, particularly in Mexico, were limited, which curtailed the traditional incentives for ratings.[124] For example, many local government laws, including Mexico's, restricted borrowing primarily to domestic lenders and national development banks. Internationally, foreign investors were wary of lending to developing countries in the wake of the Asian financial crisis. Domestically, and perhaps most importantly, the lenders that did exist lacked traditional market incentives, due to the legacy of bailouts and implicit federal guarantees.[125] Consequentially, only two municipalities in Mexico had solicited debt ratings in the 1990s, both of which were in the context of fairly unique debt offerings.[126]

2. Regulation Spurs Rating

In Mexico, two sets of regulatory changes have played an intertwined role in catalyzing these existing incentives for ratings. The first were the reforms spurring domestic capital markets by consolidating the pension sector and enhancing overall

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[123] Id. Chile for example explicitly got rated in order to signaling their international credibility rather than in order to receive a rating.

[124] See Schwarcz, supra, note 118.

[125] During this period, Mexico, Brazil and Argentina all bailed out municipalities at great cost to their own national financial stability. In Argentina's case they did so after having explicitly committed not to bail out localities. Their decision cemented the perception among borrowers and lenders alike that implicit guarantees were all but inevitable. Moreover, the weakness of capital markets actually exacerbated the likelihood of bailout since federal governments had far less leverage to resist lender demands.

[126]Fitchrating supra note 28.

fiscal transparency.[127] This was especially important for subnational debtors, because pension funds were required to invest in securities with long horizons, such as SND, in order to match the liabilities they incurred with pensions. The second far more blunt set of policies was Mexico's decision to adopt the Basel-II capital adequacy accords in its latest version of its FCL.[128] The interaction between Basel-II and the FCL, which I trace below, made ratings essentially mandatory. Equally importantly, they may have begun to address the systematic corrosion of market incentives created by the presence of implicit federal guarantees.

The Bank on International Settlements is comprised of central bankers from 55 mainly Western economic powers, and largely steered by the G-10 countries.[129] Its mission is to ensure the stability of the banking sector. Although not technically binding as a matter of treaty law, its promulgations on the banking sector are rapidly implemented by domestic central banker pronouncements or official regulations.[130] In 1988, their original Basel-I commission report had required banks to set aside 8% of the total value of all loans issued as reserve capital to guard against the risk of default.[131] These provisions were designed to ensure that liquidity shocks and risky lending decisions by banks would not snowball into broader financial crises. However, most banks found the measures unnecessarily restrictive, particularly when applied to low risk loans, and in fact

[127]FCL note 117

[128]Basel-II, note 118

[129] See www.bis.org for further information.

[130] Basle Committee on Banking Supervision, *International Convergence of Capital Measurements and Capital Standards,* available at http://www.bis.org/publ/bcbs04a.pdf (1999)

[131] Basle Committee on Banking Supervision, Basel-II Capital Adequacy Framework overview document available at http://www.bis.org/bcbs/events/b2eacla.pdf (including review of original Basel framework) (2001 revised three times since)

perversely designed, since they created incentives for more risky lending to maximize returns.[132]

As a result, the commission established a number of different categories of loans whose face value was to be multiplied by a stated applicable percentage, before being subject to the 8% withholding.[133] For example, loans for residential mortgages were given an applicable percentage of 50%. This meant that a $10 million dollar loan would be first multiplied by 50%, and than subjected to the 8% provisioning. Sovereign debts from OECD countries and those countries with no rescheduling in the last five years were given an applicable percentage close to 0, essentially eliminating capital adequacy requirements. Other sovereigns were subject to a complicated set of procedures and no formal procedures were developed for subnational debt.[134]

Despite these changes, most banks found that this structure lacked sufficient categories and could not accurately assess the growing variety of different financial instruments. As a result, in 1999, as part of its Basel-II revisions, BIS created a new set of recommendations that tied applicable percentages, and therefore capital reserve requirements, to the debt ratings of individual instruments and the identity of the lender.[135] For example, a triple AAA security from a bank only required a .5% applicable

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[132] This assumes that a lender receives a higher rate on riskier loans and therefore if it thought that it could cover the 8% threshold would seek out these investments. To get a further insight into bank responses see the comments on Basel-II posted on the BIS website.

[133]Ex. For loans with an applicable percentage of 20%, worth 10 Million dollars, the amount withheld would only be 8% of 2 million.

[134]Id.

[135] They also developed a far more complicated framework by which banks could establish their own risk weighting criteria. This latter process has delayed the Basel-II formal implementation till the year 2006, nevertheless an amendment process to the first agreement allowed these measures to take hold prior to that date. In addition the sheer complexity of the latter procedure as well as limitations by the Basle commission will initially make rating agency determinations far more significant.

percentage, where as the most risky loans required 150% applicable percentages (12% provisioning). Likewise any debts that were past due immediately incurred 150% applicable percentages (see table 1).[136] These recommendations ratified the legitimacy of rating agency evaluations and made them the de facto definition of what constitutes risk for the worldwide financial community. These recommendations for private banks were not "intended to have the direct force of law," but nevertheless have been quickly adopted without major revision by nearly all parties to the agreement, including Mexico.[137]

Table 1. Sovereign creditworthiness Risk Weights

Rating	AAA to AA-	A+ to A-	BBB+ to BBB-	BB+ to B-	Under B-	Unrated
Risk Weight	0%-.5%	20%	50%	100%	150%	100%

***These tables are adjusted slightly based on type of borrower and national context, but provide a rough guidance of risk weightings.*

3. Mexican Implementation

Mexico, in implementing these recommendations, went one step further and made the Basel-II requirements not only binding on lending to private companies but on all lending to sovereigns and subnational bodies as well. In order to encourage subnational issuers to receive ratings, the FCL mandated that all non-rated offerings be provisioned at 150% of face value.[138] In contrast, Basel-II had either allowed unrated securities to be provisioned at 100% or in certain cases ignored entirely. This provisioning penalty pressured every subnational issuer of debt, whether short- or long-term, into receiving

[136]See Basel-II note 119 (providing all these figures)

[137]Id

[138]See FCL *supra* note 117

ratings since banks were understandably reluctant to make loans that required higher provisioning levels (see table). To further control high-risk local borrowing, Mexico made all lending by Banrobas to 100% or below entities contingent on foreign technical assistance.[139]

In order to prevent rating shopping the government decried that for entities with multiple ratings, the worst given rating would govern. To prevent corruption, Mexico established a set of measures to ensure that only qualified entities could provide ratings. In practice qualified rating agencies has essentially come to mean Fitch, S&Ps and Moody's.[140] Finally, in order to preserve basic small short-term borrowing activity, Mexico promulgated an alternative set of more generous provisioning requirements for loans under 300,000 pesos.[141]

The Mexican reforms' critical feature is to separate ex ante market incentives from the hope or expectation of future bailouts. Specifically, under the new regime, banks whose portfolio is comprised of highly rated entities can utilize far more of their capital for investment purposes, rather than reserves. Even if the bank expects the federal government to provide a bailout, in which case all securities theoretically have the same downside risk, it will still prefer to hold higher rated securities since they permit far greater leveraging. Similarly, to disburse funds to lower rated entities, it will need to receive a higher interest rate. Although the magnitude of these relative preferences will

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[139] Id.

[140] Besides meeting the formal definition of qualified entities these bodies also are subject to strong international sanctions that should reduce the danger of falling prey to corruption. However, there remains the agency problem between those who benefit from corruption (individual agents) and those harmed by the sanction (the corporate whole)

[141] Id. Top-rated securities only require a .5% level of provisioning; where as mid-level investment grade securities require a 5% level and low level but still investment grade securities require 50% provisioning, a 100 times the level of triple AAA securities.

rarely correspond to a pure market, at least the general direction and pattern of incentives will begin to match, which is a significant improvement from most attempts at creating a credible commitment. In addition, the national government can easily adjust the provisioning levels to more closely reflect appropriate market incentives if they deem it necessary.

Table 2. Risk Weighting Impact on Yields

Applicable Percentage	**0**	**20**	**50**	**100**	**150**
Provisioning Level	*0%*	*1.6%*	*4%*	*8%*	*12%*
Equivalent Rate of Return	6.00%	6.10%	6.33%	6.52%	6.82%
	8.00%	8.13%	8.33%	8.70%	9.09%
	12.00%	12.20%	12.50%	13.04%	13.64%

As importantly, this system of mandatory rating makes it far easier to detect banks or borrowers that are engaging in high-risk lending or borrowing (in anticipation of a bailout), and to circumvent this process before it results in default. The capital adequacy requirements also ensure that if the federal government does not redeem defaulted obligations, it will not trigger a widespread series of bank defaults. Both of these are vital in forestalling default before political pressure makes bailouts inevitable.[142] Finally, it is worth noting that all of these benefits depend on credit rating being "honest" and not fully factoring the informal expectation of bailouts into the formal ratings. I will return to this important issue in the next section.

Not surprisingly, these collective measures have led to a dramatic increase in the prominence of debt ratings within Mexico (as well as other countries that pursued similar policies). Currently, 32 of the 33 states in Mexico are rated and 10 of them have ratings

[142]See, generally, Noel supra note 23

from at least three agencies.[143] In addition, almost a hundred municipalities are rated, as are a number of water providing agencies. This scale of subnational rating is greater than any country other than the United States and Canada. By way of contrast, there are only 13 subnational ratings for Italy, 16 in Germany, 9 in Argentina and 14 for Colombia.[144]

4. Composition of Debt

The package of reforms in Mexico has also altered the composition of subnational debt. Prior to 2000, all subnational debt was borrowed from banks, with two-thirds coming from the private sector and the additional third from the public sector. However, since 2000, bond offerings represent approximately 25% of all borrowings initiated and are now 10% of outstanding Mexican SND.[145] The widespread availability of ratings helped facilitate this shift by providing a public, easily shared, and reliable indicator of debtor quality. This public information gave remote and institutional investors far more security investing in diverse issues. Likewise, the ratings stamp attached additional legitimacy to these financings and permitted certain regulated investors to choose these funds. Moreover, interactions with rating officials have made local leaders more cognizant of bond market opportunities and the norms for entering these markets.[146] It has also hastened the financial modernization of many municipalities, which was a precursor to entering bond markets. Undoubtedly, all of these trends have also been extended by the broader changes in capital markets discussed earlier.

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[143]SHCP

[144]See Fitch Ratings, *Globalization Tide* at 9-12. These figures are from Fitch and were compiled in 2003, nevertheless the general patterns hold.

[145]See Garza, Presentation supra note 4.

[146]Id.

This shift to bond financing has a number of pronounced secondary effects. First, it dramatically increases the relevance of ratings and the constituencies interested in accurate ratings. Second, it provides lower rates for subnational debt since the bond market can pool numerous potential creditors and more easily stratify risk tranches. The bond market can also more easily draw on international capital, although as of now, Mexican municipalities are barred from undertaking foreign currency obligations. On the other hand, the multiplicity of bondholders makes restructuring these instruments extremely difficult.[147] The difficulty in restructuring these instruments may increase the rate of default and generally impede local government flexibility. At the same time, the breadth of bond market capital sources can alleviate the threat of future credit sanctions, thereby creating greater local leverage. That said, the breadth of eventual bondholders is tempered by the fact that they are usually initiated by a few powerful institutions, who should be able to maintain exaggerated leverage.

One danger of the shift to bond market dominated financing is that it may undermine the fiscal reforms that fueled its emergence. Unlike banks, not all bond investors are required to comply with Basel-II restrictions, therefore the Basel-II checks on their lending will not exist. However, the current practice of securitization chops bonds into numerous little pieces, whose resale ability is largely governed by their credit rating, rather than an independent assessment of repayment risk.[148] As a result, credit ratings should determine eventual bond pricing even without Basel-II requirements. If anything, bond lenders may eventually be most driven by credit ratings.

[147]See, Schwarcz *Private Ordering* supra. Although not required most bond issued under US law have required unanimity before undertaking any substantial modifications. As this has proven onerous in the international context, many sovereign issues now have collective action clauses which permit super majorities to readjust terms providing certain procedural concerns are fulfilled.

[148]See S&P securitization, *supra*, note 104

5. Borrower Incentives

These measures, at least on their face, do little to address borrower incentives. Specifically, a borrower anticipating a bailout will still behave in an irresponsible manner even when it is being charged higher interest rates. In turn, if it eventually defaults, it may again seek redress at the federal level.[149] In an attempt to alleviate these risks Mexico passed a number of additional measures within its FCL that were intended to limit federal involvement in Inter-Governmental Transfers ("IGT").[150] These reforms included the elimination of the federal government's discretionary IGT budget; the creation of an independent master trust instrument to handle all IGTs, and finally requirements that lenders proceed through state debt proceedings before any form of alternative relief could be considered.[151] The intent of all of these policies was to remove the federal government's autonomy to supply bailouts and extend the time before borrowers and lenders could seek federal redress. Equally importantly, they were meant to alleviate political pressure by symbolically distancing the federal government from its IGTs and placing greater onus on localities.[152] These measures also served to formalize IGTs, which helped lenders evaluate the capacity of local borrowers. The main problem with all these reforms is that they do not do anything, such as requiring a super-majority for repeal, to stop the federal government from untying its own hands during a crisis. In addition, there are still a number of loopholes governing how the federal government can adjust the trust instruments that may weaken them in practice.

[149] Similarly, lenders not implicated by Basel or Bond sanctions may also lend in reliance on historic bailout incentives.

[150]FCL *supra* note 117

[151]Id.

[152]See Hernandez, supra, note 4

Still lacking, despite these reforms, are measures to assist, rather than restrict, localities. For example, there is nothing in these reforms to ensure that credit is made available to localities that are poorly rated due to existing inequities between jurisdictions. Likewise, there are no provisions in these measures to devolve additional powers to municipalities, or expand the sources from which they can derive the revenues needed to leverage debt. These measures also do not do anything to shake Mexico' insistence that SND only be used for "investment" projects, although the ambiguity in term is sufficiently large to diffuse the significance of this restriction.[153] There is the distinct possibility, however, that if these measures alleviate moral hazard concerns and stabilize subnational debt, these capacity enhancements will be forthcoming. In addition, as I will discuss later, the actual process of receiving ratings may increase the capacity of local governments to borrow.

The dramatic growth of the rating sector, both in Mexico and elsewhere, represents a significant change in the financial architecture of localities and a mechanism to alleviate moral hazard concerns. However, to determine the overall social impact of these reforms requires a careful analysis of both ratings' accuracy and the actual rating process. In the section that follows, I begin this exploration by examining the criteria by which ratings are developed, as well as their accuracy in comparison to existing mechanisms.

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[153] Id

Section B: Ratings Criteria

The recent Mexican reforms and the growing presence of bond capital have placed ratings in a privileged role. This section analyzes the content of their criteria and finds that they are surprisingly varied and nuanced, with significant attention to local detail and managerial capacity. It also observes that the stated richness of criteria is partially supported by empirical regression analysis. The section next compares the theoretical efficacy of these criteria to the mechanisms studied in chapter one. It finds that ratings should perform better than all of these categories. Finally, it finds historic support for the accuracy of these criteria in private markets, but questions whether those results warrant completely reliance on these entities as a measure of objective risk.

Broadly speaking each of the agencies handles debt rating with a roughly similar approach and framework.[154] The rating agencies shared often overlapping rating categories, including evaluations of: 1) the local institutional and administrative frameworks and the distribution of authority amongst different levels of government, 2) the socio-economic profile of a region, 3) a locality's budgetary performance and free cash flow and 4) its debt profile and projected liabilities.[155] Most strikingly, while each agency combines a variety of quantitative insights, all of them repeatedly stress that their qualitative criteria are more important than their quantitative evaluations. To quote

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[154] Ratings information taken from Fitch Ratings, International Rating Methodology for Regional and Local Governments. International Public Finance, available at www.fitchratings.com, (2002); Fitch International Special Report, Financing of Mexican States, Municipalities, and Agencies: Alternatives and Strategies, January 31, 2002, at www.fitchratings.com; Maria Tapia, Standard & Poor's Mexican Subnational Securitization Market Entering Second Stage of Development, Nov 2004, at www.sp.com; Moody's Investors Service, Regional and Local Governments: The Mexican Case, July 2000. Unless otherwise indicated, all information on ratings is from these sources.

[155] See, e.g., Moody's (listing (1) institutional framework; (2) economic fundamentals; (3) budgetary performance; (4) debt profile; and (5) government structure and political dynamics.

Moody's, "analytics cannot be reduced to a set of ratios or mathematical formulas."[156] In general, a similar emphasis on flexibility pervades all the agencies' criteria.

The crucial difference amongst the bodies is not within their formal criteria, but rather in their tone and approach, which is usually seen in their analysis of miscellaneous factors. S&P's takes a skeptical view of municipal authority and tends to be more wary about local capture, whereas Fitch is optimistic about local control and supports capacity building investments. A similar dynamic is observed in process, as Fitch encourages dialog and transparency, while the other bodies prefer insular promulgations.[157]

Institutions

Within their analysis of institutional features, the agencies focus on determining the autonomy of the proposed borrower and, more specifically, whether a local entity should be rated equal[158] to the sovereign due to the presence of explicit guarantees and credit supports. One of the apparent discrepancies between the agencies is their treatment of implicit guarantees. Fitch's criteria, for the most part, mention only formal institutional arrangements such as the national fiscal coordination laws, and the debtors' national constitution. In contrast, Moody's finds that "explicit guarantees are few and far between. Accordingly, our analysis of the framework tends to focus on other features."[159] The remainder of the institutional overview reviews the various confines of decentralization and local government law, paying particular attention to locality's

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[156]Id

[157]Id.

[158]Generally speaking a local unit will never receive a rating higher than the sovereign since it is assumed that in a debt crisis a federal entity may rescind all transfers and otherwise commandeer local assets. Recently, S&Ps' suggested that these country ceilings could be removed when a municipality demonstrates significant fiscal autonomy and there is no history of federal intervention during debt crises. To my knowledge Bologna is the only current entity rated higher than its federal counterpart.

[159]Id; Moody's at 4

dependence on inter-governmental transfers as opposed to local tax revenue. This highly legal analysis also addresses the availability of different creditor relief mechanisms.

Socio-Economics

The socio-economic overview is concerned with the stability of the subnational government's revenue flows and the stability of their expenditure demands. For Mexican localities, the bulk of analysis is on national trends, since 80-90% of their revenues come from transfers, whereas in more decentralized localities, the assessment will be primarily local. The agencies emphasize that to ensure economic stability a jurisdiction should contain a diversified workforce, employed across a range of industries. Where a single sector or employer predominates, Fitch will actually factor that institution's creditworthiness into its rating of the local government. Other agencies are less explicit about this incorporation process but likely handle it in a similar manner. Interestingly, unlike many International Financial Institutions, Fitch considers high federal government employment levels as a positive sign since they stabilize the cashflow of the region. Likewise, other stable employers, such as universities, and geographically bound employers, such as resource extraction plants, count in a locality's favor. Besides evaluating current dynamics, all of the agencies also try to project future trends in employment and demographics.

Agencies, particularly Moody's, also attempt to assess the potential expenditure demands made on government services. Within this broad category they focus on overall demographic trends with particular concern for a region's pension liability, health insurance and education demands. Generally, a very young population will incur concern over education costs and an older population will raise the specter of increasing health

care costs. In assessing these threats, government-required mandates and historic services are considered the most significant future expenditures since they will be the most difficult to restructure. Moody's is alone in expressing particular concern regarding the population dangers of rapid migration and the particular vulnerability of well-governed regions to sudden inflows.[160]

Budgetary Factors

The budgetary assessment's central function is to determine the level of current and future free cash flow. This assessment obviously incorporates the findings from the previous sections in determining appropriate inputs, but is more focused on the actual financial management of these flows and the presence of appropriate reserves, capital accounts, and contingency planning. Often, when the borrower lacks adequate contingency plans, the agencies will create their own sensitivity tests as part of their budget evaluation. This criterion appears to be an implicit test of the borrower's financial acumen, foresight, and good faith. Fitch is particularly explicit about the importance of transparency in this process, stating that "generally the greater the quality of financial disclosure the better the results of the ratings process."[161]

Debt Profile

Not surprisingly, a locality's current debt exposure is particularly relevant to a rating agency. Central to their inquiry is an assessment of the relative standing among different instruments and what mechanisms exist to rollover or adjust any outstanding obligations. Besides a qualitative assessment of overall debt levels and leverage, agencies also derive a variety of metrics linking projected free cash flow to overall debt

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[160]Id.

[161]Id; Fitch at 9.

servicing capacity. However, according to the agencies, unlike federal fiscal rules legislation, there is no single benchmark that predominates and no standard formula to calculate between diverging measures. In addition, there is not a single blanket prohibition listed in any of the agencies' criteria. While such ambiguity would be difficult in a legal regime, it is at least somewhat justified by these agencies' long history of rating securities, their greater independence, and quite frankly the absence of any formal review.

Other General Criteria

Beyond these shared facets, each of the agencies has its own predilections. Fitch is a stickler for managerial capacity. According to their reports, "management has always been viewed as the crucial component of credit analysis at all levels of government," and they now believe "management practices are even more important to predicting favorable credit performance than appreciated in the past."[162] One of the most important factors in management quality appears to be the government's emphasis on full transparency to both international investors and local residents. In addition, officials should have demonstrated a commitment to the rule of law, responsible spending, and the participation of civil servants.[163]

More striking than its formal criteria is Fitch's generally optimistic tone with regard to the potential of sub-sovereign governments. It suggests that "creating long-term investments in the community, such as schools, mass transit, or water...is a positive credit factor," that often will enhance a locality's standing. Likewise, as mentioned above, it finds that government employment can exert a stabilizing influence. By

[162]Id; Fitch at 11.

[163]Id; Fitch at 11.

contrast, S&P's and Moody's are frequently skeptical of governments and tellingly define capacity not by positive action but by a government's "willingness to go forward with severe fiscal adjustments...although highly unattractive socially or politically."[164] Their vision parallels a neo-liberal sense of governments as highly prone to be captured by local demands, and therefore, rather than assess potential improvements, they assess the pressure that different political groups can exert over a locality. In their framework, political legitimacy is a hallmark of bad future decisions, not beneficial ones.

Issue Specific Criteria

A rating agency uses these aforementioned general factors to develop an "opinion of the willingness and capacity of an entity to repay its total financial obligations on a timely basis without considering guarantees or subordination."[165] This entity rating provides the benchmark, which is than augmented (and generally increased) by looking at specific features of a proposed issuance. Among the common features that enhance a rating are dedicated revenue sources, third-party guarantees, unique legal protections, and special contractual protection such as cross-default clauses. Although not explicitly stated, a sophisticated rating agency will consider these factors in conjunction with its overall analysis to determine if they resolve particular weaknesses of the issuer.

Theory & Reality

The above framework lists numerous criteria and insists on the absence of formulaic judgment. A common concern is that these paper factors do not correspond to reality. However, empirical studies have suggested that while a limited array of factors may predominate, no set of obvious factors can explain the entirety of variation amongst

[164]Id; Moody's at 3.

[165] Id; S&P's at 2..

rating. According to the leading piece on sovereign debt, by the New York Federal Reserve, 90% of the variation in sovereign ratings can be explained by 8 variables: 1) per capita income, 2) economic growth rates, 3) federal deficit, 4) external balance of trade payments, 5) external debt, 6) industrialized classification, 7) inflation and 8) history of default.[166] Although limited, these eight factors still encompass a wide array of relevant factors that would still provide greater nuance than most administrative agencies, fiscal rules and market participants. The remaining 10% deviation also suggests a significant amount of wiggle room beyond these eight factors. Moreover, the study results may exaggerate the extent of predictability since they analyzed only foreign currency securities during volatile periods. In contrast, domestic currency rankings tend to reveal exactly the fine distinctions blurred in this survey.

A recent survey of determinants of Mexican state ratings offers more precise, but far less comprehensive information on the subject.[167] To my knowledge, it is the first study to investigate subnational ratings in developing countries. They find that public debt variables are most strongly correlated with changes in ratings, whereas socio-economic factors play no consistent role. A few public finance measures such as expenditures levels also correspond with improved ratings. Unlike the sovereign context, only 40% of the variation across ratings can be explained by their leading factors. This implies that subnational evaluations are far more nuanced and qualitative than

[166]Richard Cantor and Frank Packard, *Determinants of Sovereign Credit Ratings, New York Federal Reserve Bank*, N.Y. Federal Reserve Board, (1996) (listing 1) per capita income 2) economic growth rates 3) federal deficit 4)external balance of trade payments 5) external debt 6) industrialized classification 7)inflation 8) history of default)

[167] See for example, Jorge Ibarra-Salazar, Gabriela Garcia-Romo, & Lida Sotres-Cervantes, *Determinant of Mexican States Governments Credit Ratings,* March 2005 (attempting to determine which influences are paramount)

comparable measures at the sovereign level. It also suggests that there is no reason to assume that rating agencies are being duplicitous about describing their rating's process.

Section C: Comparison to Existing Interventions

As discussed earlier, conventional regulatory strategies for SND can be grouped into four categories 1) blanket prohibitions, 2) administrative control, 3) fiscal rules and 4) market discipline. The current regime of rating agencies appears likely to perform better, both with regards to expanding local capacity and appropriately evaluating different borrowers, than any of the current alternatives. It does so by exercising greater oversight, considering a wider range of inputs, and providing more flexibility than any of the competing mechanisms. Although currently being deployed in conjunction with the other mechanisms, these insights suggest it could stand alone in most cases.

Blanket prohibitions, for all the reasons discussed earlier, are a poor regulatory strategy. They are usually far too broad and unnecessarily restrict numerous useful investments and permit an equal number of faulty ones. In addition, since there are relatively few borrowings in a given year, their efficiency gains are minimal. Rating agencies, by contrast, are explicit about the absence of such hard and fast categories. They list an astonishing array of factors and repeatedly suggest the foolishness of resorting to simple bright-lines. In addition, Fitch speaks quite positively about investments in basic health and educational infrastructure, which is a category of great promises generally excluded by blanket prohibitions.[168] The one caveat to this analysis is that rating agencies will not sufficiently stifle the use of SND for insurance, since their

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[168]Fitch supra note 28 at 9.

criteria are primarily concerned with repayment and not systematic efficiency in insurance provision. As a result, a blanket prohibition may need to remain in place against this use.

Rating agencies also tend to be more astute evaluators of local borrowing capacity than analogous federal administrative agencies. Rating agencies and their analysts have years of experience in multiple contexts, unlike federal agencies whose experience is limited to a single country. More importantly, agencies are autonomous bodies, free from the domestic political calculations that often mar agency interpretations. Rating agencies are also subject to strong market discipline, since their reputations depend almost exclusively on providing accurate ratings.[169] An administrative agency, in contrast, is far less transparent and individual members are often shielded from performance-based sanctions by employment regulations, political patronage, and the short life cycle of many administrations. In addition, as with many specialized bodies, rating agencies can provide their services cheaper than government counterparts. At a cost of approximately $25,000 per rating, even a hundred rating only requires an outlay of 2.5 million dollars, likely less than the costs of creating and running a federal agency able to evaluate hundreds of borrowings.[170] Lastly, the actual factors weighed by rating agencies tend to be far broader than those used by existing federal bodies. Taken together, rating agencies should provide cheaper, more holistic decisions with far fewer political distortions than even the best run federal body.

[169] Amy K Rhodes, *The Role of the SEC in the Regulation of the Rating Agencies: Well-Placed Reliance or Free-Market Interference?*, 20 Seton Hall Legis. J. 293, (1996)

[170] Id.

In comparison to fiscal rules, rating agency determinations are more nuanced and flexible. Most fiscal rules restrict borrowing based on one or a few quantitative measures, generally derived from a single snapshot of a potential borrower.[171] As a threshold matter, it is not clear from the literature that any single measure is a good proxy for overall local government borrowing capacity. Rating agencies by contrast assess a multitude of quantitative and qualitative factors, instead of a single formulaic measurement. In addition, their fiscal analysis takes a dynamic view of the borrower's capacity and attempts to evaluate future socio-economic and budget trends. As such, they provide a far more comprehensive picture of a borrower's financial flows. Their ratings also give credit for intangibles such as a past history of repayment, high levels of transparency, and strong management capability. Finally, their eventual by-product is not a binary "yes or no" decision but a scale of different grades that provides the borrower with the final decision over whether the increased costs associated with a low-rated debt issue are worth the alleged benefits.

Lastly, as discussed earlier, the deployment of rating agencies in Mexico FCL can replicate the virtues of market incentives while avoiding many of the pragmatic and political dangers engendered by relying solely on markets.[172] In addition, since rating agencies encompass such a vast array of information and bring their own specialized expertise, they may actually perform a more accurate evaluation than a decentralized reliance on the market. Rating agencies will also help market incentives to develop by stabilizing SND and dramatically enhancing government transparency. Finally, by

[171] See Hernandez supra note 6, and Giugale supra note 12.

[172] In particular in the current environment the only way to create the required credible commitment would be to allow a municipality to fail, perhaps even multiple municipalities. This is a very high price. In addition, market incentives also require a vast array of legal protection to encourage information disclosure, prevent self dealing and avoid corruption.

disseminating information broadly, agencies may help replicate the liquidity and the information gathering functions of a market.

The multitude of benefits provided by rating agencies over traditional mechanisms suggests that, whatever their flaws, they hold great promise to increase the efficacy and potency of subnational debt markets. At the same time, by reducing the dangers of moral hazard, they can enhance the overall macro-economic stability of the nation. They also encourage national governments to devolve additional borrowing capacity and discourage attempts to recentralize existing capacity. . Nevertheless, as the following section examines, they penetrate deeper into local governments than any existing mechanism and must therefore be handled carefully. In evaluating whether these trade-offs are worth it, a crucial first step is to examine the accuracy of these agencies.

Section 4. Historic Accuracy

The preceding section compared rating agency procedures to existing mechanisms and generally found them to be far better at pricing risk and reducing moral hazards. These theoretical insights are broadly supported by historical studies of rating agency accuracy in the private markets. The leading survey of Moody's historic ratings indicates that only 2.4% of investment grade offerings have defaulted within a ten-year period of their investment grade rating. For triple AAA rated debt, this percentage is a minuscule .1%. Speculative debt, in contrast, has indeed been highly risky, with more than 24% of issues defaulting within ten years and the most risky debt defaulting at almost a 50% clip. These results, which have been replicated in many surveys, suggest that agencies are broadly accurate at distinguishing risky investments in the private markets. That said,

the exact default percentages associated with different grade levels has changed over time, suggesting that agencies ability to determine objective levels of risk, as Basel-II fathoms, is more questionable. [173]

However, all of these historic surveys should be taken with a grain of salt since they have been derived primarily from loans pools comprised of private Western corporations. In the sovereign context, and even more so in the sub-sovereign developing country context, it is unclear whether rating agencies have such a positive track record. For example, prior to the East Asian and Argentinean fiscal crises, there was little warning from the rating agencies.[174] Instead, most commentators found them to be lagging indicators, whose only role was to prolong the crises after they had bottomed out by maintaining low ratings long after the defaults had been completed.[175] In addition, rating agencies tend to diverge from each other far more often in the sovereign context than in the private markets, suggesting that these ratings are more ambiguous.[176] Most tellingly, financial markets consistently require higher yields for sovereign debt than equally well-rated corporate debt, suggesting that these ratings have greater perceived uncertainty.[177]

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[173]Relative accuracy, which I discussed above, focuses on whether ratings are better for estimating borrowing risk than the competing alternatives (i.e. administrative oversight, fiscal rules, etc.) Objective accuracy, which is central to Basel-II reserve provisioning scheme, attempts to use ratings as a proxy for a specific fixed % level of risk.

[174]See generally Cantor, supra, note 151 at 27. Admittedly these were highly unlikely events, nevertheless in retrospect there appear to have been sufficient warning signs to have at least warranted downgrades

[175]Id at 22. Just as with consumer's emerging from bankruptcy a post default sovereign often is in an excellent position to borrow as they have no other outstanding loans and are often extremely gracious for whatever credit they can receive. For example following Argentina's default the rating agencies have kept its ratings at sub-speculative levels; nevertheless huge inflows of capital have arrived from China and Latin America, recognizing its "re-virgin" status.

[176]Id at 12. For example, Moody's and S&P's sovereign ratings diverged by more than half a point prior to the onset of the Tequila Crisis. Currently at least, Mexican subnational ratings are consistent amongst providers nevertheless it has been a historic concern at the federal level

[177]See generally Id.

Facially, subnational debt should have even greater ambiguity than sovereign debt, and certainly far more than corporate debt. First, local government units are vulnerable to a range of destabilizing political influences – from elections to civil wars - that have limited analogs in the corporate world. These events are exaggerated by the general political uncertainty and economic flux of many developing municipalities. Second, subnational units are creatures whose "corporate charter," i.e. the local government powers they wield, is constantly being rearranged by the influence of decentralization. This makes predictions of future cash flows and service demands highly uncertain. Third, unlike firms, government behavior is often driven by impulses other than "profit maximization," which makes them far more unpredictable. Moreover, all of these factors occur on top of the existing complexity involved in simply developing and evaluating the relevant data for subnational units.

Given these weaknesses, it may seem questionable to heavily rely solely on rating agencies. However, it is important to recognize that each of these complexities will impede any body – lender, federal government, NGO, etc - that attempts to assess local government debt capacity. It is possible that rating agencies, given their history in private markets, are more likely to ignore these political and sociological considerations than other entities; however, it is equally likely they will be more attuned to these distinctions by virtue of their experience in numerous countries. In addition, they bring a wealth of expertise evaluating traditional elements, such as debt composition and repayment characteristics, which continue to heavily influence local government repayment capacity. Even if another institution were more adept at evaluating local

concerns it is unclear that these benefits would compensate for the lack of technical capacity.

It is also possible that agencies may lack the incentives to perform their task with full diligence since they have received a guaranteed role in rating these subnational entities. However, in theory these same concerns could apply to most any alternative regulatory mechanism. In addition, agencies and their employees are still driven by market and promotion incentives (a topic I return to in the next chapter). Finally, although not directly comparable, rating agencies' track record in private markets has occurred across industries, geographic lines, and different eras. This suggests that, over time, they should develop the capacity to better handle the complexities described above.

Rating agencies relative superiority rating borrower and their historical accuracy by no means fully settles the debate over their utility. The next section addresses secondary consequences of their emergence, particularly in governance, that suggest these entities may be far from a panacea. It also examines whether the relative improvement in debt evaluation is worth the related costs.

Chapter III: Implications on Governance

Is the cure worse than the disease? SND was originally intended to be a key component of decentralization. Decentralization arose, not simply in the name of efficiency, but because of a firm moral commitment that local constituents deserved to exercise control over their destinies.[178] On its face, the emergence of rating agencies seems likely to curtail this local autonomy and impose a specific market-oriented vision of what constitutes proper governance. It also offers few means for community participation and almost no opportunities for review.

However, as the first section of this chapter explores, this simple story is complicated by a number of more subtle transformations. First, ratings have fostered local transparency, which aids citizen control over local governments. Second, all of the agencies advocate for increased decentralization and help formalize the boundaries around decentralization. Third, as the preceding sections demonstrated, these bodies hold great potential to stabilize subnational debt, replace more onerous conditions, and eventually spur further federal devolution of power. At a minimum they ensure that federal governments don't pursue draconian policies to remove subnational borrowing authority entirely.

The second section in the chapter attempts to evaluate the actual content of rating agencies' agenda by comparing it to a number of existing international (UN, World Bank, IMF) and academic prescriptions. This comparison suggests that agencies' governance agenda is widely supported and may hold significant benefits over competing proposals

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[178] See Dillinger at 16, supra, note 112.

from a number of international development bodies. This comparison also highlights the broader universe of international interventions attempting to reshape local government law. The remainder of Section B examines rating agencies role within this paradigm of "International Local Government Law", including its modification of conventional biases in favor of a private city.

The third section addresses the appropriate regulatory responses to rating agencies' newfound power. It finds that sole reliance on market incentives is inappropriate in light of agency's unique power to influence local government policy. Although only suggested tentatively, my analysis finds that measure mandating greater input and diligence are likely to be more effective than a heightened liability standard. My analysis also points to the difficulty of defining a jurisdiction from which to issue regulation, and the need for a more conscious recognition of private international law's effect on local governments. Finally, I briefly conclude my suggesting alternative ways to harness rating agencies.

Section A: Ramifications on Local Participation

1. Limitations

Rating agencies' newfound role in SND raises a number of concerns regarding local participation, community involvement, and the appropriate role of external mediation in traditional political choices. Many of these concerns are still incipient as rating agencies' involvement in developing countries is so recent that there is little empirical data to support or refute these alleged dangers. However, even absent

empirical data, the wealth of criteria that rating agencies publish at least creates a significant theoretical set of criteria from which to ground speculation.

Perhaps, the most acute example of intrusion by rating agencies is their avowed emphasis on managerial quality. Although the specific perspective varies by agency, their shared focus on this attribute squarely places these agencies in the midst of shaping which leaders get chosen to govern municipalities and which officials are selected for key roles. So far, there are no examples of agencies publicly calling for the removal/appointment of particular officials, but it is easy to imagine such a scenario. Beyond staffing decisions, agencies also wield significant influence in shaping day-to-day fiscal and social policy. Among the traditional prerogatives their criteria implicate include: borrowing purposes, spending commitments, and willingness to undertake remedial action. The problem with these criteria is less their content per se, which section B analyzes, and more the fact that they abrogate local sovereignty over these choices. Furthermore, even when valid, these impositions lack community legitimacy, which hinders their efficacy.

It also is not clear that rating agencies need to meddle as deeply as their criteria suggest they will. In the preceding section, I discussed the numerous categories and inputs rating agencies consider, as well as the inability of regression analysis to determine a predictable subset of dominant factors. The flipside of this avowed complexity is the likelihood that rating agencies are evaluating numerous surplus aspects of local performance. This means that their evaluations may be excessively intrusive and often push for policies that local communities could retain complete discretion over. This

complexity also increases the perceived arbitrariness within their evaluations and may result in the predilections of a few analysts shaping significant political decisions.

A second concern with rating agency regulation is the absence of any mechanism to review their judgments. Prior to their direct involvement in governance, and therefore public policy, this absence of review was less troubling. In a corporate setting review mechanisms are generally unnecessary since most lenders conduct their own independent evaluations and borrowers can request re-evaluation by alternative agencies. However, provision in Mexico's FCL, designed to stop rating shopping, mandate that the lowest current rating governs. In addition, rating agencies evaluations are used without any federal mediation. As a result, if rating agencies make an incorrect judgment there are no processes by which to appeal this decision or to adjust the subsequent regulatory consequences. This absence cries out for at least some administrative appeal or public comment period to ensure that community and government voices have the opportunity to correct perceived deficiencies in an agency's judgment.

A third critical concern is the lack of community input. For rating agencies to be completely effective they need access to the richest pool of information. Unfortunately, as currently constituted, rating agencies primarily evaluate the inputs they are given by local or federal government officials such as finance ministers and tax collectors. This can miss a number of important community concerns and allow official distortions to become enshrined in ratings. Official pictures of required outlays often ignore numerous informal arrangements that governments have tacitly committed to. For example, in Mexico many municipalities ignore rampant power theft as a way of essentially subsidizing access to power. An even more pressing example is the frequent history of

municipal price support for basic commodities such as food and gas. This historic lack of enforcement, or pattern of subsidies, has created an informal, but quite strong, expectation that similar policies will continue. For external monitors, like rating agencies, it will be difficult to detect such historic legacies without participation from the community. Since these obligations are usually most acute during crises, they will be particularly important to assessments of local government's ability to maintain financial obligations. These failings suggest that a public notice and comment period could be a valuable addition to Mexico's FCL.

Despite these opportunities for significant intrusion, in reality these effects will likely be more muted. Rating agencies evaluate such a wide range of factors to determine their credit scores that there will rarely be situations in which a single factor or political choice predominates. They also have no history of ever making widespread political statements or trying to influence electoral behavior. And it is not clear that local communities would even follow such prescriptions. If anything, their opacity may impede governments and communities from understanding how to best improve their ratings. In addition, although they may be perceived as a meddlesome Western body it is not clear that this perception is worse than Mexicans consistent sense that their own governments are highly corrupt. [179]

Furthermore, although rating agency criteria are formally exempt from community input, these bodies have at least suggested that they will be open to informal community dialog. For example, all of the rating agencies in Mexico have mentioned the significant iterations in their ratings process and the opportunity for local officials to

[179] Nobua Aaki, Short Run and Long Run effects of Corruption on Economic Growth: Evidence from State-Level Cross Section Data.,April 2005

explain and challenge preexisting methodologies. The agencies also insist these dialogs have played a significant role in altering their preexisting practices and shaping eventual ratings. Moreover, since agencies' primary goal is to develop accurate evaluations, they should have natural incentives to listen to any meaningful sentiments within the community.

2. Opportunities

While it forecloses certain avenues through its criteria, the presence of agencies and their public disclosures also invigorates local governments by increasing citizen control and federal devolution. This section examines these structural reforms.

Transparency

In terms of participation, decentralization advocates often have an overly idealistic image of the relationship between localities and their own citizens. In practice, local oversight is often limited by a lack of information and transparency. Rating agencies should alleviate both of these concerns and encourage more informed participation. Although somewhat varied by body, each of the agencies publishes its findings and the inputs that went into these findings. Fitch is the most open of the bodies and discloses reams of data relating to numerous measures, including collection amounts and sources, projected future expenditure, and demographic changes. In addition, in order to comply with agency requirements, local governments have been forced to dramatically enhance their own data gathering and internal transparency; which is generally added to the publicly available data.[180]

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[180]Garza, *supra* note 4.

In practice, the greatest improvement in transparency has come less from the provision of data than from distilling this array of data into a single discrete rating. A single rating facilitates cross-jurisdictional comparisons and is particularly valuable when tracked across time, since this accounts for differences in initial attributes between different jurisdictions and more directly traces the impact of municipal interventions. Taken to its logical conclusion, this transparency may eventually lead businesses and residents to make decisions on where to reside based on this information, the first step towards the theoretical Tiebout sorting.[181] Certainly, early anecdotal reports suggest that municipalities are aware of these ratings and competing with each other to improve them.

At the same time, all the agencies explicitly caution that these ratings are not meant to be evaluations of overall governance capacity, but rather merely of borrowing capacity. However, the prominence, credibility and simplicity of these metrics may overwhelm these warnings. An obvious danger of reducing the reams of data into a single rating is that these letters will blur (or exaggerate, depending on the circumstances) meaningful distinctions between localities. In addition, the existence of a single rating may reduce participants' interest in the underlying data. This is especially dangerous when municipalities have vastly different resources and challenges to face. Until further data on community practices develops this will remain an open question; however, as a policy, it seems more appropriate to enhance full disclosure and correct biases rather than to hide data.

Decentralization & Formalization

[181]See generally Musgrave *supra* note 9.

Rating agencies have also taken a highly optimistic view of decentralization. All the bodies state that they look more favorably on jurisdictions with significant revenue under their direct control. This should impose additional pressure on central governments to devolve substantive revenue generating capacity to localities. This is particularly pressing in Mexico, where less than 10% of revenues are generated by states and localities combined.[182] An additional consequence of rating agencies' involvement will be to increase the formality amongst these local-central boundaries. As American history clearly indicates, the proper boundaries and limits of local authority are constantly shifting and often are the product of historical acquiescence rather than formalized principles.[183] However, as the first step in developing their ratings, all of the agencies evaluate the distribution of authority amongst different levels of government. To allow rating agencies to evaluate these conditions, both localities and federal agencies must make often binding interpretations of law and openly acknowledge the existence and non-existence of certain powers. Likewise, since so much of SND is securitized by inter-governmental transfers, there is a particular emphasis on formalizing transfer procedures. These trends were aptly demonstrated in Mexico's recent decision to eliminate its entire discretionary transfer budget in favor of purely formalized allocations.[184] Formalizing these boundaries helps limit recentralization and opens up these issues to broader political debate, both of which should in the long term enhance local capacity given current trends.

The downside of formalization is that it threatens to freeze a particular moment in time, regardless of whether that arrangement was sensible or acknowledged by

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[182] Garza, *supra* note 4.

[183] David Barron, *Reclaiming Home Rule*, Har. L. Rev 2257, (2003)

[184] See, FCL *supra* note 117.

participants. In both overly centralized and decentralized nations, this freeze can be especially problematic. Even outside its distributional impact, freezing devolution will reduce central government flexibility during crises. More importantly, by forcing a rigid framework in all circumstances, it threatens to blur important differences in local circumstances and the need for tailored local government authority. It is also worth noting that this internal formalization is occurring at the same time as SND blurs local government's role on the international stage.[185]

3. Broader Context

It is also important to put these governance consequences in perspective. Local communities if they disagree with rating agencies policy or personnel choices are free to refuse rating agencies' edicts. They may lose access to capital, or have to pay higher rates, but that choice remains open to them. This is not to say that there won't be additional political consequences to such a choice, nor that municipal officials may pursue policies at odds with the community; but the fact remains that the existence of choices and flexible sliding scales between compliance and credit levels is a dramatic departure from most existing options. In stark contrast, World Bank and IMF loans are generally disbursed with legally binding policy conditionalities and technical assistance. They also rarely allow for any flexibility in enforcement or ratings style graduate scales.

More broadly, the core impetus for rating agencies arose because they acted as a useful proxy for direct evaluation by numerous disaggregated lenders. There is no reason to expect that what these agencies consider important is systematically more restrictive than the behavior that market lenders would solicit. If anything their criteria and

[185]See infra section 3.

protocols are more sensitive to local needs and nuances than most traditional lenders. Put bluntly, if localities wish to access global capital they will have to do so on terms that private lenders find acceptable. These harsh realities also should not disguise the fact that federal entities and development agencies can, if they support certain policy alternatives, subsidize municipalities to compensate them for reductions in credit.

These rating agencies effects on governance also have to be considered in comparison to their overall impact on stabilizing subnational debt markets, replacing more onerous alternatives, and expanding the realm of permitted borrowings. Without rating agencies' presence, SND has a long history of leading to debt defaults and eventual federal bailouts. This has resulted in a backlash of recentralization in a number of Latin American countries, and undoubtedly, the sector is now far more heavily restricted than it was ten years ago.[186] Irresponsible lending, as described above, has also crowded out alternative forms of investment, encouraged reckless borrowing, and limited decentralization more broadly. By fixing these conditions, rating agencies have expanded the SND sector, which in turns allows localities greater options for borrowing and resisting the siren song of privatization. These structural changes are significant and, to my mind, justify fairly considerable impositions since there are few existing alternatives that could supply these benefits at a lower cost.

Finally, as the next section traces, rating agencies are hardly alone in impinging on local governance in developing countries. The last two decades have seen countless articles, charters and initiatives devoted to good urban governance, the vast majority of which emerged from international bodies - ranging from the World Bank and United

[186]See, Eaton supra

Nations to countless NGO's and academic proposals. The actual content of rating agencies' governance agenda fits squarely in the middle of these mainstream good governance proposals. Admittedly, these proposals lack rating agencies' domestic and international legal ratification; nevertheless, it is important to recognize that rating agencies' agenda is relatively well supported by many elements of the global community. The increasing presence of these bodies also hints at the growing array of international channels that are reconfiguring local authority. The following section first compares these governance proposals and than examines the broader trend towards International Local Government Law.

Section B: Good Governance & International Local Government Law

Good governance has been one of the most prominent buzzwords in international development for the last two decades and has been responsible for countless articles, charters, and initiatives.[187] Although the term is amorphous, it is possible to detect themes in its usage by the differing international development advocates. Generally, the U.N is focused on redistributive issues, the World Bank is focused on process, and the I.M.F is focused on enhancing market capacity.[188] They are joined by a growing academic literature focused on increasing participation.[189] In the section that follows, I roughly compare these entities' governance agendas with the novel perspectives provided by debt rating agencies. In general, I find the agency perspectives to be more specific and realistic than many of the pronouncements by the development organizations. It also

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[187] See, e.g., Daniel Kaufman, et al, *Governance Matters from Measurement to Action,* 37 Finance & Development available at www.imf.org (2000)

[188] See, *infra,* notes 175-180. Obviously academia is very broad, but I refer here to a particular school.

[189] See, *infra,* notes 183-185.

appears that they balance redistributive and free-market concerns better than most other entities.

1. Existing Protocols

The UN, through both its general body and its more specialized urban unit Habitat, has put together a number of documents on improving governance that focus on its redistributive and human development role.[190] Central to their conception of good governance is an emphasis on programs that "develop capacities that give priority to the poor, advances women, sustain the environment and create the needed opportunities for employment and other livelihoods."[191] Towards these ends, they suggest that good governance is shaped by seven core values: sustainability, subsidiarity, equity, efficiency, transparency and accountability, civic engagement, and security. Despite these numerous categories, their perspective tends to be heavily focused on improving the delivery of basic necessities – shelter, food, and water – and far less concerned with process and efficiency. Where they do emphasize process concerns it tends to be in favor of reforms that increase local control and, particularly, those that empower underrepresented minorities. The locus for their interventions also seems to be more focused on traditional local powers – health, education, etc. – rather than broader governance issues. Finally, they generally ignore the role of international bodies, other than a few NGOs, in shaping governance at the local level.[192]

The World Bank's operative definition of governance, by contrast, points to the centrality of "the processes by which authority is exercised and the capacity of

[190]UNDP, *Reconceptualizing Governance,* available at www.un.org (1997); see also Chapter 28 of Local Agenda 21 available at unhabitat.org

[191]Id.

[192]Id.

government to discharge their allocated functions."[193] Throughout their discussion of policy interventions, they emphasize notions such as competence, transparency and accountability. These concepts are all outcome independent and far more concerned with the means by which government reaches decisions and weighs input. Furthermore, the body is generally agnostic on where leverage for progressive change will occur as they highlight both the efficacy of "Microlevel accountability... through encouraging beneficiary participation" and the potential for meaningful partnerships with international bodies.[194] Democracy and a notion of economic and cultural rights are among the areas conspicuously absent. Ultimately, the overall World Bank agenda is broad and vague, which reflects its role as an incubator for many competing ideologies.

The IMF by comparison is the most strident about its agenda.[195] Its ideal of good governance is a regime that "limits the scope for ad hoc decision making, for rent seeking, and for undesirable preferential treatment of individuals or organizations."[196] It also extends its focus onto the quality of regulation that governs the private sector and suggests that governance "demands increased transparency in financial transactions... conducive to efficient private sector activities."[197] It is the only body to focus heavily on efficiency and generally is most concerned about governance's relationship to economic growth. It also takes a rather surprising position that "Responsibility lies first and foremost with the national authorities," which is quite the

[193] World Bank, *Entering the 21st Century*, World Development Report 2000, at 118; World Bank, *Political Institutions and Governance*, in Building Institutions for Markets, (2002)

[194] Id.

[195] IMF, *Good Governance: The IMF's Role, 1-10,* available at www.imf.org (1997);

[196] Id at 7.

[197] Id at 5.

opposite of the UN and the general emphasis over the last decade towards decentralization.[198]

Outside the major institutional bodies a number of academics have highlighted an alternative approach for improving governance through "deepening democracy."[199] In these works, the authors highlight the growing inadequacy of "representative democracy plus techno-bureaucratic administration" in the face of 21st century challenges. Rather than adopt the right wing approach, which favors privatization as a cure to these challenges, the authors highlight ambitious programs like participatory budgeting in Porto Allegre and Panchayat reforms in India. Although varied, most all of these programs involve enhanced devolution of meaningful power to ordinary people. For the most part, these reforms are highly context specific, and involve significant inefficiencies. In addition, it is not clear how they can operate without the benign grace of a governmental body. Nevertheless, these academics, like the World Bank and IMF, share an emphasis on process, without as explicit a set of desired outcomes.[200]

2. Rating Agency Perspectives

The penetration of rating agencies differs significantly from each of these interventions. On its face it may seem most similar to the IMF's set of policies, since both share an emphasis on market solutions and equitable treatment of investors. However, rating agencies, unlike the IMF, work directly with local governments and help expand their scope by stabilizing subnational borrowing and permitting enhanced

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[198] Id at 9.

[199] Archon Fung and Erik Olin Wright, *Thinking About Empowered Participatory Governance,* Politics and Society 29 ; Judith Tendler, Good Government in the Tropics, MIT press Cambridge 2000.

[200] Id.

devolution. In particular, as discussed earlier, they facilitate alternative sources of capital to governments in lieu of privatization. Moreover, while the IMF criticizes ad hoc treatment, all of the rating agencies, and particularly Fitch, laud managerial discretion.[201] The rating agencies also lack the IMF's commitment to stark standards and purely efficiency-based criteria.

The contrast with the UN is equally stark, although on a different set of criteria. First, there is a strong emphasis through the rating agencies' criteria on growth and congruence between expenditures and cash flows. In the UN vision, these concerns are all secondary to immediate basic services and redistributive reforms. This difference is in part one of context, as the UN and Habitat address municipalities in greater economic distress than those traditionally targeted by subnational capital. Nevertheless, there is little in the UN materials suggesting their emphasis would shift in the middle-income countries.

Beyond outcomes, agencies and the UN differ radically in their governance mechanisms. The UN repeatedly emphasizes broadening participation and equalizing representation, like Fung & Olin, whereas rating agencies necessarily work through a highly anti-democratic and elitist mechanism. On the other hand, one of the strongest legacies of SND agencies is the increased transparency and accountability of governments, which ranks highly on both the UN and World Bank criteria, and has eluded solution through many more conventional programs.

Finally, when compared to all these bodies, the rating agencies' criteria and procedures are far more specific and detailed. Amongst the various alternatives, agencies

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[201]Fitch supra note 28 at 4.

are unique for at least utilizing published criteria and consistent procedures for handling competing concerns. These agencies are also far more hands on and can initiate investigations into the specifics of local conditions. By stark contrast, the IMF denies any role for the institution as an investigative agency. In addition, unlike intermittent World Bank and UN disbursements, subnational borrowing is a permanent reoccurring source of capital. Therefore, governments have a far stronger incentive to maintain their level of performance since they are rated every three months. Finally, of all the entities, their output (letter ratings) is the most easily digested by the public and compared by citizens and public officials alike.

3. Implications for International Local Government Law

The preceding analysis examined a variety of international proposals to reshape local governance and with it local government law. This international involvement in local affairs represents a rather dramatic alteration in traditional paradigms of international law. Under historic notions, local governments were neither subjects of international law nor did they have standing to receive redress at international tribunals. If they violated international obligations the federal government was the party in default and charged with responsibility for providing appropriate recompense. This traditional, so-called Westphalian, notion of statehood began to crumble following the post World War II recognition of human rights and the ability of individual rights to receive international redress. However, there has been no comparable public recognition of the fact that local governments, and their relationship to central governments in particular, are increasingly being mediated by international actors.

This process of "international local government law"[202] ("ILGL") includes a variety of mechanism ranging dramatically in their level of formality and traditional "legality."[203] They include international treaties such as NAFTA and CAFTA, which under the guise of investor protection mechanisms have altered takings law and restricted traditional local land use power.[204] They encompass the range of conditionalities tacked onto loan disbursements by International Financial Institutions, which have transferred entire regulatory segments between levels of governments.[205] More informally, they involve non-binding international agreements, such as Local Agenda 21, that publicize local concerns and advocate for them on the international state.[206] And finally, they can even include trans-national networks of local regulators who share best practices and promote local concerns globally.[207] Subnational debt markets, and the newly initiated role of rating agencies, are the latest strand in this growing array. While grounded in this rubric, SND also does a better job of highlighting local variety on the international stage and consciously grappling with ILGL's tendency to emphasize a private vision of city governance. It is also goes the farthest towards recognizing localities in the sphere of private international law.

SND shares a number of characteristics with these emerging, and not yet self-conscious, institutions. First, they are all challenging the traditional paradigm that

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[202] Gerald Frug and David Barron, *International Local Government Law*, Draft July 31, 2005

[203] The term legality is of course fraught with peril and a subject of considerable debate, for these purposes I use it to simply refer to laws codified in statutes and treaties.

[204] Vicki Been, "Does an International Regulatory Takings Doctrine Make Sense?, 11 N.Y.U Envtl. L.J. 49, (2002)

[205] See Santosi, *supra*, at note 75.

[206] International Instruments addressing Good Governance, UN-Habitat, 2002

[207] The making of Local Agenda 21: An interview with Jeb Brugman, Local Environment, Vol 7, No 3, 251-256, 2002

localities lack standing in international forums. In SND's case it does so by directly appealing to international capital markets and BIS regulators; whereas other efforts have often resorted to domestic and international political lobbying. Second, these bodies are pressing international agreements to openly recognize them as legitimate subjects.[208] This process includes the effort to add formal reservations to treaties, such as NAFTA, stating that they must be interpreted in accord with traditional local prerogatives and not unduly burden local governance.[209] Finally, as SND aptly demonstrates, these bodies are internationally agnostic and willing to seek recognition from non-traditional sources such as private financial agreements and environmental compacts.

Besides adding another strand to the typical array of ILGL mechanisms, SND is also challenging commonly held theoretical conceptions of ILGL. First, unlike many of the other fields, rating agencies' involvement in SND does not attempt to paper over differences amongst localities but rather highlights these distinctions by creating public individualized rankings. Moreover, rating agencies are highly local context-sensitive unlike most ILGL mechanisms. This is particularly apparent in their statement that all ratings begin with an analysis of the local distribution of authority. It is still too early to tell whether in practice their ratings will be truly customized as opposed to formulaic; nevertheless, the rhetoric is striking. SND also highlights the role that national choices play in regulating cities' access to capital, in contrast to the global cities literature which suggests a far more deterministic perspective.

[208] Deborah Z. Cass, *The Word That Saved Maastricht? The Principle of Subsidiarity and the Division of Powers within the European Community*, 29 Common Market Law Review 1107, 1107 (1992)

[209] Perspectives of Inter-Governmental Policy Advisory Committee, IGPAC (a group formed to assess the impact of trade agreements on varying levels of local government).

Scholars of ILGL have also expressed a pronounced fear that the hollow language of many instruments is contributing to the neutering of important social distinction in favor of what they call a "private city."[210] SND initially seems likely to continue this enterprise, as one of the hallmark institutions of Western capitalism is now dictating local government policy based on its experience from capital markets. However, as with its relation to privatization, it accepts the paradigm of the private city, but actually gives municipalities tools with which to resist these dictates. For example, especially in Fitch's conception, governments can use SND to build public low-income housing without having to rely on charity or private developers. Furthermore, by obviating the presence of implicit guarantees, SND is no longer making the federal government liable on the international stage for actions of its subsidiary units.

Despite demonstrating the expanding circle of ILGL, SND also depicts its limitations. Specifically, localities have not been able so far to influence rating agencies criteria in a formal manner, nor have they been able to reduce the overall direction of their relationship to the international community. Although I argue that they have still benefited, they are now more vulnerable than ever before to international and domestic impositions. To truly harness these changes will require a self-conscious recognition of localities role on the international state. It will also, as the next section demonstrates, require alternative legislative forms that match local empowerment with local burdens. Finally, in evaluating the extent of SND intrusion/empowerment, it is vital to recognize these broader changes to notions of local autonomy.

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[210] Frug, *supra*, (quoting Sam Bass Warner)

Section C: Regulation, Alternatives and Expansions

As the preceding sections demonstrated, ratings agencies wield tremendous power. In the words of Thomas Friedman, ""the United States can destroy you by dropping bombs and [rating agencies] can destroy you by downgrading your bonds."[211] Although I argued earlier that these bodies should improve SND regulation and not too severely abrogate local authority, these outcomes depend on agencies not abusing their power and living up to their theoretical pronouncements. Besides the threat of abuse, the preceding sections also illustrated the need for a few correctives, including increased community input. Despite these compelling arguments for increased regulation, rating agencies have been largely unregulated throughout the world. [212] In most jurisdictions they are subject to little more than basic registration requirements and if regulated are left to the total discretion of finance ministers. Generally, when examined, this absence of regulation has been justified by claiming that market incentives would prove to be the most adept regulators of process and output. [213] Critics have also argued that regulation will cause more harm than it can solve.[214]

However, as I trace below, I think this reliance on market incentives is misplaced for SND and understates the threat of cabalistic and inefficient behavior. Replacing market reliance with alternative regulations, however, is a complicated endeavor, whose complete treatment is beyond the scope of this paper. However, in the latter half of this section I begin this process by tracing key concerns regarding liability standards and

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[211]Thomas Friedman, *A Manifesto for the Fast World*, N. Y. Times Mag., Mar. 28, 1999 at 40

[212]See generally Rhodes *supra* note 145.

[213]See Schwartz, *supra* note 112; Rhodes *supra,* note 145.

[214] Id.

jurisdiction that will shape any eventual proposal for regulation. In particular, as the last chapter hinted at, I find the absence of recognition for ILGL impeding the development of appropriate regulation. I conclude this thesis by considering ways in which to harness rating agencies in the future.

1. Market Incentives

According to the standard narrative in favor of purely market-based regulation, rating agencies are subject to three pressures – reputation, competition, and accountability - that should ensure their accuracy.[215] Under this view, borrowers will only pay for ratings if lenders value these metrics. Lenders will only value these metrics if the agencies have a reputation for accuracy. Therefore, long-term economic pressure should ensure that ratings are as accurate as possible. In addition, the competitive pressure between different agencies should drive out any entities that do not perform adequately. Competition should also detect and publicize any mistaken ratings. Finally, since ratings are public, it will be difficult for agencies to hide from or disclaim responsibility for incorrect ratings.[216]

Unfortunately, all of these arguments are specious in the context of subnational borrowing. First, subnational ratings are now required by law, and reputation will therefore play a small role in determining whether borrowers solicit ratings.[217] More generally, subnational debtors are a small component of rating agencies' portfolio and a mistaken evaluation in this context is unlikely to influence their overall reputation. Second, the registration procedures that determine qualified SND agencies require them

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[215] Id.

[216] Id.

[217] This, of course, assumes that government will not be monitoring and responding to rating's accuracy.

to have a "national reputation." This requirement effectively confines the field to the three established entities.[218] This allows them to act like an oligopoly, which is visible in the increasing convergence among their subnational ratings.[219] Lastly, by rating SND on country specific scales, agencies reduce the ability to make cross border evaluations that could gauge their overall accuracy. In addition, the complexity of rating SND entities and their frequent bailouts diminishes market expectations, further reducing accountability.

These dangers are somewhat tempered by organizational incentives within rating agencies. Junior analysts are likely to be driven, in part, by the hope for promotion. In evaluating an analyst's job performance, their historic accuracy rating entities is likely to play an important role. Nevertheless, for many employees, promotion will provide a limited motivation and not fully encourage maximum efforts. In addition, if rating agencies are inadequately staffing or training employees, no amount of employee dedication is likely to compensate.

The historic reliance on markets also arises from an implicit assumption that the consequences of a single inaccurate rating are benign. In private markets, this is largely true, as most lenders will be highly diversified. Even in the worst-case scenario only a few financial entities will suffer substantial harm. However, rating agencies' role in SND and Basel makes an entire government's debt capacity turn on their evaluations. As such, the consequences of mistakes are far higher for SND. Anti-regulation proponents also ignore the possibility that agencies will willfully abuse their position. In one prominent American case, a municipality alleged that S&P's had public criticized their bonds after

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[218] See Rules 2a-7, 3a-7, 15c3-1 of the Investment Company Act of 1940, 17 C.F.R. S270;

[219] See Salazar, *supra,* note 137 in appendix.

the city refused to hire S&P's to provide ratings. Although the case was resolved in favor of the rating agency, it hints at the havoc that these bodies can wreck if they are so inclined.

2. Regulatory Substantive Challenges

In terms of a regulatory regime, I think it makes sense to subject agencies to procedural and input requirements, but I am wary that heightened liability standard will be unmanageable. For all the reasons described above, rating agencies depend on the quality of their inputs and the information they collect. If they are systematically ignoring certain vital streams of information their ratings will suffer. Their current stated procedures are particularly weak at soliciting local community input. Therefore, regulatory provisions requiring them to hold public hearings and solicit public comments could improve their awareness of social concerns and hidden financial pressures. These procedures also offer significant symbolic value. The cost of participating in such endeavors is relatively low and therefore won't unduly burden these actors. Beyond soliciting prior community input, regulation could also create statutory notice and comment periods that allowed feedback and corrective action, before ratings achieved binding status. Again these add little in costs but aid the process significantly. Given the discretion involved in creating ratings and the comparative expertise of these bodies, regulators should likely avoid measures that require second guessing outcomes.

By comparison raising the liability standard applicable to these bodies will be conceptually challenging and likely self defeating. First, any form of particularly strict liability is unworkable given the exigencies involved in rating debt and the relatively limited compensation that agencies receive. This suggests the only choice is between a

liability standard of negligence and recklessness, the current standard in the United States. Negligence might be appealing since it would encourage far greater internal monitoring at agencies; however this would raise the cost of ratings dramatically. These agencies would also be unable to insure against this risk and therefore would be more likely to exit these markets rather than adjust their behavior. Any proposed liability regime would also have to overcome a liberal reading of ratings as a form of protected corporate speech. As a result, heightened liability may be best reserved for the limited circumstances in which agencies have failed to follow the procedural standards suggested above. A rebuttable presumption of this sort could act as a powerful stick without driving away agencies entirely.

3. Regulatory Challenges Jurisdiction

Theoretically, legislative responses could be created at the local, national, or international level. However, both national and local legislation may exercise a chilling effect and lead rating agencies to avoid these markets. They might also make investors distrustful of ratings from those jurisdictions due to a fear of bias.[220] Since so much of capital availability and regulation turns on these ratings, this is an ineffective long-term strategy. It also suggests that regulation would be best developed by international bodies, or in prominent Western markets from which agencies cannot afford to exit. Unfortunately, current regulatory conventions make this quite difficult.

In the United States, and most other western jurisdictions, rating agencies are only subject to minimal registration requirements with local financial authorities. In part, this is a consequence of the heightened market incentives that exist in these countries. In the

[220] See generally, Rhodes *supra* note 145.

United States it also stems from historic preferences to only lightly regulate voluntary corporate transactions, even those with an international component. Given these biases it is hard to imagine the U.S. passing measures that would address rating agency behavior in developing countries. Perhaps the only imaginable route to such regulation would be if these entities were so closely identified with the United States that they could be subject to incorporation under the auspices of state action, and thereby subject the U.S. to liability. However, this result is unlikely to occur since these bodies, although having originated in the west, are incorporated throughout the world and are staffed by international employees. In addition, they are invited to give ratings in many countries by enactments like Mexico's FCL and have been ratified by international regulators like the BIS. As a result, it is difficult to imagine that they might be treated analogously to cross-border polluters.

International law is similarly inhospitable. As discussed earlier, under traditional public international law principles localities are not a party with standing in international bodies or international courts. This result leaves them at the mercy of federal officials in public international institutions or commercial officials in private international institutions – neither of whom is well suited to understanding the particular dilemma of local governments. Likewise, the emissaries to commission like BIS tend to come from the national government and represent only national concerns. This regulatory lacuna highlights the need for a more self-conscious recognition of ILGL.

4. Harnessing Rating Agencies

As there are no signs of rating agency authority abating, or being managed by regulation, the question remains whether they can be utilized for alternative means. This

commandeering could take two forms. First since these bodies already have access, infrastructure, and contacts in developing municipalities they could be paid to evaluate other important facets of governance such as corruption or performance on social indicators. To ensure these ratings retained the traditional market incentives for accuracy, international development organizations could condition payments based on the accuracy of these ratings. With these metrics the international community could reward innovative leadership and more rapidly disseminate best practices. They could also tie development aid to performance against these benchmarks.

Alternatively the donor community and international financial community could develop credit support mechanisms that compensate governments that engage in progressive policies, which are viewed skeptically by rating agencies. Moreover, if the donor community disagrees with agencies' evaluation criteria, they could develop alternative pools of capital or simply preferentially lend to these "unfairly" treated borrowers. In many ways this would be the SND analog to microcredit, which found profits in borrowers conventional financial institutions ignored. Finally, if subnational debt truly becomes reinvigorated by these bodies there will be numerous alternative approaches to structuring development projects that can retain a role for the state rather than rely on privatization.

Conclusion

Subnational debt, if managed effectively, holds great promise to expand local capacity, improve management, and resist the growing tendency of municipalities to depend on privatization for capital. If SND is managed poorly, history has aptly

demonstrated the potentially dire consequences to lenders, local governments, and particularly national governments. Rating agencies' recent development in Mexico suggests they may play an important role in stabilizing SND markets, pricing risk and eliminating moral hazards. Although not without flaws, their methods appear both more effective and less intrusive than the majority of proposed and existing alternatives. These relative benefits also shouldn't eliminate efforts to improve these bodies further by enhancing community oversight and regulating their untrammeled discretion. Besides, its technical function in regulation, the emergence of these institutions also highlights the growing array of international measures, particularly governance proposals, which are targeting local governments and their relationship to central governments. It is too early to tell whether these changes will disempower localities but it is already clear that existing regulatory frameworks and international law paradigms are inadequate to handle these changes. Historically, all of these practical and theoretical roles for SND and rating agencies have slipped under the radar. If nothing else, I hope this paper has corrected this longstanding absence of attention and revealed the contours of these often hidden forces.

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APPENDIX

Moody's Ratings

Mexican Subnational Credit Rating	National	Global	
Nation	**Aaa.mx**	**Baa1**	**Estable**
States			
Baja California	Aa3.mx	Baa3	Estable
Chiapas	A2.mx	Ba2	Estable
Chihuahua	A1.mx	Ba1	Estable
Distrito Federal [1]	Aaa.mx	Baa1	Estable
Durango	A2.mx	Ba2	Estable
Guanajuato	Aa1.mx	Baa1	Estable
Guerrero	A2.mx	Ba2	Estable
México	Ba3.mx	B3	Estable
Michoacán de Ocampo	A1.mx	Ba1	Estable
Morelos	A2.mx	Ba2	Estable
Nayarit	Aa3.mx	Baa3	Estable
Nuevo León	A3.mx	Ba3	Estable
Oaxaca	A2.mx	Ba2	Estable
Puebla	Aa3.mx	Baa3	Estable
Querétaro	Aa3.mx	Baa3	Estable
Quintana Roo	A2.mx	Ba1	Estable
Sinaloa	A2.mx	Ba2	Estable
Tabasco	Aa3.mx	Baa3	Estable
Tamaulipas	Aa2.mx	Baa2	Estable
Tlaxcala	Aa3.mx	Baa3	Estable
Veracruz	A1.mx	Ba1	Estable
Yucatán	A2.mx	Ba2	Estable
Zacatecas	A2.mx	Ba2	Estable
Municipalities			
Aguascalientes	Aa2.mx	Baa2	Estable
Atizapán de Zaragoza	A1.mx	Ba2	Estable
Centro	A2.mx	Ba2	Estable
Chicoloapan de Juárez	Baa1.mx	B1	Estable
Coacalco	Baa2.mx	B1	Estable
Coatzacoalcos	A1.mx	Ba1	Estable
Colima	A3.mx	Ba3	Estable
Cuautitlán Izcalli	A3.mx	Ba3	Estable
Culiacán	Baa1.mx	Ba3	Estable
Durango	A3.mx	Ba3	Estable
Ecatepec de Morelos	Baa2.mx	B1	Estable
Guasave	Baa2.mx	B1	Estable
Huixquilucan	Baa1.mx	Ba3	Estable
Ixtlahuaca	Baa1.mx	Ba3	Estable
León	Aa3.mx	Baa3	Estable

Manzanillo	A1.mx	Ba1	Estable
Mérida	Aa3.mx	Baa3	Estable
Metepec	Aa3.mx	Baa3	Estable
Monterrey	Aa3.mx	Baa3	En revisión para una posible baja
Oaxaca de Juárez	A3.mx	Ba3	Estable
Puerto Peñasco	Baa2.mx	B1	Estable
Querétaro	Aa1.mx	Baa1	Estable
San Pedro Garza García	Aa3.mx	Baa3	Estable
Sinaloa	Baa1.mx	Ba3	Estable
Solidaridad	Baa2.mx	B1	Estable
Tampico	A2.mx	Ba2	Estable
Tecámac	Baa1.mx	Ba3	Estable
Tepatitlán de Morelos	A2.mx	Ba2	Estable
Tepic	A3.mx	Ba3	Estable
Texcoco	Baa1.mx	Ba3	Estable
Tlalnepantla de Baz	A2.mx	Ba2	Negativa
Toluca	Aa3.mx	Baa3	Estable
Tonalá	A3.mx	Ba3	Estable
Tultitlán	Baa1.mx	Ba3	Estable
Uruapan	A2.mx	Ba2	Negativa
Zapopan	Aa3.mx	Baa3	Estable
Zapotlán el Grande	Baa3.mx	B2	Estable
Zitácuaro	Baa1.mx	B1	Positiva
SISTEMAS DE AGUA			
OPDM - Tlalnepantla	Baa2.mx	B1	Negativa
SIAPA - Guadalajara Z.M.	A2.mx	Ba2	Estable
SIDEAPA - Durango	Baa2.mx	B1	Estable