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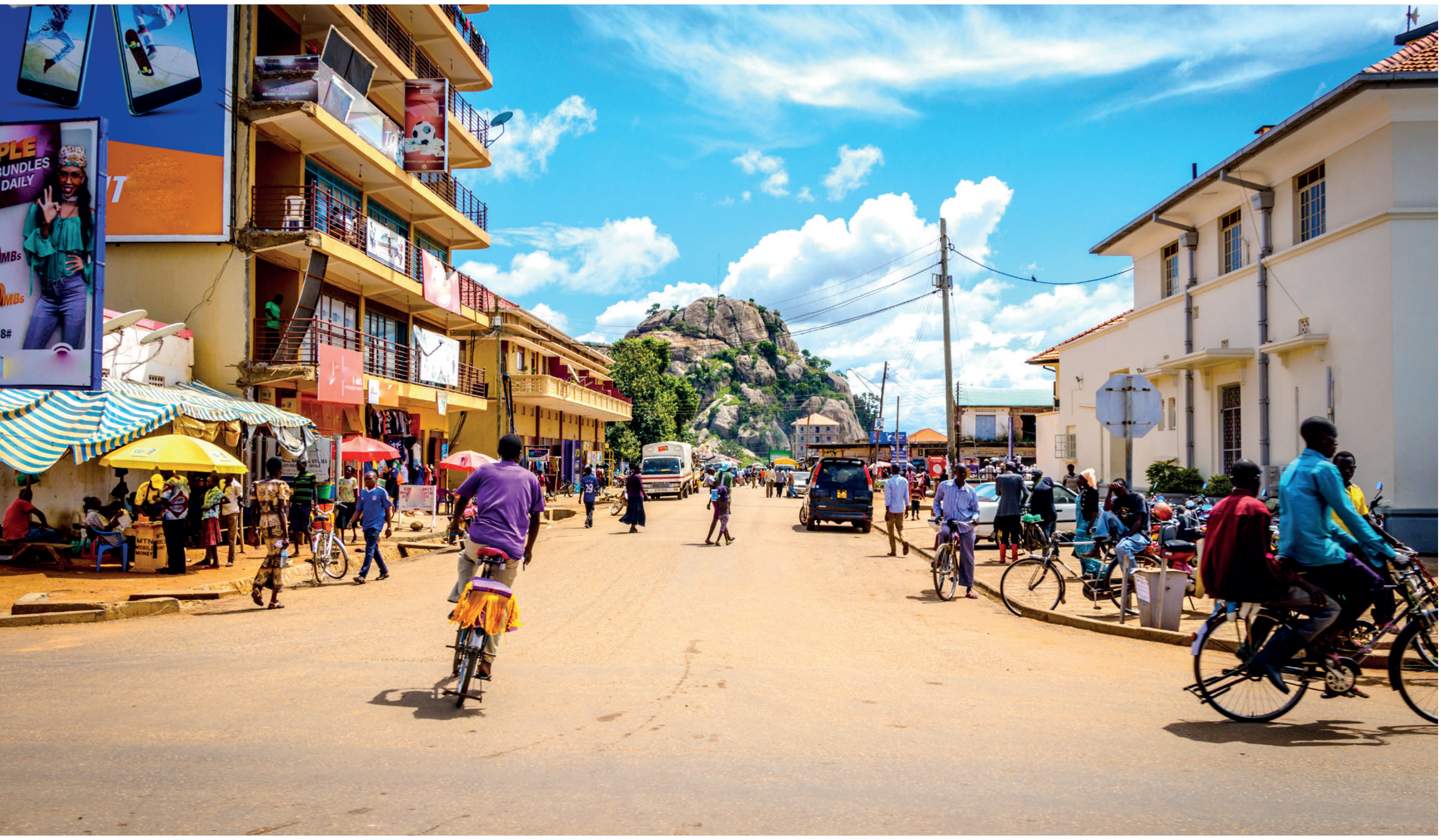
Sub-National Borrowing **in Africa**[1]



Street view in Soroti, Uganda @Shutterstock

Introduction

Cities in sub-Saharan Africa are growing at an unprecedented rate due to internal migration and general population growth. Urban population growth brings with it many positive benefits, but in cash-constrained municipalities, this can be particularly problematic as the financial resources cannot keep pace with municipal infrastructure needs. This had not been as challenging in the past for several reasons: (1) cities were not growing as rapidly, (2) cities could rely on national governments for transfers of resources sufficient to meet municipal investments, and (3) national governments were themselves not pressured by international agreements and external, unfunded mandates to meet global development goals. In short, the confluence of these factors has widened the infrastructure finance gap in cities in sub-Saharan Africa and has made municipal leaders recognize the need to expand the variety of mechanisms available to help to close the infrastructure finance gap.

Academic literature suggests that the reason that cities in sub-Saharan Africa have not been able to successfully access finance for capital investment into infrastructure is due to internal challenges including (1) low capacity of municipal workers to consider different instruments, (2) lack of long-term capital investment plans at a city-wide level, (3) lack of financially-sustainable, revenue-generating projects or (4) a mismatch between the lifespan of municipal assets and the investment preferences of institutional investors.

This paper seeks to demonstrate that while there is much in the extant arguments, another often-ignored but critical reason why cities in sub-Saharan Africa have not been able to successfully access finance for the infrastructure investments is predominantly due to an extrinsic challenge: *the lack of a clear devolution of power from the central government to municipal government.*

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Aerial view of Lagos, Nigeria @Shutterstock

Sub-National Borrowing Experience in Africa

Cities, which are larger aggregations of human settlement, arose from the belief in "success in numbers," whether for agricultural purposes, protection, or the idea of cost-sharing for public goods. In most societies, over time, these cities were subjugated into national polities, where power and decision-making were concentrated into a single person or agency, a trend which has continued in a number of instances to the present day. Some countries, particularly those that had profound influence over contemporary development patterns in sub-Saharan Africa based on their colonial-era dominance, have limited decentralization; this phenomenon has impacted the post-colonial politics and practices across much of the African continent.

During the past half-century, as national leaders have increasingly explored financial innovations within the African context and simultaneously committed to the delivery of international development standards through conventions like the Millennium and Sustainable Development Goals, sub-national leaders have also increasingly expressed interest in more autonomy for political and financial decision-making. Of critical importance to this argument, therefore, is the recognition that without a clear commitment to the decentralization of powers, irrespective of the strengthening of internal fiscal capacity of local government, utilization of the full range of tools (including bonds) for municipal finance will be limited.

For much of the post-colonial period, cities have been heavily reliant on transfers from the central government to cover the costs of urban infrastructure. Large sums of money were not involved, in part because cities were small. But insufficient monies were allocated and there is now a massive infrastructure backlog as well as lack of clarity on how future urban infrastructure needs might be met. Where there is a shortfall, cities have considered other mechanisms: loans from municipal development funds administered by central government agencies, loans from development finance institutions, and (in rare cases), loans from commercial banks. Based on the lack of a clear devolution of power from the central government to municipal governments which would be constitutionally protected and enshrined, cities in sub-Saharan Africa have generally been locked out from considering one of the most potent financial instruments widely used in the rest of the world: municipal bonds.

Municipal bonds are arguably one of the most transparent of financial instruments available to municipalities: relative to the other tools, they require a higher degree of transparency, are less subject to interference by national government or other stakeholders, and are priced at the time of their issuance off of investors' perceptions of the creditworthiness (willingness and ability to repay debt) of the city relative to prevailing market conditions for other issuers. More important, bonds typically offer the longest term for financial repayment on projects that require a large injection of capital (typical conditions for urban infrastructure investments). This is particularly meaningful in sub-Saharan Africa, where municipalities face an ever-increasing infrastructure investment gap and have exhausted other avenues (transfers, loans) as mechanisms.

Some academics claim that the reason why cities in sub-Saharan Africa do not raise funds through municipal bond issuances is driven by the concept of African exceptionalism: the idea that Africa is unique and that its growth and development pathways are markedly different from those found elsewhere around the world. This paper will argue that, while the concept of African exceptionalism is highly relevant in differentiating the African experience from those of other contexts, in terms of the financial decentralization required to issue a municipal bond, there is nothing particularly unique about African cities. Instead, the current uniqueness of Africa is derived not from its development pattern but from its current place on the progression along the pathway towards financial decentralization relative to other cities and countries. That said, each of Africa's 54 countries is unique, and its development during the pre-colonial, colonial and post-colonial eras makes it such that there is no "one-size-fits-all" approach that would proscribe the necessary steps to unlock additional financial resources. During the pre-colonial era, African civilizations allowed for a higher level of decision-making than that allowed during the colonial era, driven by the desire of mercantilist European economies to extract resources with the highest level of efficiency possible. The two prevailing systems in colonial sub-Saharan Africa – the French policy of assimilation and the British one of indirect rule – both centralized power at the colonial level, not at the sub-colonial level, which continued into the post-colonial era. The legacy left by colonial powers hampered decentralization, which directly negatively influenced the likelihood of financial decision-making and urban planning at the sub-national level, which meant that cities until recently did not even consider how to finance needed urban infrastructure since it was handled at the national level. Former colonial powers, which themselves have issues with decentralization, have continued to exert strong influence over sub-Saharan Africa, particularly in francophone countries; this has not been as pronounced in former British colonies, which have encouraged more independence. Based on this colonial heritage, which has held over into political decision-making today, cities in sub-Saharan Africa have largely been unable to raise finance through bond issuances, with rare exceptions.

Sub-National Borrowing Experience in South Africa, Senegal and Nigeria

Cities in sub-Saharan Africa have largely been unsuccessful in using municipal bonds as meaningful instruments, despite the fact that they have met many of the pre-conditions laid out above (matching investment needs with available finance, development of creditworthiness, bankable projects and internal capacity), highlighting the fact that the challenge can be found in the lack of decentralization. Cities that have been successful – Johannesburg and Douala – have done so through either a significant amount of decentralization (South Africa) or no meaningful decentralization (Cameroon). Cities that have not been successful – Dakar and Kampala – have faced challenges because of the lack of decentralization to sub-national governments.

The Enabling Environment for Municipal Bond Issuance in South Africa

Alone in sub-Saharan Africa, South Africa explicitly and constitutionally enshrines the right of municipalities to borrow, through the Municipal Finance Management Act (MFMA). The MFMA, implemented in 2004, ensures that borrowed capital is used only for infrastructure investments, as long-term debt can only be raised to finance capital expenditures and not to fund current expenses. Thus, a bond issuance cannot be used to balance the budget due to a shortfall in any given year. From the outset, there is no ambiguity about municipal debt including bonds; the schedule of terms in Chapter 1 defines debt as "a monetary liability or obligation created by a financing agreement, note, debenture, bond or overdraft, or by the issuance of municipal debt instruments".

Chapter 6, which deals with municipal debt, differentiates between short-term and long-term debt, stipulating that short-term debt may be incurred "only when necessary to bridge shortfalls within a financial year during which the debt is incurred" or to meet "capital needs within a financial year", while provisions for long-term debt are more permissive, allowing debt for "capital expenditure on property, plant or equipment to be used for the purpose of achieving the objects of local government" or for "re-financing existing long-term debt". Through this legislation, municipalities became free to pursue transactions in the capital markets, with the understanding that "neither the national nor a provincial government" would "guarantee the debt of a municipality or municipal entity", except in certain clearly defined circumstances.

Therefore, unlike in most of Sub-Saharan Africa, local governments across South Africa were given significant latitude to creatively pursue municipal debt through capital market transactions, while simultaneously understanding that there would be no safety net in the case of an inability to meet the debt service requirements stipulated in the transaction documents. As a result, since 2004, local governments across South Africa have successfully issued an aggregate of nearly 10 billion rand (760 million US dollars at today's exchange rate) of municipal bonds from the cities of Johannesburg, Tshwane (Pretoria), and Ekurhuleni.

Sources: *Constitution of the Republic of South Africa https://www.gov.za/documents/constitution/Constitution-Republic-South-Africa-1996-1), Municipal Borrowing Bulletin (http://www.treasury.gov.za/)*

The Lack of Enabling Environment for Municipal Bond Issuance in Senegal

Senegal, a former French colony, is an archetypal example of a highly-centralized government with limited devolution of power, despite some efforts from forward-thinking leadership. Despite the limited devolution of power, Senegal's capital – Dakar – was able to creatively finance its urban infrastructure through a series of increasingly-autonomous tools.This started with an increasing reliance on transfers of funds from the central government and moved on to borrowing from a government-run municipal development fund as a precursor to a loan from a development finance institution and, later, a loan from domestic commercial banks.

Although most of the conditions for a successful municipal bond issuance were met – both internally (from a financial and planning perspective) and externally (through sufficient available finance from interested investors and a favorable interest rate for bonds relative to loans) – the national government halted the transaction, citing constitutional reasons, which most understood to be politically-driven. As a result, local governments in Senegal have not issued any municipal bonds.

Source: *http://journals.sagepub.com/doi/abs/10.1177/0956247817741853?journalCode=eaua and https://www.africaresearchinstitute.org/newsite/publications/briefing-notes/dakars-municipal-bond-issue-a-tale-of-two-cities/).*

A Success Story: Sub-National borrowing experience in Nigeria

Across sub-Saharan Africa, Nigerian states have been the most prolific issuers of sub-sovereign debt at the regional level, driven primarily by the devolution of power through a highly-federalized system from the central government to states and their governors. Since 1986, more than half of Nigeria's 36 states have issued state-level bonds.

Encouragement from the Ministry of Finance, particularly through some recent modifications to existing regulations, help to drive the local market. In 2016, the Minister of Finance relaxed the regulations around state bond-raising; the requirement that states' borrowing cannot surpass **50% of their 12-month revenue** was scrapped, and instead, they must simply ensure that internally-generated revenue (IGR) is not "less than 60% of consolidated revenues for three years."

A further important consideration that has cemented state-issued bonds in Nigeria as an important form of finance is the relatively high percentage of debt bought by the central government itself.

Source: *Ministry of Finance of Nigeria*

This begs the important question: why are national governments across Africa so afraid of decentralization, particularly financial decentralization? Financial decentralization, on the surface, should be desirable for national governments: when done correctly, it frees up capital traditionally ear-marked for cities that can instead be used in less financially-sustainable areas (typically rural areas) and allows national governments to hand over responsibilities for urban management to sub-national ones. However, with this ceding of power over financial decision-making comes perceptions of increased power on the sub-national level, which can lead to political challenges in the future. Additionally, in financially-weak countries, additional obligations and contingent liabilities taken on by sub-national governments may lead to a weakening of the national government's abilities to take on additional debt in the future (although it should be noted that most cities borrow a fraction of the overall national debt, and this is generally policed by the financial markets and their demonstrated interest in taking on sub-national debt).

A separate but related argument centers on the appropriate sequencing for sub-national governments that are contemplating issuances in the capital markets: whether to pursue a credit rating, a traditional signal that indicates readiness to issue, early in the process or to instead commission a rating only upon confirmation of political and constitutional ability to issue a bond. There are definitive arguments for both approaches: an early credit rating, particularly if conducting as a "shadow" (or confidential) rating can give the sub-sovereign leadership a sense of the city's performance and marked areas of improvement that would serve to make an issuance less risky and therefore more competitive. However, should the potential issuer be unable to ultimately issue a bond, the somewhat invasive process of credit rating may damper enthusiasm for further ratings and the required transparency of political and financial decision-making associated with good credit ratings.

Concluding Remarks

Ultimately, this work's main argument is that cities face a significant barrier in their quest to access the magnitude of finance required to meet their long-term infrastructure investment needs: lack of sufficient autonomy to make long-term financial decisions as manifested through incomplete financial decentralization. Although this work has highlighted one of the key challenges in the successful implementation of sustainable financial schemes at the sub-national level, it is important to stress that no one factor should be viewed as the sole obstacle to robust funding options. Instead, a more complete picture is informed by a wider range of inputs including, but not limited to, municipal creditworthiness, macroeconomic stability, project strength and many others. Ideally, the concerns about financial and political decentralization raised in this paper will help to inform national policy-makers, city officials, aid workers, and other key stakeholders in the process to better understand the challenges facing the expansion of the financial instruments available to sub-national governments in sub-Saharan Africa.

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