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Fiscal and Debt Sustainability in Africa

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Abstract

Fiscal sustainability concerns in Africa have increased recently following heightened fiscal vulnerabilities attributed to external factors including falling commodity prices that weakened fiscal revenues and growth, particularly for commodity-exporting African countries. To entrench fiscal sustainability, countries need to strengthen domestic resource mobilization and improve public investment management. Consequently, measures to increase tax revenue collections, savings mobilization and efficiency of public spending are critical. The G20 should support debt reporting, data harmonisation, tax compliance, combating illicit financial flows and developing effective debt resolution frameworks.

1 In addition, valuable inputs were provided by Annalisa Prizzon (Overseas Development Institute); and Witness Simbanegavi and Njuguna Ndungu (African Economic Research Consortium).
Challenge\textsuperscript{2}

Implementing the sustainable development strategies requires scaling up financial resources. Sub-Saharan African countries (SSA) have low domestic saving rates and continue to face severe infrastructure backlogs. Concerted efforts to close the infrastructure gap, however, have contributed to the accumulating public debt. While fiscal policy may drive a country's development, it can also lead to unsustainable debt if not well managed.

Declines in official development assistance and weaknesses in domestic revenue mobilization have necessitated increased use of debt, fueling concerns about a new debt crisis for SSA (see Table 1). The number of African countries at high risk or in debt distress has more than doubled from the 8 in 2013 to 18 in 2018. Close to 40% of SSA countries are at risk of retreating into a major debt crisis (World Bank, 2018).

On average, debt levels are significantly lower than what triggered the HIPC and MDR initiatives. However, there is a substantial variation across countries. Country-specific policy responses are required to balance the growing demand for development financing and debt sustainability. In this regard, detailed breakdown of external debt by creditors will be critical for implementing the Argentina Communique.\textsuperscript{3}

The composition of external public debt in SSA has changed drastically over the past decade. The share of multilateral and concessional debt in external debt decreased steadily while the share of non-Paris club sovereign creditors doubled from 15% in 2007 to 30% in 2016, with the share of Paris club creditors decreasing from 25% to 7% (Mustapha and Prizzon, 2018; World Bank, 2018). The share of market-based debt (incl. domestic debt) also has grown significantly.\textsuperscript{4}

\textsuperscript{2} The more detailed analysis of the challenge facing the African countries is available at: https://www.afdb.org/fileadmin/uploads/afdb/Documents/Publications/WPS_No_227_Public_Debt_Sustainability_in_Africa_Building_Resilience_and_Challenges_Ahead_H.pdf.

\textsuperscript{3} Defined by sustainable financing practices for both borrowers and creditors. See Berensmann (2018) for some of these ideas.

\textsuperscript{4} Eurobonds issues by SSA governments stood at about USD200 million in 2006 but rose to about USD 6.3 billion in 2015 (Hogan Lovells, 2017 database), a more than thirtyfold increase in just a decade. Eurobond
Increased reliance on non-traditional creditors and commercial financing has increased the cost of debt. Debt servicing costs averaged 11 percent of government revenues in 2016, up from just 4 percent in 2013 (IMF, 2018). Interest payments have rapidly risen as a share of government revenues just like the costs for public debt relative to private debt contracted over the same period (Figure 3). In addition, some SSA countries with large bond financing now face large bullet payments, most of which will be maturing in the next few years and presenting a potential refinancing risk (World Bank (2018)).

External debt and investment show a positive correlation, suggesting the increasing use of debt for growth-enhancing purpose (Figure 4). The quality and efficiency of public investments, however, are crucial for ensuring growth and fiscal sustainability. SSA countries compare unfavourably in terms of public investment efficiency relative to other regions, with an efficiency gap of up to 54% (see Barhoumi et al., 2018).

Despite aid and Foreign Direct Investment, Africa is a net creditor to the rest of the world of valuable development finance once Illicit Financial Flows (IFFs) are taken into account. Between 1980 and 2009, illicit transfers increased within a range of US $1.22 to $1.35 trillion, amounting to 6% of Africa’s GDP. IFFs end up weakening financial systems and reducing legitimacy of the state in the eyes of their citizens.

Proposal

Policies for fiscal sustainability: what African countries and G20 should do.

- Strengthening public investment management through key measures; namely fact based project selection using standardized technical and financial feasibility diagnostics; streamlining delivery of infrastructure by

issues by SSA have proved quite popular with investors, with many such issuances being oversubscribed (e.g., Senegal).

5 Defined as “money that is illegally earned, transferred, or utilized, whereby somewhere at its origin, movement, or use, the money broke laws and hence it is considered illicit” Global Financial Integrity


7 The relevance of countering IFFs has been recognized by the international community: with a global commitment through the Sustainable Development Goals and the Addis Ababa Action Agenda, have committed to “redouble efforts to substantially reduce IFFs by 2030.”
improving the rigor of project designs, contractor selection and management; and more effective use of existing infrastructure, via effective project monitoring, adequate maintenance, and cost-reflective infrastructure tariffs. Others include strengthening multiyear budgeting and infrastructure governance and technical capabilities. Diagnostics, such as public investment management assessments and public expenditure reviews should be undertaken periodically to inform requisite remedial reform measures. G20 countries can support African countries through building and strengthening technical capacity for project appraisals, as well as strengthening public sector capacity to oversee or implement large-scale infrastructure projects.

- **Increasing domestic revenue mobilization**, by shifting from commodity taxation towards more neutral, broad-based value-added or sales taxes and personal income tax. Simplifying the registration process for businesses, leveraging new technologies to modernize the tax collection system, deepening regional integration and tax coordination, are necessary elements of a broad-based strategy to broaden the tax base. G20 countries can support African countries to strengthen capacity for tax revenue mobilisation; e.g., design of new tax codes, digitisation of tax systems, including capacity to levy taxes on e-commerce and related transactions.

- **Increasing domestic savings** by improving monetary frameworks, supporting the development of long-term savings instruments, aligning exchange rates on their long-term sustainable level, and reducing monetary financing to tame inflation.

- **Developing and implementing fiscal rules** to reduce fiscal discretion and allow for more effective fiscal policy. Fiscal rules, if well designed and implemented, can help reduce the pro-cyclicality of government spending, encouraging savings accumulation during hay days.

**Policy measures for debt sustainability**

**Recommendations to the G20 on fiscal and debt sustainability**

- Accelerate the projects on **debt data reporting and standardization**. Support countries to establish publicly available debt registers; set up Debt
Management offices, or strengthen capacity where the offices already exist; and ensure linkages between the debt management functions and other public finance management functions. Support development of medium term public investment programs that are linked to the raising of public debt.

- Put in place a **framework for an orderly debt resolution mechanism** in the context of more diffuse creditor base and other new features of the debt.

- Support efforts by African countries to **enforce compliance with taxation** in face of domestic revenues lost to profits shifting, and support DRM capacity development more broadly. This would require technical assistance in formulating revenue mobilization policies, attendant legislation and regulations. It would also require support with procurement of software for revenue recording and collection.

- Step up efforts to **combat illicit capital outflows from Africa**, including helping track and repatriating illicit funds back to African countries. Support should be provided to assessing key risks relating to money laundering and illicit financial flows, and defining mitigation measures; building human and institutional capacity to uphold relevant laws, investigate suspicious activity and recover stolen assets; and providing the infrastructure necessary to track and report cash movements across borders.

- Ensure **that multilateral development institutions are adequately capitalized** and can use their own resources - and the leverage their credibility affords - to offer countries alternative meaningful solutions to expensive or risky foreign-currency borrowing in international capital markets. Given their development mandate, political neutrality and strong technical expertise and due diligence capacity, multilateral financing is more likely to yield development benefits and have a catalytic role.

- **Support countries to improve long-term debt management capacity, governance, and transparency including: Reviewing debt sustainability assessment methodologies** to capture new realities, notably security-related expenditures and the quality of public investment, and take into account unique features of African economies, institutions and operations of various
markets, including the financial and labour markets.

- **Develop innovative tools to finance development.** Support the development of African domestic capital markets, potentially through the introduction of African-wide safe assets, with senior tranches potentially guaranteed by the MDBs and marketed to international investors as a mezzanine, investment-grade exposure to frontier market debt.

- **Design standard terms and assist African countries in negotiations over innovative sources of funding** that limit the need for foreign currency borrowing and exploit mutually advantageous exchanges with traditional or new bilateral lenders. Attention should be paid to crowding-in private capital through risk mitigation instruments to unlock resources that can substitute debt. Multilateral lenders can provide benchmarks and guidelines, as well as low-risk financing tranches for long-term projects.

**What African countries should do to improve debt sustainability.**

Emphasis should be placed on more effective and efficient use of debt, including through institutional and governance reforms to strengthen debt management and data transparency. The specific measures include:

- **Reducing reliance on risky and volatile debt sources.** Developing innovative and alternative mechanisms of development financing such as Public Private Partnerships, securitization of infrastructure assets, privatization as recently demonstrated by Ethiopia. In addition, creation of an asset class for public projects, using the leverage afforded by safe capital from multilateral institutions is equally important. However, it is important to adequately quantify and mitigate the underlying fiscal risks from PPPs and government guarantees.

- **Increasing the maturity of external debt** when possible at reasonable costs, making use of guarantees provided by multilateral institutions to tap liquidity at the long-end of the yield curve (20 to 30 years’ bonds), on the model of Kenya’s recent issue of a 30-year bond in February 2018.

- **Using more flexible, counter-cyclical and state-contingent debt instruments** to relieve the debt burden during recessions, through commodity hedging
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or GDP-indexed instruments. Key implementation challenges should be mitigated, notably the high liquidity and novelty premium charged at first issuance and the increased risk of moral hazard, especially when the borrower assumes excessive risks in the knowledge that relief will be provided. Fiscal rules may also be considered in the management of windfalls.

- Developing **domestic safe assets** through enhanced credibility and independence of monetary and debt management authorities, with the support of the MDBs’ debt management initiatives and technical assistance.

- **Greater transparency** in debt management, including commitment by governments to release in real-time all data on old and new debt from all sources. This will require efforts to standardize data gathering practices, develop data collection systems, address data gaps, notably in the accounting of SOE-related liabilities and contingent liabilities arising from sovereign guarantees to individual projects, and consolidate government accounts, across regional levels, agencies, ministries and institutions.

References

Appendix

Figure 1: Primary balance deterioration occurred mostly through deteriorating revenues

(a) Real GDP Growth

(b) Commodity prices variability over time

(c) Government revenue and expenditure

(d) Primary fiscal balance

Source: AfDB Statistics Department
Figure 2: Public debt accumulation in Africa

Source: AfDB Statistics Department
Figure 3: Interest rates on Africa’s debt

![Median interest rate on debt](image)

![Interest payments on external debt, total Africa](image)

Source: AfDB research department

Table 1: Risk of debt distress in selected low-income African countries as from 2017

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<th>Moderate risk</th>
<th>High risk</th>
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Note: The assessment of debt risk is based on average CPIA scores over the recent years and two types of debt burden indicators namely, the size of debt and the debt servicing. Under each broad indicator a pair of sub-indicators is used – the share of exports and the share of Gross National Income (GNI). A set of complementary indicators is appended to each broad indicator to support the analysis (see IMF DSA analysis). A country is classified as at (a) **Low risk**, when all the debt burden indicators are well below the thresholds; (b) **Moderate risk**, when debt burden indicators are below the thresholds in the baseline scenario, but stress tests indicate that thresholds may be breached if there are external shocks or abrupt changes in macroeconomic policies; (c) **High risk**, when the baseline scenario and stress tests indicate a protracted breach of debt or debt-service thresholds, but the country does not currently face any repayment difficulties.

Source: Compiled by AfDB Staff from IMF Article IV, and AfDB Statistics Department
Figure 4: Debt is associated with increased public investments in Africa

Source: AfDB Research Department  \( R^2 = 0.03 \)

Figure 5: Number of countries with increases in government consumption, public investment, or both between 2013 and 2016

Source: Coulibaly, Gandhi, and Senbet (2019).
Sample excludes São Tomé and Príncipe, South Sudan, and Gambia due to data availability
Figure 6: Composition of public external debt

Source: AfDB Statistics Department