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LGA Debt and Borrowing

Reform discussion note

NATIONAL LOCAL GOVERNMENT FINANCE COMMITTEE

N L G F C

Introduction

LGA borrowing is internationally an important component in the fiscal decentralization architecture. It allows a LGA to carry out more ambitious investments than otherwise would be possible. In principle, it also promotes intergenerational equity by having the future generations of citizens which will benefit from a facility's services pay for its construction[1]. However, for LGA borrowing to be a realistic and significant component for LGA financing, it will require solid own source revenues for LGAs to establish LGAs a creditworthy (see discussion note on OSR reform), as well as a proper guiding legal and policy framework. This note focuses on the latter.

In addition to deliberate LGA borrowing for capital investments, it has also happened that LGAs operates recurrent activities at a deficit and in this manner accumulate unsustainable debts. This note provides recommendations on how to also address this type of debt through the future FDS.

1 See e.g. http://www.nalas.eu/knowledge-center/Basic-Principles-of-Local-Government-Borrowing

Legal and Policy Framework

The Local Government Act allows councils to obtain overdrafts and loans from local financial institutions such as banks. Overdrafts may be used to address short-term regular expenditure needs. On the other hand, loans are intended to assist councils make long-term investments. Council approval is required before an overdraft can be obtained. However, for a council to obtain a long-term loan, it must have the approval from the Minister of Finance in line with the Public Finance Management Act[2].

The Development Fund for Local Authorities (DFLA) is the only institution in Malawi that lends investment finance to local governments. DFLA was established (as a Trust Fund) in 1993 with a start-up capital of about US$ 8.5 million, as part of the World Bank funded Local Government Development Project (LGDP)[3].

DFLA Performance

The DFLA has since 1993 provided grant and loan finance for local government investments. DFLA has lent or granted funds to 31 local governments for a range of investments (construction of roads, market facilities, and other infrastructure, purchase of vehicles, etc.). Most DFLA grants/loans were approved in the period between 1994 and 1998; after the late 1990s DFLA activities appear to have ground to a standstill for several years, because of capital depletion – itself due to poor rates of repayment, debt cancellation, attrition through the conversion of loans to grants (which became an ever-larger proportion of DFLA funding), and management costs. Since 2010, DFLA has re-commenced operations on a very modest basis of a greatly diminished capital of about US$ 1.4 million and is seeking to replenish its revolving fund. Although it is still – in legalistic terms – a functioning institution, DFLA was by the World Bank deemed as effectively non-operational and no longer a significant source of investment finance for local governments, few of which are even aware of the Fund's continued existence[4].

The DFLA does not issue annual reports on its activities and performance, but interviews and review of past analyses[5] suggest that the DFLA has performed relatively poorly, but that the Government recently has sought to recapitalise the fund[6]. In general, only one LGAs per year is provided with a loan and typically for a small capital project like market construction likely to contribute to OSR generation. According to availed data from DFLA, the most recent loan was provided to Blantyre City for their property valuations.

The DFLA is a relatively small organization with a board of directors chaired by the Secretary for Local Government just as MALGA also is represented on that board. The day - to - day business is steered by a Secretariat which is very lean (CEO, Director of Operations who also doubles as Credit/Loans Director, Director of Finance and Assistant Accountant). However, this lean Secretariat is understandable considering their current very small loan portfolio.

The average annual loan issued over the last seven years is 158 million MWK or 190,000 USD per year. In per capita terms this translates into 0.01 USD/capita and is thus a relative insignificant part of total LGA revenue. However, as the loans generally is allocated to only one LGA each year then the fund could potentially support innovative investments although this probably would require additional technical expertise within DFLA – potentially for linking access to wider financing or Public Private partnerships (PPP) arrangements. Note that the mandate for approval of LGA bank borrowing lies with the Ministry of Finance (as per the provisions of the Local Government Act) and that further reform of LGA borrowing would require coordinated approach by the involved ministries and DFLA.

2 Ministry of Local Government and Rural Development 2013: Guidebook on The Local Government System in Malawi (Revised October 2013).

3 Word Bank 2016: Republic of Malawi, Malawi Urbanization Review: Leveraging Urbanization for National Growth and Development, Report No: AUS10133, April 15, 2016. Note the Local Authorities Loans Fund Act no 39 of 1971 is apparently the original legal basis for the Fund and has not been changed.

4 Ibid, page 46.

5 The World Bank's ICR (2001) for LGDP was very critical about the DFLA and noted that: "The financing mechanism (DFLA) set up by the project was a failure" (p. 17). While the DFLA, as a form of revolving fund, was expected to reconstitute itself through LG repayments, this did not happen " … due to the chronic failure of local authorities to service their debt obligations". The ICR further notes that: "The DFLA apparently never incorporated any systems to assess the creditworthiness of the local authorities to which it "lent". In practice, the costs of new sub-projects financed under the LGDP would automatically appear as "loans" to the local authorities with no ex ante analysis, discussion, or agreements". Although infrastructure investments were completed (behind schedule), the DFLA was evaluated as being un-sustainable

6 In FY 2020/21 development budget the government set aside 800 million MWK for recapitalization of DFLA and the Fund is thus still operational.

LGA Indebtedness

In addition to the limited long-term debts, several LGAs have also accumulated various debt to suppliers, service providers and even for own staff salaries[7]. In June 2021 it was reported that "The Malawi Local Government Association (MALGA) expressed excitement with the decision by the Central Government to sanction audit of debts in the councils, a process that will pave the way for a bailout package for the councils". It was further noted that "cumulatively, the councils owe various suppliers and service providers in excess of K14 billion, which they have failed to settle due to inadequate funding"[8].

Review of the most recent LGA financial statements of (2019/20) indicates that:

- LGAs generally have a total positive net balance (total assets / liabilities) because of the accrual accounting principles whereby properties, land and buildings are included in the overall balance.
- A narrower comparison of current assets and liabilities reveal that most LGAs still have positive balances in particular Blantyre City Council with a net balance of 7.8 billion, but also significant surpluses in some rural LGAs. Such assessments of net positive balances are of course on the assumption that LGAs debtors are capable and willing to pay their debts (that for instance include substantive owed property taxes or similar revenues).
- However, several LGAs have substantive negative balance sheets – this includes Mzuzu City Council, Nkhata Bay District, Machinga and Karonga District LGAs[9]

7 https://www.zodiakmalawi.com/nw/national-news/66-news-in-southern-region/3434-nsanje-district-council-employees-not-paid-for-3-months

8 Malawi Nyasa Times 19 June 2021 https://www.nyasatimes.com/malga-excited-with-govts-positive-response-to-calls-for-bailout-for-councils/

9 See details in Situational Analysis, Annex 6.

Reform Recommendations and Options

Long-term borrowing for capital outlays is a sound element of LGA financing, but the institutional arrangements require strengthening. It is recommended:

- To review in depth the performance of the DFLA (performance of loan portfolio and DFLA procedures for granting loans and subsequent monitoring and reporting of results).
- To explore options for strengthening its role in LGA borrowing including possibly greater focus on technical assistance to LGA for access to alternative credit facilities in connection with specific PPP arrangements etc.
- Improve overall transparency and accountability of DFLA to ensure:
    - Transparent allocation of LGA credit based on solid assessments of LGA credit worthiness and relative needs.
    - Transparent annual reporting on results.

LGA indebtedness incurred based on deficit operation of recurrent activities constitutes a risk to fiscal stability of LGAs. It is recommended to:

- Map LGA indebtedness in detail and ensure that indebtedness is regularly monitored (at better quality than currently contained in annual LGA financial reports).
- Address LGA indebtedness through:
    - Review the underlying local specific reasons for LGA indebtedness.
    - Where there is a chronic underfunding of justifiable levels of staffing and administrative cost, ensure that LGAs are assisted to cater for these costs on a sustainable basis (through revised allocation of GRF and/or enhanced OSR generation).
    - Where there is need for adjustments on the expenditure side (including staff reductions etc) – assist the LGAs to undertake these reductions in a fair manner with settlements of outstanding debts.

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