



MAKING TRANSPARENCY PAY:

DESIGNING THE RIGHT INCENTIVES FOR DEBT MANAGERS IN AFRICA

Moritz Kraemer

November, 2020



INTRODUCTION

Debt transparency of less developed sovereigns, or the lack thereof, has come to the forefront in recent months, as the debt crisis in Sub-Saharan Africa (SSA) has moved centre stage. Most acutely, the debt restructuring of Zambia, whose solvency situation had been in dire straits even before the pandemic, has been held up by inter-creditor squabbles over fair burden sharing. The lack of reliable information is one important roadblock on the path to a resolution. Unfortunately, Zambia is no special case. It is merely the canary in the copper mine.

Unfortunately, deficient transparency surrounding the inventory of public obligations in frontier markets should not have come as a surprise to anyone. Debt management performance assessments, periodically conducted by the World Bank, have repeatedly laid bare institutional deficiencies in debt management practices. Data quality has been a lingering challenge for many years: experiences in SSA have too frequently been characterised by the lack of timely and robust information, if compared with issuers elsewhere. Indeed, the only sovereign ratings ever withdrawn by Standard & Poor's, because of a lack of data visibility, were all African. Some of the problems are undoubtedly owed to institutional capacity challenges and weak governance structures. Sustained and targeted technical assistance can go a long way in remedying those shortcomings. Africa's development partners have been actively engaged in many countries to assist governments in doing just that. It remains work in progress.

But that is only one facet of the problem. More worryingly, situations may have arisen where the incentives of policymakers are skewed in a way that is detrimental to debt transparency. In an environment of underdeveloped, institutionalised checks and balances, incentives can arise that make it attractive for some policymakers to resist disclosure of the amount of debt, the use of proceeds, or both. The crisis in Mozambique was probably the most egregious example of such a situation. To be sure, misaligned incentives and obfuscation are not a uniquely African phenomenon. Face-to-face meetings with the Finance Minister of Greece, just before that country's debt crisis detonated, raised similar concerns. He solemnly declared that he could not confidently say how much the government owed. He simply did not know. Given previous experience with data made available by Athens, such a depressing assertion is not surprising. But since the European episode did not end well, it is no real consolation for African sovereigns that others might also be subject to similar challenges.

Fixing institutional shortcomings takes time. Making improvements stick requires the consistent commitment of successive sets of policymakers. And, as students of capacity building efforts over the decades can readily attest, backsliding is always a risk to reckon with. This cautious assessment is not to be confounded with an argument against capacity building. Quite on the contrary. It underlines the need for sustained efforts to protect institutional reforms from reversals.

But the concern about the quality and stability of governance structures also supports another conclusion. When poorly paid public officials handle complex transactions under patchy supervision,

the temptation to cut some corners will never be too far away. The expectation is that most policymakers adhere to high ethical standards of public service. They are unlikely to abuse their discretionary power with the aim to obfuscate the true liabilities of the state. Policymakers in Africa are exposed to similar incentives that policymakers face elsewhere, too. There is no readily available evidence that they respond differently to opportunities open to them to abuse their discretionary power. But given the more fragile state of public finances in many African countries, as well as their much lower debt-bearing capacity, it is undisputed that restructuring risks are higher in the African continent. And it is in those restructuring episodes that debt transparency issues can hold up a swift and orderly resolution. Experience suggests that procrastination in the debt restructuring process often leads to deeper economic slumps, bigger haircuts and longer episodes of lost market access than a faster debt work-out would have brought about.

MIMIC PRIVATE SECTOR EXECUTIVE PAY TO ALIGN INCENTIVES

The lack of transparency hurts creditors and debtors alike. Nevertheless, the social burden is typically much greater on the debtors' side. For the society (the principal), the incentive for debt transparency is, therefore, very high in order to avoid such scarring recessionary outcomes. Thus, the challenge is to fully align the collective interest with that of the policymakers in charge (the agent).

In the corporate world, an analogous challenge exists. Shareholders (the principal) need to ensure that the executives of the company (the agent) take decisions that promote the welfare of the owners, who are generally detached from day-to-day decision making. In business, this alignment of interests is achieved through variable pay for executives. Their executive pay is related to the financial success of the company. This can be achieved through pay being made in the form of stock options, performance share plans, or restricted stock, often vesting over time or only when the executive meets specific performance goals. Today, the CEO of a typical S&P500 company takes home variable pay exceeding their fixed salary. They are, therefore, strongly motivated to take strategic decisions that maximise the market value of the firm. The interests of the principal (owner) and the agent (management) are better aligned.

Bridging the potential gulf in interests between finance officials and the general population is harder. There is no comparable equity, like shares or stock options, that could be instrumentalised to better align the incentives. However, the challenge is not insurmountable. The case of Mozambique, for example, made clear that the shenanigans, once discovered, led to a precipitous drop in the market value of outstanding government debt securities: rates on short term bills quintupled to over 25% between 2015 and 2017. Had the officials responsible for the irregularities received a share of their remuneration in restricted government bonds, their personal wealth would have cratered. The anticipation of this personal finance risk would lead officials to pause and consider the consequences, before misconducting themselves.

Conversely, astute and transparent debt identification and management practices will enhance investor confidence and should, over time, bring down the sovereign's borrowing costs and yields in the secondary market. In fact, it is possible that the mere announcement that officials will be partly paid in government bonds produces such a positive outcome¹. An official that owns government securities as a variable pay component, would profit personally from those improvements while benefitting the country and society in its entirety. In essence, if officials keep having some skin in the game, even after they have departed from their debt management duties, they are likely to act so as to reduce the downside risks to the market value of government securities, increasing the upside risk that rates will fall and bond prices rise.

THE DEVIL IS IN THE DETAILS

There are many thorny design issues associated with such payment schemes. Most importantly, how to ensure that the variable pay captures, as much as possible, any actions that fall within the remit of the debt manager? For example, the reduction in oil prices might reduce the value of government bonds of oil exporting nations. It would not be fair to penalise the debt managers for such an event, which is obviously outside their control. Depending on the circumstances, a relatively elaborate benchmarking framework, for example comparisons with peer countries, might be helpful.

A contractual agreement between the government and the debt manager must also be designed, so as to insulate debt managers against adverse actions by individuals outside their span of control. For example, a situation could arise where a senior government official, such as a cabinet member, contracts government debt in a clandestine way. If debt managers are kept in the dark about this, they should not have to accept what is effectively a pay cut, when bond prices fall as a consequence of the "secret debt" becoming known.

There is also the question of how long the lock-in period should be. A typical vesting period for the variable pay of corporate executives is three years. This strikes a balance between the desire to choose a sufficiently long period to discourage a short-term bias in decision making, whilst being short enough to still maintain a nexus between the executive's action and their remuneration. A three-year vesting period also appears an appropriate time frame for the institutional contexts in which most debt-managers operate.

Another important consideration is the determination of the relative size of the variable pay component. Too high a proportion may discourage applications from talented candidates, especially if the pay system has not yet been able to build up a credible track record. On the other hand, if the variable proportion is too low, the incentives may be too diluted to create a discernible effect on

¹ An official would get a defined percentage of their total pay in bonds, not a defined percentage of bond issuance volume. There is no incentive to borrow too much. On the contrary, over-borrowing could reduce the value of the bonds held by the official as variable pay.

behavior and performance. A share of between one quarter and one third may, in many instances, be the sweet spot in this trade off. The debt official bears additional financial risks to their total payout, compared to the traditional all-cash approach. This added risk could be compensated by raising the overall expected pay (fixed and variable), if performance is satisfactory.

Conflict resolution is an important element of any comprehensive variable pay strategy. No work contract will be able to capture all possible circumstances. Controversies about the appropriate interpretation of contractual clauses may arise. In order to make the variable pay-approach credible, a transparent and independent arbitration procedure would be required, to minimise the risk that a variable pay component is abused for political reasons, for example after a handover of power to the erstwhile opposition. In the light of sometimes weak or politicised judicial institutions, the government could subject itself to an outside court in case of disputes, such as the Court of Justice of the African Union. This should also help tie future governments to the commitments made vis-à-vis the debt managers.

WALK BEFORE RUNNING

The proposal to introduce variable pay for civil servants is a significant rupture with the prevailing civil service culture in many sovereigns. It may be appropriate, to begin with small steps and advance the concept further as familiarity and acceptance grows with experience. As a first step, for example, part of the pay could be deferred and paid out in the future, in cash instalments over a period of three to five years. The payout would be subject to simple, observable facts: for example, payment would be withheld, if the official in question is being formally prosecuted for non-trivial irregularities related to the execution of their duties. If the official is sentenced with no further recourse to higher courts, the outstanding payment would be forfeited for good.

In addition, a time-deferred bonus could be paid, subject to the country making objective progress in its debt management practices and transparency. The bonus could be linked to progress in debt transparency metrics, to be developed and independently administered by outside institutions, such as the World Bank, other development partners, or established civic organisations such as Transparency International. Public finances will probably not have to bear any net cost for those bonus payments. As good debt identification and management practices enhance investor trust, the public savings through lower borrowing costs should, in most cases, be a multiple of the bonus payout. Put differently, the bonus is an investment with a healthy return in the form of lower debt service costs. Again, the incentive of the debt manager is to engage in strategic actions that will benefit the country.

This proposal, to introduce some element of variable pay, will not be able to fully eliminate conflicts of interest. But except in those rare cases where officials are outright corrupt and dishonest, a smarter remuneration system can be an important tool to reduce the risk of rogue behaviour of public officials. It may also attract talented managers, as a financial upside of good performance is

introduced. That prospect can help make public sector pay, which often lags behind that of private employers, a more appealing offer for the most qualified individuals. Finally, the confidence-building signalling effect, inherent in the introduction of such a scheme, needs to be considered as well. When an incentive-aligning remuneration scheme is introduced for such pivotal roles as debt management, the government's creditors should take heart. If they believe that the variable pay element will reduce the risk of a Greek- or Mozambique-style transparency shock, the government will save interest outlays. These savings can be deployed to other policy areas, where additional funds are often desperately needed, such as investment in social services.

YOU GET WHAT YOU PAY FOR

The question will arise, as to why special pay arrangements should be introduced in the field of debt management, rather than anywhere else. Indeed, if well designed, there is a good argument to be made for performance-enhancing pay-reforms for other public servants as well. But officials managing public debt are a logical place to begin.

Firstly, their failure or fraudulent behaviour will have exceptionally large negative repercussions for society as compared to, say, a manager of a public hospital. Similar to Mozambique, a fully-fledged economic, social and financial crisis can result. Creating a similar amount of havoc elsewhere in the public sector is not that straightforward.

Secondly, even in advanced economies with more robust governance institutions, there is often a carve-out from civil servant pay schedules for public employees with rare skills that can add a lot of value to the jurisdiction. For example, in most U.S. states the highest earning official is the college football coach of a state-owned university, often earning multiples of their respective governors. Whilst not as extreme, separate pay regimes also often apply to debt management specialists. This is due to the recognition that debt management often requires specific technical skills and market knowledge that may not be available at the going pay rate for civil servants. For example, the Chief Executive of the British Debt Management Office draws a higher salary than the Prime Minister. In managing public debt as much as elsewhere, you get what you pay for.



ABOUT EMEA

The Euro-Mediterranean Economists Association (EMEA) is a Barcelona-based regional think-tank established in 2012 that serves as a leading independent and innovative policy research institution; a forum for debate on the political and socio-economic reforms in Mediterranean and Africa; and promoter of actions and initiatives that fulfill objectives of sustainability, inclusiveness, regional integration and prosperity. It strives to contribute to the rethinking of the Euro-Mediterranean and Africa partnerships in view of the new dynamics of an emerging multi-polar world.

EMEA has a large network of economists, high-level experts and institutional partners (research institutes, think tanks and universities) in the Euro-Mediterranean and Africa. EMEA builds on the collaborative research network MEDPRO (funded by the EU's Seventh Framework Programme (2009-13) and provides forward-looking thinking and political and socio-economic integrated analyses on the Euro-Mediterranean region. EMEA is also the promoter and co-funder of the Euro-Mediterranean Network for Economic Studies (EMNES), co-funded by the European Commission (DG NEAR) between 2015 and 2019. EMNES is a regional network composed of 30 institutions and more than 100 experts and researchers in the Mediterranean region.

From January 2020, EMEA coordinates The Euro-Mediterranean Network for Economic Studies (EMNES). EMNES, aims to provide a renewed vision for socio-economic development in the Mediterranean region, mainly focusing on employment creation, social inclusion, sustainable development and regional integration. It performs economic and policy research exploring the pillars of inclusive and sustainable economic models in the Euro-Mediterranean region.

DISCLAIMER:

The contents of the documents are the sole responsibility of the authors and can under no circumstances be regarded as reflecting the position of the Euro-Mediterranean Economists Association.

© Copyright 2020, EMEA - Euro-Mediterranean Economists Association
Published by the Euro-Mediterranean Economists Association

All rights reserved – No part of this publication may be reproduced, stored in a retrieval system or transmitted in any form or by any means – electronic, mechanical, photocopying, recording or otherwise without the prior permission of the authors.

