Chapter 18

Sub-Saharan Africa
South Africa

Despite sophisticated financial markets, the country is slow to reinvigorate its municipal bond market amid rapid changes in its political and fiscal structure.

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Lessons

In marked contrast to other countries of Sub-Saharan Africa, South Africa has a sophisticated private financial market. Municipal borrowing—through bonds and from intermediaries—has been a feature of local government funding for years, though before the early 1990s such borrowing was implicitly or explicitly guaranteed by the state. Aggregate lending volumes have stagnated and declined in recent years, however, primarily as a result of the interplay between a deficient policy and regulatory framework and poor budget discipline and financial management practices in local governments.

South Africa has taken measures to address these deficiencies. However, these measures, combined with ongoing reforms in the organization of the local government system (such as changes in boundaries), have led to a lack of stability, creating an uninviting investment environment for private lenders.

Today, prospects for growth in municipal borrowing are uncertain even though the potential demand for loan finance far exceeds existing volumes. South Africa has many of the basic conditions for expanded local borrowing, including a sophisticated and liquid financial sector, local authorities with substantial fiscal capacity, and a sound policy and legal framework that is soon to be introduced. Other factors, however, such as weaknesses in budgetary and financial management and the nature of certain structural and regulatory reforms, militate against growth in local borrowing. The next five years will be critical in determining the long-term outlook for municipal borrowing in South Africa.

South Africa is unique in many ways. It has the institutions and policies that many countries seek. It has efficient and vital capital markets for national government, public enterprise, and corporate bonds. It has substantial experience with municipal securities, a large and liquid financial sector eager to lend to municipalities, and clearly stated, market-oriented policies on the verge of being enacted into law.

Despite these strengths, some key indicators are headed the wrong way. The number of lenders to municipalities is shrinking. Private lending to municipalities is stagnant, and the government-owned lender is actively competing for the business of large and creditworthy municipalities while the market's structure is becoming steadily desecuritized.

All this points to a need for clear, stable, and effective legal and financial arrangements within which municipalities can plan. The disruptions of the post-apartheid transition period since 1994 have been unavoidable, and South Africa has managed this transition fairly well. Long-term borrowing and lending, however, depend on long-term predictability. Successive changes in municipal borders, powers, and functions have made it difficult for municipalities or investors to anticipate the future. These changes have made municipal borrowing expensive and have caused many private lenders to withdraw from the market, at least until conditions stabilize. Clear remedies for defaults have not yet filled the vacuum created by the disappearance of implicit government guarantees. With the finalization of legislation expected during 2003, the new municipalities and their legal framework will be settled. The municipalities then must be allowed time to find their footing. Any further uncertainty could prevent municipalities from obtaining long-term credit for infrastructure.

Efforts are also needed at the municipal level. If the supply of "bankable" projects and municipal debt securities is to grow significantly, municipalities must develop the basic skills and experience in accounting, planning, reporting, and marketing that support wise borrowing choices. Demand for credit should be the natural consequence of careful and informed municipal capital planning. Borrowing may be the most powerful tool in a municipality's financial toolbox, for it can lay the foundation for economic development and a virtuous cycle of growth. If used unwisely, however, it can leave crippling debt for the next generation (box 18.1).

Once the legal framework is finalized and stabilized and the basic skills and experience are developed, investors will have no reason not to come to the table. Assuming that borrowing does expand, financial crises will eventually occur in some municipalities, as they do in any country. How well South Africa deals with these crises will indicate the likelihood of long-term success. If sound financial emergency mechanisms are in place and if they prove effective, some diminution in loan volumes still may occur, but that would probably be followed by a resumption of steady growth in South Africa's municipal credit market.

Local Government. Before the advent of democracy in 1994 South Africa had a variety of local government systems, with about 1,300 municipalities throughout the country. In urban areas separate white and black local authorities were subsidiary to the four provinces that then existed. White local authorities included the core cities and virtually all the economic activity. These local authorities had their own councils, staff, and revenue sources, including property taxes and revenue from utility services. Black local authorities, often located nearby and providing cheap labor for the core cities, had limited services and widespread poverty. Other areas where black people lived were included in "independent homelands" and "self-governing territories," where a variety of administrative and traditional authorities provided local governance and limited services.

Since 1994 the legal and financial underpinnings of municipalities have undergone a series of changes aimed at democratizing and deracializing municipalities. In 1994 the "homelands" were reincorporated into the republic, and negotiations were initiated to determine local government boundaries. This process resulted in the creation of 843 municipalities after local govern-

Box 18.1. A South African Parable

Not long ago a district councilor asked his municipality's accounting firm for help. Collections of budgeted revenues had been falling steadily, while expenditures and responsibilities for providing services had increased with the addition of new territory. Every month the municipality was spending more money than was coming in. Unpaid suppliers threatened to withhold services, and local banks refused to extend more credit. Fortunately, he told the accountant, the municipality had been offered a lifeline—a euro-denominated loan at only 3 percent interest from an overseas development agency. The councilor wanted help building a case for South Africa's National Treasury to guarantee the loan, as required by the development agency. With the loan proceeds, the municipality could launch tourism projects necessary for its economic development.

The hard truth is that this municipality can ill afford a 3 percent euro interest rate (which could amount to 50 percent a year in South African rand if the exchange rate were to fall at the rate it did in 2001). In fact, municipalities are legally barred from borrowing in a foreign currency. Nor was the municipality able to convince the National Treasury to guarantee the loan: government policy. It is clear that municipalities' access to credit must depend on their own creditworthiness. Before the municipality borrows, it must increase its revenues, cut its expenditures, or both, even if that means delaying important projects.

The loan the overseas agency had offered to the district council is part of a "low-cost" lending program intended to help South African municipalities build infrastructure and pursue economic development projects. The agency's project officer in South Africa is under heavy pressure from his agency and his government to place the project funds and demonstrate concrete successes.

Well-intentioned development programs that make credit available to the noncreditworthy do South African municipalities no service. Some development programs do more to support employment and careers in development agencies than to help build sustainable systems and structures. This loan would be a negative-sum transaction: The donor has spent large amounts to create and staff the lending program, and lending the money at the 3 percent euro interest rate would create additional cost. The municipality would be asked to assume additional debt when it cannot even meet its existing obligations, a step that would probably accelerate its developing financial crisis. Unfortunately, neither the council nor the management staff has the training and experience to recognize that the “low-cost” loan could turn out to be quite expensive. The municipality, reluctant to believe that the infusion of cash would not relieve its budget crisis, continues to search for a sympathetic ear in the national government.

ment elections in 1995. Neighboring white and black urban areas were amalgamated, with the intention that revenues generated in the core cities could be used to extend services to underserved areas. In 1996 a new constitution established a decentralized system of government featuring autonomous local, provincial, and national spheres of government. In 2000 a second step in the consolidation of municipalities reduced the number from 843 to 284 and, in many cases, integrated rural and urban areas.

These 284 new municipalities consist of three groups:

- Local municipalities (232).
- District municipalities (46), which typically include several local municipalities within their borders.
- Metropolitan municipalities (6), which include South Africa’s largest cities.

This series of changes has brought clarity and certainty to the institutional framework for the six metropolitan municipalities. For the 278 local and district municipalities, however, which cover the same territory, an important step remains—sorting out their respective powers and functions. Although recent amendments to the Municipal Structures Act have created a legal framework within which district municipalities will eventually provide most services, in many cases services are still provided by local municipalities. By ministerial regulation, legal authority remains mainly with local municipalities for the present time.

How the eventual transfer of responsibility from local to district municipalities will occur, and what it will mean for fiscal powers, are being debated. The uncertainty associated with this ongoing transition makes it difficult for local and district municipalities to plan capital spending strategically and to borrow to finance their capital investment plans.

Local Government Revenues and Expenditures

Municipalities spend a little less than a quarter of the total budgets of all three spheres of the South African government. In the 2000/01 financial year aggregate municipal spending was budgeted at some 61.8 billion rand (R), while national government spending was budgeted at R 84.3 billion, and provincial spending at R 110.5 billion

Municipal revenues in South Africa come from own-source revenues (local government taxes and tariffs) and from intergovernmental transfers, mostly from the national sphere.

Own-Source Revenues

While municipalities generate about 92 percent of their own revenues in the aggregate, the experience of large urban centers differs from that of other municipalities. The six metropolitan municipalities, with strong revenue bases, generate some 97 percent of their own revenues, while municipalities with annual budgets of less than R 300 million generate only 65 percent of their own revenues in the aggregate. Many poor and rural municipalities generate less than 10 percent of their own revenues.

Most of the own-source revenues of municipalities come from tariffs for utility services such as water, sewerage, and solid waste disposal. National policy, reflected in legislation, calls for these services to be self-financing.[1] In some cases they generate a surplus, and in others, losses. Much depends on the ability of the served population to pay and the seriousness with which the municipality pursues collections. Many municipalities provide electricity service to their residents, though this function is to be transferred to new regional service entities. This prospect causes concern among municipalities that make a profit on electricity service or that rely on the threat of cutting it off to collect other taxes and tariffs.

The second biggest source of municipal revenues is the property tax, but this tax is available only to local and metropolitan municipalities. With the December 2000 advent of "wall-to-wall" municipalities, property taxes now may be imposed on essentially all property in the country. This represents a significant expansion of the tax base compared with that of apartheid-era local authorities, which generally included only urban areas. Historically, some municipalities imposed taxes on land value only, though most imposed taxes on both land and improvements, often using different rates. National legislation is expected to soon provide uniform regulations to replace the patchwork of apartheid-era provincial ordinances, but such legislation will leave tax policy decisions largely to local councils.[2]

For district municipalities own-source revenues come mainly from the regional services council levy, a business tax also used by metropolitan municipalities. It is generally recognized that this tax is in need of reform.

Intergovernmental Transfers

The national government transferred some R 6.5 billion to municipalities in the 2000/01 financial year. These transfers, and their share in the national budget, have been increasing and are expected to continue to grow for at least the next three years. The transfers come from many small programs that South Africa's National Treasury has been working to consolidate. There are three basic types of transfers, and ultimately there may be as few as three transfer programs:

- Unconditional transfers, generally determined by a poverty-based formula and often described as subsidies for providing basic municipal services to people who cannot afford to pay the full cost. These transfers account for 57 percent of the national transfers to local government. The largest is the "equitable share" transfer, guaranteed by the Constitution.
- Conditional transfers intended to help municipalities build infrastructure. The largest conditional transfer is the Consolidated Municipal Infrastructure Programme grant. Infrastructure-related transfers make up 35 percent of the national transfers to local governments.
- Conditional transfers intended to help municipalities improve their capacity or restructure their operations. These account for 8 percent of the national transfers to municipalities.

In addition to consolidating the transfer programs, the National Treasury is committed to making the transfers as predictable as possible to facilitate local planning and capital investment decisions. This predictability is particularly important for poor municipalities that rely heavily on national transfers for general operating revenues and, potentially, to secure borrowing.[3]

Provincial transfers to local government, made at the discretion of each province, are less well documented. The total in the 2000/01 financial year was estimated at R 1.2 billion. These transfers are usually tied to arrangements under which a municipality delivers a service on behalf of the province, though they also have been used to provide assistance to financially troubled municipalities.

Role of Municipal Borrowing in Financing Capital Investment

All municipalities in South Africa—metropolitan, district, and local—have infrastructure responsibilities. Municipalities are responsible for local services such as potable water supplies, wastewater and solid waste disposal, city streets and street lighting, and, in many cases, electricity. All these responsibilities require physical facilities, which in turn require capital investment.[4]

Extending services to unserved and underserved areas has received the most attention recently and, given South Africa's history, is the most pressing need. However, at least three other types of investment needs also must be considered. First, services above the basic level must be available to those who can afford to pay for them. Second, if South Africa is to create the conditions for increasing employment and thereby lifting more people out of poverty, well-chosen investments must be made in economic infrastructure that will help generate private direct investment. Third, and often overlooked in current debates, ongoing investment is needed to upgrade infrastructure that has reached the end of its useful life. While some attempt has been made to quantify the "backlog" investment needed to extend services to underserved areas,[5] little has been done to quantify the need for strategic or replacement investment. Even the "backlog" analysis may be of little use; demand for infrastructure probably has no practical limits, and the experience of industrial countries suggests that backlog investment grows in proportion to a country's wealth rather than reaching some theoretical ultimate state.

How are South African municipalities to finance such capital investment if they lack the current resources to do so? Like municipalities elsewhere, they can look for private equity investors, apply for intergovernmental grants, or turn to the municipal debt market.

Private Equity Investment through Public-Private Partnerships

Public-private partnerships are one important channel through which private equity investment can contribute to the provision of local infrastructure. In the three years that South Africa's Municipal Infrastructure Investment Unit has been tracking the local infrastructure sector, projects using public-private partnerships have attracted some R 1.69 billion in private investment (including the projected capital investment over the lifetime of the contracts). The public-private partnerships that South African municipalities recently have entered into can be broadly divided into three groups:

- Short-term partnerships that do not involve capital investment and usually require the municipality to make payments to the contractor for services rendered.
- Long-term partnerships requiring fee payments to the municipality or investment in municipal infrastructure.
- Divestiture arrangements under which the municipality transfers a facility to a private firm, though it may retain some regulatory role.

Notable examples of public-private partnerships have been formed in the municipalities of Nelspruit, Richards Bay, and Johannesburg.

In 1995, as a result of the redrawing of municipal boundaries, Nelspruit's land area increased eightfold and its official population increased tenfold to 240,000, but its income grew by only 38 percent. Many newly incorporated areas had never received water and sanitation services. To extend service to all residents, Nelspruit needed to make large-scale investments in infrastructure. However, many residents of the new areas are very poor and can contribute little toward the cost of new infrastructure. To deal with these problems, in 1999 Nelspruit granted a concession for water and sanitation services, the largest long-term municipal public-private partnership in South Africa. The contract calls for a private firm, the Greater Nelspruit Concession Company, to take over, manage, maintain, build, rehabilitate, and, after 30 years, transfer back to the municipality all of Nelspruit's water and sanitation assets. Every resident is to receive basic service within five years. By early 2002, R 35 million had been invested, but the project has not attracted private finance; most of the funding has been put up by the government-owned Development Bank of Southern Africa. The main barrier to private investment appears to be the possibility that the national government will impose tariff caps. Although the government has never done so, South African legislation provides for this possibility.

In 2000 the municipality of Richards Bay signed a 20-year concession contract for the operation, maintenance, and development of its airport. The contract involves R 13 million in payments to the municipality, which will be used to repay debts associated with the facility. Another R 7 million will probably be invested in upgrading runways, depending on the results of an independent assessment later in the contract period. In addition, 20 percent of the concession firm's equity and 20 percent of its dividends will go to a trust fund for the development and support of local communities, particularly traditional communities near the airport.

In 2000 Johannesburg sold Metro Gas, a gas distribution business serving approximately 15,000 business and residential customers, to U.S.-based Cinergy Global Power for R 110 million. The new owner is expected to invest another R 276 million in the facility over 10 years, making the deal arguably the biggest municipal privatization in South Africa.

Experience has shown that the ability of municipalities to make wise and effective use of public-private partnerships depends on their ability to identify and articulate their needs, negotiate with potential partners, live up to the commitments they make in their agreements,[6] and manage the contracts they establish with private service providers. Local politics in South Africa, as elsewhere, can be turbulent, and public-private contracts have sometimes become political touchstones. Implementing any public-private partnership necessarily involves some tension between the municipal council's short-term interests in keeping tariffs low and service levels high, and the concessionaire's interest in earning a return for investors, so it is essential that contracts be clear and thorough. It is also critical that key decisions related to the partnership—such as tariff and collection policy—have broad support from the community. Finally, it is important that the community be able to give the private investor reasonable assurances, based on the community's legal standing and the commercial viability of the services involved, that the revenue streams for repaying the investment will be adequate.

The prognosis for private equity projects in South Africa is unclear. For investors, it may depend on South Africa's willingness to clarify tariff issues.[7] It also will depend on whether a significant number of municipal projects can be identified that will generate reliable cash flows. For municipalities, policy considerations may come into play, with some municipal councils preferring to retain ownership and control over essential municipal assets. For others, political interests may be at stake. South Africa's powerful labor unions, for example, often see public-private partnerships as a threat. All these limitations suggest that public-private partnerships will provide only a fraction of the investments needed—and that most infrastructure investment must be funded from other resources.

Intergovernmental Transfers for Infrastructure

In the 2000/01 financial year the national government provided only about R 2.4 billion in infrastructure transfers to local government. Infrastructure grants are made through a number of separate (generally sectoral) programs and are tied to specific projects. South Africa's National Treasury is committed to consolidating these grant programs and allowing municipalities more discretion in deciding how to allocate funds and what infrastructure they most need to build, and efforts to ensure this are under way. The aim is to avoid the bottlenecks and unintended results that sometimes have occurred under the current system, which may make grants available for extending one service to an area but not other services.

With the consolidation of these grant programs into one or two, it might be possible to reshape the infrastructure transfers into predictable revenue streams that the municipalities could then leverage through borrowing. In contrast to lump sum grants, this approach would allow more municipalities to receive simultaneous streams of revenue, helping the local government sphere build infrastructure more quickly.

Municipal Borrowing

Public-private partnerships will clearly finance only a fraction of South Africa's infrastructure investment needs in the foreseeable future. Infrastructure transfers are also small relative to investment needs. In most cases, therefore, municipalities will have to finance infrastructure from taxes and tariffs. Borrowing against these revenue streams, and possibly against infrastructure transfer streams as well, would allow municipalities to build infrastructure more quickly and distribute the financial burden more equitably across the generations that will use it.

South African municipalities generally understand that borrowing is not a new or separate source of revenue and that borrowed capital and interest must be repaid with revenues from taxes, tariffs, and intergovernmental transfers. The good news is that municipalities in South Africa, unlike those in many other African countries, have significant recurring revenue streams available for leveraging. Borrowing, provided it is done wisely, can help these municipalities deliver tangibly on the promise of democracy.

The South African policy on municipal borrowing, as laid out in the government's 1998 *White Paper on Local Government* and its 2000 *Policy*

Framework for Municipal Borrowing and Financial Emergencies, clearly calls for such borrowing to be based on a market system, with lenders pricing credit to reflect the perceived risks.

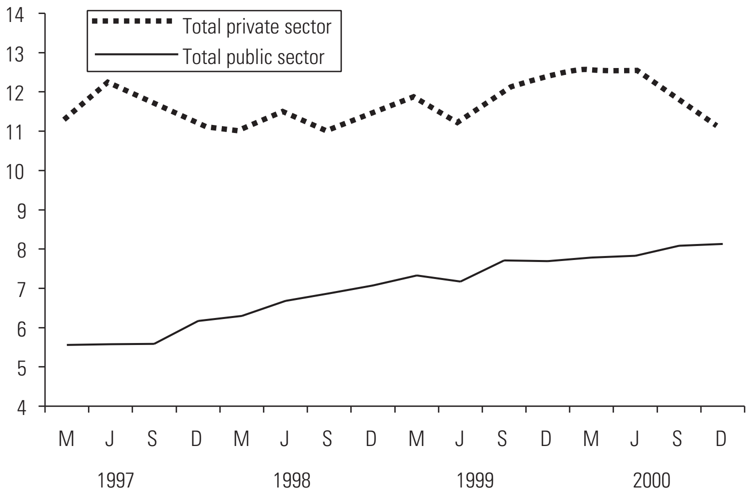
Potential Size of the Municipal Debt Market. Outstanding long-term municipal debt (to the public and private sector) in South Africa was estimated to be around R 19 billion by mid-1997. Though relatively stable for years, this figure declined slightly after June 2000, in the run-up to the December 2000 municipal elections. In the aggregate, municipalities clearly have the financial capacity to responsibly service a great deal more long-term debt.

Quantifying the potential size of the South African municipal debt market is inevitably a speculative exercise, but some indication of that size can be gleaned from municipal capital budgets. For the 2000/01 financial year these totaled some R 13.7 billion. Budgeted amounts may be higher than actual spending, but the previous year's actual capital expenditures are estimated at R 10.3 billion. If half of all capital spending were debt financed and the other half "pay as you go," this would suggest a potential debt service capacity of R 5.1–6.8 billion a year.

Based on these debt service capacity figures and a 10 to 12 percent annual interest rate on 20-year financing (a reasonable rate for low-risk debt in the South African capital market), total municipal debt capacity could be expected to be between R 38 billion and R 85 billion—two to four times the current outstanding debt of South African municipalities in 2000. If municipal budgets continue to grow, debt service capacity also will grow. Naturally, much depends on assumptions about interest rates, the term of the debt, and the degree of leverage. Still, it is not unreasonable to conclude that the financial capacity of South African municipalities could support a municipal debt market around three times the current size.

Trends in Municipal Borrowing. Actual lending in the municipal sector, however, has fallen far short of the performance that these figures imply. Long-term private lending to South Africa's municipalities has been essentially flat for at least four years. National Treasury data, collected since 1997, show that municipal debt owed to the private sector generally remained between R 11 billion and R 12 billion during 1997–2000. At the same time debt owed to public sector institutions, including the Development Bank of Southern Africa, grew significantly, from R 5.6 billion to R 8.1 billion (figure 18.1).

This increasing reliance on public sector lending to municipalities is worrisome given South Africa's goal of expanding private investment. The



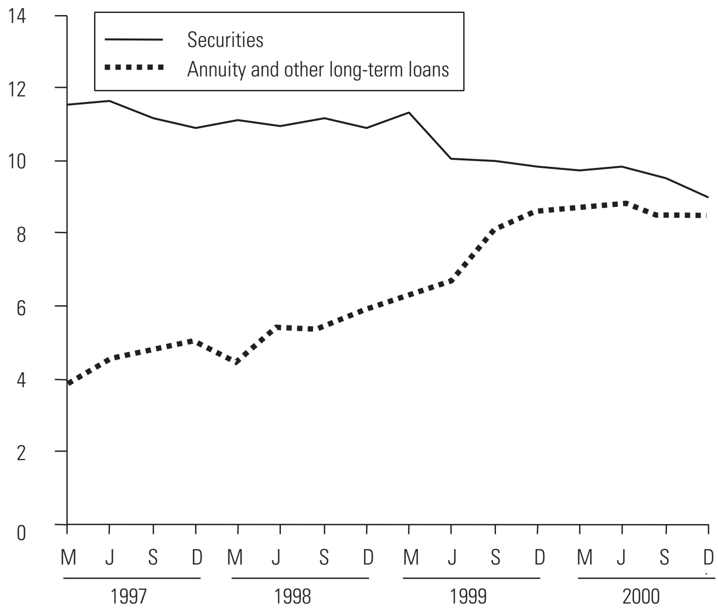
Source: South African National Treasury.

Figure 18.1 Outstanding Municipal Debt, South Africa, 1997-2000 (billions of rand)

Development Bank of Southern Africa accounted for more than 30 percent of outstanding municipal debt by the end of 2000, a share that had nearly doubled since 1997. Most of its portfolio is with large, relatively robust metropolitan municipalities. Several of these municipalities have reported recent price competition by the Development Bank for their borrowing needs in cases where private lenders have been ready and willing to lend. In the short term, having a discount lender willing to "beat any price in town" because of historical or current advantages conferred on it by the state (such as a lower cost of capital) is advantageous for municipal borrowers. In the long term, however, this will undermine the development of private lending. Private lenders will have no incentive to spend time considering a potential loan if they are consistently undercut by a government-owned lender.

Most new private lending since 1997/98 originated through a single specialized entity, the Infrastructure Corporation of Africa. The company's appetite for debt, through originating new loans and acquiring existing debt, has helped offset the exit from the market by other actors, and its market share has grown even faster than that of the Development Bank of Southern Africa. Like the bank, the Infrastructure Corporation of Africa extends most of its municipal loans to large metropolitan municipalities. Together, the two institutions now account for about half of all outstanding municipal debt. Insurance companies have sold most of their municipal debt holdings, and pension funds have cut theirs significantly. This increasing concentration of municipal debt stock in the hands of a few lenders does not bode well for the South African government's goal of "a vibrant and innovative primary and secondary market for short- and long-term municipal debt" (South Africa 1998).

Another undesirable trend is the changing nature of the debt stock. Municipal securities, which are (at least potentially) freely tradable on South Africa's capital markets, have steadily declined, while loans, which are less mobile and generally remain in the originator's portfolio, have increased markedly (figure 18.2). Because securities can be traded, term risk is lessened where there is a market for the bondholder to sell the bond if neces-



Source: South African National Treasury.

Figure 18.2 Outstanding Municipal Debt by Form, South Africa, 1997–2000 (billions of rand)

sary. This liquidity brings more potential investors into the picture, which is highly desirable in South Africa.

The shift to loans can be attributed to two main factors. First, the reliable and public accounting, budgeting, and financial information that investors and rating agencies need is not readily available for most municipalities. Thus investors' due diligence requires analysis and often proprietary recasting of municipal financial statements. That leads to high transaction costs in originating loans and transferring them among investors. This situation favors large, specialized investors with experience lending to municipalities over casual investors that otherwise might be willing to buy a relatively small amount of rated municipal debt as part of their portfolios.[8]

Second, there is a lack of clear remedies in a municipal default, and some institutional investors have dealt with this legal gap by structuring highly secured loans that are specific to the originating institution.[9] Some of these specialized structures could be securitized, but the excess of capital supply over municipal demand means that there is little incentive to go to the effort.

Assessment

This discussion raises an obvious question: Why has such a large discrepancy arisen between the potential size of the municipal debt market and actual lending activity? If there is so much scope for additional borrowing, why has it not happened? Four main factors appear to be responsible.

Local Government Reform

Local government in South Africa has been subjected to continuous reform since 1994, a process that has involved all key parts of the sector—institutional, fiscal, and organizational. Two aspects of this reform have affected municipal lending activity. First, the process of change has created a great deal of uncertainty for investors, discouraging exposure to municipal risk. Second, some of the reforms themselves, such as those related to boundary demarcation, have adversely affected the structural basis of many municipalities' financial positions (depressing ratios of revenue to population, for example), reducing their credit capacity. While the effects have been relatively minor for large metropolitan areas, they have been significant for many secondary cities and towns, which previously had been viable credit risks and which, after the metropolitan municipalities, represented the largest sector of the market for municipal credit.

Thus both the fact of continuous reform and the nature of that reform have curbed lending. That is not to argue against such reforms. However, it does suggest that the impact of the reform and the length of the process can have long-lasting adverse effects on the ability of local governments to finance and deliver much-needed infrastructure and that such reform should be carefully assessed and guided in light of these effects.

Budgetary Performance and Financial Management

A combination of poor budgetary performance and weak financial management has undermined the creditworthiness of a significant number of local authorities in South Africa. Some local governments are well managed and pursue disciplined fiscal policies. However, these tend to be the exceptions, and poor fiscal management and discipline are common throughout the municipal sector, even in the larger urban centers. Johannesburg, for example, ran into major financial difficulties in the second half of the 1990s, though its performance has since improved considerably. Many municipalities run budget deficits—while disguising them with formal budgets that unrealistically inflate revenues to achieve budget "balance" as required by law. Most municipalities have limited human resources and systems capacity and a flawed municipal accounting system that undermines their ability to provide financial data that investors can regard with confidence.

Legal and Regulatory Framework for Municipal Borrowing

South Africa still has not enacted a sound, comprehensive legal and regulatory framework for municipal borrowing. Uncertainties relating to processes and the rights and recourses of borrowers and lenders in the municipal sector remain, discouraging lending. For example, because rich, white local authorities rarely defaulted on debts under the apartheid regime, and because municipal debts were viewed as guaranteed by the national and provincial governments, South Africa's law on remedies in the event of municipal defaults is underdeveloped. This has led to prolonged uncertainty and ineffective remedies in some recent municipal financial crises. Work initiated in 1998 to develop a comprehensive municipal borrowing framework resulted in a "best-practice" policy framework and draft legislation promulgated by the Cabinet in mid-2000. Constitutional and political difficulties, however, halted the progress of this legislation, and by early 2003 it still had not been enacted.

Activities of Public Sector Lenders

The Development Bank of Southern Africa has advantages over private lenders as a result of its connection to the government and its ability to compete directly with these institutions for municipal clients. These advantages have led to complaints that the bank is "squeezing out" such players from the market and thereby suppressing the development of private activity in the sector.

Challenges

Beyond the four factors discussed in the previous section, others also may have played some part in stifling the development of the municipal debt market in South Africa, such as high real interest rates and poor capital planning by local authorities. In early 2003 there were several reasons to hope that South African municipalities' access to private credit could improve in the short to medium term:

- The December 2000 demarcations resolved long-pending amalgamation and boundary questions. The division of functions between local and district municipalities still needs to be clarified if they are to access capital markets autonomously. However, for metropolitan municipalities (and for local and district municipalities willing to cooperate on debt issues), the chronic uncertainty relating to boundaries is over.
- The December 2000 municipal elections put municipal councils in place for five-year terms. This placed councils in an excellent strategic position to assess their infrastructure needs and debt capacity and plan for the responsible use of debt as part of their strategies for service delivery and economic development.
- South Africa's National Treasury has begun providing three-year indicative allocations for most intergovernmental transfer programs. For municipalities that cannot rely on own-source revenues from taxes and tariffs, predictability in intergovernmental transfers is key. Clear indications of future transfers could enable these municipalities to access credit at whatever scale fits their capital needs.
- A November 2001 constitutional amendment empowers municipal councils to make legally binding commitments relating to future budgets and revenues that will secure debt. Before this amendment,

the weight of legal opinion was that a municipal council could not make such binding commitments, a restriction that would clearly limit investors' willingness to invest in long-term municipal debt.

- Legislation to give effect to the government's policy framework on municipal borrowing, including in the event of municipal default, is included in the Municipal Finance Management Bill, which was approved by South Africa's Cabinet in 2001 and was due to be enacted in 2003.

All these factors point to a potential for significant expansion of South Africa's municipal debt market. Three main challenges must be addressed if this is to occur.

Finalizing the Legal Framework

South Africa's government set out a clear vision for a legal framework for municipal borrowing in its 1998 *White Paper on Local Government* and its 2000 *Policy Framework for Municipal Borrowing and Financial Emergencies*, but not all the policies described in these documents have been enacted into law. The most important legislation is the Municipal Finance Management Bill. This bill has three key parts:

- *Finance management.* The bill regulates the budgeting, accounting, and financial reporting of local governments, requiring clear and consistently formatted information about municipalities' financial condition. This information should facilitate municipal borrowing by enabling lenders, rating agencies, and other players to make investment decisions more quickly and efficiently.
- *Borrowing.* The bill regulates short- and long-term municipal borrowing, implementing the elements of the government's policy framework that relate to borrowing. Key provisions of the bill limit short-term borrowing to cash flow management within the financial year; limit long-term borrowing to financing property, plant, and equipment; and allow municipal councils, under certain conditions, to pledge assets and future revenue streams to secure debt. A constitutional amendment paving the way for these security provisions was adopted by Parliament in November 2001.
- *Financial emergencies.* The bill creates a process, including an agency within the National Treasury, to deal with municipalities in financial crisis, implementing the financial emergency provisions of the policy

framework. The goal is to restore a municipality to financial health as soon as possible while balancing the interests of citizens, the municipal council, creditors, and other stakeholders. It remains to be seen whether the provisions of the bill, once enacted, will provide a framework that is sufficiently robust and efficient to build investor confidence in municipal debt.

In addition to enacting the Municipal Finance Management Bill, a few other loose ends need to be taken care of if South Africa is to create a legislative framework that enables municipalities to freely access private credit. These include the following:

- Drafting disclosure regulations and providing mechanisms for disseminating information. If active trading in municipal securities is to occur, potential buyers of municipal bonds must have ready access to reliable information that is material to investment decisions.
- Clarifying the ability of municipalities to commit to future tariffs or to tariff setting mechanisms. The recent constitutional amendment may help, but uncertainties remain. The tariff capping provisions of the Water Services Act and Municipal Systems Act that are troublesome to private equity investors are of concern to debt investors.
- Clarifying the powers and functions of local and district municipalities in a way that limits the potential for future uncertainty and change.
- Reviewing old legislation for inconsistency with policy and revising it where necessary.[10]

Strengthening Local Government Capacity and the Budget Culture

Some South African municipalities prepare and use capital and operating budgets and financial reports. Only a few, however, have developed comprehensive capital investment programs that address their needs since the December 2000 amalgamations. These basic planning and accounting processes should be in place before a municipality goes to the capital markets, because any municipality considering infrastructure borrowing should be in a position to understand how debt service and operational expenses for infrastructure will affect its budget. The municipality must be able to realistically project the revenue from the new investment. To achieve efficiencies and plan strategically, the municipality should be able to analyze different infrastructure options and financing scenarios. Municipalities that lack these skills are not equipped to make the best decisions for their community. Both municipal councilors and managers need these skills, though at different levels of detail. A council that can ask the right questions is more likely to get the information it needs to make good decisions.

The December 2000 amalgamations exacerbated the effects of the lack of financial experience and capacity in some municipalities. This round of urban-rural consolidation blended an average of three municipalities and significant unincorporated territory into one new local municipality. This change meant that the new municipalities would have to consolidate financial information of varying quality from several sources, a process that could take a year or more. Even then it would be several years before municipalities or potential investors could discern trends in revenues or expenses. Ultimately, municipalities that want to borrow at reasonable rates, and have a choice of investors, must be able to produce a reliable record of financial performance.

The amalgamations also pose a challenge in identifying capital needs. Most municipalities include newly incorporated areas whose infrastructure needs must be considered systematically as well as previously incorporated areas whose needs must be reprioritized in the context of the new municipality. South Africa's Municipal Systems Act requires municipalities to develop integrated development plans that include capital plans. However, many municipalities have not yet completed integrated development plans; among the plans that have been developed, not all are of high quality or represent a true community consensus on needs and priorities.

Another concern is the "culture of nonpayment" in some parts of South Africa, a legacy of resistance from the apartheid era. In a few municipalities council members have encouraged citizens not to pay their tariffs and taxes. In many more, council members have failed to take the lead in helping citizens understand the need to pay for services. The practice of budgeting realistically and spending within the limits of available resources must become embedded in both the political and the management cultures of local government in South Africa.

Many of South Africa's municipalities need sustained technical assistance, training, and experience to identify their capital needs and financing options and to effectively articulate their need for credit. To borrow wisely and efficiently and to be able to pay their debts when due, municipalities in South Africa, like those everywhere, must have strong skills in the following areas:

- Budgeting and accounting.
- Identifying, analyzing, and prioritizing community needs.
- Planning an appropriate mix and sequence of projects and funding options.
- Developing specifications suitable for competitive procurement of construction and financing.
- Managing procurement issues.
- Managing projects during and after construction.
- Marketing the municipality, its projects, and its debt instruments to investors.
- Legal drafting and negotiation.

Developing these skills will take time and effort, but the payoff will be good government, well-chosen projects, and appropriate financing. Shortcuts could result in poor projects, expensive financing, and little support in local communities or the country as a whole for further municipal borrowing.

Foreign and domestic development agencies seeking to make a sustainable contribution to South Africa's municipalities would do well to consider mentoring and support to develop these basic skills. South Africa's National Treasury has launched a pilot program that is bringing experienced municipal finance managers from other countries to work with their South African colleagues. These managers will stay for one to two years, helping to get newly amalgamated municipalities' budgets and accounts in order and into compliance with the reporting requirements of the Municipal Finance Management Bill. This kind of ground-level support and capacity building is essential for financially healthy municipalities, for sound, information-based local policy decisions, and for wise borrowing.

Facing South Africa's Ambivalence about Markets

These challenges—dealing with imperfections in the legal framework and building municipal capacity—will be familiar to anyone who has worked on municipal debt policy anywhere. A more difficult issue needing to be addressed in South Africa is the society's ambivalence about the market-oriented policies being pursued. This ambivalence mirrors, and is reinforced by, global debates about economic integration and deregulation.

South Africans have mixed feelings about their private financial institutions. Many are proud of their "first-world" capabilities. The South African economy boasts well-functioning stock and bond markets, commercial and investment banks, insurance companies, rating agencies, and regulatory bodies. Many others, however, see these institutions, which developed under an oppressive regime, as instruments and beneficiaries of that repression. A deep-seated mistrust of capitalism and resentment of the role that some capitalists played in the apartheid era persist in some quarters. This history has made it difficult for many South Africans to embrace market-oriented financial institutions.[11]

Although government policy endorses the need to attract private finance, there is little confidence that the private sector will come to the table.[12] There are concerns that private lending to subnational governments will develop slowly or not at all, even if the correct policies are put into place and the necessary capacity built. Moreover, there are concerns that even if markets provide finance for large and financially secure municipalities, small and poor municipalities will be left out.

These concerns have had several consequences. First, they have made it difficult for the government to push the necessary legislation and constitutional amendments through Parliament as quickly as had been hoped. Second, concerns about the reliability of financial markets have led some in government to consider various forms of artificial stimulus for subnational borrowing, including national government guarantees and debt insurance sponsored by the Development Bank of Southern Africa. Third, there is some support within the South African government for nonmarket approaches to subnational debt—such as government on-lending—especially for provincial governments (there is presently no provincial borrowing in South Africa, which is effectively prohibited).

These nonmarket approaches would probably prove problematic in execution. With both direct government lending and guarantees, there will inevitably be defaults, imposing future costs on the national government. These contingent costs are difficult to predict and quantify. Governments throughout the world have a poor record of managing loans to subnational borrowers—the rate of default on government or government-guaranteed loans usually exceeds that on commercial loans to the same entities. Another concern is that shifting private investors' focus from the creditworthiness of the borrower or the project to the creditworthiness of the national government will result in loans being made to subnational governments that cannot afford them, increasing their financial stress. These cures for market imperfections could easily be worse than the disease.

South Africa's ambivalence about markets, while understandable given the country's history, must be overcome if its municipalities are to attract private investment. Choosing the route of relying on capital markets would mean that the focus would have to be on improving the framework, skills, and information that those markets need to function effectively. Maintaining this focus will be more difficult than taking shortcuts such as guarantees, but it will be a more sustainable and strategic choice.

Notes

1. Municipal Systems Act, No. 32 of 2000. See especially subsection 74(2).

2. A draft Property Rates Bill was published for comment in August 2000 and is likely to be adopted in 2003.

3. These transfers must be both well targeted and predictable. But there can be a tension between these two goals. As new information becomes available that would help improve targeting, the equity of adjusting targeting must be weighed against the need to ensure that commitments can be met for infrastructure that has been begun or financed in good faith.

4. With some minor exceptions, municipalities in South Africa are not responsible for social services (such as health and education), which are provided by provinces, or for policing, which is a national function.

5. The 1996 Municipal Infrastructure Investment Framework estimated the basic need at R 38.5 billion and the full service need at R 75 billion.

6. In some cases politicians and activists have actively discouraged residents from paying utility bills, and councils have been reluctant to cut off service to enforce payment. In Fort Beaufort the municipality sued to void the concession agreement and was successful in setting aside the contract.

7. The Water Services Act provides that the minister for water affairs and forestry can regulate municipal tariffs for water services. The Municipal Systems Act provides similar authority to the minister for provincial and local government with respect to all municipal services. The potential for such regulations to interfere with negotiated arrangements between a municipality and a concessionaire limits investor interest in revenue-based public-private partnerships in South Africa.

8. The apartheid-era local authorities that issued the now-disappearing securities did not necessarily have good-quality financial information either. However, with their financial strength and implicit national and provincial support, their bonds were seen as safe investments for individuals and institutions.

9. Examples include tax-structured transactions in which a financial institution benefits from depreciation on municipal assets; pledges by munic-

ipalities to banks of property tax revenues derived from the banks' own property; and deposits by municipalities with financial institutions that, with interest, equal the principal amount of the loan at maturity, protecting investors' principal.

10. Buried legislation creates an entry barrier, at least to the uninitiated. Recently a financial institution that had not previously lent to South African municipalities negotiated a loan with one of the country's biggest cities. The lender commissioned a South African law firm to review the applicable legislation. The firm found a Transvaal ordinance from 1903 and an unused exchange control regulation that required National Treasury approval of the proposed loan. Existing lenders to the municipality, either unaware of or unconcerned by these laws, had never asked for Treasury approval, and Treasury did not want to be in a position of approving—and perhaps implicitly endorsing—local borrowing decisions.

11. Investors from such countries as the United Kingdom and the United States are not necessarily viewed more favorably. While it is accepted that foreign investors found the stigma of white racism unappealing, they are nevertheless seen as benefiting from the perceived stability and low labor costs of that era, and their investments in South Africa as propping up the apartheid regime.

12. In an interesting contrast, in Eastern Europe and the former Soviet Union a broad perception that communism had failed left the typical person willing to accept more market-oriented solutions. In South Africa capitalism was seen as part of the problem, and the expected coming of democracy was often linked to diminution of the power of capitalists.