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Municipal Borrowing for Infrastructure Service Delivery in South Africa – a Critical Review

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Municipal Borrowing for Infrastructure Service Delivery in South Africa – a Critical Review

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Preface

South Africa is a fascinating country to visit. It is blessed with natural beauty and rich cultural diversity. We experienced Braai under the great blue African sky, classic African food in one of those new – posh – restaurants in Soweto, a theatre-play in downtown Joburg, and different music styles in melting clubs. At the same time, you cannot escape the troubled past of the country and the challenges it is facing today. Admittedly, the tensions in the South African society can be frightening for a European from time to time.

In such a complex situation, it is important to have partners and friends. During our field study in South Africa from mid-February to the end of April 2007 we were supported by a lot of people. We are particularly grateful to Barry M. Jackson from the Development Bank of Southern Africa (DBSA) and to Ben Pretorius from the Infrastructure Finance Corporation (INCA). Both are old stagers in the municipal borrowing market and have been more than willing to share their immense knowledge with us. Additionally, they provided us with background information on South Africa, with a lot of logistic help and – last but not least – proved that South Africans are rightly famous for their hospitality.

Of course, we would like to thank all our interview partners in Germany and in South Africa for their willingness to contribute to the study. A special thank goes to the whole INCA team who kindly offered us office space. Moreover, they set up most of our meetings with municipalities. Without them, our research would not have been that fruitful and inspiring.

This study is an independent research of the German Development Institute. It was carried out by a research team with the support of the DBSA and INCA, the two main financial institutions in the South African municipal borrowing market. Both institutions helped organize the empirical research in South Africa and gave valuable input for this study. However, they did not unduly influence any results of the study and were open to discuss even the more controversial findings. We thank DBSA and INCA for this openness. Consequently, the authors alone are responsible for all the contents and shortcomings of the study.

Klaus Liebig Bonn, January 2008

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Abbreviations

ABSA	Amalgamated Banks of South Africa
AFD	Agence Française de Developement
ANC	African National Congress
BEE	Black Economic Empowerment
BESA	Bond Exchange of South Africa
DBSA	Development Bank of Southern Africa
DPLG	Department of Provincial and Local Government
EDI	Electricity Distribution Industry Holdings
EIB	European Investment Bank
ESAs	External Support Agencies
FNB	First National Bank
FSC	Financial Sector Charter
GAMAP	Generally Accepted Municipal Accounting Practices
GDP	Gross domestic product
GRAP	Generally Recognized Accounting Practice
GTZ	Gesellschaft für technische Zusammenarbeit
IDASA	Institute for Democracy in South Africa
IDP	Integrated Development Plan
IFC	International Finance Cooperation
INCA	Infrastructure Finance Corporation
KfW	Kreditanstalt für Wiederaufbau
LDCs	Least Developed Countries
MDGs	Millennium Development Goals
MFMA	Municipal Finance Management Act
MICs	Middle Income Countries
MIG	Municipal Infrastructure Grant
NGO	Non-governmental Organization
REDs	Regional Electricity Distributors
RMB	Rand Merchant Bank
RSC	Regional Service Council
UNDP	United Nations Development Programme

USAID	United States Agency for International Development
USD	United States dollar
ZAR	South African rand

Executive summary

Background

1. **The increasing importance of sub-national borrowing for infrastructure service delivery results from three factors: decentralization trends throughout the world, the importance of infrastructure for development, and a financing gap in infrastructure investments.**

Led by efficiency and democratization reasons, many countries throughout the world have been decentralizing responsibilities for infrastructure provision from the national state to lower spheres of government during the last two decades. In many countries it is now local governments that are responsible to deliver essential infrastructure services such as water, electricity, roads, sewerage, and sanitation. It is widely acknowledged in development literature that providing sound infrastructure is crucial not only for enhancing growth, but also for directly reducing poverty. Investments in infrastructure are therefore crucial to spur development. Infrastructure spending in developing countries, however, is far below what is needed, and most developing countries experience severe infrastructure backlogs. In this context, sub-national borrowing can be an important means to finance more infrastructure spending today, which could help escape the poverty trap. Crucial in this respect, however, are functioning and liquid local capital markets and sound financial institutions that are able to channel local savings to the respective investments.

2. **The situation in South Africa, marked by a decentralized system, huge infrastructure backlogs and a strong and liquid financial sector, makes sub-national borrowing in South Africa an urgent, but also a viable option. Additionally, South Africa has a rather long tradition of municipal borrowing, and it has been put on the political agenda to reanimate municipal borrowing which dried up due to the transition process.**

Local government in South Africa plays a significant role in providing infrastructure, being responsible for the provision of essential infrastructure services such as water, electricity, sanitation, roads, and sewerage. Essential financing means and powers, on the one hand through inter-

governmental transfers and on the other hand through significant own source revenues such as user charges and property tax, generally make South African municipalities sufficiently independent and financially viable, although this strongly differs within the municipal landscape. Nevertheless, infrastructure backlogs throughout the country, especially in formerly neglected areas, are still enormous, indicating the necessity to increase infrastructure spending. The Development Bank of Southern Africa (DBSA) estimates that the total cost of providing all South Africans with basic services amounts to an additional 57 billion rand (equals roughly 5.7 billion €) for the period from 2005 to 2014. The current macro-economic situation, with annual growth rates at about 5 % of GDP, together with a good financial sector performance, create a favorable environment for increasing infrastructure investments in the coming years. Additionally, municipal borrowing is no new phenomenon in South Africa, as during the Apartheid era it was common for local governments to access capital markets to finance their investments. This, of course, had been restricted to the former privileged white areas that could achieve high standards in infrastructure provision. Due to the transition process, municipal borrowing, however, had largely dried up. It is now on the political agenda to foster and reanimate municipal borrowing for financing municipal infrastructure service delivery.

Impact of municipal borrowing in South Africa

3. **Municipal borrowing has positive effects on infrastructure provision in South Africa. Through borrowing, more capital is available to municipalities today, albeit the allocation of debt capital is still concentrated on a few municipalities. This capital is channeled into diverse infrastructure sectors, at least partly also into backlog reducing projects. However, we did not find evidence that debt financing improves the implementation of single infrastructure projects.**

In 2006, municipalities in total had an outstanding debt in the amount of around 18 billion rand, which helped finance additional capital expenditure. This debt capital, however, is not evenly distributed across all municipalities, but concentrates on the metros (six biggest cities of South Africa) and some secondary cities. As a consequence, debt capital

addresses the infrastructure needs of citizens to a very different degree. There is no uniform trend concerning the allocation of debt capital into different infrastructure sectors. Most municipalities mention water, roads and electricity, but debt capital is also used to finance fleet and municipal buildings. As loans are mostly given as general obligation, lenders do not influence the choice of projects as much as municipalities do. Given the strong political focus municipalities have on reducing infrastructure backlogs, this might indicate that borrowing not only finances growth-enhancing infrastructure, but also backlog-reducing infrastructure, albeit this point should not be overemphasized. For instance, 95 % of municipal borrowing flows to capital budgets of municipalities that need to cover an estimated 64 % of the infrastructure backlog costs. This relation between municipalities that borrow and those that need to address the backlog could be a lot worse. Finally, we find that debt financed projects are not implemented in a different way compared to projects with other funding sources in terms of cost-efficiency, faster implementation and maintenance provisions. This contradicts conventional theory, which states that debt financed projects are likely to be implemented more efficiently due to the need to repay the borrowed capital. The main reason behind this missing link is that, as mentioned above, loans to municipalities in South Africa are mostly given for general obligation, and are not project specific.

4. **Municipal borrowing in South Africa also impacts local governance in terms of transparency, accountability and financial management positively. This, in turn, we assume to result in a more efficient and needs-oriented use of resources and therefore in improved infrastructure service delivery.**

The underlying rationale of this impact is that the exposure of local governments to capital markets requires municipalities to be transparent and leads to lenders exerting a certain control function on local government finances. This link is established through four processes: External assessments such as ratings, the tender process, reporting and monitoring, and “sitting together”.

About 25 municipalities in South Africa at present already have an external rating. These ratings are publicly available and thereby increase transparency. A rating sheds light on aspects such as municipalities’

financial position and its quality of management, and can also serve as a benchmark and incentive for a municipality to improve its financials and management. The tender processes for taking up loans in South Africa additionally guarantee a high level of transparency. Moreover, even if reporting requirements for taking up a loan are comparable to those of grants, banks (as recipients of these reports) exert an additional, and often more timely and comprehensive monitoring of municipalities than government is able to do. Lastly, many municipalities "sit together" with their lenders on a regular basis, discussing financials and planned investments. Through this interaction a learning process takes place, which impacts municipalities' financial management capacity.

Prerequisites

5. **The regulatory framework as first prerequisite for sub-national borrowing is well designed in South Africa, and facilitates sub-national borrowing by encouraging actors to borrow or lend for infrastructure, by imposing rules that give municipalities clear guidance and provide lenders with predictability, clarity and confidence, and by regulating potential crises and preventing those as far as possible.**

South African lawmakers have successfully diminished some of the previously perceived uncertainties by introducing a set of regulations of which the centerpiece is the Municipal Finance and Management Act (MFMA), which was implemented in 2004. Important is that the rules make sure, not only in theory but also in practice, that borrowed capital is actually used for infrastructure investments only, as long-term debt can only be raised to finance capital expenditure and not to finance current expenses. Additionally, several regulations on budgeting, accounting, reporting, and supply chain management impose discipline on municipalities and lead to greater transparency. However, on the other side of the coin these requirements also lead to a lot of workload in municipalities' administrations, under which municipalities suffer and are sometimes not able to comply with. Especially by a clear distribution of responsibilities between single decision makers and the imposition of rules for financial emergencies and insolvency, the framework increases clarity, certainty and predictability. One of the most striking regulations in this context is

the explicit abolition of national state guarantees for sub-national debt, increasing municipalities' responsibility and self-reliance. However, perceptions of implicit guarantees and bail-out expectations are still widespread, especially for metros and larger municipalities. As the rules for municipal insolvency have not been applied yet, it is not fully clear what will really happen in the event of municipal default.

6. **The second prerequisite for a functioning sub-national borrowing market, the demand side, is characterized by a high level of diversity in South Africa. On the one hand, some very creditworthy municipalities borrow on a regular basis, and on the other hand many municipalities do not have access to debt capital at all. The main bottlenecks for broadening the municipal borrowing market on the demand side are capacity constraints, poor tariff collection, insecurity and lack of predictability over future functions and revenues, and a "conservative" borrowing attitude within some municipalities.**

The metros in South Africa not only account for the bulk of municipal borrowing in absolute terms, but on average also have a higher debt per capita ratio. They generally have a more diversified economic base, attract better staff and require higher loan volumes, thereby being more attractive to lenders. Additionally, metros seem to benefit from an implicit bail-out expectation, as mentioned above, as they are perceived to be "too big to fail". However, the size of municipalities is not the main influencing factor for an engagement with borrowing, as there are also some smaller municipalities that in fact finance a substantial amount of their capital expenditure through borrowing. The main bottleneck for municipal borrowing is the lack of both financial management and technical/project implementation capacity within municipalities. Additionally, poor tariff collection weakens the revenue base of many municipalities, which negatively affects borrowing as municipalities do not raise sufficient revenue from the infrastructure rendered to bear the costs of a loan. Moreover, a trend to re-centralize responsibilities (especially electricity through the implementation of Regional Electricity Distributors, REDs) leads to insecurity over future functions and revenues of municipalities. This again constitutes a disincentive for engaging in long term borrowing. Lastly, in some municipalities prevails a rather "conservative" attitude

towards borrowing, where decision makers do not want to shift the burden of repayment to future generations and prefer a pay-as-you-go approach to service delivery.

7. On the supply side as third prerequisite, there is little potential to expand the municipal bond market in the near to medium future, despite the success of the Johannesburg bond emissions. The reason is that most municipalities neither see the need nor the viability of issuing bonds.

After 1994, the municipal bond market in South Africa broke down due to the uncertainties of the transition process. National Treasury (and some external support agencies) would like to see a quick rehabilitation of the bond market, as they expect positive effects on transparency and accountability. Johannesburg's first bond emission under the new system in 2004 was widely praised both nationally and internationally, animating a vivid debate on municipal bonds for development financing in emerging economies. However, other municipalities in South Africa are hesitant to follow this example. The main reason for this is that bonds at present are not economic compared to loans, as bank lending rates are very low because of high competition and liquidity in the banking sector. Additionally, for most municipalities upfront and fixed costs of a bond emission are too high and do not pay off especially for smaller municipalities, which require only small volumes. Lastly, municipalities are deterred of bonds due to the difficult administration that requires a high financial capacity that many municipalities do not have. If government wants the municipal bond market to expand, more innovative approaches as e.g. bond pooling will have to be considered.

8. The interplay of public and private lending institutions is problematic on the supply side. Theory suggests that a market should be driven by private lenders, and that public lenders should complement them when necessary. We find, however, that public lenders in South Africa (the DBSA and external support agencies) at present rather than complementing private lending are competing with the private sector.

The municipal lending market is still dominated by the DBSA that holds about half of total outstanding municipal debt. Within private lending, the

Infrastructure Finance Corporation of South Africa (INCA) is the most relevant player, holding about 21 % of outstanding municipal debt. INCA is an innovative, and rather unique financial institution, as it concentrates its lending activities on municipalities, but still is fully privately owned. Also, private banks have been entering the market in the last years, mainly due to the Financial Sector Charter (FSC), that requests banks to invest in municipal infrastructure. Tensions derive from the fact that both public and private lenders target the same municipalities: metros and further top rated municipalities, as these are the most creditworthy and profitable ones. Most private lenders complain about "unfair" price competition by the DBSA in this market segment, winning most of the tenders it competes in. In fact, 64 % of DBSA's portfolio goes into the metros, instead of targeting second tier, less creditworthy municipalities that do not have access to private capital. The main problem is that the DBSA, although being a public bank with a developmental mission, still has to be self-sustaining. This means it has to earn yields in the top municipalities to afford giving subsidized loans to lower capacity municipalities. To create a sustainable municipal debt market with complementary public and private institutions it is therefore of pressing importance that the national government reformulates the field of activity for public lenders. The same problem can be observed in the activity of most external support agencies active in sub-national lending in South Africa, as they also concentrate on the metropolitan sector. As their market share is negligible, however, they are not in the focus of the critique from the private sector.

Lessons learned

9. **Sub-national borrowing has a positive impact on infrastructure service delivery in South Africa. If several shortcomings concerning the regulatory framework, the demand-side and the supply-side of the borrowing market are addressed, there is room for expanding municipal borrowing in the country.**

Concerning the regulatory framework, we recommend strengthening the cooperative system by making sure that all spheres of government are able to effectively carry out their respective control functions. Additionally, we suggest thinking about reducing reporting requirements for municipalities in the medium term – once transparency is more established.

Moreover, tender regulations for borrowing should be clarified. Lastly, as to the prevailing bailout expectations, national government should think thoroughly what precedent to set when the first severe financial crisis in a municipality occurs. On the demand side, the prevailing bottlenecks for borrowing have to be addressed by increasing capacity building at the municipal level, assisting municipalities in improving their tariff collection, and reducing the insecurity on future functions and revenues by giving a transparent outline on the compensation for potential revenue losses in the wake of the REDs. Concerning the supply side of the borrowing market, if bond usage is to be expanded, innovative instruments such as bond pooling, retail bonds and revenue bonds should be considered. The public-private interplay has to be improved, and the DBSA should refocus its lending activities away from the top municipalities. This could be supported by government subsidizing the DBSA for high risk loans.

10. Although South Africa is unique in many ways, some conclusions can be drawn for other developing – and especially middle income – countries that want to engage in sub-national borrowing or to expand municipal borrowing activities.

Most importantly, it is fundamental to build up confidence for investors, which can be supported by a stable political environment and mechanisms in place that deal with financial crises. Further, limiting long-term debt to capital investment has proven very successful in South Africa, and is crucial for setting up a functioning sub-national borrowing market. Moreover, it is necessary to ensure creditworthiness of municipalities and to impose rules that create discipline regarding financial management of municipalities. Another focus should be the role of public banks and external support agencies, ensuring that they cooperate closely with domestic private banks in order to transfer know-how and support the domestic capital market development.

11. External support agencies that are increasingly engaging in lending to sub-national spheres of government directly should make sure to bring their comparative advantages into the market and at the same time enable the private sector to fulfill its role.

Crucial in this context is that external support agencies (ESAs) do not crowd out private lenders. To avoid crowding-out private capital, ESAs

should offer sub-national finance at market rates, avoid free grant elements in top municipalities, and take the currency risk by lending in local currency. They should push innovative ways of enhancing private credits in less creditworthy municipalities and target at broadening the market. Additionally, ESAs have to assure knowledge transfer to private financial institutions. The focus should be to provide capacity building and institutional know-how, not financial capital, as this is crucial for local capital markets to become sustainable and self-reliant.

1 Introduction

As a result of decentralization policies in many countries throughout the world, sub-national spheres of governments face increasing responsibilities for infrastructure service delivery. In this context, a controversial international debate has emerged, whether to allow sub-national governments to borrow in order to finance part of their infrastructure and to what extent.

Skeptics argue that sub-national borrowing bears a high risk of over-borrowing, leading eventually to macroeconomic instability. For proponents, independent access of sub-national governments to capital markets is a logical further step of decentralization. This further step would have manifold potential advantages: Sub-national governments have more capital available today to address infrastructure needs and can distribute the financing burden on the shoulders of more than one generation. Sub-national entities would be fully responsible for their service delivery and would be held accountable by their constituency and lenders.

Based on these grounds, at least 25 developing countries started to (re-) engage with sub-national borrowing. Those are mainly Middle Income Countries (MICs), such as South Africa, which have reached a certain degree of political and administrative decentralization, along with a level of development that allows sub-national entities to be economically viable.

1.1 The background to sub-national borrowing

Infrastructure is crucial for economic growth and spurs the achievement of the Millennium Development Goals (MDGs). Infrastructure services like electricity, roads, water, and sanitation are main drivers of economic activity. Social infrastructure, such as health and education, but also access to clean water and sanitation, lead to direct positive impacts on the quality of life and reduce mortality and morbidity. As many infrastructure services possess the characteristics of public goods – non-excludability and non-rivalry in consumption – the private sector alone will not sufficiently provide them. Some responsibility remains in the hands of the national state. Dissatisfied with the delivery of services through the national state, many countries decentralize responsibilities and powers to sub-national spheres of government. Decentralization is regarded as an important step towards a

democratic political system and more efficient service delivery. However, local governments frequently only get increased administrative or political responsibilities, but no fiscal autonomy. They spend a lot for infrastructure service delivery, but still depend on the discretion of the central state to transfer sufficient resources to them. This regularly creates a fiscal imbalance. Higher current own-source revenues together with the authority to borrow could be a sensible way to rebalance responsibilities and financial resources at the sub-national level.

External support agencies have supported decentralization policies, and they are consequently interested in engaging in sub-national borrowing markets. Cities and provincial governments, particularly in MICs, are in many cases creditworthy debtors. Due to urbanization, these entities are economic core players that are decisive for economic and social development in their countries. Since some national governments gave up their restrictions on sub-national borrowing, ESAs have started adapting to this change. Some offer local currency loans without sovereign guarantees as pilot projects to sub-national entities. Most of them required a national state as borrower or at least a national state guarantee in the past. Today, some ESAs have already adapted their internal regulations to the new opportunities and abstain from national state guarantees; others are in the process of changing their regulations. This reflects the attractiveness of sub-national credit markets both from a business and a development policy point of view.

1.2 Research focus and methodology

Among MICs that engage in sub-national borrowing, South Africa is outstanding and a perfect case to examine: it looks back on a long tradition of borrowing on the sub-national level (albeit in the former privileged white areas only), it possesses highly liquid capital markets, a favorable macroeconomic situation and sophisticated financial institutions, the local government sphere has significant autonomy and responsibility, and there are needs for basic services as well as for growth-enhancing infrastructure. Thus, there is a situation in place that makes sub-national financing possible and that delivers a good environment for empirical research.

The research concentrates on municipal borrowing since South Africa's municipalities mainly engage in borrowing. Provincial borrowing is cur-

rently negligible and parastatal companies at the sub-national level do not yet play the same important role as in other countries. This might change in the future. The results of this study, however, can easily be generalized to other sub-national spheres of government.

From an analytical point of view, we distinguish between dimensions of prerequisites for the sub-national borrowing market and the impact that sub-national borrowing can have on infrastructure service delivery. The prerequisites are a regulatory framework for the municipal borrowing market, competitive lending institutions on the supply-side and creditworthy municipalities on the demand-side of the municipal borrowing market.

The South African specifics and the analytical framework bring forth two main questions:

> *Does the possibility to borrow on the municipal level lead to an improved infrastructure service delivery in South Africa? Under which conditions is municipal borrowing most likely to unfold its positive outcomes?*

To answer these questions, quantitative and qualitative data have been collected. We carried out empirical research in South Africa from February to April 2007 where we conducted 66 interviews with stakeholders in municipal borrowing. The sample includes 29 municipalities all across the country, private and public lenders, external support agencies, rating agencies, national and provincial ministries, academic experts, and one NGO. In addition, comprehensive quantitative data has been gathered which complements the qualitative data of the stakeholder interviews.

This study is targeted towards different groups of readers: first, it enhances the existing knowledge of the academic community by questioning some of the previous findings while generally supporting the reasoning behind sub-national borrowing; second, it aims at informing the South African stakeholders on the current state of the municipal borrowing market and on the crucial determinants for the future development of this market in South Africa; third, it gives policy recommendations for other countries, particularly MICs, fourth, it sheds light on the value-added that public lenders can provide and on the trade-offs they face in liquid capital markets.

1.3 Structure of the study

Chapter 2 begins with background information on the trend towards decentralization, the importance of infrastructure for development, and on financing infrastructure. At first it is presented from a theoretical point of view and then viewed from a South African perspective. Subsequently, Chapter 3 presents the analytical framework and the empirical approach used in this study to analyze the municipal borrowing market of South Africa.

First, we have a look at the impact borrowing has on infrastructure service delivery. Then we address the three prerequisites needed for municipal borrowing: the regulatory framework, the demand-side and the supply-side of the municipal borrowing market. Chapter 4 analyzes the impact on infrastructure service delivery, distinguishing between direct effects on service delivery, and indirect effects through improved local governance. Chapter 5 investigates the regulatory framework, the key regulations for the borrowing market, why they facilitate borrowing, how they regulate financial crises, and how they are implemented. Chapter 6 turns to the demand-side of the municipal borrowing market, examining the determinants for creditworthiness of municipalities and bottlenecks they face to expand borrowing. Finally, Chapter 7 scrutinizes the supply-side of the municipal borrowing market, looking at the prospects and the interplay between public and private lenders.

We close with lessons learned in Chapter 8, presenting policy recommendations for stakeholders in the South African municipal borrowing market, in sub-national borrowing markets in other countries, and in external support agencies. The Annex includes selected data of the sampled municipalities.

2 Background information on sub-national borrowing in South Africa

The need for discussing sub-national borrowing for infrastructure service delivery is due to three factors: The first factor is the trend to decentralize responsibilities for infrastructure service delivery away from the central government. The second factor is the importance of infrastructure for growth and development. And the third factor is the need to tap more

resources to finance development. This chapter starts by giving a theoretical overview on these factors (Section 2.1) and then proceeds to present the concerns of the South African decentralized system, infrastructure needs as well as the macroeconomic situation and financial sector (Section 2.2).

2.1 Theoretical background

The role of decentralization in infrastructure service delivery

Particularly during the last two decades, countries throughout the world have been decentralizing responsibilities for infrastructure delivery from the central state to lower spheres of government. The reason why many developing countries opted for reforms aiming at greater decentralization, is the principle of subsidiarity, according to which public authority should reside at the lowest level of political organization capable of using it effectively (IDASA 2006, 2). The following concentrates on the two major arguments in favor of decentralization: First, decentralization is associated with increased efficiency, as lower spheres of government are more likely to assess demand and to know peoples' priorities. Second, decentralization may lead to stronger democracy, as it makes local government more accountable for its actions (World Bank 2003; Ahmad et al. 2005).

Arguments related to **efficiency** advantages through decentralization in particular refer to higher consumer efficiency, competition, lower transaction costs and more efficient revenue rising. Consumer efficiency relates to the assumption that consumers' preferences differ within a country; and, therefore uniform levels of services in all municipalities are inefficient. In this sense, decentralized service delivery increases efficiency, as services can be provided according to local preferences. Second, vertical and horizontal competition between different government units can work as an incentive for cost-efficient service delivery, as competition restricts the possibility to endlessly increase taxes. Moreover, transaction costs may be significantly lower when services are provided locally, since local knowledge can be used and decisions can be implemented faster. Lastly, especially in developing countries a large portion of the economy falls outside the tax net. Since sub-national governments are more likely to have reliable information about the tax base, they might be able to capture more individuals for tax-paying.

Decentralization is also assumed to positively affect **democratization**, as it *"brings government closer to the people"* (Wittenberg 2003, 4). This line of argument comprises several related strands of discussion, including accountability, participation, checks and balances and a greater variety of choices. First, local government is more likely to be accountable to its constituency, since information flows are better in a geographically confined area, and people can more easily control whether local authorities consider their needs (Wittenberg 2003, 6). Second, decentralization can increase participation of the local population. This opportunity to become directly involved in government decision-making, in turn, may induce a culture of political debate and civic mindedness. This again may lead to a more aware and active citizenry more capable of enforcing their interest. Third, decentralization creates a system of "checks and balances" within government, as different spheres of government are interrelated and are likely to control each other. Lastly, decentralization widens the range of choices of citizens, as described in Tiebout's "voting by feet" model, according to which residents in a decentralized system have two options to choose from: They can vote for their favorite policies within their existing locality, or they can relocate to another locality, which offers them a better amenities-cost bundle.

The presumed positive effects of dispersing responsibility to lower spheres of government may be foiled, however, if inappropriate forms of decentralization are implemented (World Bank 2003). The matching principle of local finance emphasizes that the financial capacity of local governments should be aligned with the functional responsibilities delegated to them. Often, however, this principle is not met and local governments are assigned with increased responsibilities in providing services that are not accompanied with an accordant transfer of financing means or powers. Additionally, if local governments are too small, this might implicate efficiency losses due to decreasing economies-of-scale in service delivery. Lastly, especially in developing countries not all spheres of government have the same technical and administrative capacity. Often, central bureaucracies attract better talent while the quality of staff in local administrations is low. Hence, there is a trade-off between centralized and decentralized service delivery because, as Bird (1995) puts it "*information asymmetry works both ways: the central government may not know what*

to do and the local government may not know how *to do it*".[1] Ultimately, however, a well designed decentralization that is adapted to a country's specificities is likely to positively affect infrastructure service delivery.

Infrastructure and development

Infrastructure is crucial for economic growth in developing countries, and also plays an important role in reducing poverty and therefore spurring the achievement of the Millennium Development Goals (MDGs). Providing infrastructure services to meet the demands of businesses, households and other users is therefore one of the major challenges of economic development. It is both economic infrastructure such as electricity, roads, water and sanitation and social infrastructure such as health and education that contribute to this development. The impact of infrastructure on development is realized on the one hand through directly reducing poverty, and on the other hand through enhancing economic growth; again this is essential to reduce poverty (OECD 2006).

Infrastructure has a direct positive impact on improving the quality of life and reducing poverty. Access to clean water and sanitation has an obvious benefit in reducing mortality as well as morbidity, and thereby also increases the productive capacity of the poor. Access to transport and irrigation can contribute to more stable incomes, and enable the poor to manage risks. By facilitating the movement of food from surplus to deficit areas, an adequate transport network reduces regional variations in food prices and the risk of famine. Further benefits of transport and communication include the access they provide to other goods and services. As in many developing countries the poor are concentrated on the periphery of cities, the costs and availability of public transport are key factors in their ability to obtain employment. Also, the construction and maintenance of some parts of infrastructure – especially roads and waterworks – can contribute to poverty reduction by providing direct employment.

Additionally, infrastructure is one of the main drivers of economic activity; therefore it is essential for economic growth. Sound infrastructure lowers production and transaction costs, increases private investments and raises productivity. Telecommunications, electricity and water are used in

1 Cited in Bardhan (2002).

the production process of most sectors, and transport is an input for basically every commodity. Investments in roads, for example, lead to lower transport costs and increase access to markets. Infrastructure raises productivity by reducing the time and effort needed to secure safe water, to bring crops to the market, or to commute to work. Many empirical studies have in the past attempted to link infrastructure spending to growth of GDP, and have found a strong correlation between infrastructure and growth in developing countries (World Bank 1994, 14).[2]

Financing infrastructure

Despite its benefits for growth and poverty reduction and the huge backlogs, infrastructure spending is far below what is needed. Estimates put annual investment needs for infrastructure at 5.5 % of GDP in developing countries and 9 % in the least developed countries. Actual spending, however, falls short, averaging at 3.5 % of GDP in developing countries, indicating a large infrastructure spending gap. For example, in sub-Saharan Africa, annual infrastructure requirements are estimated to be between 17 billion US$ and 22 billion US$, annual spending, however, is about 10 billion US$. The financing gap in the region is thus 7–12 billion US$ a year, or 4.7 % in terms of GDP (OECD 2006, 11).

These figures indicate the strong necessity to increase investments in infrastructure. In this context, private participation in infrastructure provision is becoming increasingly prominent, as it allows using additional resources for infrastructure financing. However, private infrastructure provision can complement, but not replace the role government has in providing services. As many types of infrastructure have the characteristics of public goods, non-excludability and non-rivalry in consumption, they cannot be provided alone by the private sector. Additionally, given the importance of infrastructure for poverty reduction, not only economic but also political decisions have to be made when allocating services. Therefore, it is essential to increase government spending on infrastructure. As government funds in developing countries are usually scarce, borrowing is an important means to access additional funds to finance essential infrastructure services. Borrowing allows spending more money

2 See, however, the slightly more sceptical assessment in Anderson / de Renzio / Levy (2005).

today on infrastructure, which could help escape the poverty trap. The underlying idea, albeit originally formulated for foreign aid, is the concept of the *big push* that presently is back on the international development agenda (see e.g. Sachs 2005; Commission for Africa 2005; Asche 2006). The rationale of the *big push* is that developing countries have to be lifted above a certain threshold from whereon the vicious circle of poverty turns into a self-sustaining virtuous circle of social and economic development. As the responsibility for infrastructure provision today often lies in the hands of sub-national levels of government, the concept of sub-national borrowing is becoming increasingly important.

Crucial in this respect, however, are functioning and liquid local capital markets and sound financial institutions that are able to channel local savings to the respective investments. This is important especially in a sub-national context, as local governments are less likely to access international capital markets and should not bear the currency risks that come along with it.

2.2 South African background

As discussed above, three dimensions – the trend towards decentralization, the importance of infrastructure for development, and the financing gap – suggest a closer look at sub-national borrowing. Recalling this, the present section depicts how the political realization of these three dimensions in South Africa sets the context for a South African sub-national borrowing market. First, significant infrastructure needs make financing for infrastructure an urgent issue. Second, three spheres of government with substantial financial autonomy and a supporting regulatory framework lead sub-national entities to think about different ways to finance infrastructure. Third, a favorable macroeconomic situation, the political agenda, and a strong financial sector make financing for infrastructure possible.

Infrastructure needs: basic services and growth-enhancing infrastructure

There is an urgent need for more infrastructure in South Africa, both for basic services that reduce the infrastructure backlog and for growth-enhancing infrastructure beyond the basic infrastructure level. Despite huge improvements in the last ten years, there is still a significant infrastructure backlog in South Africa. “Backlog” refers to the lack of basic

services, which the provincial governments define. A few figures from South Africa illustrate the current overall state of the backlog. In 2006, 33 % of the population had no access to proper sanitation, 8 % no access to safe, potable water, and 8 % no access to electricity (National Treasury 2007).

The access to services is not evenly distributed across the country. A major split of service levels is still between former white areas on the one hand, and townships, former homelands, and informal settlements, which are mostly black areas, on the other hand. For instance, in 2003, more than 90 % of households in former homeland areas had no flush toilet on site, and almost 80 % had no electricity for cooking, compared with around 20 % respectively of households in non-homeland areas. In 2004, 40 % of African households had no piped water on site, compared to almost 0 % of non-African households. A little less than 60 % of African households had no electricity for cooking, compared with about 10 % of non-African households (Makgetla 2007, 148–9).

The differences in access to service also vary among the different provinces. To illustrate this, the 2001 Census found that the percentage of poor households without access to basic services was lowest in Gauteng with 26 % and Western Cape with 22 %. In contrast, 66 % and 76 % of poor households in Eastern Cape and Mpumalanga had no access to basic services. Looking at specific sectors of infrastructure, the access to sanitation repeats this finding. In Gauteng, only 5.8 % of households had no access to sanitation in 2001, compared to 36.2 % in Eastern Cape. Only 2.4 % of households in Gauteng and 1.7 % in Western Cape had no access to piped water, compared to 37.3 % in Eastern Cape and 25.9 % in KwaZulu-Natal. In general, the infrastructure service delivery in South Africa is best in Gauteng and Western Cape, and lacks behind most in Eastern Cape, Mpumalanga, and KwaZulu-Natal (DBSA 2006).

DBSA estimates that the total cost to provide all South Africans with basic services amount to an additional 57 billion rand for the period from 2005 to 2014. Interesting is that the six biggest cities (i.e. metros) require 44.6 % of this total sum, followed by the secondary cities which need 19.3 %. Most investments are needed for roads, sanitation, and water infrastructure. At the current rate of investment the infrastructure backlog for basic services will only end by 2065 (DBSA 2006).

Besides a lack of basic infrastructure, South Africa also needs significant investments for growth-enhancing infrastructure and upgrading existing infrastructure. Glasser / White (2004, 320) note at least three other types of investment that are much needed in South Africa. More advanced infrastructure services are needed for those who can afford to pay for higher standards. Investments for economic infrastructure are indispensable to sustain economic growth. Significant expenses are needed to upgrade the existing infrastructure since some of it is reaching the end of its economic life span. It is not possible to come up with exact figures for these types of investments, because they have not been quantified to the same extent and are a "moving target", since the needs for advanced infrastructure are changing due to innovations and global competition.

There are several **reasons for the current state of infrastructure**, i.e., for the missing basic services as well as for the state of infrastructure above the basic levels. The main reason is the apartheid legacy. Further reasons are low investments in any type of infrastructure in the past, and a decreasing size of households, which makes service provision for each household difficult.

Apartheid politics is the major reason for the lack of basic services today and for the discrepancies between different regions and areas in South Africa. Apartheid shaped the high standards maintained in white areas on the one hand, while depriving the black areas of essential infrastructure on the other hand. Facilitated by sovereign guarantees, it was common for the white local municipalities to access capital markets for infrastructure investments. The black municipalities, in marked contrast, lacked management skills and revenues, and therefore had no access to credit. (Glasser et al. 1998, 1; Buhlungu / Atkinson 2007, 27–31). The longer this system was in place, the more striking the differences in service delivery. For this reason, the backlog is strongest in the townships and former homeland areas. The differences in service delivery to African and non-African households depicted above even years after the end of the Apartheid point to the lasting impact this regime had on service levels today.

Investments for infrastructure have not been high at all time during the last decades, even for growth-enhancing infrastructure in the formerly white areas. While the percentage of total fixed investment of GDP was high in the 1970s, it has significantly dropped since the beginning of the 1980s (Sunday Times 2007), reflecting the more difficult economic and political

environment of South Africa at that time. Public sector fixed investment and investments into infrastructure remained at low levels throughout the 1990s, compared to past periods in South Africa, and compared internationally. The decreasing investments not only affected the build-up of new infrastructure but lead to low levels of maintenance investments into existing infrastructure. The result is that today, infrastructure needs are all the more pressing to catch-up with past neglect.

Because of rural-urban migration and a large-scale provision of small low-cost houses, the average household size decreased, from 4.5 in 1996 to 3.8 in 2001, together with a general population growth. Thus, while during the same time the absolute number of households with access to services increased, the total number of households increased so much that the number of households suffering from the lack of access to infrastructure services remains substantial (DBSA 2006; Makgetla 2007, 147–8).

The decentralized political system of South Africa

Of the three spheres of government, local governments play a significant role in addressing the infrastructure needs. The 1998 White Paper on Local Government fleshed out the concept of a "**developmental local government**", putting municipalities at the center of addressing developmental backlogs and granting them high autonomy and responsibility. Therefore, the municipalities have a key role in the provision of basic services (Buhlungu / Atkinson 2007, 31; Wittenberg 2003, 34). The most important services of municipalities are water supply, sanitation, health centers, electricity and other energy sources, local roads, storm-water drainage, and solid waste disposal (DPLG 2005). By providing these services, local governments have to play a crucial role in fulfilling the constitutional social and economic rights of South Africans, i.e. access to adequate housing and sufficient food and water (Sections 26 and 27). This constitutional background puts high pressure on local governments to effectively deliver services.

The distribution of functions among the three spheres is not fixed. For instance, South Africa currently attempts to establish Regional Electricity Distributors (REDs), which would take away electricity from the services that the local government sphere has to provide. The REDs would strongly impact the local government sphere's revenues and functions. There are rumors about further re-centralizing services, such as water provision.

Even the entire provincial sphere of government – the apparently weakest of the three spheres – is sometimes put up for discussion (Mail&Guardian 2007, 11).

Since 1993, a whole series of acts establish today's municipal landscape. The 1993 Local Government Transition Act establishes transitional councils, joining white and black areas into joint municipalities. The intention was that revenues generated in the core cities could be used to extend services to underserved areas, and thereby help to overcome the infrastructure backlog. Also the former homelands were reincorporated into the Republic in 1994. The result was the creation of 843 "wall-to-wall" municipalities, including the rural areas. The 1998 Municipal Demarcation Act triggered a radical re-demarcation and amalgamation of the transitional structures into 284 new municipalities, followed by a last re-demarcation in 2006 leading to now 283 municipalities. The 1998 Municipal Structures Act determines the following three different categories of municipalities (Glasser / White 2004, 315; van Ryneveld 2005; Buhlungu / Atkinson 2007, 27–31):

— Six metropolitan municipalities, "metros", (Category A), which include South Africa's largest cities and have exclusive executive and legislative authority within their areas of jurisdiction.

— 231 local municipalities (Category B), which share executive and legislative authority with district municipalities.

— 46 district municipalities (Category C), which typically include several local municipalities within their borders, i.e. they have executive and legislative authority in areas with more than one local municipality.

Decentralization is not a recent phenomenon in South Africa, but the 1996 Constitution established a new system. South Africa had had a decentralized system since the foundation of the Union of South Africa in 1910. Before the democratic transition in 1994, two separate forms of decentralization existed along racial lines: on the one hand white local governments and on the other hand black local governments, including the autonomous "native reserves" (later "homelands") of the black population. For the new post-apartheid South Africa, the 1996 Constitution is a compromise between the widely differing views of the negotiating parties on the degree of centralization. The result is *"one sovereign democratic state"* (Section 1) and at the same time *"national, provincial and local spheres of gov-*

ernment, which are distinctive, interdependent and interrelated" (Section 40) and which have to function as *"cooperative government"* (Wehner 2000, 47).

Turning to the financial side of municipalities, there are three different income sources: own-source revenues, national government grants, and borrowing. South African municipalities are substantially financed by **own-source revenues**, on average by 86 % (IDASA 2005, 1). Most of the own-source income originates from user charges (particularly electricity and water) and property tax. However, the share of own-source revenue varies significantly. The six metropolitan municipalities generate 97 % of their budgets through own revenues. The poorest municipalities have almost no income through own revenues because of high poverty and a low level of infrastructure service delivery (Glasser / White 2004, 318; Makgetla 2007, 153).

The Constitution entitles municipalities to a part of nationally raised revenues in the form of transfers. The **transfers to municipalities** can be separated into three basic types of grants: unconditional transfers ("equitable share"), conditional transfers for infrastructure ("Municipal Infrastructure Grant"), and conditional transfers for capacity building. A formula based on poverty, population, and functions of municipalities determines the equitable share, with the purpose of compensating the current costs of basic municipal services for households which cannot afford to pay the user fees. The Equitable Share is thereby an important redistributive instrument. The Municipal Infrastructure Grant (MIG) provides municipalities with capital for investments in infrastructure. The conditional transfers for capacity building assist municipalities in improving their capacity or in restructuring their operations (Glasser / White 2004, 319).

The third funding source for infrastructure service delivery is **debt capital**, through bank credits or bonds. Subsequent chapters will analyze the current borrowing market in more detail.

The macroeconomic and financial sector performance

The current macroeconomic situation in South Africa is favorable and the country has a strong and sophisticated financial sector. It is expected that sub-national entities will invest more in infrastructure in the coming years. South Africa experiences an unprecedented **sustained growth period**. The

annual growth rate reached 5 % during the last three years, marking the most stable and lasting growth period since the 1960s. All this takes place in a very stable macro-economic context, with low inflation and a rising foreign exchange position. The private sector is booming and accounts for the bulk of gross fixed capital formation growth rate, which has reached 8 % annually since 2003. The booming private sector will contribute to rising own revenues of municipalities and enable them to invest more in infrastructure service delivery.

The 2007 National Treasury Budget Speech demonstrated the impacts of this strong economic performance on the political agenda. Finance Minister Trevor Manuel could announce increased spending on all government priority areas while still retaining a budget surplus. As to infrastructure, the 2007 Budget Speech is a very supportive political statement. The national government plans to spend 372 billion rand over the next three years for infrastructure. This amounts to a 10 % growth rate of total public sector investment and a 17 % growth rate of investments of public corporations. This shows how the government is switching from a redistribution-focus to an investment-focus. Thereby, South Africa has left behind the all-time low of public sector fixed investments and infrastructure investments, in particular during the first half of the 1990s, which was also low by international comparison. Current GDP spending of 2–3 % on infrastructure is likely to rise substantially as well as public sector fixed investments, from a low of 4 % of GDP in 2002 to an expected 7 % in 2010 (Sunday Times 1.4.2007). Thereby, the government attempts to reach its target to provide basic infrastructure to all South Africans by 2014 (DBSA 2006).

Transfers to provincial and local spheres of government increased significantly during the last years, and are expected to rise even more. The subnational entities in South Africa, which are carrying out a large part of the planned investment focus of the national government, can therefore expect to have more funds available for infrastructure service delivery. The Equitable Share grew from 6.6 billion rand in 2003/4 and currently to 18.4 billion rand in 2006/07 and is planned to increase to 29.9 billion rand by 2009/10. This amounts to annual growth rates between 14.7 % and 31.3 %. The infrastructure transfers grew from 5.7 billion rand in 2003/04 to currently 9.3 billion rand (2006/7) and are planned to increase to 18.3 billion rand by 2009/10. The annual growth rates vary between 15.0 % and

54.4 %.[3] The subsidies given to local government sphere has thereby risen from 3.3 % of the national budget in 2002 to 5.9 % in 2006 and 6.5 % in 2009 (Makgetla 2007, 161). The government is increasingly focusing on transfers to poorer regions, responding to the fact that currently about half of the total transfers go to the richest municipalities, and only 12 % are being allocated to the poorest, with municipalities classified according to budget per capita (Makgetla 2007, 161). In sum, significant infrastructure investments are possible in such a favorable economic situation and will help sustain economic growth in the future.

Besides the general economic situation and the political agenda, the financial sector is equally important to enable financing for infrastructure. South Africa traditionally has a **strong financial sector**, with banks, financial institutions, stock and bond exchanges all up to international standards and offering sophisticated financial products. As Glasser / White (2004, 314) put it, South Africa has a financial sector which many countries still seek. The financial sector has had significant experience with public securities. Before 1994, South Africa developed sophisticated capital markets for infrastructure financing in the formerly white municipalities, with a variety of financing instruments available, including credits and bonds.

There are efficient and vital capital markets, with the stock and bond exchanges being the most significant on the African continent and among the best developed of emerging markets throughout the world (World Bank 2006, 20). Prior to 1994, there was a well developed municipal bond market. White municipalities regularly issued bonds. This market, however, collapsed for several years during the transition period after 1994. The reasons were the abandonment of national government guarantees, uncertainty about the fiscal capability of the newly created municipalities, and the absence of a regulatory framework for municipal debt capital.

The overall banking sector boosts with strong banks by international standards, which recently performed very well. For instance, the ratio of non-performing loans is at a historical low of 2 %. The four big players in the overall banking sector are Amalgamated Banks of South Africa (ABSA), First National Bank (FNB), Standard Bank, and Nedbank. All major banks

3 Data taken from a National Treasury presentation at the DBSA, February 2007.

have experience with the local government sphere. They have long dealt with municipalities by administering accounts for the municipalities and now lend to municipalities. In addition to the private banks, the Development Bank of Southern Africa (DBSA) is a powerful public lender with a clear developmental mission, evolving into a lender for the entire Southern African region (see Box 1, provided by the DBSA). It plays an indispensable role in financing infrastructure service delivery.

Box 1: The Development Bank of Southern Africa (DBSA)
Vision The DBSA's vision is an empowered and integrated region free of poverty, inequity and dependency. With this aim, the DBSA seeks to be a leading change agent for socio-economic development and economic integration in southern Africa, and a strategic development partner to the wider Africa region, south of the Sahara. **Mission** The Development Bank contributes to development by mobilizing and providing finance and expertise and by establishing partnerships to develop infrastructure, in order to improve the quality of life of the people of Southern Africa. The DBSA is a development finance institution wholly owned by the Government of South Africa. Its mandate is to finance infrastructure in its many forms within South Africa and the SADC region. Its lending activities are complemented by capacity building grants by the DBSA Development Fund, utilizing operational surpluses. Most municipalities in South Africa are clients of the bank or the fund or both. Lending within South Africa has historically been for municipal infrastructure to redress the poor distribution of services. Outside of South Africa lending is predominantly for economic infrastructure and largely in support of private sector participation in infrastructure services. The DBSA actively pursues partnerships with other Development Finance Institutions (DFIs), donor agencies and private sector banks. It also devotes resources to assisting with policy development, institutional development and generating and disseminating knowledge products. In the financial year 05/06 the DBSA had 500 employees and disbursed over 3 billion rand (450 million US$). At the end of March 2006, the total loan book was 17.7 billion rand, of which 47 % was for municipalities.
Source: Provided by the DBSA

Besides banks, there are strong investment institutions, some of which also play a role in credit markets for public borrowers. The prime example is the Infrastructure Finance Corporation of South Africa (INCA), a private finance institution with a core business of lending to sub-national public entities (see Box 2, provided by INCA). Moreover, South Africa has strong investment funds such as Investec and Futuregrowth, which also play a role in public securities and would be ready to buy new municipal bonds.

Box 2: The Infrastructure Finance Corporation (INCA)

Infrastructure Finance Corporation Limited, trading as INCA, is the only infrastructure debt fund in South Africa that is 100 % privately owned and operated. Apparently, nowhere else in the world such an initiative has been attempted.

INCA was established in 1996 in response to the South African government's call for increased private sector involvement in infrastructure funding. As a result of its unique position, INCA has become a primary mobilizer of funds for lending to infrastructure providers. The main funding sources it draws on are local and international market funds, raised through a series of INCA bond issues and long-term loans extended to the corporation by international financial institutions. Another source of funding available to INCA is shareholders' capital.

Since inception, INCA has advanced over 8.0 billion rand to infrastructure providers, issued more than 6.0 billion rand in bonds to the South African capital market and raised 2.0 billion rand in international loan funding. The infrastructure providers to which INCA has already lent funds include municipalities, water boards and other statutory institutions in South Africa whose main business is the establishment of social and economic infrastructure in South Africa. This funding has mainly been in the form of long-term fixed interest rate loans.

Furthermore, INCA underpins its long-term relationships with local municipalities with an annual financial review process, through its understanding of local municipalities' capacity to borrow on-balance sheet financing and base the evaluation on results generated through INCA's cash flow forecast model. INCA generates from this model financial ratios determining acceptable and manageable levels of external borrowings for purposes of infrastructure investment. As part of this process, INCA can then mark a facility available for on-balance sheet financing. This places INCA in the fundamental position of advising its clients of limitation of balance sheet financing, adding further advice of alternative methods of funding such as project finance and public private partnerships.

Box 2 continued
Because INCA has a singular focus on its core business, it is in the unique position not only to understand and price the risks involved in infrastructure lending, but also to attract investor funding. As a result it is spearheading the private sector's involvement in a vital component of the economic rehabilitation and growth of South Africa's infrastructure debt funding. In 2004, INCA joined forces with Kagiso Financial Services Limited which bought 43.96 % of the shares in INCA. 51 % of INCA shareholding is voted by black controlled companies, making it a black controlled company. The consolidation of INCA's shareholding in Kagiso Financial Services, FirstRand Bank Limited, Momentum Group Limited (managed by Futuregrowth) and Dexia Credit Local from France, provides a strong foundation for the second growth phase in INCA and adds substantially to the skills base from which INCA can draw. In addition to INCA's contribution to the national skills levy and the internship program, INCA has a special vehicle through which it gives substance to its corporate social responsibility. This is the INCA Capacity Building Fund, established in 1998, which is a joint venture between INCA and AFD. The main aim of the fund was and is to make a meaningful and visible contribution to effective and efficient local governance in South Africa.
Source: Provided by INCA

3 Analytical framework and empirical approach

In response to the decentralized political system, the need for more infrastructure services in South Africa arises. This study addresses different options to finance these services by looking at the following questions:

> *Does the possibility to borrow on the municipal level lead to an improved infrastructure service delivery in South Africa? Under which conditions is municipal borrowing most likely to unfold its positive outcomes?*

This study uses a simple analytical framework that distinguishes between two possible impacts of sub-national borrowing and three dimensions of prerequisites for a well functioning sub-national borrowing market (see

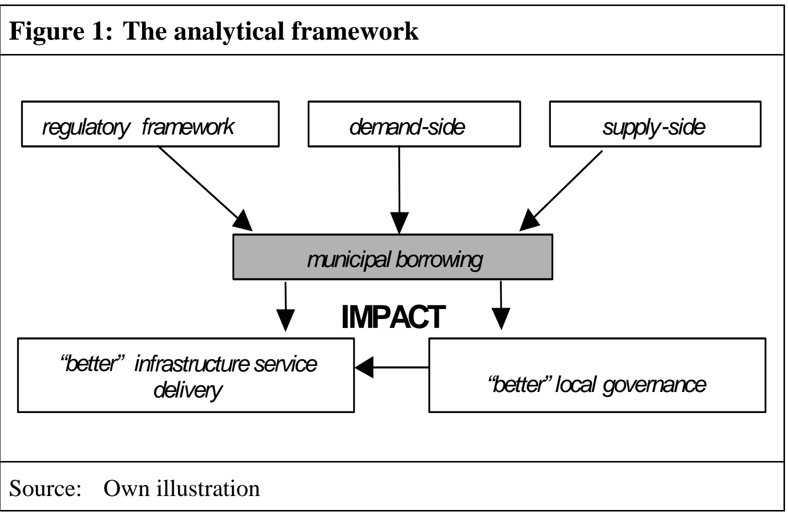
Section 3.1). Using this framework, empirical research was done between February and April 2007 in South Africa. It allowed assessing the views of relevant stakeholders in the market, including a sample of municipalities (see Section 3.2). The opinions, combined with quantitative data and background information from official documents and academic literature, allow us to answer the main questions of this study.

3.1 Analytical framework

Figure 1 provides an overview of the impact of sub-national borrowing on service delivery and the prerequisites of a functioning sub-national borrowing market. Looking at the impact dimension first, academic literature suggests sub-national borrowing can have positive effects on infrastructure service delivery at the sub-national level. This is the primary objective of engaging in sub-national borrowing and there is consensus among major scholars in the debate (see e.g. Peterson 2000; Leigland 1997; Phelps 1997; Freire / Petersen 2004). Therefore, this study assesses whether this holds true in the case of South Africa. There are two possible impact dimensions. The first one is sub-national borrowing, which is frequently assumed to contribute to a "better" infrastructure service delivery. This may be the case because borrowing of sub-national entities is allocated more efficiently on different infrastructure projects or because individual infrastructure projects are implemented more efficiently (see Section 4.2). The second dimension is sub-national borrowing, which may also positively impact on local governance, in terms of transparency, accountability, and financial management (Jackson 2006, 6; Freire / Petersen 2004, 11–12). We assume that "improved" local governance, in turn, has a positive impact on infrastructure service delivery, but we do not address this link in particular (see Section 4.3).

There are three broad dimensions of prerequisites for a well functioning sub-national borrowing market: the regulatory framework, the demand-side, and the supply-side of the municipal borrowing market. These three dimensions of prerequisites are present in most of the theoretical literature on sub-national borrowing. The roles of the three dimensions of prerequisites are as follows:

Figure 1: The analytical framework



Source: Own illustration

First, a regulatory framework has to allow sub-national entities to borrow, to regulate the tasks of different spheres of government, to set limits to borrowing by sub-national entities, and, as an overarching role, to provide clarity and confidence to the main actors involved in sub-national borrowing. This study assesses the impact of the regulatory framework on sub-national borrowing in South Africa and its implementation. In this context, we investigate if the framework contributes to a flourishing sub-national borrowing market, how its implementation works, and how crisis prevention and management works in theory and in practice.

Second, the demand-side refers in this study to municipalities, since they are the main sub-national entity in South Africa responsible for infrastructure service delivery. Borrowers' creditworthiness is a crucial demand-side factor for a working sub-national financial market and municipal financial management is key in planning profitable infrastructure projects. To determine the constraints at the demand side, we analyze different factors constituting creditworthiness at the municipal level in South Africa.

Third, both public and private lenders constitute the supply-side in the South African municipal borrowing market. In this context, we look into the potential for bonds and the interplay of public and private lending institutions in the sub-national borrowing market.

3.2 Empirical approach

To assess the validity of the developed analytical framework, we carried out an in-depth empirical research in South Africa between February and April 2007 and conducted 66 interviews with relevant stakeholders in municipal borrowing, reflecting the different dimensions of prerequisites and impacts that the analytical framework suggests. The sample includes 29 municipalities across the country, private and public lenders, external support agencies, rating agencies, national and provincial government, academic experts, and one NGO. In addition, the research gathered comprehensive quantitative data on lenders and borrowers. Therefore, the results of this study are based on a comprehensive and representative data set.

In more detail, the demand-side covers municipalities from all South African provinces but the Northern Cape. The sample includes a wide range of municipalities, both in terms of population and budget size as well as financial viability. With regard to budget per capita, the interviewed municipalities cover most of the spectrum. However, the bottom municipalities were excluded, since these municipalities are neither able to borrow today nor in the near future. The sample consists of 19 high, 9 medium, and one low-capacity municipality, according to the classification of the South African National Treasury. These 29 municipalities accumulate around 14 billion rand of a total of 18.2 billion rand outstanding municipal debt in South Africa. The debt-share of these municipalities' capital budget ranges from 0 % to 57 %. Twelve of the 29 municipalities have a local credit rating. We mainly interviewed Chief Financial Officers or other staff of financial departments in the different municipalities. In addition, our interview partners in the municipalities were town engineers, councilors, municipal managers, and mayors. Most were group interviews, including different representatives of each municipality.[4]

The sample covers most of the relevant supply-side stakeholders. It includes the Development Bank of Southern Africa (DBSA), which is the

4 It would have been preferable to conduct more interviews in the same municipality to be able to contrast the views of the representatives. However, given the time constraints on both sides of the interview table, we regard the chosen procedure as adequate. Moreover, in most cases the interviews included the most important decision makers within each municipality; therefore we can assume a representative viewpoint for the entire municipality.

most important lender in the South African municipal debt market. Furthermore, we conducted interviews with most of the private lenders in municipal debt in South Africa. The sample includes INCA, the largest private player in the field, most of the major banks, and one investment fund. In addition, we interviewed various external support agencies engaged in municipal finance in South Africa. Therefore, the supply-side sample is quite encompassing.

On the national regulatory level, we interviewed officials from the National Treasury and the Department for Provincial and Local Government. On the provincial regulatory level the sample includes: the Provincial Department for Local Government and Housing of the Free State and the Provincial Treasury of the Western Cape. Taking into account the impact of future Regional Electricity Distributors (REDs) on the municipalities' responsibilities and income sources, we also interviewed Electricity Distribution Industry Holdings (EDI), the government agency in charge. In addition, since ratings form part of the South African municipal borrowing market, the sample of this study embodies the two players in the market: CA-Ratings, the leading local rating agency, and the international rating agency Fitch.

To complement the different angles of perceptions and experiences, four academic experts and one NGO form part of the sample. Table 1 provides an overview of the sample.

Table 1: Sample of stakeholders involved in sub-national borrowing

Stakeholder		**Number of interviews**	**Interview partners**
Demand-side stakeholder	A-municipalities (4-metros)	5	treasurer, councilor, town engineer
	B-municipalities (22 locals)	24	
	C-municipalities (3 districts)	4	
Supply-side stakeholder	Public bank	5	DBSA
	Private investors	8	INCA (3x), FNB, Standard Bank, RMB, Nedbank, Future Growth
	External support agencies	8	KfW, GTZ (2x), AFD, World Bank, IFC, USAID, EIB
Framework stakeholder	National and Provincial Government	5	National Treasury, Department of Local Government (DPLG), Provincial Government (2x), EDI
	Rating agencies	2	CA-Ratings, Fitch
Others	Academic experts, NGO	5	4 experts, 1 NGO
Σ		66	

Source: Own sample

4 The impact of municipal borrowing on infrastructure service delivery

The impact of municipal borrowing on infrastructure service delivery is the most important criterion to assess its value as an economic policy instrument. Overall, we find that municipal borrowing facilitates infrastructure service delivery in South Africa. There are direct effects of borrowing on service delivery as well as indirect effects through improved local governance. Section 4.1 starts with some conceptual issues concerning the impact of municipal borrowing. Section 4.2 sheds light on four issues related to the direct effects of borrowing on service delivery. Section 4.3 looks at indirect effects, explaining how borrowing improves governance aspects at the local level.

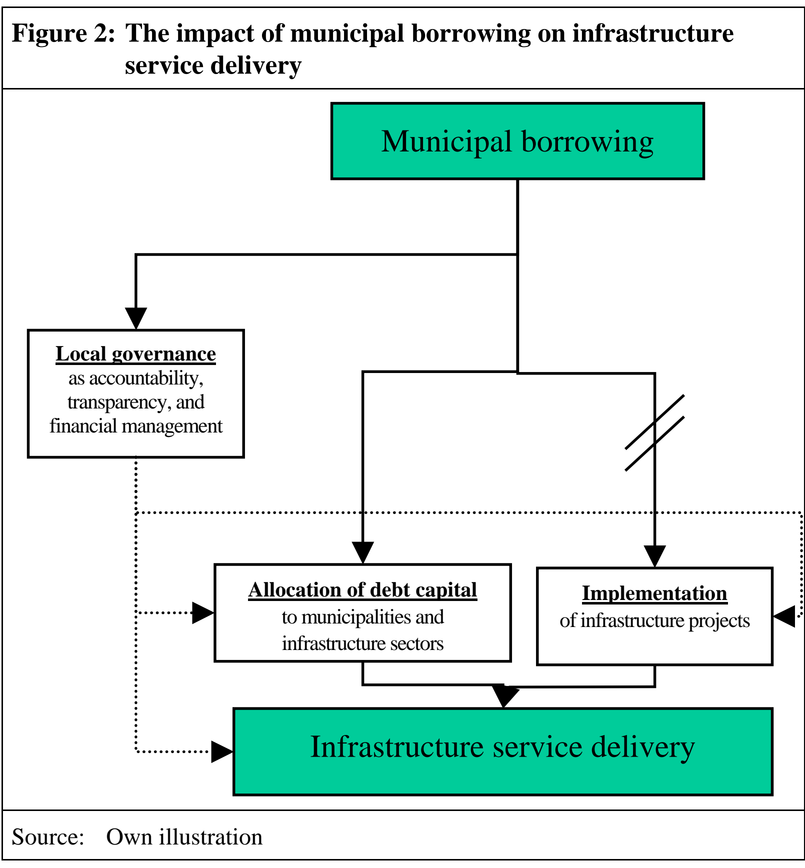
4.1 Conceptual issues

The analysis of this chapter is in line with the theory on sub-national borrowing: the primary objective of sub-national borrowing is to induce positive effects on infrastructure provision. These positive effects materialize directly through investments in infrastructure and indirectly through better local governance.[5]

Figure 2 visualizes the main structure underlying this chapter. Municipal borrowing influences the allocation of debt capital. More capital is available to municipalities today, which they channel into infrastructure projects, partly into backlog-reducing projects. Theoretically, there could be a link between municipal borrowing and the implementation of infrastructure projects. However, this study found that there is no such link, which the crossed-out arrow demonstrates. Municipal borrowing improves local governance, particularly accountability, transparency, and financial management at the local government level. The dotted lines from local governance to the allocation of debt capital, the implementation of projects, and to infrastructure service delivery suggest an indirect influence only, which we think plausible but cannot empirically prove.

5 For more extensive treatments in the literature, see Peterson 2000; Leigland 1997; Phelps 1997; Freire / Petersen 2004.

Figure 2: The impact of municipal borrowing on infrastructure service delivery



Source: Own illustration

This chapter adds a new perspective to previous empirical studies of the South African municipal borrowing market. Most studies, such as Glasser / White (2004) or Martell / Guess (2006) analyze the financial market, without investigating the impact that this market has on infrastructure service delivery, even though this is the ultimate reason why it exists.

4.2 Direct effects of municipal borrowing on infrastructure service delivery

Important to analyze are four issues related to the direct effects of municipal borrowing on improved infrastructure service delivery in South Africa: Point 4.2.1 reveals a concentration of borrowing-related impacts on citizens in some municipalities only; Point 4.2.2 shows that borrowed capital finances various sectors of infrastructure. Point 4.2.3 explains how, to some extent, this borrowing helps to reduce the infrastructure backlog. Finally, Point 4.2.4 argues that debt-financed projects are not better implemented than projects funded from other sources.

Before turning to the four issues, it is important to note that our interviews showed that most lending to municipalities is general obligation lending. From an analytical point of view, the prevalence of general obligation makes it difficult to establish a close link between lending and projects. General obligation lending means that banks tie their lending decisions to the general budget situation of a municipality and do not lend money for a specific project. In these cases, it is only the internal decision of a municipality, which projects to allocate the borrowed capital to. It appears that municipalities usually tender for a specific project, but the borrowed capital then enters into the general capital budget. It is nothing more than an accounting decision of the municipality whether to tie that capital to a specific project or not. In particular, loans from private lenders and to metros are general obligation lending. The following points analyze the entire municipal borrowing market, including general obligation lending and project-financing.

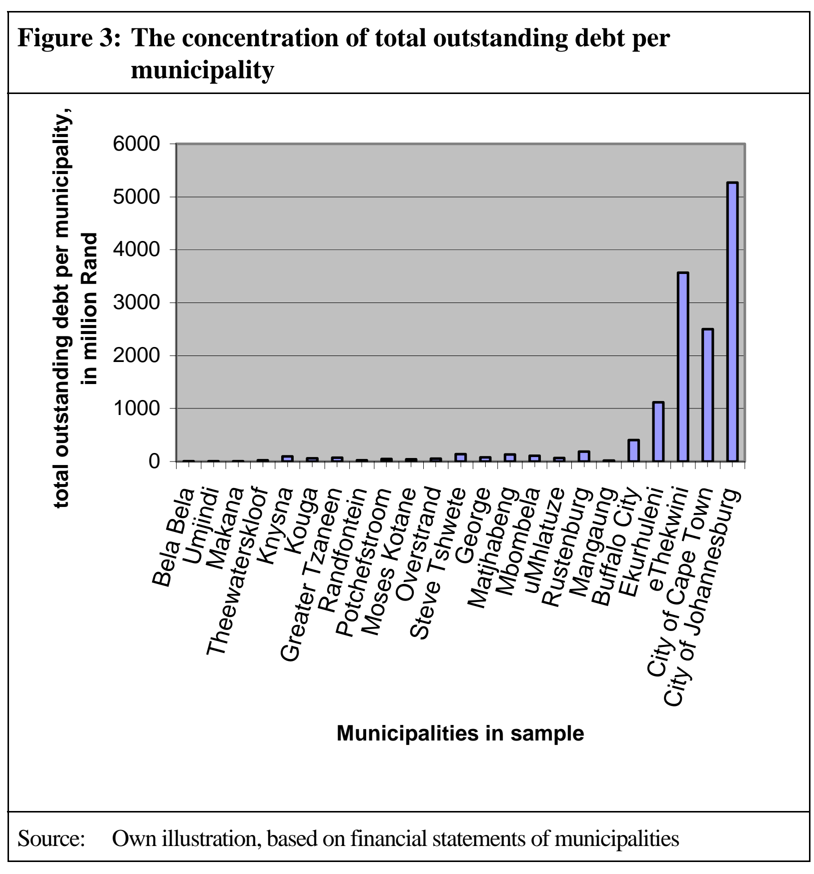
4.2.1 The concentration of borrowing-related impacts on some municipalities

Municipal borrowing in South Africa is not evenly distributed across all municipalities, but concentrated significantly on some municipalities. As a consequence, debt capital addresses the infrastructure needs of citizens in South Africa to a very different degree. In other words, only some municipalities can actually realize the positive effects that borrowing can have on service delivery for their citizens. To illustrate the different effects of borrowing on citizens, this section is divided into two main points: First, the total municipal debt capital concentrates on a few municipalities; thus,

only some municipalities have significant amounts of debt capital available. Second, analyzing debt capital per capita, again, there is a very imbalanced distribution.

The first point is that only some municipalities have significant amounts of debt capital available. The municipalities with the largest overall budgets tend to have high total outstanding debt volumes. Thus, the metros are among the most active borrowers. Figure 3 compares the total outstanding debt per municipality in our sample, with all municipalities ordered according to their budget size. There is a striking concentration on the four

Figure 3: The concentration of total outstanding debt per municipality



Source: Own illustration, based on financial statements of municipalities

visited metros (City of Johannesburg, Ekurhuleni, eThekwini (Durban), City of Cape Town) followed by Buffalo City as large secondary city and aspiring metro. A big exception is Mangaung (Bloemfontein), a large city that is not actively borrowing. The total outstanding debt in the remaining local municipalities of the sample appears almost negligible relative to these five big borrowers.

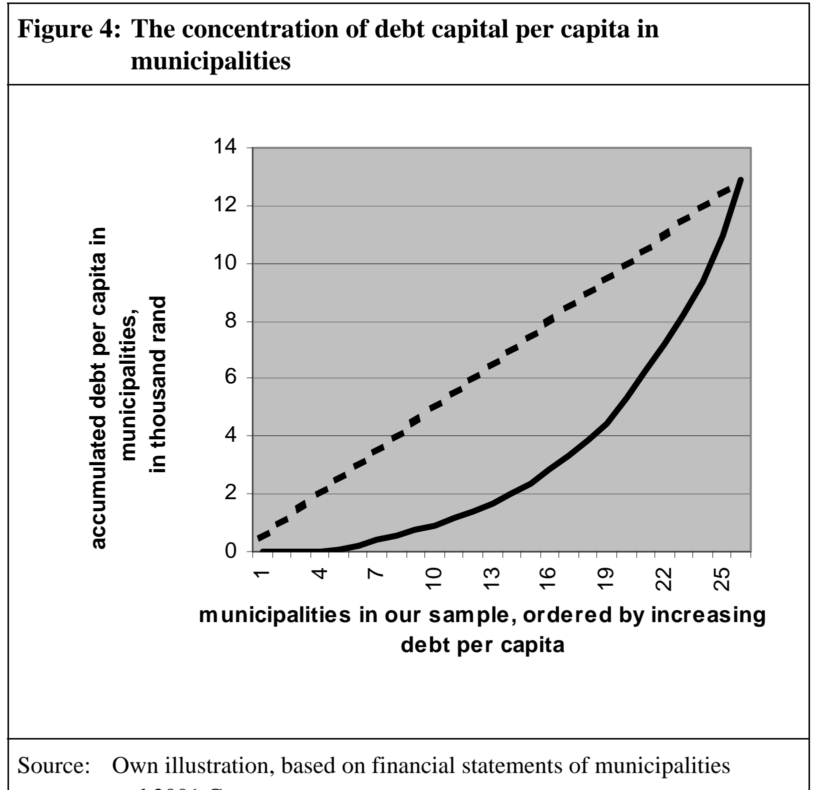
In actual figures, total outstanding debt of all municipalities of our sample is 14.0 billion rand. At the upper-end of our sample, the highest total outstanding debt with 5.3 billion rand is the City of Johannesburg, followed by eThekwini (Durban) with 3.6 billion rand, and the City of Cape Town with 2.5 billion rand. At the lower-end, omitting those municipalities that do not borrow, Umjindi has a debt of only 8.6 million rand; Bela Bela borrowed only 7.6 million rand, and Makana only 3.5 million rand. Compared to the sample, and in particular compared to the main borrowers, the impact of debt capital on infrastructure service delivery in these three municipalities is minor.

Second, we analyzed the debt capital per capita. The infrastructure needs of citizens are served to a very different degree with borrowed capital. To support this point, it is valuable to look at debt per capita in municipalities and not at their total outstanding debt. The different impact on citizens results from a very imbalanced distribution of debt capital per capita in our sample. If debt capital per capita were evenly distributed, one could infer that debt capital helps address the infrastructure needs of citizens across South Africa to the same extent. However, the Lorentz curve in Figure 4 illustrates the imbalanced distribution. Compared to an even distribution of debt capital among the municipalities in our sample (suggested by the dotted line), the curve represents the actual distribution of debt per capita. For example, one can see that half of the municipalities in the sample (municipalities 1-14 on the horizontal axis) make up only about 2 billion rand of the total of 14 billion rand debt capital (on the vertical axis).

The figure illustrates that debt per capita varies in our sample between 1,935 rand in Knysna, followed by the metros (City of Johannesburg with 1,633 rand and eThekwini (Durban) with 1,154 rand). These municipalities, therefore, have a high amount of debt capital available to serve the infrastructure needs of their citizens. At the bottom end (omitting those municipalities that do not borrow), there are municipalities like Bela Bela with 145 rand debt capital per capita, Makana with 46 rand, and Man-

gaung (Bloemfontein) with 32 rand. Hence, these municipalities use very little debt capital for infrastructure service delivery for their citizens.[6]

Figure 4: The concentration of debt capital per capita in municipalities



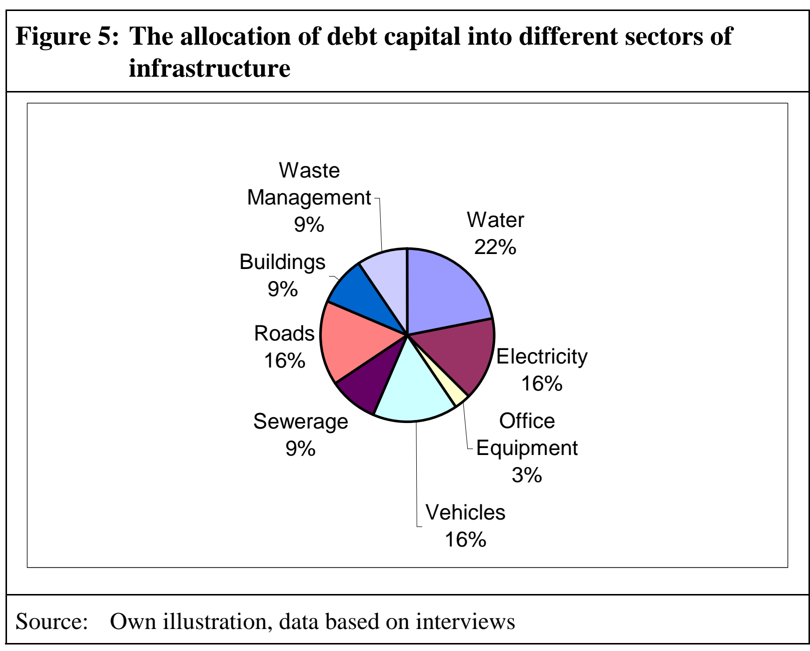
Source: Own illustration, based on financial statements of municipalities and 2001 Census

6 Based on 2001 Census data for population, and financial statements of municipalities.

4.2.2 The allocation of debt capital into different sectors of infrastructure

The leading theme of this section is diversity: Municipalities use debt capital to finance projects in diverse infrastructure sectors. After presenting the investment choices of municipalities (reflected in Figure 5) and analyzing the influences lenders have on these decisions, Box 3 presents infrastructure unit costs, which help illustrate how much infrastructure can be financed with a loan.

Figure 5: The allocation of debt capital into different sectors of infrastructure



Source: Own illustration, data based on interviews

We asked municipalities and lenders what type of projects they finance with debt capital, even if the borrowing was of a general obligation type. The infrastructure sectors that municipalities and lenders mentioned most often were water, roads, and electricity. Figure 5 presents these findings. Besides these three sectors, as Figure 5 shows, debt capital also finances

Box 3: Infrastructure unit costs (estimates, in rand)	
Water:	
• Water supply per household (with connector and bulk):	6,000
• 1 meter water pipe:	200–800
Sanitation:	
• Onsite sanitation per household:	3,650
• 1 meter sewerage pipe:	400
• Sewerage connection per household:	2,500
• Sewerage treatment works for 5,000 households:	50 million
Roads (per km):	
• Gravel roads:	300,000
• Chip and spray roads:	900,000
• Paved/sealed/paving blocks roads:	30 million–100 million
• Storm-water:	130,000–510,000
Housing:	
• Basic government-funded house:	22,000
Electricity:	
• Electricity substation for 15,000 households:	40 million
• Electricity connection per household:	3,000
Streetlight per household:	650–2,500
Source: Data from interviews with municipal engineers, and DPLG 2005	

other types of infrastructure.[7] On the one hand, this diversity points to debt capital being useful for many kinds of investments. On the other hand, this analysis shows that the needs of municipalities vary a lot, leading to different priorities in infrastructure service delivery. The complete omission

7 Figure 5 should not be misunderstood as an encompassing quantitative assessment of the allocation of debt capital all over the country. The sample and the quality of the data do not allow such a far-reaching conclusion.

of certain sectors of infrastructure, like housing, is no surprise, since the national government provides grants for housing.

Lenders do not influence the choice of projects as much as municipalities do. As explained above, banks mostly lend as general obligation. For this reason, we received only few statements of lenders, which infrastructure sectors they would like to fund. Some state that they would finance all kinds of infrastructure, ranging from roads, transport and water to electricity. Others clearly indicate that they would prefer to see investments in e.g. electricity provision for a new development, rather than roads in a township, because of the expected revenues. Hence, while one might assume that lenders influence the choice of projects a lot, this influence is not obvious.

To assess how much infrastructure can be financed with a certain loan, Box 3 presents a selection of infrastructure unit costs.

4.2.3 The impact of debt capital on backlog-reducing infrastructure

Municipal borrowing in South Africa finances both growth-enhancing and backlog-reducing infrastructure. While it is no surprise that debt capital helps financing growth-enhancing infrastructure, the indications that debt capital helps reducing the backlog by providing basic services are the crucial findings described in this section.

From a theoretical point of view, there is no conclusive argument if municipal borrowing would rather finance basic services or growth-enhancing infrastructure. On the one hand, one would assume borrowed capital to be used mostly for revenue-generating projects because revenues facilitate repayment. Such projects are much rather linked to growth-enhancing infrastructure than to basic services. On the other hand, municipalities might be more accountable to the needs of the poor in their constituencies than the national government. In such a situation, municipal borrowing might lead to more backlog-reducing infrastructure than national government investments, especially considering general obligation borrowing and the opportunity of municipalities to cross-subsidize within their budgets.

Three indications were identified that debt capital can help reduce the infrastructure backlog. First, a lot of debt capital flows into municipalities

that need to account for large backlog-reduction costs. Second, there is a general trend to focus on formerly neglected areas. Third, total outstanding debt compared to the overall cost of eradicating the backlog indicates the contribution that debt capital can make. The following paragraph, however, cautions against over-emphasizing the backlog concept in the context of municipal borrowing. Moreover, Box 4 shows the special influence the 2010 Soccer World Cup has on investment priorities of municipalities.

Box 4: Financing infrastructure for the 2010 Soccer World Cup

South Africa hosts the 2010 Soccer World Cup. The upcoming event requires South Africa to upgrade its infrastructure in various respects. Therefore, The World Cup became a major investment focus of municipalities. The total budgeted investments for 2010 currently amount to 19 billion rand. The national government funds a significant share of this sum by passing grants along to municipalities, which are in charge of implementing the infrastructure. Besides stadiums and training grounds, municipalities focus particularly on roads and public transportation infrastructure. The investments for 2010 are, in many ways, a show-case of more general issues this study investigates regarding the municipal financing sector. From this perspective, it is helpful to look at the lasting need for the 2010 projects, at the profitability, and the different financing sources of the World Cup infrastructure.

The opinions of our interviewees varied a lot when asked about the lasting need for the 2010 infrastructure. On the one hand, some affected municipalities stated that the 2010-related infrastructure upgrade is more than overdue, and would push infrastructure into the right direction. Most municipalities expected the infrastructure to have a positive impact on local economic growth. On the other hand, some municipalities also argued that the same funds could be used for other purposes, thus reducing more backlog, and thereby targeting the needs of many more South Africans. Only in rare cases does the 2010 infrastructure coincide with poverty-reducing infrastructure, as in Mangaung municipality (Bloemfontein), where new roads will connect the city center with a township hosting a training ground. Mostly, the new infrastructure is proposed for areas that already enjoy relatively modern and urban infrastructure.

The profitability of the World Cup infrastructure is not secured, because the costs of setting-up this infrastructure do not match the expected lack of revenues in the future. Currently, the costs keep rising. As all affected municipalities need

Box 4 continued

to build the infrastructure during the same time period, labor and material are scarce and prices soar. Eventually, also maintenance costs will be high and make up an unproportional share of operating budgets, particularly in smaller host cities like Nelspruit. Moreover, the grants for the host cities are for new infrastructure, and do not cover maintenance. To cope with the large costs, municipalities consider Public-Private Partnerships and leasing as a financing option (for example in the case of the possible “ABSA Soccer Stadium” in Nelspruit). The existing “FNB Stadium” in Soweto is already a showcase in this regard. On the revenue side, the municipalities worry about the required revenues to make the stadiums profitable: it is unclear if there will be enough follow-up events that keep generating revenues, in particular beyond the major metropolitan areas. For all municipalities that are involved in the World Cup a big issue will be the act of balancing both a successful event and generating revenues: soccer is most popular among black South Africans, many of which can not afford expensive tickets for matches and public transport.

The national government provides large grants for 2010 for the budgets of the municipalities. The World Cup-related infrastructure therefore gives no reason for more municipal borrowing. This is an interesting finding, since most of the 2010 infrastructure is considered to be growth-enhancing and could therefore possibly be financed by municipalities with more market-oriented means such as loans.

A large amount of debt capital is taken up by municipalities that have to account for a large amount of the total estimated backlog costs. The metros in addition to the secondary municipalities make up the bulk of municipal debt capital. This debt accounts for 19 billion rand, out of a total of 20 billion rand based on 2004/5 data. DBSA estimates that the additional capital required to eradicate backlogs within the next 10 years in these municipalities is 36.4 billion rand, i.e. 64 % of the total estimated 57 billion rand. Certainly, the mere fact that there is a lot of debt capital in budgets that need to account for a lot of backlog costs does not suggest any causality that this debt is actually used to finance the backlog. All that can be said is that 95 % of municipal borrowing flows to capital budgets that need to cover an estimated 64 % of the infrastructure backlog costs. The relation between municipalities that borrow and those that need to address the backlog could be a lot worse. One could well imagine a situa-

tion where only rich municipalities that do not have to address any infrastructure backlogs can borrow. That is certainly not the case in South Africa. The demarcation in recent years is certainly a major reason for this.

There is a general trend throughout South Africa to finance projects that help reduce the infrastructure backlog, which is most pressing in the formerly neglected areas. Based on our interviews, there is no uniform opinion about the strength of this trend. Interviewees from both municipalities and other stakeholder groups confirmed that the investment focus is placed on poor areas. However, ESAs argue that many municipalities are still biased in their investments in urban areas and do not make enough effort to serve neglected areas.

To assess the contribution that debt capital can make in eradicating the backlog, it is interesting to contrast the overall outstanding debt per municipalities with the estimated required capital to reduce the backlog. DBSA estimates the accumulated cost to eradicate the backlog across the country during the next ten years to be 57 billion rand. Water, sanitation, and roads infrastructure require the largest funds respectively. To put this into perspective, the total budgeted capital funding of all municipalities in 2005/6 amounts to 25.4 billion rand, new external loans comprising 4.4 billion rand of this total sum. Assuming stagnant budgets over the next ten years for the sake of simplicity of the argument, 254 billion rand will be available, including 44 billion rand debt capital. However, one could point to the size of the total budgeted capital funding and argue that within just a few years, this money would suffice to eradicate the backlog. Yet, municipalities need to budget for a lot of infrastructure beyond basic services. Thus, a large part of the debt capital will also not be used in eradicating backlogs. Keeping the above two indications in mind, it is nevertheless possible to argue that within the next ten years, municipal borrowing can contribute a significant sum to the estimated costs in eradicating backlogs.

While the infrastructure backlog is a very important political topic in South Africa, one should not over-emphasize the backlog in this analysis for two reasons. First, each municipality needs to strike a balance between poverty-reducing infrastructure and infrastructure that generates economic growth. The most important criterion of a municipality, as quoted by one expert is “not going bankrupt”. Second, it is necessary to keep in mind the interaction with other funding sources when analyzing the contribution of debt capital to the infrastructure backlog. Grants will remain a major fund-

ing source in addressing backlogs. Interviewees stated that particularly the Municipal Infrastructure Grant (MIG) provides municipalities with money for basic services. Many of the visited municipalities noted, however, that the MIG money is not able to tackle the backlog sufficiently. One way to supplement the MIG money is to use debt capital for backlog-reducing projects, as stated by municipalities and the government. However, some municipalities said that loans would not be used for non-revenue generating projects, which constitute a large part of the backlog-reducing projects.

4.2.4 The implementation of debt capital-financed projects

Debt-financed projects in South Africa are not implemented in a way different to projects with other funding sources. This goes against theoretical expectations, which can be operationalized in three possible ways: Debt-capital financed projects could have a more efficient cost-calculation, they could be implemented faster, and the maintenance expenses per project could be higher. The reasoning behind these expectations is that the need to repay the borrowed capital induces the municipality, first, to calculate the expenses for the project more carefully, second, to implement the projects in a fast way because of the accountability to the lender, and third, to budget for proper maintenance to increase the economic life span of the project and thereby the projected revenue base (see e.g. Peterson 2000, 13–4). In South Africa, none of these expectations could be confirmed.

There is no clear evidence that borrowing entails a more efficient cost-calculation in South Africa. Because of the prevalence of general obligation lending, it is very difficult to trace any direct link between borrowing and cost-calculation for a specific project. Even though municipalities might internally budget the borrowed money for a specific project, this study did not find any evidence that debt capital leads to a more efficient cost-calculation, when looking at the municipalities' point of view. Only a few domestic and international public lenders share the opinion that the awareness of paying back has a positive effect rather than just getting grants. Borrowing, so they assume, would discourage politically-influenced choices and lead to projects with either a financial or at least an economic rate of return that is good for economic development. One ESA further pointed out that sometimes the lender insists on a resource-saving implementation. Yet, again, there is no supporting evidence from municipalities or private lenders. The same public lenders also caution against a

too strong emphasis on this point, stating that there is not much evidence that people deal more responsibly with money when they have to pay it back.

Debt capital does not lead to a faster implementation of infrastructure in South Africa. This is a consistent finding of this study, expressed by a large number of stakeholders, both from the lending and from the borrowing side. Again, this applies as well to general obligation as to project financing. There is even the suspicion of municipalities that borrowing actually delays the project's realization. It is the lengthy process to take out a loan in the first place that is responsible for these statements. Different municipalities stated that the time-span for taking out loans differed from 48 hours to two years. Others stated time-spans in between these two extremes, such as a six or 12–14 months loan application processes. It seem to take more than one year to process issuing a bond, as experienced by the City of Johannesburg for several years and currently also by the City of Cape Town. One local municipality said that to finance a project with a loan delays it by 3–6 months. According to metros, there are also differences within the range of debt-financed projects: borrowing for general obligation seems to be faster than borrowing for a specific project, and the interaction with ESAs can be particularly lengthy because of specific developmental or environmental considerations. Whether the speed is a crucial factor for good infrastructure service delivery is open for debate. One public lender felt that a carefully targeted project might be better, while another supported the theory suggesting that debt capital would never lead to implementing projects faster; companies using their own capital will always be the fastest. Confronted with the lengthy process of getting a loan, the South African municipalities try to creatively deal with the needed time: one strategy is a phased or bridged financing, starting with readily available grants or own revenues, and proceeding at a later point in time with loan money for the same project. Tendering before the financial year starts helps speed up the long application process.

Debt-financing does not imply more maintenance expenses in South Africa. There are several reasons for this. First, it is illegal to take out debt capital for maintenance expenses, as regulated by the new accounting standards. Second, there is government regulation that the operating budget may only grow by a certain percentage per year (5 %) and maintenance has to be financed out of the operating budget. Therefore, there is no

link in South Africa between the growth of the capital budget and the money budgeted for maintenance. Since many loans are not earmarked, they do not have to be paid back with revenues from a particular project. Here again, proper maintenance of one project is not directly tied to repaying a specific loan. This matches the perspective of lenders, who do not inquire in-depth about the budgeted maintenance expenses of a specific project, but rather look at the general financial situation of a municipality.

4.3 Indirect effects of sub-national borrowing on infrastructure service delivery

In addition to direct positive effects of sub-national borrowing on infrastructure service delivery, literature assumes that there are further positive effects on local governance (Jackson 2006, 6; Freire / Petersen 2004, 11–12). This relates to transparency, accountability, and financial management. Although it is hard to empirically "prove" the claim, our interviews revealed four different processes that impact positively on local governance. We assume that better local governance, in turn, results in a more efficient and needs-oriented use of resources and therefore in better infrastructure service delivery.

4.3.1 Relevant aspects of local governance: transparency, accountability, and financial management

There are many definitions of governance and on how it should function. The one that serves this study best is used by the United Nations Development Programme (UNDP 1997, 9). It distinguishes between economic, political, administrative, and systemic governance. Sub-national borrowing particularly impacts on administrative governance, which relates to policy implementation in terms of an efficient, independent, accountable, and transparent public sector. When looking at municipalities in South Africa, this study shows that borrowing has a positive impact on accountability and transparency. Furthermore, borrowing positively impacts efficiency, resulting from better financial management.

Transparency serves as a means of holding public officials accountable. It refers to documents such as a municipality's budget or financial statement and to the processes leading to decisions. **Accountability** "is the principle that individuals, organizations and the community are responsi-

ble for their actions and may be required to explain them to others" (Warwick 2007). In the context of this study it means that a municipality that enters into a contractual agreement to perform a service, such as delivering services or a loan agreement, will be held responsible for performing according to agreed-on terms and with a stipulated use of resources and performance standards. **Financial management** is very important when it comes to the efficient use and allocation of resources. Good financial management results in needs-oriented planning and implementation and is, therefore, crucial when it comes to infrastructure service delivery.

The more transparent the governance process is, the easier it is for stakeholders to hold the right persons accountable for their action or inaction. Three types of stakeholders are relevant: the lenders, who have a legitimate interest to get their money back; the citizens, who expect an efficient service delivery according to their preferences; and the other spheres of government, who are tasked to control and support the municipalities in their efforts to deliver services in a system of checks and balances.

4.3.2 Four processes leading to improved local governance

We identified four processes that support the theoretical assumption of a positive impact of municipal borrowing on local governance: external assessment, tendering, reporting, and "sitting together". The analysis links the four processes to stakeholder groups. This is done respectively for the three relevant governance aspects: transparency, accountability, and financial management.

External assessment

A credit rating increases transparency towards lenders and citizens, it lowers credit costs and it supports efforts to improve financial management capacity. However, the rating itself might be costly and it needs to be reliable in order to live up to its objectives.

If a credit rating is performed by an independent rating agency, it is the most important external assessment tool in a capital market. It is an informed opinion by an external specialist "on the chances that a borrower will repay a loan as promised – on time, in full" (Jackson 2006, 7). The rating tells a prospective investor about the risks to lend money to a specific entity, taking into account relevant information about management

capacity, the record of repaying past loans, prospects of the investment and related issues. The information is condensed in a rating, like the well-known Standard & Poor's scale ranging from AAA for the best possible rating to a D (for default).[8] From a certain threshold onwards, a rating is called "investment grade" to indicate a low-risk investment.

External assessments such as ratings are publicly available and thereby increase transparency. A rating sheds light on aspects such as a municipality's financial position, its quality of management. It is not the borrowing itself that increases transparency, but an action taken that ideally precedes a municipality's engagement in borrowing. In South Africa, 25 of 283 municipalities have a credit rating, of which CA-Ratings, the local credit rating agency, rated 23 municipalities. Twelve of the 29 municipalities of our sample took part in the credit rating process, which mainly resulted in an investment grade rating. However, one supply-side interviewee complained that the local ratings are "as political as they are analytical". This indicates that there is some doubt about the reliability due to increased transparency caused by a local rating.

There are two ways how municipalities use the increased transparency brought by the ratings: First and most importantly, a rating lowers their credit costs since it pools information which a lender needs to get anyway. Some of our interviewees confirmed that after a rating the municipality got lower-priced credits. In some cases, though seemingly not in sampled municipalities, a rating opens up the possibility to enter the credit market. Second, a rating is used by some municipalities as a management and public relations tool. These municipalities use the information contained in the rating as a performance measurement tool for themselves to improve their quality of work, particularly their financial management. One municipality used a (good) rating to inform its citizens about the good performance in its monthly newsletter.

There are, however, also municipalities that do not favor a rating. They argue that banks are willing to lend at low rates, with or without a rating. Some municipalities also hesitate to enter a rating process due to the costs associated with it.

8 The South African Rating Company CA-Ratings uses basically the same scale but puts a "za" in front of the Standard & Poor's classification, e.g. zaAAA.

Tendering process

Tendering practices for municipal borrowing in South Africa guarantee a high level of transparency when a municipality takes out a loan. For long-term liabilities municipalities usually advertise a request for proposals 21 days in advance. All but two sampled municipalities follow this procedure. This makes the procurement of a municipal loan a very transparent process. Especially large and financially viable municipalities benefit from this, since they usually receive competitive offers both from public and private investors.

The interviewed banks even perceived too much transparency, especially with regard to the tendering procedures: It was argued that when it comes to innovation, the rules for transparency could work against innovative banks, since the transparency makes the copying of innovations easy. The first mover advantage disappears. However, relationship banking avoiding competition would go along with less transparency and most likely higher interest rates. Therefore, a competitive and transparent system results in a more resource-saving use of funds. In addition, the problem seems to be the way municipalities deal with the tendering process rather than the process itself. Banks claim that by using the lenders' bids against each other (opening secret bids before the closing date of the tender), municipalities force interest rates down. One interviewed municipality even admitted this.

Reporting and monitoring

Via reporting and monitoring, sub-national borrowing mainly increases the accountability of a municipality towards its lenders. Under certain circumstances, reporting and monitoring can also improve a municipality's transparency and accountability towards its citizens.

The reporting requirements for loans and grants are nearly the same. They are mainly determined by law. However, the recipient of the reporting is quite different. Since loans, compared to grants, have to be paid back, banks most likely have a closer look at a municipality's report than a grant-giving government.

The opinions of our interviewees regarding the governance impact of borrowing-related reporting by municipalities and monitoring by lenders range from "equal impact" to "higher impact" compared to grants. A

closer look at the reasoning, however, reveals that there are different lines of argumentation underlying the different judgments. The opinion "equal impact", as expressed by two interviewees, suggests that the reporting for grants and credits is the same. In particular the academic experts interviewed argued that borrowing-related reporting and monitoring impacts more on local governance. The reason for this is that the recipient of these reports is quite different. While grants make the municipality accountable to the national and the provincial government, credits and bonds make them accountable to banks or investors. The ones arguing that borrowing has a major impact on a municipality's accountability suppose that the accountability that comes with grants, especially with unconditional ones, is not of a very strong nature. A municipality's accountability towards its lenders is much stronger, so the argument expressed both by some municipalities and academic experts, since banks want their money back. One expert put it clearly: "*This creates more control of the local government than the central government could ever create.*"

The findings of this study support the argument that the accountability of municipalities towards banks is of a stronger nature than towards government: Municipalities complain that government, especially provincial government, even though requesting various reports on a regular basis, does not have the capacity to exert its oversight function. In addition, so the experience of many municipalities, government takes a long time to answer to a municipality's request. In contrast, banks, reply fast. They look, amongst others, at a municipality's cash-flow. However, banks do not seem to strictly follow their own principles. For instance, they still provide loans to the City of Johannesburg, even though it has not fully met all legal reporting requirements in recent years.

Reporting can also delay service delivery. The requirements that lead to an increased level of transparency bind resources, since somebody has to write these reports. Since capacity is scarce at the municipal level, it might be redirected towards report writing instead of implementing projects. Many of the interviewed municipalities complained about the high reporting workload. Many of the reporting requirements in South Africa are new, which adds to the existing workload, since municipalities have to build new competencies to cope with the requirements. As a consequence, the reporting should be as standardized as possible.

Reports such as the annual financial statement or external assessments such as ratings are also publicly available. This means that a municipality, theoretically, is more transparent towards its citizens. However, our findings suppose that citizens of the municipalities don't know or are not interested in where the funding for infrastructure projects originates. Most of the interviewed municipalities stated that citizens do not know how projects are financed, even though they are informed during public hearings about the financing. However, citizens care, when services are delivered. Additionally, citizens obviously are aware of increasing tariffs, which may come along with capital investment, since tariffs must cater for operation and maintenance. This increases the accountability of a municipality towards its citizens. Obviously, a grant financed project will also have to be operated and maintained, i.e. an accountability increase is not a unique characteristic of borrowing.

One particular financial instrument is the retail bond. It could be used to strengthen the impacts of borrowing on the accountability of a municipality towards its citizens.[9] A retail bond is a type of bond that allows an individual to invest relatively small sums. Consequently, if citizens buy bonds of the municipality they live in, the municipality is more accountable to these citizens. Then the citizens not only expect the services to be delivered, but also the loan and interest to be paid back to them.

"Sitting together"

"Sitting together" increases a municipality's accountability primarily towards its investors and partly towards its citizens. From time to time financial institutions "sit together" with municipalities to obtain up-to-date-information and to sort out possible problems. This "sitting together" takes place on a regular basis. Investors and banks assess their debtors, e.g. the cash-flow, and in case they reveal shortcomings, they try to solve problems together with the municipality. Not only banks confirmed this impression, but also the interviewed municipalities. Most of them had good relationships with their banks. These banks visited their municipalities on a regular basis. Some municipalities told that their bank would come and help resolve problems when help is needed in regard to financial manage-

9 One has to take into account that issuing a retail bond might be more expensive than taking up a loan.

ment. INCA e.g. shares its model to assess a municipality's financial viability with its customers. However, not all banks engage in sharing financial knowledge with municipalities to improve financial management. Some banks consider this as not part of their business.

All of the interviewed banks but one supported the argument that borrowing increases accountability towards lenders. The high level of accountability towards lenders is evident when looking at the City of Johannesburg; the city meets with the investors the evening before issuing its annual financial statement. This kind of "investor-relation-exercise" shows the prominent role accorded to financial institutions by municipalities. It is debatable, of course, if lenders get too much influence on investment priorities by "sitting together" which do not seem to be in line with usual democratic procedures. However, a municipality, as every debtor, has to pay back its debt and lenders have a legitimate interest in getting as much information about its investment as possible. Citizens have to make sure that they decide democratically about budget decisions, but the administration is responsible for avoiding financial imbalances. Both procedures need not be in conflict but can complement each other, as it is argued in this section.

In South Africa, a municipality also "sits together" with its citizens in the process of composing a so-called Integrated Development Plan (IDP). Here one cannot say that it is borrowing that strengthens the link between a municipality and its citizens. But since all of a municipality's projects and investments, including the ones financed by external loans, are supposed to be part of the IDP, the citizens are at least involved in setting the infrastructure priorities. Even though many municipalities use external consultants in the IDP compilation process, interviews conducted for this study suggest that there is a trend towards more ownership of the municipalities. They are all supposed to have public hearings in their wards. However, some municipalities complained that these meetings are poorly attended or that the participants in the meetings addressed their private problems instead of caring about improving the municipality's infrastructure for service delivery.

5 The regulatory framework: precondition for sub-national borrowing

After showing the impact of sub-national borrowing on infrastructure service delivery, we now turn to the regulatory framework as the first of the three prerequisites. There are several options to regulate sub-national borrowing (Section 5.1). The regulatory framework in South Africa, especially the Municipal Finance Management Act (MFMA), facilitates sub-national borrowing in several ways. Particularly by encouraging the actors to borrow or lend (Section 5.2), by imposing rules that give municipalities clear guidance and provide the supply-side of the borrowing market with predictability, clarity and confidence (Section 5.3), and by regulating potential crises and preventing those positively (Section 5.4). Additionally, functioning implementation of the law adds to the success story of South African regulations on sub-national borrowing (Section 5.5).

This chapter shows that the South African law makers have successfully diminished some of the earlier perceived uncertainties[10] by introducing a set of regulations ending with the MFMA. Interestingly, the regulations match strongly with what foreign scholars consider to be of crucial importance if a country wants to engage in sub-national borrowing. However, there are still single shortcomings in the South African framework.

5.1 Options to regulate sub-national borrowing

Looking at the academic debate on sub-national borrowing, it is striking that South African laws match all the requirements that scholars have identified to be of importance if a country wants to foster sub-national borrowing. Some, as Martell / Guess (2006, 117),[11] consider the legal framework to be of paramount importance and suggest establishing such a framework first in a sequence of reforms, followed by a viable supply-side

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10 Those were mentioned for example by Venkatachalam (2006, 9–10) who explains recent uncertainty of the development of South Africa's municipal financial markets with the changes in political and fiscal structures but also with the deficiencies in the regulatory framework.

11 Martell / Guess (2006) back their theoretical idea with empirical research done in Indonesia, Mexico, the Philippines, Poland, and South Africa.

and a creditworthy demand-side of the borrowing market. A regulatory framework should at least deal with three challenges:

First, a regulatory framework must not prohibit sub-national borrowing. Rather, the legal framework should be such that sub-national entities are allowed to engage on their own with financial markets to finance their projects. In that sense, the regulatory framework enables demand by devolution of borrowing power to sub-national entities. It is furthermore important to stipulate which levels of government may borrow. This helps regulating the interaction of different levels of government.

Second, a regulatory framework should provide predictability, clarity and confidence in sub-national borrowing. Only a clearly stated legal framework can encourage participants, ranging from investors to municipal officers to engage with sub-national borrowing. To play this overarching role, the design of the framework is crucial: The framework needs to be well formulated, comprehensible and consistent. It also has to cover all necessary aspects.

Third, a good regulatory framework can reduce the risk of imprudent borrowing by preventing over-borrowing and by providing instructions on how to deal with financial crises. Over-borrowing at the sub-national level and instability at the macroeconomic level in form of financial deficits or inflation are less likely to happen when there is a good system of regulations. There are different ways in which the national government can contribute to prudent borrowing. Which option to take is a much-debated issue (see e.g. Peterson 2000, 43). A fundamental decision that a national government has to take is whether to provide a sovereign guarantee or not. With a sovereign guarantee, the national government takes final responsibility in dealing with a financial crisis of sub-national entities. If a sub-national entity is unable to re-pay debt, the national government would step in and bail out the failed creditor.

Each country needs to decide how to deal with the above-mentioned challenges when establishing a legal framework. National governments have adopted different responses to the challenges of decentralized decision-making. A key question is how a country chooses to control sub-national borrowing in order to avoid the risks associated with it.

Plekhanov and Singh (2007, 430–432) analyzed 43 countries over a period of eight years and have developed four types of classifications of control.

First, a country can rely on market discipline. In this case, the state sets no limits and there is no perceived chance of bailing out. Secondly, there is the situation that the central government uses an administrative approach by directly controlling all sub-national borrowing. A third type of control is the rules-based approach, where the government chooses to balance the tension between compliance and missing flexibility. The final option of control is the cooperative approach. This approach uses an ongoing negotiating process between different levels of government. By coordinating interests, more flexibility is offered opposed to the rules-based approach.

5.2 The South African approach to regulate sub-national borrowing and its key regulations

According to Plekhanov and Singh (2007, 445), South Africa controls sub-national borrowing via a cooperative approach. In our opinion, South Africa lies between a cooperative approach and a market-based approach. The cooperative element originates from the South African Constitution. Article 40 states several spheres of government as "distinctive, interdependent and interrelated". Moreover, Article 3 requires a "co-operative government". Hildebrandt / Wehner (2004, 78) stress that the cooperative element of South African federalism is more obvious when looking at fiscal aspects. It is not the case that each sub-national entity has its own income sources separated from the other spheres of government. On the contrary, provinces and municipalities have very little income they can influence as the central government receives income as well as valued-added tax. South Africa reduces this "vertical imbalance" or "fiscal gap" through the cooperative element of the equitable share. One can observe the following elements of a cooperative approach: first, sharing of tax revenues between the spheres of government through the equitable share and secondly, spheres of government controlling each other in terms of who borrows how much.

In South Africa the legal setting of sub-national borrowing is also partly market-based, as sub-national entities can generally borrow as much as they want. It is municipal councils that authorize debt, not the federal government and the framework allows for very little central control, as there are no country-wide debt limits. Municipalities can even go insolvent. But, as Plekhanov / Singh (2007, 430) point out in the market discipline approach there should be no perceived chance of a bailout by the

central government in the case of a default, which is a critical issue in South Africa.

Need for new laws: abandonment of national state guarantees and uncertainty through amalgamation of municipalities

The need for new regulations occurred in 1994. The system of national government guarantees was abandoned, uncertainty arose regarding the creditworthiness of newly created municipalities and a legal vacuum developed. The explicit abolition of national state guarantees forced local governments to borrow on their own merits. The 1996 Constitution precludes national guarantees other than under carefully controlled conditions. This step was important to increase local government accountability and to impose a hard budget constraint. The other side of the coin, however, is the fact that it is riskier under such a system to lend to municipalities. Therefore, at least initially private investors were discouraged from providing debt money.

Additionally, due to the amalgamation of wealthier and poor regions during the demarcation process, private investors' uncertainty about the fiscal strength of municipalities has lowered private investment. In general, a high level of uncertainty prevailed also due to successive changes not only in borders, but also in the local governments' powers and functions, which made it difficult for both municipalities and investors to anticipate the future. As long-term borrowing and lending depends on long-term predictability, these processes decreased the willingness to provide long-term funds.

Lastly, the abolition of national government guarantees created a legal vacuum for municipal defaults or municipal inability to service debts. This revealed the necessity for a regulatory framework to deal with the many aspects of debtor-investor relationships. However, sub-national borrowing remained unregulated for almost ten years.

Legal reform: a regulatory framework for sub-national borrowing in South Africa

Subsequently, South African policy makers have addressed the lack of a regulatory framework during the last decade. A suite of policy reforms have been enacted since 1994. These reforms aim at making municipalities

more financially sustainable and accountable, and aim at regulating and facilitating sub-national borrowing. In this section, we present in detail the legislation dealing explicitly with sub-national borrowing, such as the Constitution, the White Paper on Local Government and the Municipal Finance and Management Act.[12]

Constitution (1996): The Constitution of 1996 forms the legal ceiling for local government borrowing of the new system. Chapter 7 ("Local Government") of the Constitution, as described earlier, specifies the objectives and tasks of local governments. In particular, Chapter 13, Section 230A („Municipal loans") deals with municipal borrowing, allowing municipal borrowing in accordance with further national legislation. While this section does not establish limits for credit financing of capital expenditure, borrowing for current expenditure is restricted to bridging purposes within a fiscal year.

White Paper on Local Government (1998): The White Paper on Local Government intends to establish a basis for the new local governmental system and was preceded by a long process of debate and discussion. Rather than being legislation in the narrow sense, it is to be seen as a comprehensive vision on the objectives and aims of local governments under the new constitution and as a framework for further legislation. The White Paper emphasizes in Section G ("Municipal Finance") the importance of municipal borrowing for generating additional finance to meet infrastructure backlogs. It formulates the goal of further expanding municipal borrowing so that "ultimately, a vibrant and innovative primary and secondary market for short and long-term municipal debt should emerge" (White Paper, Section G, Article 3.1). In order to achieve this goal the paper states that on the one hand national government would have to make efforts for properly defining the "rules of the game", and on the other hand, local governments should strengthen their creditworthiness through proper budgeting and sound financial management. The White Paper also defines the role of public sector lenders.

12 However, other legislation also plays a role for sub-national borrowing, as it forms the foundation of the new local government system and, therefore, has an impact on sub-national borrowing indirectly. These regulations are found in the Municipal Structures Act (1998), the Municipal Demarcation Act (1998), the Municipal Systems Act (2004), and the Municipal Property Rating Act (2004).

The Municipal Finance Management Act (MFMA) of 2003 aims to modernize budget, accounting and financial management practices by placing local government finances on a sustainable basis in order to maximize the capacity of municipalities to deliver services to communities. This act also aspires to arrange a sound financial governance framework by clarifying and separating the roles and responsibilities of the council, mayor and officials. The act is an important step to fulfill the requirements of the Constitution, which obliges all three spheres of government to be transparent about their financial affairs.

The MFMA was adopted in 2003 and was enacted on 1 July 2004. It is now the primary legislation governing municipal finance, and is a milestone for regulating municipal borrowing. The whole paper is extremely relevant to municipal borrowing, even though only one part of the act deals directly with borrowing. Other parts affect municipal borrowing indirectly, by increasing transparency and thus lending to efficiency.

The MFMA has an important impact on municipal borrowing by introducing regulations and procedures in case that municipalities incur financial emergencies or insolvencies, thus filling the regulatory gap that emerged from the abolished national guarantees.

— **Provincial / national intervention**: If a municipality has serious financial problems, the MFMA provides for provincial or national intervention to address these problems. The Member of the Executive Council for local government calls for the newly established Municipal Financial Recovery Service to prepare, implement and supervise an appropriate recovery plan for the municipality.

— **Debt relief and restructuring**: The MFMA sets rules and defines procedures for the case of a municipality going insolvent. It defines the rights of creditors and municipalities and establishes a process for debt restructuring, including regulations for a stay on legal proceedings, the suspension of financial obligations and the settlement of claims.

Below, we focus on single aspects of the MFMA, analyzing why those facilitate sub-national borrowing and how they deal with crises.

5.3 Facilitation of sub-national borrowing for infrastructure service delivery

As the MFMA is a comprehensive legal act, only single norms are mentioned. Very important are the rules that make sure that long-term debt is used for capital expenditure. Further, there are several regulations on budgeting, accounting, reporting and supply-chain management that impose discipline on municipalities and lead to greater transparency. Lastly, a clear distribution of responsibilities, and clarity and comprehensiveness of the law increase predictability and confidence.

"The rules make sure that borrowed capital is used for infrastructure"

The fact that long-term debt is indeed used to provide more infrastructure is a result of the debt regulations of the MFMA found in Chapter 6, 46.(1)(a), as previously mentioned. A municipality can only raise long-term debt for capital expenditure or to refinance existing long-term debt. The other side of the coin is that the regulation implicitly prohibits borrowing for maintenance because maintenance is part of the operating budget.[13]

Prior to the MFMA, municipalities were sometimes using long-term debt for short-term expenditure or short-term debt for long-term expenditure. Economically sound, however, is to achieve a match of the economic life span of the financed project and the credit maternity. If short-term debt is used for a longer lasting project, the project will not bring enough revenue until the debt is due. On the other hand, if long-term debt is used for short term expenditure like salaries, a municipality runs a high risk of over-borrowing.

"The rules impose a lot of discipline and increase transparency"

Several regulations on budgeting, accounting, reporting and supply chain management impose discipline on municipalities and lead to greater transparency. There are two groups of relevant norms: those that explicitly deal

13 Maintenance costs are part of the operating budget according to the new accounting regulations GRAP and GAMAP from the national government. This is problematic because the MIG does not cover maintenance, thus municipalities have to mobilize their own revenues to finance maintenance of infrastructure.

with debt in Chapter 6 of the MFMA and those that apply to municipalities irrespective if they borrow or not, mainly in Chapter 3 on municipal revenue and in Chapter 4 on municipal budgets.

Overall, there are more than 60 requirements that municipalities have to fulfill under the MFMA. Most of those requirements deal with **reporting** to provincial treasuries by accounting officers, executive mayors, auditor generals, the council, or the CFO. The municipalities commented during our interviews that the requirements for reporting were extremely high. At least ten municipalities feel that they suffer under the amount of reports they have to deliver. Some said that they need more staff to meet these reporting requirements. Clearly, staff is assigned for reporting tasks that could otherwise implement projects. Nevertheless, interviewees generally found that the MFMA is a great law and that they are getting used to the new requirements.

The only negative side effect of these reporting requirements is the workload. The hard work of the municipalities does not only add to their individual creditworthiness but also makes the whole sub-national financing market more transparent. The trade-off between transparency and burden of work should be carefully observed. The government might think of reducing requirements in the future, once the positive effects of transparency and discipline are established.

Chapter 6, Section 49 on **disclosure** needs to be mentioned explicitly because it directly increases transparency. It requires that all parties involved in borrowing on behalf of a municipality must disclose all relevant information for the decision-making process when interacting with a lender. This norm was not mentioned expressly by any of our interviewees. This might imply that the information provided to banks is self-understanding for the municipalities by now. It is either required by the banks or it might simply have become a general procedure without having to refer back to the law.

We found one set of rules particularly relevant to transparency. These are the **tender regulations** which are part of Chapter 11 of the MFMA on goods and services. Tender regulations were often mentioned as particularly cumbersome. Three municipalities explicitly said when borrowing they did not know if they have to tender or not. Moreover, other interviewees were eager to state their opinions about the advantages or disad-

vantages of tendering. Thus, tendering for borrowing purposes easily exhibits the tensions between transparency on the one hand and overregulation on the other.

There is an uncertainty if tender regulations apply to borrowing or not. This is quite disturbing. Interestingly, almost all municipalities we spoke to apply tender regulations to borrowing though there is no explicit reference to borrowing. Only some municipalities do not tender for borrowing because they either:

- bypass the lengthy tendering process, deciding to consider an unsolicited bid received outside the normal bidding process. This is possible under the vague conditions of Section 113, MFMA,
- or make a planned deal public and wait for objection. If any other lender objects, a normal bidding process is started.

The wording of Chapter 11(1) of the MFMA applies to “procurement by a municipality of goods and services”. It does not define if “services” also include financial services such as loan agreements. Nor is it possible to ascertain the intentions of the lawmaker by referring to the systematic interrelationship to Chapter 6 on debt since it does not explicitly refer to tender regulations. One could guess that since there is no reference, tender regulations do not apply. Additionally, there is a requirement that municipalities need to go public with their borrowing intentions. This requirement is stated in Chapter 6, Section 46 that expects municipalities to make their long-term debt intentions public by offering an informal statement 21 days before the finance officials meet with the Council and 21 days before the finance officials request the National Treasury and the provincial treasury for comments on the planned loan agreement. This might be a parallel requirement for borrowing procedures replacing tender regulations. We recommend that the National Treasury should clarify in Chapter 6 on debt that Chapter 11 on supply chain management applies to debt.

“The rules generally increase certainty, predictability, clarity and confidence”

As to legal certainty and clarity in general, interviewees often stated that the MFMA provides certainty and a clear set of procedures. The interviewees felt that it was understandable and concise. Looking back, Glasser / White (2004, 328) stated that there is uncertainty relating to

processes and rights of borrowers and lenders, which discourages lenders and leads to unwillingness of investors to enter the municipal borrowing market in South Africa. One major achievement in this context is the crisis regulations. These regulations have helped overcome uncertainty and unwillingness to invest and are dealt with separately after this section. When investors know what happens in case of a crisis they are more likely to make positive investment decisions. Further, the MFMA gives guidance to the supply and demand side by assigning clear responsibilities. Municipalities are thereby helped in distributing several tasks and learn about specific responsibilities. Banks, on the other hand, know with whom they need to deal or refer to.

Clear guidance is provided by the distribution of **responsibilities**. Several interviewees underlined that the MFMA clarified the fields of responsibilities of political and administrative positions. Especially councillors and municipal managers are supposed to have a better understanding of their roles. This clarification refers not only to single positions and tasks but also, as one interviewee stated, "the MFMA helped clarify the relationship between administration and politics".

Another factor that influences the confidence and predictability regarding sub-national borrowing is the norm on **securities.** In general, a municipality can provide security for any of its debt obligations with any category of revenue or rights to future income according to Chapter 6, Section 48. The critical issue here is that municipalities can pledge their equitable share for loans. In case of an emergency, this could lead to a severe lack of means to finance basic services. However, even in the case of default, a not further specified minimum level of municipal services is retained from the grasp of creditors. Generally, it provides confidence and certainty to the investors, if they know how to secure a loan. However, during the interviews, we received little information regarding the actual situation of municipalities pledging the equitable share or not. Two of the major banks we spoke to said that they do not take the equitable share as collateral, but mentioned that other banks do. Clearly, if it often happens that a municipality pledges the equitable share, this could be a risky aspect of sub-national borrowing, as the instrument of sub-national borrowing might then be associated with putting the free delivery of basic services at risk. On the other hand, it is difficult to provide any securities for infrastructure loans as it is not suitable to close a road or a water pipe compared to taking away

a house that was financed. We got the impression that banks often do not request for a security but consider e.g. the equitable share when looking at the financial statements. In conclusion, the mere existence of a rule on securities can create the possibility of confidence and predictability for investors.

5.4 Crisis prevention and control policies

As mentioned above, a good regulatory framework can reduce the risk of imprudent borrowing by preventing over-borrowing and by providing instructions on how to deal with financial crises. In South Africa neither the provincial nor the national government may guarantee the debt of a municipality according to Chapter 6, Section 51, MFMA. Further, there are detailed norms on financial emergencies and insolvencies.

The explicit abolition of national state guarantees

Municipalities feel that though the national state guarantees were abolished it has no affect on their ability to borrow. This is an ambivalent observation and means that municipalities think that banks have not decreased lending because of missing guarantees. At the same time, abolishing these guarantees has led to several positive outcomes. Curiously, one can observe such positive changes despite a clear perception of implicit guarantees by most of our interviewees.

Seven municipalities answered with no when asked whether anything has changed since state guarantees no longer apply. However, after having been asked explicitly, five municipalities stated that they were very content not having guarantees to back them. This situation makes municipalities more responsible for themselves and self-reliant. Indeed, the absence of guarantees leads to more independent local government. A municipal finance officer is now forced to convince banks that the municipality is a good debtor. The banks do not refer to anything else when approving loans for municipalities. However, we did not have the impression that abolishing guarantees had a vast impact and produced such a “clear cut” change as foreseen by the literature.

Despite the positive perception of self-sustainability, many interviewees thought that implicit guarantees still exist, at least for the metros. The central government does not **bail out** explicitly but there are assumptions

that at least it provides a grant if a big city is in trouble (i.e. bridging finance). Since the constitution only precludes guarantees other than under carefully controlled conditions, there is immense uncertainty as to what will happen if a municipality runs into serious financial trouble. Eight interviewees said that they do not think that the National Treasury would disappoint bigger cities. Two interviewees even thought that the National Treasury might help smaller municipalities as well. Several of the interviewees explained that they could imagine a kind of "national intervention" in a subtle form, e.g. awarding a conditional grant. They did not perceive that there was an option of a clear and open financial bailout. Interestingly, higher spheres of government interviewed stated that there were definitely no implicit guarantees.

Rules on insolvencies and financial emergency

Since regulations that apply to crisis have not been used, it cannot be guaranteed that they are well designed. However, because the regulations simply exist, investors feel secure. This also contributes to a good environment for borrowing on the municipal level. There seem to be other ways of dealing with financial crisis, e.g. restructuring of debt.

We assume that the MFMA is so strong in preventing a financial crisis via discipline and transparency and that the municipalities are so conservative in their approach to borrowing that there is no need for insolvency regulations so far. There might be another reason why insolvency regulations have not yet been applied; this is related to the role of the provinces. They were sometimes mentioned (similarly to the district municipalities) as the weakest of the three spheres of government. The relationship with municipalities in terms of oversight is not very well established yet. Might the slight assumption of provinces as bad performers or rather the fear of failing as overseers hinder the application of the crisis regulations?

Most of the interviewees perceived the crisis regulations as last resort; as rules that comfort investors and impose discipline on the municipalities. When asked if they had financial crisis yet and if crisis regulations were applied, they usually denied, however often brought up an example of another municipality experiencing crisis and some form of provincial oversight or intervention. Mostly, those cases were finally dealt with by a larger bank involved that managed the restructuring of the debt. In terms of numbers, there were at least six municipalities mentioned in several

interviews in the context of crisis and restructuring of debt.

In conclusion, the question remains what will happen if a more severe crisis occurs than the ones previously acknowledged, e.g. a crisis that includes more borrowed capital. Neither the actors know if national government would support them financially, nor do they know if the quality of the regulations on crisis and insolvency have been proven.

5.5 Why implementation works

Disregarding that financial crisis regulations have not been implemented yet, the MFMA is a law that "is lived". When interviewees mentioned that the MFMA is a law, they could only do so, because they live the law and they know very well what the MFMA contains. Implementation works comparatively well in South Africa. Firstly, there is the political will from above to decentralize fiscal responsibility for infrastructure financing and foster sub-national borrowing. Secondly, the people put pressure on the municipalities from below expecting them to deliver infrastructure. And, thirdly, because the municipalities seem well informed and know how to implement the law. Lastly, if municipalities struggle with understanding or implementing the law, there are appropriate mechanisms from national government in place to help out.

Pressure from above: political will from national government

From a historical perspective, democratization started with the ANC initially opposing federalism. The Homelands were created in the 1960s and 70s with the "excuse" of federalism. The black population, so it was said, would have the possibility to keep its cultural identity, its values and personal development when living separately (Hildebrandt / Wehner 2004, 71). In reality, however, federalism had been conceived to stabilize the Apartheid regime. But the ANC could not realize its ideal of a central state as there were too many parties involved in the negotiations that favored federalism. This concept is no longer contested since there is a decentralized government in place with three spheres of government and a decentralization of responsibilities to provide services for its citizens. On the contrary, South Africans are not only open for change after Apartheid but make efforts in improving it with all powers of government. The pressure from above towards municipalities starts with the self-set obligation of the

government to provide each South African with the right to water or the right to housing. If a municipality is not able to fulfill its constitutional duties, the province will intervene.

Pressure from below: expectations of citizens

As pointed out in the previous chapter on the impact of sub-national borrowing on infrastructure service delivery, citizens care a lot about planned infrastructure to be realized (focused in the IDP). Since there is a possibility to enter the market and approach banks, municipalities can not simply point to the national government not providing enough transfers.

Well informed municipalities

The financial administrative staff we visited always knew about the MFMA and mostly about other regulations, too. Most of the staff was familiar even with the crisis regulations and the explicit abolition of national state guarantees. Some knew whole passages of the Act by heart. Thus, the will to implement the law is clearly in place.

Information mechanisms from national government

Overall municipalities seemed to be content with the help offered from National Treasury to implement the MFMA. Moreover, provincial governments or district municipalities sometimes assist in implementing, e.g. by providing a table summarizing when and to whom the local municipalities have to report to. A program worth mentioning because of its broad size is Siyenza Manje, jointly carried out by DBSA and National Treasury entailing capacity building as well as technical assistance in the field of municipal financial management. Some interviewees mentioned that the provincial governments or National Treasury and DPLG required filling in different reporting forms or gave contradictory answers to questions. Thus, the cooperation between the different ministries and spheres of government could be optimized and standardized to make fulfillment of the rules more straightforward.

Generally, the legal framework seems to be good not only in theory but also in practice. Certainly, implementation requires capacity and capacity is a major constraint in South Africa. But as one interviewee stated: “It would be wrong to criticize the regulatory framework on account that

some municipalities have problems to comply, because they would be unable to comply with any sort of regulation."

6 Creditworthiness of municipalities: the main demand-side requirement for sub-national borrowing

As concluded in Chapter 3, the demand-side of the market forms an important prerequisite for a functioning municipal borrowing market. Crucial in this context are creditworthy municipalities that are both willing and able to engage in borrowing as a means to finance infrastructure investments. This chapter starts off by giving a short overview about the general concept of creditworthiness (Section 6.1). As the income structure lays the ground for municipalities' creditworthiness, the municipal income structure in South Africa is presented subsequently (Section 6.2). Finally, the chapter focuses on the specifics of the municipal borrowing market in South Africa. At first it illustrates the present scope of municipal borrowing in South Africa (Point 6.3.1), and secondly, it depicts the main obstacles for broadening the borrowing market (Point 6.3.2). We find that the decentralized system in South Africa is generally well designed, providing municipalities with sufficient financing means and powers. Nevertheless, the borrowing market is still largely concentrated among a few, bigger municipalities as a consequence of several bottlenecks in the municipal system in practice.

6.1 The concept of creditworthiness

Creditworthiness of sub-national entities is a demand-side requirement for sub-national borrowing. Generally speaking, creditworthiness refers to the ability and willingness of a borrower to repay the debt. Creditworthiness leads to a good credit rating, which enables sub-national entities to attract lenders and borrow at reasonable prices. Phelps (1997), among others, considers information about creditworthiness to be a key factor for a working sub-national borrowing market.

The assessment of creditworthiness is very complex, as many different factors influence the ability to repay debt. Theoretically, two groups of different factors at two different levels can influence the creditworthiness

of sub-national entities: these are financial-economic and political-institutional factors, both at the local and at the national level (Spahn 1999, 4; Peterson 1998). Nevertheless, local factors are the most important in practice.

Local financial factors include key figures like the total debt burden, the ratio of debt to revenue, debt per capita and the financial deficit. However, determinants of the general local economic performance also influence the creditworthiness of sub-national entities. Important in this context are, for example, demographic factors, growth prospects, key industries, poverty, employment levels, and the diversification of the local economy.

Local institutional-political factors comprise the quality of governance, and financial management capacities like accounting, planning, reporting, public disclosure, and marketing skills (Jackson 2006). Additionally, the capacity to secure planning of profitable infrastructure projects also determines the ability of sub-national entities to use the provided capital for profitable infrastructure projects. Only with excellent financial management skills and project implementation skills, sub-national entities are able to plan the right kind of projects, to attract investors and manage projects in a profitable way. Without financial management skills, there is also a danger of over-borrowing: it might not be sound economic considerations that lead to borrowing, but rather political decisions, illusions about the "low" burden of future repayments, unrealistic revenue projections and unsound financial management (Bahl 1981, 263; Zimmermann 2006, 293–4).

6.2 Municipal income structure

The structure of municipal income sources is an important determinant for local creditworthiness. Hereby, the stability and predictability of the revenue stream is the most important factor, irrespective of whether funds come from intergovernmental transfers or own-source revenues. However, to assure municipalities' independence and flexibility, it is essential that a part of the revenue is raised locally. This means local taxes and/or decision-making about some significant revenue sources should be left at the local level. The design of the municipal income structure in South Africa will be presented in this section, concentrating on own-source revenues

and intergovernmental transfers. The third source of income, borrowing, is discussed in the next section.

Own-source revenue

On average, South African municipalities obtain 86 % of their income from their own resources (IDASA 2005, 1). However, it is important to keep in mind that this is an unweighted average, and the share of own-source revenue varies significantly among the municipalities. While the six metropolitan municipalities generate about 97 % of their budget through own revenues, smaller municipalities with annual budgets of less than 300 million rand generate on average only 65 % through own revenues. Municipalities in poor, rural areas sometimes even generate less than 10 % of their income through own resources (Glasser / White 2004, 318).

Most of the own-source income of local and metropolitan municipalities comes from user charges and taxes. Thereby, **user charges** are the biggest source of revenue of the operating budget. The lion's share of the income can be generated through surplus-services like electricity and water, some through break-even services such as refuse or sewerage. In 2005/06, municipal operating budgets were planned to be mainly funded by electricity sales of 24.3 billion rand (26 %), water tariffs of 11.2 billion rand (12 %), and other service charges (sanitation, refuse removal, etc.) of 28 billion rand (30 %).

Property tax is the only available tax for local and metropolitan municipalities, in 2005/2006 generating some 17 billion rand (18 %) of local operating revenue. District municipalities are not allowed to raise property taxes. Their own-source revenue previously came from the regional service council (RSC) levy, a business tax on payroll and turnover (Wittenberg 2003, 42). Since this tax has been declared unconstitutional, it was replaced by national government grants in June 2006, until better means of income are identified (van Ryneveld 2005, 176).

Intergovernmental transfers

Grants from the national government supplement own-source revenues. With 13.2 billion rand, grants from national government contributed 14 % to local operating budgets, again differing substantially among municipalities. A large number of transfers go into municipalities' capital budgets, so

all grants amounted to some 17 billion rand in 2005/2006. This constitutes a substantial increase compared to 2001/2002, when government transfers totaled 8 billion rand (National Treasury 2006, 105).

The transfers to municipalities as a whole can be separated into three basic types of grants (Glasser / White 2004, 319):

— **Unconditional transfers** (the "equitable share"), which are determined by a poverty-based formula and defined as subsidies for providing basic municipal services to households which cannot afford to pay the full cost. The formula that determines the equitable share for local government is based on the three following components: population (number of households), poverty rate (number of poor households), and functional responsibility of a municipality. However, the formula has changed almost every year since it was first introduced in 1998 (Wittenberg 2003, 41). Although the equitable share is an unconditional transfer and there are no restrictions how to spend it, the Department of Provincial and Local Government (DPLG) encourages municipalities to spend their equitable share on the delivery of basic services (IDASA 2005, 3). For better planning, the equitable share is assigned three years in advance. In the financial year 2005/2006, the equitable share accounted for over half of all national transfers to local governments (National Treasury 2006, 105).

— **Conditional infrastructure transfers**: The bulk of these transfers is formed by the Municipal Infrastructure Grant (MIG). The MIG is directed to infrastructure backlogs only, and does not cater for maintenance of existing infrastructure. Many municipalities, however, struggle to provide the required reports such as business plans etc., leading to a situation in which not all the available MIG-funds are actually accessed. In 2005/2006, conditional infrastructure grants accounted for about 37 % of total transfers to local government.

— **Conditional capacity transfers** intended to assist municipalities improve their capacity or restructure their operations, such as the Restructuring Grant, the Financial Management Grant, and the Municipal Systems Improvement Grant. These capacity related transfers accounted for only 4 % of total transfers in the financial year 2005/2006.

Concluding, one can say that the intergovernmental fiscal structure is in principle well designed: First, municipalities are generally well equipped with financing means and powers that are adequate to cater for their ex-

penditure responsibilities. Additionally, it has to be highlighted that a substantial part of municipalities' income stems from own-source revenue, albeit this differs remarkably within the municipal landscape. Lastly, unlike other developing countries, intergovernmental transfers are rather stable and predictable, thereby positively affecting municipalities planning reliability. The general setting of the decentralized system is therefore adequate to promote municipal borrowing. However, as the following section shows, there are still many obstacles that impede a broadening of the municipal borrowing market.

6.3 Municipalities as borrowers: main characteristics and bottlenecks

6.3.1 High concentration of borrowing on a few municipalities

In comparison with other middle income countries, the sub-national borrowing market in South Africa is highly developed. Municipalities can – and do – access capital markets on their own merits to finance their infrastructure investments, where in other countries sub-national entities are still largely reliant on central government. As concluded before, however, the bulk of municipal borrowing in South Africa is concentrated on a few, bigger municipalities that are perceived to be most creditworthy. Many municipalities do not have access to private capital at all.

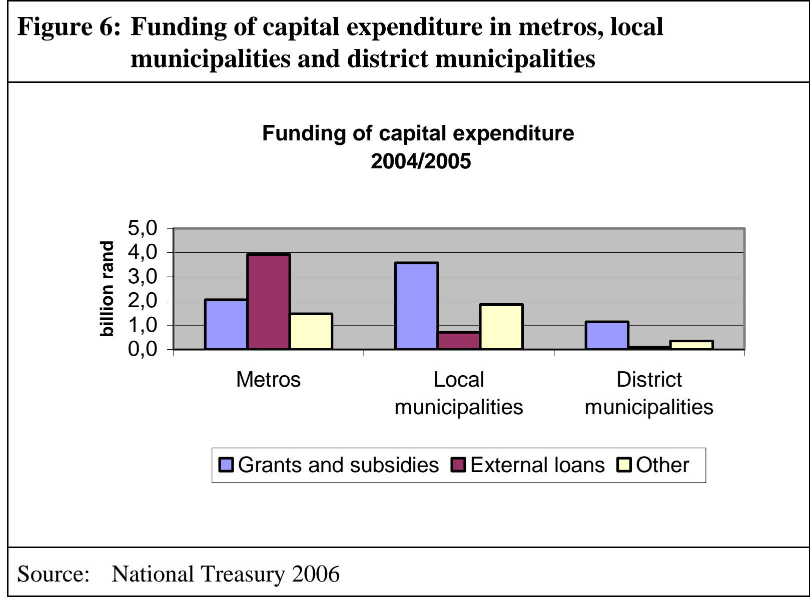
Municipalities in South Africa can only borrow for capital expenditure (i.e. mainly investments in infrastructure), meaning that municipalities can only borrow into the capital budget. The share of loan funding of capital expenditure varies significantly among municipalities, as Figure 6 indicates.

Whereas metropolitan municipalities in 2004/2005 financed over 50 % of their capital expenditure by loans, in local municipalities loans only make up about 12 % of capital budget funding. For district municipalities borrowing is a rather negligible source of income.

These figures illustrate that until now borrowing is mainly concentrated on metropolitan municipalities, and that borrowing is not a very relevant financing source for many municipalities' infrastructure investments.

This picture of high concentration is reflected when looking at municipalities' credit ratings in South Africa: Out of the 283 municipalities, only 25 have a credit rating at present, 23 of them rated by local CA-Ratings. Ratings range from zaBB-, which is under investment grade, to zaAA- (very strong). All metros have a good long-term credit rating around zaA, giving an indication on why metros are the main players in this field. However, the rated municipalities are not necessarily the top 25 municipalities in terms of creditworthiness. Certainly, very bad performing municipalities and municipalities not wishing to borrow at all are not included, as they are afraid to get a bad rating. Then again, there are several rather good performing municipalities that are reluctant to pay the costs for a rating, as most banks and financial institutions are willing to provide finance without external ratings and prefer to calculate risks according to their own models (required by Basel II, anyway). In order to get a credit, a rating it is not required, thus an evaluation of the municipal borrowing market should not rely too strongly on the amount of municipalities rated.

Figure 6: Funding of capital expenditure in metros, local municipalities and district municipalities



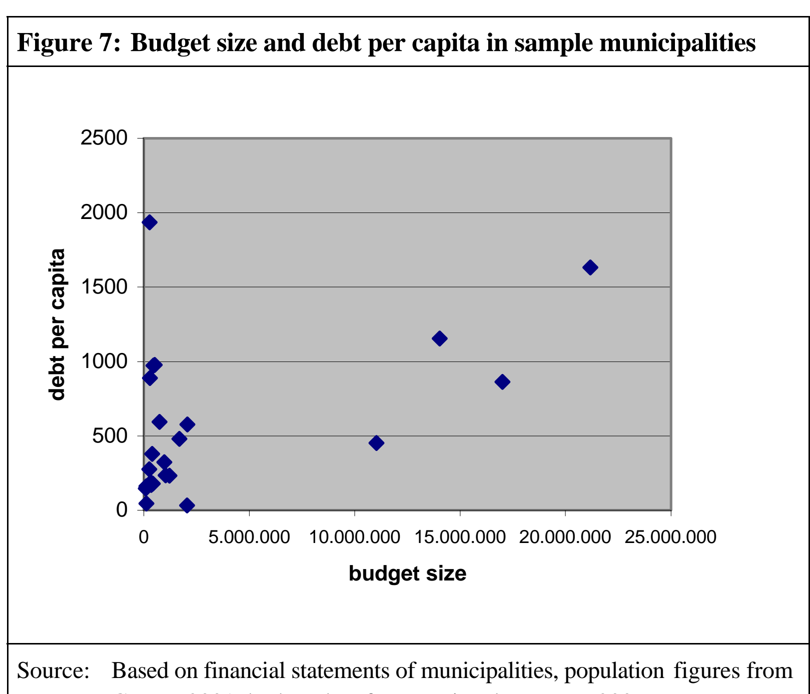
Source: National Treasury 2006

The large concentration of capital on metros and larger municipalities in absolute terms raises the question, whether the (budget) size of municipali-

ties is an important determinant for their engagement with borrowing. It is quite obvious that bigger cities have a higher amount of debt in absolute terms. However, to analyze the influence of the budget size, we need to have a look at debt per capita. The question is, if the propensity to lend (proxied by debt per capita) increases with budget size.

Due to the small sample size, a regression analysis is not possible. The scatter diagram (Figure 7) reveals that the four sampled metros deviate extremely. We computed the simple arithmetic average of debt per capita in metros and in the interviewed local municipalities. The difference is striking: With an average of 1026 rand debt per capita in the metros, this ratio is more than twice the average debt per capita in the local municipalities (463 rand). This might be an indication that a **large budget is beneficial for borrowing**.

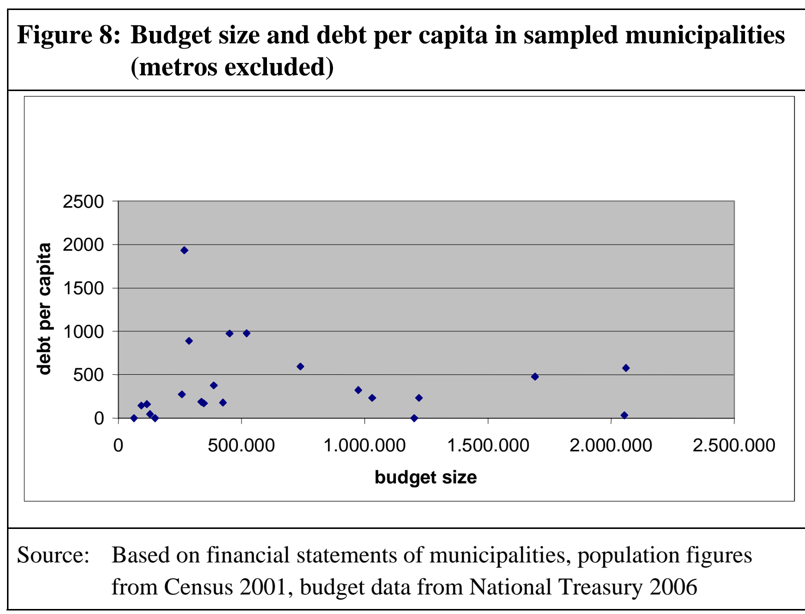
Figure 7: Budget size and debt per capita in sample municipalities



Source: Based on financial statements of municipalities, population figures from Census 2001, budget data from National Treasury 2006

Possible reasons are: First, metros generally have a more diversified economic base, making them more stable and therefore more creditworthy. Second, metros attract better staff because well educated financial managers might be reluctant to work in small, remote municipalities, especially considering the scarcity of well trained personnel in South Africa. Third, metros require higher loan volumes, making them more attractive to lenders due to lower transaction costs relative to the amount rendered. Additionally, metros in South Africa seem to benefit from implicit bail-out expectations.

Figure 8: Budget size and debt per capita in sampled municipalities (metros excluded)



Source: Based on financial statements of municipalities, population figures from Census 2001, budget data from National Treasury 2006

However, Figure 8 shows a scatter diagram for the sampled local municipalities only (exempting the metros). Although a robust statistical analysis is not possible due to the sample size, the diagram strongly suggests that among local municipalities **budget size is not an important influencing factor**.[14] Mangaung (Bloemfontein), for example, is a large local munici-

14 The result remains stable if one relates debt per capita and budget size at a logarithmic scale.

pality with a very low debt per capita-ratio, whereas Knysna lies at the other end, with a small budget but a very high outstanding debt per capita. The analysis reveals that a large budget, although being beneficial for borrowing in some ways, is not the major determinant for municipalities' engagement in borrowing. In this context, a further reduction of the number of municipalities (with the effect of the single municipalities getting bigger), as claimed by some interviewees, need not be necessarily beneficial in terms of creditworthiness. A more comprehensive approach to determining municipalities' creditworthiness in South Africa is therefore crucial.

6.3.2 Main bottlenecks to broaden the borrowing market

Four factors have been identified as major bottlenecks for borrowing: Lack of capacity, weak income generation, insecurity and lack of predictability on the future income structure, and a conservative attitude towards borrowing among decision makers.

Lack of capacity

As mentioned above, both financial management capacity and implementation capacity influence municipalities' ability to engage in borrowing. Most stakeholders, especially lenders and rating agencies, referred to the lack of capacity as the main constraint for municipal borrowing in South Africa. This constitutes in a severe scarcity of well-educated financial managers and engineers, leading to high vacancies in municipalities' administrations and a lack of qualification of decision makers. Some municipalities in our sample did not have a chief financial officer for months, and suffered from vacancy rates of up to 50 %. Additionally, high fluctuations among the staff and a weak succession planning further disable a consistent policy. The Mail&Guardian (2007a) published figures based on a report showing that of the 231 local municipalities 42 had only one technical professional (i.e. civil and transport engineer or technician) on staff and 79 municipalities had none.

The lack of financial management capacity directly impacts the ability to borrow, as it leads to an inability to understand and deal with debt instruments. Many municipalities do not have the expertise to write the necessary reports, which lenders require, and to comply with the rather compli-

cated tender processes.

The lack of technical capacity and engineers has an indirect effect on borrowing, as it leads to an inability to spend available funds – in spite of huge backlogs and infrastructure needs. A quote from one interviewee brings the problem to a point: "If municipalities cannot even spend their grant money, why should they take out a loan?" For example, the total allocation of the MIG in the last year amounted to 6.3 billion rand, of which only 3.6 billion rand were actually transferred to municipalities, and only 2.9 billion rand were spent. This means that not even 50 % of the funds could be accessed in the first place, and only 84 % of the transferred amount could be spent (Business Day, 27.2.2007). Given the huge gap between planned and actual expenditure, obviously more money from borrowing would not necessarily lead to better service delivery. The lack of implementation capacity not only makes borrowing superfluous for many municipalities, but under these circumstances borrowing can be a very risky alternative to grant funding. If the loan money is not translated into an infrastructure project in a timely manner, and does not result in a service delivery that leads to higher revenues, the cost of a loan will rapidly exceed its benefits, and interest payments will rapidly exceed the income generated from the investment.

As long as these capacity issues are not addressed in a more systematic way, borrowing will not become a viable option for municipalities to finance their infrastructure needs. Additionally, with the soccer World Cup 2010 coming up, the scarcity of technical capacity seems to become aggravated: Many municipalities complained about technical staff being drawn off for 2010-related constructions, further diminishing constructors available for "normal" municipal infrastructure and significantly pushing up prices. Trained staff is not only drawn off because of the World Cup, but is also often poached by the private sector. This situation could force the government to review its rule that only 30 % of municipal income can be spent on wages in order to offer a more competitive wage for these essential skills (Business Day, 2.3.2007).

Weak revenue base

Problems related to the generation of income were mentioned most frequently by the sampled municipalities when asked about their obstacles to expand borrowing. Most interviewees referred to poor tariff collection as

most important constraint. User charges are the main income source of municipalities and therefore the actual and future tariff collection is a significant factor for a municipality's ability to repay a loan. The generation of sufficient revenue through tariffs is presently restricted by two factors: poor tariff collection and restrictions in tariff calculation.

With collection rates ranging between 80 % and 97 % in our sample, municipalities loose a substantial amount of their income that could be used to service a loan for infrastructure services. The reasons for weak tariff collection are twofold: first, most municipalities suffer from high poverty and unemployment rates, leaving a large share of households that are not able to pay for basic services. Second, however, municipalities also complain about a "culture of non-payment" meaning that there are also households able but not willing to pay. Most municipalities, however, have taken measures to improve their credit control policies in the past years, e.g. by changing to pre-paid service delivery. Dependant on how these measures work out, municipalities could significantly improve their revenue collection, and therefore improve their borrowing capacity in the near future.

Another aspect affecting municipalities' revenue from services rendered are restrictions on tariff calculation set by the central government. Ceilings on tariff increases (municipalities indicated that these range between 5–7 %) restrict municipalities in their flexibility and self-reliance, especially as tariffs are the major source of income, and therefore restrict municipalities' control over their own revenue base. While a ceiling on tariff increases might be politically desirable, it does not necessarily make sense from an efficiency point of view, where higher tariffs might be necessary to cater to rising costs.

Insecurity and lack of predictability over future income structure

A third set of factors negatively influencing municipalities' willingness to borrow is insecurity over future functions and revenues, as some interviewees mentioned. Formerly, this insecurity resulted from the amalgamation and demarcation processes. As the demarcation process is now finalized, and, additionally, the equitable share is now agreed upon for three years in advance, important sources of insecurity have been addressed.

However, the predictability of the future revenue streams is challenged by

new insecurity over future responsibilities for service delivery. The most important issue in this context is the planned Regional Electricity Distributors (REDs). It is envisaged to implement six of these REDs to cater for the electricity distribution in the whole country and to absorb municipalities' role in electricity provision. As electricity is the main income source for most municipalities, making up about 25 % of municipalities' operating income, implementing REDs will severely impact municipalities' income structure in the future. Some municipalities voiced the opinion that with REDs, creditworthiness of municipalities would decline, "without leverage" and the "credibility towards banks is negatively influenced, as we cannot say what income we will have." Irrespective of whether municipalities agreed or disagreed with the REDs (opinions are rather ambivalent), the major problem in this context is that there is no clear outline on when the REDs will come and how the compensation for the loss of electricity as revenue source will look like. As long-term borrowing depends on long-term predictability, this negatively affects municipalities' willingness to take out loans.

Additionally, there are rumors that the municipalities will no longer be responsible for water services. If you argue using economies-of-scale, there seems to be a trend to re-centralize responsibilities to bigger delivery entities. As long as these developments are unclear and municipalities do not receive precise and transparent perspectives on future functions and income structures, municipalities will be hesitant in borrowing for long-term periods.

Either way, even if the financial compensations are adequate, municipalities will be less self-reliant and less flexible. They will rely more on national state transfers. This, in turn, can negatively affect the responsible handling of borrowing at the local level. Implicit bail-out expectations might rise when local governments are mainly funded by transfers.

"Conservative" borrowing attitude

A last set of obstacles for more borrowing are general, subjective reservations against borrowing by both political and administrative staff. Several interviewees pointed out the benefits of borrowing by making more capital available today and the positive leverage effects of borrowed capital. But some municipalities also cautioned against borrowing in general. They told that they were "conservative" borrowers, and did not wish to shift

their financial burden to future generations. They preferred a pay-as-you-go approach to infrastructure service delivery. This, however, contradicts conventional theory. It states that it is efficient to finance bulk capital investments by loans and to distribute the burden of repayment among the future beneficiaries of the infrastructure rendered by the loan. Interviewees on the supply-side of the borrowing market generally agreed that it is right to spread the load of payment. While it might be reasonable for some, especially bad performing municipalities, not to engage in borrowing, others seem to overestimate the risks and underestimate the benefits of financing infrastructure investments by debt capital.

This "risk-averse" attitude towards borrowing should not be underestimated as an influencing factor of municipal borrowing decisions. While in other countries the problem of allowing sub-national spheres of government to borrow has led to misuse and over-borrowing; this seems to be the opposite in South Africa. This attitude might be facilitated by the grant and transfer system, that does not set incentives for municipalities to make an attempt to be more self-sustaining and to rely less on transfers. Some municipalities argue that they did not need loans, because they received enough transfers from central government to finance their expenditure. Additionally, this risk-averse borrowing policy might result from regulations from the MFMA. According to these regulations, decision makers of municipalities can be held personally responsible for misusing funds and even prosecuted. This certainly has increased responsibility and accountability of decision makers of local governments, but might have discouraged the willingness to opt for innovative financing means.

7 Strong financial institutions: supply-side requirements for sub-national borrowing

Efficient lenders and innovative financing instruments are necessary for a functioning sub-national capital market. In South Africa there are diverse financing instruments employed by public and private lending institutions. First, this chapter contrasts bank credits and bonds as financing instruments for municipalities in theory (Section 7.1). Thereafter, it focuses on the question if there is a need for more municipal bonds in South Africa (Section 7.2). Third, the chapter investigates the role of public versus private actors in the South African sub-national capital market (Section 7.3).

7.1 Comparative advantages of banks and bonds in academic literature

Bank credits and bonds are the two main financing instruments of sub-national borrowing. While bank credits are more widely used in sub-national markets in developing countries, some academic experts and external support agencies push the idea of bonds. Contrasting both financing instruments according to several criteria reveals their different strengths and weaknesses; those are the price of capital and the scope of borrowers, maturities, and monitoring functions.

Price of capital and the scope of borrowers: Usually, it is cheaper for a sub-national entity to borrow from a bank than to issue a bond. The price of issuing a bond can be very high, which will deter small sub-national entities from issuing bonds (Jackson 2006, 11). This suggests that bonds are predominantly attractive for large sub-national entities, whereas smaller ones are more likely to use bank credits. Moreover, literature on bank-dominated financial systems (Levine 2004) considers banks to be conservative in their lending decisions. Sub-national entities which have innovative ideas might not receive credit; therefore, they issue bonds instead.

Maturities: The maturity of the debt capital should be long enough to match the cash-flow of the related infrastructure project. While public banks can offer long maturities, commercial banks rarely do. If banks do not offer the needed long-term capital, bonds might be an option (Peterson 2003; Leigland 1997). However, there is no guarantee that every sub-national entity can issue a bond with long maturity. A further advantage of bonds with long maturities is that they can attract new investors such as pension funds that want long-term investments.

Monitoring functions: Both banks and investors in bonds can play a monitoring function for sub-national entities. It is desirable for lenders to have strong monitoring functions because it pressures borrowers to deal with the debt capital responsibly. Banks monitor borrowers as a financial intermediary, or, in other words, they engage in "delegated monitoring" (Diamond 1984). Banks usually work with borrowers for a long period of time. This is a type of "relationship banking" (Peterson 2003). It increases the capacity and incentive to monitor the borrower. But with bonds, issuers are monitored in a different way. The public character of bonds urges

sub-national entities to live up to high standards of public disclosure and this can create good financial management skills. Therefore, bonds increase transparency of borrowers towards their lenders, but also towards the public. Furthermore, the pricing process of secondary bond markets should mirror the performance of sub-national entities and should guarantee that capital is channeled to responsible sub-national entities with profitable projects. Nevertheless, perfectly working capital markets are rare (Singh 1997). In the sub-national markets the pricing process of secondary bond markets does not work perfectly, so that the price of the bonds does not necessarily reflect the performance of sub-national entities. A further weakness in the monitoring function of bonds occurs because risk-averse investors tend to diversify their portfolio, which decreases their incentive to monitor the issuer of a specific bond (Stiglitz 1985).

7.2 Bond issuance in South Africa

As depicted above, bank credits and bonds both have strengths and weaknesses. While bank credits are the common municipal financing instrument in South Africa today, South African municipalities are reluctant to issue bonds. Out of the 29 interviewed municipalities only four could imagine issuing a bond in the near future. This is particularly interesting since issuing bonds had been a common instrument of municipal financing prior to 1994. One reason is that South African pension funds were required to invest in municipal bonds. However, the municipal bond market has virtually disappeared. This is due to the uncertainties of the transition phase and also because the pension funds are no longer required investing in bonds.

Johannesburg was the first and so far the only city to issue a bond in the new Republic of South Africa in 2004. By 2007 three other “Joburg bonds” have followed (see Box 5).

Box 5: The "Joburg Bond"

COJ01 is the inconspicuous acronym for a big event in municipal financing in South Africa: In April 2004, Johannesburg was the first (and so far only) municipality to launch a bond after the breakdown of the municipal bond market in 1994 due to the transition process. The issue was widely praised both nationally and internationally, animating a vivid debate on municipal bonds as a means to finance development in emerging economies. The issue in the amount of 1 billion rand even scooped the Bond of the Year-Award from the Bond Exchange of South Africa (Besa). Being 1.5 times oversubscribed, the bond certainly can be seen as a success, especially considering the cities pioneering in this respect. However, with 230 basis points over the government benchmark bond (see Table 2), Johannesburg paid a high price for that success, as it certainly pays a higher interest compared to bank lending rates at that time.

Only two months later, the City issued a second bond, again worth 1 billion rand. COJ02 was an innovative issue, as it was accompanied by a 40 % guarantee from the International Finance Corporation (IFC) and the DBSA (20 % each). The enhancement was necessary to guarantee investors confidence for the longer maturity of 12 years and led to an 3-notch rating uplift (from A- to AA-), thereby allowing for a better pricing than the first bond in spite of the longer maturity (see Table 2). Although it was a success to reduce basis points, the bond remained expensive compared to loans.

The main motive for the bonds, in addition to publicity reasons, was an attempt to diversify funding sources. As banks were overexposed to Johannesburg, the City had reached its credit limits with almost all banks and basically had to go the bond route to obtain more funds.

Only 40 % of the proceeds of the first two bonds are used to finance the city's capital expenditure program. The rest is used to refinance existing, more expensive debt that Johannesburg had accrued in the late 1990s, when it was experiencing financial distress. The refinancing of the onerous debt arrangements through the bonds will save the city interest payments of about 20 million rand annually over the next 6 years.

As the table indicates, the market development of the bonds has been remarkably positive, with spreads substantially going down between the respective issuing

Box 5 continued

dates and February 2007 spreads. Another indication for increased market confidence is the fourth launch in June 2006. Again, this bond has 12 years maturity and is issued at significantly lower cost – this time even without public credit enhancement schemes.

Despite the success of these bond emissions, other municipalities have been hesitant to follow Johannesburg's example, even though many scholars have been convinced that the Johannesburg bond would be an initial step in enhancing the bond market. Even before the first bond was issued, some scholars (e.g. Glasser et al. 1998; Glasser 2004) were optimistic about rehabilitating the South African municipal bond market. Martell / Guess 2006, 100 even expected 50 bond issuances by 2010. Apart from the authors that praise bonds as an appropriate municipal financing instrument, the South African government would also like to see the bond market emerging.

Table 2: Johannesburg's bond launches

	Issued amount (billion rand)	Coupon	Initial credit spread (bps)*	Credit spread on Feb 07 (bps)*	Issue date	Tenure (years)	Rating (Fitch)
COJ01	1.00	11.95 %	230	90	Apr 04	6	A-zaf
COJ02	1.00	11.90 %	164	120	June 04	12	AA-zaf
COJ03	0.70	9.7 %	154	100	Apr 05	8	A-zaf
COJ04	1.20	9.0 %	120	103	June 06	12	A-zaf

* over government benchmark bond (R153 for COJ01, R157 for COJ02 and COJ03, R203 for COJ04)

Source: Besa

7.2.1 Expected benefits of bonds

National Treasury, some academic experts, and the private lending institutions would like to see the municipal bond market rehabilitate quickly. They expect bonds to positively influence local governance in terms of

transparency and accountability[15] (see Table 3). The four municipalities that have either issued a bond (Johannesburg), plan to issue a bond (Cape Town) or could imagine issuing a bond in near future see some benefits arising from bonds, albeit they favor bonds for different reasons.

Table 3: Perceived benefits of bonds

Main benefits	Number of stakeholders
Strengthen good governance (transparency, accountability)	6
Diversified debt portfolio	2
Flexibility and cost effectiveness	2
Other	5

Source: Based on interviews

Since bond issuance goes along with many disclosure requirements, some interviewees argued in line with theory that bonds contribute to more transparency in local government, from which the public would profit as much as lending institutions. Thereby, the monitoring function of the public would be strengthened and accountability would be increased.

To have a more diversified debt portfolio is another advantage of bonds. This was one reason for the emission of the first Johannesburg bond, as depicted in Box 5. When a municipality is close to its maximum credit line with DBSA, it might think about issuing a bond.

Other benefits of bonds are their greater flexibility and their ability to catalyze further investment. In the long run bonds are cost effective, if they are launched with a good rating. This argument was also partly used by the four municipalities that were in favor of bonds. Johannesburg explained that a bond gave more flexibility to the city, since it can eventually buy back debt at a lower rate on the bond market. Moreover, they pointed

15 For the impact of sub-national borrowing on governance determinants, see Section 4.3.

out that bonds had fewer conditions than loans and longer maturities.[16] From its bond emission, Cape Town expects a steady stream of capital funding at cost effective rates and hoped that it will also be easier to borrow afterwards. Additionally, they believe that issuing a bond will lift the city's image. One municipality would like to support the policy of the National Treasury even though there is no need to issue a bond in the near future. This interviewed municipality believes that the main municipalities involved in the bond market were important for investors' confidence in the entire market.

Two lending institutions stressed that more bonds would be beneficial, since this would hinder the pricing from decreasing too low. According to them, the interest rates for bank loans are quite low at the moment because of certain market distortions. Since bonds are not touched by these distortions, they would reflect the proper market price. However, this argument reflects subjective interest of one angle of the market, which can barely be counted as a benefit for the whole sector. A well functioning market for both banks and bonds should lead to more competition, as one stakeholder points out.

There seem to be benefits arising from bonds. In the case of Johannesburg, bond issuance has worked well in the new Republic of South Africa. But still other municipalities have been reluctant to issue bonds. Kehew et al. (2005, 41) argue that there are few bonds because many municipalities are not able to provide the required information. Furthermore, there are unclear regulations on what will happen in case of a default. However, since the MFMA was introduced in 2004, regulations have been quite clear. Still, we found that municipalities are not interested in issuing bonds.

7.2.2 Perceived obstacles for issuing municipal bonds

The remaining 25 municipalities are not interested in bond issuance. They especially pointed to the reasons shown in Table 4.

16 The maturities of bank loans are relatively long in South Africa and can reach 10 to 20 years. However, loans that have longer maturities than 10 years are not awarded in form of a bullet loan.

Table 4: Perceived obstacles for bonds		
Main reasons	**Number of municipalities**	**Number of other stakeholders**
Not economic, because of low-interest loans	4	9
Amounts too small, therefore too high fixed costs	4	7
Difficult administration / capacity constraints	3	4
Other	4	7
Source: Based on interviews		

Most interviewees believed that the main reason why bonds are no longer preferred is due to the low-interest loans available at the moment. Therefore, municipalities have no incentives to issue bonds.

Since bonds are not only more expensive to service than loans, but also have higher fixed costs, many municipalities felt that they were too small for issuing a bond. Fixed costs accrue for road shows and administration as well as for listing fees at the bond exchange. In addition, it is necessary to get an expensive rating from an international rating agency such as Fitch, Standard & Poor's, or Moody's. It does not make sense to issue a bond smaller than a certain amount due to the fixed costs that arise. The opinions of our interviewees varied. They believed that the minimum amount was between 400 million and one billion rand. However, most of the municipalities do not require large amounts of money at once. Even if they needed it, it would affect their debt to income ratio negatively,[17] thus unable to attract investors.

Moreover, many interviewees said that the administration of a bond is difficult and requires some expertise: municipalities that wish to issue a bond have to fulfill bond exchange requirements and maintain investor

17 Some municipalities pointed out that many private lenders have contracts that require a ratio of debt to income that is not higher than 50 %. If it surpasses the 50 % line, lenders have the right to claim their outstanding debt immediately.

relations. Most of the municipalities are not familiar with these tasks and lack the knowledge and capacity to properly manage the administration. It is a bit surprising to get this response from the municipalities since there had been a vivid bond market before 1994. However, one has to keep in mind that large parts of the old municipal staff have retired by now. In addition, the requirements for bond issuance became more challenging with the introduction of the MFMA.

Three interviewees pointed out that the focus on bonds derives from the USA. Thus, when the National Treasury promotes bonds as efficient municipal financing instrument, it forgets that there are certain incentives in the USA that do not apply to South Africa. In particular, there are no tax deductions for bonds. Moreover, one municipality warned that the bullet type of repayment of a bond is not a good way to finance infrastructure, because at the time to pay back the bond there could be a financial crisis. Thus, loans are better because of smoother amortization. One municipality, which could imagine issuing a bond, does not dare to follow Johannesburg because it is much smaller. In their opinion, bigger cities need to prove that bonds work before smaller cities can join.

7.2.3 Innovative approaches to promote the municipal bond market

Even though some interviewees saw benefits arising from bonds they did not believe in a quick rehabilitation of the South African bond market as long as loans remain as inexpensive as they are today. It is striking that most municipalities in our sample are not interested in issuing a bond in the near to medium term future. Thus, if the government wants to strengthen the bond market for the previously outlined benefits, it cannot proceed by purely encouraging municipalities to issue bonds. Either it abstains from putting pressure on individual municipalities to issue bonds[18] or it supports more innovative approaches to enable municipalities to overcome the perceived obstacles. Then municipalities would eventually consider bonds themselves. Bond-pooling, retail bonds and revenue bonds were all suggestions mentioned by the interviewees to facilitate an emerging municipal bond market.

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18 Several interviewees reported that National Treasury actually wanted eThekwini (Durban) to be the first municipality to issue a bond.

Bond-pooling

One reason why municipalities do not issue bonds is that they are too small to bear the high fixed costs that accompany bond emissions. One possibility to address this problem is bond-pooling, i.e. several smaller municipalities issue a bond together. Two interviewed municipalities could imagine issuing a pooled bond, whereas they would be too small to issue a bond on their own. The two district municipalities of our sample have already played with the idea of issuing a pooled bond of the local municipalities in their jurisdiction. Apparently, local municipalities are hesitant, because they fear that the district municipality will interfere in their affairs. In addition, INCA could be seen as a pooled bond itself. It already lends relatively small amounts to many municipalities. Thus, one could argue that bond-pooling already exists.

Retail bonds

A retail bond is another way to overcome high fixed costs because it does not have to be listed. Thus, bonds with smaller amounts are worthwhile. As municipal retail bonds are often sold to residents, their positive side-effects may be creating a savings culture and promoting active citizenship. Surely, this type of bond strengthens accountability and fosters identification. Johannesburg will issue a retail bond by the end of 2007. However, the retail bond is probably not the cheapest way for Johannesburg to raise money and therefore will put a burden on tomorrow's tax payers. Thus, the problem is that only a few wealthy residents can afford these municipal retail bonds and profit from their purchase, while all citizens have to repay the debt in the future.

Revenue bonds

Revenue bonds are serviced out of the revenue of a specific project and not out of the budget. They can be issued for projects such as building an airport, a toll road, or water utilities. For municipalities that cannot issue a general obligation bond this could be a way to finance revenue generating projects. However, as mentioned before, South African municipalities prefer to borrow for general obligation, because then they can decide independently how to allocate their money. Therefore, it is questionable if municipalities would be interested in revenue bonds.

7.3 The interplay of public and private lending institutions

Theory suggests that a market should be driven by private lenders and that public lenders should complement them where necessary. This section deals with the question if the ideal of public-private interplay is possible in such a way that the needs of municipalities are met. It finds that public lenders currently do not live up to their role. Instead of complementing private lenders, they compete against them for the top municipalities.

7.3.1 The role of public and private lending institutions in theory

Within the banking sector, both private and public actors – either national public financial institutions or external support agencies – are active in sub-national borrowing. The crucial issue is not to exclude either private or public actors. The issue is to what extent public actors play a beneficial role. The right mix of public and private actors is important to create a self-sustaining sub-national financial market.

Private actors have the advantage of tapping new sources of capital and allocating capital strictly according to risk, thereby strengthening efficient market mechanisms. According to many scholars, the overall objective should be a privately-dominated sub-national borrowing market. Freire / Petersen (2004), editing a World Bank volume with 18 country studies, aim at improving sub-national governments' access to private credit markets. Venkatachalam (2005) believes crowding-in private funds should be the ultimate goal of public sector activities.

Public actors have two key roles to play: They should target borrowers that might otherwise be unable to borrow in purely private financial markets with usually higher interest rates; and they should initially boost capital markets and crowd-in private lending institutions. In this sense, public actors can supplement private actors and rectify market failures. The crucial means for public actors is their access to low-cost capital. The price of publicly provided loans can be low since public banks can refinance themselves quite cheap through a government supply of capital, tax exemptions, or by a sovereign guarantee. This enables them to pass on lower interest rates to sub-national entities. However, the problem evolving from low prices is the danger of crowding-out private financial institutions in tendering processes for credits. Another problem that can arise is when

public institutions allocate credits incorrectly. Peterson (2000) notes that few countries have been successful in establishing self-sustaining municipal credit markets. According to him, one reason is that public actors are too prominent in these markets.

A new phenomenon is that **external support agencies (ESAs)** offer local currency loans without sovereign guarantees to sub-national entities. This development has to be seen in the context of decentralization and the shifting of responsibilities for infrastructure service delivery to sub-national entities. Adapting to this change, several external support agencies consider modifying their regulations, which so far have mostly required a national state as borrower or at least a national state's guarantee. For instance, the World Bank runs a pilot program with the International Finance Corporation (IFC), where the IFC lends to sub-national entities without sovereign guarantees and the World Bank offers capacity building. The French Agence Française de Développement (AFD) can already lend to sub-national entities without sovereign guarantees.

The interest of ESAs has several, substantive and strategic reasons: urbanization has led to a greater need to finance infrastructure at the sub-national level and ESAs have been supporting decentralization trends through policy advice. They now fill the gap on the financing side and have started providing financial support directly to local governments. ESAs regard sub-national borrowing as crucial for developing a domestic financial system, which, in turn, is important to improve a country's investment climate and to enable people to become economically active. Cities with millions of inhabitants can be more prospective debtors than many national states. Sub-national borrowing takes place mainly in middle income countries (MICs). Supporting these markets becomes a means for ESAs to keep interacting with these countries. Moreover, ESAs stress the important role MICs play not only for their own development but also for the development of Least Developed Countries (LDCs) through spill-over effects.

As theory suggests, South Africa acknowledges in the White Paper for Local Government that *"public sector financial institutions [...] are key agents to support the development of an effective market for municipal debt and to enhance the overall level of investment in the municipal sector"*. At the same time, the paper aims at creating *"a vibrant and innovative primary and secondary market for short and long term municipal*

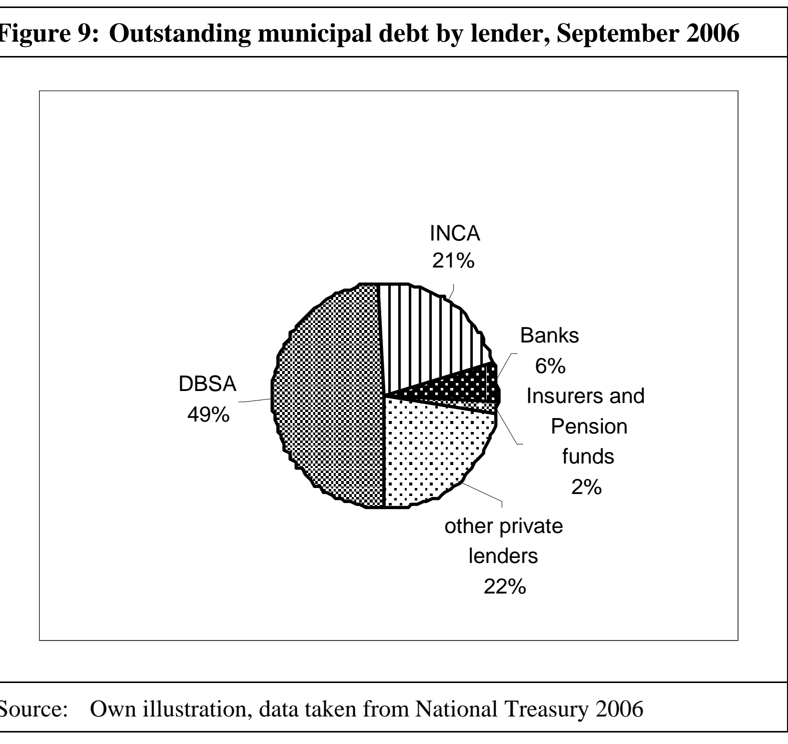
debt" (Republic of South Africa 1998). To achieve this end in a sustainable manner, private investors must be included. Therefore, the paper further states that public sector financial institutions *"should actively support financial markets and endeavor to engage the private sector in these markets.*"

7.3.2 The South African supply-side of the municipal borrowing market

In sub-national lending, the main public actors are the DBSA and external support agencies. While the DBSA was established in 1983 to redress the poor distribution of services in the former black townships and homelands, it became an important financier of municipalities throughout the country during the uncertain transition phase of the 1990s. It filled the gap that private banks left in municipal lending and thus rectified a market failure. Since then, debt owed to the DBSA has been growing significantly, and the institution gained by far the largest market share in municipal lending (49 %, see Figure 9), mainly in the form of long-term loans (National Treasury 2004, 33*)*. External support agencies have only recently entered the market and possess a marginal share only. One reason for this is that most of the ESAs are still not allowed to lend directly to municipalities. From our sample only AFD gave project-bound loans to municipalities so far. EIB, USAID and IFC are indirectly involved through on-lending or through credit enhancement activities. KfW and the World Bank envisage changing their directives. Thus, it can be expected that the market share of ESAs will rise in the future.

The main private actors are INCA and the four biggest private banks, namely ABSA, FNB, Nedbank, and Standard Bank. Since its creation in 1997, INCA has originated the majority of private sector lending to municipalities. INCA's activities in both initiating new loans and acquiring existing debt have helped offset other actors' market exit. One year later, ABSA partly reengaged in municipal funding. The other private banks did not follow this path until recently. Together, DBSA and INCA account for more than 2/3 of total outstanding municipal debt, as illustrated in Figure 9.

Figure 9: Outstanding municipal debt by lender, September 2006



Source: Own illustration, data taken from National Treasury 2006

The outstanding debt of public sector lenders in the municipal market is 9 billion rand, from which 8.9 billion belongs to the DBSA (National Treasury 2006). The total outstanding debt of private sector financial institutions amounts to 9.3 billion rand (51 %), declining from 11.4 billion rand in September 2005. From this, INCA has the biggest share (21 %) with an outstanding debt of 3.8 billion rand. The other private banks amount to 1.1 billion rand exposure, which equals 6 % of the total. The remaining debt belongs to insurers (295 million rand), pension funds (13 million rand) and other private lenders such as various nominees of private banks. The share is relatively high since it also includes bonds (National Treasury 2006).

7.3.3 The rationale for private lenders to enter the municipal borrowing market

The private lenders in our sample currently aim at increasing their lending activities in municipalities. In theory, a bank's decision to lend is determined by the perceived level of risk and the expected profit.

Risk level: The implementation of the MFMA has led to decreased risk levels through inducing security for investors. Therefore, the MFMA was crucial for private lenders to re-enter into the municipal credit market. Moreover, the appetite for risk increased over the last years, because the ongoing, strong economic growth in South Africa provided the South African banking sector with a high level of liquidity.

Profit: Many private banks believe that it is impossible to make a reasonable profit by lending to municipalities. According to them, public lenders push the prices to sub-economic levels. However, INCA and pension funds, such as Future Growth, make profits; otherwise they would not have survived all these years. One could therefore assume that for private banks the margin that can be realized in municipalities is not sufficient or they do not have the same expertise as e.g. INCA in the municipal credit market.

In summary, the perceived risk decreased but the expected profit is low. One of the reasons why private banks, nevertheless, want to increase their municipal lending is due to the introduced Financial Sector Charter (FSC). The FSC is a regulation which deliberately distorts the market by setting incentives for private banks to enter the municipal infrastructure market (see Box 6). Indeed, all private banks interviewed highlighted the pressure that the FSC exerts on them. Three said that they are only in the market due to the FSC. Additionally, one external support agency reported that shortly after the FSC was enforced many private banks approached the agency to receive information about municipal credit markets and possibly getting support from the ESA.

Box 6: The Financial Sector Charter

The Financial Sector Charter (FSC) dates back to August 2002. It was signed at a financial sector summit as one Black Economic Empowerment (BEE) charter. One of its aims is to "establish an equitable society by effectively providing accessible financial services to black people and by directing investment into targeted sectors of the economy." (FSC 2002, para 1.2). It applies to all operations of the financial sector in South Africa (4.1).

Relevant for the present study is the part on so-called "targeted investment". That refers to "debt financing or other forms of credit extension or equity investment in projects or areas where gaps or backlogs in economic development or job creation have not been adequately addressed by financial institutions" (para 2.34). Specifically mentioned as one of four investment areas are "transformational infrastructure programs" in underdeveloped areas, namely in sectors such as transport, telecommunication, water, wastewater, solid waste, energy, social infrastructure and municipal infrastructure and services (2.34.1). Each financial institution reports annually its investment into the four targeted areas of (1) infrastructure, (2) agricultural development, (3) low-income housing and (4) black small and medium enterprises. The Charter Council oversees the implementation of the Charter and reviews the reports. As it is independent, its representatives should reflect the interests of all financial institutions (e.g. there are representatives from National Treasury and from trade associations). The first reporting of financial institutions took place in March 2005. The council subsequently prepares an annual review which outlines progress (15.1.2). In the Annual Review 2005, the council observed that investment tends to cluster around the metros Johannesburg, Durban and Cape Town. Out of the target of 25 billion rand, 6.6 billion rand were invested in 2005 (2005 Annual Review on Transformation, page 36). So called transformation reports have been handed in by over 100 financial institutions (2005 Annual Review on Transformation, page 4).

Box 6 continued

How do financial institutions measure their progress and how can they collect points? With the help of the scorecard provided in Annex A of the charter, financial institutions assess their own progress. At the same time, the government and the private sector can use the scorecard for awarding contracts to financial institutions (para 16.1). The four areas of "targeted investments" account for 17 points out of 100, with annual investment in transformational infrastructure accounting for four points. The Charter Council rates the financial institutions each year. The rating starts with an A (best) and ends with an E (worst) according to the percentage of compliance.

Financial institutions can gain charter points with several investment instruments, such as loans, bonds, leases, guarantees, equity (Pimstone 2006, 11). Funding translates into charter points to a greater or lesser extent depending on the area being less or more developed (this is measured by an index reflecting a certain infrastructure level). Different municipalities have different index numbers; the lower a number is the more developed the municipality. The funding is multiplied by the index number and then translated into points. The index number is always shown in percentage.

For example, Johannesburg has an index of 18.78. This amount is the proportion of borrowing, which qualifies for charter points. On the other hand, Msinga municipality has an index of 89.96. An institution can collect charter points and contribute to the broader investment goal via direct investment as well as indirect investment. Latter is, for example, the case if a financial institution invests through INCA or DBSA. If one invests through INCA, the scoring equates the percentage that INCA as an intermediary invests in underdeveloped areas or better what the recipient of INCA's investment invests in ("look through principle"). INCA is rated in a way that a 40 % proportion of the investment qualifies for charter points if one invests through INCA (Pimstone 2006, 5). The same applies to DBSA. One example would be as follows: an intermediary invests 50 % of its total funding in a municipality with 70 % charter index rating and 50 % in a municipality with a rating of 20 %. Then the intermediary would be rated at 45 %. Thus the scoring of the charter points really depends on the infrastructure investment vehicle (municipality, parastatal, e.g. Escom, intermediary, direct project). To achieve a

Box 6 continued
final scoring, a difficult calculation is applied in which numbers are multiplied by the four points that one gets for infrastructure out of the 17 points for “targeted investment” (Pimstone 2005, 23). **How much money should banks invest in targeted infrastructure?** The amount a financial institution is obliged to invest depends on the institution’s market share and choosing in which sectors to invest in (Pimstone 2006, 5). For transformational infrastructure in total, financial institutions allocated 25 billion rand in the Charter (Pimstone 2006, 5). The requirements have to be fulfilled until the end of 2008. The Charter will be applied until the end of 2014 (4.2). However, its principles will still be relevant (4.4) and the Charter Council is responsible to decide on further steps.

INCA is not touched directly by the FSC as they are not a bank but a private debt fund. Indirectly, they noted that the competition has become stronger, since private banks started targeting the municipal credit market. Unlike private banks, INCA has lent to municipalities long before the MFMA was launched and entered the municipal market to realize profits. Interestingly, INCA expressed that they do not fear the competition of private banks but rather of the DBSA. This is because the DBSA has certain advantages in competition such as reduced capital costs and tax exemptions. Private banks also complained about this and further underlined the dilemma of being pushed into the market by the FSC and at the same time being out done by the DBSA.

7.3.4 Tensions in the public-private interplay

There are significant tensions in the South African municipal credit market between private lenders on the one hand and the DBSA on the other hand. Indeed, the proper role of the DBSA is probably the most hotly debated issue in municipal finance. ESAs have hardly been mentioned, probably because their market share is still negligible. Public lenders (i.e. the DBSA) can and do offer cheaper interest rates than private lenders. The reason there are tensions in the interplay of public and private lending institutions is

because all lenders mainly target the same municipalities for their lending activities; the metros and the next top-rated municipalities (see Table 5).[19]

It is not surprising that private lenders focus on this market segment. Here, risks are lower and profits are higher due to the larger amounts of borrowed capital. The high exposure of the DBSA in this market, however, deserves a closer look.[20] The data suggests that public and private lenders rather than complementing each other, as envisaged in the White Paper on Local Government, are competing for the profitable metropolitan market. Given South Africa's sophisticated private financial institutions and its goal of creating a "*vibrant and innovative primary and secondary market for […] municipal debt*", it is questionable why the market share of private lenders is so small in the comparatively attractive market of the top municipalities.

The DBSA justifies the 64 % share of its portfolio in the six metropolitan municipalities with the government's decision that the bank has to be self-sustaining. Thus, it has to earn yields in the top municipalities (or as DBSA calls them "market one" municipalities) to afford giving subsidized loans to the lower capacity municipalities in the so called "markets two and three".[21] Moreover, the DBSA claims that it takes a comprehensive approach when lending to a municipality as it conducts economic and social appraisals and assesses the economic and social costs of a project. With its project-bound lending it can make sure that big cities address development issues.

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19 The only exception is USAID that claims to target the "unbanked" middle municipalities, i.e. those that have no access to debt capital so far, but that could take out loans. However, we could not find any evidence that USAID indeed gave any loans or credit enhancement to those middle municipalities. Either USAID's engagement is unknown to our interview partners or the Agency failed with its approach.

20 In the future, the same will hold true for the activities of ESAs.

21 According to Glasser et al. (1998) market one is made up of municipalities that have the possibility of direct or indirect access to the capital markets. Market two consists of municipalities which have or could have predictable, stable and sufficient revenues to meet their service delivery responsibilities, but whose capital requirements are relatively small, or who lack the skills and capacity to develop and pursue borrowing options. Market three includes those municipalities that do not have and cannot develop adequate financial resources to meet their responsibilities.

Table 5: Targeted market segments of lending institutions

Lending institution	Targeted market segment
DBSA	All bankable municipalities, but 64 % of portfolio in metros.
INCA	All bankable municipalities, but 80–90 % of portfolio in Top 20
FNB	Aiming at 180, but currently dealing with 50
Nedbank	Top 10
RMB	Metros plus next top 10
Standard Bank	Top 35
AFD	Metros (so far Johannesburg and eThekwini)
EIB	Metros (Tshwane and eThekwini through INCA)
IFC	Top 20–40
KfW	Metros plus Top 20
USAID	„Unbanked“ middle municipalities
World Bank	Metros plus Top 20

Source: Based on interviews

The same arguments are used by ESAs. Some of them argued that their projects add value in top municipalities, since they are ecologically or socially innovative. Others pointed out that it is right to focus on the top municipalities, because 85 % of economic growth in South Africa is generated there. However, since the market share of external support agencies

is marginal, private lenders did not complain a lot about them in the interviews. There is one case that private and public lenders mentioned with one ESA involved: the case is quite spectacular because the ESA won a tender with a concessional offer of -200 basis points for a water project in Soweto (Johannesburg), in which private lenders also participated. In general, however, private lenders rather hope to profit from external support agencies, which might cooperate with them through credit enhancements mechanisms.

As shown above, DBSA's loan portfolio is filled with large metropolitan municipalities although it is a development bank. Therefore, it became an active price competitor in the market. In theory, competition is positive as long as price incentives are not distorted. Since the DBSA has some advantages in competing with others, all private banks and INCA complained about "unfair" price competition. It is not easy to determine a "fair" price. In theory, a price is considered to be fair if the risk of a loan is properly priced and a reasonable profit is made. However, it is difficult to say if the current price for municipal loans is appropriate, since we do not know the equilibrium price. It is obvious that the price is lower today compared to some years ago. This might be closer to the equilibrium price since liquidity in the market has increased and risks have decreased. Or it might be below the equilibrium price if direct or indirect subsidies of public lenders have distorted the market.

Asking stakeholders if the current price is appropriate, we found that municipalities are satisfied with the decreased interest rates. For all municipalities, the price of a loan is the most important decision criterion in a tender and many municipalities pointed out that they especially appreciate the DBSA for their lower interest rates. But banks complained that it is impossible to win a tender when the DBSA submits a bid. Thus, there is a trade-off between low interest rates inducing municipalities to overcome the backlog. On the other hand private lenders need a reasonable profit to become interested in the market and to make it sustainable, which is also a goal of government. This trade-off has already been identified by Glasser et al. (1998).[22] They noted that the DBSA has two conflicting missions

22 On behalf of the Department of Finance, Glasser et al. carried out a study for the formulation of a regulatory framework for municipal borrowing in South Africa. Their findings were partly incorporated in the MFMA.

(being self-sufficient and funding socially desirable investments) that can be traced back to conflicting desires of South African policy makers: creating a borrowing market with private lenders, and wanting to invest visibly and quickly to alleviate the accumulated backlog. It is indeed remarkable that we found the same complaints about this dilemma almost ten years later. Apparently, the government has not solved this conflict in the meantime.

7.3.5 The need to improve the public-private interplay

Compared to the conclusions of Glasser et al. (1998),[23] we caution to deny public lenders a place in sub-national borrowing. Asked for the necessity of public lending institutions, the interviewees frequently highlighted that public lenders are important for capacity building in smaller municipalities or for risk-sharing in places where private lenders would not lend. It was also appreciated that public lenders keep an eye on development, whereas private lenders predominantly would want to make profit. Moreover, it was mentioned that private lenders in contrast to public lenders do not offer a loan smaller than 15 million rand, as it is not worth the effort. Another argument underlining the importance of the DBSA is that without its engagement INCA had a monopoly in the second tier municipalities, a market segment which is not yet targeted by the other private banks. Public lenders can play a healthy role as competitors to prevent excess profits of private lending institutions.

Hence, there is a broad understanding why public lenders are indispensable. However, many if not most stakeholders criticized that public lenders, particularly the DBSA, would currently not live up to their role. The two main concerns that nearly all interviewees shared were: first, the DBSA should focus its lending away from the metros to the poorer and riskier “market two” municipalities; second, the DBSA should put more effort in strengthening the capacity of these municipalities. Considering that our interviewees felt that the private banks all target the top municipalities, one can assume that competition will also work without the DBSA in this market. If the DBSA remains in this market, the government’s goal to create a sustainable private municipal debt market can hardly be met.

23 Glaser et al. (1998) recommend a “tabula rasa” regarding public sector lending.

Therefore, it is of pressing importance that the national government reformulates the fields of activity for the DBSA (and possibly for ESAs in the future).

8 Lessons learned

The South African municipal borrowing market is an exceptionally interesting case. Positive impacts can be identified and have been described in this report. A lot of prerequisites for successful borrowing are currently in place and were analyzed in detail in the previous chapters. However, there is a strong perception that the market does not really "take-off". Obviously, some bottlenecks still need to be overcome before the market can be broadened. In this chapter, we draw conclusions for South African actors (Section 8.1), for other countries (Section 8.2), and for external support agencies (Section 8.3). There is a lot that can be learned from the South African case, which policy makers from other countries and external support agencies should keep in mind when fostering sub-national borrowing.

8.1 Lessons for South Africa

Looking at South Africa, we find that sub-national borrowing has a positive impact on infrastructure service delivery. We think that there is room for more borrowing, if certain shortcomings are addressed. Hence we recommend policies that can contribute to an environment that enables more sub-national borrowing, related to the three prerequisites: the regulatory framework, the demand-side and the supply-side of the municipal borrowing market.

The regulatory framework

Compared to how other legal systems control sub-national borrowing, the South African system lies **between a market-based approach and a cooperative system** in which several spheres of government are in an ongoing negotiating process. A fully market-based system cannot function if actors assume that national government will assist in case of a financial crisis of a municipality. We consider it correct that South Africa has not moved to a fully market-based system yet, but still works with some cooperative mechanisms. However, if one adheres to a cooperative model, one

should make sure that the respective spheres of government are able to effectively execute their respective control functions.

Looking at the **trade-off between transparency through regulation and the burden through regulations**, it seems that South Africa regulates a lot. This is good for transparency, but sometimes difficult to implement as there is a lot of administrative effort and capacity needed. In our opinion, one should reconsider if all the requirements of the MFMA are needed and worth it. Once municipalities manage to cope with the initial implementing difficulties of the MFMA, and transparency and security are more established, one should think of reducing requirements.

Concerning **tender regulations**, National Treasury should clarify in Chapter 6 on debt that Chapter 11 on supply chain management applies to borrowing. Also the norm on unsolicited bids in Chapter 6 has a weak wording and should be clarified.

Concerning **reporting requirements**, the different institutions of national (e.g. DPLG and National Treasury) and provincial governments should state clearly what information is required from municipalities. They should deliver the same standard forms to municipalities, if they request the same information from municipalities.

The national government does not **bail out** explicitly, but there are assumptions that at least they provide a grant if a municipality is in financial trouble. National government should be aware of the perceived chances of bailout and consider what precedent to set when the first severe crisis occurs to a municipality.

The demand-side of the borrowing market

Major obstacles for municipalities to engage in more borrowing are capacity constraints, a weak revenue base, insecurity about the future income structure and a conservative borrowing attitude. To promote an expansion of the municipal borrowing market, the following points should be addressed:

It is paramount to **increase capacity building** at the municipal level, targeting both financial management capacity and technical/implementation capacity. This will accelerate municipalities' ability to access capital and to use this capital more efficiently. In the medium term, this will make

municipalities more self-sustaining and less dependent on government funds.

One should support and encourage municipalities to improve their **credit control policies** to achieve a more stable and reliable revenue base that is essential for borrowing. Possible measures could be, for example, a transition to pre-paid service delivery.

An important point is to reduce **the insecurity about the future functions and income structure** of municipalities. It will be essential to give a transparent outline of the compensation for potential electricity income losses that come along with the creation of the REDs. If there are further re-centralizing tendencies, such as the REDs, and municipalities loose even more revenue sources in the future, the potential of municipalities to borrow might face limits. This could lead to a situation where parastatal companies carry out the bulk of infrastructure investment, still working on a sub-national level, but at a more aggregated level than municipalities.

The supply-side of the borrowing market

Municipal bonds: From our analysis of the prospects of the bond market, we cannot support National Treasury's policy to push the development of the bond market. In the short term, from the perspective of a municipality, there are hardly any advantages of bonds compared to inexpensive loans available in the market. Since bonds certainly have their merits, there might be a more prominent role for bonds in the long run, partly because the price for credits might rise. In the meantime, innovative ideas such as bond pooling might be a way forward to overcome obstacles.

The interplay of public and private lenders: Our analysis shows that there definitely is a place for public lenders to promote competition and to rectify market failure. However, the DBSA and external support agencies do not live up to an ideal role. Instead of fostering small municipalities to become creditworthy, their investment concentrates too much on the top municipalities. As a consequence, they are competing directly with private lenders instead of complementing them. To improve the public private interplay, we have the following recommendations:

The DBSA (and external support agencies) should refocus its lending away from the top municipalities towards the smaller and low-capacity municipalities. With such a new policy, we would expect the borrowing

market to broaden. However, by only financing high-risk municipalities, the DBSA cannot be self-sustaining.

To make such a new policy financially sustainable for the DBSA, we suggest two solutions: First, the DBSA could also be profitable even when focusing only on small and low-capacity municipalities. For example, by pooling the municipalities together lending risks are reduced. Second, government could subsidize the DBSA for high-risk loans. Therefore, a new service delivery agreement between the government and the DBSA might be appropriate.

This new service delivery agreement could stipulate that the lending volume is only one among the criteria to judge the success of the Development Bank, with innovative risk sharing projects being another one. DBSA might consider rewarding project managers when engaging with such projects. Moreover, making more municipalities creditworthy through capacity building and technical advice should become more important than simple bulk loans to big municipalities.

We suggest that the DBSA should be complementary to the lending of private institutions by restricting the share that the DBSA may gain in a tender, and by facilitating joint bidding between public and private lenders. Additionally, the maximum share of DBSA's exposure to metros might be limited.

External support agencies should seek for innovative ways of enhancing private credits in less creditworthy municipalities instead of focusing on the metros. Focusing on metros is particularly questionable if external support agencies burden them with additional transaction costs due to their specific project-related delivery mechanisms. For all public lenders, it is probably more important to concentrate on capacity constraints instead of providing financial means since liquidity in the South African capital market is high.

8.2 Lessons for other countries

South Africa is a special case in many ways and lessons for other countries can only be drawn with caution. Nevertheless, we think that sub-national borrowing generally can also have a positive impact on infrastructure service delivery in other countries. In the first part of the following sec-

tion, we briefly point to the specifics of South Africa. Second, we try to draw some general conclusions that apply to several countries. Overall, it is important to keep in mind that we do not want to recommend borrowing in different countries with different political and economic systems, without considering the risks that can come along with borrowing. Every country should use sub-national borrowing according to its specific political culture, to the level of decentralization, to its acceptance of unequal development, to its institutional capacities, to its macroeconomic and financial situation, and to the depth of its capital markets. We point out that establishing the prerequisites for a municipal borrowing market – a regulatory framework, supply-side institutions, and a creditworthy demand-side – is a desirable activity, enabling the actors to lend and to borrow.

Specifics of municipal borrowing in South Africa

Looking at the setting for sub-national borrowing in South Africa, we found that South Africa is unique in several ways.

First, South Africa carries the **legacy of Apartheid**. On the one hand, while there are other unequal and diverse countries, racial issues make South Africa an even more distinct case. Apartheid has increased the capacity shortcomings and has led to huge infrastructure backlogs in formally disadvantaged areas. On the other hand, it is also the history of Apartheid that awakened enthusiasm to change inequalities and work on realizing same opportunities to all South Africans, e.g., in the form of access to infrastructure.

Second, South Africa – compared to other countries – has a relatively **stable institutional and political setting**. Democracy functions well. The “voice“ of its citizen is heard through elections, civil society organizations and the press. The institutional and political setting provides investors with strong predictability.

Third, South African **municipalities are advanced** in terms of fiscal decentralization since they have significant and stable income sources. They receive many transfers from national government and some have their own income sources, making them less dependent on the national government.

Fourth, with the DBSA, South Africa has a **strong public development bank**. Such a public lender is valuable to play a lead role in developing a municipal market, leading municipalities to the capital markets, and

crowding-in private lenders. In addition, one can observe **strong private banks** that increase competition. South Africa does not only have unusually many actors on the financing side but also an unusually high level of liquidity in the financial sector. Such a strong financial sector with a long history of long-term investment lending in the local currency is non-existant in many developing countries.

Moreover, the **overall economic and financial situation** is exceptionally good. The economy is very healthy and is growing; the good national government budgetary situation allows South Africa to increase intergovernmental transfers for infrastructure service delivery. And the strong rand can easily convince ESAs to lend to South African actors in their own currency.

Other countries have to keep these specifics of the South African case in mind, in order not to blindly try to learn from municipal borrowing in South Africa. Nevertheless, the following conclusions and recommendations for other countries are valid.

Conclusions and recommendations for other countries

As we have seen in South Africa, it is important to **build up confidence of investors.** The reason is that investors want to have predictability as to what will happen to their debtor and their credit. Political and regulatory decision can help create this confidence. In South Africa, there is a very stable political environment that is probably not existent in many other LICs or MICs. Yet, each government can influence some aspects of security and certainty, irrespective of the political setting in that country, such as dealing with a financial crisis. An insolvency law need not be in place, as countries can have several approaches to crisis regulation (e.g. an administrative approach in which the national government strictly controls and approves sub-national borrowing, leading implicitly to national guarantees). In choosing an approach to control sub-national borrowing, a country will also want to look at the institutional capacities of its different spheres of government. The South African example has shown that the mere existence of crisis-mechanisms provides security to lenders and attracts investors.

Limiting long-term debt only to capital investment had a very good impact on infrastructure service provision and financial management in

South Africa. We also recommend other countries to clarify the use of short-term debt and long-term debt. It is important to have an institutional setting in place that ensures implementation of the law. In South Africa, a strong political will of the national government combined with municipalities eager to understand and implement the law facilitates legal implementation.

Creditworthiness of sub-national entities is crucial in making the sub-national borrowing market work. To be creditworthy, first of all, sub-national entities need to have sufficient financial autonomy. In addition, sub-national entities will only be able to receive long-term credits for capital expenditure when their incomes sources are steady and predictable, regardless of the type of income. Concerning other MICs, own income sources will be more realistic than in Least Developed Countries (LDCs). LDCs might rely more on transfers from the national government or on grants from ESAs. In this case, it should be transfers and grants that constitute the predictable income source.

Rules that impose a lot of **discipline regarding financial management** on administrative as well as political staff can lead to more capacity, transparency, responsibility and creditworthiness. Making public information about finances of a sub-national entity also is helpful for investors. Transparency can be fostered by national government, e.g., facilitating independent ratings or audits. Rules will only have an impact, again, when national government makes sure that rules are taken seriously and implemented. This can be ensured by creating the right political environment, putting pressure, fostering responsibility, and providing helpful information mechanisms and capacity building facilities. In addition, national governments should observe the trade-off between the positive effects through regulations and an overburdening of municipalities because reporting takes capacity that could otherwise be used to implement infrastructure. Thus “overregulation” is only justified as long as it still improves transparency and creditworthiness.

Other countries should not expect that a sub-national borrowing system is easily implemented throughout the country. Rather, one should expect a **significant concentration of debt capital** in a few creditworthy entities with reliable income streams, a sound economic base and good financial management. Large metropolises and exceptionally creditworthy small municipalities (or other sub-national entities) might lead the demand-side

of a credit market. Perhaps, a majority of entities will not be able to access the capital markets. The South African experience suggests that this may be a normal step when working towards a bigger municipal borrowing market, especially in diverse and unequal countries. In the short term, the concentration of debt capital might even increase inequalities in infrastructure provision within a country. A country either has to accept those inequalities or deal with them by increasing transfers to weaker entities.

We cannot give a clear recommendation on whether to prefer **general obligation lending** or project-specific lending. On the one hand, financial institutions in other countries could finance poverty-reducing projects via general obligation loans, like in South Africa. The possibility of the debtor to cross-subsidize within their budgets makes this feasible. General obligation lending is good to strengthen debtors in their decision making power on what kind of infrastructure to finance. On the other hand, if other countries want to improve the implementation of projects (better cost-calculation, faster implementation, more maintenance), the regulation in these countries should be such as to allow and encourage lenders to finance specific projects and also maintenance expenses.

Moreover, other countries can **learn from the success of the DBSA**. The DBSA has led quite a few municipalities to the capital market, which had not been used to the logic of a capital market before. However, the South African case also shows that it is not easy to find “exit”-options for public development banks once they are in the market. Other countries should **carefully assess the role that ESAs play** in their market. They should force them to cooperate closely with domestic private banks in order to transfer know-how, to raise domestic capital, and to support the domestic capital market development.

8.3 Lessons for external support agencies

As shown in this study, external support agencies focus too much on lending to metropolitan municipalities in South Africa. Especially, if in the near future more ESAs change their regulations to enable sub-national lending without central state guarantees, the current tensions between public and private lenders will be intensified. Therefore, we strongly recommend that ESAs find different ways of engagement bringing their com-

parative advantages into the market and at the same time enabling the private sector to fulfill its role.

Having in mind that building a sustainable local financial market is a main goal of the ESAs, they should try **not to crowd-out private lenders**. To avoid crowding-out private capital, ESAs should offer sub-national finance at market rates, stop providing free grant elements to top municipalities, and also start taking currency risks by lending in local currency.

As suggested to the DBSA, ESAs should push **innovative ways of enhancing private credits** in less creditworthy municipalities instead of focusing on the bigger cities. It is difficult to design these innovative credit enhancement schemes so that they achieve the double objective of **broadening the market** and crowding-in the private financial institutions. External support agencies can offer (partial) guarantees to private banks as the IFC is doing in South Africa today. However, they should concentrate the guarantees on those municipalities with less exposure to the capital market.

In most countries, ESAs will have to **transfer knowledge** to the private financial institutions about the nature of the municipal borrowing market and about profitable techniques to operate in this market segment. INCA can probably work as an example of international benchmarking.

ESAs should avoid to randomly privilege individual private lending institutions since this could lead to market distortions. **Cooperation should be offered at transparent rates** to all private banks in a frequently repeated tender procedure. Rates should get closer to actual market rates as soon as the initial exaggerated risk perception has been overcome.

Especially when looking at countries with such a liquid financial market as in South Africa, ESAs should **concentrate on capacity building** and not on providing financial capital. Although this is common knowledge in most ESAs, it is questionable if this insight has already been transformed into daily policy. It sometimes seems paramount for ESAs to fully use their budgeted capital or even to increase their exposure in some fields of activity. At the moment, sub-national borrowing is very prominent, and all stakeholders in the international development finance system should avoid the situation where ESAs become a part of the problem instead of being a part of the solution.

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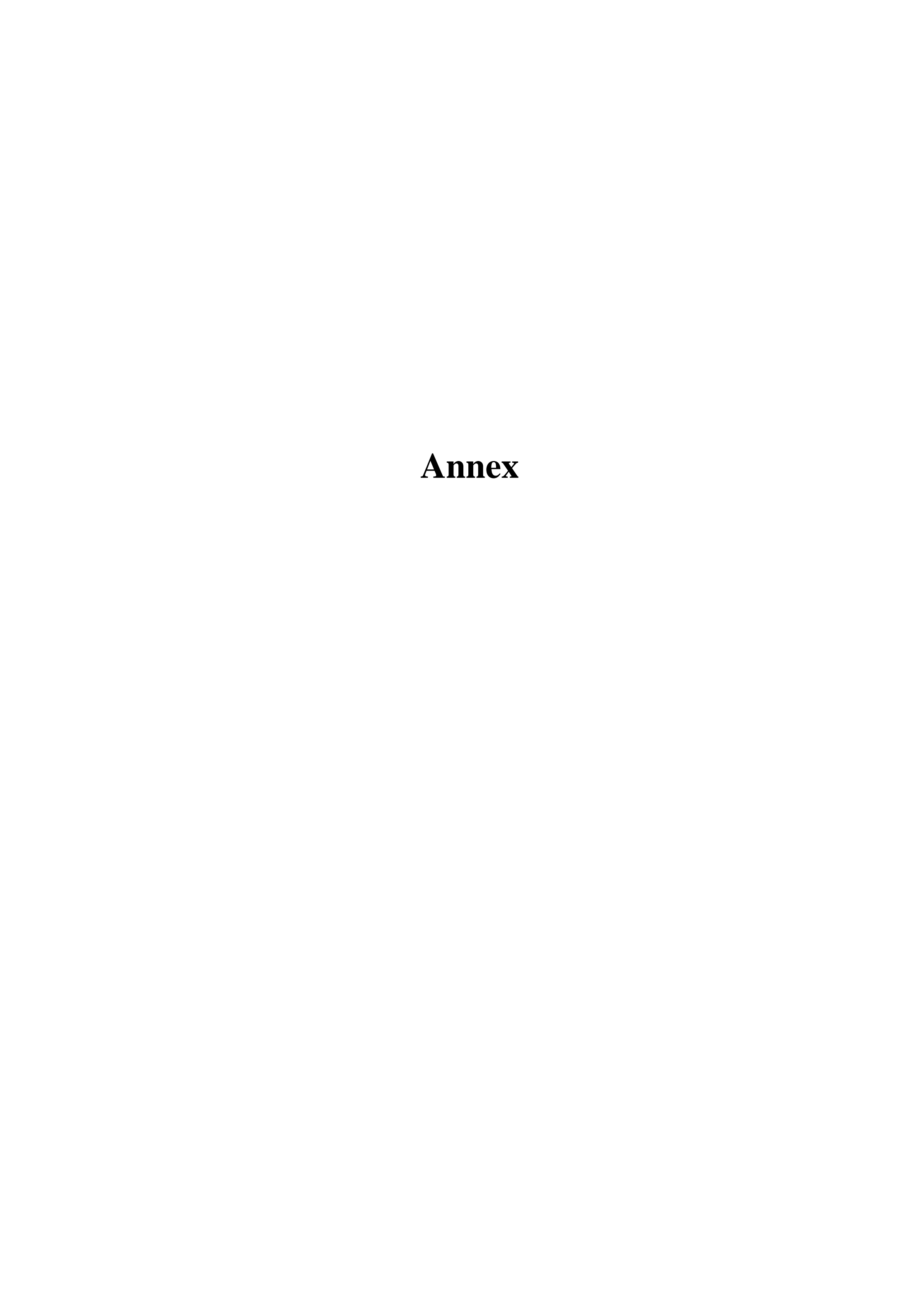

Annex

Selected data of municipalities in the sample

Province	Municipality	Population (Census 2001)	Budget (06/07) (ZAR'000)	Capital budget (06/07) (ZAR'000)	Outstanding debt (ZAR) (30/06/2005)	Debt/ capita (ZAR)	Rating[a]	Capacity level[b]
Gauteng	Johannesburg	3,225,309	21,176,125	3,193,219	5,266,862,000	1,633	A-(zaf) ZaA+	High
	Ekurhuleni	2,478,631	11,028,036	1,222,513	1,118,953,567	451	zaAA-	High
	Randfontein	128,731	347,124	53,220	21,979,596	171	-	High
Limpopo	Bela-Bela	52,124	93,602	18,923	7,578,542	145	-	Medium
	Mookgophong	30,759	63,199	20,113	n.a.	n.a.	-	Medium
	Polokwane	508,277	1,201,208	386,049	n.a.	n.a.	zaBBB+	High
	Greater Tzaneen	375,586	337,268	35,050	70,696,749	188	zaBBB	High
Mpuma-langa	Steve Tshwete	142,772	520,675	144,594	139,560,173	978	-	High
	Mbombela	476,593	1,030,431	443,555	111,375,181	234	zaAA-	High
	Umjindi	53,744	115,998	18,414	8,642,999	161	-	Medium
	Ehlanzeni District	1,447,053	236,348	137,748	n.a.	n.a.	-	High
	Taba Chweu	81,681	149,083	15,559	n.a.	n.a.	-	Low
North-West	Rustenburg	387,096	1,691,133	777,966	185,556,480	479		High
	Moses-Kotane	237,175	424,977	240,075	42,374,949	179	-	Medium
	Potchefstroom	128,353	386,980	39,653	48,551,286	378	zaA-	High
KwaZulu-Natal	eThekwini	3,090,122	14,033,127	2,847,033	3,565,772,000	1,154	AA	High
	uMhlatuze	289,190	1,220,164	448,052	67,128,540	232	-	High

Free State	Matjhabeng	408,170	974,041	163,174	132,085,191	324	-	High
	Mangaung	645,440	2,054,487	451,947	20,438,828	32	-	High
Eastern Cape	Buffalo City	695,278	2,060,362	475,975	401,502,150	577	zaA-	High
	Amatole District	1,664,483	519,179	185,210	n.a.	n.a.	-	High
	Makana	75,302	128,839	11,928	3,477,686	46	zaBB-	Medium
	Cacadu District	388,206	175,238	16,023	n.a.	n.a.	zaBBB-	Medium
	Kouga	70,695	287,058	82144	62,830,688	889	-	Medium
Western Cape	George	135,409	739,263	229,612	80,512,848	595	zaA-	High
	Knysna	51,468	268,215	38,082	99,589,579	1,935	-	Medium
	Overstrand	55,451	451,211	106,649	54,012,380	974	-	High
	Theewaterskloof	93,276	257,941	51,271	25,615,261	275	-	Medium
	Cape Town	2,892,243	17,002,727	2,879,234	2,498,030,000	864	zaA+	High

a All ratings by CA-Ratingsbut the Johannesburg Bond rating (Fitch) and eThekwini (GCR)

b According to the classification of the National Treasury (high/medium/low)

Source: Data taken from the South African National Treasury, annual financial statements and other documents of municipalities, CA-Ratings, and from the 2001 Census of South Africa.

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