With the end of the apartheid era in 1994, the Republic of South Africa entered a new stage of development with far-reaching institutional reform. After the first democratic elections in 1994, a new constitution was adopted that fundamentally changed the way the government was structured and operated. The 1996 South African Constitution created three independent and interrelated spheres of government at the national, provincial, and local levels. The national government was primarily tasked with formulating policy and delivering critical national services such as police and defense services. Provincial governments were made responsible for the delivery of health, education, and social services, while local government, as the sphere closest to citizens, was mandated with the delivery of basic services and amenities. Local government was established as an autonomous sphere of government with executive and legislative powers vested in its Municipal Council.  

In the post-apartheid era, South African municipalities faced a dual challenge of extending the delivery of basic services to all citizens, while simultaneously improving the quality and efficiency of existing services offered to residents. The need for infrastructure investment was
immense, driven by huge backlogs of inadequate investment during the apartheid regime, reflected in aging electricity networks and water and sanitation systems. Rapid urbanization and the need to accelerate economic development also required the development of new infrastructure.

From 1994 to 2000, the municipal sector was restructured and consolidated into 283 newly formed municipalities. The amalgamation process integrated poor and wealthy urban communities, and created cities that brought together business hubs, wealthy suburbs, and townships under one administration.\(^2\) Since the adoption of the Constitution in 1996, a series of important legislative and institutional reforms have been carried out to develop a framework for strengthening local government capacity in providing critical infrastructure and services.

The government’s 1998 “White Paper on Local Government” stressed the importance of leveraging private sector finance to meet the infrastructure requirements of municipalities over the long term.\(^3\) The White Paper proposed a three-pronged approach to deepen municipal credit markets. First, it proposed national legislation to better define the borrowing powers of municipalities and the rules governing interventions. A comprehensive framework for monitoring the financial position of municipalities was also suggested as a way of promoting financial discipline. Second, the White Paper encouraged the use of credit enhancement measures to improve the credit quality of municipalities and accelerate lending to local government. Third, concessional lending through state-sponsored entities was seen as a viable alternative to market-based lending in those cases where the quality of municipal credit prevented municipalities from accessing the market.

The 1998 White Paper was followed by extensive stakeholder consultation between 1998 and 2003, leading to the enactment of the landmark Municipal Finance Management Act (MFMA). The act sought to “secure sound and sustainable management of the financial affairs of municipalities and other institutions in the local sphere of government and to establish treasury norms and standards for the local sphere of government,”\(^4\) with the aim of improving the delivery of services by municipalities. As part of the financial management, the MFMA provides the overarching regulatory framework for borrowing by local authorities. The act provides a comprehensive set of ex-ante rules regulating the
types of borrowing and the conditions under which such borrowings can take place. Equally important, Chapter 13 of the act stipulates a procedural approach for dealing with municipalities in financial distress.

Since 2005, activity in municipal credit markets has risen rapidly. All metropolitan municipalities have in the last decade borrowed funds from the banking sector, capital markets, or both, to finance infrastructure development. Long-term borrowing increased rapidly in the run-up to the 2010 FIFA (Fédération Internationale de Football Association) World Cup, changing the landscape of municipal finance from a high level of dependency on fiscal transfers to one where borrowing plays an increasingly important role in financing capital expenditure. However, there are continuing challenges, including the lack of a fully developed secondary market, and incompatibility of short-to-medium-term debt maturities with long-term assets of infrastructure, and the need to crowd-in more private financing in the market.

The infrastructure financing needs of South African municipalities will remain substantial over the next 10 years, estimated at approximately R 500 billion (approximately US$59.3 billion). According to the national government, existing sources of capital finance, namely, municipalities’ internally generated funds and intergovernmental grants, are insufficient to meet the estimated demand. Expanding and deepening the subnational credit market is viewed by the government as critical to providing a long-term financing source. In addition, the government has broadened the financing strategy to include other sources of capital finance, such as development charges, land leases, and public private partnerships (PPPs). The national government also views sound financial management practices as essential to the long-term sustainability of municipalities.

This chapter reviews the South African strategy of leveraging private financing for infrastructure and the accompanying legislative and institutional reforms. The rest of the chapter is organized as follows. Section two examines institutional reforms since the 1996 Constitution, particularly the enactment of the landmark MFMA, which defines a framework for municipal finance and access to the financial market. Section three presents the borrowing framework for municipalities—ex-ante rules for municipal borrowing and an ex-post system for addressing municipal financial distress. Section four discusses the development
of the municipal credit market since the enactment of the MFMA, its progress, and challenges. Section five presents the government’s strategy for leveraging private finance by linking four complementary elements: debt financing, land asset-based financing, and PPPs from the financing side, and enhancing borrowers creditworthiness from the demand side. Section six provides concluding remarks.

Historical Context and Institutional Reforms

The New Constitution

The 1996 Constitution of the Republic of South Africa created a broad legislative framework for a general system of governance and provided the core institutional framework for the legislative, executive, and judicial branches of government. The Constitution elevated provincial governments and local municipalities from being merely creatures of statute to constitutional authorities. Local government was established as an independent sphere of government with executive and legislative powers vested in its Municipal Council. Moreover, the Constitution entrenched the autonomy of local government by prohibiting any actions by national and provincial government that might compromise or impede the ability of a municipality to discharge its constitutional obligations.

Section 139 of the Constitution opted for an administrative solution to dealing with municipalities in financial distress by allowing provincial government to intervene in the affairs of local government when a local government fails to fulfill its obligations. How these provincial interventions would be carried out, and their implications for the rights and obligations of borrowers toward their creditors, were clarified in subsequent national legislation. In addition, the Constitution limited the power of the national government to guarantee subnational debt by requiring that any such guarantees be done in accordance with national legislation. Such legislation could only be enacted after consideration of the recommendations of the Financial and Fiscal Commission, a body established to safeguard the probity of public finance policies and legislation.

The government’s 1998 White Paper on Local Government concluded that there were too many municipalities in South Africa, and that many were not financially viable. The 1998 Municipal Structures Act provided a legislative framework for the consolidation and rationalization of
municipalities in accordance with the new constitution. The act established three types of municipalities and the criteria for each type.\footnote{15} Category A municipalities comprise the six largest municipalities with exclusive municipal executive and legislative authority in its areas. Category B municipalities comprise 231 local municipalities that share municipal executive and legislative authority in its area with a category C municipality within whose area it falls. Category C municipalities comprise local municipalities that fell under a district municipality.\footnote{16} The number of municipalities was reduced from 843 to 284. During this process, a number of urban municipalities were transformed into metropolitan municipalities, and their fiscal accounts were consolidated, enabling cross subsidization between richer and poorer areas. Following the 2011 local government elections, the number of municipalities was further reduced to 278, comprising 8 metropolitan municipalities, 44 districts, and 226 local municipalities.\footnote{17}

The financial crisis of the then Greater Johannesburg metropolitan municipality in 1997 became the first to test the provisions of Section 139 in the Constitution (box 13.1). Lessons from the crisis subsequently

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**Box 13.1 Section 139 Intervention in the Greater Johannesburg Metropolitan Municipality**

The Greater Johannesburg Metropolitan Municipality was created in 1995 with four independent local councils under the overarching Greater Johannesburg Metropolitan Council (GJMC). Each local council could approve its own budget, and the balanced budget applied only to the aggregate budget of all councils.

Councils rolled out ambitious spending plans without adequate finance, assuming that shortfalls would be offset by surpluses of other councils. The crisis hit the GJMC in July 1997 with unpaid bills of R 300 million to Eskom, the national electricity supplier. All local councils faced severe cash flow pressure due to low revenue collection and overambitious capital budgets, and the GJMC itself had underfunded reserves of R 1.8 billion.

The Minister for Development Planning and Local Government made a legislative intervention in late 1997 (the first time a provincial government used Section 139 of the Constitution), supported by the National Treasury. An emergency loan was arranged with the Development Bank of South Africa, and a Committee of experts was instrumental in bringing expenditure in line with revenues. The crisis led to broader reform of the municipal governance structure in the country.

influenced the drafting of the Municipal Financial Management Act and its emphasis on ensuring that the deleterious effects of municipal financial crises on service delivery are contained.

**White Paper on Local Government**

The ending of national government guarantees on municipal borrowing placed the obligation for debt service with the subnational governments themselves. The capital market would then need clarity on a framework for borrowing rules, including remedies in the event of municipal financial distress and emergency. Since such a framework was yet to be developed, municipal credit markets (and, in particular, the bond market) started to collapse after 1996. No new bonds were issued by any municipality until 2004 (after the enactment of the MFMA in 2003). Naturally, this limited the ability of municipalities to finance infrastructure development through debt financing.

The national government's 1998 White Paper on Local Government aimed to address these concerns. The White Paper and the 2000 Policy Framework for Municipal Borrowing and Financial Emergencies make it clear that government policy regarding municipal borrowing must be based on a market system and on lenders pricing credit to reflect the risks they perceive.

The government's 1998 White Paper on Local Government stressed the importance of using capital markets to leverage private investment. It notes that “Ultimately, a vibrant and innovative primary and secondary market for short and long term municipal debt should emerge. To achieve this, national government must clearly define the basic ‘rules of the game.’ Local government will need to establish its creditworthiness through proper budgeting and sound financial management, including establishing firm credit control measures and affordable infrastructure investment programmes. Finally, a growth in the quantum, scope and activities of underwriters and market facilitators (such as credit-rating agencies and bond insurers) will be required. … The rules governing intervention in the event that municipalities experience financial difficulties need to be clearly defined and transparently and consistently applied. It is critical that municipalities, investors, as well as national and provincial government, have a clear understanding of the character of
their respective risks. Risks should not be unduly transferred to national or provincial government."

As reviewed by the South African National Treasury (2001), the White Paper stresses the importance of both private sector investors and capital markets. Private sector lenders and investors are important not only because they bring additional funding to the national table but also because they tend to have better expertise for evaluating projects and credit risk and for managing outstanding loans than do public sector lenders. Active capital markets, with a variety of buyers and sellers and a variety of financial products, can offer more efficiency than direct lending for two reasons: (a) competition for municipal debt instruments tends to keep borrowing costs down and creates structural options for every need; and (b) an active market implies liquidity for an investor who may wish to sell, and liquidity reduces risk, increases the pool of potential investors, and, thus, improves efficiency.20

The White Paper provided the basic foundation for the formulation of more detailed policies and laws governing local government. It included proposals on how local government would relate to the national fiscus21 and general guidelines on financial structures for local government. More important, the White Paper acknowledged the need to leverage private sector finance to meet the infrastructure requirements of municipalities.22

The White Paper proposed a three-pronged approach to deepen municipal credit markets. First, it proposed national legislation to better define the borrowing powers of municipalities and the rules governing interventions. A comprehensive framework for monitoring the financial position of municipalities was also suggested as a way of promoting financial discipline. Second, the White Paper encouraged the use of credit enhancement measures that could be used to improve the credit quality of municipalities and accelerate lending to local government. Third, concessional lending through state-sponsored entities was seen as a viable alternative to market-based lending in those cases where the quality of municipal credit prevented municipalities from accessing the market.

**Municipal Finance Management Act**

From 1998, when the White Paper was issued, to 2003, a series of legislative reforms was carried out to pave the way for the development of
a unifying framework for the management of municipal finance. This included introduction of the Public Finance Management Act of 1999 to regulate financial management within the public sector, in order to ensure that the revenue, expenditure, and assets and liabilities of national and provincial government would be managed effectively. The act made the newly established National Treasury responsible for the establishment of uniform treasury norms and standards, and required that every government department or constitutional institution should have an accounting officer. The accounting officer would be the chief executive, and this individual would ultimately be responsible for the institution’s finances. The act thus introduced greater accountability for public finances.

The enactment of the MFMA 2003 marked the culmination of an extensive consultation process among stakeholders. It necessitated two constitutional amendments before the bill could be enacted. Since its first tabling in Parliament in 2000, 41 committee hearings were held to discuss and deliberate on the bill, which reflected the challenges associated with safeguarding the independence of local government while allowing national and provincial governments to fulfill their policy making and oversight functions. Three consecutive versions of the Municipal Finance Management Bill were ultimately tabled before the enactment of the final act in 2003.

The extensive consultation process was needed in order to synthesize the interests of the various parties—the Treasury, lenders, and local government. A case in point is the challenge of addressing financial distress in municipalities when the interests of borrowers and lenders diverge, and the national government has multiple objectives: the fiscal sustainability of municipal government, delivery of essential public services, and development of municipal capital markets. At the heart of the procedures for dealing with municipal financial distress are debt and fiscal adjustment.

However, under the original Section 139 of the Constitution (1995–2002), few remedies existed to effect debt and fiscal adjustments for a financially troubled local government. Budgets, spending, and taxes were under the purview of the Municipal Council. Intervention into local government affairs by provincial government was limited to cases where an “executive obligation” was not fulfilled. The province could
only issue a directive to the council or assume responsibility for the obligation.

Various proposals were put forward to effect debt and fiscal adjustments for a financially troubled municipality. In July 2000, the Department of Finance (now the National Treasury) put forward the Policy Framework for Municipal Borrowing and Financial Emergencies. It clarified the powers and procedures of municipalities to raise debt. It acknowledged that, with the ending of national government guarantees, the system of municipal borrowing with national guarantees would need to be replaced by local responsibility for raising market-based financing. To assure that municipal borrowing from capital markets is effective and efficient, the legal and regulatory environment must be clear and predictable. Both borrowers and lenders must have good information, and the risks from poor decisions must be appropriately assigned. It also noted the need for a systematic approach to dealing with financial emergencies of local government. It proposed the establishment of an administrative agency overseen by the judiciary to manage the financial recovery of local authorities.

The first version of the Municipal Finance Management Bill was tabled in Parliament in July 2000. This was followed by a revised bill published in August 2001 and reintroduced in Parliament in 2002. The basic framework defining the municipal borrowing power and procedures was already articulated in the original bill. For example, Chapter 6 of the original version regulated municipal borrowing and contained a number of important changes. The bill described the specific procedures for securing short-term debt. A municipality was permitted to incur short-term debt only if a resolution of the municipal council had approved the debt agreement and the accounting officer has signed an agreement that created or acknowledged the debt. Clause 45 of the bill therefore put in place a system of checks and balances to ensure that short-term financing is not abused by either the political or administrative arms of the municipality.

The debates and amendments focused on several issues, including two main issues of particular concern to municipal borrowing.

The first issue concerns the borrowing power of municipalities. Specifically, it concerns the balance between the intervention power of other spheres of government (national and provincial governments) and the
autonomy of local governments, as empowered by the South African constitution, when a municipal government faces financial stress or insolvency. The original bill envisaged the Municipal Financial Emergency Authority as an independent financial recovery service outside the influence of the executive and legislative branches. The final version of the bill reduced the powers of the Municipal Financial Emergency Authority and shifted the responsibility for overseeing an intervention to the Member of the Executive Council (MEC) responsible for local government within the province. A national entity, in the form of the Municipal Financial Recovery Service, would assist in implementing the financial recovery plan, while the MEC for local government leads the intervention. The revision tried to strike a balance between local autonomy and intervention in the South African system of decentralization.

The second issue concerns the protection of private creditors in the event of municipal fiscal stress. Despite the need for capital markets to finance infrastructure, long-term private lending to municipalities was essentially flat from 1997 to 2001. Municipal debt owed to the private sector did not change greatly during the period, generally remaining between R 11 and R 12 billion. At the same time, debt owed to public sector institutions, including the Development Bank of Southern Africa (DBSA), grew significantly—from R 5.6 to R 8.1 billion. This increasing reliance on public sector debt was viewed as inconsistent with the government’s policy goal of increasing private sector investment. While new policies and legislation will not, by themselves, guarantee that private sector lending increases, there would be no chance of an increase without clear policies and legislation, according to the government.28

The revised bill afforded additional protection to creditors. Credit agreements for the refinancing of short-term debt could be upheld if the creditor had acted in good faith when entering the agreement with the municipality. Refinancing of long-term debt was permitted by the bill under certain conditions (Section 3). The bill sought to promote an open and transparent municipal credit market by providing within the legislation assurances to lenders that they could rely on the written representation of the municipality signed by the accounting officer.29

Two constitutional amendments (South Africa Act No. 34 of 2001 and South Africa Act No. 3 2003) paved the way for dealing with financial distress within municipalities. The amendments make the debt issued
by the current local council valid beyond the term of the council and expand the power of other spheres of government to intervene in legislative aspects, such as the budget or the imposition of taxes. The MFMA, enacted in 2003, contains a new framework for municipal finance and borrowing. Chapter 13 of the act spells out detailed criteria for interventions and financial recovery plans, specifies the role of higher-level governments and courts in the insolvency mechanism, and outlines the fiscal and debt adjustment process. Only courts can stay debt payments and discharge debt obligations.30

Intervention is potentially strong and can involve substantial loss of local political autonomy. Types of interventions include the issuance of directives, full loss of municipal autonomy in financial matters under mandatory interventions, and dissolution of the Municipal Council in extreme circumstances. Primary responsibility lies with the provincial government, but the central government may intervene when the province is unable or unwilling to act.31

The South African experience demonstrates the complexity of subnational borrowing and insolvency legislation and the importance of building political consensus among various stakeholders. Broad support may require concerted effort over a number of years. It took South Africa two years to develop the basic policy framework (1998–2000), another year for cabinet approval (2001), and an additional two years of parliamentary debate on the constitutional amendments and on the MFMA (2001–03).32

**Regulatory Framework for Municipal Borrowing**

The MFMA was enacted in 2003 to ensure the sound and sustainable management of the financial affairs of local governments and their institutions. The act is a comprehensive piece of legislation that regulates the preparation of municipal operational and capital budgets and the management of revenue, expenditure, and debt. In addition, the act enhances political and managerial accountability by clearly specifying the roles and responsibilities of the mayors and accounting officers. An essential part of the act was to provide a framework for municipal borrowing, averting financial crises, addressing financial distress, and ensuring the sustainable financial management of municipalities. The
act regulates municipal borrowing by providing a comprehensive set of ex-ante rules and creating a sound framework for dealing with financial distress.

**Legal Provisions Governing Borrowing**

The MFMA seeks to ensure the long-term fiscal sustainability and sound governance of local government. Reforms around capital budgeting are designed to bring greater certainty and transparency to municipal budgets by ensuring that the costs and benefits of a project over its lifetime are fully disclosed. Specifically, Section 19 of the MFMA enforces prudent financial management by requiring that the total cost of the capital project be disclosed, along with the implications of such capital expenditure on future operational costs and on municipal tariffs and taxes. The act also places the onus on a municipality to ensure that the various possible types of funding available are considered and analyzed in choosing the appropriate mix of financial sources.

Chapter 6 of the MFMA sets out the procedures for securing short- and long-term debt. Municipalities can incur debt, following the approval of the municipal council and a signed debenture agreement by the accounting officer. Long-term borrowing is restricted to financing capital expenditure to ensure that future generations are not held accountable for operational expenditure incurred by the current generation. (From a public policy perspective, long-term borrowing relieves current generations from bearing excessive costs by paying cash for infrastructure that will serve many generations ahead.) The act adopts a broad definition of debt, which it defines as “a monetary liability or obligation created by a financing agreement, note, debenture, bond, overdraft or by the issuance of municipal debt instruments; or a contingent liability such as that created by guaranteeing a monetary liability or obligation of another.” By including contingent liabilities in the definition, the act promotes a comprehensive approach to managing and monitoring both short- and long-term debt.

Refinancing of debt is strictly controlled, as follows: (a) long-term debt is refinanced only if the existing long-term debt was lawfully incurred, (b) refinancing does not extend the term of the debt beyond the useful life of the assets for which the original debt was incurred, (c) the net present value of projected future payments (including principal and interest
payments) after refinancing is less than the net present value of projected future payments before refinancing, and (d) the discount rate used in projecting net present value must be in accordance with prescribed criteria.35

Chapter 6 makes allowances for the provision of security as collateral, but places strict conditions. A municipality may, by resolution of the council, pledge security for any debt obligations of its own or its municipal entity, but the act restricts the municipality’s ability to pledge any infrastructure involved in delivering minimum levels of basic services. Such infrastructure can only be pledged subject to the constraint that in the event of default, the creditor may not sell or change the asset in any way that will affect the delivery of basic services.36

The act permits municipalities to issue guarantees, provided they receive the approval of the National Treasury, and only if such a guarantee is backed by cash reserves for the duration of the guarantee, or if the municipality’s exposure to risk in the event of a default by the guaranteed entity is insured by a comprehensive policy. Checks and balances introduced include the provisions in Section 51 of the act, which explicitly prohibit national or provincial governments from guaranteeing municipal debt, except to the extent granted by Chapter 8 of the Public Finance Management Act of 1999.37

**Legal Provisions Governing Resolution of Financial Distress**

Chapter 13 of the MFMA governs the resolution of financial distress and emergencies of municipalities. It provides a framework for debt relief and restructuring and the types of, and criteria for, provincial and national interventions. More important, the MFMA recognizes the rights of municipal creditors and the role of the courts in enforcing credit agreements. Thus, the act aims to foster greater confidence in the regulatory framework of local government, which over time will improve the ability of local government to access capital markets or commercial loans at lower rates.

**Triggers for financial distress and emergencies.** Section 135 of the MFMA places the primary responsibility for avoiding, identifying, and resolving financial problems in a municipality with the municipality itself. To facilitate the timely identification of any such problems, Section 71 of the MFMA makes it mandatory for the municipality’s
accounting officer to produce monthly budget statements no later than 10 days after the end of every month, and requires the accounting officer to report to the Municipal Council on any anticipated or actual shortfalls, overspending, and overdrafts. The act provides for a supervisory role for the National Treasury.

Although the MFMA does not provide an explicit legal definition of financial insolvency, it does make reference to instances when it is either mandatory or discretionary for the provincial government to intervene in the event of a financial crisis. Intervention in the financial affairs of a municipality becomes mandatory “as a result of a crisis in its financial affairs” or when a municipality “is in serious or persistent material breach of its obligations to provide basic services or to meet its financial commitments, or admits that it is unable to meet its obligations or financial commitments” (Section 139). That is, an intervention by the provincial government must occur not only if the municipality fails to pay its creditors, but also if it fails to supply basic services.

There are, however, other instances when a municipality must notify the provincial government and the relevant minister. The act categorizes such intervention as discretionary and, in such cases, it would then be up to provincial government and officials to decide whether or not to intervene. These instances are outlined in Sections 135, 136, 137, and 138. They require that the municipality notify the provincial government if any of the following occur:

(a) the municipality fails to make payments when they are due,
(b) the municipality defaults on its financial obligations due to financial difficulties,
(c) current expenditure exceeds current revenue for two consecutive financial years, or the deficit exceeds 5 percent in a particular year, and
(d) the municipality does not produce its financial statements on time, or its accounts are not signed off by the Auditor General.

**Early warning system.** The MFMA outlines a comprehensive system of monitoring and reporting, serving as an early warning system to identify financial problems in municipalities. Each layer of reporting allows financial problems to be identified, analyzed, and addressed. Periodic reporting is prescribed by Section 71, which requires the accounting officer of a municipality to report the differences between any budgeted and actual expenditure, revenue, and borrowings. All material differences
must be accompanied by an explanation, and the report must be submitted to the mayor and the relevant provincial treasury by no later than 10 days after the month ends. Provincial treasuries are required to consolidate reports and submit a statement on the state of municipalities.\textsuperscript{39} Hence, both the provincial and national treasury are able to identify current or potential financial problems and take remedial action to assist the municipality through less intrusive means.

Notwithstanding the reporting provisions in the MFMA, Section 135(5) places the responsibility on the municipality to report serious financial problems to the MEC for local government and finance in the province. Similarly, should the MEC for local government become aware of any serious financial problems, the MEC must assess the situation and determine whether an intervention in terms of Section 139 of the Constitution is warranted.\textsuperscript{40}

**Fiscal adjustment.** The Municipal Financial Recovery Service is a legal mechanism created to administer the financial recovery of municipalities. Established through Section 157 of the MFMA, the Municipal Financial Recovery Service is responsible for preparing a financial recovery plan and monitoring its implementation at the request of the MEC of finance in the province concerned.\textsuperscript{41} The Municipal Financial Recovery Service may also assist in identifying the causes of financial problems and potential solutions. Prior to its implementation, the recovery plan must be submitted to the municipality, MECs for local government and finance, organized government in the provinces, organized labor, and suppliers or creditors of the municipality. Comments received from these stakeholders must be taken into account when finalizing the financial recovery plan.\textsuperscript{42} Under the current legislative framework, the Municipal Financial Recovery Service falls within the National Treasury, and its staff are employed within the public service.\textsuperscript{43}

To secure the municipality’s ability to deliver basic services and meet its financial commitments, the financial recovery plan contains a minimum set of activities that the municipality must perform to restore its financial health and service delivery obligations.\textsuperscript{44} In the case of mandatory intervention, the financial recovery plan’s interventions must set out spending limits and revenue targets, outline budget parameters, and identify specific revenue-raising measures. The plan
creates a binding legislative and executive obligation on the municipal council. This provision was included to counter the potential risk of a newly elected municipal council implementing its own spending priorities and creating further financial strain on the municipality.

**Debt relief and restructuring.** Chapter 13 of the MFMA provides for the resolutions of financial problems in municipalities, and Part 3, in particular, provides for debt relief and restructuring. “If a municipality is unable to meet its financial commitments, it may apply to the High Court for an order to stay, for a period not exceeding 90 days, all legal proceedings, including the execution of legal process, by persons claiming money from the municipality or a municipal entity under the sole control of the municipality” (Section 152(1) of the MFMA). The act provides for a voluntary form of liquidation while protecting the municipality and preventing creditors from incurring further losses.

Similarly, under the provisions of Section 153 of the MFMA, the Court may suspend or terminate the municipality’s financial obligations and settle claims (in accordance with Section 155), under certain conditions, including that the provincial executive has intervened in terms of Section 139, a financial recovery plan to restore the municipality to financial health has been approved for the municipality, and that the financial recovery plan is likely to fail without the protection of such an order. More important, in an attempt to protect the delivery of basic services, the court must ensure that all assets not necessary to the delivery of basic services have been liquidated in accordance with the financial recovery plan.

The court must be satisfied that (a) the municipality cannot currently meet its financial obligations to creditors, and (b) all assets not reasonably necessary to sustain effective administration or to provide the minimum level of basic municipal services have been or are to be liquidated in accordance with the approved financial recovery plan for the benefit of meeting creditors’ claims (Section 154).

Section 151 of the MFMA guarantees the legal rights of a municipality’s creditors and their recourse to the courts. When the court issues an order to settle claims against the municipality, the MEC for local government must appoint a trustee to prepare a distribution plan. Preference in a distribution plan is given to secured creditors, and, thereafter,
the preferences as outlined in the Insolvency Act (1936) are applied. Any distribution plan must be approved by the court prior to settlement.

**Fiscal monitoring.** The National Treasury started systematic monitoring of local government fiscal positions in 2009. The 2011 report, “State of Local Government Finances and Financial Management,” shows improvements in local government fiscal management, as demonstrated by an increase in unqualified audit reports as a share of total audit reports during that year. The report also evaluates seven areas of fiscal management, from cash management to debt growth, and identifies 66 of 283 municipalities under financial stress. Not all of the stress was related to debt problems. Some problems, as identified in the Auditor General’s reports, emanated from weak financial management, poor governance, and low levels of capacity within municipalities. The 2011 report also noted that 19 municipalities and 3 district municipalities (about 6 percent of the country’s population) were under constitutionally mandated Section 139 interventions. As analyzed in the next section, the MFMA has revitalized municipal credit markets. The findings from the implementation experience of Section 139 of the MFMA will help strengthen the regulatory framework.

**Development of Municipal Credit Market**

Changes in the legislative and regulatory framework will invariably impact the working of municipal credit markets. The MFMA regulates both short- and long-term borrowing by municipalities and determines the permissible uses of borrowing, and places certain obligations on the municipality in raising long-term debt. These factors have influenced the demand side of municipal credit markets and the landscape of local government borrowing. Regulatory reforms also improve the credibility of financial information, giving potential lenders more accurate information on the financial position of municipalities. This allows them to assess the credit quality of local governments and price their risks accurately. According to lenders, the promulgation of the MFMA and the concomitant reforms in financial management and reporting have enhanced the credibility of information produced by municipalities, enabling commercial lenders to profile municipal risks more accurately.
Having a legal framework that dealt with financial emergencies was also an important consideration by lenders in the extension of credit toward local government.\textsuperscript{45}

**Municipal Borrowing**

Total municipal borrowing (total closing balances in outstanding municipal borrowings) grew from R 18.7 billion in 2005 to R 38.1 billion in 2010, representing an average annual growth of 15 percent (figure 13.1).\textsuperscript{46} Private sector lending to municipalities outpaced public sector lending except in 2009, when the global financial crisis impacted the domestic lending market.

**Figure 13.1 Trends in the Municipal Borrowing Market, South Africa, 2005–10**

![Graph showing trends in municipal borrowing](image)

*Source: South African National Treasury 2011c, with data from the National Treasury local government database.*

**Metropolitan Borrowing**

Capital expenditure in South Africa’s six metropolitan municipalities, which cover 35 percent of the population, tripled during 2004/05 to 2009/10.\textsuperscript{47} World-Cup-related expenditure accounted for a significant
portion of this increase, particularly for the cities of Cape Town, eThekwini, Johannesburg, and Nelson Mandela Bay.

The six original metropolitan municipalities used external borrowing to finance a large portion of this increase in capital expenditure. External borrowing was the highest source of funding of capital expenditure from 2005/06 to 2007/08, with government transfers becoming the most significant source starting in 2008/09 (figure 13.2).

Given the increased capital expenditure and borrowing activity, the cumulative amount of long-term debt has increased markedly since 2005. However, the increase relative to revenue is less dramatic (figure 13.3); metropolitan revenues increased strongly from 2005/06 to 2008/09, and, thus, borrowing relative to revenue remained at around the same level of 35 percent of total revenues. Long-term debt as a share of revenues

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**Figure 13.2 Metropolitan Municipality Capital Expenditure, South Africa, 2004/05–2009/10**

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<th>External loans</th>
<th>Grants and subsidies</th>
<th>External Loans/Capex</th>
<th>Grants/Capex</th>
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<td>3,350,497</td>
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<td>2005/06</td>
<td>9,188,683</td>
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<td>3,737,871</td>
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<td>2007/08</td>
<td>17,018,685</td>
<td>6,273,537</td>
<td>6,195,073</td>
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<td>36.4 %</td>
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<tr>
<td>2008/09</td>
<td>25,490,729</td>
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<td>2009/10</td>
<td>22,721,404</td>
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<td>38.5 %</td>
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</tbody>
</table>

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Source: http://www.mfma.treasury.gov.za

Note: The data cover six metropolitan municipalities: Cape Town, Ekurhuleni (East Rand), eThekwini (Durban), Johannesburg, Nelson Mandela (Port Elizabeth), and Tshwane (Pretoria).
rose above 40 percent in 2009/10, owing to weaker revenue and increased borrowing.

The city of Johannesburg was the most active metropolitan borrower (figure 13.4); at the end of 2009/10, its cumulative long-term debt was R 10.6 billion, accounting for over a third of overall metropolitan municipality outstanding borrowing of R 34.1 billion for that year. This was followed by eThekwini and Tshwane, whose long-term debt was R 8.7 and R 5.6 billion, respectively, at the end of 2009/10. Nelson Mandela Bay’s share of total debt by metropolitan municipality increased from 2 percent in 2008/09 to 4 percent in 2009/10 as its borrowing increased from R 442.4 to R 1.46 billion, largely due to the raising of new loans for 2010 World-Cup-related infrastructure. Previous research reveals that this dramatic increase in debt contributed partly to the city’s subsequent financial woes.⁴⁸
Municipal credit markets in South Africa remain relatively undeveloped, with a limited amount of borrowing instruments available to municipalities through which to raise financing. Amortizing loans from domestic commercial banks are the principal borrowing instrument used by the metropolitan municipalities. Bonds are becoming an increasingly important source of borrowing, with bonds (amounting to R 15.2 billion) accounting for 55.5 percent of outstanding debt in 2009/10 (figure 13.5). Johannesburg, in 2004, was the first South African metropolitan municipality to enter the bond market, followed by Cape Town in 2008, and, most recently, by Ekurhuleni in 2010.

Debt service costs as a share of revenue is a critical measure of the debt sustainability of a government. Based on international experience,
prudential guidelines suggest that debt service costs are often capped at no more than 15 percent of municipal total revenues. For the six original metropolitan municipalities in South Africa, aggregate annual debt service costs (including interest and principal repayments) increased from R 2.8 billion in 2004/05 to R 6.1 billion in 2009/10, and the ratio of debt service to revenue increased from 4.5 percent in 2007/08 to 7.4 percent in 2009/10 (still well below the prudential limit of 15 percent) (figure 13.6).

**Borrowing by Secondary Cities**

The growth of secondary cities reflects the rapid urbanization in South Africa. The 19 secondary cities comprise 1.8 million households and a population of 6.25 million, or 13 percent of the country’s population. Many of these secondary cities are likely to become the next generation of metropolitan municipalities. Secondary cities are critical urban nodes, and the demand for public services infrastructure within these cities has increased significantly. While, traditionally, secondary cities have largely relied on fiscal transfers to finance capital expenditure,
Aggregate borrowings by the secondary cities increased over the last five years, from R 2.4 billion in 2004/05 to R 4.2 billion in 2009/10. Most secondary cities have been conservative borrowers relying largely on fiscal transfers. However, a small number of secondary cities, particularly uMhlathuze, George, Rustenburg, and Msunduzi, borrowed aggressively during this time to augment capital budgets, with an increase in borrowing from 2004/05 to 2009/10 of 1,749, 523, 395, and 70 percent, respectively, though from a low base (table 13.1).

Two of these 19 secondary cities, Msunduzi and uMhlathuze, ran into financial trouble as a result of this rapid increase in long-term debt and debt service costs relative to their revenue increase. For Msunduzi, the provincial government staged a constitutionally mandated Section 139 intervention, and uMhlathuze municipality adopted a voluntary recovery plan. Financial recovery plans were implemented in both cases.\(^{51}\)

To summarize, the MFMA is viewed by lenders as the most critical factor in revitalizing the municipal credit markets.\(^{52}\) Borrowing by metropolitan municipalities tripled between 2004/05 and 2008/09, which suggests a willingness by market participants to lend to metropolitan
municipalities and secondary cities. Commercial loans have been the mainstay of municipal lending, but bond markets are an increasing source of funding for metropolitan municipalities, which reflects an increasing confidence from debt capital markets in local government and its regulatory framework. From the perspective of municipalities, the MFMA has also brought regulatory certainty by specifying the borrowing power of municipalities and the procedural rules for incurring debt. More important, the act regulates capital budgeting, thus ensuring that borrowed funds are used for the development of infrastructure. The act also addresses the concern of investors by developing remedies in the event of municipal financial distress and emergency.

Analysis of South African municipal borrowing and debt cannot be separated from the consolidated public debt of South Africa. Debt limits

Table 13.1 Secondary City Long-Term Borrowing, South Africa, 2004/05–2009/10

<table>
<thead>
<tr>
<th>City</th>
<th>2004/05</th>
<th>2005/06</th>
<th>2006/07</th>
<th>2007/08</th>
<th>2008/09</th>
<th>2009/10</th>
</tr>
</thead>
<tbody>
<tr>
<td>uMhlathuze</td>
<td>51,097</td>
<td>134,954</td>
<td>429,379</td>
<td>411,670</td>
<td>767,236</td>
<td>893,888</td>
</tr>
<tr>
<td>Msunduzi</td>
<td>356,834</td>
<td>336,123</td>
<td>315,412</td>
<td>421,126</td>
<td>463,577</td>
<td>607,435</td>
</tr>
<tr>
<td>Madibeng</td>
<td>316,610</td>
<td>347,094</td>
<td>373,393</td>
<td>394,221</td>
<td>445,137</td>
<td>486,051</td>
</tr>
<tr>
<td>George</td>
<td>61,626</td>
<td>141,142</td>
<td>227,313</td>
<td>310,108</td>
<td>403,515</td>
<td>384,016</td>
</tr>
<tr>
<td>Rustenburg</td>
<td>70,112</td>
<td>89,473</td>
<td>88,330</td>
<td>156,649</td>
<td>359,459</td>
<td>346,941</td>
</tr>
<tr>
<td>Emalahleni</td>
<td>258,895</td>
<td>242,690</td>
<td>226,485</td>
<td>210,280</td>
<td>300,339</td>
<td>272,243</td>
</tr>
<tr>
<td>Drakenstein</td>
<td>106,305</td>
<td>92,491</td>
<td>56,799</td>
<td>142,312</td>
<td>186,167</td>
<td>250,987</td>
</tr>
<tr>
<td>Steve Tshwete</td>
<td>101,930</td>
<td>124,809</td>
<td>113,443</td>
<td>134,424</td>
<td>152,393</td>
<td>167,503</td>
</tr>
<tr>
<td>Matlosana</td>
<td>190,097</td>
<td>180,377</td>
<td>170,657</td>
<td>160,937</td>
<td>151,590</td>
<td>141,105</td>
</tr>
<tr>
<td>Mogale City</td>
<td>327,035</td>
<td>205,125</td>
<td>185,800</td>
<td>155,299</td>
<td>153,134</td>
<td>119,931</td>
</tr>
<tr>
<td>Govan Mbeki</td>
<td>114,310</td>
<td>111,423</td>
<td>108,536</td>
<td>105,649</td>
<td>102,762</td>
<td>99,875</td>
</tr>
<tr>
<td>Emfuleni</td>
<td>125,167</td>
<td>120,811</td>
<td>116,455</td>
<td>112,099</td>
<td>105,254</td>
<td>99,492</td>
</tr>
<tr>
<td>Newcastle</td>
<td>12,740</td>
<td>33,437</td>
<td>66,565</td>
<td>78,037</td>
<td>78,045</td>
<td>84,877</td>
</tr>
<tr>
<td>Sol Plaatje</td>
<td>59,806</td>
<td>56,635</td>
<td>53,464</td>
<td>49,950</td>
<td>64,964</td>
<td>66,435</td>
</tr>
<tr>
<td>Polokwane</td>
<td>92,492</td>
<td>92,492</td>
<td>92,492</td>
<td>92,492</td>
<td>92,492</td>
<td>50,000</td>
</tr>
<tr>
<td>Mbombela</td>
<td>100,706</td>
<td>93,604</td>
<td>85,260</td>
<td>77,653</td>
<td>65,758</td>
<td>58,151</td>
</tr>
<tr>
<td>Stellenbosch</td>
<td>8,356</td>
<td>33,580</td>
<td>33,597</td>
<td>38,204</td>
<td>29,768</td>
<td>38,183</td>
</tr>
<tr>
<td>Matjhabeng</td>
<td>54,140</td>
<td>48,987</td>
<td>43,834</td>
<td>38,681</td>
<td>39,095</td>
<td>29,591</td>
</tr>
<tr>
<td>Tlokwe</td>
<td>32,808</td>
<td>25,013</td>
<td>17,218</td>
<td>32,498</td>
<td>22,483</td>
<td>22,686</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2,441,895</td>
<td>2,511,089</td>
<td>2,805,261</td>
<td>3,073,118</td>
<td>3,983,998</td>
<td>4,220,219</td>
</tr>
</tbody>
</table>

Source: Secondary city annual financial statements.
for subnational governments must take into account the fiscal space available for the total public sector, that is, national and subnational. For any given resources available to repay the total public debt, the borrowing space is ultimately split between national and subnational entities (Liu and Pradelli 2012). National government debt has been managed countercyclically and is mostly denominated in domestic currency.\textsuperscript{53} Total debt outstanding has declined from about 58 percent of gross domestic product (GDP) in 1998/99 to about 36 percent in 2010/11, albeit with an increase from 2008/09 to 2010/11, due to countercyclical fiscal policies. Yields on foreign currency debt are lower than those on domestic currency debt and are mostly long term.\textsuperscript{54} The market estimates a low default risk, which, like those of its peers, varies with global risk aversion. South African government debt has attracted nonresident interest despite the exchange rate risk.

**Broadening the Strategy for Leveraging Private Financing\textsuperscript{55}**

Over the next 10 years, the municipal infrastructure financing needs of South Africa will remain substantial—an estimated R 500 billion (US$59.3 billion) (figure 13.7), of which R 421 billion (US$49.9 billion) is required to finance new infrastructure and rehabilitation, and R 79 billion (US$9.4 billion) is required for the eradication of backlogs.\textsuperscript{56} According to the national government, revenues to municipalities from own revenues and national fiscal transfers are insufficient to meet the scale of municipal infrastructure investments. Thus, the government has laid out a strategy of leveraging private finance through multiple sources—borrowing, development charges, land leases, and PPPs—to mobilize additional resources to fund infrastructure investments. At the same time, sound financial management practices are essential to the long-term sustainability of municipalities.

While municipalities need to explore ways of leveraging primary sources of finance to mobilize additional resources for funding infrastructure investments, the capacity of municipalities to leverage private finance differs significantly. The investment needs of the 140 municipalities that are anchored by smaller cities and large towns (so-called B2 and B3 municipalities) amount to about R 98 billion (US$11.6 billion).\textsuperscript{57} These municipalities often find it difficult to access capital markets, either because the scale at which they wish to borrow...
makes lending expensive, or because weaknesses in their financial management make them a poor credit risk for lending institutions.

The investment requirement of the 70 mostly rural municipalities (so-called B4 municipalities) is estimated to be R 131 billion (US$15.5 billion) over the next 10 years; however, the borrowing capacity of these municipalities is very limited. Since average household incomes in these municipalities are very low, their ability to collect revenues from property rates and service charges is limited. Consequently, these municipalities will continue to rely mainly on government transfers to fund their capital budgets. Generally, borrowing to finance their infrastructure needs is not an option, unless provided on special terms by development finance institutions.

**Deepening Municipal Credit Markets**

As noted, private sector lending to municipalities outpaced public sector lending from 2005 to 2009. During the recession of 2009–10, total public
sector lending exceeded private sector lending for the first time since 2005. Private lenders became more risk averse, with total debt from late 2008 to the end of the third quarter of 2010 remaining flat. In addition, the Infrastructure Finance Corporation Limited, a major lender to municipalities, withdrew from the market in 2009, citing declining margins due to competition from public sector lenders. In contrast, public sector lending—almost entirely from the DBSA accelerated during this period, resulting in total public sector lending exceeding private sector lending.

The municipal bond market remains small and underdeveloped, accounting for only 2 percent of total government bonds listed on the Johannesburg Stock Exchange. Bonds have been issued by three metropolitan municipalities (Cape Town, Ekurhuleni, and Johannesburg). Municipal bond repayments are typically structured with a large, lump-sum (or “bullet”) payment at the end of the repayment period. This creates a spike in municipal debt repayment profiles that requires careful management to minimize the risk of default. Ideally, the debt service profiles of municipalities should be growing broadly consistent with revenue growth. Deferring higher levels of debt service to later years can indicate current fiscal pressure. If adequate reserves (a sinking fund) are not set aside over the period of the bond, the municipality could be forced to refinance the final bullet payments with additional debt. International experience shows that the development of serial maturities is crucial for market development and for managing refinancing risks and maturity profiles.

Although there has been a recent recovery in private lending to municipalities, there is a concern that both the historical and current level of private lending to municipalities is still limited, notwithstanding the legislative and policy reforms that have been introduced to stimulate private sector participation (see section three). Recent research indicates that the development of the municipal credit market is being limited by the following five factors:

- **Lack of a developed secondary bond market.** A secondary market would enhance the liquidity of bond instruments because it enables municipal bondholders to trade the instrument. The limited size of the municipal bond issuances to date is itself an obstacle to the development of a secondary market. The South African bond market is dominated by
pension funds and insurers that invest funds with the intention of holding until maturity. The lack of a developed secondary municipal bond market means investors with shorter time horizons are reluctant to buy long-term instruments whose term matches the economic life of infrastructure investments.

- **Short maturities on loans.** The short maturities offered by banks means that municipalities cannot obtain loan tenures that are in line with the life span of assets. Municipalities are compelled to finance long-life assets with medium-term funds. This means that rates and tariffs have to be higher in the medium term, and funds have to be used to fund higher debt service costs rather than services over the period of the loans.

- **Creditworthiness.** Borrowing should be used to finance infrastructure that will generate income for the municipality, either directly through tariff income or indirectly through higher property rates income. Currently, many municipalities are using borrowing to fund social infrastructure, which costs money to operate but does not expand their revenue base. This negatively impacts the creditworthiness of municipalities and, together with many municipalities’ overall poor financial performance, has reduced their capacity to incur further debt.

- **Lack of treasury management capacity.** Treasury management skills and capacity vary significantly across municipalities. Most municipalities do not have clear borrowing strategies that support their infrastructure investment programs. Improving treasury management capacity within municipalities will help optimize their borrowing activities, including their debt profile.

- **The role of the DBSA.** While the increased lending by the DBSA to municipalities is a welcome development, going forward it needs to explore strategies for partnering with the private sector to crowd-in lending to local government in line with its mandate. Also, the DBSA’s loan book should reflect an appetite for risk that is somewhat different from that of private sector institutions and more commensurate with lending to municipalities at the lower end of the market.

Through the Regulatory Framework for Municipal Borrowing (1999) and the MFMA (2003), the government has already implemented a range of measures to facilitate municipal borrowing, as presented in
sections two and three of this chapter. With the ending of the sovereign guarantee for municipal debt, except those approved following Chapter 8 of the Public Financing Management Act (1999), the MFMA provides legal recourse to investors through Chapter 13 of the MFMA.

Section 48 of the MFMA states that a municipality may provide any appropriate security for its debt obligations, and presents a range of options in this regard, including pledging specific revenue streams, ceding rights to future revenues, and so on. These provisions are supported by a provision in the annual Division of Revenue Act that allows municipalities to pledge future conditional grants as reflected in the medium-term expenditure framework. It is important that these credit enhancements are carefully designed and implemented to reduce moral hazard, and that they do not impede the delivery of basic services.

There is no legal provision that allows the national government or provincial governments to lend funds directly to municipalities. The national development finance institutions (such as the DBSA) are responsible for lending to municipalities, in accordance with their mandates, and may provide interest rate subsidies in accordance with their developmental role. The government is committed to facilitating the development of secondary markets for municipal debt to enhance the liquidity of the municipal credit market, lower the risk of lenders, and, thus, lower the cost of borrowing for municipalities.

**Facilitating Municipality Access to Private Finance**

The government is also exploring ways of enabling municipalities with no, or only limited, access to financial markets to access private finance.

**Pool finance for secondary cities.** The basic idea of pool finance is to create an instrument for secondary cities with similar credit qualities that will allow them to pool their financing needs and approach the financial markets collectively.

Secondary cities have large funding requirements (borrowing was R 4.1 billion [US$500 million] at the end of 2010), adequate own revenues, and good institutional capacity. However, they lack the finance expertise to issue bonds independently, and the scale of their financing needs makes it uneconomical to approach the bond market separately.
It is envisaged that this bond pooling instrument would reduce transaction costs of the underwriting process due to increased economies of scale.

Such bond pooling would be cost-effective for secondary cities since they would benefit from the longer maturities and lower debt costs generally associated with bonds. In addition, bond pools can be structured to achieve higher credit ratings in the primary market, which would further reduce the cost of the debt.

**DBSA fulfilling its developmental role.** Development finance institutions in some developing countries have been instrumental in lending to municipalities with good potential but whose balance sheets are comparatively weak, thus developing the lower end of the capital market. The government and the DBSA have agreed that the DBSA should increase its support for municipalities in line with its developmental mandate. This will entail increasing lending to those municipalities that currently do not have access to credit markets. It is also envisaged that the DBSA will increasingly play the role of market facilitator and, thereby, crowd-in private finance, instead of acting as a primary lender and effectively crowding out private finance. Steps that the bank is being encouraged to take in this regard include:

- Championing a model that involves private sector cofinancing of the projects it invests in
- Providing technical support to municipalities to build their capacity to participate in credit markets generally, and not simply to facilitate the DBSA’s own lending activities
- Facilitating municipalities’ entry and participation into private capital markets by underwriting municipal borrowing or offering limited guarantees to municipalities
- Managing the development of a bond pooling instrument for secondary cities (using the DBSA’s extensive treasury expertise)
- Encouraging the development of the secondary market in municipal bonds by selling its current holdings of metropolitan municipality bonds to secondary investors that are more likely to trade them.

To support these initiatives, the government has raised the DBSA’s callable capital by R 15.2 billion to R 20 billion, thereby increasing its
lending capacity to R 140 billion. The government is also exploring ways to reduce the DBSA’s exposure when lending to municipalities that are a credit risk.

**Developing the treasury function capacity in municipalities.** Generally, the treasury function capacity of municipalities is weak, even among some metropolitan municipalities. The result is that municipalities are not managing their borrowing optimally. This leads to municipalities either underutilizing their borrowing capacity or borrowing excessively and getting into financial difficulties. It is also reflected in the unevenness of many municipalities’ debt profiles. The National Treasury will be exploring ways to strengthen municipalities’ treasury functions, which may include providing specific training, developing appropriate guidelines, and providing technical advice to municipalities on how to optimize their borrowing strategies.

**Development Charges, Land Leasing, and PPPs**

**Development charges.** A development charge is designed to pass on the up-front costs to the responsible developers, who will then pass it on to their customers. The municipal infrastructure required to support new property developments is typically very costly. There are essentially two approaches to financing it.

In the first approach, the municipality borrows the required funds on the strength of its balance sheet and then repays the debt with income derived from all ratepayers and customers of the municipality, including those that benefit from the new development. In the second approach, the property developer is required to pay a development charge equivalent to the up-front cost of the new municipal infrastructure (and the cost of using the capacity of existing infrastructure) and passes these costs on to whomever buys into the development. Essentially, the new landowners finance the cost of the infrastructure, which may be through commercial debt, such as home loans in the case of residential property developments.

One instrument that brings together the debt instrument and benefits taxation is the use of tax incremental financing, which helps link local governments’ own revenue with infrastructure financing. Applying the “benefit” principle of public finance means that those who
benefit more from a product or service should pay for it in proportion to the value they derive from it. Tax incremental financing is used for financing infrastructure and other community improvement projects in many countries, including the United States. Tax incremental financing uses future gains in taxes to finance current improvements, which are projected to create the conditions for future gains. The completion of an infrastructure project, such as power and water, often results in an increase in the value of the surrounding real estate, which generates additional tax revenue. Tax incremental financing dedicates tax increments within a certain defined district to finance the debt that is issued to pay for the project. It creates funding for public or private projects by borrowing against the future increase in these property tax revenues.

A development charge is designed to pass on the up-front costs of the new municipal infrastructure associated with specific developments to the responsible developers, who, in turn, will pass it on to their customers—the users of the new infrastructure. These users derive a direct benefit from the provision of infrastructure, since its value is reflected in their property valuations.

Development charges are, thus, an important component of a sustainable system of municipal infrastructure finance and, if used judiciously, can play an important role in accelerating the overall development of municipal infrastructure. This is because, without these charges, the infrastructure required for new developments would have to be financed within the confines of the municipality’s capital budget. This means that the new infrastructure would need to be prioritized relative to other municipal projects, which may result in it being delayed for many years, particularly where municipalities’ scope to borrow is limited due to weak balance sheets and poor credit ratings.

When the municipality decides to invest in the new infrastructure, it would mean delaying other capital projects. It would also mean that the costs related to specific developments are unfairly borne by all residents in general, since the municipality would raise the required funds from its entire rates and tariffs base.

It is generally accepted that using development charges is economically efficient in that the user pays. Their absence creates distortions in the economy, particularly through underpricing the cost of development
in some municipalities and contributing to the underprovision of municipal infrastructure more generally. This, in turn, acts as a significant constraint to growth and job creation.

Development charges are not a general revenue source for municipalities. Rather, they are a one-off fee that must be used to cover the cost of municipal infrastructure associated with a new development. They do not cover the ongoing operating costs of the services that the infrastructure is used to provide or the future cost of the rehabilitation or replacement of the infrastructure. These costs ought to be funded through property taxes and user fees. Development charges are also not intended to cover the cost of infrastructure that is internal to a development, such as sewerage or water connections to private stands or infrastructure within the boundaries of a new development. These costs are always borne fully by the landowner.

Development charges are imposed to meet the costs of bulk and connector infrastructure, such as water mains that bring services to the boundary of the development, and infrastructure costs associated with the utilization of existing capacity or the need to expand the capacity of water storage and treatment facilities, substations, and sewerage treatment works.

The use of development charges has declined in recent years. Among the metropolitan municipalities, development charges were 2 percent of the value of buildings completed in 2004/05. This declined to 1.7 percent in 2009/10. Implementation is also uneven across municipalities. Both the decline and uneven implementation can be ascribed to weaknesses in the regulatory framework that make them administratively complex.

The National Treasury has done extensive work in relation to municipal development charges and is in the process of developing a framework that will set norms and standards to ensure that these charges facilitate (and do not stifle) new property developments. Certain municipalities have already begun revising their policies related to development charges, in line with National Treasury’s research findings. All municipalities are encouraged to do the same.

**Land-based financing strategies.** Land assets are an important ingredient of subnational government finance in most developing countries. Land frequently is the most valuable asset on the asset side of subnational balance sheets. Direct sales of land by subnational governments are the
clearest example of “capital” land financing. In addition, there are other instruments for converting public land rights to cash or infrastructure. Land may be used as collateral for borrowing, a practice that has a long history of financing urban investment. Today, land often is the most important public contribution to PPPs that build metro (subway) lines, airports, or other large infrastructure projects. Beyond physical land, rights to more intensive land development—a higher Floor Space Index or higher Floor Area Ratio—may also be sold by public development agencies. These “excess density rights” in effect represent the publicly controlled share of privately owned land. The development rights have economic value that can be sold by public authorities, as has happened in Mumbai, São Paulo, and the United States.61

Due to the recent rapid growth in land prices, municipal land sales have become an attractive way to mobilize finance for municipal infrastructure (and sometimes also to finance operating deficits). However, this use of municipal-owned land undermines the long-term financial health and wealth of the municipality. Even when a municipality invests the funds in municipal infrastructure, it is exchanging an appreciating asset (land) for a depreciating asset (infrastructure). As a principle of good stewardship, municipalities should always use the proceeds of municipal land sales to purchase other land for the municipality in order to maintain and grow the value of the municipality’s land portfolio and to facilitate the realization of its spatial development strategy.

Apart from selling land, there are a range of other land-based strategies to raise finance for infrastructure investments that municipalities can explore. First, municipalities can use municipal land as security for raising loans to fund infrastructure related to the development of that land or other infrastructure. This is fairly common practice among municipalities.

Second, municipalities can use leaseholds on municipal land. The experience of other developing countries is that this strategy has the greatest potential where there is rapid urban growth, such as in the metropolitan municipalities and cities. The municipality will sell the development rights to the municipal land to a developer subject to the proposed development being in line with the municipality’s spatial development framework. The parties may agree that part of the proceeds of the sale
should be used to provide infrastructure to the approved development. The developer’s rights to the property are spelled out in a leasehold agreement. Typically, this agreement should require the lessor to pay a rental at least commensurate with the rates that would be raised on the developed property. The leasehold agreement will have a specific term (20, 40, or 99 years), depending on the type of development. Usually, the developer is allowed to sell the leasehold to a third party under certain circumstances. Once the term expires, all rights in the property revert to the municipality. The leasehold system enables a municipality to partner with private developers to accelerate the development of inner-city land while retaining ownership of the land.

Third, municipalities can use land-use exchanges. The basic idea is that certain municipal offices or functions (such as stores, workshops, or vehicle depots) are located on land that can and should be used for alternative, higher-value purposes. Where this is the case, the municipality should explore relocating these offices or functions to suitable alternative locations (often on the city outskirts), and so release the high-value land for development.

In many instances, inner-city land is owned by either other spheres of government or state-owned enterprises. Municipalities need to engage with these property owners to explore ways in which they, too, can facilitate development through similar land-use exchanges.

Land-use exchanges may involve land swaps, lease swaps, or simply buying land with the funds generated from either selling or leasing the vacated land. The net result should be a more appropriate use of land that fosters development. The best known example of this kind of development is the Victoria and Alfred Waterfront in Cape Town, where a harbor was turned into a shopping mall and tourist destination.

International experience shows that the fiscal risks from land-based financing will need to be managed prudently. Land sales often involve less transparency than borrowing. Many sales are conducted off-budget, which makes it easier to divert proceeds into operating budgets. Capital revenues from sales of land assets exert a much more volatile trend and could create an incentive to appropriate auction proceeds to finance the operating budget, particularly in times of budget shortfalls during economic downturns. Furthermore, land collateral and expected future land-value appreciation for bank loans can be linked
with macroeconomic risks. It is critical to develop ex-ante prudential rules, comparable to those governing borrowing, to reduce fiscal risks and the contingent liabilities associated with the land-based revenues for financing infrastructure.

**Public-private partnerships.** PPPs are important service delivery mechanisms that facilitate rapid infrastructure development. They allow municipalities to take advantage of private sector expertise and experience. There are different types of PPPs that involve models for risk sharing between the municipality and its partners. In many cases, the private party is in a better position to raise debt and equity to finance the project. Municipalities can take advantage of private sector expertise and experience in the construction of the infrastructure. Furthermore, the development of PPPs for economically justifiable projects eases the pressure on the municipality’s budget and allows better allocation of funds toward addressing social needs of the community.

There are fiscal risks associated with PPPs. Often, subnational governments provide explicit or implicit guarantees for market borrowings of public enterprises that form partnerships with private investors. Challenges arise from implicit guarantees, which influence creditors’ risk assessment. Moreover, there is a lack of standardized accounting, recording, collecting, and disclosing of such debt incurred by off-budget financing vehicles in many developing countries. These tasks are challenging because of an array of complex arrangements of PPPs. Subnational-owned enterprises may have different quasi-fiscal relations with the budgets of their owners—subnational governments. Adding to the complexity is the wide variety of legal contractual relationships in PPPs. There is no standard uniformity in these contractual relationships; they vary across and within sectors.

**Enhancing Creditworthiness of Municipalities**

Sound financial management practices are essential to the long-term sustainability of municipalities. Generally, municipalities are encouraged to access private finance on the strength of their balance sheets and their credit ratings. Municipal financial management involves managing a range of interrelated components: planning and budgeting,
revenue, cash and expenditure management, procurement, asset management, reporting, and oversight. Each component contributes to ensuring that expenditure is developmental, effective, and efficient and that municipalities can be held accountable.

The reforms introduced by the MFMA are the cornerstone of the broader reform package for local government outlined in the 1998 White Paper on Local Government. The MFMA, together with the Municipal Structures Act (1998), the Municipal Systems Act (2000), the Municipal Property Rates Act (2004), and the Municipal Fiscal Powers and Functions Act (2007), sets out frameworks and key requirements for municipal operations, planning, budgeting, governance, and accountability.

Since 2008, the National Treasury has paid attention to strengthening municipal budgeting and reporting practices. Key initiatives have been the introduction of the Municipal Budget and Reporting Regulations in 2009, the enforcement of in-year financial reporting processes, and firmer management of conditional grants in accordance with the annual Division of Revenue Act. These reforms have been supported by strengthening the National Treasury’s local government database and by publishing an increasing range of local government financial information on the National Treasury’s website. The National Treasury is currently working on a number of reform initiatives, including a standard chart of accounts for municipalities, strengthening revenue and cash management policies, and finalizing the regulations for financial misconduct to facilitate the enforcement of the provisions dealing with financial conduct in Chapter 15 of the MFMA.

Conclusions

South Africa developed a comprehensive regulatory framework for the financial management practices of local government within the fundamental changes in the country’s political structure and municipal system. Designing the regulatory framework in a federal system, where the subnational spheres of government are autonomous, was a consultative process in South Africa. The legislative process coordinated institutional and policy reforms and synthesized different interests of the national government, provincial government, local government, and creditors.
A key challenge was to reach a proper balance between the autonomy of local government, as granted by the 1996 Constitution, and the national government’s obligation to ensure fiscal sustainability of local governments.

The South African experience shows that the benefits of having a strong regulatory framework are numerous; in particular, the regulatory framework has provided certainty and clarity on rules and procedures, giving confidence to the capital markets to finance much-needed infrastructure to its citizens, thereby improving the quality of their lives.

The enactment of the law has helped revitalize municipal credit markets. Borrowing by metropolitan municipalities tripled and borrowing by secondary cities doubled between 2004/05 and 2008/09, suggesting a willingness by market participants to lend to metropolitan municipalities. Historically, commercial loans have been the mainstay of municipal lending, but bond markets are now an increasingly popular alternative source of funding for metropolitan municipalities. This reflects the increasing confidence that the capital markets have in the regulatory framework and local government finance.

Notwithstanding the expanded activities of municipal credit markets, the markets would need continuing expansion and deepening to support substantial infrastructure investment demands. South Africa faces infrastructure financing requirements over the next decade, estimated at approximately R 500 billion. The demand for municipal infrastructure is spread across all municipalities but is greatest in the metropolitan municipalities and secondary cities. The municipal credit markets face challenges: the secondary market for municipal securities is almost nonexistent; there is a mismatch between the long-term asset life of infrastructure and the relative short maturities; and the capacity of many municipalities to manage a debt portfolio and access markets is weak. The DBSA also faces the challenges of crowding-in private creditors.

The government envisions multiple strategies for leveraging private financing for infrastructure investments. The government is exploring ways of deepening and broadening the municipal capital markets through developing a bond pooling instrument for secondary cities and building municipal capacity in managing a debt portfolio and accessing markets. It is encouraging the DBSA to fulfill its developmental role.
and become a market facilitator and, thereby, crowd-in private finance, instead of acting as a primary lender and effectively crowding out private finance.

Going beyond the development of competitive municipal credit markets, the government is also exploring ways of mobilizing private financing for infrastructure through development charges, land-based financing, and PPPs. International experience has demonstrated the enormous potential of these instruments in leveraging private financing, provided that the fiscal risks from land-based financing and PPPs are prudently managed.

Notes

The findings, interpretations, and conclusions expressed in this work are those of the authors and do not necessarily reflect the views of The World Bank, its Board of Executive Directors, the governments they represent, or any other institutions with which the external authors may be affiliated.

5. From a public policy perspective, matching the debt maturity term with the asset life of infrastructure is consistent with intergenerational equity (Liu 2008).
16. Before the 2011 local government election, there were originally six Category A metropolitan municipalities based in the six largest cities in South Africa,
namely, Cape Town, Ekurhuleni (the East Rand), eThekwini (Durban), Johannesburg, Nelson Mandela Bay (Port Elizabeth), and Tshwane (Pretoria). In 2011, Mangaung (Bloemfontein) and Buffalo City (East London) were also declared as Category A municipalities. Category B, or local municipalities, cover the areas that fall outside the Category A municipalities. In 2010, there were 231 local municipalities and 44 district municipalities.

18. In 2004, the City of Johannesburg went to market following its recovery from a financial crisis.
21. The national fiscus refers to the government’s fiscal activity and includes revenues, expenditures, and debts.
23. Second Amendment Act 2001, which allowed municipalities to borrow; Second Amendment Act of 2003, which legalized provincial intervention in local government.
26. This model was informed by insolvency practices in the private sector, where the Master of the High Court appoints an insolvency practitioner to sequester an estate.
29. Clause 49(2) of the Municipal Finance Management Bill (B1D-2002).
33. Section 45 of the MFMA (2003).
34. Definitions in Chapter 1 of the MFMA (2003).
35. Section 46(5) of the MFMA (2003).
37. Sections 70(b) and 66(3)(c) of the Public Finance Management Act allow for guarantees to be granted in special cases by the national Finance Minister in consultation with the national minister responsible for a specific portfolio, that is, the Minister of Cooperative Governance and Traditional Affairs, who is responsible for local government. Any guarantee issued by the Minister of Finance binds the effectively national revenue fund.
38. A discretionary intervention may be initiated if any of the above-mentioned conditions are met in a municipally owned entity.
39. In the case of certain larger metropolitan municipalities and secondary cities, such reports must be submitted to the National Treasury.
40. Section 136(1) of the MFMA.
41. In case of discretionary intervention, the recovery plan may be prepared by the Municipal Financial Recovery Service or by a suitably qualified person appointed by the provincial executive.

42. Section 141(3)(c) of the MFMA (2003).

43. As noted, the Municipal Financial Recovery Service as established in the act can be thought of as an administrative support structure, in contrast to the quasi-judicial structure proposed in the previous versions of the Municipal Finance Management Act.

44. Section 142 of the MFMA.


46. Data from the 2004/05 to 2009/10 audited annual financial statements were been collected and analyzed and cover the original six metropolitan municipalities.

47. Data on metropolitan municipalities up to 2010 are for six metropolitan cities: Cape Town, Ekurhuleni (East Rand), ethekwini (Durban), Johannesburg, Nelson Mandela (Port Elizabeth), and Tshwane (Pretoria). In May 2011, the number of metropolitan municipalities was increased from six to eight (see note 16).


51. As mentioned, 22 municipalities (6 percent of the country’s population) are under section 139 intervention. The lessons to be learned from these cases, and from the Msunduzi and uMhlathuze financial recoveries, will help strengthen implementation of the MFMA.

52. Interviews by DNA Economics of South Africa during 2010–11 with commercial banks for the National Treasury demonstrated that lenders view the MFMA as the most important factor in revitalizing the municipal credit markets.


54. Inflation-linked long-term debt and fixed-income long-term debt accounted for 81 percent of national government debt in 2010 (International Monetary Fund 2011).

55. Unless otherwise indicated, this section draws mainly from reports by the South African National Treasury (2011b, 2011c).


60. Tax incremental financing is based on the authors’ own research.


62. This draws from Peterson and Koganova (2010).

63. The discussion of fiscal risks from PPPs draws from Canuto and Liu (2010) and Irwin (2007).
64. This section draws from South African National Treasury 2011b.

**Bibliography**


