POLICY REVIEW: MUNICIPAL BORROWING AND FINANCIAL EMERGENCIES

BACKGROUND

In December 2000, the Cabinet adopted the Policy framework for municipal borrowing and financial emergencies (Notice 2739 of 2000). This Policy Framework fleshed out the principles laid out in the 1998 White Paper on Local Government and, in its turn, guided the drafting of the municipal borrowing and financial emergency provisions of the Municipal Finance Management Act (MFMA), No. 56 of 2003.

More than 15 years since the original Policy Framework, municipalities have substantial experience with municipal borrowing and financial emergencies in terms of the Municipal Finances Management Act. Municipal infrastructure needs have evolved, and cities understand these better.

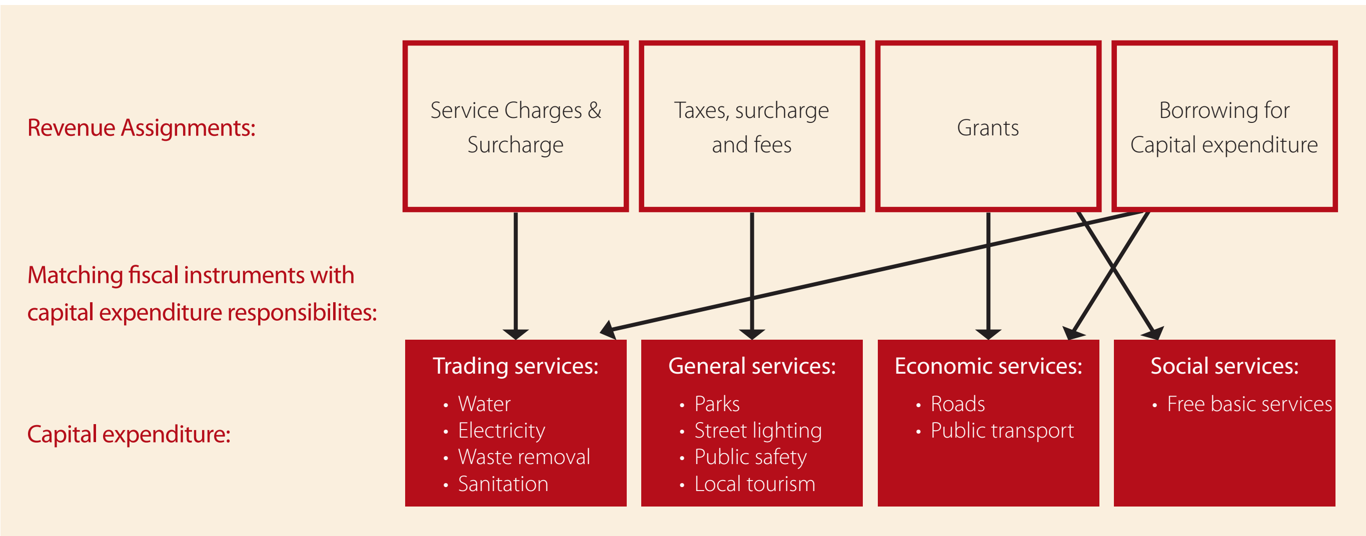
POLICY REVIEW

National Treasury, in close coordination with the cities, has therefore undertaken a review of the legislation, its impact, and the current context. Inputs and comments from the municipalities are actively encouraged.

In 2016, cities have additional priorities that were not fully anticipated sixteen years ago. Notable contextual developments since the original Policy Framework include:

- **Spatial awareness:** The embedded inequality of South African cities has been reinforced by spatially shortsighted investments over the last two decades. To build inclusive and productive cities, new tactics and new metrics are needed.
- **Investment needs:** Awareness of infrastructure and service delivery concerns has expanded beyond providing basic services to all citizens, and municipalities are increasingly aware of the need to invest for population and economic growth, and to rehabilitate or replace aging infrastructure.
- **Slowing growth:** South Africa's economic growth rates have not returned to precrisis levels, and the overall trend of economic growth has been slowing for the past 4 years.
- **Municipal development planning:** A 2010 Constitutional Court decision made it clear that responsibility for spatial transformation of cities lies with municipalities:
  "The Constitution envisages a degree of autonomy for the municipal sphere, in which municipalities exercise their original constitutional powers free from undue interference from the other spheres of government."
- **New investors:** The 2009 - 2011 period saw a surge of new investment from institutional investors, though financing from these has since levelled off. International DFIs have also begun lending directly to some municipalities.

Figure 1: Municipal revenue instruments for capital expenditure



FUNDAMENTAL PRINCIPLES

Government's policy is to rely on market discipline to prevent municipalities from becoming over-indebted.

Lenders invest in municipal debt instruments at their own risk, based on the cred-it-worthiness of municipali-ties. This avoids over-borrowing and bailouts that have plagued other emerg-ing economies.

A municipality that wants to use borrowing to invest in infrastructure must be creditworthy: it must have (i) adequate revenue to sup-port its obligations and (ii) the management and finan-cial capacity to make strate-gic borrowing decisions.

Municipalities of any size can be creditworthy, and those that are not credit-worthy should not borrow.

The fundamental principles articulated in the Policy Framework will remain: (i) national legislation defines a clear set of rules around transparency, disclosure, and consultation, and pre-scribes penalties for the violation; (ii) in line with the fiscally decentralised orientation of the Constitu-tion, it is the responsibility of municipalities to borrow wisely, and of financial in-stitutions to lend prudent-ly; (iii) national government does not guarantee munici-pal borrowing, and will not assume responsibility for municipal debts.

KEY POLICY ISSUES UNDER REVIEW

1. PROJECT-BASED FI-NANCING INSTRUMENTS

Project finance is a form of debt financing where repayments are based on the cash flows of a project, rather than from the general balance sheet. It is therefore occasionally referred to as "off balance sheet" financing, though in accordance with South African accounting practices, a project finance obligation would be reflected on balance sheets.

- Revenue bonds are linked to a specific revenue stream for repayment. If a city borrows to invest in a large infrastructure project, then service charges, tariff revenue, or develop-ment charges generated from the investment can be pledged as a revenue stream to repay the debt.
- Land value capture instruments ringfence specified revenues for investment in a specified area. Examples are special improvement districts, business improvement districts, special rating areas and tax increment financing (below). The general notion behind land value capture instruments is that city investment in infrastructure or services result in specific private property increasing in value, disproportionately to other similarly situated properties, then the city should be able to recover a portion of the increased value to help pay for the investment it has made.
- Tax increment financing originated as an instrument for the redevelopment of blighted urban areas with low property values. Public and private investment in such areas could increase property values and rates collections. The increment can then be used to finance the cost of the public investment. Tax increment financing should be applied in areas that would remain unproductive in the absence of public sector intervention.

Proposed policy revision on project-based financing instruments:
It is likely that the revised policy framework will explicitly note that project finance, revenue pledges, and limited recourse arrangements are permitted; subject to the principles of the municipal borrowing policy framework and the restrictions embodied in the Municipal Finance Management Act.

2. DEVELOPMENT CHARGES

If infrastructure is financed through debt, there are several options to service the debt:

- When funded from a municipality's general revenues and accumulated surpluses, the cost is borne by local taxpayers and consumers.
- When funded from national transfers, the cost is borne by all national taxpayers.
- When funded from specific user charges or impact fees, the cost is borne by those who use the infrastructure, or create the need for it.

[1] "Project finance" debt need not be issued by a municipality. Project debt instruments could also be issued by a creditworthy private sector entity, which would build and operate a facility, such as a water or electric plant, and sell the output to a municipality. The JSE is preparing listing requirements for such instruments.

Each of these approaches carries its own social and political dynamic, and has its own economic and financial implications. Capital recovery fees can be collected when e.g. a developer connects his new development to the city's water and sanitary sewer lines. Impact fees can be collected when the developer builds a shopping mall that generates traffic requiring upgrades to offsite streets, or paves over a formerly pervious surface, causing more runoff and the need for storm drainage improvements downstream.

Development charges have the potential to allocate costs more equitably: If we accept that affluent households, industrial and commercial users, and others that can afford to, should pay at least in proportion to what they use, or to the impacts they cause, then we would want to encourage greater reliance on development charges.

> ***Proposed policy revision on development charges:***
> *The revised policy framework is likely to encourage the use of development charges, with the proviso that they be clear, transparent, and non-discretionary.*

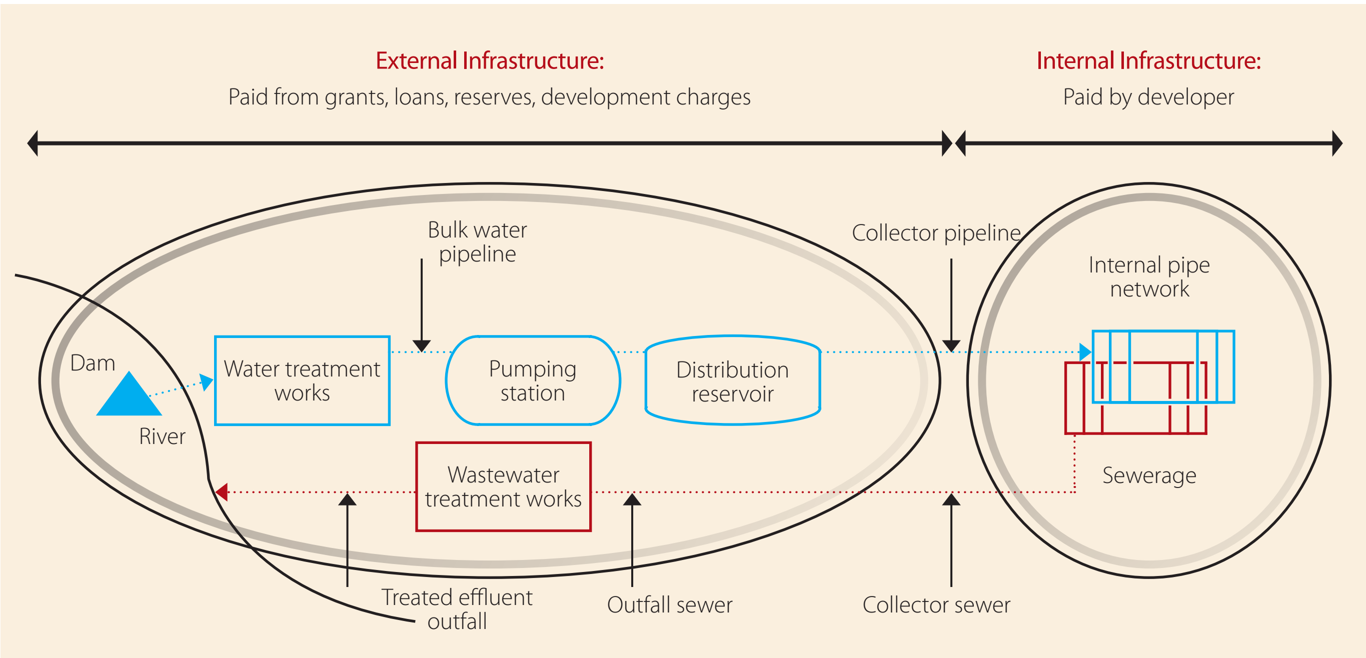
3. PLEDGING

Pledging means that a security is given when taking on debt. If the debt is not repaid, the creditor keeps that which has been pledged. In 2010, the National Treasury issued MFMA Circular 51, which reported on a provision of the 2010 Division of Revenue Act, providing: "8(5) A municipality may only, after obtaining the approval of the National Treasury, pledge, offer as security or commit to a person or institution future conditional allocation transfers due to the municipality for the next financial year and the 2012/13 financial year, for the purpose of securing a loan or any other form of financial or other support from that person or institution."

Lenders or borrowers may mistakenly see approval by National Treasury as an implicit promise that the anticipated transfers will be made in the outer-years. This is not correct, since the legislative branch retains the exclusive power to determine the budget and there is no guarantee that the indicative amounts for future financial years will actually be appropriated as anticipated. Nevertheless, the provision creates ambiguity, which is;

> ***Proposed policy revision on pledging:***
> *It is likely that the revised policy frame-work will eliminate the National Treasury approval for pledging, so that National Treasury's role would be limited to advice and comment in terms of section 46 of the MFMA.*

Figure 2: Development charges



4. SUPPLY SIDE / INVESTOR ISSUES

Because municipal infrastructure typically has a long useful life, it is appropriate to finance it with long-term debt. The importance of matching the term of financing to the useful life of the asset was recognized in the White Paper on Local Government, in the original a "Policy framework for municipal borrowing and financial emergencies," and is widely ac-cepted as a policy goal. The typical term of municipal infrastructure borrowing has grown from the 5-7 year range to the 10-15 year range, with some examples of 20 year borrowing. Lending terms are adjusting to infrastructure lifetimes, but some municipal infrastructure has an even longer life, requir-ing maturities of 20-30 year range, or even beyond.

Proposed policy revision on supply side/ investor issues:
With this in mind, National Treasury is exploring policies that would encourage institutional investors, including pension funds and insurance companies, to be-come more active lenders, and exploring ways to support the development of a liquid secondary market, so that a holder of a municipal bond can reliably sell the bond if liquidity needs so require.

5. POOLED FINANCE BORROWING

Gauteng SALGA and Gauteng municipalities, with the support of international develop-ment finance agencies, had been considering a pooled finance mechanism to collectively raise finance for infrastructure investments. While Gauteng's metropolitan municipalities have access to the capital markets, smaller municipalities have reportedly not been able to access affordable private sector credit to address their infrastructure needs.

In a true pool, each borrower is jointly and severally liable for the full cost of the aggre-gate funds borrowed. This presents a moral hazard, and is not appropriate in the context of municipalities of very different financial and managerial capacity. Well-managed mu-nicipalities would become the guarantors of poorly-managed municipalities.

Proposed policy revision on pooled finance borrowing:
The revised policy framework is likely to expressly require that any pooling struc-ture must avoid assumption of financial risk by one municipality on behalf of an-other, and include a clear plan to cover the costs of establishment and operation.

COMMENTS AND FEEDBACK

Inputs and comments from the municipalities are actively encouraged.
Please direct your inputs to

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