6

Leveraging private finance

Introduction

Local government legislation is designed to regulate, reform and stabilise municipal finances in a macroeconomic environment that is more enabling for private investment. Despite this, municipalities have not yet used the opportunity to borrow more creatively from capital markets, thereby expanding the potential financing instruments and sources of financing for major programmes.

Municipalities are not using favourable macroeconomic conditions to increase borrowing

It is estimated that for the three years to the end of 2009/10, an average of only 18.5 per cent of the value of all capital budgets will be financed from external loans, compared to 27.6 per cent over the four years up to the end of 2006/07.

On average 57 per cent of external loans of municipalities are with private sector institutions, while the rest are with the public sector through the Development Bank of Southern Africa (DBSA). The annualised average growth of outstanding capital balances of loans with the private sector has increased at a slower pace of 3.3 per cent, compared to 5.1 per cent with the public sector, in real terms between 2003/04 and 2006/07.

Effective leveraging of private finance through the optimal use of borrowing and public private partnerships (PPPs), supports economic growth through ensuring the timely provision of infrastructure. It also releases municipal resources for poverty alleviation as well as encouraging improved governance practices by municipalities.

Effective leveraging of private finance releases municipal resources for poverty alleviation

This chapter gives an overview of:

- the financing needs of municipalities
- sources of infrastructure financing

- borrowing instruments
- lending institutions
- managing credit risk
- the regulatory framework impacting on municipal borrowing
- constraints to leveraging private finance.

Financing needs of municipalities

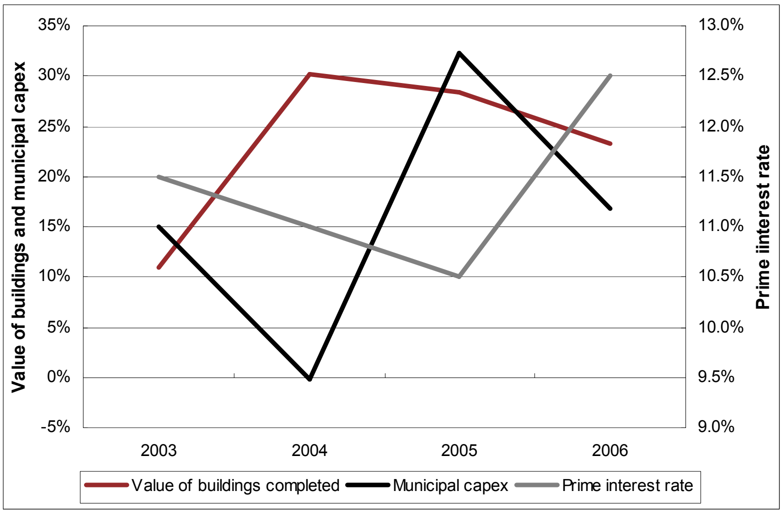
Municipal investment needs arise from spending pressures associated with growth in the economy, the replacement of assets and combating of poverty.

Impact of economic growth

Municipalities are key role-players in creating favourable conditions for economic development. The robust performance of the South African economy over the last four years was fuelled by unprecedented growth in construction, financial services, transport and communication and wholesale and retail trade. These sectors operate and trade within the boundaries of municipalities.

Figure 6.1 shows that the average annual growth in the real value of residential and non-residential buildings was 27.2 per cent between 2003 and 2006, compared to 15.6 per cent for municipal capital expenditure over the same period.

Figure 6.1 Growth in value of buildings completed and municipal capital expenditure and prime interest rates, 2003 – 2007



Source: StatsSA and South African Reserve Bank

Municipal capital expenditure is lagging behind construction activity

These trends suggest that municipal capital expenditure is lagging behind construction activity. Figure 6.1 further illustrates a more stable trend in construction activity over the prime interest rate cycle, compared to the relatively more erratic trend in municipal capital expenditure.

The rejuvenation of city precincts, expansion of suburbs and connections of townships to central business districts will continue to support construction activity. This will require greater municipal investment in bulk and reticulation infrastructure for electricity, water and sanitation, waste management systems, roads, storm water drainage systems and so on. All revenue sources therefore, will have to be optimally leveraged to meet the increased demand for services.

Replacement of assets

The management and maintenance of existing infrastructure is lagging behind and could become a binding constraint to future local economic development. Municipalities need to put measures in place to avoid system failures such as water leakages, pollution, power failures and damaged road surfaces.

Municipalities also need to focus on infrastructure management and maintenance

Renewed focus on infrastructure management and maintenance will improve the reliability of municipal services and enhance their potential for sustained local and national economic growth. Municipalities have budgeted to spend R7.3 billion on the maintenance of existing infrastructure in 2009/10. This is already R2 billion more than what was spent in 2006/07 and it is estimated that approximately R7 billion per year will be needed to address the full maintenance costs of municipalities.

The challenges that backlogs present

During 2007/08, municipalities experienced a huge financial challenge in the run up to the December 2007 deadline for the eradication of the bucket sanitation system. In some municipalities in the Free State, national government had to provide an extra R147 million through the municipal infrastructure grant to finance the increased costs associated with unforeseen geological obstacles.

A further challenge is responding to the demand for higher standards of sanitation services expressed by certain communities. These communities have indicated that they would rather wait for waterborne sanitation than accept a more basic service, such as ventilated pit latrines. This means that these municipalities are not able to meet the targets set by national government.

Combating poverty

The total cost of eradicating all backlogs in access to basic services is estimated to be around R70 billion. To improve their viability and sustainability, municipalities need to have a sustainable indigent policy to meet the demand for pro-poor social development within their jurisdictions. Eradicating backlogs in water and sanitation, electricity and waste management in established and developing low income areas is therefore a major priority. This needs to be a central component of a municipality’s overall financing strategy.

Some municipalities will remain dependent on fiscal transfers over the medium to long-term

It is widely recognised that municipalities differ in terms of their fiscal capacity and that some municipalities will remain dependent on fiscal transfers over the medium to long-term. This is because of their low revenue base, demographic structure and the generally low level of economic activity in some areas. The latter group needs appropriate capacity building initiatives to help them achieve financial sustainability.

Metros and larger local municipalities

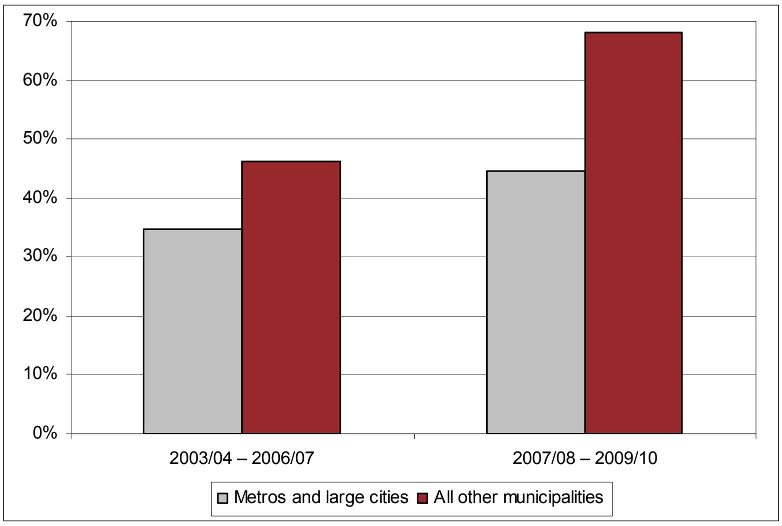
More than 25 per cent of urban dwellers live in formal areas, of which 40 per cent are regarded as poor. Approximately 38 per cent of the poor live in South Africa's nine largest cities[1].

Potential exists for metros to tap into external municipal financing sources to support critically needed investment in infrastructure to fully realise the potential of their integrated development plans.

Over-reliance on national transfers for future municipal capital investment

Figure 6.2 shows the reliance on national transfers as a financing source for future municipal capital investment. Development plans, based on sound partnerships with national and provincial government, the private sector and the electorate, have now become obligatory and should help to reduce this over-reliance.

Figure 6.2 Grants and subsidies as a percentage of municipal capital expenditure, 2003/04 – 2009/10



Source: National Treasury local government database

Sources of infrastructure financing

It is crucial for municipalities to develop a financing strategy that optimises the leveraging of grant funding, own and external sources of finance and off and on-balance sheet funding.

Current fiscal policy developments have become favourable as national government is not planning to introduce any domestic financing instruments over the medium-term. Instead, it projects to reduce its debt stock of R449.6 billion to R438 billion by 2010/11.

Financially sound municipalities need to enter the market and diversify their sources of finance

The decreasing borrowing requirement of national government has created liquidity in the domestic capital market and a unique opportunity for other players, including financially sound municipalities to enter the market and diversify their sources of finance.

[1] Stats SA, Census 2001 and Community Survey 2007.

Scope for more borrowing

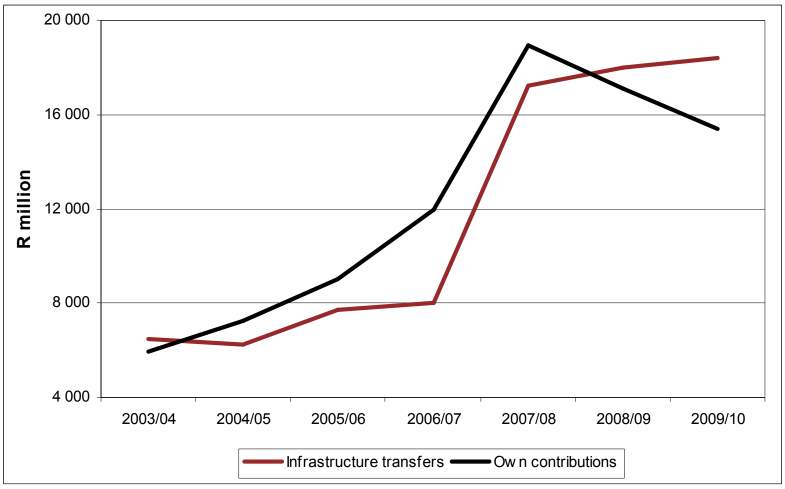
Approximately 80 per cent of the country's GDP is generated in 27 of the country's largest cities. (This includes the six metros and the 21 secondary cities). However, capital investment as a percentage of GDP by these municipalities remains low, at around 0.8 per cent. Municipalities' debt as a percentage of revenue is also low, at approximately 1 per cent. Taking the current credit rating of municipalities into account, there is scope to borrow a further R30 billion over the next three years to boost municipal infrastructure investment.

The additional funds could be raised through long term municipal bonds and bank loans and would allow creditworthy municipalities to address backlogs and invest in bulk projects needed for service delivery.

National transfers

Over the past 14 years, the rollout of pro-poor municipal infrastructure has been funded mainly through national transfers. Excluding transfers for the 2010 FIFA World Cup, infrastructure transfers increase by an average annual 13.3 per cent in real terms, between 2003/04 and 2009/10. Figure 6.3 shows that transfers for infrastructure are projected to exceed municipal own contributions, including external loans as a financing source for municipal capital expenditure.

Figure 6.3 Growth in capital transfers relative to own contributions, 2003/04 – 2009/10



Source: National Treasury local government database

If metros and larger municipalities were to borrow more from financial markets, this would release more funds from the national fiscus to benefit smaller municipalities.

Current revenues

Current revenues are income derived mainly from rates and service charges. Surpluses generated from these sources can be used to finance assets. However, increasing property rates and service charges may not be the only answer to finance infrastructure. This is because it would place an immediate burden on current residents who may not be there to enjoy the benefits of the completed infrastructure in the future.

Development charges

South Africa has experienced unprecedented growth in residential and non-residential property developments over recent years. As the trend in property development is expected to continue in the future, albeit at a pace related to the prevailing economic conditions, municipalities will have to form strong partnerships with developers. These partnerships could unlock potential revenue sources through development charges.

Development charges are an off-balance sheet source of finance for capital projects as they relate to residential and non-residential developments of land and buildings. A municipality would typically enter into an agreement with property owners or developers that allows it to recoup some of the cost of infrastructure development from the individual property owners who will benefit directly from the infrastructure. Municipalities will need to become more proactive partners in property developments in their areas.

The benefit of this source of finance is that development charges are equitable in the sense that the infrastructure costs are not covered by a general increase in local taxes, but are recovered from residents who will benefit directly from the developments.

Public private partnerships

Public private partnerships (PPPs) are important service delivery mechanisms that facilitate rapid infrastructure development. 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[2].

PPPs allow municipalities to take advantage of private sector expertise and experience

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 for better allocation of funds towards addressing social needs of the community.

Public private partnerships

PPPs are a good way to generate more revenues from municipalities' existing assets. The Johannesburg Water Management contract for example, turned around the operational and financial performance of the utility. Revenue increased by 46 per cent in four years and power and chemical consumption decreased by 9 and 57 per cent respectively.

Before it was turned into a PPP, Cape Town's Epping Fresh Produce Market generated R3.5 million per annum. Its revenue has since grown to R6 million per annum, in addition to the sale of the ongoing operations of R16 million and R22 million owed to the City by the traders.

Borrowing instruments

Borrowing carries an intrinsically higher risk as a financing option

Borrowing as a financing option carries an intrinsically higher risk compared to financing from own resources and national transfers. The risk of procuring infrastructure through PPPs is essentially the same as borrowing. With borrowing, there are different financing options

[2] Introducing Public Private Partnerships in South Africa.

available to municipalities - the public sector through the Development Bank of Southern Africa (DBSA) and the private sector through banks, Infrastructure Finance Corporation (INCA) and other financial institutions.

Among lenders, different forms of instruments are offered, such as notes (short and long-term loans and other structured debts) or direct loan placements and bond issues.

A municipality will identify projects that have the potential to generate income and those that only offer public services. The financing approach for income-generating and public services projects will differ. Projects that offer public services such as libraries can be financed from rates income, cross-subsidising or even issuing general obligation debt. Cross-subsidisation for the benefit of poor households is feasible in most urban areas as there are large concentrations of high income households that are likely to be both able and willing to pay more for services, as well as demand higher levels of service.

Projects with the potential to generate revenue have the ability to attract private sector investment because financial institutions would have assurance about where the money to repay the loan originates. The choice of selecting an appropriate debt instrument involves looking at the tenure of the instrument, how the capital and interest are to be financed (for example, using an amortising or bullet profile) and any credit enhancement required.

Projects with the potential to generate revenue have the ability to attract private sector investment

Long-term loans

Over the years, municipalities have preferred long-term loans over bonds. This is partly because loans are less complicated to administer and only a few municipalities can absorb the high initial transaction costs associated with bond issues. Municipalities also may not have the technical capacity to issue bonds. Long-term loans amount to approximately 73 per cent of total local government debt.

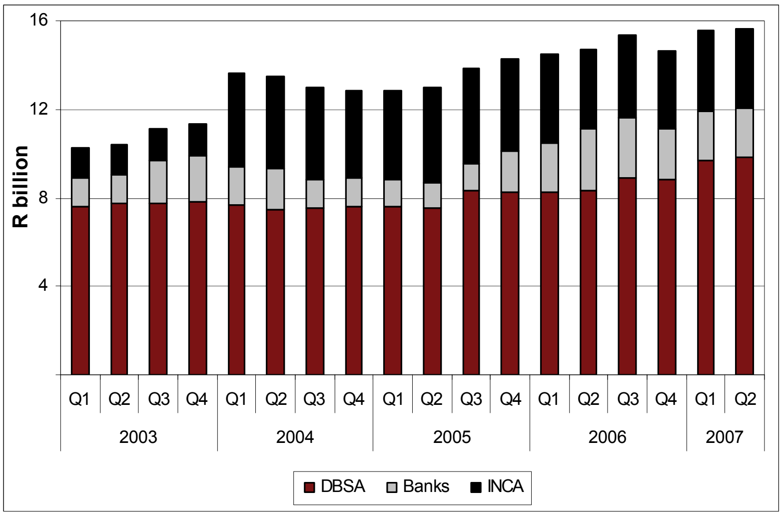
Long-term loans may be offered at floating rates to the benefit of a municipality when its financial position improves and interest rates drop. The municipality will benefit from refinancing its debt, resulting in borrowing costs being lower than at the time when the loan was concluded. Despite the benefits of floating rates, their disadvantage is that the debt service costs can go up unexpectedly and the municipality’s revenues may not increase in-line with the interest costs. Floating rates are largely in favour of the lender and the cost of financing debt at fixed rates is predictable.

The disadvantage of financing infrastructure from long-term loans is that banks may not be able to match the tenure of loans with the life-span of some of the assets that the municipality wants to build. Some municipal assets have very long life-spans, such as bridges.

South African banks usually price loans using an amortising profile, rather than a bullet profile. With amortised loans, monthly repayments incorporate capital and interest until the redemption of the loan. The bulk of initial repayments will comprise mostly of interest and the capital (principal) will be evenly spread during the tenure of loan. For a loan with a bullet profile, the capital is only paid by the municipality when the loan is redeemed and interest will be paid during the tenure of the loan.

Amortised loans result in a higher cost of borrowing compared to a bond issue. This is because the interest is based on what the bank's risk perception is of the municipality rather than the perception of a multitude of lenders in a functioning market. Outstanding long-term loans amounted to R15.6 billion as at June 2007.

Figure 6.4 Outstanding long term loans (supply side), 2003 – 2007



Source: National Treasury borrowing monitoring analysis

Short-term loans

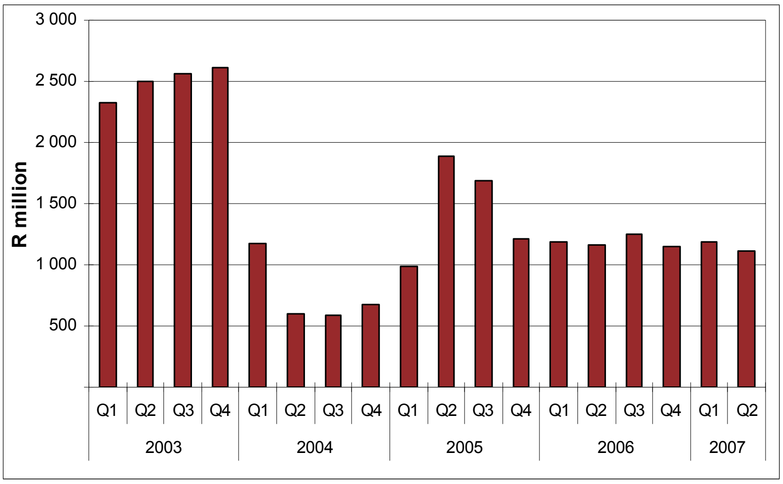
Short-term debt is permitted in terms of section 45 of the Municipal Finance Management Act (2003) (MFMA). The Act makes provision for short-term debt to be incurred for bridging finance for operational purposes only and to be redeemed within the current financial year in which the debt was incurred.

The risk of allowing short-term debt to accumulate is that cost of servicing the debt can quickly become unaffordable. This may result in the need to finance old debt with new loans. Figure 6.5 shows that this was the case before the budget reforms that came about with the implementation of the MFMA.

Ideally a balanced budget should limit the risk of a municipality being over-exposed to short-term debt, which may result in the rolling-over of debts.

According to the Quarterly Bulletin of the South African Reserve Bank, outstanding short-term loans amounted to R2.6 billion in the fourth quarter of 2003. As part of the budget reforms, municipalities were required to reduce their short-term debts incurred before 2003/04 by end of June 2008.

Figure 6.5 Quarterly outstanding short-term debt, 2003 – 2007



Source: SARB Quarterly Bulletins

Overdrafts are the largest contributor to short-term debt instruments, and they have shown a significant decline, from R2.2 billion to R1 billion between 2003/04 and 2007/08. Short-term loans amounted to R23 million and the remaining R92 million are tax-structured loans. Short-term debt accounted for 5 per cent of total municipal debt in the second quarter of 2007.

Municipal bonds

Municipal bonds are an ideal instrument for financing large capital projects

Municipal bonds are an ideal instrument for financing large capital projects. They address the shortcomings of loans as the period of tenure of bonds can go up to more than 30 years and the issuer (municipality) is able to negotiate the interest rate payments and the repayment period to meet its own and investors' needs. With bonds, there is a diverse pool of investors involved, whereas only two parties are involved in bank loans.

As bond issues involve underwriters, credit rating agencies, trustees and the general public, they create an obligation for greater accountability and transparency on the part of the municipality. All stakeholders and investors demand up to date knowledge of the financial affairs of the municipality and the issuer is required by the debt disclosure regulations of the MFMA to obtain an annually renewable credit rating.

The regulations are aimed at improving transparency to protect investors. For example, investors will know the extent to which changes in local taxes and service charges will affect the servicing of the bond repayments.

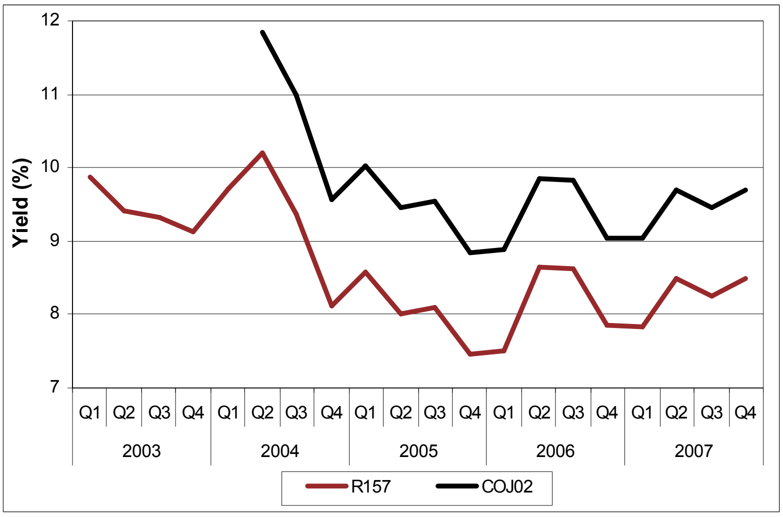
For a successful bond issue, a municipality must have a good revenue collection and revenue growth rate, as this serves as an indicator of the ability of a municipality to meet its bond repayment obligation.

The City of Johannesburg and the City of Cape Town are the only municipalities that have recently issued bonds

The City of Johannesburg and the City of Cape Town are the only municipalities to have recently issued bonds. The benefit of issuing municipal bonds is that they are priced against government bonds, which are a true reflection of the pricing in the market. This can potentially reduce the cost of borrowing for a well run municipality.

The COJ2, the City of Johannesburg's second bond, was priced at 11.9 per cent at the time of issue in June 2004. It further improved to a yield of 9.7 per cent in December 2007. Since municipal bonds are priced against government bonds, which are very low risk, it is worth noting that the COJ2 is moving in sync with the R157 government bond. As the spread narrows or comes closer to the government bond, it indicates that the risk profile of the municipality has improved and the market is gaining confidence, which is then reflected in the price.

Figure 6.6 COJ2 and R157 spread, 2003 – 2007



Source: Bond Exchange of South Africa

The City of Johannesburg and the City of Cape Town have successfully launched bonds totalling R5.7 billion and R1 billion respectively. The City of Johannesburg's first issue, COJ1, launched at a coupon rate of 11.95 per cent in 2004 and the City of Cape Town's at a rate of 12.57 per cent in 2008. The premium in the coupon rate, above the yield of the R157 government bond, was a reflection of the relatively low credit rating based on an unfavourable audit report on the financial state of the municipality at the time. Moreover, the municipal bond market was not yet established at the time of the initial issue.

Lending institutions

There are a number of public and private institutions active in the long-term municipal debt market. The private sector's share of this market has remained stable at around 57 per cent since 2003/04.

The Development Bank of Southern Africa

DBSA is the largest public lender to municipalities

The Development Bank of Southern Africa (DBSA) is the largest public lender to municipalities, with a 46 per cent share of total municipal debt in June 2007. Providing financing to all categories of municipalities, DBSA's share of the total municipal debt market has increased by an annualised growth of 6 per cent since 2003.

Although DBSA is lending to all municipalities, its bias in favour of the metros might be justified by the fact that the bank is fulfilling its mandate to fund social projects and projects that contribute to the broader transformation agenda. However, this bias is seen as potentially limiting for metros entering the bond market, as annuity loans are considered to be cheaper, when taking into account the initial fixed costs of bonds.

The DBSA therefore needs to provide more assistance to municipalities that are not creditworthy so that they reach the stage where commercial banks develop an interest in funding them. Such interventions would ensure that the DBSA crowds in private sector finance in the local government environment.

Infrastructure Finance Corporation

INCA is a significant private lender to municipalities

The Infrastructure Finance Corporation (INCA) is a significant private lender in the market. It was established to support the country's stalled municipal bond market by issuing bonds to raise funds. It acts as a bond bank that issues debt in the financial markets against its portfolio of municipal loans and also buys outstanding debt, thus providing liquidity in the municipal bond market.

INCA accounted for R3.6 billion or 23 per cent of municipalities' outstanding long-term loans as at 30 June 2007. Loans are not extended to municipalities that cannot demonstrate adequate financial management capacity.

Banks and other financial institutions

Banks provide both short and long-term debt to municipalities

Banks and other financial institutions play an important intermediary role of linking the supply of capital with demand. They provide both short and long-term debt to municipalities. They accounted for R2.2 billion of outstanding long-term loans in June 2007.

Their approach to the long-term municipal borrowing market is that they would normally require municipalities to securitise their assets before they can lend to them. Securitisation is the process where a municipality moves some of its assets to a low risk vehicle (normally called a special purpose vehicle).

With securitisation, a pre-defined set of assets cannot be seized by a third party when a municipality becomes bankrupt, the financial institution's risk exposure is thus lessened. This is then reflected in the pricing of the loan.

Pension and insurance funds are very inactive in the market, only accounting for R22 million (0.2 per cent) as at 30 June 2007. It appears that these players have withdrawn from the market and that the outstanding debt may be debt that was issued in the past and has not been redeemed. The lack of suitable municipal debt finance products, such as bonds with longer repayment cycles, could be an explanation for the low involvement in the market.

Managing credit risk

Leveraging municipal revenue with private capital carries risks

Leveraging municipal revenue with private capital carries risks. Large infrastructure projects tend to take more than a year to build. The cost of material, labour and other overheads tends to escalate during the construction phase of the asset. An example of this is the cost of building and rehabilitating stadiums for the 2010 FIFA World Cup, where medium-term allocations had to be brought forward to cover unexpected cost escalations.

A recessionary cycle can result in a downward revision of municipal allocations over the medium-term. A recession will result in interest rate fluctuations. The cost of financing infrastructure through debt can increase substantially if interest rates increase, which in turn may lead to defaults. Options available to mitigate risks to provide comfort to investors include credit enhancements and improved credit ratings.

Credit enhancements

Credit enhancements are designed to reduce risk exposure

Credit enhancements are programmes that are designed to reduce risk exposure both for the investor and the municipality.

Municipalities would be required to apply credit enhancement procedures when applying for debt in order to reduce the risk that the potential lender may be exposed to. Credit enhancement is a process of reducing risk by providing collateral, insurance or other agreements to assure the potential lender that the lender will be compensated if the municipality defaults on its loan.

Credit enhancement may be in the form of partial guarantees, where the guarantor covers a portion of the debt service costs, or comprehensive guarantees, which involve guaranteeing the debt entirely, irrespective of the cause of default.

City of Johannesburg bond benefits from credit enhancement

The R1 billion bond matures in 2018. It amortises over the last three years (principal is paid in three instalments). The International Finance Corporation (IFC) and the DBSA assisted in structuring the transaction and together provided a partial credit guarantee for up to 40 per cent of the principal amount outstanding. This amount can be used to repay up to the full amount and principal and the amount falling due to bondholders on any given payment date, subject to guarantee limits.

The enhanced bond was rated AA- by Fitch Ratings. The issue was oversubscribed 2.3 times, reflecting a strong endorsement by the market of the issue and the credit enhancement structure.

Source: The Municipal Fund: Global Financing for Local Needs, IFC

Credit ratings

Municipalities need a credit rating to access capital markets

As an indicator of risk, a credit rating is essential for municipalities to access capital markets. A good rating reduces the cost of financing while a bad rating will result in a premium being demanded to offset the increased risk.

Another benefit of a credit rating would be that it increases the marketability of the borrower and its debt instruments. It opens up more financing options and enhances the municipality's ability to choose the most efficient and cost effective source of finance.

A rating methodology will look at the economic base of a municipality. The economic base will ultimately generate resources to pay the debt, which include the strength and diversity of its large taxpayers, unemployment rates and debt burden ratios per capita, as it demonstrates the ability of its residents to absorb the debt, amongst other things.

Table 6.1 Credit ratings from Moodys

Municipality	Long term	Short term
Amathole District municipality	BBB	A2
Breede Valley municipality	BBB-	A3
Buffalo City	A-	A2
City of Cape Town	A+	A1
City of Johannesburg	A+	A1
City of Matlosana	BBB	A2
City of Tshwane	A+	A1
Ekurhukeni metro	AA-	A1+
Emnambithi / Ladysmith municipality	BB+	B
George municipality	A-	A2
Greater Tzaneen municipality	BBB-	A3
Lephalale municipality	BB+	B
Makana municipality	BB-	B
Mbombela municipality	A-	A2
Mogalakwena municipality	BBB-	A3
Nelson Mandela Bay metro	A	A1
Polokwane municipality	BBB+	A2
Tlokwe municipality	A-	A2
uMngeni municipality	BB-	B
West Coast district municipality	BBB+	A2
Westonaria municipality	BB	B

Source: Moodys Investors Service

Regulatory framework impacting on municipal borrowing

South Africa's well developed capital markets need to be supported by national government regulations and procedures that set out the rules for both municipalities and investors in terms of disclosure requirements and procedures governing defaults.

The White Paper on Local Government (1998) recognises the need for municipalities to source alternative financing to address infrastructure backlogs. It also acknowledges the role that the private and public sector can play in terms of mobilising funds and additional infrastructure investment from the private sector.

National government does not stand surety for municipal debt and there are no regulations limiting the supply and demand for borrowing by municipalities and investors. However, the Regulatory Framework for Municipal Borrowing (1999) recommends that every municipality should adopt a written debt policy when planning to issue debt.

National government does not stand surety for municipal debt

This policy will assist in determining borrowing limits that a municipality can cope with. The debt policy will also provide comfort for credit rating agencies and potential lenders that the municipality is committed to being responsible and prudent when borrowing.

In 2002, national government made a constitutional amendment[3] that allowed municipal councils to make firm financial commitments to investors regarding future budgets and revenue streams. Previously, there had been a line of legal precedent that could have allowed a council to repudiate the debts of a predecessor council. It also allowed the pledging of various types of security and created specific remedies in the event of financial emergencies.

The MFMA is the overarching legal framework giving all municipalities equal borrowing powers

The MFMA is the overarching legal framework giving all municipalities equal borrowing powers. Section 46 of the MFMA limits long term borrowing to financing capital investments in property, plant and equipment through a council resolution signed by the mayor to approve the debt agreement.

Before a municipality issues debt, the purpose of the loan in relation to infrastructure financing must be aligned with the municipality's integrated development plan. In addition to this, a municipality invites National Treasury, the relevant provincial treasury and the public to submit written comments to council.

Municipal borrowing and pro-poor policies

The most critical issue for municipal borrowing regarding the development of pro-poor policies is that indigents who do not have the ability to pay are able to access services.

A clear indigent policy will not only benefit the poor but will have a positive impact on municipal credit ratings. The risk related to lending to municipalities is related to the stability of revenue flows and a clear indigent policy enables accurate calculation of revenue flows.

Source: Report from Urban Policy Lekgotla

Since municipalities table multi-year budgets, the projections of anticipated revenue and expenditure for the medium term assist lenders when making risk assessments on a municipality's credit applications. Multi-year budgeting should be simplified by the fact that local government allocations are also published over the three years in terms of the Medium Term Expenditure Framework (MTEF) and updated annually to improve predictability and transparency.

The recently gazetted debt disclosure regulations set out clear guidelines on the disclosure requirements needed when incurring debt. The regulations enforce section 49 of the MFMA and do not introduce additional disclosure requirements. Municipalities are required to disclose details on current and defaulted loans, debt repayment plans and the revenue for the three preceding financial years. In addition, it is mandatory for the municipality to obtain a credit rating (reviewed annually after the issue), if it intends incurring debt using alternative instruments other than loans.

[3] Amendment of section 156 of the Constitution.

With legislation designed to improve regulations on borrowing by local government, the policy framework for municipal borrowing and financial emergencies, is also crucial as it sets out remedies and financial recovery plans when a municipality defaults on its debt obligation.

The framework, together with chapter 13 of the MFMA, provides for a designated person that will prepare the financial recovery plan in consultation with the relevant MECs of local government and finance and the Municipal Financial Recovery Service (MFRS). The MFRS will facilitate necessary recovery plans to assist municipalities that are in need of financial recovery assistance.

Constraints to leveraging private finance

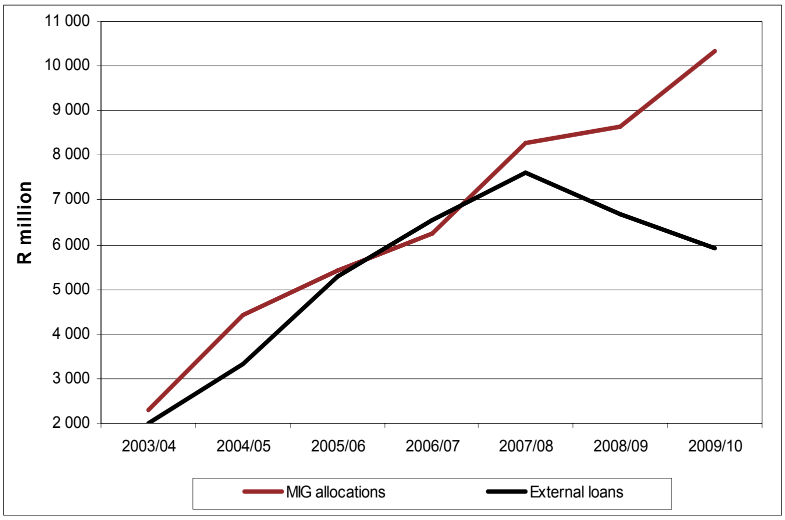
Any form of leveraging of finance for infrastructure purposes must be aligned with a municipality's IDP. Not only is it a challenge for municipalities to align their IDPs with their budgets, but the variance between the actual versus budgeted expenditure is also a concern.

Municipalities are still underspending national transfers

Despite the efforts of various capacity-building programmes, municipalities are still underspending national transfers. Some of this may be attributable to the misalignment of national and municipal financial years and the tendency to plan more for the short-term than the long-term. Municipalities tend to report improved expenditure levels towards the end of their financial year. This is an indication of the lack of planning for the execution of their capital spending programmes.

The municipal infrastructure grant (MIG) has grown by an annualised rate of 24 per cent between 2003/04 and 2009/10, external loans grew by 16 per cent for the same period and are set to decline from 2007/08.

Figure 6.7 Growth in MIG and external loans, 2003/04 – 2009/10



Source: National Treasury local government database

It is evident that the growth in the MIG provides an incentive for municipalities not to borrow. Figure 6.7 suggests that councillors prioritise grant funded capital projects compared to those that will require external finance.

Some financial institutions believe that the lack of borrowing may be due to a very complicated and highly regulated municipal environment. Another observation is that municipalities generally take a short-term view of their capital projects and they would rather implement a series of small projects that will exhaust capital grants by the year end.

Conclusion

Municipalities' capital expenditure is not keeping pace with the growing economy and an expanding population. Capital investment strategies need to be well designed and include provisions for new infrastructure and for the replacement of deteriorating infrastructure.

Carefully designed finance strategies to suit the financial situation and potential of each locality will have to bring in a more focused role for private finance.

Private finance is available and is currently utilised to finance a number of infrastructure projects around the country. However, analysis of the financing of municipal capital budgets reveals that there is potential for municipalities and private financiers to draw on established relationships and broaden the scope of their transactions.

Municipalities that are well positioned for more investment by the private sector, such as metros and the large secondary cities, should diversify their finance mix into bonds and PPPs. This will free-up significant resources that national government can use to assist struggling municipalities that will always be grant dependent.