

**FINANCING ECONOMIC DEVELOPMENT AT THE LOCAL LEVEL: AN  
ANALYSIS OF THE APPROPRIATENESS OF A MUNICIPAL BOND MARKET IN  
SOUTH AFRICA**

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The onset of democratic transformation in South Africa in the early 1990s had a profound effect on local government which progressed from being the third tier of government to an equal autonomous sphere, with implications for greater delivery responsibility. Furthermore the number of municipalities was rationalised from 843 to 284 in an extensive re-demarcation process.

This transformation led to a series of financial crises arising not least from the non-payment of service bills by a significant percentage of residents and related to this, an inability to fund services to all municipal residents in terms of a revised constitutional mandate. At the same time, the South African government, as a component of a tighter fiscal framework informed by the objectives of fiscal federalism, reduced local government income sources by decreasing intergovernmental grants from nationally-collected revenue.

The lack of financial resources for greater expenditure requirements, combined with a revised system of intergovernmental fiscal relations has caused municipalities to explore new avenues for revenue-generating, one of these being municipal bonds. This paper explores the prospects for re-introduced municipal bonds in South Africa, the City of Johannesburg R1 billion issue in April 2004 being the first in the post-apartheid era.

Two important issues are addressed. First, the dominance of the Development Bank of Southern Africa (DBSA) in lending to municipalities and the implications this holds for private-sector financial institutions to compete (section 3). Second, the limitations of municipal bonds in providing support for the financial needs of the recently transformed local government entities (section 4). The background for these issues is provided by a discussion of (i) how municipal debt fits into the current system of fiscal federalism in South Africa (section 1), and (ii) an exposition of the evolution of the local bond market in section 2. The requirements for a vibrant municipal bond market are analysed in section 5, before a conclusion is reached concerning the appropriateness of a municipal bond market in South Africa (section 6).

## **1. SOUTH AFRICAN MUNICIPAL DEBT IN THE CURRENT SYSTEM OF FISCAL FEDERALISM**

Fiscal federalism involves the devolution of both financial powers and responsibilities (aligning with political and administrative decentralisation), to varying degrees, to sub-national tiers of government. Although controversial, there is broad consensus that there is no clear degree of decentralisation that should be prescribed for any one country. It is also evident that fiscal federalism is increasingly popular as an inter-governmental structure for a range of countries across the world.

While there is no doubt that local representation was a major factor in influencing the current system of decentralisation in South Africa (to represent local interests and protect minority interests), a tendency towards greater levels of decentralisation (to promote allocative efficiency) was also an important influence. As Heese (2000: 25) argues: “Bringing government closer to people is an enduring goal”. Of concern, however, is whether local government can afford this role, or whether national government is essentially “exporting” its deficit in light of the considerable infrastructure backlogs.

There is also concern surrounding the synchronicity of structural reforms (such as financial stabilisation) with decentralisation, compounding the uncertain assumption that municipalities are necessarily able to raise sufficient own revenue sources. This assumption needs to be understood in light of South Africa’s public expenditure framework whereby local government only receives a small portion of nationally collected revenue and therefore needs to raise the bulk of its funding through, amongst other things, accessing capital markets.

The extent of fiscal federalism is key to sub-national borrowing. Increased sub-national access to credit markets usually derives from increased fiscal devolution (Peterson and Freire 2004: 12). Ajam (2003: 303-304) argues that sub-national governments are typically less able than central government to issue debt obligations and, in the interest of coordinated macroeconomic policy and macroeconomic objectives, central government supervision of sub-national debt operations is important. This necessitates maintaining sub-national debt

below pre-determined limits. Peterson and Freire (2004: 19) point out that major financial crises in Latin America in the late 1990s and in 2002 were, in part, caused by the destabilising effect of excessive sub-national borrowing on the national aggregate debt exposure.

An active market in government securities accompanied by the participation of bond-rating agencies is also important for accessing sub-national debt markets (Ajam 2003: 303-304). The issue of an active market is relevant in light of South African local government's limited presence in the bond market. Hence, given the recent emergence of South Africa's municipal debt market, lack of liquidity represents a fundamental constraint to its growth (Faure 2004) and somewhat of a vicious cycle – lack of liquidity constrains the attractiveness of the market to investors and inherently inhibits further deepening of the market. This situation poses an important consideration in light of policy assumptions that local government should be able to raise the bulk of its own revenue.

A further constraint to be considered in assessing the limitations of sub-national debt markets surrounds market failure. The devolution of powers from the centre and the autonomy of sub-national government will determine the extent to which sub-national government can be held accountable. "If sub-national governments do not have substantial own tax-revenue sources, potential borrowers and bond-rating agencies will set their interest rates based on their perception of the terms under which tax-sharing or intergovernmental grants are likely to be made" (Ajam 2003: 304). A lack of clarity on the relationship between the centre and sub-national government can also result in adverse selection and moral hazard for the latter (Peterson and Freire 2004: 20).

Regardless of national government policy to the contrary (as has been the case in South Africa), it is unlikely that national governments would ever allow a sub-national debt default. In theory, this effective underwriting should make sub-national governments more attractive to financial institutions (Ajam 2003: 305), but it also means that national government needs to carefully regulate the financial behaviour of municipal financing.

As will be explored in the next section, the South African national government has gone to

pains to distance itself from local government's debt obligations, insisting that fiscal autonomy accompanies the decentralisation of fiscal functions.

## **2. THE EVOLUTION OF THE MUNICIPAL BOND MARKET IN SOUTH AFRICA**

Although South Africa previously had an active municipal bond market in terms of volumes traded, this outcome requires interrogation. Until 1988, the municipal bond market was underpinned by the system of prescribed asset requirements (Putman 2000: 1). Financial institutions were required to invest a prescribed percentage of their portfolios in government debt. Local government loans were seen as almost risk-free (or gilt-edged), as it was assumed that national government would come to the aid of municipalities if they encountered financial problems (USAID 1997: 105). There were, in fact, no defaults on municipal bonds as municipal bonds were issued by well-resourced white municipalities, which generally borrowed conservatively.

However, there was no *bona fide* municipal bond market activity. Because of the large demand for municipal securities under the prescribed assets requirements regime, securities were privately placed with financial institutions and there was no secondary trading (Putman 2000: 1), nor credit ratings. Because of their implicit guarantee, financial institutions did little or no credit analysis of municipalities.

The post-1996 constitutional recognition of local government as an independent sphere of government and the repeal of the prescribed assets requirements saw most investors disposing of their municipal investments (Putman 2000: 2). An independent local sphere standing on its own two feet with absolutely "no bail-outs" by national government was a decidedly less attractive investment-prospect for most financial institutions. The result was that, despite the need for capital markets to finance infrastructure, long-term private lending to municipalities has been flat since 1996, remaining at around R11 and R12 billion (National Treasury 2003: 42). With two notable exceptions, there was limited interest in lending to municipalities. The two exceptions refer to lending by INCA (Infrastructure Finance Corporation) and DBSA.

INCA is a privately owned infrastructure debt fund which lends money to infrastructure suppliers such as municipalities, water boards and other statutory institutions. INCA's

position in the local government lending market is unique; established in 1996 at a time when private banks were withdrawing from the local government market, in response to government's call for increased private sector involvement in infrastructure funding (INCA 2004b). Over the last 7 years, INCA has loaned out R6.1 billion (INCA 2004a: 2). INCA raises money from local and international market funds through a series of bond issues and long-term loans.

Because no other private sector lenders were interested in financing municipalities, concessional loan finance was of great importance specifically for "projects with economic returns that would not be calculated by private sector institutions" (Heese 2000: 89), at least over the interim. There was also a need to demonstrate to the private sector that there were viable investments in local government, thereby leading the market.

This concessional finance role was played by DBSA. DBSA's share of municipal debt doubled over the four-year period between 1996 and 2000 (National Treasury 2001: 190) and has continued to increase in the period beyond this (National Treasury 2003: 42). Clearly DBSA has managed to consolidate its position in the municipal borrowing market with a lack of competition from private sector banks and a desperate need for financing from municipalities. According to its 2003/04 Annual Report, R287.9 million out of R757.06 million of loan approvals up to the 31 March 2004 were to local government (DBSA 2004: 79). Furthermore, in the period 2003/04, 95% of new customers were municipalities (DBSA 2004: 51). The key concern surrounding this role, as will be forthwith explored, is whether the balance between leading private sector investment has been outweighed subsequently by a dominant, crowding out role.

### **3. DBSA's ROLE IN THE MUNICIPAL BORROWING MARKET**

Increased stability and predictability in the local government sector, marked most notably by the finalised demarcation process in 2000 and a renewed focus on financial governance and creditworthiness through the Municipal Finance Management Act (MFMA) of 2003<sup>1</sup>, has led

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<sup>1</sup> The MFMA, from 1<sup>st</sup> July 2004, forces municipalities to improve financial governance through increased accountability and oversight, specifically through regular reporting (National Treasury 2004a: 36). In this way,

to renewed interest in municipal borrowing. Although it is difficult to identify a definitive trend at this early stage, reforms may mark a new period of increased lending to municipalities.

Perhaps the clearest indicator of the renewed interest is the increasingly vocal criticism of the dominance of the municipal borrowing sector by DBSA. Many financial institutions either active or interested in the municipal borrowing market have expressed frustration with what these financial institutions see as DBSA's dominance of the market (Kemp 2004; Mutiga 2004; Leigland 2004b; Du-Pont-Bouma 2004).

DBSA's perceived dominance of the municipal borrowing market can be tested by comparing loans to South Africa's four biggest cities (Johannesburg, Tshwane, Cape Town and eThekweni), which together represent 87.62% of total metropolitan borrowing<sup>2</sup>, by DBSA and commercial / private lenders. As is evident from Figure 1 below, DBSA is not only the single biggest lender to municipalities but, in fact, represents almost as important a source of capital funding as that of all commercial banks together (including INCA), at least for South Africa's biggest cities.

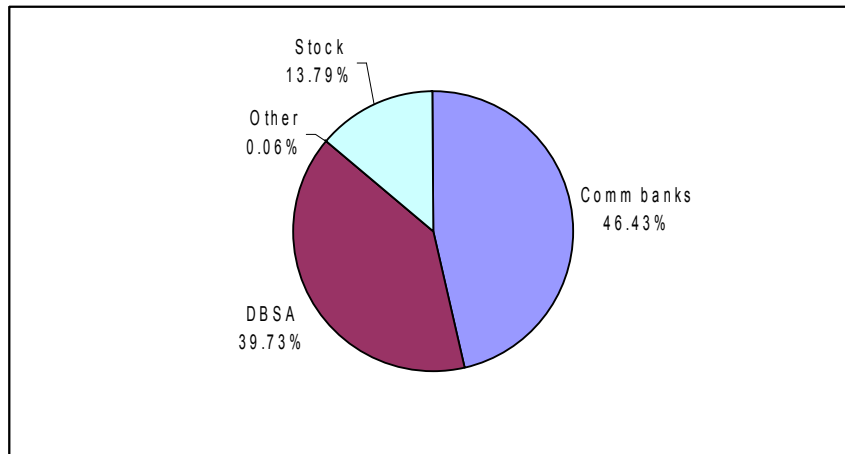
Furthermore, in a comparison of borrowing between South Africa's biggest cities, it is evident that DBSA offers funding to municipalities at a considerably lower rate than that offered by commercial banks. This is suggested by a calculation of the differential in basis points between commercial bank loans, DBSA and the average of all loans, as depicted by Figure 2 below. DBSA lends at 368 basis points below that of commercial banks and compared to a comparable government bond yield, DBSA lends at an average rate of 189 basis points less than commercial banks do.

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municipalities will be assisted through national municipal finance policy to improve the problem of low standards for disclosure, auditing, accounting and financial reporting, as noted in the 2004 Auditor-General's report on local government (Auditor General's Office 2004: 7). Implementation, however, is likely to be time-consuming.

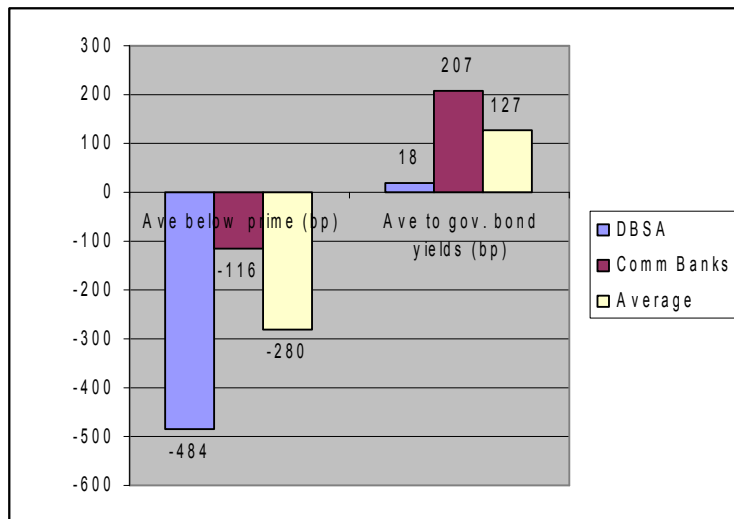
<sup>2</sup> Total borrowing in all metropolitan municipalities was recorded as R12.3 billion in June 2003 (National Treasury 2004a), while borrowing in these four cities was R10.78 billion at the same date, i.e., 87.62% of total borrowing in metropolitan municipalities.

**Figure 1. Breakdown of lending in major cities by lending source**



Sources: Annual financial statements of Johannesburg (2003b), Tshwane (2003), and Cape Town (2004); data for eThekweni provided by Finance department, eThekweni (eThekweni 2004).

**Figure 2. Spread of interest rates between DBSA, commercial banks and a combined average**



Sources: Adapted from data in annual financial statements of Johannesburg (2003b), Tshwane (2003), and Cape Town (2004); data for eThekweni provided by Finance department, eThekweni (eThekweni 2004); data supplemented by interviews with finance department officials in the four cities; prime interest calculated using SARB 2005, Government bond yields details the yield on a representative basket of government bonds (at the same maturity as the loan concerned) (See BESA 2004b); averages are calculated on the basis of the loan value.

The lack of diversity in the borrowing market has also been cause for concern by the National Treasury. In 2001, the National Treasury (2001: 190) commented that the increasing reliance of local government on public sector debt was inconsistent with government's policy goal of

increasing private sector investment. In 2003, the National Treasury (2003: 42) claimed that although securities used to be the main instrument of municipal borrowing, DBSA's increased market share of long term loans to municipalities had resulted in securities declining from 68.3% to 35.9% over the period March 1997 to December 2002. The National Treasury (2003: 42) concluded that the absence of tradable municipal securities poses a challenge to the development of a municipal bond market.

It is important not to create the impression that the stagnation in the municipal borrowing market has been caused by the dominance of this market by DBSA. In fact, as the National Treasury (2004a: 33) makes clear, the stagnant municipal borrowing market is related most directly to the transition process in local government, the related uncertainty in the financial markets and the retreat of the private sector from the municipal market. Nevertheless, the dominance of DBSA remains a distortion in the market by crowding-out the private sector and causing an over-reliance in the municipal borrowing market on concessional finance.

DBSA's dominance is a function of its role as a national development finance institution, with national government as its sole shareholder, enjoying exemption from certain provisioning requirements and having a higher credit rating than other banks (MIIU 2004). This essentially gilt-edged status enables DBSA to access cheaper financing than other financial institutions and to lend to municipalities at a lower rate than other financial institutions, while still achieving the same or better margins. But using concessional finance to compete with other financial institutions in the municipal borrowing market over the long term crowds-out other players with a number of negative consequences. Private financial institutions are loathe to develop and place at risk the expertise and capital required to bid for projects requiring finance in the municipal market, for fear of being undercut (MIIU 2004). When private sector banks do lend, they are forced to reduce the cost of their loans to compete with DBSA.

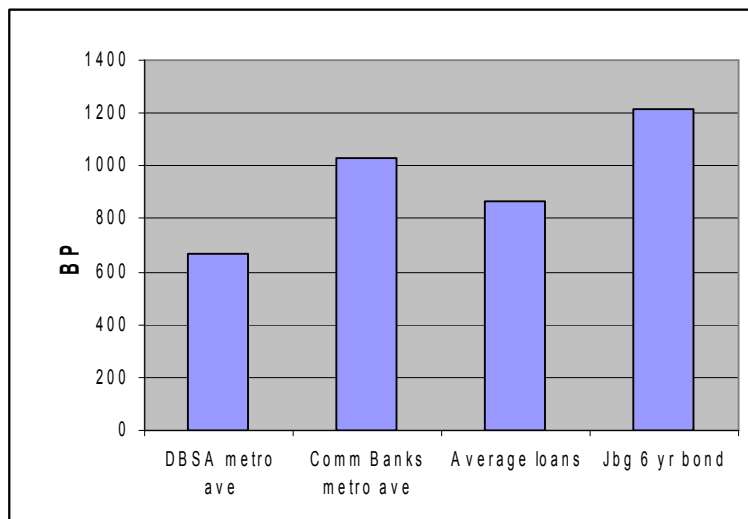
In 2004, 65% of DBSA's portfolio of lending to local government went to metropolitan municipalities (National Treasury 2004a: 33); an increase from 59% in 2001 (National Treasury 2001: 190). This implies that DBSA not only crowds-out other lenders in the municipal borrowing market but does so in the most attractive section of the market, through deals with the most creditworthy municipal borrowers (Leigland 2004a: 10).

Some commentators argue that given local government's responsibility for poverty

alleviation, particularly in larger urban townships, that it is appropriate that DBSA provides cheaper finance to metropolitan municipalities (Dietrich 2004). But it must be understood that while superficially it may seem that DBSA is correct in supporting urban local government by offering cheap long-term finance, there are negative externalities that impact on the municipal borrowing market if this is its sole focus. By crowding-out the private sector from the metropolitan borrowing market, liquidity in this market is reduced, as is competition between lenders. In addition, the opportunity cost of lending to metropolitan areas is that smaller less credit-worthy municipalities which the private sector will not lend to, but who are clearly more deserving of concessional finance continue to be sidelined in the municipal borrowing market.

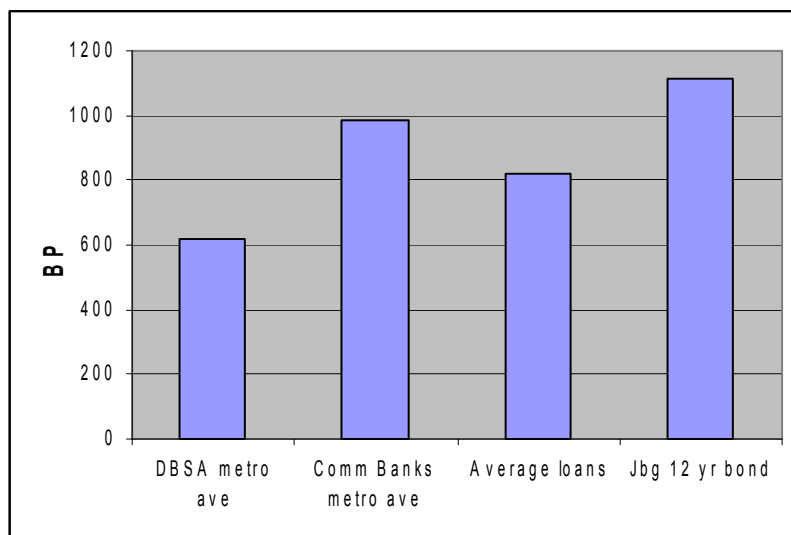
One of the most important unintended consequences of DBSA's dominance is that the artificially low cost of bank loans ensures that, in most cases, it is cheaper for metropolitan municipalities to access bank finance than it is to issue a bond (Kemp 2004; Leigland 2004b). This contention can be tested by comparing the yields on Johannesburg's two bond issues against the average cost of DBSA and commercial bank loans to the four major cities benchmarked against the prime interest rate. Figures 3 and 4 below demonstrate that while the bond issue may have relieved expensive debt for Johannesburg, they by no means represent an attractive option for the average major city when compared to loan finance.

**Figure 3. Comparison of loan interest rates and Johannesburg 6-year bond yield (April 2004)**



Sources: SARB 2005, Johannesburg 2004b. Own calculations.

**Figure 4. Comparison of loan interest rates and Johannesburg 12-year bond yield (September 2004)**



Sources: SARB 2005, Johannesburg 2004b. Own calculations.

In mitigation of the evidence demonstrating that loan finance is cheaper than issuing a bond, DBSA argues that the relatively high cost of issuing a bond is due to the lack of liquidity in the municipal bond market and the fact that the municipal bond market is relatively new and (for investors) untested (Dietrich 2004; Mogototoane 2005).

It is presumed that once the level of bond issuances reaches a critical mass, generally assumed to be at a level of about 3 or 4 major bond issuances, trade in municipal bonds will increase, liquidity will rise, and the cost of issuing a bond will drop (Faure 2004; Jones 2004; Glasser 2004; Dietrich 2004; Raine & Padayachee 2004; Mogototoane 2005). In addition, some commentators argue that the recent lack of creditworthiness in municipalities has also caused the market for borrowing to stagnate generally and that this is an additional reason for the lack of movement in the municipal bond market (Dietrich 2004; Raine & Padayachee 2004; Mogototoane 2005).

While there is an element of truth in both positions (and diversification is an important element of future lending, as discussed below), the role of DBSA in lending to metropolitan municipalities is so significant that its potentially negative impact on the growth of the municipal bond market cannot be discounted (Glasser 2004; Leigland 2004b). The evidence provided above of the differential between loan finance and the cost of bond issues confirms

this.

In addition, there is a further negative externality for smaller more-marginalised municipalities. As it is only larger (essentially metropolitan) municipalities that have the option of separately securitising a bond issuance, inhibiting the growth of the municipal bond market ensures that DBSA and other lenders are not forced to increase lending to other municipalities; that is, if metropolitan municipalities diversified into the bond market this would open up the market for bank loans to other borrowers. In this sense, it is possibly smaller municipalities (who are unable to issue debt and who are not favoured by DBSA's metropolitan loan focus), who are compromised most by the current set of arrangements.

Increasing pressure on DBSA from the National Treasury, together with increased demand for different borrowing arrangements from municipalities, has recently led to diversification by DBSA away from loan financing into municipal securities, which includes increased activity in the municipal bond market and the crafting of lending instruments for municipalities such as special purpose vehicles (SPVs) to consolidate municipal debt. Evidence of the former is that DBSA was a joint underwriter for Johannesburg's second bond issuance. Although growth in the municipal securities market will eventually reduce DBSA's market share of municipal borrowing, DBSA's actions in support of the municipal bond market act to allay increasingly sharp criticism by government of DBSA's dominance of municipal borrowing and shows that DBSA is taking on a broader role in expanding this market (Dietrich 2004; Raine & Padayachee 2004; Jackson 2004).

DBSA may also support diversification in municipal borrowing through its collateralised debt obligation instrument to be released sometime in the near future (DBSA creating a tool for municipalities to access capital markets 2003; Raine & Padayachee 2004). A SPV has been constructed to contain DBSA's debt for 89 municipalities, totalling a R2 billion bond (Raine & Padayachee 2004). This is also being touted by DBSA as a way of bringing in new financial investors into the municipal debt market.

#### **4. THE JOHANNESBURG BOND ISSUANCES OF 2004: THE REBIRTH OF THE MUNICIPAL BOND MARKET?**

Johannesburg's recent bond issuances are highly significant as the first local government bond issue since the promulgation of legislation enabling councils to issue debt – the MFMA of 2003. However, Johannesburg's particular financial situation, arising from a severe financial crisis seven years before the first bond issue, should be taken into account in order to accurately assess whether calls for further municipal councils to issue bonds (National Treasury 2004b: 169) are feasible.

Johannesburg's organisational crisis became publicly apparent in July 1997, when the Greater Johannesburg Transitional Metropolitan Council was unable to settle a R300 million bill for bulk electricity. Johannesburg embarked on a strategy to ensure financial stability. This was achieved firstly by securing a loan from DBSA to enable operating cash flows, loan repayments and payment to major creditors, followed by fundamental organisational restructuring, steered by a new management team (Johannesburg 2003a). A strategy of sustainability was pursued once these stabilisation measures were in place so that capital spending could resume.

Despite this financial crisis, Johannesburg's economic significance provides the basis for inherent interest from capital markets. Of South Africa's US\$78 billion National Economic Product, and Gauteng's US\$30 billion, Johannesburg accounts for some US\$12 billion, providing services to over 3.2 million people, including 100 000 businesses, and employing 25 000 staff members in 14 separate entities (Johannesburg 2004b). Furthermore, the city's improved operations and financial management facilitated an upgrade in credit ratings – from BBB+ in 1999 to A- in 2003, as assigned by Fitch and an A from CA ratings in 2003 (none were commissioned in 1999) (Johannesburg, 2004b). In assigning its rating, Fitch favoured the city's large economic entity and the turn-around in its financial and organisational management (A-rating for R1bn Jo'burg bond 2004).

Johannesburg released an unsecured six-year R1 billion bond in April 2004 on the Bond Exchange of South Africa (BESA). The bond was earmarked for use in debt restructuring as well as to pay for infrastructure needs at more affordable rates than other (loan) options open to the city – at 230 basis points above the benchmark (the R153 government bond), while

expanding its investor base and debt maturity profiles (BusinessMap 2004). With 18 bids received, 14 new investors committed to the bond, at a better than expected market price (Johannesburg 2004b). The first bond's superior rates are expected to save the city R20 million in debt obligations annually over the next six years (Johannesburg 2004a).

A second twelve-year bond, also for R1 billion, was issued on the 15<sup>th</sup> September 2004 (BESA 2004a; Johannesburg 2004b). The issue, unlike the first, was 40% guaranteed by the International Finance Corporation (IFC) and DBSA - a guarantee made possible because of its longer term - and was priced 164 basis points above the benchmark (R157 government bond), with a 150% over-subscription at the clearing price, gaining 7 new investors for the city (Johannesburg 2004b). The city intends to issue paper regularly now that it is in a position to do so, given its current ratings (Johannesburg 2003a; Ngobeni 2004).

Ngobeni (2004) highlights the significance of a publicly traded debt instrument (in comparison to a loan) which requires greater levels of accountability, and, on the positive side, can play a marketing role in highlighting a city's financial status.

Johannesburg's experience indicated that despite risks associated with local government, there is an appetite for investment at attractive prices, assuming adequate institutional structures and systems are in place (Kemp 2004; Jones 2004).

While there has been a presumption that Johannesburg's bond issuances herald the beginning of a new municipal bond market, in reality the Johannesburg experience is unique and therefore does not in and of itself indicate a trend in the municipal bond market. As has previously been discussed, DBSA's role in the municipal debt market explains South African bank loans being cheaper than direct debt issue. It is, therefore, inaccurate to laud Johannesburg as the forerunner in the municipal bond market. In fact, Johannesburg's until-recent poor credit rating makes it one of the only municipalities big enough to securitise a bond issue but with a historical credit rating that it is more attractive to issue a bond. This facilitates the retiring of previously arranged, more expensive loans – a scenario that does not apply to other cities with cheaper long-term loans and better historical credit ratings.

Nonetheless, it is unlikely that DBSA will continue to undercut commercial banks in municipal finance indefinitely (Jackson 2004; Ngobeni 2004; Raine & Padyachee 2004), not least because of pressure on it to extend its developmental focus when lending to local government. As Glasser, et al. (1998: 120) argue: “it is not recommended that any governmental or quasi-governmental entity, including DBSA, be designed or encouraged to act as a general provider of municipal credit [in the interests of sustainability]”.

For DBSA, this implies a significant shift from the premise of “market-based” borrowing, which favours large, well-capacitated cities, especially at concessional rates that crowd out private sector players (Glasser, et al. 1998 120-121). To this extent, once there is less of a subsidy in municipal bank finance, Johannesburg’s experience in using bonds will become an attractive option for similarly capacitated cities.

It seems likely that one of the most profound impacts of the growth of a municipal bond market will be a positive externality for smaller municipalities excluded from the bond market. As larger municipalities utilise finance through bond issuances, this will open up the market for bank loans to smaller, poorer municipalities, which are in greater need of such loans.

This also points to another problem with DBSA’s municipal lending policy; a preference to lend money to large metropolitan councils at the expense of smaller municipalities. The opportunity cost of this policy is that smaller municipalities have less access to development finance than if DBSA lending were not biased towards large municipalities. It is questionable whether a national development finance institution should be using development finance to compete with the private sector for the business of large viable municipalities. Small wonder that DBSA’s credit rating is AAA (domestic), Baa2 (international, Moody’s) and BBB (international, Standard and Poor’s) (DBSA 2004: 79). Development finance should rather be used to support or at least equally represent the development of municipalities with ratings that retard access to private sector finance. This would imply a less favourable rating for DBSA as a whole – something the DBSA’s only shareholder - the South African government - may be willing to accept if the institution is to lead the market in pioneering more risky but developmentally significant ventures.

In conclusion, contrary to the hype surrounding the issue of the Johannesburg bond, a sober

assessment of the history of the bond market, the context of Johannesburg's issuances and the state of play in the current debt market reveals that prospects for growth, under current conditions, are limited. A compensating role by DBSA supporting the issue of bonds, however, especially for smaller municipalities, may be able to mitigate some of these hurdles. Innovation and review of challenges are key to achieve the goal of the emergence of a vibrant municipal bond market.

## **5. REQUIREMENTS FOR A VIBRANT MUNICIPAL BOND MARKET**

In an effort to identify what is required to develop a vibrant municipal bond market, it is useful to explore what has been done in other countries. Leigland (1997) surveyed the attempts of four emerging economies: South Africa, Poland, the Philippines, and Indonesia. He identified a number of key problems retarding the development of this market, namely:

- a lack of experience in the markets of emerging economies with debt issuance of any kind,
- the lack of an active secondary trading market,
- government controls on investments in municipal or other bonds,
- the lack of a tax incentive to ensure an acceptable return on investments,
- insufficient local tax revenues to support possible municipal bond payment obligations,
- a lack of acceptable standards for disclosure, auditing, accounting and financial reporting,
- the high cost of using bonds for infrastructure financing,
- inadequate municipal risk assessment,
- the absence of long-term debt amortisation due to investor uncertainty and the lack of secondary markets, and
- the lack of a collective approach to assisting small borrowers especially given the small number of entities capable of selling municipal bonds.

South African municipalities are compromised by the lack of an active secondary market, the absence of a tax incentive, inadequate municipal risk assessment, and a limited availability of the collective option. But, South Africa has an experienced market, government controls on investment, and sound financial reporting. The country's well-developed financial system therefore puts it ahead of many other emerging economies.

Ironically, the need to collect own revenue sources, arising from decentralisation, is also a hindrance to investors. Since most South African municipalities are responsible for more than

two thirds of their income through own revenue (National Treasury 2004a: 29), their ability to raise local taxes to a varying degree, represents significant risk to potential investors – an important precondition for the development of the municipal bond market (Kemp 2004; Mutiga 2004).

Given the international experience and the current and historical state of the local municipal debt market, what is required of policy-makers to encourage the development of the municipal bond market?

*(a) From a National Treasury perspective*

Past experience of prescribed asset legislation suggests that compulsion of investment and underwriting of municipal debt does not serve to develop nor sustain a municipal debt market. In light of this, asserting the importance of fiscal independence by not underwriting loans is an important strategy to overcome moral hazard.

It is also appropriate for the National Treasury to support greater levels of sustainability by compelling municipalities to “modernize budget and financial management practices by placing local government finances on a sustainable footing in order to maximise the capacity of municipalities to deliver services ... [putting] in place a sound financial governance framework” (National Treasury 2004c).

These measures will, in the long term, place local government in a position to offer attractive investments, supporting municipal capital markets. Nonetheless, they are of little consequence if the structural implications of DBSA’s role in offering concessional finance is not considered.

*(b) The development finance network*

Notwithstanding the long-term objective of sustainability pursued by the National Treasury, there still needs to be concessional finance to support local government over a transitional period. Furthermore, such finance should be extended to those councils that have developmental needs, but limited financial appeal.

The current role played by the development finance system, and DBSA in particular, should be reviewed. The extent of unintended consequences arising from the offering of preferential finance in terms of market distortion (the crowding-out of private sector players) needs to be considered, not only in terms of the loan but also the nascent bond market, and should be critically appraised. Support of large, essentially financially stable councils, may well be directing resources away from smaller, less viable municipalities, as well as undermining the viability of a traded debt market. In light of the existence of a range of private sector players interested in the municipal debt market, there is no reason why this cost should be borne by struggling municipalities in favour of those that are better capacitated.

While it is sound that development finance institutions should have mixed risk exposure to ensure their sustainability, it is questionable whether DBSA should pursue a AAA domestic rating as a scorecard objective (DBSA 2004: 54). This falls under a wider development finance debate which should be considered by DBSA's sole shareholder – government.

DBSA's analysis as to the absence of a municipal bond market in South Africa – “Institutional investors in South Africa are wary of municipal debt. An understanding of this asset class has been clouded by recent changes in the laws and regulations pertaining to municipalities” (2004: 25) – can be contested from a supply rather than demand side. That is, it is not sufficiently attractive for suitable councils to issue debt.

DBSA's conclusion – “... the need to play a catalytic role in developing capital markets as an alternative source of capital for municipalities [via partial guarantees for bond issues and collateralised debt obligations]” – is appropriate, not least to play a correcting role for its other forms of intervention in the market (DBSA 2004: 25). It is not inappropriate for DBSA to play a role in supporting concessional finance to local government. But the nature of this role, specifically its duration, recipient profile, and the mechanism used (loans versus bonds) must be considered.

### *(c) Co-ordination of policy*

A crucial concern is where the responsibility for assessing these issues should fall. There are a number of players who need to closely interface, namely: the Department of Trade and Industry (responsible for development finance institutions), the National Treasury (in light of

its role in financial management regulations), as well as the Department of Provincial and Local Government. Ideally, this policy compilation should include consultation with the Banking Council, BESA and the South African Local Government Association.

Perhaps the most significant finding of this research is the realisation of the limitations of economic theory, which would suggest government's primary concern in relation to sub-national debt should be that of moral hazard. While it is always important to prevent this risk, structural concerns have caused such limitations on borrowing that moral hazard has not even arisen. The absence of adequate borrowing is of key concern if the promises of fiscal decentralisation – to fund development prioritised at the local level – are ever to be meaningfully realised by municipalities that need to access increased levels of finance. To this extent, a well-functioning debt market, including a bond market, must be encouraged by complex and nuanced policy co-ordination.

## **6. CONCLUSION: THE APPROPRIATENESS OF A MUNICIPAL BOND MARKET IN SOUTH AFRICA**

Although it has been popular to assume the contrary in light of local government's finance needs, coupled with a well-traded and growing bond market, Johannesburg's recent bond issuances does *not* necessarily mark the budding of a municipal bond market.

International experience has clearly demonstrated that regulatory environments can be a key determinant as to whether a municipal bond market is supported and sustained, or deterred by inadequate structural arrangements. Although in South Africa the significance of this regulatory and policy framework applies similarly, this has been limited by the extent to which DBSA has influenced the debt market via concessional financing. Other factors, such as autonomous fiscal capacity and sound financial management of market infrastructure, are already in place.

While, until recently, reticence to issue municipal debt could be explained by structural transition, it is a less plausible explanation as time and systems (including key financial regulation legislation) progress. Based on the views of suitable issuers, the more important issue is the alternative provided by cheaper finance – either from DBSA or those banks

competing with DBSA. The fact that this finance is cheaper than direct bond issues suggests the impact of DBSA's concessional role and that crowding-out of private players is probable.

There is therefore limited applicability of the Johannesburg bond issues for similarly-sized cities that have more stable histories, although securitisation of a range of municipal debt (as already offered by INCA) may be an attractive option for municipalities that are less attractive options for banks. Nevertheless, appropriate policies by the National Treasury and in regard to the development finance framework may encourage the development of a municipal bond market.

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