Unlocking Infrastructure Financing to Accelerate Service Delivery
Municipal Innovative Infrastructure Financing Conference 2018

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1. **Foreword by Mr Simphiwe Dzengwa, Executive Director: Municipal Finance, SALGA**

South Africa has a dual challenge of having to invest in the provision of new infrastructure while at the same time spending sufficient resources in the maintenance of old infrastructure. In a context where resources are scarce and over reliance on the fiscus is futile option, the local government sector has to explore new avenues, tools and instruments for infrastructure financing. This is very important for continued sustainable service delivery, meeting infrastructure needs of a growing population, stimulating economic growth and job creation. Understanding the various infrastructure financing options and tools is the first step toward tacking these challenges head-on.

In assessing infrastructure challenges our members encounter and understanding the changes currently taking place in the local government space, SALGA has conceptualised the Municipal Innovative Infrastructure Financing Conference. The theme of the conference, “Unlocking Infrastructure Financing to Accelerate Service Delivery”, underpins just how critical adequate financing of infrastructure is to the core mandate of local government and the provision of sustainable basic services.
The ability of municipalities to conceptualize, package and finance infrastructure projects has its own unique challenges and we have identified them as follows;

• Historical burden: vast areas of the country still face severe infrastructure backlogs, poor or inadequate Infrastructure capacity and lack of integratedness in infrastructure planning and execution.

• Migration: People move from rural and smaller municipalities to the metros and intermediate cities. This internal migration causes great strain in terms of infrastructure and service requirements in informal settlements and inner-cities where these migrants move to.

• Climate change: People adapt to such changes by their demand for local infrastructure. Moreover, the technical conditions for the supply side change.

• Technical infrastructure realization: Infrastructure investments are often extremely complex. These are compounded by different regional conditions, long and differentiated planning and construction phases, maintenance issues, and political or legal requirements.

• Funding of infrastructure: The complexity of the technical infrastructure delivery translates into the funding. Moreover, local infrastructure is basically intended to generate positive externalities. This means that the investor is (directly) rewarded for some of the benefits that he creates for others.

• Assessment of citizens: They are often unsatisfied with the speed and degree of local infrastructure development they encounter; which sometimes even leads to (violent) protests.[1]

Thus, the following basic approaches to cope with those challenges have been outlined by SALGA as follows;

• To expand funding;

• To develop a new instrument to fund special local infrastructure investments;

• To coordinate and integrate infrastructure funding;

• To foster capacity development;

• To develop a national municipal project pipeline

• To match-make between infrastructure project owners, planners, project preparators, funders and executors
In meeting one of our core functions as per the Local Government White Paper, we have envisioned this conference to be a knowledge sharing and exposure platform for municipalities on raising finance for infrastructure. It is meant to accomplish three things in the main, viz.; create a general understanding among stakeholders of the various infrastructure funding options; expose the various participants to practical measures to pursue after conference in realizing their infrastructure needs; and in fostering partnerships between the various players so that there’s an escalated infrastructure delivery in all our municipalities.
2. **ABSA Municipal Bond Alternative Source of Funding for Infrastructure Development**

Metropolitan municipalities and large cities in South Africa have over the years come under pressure from rural-to-urban migration which has put a burden on existing infrastructure. The trend is the same with many countries on the African continent.

More than half of the world’s population now lives in towns and cities, and this could rise to as much as 75% by 2050 (United Nations Population Division, 2014). This presents huge challenges for urban authorities as they need to provide adequate infrastructure; such as roads, electricity, water and sewerage for their growing communities, as well as attracting the critical investment needed to stimulate job creation.

Infrastructure investment requires significant funding; and revenue collected from rates and taxes, as well as borrowings from Banks and Development Finance Institutions (DFIs) alone is inadequate. In South Africa, the country’s budget faces on-going constraints. With reduced transfers from the fiscus, municipalities have no choice but to look at external funding for their infrastructure funding needs. We believe that municipal bonds are an important alternative source of infrastructure funding.
One of the major advantages of municipal bonds is the ability to structure the tenor of the instrument in line with the needs of the client, e.g. as long as 10 to 13 years in some cases. Funding stability is crucial for long-term investors such as insurance and pension funds.

South Africa is currently one of the largest issuers of municipal bonds in sub-Saharan Africa in line with the sophistication of its financial services sector as well as well-managed metropolitan municipalities such as Johannesburg, eThekwini, Tshwane, Ekurhuleni and Cape Town. These cities have received favourable ratings from global rating agencies such as Moody’s. Positive ratings are an important indicator for investors when assessing municipal bonds.

The latest figures show that the municipal bond market in South Africa is about R25 billion. Absa has successfully raised bonds on behalf of the City of Ekurhuleni, including a R1.3 billion bond from both local lenders and DFIs in order to finance much needed infrastructure projects.

The municipal bond market in Africa is still relatively small compared to developed markets such as the United States whose bond market was which at the end of the third quarter of 2017 estimated at $3.8 trillion (US Federal Reserve – December 2017) at the end of the third quarter of 2017. Africa has the potential however to grow in this market, especially in South Africa’s secondary cities whose infrastructure requirements have grown over the years.

Markets such as Ghana, Kenya and Nigeria are also prime markets for bonds.

Yields for municipal bonds vary depending on the tenor and amounts being raised, as well as the currency in which the bonds have been issued. In South Africa, all the municipal bonds issued so far have been Rand denominated; whereas in other markets in sub-Saharan Africa, some have been denominated in foreign currency linked to their domestic currencies. The latter can often present significant risk, especially when the local currency weakens, putting pressure on the municipal authority to ensure strong revenue management and collections to be able to pay investors when the bonds are due.

To attract investors, it is important for municipal authorities to have robust and audited financials; strong corporate governance and accountability; obtain a credit rating and seek financial advice on how to restructure their balance sheets.

Our role at Absa, both in South Africa and on the continent is to partner with municipal authorities in assisting them in navigating the regulatory environment and develop an optimal structure that will achieve a successful issuance of municipal bonds.

Looking to the future, we expect more activity in the municipal bond market in the region, with South Africa leading the way as we already have the expertise that other countries can benefit from.
3. Municipal Innovative Infrastructure Financing Conference

The South African Local Government Association (SALGA) is an organization mandated by the Constitution to assist in the comprehensive transformation of local government in South Africa from pre-1994 regime to the new dispensation under the country’s first democratically elected government. Section 163 of the Constitution envisages an important role for organized local government and provides that an Act of Parliament must cater for the recognition of national and provincial organizations representing municipalities, and determine procedures by which local government may consult the national and provincial government, designate representatives to participate in the NCOP and nominate persons to the Finance and Fiscal Commission.

The SALGA 2017-2022 Strategic and Annual Performance Plan is a guiding document that the association intends to consult over the next five years in order to effectively execute its mandate.

**Goal 3: Financial Sustainability of Local Government and Greater Fiscal Equity** provides the following principles;

Goal Statement: Improvement of financial health of municipalities through:

- A revised local government fiscal framework,
- Effective revenue management and enhancement
- Access to alternative/innovative funding sources
- Sound financial management

**Strategic Objectives:**

- To develop and support the implementation of financial strategies for the long-term sustainability and viability of local government
- To support innovative revenue enhancement strategies for local government
- To strengthen financial management systems and controls

It is against the backdrop of this institutional mandate and strategic objectives that SALGA has envisioned the Municipal Innovative Infrastructure Financing Conference. The White Paper on Local Government provides as an example of one of SALGA’s key roles “The Facilitation of Shared Learning Between Municipalities.” SALGA seeks to facilitate such a learning on aspects of infrastructure financing through this dedicated conference.
Why Infrastructure Financing?

Funding for local government capital infrastructure in South Africa is limited, considering the constitutional mandate to provide basic infrastructure services to communities. Given the limited resources in the form of grant funding and own revenue, municipalities have to find innovative streams of investing in infrastructure and augmenting capital budget deficits in order to accelerate the eradication of infrastructure backlogs and to fulfil their developmental role.
National Treasury is in the process of revising the Municipal Borrowing Policy Framework. Research undertaken by the department has indicated that municipalities with strong balance sheet positions and cash flows are not leveraging these strong borrowing capabilities. Municipalities have been borrowing less than they should due to large scale infrastructure grants from central government. This trend of grant funding is shifting and requires a mindset shift in funding municipal infrastructure. The Minister of Finance in his 2018 Budget Speech announced that municipal infrastructure grants will be reduced by R 3.5 Billion in the medium term. This will have a knock on effect on the access of funding to invest in municipal infrastructure.

The imminent rapid urbanization has led to programmes that urban municipalities (metropolitan and secondary cities) have to undertake as envisioned in the Integrated Urban Development Framework (IUDF). The areas aligned to the IUDF in terms of this conference are Policy Lever 4: Integrated Urban Infrastructure and Policy Lever 9: Sustainable Finance.

Sources of capital expenditure funding per group of municipalities

The figure above depicts the funding mix for capital expenditure per group of municipalities for the 2014/15 financial year (source: Municipal borrowing Bulleting Issue 2 September 2016). It demonstrates that across all municipal groups grant funding is the main source of capital infrastructure funding.

The objectives of the conference are to;

• Be a one stop shop between municipalities and financiers

• To showcase best practices on municipal innovative infrastructure financing

• To provide a focus on the evolution of municipal trading services and how innovative infrastructure financing can help municipalities with this evolution
4. **SALGA | GIZ Innovative Infrastructure Financing Instruments**

This discussion papers have been written as a part of “Action Research”\(^1\). Action Research aims at solving an acute social problem by guiding a reflective process of suitable knowledge creation in a system or community of practice. This type of research invites stakeholders to actively participate in a social change process. There are thus two processes in inter-connection and inter-action:

**Knowledge creation social change.**

The more general problem that we deal with in this discussion paper is the funding of local public infrastructure in South Africa. There seems to be too little funding; and the given funding seems to be not as fair, equitable, efficient or effective as possible and wanted.

The more specific questions posed with each discussion document are:

“How can this problem be solved by Municipal Pooled Financing?”

Nevertheless, the posed problems have by far not yet been solved. The Action Research process thus should go on. All stakeholders are still cordially invited to participate. These pieces of Action Research have been developed in a cooperation between SALGA and GIZ.

**Municipal Infrastructure General financing options:**

- Own public budget: savings, internal cross-financing;
- Other public budget: grants;
- Advance payment of citizens: Tax Increment Financing (TIF);
- Borrowing from 3\(^{rd}\) parties:
  - Bank loan;
  - Municipal Bonds (MB);
  - Municipal Pooled Financing (MPF);

\(^1\) For more see: Burns (2007); Greenwood/ Levin (2007).
• Partnership: Pay for Success in Social Public Private Partnership (PSSPPP)

Below are the extracts from the four discussion documents. The full documents can be retrieved from the Conference webpage tab: https://www.salga.org.za/dev/miif/index.html#register

5. Tax Incremental Financing

A Basic Theory of Property Value Capture

The values of (real estate) properties depend on the infrastructure that they are connected to. The infrastructure enables owners or residents to get into exchange with each other – economically or socially. It thus increases their productivity or their cohesion.

Typically, infrastructure is a public good, which means that individuals cannot be excluded from its use; and in their use, they do not rival with each other. Therefore, it has become a government task to provide infrastructure. If the impact of a specific infrastructure item is local, then it is the task of the respective local government to provide it.

An inherent problem in the provision of public goods is free-riding. Individuals can basically use them without paying. To solve this problem, a government has got the power to tax. For the specific case of local public goods, the local government has got the power to tax property. Since (real estate) property is immobile, owners can hardly avoid to pay this tax. Hence, it is considered a very strong and effective government instrument.

In theory, one may affirm that the property tax is fair. The reasoning goes as follows, taking a park as an example:

If a local government invests into a park, then it has to bear the costs of this investment. In specific, it has to pay the gardeners that keep the park well-kept and attractive. However, it may not be efficient or fair to build a fence around the park and to demand an entrance fee from visitors. They thus could enter for free and socially engage and recover for higher productivity; and these are just two ways in which they benefit from the park. Normally, the visitors will be the property owners or residents out of the neighbourhood. They can freely benefit from the park because they live within its vicinity.
What thus happens is that the benefits from the park capitalize into the property values of the neighbourhood. The properties become more valuable because they also give access to a local public goods – to a park that the local government has invested in.

The government’s claim to be compensated for its investment costs, based on the value that it has created for others, is called “value capture”.

**The Property Tax as the Basic Instrument**

The basic instrument for local government to execute property value capture is the property tax. This tax can be judged as fair in the sense of the “benefit principle”. Citizens pay for a public service to the degree that they (potentially) benefit from it. – The more property owners benefit from a park, the more these benefits capitalize into the values of their properties, the more they have to pay in property taxes.

Based on this theory, it seems rather easy to justify this type of tax. In practice, however, it has shown to be rather difficult to implement. The reasons for these difficulties lie in some special characteristics of (real estate) property; which are:

1. Real estate is immobile; it is bound to a specific piece of land. Each piece of land is unique – also in the benefit that it offers.
2. A real estate can be designed and created individually. It thus can get a very specific functionality.
3. A real estate is normally a long-term investment. However, the maximum duration of useful life depends on the initial quality of the structure and the investments in maintenance that are made.
4. A real estate is an extremely illiquid form of capital; which means that it cannot be transformed so easily into any other form.
5. The transaction of a real estate incurs relatively high specific transaction costs. Difficult parts of the transaction are in particular:
   a. To assess the quality of the real estate;
   b. To include all relevant aspects into the contract;
   c. To execute all the rights and obligations;
   d. To monitor the execution;
   e. To move tangible and non-tangible assets from one location to another.
Therefore, the (fair) value of a real estate is difficult to measure. To get as close as possible to that value, there are three basic approaches:

1. The “sales comparison approach”: The valuer compares the characteristics of the property to be measured with those of other properties that are similar and of which the values are already known, because they have been recently sold. She infers from these values to the searched value; with some corrections, due to the given differences in characteristics.

2. The “cost approach”: The valuer sets up a model in which the land is vacant. Then, she calculates what it would cost to:
   a. reproduce the same estate; or
   a. replace it by a different one which – nevertheless – offers the same benefit.

3. The “income approach”: The property is regarded as an investment object. The valuer predicts its cost and income streams and calculates its capital value out of them. As indicators, she may use, for instance, the Net Operating Income (NOI) or the Net Present Value (NPV).

Moreover, for the purpose of property taxation, in the sense of the benefit principle, it needs to be found out which is the share of the value that comes from local public services. To break down the value of a property into different value factors or contributors, one can use for instance a method called “hedonic pricing”. However, this method is also very demanding with respect to the assumptions, conditions, data and application. Altogether, the probability of error in measuring the property value share from local public services can become considerably high.2

Because of all the difficulties in the implementation of property taxes, property owners tend to encounter their tax bills with special scepticism or aversion. To reduce this tendency, the local government should invite property owners to participate not only in the legislative but also in the implementation process. Participation might improve the valuation conditions, the collection of data, the valuation results and generate understanding, consensus or, at least, acceptance.

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Property Value Capture in South Africa – The Legal Framework for Property Taxation

The Constitution of the Republic of South Africa from 1996 empowers its municipalities to impose “rates” (taxes) on property (Section 229). The fundamental legal rules for property rates are stipulated in the:

“Local Government: Municipal Property Rates Act (MPRA)

In its preamble, the MPRA defines the following purposes of property rates:

• To be “developmental in nature”, which mainly refers to service delivery and economic and financial viability;

• To be a “sufficient and buoyant” source of revenue which helps to overcome historical injustices and imbalances.

Hence, the purposes go beyond value capture. They invite municipalities to think in their property rate policies also about the dynamics and distribution of economic and social capital, in space and time.

The Act’s rules leave a lot of room for conceptual differentiation and different treatment. Nevertheless, in particular, chapter 2, part 1, section 3 stipulates that:

“(3) A rates policy must—

a. treat persons liable for rates equitably;

b. determine the criteria to be applied by the municipality if it—

(i) levies different rates for different categories of properties;

(ii) exempts a specific category of owners of properties, or the owners of a specific category of properties, from payment of a rate on their properties;

(iii) grants to a specific category of owners of properties, or to the owners of a specific category of properties, a rebate on or a reduction in the rate payable in respect of their properties; or

(iv) increases rates;

c. take into account the effect of rates on the poor and include appropriate measures to alleviate the rates burden on them;

d. take into account the effect of rates on organizations conducting specified public benefit activities …;
e. take into account the effect of rates on public service infrastructure;
f. allow the municipality to promote local, social and economic development;

In part 4 of the same chapter, the MPRA gives rules for the establishment of special rating areas:

“22. (1) A municipality may by resolution of its council—

a. (a) determine an area within that municipality as a special rating area;
b. (b) levy an additional rate on property in that area for the purpose of raising funds for improving or upgrading that area; and
c. (c) differentiate between categories of properties when levying an additional rate referred to in paragraph (b).

(2) Before determining a special rating area, a municipality must—
a. (a) consult the local community, including on the following matters:
   (i) the proposed boundaries of the area; and
   (ii) the proposed improvement or upgrading of the area; and
b. (b) obtain the consent of the majority of the members of the local community in the proposed special rating area who will be liable for paying the additional rate.

(3) When a municipality determines a special rating area, the municipality—
a. (a) must determine the boundaries of the area;
b. (b) must indicate how the area is to be improved or upgraded by funds derived from the additional rate;

Here, the MPRA gives guidance for a special funding of a special development project. The link between the special rate and the special investment is, however, kept rather flexible. A municipality can, for instance, in coordination with the community, choose boundaries for a special rating area that deviate from the impact area of the infrastructure. Thus, redistribution may result from that deviation that goes beyond or even contradicts the principle of property value capture.

Chapters 4 to 8 determine how the municipality has to value property. As the general basis of valuation, chapter 5 sets the market value, which is defined as:
“46. (1) … the amount the property would have realized if sold on the date of valuation in the open market by a willing seller to a willing buyer.”

This definition is very much in line with value capture. The value of a property finally arises out of the demand for it, because its use offers or promises to offer a certain benefit. A question with respect to TIF might just arise out of the “date of valuation”: Can it also be projected into the future?

About the valuation practices, methods and standards, the MPRA states:

“45. (1) Property must be valued in accordance with generally recognized valuation practices, methods and standards, and the provisions of this Act.

(2) For the purposes of subsection (1)—

a.   (a) physical inspection of the property to be valued is optional; and

a.   (b) comparative, analytical and other systems or techniques may be used, including aerial photography and computer-assisted mass appraisal systems or techniques, taking into account changes in technology and valuation systems and techniques.

In part 2 of chapter 4, the required qualification, functions and conduct of municipal valuers, assistants and data collectors are described.

The MPRA thus sets standards for valuers and valuation that might build trust of property owners into them.

As a valuation process also might fail, property owners are given rights to appeal. In chapter 7, the functions of appeal boards are defined. For rights and options for the community to participate in the whole property taxation process, the MPRA also refers to the Municipal Systems Act. Altogether, the two Acts lay a solid foundation to lead a participation process that might generate more fairness, equity, efficiency, understanding and acceptance in value capture.
6. Municipal Bonds

What are municipal bonds?

A municipal bond is a standardized debt instrument, a debt security, issued by a municipal entity.

In the following categories, bond standards may be set:

- Type of issuer: The issuer can be any type of municipal entity, as also for instance a school council or a local public water board.

- Number of issuers: A bond can be issued by one (single) or several (joint or pooled) municipal entities. In the latter case, the joint issuers need to find arrangements on how they share the
  - Rights and obligations,
  - Revenues and expenditures,
  - Assets and liabilities, and
    - Risks that arise out of the joint bond venture.

- Principal: The principal should be fixed to an amount that is:
  - high enough so that the relative transaction costs are kept reasonably low; and
  - low enough so that also lower income citizens can afford to buy a municipal bond.

The total amount of debt can be varied (in multiples) by the number of municipal bonds issued.

- Maturity: A major distinction is made between short term municipal bonds (so called “notes”) and long term ones. The criterion for notes is one year of maturity, as a maximum. Municipal entities normally use these notes for bridge financing—so when they expect to collect some revenue, soon, but need the cash, now. Long-term bonds are normally integrated into infrastructure projects. A term of 10 or 30 years is still very common.

- Coupon: The price for borrowing is the interest. Bonds express their interest claims in coupons. For municipal bonds, a coupon for every half a year is a common standard, too.
• Securitization: There are two main principles of securitization:
  o General obligation: Principal and interest are secured by the “full faith and 
    credit” of the borrower, including all its assets and revenues, as there are for 
    municipalities, in particular: charges, fees and property rates.
  o Project obligation: Principal and interest are secured by the assets and 
    revenues that are generated by the specifically funded (infrastructure) 
    project. The lender is given a priority right on these. All other assets and 
    revenues of the borrower are excluded from that obligation.

• Use of funds: Here, we distinguish between the following two types:
  o Free use: The issuer can spend the principal for whatever purpose.
  o Specific use: The bond stipulates the purposes that the principal is spent 
    for. In a “green” bond, for instance, the principal is dedicated to specific local 
    public projects with a positive ecological impact [see next subsection].

• Taxation: Municipal bonds are taxable or tax exempt. This distinction can be made 
  with respect to different tax authorities and different tax types. One reason for a 
  bond to be tax exempt is that the benefits that the bond holder generates for the 
  municipality or other public entities are not fully covered by the interest payment.

• Special options: Municipal bonds can offer different options to the borrower or to 
  the lender to change the status of the bond during the tenure. For instance, if the 
  municipal bond is callable, the borrowing municipal entity is allowed to redeem 
  it, before (stipulated) maturity. Certain standards may be in place as to when and 
  to what degree the municipal bond can be redeemed.

What makes a municipal bond essentially different from a similarly standardized 
 corporate bond, is the special status of the issuer. – Just to remember:

A municipality has its own territory. On this territory, the local community gives it a 
 mandate. From that mandate, specific powers and functions are derived. To justify 
 its powers and fulfil its functions, the municipality has to follow specific rules and 
 processes. In an intergovernmental system, these powers and functions, rules and 
 processes become related to other public entities of the same or a different public 
 sphere.

Hence, due to this special status, the following aspects can become rather relevant 
 for a municipal bond:
- Economic and social development and planning: The issuance of a municipal bond should be part of a broader and consistent socio-economic plan by the municipality.

- Positive externalities: A major task of local government is to provide those goods to the community which generate significant positive externalities, as it is typically the case for infrastructure. The specific problem with those goods is to generate sufficient own revenue.

- The power to tax: In order to internalize externalities, the government is given the power to tax. However, citizens might still find ways to avoid or evade taxes.

- Intergovernmental grants: If also other spheres of government profit from municipal infrastructure delivery, it seems easy to justify that they contribute to the cost recovery. However, different entities may have different norms, different incentives, preferences, endowments and information. Hence, there may be an increased risk of misallocation of resources.

- Public participation: According to democratic principles, a municipal entity needs to integrate the community into their decision making. The process may thus diverge in form, content and speed from the expectations of a bond market.

- Social cohesion: The effectiveness of infrastructure funding and delivery may be highly correlated with the degree of social cohesion in the respective municipality.

All these aspects will thus determine the municipal bond market outcomes.

The essential outcomes are:

- Price;
- Fluctuation of price;
- Liquidity/ transaction volumes;
- Yield/ return.

To make municipal bonds successful on the market, it needs a highly detailed, structured, skilful and diligent management process.

The main players and measures in such a process typically are:

- Municipal issuer: The municipality first finds out what its financial capital needs are. The respective figures may be derived from its general socio-economic planning. Then, it checks to what degree these needs could best be covered by municipal bonds. It integrates those figures into its budgetary planning process.
• To implement its borrowing plans, the municipality may be required to get the consent from its community. A very explicit consent could be given in a specific referendum. The reason for the requirement would be that municipal borrowing particularly affects the financial plannings of the citizens. In one way or the other, they will have to carry the costs in the future.

• If consent is given, the municipality can start to promote the issuance of its bonds. This is in particular done via an “official statement”; which is equivalent to a “prospectus” in the case of corporate issuance. Thus, the official statement informs about the financial status and plans of the municipality, in general and in specific. In specific, it informs about:
  o the terms and conditions of borrowing;
  o how the borrowed money will be spent;
  o how the debt is going to be repaid.

• Thus, a contract is drafted between the municipality and potential bond buyers/lenders.

• If a full contract is successfully concluded, the bonds issued, the municipality has to provide its creditors and other stakeholder with relevant news. In a standard way, this will be done via Special Bond Reports or Material Event Notices.

• Municipal advisor: The municipal advisor is an expert for municipal bond management who tries to promote the particular interests of the municipal issuer. Thus, she analyses the relevant financial state of the issuer, explains the issuance process to them and advises them on how to optimally proceed. One major part of the advisory deals with the management of the stakeholder relationships.

• Bond counsel: The bond counsel mainly consists of legal experts. The municipality establishes it to deal with legal matters, related to the bond issuance. Thus, the counsel performs in particular the following tasks:
  o To monitor compliance with all applicable laws and regulations;
  o In particular, to interpret and apply tax regulation;
  o To draft relevant legal documents, as the loan agreement, for example;
  o To document and register relevant legal actions;
  o To anticipate and advice on (potential) legal issues.
Credit rating agency: A credit rating agency (CRA) assesses the credit-worthiness of the municipal issuer, in general, or the issued bond, in particular. The credit-worthiness describes the ability of the issuer to redeem the bond. For its assessment, the CRA uses standardized information, categories and methods. It may give an outlook and recommendations on how the credit-worthiness could be improved.

Underwriter: The underwriter is the administrator of the issuance and the distribution of the bonds. This organization serves as a coordinator between demand and supply on the bond market. It thus analyses given market conditions and derives terms and conditions for a bond that could be market suitable or even optimal. To strengthen its commitment, the underwriter in some cases assumes parts of the issuance risk. This means that it will keep those bonds which could not be sold under the terms and conditions suggested by it.

Broker: The broker is the organizer and executor of the bond transaction. Since municipal bonds can be highly complex products, their transactions may still incur a lot of measures. After the commitment to a transaction, several different exchanges have to be made. There are different obligations for buyer and seller, which may be fulfilled in different points in time. These obligations incur transaction risks. The broker uses his special technical, human and organizational capacities to optimally manage these risks. The transaction results will be documented – in accordance with legal requirements.

This management process is guided by an extensive system of laws and regulations, by market conventions and by the specifically developed capacities of the actors.

What are Municipal Bonds Strengths and Weaknesses?

The strengths and weaknesses of municipal bonds can more easily and adequately be detected, analysed and evaluated in comparison with their main alternative. This alternative is normally municipal bank lending. The three main differences between these two types of lending are:

1. Bundling: In municipal bond lending, activities are less bundled; which means, there are more different and independent actors involved in the process.

2. Competition: Municipal bond lending tends to be more competitive, because there are more actors involved; and processes, services and products are more standardized.
3. Control: Municipal bonds spread their effects more widely. It therefore needs a wider network of control to make the effects beneficial. Such a network needs to be carried by some stronger institutions.  

Thus, the following points can be considered as the basic, potential strengths of municipal bonds:

• They promote specialization; which promotes greater knowledge.
• They create competition; which leads to improvements of services, in quality and price.
• They enforce public disclosure; which forms a basis for a fruitful public discussion and an effective public control.
• They are marketable/liquid; which gives individual lenders more flexibility in their revenue, expenditure, asset, liability and risk management.
• They are dividable and distributable; which makes an overall reduction of risks more efficient.

The basic weaknesses of municipal bonds might be:

• Their terms and conditions are less specified, less flexible.
• The relationship between debtor and creditor is more anonymous, less trustful, less intensive and less fruitful.
• There are less synergies arising out of different activities in the planning and implementation process.
• There are more transaction costs, as for example:
  o Municipal advisor fees and expenses;
  o Bond counsel fees and expenses;
  o Underwriter’s discount;
  o Bond insurance premiums;

3 See GIZ (2012); Kim (2016).
Rating agency fees;
Registration costs.

How much these basic, potential strengths can be realized and the basic, potential weaknesses mitigated, depends on the following factors:

• Financial market conditions: The better the conditions are on the overall financial market, the stronger municipals bonds can become as one of the options. Essential conditions are:
  • number and structure of participants,
  • values and preferences of participants,
  • information technology,
  • transaction costs, and
  • regulation.

• Institutional structure of and around the municipality: A municipality is embedded into a wider institutional structure (laws, regulations, conventions). The ways, in which it is allowed to practice bond borrowing, depend on this structure. Inner and outer structure should be compatible.

• Individual and institutional capacities: It depends on the specific capacities, the respective knowledge and skills, how well the municipality can practice bond borrowing.

• Financial state of municipality: Bond borrowing becomes easier, when the municipality is in a good financial state, in particular, when it has a strong own-revenue basis and extensive, attachable assets.

• Type of infrastructure to be funded: A municipal infrastructure project can be more easily funded via bonds, when the project is technically and financially rather less complex and rather routine or standardized.
7. Municipal Pooled Financing

What is “Municipal Pooled Financing”? Municipal Pooled Financing (MPF) is a cooperation between municipalities to jointly borrow money. Specific, joint rights and obligations arise out of such a cooperation; which refer to:

1. Liabilities;
2. Assets;
3. Expenditure;
4. Revenue;
5. Risks;

The Potential Strengths, Weaknesses, Opportunities and Threats (SWOT) of MPF

Strengths and Weaknesses

In general, the following potential strengths can be ascribed to MPF – as an infrastructure funding tool:

1. Funding options: MPF gives the municipalities another option and thus more power and flexibility in its general financial management. There can be a higher diversification of risks.
2. Higher market power: Jointly, municipalities reach a higher capital market share on the demand side. Thus, they might be able to correct a former imbalance of power.
3. Lower average administration costs: Each member spends relatively less money on borrowing capacities and structures.
4. Adaptation to cash-flows: The financial rights and obligations can be shared in such a way that they better fit the cash-flows of the funded (infrastructure) investments.
5. Positive incentives to improve credit-worthiness: Members implement rules and put pressure on each other to improve their credit-worthiness because each one profits from the other’s improvement.

6. Generation and use of more specific capacities: The specific MPF-institutions incentivize and integrate a specific knowledge that may help the municipalities to make their financial management, their borrowing more economical, efficient, effective and equitable.

**Potential weaknesses of MPF are in general:**

1. Less transparency: An MPFM is less transparent due to the integration of different elements/members and strategic motivations and behaviour.

2. Costs for additional structure: Additional costs are incurred by setting up and maintaining specific MPF-capacities. These capacities might gain an own (cost) dynamic over time.

3. Less suitable internal conditions: Due to collective decision-making, single members have to move away from their individually optimal options.

4. Less suitable external conditions: The new, larger, more complex environment imposes norms on the mechanism which are less suitable for individual members – so for instance, in accounting.

5. More difficult and costly rating: As MPF is more complex, an MPFM is more difficult and costly to rate. The probability of error is higher.

6. Moral hazard between members: Based on internal asymmetries (in information or power), individual members can avoid to make their due contributions.

7. Moral hazard between MPFM and lenders: Based on external asymmetries, lenders may impose unjustified obligations on the MPFM; and – in reverse – the mechanism may fail to meet justified ones.

**Opportunities and Threats**

The opportunities and threats for an MPFM arise out of its specific environments. These environments create them, based on their own purposes and characteristics. For an MPFM, some of the most relevant environments are:
1. Financial capital market;
2. Foreign exchange market;
3. Central banks;
4. Rating agencies;
5. Political market.

**Credit-Worthiness**

**The General Concept**

The conditions under which a PFM can borrow money depend on its credit-worthiness. Its credit-worthiness is negatively related to the credit risk that it causes. The credit risk can be defined as an assessment of the likelihood that the borrowing entity will default on its obligations. Basically, the higher this likelihood is, the higher (potential) lenders will set the conditions for a transaction. The conditions include not only the interest rate but also securitization, payment modalities, reporting or (internal) policy measures.

In a complex world, it is difficult to measure credit risk. Thus, there are a lot of different concepts and tools to do this. Normally, one would derive a specific concept for a class of borrowers and use a combination of tools, also following practicability criteria. In our case, the class of borrowers would be: MPFM (in South Africa).

**Some of the basic tools to measure credit risk are budget ratios; as for instance:**

- Debt / Capital Balance;
- Debt Service / Operating Revenue;
- Operating Expenditure / Operating Revenue;
- Capital Expenditure / Total Expenditure;
- Own Source Revenue / Total Revenue;
- Personnel Cost / Operating Expenditure.

But credit-worthiness also depends on the capacities of the organization. Thus, it
should be looked at the following aspects:

- Specific capacities of the main decision-makers;
- Governance structure;
- Accounting standards;
- Communication network;
- Reputation.

Finally, the organization’s ability to meet its obligations depends on the strength of its environment. Some indicators of this strength are:

- Real GDP (per capita);
- Unemployment rate;
- Poverty rate;
- Political stability;
- Ecological risk.

As borrowing is a time line interaction, these indicators should also be analysed in a time line. In this sense, past values are recorded and future values projected/extrapolated.

The whole credit rating should be performed in a holistic spirit. Such a spirit recognizes that the interaction between two complex social systems, lenders and borrower, can be highly dynamic and thus difficult to predict. The whole can be different from a simple addition of its parts. This also means that the credit risk of a PFM can be different from the mean of the credit risks of its members.

**A Specific Institutional Design for South Africa**

The quality of an MPFM depends on its environment. The design of such a mechanism should therefore be developed in coordination with it. Presently, the specific South African environment can be described as follows:

Favourable characteristics are:
• A clear developmental perspective;
• An investment-conducive basic legal framework;
• Strong democratic institutions;
• Strong international relations;
• A young and dynamic population;
• Open and intensive economic, social and political discourse.

Unfavourable characteristics are:
• Weak economic growth;
• High indebtedness of central government;
• High indebtedness and low disposable income of private households;
• Deficiencies in local public revenue management;
• Underdeveloped risk management;
• Deficiencies in local accountability;
• Weak culture of compliance and sanctions.

Hence, in order to make MPF a useful funding instrument in South Africa, two main tasks have to be fulfilled:
• There exists a very special, value and tradition-based, extensive and sophisticated institutional design.
• Unfavourable characteristics of the specific environment have been isolated, removed or turned into favourable ones.

The essential parts of such an institutional design could be:
1. A framework for legal forms of financial institutions;
2. An MPFM membership framework;
3. An MPFM asset and liability framework;
4. An MPFM revenue and expenditure framework;
5. An MPFM risk management framework;
6. An MPFM accountability framework;
7. An external financial emergency authority;
8. An MPFM support framework.

8. **Pay for Success in Social Public Private Partnership (PSSPPP)**

**General Description of PSSPPP**

“Pay for Success in Social Public Private Partnership (PSSPPP)” is a partnership between public and private sector entities to achieve specific social goals by providing specific services, and in which the providing partners are paid according to successes.

The basic rationale of such a partnership is to institutionalize the cooperation between entities that have each an own identity, follow a specifically adapted logic and have particularly relevant strengths. The central institution of a PSSPPP is its contract; which in particular stipulates:

- What the social goals are;
- What the measures to achieve them are;
- Which tasks are assigned to which partner;
- What the rights of a partner are;
- What the responsibilities of a partner are;
- Which resources are required;
- How resources are procured, developed and used;
- How success is measured;
- How success translates into payment/gain;
- How failure translates into loss.
The typical participants of a PSSPPP are:

- Government: The main owner of the social goals. Thus it initiates and leads the partnership.
- Service providers: They implement the measures that are intended to achieve the social goals.
- Investors/ Funders: Under agreed terms, they provide financial resources for the partnership.
- Intermediary: Helps to transform conflicts between participants into common achievements.
- Evaluator: Measures and interprets achievements according to pre-set indicators and methods.
- Beneficiaries: They receive the services and give feedback on how they assess their qualities.

A PSSPPP seeks to combine the relevant knowledge of different partners out of different sectors to achieve a social goal in an efficient manner; which means:

- A pre-determined social goal is achieved with a minimum of resources; or
- A maximum social goal is achieved with a pre-determined amount of resources.

The partnership thus takes place in at least three spaces: a social, an economic and a political one; as for instance:

- The decision to initiate a PSSPPP is political.
- The main goals are social.
- The measures are chosen and used economically.
- The government is a mainly political partner.
- The service providers and the investors are mainly economic.
- Intermediary, evaluator and beneficiaries are mainly social.
A SWOT-Analysis for PPP

Basically, strengths (S) and weaknesses (W) do not exist by themselves. They are related to a specific context in which they appear as such. The considered context can be theoretical or practical, in nature. The extent of a strength or a weakness would normally be measured or estimated in comparison to something that has a similar function.

In our case, the strengths and weaknesses of a PSSPPP have been identified in the context of various social and economic theories and mainly in comparison to a social public project in which the service providers are chosen in an open tender process.

Thus, the theoretical strengths of a PSSPPP are:

- There is a more holistic approach in the planning and realization of the project; in particular, inter-connections and life-cycles are better considered.
- The public sector can mobilize more and more specific financial and non-financial resources for its project.
- The public partner can better integrate and use specific knowledge of the private sector.
- The private sector gets more involved into social matters so that it considers social impacts more carefully.
- The private partners are given stronger and more lasting incentives to perform.
- The private partners are given more space to:
  - Use their own, sector-specific skills;
  - Develop project-specific capacities;
  - Develop and implement innovations.
- There is more flexibility in the service delivery.
- Partners can be made more easily accountable.
- Risks can be better managed; as for instance, they are assigned to the partner that can absorb them best.
Based on a more comprehensive M&E, the efficiency and effectiveness of services can be improved.

**The theoretical and thus potential weaknesses of a PSSPPP are:**

- Partners can free-ride where there is only implicitness in the contract.
- There are additional transaction costs.
- By the influence of private partners, social goals might be neglected.
- There is a lack of efficiency due to less competition.
- The selection of private partners can be biased; in particular, they are chosen according to their political power.
- Political inner-dynamics decreases the speed and quality of service delivery.
- There is less control over the process.
- Partners cannot be exchanged so easily when they fail.
- The performance evaluation is deficient; which can mean that:
  - There are no suitable indicators for relevant aspects of the project;
  - The measurement of given indicators is difficult.

The context in which a PSSPPP – with its specific strengths and weaknesses – find itself can be positive or negative. In the first case, we call it an opportunity (O), in the latter case, a threat (T).

**Typical opportunities for a PSSPPP would be:**

- Stakeholders have a good understanding of and high commitment to the principles of sustainability.
- There are external institutions that support partnerships for sustainable development.
- There exists a good general relationship between the public and the private sector.
The social goals are rather easy to define and their achievements rather easy to measure.

There is good practice in generating and keeping special capacities and know-how.

There is high integrity and good conflict management; especially when conflicts arise out of the differences in logic of the different partners.

Some typical threats are:

- Partners just follow their own typical logic.
- Communication breaks down.
- There is no positive spirit that goes beyond the explicit regulations of the PSSPPP-contract.
- Impatience, distrust and pessimism cause partners to invest less.
- The project is not sufficiently integrated into already existing structures and plans.
- The benefits do not internalize; which means, there is no direct or indirect return for those who funded or created them.4

**PPP in South Africa**

**Institutional Framework**

The South African government has made special efforts in developing an institutional framework for PPPs. However, there exists a divide between the national and the provincial sphere on the one side, and the local sphere on the other side.

For the national and the provincial sphere, the Public Finance Management Act (1999) has become the basis of the PPP institutional framework. As its main element, the National Treasury (NT) issued Regulation 16 (2004). The NT-PPP-unit PPP Manual further elaborates on this regulation. This manual has been structured along the NT-PPP-Project-Cycle; which consists of the following 6 phases:

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4 See: Horesh (2000); Liebman (2011); Liebman/ Sellman (2013); Social Finance (2016); USAID (2006); Wikipedia (2017a) and (2017b); World Bank (2016).
1. Inception;
2. Feasibility Study;
3. Procurement;
4. Development;
5. Delivery;

The cycle is explained in 9 modules; of which at least two apparently have not been concluded.5

For the local sphere, PPPs are based on the Municipal Systems Act (2000) and the Municipal Finance Management Act (2003). A respective elaboration of that base in a separate manual has been planned, but apparently not yet been realized.

NT Regulation 16 on PPPs

NT Regulation 16 brings clarity into two PPP issues:
1. The meaning of key terms;
2. Treasury approvals.6

The NT PPP Unit

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5 See NT: PPP Unit (2004). The 9 modules have the titles: 9 Modules: M1: South African Regulations for PPPs; M2: Code of Good Practice for BEE in PPPs; M3: PPP Inception; M4: PPP Feasibility Study; M5: PPP Procurement; M6: Managing the PPP agreement; M7: Auditing PPPs; M8: Accounting Treatment for PPPs (to be inserted); M9: An Introduction into Project Finance (to be inserted).
6 See NT: PPP Unit (2004), especially Module 1.
In 1997, the South African government established a task team to develop an enabling environment for PPPs. Some of the task team’s major activities were:

- To learn from international experience, also by including technical and financial assistance from organizations for international cooperation;
- To assist own, domestic, pioneering projects, which were related to: toll roads, security prisons, water services and tourism concessions;
- To draft a strategic policy framework, which also informed Treasury Regulations;
- To prepare the establishment of an institution for the facilitation and improvement of PPP projects according to common values.

In 2000, a special PPP unit was established in NT.

**Its vision is:**

Facilitating and enhancing quality public service delivery by being a catalyst for efficient, effective and value-for-money best practice solutions

Its mission is:

- To enable National Treasury and provincial treasuries to effectively regulate PPPs
- To evolve as a dynamic and sustainable center of excellence for PPPs
- To drive PPP deal flow by identifying project opportunities that yield value for all stakeholders
- To provide technical assistance to public institutions through project feasibility, procurement and management; and
- To promote an enabling environment for PPPs by:
  - facilitating certainty in the regulatory framework
  - developing best practice guidelines
  - providing training
  - disseminating reliable information; and
  - driving black economic empowerment in PPPs.
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