POLICY FRAMEWORK FOR MUNICIPAL BORROWING AND FINANCIAL EMERGENCIES

Department of Finance

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1. INTRODUCTION: BACKGROUND AND OBJECTIVES

1.1 Background

Municipalities are fast emerging as the fulcrum of South Africa's newly created system of multi-sphered government. First, the Constitution recognizes local government as an independent sphere with its own unique set of roles and importance. Second, it is central to the implementation of Government's growth strategies. For example, over 80% of the nation's GDP is urban based, with the economic nodes concentrated in the country's metropolitan centres. The governance and management of these areas is obviously critical to achieving government's broader economic objectives. Similarly, there is greater recognition that non-urban local governments will play an essential role in facilitating Government's push for integrated rural development. Third, the delivery of basic municipal services to all communities - urban and rural - is dependent on the effective performance of local government. Finally, at the political level, the 1999 national election campaign revealed the importance communities gave to their interface with local councils and administration – an interface that may well signal the strength of South Africa's new democracy.

In sum, the final shape, capacity and performance of local governments in South Africa will have direct implications for the political, social and economic fabric of the society.

Recognizing this, government published the *White Paper on Local Government* in March 1998. The intention of that document was to provide a general framework for the formulation of more detailed policies and legislation on a range of matters, including the fiscal and financial structure of the local sphere. As with the document on fiscal transfers from central to local government ("*The Introduction of an Equitable Share of National Revenue for Local Government*", published by the Department of Finance in 1998), the document that government publishes today is a detailed follow-up to the White Paper. It expands on the framework for municipal finance and focuses, in particular, on the design of the regulatory framework for local government borrowing. In addition it deals in detail with the related matter of central government's response to the financial and fiscal difficulties that the municipal sector confronts. *The central objective of this document is thus twofold: first, to provide the policy framework for the overall financial structure of the local sphere and the borrowing powers of municipalities*; *and, second, to outline government's main initiatives in respect of municipalities which face financial crisis*. Any consequential legislation will be tabled in Parliament during 2000, while the envisaged fiscal programmes will be introduced from fiscal year 2000/01 onwards.

1.2 Imperatives underlying policy framework

Four key factors have driven the formulation of the policy framework presented here:

- First, *the Constitution* – at S. 230 – both grants to municipalities the right to borrow and creates the expectation that these rights will be coherently regulated by legislation passed by central government. To date, central government has not developed a sufficiently thoroughgoing regulatory framework, established in law, in this area. In particular, the elements of existing legislation which address local authority borrowing issues (e.g. Section 10G of the Local Government Transition Act, as amended) do not properly take account of the changed institutional and policy environment which now exists. There is thus currently a partial regulatory and legislative vacuum in respect of the financial structure of the local sphere and the borrowing powers and obligations of municipalities. This document is meant to provide the policy basis for the legislation and regulations which will address this vacuum.

- Second, and due in part to the existing vacuum, *the municipal debt market has stagnated*. Studies conducted by the Department of Finance indicate that between March 1998 and March 1999 direct private sector lending to municipalities grew by only R1,84bn. Of this, almost R500m was accounted for by one institution (INCA.) Moreover, over 80% of this growth took the form of short-term lending. The long term debt market – which is especially critical for providing financial resources for municipalities for investment in infrastructure which is critical to both economic and social development (water, power, roads and waste) – has largely dried up.

- Third, *policy imperatives* dictate the need for clear legislation on borrowing powers. Government has repeatedly emphasised (e.g. in the *Municipal Infrastructure Investment Framework,* 1995, and later in the White Paper) that private finance will need to form an important source of funding for capital investments in the municipal sector. But, unlike the pre-1994 era, such funding will not be guaranteed by the central fiscus. Instead, municipalities will have to raise private finance on their own books and bear the responsibility for servicing the debt. *This policy shift from national guarantees to local responsibility for private debt now requires the introduction of a legal and regulatory framework that clarifies the rights and obligations of borrowers and creditors.* Without it, a broad municipal finance market may be extremely slow to develop with market players remaining unwilling to make investments in the municipal sector. Ultimately government's delivery goals will remain hostage to policy uncertainty.

- Finally, many municipalities have encountered *increasing financial difficulties* in recent years. For a number of reasons it is important that government respond systemically to this situation. First, it is obviously critical that the delivery of essential services - which is threatened in some cases - is maintained. In acting here, however, central government cannot allow itself to get drawn into a succession of ad hoc responses it has neither the capacity nor the fiscal resource to sustain. In other words, central government needs to respond in a manner which provides municipalities' with the incentives to perform their functions effectively and manage their fiscal and financial affairs prudently. Third, in the absence of such a response it is unlikely that local government will be able to attract significant investment from the private sector.

1.3 Context: local government reform

As outlined in the White Paper, local government in South Africa is undergoing a major process of restructuring and transformation in a number of different areas. The overall objective is to give municipalities sufficient resources and capacity to carry out their extensive responsibilities in respect of the development and management of the services for which they are accountable. There are three key dimensions to this transformation.

- At the *institutional* level, the process has involved the amalgamation of the racially fragmented local authorities and the creation of democratic municipal governments. Currently a demarcation process is underway to redefine the boundaries and numbers of the local governments, and legislation such as the Municipal Systems Bill is currently under consideration by government. As a result of these initiatives it is expected that the total numbers of municipalities will greatly reduce. Metropolitan centres will see the emergence of metropolitan governments and a uni-city structure. In addition, outside these metropolitan nodes, the roles and functions of district councils are being redefined especially in relation to smaller primary municipalities and rural local governments.

- Supporting this overall institutional change is the evolving *fiscal framework* for the local sphere. This includes the preservation and strengthening of the local tax bases (rates and levies) and the rationalisation of municipal authority to change tax rates and implement user-charges. In addition, Government has replaced the ad-hoc intergovernmental grants of the apartheid era with a more efficient, equitable, and predictable system of recurrent ("equitable share") and capital (CMIP) transfers. Changes to the municipal accounting system (the introduction of GAMAP) are also gradually being introduced as part of the Public Finance Management Act. Finally, the local budgeting process is being developed to ensure that local governments are placed in the overall MTEF and budgetary framework as an independent third sphere of government. Such changes will facilitate greater transparency in the fiscal management of local governments.

- The third aspect, the *financial framework*, which is the focus of this report, sets out the policy and regulatory environment that will guide and structure access by local governments to debt finance.

Taken together, the institutional, fiscal, and financial frameworks form the policy basis for the establishment of an independent and accountable tier of local government as envisioned in the Constitution and the White Paper. These three dimensions are closely connected. For example, without clarity on the institutional aspects of the demarcation and amalgamation process, local governments will find it difficult to access private finance. The demarcation and amalgamation process will determine the potential fiscal base of the new municipalities and will hence have a major impact on their creditworthiness. Similarly, the fiscal framework will determine the overall revenues of the local government and hence the level of fiscal resources that are potentially available to gear in private finance. *Put differently, by clarifying the rights and obligations of creditors, borrowers, and other tiers of governments, the financial framework will enable local authorities to pledge their fiscal base that emerges from the institutional and fiscal frameworks in an efficient and accountable manner.*

1.4 Limits of the financial framework

Three important limitations to the scope of this exercise need to be noted:

- Another aspect of the institutional reform of local governments is the use by municipalities of public private partnerships (PPPs) to deliver municipal services. PPP structures (such as water concessions) may facilitate direct access to private capital through the revenue base of the service in question rather than via the balance sheet of the local government. Regulating this practice is an important aspect of the financial framework of local governments. This document does not address this issue in any detail. It is being dealt with separately as part of the Municipal Services Partnership (MSP) process which is managed by the Department of Provincial and Local Government.

- The financial framework inevitably raises the issue of access by municipalities to concessional loan finance by local governments, the primary source of which is the Development Bank of Southern Africa. This document does not deal with this matter in any detail. It is a critical and complex area that will require systematic attention once the overall borrowing framework is in place.

- Finally, it is important to recognise that the financial framework will not, by itself, make local authorities creditworthy. A coherent policy and legal framework is necessary condition for this, and it may create incentives for municipalities to operate in a manner which promotes their creditworthiness, but ultimately this is a matter between local politicians, local officials and local voters. Central government can create an environment in which good financial management is rewarded – through facilitating access to capital markets by well-managed local authorities, for example – but it cannot take over the function of local financial management from municipalities themselves.

2. OVERALL VISION

2.1 Problem statement

Municipalities in South Africa have constitutional responsibility for ensuring the delivery and management of local services which are key for both economic growth and social equity, including bulk and reticulated electrical power, water and sanitation, roads and waste removal. In addition they have responsibilities for community facilities (such as sports fields) and, to a limited extent, some social services (such as health clinics.) It is a commonplace that significant investment in the infrastructure necessary for the delivery of these services and facilities is required. The *Municipal Infrastructure Investment Framework* (1997), estimated that an amount of between 67bn and R114bn (1996 prices) would be needed over a 10 year period. Estimates from other sources have produced similar figures.

Stimulating such investment – as well as direct participation through contributions from the fiscus – has been a cardinal principle of government's overall policy towards the municipal sector from 1994. Government initiatives in this area include the Consolidated Municipal Infrastructure Programme (CMIP) and its progenitors, the introduction of the equitable share of national revenue for local authorities, the Community Water Supply and Sanitation Programme, the establishment and capitalisation of the Municipal Infrastructure Investment Unit, the Municipal Services Partnerships policy framework, and so on.

While mechanisms such as PPPs offer ways in which such investment can take place outside of the balance-sheet of local authorities in respect of some local services (with the local authority playing a regulatory rather than a delivery role in respect of a water concession, for example), it is obvious that it is neither possible nor appropriate for all the required investment to take place in this form. It is also clear that in certain sectors – local roads, for example, or many community facilities – the scope for off balance-sheet investment is much more limited than in others (such as water and sanitation.)

Ensuring access by local authorities to sufficient investment capital to allow them to play their constitutionally mandated role is thus a critical element both of the overall structure of governance in SA and to government's delivery objectives. The policy framework outlined here focuses on how this is to be done in an optimal manner.

The market context in which this framework has been formulated constitutes part of the problem it needs to address. As has already been pointed out, access by municipalities to private capital has become increasingly constrained. In recent times there have been only a limited number of new municipal bond issues and few of the previously issued municipal bonds are being traded. A somewhat better primary market remains for municipal short-term debt (such as overdrafts or more formal loans of short fixed maturity), but loan structures of this type are not necessarily well suited for providing capital on the terms which local authorities need for investment in large infrastructure projects with long construction and depreciation tenors. In addition, a number of the larger banks are lending to muncipalities through complicated lease structures which provide tax incentives for the lending institutions which were never intended by central government, with deleterious effects on the central fiscus (and, possibly, unintended consequences at the local level.)

The final important element that this document addresses is the increasing deterioration of the financial and fiscal stability of the municipal sphere. This is closely related to the ability of municipalities to access private capital in that it constitutes the single most important factor underlying decreasing municipal creditworthiness, hence the stagnation in the municipal debt market outlined above. Obviously, however, this situation has implications which extend far beyond the ability of municipalities to borrow and which go to the very core of governance and delivery in SA. It is thus crucial that central government respond to the situation in its own right. In doing so, however, it is important that any responses support the overall financial framework for local government. Government policy in these contiguous areas needs to be coherent and mutually supporting rather than internally contradictory. This document outlines an overall framework which is based on this principle.

2.2 Vision

In this context, and for reasons which are given in detail below, government believes that access by municipalities to private capital markets is an important element of ensuring an efficient system of local government. Ultimately government wishes to promote the emergence of a vibrant and innovative primary and secondary market for short and long term municipal debt.

It is important to stress, however, that in pursuing this goal, central government wishes to avoid the apartheid-era practice of generally underwriting municipal borrowing and, in effect, transferring municipal liabilities onto itself. Government's central objective is not to produce a short-term inflow of "soft" or subsidised funds to municipalities. It is, rather, to develop a sustainable market for municipal debt where risk is properly priced. In the long term an environment needs to emerge where loan finance becomes increasingly available and decreasingly costly to municipalities because the regulatory and institutional frameworks encourage appropriate behaviours, municipalities are increasingly well managed, and ancillary market facilitators are increasingly active.

The main elements of this system are simply described in Diagram I. It is important to recognise that the existing – residual - municipal debt market in South Africa is largely an intermediated one i.e. most loans are originated and held by banks and other financial intermediaries. In the long term, and because it has the potential to lower the cost of capital to the municipal sector, government wishes to see this market supplemented by the development and expansion of a securities market, where municipalities – particularly the larger ones – are issuing debt in the form of bonds which may then be traded in the secondary market. The framework outlined below is specifically designed to encourage this. But it is also meant to promote the growth of a market for other forms of debt (i.e. bank lending), which, from a practical perspective, is where much of the growth in the municipal debt market is likely to lie in the short and medium term.

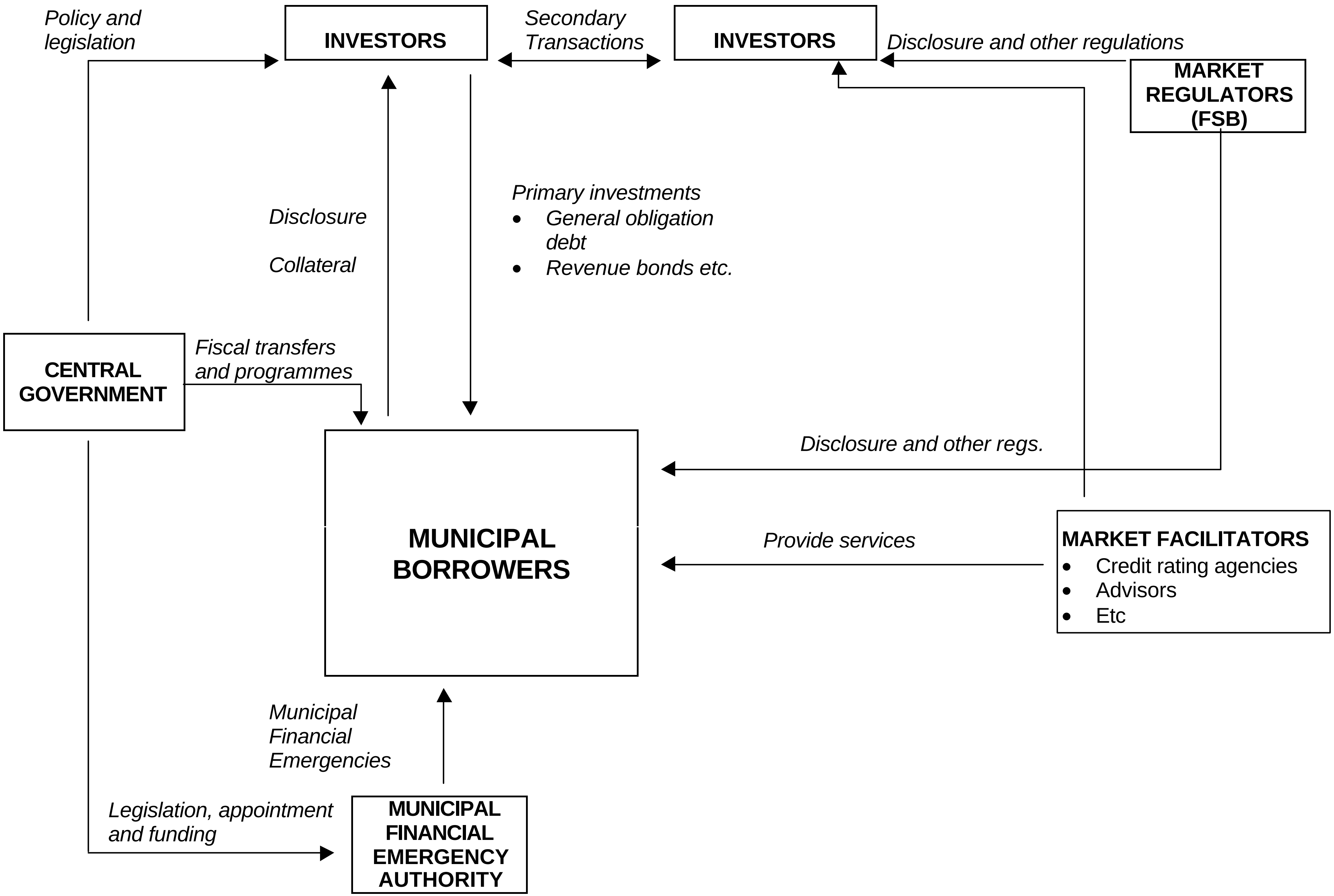


DIAGRAM 1: MAIN ELEMENTS OF MUNICIPAL DEBT MARKET

2.3 Points of departure

The points of departure for this vision - and the detailed policy framework which underpins it - fall into two main categories: the general policy principles which need to be considered in designing such a system; and the existing legal and institutional structure of the local sphere.

2.3.1 Policy principles

There are five main reasons why access to financial markets is considered important for local authorities. These may be summarised as follows:

- *Access to capital*. Local governments in SA are responsible for infrastructure that requires large, "lumpy" capital investments on a periodic basis. Given the extensive needs in SA, financing this investment on a "pay-as-you-go" or "taxation-in-advance" basis is usually neither possible nor efficient. Particularly where the need for capital greatly exceeds what is available on a grant basis from the central fiscus, access to capital markets can provide municipalities with the capital resources necessary to finance infrastructure investments efficiently.

- *Inter-temporal equity.* The benefits of the infrastructure investments that municipalities make often endure for extensive periods and accrue to future generations of taxpayers and consumers. It is equitable for such generations to bear some of the costs of these benefits. Financing investment over time with funds accessed from capital markets allows for this.

- *Efficiency*. Because capital markets allocate capital resources on a commercial basis, capital is allocated efficiently. Moreover, the opportunity costs of capital provide incentives to ensure efficient standards of delivery and discourage "overbuilding" and wasteful investment.

- *Accountability.* Markets tend to punish poor fiscal and management performance through pricing (pushing up interest rates or making capital increasingly scarce.) This can promote accountability and fiscal discipline at the local level. It may also provide other stakeholders (national government; the provinces; aid agencies and so on) with a convenient means to assess the relative performance of municipal governments.

- *Short-term matching of revenues and expenditures.* In the short term – for example within a given financial year – municipal revenues and expenditures are seldom completely congruent in time. Short-term borrowing allows municipalities to deal with this lack of synchronicity.

International experience suggests that achieving these benefits depends on the method of access and the conditions under which this access occurs. In principle there are two main routes here: local governments can access capital markets through "on-lending" from central government, most often through a public intermediary (a financial parastatal), or they may access the markets directly.

In SA the DBSA, which is increasingly active in the municipal market, already represents one "indirect" access mechanism. As already recorded, the interface between this mechanism and the private market in respect of municipal debt is an important issue which will require further attention once the policy framework outlined below is established in legislation. The DBSA aside, there are three broad reasons that government wishes to facilitate direct access by municipalities to the capital markets:

- *Limitation of implicit or contingent liabilities*. It is important to protect central government from ultimately inheriting the debts of local government. When subsovereigns borrow through central government the debts of these bodies easily become the implicit or contingent liabilities of central government. Policy and legislation need to ensure that central government is not perceived as banker of last resort. This is necessary for prudent fiscal management at the national level and is fundamental to government's ability to maintain its macro targets. It is also needed to ensure that municipalities face strong incentives to improve their own management and creditworthiness, knowing that it is unlikely that central support will be forthcoming to compensate for local mismanagement or policy errors.

- *Systemic discipline*. International experience suggests that the indirect borrowing route can result in situations where credit allocation decisions become increasingly less commercial in character. Under such conditions, capital does not necessarily flow to the most productive uses, but to those players which are politically the most astute. In other words the efficiency and accountability outcomes mentioned above become diluted. Incentives for inefficient and wasteful decision-making can replace those which encourage the productive use of capital and tight financial management.

- *Expanding investment resources*. Subsovereign borrowing via the state can result in the "squeezing out" of private capital from the municipal sector, thereby narrowing the aggregate resource available for investment. Moreover, central control of borrowing can also create incentives for local governments to elude these restrictions through innovative off-budget schemes. Centralised borrowing, therefore, does not necessarily increase the ability of central government to control the liabilities of local government, but it may simultaneously diminish the overall financial resource base for investment in worthy projects.

In sum, direct access to capital markets offers the potential for a more transparent, market-based system to develop where there is a greater chance of achieving the benefits of accessing capital markets discussed above. However, it is also true that moral hazard problems – which arise from the assumption by capital markets that borrowing by local governments is ultimately backed by central government - may also develop where there is direct borrowing by subsovereigns from private financial markets. Ultimately, such problems can never be eliminated completely. The basic objective of the detailed policy framework given below is to ensure that such risks are managed through an appropriate regulatory framework while allowing market discipline to guide the allocation of capital in order to maximise the potential benefits that this offers.

2.3.2 Legal and institutional structure

The existing legal (constitutional) and institutional structure of the local sphere is relatively coherent in its fiscal aspects. Broadly speaking, expenditure responsibilities, policy authority and revenue raising powers are congruent. For example, 90% of municipal revenues are generated internally through rates and service charges - the balance being transferred from central government in the form of subsidies and agency payments – and local authorities have wide discretionary powers over the use of these revenues. Moreover, although this needs to be regulated by national legislation, the constitution gives to local government sufficient autonomous fiscal powers for municipalities to pledge their tax base in order to borrow for capital investment programmes. This constitutional and institutional structure offers a solid basis for the development of the decentralised, direct-access framework system that is outlined below.

It should also be noted that the bulk of local revenues (about 60% in aggregate) are generated by the "trading services" – electricity, water, sanitation and refuse removal. This is due largely to the unique role that municipalities in SA play in the direct delivery of such services (which roles may alter as the structure of these industries changes over time.) The important point, however, is that it is in these areas where the need for large scale capital investment – hence borrowing capacity - lies.

2.4 **The policy framework and the overall vision**

The policy framework presented here thus represents a relatively harmonious integration between sound public finance principles and the overall policy direction of government as presented in the White Paper and subsequent documents. This is possible because of the fundamentally coherent fiscal structure of local government as defined in the constitution. The overriding theme that characterises this framework is the decentralisation of fiscal, borrowing and expenditure powers in a co-ordinated fashion. In particular, *the policy framework needs to clarify the rules of the game in three areas: municipal borrowing powers and procedures; information disclosure and market regulation; and executive, administrative and legal procedures when municipalities encounter financial difficulties.* Sections 3, 4 and 5 outline government's approach in each of these areas.

2.5 The policy vision and market segmentation

In respect of their access to capital markets municipalities in SA are typically divided into three broad categories:

- Those which do not require external assistance to obtain commercial loans or access to the bond market. Most current estimates put this number at about 100 to 150 (of a total of about 850) at the current time;

- Those which are not currently viable credits, but which are not rendered incapable of becoming creditworthy by structural factors (such as an insufficient tax base);
- Those which are poor candidates for private capital investment due to fundamental structural weaknesses which are likely to persist for the mid- to long term.

The impact of the institutional restructuring currently underway – particularly the redemarcation of municipal boundaries – on the number of municipalities which fall into each of these categories remains to be seen. Ideally, from a financial point of view, the number falling into the third group will be significantly reduced or even eliminated completely. Notwithstanding these developments, this policy framework does not assume that all local governments will develop the capacity to access capital markets. For example, it is possible that certain municipalities may remain incapable of accessing capital markets in the medium to long term, even after the new policy framework has been introduced and consolidated.

For a number of reasons the market segmentation described above validates rather than undermines this financial framework as a complement to the institutional and fiscal reforms described earlier. First, for fiscally weaker municipalities, the CMIP program and the equitable share subsides – which benefit poorer rather than richer municipalities - provide an important source for funding infrastructure investment and the recurrent costs of basic service delivery. Put differently, intergovernmental grants – which do not impose a financial burden on the recipient municipality - are a more appropriate mechanism for funding investment in very poor municipalities than is credit which they cannot afford.

Second, a vibrant and broad municipal bond market will enable more municipalities to draw on private finance for capital investments allowing fiscal funds channeled through CMIP and other grant mechanisms to be better targeted at the poorer cases.

Finally, a dynamic municipal financial market will in turn enable market investors greater ability to diversify their risks and hence fund a wider range of municipalities than is currently possible.

3. MUNICIPAL BORROWING POWERS AND PROCEDURES

This broad area may, in turn, be broken down into four sub-areas: the entities that may issue debt; their powers to do so and any restrictions on these; the type of debt that may be issued; and the use to which debt finance may be put. These are dealt with in turn.

3.1 Entities authorised to issue debt

At S 230 the Constitution gives a general power to municipalities – which may be regulated by national legislation - to issue debt. In regulating this authority two initial questions arise: should certain municipalities have more circumscribed powers than others and, if so, why? And what of the borrowing powers of entities which are not, strictly speaking, municipal governments but which nevertheless form part of the municipal sphere (e.g. a municipal corporate enterprise which is financially "ringfenced" from the municipality itself?)

In respect of the former, South Africa has a tradition of classifying (or "grading") municipalities for various reasons. In respect of legislatively limiting the ability of some municipalities to issue debt, however, there is little justification for pursuing this approach. There are two broad reasons for this:

- First, there seems to be no need to limit borrowing by legislative or administrative action. In fact, in SA the main problem is lack of access to credit, not overborrowing by uncreditworthy municipalities. Now that there are clearly no sovereign guarantees to municipal debt, the market has clearly demonstrated that it will be selective in extending credit to municipalities, and is best placed to distinguish good from bad credits.

- Second, practices which promote creditworthiness should be encouraged. Classifying a municipality in a way that incentivises it to seek assistance from central government and avoid responsible borrowing on its own would have precisely the opposite of the effect that Government wishes to achieve. Artificially limiting market access runs counter to the basic policy goal of maximizing private investment and encouraging good financial management in order to achieve that access.

The optimum policy approach, therefore, is to avoid legal distinctions amongst municipalities as to their powers and duties with respect to borrowing.

With respect to those entities which are not municipalities per se, local and international experience suggests that, in addition to private service providers, municipal services may be effectively delivered by a variety of agencies – such as municipal corporations - which are not themselves municipal governments, but which operate under the broad ownership or control of such governments.

As indicated in the "*Egoli 2002"* plan to restructure Johannesburg and restore its fiscal health, such entities can play an important role in developing municipal infrastructure. The issuance of debt by such entities should therefore be allowed, but only insofar as, and subject to the qualifications which follow, they do not borrow against the revenue streams or assets of the municipality itself or any other municipal entity. Although municipalities should be permitted to underwrite or guarantee the debt of municipal entities, such underwriting should constitute an act of municipal borrowing. Any such guarantees will need to be issued by the municipality according to the procedures applicable to municipal borrowing, and will need to be transparently recorded as liabilities on the municipal balance sheet. In addition, the practice of establishing entities specifically for the purposes of borrowing should be specifically prohibited.

3.2 Powers to issue debt

There are two distinct levels to the question of debt-issuance powers: whether or not any governmental entity (national or provincial government) *beyond the municipality* should have any overriding authority (through approval or review procedures) over municipalities' power to issue debt; and who*, within the municipality*, should be empowered to issue debt, and how.

With respect to the former, the existing approach, as embodied in the LGTAA should be retained i.e. borrowing should be authorised by the municipal council without any requirement for national or provincial approval[1]. There are three chief reasons for this:

- First, this approach is consistent with the fiscal constitution of the local sphere. Because most borrowings will be secured by revenues which are raised locally, because municipal debt is not underwritten by the central fiscus, and in the context of a hard municipal budget constraint, there is little moral hazard danger with allowing municipalities these powers. In fact, ensuring that borrowing decisions are local decisions will strengthen local accountability, a principle which is stressed repeatedly in the White Paper and which is pointed to as one of the primary virtues of allowing subsovereigns access to capital markets.

- Second, it removes any implicit national or provincial government liabilities - which might easily arise if these spheres authorise local borrowing – and thus follows the overall policy stance of government in avoiding implicit or sovereign guarantees.

- Third, as argued in respect of the classification of municipalities, investors – whose funds are at risk when lent – aided by credit rating agencies and the new accounting rules are much better placed, and have much stronger incentives, to assess whether any municipality is capable of borrowing than is any organ of government.

With respect to the latter – authorisation within the council – borrowing should be authorised by the municipal council at the recommendation of the chief executive. To facilitate efficient management, however, councils should be authorized to delegate to the chief executive the power to borrow for a short term

[1] The approach taken here will not derogate from the existing powers of the Minister of Finance in the LGTAA to limit the budget growth – hence, indirectly, borrowing volumes – of the municipal sector from year to year for national economic reasons.

up to a limit specified by council. Such delegation may be useful in providing the CEO with the needed flexibility to manage daily operations more efficiently without sacrificing council oversight and accountability.

In order to maximise public accountability and sound fiscal management, local authorities should only issue long-term debt once a written debt policy and a capital improvement strategy (which may form part of its Integrated Development Plan) are in place. The debt policy determined by Council would establish the overall limits and general direction to executive officials in the planning and issuance of debt. Similarly, an investment plan should broadly prioritise a municipality's capital needs.

3.3 Types of debt that may be issued

The question of the type of debt, or debt instrument, that municipalities may issue – and any regulation thereof – is best approached by examining the kinds of security that may be given by municipal borrowers[2]. Until recently, most South African municipalities have given only unsecured general promises to pay, and most lenders have accepted whatever remedies they have at law. Increasingly, however, and following trends elsewhere in the world with established municipal debt markets, the parties are exploring ways of enhancing a creditor's security by contract. Pledges of particular physical assets, of receivables, and of particular revenue streams have all been used. The provisions which allow this under the LGTAA – which permit the local council to "furnish any security" for a loan is a very broad, open-ended authorisation whose limits have not yet been explored. It will be necessary, as part of the new legislation which will govern municipal borrowing, to spell out in greater detail what powers municipalities have to pledge security in order to collaterise debt.

Government's overall policy position on this matter is characterised by two broad principles:

- The contracting parties should be allowed broad leeway to craft security provisions that meet their needs. In addition to the conventional "full faith and credit" (general obligation) provisions, this should include special security arrangements including the pledging of assets, of local tax and tariff revenue streams, of intergovernmental grants or transfers, and tax and tariff level covenants;

- Certain limits should, however, apply. Specifically, municipalities should not be permitted to pledge assets deemed essential to the maintenance of public health and safety, nor should they be allowed to pledge revenue streams to the extent that this may compromise their ability to deliver certain essential services, which will need to be defined in law.

[2] It should be noted here that security (in the sense of collateral) and remedies are aspects of the same question. Debt markets require clarity about both. Before they invest, creditors want to know what their remedies or security will be in the event of default. The remedy issue forms the subject of section 5 of this document. This section focuses specifically on the question of security insofar as it determines the type of debt instrument issued.

In legislating revenue pledges it may be necessary to distinguish between the rules that apply to old general debt and those that apply to new debt issues. Creditors with general obligation claims against municipalities may see the value of their collateral diminished by the issuance of instruments which "ringfence" certain revenues as security for the new debt issued. Legislation will need to ensure that existing debt holders are not unfairly prejudiced by a deepening of municipalities' rights to enter into covenants of this type.

3.4 The use and quantum of debt issued

Most countries place limitations on the use of debt by local governments, with a distinction usually made between short and long term debt. Any dividing line between the two is arbitrary, but for the purpose of this document short term debt is defined at that which is payable within a year and long term debt is that with a maturity of more than 12 months.

The rules about the type of debt – duration and purpose - that can be raised in today's market are determined by the new Constitution, the LGTAA, and Department of Finance Regulation No. 412. Under these rules, municipalities may borrow long-term for "capital expenditure which has been budgeted for and approved by council." In addition, short-term borrowing for operating capital is permitted subject to the constraint that municipalities settle their account by the end of the current fiscal year by legislation, and within 12 months in terms of the Constitution.

With regard to short term debt, policy needs to reconcile two competing imperatives. On the one hand, municipal revenue flows are not evenly spread over the year (some property taxes are paid annually, for example), and access to debt finance may be necessary to supply sufficient working capital to allow municipal managers reasonable operational flexibility. On the other, it is important to ensure that short term debt does not become an indirect way of financing operational deficits over time, which are both problematic from the point of view of prudent fiscal management and prohibited by the Constitution.

In order to achieve this, municipalities should be able to bridge operating cash short-falls in anticipation of - and at levels appropriate to - specific and realistic future income streams to be realised within the fiscal year. In addition, municipalities should be allowed to bridge capital requirements in anticipation of specific and realistic grants to be received or long term debt to be issued within the fiscal year. Following current practice, however, short-term debt should be paid off annually with appropriate safeguards against immediate reborrowing. Enforcement of this should be directed at both borrowers and lenders. For example, lenders should be precluded from extending new short-term credit if a borrower is not in compliance with the relevant restrictions.

With respect to the permitted uses of long term debt, a fairly cautious approach has been adopted as is the case at present, such borrowings should be used only to fund capital investment in property, plant and equipment. If experience with municipal borrowing is positive in the medium term after the new framework has been legislated, permitted usages could be expanded (to include, for example, the funding of retrenchment programmes.) In no event, however, should long term debt be used to finance current account budget deficits.

As regards the amount of long term debt that a municipality may issue, consideration has been given to developing a general "rules" based control that could be used to impose a countrywide limit on municipal borrowing. For example, a limit to annual debt service payments in relation to revenues could be set for the municipal sector, and varied annually by regulation if necessary.

After careful consideration government has decided not to pursue this route. There are four main reasons for this:

- First, it is technically difficult to develop a realistic and implementable set of measures which will both achieve this effect and which are impervious to manipulation by municipalities themselves. In the case referred to above (debt service burden:revenues), for example, revenue projections may easily be adjusted to suit any given municipalities' preferred outcome. Whilst it may theoretically be possible to curtail such manipulation, the practical implications of regulating such a system in the SA context make such a course difficult to contemplate in reality.

- Second, such an approach implies that government is better able to make credit judgements than are investors whose funds are at risk. Obviously, if municipal debt was implicitly or explicitly underwritten by central government, setting credit limits would make sense. In the absence of such underwriting, however, and in the context of hard municipal budget constraints, the markets are best placed to judge the capacity of any given municipality to borrow.

- Third, it would be extremely difficult to set a limit which is appropriate for all municipalities at any given time. A prudent limit in Durban, for example, is unlikely simultaneously to be appropriate for Parys. Any national limit is likely to only suit a few, "average" cases: it will inevitably be too low for some - who may require major investments at a given time, or who may have accumulated reserves in certain areas - and too high for others which are on the margin of creditworthiness. In the latter cases in particular, establishing a limit could be seen by both municipalities and the markets as an implicit permission or endorsement to borrow to that level.

- Finally, although ratio tests may conceivably be applied to fund general debt, they will generally not make sense when applied to self-financing or "enterprise" projects, and they could restrict the ability of rapidly growing areas with bright prospects (e.g. Midrand in the late 1990s) to expand services to meet demand.

Government has therefore decided to eschew establishing municipal credit limits by legislation or regulation as they are unnecessary, impractical to implement, and run contrary to the decentralist policy orientation of its overall approach to municipal borrowing. The amount of borrowing municipalities incur is a matter best left to they and the markets to decide. If, however, municipalities overborrow and if, as a result of that overborrowing, investors find it difficult to recover their investments they will both need to face the full consequences of their decisions.

3.5 Summary of policy

Government's policy framework in respect of the borrowing powers and procedures of municipalities may be summarised as follows:

- To give all municipalities equal borrowing powers in law. Legal distinctions between municipalities or categories of municipalities will be avoided insofar as their powers and duties in respect of borrowing are concerned;
- To allow municipal entities to borrow, although the extent of such borrowing will remain a decision of the municipality itself. Insofar as the borrowings of municipal entities are underwritten by the municipality, the issuing of any and all such guarantees will constitute an act of municipal borrowing and the resultant liabilities will be recorded on the municipal balance-sheet as such;
- To allow municipal borrowers and lenders broad leeway to craft security provisions which meet their needs (including revenue bonds, tariff covenants etc.), provided that minimum essential services – which need to be clearly defined – are maintained at all times;
- To nevertheless ensure that existing debtholders are not unfairly prejudiced by a deepening of municipalities' rights to enter into new security covenants;
- To require that borrowing be authorised by municipal councils at the recommendation of the chief executive, without a requirement for national or provincial approval of such borrowing
- To provide that short-term borrowing may be authorised either by council resolution in each individual instance or by a general resolution that the chief executive may borrow up to specified limits;
- To allow municipalities to determine their own debt levels;
- To ensure that borrowing is not used as a source of funding for current budget deficits;
- To limit short-term borrowing to the amount required to bridge operating cash shortfalls in anticipation of specific and realistic future income streams to be realised within the fiscal year and/or to bridge capital requirements in anticipation of specific grants to be received or long term debt to be issued within that fiscal year;
- To prohibit the borrowing of money in foreign currencies;
- To require that short-tem debt be paid off annually, and remain paid off for some reasonable period, with both borrower and lender responsible for enforcement;
- To limit long-term borrowing to funding of capital investment in property, plant and equipment.

4. THE OPERATION OF THE PRIMARY AND SECONDARY MUNICIPAL DEBT MARKETS: DISCLOSURE, REGULATION AND MARKET FACILITATORS

4.1 Overview

For a healthy municipal securities market to develop, pricing and trading mechanisms (e.g. exchange and listing operations, settlement and clearing practices) must operate efficiently. Slow and imprecise mechanisms drive up transaction costs and add to the risks for investors. Fortunately, South Africa has a relatively sophisticated financial sector with up-to-date exchange and clearing operations. There are no fundamental impediments, from a mechanical or regulatory point of view, to the development of a vibrant municipal securities market. Satisfactory infrastructure exists to support the development of both over-the-counter and exchange-based trading, and clearing and settlement procedures are adequate and straightforward. Republic of South Africa bonds and large parastatal issues, conceptually similar to municipal securities, trade easily within the existing framework. Settlement is handled electronically, with delivery of funds against bonds, and within three days of trade, in accordance with international practice. Government does not believe that any change to the operation of the actual market is required as a matter of policy.

However, the lack of clear and sufficient information about municipal finances is an impediment to municipal lending generally, and even more so to a market for municipal securities. Although tradable municipal debt instruments are common, there is a very limited market for municipal securities. This is largely due to potential investors' concerns about the ability and willingness of municipalities to honour their long-term obligations. The availability of information obviously affects the attractiveness of debt securities. Inadequate information can inhibit lending - as investors are unable to measure or quantify risks – and drive up the cost of borrowing. Ensuring the availability of information which would allow investors to satisfy themselves as to municipal creditworthiness is therefore critical both to expanding the overall volume of investment in the municipal sector and in shifting to the character of the market from a predominantly bank-based model – where both liquidity constraints and loan structures are not particularly appropriate for large capital investment in infrastructure – to a securities-based model.

One strength of a securities-based municipal debt market is that it is more broad-based than a bank-lending model, and can generate and aggregate investment capital from multiple sources. Municipal securities markets can attract funds from individuals, investment funds (unit trusts), bank and non-bank financial institutions, pension funds, and others. Securities markets can generate more total capital both by aggregating smaller investments and by assuring liquidity and flexibility to investors whose needs change.

While bank lenders in one-on-one transactions should be able to look out for their own interests effectively, investors in securities often lack the knowledge (and the leverage) to protect their interests. Accordingly, governments world-wide usually regulate the sale and trading of municipal securities for the protection of investors. The regulation of debt markets, including requirements for public disclosure by municipal borrowers, is especially important for the development of municipal securities markets.

This section focuses on improvements to the operation of the municipal debt marketplace that are required if primary and secondary markets are to be simultaneously stimulated.

4.2 Disclosure

Certain basic shifts in government's approach to municipal borrowing imply that greatly improved disclosure of local government finances and operations will be critical to the re-ignition of the South African municipal securities market. Two of these are particularly important: first, the withdrawal of any implicit or explicit central underwriting of municipal debt means that credit assessments need to be taken far more seriously than in the past. Second, the likely proliferation of types of loan structure will inevitably mean that more complex and nuanced assessments will become necessary before credit judgements are made. Knowledge of the particulars of each municipality or project will be needed to calculate risk versus reward and make individual investment decisions in a market setting. In sum, from the standpoint of creditworthiness and security pledged, the market for local government securities that is to be re-established in South Africa will be much more information-driven and dependent than previously was the case.

The primary purpose of disclosing such information is to enable investors to make informed investment decisions and to allow the market to effectively allocate capital through pricing[3]. Better information will make capital markets operate more efficiently, and enable investors to distinguish good credits from bad. The main target of such information is obviously the investor. Individual and institutional investors need information to evaluate municipal debt quality. The party which is ultimately responsible for disclosure is the party which wishes to attract the debt finance and which is thus responsible for debt service payments (the municipality.) However, borrowers can be assisted – or even largely superseded – in collecting, packaging and transmitting information by underwriters and brokers, and even by governmental authorities depending on the nature of the information that is to be furnished.

Increasingly in world practice disclosure relating to securities is not a once-off event. Disclosure in connection with the original offering is often supplemented by requirements for continuing disclosure to the market for as long as the debt is outstanding. Such continuing disclosure may be on a periodic recurring basis (sending out or otherwise making available current financial reports and other

[3] Aside from the immediate needs of the bond market, effective democratic government will depend on regular reporting of the operating results and financial condition of local governments in a consistent format – hence the existing reporting and auditing requirements now found in South Africa regarding local government finances. This report does not deal with this sort of disclosure, which may, of course, be of assistance to investors in making credit decisions. It focuses, rather, on disclosure of information that is intended specifically for the securities market. However, as discussed below, because of the economic interests involved and the importance of thoroughness and timeliness, disclosure can have substantial beneficial impacts throughout local government operations .

operating data) and/or episodic disclosure when events occur that may have a material impact on the borrower's creditworthiness. Disclosure can be required by (1) central governmental fiat, (2) securities market regulation, (3) as a by-product of the operation of the market through contract between issuers and lenders (usually as part of a borrowing contract that contains covenants as to issuer behaviour) or (4) market practice and convention.

Government believes that a combination of these approaches is best suited to the South African situation where a voluntary and market based disclosure system – with the burden for disclosure ultimately falling on the borrower – is underpinned by effective securities regulation that provides a baseline of disclosure and common procedures and penalties for those that are reckless or untruthful.

This system envisages three interrelated components:

- A *law* - or aspects of a law - which would prohibit fraud in connection with the issuance of any municipal debt, would affirmatively require the disclosure of information material to an investment decision, would authorise regulations to specify fraudulent acts and material information, and regulate disclosure a disclosure documentation. The eventual establishment of a repository for disclosure information and a registry for debts, defaults, and security interests could also be authorised by legislation.

- Regulations adopted pursuant to the law would specify specific acts that would be considered fraudulent, and the minimum information that would count as "material" (e.g. financial statements and projections, pending litigation, or defaults). As the market develops, regulations would probably become more detailed and a registry could be established. Regulations could also provide exceptions to disclosure requirements in the case of private placements with sophisticated investors;

- Eventually, industry *guidelines or standards* could be developed which would reflect the market participants' expectations for disclosure, with the detail and flexibility that government regulatory approaches could not achieve. This would be a non-governmental function. These guidelines would likely be adopted and periodically revised by an organisation such as IMFO or by an association of bond dealers and investors.

Violations of the law or regulations would be actionable by the aggrieved party in a civil suit, and would subject the violator to criminal sanctions. While the law would be relatively permanent, FSB regulations would evolve over time to increase minimum disclosure requirements as the capacity to develop and present information evolves and as particular practices requiring regulation are identified.

There would be no criminal penalty for non-compliance with industry standards. The standards would exist primarily to establish the acceptability of disclosure documentation in trade, i.e. its merchantability. These standards could provide model formats for disclosure, and describe particular information deemed appropriate for particular types and structures of financing. They would likely be developed and revised constantly, in a way that government legislation and regulation could and should not be.

Balancing the disclosure regulations with market activity will be an ongoing challenge. The goal is to assure investor confidence in municipal securities without hindering the development of a municipal securities market by over-regulation. Thus, government intends to take a step-wise approach to the evolution of regulations and institutions to support municipal securities disclosure. While basic disclosure and protection against fraud is critical, it is important not to burden the market with overly stringent disclosure regulations too early in its development. As the volume of municipal securities issues increases, an official, or officially-sanctioned repository system for filing and dissemination of disclosure information would be established. Because some or all disclosure obligations could be satisfied by filing disclosure information centrally, such a repository system can make it easier for municipal issuers to comply with initial and continuing disclosure requirements. A public repository system can also make it easier for potential investors, rating agencies, and news services to access the information. However, government believes that it need not be established until and unless there is sufficient industry demand to make such an operation self-financing.

4.3 Market institutions and actors

As noted in the introductory comments to this section, satisfactory institutional mechanisms exist to support both over-the-counter and exchange-based trading. Government sees no reason to limit trading to any one venue, and encourages continued evolutionary improvements in the efficiency and transparency of pricing and trading mechanisms.

Objective credit ratings of municipal securities by independent credit rating agencies are a key support for an active market in municipal securities. They help individual and institutional investors make judgements about credit quality without the burden of investigating and analysing each issue. Several private agencies are already developing informational databases on a large number of municipalities, and rating the credit quality of a smaller number. These agencies have evolved substantially over the last several years. They need reliable data from potential municipal issuers, including audited financial statements, and clear and well-documented projections about future conditions. Improving municipalities' capabilities in these areas, and reporting in accordance with new accounting rules, will provide these agencies with increasing impetus.

Other functions important to healthy municipal bond markets either already exist or are likely to evolve without support from government. As a matter of policy, government encourages the evolution and specialisation of these functions:

- Financial advisors can assist municipalities in developing and implementing financial strategies.
- Underwriters can help package and pre-sell initial issues of municipal debt to a wide range of investors.

- Legal counsel to assist various actors and to assure compliance with disclosure regulations is available, though experience will be gained over time.
- Bond insurers are likely to begin operations in South Africa as the volume of municipal debt increases. Such insurers can greatly facilitate the evolution of markets by removing most of the risk from the investor.
- Existing financial institutions can play the role of trustee, paying agent, and registration agent, which are important in assuring predictability and objectivity.

4.4 Summary

Government's policy position in this area may be summarised as follows:

- To require borrowers –
    - By law, to disclose all information material to an investment decision. Materiality will be defined by Regulation
    - To disclose the specific information defined in the Regulations
    - To act in accordance with market standards on disclosure in order to attract investment
- To require continuing disclosure at least annually, and on the occurrence of a material event that could affect the security of an investment
- To apply disclosure standards and penalties equally to bond exchange and OTC transactions
- At such future time as a bond registration and repository system may become appropriate, to establish these
- To support the growth and evolution of market facilitators such as credit rating agencies, underwriters, bond insurers and so on.

5. MONITORING, INTERVENTION AND REMEDIES

5.1 Background

Fiscal crisis in local government is not new in South Africa. The creation of black local authorities in the early 1980s largely segregated the problem along racial lines: core white municipalities not responsible for high-need low-revenue black residential areas found it relatively easy to manage their finances without problems, while black local authorities were almost uniformly in fiscal crisis from the dates of their creation. A variety of ad hoc measures was taken to keep essential services running in black local authority areas – including intergovernmental transfers and loans, assignation of Regional Service Council revenues and even, on occasion, grants from the private sector. On the other hand, the larger white municipalities – which benefited from a substantial revenue base and implicit central guarantees - had reasonable credit ratings in the market and could raise loans when they needed them. Smaller municipalities were assisted by the government?s Local Authorities Loan Fund. It was taken for granted that black local authorities could not raise funds in the market at all; such capital programmes as were undertaken were financed by grants or loans from the government or the Development Bank of Southern Africa.

Amalgamation of formerly segregated jurisdictions in the mid-1990s, accompanied by a heightened emphasis on service delivery, meant that the problems of black local authorities were imported into the new municipalities. The new structural circumstances have been compounded by a range of other difficulties - a lack of experience and capacity; non-payment of local taxes and service-charges, the persistence of an opaque accounting system etc. – which have aggravated the overall problem.

Thus at 31 December 1998, Project Viability found that 151 municipalities were in fiscal crisis, with about 200 more suffering from financial problems which did not then amount to a crisis, but which may contain the seeds of serious difficulties later. The main reasons were found to be institutional (no coherent framework for operations), financial (in every possible respect - accounting, internal controls, cash flow and asset management and credit control), lack of community co-operation in the form of non-payment, poor management of the revenue base and poorly maintained, inefficient infrastructure. From an economic point of view, it is particularly alarming that some of the largest local authorities are experiencing severe fiscal difficulties. In 1997 Johannesburg had urgent need of a large loan (R585 million) from the DBSA; less than two years later, it is again in difficulty. More recently, it has been reported that Pretoria faces increasing financial problems. And an increasing number of medium-sized towns (such as Welkom) appear to be drifting into effective bankruptcy.

Finally, although both common law and aspects of existing statute give investors certain rights when municipalities default on their debt service obligations, neither the legal nor institutional channels for recourse are particularly robust. Moreover the distinctive nature of municipalities - as opposed to corporate entities in the private sector, for example - creates a situation where the recovery of bad debts necessarily assumes a different character than it does conventionally in the private sector. For example, municipalities cannot be liquidated and, for public interest reasons, it is important that certain essential services (e.g. provision of water and sewerage reticulation) always be kept in operation. Moreover, unlike a Board of Directors, municipal councils are organs of democratic governance with certain rights and obligations created and specified in the Constitution. Conventional debt recovery processes are thus not adequate or entirely appropriate to the municipal environment.

Yet, from a policy perspective remedial processes through which investors can reliably deal with debt defaults by municipalities are critical to the broader objective of stimulating a municipal debt market as uncertainty in this area negates the ability of creditors to analyse and quantify investment risk and thus acts as a major constraint on market appetite for municipal credit. It also prevents the accurate pricing of risk and thus inhibits the efficient allocation of capital by the market. Lack of clear lender remedies is one of the major barriers to municipal lending in South Africa today and it urgently needs to be addressed.

5.2 **Objectives**

Thus far government has responded to these problems with a number of legal and programmatic initiatives, ranging from Project Viability and the Municipal Support Programme to interventions made in terms of s. 139 of the Constitution. But the systemic nature of the crisis renders ad hoc solutions to the problems of individual local authorities inadequate. What is needed instead is a systematic programme of assistance to local authorities, designed to advise, support and (where necessary) to supervise them in strengthening their financial position. It is also critical that such a programme provide municipalities with incentives which promote sound fiscal management and do not draw either investors or municipal borrowers into behaviours that will deepen rather than alleviate the problem via the credit system.

In other words, given the nature and scale of municipal financial problems - and the importance of wider efforts to complete the overall reform of the municipal fiscal and financial system - it has become imperative that government establish a thoroughgoing and coherent policy, legal and institutional framework for dealing with municipalities in financial distress. This document outlines the key elements of that framework. It is important to stress, however, that in doing so it builds on rather than replaces existing programmes and law. Although some major new steps are outlined, these need to be seen in the context of what government is already doing. The basic objective is as much a systemisation and rationalisation of all of government's efforts in this area into an integrated framework which supports the other aspects of the fiscal and financial framework as it is to add new programmes and institutions to respond to the problem.

The overall structure of the system is outlined in Diagram II. Two critical elements of the system should be noted:

- First, government is putting in place an integrated but diverse set of measures which combine monitoring support, capacity building and direct expenditure of significant sums from the fiscus with other measures which involve executive and legal interventions when municipalities experience financial difficulties. It is important to stress that these interventions will only be invoked as a last resort i.e. when, following the full range of grants and capacity building measures applied to any given municipality earlier, it nevertheless cannot avoid a financial crisis. The more drastic intervention measures will only be used in a worst case scenario and it is expected that they will only be required occasionally;

- Second, although the emphasis in this document – and particularly in the following section – is on state sponsored measures to deal with municipal financial problems, this does not imply that it is, or should be, only up to central government to deal with such issues. The overall financial system described in this document – including those provisions which are designed to promote the proliferation of different sorts of loan structure and security – is designed to encourage municipalities and investors into voluntary arrangements whereby they may resolve financial problems before, or during, any involvement by central government. The intervention measures described below, for example, will inevitably be painful experiences for both municipalities and investors. It will be in their mutual interests to work together to avoid them.

5.3 Legal, institutional and programmatic initiatives

Government is responding to the problems described above with a number of initiatives, two of which are new and will be implemented in FY 2000/01. The others are already in place, but will be broadened and strengthened from 2000/01 on. In general terms, these initiatives can be divided into three main categories: expenditure, support and monitoring programmes; executive and administrative interventions; and legal remedies.

5.3.1 *Expenditure, support and monitoring programmes*

<u>Existing situation</u>

Government has three key programmes of this type: Project Viability; the Municipal Support Programme and Financial Support Grants:

- Since 1995 the Department of Provincial and Local Government has been monitoring the finances of municipalities through a quarterly survey known as *Project Viability*. Responses to the questionnaires are captured, assimilated and analysed at national level. The primary focus of the analysis is on the short-term liquidity of municipalities. In order to assess the liquidity situation of municipalities a number of direct and indirect high level indicators are used. The basic purpose of the survey is to indicate to the Department which municipalities appear to be running into financial difficulties.

Once a municipality has been identified as having financial difficulties the relevant Province is informed and a detailed management audit is conducted to determine the magnitude of the problem and formulate a stabilisation programme. The MECs for Local Government may then either instigate a Section 139 or LGTAA intervention (see below) and/or use the facilities of the Municipal Support Programme to address capacity problems within the municipality in order to restore financial stability.

Provinces have so far conducted about 300 management audits of which about 250 have shown that, unless urgent measures are taken, a sizeable number of municipalities may experience complete financial collapse.

Project Viability is an important governance tool. The project has experienced a number of problems, but these have more to do with response rates and the veracity of the information provided than with the fundamental structure of the programme.

- The aim of the *Management Support Programme* (MSP) is to stabilise financially distressed municipalities. This is done through capacity building and developing the administrative and financial systems necessary to restore the municipality into a viable entity. In addition, the programme assists municipalities to restore sound financial practices, cash funded budgets, sound accounting systems and internal controls.

  The MSP budget for FY 1999/00 is R75m. The funds are sourced from the Transitional Grant amounts on the budget of the Department of Provincial and Local Government and transferred to Provinces for expenditure on MSPs in their provinces.

  The MSP has also experienced a number of difficulties since inception, mainly related to the capacity of provinces to implement and monitor the programme effectively. However these appear not to be fundamental, and government believes that with certain management improvements it should be able to deliver on its objectives successfully.

- In 1999/00 an additional R62m was also transferred to Provinces for expenditure on general Financial Support for local authorities confronting financial difficulties. Of the three programmes discussed here, this has confronted the most difficulties. First, criteria for the allocation of funds are not clear or uniform. It is thus not evident that municipalities most in need are those which are actually benefitting. Second, the funds are largely given out on an unconditional basis, which does little to create incentives for sound financial management at the local level. Third, as with the MSP, a lack of capacity at the provincial level has tended to inhibit the effective use and management of this resource.

New initiatives

No fundamental changes are required in respect of *Project Viability*. However, Government does need to explore various ways in which the difficulties experienced as regards response rates can be addressed. In addition, the possibility of a wider distribution of the disaggregated PV data needs to be fully assessed.

Similarly, no basic alteration to the structure of the *MSP* is necessary. In fact, government intends to spend increasing amounts on this programme over the 2000/01 MTEF period, such that total expenditure on the programme by 2002/03 will have been doubled. In addition, the management of the programme by Provinces and by central government will be improved.

Important changes are planned with respect to the *Local Government Support Grant*. On the one hand government intends to phase out the existing under-funded and ad hoc programme over the new MTEF (i.e. by 2002/03.) On the other hand, the programme will be replaced with a new far more substantially funded and better-designed initiative, the *Financial Restructuring Grant (FRG)* from 2000/01 on. This programme will be managed directly from central government rather than via the provinces. Clear and uniform criteria for grant allocations will be established. Essentially, grant funds will be made available from central government to a recipient local authority in exchange for commitment to a normalisation (budgetary restructuring) plan, the clear objective of which must to be to pre-empt a fiscal crisis and restore budgetary balance. The continuing flow of grant funds will be conditional upon the progressive implementation of the agreed restructuring plan. Municipalities will be required to offer a credible analysis of the causes of their fiscal distress, as well as evidence of a viable plan to address this. The municipal Council will need to agree to this plan in the form of a Resolution. The plan will in all crucial respects be similar to the budget restructuring plan which would be produced in the case of municipal Financial Emergency (see below), but will be voluntarily proposed by the municipality concerned in exchange for the receipt of grant funds which will assist it in undertaking a budgetary restructuring.

Government will decide on the funding level of the FRG annually as part of the national budgeting process. Because there are limits to the amount that can be made available for this form of pre-emptive restructuring the programme criteria will give preferential access to those local authorities whose collapse would imply a significant risk for the country as a whole.

Further details regarding the FRG are given in Appendix I.

5.3.2 Executive interventions

<u>Existing situation</u>

Section 139 of the Constitution, read in relation to other relevant provisions (e.g. Sections 44 and 155) state that provincial and national government have the legislative and executive authority to see to the effective performance by municipalities of their functions. These sections provide for provincial government – and, if this is not done effectively – national government to intervene in the affairs of local authorities when they fail to do so. Such failure clearly includes – and is often manifest in – the development of a fiscal crisis.

In addition, section 10G(2)(m) of the LGTAA provides for a provincial MEC to issue instructions to a municipality to take measures to rectify its financial position when this position has become unsound. In both these cases the purpose of the intervention is to restore the municipality to a proper level of functioning, not as a permanent take-over of municipal functions or obligations.

In recent years both national and provincial governments have used these provisions to intervene in a number of different cases. More than 30 LGTAA instructions have been issued in KwaZulu-Natal, for example, and eight S 139 interventions were initiated in 1999. These have not had particularly successful outcomes. In no case (aside from Butterworth which is unique for legal and technical reasons) has any S 139 intervention been uplifted because the municipality has effectively been restored to financial health.

The reasons for this are diverse and complicated. However, an overall assessment of the brief history here points to a number of key lessons:

- The likelihood of an intervention being successful is largely a function of the severity of the problem it confronts. Where the problems are limited in scope and depth, the interventions have a better chance of leading to a turnaround within a reasonable period of time. Where the problems are fundamental or structural in character, the interventions have a more limited chance of success, at least in a short period of time;

- Both national and provincial governments have limited capacity to manage and implement such interventions. While some implementation capacity can be brought in from the private sector in terms of the MSP, this does not eliminate the importance of managing and monitoring the intervention on the part of the intervening authority. For provinces which are often struggling with their own budgets and capacity shortages, this can be a major difficulty. And central government also has limited resources in this regard;

- The existence and use of these procedures have not led to a restoration of private sector confidence in the municipal debt market. The existing executive and administrative intervention provisions have not obviated the need for a process, overseen by the judiciary, to ensure that creditor claims are properly addressed in the case of default. Moreover, the more that central and provincial government is drawn into responsibility for dealing with the consequences of poor municipal decision-making and fiscal management, the greater the prospect of moral hazard problems arising;

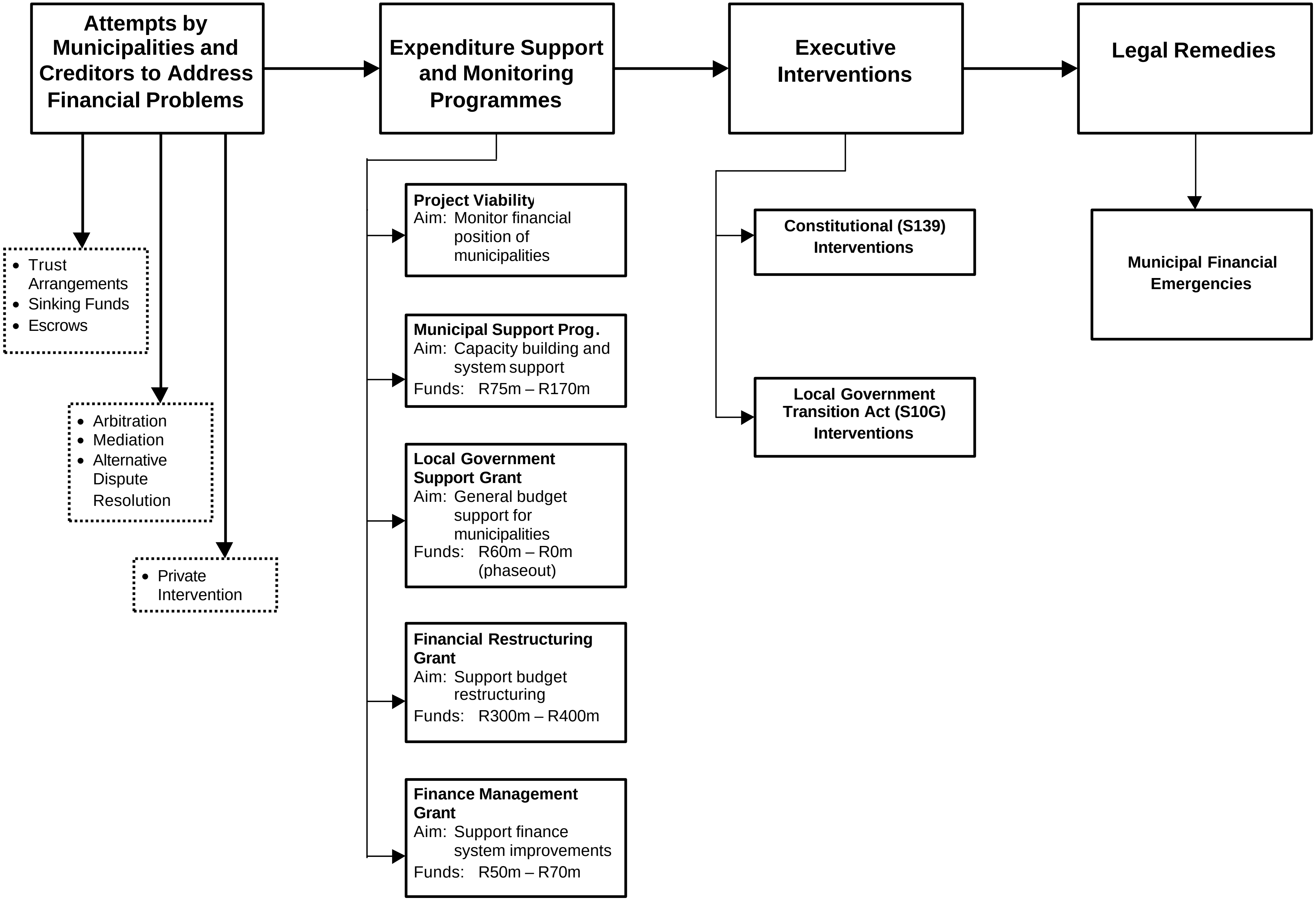


DIAGRAM II: SYSTEM FOR MUNICIPALITIES IN FINANCIAL DISTRESS

- The existing intervention procedures are complicated and messy and are not necessarily conducive to effective rectification. This is partially because the existing constitutional and legal provisions are not entirely optimal, particularly with respect to situations where interventions fail to bring about the desired results. If such problems are to be avoided a system with clear and clean procedures and authorities is needed.

New government initiatives

These problems will largely be addressed by the new legal remedies discussed below. These aside, government does not believe that the existing executive intervention provisions are in need of any fundamental revision. However, two adjustments are important:

- A uniform set of procedures for S. 139 interventions needs to be developed;
- Provincial and national government need to expand their capacity to monitor and manage such interventions.

5.3.3 *Legal remedies*

Existing situation

The existing position regarding legal remedies available to private sector investors should municipalities run into financial difficulties and default on their obligations is referred to at several points above. The key features of the current situation may be summarised as follows:

- Common law and statute allows creditors to approach the courts for redress in the event of default. This channel, however, offers a remedy that is neither comprehensive nor appropriate to municipal circumstances. First, the only real redress available to creditors in this instance is the attachment of municipal assets to settle outstanding liabilities. By definition, most assets held by municipalities (roads, water systems etc.) are not practically "attachable" for these purposes. And the inevitable politicisation any process whereby available assets are attached mean that such recourse is not a viable route to satisfy legitimate creditor claims.

- In the context of these limitations, and because it is not legally or practically possible to liquidate a municipality, the ability of creditors to satisfy their claims in the event of default is likely to be very closely tied to the ability of the fiscal position of any municipality to be restored to normality. This requires the development and successful implementation of a "turn around plan" (budgetary restructuring.) However the current legal and institutional situation in South Africa does not allow for this in respect of local government. The administrative and executive interventions referred to above are obviously one means through which a turn-around could be effected, but there is no appropriate provision for a due legal process to satisfy legitimate and enforceable claims should these fail or should municipalities default notwithstanding such interventions.

Put in the context of the borrowing framework outlined earlier, the corollary of moving towards a modern, decentralised framework for municipal finance where moral hazard is minimised, capital is allocated efficiently, risk is properly priced and incentives for prudent financial management are real is a clear legal and institutional framework for dealing with municipal default and bankruptcy.

It should be stressed here that the ultimate objective of this is not investor protection at all costs. If investors make poor credit decisions they should take the losses that this implies. But it does entail putting in place a legal and institutional process which allows investors to make proper credit judgements and which is potent enough to ensure that the problems causing a municipal fiscal crisis are thoroughly addressed.

It may also be stressed that the necessity for this sort of framework does not derive exclusively from imperatives related to capital market development for municipalities. The system outlined below has been driven also by the need to ensure that there is an effective means of addressing municipal financial emergencies – even where no or little borrowing has occurred – when all other means have failed and when there is no prospect of the situation improving without far-reaching steps being taken. Unfortunately, this situation seems to be becoming increasingly common in SA today.

New initiatives

Government believes that the key to this is the institution of a set of statutory procedures, overseen and authorised by the judiciary, whereby an administrative agency with some independence from the executive, oversees fiscal and financial "turn-arounds" analogous to judicial managements in the private sector but designed for the particular circumstances of the municipal sector. The municipal turn-around plans will be developed and implemented by an Administrator equipped with the necessary powers on a case-by-case basis.

An overview of the nature of this procedural framework is given here with further details provided in Appendix I. This framework draws on a combination of existing SA practice regarding judicial managements and liquidations in the private sector, and international experience in countries such as the USA (Financial Control Boards) and New Zealand which have attempted – often successfully – to come to terms with municipal financial failure.

- A Municipal Financial Emergency Authority (MFEA) will be established as a separate agency to oversee the adminisitration of municipal financial emergencies in a manner analogous to the Master of the High Court in respect of judicial managements. The head of the MFEA will be appointed by the Minister of Provincial and Local Government and will have a small professional and support staff. The MFEA will supervise recovery plans for municipalities where a situation of Financial Emergency has been declared. The MFEA will appoint and oversee an Administrator who will develop and implement such a plan in each case. The MFEA itself will be funded from the budget of the Department of Provincial and Local Government, but will not itself form part of the Department. In general, the costs of the Administrators employed in respect of any Financial Emergency will be recovered from the budget of the local authority concerned.

- On application by affected parties, a Financial Emergency may be declared by a judge of the High Court where certain minimum conditions exist – such as a loan default – and where there is a serious fiscal and financial problem within the municipality which has no reasonable prospect of resolution otherwise. The Court will also have the powers, under certain extreme conditions, to order extraordinary relief (such as the modification or suspension of creditor claims) and to terminate the Financial Emergency. Generally speaking, a situation of Financial Emergency would only come into play after the support and executive processes discussed earlier have been exhausted.

- Where a Financial Emergency has been declared the MFEA must appoint an Administrator, who will generally be contracted in from the private sector or civil society, to develop and implement a recovery plan for the municipality. The Administrator shall intervene in the affairs of the municipality to the extent appropriate to the municipality's condition, using the least intrusive practical means to effectively address the situation. Where the municipality takes necessary actions to the satisfaction of the Administrator, the Administrator need not exercise its powers in lieu of the municipality. The primary objectives of the intervention by the Administrator are to restore fiscal integrity and full democratic local governance as soon as possible.

- Nevertheless the Administrator will have ultimately have all the powers of a municipal council. These include the following:

    - To establish, or to require the municipality to establish, a recovery plan to address:
        - any immediate fiscal crisis,
        - any longer term financial problems, and
        - any management problems
    - To establish and disestablish any committees or consultative bodies as Administrator deems useful
    - To approve, disapprove, modify, or make expenditures
    - To approve, disapprove, modify, or incur new debt
    - To establish or amend, in connection with an approved recovery plan:
        - property rates and other taxes
        - charges, fees, and tariffs
        - other revenue measures
        - a budget for the municipality
        - accounting procedures for the municipality
    - To collect all revenues due to the municipality
    - To take custody of all funds of the municipality
    - To take custody of, safeguard, and operate all municipal property, plant, and equipment
    - To undertake accounting reviews and make accounting revisions, in accordance with applicable law, and to audit municipal funds

> To hire, fire, and manage all municipal employees, subject to the provisions of the labour laws and such collective bargaining agreements as may exist
> To negotiate with organised labour, and to agree upon modifications to the terms of any collective bargaining agreement of the municipality
> To negotiate with creditors, and to agree upon modifications to the terms of any agreement with regard to debt of the municipality
> To liquidate assets which are not essential for the provision of basic services.
> To do all things necessary to the implementation of the recovery plan, subject only to the limits of the executive and legislative power of the municipality

5.4 Summary

Government's policy initiatives in respect of municipalities in financial distress may be summarised as follows:

- To modify Project Viability to address newly demarcated municipalities
- To refocus and expand the Municipal Support Programme to support the transition to the newly demarcated municipalities
- To expand the Financial Support programme into a Finance Restructuring Grant as a structured and focused conditional grant programme run directly by central government
- To standardise procedures regarding normal (i.e. S 139 of the Constitution and S 10G of the LGTAA) provincial and central government interventions in the affairs of a local authority when it runs into financial crisis
- To establish by statute a set of procedures, authorised by the judiciary and overseen by a Municipal Financial Emergency Authority, to deal with municipalities when, notwithstanding all other interventions, they run into a situation of financial crisis.

6. CONCLUSION: THE POLICY FORMULATION AND LEGISLATIVE PROCESS

The policy framework elucidated in this document was ultimately the product of a Task Team chaired by the Department of Finance and representing a number of key stakeholders in the local sphere, including the South African Local Government Association, the Department of Provincial and Local Government, the DBSA and the Banking Council of South Africa. The Team was advised by a number of local and international technical experts (see Appendix II.) The work of these experts was supplemented by investigation undertaken by the Departments of Finance and Provincial and Local Government on the issue of municipalities in financial distress.

The document is thus based on extensive consultation with a wide range of stakeholders in both the public and private sectors in South Africa. It also draws significantly on the international experience in the area of municipal finance in both developed and developing countries.

As outlined earlier, in order to implement the policy framework elucidated here, government intends to pass legislation in 2000. In this context, this document has been published for two main reasons: first, to outline government's current policy position on these matters; and, second, to provide the general public – and particularly those sectors with a direct interest in local government – with the detailed thinking underlying the draft legislation which is published simultaneously with the document. This may assist those individuals and organisations who wish to comment either on the legislation itself or on the policy which underlies it.

APPENDIX I: NEW CENTRAL GOVERNMENT INITIATIVES IN MUNICIPAL FINANCE

This Appendix sets out details of the two new initiatives proposed in sections 5 of the main document: the Financial Restructuring Grant and the Municipal Financial Emergency programmes.

1. Financial Restructuring Grant (FRG) programme: overview

The FRG is a conditional grant programme, administered by the Department of Finance, designed to facilitate budget and associated institutional where such restructuring may have positive externalities at the national level.

Funds will be used in accordance with a budget restructuring plan – proposed by the affected municipal Council and approved by the Department – designed to improve the financial position of the recipient municipality within a specified period. The actual formulation and implementation of the plan will be the task of project managers appointed and accountable to the applicant Council.

The FRG programme will be funded from the national budget. Allocations will be made as part of the normal MTEF process. Given budgetary constraints the grant programme will be focused on those municipalities where financial and institutional improvements will have particularly positive impacts on the national economy.

Eligibility for FRG assistance will thus initially be restricted to municipalities with annual budgets exceeding R500 million. This is restriction is necessary in order to avoid duplicating the support offered by the Local Government Support Grant (associated with the Municipal Support Programme) and because there are limits to the amount of national funding that can be made available to support this form of restructuring.

Eligible municipalities will be required to motivate for assistance through providing:

a) A credible analysis of the causes of their financial position;
b) Evidence of concerted efforts improve their situation over a period of at least six months prior to application;
c) A restructuring plan that clearly indicates the restructuring actions, the resources necessary to implement these, the associated time frames, the financial implications of each action and an overall financial plan which projects these – and demonstrates the overall improvement in financial health of the municipality – over a three year period. The total size and length of the grant, and timing of disbursements will need to be included here, as will verifiable benchmarks and conditions against which disbursement of the grant should be made in relation to revenue or expenditure targets and other milestones.
d) A proposed management team for plan implementation, including any external consultants.
e) Evidence of Council commitment to the plan.

The Department of Finance will assess the plans submitted by eligible municipalities, primarily for viability. Should the Department find the plan to be a credible solution, it will negotiate a grant agreement with the municipality that will bind it to the implementation of the plan. Beneficiary municipalities will be required to submit ongoing progress reports, although the Department will also commission independent evaluations. Non-compliance with the grant agreement will result in suspension or termination of the grant, repayment of the entire grant, or subjection to the more stringent municipal finance emergency procedures.

Allocations will be made on a multi-year basis, to a maximum of three years, subject to the availability of funds in the outer years. The full amount, annual allocations and timing of the disbursements should be proposed by the applicant municipality, but will be subject to review by the Department of Finance.

2. The Municipal Financial Emergencies and the Municipal Financial Emergency Authority

Government will establish a set of statutory procedures – and an institutional framework for managing these – to deal with municipalities in financial crisis i.e. where a High Court declares a state of Financial Emergency. The basic objective of these procedures will be to manage the affected municipality back to a position of financial health so that it may function sustainably and pay its debts.

Financial Emergencies will result only in worst case scenarios and only where the full range of other measures – including the FRGs (if the affected local authority receives one) - has failed to halt financial decline.

In detail, the institutional and procedural framework government will establish in legislation is as follows.

Municipal Financial Emergency Authority

The MFEA will be a specialist and autonomous administrative instrument of state and will operate at an arms length from government in a manner analogous to the Master of the High Court. The head of the Agency will be appointed by the Minister of Provincial and Local Government.

In respect of any Municipal Financial Emergency, as declared by a judge of the High Court (see below), the MFEA will be authorised to:

- Take such measures as it may deem necessary and advisable to determine the nature and extent of the emergency, and to supervise the formulation and implementation of a recovery plan for the municipality;

- Appoint an Administrator to temporarily exercise control over some or all of the executive and legislative authority of the municipality;

- An Administrator may be any legal person, and shall be appointed with primary regard to financial and management expertise in the municipal sphere.

- Require regular reports of such an Administrator.
- Establish the compensation for such an Administrator.
- Require that the compensation and expenses of the Administrator be paid by, or recovered from, the municipality.
- Approve or disapprove any recovery plan developed by such an Administrator.
- Apply to the High Court for a declaration that a financial emergency no longer exists in the municipality.

Parties

Any of the following parties may file an application with the High Court alleging the existence of one or more of the conditions listed in 1(c), below, and requesting the declaration of a financial emergency:

- A creditor
- The Municipal Manager or Chief Financial Officer
- The municipal council
- The MEC responsible for Finance or Local Government
- The Minister of Finance
- The Minister of Provincial and Local Government
- Organised labour

Minimum conditions

The threshold for the declaration of a Municipal Financial Emergency will be the existence of one or more of the following conditions:

i) There has been a default on a municipality's financial obligations, including failure to make any payment as and when due to a supplier, an employee, or a creditor
ii) There has been a default by a municipality on a promise or agreement made in connection with borrowing
iii) Actual current expenditures have exceeded actual current revenues for 3 fiscal years or more.
iv) A municipality has experienced an operating deficit in the prior fiscal year in excess of 10% of actual operating revenues

High Court powers and procedures

However, the finding of a Financial Emergency will not follow automatically from the existence of the above conditions. On application of by any party listed above, the High Court will make a determination as to whether (a) the above conditions exist, and (b) there is a serious fiscal or financial problem within the municipality which prevents the municipality from meeting its obligations. The Court is not obliged to declare an Emergency if it is satisfied that the municipality has taken steps that have a reasonable chance of resolving any fiscal or financial problem.

In connection with a declaration of financial emergency, if the High Court determines that irreparable harm to the municipality or to creditors would otherwise occur, the Court may on a temporary, emergency basis not to exceed 90 days, stay litigation or execution by any creditor.

The following parties shall be given notice and an opportunity to be heard (to the extent practicable if the application is heard as a matter of urgency), in the event of an application under this section:

- the municipal council
- the municipal manager
- the Chief Financial Officer, and
- the MEC for Finance or Local Government and the National Minister of Finance and Minister of Provincial and Local Government.

Powers of the Administrator

The Administrator shall intervene in the affairs of the municipality to the extent appropriate to the seriousness of the municipality's condition. The Administrator shall use the least intrusive practical means to effectively address the condition of the municipality, co-operating with the municipal council and officials to the extent possible. Where the municipality takes necessary actions to the satisfaction of the Administrator, the Administrator need not exercise its powers in lieu of the municipality. The primary objectives of the intervention are to restore fiscal integrity and full democratic local governance as soon as possible.

Notwithstanding, the Administrator may exercise so many of the following powers (and associated responsibilities) as are needed:

Extraordinary relief

In rare and exceptional circumstances, where the Administrator believes that there is no possibility of a recovery plan succeeding with only the powers and duties described in subsection 1(e) above, the Administrator, with the concurrence of the MFEA, may apply to the High Court for extraordinary relief in the form of:

Coordination with other provisions

The financial emergency approach outlined above is independent of the redetermination of municipal boundaries by the Municipal Demarcation Board pursuant to the Local Government: Municipal Demarcation Act, and the consequences of such a redetermination under the Structures Act. However, legislation will provide that a redetermination of boundaries under the Demarcation Act, and the subsequent §12 notice, automatically ends the financial emergency unless (a) a resulting municipality is at least 50% made up of the old municipality, or (b) within 15 days of the §12 notice, a party named in 1(b) above applies for an extension of the emergency declaration to the newly established municipality, and demonstrates to the satisfaction of the court that financial, fiscal, or management conditions are such that a financial emergency will also exist in the newly established municipality.

The financial emergency approach outlined above does not affect the dissolution of a municipal council in accordance with section 34 of the Structures Act. If a municipal council is dissolved, a new election will be held, but its powers will be limited by any recovery plan that may have been approved by the MFEA until the conditions giving rise to the state of financial emergency are determined by the High Court to no longer exist.

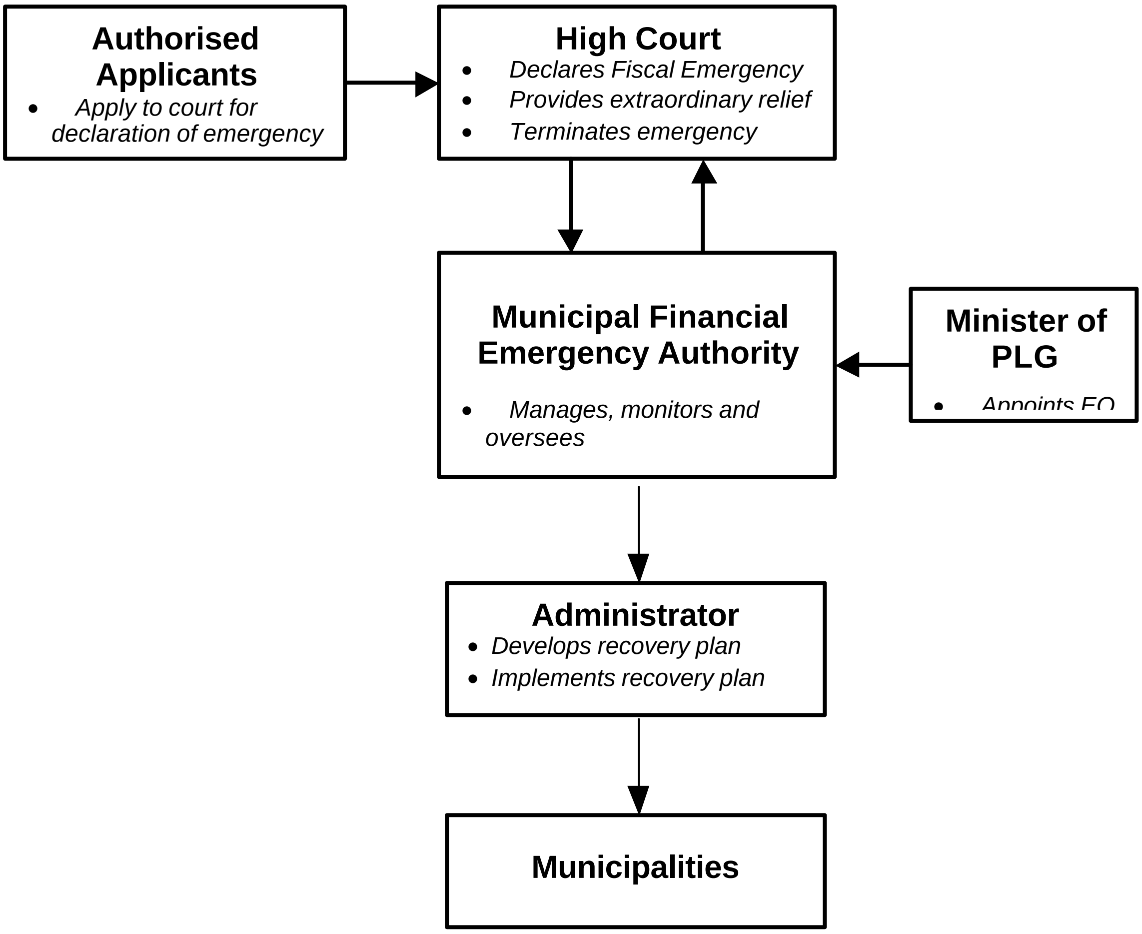
To the extent that any recovery plan approved by the MFEA relieves the municipal council of executive obligations and vests them in the Administrator, the provisions of Sec 139 of Constitution would become inapplicable since the municipality would no longer have any "executive obligation in terms to legislation."

Constitutional amendment

In order to ensure that the system outlined above is immune to constitutional challenge, S 13 will need to be amended to authorise national legislation to (a) establish structures and procedures to deal with financial emergencies in municipalities and (b) to provide for these structures to exercise executive and legal authority on behalf of the municipality to the extent necessary to deal effectively with the emergency. The proposed amendment is available in Appendix III and the supporting provisions for inclusion in the Municipal Finance Management Bill are available in Appendix IV.

Overview

The system described above is expressed in simple form in the following diagram:


Authorised Applicants
Apply to court for declaration of emergency
High Court
Declares Fiscal Emergency
Provides extraordinary relief
Terminates emergency
Municipal Financial Emergency Authority
Manages, monitors and oversees
Minister of PLG
Administrator
Develops recovery plan
Implements recovery plan
Municipalities

APPENDIX II: TASK TEAM AND ADVISORS

The Task Team convened by the Department of Finance comprised the following individuals:

Stakeholders

Roland White (Chairperson), Department of Finance
Mandla Maleka, Department of Finance
Jackie Manche, Department of Constitutional Development
John Douw, SALGA
Bethuel Jwili, IMFO
Barry Jackson, DBSA

Local advisors

Enos Banda, Zader Financial Services
Gert Steenkamp, Consultant
Daan Wandrag, Imali Capital
Alan Yorke, Deloitte and Touche

International advisors

Roy Bahl, Georgia State University
Junaid Ahmad, World Bank
John Zohrab, Highway Technologies.

The team oversaw a research and policy formulation exercise conducted by a consortium led by Research Triangle International. The consortium members included Matthew Glasser (leader), Thomas Cochran, Michael DeAngelis, Marlene Hesketh (RMB), Ronald Johnson, Chris Kapp, John Petersen and Paddy Roome. Marie du Plooy and Plaatjie Mahlobogoane were seconded to the consortium by the Department of Finance.

APPENDIX III: PROPOSED CONSTITUTIONAL AMENDMENT

(Insert in Chapter 13 after section 216 of the Constitution of the Republic of South Africa)

National legislation must -

(a) establish structures and procedures to deal with financial emergencies in municipalities; and

(b) provide for these structures to exercise legislative and executive authority on behalf of a municipality to the extent necessary to deal effectively with the emergency.

APPENDIX IV: FINANCIAL EMERGENCIES PROVISIONS FOR INCLUSION IN MUNICIPAL FINANCE MANAGEMENT BILL

The following sections will be included in the Municipal Finance Management Bill. They require enactment of the proposed constitutional amendment.

ARRANGEMENT OF CHAPTERS

Chapter 10

Financial emergencies

Chapter 1

"administrator", in relation to a municipality in a financial emergency, means a person appointed in terms of section **70** as the administrator for that municipality**;**

"court" means a High Court having jurisdiction, and includes any court superior to the High Court;

"Emergency Authority" means the Municipal Financial Emergency Authority established in terms of section **60;**

"Executive Officer", in relation to the Municipal Financial Emergency Authority, means the person appointed as the Executive Officer of that Authority;

"financial emergency" means a financial emergency within the meaning of Chapter 10;

"recovery plan" means a plan prepared and approved in terms of section **71**;

Chapter 5

22. (6) A municipality in respect of which a financial emergency has been declared, may incur long term debt to support financial restructuring, if so provided in the approved recovery plan.

Chapter 10

Part 1: Establishment, functions and administration of Municipal Financial Emergency Authority

Establishment

60. (1) A Municipal Financial Emergency Authority is hereby established as an institution outside the public service but within the public administration as envisaged in section 195 of the Constitution**.**

(2) The Emergency Authority is a juristic person.

Functions

61. The Emergency Authority must oversee the administration of municipalities declared to be in a financial emergency with a view to normalising their financial affairs, and for this purpose –

(a) must perform the duties and may exercise the powers assigned to the Authority in terms of this Act;
(b) may monitor the implementation of recovery plans;
(c) may suspend, dismiss or discharge administrators, when necessary;
(d) may collect information on financial emergencies and best practices in resolving financial emergencies; and
(e) must prepare and submit annual reports to the Minister responsible for local government on its activities

General powers

62. The Emergency Authority may do all that is necessary or expedient to perform its functions effectively, which includes the power to –

(a) determine its own staff establishment and the terms and conditions of employment for its staff within any policy framework determined by the Minister responsible for local government in consultation with the Minister of Finance;
(b) appoint employees and seconded personnel to posts on its staff establishment;
(c) obtain the services of any person by agreement, including any state department, functionary or institution, to perform any specific act or function;
(d) open and operate its own bank accounts, subject to the Public Finance Management Act, 1999 (Act 1 of 1999);

(e) perform legal acts, or institute or defend any legal action in its own name;
(f) engage in any lawful activity, whether alone or together with any other person; and
(g) do anything that is incidental to the exercise of any of its powers.

Appointment and responsibilities of Executive Officer

63. (1) The Minister responsible for local government, acting with the concurrence of the Minister of Finance, must appoint a person as the Executive Officer of the Emergency Authority.

(2) A person appointed as the Executive Officer holds office –
(a) for an agreed term not exceeding five years, but which is renewable; and
(b) on terms and conditions set out in a written employment contract which must include terms and conditions setting performance standards.

(3) The Executive Officer –
(a) manages the Emergency Authority;
(b) is responsible for the performance by the Authority of its functions and the exercise of its powers; and
(c) takes all decisions of the Authority in the performance of its functions and the exercise of its powers, except those decisions of the Authority taken in consequence of a delegation or instruction in terms of section **68.**

Acting Executive Officer

64. When the Executive Officer is absent or otherwise unable to perform the functions of office, or during a vacancy in the office of Executive Officer, the Minister responsible for local government may designate another employee of the Emergency Authority, or a person seconded to the Authority, to act as Executive Officer.

Staff

65. (1) The staff of the Emergency Authority consists of –
(a) the Executive Officer of the Authority; and
(b) persons in the service of or seconded to the Authority.

(2) An employee of an organ of state may be seconded to the Emergency Authority by agreement between the Authority and such organ of state.

(3) Staff members referred to in subsection (1) (b) and persons seconded to the Emergency Authority perform their duties subject to the control and directions of the Executive Officer.

Pension rights

66. The Emergency Authority is regarded to be an employer for the purposes of the Government Employees' Pension Law, 1996 (Proclamation 21 of 1996), in regard to employees who elects to become members of the Government Employees' Pension Fund.

Funds

67. (1) The funds of the Emergency Authority consist of –

(a) money appropriated annually by Parliament for the purposes of the Authority;
(b) any government grants made to it; and
(c) any other money legally acquired by it.

(2) The Emergency Authority may accept donations but only with the approval of the Minister responsible for local government.

Delegation

68. (1) The Executive Officer of the Authority may delegate, in writing, any of the powers or duties entrusted to the Authority in terms of this Act to a member of the staff of the Authority.

(2) A delegation in terms of subsection (1) –

(a) is subject to the limitations or conditions that the Executive Officer may impose; and
(b) does not divest the Executive Officer of the responsibility concerning the exercise of the delegated power or the performance of the delegated duty.

(3) The Executive Officer may confirm, vary or revoke any decision taken in consequence of a delegation in terms of subsection (1), provided that no such variation or revocation of a decision may detract from any rights that may have accrued as a result of the decision.

Part 2: Declaration, administration and termination of financial emergencies

Application for declaration of a financial emergency

69. (1) An application to court for a declaration that a municipality is in a financial emergency may be made by –

(a) a creditor of the municipality;
(b) the council , the municipal manager or the chief financial officer of the municipality;
(c) the MEC for finance in the province;
(d) the MEC for local government in the province;
(e) the Minister;
(f) the Minister responsible for local government; or
(g) organised labour.

(2) An application in terms of subsection (1) may be made only if one or more of the following conditions exist:

(a) the municipality has defaulted on the payment of an amount due and payable to a creditor or, if an amount has been prescribed, above that prescribed amount;
(b) the municipality has defaulted on an agreement providing security for any debt of the municipality;
(c) the municipality's actual current expenditure have exceeded actual current revenue for at least the three preceding financial years; or
(d) the municipality had an operating deficit in excess of a prescribed percentage of actual operating revenues in the most recent financial year for which financial statements have been prepared.

(3) In considering an application in terms of subsection (1), the court may declare that a municipality is in a financial emergency if –

(a) at least one of the conditions listed in subsection (2) exist; and

(b) there is a serious fiscal or financial problem in the municipality that impedes the municipality from meeting its obligations.

(4) The court is not obliged to declare a that a municipality is in a financial emergency if it is satisfied that the municipality has taken steps that have a reasonable prospect of resolving the fiscal or financial problem referred to in subsection (2) (b).

(5) If the court declares that a municipality is in a financial emergency it must order the Emergency Authority to appoint an administrator for the municipality**.**

(6) Without derogating from the rules of court –

(a) any application in terms of this section must be heard by the court as promptly as possible; and

(b) notice of the application must be given to –

- (i) the mayor of the affected municipality, where applicable;
- (ii) the municipal manager of the municipality;
- (iii) the chief financial officer of the municipality;
- (iv) the MEC for finance in the province;
- (v) the MEC for local government in the province;
- (vi) the Minister; and
- (vii) the Minister responsible for local government.

(7) If the court declares that a municipality is in a financial emergency, it may order that legal proceedings by any creditor and the execution of any process against the municipality be stayed for a period not exceeding 90 days to allow for the appointment of an administrator and the preparation of a recovery plan for the municipality.

Appointment of administrator for municipality

70. (1) The Emergency Authority must give effect to a court order issued in terms of section **69** (5) and promptly appoint an administrator for the municipality.

(2) The Emergency Authority must determine the compensation of the administrator, and may require that the compensation and expenses of the administrator be paid by, or recovered from, the municipality.

(3) A person appointed as an administrator must have appropriate financial and management experience and skills to address any problems underlying a financial emergency.

Recovery plan

71. (1) The administrator appointed for a municipality must –

(a) conduct a sufficiently detailed investigation into the municipality's condition to determine the underlying fiscal or financial problems; and

(b) prepare and submit a recovery plan to the Emergency Authority as soon as possible, but in any event within the time frames determined by the Authority.

(2) When preparing the recovery plan the administrator must consult –

(a) the municipality; and

(b) the municipality's creditors, following a procedure that may be prescribed.

(3) The recovery plan must –

(a) be designed to restore the municipality to a sound financial and fiscal condition as soon as possible, and to restore its creditworthiness;

(b) identify the underlying fiscal or financial problems of the municipality;

(c) describe a general strategy for addressing these problems;

(d) describe, so far as is reasonably possible, the specific actions intended to be taken by various parties;

(e) describe the anticipated time frame for recovery, and milestones to be achieved;

(f) identify the principal objectives of the plan, and methods for achieving those objectives; and

(g) identify which of the administrator's powers referred to in section **72** may be used in implementing the plan.

(4) The administrator must –

(a) submit a copy of the recovery plan to the municipality, the Emergency Authority and the parties involved in the court proceedings in which the financial emergency was declared; and

(b) allow public access to the recovery plan in the prescribed manner.

(5) Councillors, officials and staff of the municipality must co-operate with the administrator in investigating the financial emergency and in developing and implementing the recovery plan.

(6) The Emergency Authority must approve the plan if it complies with subsection (3).

(7) The administrator must report to the Emergency Authority, the municipality and creditors at such intervals or upon the reaching of such milestones as the Authority may determine from time to time.

(8) Reports must be in the prescribed form.

(9) (a) The administrator may amend a recovery plan as the need may arise.

(b) The administrator must –

(i) submit a copy of the amendment of the recovery plan to the municipality and the Emergency Authority; and

(ii) allow public access to the amendment in the prescribed manner.

(c) The Emergency Authority must approve the amendment if the recovery plan as amended would still comply with subsection (3).

(10) The administrator must endeavour to bring the municipality to a sound financial and fiscal condition as soon as possible.

Powers of administrator

72. (1) The administrator appointed for a municipality has access to any structure, functionary, official, premises, documents or records of the municipality.

(2) To the extent permitted in the recovery plan and subject to subsection (3) and any other applicable legislation, the administrator may exercise on behalf of the municipality any of the municipality's executive or legislative power necessary to restore the municipality to a sound financial and fiscal position.

(3) A recovery plan –

(a) may not permit the liquidation of assets needed for the provision of minimum municipal essential services; and

(b) may provide for the suspension of the remuneration and other benefits of members of the council or officials should they fail to co-operate in the implementation of the recovery plan.

(4) When exercising the powers permitted in the recovery plan, the administrator must consider the least intrusive practical means to effectively address the financial emergency, allowing the structures and functionaries of the municipality to act where they can and are willing do so in a timely and responsible manner.

Application for termination of a declaration of financial emergency

73. (1) An application to court for the termination of a declaration of financial emergency may be brought by –

(a) the Executive Officer;

(b) the council of the affected municipality; or

(c) the applicant in the application to declare a financial emergency.

(2) Without derogating from the rules of court, notice of application for the termination of a declaration of financial emergency must be given –

(a) in the prescribed manner to all creditors to whom the municipality owes an amount in excess of a prescribed amount;

(b) to any creditor who filed the original application for declaration of a financial emergency;

(c) to the municipal manager and chief financial officer of the municipality;

(d) to the MEC for finance in the province;

(e) to the MEC for local government in the province;

(f) to the Minister;

(g) to the Minister responsible for local government; and

(h) in the prescribed manner to organised labour.

(3) Should the court find that a financial emergency no longer exists, the court must terminate the declaration of financial emergency and discharge the administrator appointed for the municipality.

Effect of boundary redetermination

74. (1) If the boundaries of a municipality under a declaration of financial emergency are redetermined in terms of the Local Government: Municipal Demarcation Act, 1998 (Act 27 of 1998), and the MEC for local government in the province issues a notice in terms of section 12 of the Municipal Structures Act regulating the legal, practical and other consequences of the total or partial disestablishment of the existing municipality, then the declaration of financial emergency **–**

(a) automatically extends to any resulting municipality having at least 50 percent of its territorial area within the former municipality; or

(b) automatically terminate upon the issuance of the MEC's notice, and be of no further force and effect, as to any resulting municipality having less than 50 per cent of its territorial area within the former municipality.

(2) An automatic extension in terms of subsection (1) (a) may be terminated in accordance with section **73** at any time.

(3) An automatic termination in terms of subsection (1) (b) may be avoided where a party named in section **69** (1) –

(a) files an application with the court within 15 days of publication of the MEC's notice in terms of section 12 of the Municipal Structures Act; and

(b) demonstrates to the satisfaction of the court that financial, fiscal, or management conditions are such that a financial emergency will also exist in the newly established municipality.

Part 3: Additional remedies

Application for extraordinary relief

75. (1) If the administrator on reasonable grounds is of the view that the financial emergency cannot be resolved by the application of sections **71** and **72** alone, the administrator may, after consulting the Executive Officer, apply to a court for an order –

(a) to stay legal proceedings by any creditor and the execution of any process against the municipality for a period not exceeding 90 days at a time;

(b) to suspend the obligations of the municipality to its creditors until the declaration of the financial emergency is terminated; or

(c) to terminate the obligations of the municipality to its creditors, and to settle claims proportionally, taking into account the preference of claims.

(2) Without derogating from the rules of court, notice of an application for extraordinary relief under this section must be given **–**

(a) in the prescribed manner to all creditors to whom the municipality owes an amount in excess of a prescribed amount;

(b) to any creditor who filed the original application for a declaration of a financial emergency;

(c) to any creditor whose rights would be affected by the extraordinary relief;

(d) to the municipal manager and the chief financial officer of the municipality;

(e) to the MEC for finance in the province;

(f) to the MEC for local government in the province;

(g) to the Minister;

(h) to the Minister for local government; and

(i) in the prescribed manner to organised labour.

Suspension of municipal obligations

76. (1) Before granting an application in terms of section **75** (1) (b), the court must be satisfied that **–**

(a) the municipality cannot meet its obligations to its creditors; and
(b) all assets and rights not necessary to provide minimum essential municipal services have been liquidated for the benefit of meeting creditors' claims.

(2) If the court grants an application referred to in subsection (1), it must give preference to the rights of secured creditors as to assets or rights with which they are secured, provided that such security was given in good faith and at least six months prior to any application in terms of section **69** for a declaration of financial emergency.

Termination of municipal obligations and proportional settlement of claims

77. (1) Before granting an application in terms of section **75** (1) (c), the court must be satisfied that –

(a) the municipality cannot meet its obligations to its creditors and would not be able to do so in the foreseeable future;
(b) all assets and rights not necessary to provide minimum essential municipal services have been liquidated for the benefit of meeting creditors' claims; and
(c) all employees have been discharged except those that are affordable in terms of reasonably projected revenues.

(2) If the court grants an application referred to in subsection (1), it must **–**

(a) give preference to the rights of secured creditors as to assets or rights with which they are secured, provided that such security was given in good faith and at least six months prior to any application in terms of section **65** for a declaration of financial emergency; and
(b) treat unsecured claims as concurrent and order that such claims be settled proportionally.

Chapter 11

78. (1)

(q) the administration of financial emergencies;

(r) the assignment of additional duties and powers to the Emergency Authority:

(s) the suspension, dismissal or discharge of administrators appointed for municipalities declared to be in a financial emergency;

(t) the settlement of claims against a municipality following an order of court in terms of section 73;

Chapter 12

86. (4)

(d) obstructs, or fails to co-operate with, an administrator in the fulfilment of the administrator's duties under this Act.

Chapter 13

90. (2) Schedule 3 of the Public Finance Management Act is hereby amended by the insertion in Part A after item 17 of the following item:

"17A. Municipal Financial Emergency Authority".