Expanding Municipal Finance in Zimbabwe: Recommendations for Addressing Current Constraints

Office of Environment and Urban Programs Working Papers

Financing Urban Development
Project No.: 940-1008

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September 1997

Environmental and Urban Programs Support Project
Contract No.: PCE-1008-I-00-6005-00
Project No.: 940-1008
Contract Task Order No. 06
Sponsored by the Office of Environment and Urban Programs (G/ENV/UP)
U.S. Agency for International Development
Washington, DC 20523

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Abstract

This report analyzes the options for expansion of the current municipal finance system in Zimbabwe, particularly for urban local authorities or urban councils (UCs), including by means of access to the domestic capital market. Certain UCs currently have access to the open market, but under very controlled and sheltered conditions. Options for expanding and liberalizing this access are discussed, and constraints on this more commercial approach are identified. The conclusion drawn is that whereas constraints exist, a number are being addressed under either the new structural adjustment program or a range of planned and ongoing municipal development activities. The recommendation is made that a public-private effort be organized to propose the policy framework and design specific mechanisms that will allow expanded market access for municipal borrowers.

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Executive Summary

The question of how urban councils can gain access to expanded financial resources for capital investment is repeatedly being asked in Zimbabwe today. Urban councils have a critical need for capital funds to respond to citizens' demands for new and upgraded municipal infrastructure. And as the traditional sources of funds for these purposes—central government funds and donor loans—decline relative to the ever-expanding need for investment, the understanding has grown that new, more sustainable sources of financing are required.

Clearly the best approach for the long term is to raise capital funds through the Zimbabwean financial markets. This approach has successfully been used to a limited extent in Zimbabwe in the past. But what will it take to expand this avenue to a larger group of urban councils? And what constraints stand in the way of expanded market mechanisms being implemented in the near future? This report is an attempt to address these questions and to identify the specific resources that are currently available and that can help make these measures a success.

The report is based on a review of extensive written material and on numerous interviews held in Zimbabwe in the spring of 1997. The finding is that there is great enthusiasm in both the public and private sector for the idea of expanded financial market access for urban councils. At the same time, these is some skepticism about the feasibility of this approach under current conditions—including macroeconomic, institutional, and financial conditions at the municipal level. Developing an expanded municipal finance market will require bringing together both the enthusiasts and the skeptics, in order to design options that respond to both.

Enormous resources exist that can contribute to the success of an expanded system. At the same time, a number of constraints exist that will need to be overcome. The recommendation of this report is that Zimbabwe should proceed energetically with the development of an expanded system, by organizing a joint public-private effort to draw in the expertise needed, and largely already available, to carry out this very important effort.

The Relevance of Municipal Finance to Zimbabwe's Development Agenda

In Zimbabwe as around the world, urbanization is increasing at a rapid rate, thus increasing the pressure on cities to provide services. At the same time, local governments are recognized as important players in the development agenda for the national economy. Thus, cities require capital investment to adequately meet demands for water, power, sanitation, roads, and other infrastructure.

The emerging view internationally is that local governments can access capital from open market sources if the following conditions are in place:

- Markets are operating according to commercial principles,
- Appropriate mechanisms and financial instruments are developed specifically for this purpose, and
- Disciplined financial management practices are employed at the local-government level.

The current municipal finance system in Zimbabwe operates under a set of incentives that are unique to Zimbabwe, and is governed by a number of policies, controls, and regulations (such as a prescribed asset requirement) that affect the behavior of participants in the system and constrain the amount of resources that are available. As a result, the system is restricted in size and appears to be unable to meet the potential demand for municipal infrastructure investment capital, although this demand has not been quantified. Nevertheless, the system makes funds available to local authorities for capital investment purposes from a number of sources, both public and private, as described in Section IV.B of this report.

Critical Constraints on an Expanded Municipal Finance System

As discussed above, a thriving municipal finance system can be seen as having three components. The first element is most constrained by macroeconomic conditions in Zimbabwe. The latter two elements are not as constrained although there is a need for improvement. In fact, the planned macroeconomic reforms can serve as a framework for a transitional strategy that encourages both municipalities and financial institutions to prepare for true open market conditions. The constraints in Zimbabwe are summarized below and discussed in detail in Section VII.2.

Municipal Constraints
Detailed information is lacking on financial condition and organization of the municipal sector; Urban councils function under an unsustainable system of operating cross-subsidies; and Urban councils lack control of local government borrowing and tariff-setting.
Financial Sector Constraints
Decision-making and competitiveness are influenced by government controls; Private bond market is still in development; Credit analysis and credit rating expertise for the municipal sector is limited; and Even when fully developed, the municipal market will not be large.

Macroeconomic Constraints
GOZ is concerned with financing the budget deficit; The level and terms of financing are affected by inflation and other macroeconomic conditions; and The current structural adjustment program requires belt-tightening by shifting responsibilities to the local level without addressing the financing needs of local authorities.
Policy and Regulatory Constraints
A policy framework for municipal finance is needed that defines goals, quantifies demand for capital, and clarifies roles and responsibilities; Support from GOZ transfers is unpredictable; GOZ intervenes in the budget and management of local governments; Urban and rural councils need a unified system of finance with the same budgeting and accounting standards; and GOZ needs to conduct activities in privatization and municipal finance in a coordinated manner.

The sections below summarize the report's recommendations to GOZ and to USAID.

General Recommendations for Zimbabwe

1. Develop a national policy framework for local government infrastructure finance, with the assistance of interested parties, that addresses (among other things) the infrastructure investment need, the GOZ/local government relationship, and the role of the private sector.

2. Create a mechanism for ongoing public-private dialogue on municipal finance market development that can include financial institutions, existing investors, GOZ and local government officials, and the private sector.

3. Address the macroeconomic conditions and regulatory impediments that constrain the development of an active municipal finance market.

4. Develop and begin implementation of a transitional strategy, from the current municipal finance system to an expanded, more market-based system, that will take into consideration other economic reforms that will be taking place in Zimbabwe over the next few years, and ultimately result in an expanded open market system of municipal finance.

5. Move forward simultaneously on commercialization, privatization, and municipal finance market development, as related strategies.

Recommendations for USAID

1. Work on developing a secondary mortgage market and municipal finance market simultaneously at the policy level, since the issues underlying them are very similar.

2. Facilitate the development of a public-private sector dialogue on municipal finance by co-sponsoring a conference on the topic of municipal finance.

3. Seek support at the conference for creation of a policy framework on municipal infrastructure finance. Design and support a process for its creation.

4. Coordinate with the World Bank to develop ways to use the new Local Government Capital Development Project to carry out some of the recommendations in this report. In particular, coordinate on policy development activities, and evaluate the feasibility of using the loan funds as co-financing on municipal projects where private financing is being sought.

5. Provide targeted technical assistance on one or more municipal finance issues instead of a more detailed municipal bond market study. Potential areas for assistance might include: design of a transitional strategy for the deregulation of the current municipal finance market, a capital planning exercise with local authorities, or development of models for public-private co-financing.

List of Acronyms

BAN	Bond Anticipation Note
CABS	Central African Building Society
FRP	Financial Recovery Plan
GDLF	General Development Loan Fund
GOZ	Government of Zimbabwe
HG	USAID Housing Guarantee loan
IMF	International Monetary Fund
LAPF	Local Authorities Pension Fund
LGCDP	Local Government Capital Development Project
MLGRUD	Ministry of Local Government, Rural and Urban Development
MOF	Ministry of Finance
MPCNH	Ministry of Public Construction and National Housing
PCMU	World Bank Programme Coordination and Monitoring Unit
PSHP	Private Sector Housing Program
PSIP	Public Sector Investment Program
RAN	Revenue Anticipation Note
RDC	Rural District Councils
RHUDO	USAID Regional Housing and Urban Development Office
TAN	Tax Anticipation Note
USAID	U.S. Agency for International Development
ZIMPREST	Zimbabwe Program for Economic and Social Transformation—Proposed International Monetary Fund (IMF) Structural Adjustment Program for Zimbabwe

Expanding Municipal Finance in Zimbabwe: Recommendations for Addressing Current Constraints

I. Purpose of the Assessment

The United States Agency for International Development (USAID) and the Government of Zimbabwe (GOZ) are working in partnership to implement the Zimbabwe Private Sector Housing Program (PSHP). Initiated in 1992, the program is designed to enact policy changes in order to promote private-sector-based solutions to Zimbabwe's urban development needs.

By addressing the major policy obstacles to the sustained production of low-cost housing, the Private Sector Housing Program is expected to achieve the following results:

A. Increase the production of affordable housing for low-income households;

B. Increase levels of private mortgage financing for low-income households with the introduction of new financial instruments and a modified financing incentive structure;

C. Increase the role of the private sector in housing construction, land development and housing finance through a greater reliance on private developers, planners, surveyors, builders and finance institutions;

D. Expand the production of lower-cost building materials and increase related employment opportunities as a consequence of improved efficiency and capacity in the private construction and building materials industries; and

E. Broaden and deepen the financial sector through the creation of new financial instruments and increased competition that will facilitate expanded investment and growth.

In Zimbabwe, there is a broad consensus on the need to expand the financial resources for local governments to assist them in meeting the municipal service requirements of their growing populations. In order to increase the resources and funding options available to local authorities, USAID/Zimbabwe agreed to conduct an analysis of the potential for an expansion of the Zimbabwean municipal bond market. A Senior Finance Advisor, Priscilla Phelps, was asked to carry out an analysis in March 1997 of the municipal bond market in Zimbabwe, and to look at options for expanding the use of bonds and other mechanisms that employ the private market to provide capital finance to local governments. This report is the result of Ms. Phelps's mission to Zimbabwe.

II. The Relevance of Municipal Finance to Zimbabwe's Development Agenda

Around the world, the impact of urban growth, and cities' related need for financial resources, is gaining increasing prominence in national development agendas. Local governments are being recognized as important players in the development agenda of nations, and the capital constraint that they frequently confront is being recognized as a critical national policy issue that must be addressed if a country's economy is to thrive. Cities contribute to national development in a number of ways; some of them are discussed briefly below.

Population is increasingly concentrated in urban areas. As the result of shifts in economic activity and social opportunity, the number of urban residents in many countries worldwide is growing faster than the overall population. Zimbabwe is no exception to this "urbanization" trend. Urban population has grown from less than 20% of total population in 1975 to 31% in 1995 (and is forecast to reach 36% in 2000), while the national population increased from 6,143,000 in 1975 to 10,413,000 in 1995. The result of this phenomenon is an expanded need for infrastructure investment in urban areas in order to maintain living conditions, social order, and labor productivity.

Simultaneously around the world, the expectations and demands placed on local governments are growing. To attain fiscal balance at the central government level, national authorities are delegating more responsibilities to the local level. At the same time, people are demanding more accountability in the delivery of services in return for the taxes and fees that they pay. In order for local governments to live up to these higher expectations, and maintain credibility with their citizenry, they must have the financial resources to deliver expanded and more efficient services.

In Zimbabwe, urban local authories (urban councils) carry out a range of responsibilities that is broader than that of many other local governments around the world. It includes lighting, street paving, street cleaning, and parks maintenance as well as water, sanitation, solid waste management, housing, education, and health care. Urban councils also operate a number of enterprises, including beer halls and farms.

The desire for national economic growth puts pressure on cities and also fuels the demand for urban investment capital, since in economies at every development stage, economic activity depends on adequate investment in water, power, sanitation, roads, and other forms of infrastructure. This infrastructure is often the responsibility of local governments. While the private sector is being asked to provide a significant amount of the needed investment, governments—including local governments—will continue to play a crucial role in creating the conditions for economic growth.

In Zimbabwe, new investment is being sought from both local governments and the private sector. Urban council enterprises, in particular, are considered candidates for commercialization or privatization, as they have become less competitive and profitable over time, and in a number of cases create a drain on urban council resources. Basic municipal services are also privatization candidates. Some core services—such as solid waste management—have already been privatized, and others, including water facilities, are being evaluated by certain urban councils as potential candidates for privatization, especially where they are well-run and located in larger urban centers.

Lastly, municipalities have a role to play in encouraging the entry of capital from international sources and helping to integrate the country into the global financial system. International investors seek investment opportunities that will provide returns at or above the market rate. In developing countries, these opportunities may be found in the public sector, as well as the private sector, especially where there is a backlog of investment needs. But investors will seek these opportunities only if the financial practices and financial instruments being presented to the market meet international standards and expectations.

In Zimbabwe, the financial sector is very interested in helping to develop a municipal finance system. As well, it is in the interest of the GOZ to ensure that the urban councils and the private sector set high standards in municipal finance that conform to international investment practices, even if at present, investments will be made only from domestic sources. The emerging view internationally is that local governments can access capital from open market sources if the following conditions are in place: (1) markets are operating according to commercial principles, (2) appropriate mechanisms and financial instruments are developed specifically for this purpose, and (3) disciplined financial management practices are employed at the local-government level.

Private financial mechanisms designed for investing in municipal infrastructure take a number of forms worldwide, and all have potential relevance for Zimbabwe. When the borrower is a local government entity, the range of options generally includes (1) loans made by banks or by special-purpose financial intermediaries (public or private), (2) municipal bonds issued through the capital market, or (3) hybrid models where loans are obtained from market intermediaries that themselves issue bonds in the capital market.[1] Privatization of municipal services also entails market-based financing. With privatization, construction, operation, and/or ownership is placed into private hands, and capital is raised as either debt or equity by the private entity to finance costs of the purchase as well as improvements to the facility being privatized. In fact, municipal financing on the open market can be considered a form of privatization, in this case not of ownership or operation, but of only the investment function.

Open-market-raised capital alone is not appropriate for all local government activities, because not all municipal functions produce adequate revenue to be debt-financed in this way; grant and/or equity funds are also required, and careful analysis is necessary to identify the appropriate combination of market and non-market resources in each situation. But if local governments are allowed to borrow under market conditions when appropriate, this demand helps ensure that capital will be available on a sustainable basis for urban services over the long run.

[1] This report uses the U.S. terminology that refers to debt instruments issued in capital markets as “bonds,” not as “stocks,” as these instruments are sometimes referred to in Zimbabwe.

The transition to private financing for municipal infrastructure has led many countries to realize that the roles of the private sector and public sector in providing resources must be more clearly defined. Once that is done, the private sector then becomes more willing to provide capital on a market basis because it is able to understand the risks and returns associated with such transactions, and the expectations of all parties involved become more realistic. South Africa has recently carried out such a clarification process, with very positive outcomes in terms of the initiatives it has sparked from the private sector. Zimbabwe, too, should expect to undertake such a policy discussion in the context of its overall development policy, in recognition of the fact that as urban areas develop, they will be able to contribute more directly to the development of the country of Zimbabwe as a whole.

III. The Role of Municipal Finance in the Implementation of the PSHP

PSHP funding is used to service plots and construct affordable houses for the low-income households in the local authorities participating in the program. Off-site infrastructure may be financed under the PSHP provided the repayments for capital costs and interest can be absorbed within the affordability levels of the target beneficiaries. Otherwise, most off-site infrastructure works such as water storage tanks, trunk water and sewer lines, trunk roads, and sewage treatment plants needed to serve the PSHP and other projects are funded through municipal finance. Local authorities obtain the bulk of this financing from the government's Public Sector Investment Program (PSIP). Large cities and towns also obtain some financing from the open market; secondary and smaller towns frequently have some own-source revenues at their disposal. Both PSIP and own funding for off-site infrastructure and community facilities (e.g. schools, clinics, and administration blocks for new large housing estates) are declining for most local authorities, however, and this trend will increasingly put pressure on the local authorities to demonstrate self-reliance and innovation in municipal financing. Only if they can do so will they be able to develop and maintain sufficient capacity to meet expanding demand such as that posed by the PSHP schemes.

IV. Current Context for Municipal Finance in Zimbabwe

A. Overview of the Present System

The current municipal finance system in Zimbabwe makes funds available to local authorities for capital investment purposes from a number of sources, both public and private. The system operates under a set of incentives that are unique to Zimbabwe, and is governed by a number of policies, controls, and regulations that affect the behavior of participants in the system and constrain the amount of resources that are available. As a result, the system is restricted in size and appears to be unable to meet the potential demand for municipal infrastructure investment capital, although the precise level of this demand is difficult to quantify.[2]

Public sector funds are provided from the urban councils' own reserves and internal borrowing, and from GOZ funds allocated through the PSIP mechanism. Other funders of the PSIP include the World Bank and USAID. (These public sources are discussed in more detail in Section IV.B.)

Only those urban councils classified as "cities" are able to borrow on the open market. Urban councils are designated as cities based on a set of criteria contained in the Urban Councils Act. These criteria include financial position, financial management practices, ratable base, ratable base and number of public institutions. The urban councils currently classified as cities are: Harare, Bulawayo, Mutare, Gweru, and Kwekwe.

Private sector funds are borrowed by cities mostly from insurance companies and pension funds either directly as loans, or indirectly through the institutions' purchases of municipal bonds. Municipal bonds are prepared for issuance by discount houses and merchant banks and sold on an allocation basis. Discount houses in some cases also purchase municipal bonds for their own portfolios. Commercial banks do not invest in municipal bonds, but do provide municipalities with checking services and overdraft accounts or lines of credit, a type of short-term loan.

Zimbabwean pension funds and insurance companies are subject to a prescribed asset requirement, and the current market for municipal debt can be partially attributed to this requirement. Under this policy, the GOZ requires that a certain percentage of the institution's assets be held in designated ("prescribed") investment vehicles, generally government debt instruments (short-term GOZ notes, long-term GOZ gilts, or municipal bonds). The prescribed asset requirement may originally have

[2] The term "municipal finance" is used in this report to mean financing for the provision of services by a local government or its instrumentalities. In Zimbabwe, these local governments could include both urban and rural district councils or any local government entity borrowing funds for service provision, although the emphasis in this report is on urban councils. Also, although the focus of this report is infrastructure finance (also referred to as capital finance), local governments have a range of interrelated financing needs that can be addressed by the financial markets. These needs include lines of credit, cash management, and short- and medium-term borrowing. The discussion in this report applies to any local government financing requirement that could be met through a commercial transaction. Lastly, housing is a local government function that requires capital investment for infrastructure both on- and off-site. Municipal finance mechanisms could be used for these purposes.

been motivated by prudential objectives (ensuring safe investments were made by financial institutions), but remains in place today as a fiscal mechanism that ensures the public sector preferential access to the domestic financial markets.

Both the bonds issued and loans taken out by local authorities qualify as prescribed assets on the balance sheets of the investor institutions, and because there is generally a shortage of these assets (especially those with longer terms), municipal bonds are often oversubscribed when first issued. This excess demand also may also depress interest rates on the bonds, since they are being purchased for purposes other than pure investment. The statutory prescribed assets requirement is 45% of assets (55% prior to May 1997, and down from an earlier 60% level). However, in practice some institutions appear to keep the level as low as 35%.

Currently, all municipal bonds are considered to carry a GOZ guarantee. Whether these guarantees are implied or provided in statute was not determined during this analysis, but the universal assumption of those involved in issuing and purchasing bonds is that the approval of borrowing powers by the GOZ—which is required before a local authority can borrow in the open market—carries with it a full faith and credit guarantee of the GOZ. Bonds are purchased by investors based on (1) the strength of the perceived GOZ guarantee and (2) the financial analysis of the project performed by the Ministry of Local Government, Rural and Urban Development (MLGRUD) and the Ministry of Finance (MOF); financial institutions perform little or no credit analysis of their own. Direct loans are not considered to carry the GOZ guarantee, although urban councils must obtain permission before such a borrowing takes place and the loans qualify as prescribed assets.

Zimbabwe's treasury finance system is in some respects an asset that can support the development of an expanded municipal finance system. Because the GOZ issues treasury securities in the open market to finance government activities, systems are in place for listing and trading government securities, investors are accustomed to holding securities of the public sector, and interest rates on treasury instruments can serve as the baseline (or "reference rate") for pricing municipal securities.[3] International experience seems to show that having a system of treasury finance, as Zimbabwe does, can be an advantage when a country is attempting to develop municipal finance mechanisms, even though the municipal financial instruments will be different from treasury securities.

In other ways, Zimbabwe's treasury finance system may deter local government finance. The principal deterrent is the competition for funds between the GOZ and local authorities, a situation that is largely under the control of the GOZ. A primary reason why the prescribed investment regime exists is to finance various needs of the GOZ and some of its parastatals, including their budget

[3] Central government securities are generally considered very low risk, or risk-free, because of the depth of resources available to repay them. Municipal securities are considered somewhat higher risk, although the risk differential will vary depending on the local government and structure of the financing. Therefore the interest rates on central government securities will generally be the lowest in the market, and can serve as a basis for the pricing of other riskier securities. Central government interest rates are sometimes referred to as "risk-free" rates.

deficits. But the amount of funds that can be borrowed on the domestic financial market is finite, and the ability to borrow internationally, limited. The GOZ guarantee of urban council debt makes it, in effect, GOZ debt and puts the urban councils in the queue behind the GOZ when domestic financing is being allocated.

In the financial market, the prescribed investment requirement influences the pricing of debt instruments. It generally appears to have the effect of keeping interest rates artificially low, especially in those cases where government commercial paper and gilt sales take place only at or below a posted interest rate that is below market and during those times when there is excess demand for the paper because there has been a shortage of issues that qualify as prescribed investments. (Excess demand, and lower interest rates, may also result from the overall shortage of long-term investment vehicles in the market.) While municipalities benefit from these lower rates in the short run, they become the standard for government financing, stifling innovation and crowding out potential lenders to the municipal sector who would require a higher rate of return. In other cases, it has been suggested that prescribed assets may result in higher-than-market rates, when financial institutions are compelled to lend at inconvenient times and charge borrowers a penalty for doing so. In both cases, factors other than true market mechanisms influence interest rates.

Until the prescribed investment requirement is eliminated or lowered, the amount of funds the private sector will make available for borrowing by the public sector is likely to be constrained, as lenders make loans to other sectors able to pay market-based interest rates. Also, until real interest rates increase and interest rates become less volatile, savers may also be driven away, giving financial institutions fewer resources to lend.[4]

Local governments take a "back seat" to the GOZ, in the words of a representative of one financial institution, and as a result have limited discretion over their own financing strategies. This situation, in turn, discourages the financial sector from developing the expertise to analyze the municipalities and from structuring financial products and services for them. It also discourages urban councils from communicating their needs to the financial sector, and from making themselves more creditworthy borrowers and attractive clients for the open market. As a result, even in the relatively sophisticated Zimbabwean financial sector, the financial needs of local governments clearly appear to be not fully addressed, although the interest and expertise is available to do so.

[4] The amount of savings in a financial system is generally considered to be a function of the level of real interest rates (nominal interest rate minus inflation), although other factors, such as the alternative savings mechanisms available to savers, will also influence the tendency of people to save. In high-inflation environments, savers may save by purchasing goods (land, building materials, gold, etc.) as a way to protect the value of their resources, especially if bank real interest rates are low or negative, thus reducing the amount of funds in the system available to be borrowed.

B. Resources Available to Urban Councils

Financial resources are available to urban councils from a number of sources today. These include:

1. Public Sector Funding Sources

Ministry of Local Government, Rural and Urban Development (MLGRUD): General Development Loan Fund (GDLF). The MLGRUD's GDLF receives its funding from the government budgets. The GDLF provides loans to local authorities for bulk infrastructure (water storage and supplies; sewage treatment plants; trunk roads and stormwater drainage; heavy-duty plant and equipment) and basic urban services. The source of the bulk of GDLF funds is the World Bank (IBRD) Urban Sector II Program ("Urban II"), through the PSIP. The World Bank funds 20% and GOZ 80 % for local expenditures. For foreign expenditures, the World Bank pays 100%. GDLF loans carry interest at prevailing GOZ rates, currently at 15%, over 25 years with a 3-year grace period on the principal repayment and interest. Interest is, however, capitalized during the grace period. GOZ reviews the interest rate annually, as with all its loans. The interest rates have generally been increasing over the past 10 years. Some Z$232 million (US$20.7 million)[5] was allocated for Urban II during the 1995/96 fiscal year.

Ministry of Public Construction and National Housing (MPCNH): National Housing Fund (NHF). Like the GDLF, the National Housing Fund obtains its funding from the government budgets. The NHF provides loans to local authorities for both housing construction and housing-related infrastructure.

GOZ has access to some funding from the World Bank under Urban II and from USAID under the Private Sector Housing Program, both for on-site infrastructure only. Through the PSIP, GOZ funding (80%) is combined with the World Bank's financing (20%) provided under the Urban II loan. Under USAID's PSHP, the GOZ has to match every Zimbabwean dollar released by USAID. NHF loans carry interest at prevailing GOZ rates, currently at 15%, over 25 years. Loans from the World Bank and USAID have a 3-year grace period on principal repayment and interest. Interest is capitalized during the grace period. The NHF interest rate is reviewed annually by GOZ and the rates have generally been increasing over the past 10 years. The amount of funds allocated in the 1995/96 fiscal year was Z$65 million under the ongoing Urban II and Z$40 million under the now-commencing USAID PSHP.

The PSIP system approves loans for one year at a time, even if the project spans a number of years and requires multi-year funding. The GOZ will approve an entire project up front, but local authorities have to return and request additional PSIP funding for subsequent years. This arrangement also applies to GDLF loans. The procedure makes efficient work scheduling difficult

[5] At the time of this report, the exchange rate in the Zimbabwe market was approximately Z$11.2 = US$1.

and distorts cash flows among contractors. It may also result in considerable costs to government for penalties claimed by contractors for delayed payments.

Internal Funds of Local Government. Internal (or own source) funds are accumulated by local governments when there is net operating income (or surplus) in a fiscal year, or when reserves are funded from current income, earnings are made on prior surpluses, or assets (including land) are sold. Internal funds are a very important source of financing for local government capital investment. They not only are a low-cost source of financing, but also represent equity that allows local authorities to raise other funds, including private debt. Other forms of equity may be available, for instance from GOZ grants, but ensuring the availability of internal funding is a critical aspect of municipal finance development.

At fiscal year end 1995, the MLGRUD report on 1994/95 budget performance and 1995/96 budgets showed a cumulative capital expenditure estimate for the 22 urban councils of Z$1.7 billion for 1995/96, against which the councils had budgeted Z$117 million of their own internal sources of funding (7%). Clearly the urban councils understood their responsibility to provide financing for capital purposes from internal sources. Reports provided of 1995/96 financial results did not include capital expenditure results, so a comparison to these budgets could not be made; however, nearly one-half of the councils had operating deficits for the 1995/96 fiscal year. At year end 1995/96, the accumulated operating deficit of all local authorities was Z$199 million, including a deficit for the year of Z$54 million, reduced to Z$44 million by internal transfers of funds from reserves. The declining operating surpluses of urban councils suggests that the availability of internal funds for capital purposes may be minimal.

The Urban Councils Act empowers local authorities to establish a number of internal funds for various purposes (some of which relate to capital financing) using borrowed funds or internal funds used for lending purposes. The Act stipulates the proper sources and uses of funds in certain of these accounts, although others may be created and may have their own bylaws. The funds that are associated with capital investment include, especially: the consolidated loans fund (to account for all borrowed and repaid funds), the capital development fund (for accumulation, transfer, and repayment of funds for capital improvements and replacements, and proceeds of sales of assets), the estates account (related to land investments), and the housing account.

In the absence of other borrowing options, municipalities make “special loans” by taking funds that were originally borrowed for one purpose, such as housing, and reusing them within the urban council for another purpose such as equipment purchases. For example, by structuring loans to homeowners for a shorter term than the loan term of the underlying loan borrowed by the urban council, treasurers are able to relend borrowed funds internally a second or third time while waiting to repay the original loan. Such measures greatly complicate internal accounting (and contribute to the perception that urban council financial statements are difficult to interpret) but are a creative response to the shortage of appropriate, flexible borrowing mechanisms for urban investments.

According to the Urban Councils Act, any borrowing, including internal borrowing, requires approval from the GOZ.

2. Private Sector Funding Sources

Pension Funds. Urban councils are able to borrow directly from pension funds, such as the Local Authorities Pension Fund (LAPF). As of 1995, LAPF was serving as the pension fund for 33 local authorities. It is one of the institutions subject to the prescribed asset regime discussed earlier. LAPF makes direct loans and also buys the bonds of local authorities. As of June 1995, it had assets of Z$643 million, and investments of Z$620 million. Of this investment amount, loans to local authorities and statutory bodies (parastatals) made up Z$95 million, or approximately 15% of the investment portfolio, and bond holdings totaled Z$227 million, or approximately 35%, including Z$45 million of municipal bonds.

LAPF makes amortizing loans for 10 to 25 years at the current rate of 22%. Its priority in lending is the infrastructure sector. While it has made loans for investment in schools and has some interest in the health sector, it finds lending for housing more difficult because of the social considerations the sector entails. LAPF does not have an in-depth credit analysis system; borrowers are asked to provide 3 years of audited financial statements. Project-based loans[6] are rare; however, LAPF is participating in a syndication for the City of Mutare's Pungwe water project organized by Stanbic Bank. This project loan has a GOZ guarantee.

Insurance Companies. Insurance companies such as Old Mutual Insurance Company also lend directly to urban councils. Old Mutual has made loans to Bulawayo and Harare, without a GOZ guarantee, on terms similar to those available from the bond market (see below). It is also interested in investing equity capital into infrastructure projects.

Municipal Bonds. As already discussed, the five cities of Zimbabwe have the potential to issue municipal bonds in the "open market," although only Harare and Bulawayo have taken advantage of this market access. This access is dependent on the approval of borrowing powers by the MOF for each instance of borrowing. As of February 1997, Harare had a total of Z$484 million in bonds outstanding, with coupon interest rates ranging from 6.75% to 18% and terms up to 16 years remaining. Bulawayo's portfolio of outstanding bonds totals Z$241 million with coupons ranging

[6] "Project loans" or "project financing" refers to an approach to financing in which the revenues resulting from the particular project or function being financed serve as the main source of security for the investment capital. This type of loan relies heavily on high-quality financial feasibility analysis in order to appraise the potential financial outcomes from the project. The importance of this approach to financing in the municipal sector is that a project sponsor, such as an urban council, which may not be in excellent financial condition, may have a feasible project it needs to finance that can be "project financed" on the basis of project income, making the financial condition of the sponsor of less importance.

from 6.75% to 18% and remaining terms up to 18 years. Current trading yields on the bonds of both cities are 17-18%.[7] Original bond terms vary up to 20 years.
Municipal bonds are prepared for issuance by discount houses and merchant banks and sold on an allocation basis. For example, Bard Discount House packaged and sold the City of Harare bond issue in 1996 for Z$100 million, and Trust Merchant Bank Limited was, when interviewed, preparing a Z$100 million issue for the City of Bulawayo.

According to several of those interviewed, municipal bonds should have interest rates slightly higher (less than one percentage point or 100 basis points) than GOZ treasury bonds of the same term, but because the GOZ has borrowed only short-term in the past few years, municipal bonds are left without this treasury rate as a point of reference. The differential in yield between outstanding municipal and GOZ bonds of similar term is approximately one-half of one percent or 50 basis points in favor of GOZ bonds across all bond terms. Depending on one's perspective, this spread may reflect the fact that the municipal bonds are guaranteed by the GOZ (explaining a small spread) or may reflect shortcomings in the market's ability to evaluate risk (calling for a larger spread). In theory, the lack of a reference rate makes it difficult to set the interest rate on the bonds when they are originally issued. In developed financial markets, setting an incorrect interest rate can result in a failed or prolonged bond sale. Yet bond issues in Zimbabwe are generally oversubscribed, not because of good pricing, but because of the shortage of longer-term investment options in the market, aggravated by the prescribed assets requirement. Bonds are even sold at times "below market" because of this shortage.

In more developed financial markets, the use of bonds allows borrowers to gain access to a very different pool of investors, and therefore a different pool of investment funds, than borrowing directly using loans. This arrangement allows flexibility in the structuring of bonds, and lowers borrowing costs by increasing competition. Among the benefits of bonds over loans is the ability for an investor to trade a bond during its term, which cannot be done with a loan. But because of the prescribed asset requirement in Zimbabwe, lenders to municipalities and purchasers of bonds are virtually the same parties, with the exception of certain insurance companies and pension funds that do not make direct loans. At the same time, most purchasers of municipal bonds, eager to have one of the few long-term instruments in the market, rarely trade the bonds after purchasing them, but follow a "buy and hold" strategy. For these reasons, municipalities do not yet take full advantage of the bond instrument, nor will they be able to until the prescribed asset regime is reduced and the market becomes more active, with a more diverse set of investors.

Building Societies. Building Societies can make loans to local authorities for housing-related infrastructure and community facilities under the Building Societies Act. Recently, Harare borrowed from Central African Building Society (CABS) at 22% interest for a trunk sewer line to link the new Tynwald low-income housing project to an off-site existing trunk sewer in Warren Park. This source appears to be used only to a limited extent by urban councils.

[7] Bard Discount House Limited, "The Fixed Interest Desk" report, Harare, Zimbabwe, 28 February 1997.

Short-term borrowing. Local authorities borrow short-term from commercial banks with whom they hold a variety of accounts. Overdraft accounts or lines of credit (sometimes referred to in Zimbabwe as "bridge financing") of 30 to 90 days are common. Interest rates on these loans were not established during this assessment, but are assumed to be similar to corporate interest rates for the same type of account.

No open market instruments exist for municipalities to borrow short-term, such as commercial paper or notes, although at least one institution interviewed expressed the opinion that there would be a market for such an instrument.[8]

3. Adequacy of Current Options

The range of financing vehicles available to urban councils is quite diverse, including bonds, loans, and overdraft accounts from the private market, own-source funds, and public sector loans. Urban councils would clearly be helped by the addition to the mix of more grant funds as well as by certain additional instruments and techniques such as shorter-term notes or commercial paper, the use of leasing as a financing option, and expanded use of project financing. However, the shortage of instruments rarely represents the fundamental constraint on the development of a financial market. The shortage of funds (due to broader macroeconomic conditions) and the lack of proper commercial incentives (due to regulatory constraints) are more apt to be the true constraints on the expansion of a market. Both of these appear to be important factors constraining the municipal bond market in Zimbabwe.

C. The Institutional Context

1. The Municipal Sector/Intergovernmental Relations

Zimbabwe maintains a categorical distinction between its urban and rural local governments or councils. The urban councils, which are governed by the Urban Councils Act, number 22, including 5 cities (Harare, Bulawayo, Mutare, Gweru, and Kwekwe); 7 municipalities (Chitungwiza, Masvingo, Marondera, Kadoma, Chinhoyi, Chegutu and Redcliff); 8 Town Councils or Boards (Karoi, Bindura, Gwanda, Rusape, Shurugwi, Kariba, Norton, and Victoria Falls); and 2 Local Boards (Hwange and Ruwa). The Urban Councils Act was last updated in 1995, and is undergoing another revision in 1997.

As discussed earlier, city status is conveyed to municipalities based on a range of considerations including financial position, financial management practices, ratable base, and number of public

[8] Short-term borrowing by municipalities in anticipation of tax payments (tax anticipation notes, or TANs) or other revenue receipts (revenue anticipation notes [RANs]), for instance, is common in the United States and is considered a very low-risk investment.

institutions; other categories generally reflect population size. Table 1 shows the population, revenue, and per capita revenue of the 22 urban councils in 1995/96.

Table 1
Population and Revenues of Zimbabwe Urban Councils

Urban Councils (UCs)	Estimated UC Population, 1995[9]	UC Revenue, in Z$, 1995/96[10]	Per Capita UC Revenue, in Z$
Harare	1,390,000	880,762,145	$634
Bulawayo	628,000	338,723,220	539
Chitungwiza	316,000	133,656,758	423
Mutare	151,000	113,596,277	752
Gweru	147,000	150,113,510	1,021
Kwekwe	98,000	62,638,000	639
Kadoma	78,000	50,012,000	641
Masvingo	60,000	39,633,014	661
Chinhoyi	50,000	19,632,426	393
Marondera	45,300	41,149,000	908
Chegutu	36,700	19,050,335	519
Redcliff	34,400	22,789,000	662
Bindura	24,300	18,012,723	741
Kariba	23,800	21,932,946	922
Hwange	23,000	6,223,031	271
Rusape	23,000	9,052,000	394
Norton	21,000	14,312,727	682
Victoria Falls	19,300	29,097,693	1,508
Karoi	17,000	9,890,345	582
Gwanda	15,000	8,254,000	550
Shurugwi	10,000	5,227,314	523
Ruwa	6,000	7,612,774	1,269
	3,216,800	Z$2,001,371,238	Average Z$692

[9] Source: Extrapolated from 1992 Zimbabwe National Population Census.

[10] Ministry of Local Government, Rural and Urban Development, Financial Analysis Section, *Report on Urban Council's Finance and Management as per Preliminary Accounts for 1995-96 and Budgets for 1996/97.*

The Urban Councils Act governs the 22 urban councils closely, laying out the requirements associated with a wide range of urban powers, from the organization of elections to the contracting of sidewalk construction. While delegating a large and diverse group of functions to the urban councils, the Act at the same time reserves considerable oversight, approval, and intervention powers for both MLGRUD and the President. One of those reserved powers mentioned repeatedly by urban council officials, and others familiar with the present system, is the requirement for approval of rents and other charges in "high density" (i.e., low-income) areas within the urban council area. Requiring approval by MLGRUD of all rents and fees in effect requires approval of the budget in general, since fees charged in high-density areas are dependent on those charged in other areas and on overall expenditures. The approval process can become delayed in MLGRUD (attributed by the Ministry to local authority delays) resulting in income losses for the municipalities, which legally cannot raise rates before receiving approvals.[11]

Most urban councils serve a large number of low-income people, but on average urban residents have considerably higher incomes than their rural counterparts. In 1995, national household net income for Zimbabwe as a whole was Z$6,049, while urban household incomes averaged Z$14,624 (Harare and Bulawayo average). This differential is partially responsible for the high rates of urbanization in Zimbabwe, with Harare's growth rate at 6% in 1995 and Bulawayo's at 7%.

The financial condition of urban councils varies considerably, but until recently had generally improved over the past several years. Urban council revenues come from a variety of sources, the principal ones being tariffs for water, sewerage, and solid waste, as well as taxes (including property taxes or rates). Urban councils carry out a number of enterprises, including liquor sales. Revenues from liquor sales figure prominently in the income of certain councils, such as Chitungwiza, where liquor sales made up more than one-third of the council's income in 1995/96. Generally, these enterprises contribute a decreasing share to urban council net income, and in some cases are producing considerable losses, especially where competition has increased. Divestment of these enterprises is one focus of the recent "commercialization" campaign.

Improvements in the financial condition of urban councils observed until recently were due to a considerable extent to the work on Financial Recovery Plans (FRPs) initiated by MLGRUD and the Ministry of Public Construction and National Housing (MPCNH), and now continued under the World Bank's Urban II projects. Kwekwe, for example, had an accumulated deficit of Z$13.4 million as of 1987/88 which it had reduced to Z$1 million by 1993/94 after putting a Financial Recovery Plan in place. The Urban I and Urban II projects have provided debt funds to urban councils through PSIP, and assisted in strengthening the financial management capacity of the councils, expanding the use of audits and information systems and encouraging the adoption of Financial Performance Plans (developed from the FRPs) and Strategic Plans.

[11] Some steps have reportedly been taken to reduce government control over tariff-setting since the information was gathered for this report.

The urban councils had a collective deficit for the year 1995/96 of Z$54 million, reduced to Z$44 million by internal transfers of funds from reserves. The financial condition of urban local authorities has been adversely affected in the last two years by funding changes in the health sector. Traditionally this sector has been funded jointly by local governments and the GOZ, with the GOZ responsible for running certain facilities and reimbursing the local authorities for other costs, particularly costs associated with implementing directives of the Ministry of Health. Unexpectedly, according to many interviewed, the funding policy changed with little advance notice to urban councils. In its September 1996 report on Urban Local Authorities' 1996/97 budgets and 1995/96 budgets, MLGRUD attributed almost the entire decline in the financial position of local authorities to losses in their health accounts. The health accounts of the 22 local authorities had a combined deficit for the 1995/96 fiscal year of Z$181 million, which more than absorbed surpluses in other municipal accounts. The eleven councils with deficits in the health sector highlighted in the report included all five cities. Deficits were as high as nearly Z$97 million in Harare. The liquor enterprises of local authorities that were originally intended to subsidize health and other welfare activities have themselves been experiencing declining net income, contributing even further to the net losses in this account.

Capital budgeting and capital expenditures data do not seem to be systematically reported by urban councils, making it difficult to estimate either total demand for capital investment funds or actual investment. Capital expenditures are forecast by municipalities in their Strategic Plans, which may or may not be submitted to MLGRUD during the budget process. Neither the year end 1996/97 report from the World Bank Urban II Coordination and Monitoring Unit (PCMU) nor the one from the MLGRUD Financial Advisor showed capital expenditures of urban councils for the year.[12] The 1994/95 report from the Financial Advisor showed combined budgeted capital expenditures for 1995/96 totaling Z$1.7 billion. Kwekwe's Strategic Plan for 1994/95 to 1999/2000 showed capital expenditures of Z$20.2 million over that period;[13] Masvingo's 1996/97 capital expenditures were estimated at Z$67.5 million.[14]

The lack of capital planning information may partially reflect the local authorities' feeling that they lack control over the implementation of capital plans, due to the shortage and uncertain timing of financial resources. They appear to be caught in a dilemma between developing aggressive budgets and plans, in order to gain some resources from the GOZ, and budgeting more cautiously in order not to raise expectations of citizens, but then receiving wholly inadequate government allocations.

There does not appear to be a standard format for the presentation of capital budgets, complicating the effort to develop an overall estimate. Better information will need to be developed and made

[12] Elsewhere, the Urban II project estimates urban council primary/offsite infrastructure works in progress or planned for the period July 1997 through December 1998 at over Z$1.4 billion, of which approximately Z$19 million (1.34 percent) could be met from urban council own resources. *(Source: World Bank/Harare)*

[13] Municipality of Kwekwe, Zimbabwe, *Integrated Strategic Development Plan, 1994/95-1998/99*.

[14] Municipality of Masvingo, Town Treasurer, *Estimates 1996/97*.

available to outside parties if more private investors are to be brought into the municipal sector. Cities that have access to the financial markets appear to have somewhat greater control over the capital investment process, although no figures were available on the amount of borrowing powers approved by the MOF relative to those requested, or on the time requirements of the approval process.

Future demand for capital funds for municipal services in Zimbabwe will come not only from urban councils, but also from the 57 Rural District Councils (RDCs) where the great majority of the country's population resides. RDCs are governed by the Rural District Council Act and for historical reasons have a different relationship with the GOZ. Services and investment have traditionally been delivered directly to the RDCs by GOZ ministries, as have significant grant funds, but increasing responsibilities are being decentralized to these authorities, as to the urban local authorities, with the expectation that they will need to become accustomed to borrowing funds for investment purposes, and to enhancing their revenues. Borrowing experience is limited in the RDCs; between 1993/94 and 1995/96, 83% of the RDCs received no loan larger than Z$500,000. The General Development Loan Fund (in MLGRUD) loaned Z$2.1 million to all RDCs in 1994/95 and Z$3.0 million in 1995/96. However, many of the RDCs are in sound financial condition (only 5 were known to have run a deficit in the 1995/96 fiscal year) and they will soon be supported by a capacity-building program of the World Bank.

Consultants to the World Bank recently estimated the RDC's 5-year demand for investment funds at Z$427.5 million.[15] This estimate was based on "absorptive capacity" of the RDCs, rather than demand for funds, and assumed that the funds would be given in the form of grants that would be used as internal loans. While this is not an estimate of the demand for market financing, is still relevant to this discussion. Assuming some RDCs will have the financial capacity and resources to also participate in the municipal finance marketplace, the financing needs of these councils should be considered simultaneously with those of the urban councils, where appropriate. Doing so would expand the overall size of the municipal finance market, which would encourage its development by reaching better economies of scale, thereby generating interest among a larger number of potential investors.

2. The Financial Sector

The financial sector in Zimbabwe is sophisticated and quite diverse, especially considering the size of the private economy. One recent report characterizes the financial sector as "strong and well-functioning."[16] A number of reforms over the past several years have liberalized and deregulated the financial sector, and brought about interest rate deregulation in many areas and the opening of the market to new financial institutions. However, other reform measures that were anticipated have

[15] Diana Conyers and Ben Hlatshwayo, *The Capacity of the Rural District Councils to Absorb Capital Development Funding*, report prepared for MLGRUD, at the request of the World Bank, June 1996.

[16] Government of Zimbabwe, *ZIMPREST: 1996-2000* (Draft), August 1996.

not taken place and are now expected over the next few years, including: amendments to the Banking and Reserve Bank Act (both in draft), passage of a Unit Trust Act, establishment of a Securities and Exchange Commission, and improved trading systems. All of these actions have implications for the development of a viable municipal finance market.

The financial sector is diverse institutionally, and was characterized as generally sound by those interviewed. The sector includes merchant banks, commercial banks, building societies, and discount houses (which not only trade securities, but also invest for their own portfolio, and prepare bond issues for local authorities and others). Leasing companies, which are able to capitalize on certain advantages in the tax code, are active, although were reportedly more so before recent changes in the tax code were enacted. They do not currently appear to be serving the municipal sector.[17] Even in the absence of legislation, there are a number of unit trusts (mutual funds investing the funds of multiple individual investors), although none has invested to date in municipal bonds.

Current non-bank institutions in the financial market include pension funds, such as the Local Authorities Pension Fund, discussed above, and insurance companies. Both of these currently provide capital under the prescribed investment regime, buying local authority bonds, which they consider to be GOZ guaranteed, and lending directly without a guarantee.

New institutions entering the financial market recently have tended to be merchant banks or non-bank entities. Examples include trade financing vehicles, each of which has foreign investors, as well as *bureaux de change* and money brokers.

Certain financial functions are missing from the sector at present. There are no credit rating services for the municipal sector, although a committee of banks recently met to discuss the need for expanded credit rating services in Zimbabwe. Credit ratings and other credit analysis provide critical information to market participants about the financial condition of municipalities and other borrowers in the financial market. Similarly, financial institutions, by their own admission, have limited in-house credit analysis capability. There is no swap market in Zimbabwe, which makes floating rate lending riskier for banks. Even so, both fixed and floating-interest rate loans are made in Zimbabwe; nearly all lending to the municipal sector is at fixed rates.

Local governments and the GOZ are able to borrow long-term largely on the strength of GOZ guarantees, but for other borrowers, the longest-term funds available fall in the 5- to 8-year range. Project finance activity, and capability, are very limited. “Balance sheet” lending (lending on the basis of other assets and general financial condition) is the most common approach. In general,

[17] Leasing companies purchase and retain ownership of buildings and equipment and lease them out, on a short- or long-term basis, to other parties. The lessee (user) may not have adequate credit capacity to purchase the leased asset itself, or may prefer the flexibility of leasing over ownership. The lessor (owner) may realize tax savings from leasing that the lessee would not, therefore lowering the cost of the lease relative to owning for the lessor. Municipalities may lease for these reasons, as well as to avoid the need for voter approval of a capital financing (as in the U.S. State of California). So far, municipal leasing is found in only a few countries.

Zimbabwean financial institutions follow a fairly conservative approach, which is probably rational given the constraints imposed by the regulatory regime and the absence of both internal and external credit analysis.

A recent project financing of 4,000 housing plots by G. S. Developments Private, Ltd., demonstrated that an income stream can be used in the Zimbabwean market as security for financing—in this case with the help of some subordinated, concessionary funding that reduced the risk for lenders. A number of those interviewed were familiar with this transaction and interested in this type of approach.

The new direction in the financial sector is toward more competition, with increasing emphasis by the government on supervision rather than regulation. In addition, the new Banking and Reserve Bank Act, once enacted, will "decompartmentalize" the financial market, opening up markets to existing (and new) institutions from which they are now excluded. In spite of the restrictions now in place, there is a spirit of entrepreneurism in the Zimbabwean financial sector, and a surprising amount of experimentation taking place, along with strategies to develop new products and client groups. The further liberalization of the financial sector, which is widely expected, is welcomed by most of those involved, and should be good for the municipal sector.

Except for the few financial sector professionals in Zimbabwe working directly with cities, most in the financial sector have limited access to information about the operations and performance of urban councils. Newspaper stories seem to be the most frequently consulted source. Some who have had the opportunity to review urban council budgets or financial statements found them to be very difficult to understand. Similarly, the financial information provided in municipal bond prospectuses is limited because of the assumed government guarantees; private issuers of financial instruments disclose considerably more data and analysis. While this information gap makes it difficult for the financial sector to design and offer services to the municipal sector, there is still interest by financial professionals in developing services and financial market access to urban councils. Efforts to expand the information flow between the financial sector and local government are strongly suggested; these could have a very positive effect on the development of the municipal finance market.

3. Other Local Organizations

Two local organizations are potentially very important in the development of a municipal finance system in Zimbabwe:

Treasurer's Forum of the Urban Councils Association of Zimbabwe. This organization is composed of the treasurers of the urban councils. It meets quarterly and has an annual conference on matters of interest to treasurers. Treasurers can play an important role in upgrading the financial practices of councils, as well as in communicating information about the legal and administrative impediments that exist at the local level.

Institute of Finance & Accountants. This organization is involved in establishing accounting standards for the public sector under Urban II. Currently different standards are being used by the various urban councils, and this lack of uniformity will impede the ability of urban councils to communicate with the financial sector and potential investors. A new financial management system—PROMUN—is also being installed in the urban councils under Urban II and in two ministries under USAID's Private Sector Housing Program. Full implementation of such a system is a crucial element in an expanded local finance system.

4. Development Agencies/Donors

A number of donors are active in urban development and finance in Zimbabwe, including the World Bank, the Nordic Development Fund (co-financing the institutional development component of Urban II), the British Overseas Development Agency (which is supporting the Rural District Council Capacity Building Program), and the United Nations Development Programme (currently carrying out a study on tax burdens for the Ministry of Finance), as well as USAID.

The World Bank has sponsored Urban I (for 4 urban councils) and Urban II (for all 22 urban councils). Urban I took place between 1990 and 1992 and Urban II is expected to close out at the end of 1998. To date, the loan funds under Urban II are approximately 50% disbursed. The Bank's next project is the 2-year Rural District Council Capacity Building Program with the 57 RDCs. The program will provide technical support, training, and capital funds to improve RDC capacity to carry out current and future responsibilities.

The Local Government Capital Development Project (LGCDP) is the next major program proposed to be funded by a World Bank loan. This project will include both rural and urban councils and will focus on, among other things, private financing of municipal infrastructure.

In order for donor resources to be leveraged to assist municipal finance development, a collaborative strategy may be called for. It is common opinion that better coordination among donors working in the municipal sector might be fruitful for all involved. It was suggested also that the Urban Councils Association would be a logical body to assist GOZ in developing this coordination, since it is able to represent and communicate municipal priorities.

V. Adequacy of Current System

The current system of capital financing is inadequate to provide the urban infrastructure needed by a growing and urbanizing Zimbabwe. Estimating the funding gap precisely, however, is very difficult because current urban council capital budgets and funding requests (to the extent they are available) are very much influenced by the common understanding that the funding available for infrastructure investment is extremely limited.

Without modernization, the current system will continue to impede Zimbabwe's development and economic integration. Significant resources exist to develop an improved system, as described later in this section. The principal reasons for pursuing a more market-based municipal finance system are as follows:

A. Need to Address Infrastructure Financing Gaps

Local authorities are meeting only a portion of their infrastructure financing needs under the current system, resulting in (1) reduced service levels for citizens, (2) reduced credibility of the local government, (3) increased costs as estimates rise due to inflation during funding delays, and (4) ultimately, slower development for the country. The current budgeting system does not appear to produce capital budgets that reflect actual investment needs or capacity to deliver investments at the local level, making capital market planning very difficult.

To quantify the extent of the funding gap, urban councils would need to estimate the capital improvements they would make if they were constrained not by the availability of debt, but only by the need for matching grant funds and the ability and willingness of citizens to repay borrowed funds through rates and fees. While urban councils provide an impressive array of services, they appear to do it at a remarkably low cost per capita, suggesting that citizens could potentially pay more if they desired additional, or higher quality, services. The average per capita revenue of the urban councils of Harare and Bulawayo is only about Z$640, while the per capita income is Z$14,624, meaning that residents pay less than 4.5% of their income for all municipal services. (These averages, of course, mask significant variations in ability to pay, and ignore the fact that some urban council revenue comes from non-household sources.)

At the same time, lack of funds is not the only constraint: own-source revenues, grant funds and/or private funds, are needed to serve as project equity; more information is needed about the financial condition and capital requirements of urban councils; feasible, economically viable projects have to be developed; private partners need to be identified where appropriate; and municipal capacity will have to be demonstrated. But the standards and procedures for developing good projects will only be established and followed once there is some promise that funds will ultimately be available. All parts of the system will need to develop in tandem.

B. Need to Further Decentralize Governmental Decision Making

The development of an enhanced financing system will be facilitated by GOZ willingness to devolve more financial decision-making to the local level. The current system encourages dependency by local governments on the technical capacity of the GOZ, and discourages local experimentation. Interventions such as the fee approval process add uncertainty to the revenue-raising process, and therefore increase the perceived risk of a municipal investment by investors. (Private partners will have similar concerns; broader revenue powers will need to be delegated to the urban councils if private partnerships in urban service delivery are to succeed.) A more commercial financial system will give local governments the resources they need to carry out the decentralization objectives of the GOZ but will also require greater autonomy for local authorities, to allow them to make the financial commitments that investors and other private partners will require.

The involvement of the GOZ in urban council decision-making, such as approval of rates and borrowing, is somewhat inconsistent with the GOZ's objective of greater decentralization of responsibility to the local level. Replacement of this approach by a set of negotiated national guidelines or policy objectives for urban councils would provide more autonomy to municipal officials as well as more security to private firms, lenders, and investors operating in the municipal sector.

C. Need to Reduce the Opportunity Costs of the System

Delays are now built in to the current municipal financing system that create enormous opportunity costs for municipalities. These are hidden costs that can sometimes be hard to quantify, but that result in increased costs or reduced revenues over time. Examples of opportunity costs being experienced in the current municipal finance system include: (1) increases in project costs due to inflation during waits waiting for funding, (2) delays in revenue increases due to time lags in completing improvements, (3) extra carrying costs (especially interest costs) that result from delays on projects already under construction that are awaiting incremental funding approval, and (4) extra costs budgeted by contractors to compensate for uncertainties in project start and completion dates and payment schedules.

All of these opportunity costs increase costs and decrease the value of capital investments. They result in raised rates needed to recover costs, and reduced affordability for users. All of these costs, in theory, could be avoided if the municipal finance system were to become less constrained, more transparent, and more predictable for participants.

D. Need to Provide Resources on a Sustainable Basis

The current financing system is not sustainable. It relies on the good will of donors, unpredictable GOZ contributions, and financial sector controls that may not be in place much longer. It is not sustainable economically because of the backlog of needed investment that it is helping to create. The ideal municipal finance system is one which is based on appropriate and predictable sources of funds coming from both the public and the private sector, combined in ways that the resulting investments are affordable for users and attractive to investors. A sustainable system will attract capital on an ongoing basis by presenting attractive investment projects that acceptably balance risk and return. Such an ideal system may take some time to develop, but the goal of a new system in Zimbabwe should be to ensure sustainability to the extent possible. The involvement of the financial sector in the design of the new system and its lending mechanisms will be critical to ensure that private investment opportunities are maximized.

The sustainability of a municipal finance system is partially related to its efficiency, meaning in this case the minimization of costs for issuing, trading, and repaying loans, bonds or other financial instruments. Bonds are generally considered very efficient because of their low transaction costs, but generally only once financing needs reach a certain size. In systems with many smaller borrowers, such as Zimbabwe, other types of intermediaries are sometimes created to access capital on behalf of borrowers. One type, called a multi-project or pooled financing vehicle, raises funds in the market using bonds or other financial instruments and then uses the proceeds to make loans to local governments for qualified purposes. Many other examples exist of innovative approaches to access capital markets efficiently that should be considered for the Zimbabwe market. (Some of these have been mentioned earlier, including leasing, project finance, public/private co-financing, commercial paper, notes, etc.)

VI. Developing a Municipal Infrastructure Policy

In general, Zimbabwe lacks a policy framework for supporting a sustainable system for operating and financing all urban services. Such a framework would systematically address many of the issues covered in the assessment, and would assist the urban (and rural) councils in identifying costs and benefits, setting minimum delivery levels, estimating investment needs, and identifying resources for delivering them. It would also clarify the role that the GOZ is willing to play in the provision of resources at the local level, and guide all participants, including local governments, private partners, financial institutions, donors, and vendors.[18]

The health sector may be an extreme example of municipalities finding themselves with a critical mismatch between costs and resources, but is not the only one. One result of the lack of a clear and predictable funding system is a complex system of cross-subsidies and financial survival techniques being carried out by urban councils. This type of ad-hoc approach will, however, hold back the development of a commercial finance market. Not only is the financial status of local authorities compromised, but the uncertainty and lack of transparency of a number of aspects of the current system is discouraging private sector involvement.

[18] South Africa has recently put in place a comprehensive policy framework for infrastructure finance that might serve as a useful model for an overall municipal finance strategy in Zimbabwe. See *Republic of South Africa: Municipal Infrastructure Investment Framework.* Ministry in the Office of the President, and the Department of National Housing. 25 October 1995.

VII. Constraints Analysis

A. Critical Constraints on an Expanded Municipal Finance System

A number of constraints exist now in Zimbabwe that will keep a more commercial municipal finance system from readily emerging, as discussed below. All of these constraints have been encountered elsewhere; in time all can be addressed and reduced, if not removed entirely. Some, such as the macroeconomic constraints on the overall financial system, are beyond the control of the people and institutions most directly involved in municipal finance issues in both the public and the private sectors. However, these individuals and institutions stand to benefit if decision-makers on these matters come to understand how municipalities, and the country as a whole, will benefit if these larger reforms are carried out.

As discussed above, a thriving municipal finance system can be seen as having three components: (1) markets operating according to commercial principles, (2) appropriate mechanisms and financial instruments, developed specifically for municipal purposes; and (3) disciplined financial management practices at the local government level.

The first of these elements is the most constrained by macroeconomic conditions in Zimbabwe that restrict the availability of financial resources and thwart the development of commercial incentives in the system. The other two elements are less constrained, and can be addressed while macroeconomic reforms are being carried out. In fact, the planned macroeconomic reform can be used as a framework for a transitional strategy that encourages both

municipalities and financial institutions to prepare for the true open market conditions expected over the next several years.

1. Municipal-Level Constraints

Lack of information. The overall financial condition and financial organization of municipalities is difficult to assess—especially by the private sector, which may have an interest in serving the municipal sector, but lack detailed information about it. Similarly, the size of the total municipal capital requirement could not be determined. Although a 5-year strategic planning process has begun in most municipalities, the plans have not been sufficiently developed or aggregated to assist in this regard.

Inadequate financial resources. Municipalities are responsible for a very wide range of services. Minimal capital support is provided by the GOZ, even for social investments that are traditionally supported centrally (health, education). The result is a complex and unsustainable system of operating cross-subsidies that complicate financial reporting and undermine the financial health of urban councils.

Lack of control by local authorities. The GOZ retains extensive controls on local government borrowing and tariff-setting. This control will increase uncertainty and risk for private investors, and undermine both private financing and privatization activities.

2. Financial Sector Constraints

Regulation and control. Financial sector decision-making and competitiveness is influenced by government controls, including prescribed asset targets for pension funds and insurance companies that, among other problems, distort the pricing of municipal debt. Further, GOZ control of municipal entry to the market constrains the growth of the market and the development of market mechanisms.

Need for further market development. Two very different factors may constrain the sale of longer-term debt unless measures are taken to address them. First, the private bond market is still developing in Zimbabwe. Although bonds are listed and sold, secondary trading is very limited and the mechanisms to trade are not well established. Therefore, there is limited experience with bonds. Not only should alternatives to bonds be investigated, but also the need for further development of the bond market should be addressed by the GOZ to the extent that no private sector party can carry out the needed reforms. Second, in the absence of GOZ guarantees, urban councils may be able to raise only shorter-term debt. New techniques to lengthen the term of financial instruments should also be explored by the private sector, including the development variable-rate financial instruments for the municipal sector, the design of credit enhancements.

Limited credit analysis and credit rating expertise. Municipal bonds are purchased today largely on the strength of the perceived GOZ guarantee and the credit analysis performed by GOZ; financial institutions perform little or no credit analysis of municipal bonds. New skills will be needed to appraise and manage risk in the municipal sector.

Moderate size of municipal market. The interest of financial institutions and intermediaries will increase as the size of the market increases, yet even when fully developed, the municipal market will be fairly modest in size.[19] For that reason, it will be advantageous to address simultaneously the financing needs of all creditworthy councils, whether they are urban or rural, as the system is developed. To gain economies of scale in financing, new mechanisms to centralize and pool credit demand from municipalities will likely need to be developed. The moderate size of the market also affects the level of trading that will take place; mechanisms to provide liquidity for investors in municipal debt may also be needed.

[19] The World Bank's Z$1.4 billion estimate of works in progress or planned shown in Section IV C is equivalent to US$125.

3. Macroeconomic Constraints

GOZ priorities. Larger economic objectives, including the need to finance budget deficits, drive the policy agenda that limits the amount of financing available to municipalities. Unless policy discussions are held to address the role of the municipal sector in national development and clarify its needs, urban councils will continue to have limited access to financial resources.

Macroeconomic conditions. Inflation and other macroeconomic conditions limit the amount and type of financing flowing into the Zimbabwean market, by discouraging both savers and lenders from participating. These conditions affect both the level of financial resources available, and the terms on which they can be borrowed, raising the cost and shortening the terms of loans.

Lack of focus on municipal sector. The proposed Zimbabwe Program for Economic and Social Transformation (ZIMPREST) structural adjustment program appears to call for a significant reduction in GOZ financing through the financial markets. To some extent, this belt-tightening will be accomplished by shifting responsibilities to the local level. However the ZIMPREST plan does not address the financing needs of the local authorities during the period of the program. This omission should be addressed.

4. Policy and Regulatory Constraints

Lack of an investment framework. A policy framework for municipal finance is needed that defines the goals and objectives of a municipal financing system, quantifies the overall demand for capital, and the clarifies the roles and responsibilities of the public and private sectors. *Significant* interest exists in developing such a framework in both the public and the private sectors.

Low level and uncertainty of GOZ transfers. The lack of intergovernmental transfers of either operating funds or capital funds complicates the development of private financing schemes. Intergovernmental grants equalize municipal income; help subsidize uneconomic, yet socially desirable, investments; and provide a form of credit enhancement to private lenders. The lack of predictable support from the GOZ will constrain municipal finance development. The current policy should be reexamined in this context.

Interventions by GOZ. The involvement of GOZ in the budget and other management decisions of local government represents a critical risk for private investors. Replacement of this approach by a set of negotiated national guidelines or policy objectives for municipalities would offer more autonomy to municipal officials and more security to private firms, lenders, and investors operating in the municipal sector.

Rural/urban segmentation. Both urban and rural councils need financial resources, and should access them via a unified system of finance, whether through the public or the private sector. Similarly, systems of budgeting, accounting, and reporting ideally should be the same for both, even if the structure of the councils is somewhat different. In addition, merging the investment demands of both would give investors a better sense of the true size of the potential market.

Need for greater coordination. Private financing should be perceived as a part of a "commercialization continuum" that allows for private involvement in the provision of municipal services when beneficial to the municipality, whether in the role of contractor, operator, or financier. The changes being made in financial practices to accomplish commercialization of various urban council functions will also enhance the ability of these same functions to be commercially financed, if preferable. For these reasons, it should be more effective for the GOZ to carry out activities in the two areas of privatization and municipal finance in a coordinated fashion.

B. Resources Available to Address Constraints

A number of favorable conditions are already in place in Zimbabwe that will contribute to the development of an expanded municipal finance system. Some of these are discussed in this section to help convey a sense of the initial position of Zimbabwe relative to other countries that have taken similar steps to expand and commercialize their municipal finance systems.

1. Fiscal Practices at the Municipal Level

Urban councils have relatively sophisticated accounting systems that allow all local government functions to be viewed as enterprises with their own costs and revenues. This system provides management information to municipalities about the "profitability" of various services that allows management intervention, policy change, and municipality-to-municipality comparisons. Not all negative results can be easily managed away, as the current health financing problem shows, but the systems will be an excellent management tool as well as a valuable source of information as more commercial financing develops.

Although it is not viewed by municipalities as a financing strategy, the current commercialization program of the GOZ is focusing new attention on the profitability and efficiency of service provision, and encouraging municipalities to divest unprofitable enterprises. The commercialization program and the management changes that are made in connection with this effort will be very valuable as more councils consider market-based financing.

Zimbabwean urban councils have experience with borrowing and the repayment of debt. The repayment performance of the PSIP is reportedly good; similarly, no bond or municipal loan defaults were reported. However, the deficit spending resulting from changes in the health sector financing are a concern in this regard, and should be resolved as soon as possible, as it undermines good credit discipline.

2. High Payment Rates of Local Rates and Fees

The low incomes of many Zimbabweans are an impediment to the development of a more commercialized credit system to the extent that rates and charges needed to repay borrowed funds could become less affordable to the users of urban services. The discussion in this paper is not meant to downplay the seriousness of this problem. The recommendation to clarify the relationship between central and local government with respect to the provision of grants and other funds would need to have as its focus the economic reality of present-day Zimbabwe, and the need to minimize inequity as well as financial uncertainty at the local level.

At the same time, relative to other very-low-income countries, the Zimbabwean people comply to a great degree with the tax and tariff systems of local governments. When compared with South Africa, for instance, where rate strikes continue as a form of political protest that seriously undermines the creditworthiness of local governments and greatly increases the risk to investors, Zimbabwe's performance on this aspect of financial management is far superior.

As municipalities switch from the balance-sheet lending system of today to more commercial cash-flow-based lending, high payment rates will become an absolutely invaluable asset. To maintain this level of compliance by citizens, governments must seek that rate and tariff burdens are fair and equitable among all classes of users, and allow citizens to have a voice in setting priorities for the expenditure of government funds. They also must see that other public sector debtors and commercial and industrial users are held to the same payment standard as individual citizens.

3. ZIMPREST

Zimbabwe is embarking upon the next phase of its structural adjustment program, ZIMPREST. The economic and macroeconomic conditions that have precipitated ZIMPREST also will affect the feasibility of the measures recommended in this report. The results of ZIMPREST will determine, to a great extent, the success of reforms in the municipal finance arena, as well. ZIMPREST is designed to further deregulate and liberalize the economy, including the financial sector. If successful, it will establish national policies in a number of areas consistent with the recommendations made here. It will encourage privatization and private initiative in many sectors, including basic services, and it is expected to reduce deficit spending of GOZ and do away with the prescribed investment regime.

The role of local government *per se* is not discussed in the ZIMPREST report. The distinction between public and private is clear, but "public" refers almost exclusively to the GOZ. To ensure that local governments, and their resource requirements, are taken into consideration and not unduly restricted during the ZIMPREST program, it may be necessary for this issue to be raised, perhaps in the context of the commercialization dialogue. Whereas ZIMPREST is a 5-year program, it is not necessary to wait to proceed with the recommendations of this assessment until 5 years have passed; some of the effects of reform may be felt soon, but some of the required changes discussed here will take more time. For that reason, the development of an expanded municipal finance market can proceed while macroeconomic reforms are going forward.

4. Liberalization and Innovation in the Financial Sector

The Zimbabwean financial sector is well developed and within many parts of it is found a great entrepreneurial spirit. Financial sector players in Zimbabwe generally anticipate increased competition in their sector in the next few years, and even in the absence of proper incentives, are experimenting with some of the ideas and financial mechanisms that will be needed in a more liberalized environment. The financial sector is interested and willing to assist in the development of more market-based financing mechanisms for municipalities. This spirit of innovation and leadership should be tapped as activities are undertaken to build a new financial market for local authorities. Only through this kind of public-private partnership will mechanisms be designed that address the needs of both sets of participants in the future system.

5. World Bank Local Government Capital Development Project

The planned Local Government Capital Development Program of the World Bank should be viewed by the GOZ as an important resource for carrying out the recommendations made in this report. Not only does the project share the objective of private financing, but many of the capacity-building and information systems improvement activities expected to take place under the program will help to create the conditions necessary at the municipal level for municipal finance. An effort should be made to coordinate any activities that USAID and other donors continue to carry out in connection with municipal finance, not only with the GOZ, but also with preparers and implementers of the LGCDP. This coordination will allow those resources to be leveraged by the GOZ not only with capacity improvements that are already taking place under Urban II, but also with the knowledge gained in the development of this report. In addition, if a collaborative mechanism is created between the public and private (especially financial) sectors, even greater impact will be realized from the program.

VIII. General Recommendations for Zimbabwe

A. Develop a national policy framework for local government infrastructure finance, with the assistance of interested parties, that addresses (among other things) the infrastructure investment need, the GOZ/local government relationship, and the role of the private sector.

B. Create a mechanism for ongoing public-private dialogue on municipal finance market development that can include financial institutions, existing investors, GOZ and local government officials, and the private sector.

C. Address the macroeconomic conditions and regulatory impediments that constrain the development of an active municipal finance market.

D. Develop and begin implementation of a transitional strategy, from the current municipal finance system to an expanded, more market-based system, that will take into consideration other economic reforms that will be taking place in Zimbabwe over the next few years, and ultimately result in an expanded open market system of municipal finance.

E. Move forward simultaneously on commercialization, privatization, and municipal finance market development, as related strategies.

IX. Recommendations for USAID

A. Work on developing a secondary mortgage market and municipal finance market simultaneously at the policy level, since the issues underlying them are very similar.

B. Facilitate the development of a public-private sector dialogue on municipal finance by co-sponsoring a conference on the topic of municipal finance.

C. Seek support at the conference for creation of a policy framework on municipal infrastructure finance. Design and support a process for its creation.

D. Coordinate with the World Bank to develop ways to use the new LGCDP to carry out some of the recommendations in this report. In particular, coordinate on policy development activities, and evaluate the feasibility of using the loan funds as co-financing on municipal projects where private financing is being sought.

E. Provide targeted technical assistance on municipal finance issues instead of a more detailed municipal bond market study. Potential areas for assistance might include:

1. Design of a transitional strategy for the deregulation of the current municipal finance market.

2. Capital planning exercise with local authorities.

3. Development of models for public-private co-financing.

Attachments

Attachment A
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Attachment B
Materials Reviewed

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Attachment C
Glossary of Terms

Note: Items in SMALL CAPS are defined elsewhere in the glossary.

Allocation . . . . As used in this report, distribution of SECURITIES available for initial sale among interested buyers on a basis other than price; for example, equal shares.

Balance sheet lending . . . . Lending that entails using existing assets of the borrower, as shown on the borrower's balance sheet, as SECURITY for the lender. The borrower may be an individual, corporation, or government entity. Under the alternative approach, sometimes referred to as CASH-FLOW LENDING, the future earnings and profits of a borrower are considered a principal source of security for the LOAN.

Basis point . . . . The smallest measure in quoting YIELDS on BONDS, equal to one one-hundredth of one percent, or 0.01 percent. 100 basis points is one percent.

Bond . . . . An interest-bearing corporate or government SECURITY that requires the ISSUER to pay the bondholder specified sums of interest, usually at specific intervals, and to repay the principal amount of the BOND at maturity. Bondholders have an IOU from the issuer, but receive none of the corporate ownership privileges received by stockholders.

Capital asset . . . . Long-term assets that are not bought or sold regularly. Capital assets represent fixed investment in the ongoing activities of the corporation or government entity.

Capital market . . . . Markets for the trading of capital funds (DEBT, or BONDS; and EQUITY, or stock). Capital markets include both private placements of debt and equity, and SECURITIES traded publicly in organized FINANCIAL MARKETS such as a stock or bond market.

Capital budget . . . . Also referred to as "capital improvement plans" (CIPs). This type of budget document shows the multi-year plan of expenditures for major, non-recurring investment projects, such as those in buildings, roadways, and other INFRASTRUCTURE. Equipment purchases and major repair work may also be included in a CIP.

CIPs sometimes include a financing plan that shows sources of investment funds.

Capital constraint . . . . Situation where the demand for capital investment financing exceeds the supply of funds available to finance at affordable interest rates.

Carrying costs . . . . Costs of owning land or other major assets (for example, taxes and interest on funds borrowed to finance the purchase of the asset) prior to sale of the asset or placement of the asset into its income-producing use. While certain carrying costs can be capitalized into the value of the asset, they use up cash intended for other purposes, and if incurred in excess of expectation, can transform a profitable project into one that is unprofitable. Delays during construction are one factor that increases carrying costs.

Cash flow . . . . The movement of cash in and out of a business's or government's cash account during a particular period. Operating activities, investments, and financing activities all affect the flow of cash. When cash inflows exceed outflows, the entity is said to have a positive cash flow; when outflows exceed inflows, a negative cash flow exists. Even companies in good financial condition can experience periods of negative cash flow. Lenders and bondholders have an interest in the cash flow of an organization because debt service payments are made from cash flow.

Cash-flow lending . . . . Lending that relies on the future CASH FLOW of the business or government agency, as the source of LOAN repayment and loan SECURITY. This type of lending is the opposite of BALANCE-SHEET LENDING, where the existing stock of assets shown on the balance sheet is considered the primary loan security, a more conservative approach.

Commercialization . . . . In Zimbabwe, the movement to plan and operate government activities more as enterprises, and to allow increased competition. Commercialization may either entail private sector involvement (in operations, procurement, etc.), or simply be a change in philosophy of government with respect to existing activities. For example, a beer hall owned by an urban council could be commercialized by being sold to or operated by a private company, or the municipality could allow competition and change its operations in such a way as to make the activity more competitive with private beer halls.

Commercial principles . . . . . . Principles of the private market, such as market-based interest rates, transparent subsidies, full repayment of the costs of borrowed funds, free choice by investors in the selection of investments, and open competition to lower costs.

Concessionary funding . . . . . . Funding provided by governments, donors, or other non-market sources, the terms of which are more favorable to the borrower than funds available through private (OPEN MARKET) channels. The concession may consist of a lower interest rate, a longer repayment period, or LOAN requirements (such as SECURITY) that are more lenient than those available commercially. The concession is in effect a subsidy to the borrower.

Coupon rate . . . . The interest rate on a debt SECURITY, expressed as an annual percentage of the face value of the security. For example, a 5% coupon rate on a Z$1,000 BOND would pay Z$50 annually. Coupon rates do not change if the market value of the security changes. Formerly, coupons were small IOUs attached to bond certificates, and were presented at the time of interest payment.

Credit enhancement . . . . A mechanism or arrangement that improves the marketability of a BOND by lowering the bondholders' RISK. Enhancements generally have a cost, but in return result in lower interest costs. Enhancements can be internal to the bond (reserve funds) or external (bond insurance, LETTER OF CREDIT, sovereign guarantee).

Credit analysis . . . . Analysis of the books and activities of an organization to determine its creditworthiness.

Credit rating agency . . . . An institution that issues an independent opinion of the ability and willingness of an ISSUER to make full and timely payments of interest and principal on the outstanding or anticipated DEBT. Credit ratings generally take into account four principal credit factors: economic factors, debt factors, governmental/ administrative factors, and fiscal/financial performance factors.

Cross-subsidy . . . . A cross-subsidy takes place when a financial surplus, raised from one class of users of a service, is used to lower the cost to another class of users of the same service, or when the surplus from one service is transferred in order to decrease costs of users of another service. There may be economic or social justifications

	for such transfers; however, many cross-subsidies are unintentional, and have unintended side-effects, such as encouraging excess consumption of the service by users whose costs are subsidized.
Debt	Money or other objects of value that one party owes to another, based on an agreement that may be written, oral or implied. Debt owed in the form of a BOND or LOAN generally entails the payment of periodic interest and return of principal periodically or in a lump sum at the end of the debt period.
Equity	Finance — The net worth of a company or public entity; that is, the value of its assets minus its liabilities. One component of equity is the accumulated retained earnings of the entity. Investment — Position of partial ownership of a corporation through the holding of shares (stock). Unlike DEBT holders (lenders), stockholders have rights as owners in the corporation.
Financial market	Market where capital and credit are traded in an economy. Money markets are used for trading short-term DEBT instruments; CAPITAL MARKETS are used for trading long-term debt and EQUITY instruments such as BONDS and stocks. Financial markets include: foreign exchange markets, commodities markets, bond markets, and stock markets.
Financial instrument	Legal document that contains the description of a legal relationship or grants a right. Example: a BOND, by which an ISSUER gives the purchaser of the bond the right to be paid interest and to have the principal returned at a specified time.
Financial intermediary	Financial institution that serves as a go-between for savers and borrowers and redistributes savings in the economy to productive uses. In the process, intermediaries also help savers diversify their RISK and provide them with liquidity.
Infrastructure	A country's basic system of public investment, including roads and other transportation, telecommunications, electricity, water and wastewater systems, etc.
Internal funds	Internal (or own-source) funds are the accumulated surpluses of local governments that result from net operating income (or surplus) in one or more fiscal years. Own-source funds can also come from RESERVES from current income (such as replacement reserves), interest earned on prior surpluses or other investments, and sale of CAPITAL ASSETS (including land).

Issuer . . . . A corporate entity, political subdivision, or other authority that borrows money through the sale of BONDS or other DEBT instruments.

Lease . . . . FINANCIAL INSTRUMENT or contract that grants the use of property for a specified time to another party in exchange for rent payments. The lessee is the owner of the property being leased; the lessor is the user of the property. Leasing is sometimes referred to as "lease-financing," since the lessor is, in a sense, using the financial capacity of the lessee to acquire an asset.

Leasing companies purchase and retain ownership of buildings and equipment and lease them out, on a short- or long-term basis, to other parties. The lessee (user) may not have adequate credit capacity to purchase the leased asset itself, or may prefer the flexibility of leasing over ownership. The lessor (owner) may realize tax savings from leasing that the lessee would not, therefore lowering the cost of the lease relative to owning for the lessor. Municipalities may lease for these reasons, as well as to avoid the need for voter approval of capital financing (as in the U.S. State of California). So far, municipal leasing is found in only a few countries.

Letter of credit . . . . A CREDIT ENHANCEMENT purchased by a government to secure a higher credit rating for its BOND issue. It is typically a contractual agreement between a major bank and the issuing government consisting of an unconditional pledge of the bank's credit to make principal and interest payments of a specified amount on an ISSUER'S DEBT for a specified period of time.

Line of credit . . . . A commitment by a bank to lend funds to a borrower up to a specified amount, into the future. The line is considered good until further notice and may be terminated at the bank's option. A line of credit is usually used for temporary financing or liquidity purposes by borrowers with strong credit standing, and it often terminates automatically if an ISSUER violates various terms and conditions, including terms of a BOND indenture (e.g., regarding the debt service reserve fund). It is therefore not a very good CREDIT ENHANCEMENT mechanism.

Loan . . . . The borrowing and return of cash with regular payments of interest during the period outstanding. Also used to refer to any transaction where an owner of property (the lender) allows another party (the borrower) use of the property. Regularly during the loan the owner is paid interest for the use of the property; the property is returned at the end of the period.

Macroeconomic policy . . . . . . Central government policy that affects the functioning of a nation's economy as a whole, including price and interest rate levels, unemployment, inflation, and industrial production.

Municipal bond . . . . DEBT obligation of a state or local government or its instrumentalities. Funds raised are used for general or special purposes and they may be secured by the revenues and assets of the entire government (general obligation bond) or a specific source (revenue bond). In the United States, interest paid to municipal bondholders is generally tax-exempt; however, taxable municipal bonds are issued in the United States and many other countries.

Municipal finance system . . . As used in this report, the system of: (1) institutions (financial institutions, FINANCIAL INTERMEDIARIES, and supporting institutions such as CREDIT RATING AGENCIES, trustees, CREDIT ENHANCEMENT organizations, trading systems, etc.); (2) FINANCIAL INSTRUMENTS (LOANS, BONDS, LEASES, etc.); (3) sources of funds (domestic savings, foreign investment, etc.); and (4) the policies and regulations that govern their interaction. Together, these elements make it possible for borrowers to gain access to funds for needed local government purposes—ideally, on a sustainable basis—including access to the private CAPITAL MARKET.

Notes (BANs, RANs, TANs) . Short-term DEBT instruments, usually with maturities of less than one year. Bond anticipation notes (BANs) are used to start capital improvement projects, and are paid off when long-term BONDS are issued. Tax anticipation notes (TANs) and revenue anticipation notes (RANs) are usually used to meet CASH FLOW demands until these other sources of revenue become available to pay off the obligations. Notes can be and often are rolled over. The danger is that if interest rates go up, the cost of borrowing can go up precipitously and quickly.

Open market . . . . Private FINANCIAL MARKET where individuals, corporations and government agencies carry out financial transactions under COMMERCIAL PRINCIPLES.

Opportunity cost . . . . A term that can mean either (1) the highest rate of return realizable on an alternative investment with the same level of

RISK as the one being considered, or (2) the differential between the highest alternative rate and that being considered. Generally, it refers to the cost of making a bad investment decision or of delaying making an investment decision. For example, the opportunity cost of keeping cash under a mattress might be the rate of return on a money market investment with a similar level of risk.

Overdraft account . . . . See LINE OF CREDIT.

Own-source funds . . . . See INTERNAL FUNDS.

Parastatals . . . . Also referred to as public enterprises. They are enterprises owned, and often operated, by the central government, often on a monopoly basis. COMMERCIALIZATION activities in Zimbabwe include examining options for the future of parastatals. Examples of parastatals in Zimbabwe are the Zimbabwe Electricity Supply Authority (ZESA), Air Zimbabwe, and the National Railways of Zimbabwe.

Pooled financing . . . . An approach to municipal financing in which a FINANCIAL INTERMEDIARY raises funds in the OPEN MARKET on behalf of multiple borrowers, for instance by issuing BONDS, and then lends the funds to borrowers according to established terms and criteria. If properly structured, pooled financing vehicles lower RISK for lenders or bondholders and lower TRANSACTION COSTS for borrowers. Pooled financing vehicles take advantage of economies of scale in financial transactions.

Prescribed asset . . . . A fiscal policy, employed in Zimbabwe and elsewhere, under which a central government requires a certain percentage of financial institution assets to be held in designated (“prescribed”) investment vehicles, generally government DEBT instruments (short-term notes, long-term gilts [central government BONDS] or MUNICIPAL BONDS). The prescribed asset requirement may be motivated originally by prudential objectives (ensuring safe investments are made by financial institutions), but may persist for fiscal reasons since it ensures the public sector preferential access to the domestic FINANCIAL MARKETS.

Primary market . . . . Market for selling original issues of SECURITIES. The ISSUER of the securities receives the proceeds from primary market sales—unlike SECONDARY MARKET sales, where investors, brokers, and dealers receive the proceeds.

Privatization . . . . Form of COMMERCIALIZATION that entails involving the private sector in the operation or ownership of assets employed in the provision of a service or activity that historically has been carried out by the local or central government.

Project financing . . . . "Project loans" or "project financing" refers to an approach to financing in which the revenues resulting from the particular project or function being financed serve as the main source of SECURITY for the investor. This type of LOAN relies heavily on high-quality financial feasibility analysis in order to appraise the potential financial outcomes from the project. Revenue bonds (see MUNICIPAL BOND) are a type of project finance. The importance of this approach to financing in the municipal sector is that a project sponsor, such as an urban council, which itself may not be in excellent financial condition, may have particular projects that can be "project financed" on the basis of project income rather than overall municipal income.

Real interest rate . . . . Market interest rate minus inflation. Only if interest rates exceed inflation is a lender receiving a real return on the funds lent. Otherwise, the value of funds repaid will be less than the original principal, when adjusted for inflation. If savers do not receive a real interest rate on savings (0% or lower real interest rate), the value of their saved funds will diminish over time. This situation creates a disincentive to save. These funds might be better spent on an asset whose value will rise with inflation.

Reference rate . . . . An interest rate that serves as the basis or reference point for other SECURITIES' interest rates. This may be the lowest rate in a market, such as a TREASURY SECURITY interest rate, or another reliable or stable rate such as the prime rate (the interest rate offered to high-quality commercial customers by commercial banks) or LIBOR (London Interbank Offered Rate—the rate at which international banks lend Eurodollars).

Reserves . . . . Accumulations of cash funded out of capital funds, current income, or surplus, and designated for specific purposes. Reserves may be funded in advance of predictable expenditures (such as debt service) or may be held as contingency funds in case of unexpected events (to pay for major repairs or to cushion against extreme changes in tariffs). Reserves are a form of CREDIT ENHANCEMENT. By funding various reserves out of the proceeds of a BOND issue, ISSUERS can improve the credit quality and lower interest costs of a bond issue by lowering the perceived RISK of bondholder repayment.

Risk .... Uncertainty of outcomes in a financial transaction, especially the possibility that the financial outcome will be more negative than expected. Types include interest rate, foreign exchange, repayment, inflation, and political risk.

Secondary market .... Markets where SECURITIES are bought and sold after their original sale in the PRIMARY MARKET. In the secondary market, securities are bought from prior investors and dealers, rather than from the ISSUER of the securities.

Security .... Finance — Collateral provided to the lender by the borrower in a LOAN transaction. In the event of non-payment, the lender can take possession of the security and, if necessary, sell it for cash. For example, for a mortgage loan, the house generally serves as collateral.

Investment —An instrument (document) that gives evidence of an ownership interest in assets, or of a creditor relationship. In a MUNICIPAL BOND transaction, the security held is the BOND, which shows that the bondholder is owed interest and the return of principal during the bond term. Options, warrants, and stocks are some other examples of securities.

Spread .... Difference between two interest rates or YIELDS, especially between the rates at which SECURITIES are bought and resold, or between rates bid and offered in a market. If an underwriter buys a new BOND from the ISSUER at $99 and sells it to the public at $100, the spread is $1. If a POOLED FINANCING institution raises funds at 10% and lends them at 13%, the spread is 3%.

Subordinated funding or loan Where multiple lenders make LOANS to the same borrower or project, the subordinate lender can make a claim on the assets of the borrower only after senior lenders have their claims satisfied. There can be many levels of subordination. Because senior lenders have a greater chance of being repaid, and are therefore subject to less repayment RISK, senior loans generally carry lower interest rates than subordinated loans.

Swap/swap market .... Exchange of one SECURITY for another. Swaps may entail the exchange of variable-rate securities for fixed-rate securities, exchange of short-term securities for long-term securities, exchange of securities denominated in different currencies, etc.

Swaps are carried out to accomplish investment objectives such as lower RISK, longer maturity, or higher return. The swap market is the place where these exchanges take place.

Syndicate . . . . An alliance of underwriters (generally investment houses, merchant banks, or other financial institutions) who sell a BOND issue, led by a senior manager who coordinates the sale. Syndicates vary in size, depending on the amount of the bond issue and the ease with which it is expected to sell.

Transaction costs . . . . Costs of buying and selling SECURITIES, such as BONDS. These costs include fees paid to the underwriter and to the dealer and/or broker, and taxes.

Treasury securities . . . . DEBT obligations of a central government, secured by its full faith and credit. U.S. treasury securities are issued regularly and vary in length. Examples: treasury bills (less than one year), treasury notes (1 to 10 years) and treasury bonds (more than 10 years).

Central government securities are generally considered very low RISK, or risk-free, because of the depth of resources available to repay them. Therefore the interest rates on central government securities will generally be the lowest in the market, and can serve as a basis for the pricing of other riskier securities. The treasury interest rate is sometime referred to as the “risk-free” rate.

Urban council enterprises . . . . Activities carried out by urban councils in Zimbabwe, and provided for in urban council budgets, that produce revenues, but are outside of core public sector functions. Examples include the operation of beer halls or other retail activities, livestock farms, and guest houses.

Yield . . . . BOND income expressed as an annualized percentage rate. Sometimes used to refer to COUPON RATE only, more commonly the yield also factors in whether the bond was originally purchased at a premium or discount relative to par value (face value of the bond).