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Report to USAID on Technical Assistance Workshops to the Financial and Fiscal Commission of South Africa

and

Paper on Borrowing by Subnational Units of Government: General Principles and Examples From International Experience

August 1996

Prepared for the
USAID Workshop with the Financial and Fiscal Commission of South Africa

August 5-9, 1996

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1. Introduction

This is a report to USAID under Contract No. PCE-0025-Q-00-3071-00, Delivery Order No. 32. The work leading up to and including this trip to South Africa took place during July and August 1996, and represented the first half of a two-part sequence of activities to assist the Financial and Fiscal Commission (FFC) of South Africa, or other South African counterparts with responsibility for subnational fiscal policy. The centerpiece of this trip was a five-day workshop at the FFC (August 5 - 9) that focused on issues of local public finance in South Africa. Participating in this workshop were FFC staff, the USAID team of international experts (Dr. Rudolph Penner, Team Leader; Dr. John Crihfield; Dr. Remy Prud'homme; and Dr. Michael Wasylenko), Russell Hawkins (USAID/South Africa), representatives from the South African Department of Finance, and representatives from the South African financial community. (See Appendix.) In preparation for these workshops, numerous papers and reports were compiled by Barents Group and the FFC and distributed to workshop participants. Barents Group also wrote a paper on borrowing by subnational units of government (attached to this report).

The workshops were structured around several key issues in local government finance in South Africa today. For each issue an initial presentation was given by either the FFC or by a member of the international team of experts. The following topics were covered:

- The Structure and Institutions of Local Government in South Africa
- The Constitution and Local Government
- Local Revenue Structures and Finances
- Local Government Borrowing
- Grant-Loan Linkages
- Local Government Grants
- Local Revenue System
- Legislative Initiatives
- Wrap Up

We wish to acknowledge the assistance of Russell Hawkins and Carlene Dei of USAID/South Africa for assisting in making arrangements for our trip. We also wish to thank Chairperson Murphy Morobe, Deputy Chairperson Dr. Antony Melck, Director Dr. Pundy Pillay, Deputy Director Colin Donian, and the staff of the FFC for their hospitality for the duration of our stay in South Africa.

2. Background and Overview

The success or failure of the current South African government will depend, in large part, on its success or failure in improving housing, sanitation, water availability, and health services for its poorest residents. In most countries, local government has an important role in providing all these benefits, and therefore, it is clear that South Africa will have to develop effective local governments in order to successfully serve its people.

Given the importance of local government, it is a bit puzzling that it did not receive the attention that it deserved while the new draft constitution was developed. Most of the intellectual effort of intergovernmental experts in South Africa was devoted to developing the relationships between the nine new provinces and the central government, a task that was performed quite well. Local governments were to some extent left to fend for themselves, and they have evolved differently in different areas.

Severe dangers are inherent in this unplanned evolution. Two levels of local government have been created. In urban areas, metropolitan governments have been established over municipal substructures. The substructures have been designed to merge extremely affluent and extremely poor areas. For example, in Johannesburg, four new substructures have each had to absorb parts of Soweto. In rural areas, District councils will be above substructures. Very little is known about what is occurring in these areas.

It seems that South Africa has made the philosophical decision to use local government to redistribute income. The problem is that local government is ill-suited to perform this task. If local governments attempt to tax the rich to aid the poor, the rich are likely to flee to another jurisdiction, leaving the inner city as an empty shell. This has happened in the United States, as affluent whites and blacks have fled to the suburbs. Fleeing to the suburbs will be more difficult in South Africa, because jurisdictional boundaries have been drawn to encompass very large areas. On the other hand, the incentive to flee will be greater because of much greater disparities in income distribution. One jurisdiction in Johannesburg has already tripled its property tax rates -- an extremely dangerous development.

It is much easier for the central government to design a redistribution policy. It can levy the same tax on the affluent regardless of where they live, presuming that they do not choose to leave the country. Some of the revenues can be returned to local government in the form of grants aimed at assisting those who are most disadvantaged within localities.

Another danger lies in ambiguities in the relations between metropolitan, district, and local governments. The constitution reads as though there are three levels of government. There are, in fact, four -- central, provincial, metropolitan or district, and local substructures. The apportionment of relative taxing powers and spending responsibilities between the lowest two levels are not well defined and, as noted above, are evolving without guidance. Proposed legislation regarding metropolitan areas has been drafted and that will help some, but there is much to be done.

Yet another problem arises because policy toward the structure of government was changed significantly between the interim and final constitution. The former made local government clearly subservient to the provinces. The latter has local and provincial governments deal with the central government on an equal basis. Some parts of the new constitution clearly reflect this new philosophy, but other parts seem more consistent with the interim constitution.

It is obvious that a large number of important decisions have to be made regarding local government. Some sort of control has to be exercised over their taxing power; a grant structure has to be designed; the roles of the lowest two levels of government have to be better defined; and the constitutional relationships among the central government, the provinces and the two levels of local government has to be clarified.

3. Recommendations

The essential recommendations of the international team can be summarized in terms of two key issues: the gathering and analysis of data, and identifying a system of constraints for the structure of local governments.[1] Numerous other recommendations were also suggested.

Gathering and Analyzing Data. Every member of the international team stressed the importance of database development and the development of analytic capabilities. Although it is not clear whether the FFC should be responsible for the initial development of data, it is important that all financial, economic, social, and demographic data be available to the FFC. (Other candidates for the development of fiscal data for local governments include the Department of Finance and the Department of Constitutional Development and Provincial Affairs.) Local financial information would include current data on local government taxes, information on local government finances (budgeted amounts compared to actual results), local government policy initiatives, and balance sheet information. Since local government fiscal data are incomplete, it was urged that the FFC contact directly and regularly all six South African metropolitan area governments and a reasonable sample of rural district governments so as to establish a

[1] The specific recommendations of the non-Barents Group team members (Dr. Remy Prud'homme and Dr. Michael Wasylenko) are included as attachments to this Trip Report.

credible time series of local government fiscal data. It is also important that the FFC develop appropriate analytic methodologies in forecasting revenues and expenditures for subnational governmental units and in evaluating alternative fiscal policy scenarios. The FFC may wish to consider providing its evaluations and forecast to the public on a regular basis (e.g., as news releases), although the question of whether to be vocal or quiet in policy discussions is, ultimately, one that requires political judgment on the part of the FFC.

Constraints on Local Governments. The question of constraints on local governments arose in numerous contexts, including constraints on local government borrowing, constraints on local government taxing powers, and constraints on local government spending. The overriding concern is that local government fiscal policy will go too far in attempting to redistribute income from wealthy metropolitan substructures to poor substructures, with the potential of undermining local economies as affluent people flee the cities or the country to avoid high tax burdens. Central government taxation, accompanied by grants to subnational units of government, mitigates the relocation effects of policies to redistribute income.

Other Issues. Numerous other issues arose throughout the week. (Many of these are included in the recommendations attached to this report.) Some of the most important of these are the following:

- Grants to local areas should be based, in large part, on per-capita allocations; it is also important to incorporate other criteria such as tax capacity, and, perhaps, minimum levels of tax effort.

- Specific capital grants should be considered for other types of local public infrastructure besides housing.

- The new Constitution must be clarified with regard to the structure of metropolitan areas, municipal substructures, rural districts, and local councils. It was strongly suggested that the details of local government structure be left to legislation rather than to the Constitution.

- It was strongly urged that the FFC take the lead in anticipating the policy demands of the Parliament, provinces, and local governments.

- Provinces and local governments should be encouraged to develop own-sources of revenue, such as provincial surcharges on the national income tax, local property taxes, and excise taxes on the services of public utilities (in particular, electricity and water). Sound own-source revenue streams will also be essential for subnational units of government to regain access to the capital markets. Policy recommendations must be accompanied by in-depth analysis of these and related policies.

4. Future Directions

The week-long workshops during early August 1996 constitute the first part of the delivery order for this USAID contract. There are several options for the second part of this delivery order, which is to occur sometime before mid-July 1997. One option is to plan another week-long set of workshops with a somewhat broader audience that could include the FFC Commissioners and representatives of other institutions deemed appropriate by the FFC. A second option is to plan workshops that focus more narrowly on issues and proposals identified by the FFC as having special importance to the issues it faces. A third option is to support a technical analyst for several weeks at the FFC, whose role would be to address a special need. A fourth option is to conduct workshops at another counterpart South African institution, in a manner similar to the just-completed workshops. In the end, it was recognized by the international team, USAID/South Africa, and the FFC that the driving principle is to provide assistance that bests serves the needs of the FFC.

More generally, it was clear that much work remains to be done on issues of local and provincial fiscal policy in South Africa. This was made clear by discussions with the FFC as well as with representatives of the Department of Finance and the Department of Constitutional Development and Provincial Affairs. The demands for public services at the local level are enormous, and expectations have been heightened by political promises that will be difficult to fulfill. At the same time, infrastructure development in basic services such as water, sanitation, electricity, and communications, and development of systems of education and health are crucial for the long-run stability and growth of the South African economy. It is essential, therefore, that sound economic and fiscal policy be established from the beginning for provinces and local areas.

Appendix
List of Officials Contacted

Russell Hawkins	USAID/South Africa
Richard Harber	USAID/South Africa
Carlene Dei	USAID/South Africa
Murphy Morobe	Chairperson, Financial and Fiscal Commission (FFC)
Dr. Antony Melck	Deputy Chairperson, FFC
Dr. Pundy Pillay	Director, FFC Secretariat
Colin Donian	Deputy Director, FFC Secretariat
Jackie Manche	FFC Research Analyst
Kuben Naidoo	FFC Research Analyst
Clive Pintusewitz	FFC Research Analyst
Annaleeze Prosee	FFC Staff
Colleen Rip	FFC Research Analyst
Siyasanga Giyose	FFC Intern Researcher
Betty Kaseke	FFC Research Analyst
Peter Vas	FFC Researcher from the United States
Ismail Momoniat	Department of Finance, Republic of South Africa
Nigel Palmer	UAL Merchant Bank Limited, Johannesburg
David J. O'Neil	KPMG-Johannesburg
Roland White	Consultant to the South African Dept. of Finance
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De / From : Remy Prud'homme

Nombre de pages / Number of pages: 1 (cette page incluse / including this page)

Suggested Work Program for the FFC

It is obviously difficult for us to tell or even suggest FFC what it should do. FFS's function is as much political as technical. It is not merely to find outhe "truth"; it is to find out and deliver those truths that can be usefullyaccepted, digested and utilized by the body politic. Our limited understanding of these legitimate political constraints makes it hard for us to identify and prioritize tasks for FFC, and the following suggestions are offered in a spirit of prudence and modesty.

Information - It is certainly important and probably necessary for FFC to obtain, process and disseminate information on what is currently happening in the area of local government finance. There is presently a lack of meaningful information that is worrying. Policy decisions are being made on a grossly insufficient information basis. IfFFC succeeds in becoming a center of knowledge on these matter, this will strengthen its status,and give weight to its recommendations. How could this be achieved? The danger here is exhaustivity. If FFC attempts to obtain data on all local governments (a very needed task, that will hopefully bteken up some day by the Statistical Office, or someother Agency) it will not succeed, and even if it did, it would not get a good understanding of what is happening. It will be much wiserto focus on a limited (5-8 I would say) number of local governments, to visit them regularly, to talk to their leaders and to their administrative staff, to collect data on their accounts,on their tax bases, on the subsidies they receive, so as to be able to answer questions such as: how are property valued?; what is the shareof residential v. commercial property tax base?, how is the so-called electricity "surplus" calculated? I believe that this information task should not bthe responsibility of just one or two FFC staff members, but that every one of them should, in addition to his other tasks, be allocated the responsibility to oversee one local government.

Constraints on LocalGovernments (LGs)- Another important and probably urgent task for FFC is the design of a set of constraints on LGs borrowing, taxing and spending powers. LG should in principle be free, which means free to make mistakes.Nevertheless, this freedom need not be total and absolute. In most countries, including countries where LGhave existed for centuries and are therefore experienced and mature, there are constraintsimposed upon their behavior by the central government (in unitary systems) or by state governments (in federal systems). These constraints are numerous in the area of *borrowing*: the amount of LG borrowing may be subject to central government approval, or may be limited as a functiomof LG income or debt; similar rules must be developed in the casof South Africa —although this is not the most pressing area becausc the lending communitydocs not seem to be ready to lend much in the coming years. There are also often constraintsin the area of *taxing* powers of LG, e.g. in the USA many States limit the real rate of property taxation,or in France, the central government limits the rate at which some LGs taxrates can be increased. Such limits are particularly desirable for South Africa at present. Theycan relate both to (i) the speed at which tax rates or tax payments can be increased over time (not more than 10% —or 20%— irreal terms per year), and to (ii) absolute or relative levels of taxation achievable (not morthan twice the national average, or in the case of the property tax notmore than 2% of the market value or 5% of household income). The area of LG*spending* is more difficultto regulate. But a number of constraints can nevertheless be introduced, for instance on wage increases (not more than inflation + x%), on recruitment, or on the ratio of operating expenditures relative to investment expenditures.

Grants to LGs formula — Some sort of grant system from the central government to LGs will most probably have to be developed, if LG are to perform efficiently their important functions. FFC has already marshaled the idea that grants should be automatic, that is by formula, rather than ad hoc. It is not too early to begin doing for LGs what has been done for provinces, that is develop an appropriate formula. This is a difficulttask, in part because of the uncertainty in the respective role of metropolitan government municipalities and substructure municipalities, but one that will soon appear necessary. Here is not the place to discussin depth the appropriate criteria. Two can be briefly mentioned. One is simply population: in somewhat paradoxical fashion an equalitarian per capita amount goes a long way to reduce inequalities[1] The other is tax capacity: LG with a low tax capacity are "compensated", at least in part, and receive an additional amount of grant.

Additional taxes for LGs — All the three sub-national levels of government needown revenues, that is access to tax bases. Their resources must depend, at least at the margin, by their decision to increase (or decrease) tax rates, if they are to behave in a responsible and accountable fashion. On the otherhand, few tax bases are really appropriate for subnational government taxation. A compromise must therefore be arrived at. It is desirable that this compromise include morethan one tax for each level of government, for at least two reasons. One is that the economicdistortions created by a (local) tax increase exponentially with the tax rate, so that two taxes with a 5% rate will be less harmful than one tax with a 10% rate.The other is that for a given LG, a portfolio of taxes is better protection against short-term or long term trends than a single tax. Designing a sub-national tax system that is fair, robust, distortions minimizing, administratively feasible, and sustainable, is thereforea difficult task, but one that falls clearly within the mandate of FFC.

Electricity distribution — Power (and also water) distribution is a municipal function. The delivery of electricity issaid to have been an important source of revenues for LG, which would mean that powertariffs exceeded power costs. At present, it seems that nobody knows for sure whether this statement reflects an economic reality, or whether itis an accounting artifact. What is likely, however, is that the entire issue of electricity (and also water) production, transportation, and distribution will be raised and discussed. The potentials of privatization will be examined. The needs ofthose who don't have access to electricity (and also water) will be taken into consideration as well as the continuation of the servicdo those who are presently services. Municipalities have a major stake in theoutcome of such discussions. Making sure their interests are taken into consideration might be an important role for FFC, and would fall within its mandate. This cannot be done effectively without a serious understanding of the entire area.

[1] Consider two LG of similar population. LG A, a rich area, has a tax capacity of 100, whereas LG B, a poor area, has a tax capacity of only 10: there is a one to ten disparity between A and B. Let us assume that a grants system is introduced that gives the same amount, 90, to both A and B. The income at the disposal of LG A is now 190, whereas the income at the disposal of LG B is now 100: there is a one to two (or more exactly 1.9) disparity between A and B. This may be considered too much, but it is much less that the initial one to ten disparity.

Summary and Future Directions for the Financial and Fiscal Commission of South Africa: Conclusions Based on a Five Day Seminar: August 5-9, 1996

Michael Wasylenko

Background

Economists have come to believe that better political and economic institutions enable some countries to grow faster than others.[1] Economic growth for South Africa may well depend on how well it designs its Constitution and how prudently it handles income redistribution. Shaping the environment in which it delivers public services and how it finances those services can have profound effects on economic growth.

Given the above, it is my understanding that the Commission is one of the few institutions in South Africa charged with examining the long-term implications and the effectiveness of legislation governing local governments and with determining how individual pieces of legislation interact and affect local economies and ultimately the national economy. The Commission can meet these responsibilities by continuing its careful analysis and thinking and by developing sound fiscal initiatives. I believe that the Commission has a central role in fostering economic growth in South Africa, and even that may understate its potential importance to the economic success of the South Africa.

Priorities and Directions

Shaping a clear fiscal environment is central to subnational governments being able to deliver the infrastructure and other services that will improve the welfare of the majority citizens of South Africa. Throughout the week, the seminar participants have identified several inconsistences and a number of points that need clarification in the proposed Constitution. The Financial and Fiscal Commission should identify the problematic paragraphs and submit clearer wording on fiscal issues to the framers of the Constitution for their consideration.

Provinces At present, the provinces appear to have a fundamental imbalance between the services they are asked to deliver and the resources available to finance reasonable levels of those services. On the revenue side, the Financial and Fiscal Commission should give priority to drafting legislation allowing provincial governments to utilize a surcharge on the personal income tax.

On the expenditure side, provinces will deliver education, health care and welfare. Major

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[1]Mancur Olson, Jr., "Distinguished Lecture on Economics in Government: Big Bills Left on the Sidewalk: Why Some Nationals are Rich, and Others Poor," Journal of Economic Perspectives, 10 (2) Spring 1996: 3-24.

portions of education and health care will be financed through foundation grants. Some consideration should be given to financing and delivering welfare services at the central government level. Welfare programs tend to become more costly over time and provinces will likely struggle to match revenues with expenditure responsibilities that include services. Moreover, welfare services are largely pure income redistribution. Reinforcing a major tenet of public finance, redistributional services and taxes should be financed at the highest level of government, so that residents can not easily avoid payment by moving elsewhere.[2] Relieving provincial governments of the responsibility for welfare services also will permit provinces to focus more on local governments and to offer more guidance to local governments on their delivery of better local services.

I would make the development of a five year forecast for provincial expenditure and revenues a priority and give every consideration to proposing both more revenue authority and less expenditure responsibility if an imbalance between revenue sources and expenditures is found. Moreover, to the extent that welfare is a redistributional function it should be financed at the central government level.

Local Governments. The system of local government service delivery needs to be rationalized. The Commission should consider whether the 39 districts, especially those in very rural areas of South Africa, might better serve residents if these districts had more functional responsibilities than the six metros. Correspondingly, the local councils in these rural districts might have less responsibility for service delivery than other municipalities. The same government structure does not fit all places, and with low capacities for management and administration in many rural areas, consolidation of the service delivery areas to the district level would take advantage of economies in administration by avoiding duplicative functions in a number of small places and would allow more even administration throughout the district.

It is important for the Commission to develop relationships with provinces, districts and local governments to bolster its own knowledge of and credibility among local governments. Such relationships will in turn give members of Parliament more confidence in the recommendations of the Commission regarding subnational governments.

The Commission staff working through established protocol should gain access to three or more rural districts and the six metros. The Commission should collect budget data for the districts as well as for the local governments within the districts. The Commission should monitor projects and development in the districts and local areas. The same should be done in the six metros.

The data collected should include fiscal data as well as population and other demographic information in the areas. Combined with regular census data, the Commission should produce a

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[2]Martin Feldstein and Marian Vaillant, "Can State Taxes Redistribute Income, National Bureau of Economic Research Working Paper No. 4785 June 1994.

profile of these areas and be able to speak knowledgeably about how policies will affect these districts and metros. Gradually the data base should broaden to include all or at least a representative sample of districts and the local governments within them.

The Commission should advocate and advise on the training of local government officers in the selected districts. Where warranted, the Commission might also devise legislation for funds that would support budgeting and management training for a cadre of local civil servants.

Based on information about local government and expenditure responsibility and revenue authority, the Financial and Fiscal Commission staff should estimate the size of the overall gap between expenditures and revenues for municipalities and other governments in the selected districts and metros. The gap should be estimated for each of the next five years. By extrapolating the estimated gap to all local governments, the amount of grants needed from central to local government in each of the next five years can be estimated.

After determining the amount of grant funds needed, the Commission should develop a formula to distribute the grant revenue to local governments with an eye toward their inherent longer-range fiscal deficits and their capacity to raise revenue from own resources. The initial grant formula might be simple and straightforward (for example, the same per capita grant to all local governments) so that the formula is transparent to all local governments. As local governments become more sophisticated about grants and as the Commission develops a better understanding and better measures of the fiscal capacities of various local governments, the grant formula could be modified to account more precisely for fiscal disparities.

BORROWING BY SUBNATIONAL UNITS OF GOVERNMENT: GENERAL PRINCIPLES AND EXAMPLES FROM INTERNATIONAL EXPERIENCE

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1. INTRODUCTION

Borrowing in capital markets is an alternative to direct taxation as a form of own-source revenue for local, state, and other subnational units of government. In the United States, local and state governments obtain about 5 percent of their revenues from this source, and state and local debt now exceeds $1 trillion. Borrowing is an important source of funds for local governments, helps them better match revenues to recurrent expenditures, and provides a mechanism for funding long-term capital projects. Interest in municipal, provincial, and other forms of local borrowing is growing throughout the developing world, from St. Petersburg, Russia to Johannesburg, South Africa. But even in well-established markets, shenanigans or worse are lurking. For example:

- In the U.S., which has the largest and most liquid municipal bond market in the world, municipal-bond brokerage houses are under investigation by the Securities and Exchange Commission for concealing high bids to the sellers who employ them.[1] According to The Economist, "the SEC's new-found zeal has been to tarnish the market's already grubby reputation."[2]

- In Italy over 400 local authorities have declared bankruptcy, including major cities such as Naples.[3]

Despite its large size, government borrowing remains a relatively small part of state and local revenues in the U.S. For state governments, sales and gross receipts taxes were the largest single source of revenue in 1992, closely followed by federal grants. (See Table 1.)[4] Each of these sources provided almost seven times as much revenue as state borrowing. The major single source of revenue for local governments is grants from federal and state governments, and the largest own-source of revenue is property taxation.

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[1] See *Wall Street Journal*, "Muni Brokers Under Watch by the SEC," July 23, 1996, p. C1.
[2] See *The Economist*, March 30, 1996, p. 70.
[3] See *The Economist*, November 4, 1995, p. 83.
[4] 1992 is the last year for which the Advisory Commission on Intergovernmental Relations compiled data.

TABLE 1: State and Local Government Revenues in the United States, 1992 (millions of $)

	Individual Income	Corporate Income	Sales and Gross Receipts	Other	Property	TOTAL TAXES	Charges and Misc.	TOTAL OWN-SOURCE REVENUE	Federal Grants	Federal and State Grants	TOTAL REVENU	Net Change in Debt
State governments	104,401	21,566	162,721	39,134	0	327,822	107,610	435,432	159,000		594,432	26,347
% total revenue	18	4	27	7	0	55	18	73	27	0	100	4
Local governments	10,562	0	33,429	11,386	171,723	227,100	130,179	357,279		236,000	593,279	27,964
% total revenue	2	0	6	2	29	38	22	60	0	40	100	5
Total state and local	114,963	21,566	196,150	50,520	171,723	554,922	237,789	792,711	159,000	236,000	1,187,711	54,311
% total revenue	10	2	17	4	14	47	20	67	13	20	100	5

Source: Advisory Commission on Intergovernmental Relations. Significant Features of Fiscal Federalism, Volume 2, 1994. Table 31, Table 33, and Table B. Note: "Net change in debt" is not included in total revenue.

TABLE 2: Federal Government Tax Revenues in the United States, 1992 (millions of $)

	Individual Income	Corporate Income	Sales, Gross Receipts, and Customs	Gift and Death	All Other	TOTAL TAXES	S&L taxes /Fed taxes
Federal government	476,465	100,270	64,282	11,143	6,881	659,041	0.84

Source: ACIR. Significant Features, 1994. Table 35.

These sources bring in many times more revenue than arrives through various forms of local borrowing.

2. Reasons for State and Local Government (or Provincial and Municipal) Borrowing[5]

There are 3 major reasons why governments turn to debt markets for their financing needs:

1) A mismatch in the timing of receipts and expenditures within a fiscal year

2) To fund long-term capital projects

3) To fund deficits

Mismatches in the timing of receipts and expenditures

The most straightforward form of local debt finance is used to correct mismatches in the timing of receipts and expenditures during the budget year. What can cause such mismatches?

- Seasonal differences in the timing of receipts and expenditures. For example, the State of Illinois would often issue short-term debt instruments at the beginning of its fiscal year in July to be repaid at the end of its fiscal year in June. Why? The State would typically receive large inflows of personal and corporate income tax revenue towards the end of its fiscal year. Its expenditures, however, were relatively stable throughout the year. Thus, borrowing early in the fiscal year helped smooth out the State's revenue inflow.

- Delays in payments of transfers from higher levels of government. For example, the State of Illinois borrows in anticipation of receiving federal matches for payments that the State makes for the Medicaid program (the federal-state program for health care for the poor).

The State of Illinois practices another form of "borrowing": deferring payment to its providers. For example, medical providers often wait months to receive payment for services. Several years ago the state came up with additional creative financing, called "lapse period spending." This trick permits the state to use current fiscal year revenue during the first three months of the fiscal year to pay off debt from the previous fiscal year.

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[5] Sections 2, 3, and 4 draw, in part, from Shannon Mudd, "Debt Financing by Regional and Local Governments," September 1995 working paper.

Securities issued to smooth over differences between expenditures and revenues during the fiscal are often called tax anticipation bills. They generally carry little risk to investors because they are for short periods (less than a year, or perhaps, less than 15 months in Illinois!) and are associated with relatively predictable tax flows. Many local governments simply borrow directly from banks (rather than sell debt instruments).

Funding Long-Term Capital Projects

Capital projects are those that typically have large initial costs and provide benefit flows that last many years. Debt issuance is justified by the "pay-as-you-use" principle, which means matching those who receive project benefits (for example, those who use a bridge) to those who pay for the services (for example, those who pay bridge tolls or property taxes). Consider the following World Bank deal that collapsed due to failure to meet this test. The Bank offered a regional government in Russia a loan with a 17-year maturity to purchase buses that would last about 10 years. Officials in Nizhny Novgorod declined the loan arguing that after 10 years taxpayers would still be paying for buses that would no longer provide service. In general, the maturity of the bond issue helps to match the recipients of the services of a project to those who pay for service.

Deficit Financing

When a government spends more in a year than it receives, it has a deficit. Deficits are financed in two ways: by printing money, or by borrowing. Although central governments can print money, this option is not available to lower levels of government, at least, not anymore in the United States. What causes deficits?

- Unexpected events that require large expenditures, such as wars or natural disasters (e.g., hurricanes, floods)
- Recessions, which lower tax inflows and raise public welfare expenditures
- Political decision making that puts off difficult questions of raising taxes or cutting service programs

3. Forms of Local Public Debt

Local government borrowing can take several forms:

- Loans from a single bank (for example, for short-term tax anticipation notes)

- Issuance of debt instruments for long-term borrowing (e.g., municipal bonds); these are promises to pay at specified dates in the future; institutions and individuals offer bids on what amounts and at what price they will purchase debt; governments can sell debt directly, or through underwriters, who buy debt from government and then sell to others.

For loans and debt, a key consideration is the revenue stream that will pay off the obligations (collateral, that is, other assets to back the debt issue, is usually a lesser consideration).

Bonds can take several forms:

- Discount bonds: These are debt instruments that offer a single payment at maturity and their return is derived from the difference between purchase price and face value, and time to maturity.

- Coupon bonds: Securities issued with time-to-maturity usually greater than one year; interest payments are made on a prescribed schedule (e.g., semi-annually). Investors receive full face value at maturity.

- Serial bonds: Securities that make regular principal payments as well as interest payments. Serial bonds are consistent with the pay-as-you go principal, since principal must be paid during the life of the bond.

Municipal bonds also differ by what resources the government pledges to fulfill its financial obligations. Two of the most important types are the following:

- General Obligation Bonds: These are "full faith and credit" obligations. The government pledges to use all of its resources, borrowing ability, and tax authority to make its contractual payments. In order to make this kind of pledge, it is important for local government to have an independent tax authority. With this authority and to avoid default, local authorities could raise taxes.

- Revenue Bonds: Government commits a specific income source to cover bond obligations (for example, utility charges, housing rents). Usually these revenue streams are directly tied to the project for which the bonds are issued.

The relative importance of these types of borrowing in the United States is shown in Table 3. Long-term borrowing constitutes by far the largest component of total borrowing. Of this, nonguaranteed debt (e.g., revenue bonds) exceeds guaranteed borrowing (general obligation bonds) by over two-to-one. Short-term borrowing is a small part of total state and local government borrowing. The table also indicates that total borrowing by state and local governments is dwarfed by borrowing of the central government.

TABLE 3: Federal, State, and Local Government Borrowing in the United States, 1992 (billions of $)

	ALL TYPES	State Debt: Short-Term	State Debt: Long-Term: Guar.	State Debt: Long-Term: Non-Guar.	Net Change Total, 1991-92	Local Debt: Short-Term	Local Debt: Long-Term: Guar.	Local Debt: Long-Term: Non-Guar.	Net Change Total, 1991-92
Federal	4,083								
% of total debt	81								
State	372	3	97	272	26				
% of total debt	7								
Local	598					18	198	382	28
% of total debt	12								
TOTAL	5,053								

Source: ACIR. Significant Features. Tables 88, 91, 93.

Notes: Short-term debt is interest-bearing debt payable within one year from the date of issue, such as bond anticipation notes, tax anticipation notes, and warrants. Long-term nonguaranteed debt is payable solely from pledged specific sources (e.g., earnings of revenue-producing activities, such as utilities, from special assessments, or from specific nonproperty taxes. Long-term guaranteed debt is secured by unconditionally pledged taxes of the government issuing the debt. It includes debt payable initially from specific taxes or nontax sources, but representing a liability payable from any other available resources.

4. Restrictions on Local Borrowing

One of the first issues faced by the Financial and Fiscal Commission of South Africa was the extent to which central and provincial governments should exert control over borrowing of the provinces. A related issue was the extent to which this process of oversight should be controlled by the central government.[6] The FFC's position was that central and provincial authorities should coordinate borrowing, but that the Minister of Finance should not have ultimate control, and that , in the end, normal capital market mechanisms should determine the allocation of capital. The following discussion outlines general issues that relate to the question of restrictions on local borrowing in the context of the various forms of local borrowing described earlier.

Tax anticipation bills: In the United States, many state and local governments require that tax anticipation bills be paid off by the end of the budget cycle. This is also the intention of recent South African legislation, where "bridging finance" for recurrent expenditures must be redeemed within the current fiscal year.

Revenue Bonds: In the United States most state and local governments do not place restrictions on this form of debt, and capital markets, in effect, discipline borrowers. A government will be unsuccessful in placing a bond issue if the revenue stream committed for payment is thought to be insecure. Issues that are perceived to be risky will require higher returns, and governments that default will pay higher rates or face more difficulty in placing issues in the future. That the market punishes defaulters is clear. For example, a recent econometric study of state government borrowing in the United States shows that markets impose a default premium that increases nonlinearly with borrowing (measured as the ratio of debt to gross state product).[7]

General Obligation Bonds: These bonds constitute a deeper commitment by local governments to investors than do revenue bonds, since government is expected to use its "full faith and credit" to make good on its obligations. Concern for this deeper commitment has also led to restrictions by upper level government on local government in the United States.

Federal restrictions: The only federal restriction is one that mandates information disclosure to investors.

State restrictions: 44 of 50 state governments impose one or more of the following restrictions on general obligation bonds:

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[6] See Financial and Fiscal Commission, "Recommendations on the Borrowing Powers of Provincial Governments Bill," November 1995.

[7] See World Bank, *India Country Economic Memorandum*, Report No. 14402-IN, May 30, 1995, p. 60. This study also states (p. 59) that in Canada market discipline works well in the absence of binding restrictions on provincial deficit financing.

- Volume of Debt Outstanding: Often this is defined as a percentage of the property tax base (but other measures of fiscal capacity could be used). These restrictions are often viewed as ineffective because as soon as the limit is reached, the state government simply raises the ceiling.

- Interest Rate Ceilings: These restrictions are also often viewed as ineffective because as interest rates rise, the interest rate ceilings are also raised.

- Referenda: These are the most effective publicly-imposed restriction on local borrowing in the United States. In order for local governments to gain approval for bond issues, the issues must be approved by voters. In Illinois, well over half of bond referenda fail.

5. Other Examples from International Experience

Earlier discussion refers to experiences in local public borrowing in several countries. This section provides additional examples with discussion of subnational borrowing in St. Petersburg, Australia, and India.

St. Petersburg[8]

Since the collapse of the Soviet Union in 1991, municipal borrowing has emerged in several Russian cities. The sizes of the issues are relatively small. In St. Petersburg trading in municipal bonds is limited to three local exchanges. The city sells issues to dealers, who then sell them by auction to the highest bidders. Most of the debt is very short-term (3 months), and due to Russian inflation, annualized rates of return exceed 100%. Most debt instruments are simple discount bonds (GGKOs). Interest earned from these municipal bonds is not subject to Russian tax. (Interest on central government bonds--GKOs--is not taxed, either.) Thus, policy towards the taxation of municipal bonds in Russia and the U.S. share similar market-distorting consequences caused by subsidizing municipal borrowing. Repayment is based on revenues from the property tax, with municipality-owned real estate assets serving as further collateral. However, neither of these securities is considered very reliable. A further problem is that the municipality has other obligations (e.g., to its employees) and it is not clear whose claims on municipal revenue has highest priority.

[8] This section is based on information described in Progressor Research and Innovation Center, St. Petersburg Administration Municipal Loans, 1995.

Australia[9]

Provincial borrowing in Australia has roots in circumstances that resemble those facing South Africa today. In 1923 the Australian Loan Council was formed, which comprised representatives of the central government and the states. At the time Australia did not have a well-developed financial market for long-term debt. The domestic debt market was thin, it was difficult to place debt issues overseas, and there were large vertical imbalances between the revenues and expenditures of the central government and the states. Over the years the influence of the Council grew. Today the Council controls total borrowing of the states, and allocates borrowing limits for each state. Within its constraint, each state can borrow separately in the capital markets at whatever terms it can arrange. Each state determines how to use its funds and is responsible for its own debt (i.e., the central government provides no bail outs).

India[10]

State governments in India cannot borrow without the permission of the central government, and are constitutionally barred from borrowing abroad. In general, there is no market discipline to state debt. Debt issues are not rated, and they are implicitly guaranteed by the central government. Financial institutions, state provident funds, and Indian Public Enterprises are mandated to hold state debt by current law, but with the implicit central government guarantees, this is a relatively painless restriction.

6. Implications for South Africa

In comparison to the other countries and other periods mentioned above, South Africa's market for government securities is substantially more advanced than those in Russia and India, but is much less so than markets in the United States. In some important respects the situation in South Africa today resembles that of Australia in the 1920s.

Many factors suggest a cautious approach towards municipal and provincial borrowing in South Africa. Several issues that seem to be particularly important are as follows.

New provincial and municipal jurisdictions create funding uncertainties. New jurisdictions create uncertainties in the fiscal responsibilities of local jurisdictions, and in the ability of local jurisdictions to pay off debt. Under the best of circumstances, redrawing jurisdictional boundaries creates new expenditure responsibilities and changes

[9] See World Bank, op. cit., p. 61.
[10] See World Bank, op. cit., pp. 59-62.

revenue bases. Even with established capital markets, these changes generate uncertainties regarding legal status, fiscal administration, revenue estimation, and expenditure requirements.

There are insufficient independent sources of revenue for subnational jurisdictions. The nine new provinces have virtually no practical source of own revenue. This makes them almost completely dependent on grants from the central government, and extremely limits their ability to gain the "full faith and credit" of capital markets. Without meaningful taxing authority, provinces cannot fully back provincial debt issues without implicit guarantees by the central government. Local jurisdictions, with their history of property taxation and revenues from services providers (e.g., electricity, water), have more substantial and credible sources of independent revenue.

There are unstable sources of revenue, especially in the former Black Local Authorities. Although some local areas have several strong revenue bases, others--in particular, former Black Local Authorities--have histories of not paying taxes or in boycotting fees and taxes that were imposed. Given the substantial expenditure needs of these areas, and the need to make the cost of service reflect more closely the benefits of services received, it is very important to broaden the tax base to include all local areas. Broadening the local tax and user fee base will provide stimulus to "revenue-type bonds" that are dependent on committed sources of funds.

Vertical mismatches and the role of the central government. As they are now constituted, municipal and provincial governments in South Africa spend much more than they bring in as own-source revenue. These differences are now filled by intergovernmental grants from the central government. There are numerous reasons to narrow the mismatches. Some services, such as education, are more efficiently provided and are more responsive to local demand when assigned to lower levels of government. It is also likely that local jurisdictions will spend their own revenues more efficiently if local taxpayers and voters have to pay for them directly. Bringing revenues and expenditures closer to the people strengthens the local resource base, and thereby provides a stronger economic base from which to issue local debt.

Negative spillovers from isolated defaults. A default in a single subnational jurisdiction could poison the entire market for local public debt, even for otherwise economically healthy municipalities and provinces. In other words, for a fledgling municipal and provincial bond market such as in South Africa, it may not be enough to assume that the market alone can provide sufficient discipline. Until the market for municipal and provincial debt is well established, there may be significant spillover gains from explicit central government guarantees of subnational debt. Such guarantees would be conditional on stringent central government regulations of subnational borrowing.