PROJECT APPRAISAL DOCUMENT
ON A
PROPOSED LOAN
IN THE AMOUNT OF US$ 15.0 MILLION
TO THE
REPUBLIC OF SOUTH AFRICA
FOR A
MUNICIPAL FINANCIAL MANAGEMENT TECHNICAL ASSISTANCE PROJECT
August 12, 2002

Water and Urban 1
Eastern and Southern Africa
Africa Region
CURRENCY EQUIVALENTS
(Exchange Rate Effective November 30, 2001)
Currency Unit = South Africa Rand
ZAR 1.0 = US$0.101
US$1.00 = ZAR 9.9

FISCAL YEAR
April 1 – March 31

ABBREVIATIONS AND ACRONYMS

CAS - Country Assistance Strategy
CMIP - Consolidated Municipal Infrastructure Program
CQ - Consultant's Qualification
DBSA - Development Bank of South Africa
DPLG - Department of Provincial and Local Government
FMR - Financial Monitoring Reports
GAMAP - Generally Accepted Municipal Accounting Practices
GDP - Gross Domestic Product
GEAR - Growth, Equality and Redistribution
GPN - General Procurement Notice
IBRD - International Bank for Reconstruction and Development
IDP - Integrated Development Planning
LG - Local Government
M&E - Monitoring and Evaluation
MFMA - Municipal Financial Management Act
MFMB - Municipal Financial Management Bill
MFMTAP - Municipal Financial Management Technical Assistance Project
MSP - Municipal Services Partnerships
MSSP - Municipal Sector Support Project
MTEF - Medium-Term Economic Framework
NIIF - National Infrastructure Investment Framework
PIP - Project Implementation Plan
QCBS - Quality and Cost Based Selection
RDP - Reconstruction and Development Program
RSA - Republic of South Africa
SANT - South Africa National Treasury
SOE - Statement of Expenditures
TA - Technical Assistance

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Country Manager/Director: Fayez Omar
Sector Manager/Director: Alain Locussol/Praful Patel
Team Leader/Task Manager: David DeGroot/Junaid Ahmad
# SOUTH AFRICA
MUNICIPAL FINANCIAL MANAGEMENT TECHNICAL ASSISTANCE PROJECT

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2. Other

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MAP(S)
IBRD No. 31738
SOUTH AFRICA
Municipal Financial Management Technical Assistance Project

Project Appraisal Document
Africa Regional Office
AFTU1

Date: August 12, 2002
Team Leader: David G. DeGroot
Sector Manager/Director: Alain Locussol
Country Manager/Director: Fayez S. Omar
Project ID: P076901
Lending Instrument: Technical Assistance Loan (TAL)

Project Financing Data

<table>
<thead>
<tr>
<th>For Loans/Credits/Others:</th>
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<tbody>
<tr>
<td>Amount (US$m):</td>
<td>$15.0</td>
<td></td>
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Borrower Rationale for Choice of Loan Terms Available on File: Yes

Proposed Terms (IBRD): Fixed-Spread Loan (FSL)
Grace period (years): 5
Commitment fee: 0.85% the first 4 years; 0.75% thereafter
Front end fee (FEF) on Bank loan: 1.00%

Initial choice of Interest-rate basis:

Type of repayment schedule:

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<th>Financing Plan (US$m):</th>
<th>Source</th>
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<th>Foreign</th>
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<td>Total</td>
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Borrower: REPUBLIC OF SOUTH AFRICA
Responsible agency: SOUTH AFRICA NATIONAL TREASURY WITH ASSISTANCE OF DBSA
Address: 40 Church Square, Pretoria, South Africa
Contact Person: Mr. Ismael Momoniat, Deputy Director General
Tel: (012) 315 5165 Fax: (012) 315 5045 Email: ismail.momoniat@treasury.gov.za

Estimated Disbursement in US$m Equivalent (Bank FY/Semesters):

<table>
<thead>
<tr>
<th>Source</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
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<td></td>
<td></td>
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<tr>
<td></td>
<td>Sem. 1</td>
<td>Sem. 2</td>
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</table>

Project implementation period: 4 years
Expected effectiveness date: 12/12/2002 Expected closing date: 06/30/2006
A. Project Development Objective

1. Project development objective: (see Annex 1)

In the context of the Government's overall public finance reform and local government transformation program, the project will support selected municipalities in implementing the new budgeting and financial management system and assist the National government to complete selected analytic work on policy reforms. Achievement of the project objective is necessary to create a platform for efficient and equitable delivery of services at local government level.

2. Key performance indicators: (see Annex 1)

(a) Implementation of the new budgeting and municipal financial management systems in at least 15 municipalities
(b) Design and Implementation of Municipal Financial Management monitoring system
(c) Completion of selected analytical reports and strategic implementation plans

B. Strategic Context

1. Sector-related Country Assistance Strategy (CAS) goal supported by the project: (see Annex 1)

Document number: [R99-29/1] Date of latest CAS discussion: 03/23/1999

Capacity building and knowledge sharing are the CAS goals supported by MFMTAP. The South African government has managed the macro economy very effectively, leading to diminishing deficits and rapid revenue growth. Delivery of services to the poor majority, however, is not improving as rapidly. Therefore, the government wishes to tap the World Bank's international experience to assist it to more effectively and efficiently deliver public services. The Bank has unparalleled experience with local government capacity building and delivery issues, and MFMTAP finances technical assistance to support the implementation of best practices that will lead to improved and expanded services for the poor.

2. Main sector issues and Government strategy:

The main sector issues are to assist local governments to be more effective financial managers, planners and providers of basic services, and to assist central government in more effectively targeting fiscal resources to support local service provision to the poor, including mobilization of private resources.

2.1 Public Infrastructure Investment Policy

The policy context for MFMTAP is clear. Three key policy statements outline Government's vision for infrastructure investment, namely the Reconstruction and Development Program (RDP), Growth, Equality and Redistribution (GEAR), and the draft National Infrastructure Investment Framework (NIIF). The three documents jointly argue that social and economic infrastructure delivery contributes to the redistribution of opportunities and income, and to increasing the productivity of labor and business and thus the achievement of higher growth rates.

The RDP saw infrastructure as essential to growth, to meeting basic needs and to alleviating poverty. It made a case for integrated regional, urban and rural development as the basis for removing backlogs and creating viable communities and dynamic local economies. The RDP White Paper of 1994 emphasizes the need for Government to plan, coordinate, drive and monitor programs. While the RDP never equated development purely with infrastructure investment, it deemed more and better service delivery as essential aspects of the development process, and thus directed considerable funds towards meeting basic
infrastructure needs.

GEAR contends that higher economic growth is a prerequisite for sustainable development. An average 3% growth rate is insufficient to reverse the unemployment crisis and to provide resources for the expansion of social service delivery and redistribution of income and wealth. To overcome current economic conditions it calls for, among other things, a climate of fiscal discipline, alongside accelerated public sector investment. This should include an increase in "infrastructure development and service delivery making intensive use of labor-based techniques". The policy framework suggests that an increase of about 8 percent per year in discretionary RDP-related capital spending could be accomplished within the GEAR framework. In the absence of accelerated growth, such spending would increase with little more than 2 percent per year in real terms. The GEAR model assumes average real increases of between 2 percent and 3 percent per year in general government investment and capital formation by public corporations.

The draft National Infrastructure Investment Framework (NIIF), developed in 1996, indicated that South Africa currently faces a backlog in infrastructure of at least R170 billion. It accorded infrastructure a key role in ensuring productivity and growth, and also contended that more growth and production would lead to more investment in infrastructure as well as wealth redistribution. Considering the country's infrastructure requirements per sector (e.g. energy, water and sanitation, transport), it proposed integrated investment programs for municipal, rural, social, economic and 'consolidated' infrastructure development. Its reform proposals were primarily institutional and financial as it called for better coordination of investment to ensure optimal sequencing, spatial allocation and sectoral balance. It saw a new dynamic public-private relationship as crucial, leaving Government with the challenge to get the signals and incentives right that would facilitate such a partnership. Hence, it argued, the need was for a stable financial environment to enable long-term planning and lower risk. NIIF called for medium-term fiscal guidelines, the quantification of public sector borrowing requirements, clearer utility pricing policies, the rationalization of intergovernmental fiscal relations and a regulatory framework for private sector investment.

2.2 Municipal Sector Policy

Municipalities are fast emerging as the fulcrum of South Africa's newly created system of multi-tiered government. First, the Constitution recognizes local government as an independent sphere with its own unique set of roles and importance. Second, it is central to the implementation of Government's growth strategies. For example, over 80% of the nation's Gross Domestic Product (GDP) is urban based, with the economic nodes concentrated in the country's metropolitan centers. The governance and management of these areas is obviously critical to achieving government's broader economic objectives. Similarly, there is greater recognition that non-urban local governments will play an essential role in facilitating Government's push for integrated rural development. Third, the delivery of basic municipal services to all communities - urban and rural - is dependent on the effective performance of local government. Finally, at the political level, the 1999 national election campaign revealed the importance communities gave to their interface with local councils and administration – an interface that may well signal the strength of South Africa's new democracy. In sum, the final shape, capacity and performance of local governments in South Africa will have direct implications for the political, social and economic fabric of the society.
Recognizing this, government published the White Paper on Local Government in March 1998. The intention of that document was to provide a general framework for the formulation of more detailed policies and legislation on a range of matters, including the fiscal and financial structure of the local sphere. As with the document on fiscal transfers from central to local government (“The Introduction of an Equitable Share of National Revenue for Local Government”, published by the Department of Finance in 1998). Recently, government published a policy framework for municipal borrowing, which is a detailed follow-up to the White Paper. It expands on the framework for municipal finance and focuses, in particular, on the design of the regulatory framework for local government borrowing. In addition it deals in detail with the related matter of central government’s response to the financial and fiscal difficulties that the municipal sector confronts.

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

- At the administrative level, the process has involved the amalgamation of the racially fragmented local authorities and the creation of democratic and unified municipal governments. The recently completed demarcation process redefined the boundaries and numbers of the local governments. This had lead to the creation of 47 district councils, 243 local councils and six metropolitan uni-cities covering the entire country. In addition, legislation such as the Municipal Systems Act has recently been enacted. Finally, outside the metropolitan nodes, the roles and functions of district councils are being redefined especially in relation to smaller primary municipalities and rural local governments.
- Following the administrative mergers and demarcation, elections of the new government units were held in December 2000.
- At the institutional level local governments have the mandate and discretion, supported by important legislation, to restructure their systems to bring communities and the private sector into partnerships to tackle the challenge of delivery. As such, the legislation supports the role of local governments as enablers of service provision while leaving the direct delivery of services in hands of communities, private sector, and others - as needed, feasible, and deemed necessary. In particular, the legislative environment of the Municipal Systems Act provides a tool for participatory Integrated Development Planning (IDPs) to assist municipalities in conceptualizing and executing their developmental mandates.
- Supporting this overall institutional change is the evolving fiscal framework for the local sphere. This includes the preservation and strengthening of the local tax bases (rates and levies) and the rationalization of municipal authority to change tax rates and implement user-charges. In addition, Government has replaced the ad-hoc intergovernmental grants of the apartheid era with a more efficient, equitable, and predictable system of recurrent (“equitable share”) and capital (CMIP) transfers. Changes to the municipal accounting system (the introduction of the Generally Accepted Municipal Accounting Practices - GAMAP) are also gradually being introduced and will soon be mandatory as part of the Municipal Finance Management Bill (MFMB), 2001. Finally, the local budgeting process is being developed to ensure that local governments are placed in the overall Medium-Term Economic Framework (MTEF) and budgetary framework as an independent third sphere of government. Such changes will facilitate greater transparency in the fiscal management of local governments.
- The financial framework, which is the focus of the policy framework for municipal borrowing, sets out the policy and regulatory environment that will guide and structure access by local governments
to debt finance.

Taken together, the administrative, institutional, fiscal, and financial frameworks form the policy basis for the establishment of an independent and accountable tier of local government as envisioned in the Constitution and the White Paper. These four dimensions are closely connected. For example, without clarity on the institutional aspects of the demarcation and amalgamation process, local governments will find it difficult to access private finance. The demarcation and amalgamation process will determine the potential fiscal base of the new municipalities and will hence have a major impact on their creditworthiness. Similarly, the fiscal framework will determine the overall revenues of the local government and hence the level of fiscal resources that are potentially available to gear in private finance.

2.3 The Next Phase – Translating Policy into Implementation

The South African municipal sector is therefore at a unique point in the country’s history. The entire municipal sector, therefore, is poised to move forward from political, functional and jurisdictional reforms, to a strong focus on promoting growth and equity. In this context, local government transformation is now shifting into another phase in which the focus is moving towards building the capacity of municipalities to expand sustainable delivery capacity to underpin real growth. Central government can assist this capacity building process in a number of ways, and a broad approach to the sector as a whole should guide such assistance.

Central government, particularly the National Treasury and the Department of Provincial and Local Government (DPLG), have supported the municipal sector transformation process over the last five years focusing on stabilizing municipalities operational and delivery capacities. That phase of the transformation process is well underway. The second phase of municipal transformation now needs to commence following completion of the demarcation exercise and election of new local leaders. In this second phase, the focus must shift to building the capacity of municipalities to expand sustainable delivery capacity to underpin real growth. Central government can assist this capacity building process in a number of ways, and a broad approach to the sector as a whole should guide such assistance.

A crucial area for near term assistance is the adoption by municipalities of innovative municipal management systems. At present, municipal financial management systems, for instance, are diverse, noncomparable and, frequently, opaque. Accurate information on municipal finances can be difficult to obtain, compare and understand. This situation has at least three negative impacts on a municipality’s development potential. First, elected officials and the public in general have difficulty understanding their municipality’s finances. This can lead to a lack of transparency and accountability at the local level. Second, without clear information on municipal finances, central government encounters difficulties in efficiently targeting fiscal transfers and preventing local financial crises. Third, in the absence of clear financial information private financiers cannot properly assess the creditworthiness of municipalities and will, therefore, be less likely to lend to municipalities or will charge premiums on loans.

In short, one of the cornerstones of a new era of sustainable growth in South Africa’s municipal sector must be a transparent, consistent system of financial management. The municipal amalgamation process that has emerge from final demarcation of district and metropolitan boundaries in SA presents a golden opportunity for introduction of a sector wide, uniform system of accounting and budgeting that meets international standards.
In preparation for this key opportunity the Intergovernmental Relations Branch of the National Treasury has prepared the Municipal Financial Management Bill (MFMB). The Bill delineates standard accounting and budgeting guidelines to be adopted by all local authorities in SA following the Bill’s ratification in Parliament. The new systems prescribed in the Bill are currently being piloted in 7 cities around the country.

In this context, several points need to be emphasized. First, the focus on capacity building follows international best practice which suggest that capacity building of local governments is best done in the context of an ongoing decentralization process. This enables all levels of government to benefit from the potential synergy between capacity building and decentralization. Second, the focus on financial management as an important vehicle for capacity building is a strategic choice. It provides a necessary and powerful plank to induce changes in the institutional and planning mechanisms of local government. In that sense, financial management offers a key entry point into broader local government transformation and ultimately improvement in service delivery. In other words, focus on financial management capacity enables central government to catalyze coordination on overall capacity building approaches because financial sustainability is a key driver for ensuring broader local government transformation.

2.4 Fiscal and Financial Issues

Government believes that access by municipalities to private capital markets is an important element of ensuring an efficient system of local government. Ultimately government wishes to promote the emergence of a vibrant and innovative primary and secondary market for short and long term municipal debt. It is important to stress, however, that in pursuing this goal, central government wishes to avoid the apartheid-era practice of generally underwriting municipal borrowing and, in effect, transferring municipal liabilities onto itself. Government's central objective is not to produce a short-term inflow of "soft" or subsidized funds to municipalities. It is, rather, to develop a sustainable market for municipal debt where risk is properly priced. In this overall policy context for local governments in which access to capital markets is essential for financing improved service delivery, particularly to the poor, the emphasis on financial management budgeting capacity is of paramount importance.

3. Sector issues to be addressed by the project and strategic choices:

The project addresses the key issues of: (a) strengthening local government’s capacity for financial management and (b) supporting central government’s capacity to more effectively target fiscal transfers to achieve equitable development goals. The main strategic choice embodied in the project is the exclusive focus on technical assistance, in keeping with the CAS objective of capacity building through knowledge sharing. Understanding the strategic nature of this aspect of the project is essential.
The objective of accessing global experience and expertise from within and outside the Bank rather than accessing finance through the Bank system has defined the relationship between South Africa and the World Bank Group since the early nineties. This relationship and its focus on access to knowledge as distinct from finance started around the time the Bank itself was beginning to define the “knowledge Bank.” Indeed, South Africa’s re-entry into the Bank and the ensuing relationship was a major learning ground for the Bank in formally institutionalizing the “knowledge Bank.” The relationship has helped sharpen the concept of the knowledge bank within the country team: a process by which the Bank’s knowledge resources are used to support and complement the capacity of our clients to undertake institutional change. The shifts are from finance to knowledge and from directly supporting projects and programs to complementing the capacity of the clients to engage in institutional reform.

Three elements have defined the operationalization of this principle. First, an emerging trust that ideas and approaches drawn from the international experience are fire-walled from a lending agenda. Second, that to best deliver the knowledge Bank, capacity on the ground for “real time” delivery is needed. It is therefore not a surprise that the shift to “knowledge bank” happened at the same time as the Bank’s shift to a policy of decentralizing its services. Third, was the establishment of innovative linkages between the country office in South Africa and global expertise within and outside the Bank and the use of flexible TA resources to deliver this expertise in various ways.

In deciding to access a Technical Assistance (TA) loan, SANT and Government of South Africa are exploring an important step to institutionalize the “knowledge” engagement with the Bank that has successfully defined the relationship for over a decade. This presents an important turning point for the Bank’s relationship with South Africa and throws open a distinct challenge. Important because it is a step in the institutionalization of a unique country relationship. In addition, Government of South Africa is assuming that by institutionalizing the relationship through a financial instrument, SANT and other departments within Government will gain access to knowledge that goes well beyond the expertise to be directly financed through MFMTAP. The challenge for the Bank therefore, is to ensure that the demand for global experience and expertise is met efficiently and effectively on a continuous basis for furthering the relationship between South Africa and the World Bank. The Bank’s South Africa country team is fully aware of the new institutional relationship that is emerging through this proposed loan and accepts the challenge and is committed to ensuring that international best practices and expertise are accessed by South Africa as the country seeks to continue its agenda of institutional reform. Recognition of this strategic approach is key to understanding the role of this proposed TA loan in the overall relationship with South Africa.

An important policy challenge in delivering the knowledge bank is to broaden its scope to beyond just technical assistance. Creative mechanisms must be developed to ensure that the capacity residing in Bank managed-programs and members of the Bank group such as Cities Alliance Program, Water and Sanitation Program and most importantly the World Bank Institute are leveraged to directly support the local governments in South Africa. The South Africa Country Team will need to explore these linkages in order to deliver the knowledge bank successfully to South Africa.

Finally, it is important to stress that the choice of the local government sector to initiate a proposal for a TA loan is not an accident. It is in this sector that the Bank has been the most successful in initiating a comprehensive approach to implementing its knowledge bank function.
C. Project Description Summary

1. Project components (see Annex 2 for a detailed description and Annex 3 for a detailed cost breakdown):

<table>
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<tr>
<th>Component</th>
<th>Indicative Costs (US$M)</th>
<th>% of Total</th>
<th>Bank-financing (US$M)</th>
<th>% of Bank-financing</th>
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<tbody>
<tr>
<td>a. Implementing Reforms</td>
<td>10.00</td>
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<td>10.00</td>
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<td>b. Design and Implementation of a Municipal Sector Monitoring and Early Warning System</td>
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<td>24.3</td>
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<td><strong>Total Project Costs</strong></td>
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<td><strong>99.3</strong></td>
<td><strong>14.85</strong></td>
<td><strong>99.0</strong></td>
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</table>

| Front-end fee                                       | 0.15                    | 0.8        | 0.15                  | 1.0                 |
| **Total Financing Required**                        | **20.00**               | **100.0**  | **15.00**             | **100.0**           |

2. Key policy and institutional reforms supported by the project:
   a. Implementation of Municipal Financial Management Bill/Act (MFMB/A)
   b. Design and implementation of a municipal financial management monitoring system
   c. Additional intergovernmental fiscal policy reforms.

3. Benefits and target population:

   The main project benefits will be improved financial management in the largest cities of SA leading to increases in provision of basic services and infrastructure. The primary beneficiaries of these services and infrastructure will be the poor and those discriminated under the apartheid system.

4. Institutional and implementation arrangements:

   Several important implementation issues underpin the strategic nature of the proposed loan. First is the need to ensure that the administrative arrangements are not cumbersome and do not impose administrative burdens on the host country. Second, institutional mechanisms must be created to facilitate the operationalization of the “knowledge bank” concept. Third, greater access to grant funding for sustaining access to global expertise must be ensured. SANT has overall responsibility for project implementation. SANT will contract the DBSA to manage the day to day project operations and financial management as governed by the Memorandum of Understanding (MOU) between SANT and DBSA.

   Given the emphasis of the project on knowledge management, the Bank will assign appropriate skills in the field and at headquarters as necessary for the duration of the project to assist SANT in management and implementation of the project. The Bank will support SANT in defining and implementing mechanisms for identifying key areas of TA support and access to global expertise from within and outside the Bank. In this task, the Bank will support SANT to identify sources of grant financing from the donor community and support the Government's access to these funds. This role is not one of donor coordination – which is the prerogative and responsibility of Government – but one of supporting Government where possible.

   The Bank and SANT will jointly commission an independent review team that will periodically assess the utility of the project and make recommendations to improve its implementation. A commitment to
such a periodic review in addition to internal Bank project review is one signal that the Bank is accepting the challenge of meeting its commitment to the operationalization and implementation of the "knowledge bank" function.

In terms of the project design, it is important to emphasize that there several layers of incentives embedded in the implementation arrangements of the project. First, GOSA has instituted a fiscal grant as an incentive. It will reward those local governments on the basis of performance, thus creating an incentive for local governments to avail of the capacity vehicles to improve their operations. Second, the contracts for financial advisers will have explicit incentives structures to reward good performance or penalize poor performance of the consultants. In this context, part of the bid criteria will seek to have the bidders propose mechanisms through which local capacity within councils will be expanded. Third, the monitoring and evaluation component of the project will be an important mechanism for central government to assess the performance of local governments. It will also allow local governments benchmark each other, thus creating competition and further incentives to improve service delivery.

For the M&E system to play this positive role, however, will require the institutional design of the systems is appropriately structured. For example, the design will need to ensure that the M&E system is managed independent of local governments and that the data is publicly available. In addition, the M&E system to be effective, it will be critical to ensure that baseline survey is carried out across the selected local governments up front.

D. Project Rationale

1. Project alternatives considered and reasons for rejection:

   As elaborated in Section 2.2, South Africa has implemented a bold policy framework for decentralizing powers to local government. The challenge now is to translate this policy framework into implementation. In this phase, policy focus would need to shift to supporting the capacity of local governments to implement service delivery and take on their mandated role as developmental local governments.

   In 1999/00 the Bank, in response to a request from the Department of Provincial and Local Government (DPLG) prepared the Municipal Sector Support Project (MSSP). This project addressed a broad array of local government capacity building requirements—including municipal financial management—and proposed to provide budget support for the intergovernmental infrastructure grant system. This project was not pursued further by DPLG which did not, at the time, feel prepared to engage in a large Bank-supported operation.

   MFMTAP was, then, "extracted" from MSSP by SANT to meet the urgent need for experienced international advice to implement financial management reforms. More importantly, as described in Section 2.2, it was recognized that capacity support in the area of financial management is a logical and necessary entry point into crowding in broader capacity support for local government transformation. In addition, given that SANT is providing a Financial Management Grant (FMG) - 350 million rands—over four years beginning in FY2001, technical assistance to local governments to effectively use this resource is an important complement to overall policy framework.

   Finally, a focussed TA loan was deemed more suitable as a way to manage the institutionalization of the "knowledge bank" relationship that has characterized the relationship between South Africa and the World Bank.