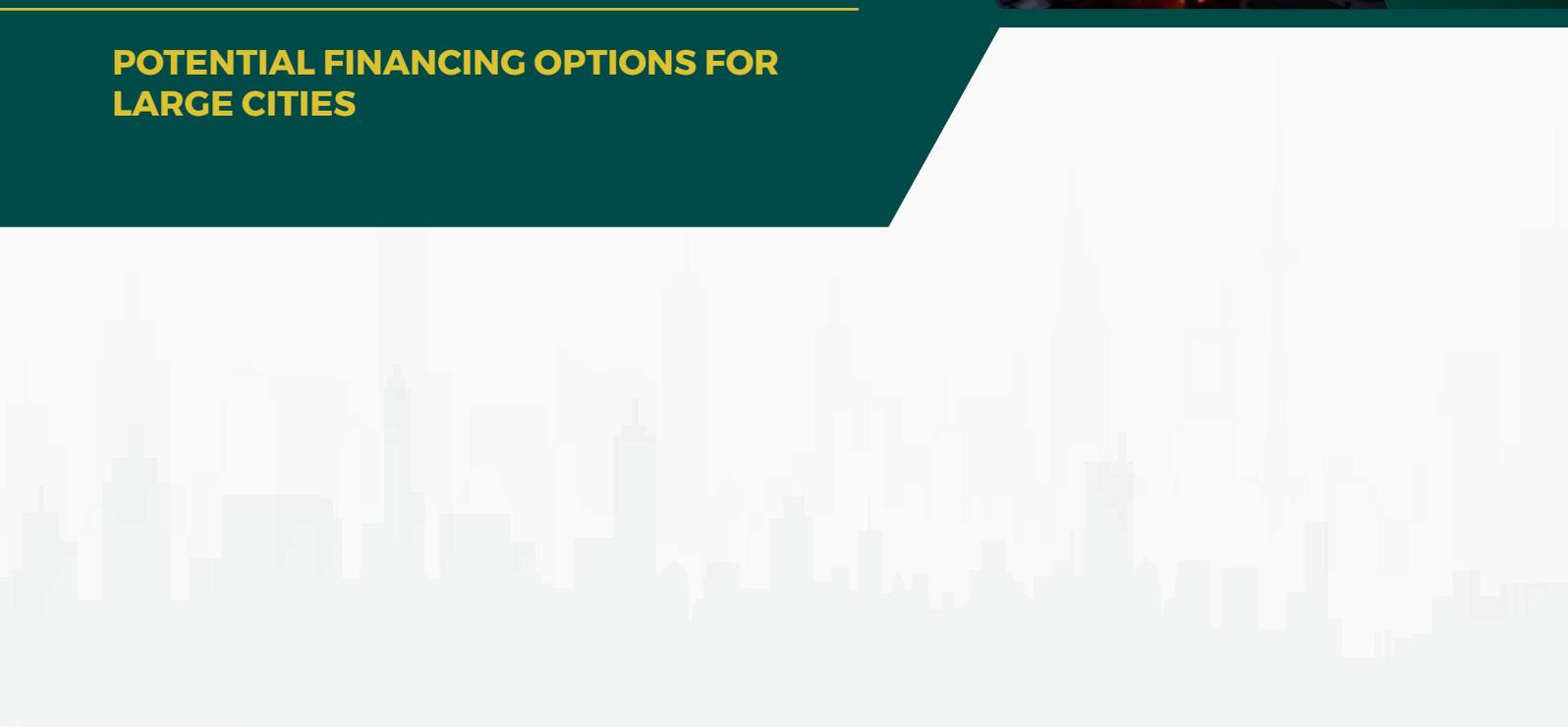




For an Equitable Sharing
of National Revenue

POLICY BRIEF 11

**POTENTIAL FINANCING OPTIONS FOR
LARGE CITIES**





EXECUTIVE SUMMARY

In South Africa large cities face a myriad of challenges including rapid urbanisation, poverty, inequality, unemployment and huge infrastructure needs. Although these are not unique to large cities, the magnitude of the challenges in large cities is greater and is increasingly becoming a major risk to the socio-economic development of the country. The ability of cities to deal with these challenges depends, to a large extent, on their ability to generate more of their own revenues. As transfers and own revenues for large

cities are heavily constrained, it is critical that cities leverage non-traditional and other innovative financing mechanisms. This policy brief summarises the findings of a study that evaluated different non-traditional revenues sources for South Africa's large cities. Findings from the study suggest different options to enhance borrowing for large cities as well as strategies to improve public private partnership (PPP) deal flows in large cities. In addition, the study brings to the fore the value of land value capture mechanisms.



BACKGROUND

The twin challenges of rapid urbanisation and the ongoing downturn in economic activity have placed tremendous fiscal pressures on the nation's many municipalities. Urbanisation, which is characterised by populations concentrating in large cities, has multiplied the demand for water, sanitation, roads, waste and energy infrastructure in large cities. Although large cities have demonstrated significant fiscal effort (relative to other categories of municipalities), own revenue sources and transfers are insufficient to meet the ever increasing expenditure needs. Despite being hubs of economic activity and engines of growth, large cities have not been able to significantly leverage non-traditional revenues streams. The inability of cities to compliment traditional revenue sources with non-conventional sources, or even leverage capital markets, when they have huge infrastructure needs and backlogs begs the research questions:

- What are the alternative and innovative financing mechanisms for large cities?
- How can large cities with no access, or limited access, to financial markets be enabled to leverage credit finance to augment fiscal transfers?

This policy brief summarises the findings and policy options that emerged from a study that sought to interrogate these questions.



RESEARCH FINDINGS

Improving access to capital markets for large cities

Given their different expenditure needs and fiscal capacities municipalities should ideally be treated differently in the allocation of scarce national resources. Taking the principle of differentiation a step further it can be argued that conditions on grants should be relaxed for large cities as they have relatively better capacity to manage grant funds and implement large and small capital projects.

The borrowing framework for large cities should be linked to the transfer framework whereby large cities use their infrastructure grant funding to leverage private capital. To help deepen the municipal credit market system and enhance positive competition among municipalities, a local government credit market should be established with one of the local development finance institutions (DFIs) establishing a municipal credit rating system. Considering its long history in the municipal credit market, the DBSA is probably the most appropriate institution to establish a credit rating system for municipalities.

Public private partnerships in large cities

Another mechanism to enable local governments to access private funding is PPPs. In South Africa the adoption of PPPs as an infrastructure delivery model has been very low, owing to the following constraints:

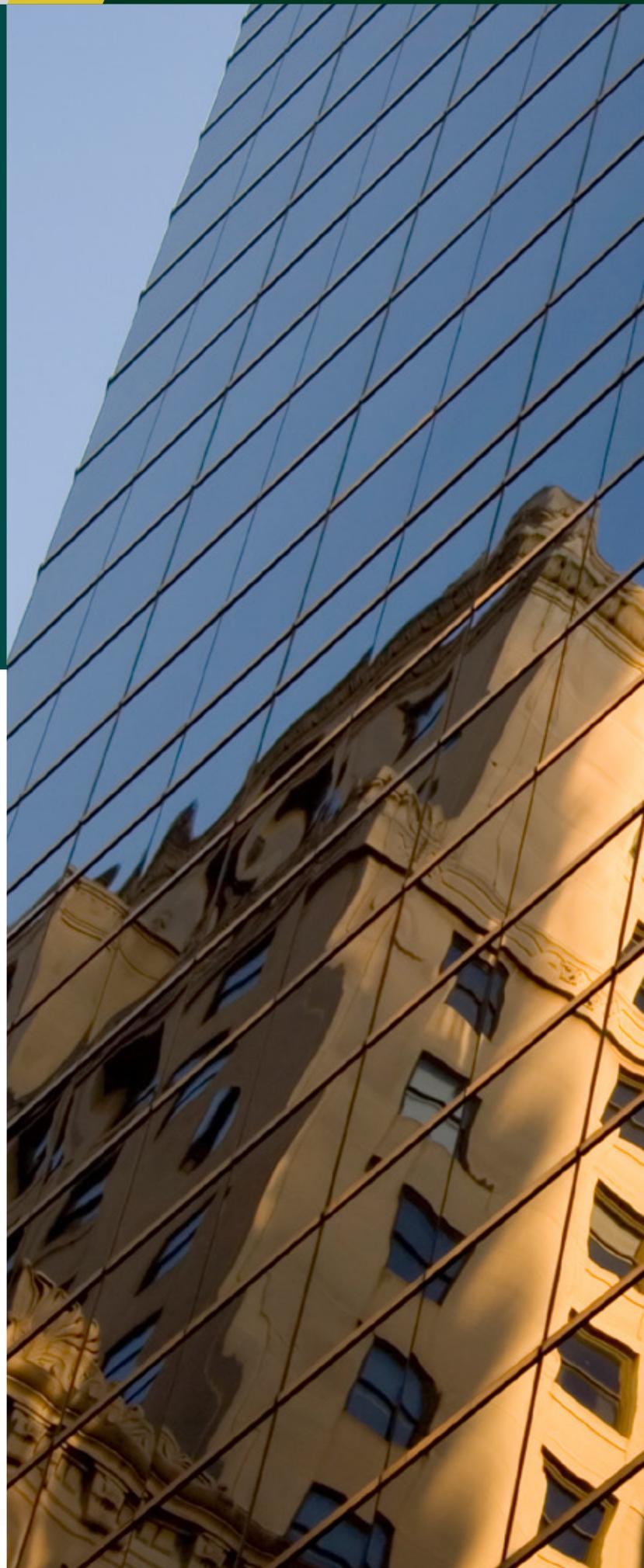
- Regardless of size and value, the process of getting a PPP deal approved is cumbersome as all projects have to go through a similar, rigorous feasibility assessment and an even more rigorous procurement process.
- Infrastructure projects serving the poor are often not bankable because “user fees from the poor are not sufficient to cover the payment to the private sector”.
- Many municipalities have poor debtor books and are perceived to be a credit risk when they approach financial institutions for funding of a PPP.
- Specialised capacity to originate, implement and manage PPPs within municipalities is thin.
- Although the PPP Unit at National Treasury is doing well in regulating PPPs, it lacks the resources to promote PPPs and build capacity within municipalities to originate, implement and manage them.

- PPPs are viewed with suspicion by some municipal communities. There is political mistrust of PPPs, as municipalities view private sector participation as a form of privatisation of state owned assets. On the other hand the private sector sees municipalities as striving to shift most of the risk to them. Trade unions also consider private sector involvement in the provision of public infrastructure services a threat to jobs and incomes.
- PPP uptake is partly constrained by the relevant legislation. Municipal outsourcing, including PPPs, resides in two laws, the Municipal Systems Act (MSA) and the Municipal Finance Management Act (MFMA), as well as the Municipal Supply Chain Management Regulations. The two acts reside in different government departments (Cogta is responsible for the MSA and National Treasury for the MFMA). The two acts (section 78 of the MSA and section 120 of the MFMA) require that feasibility studies be undertaken before a municipality proceeds with a PPP. The challenge is that the process of trying to satisfy the requirements of the two pieces of legislation is long, arduous and full of duplication.

In summary, the discussion on PPPs confirms there is a need to improve the PPP deal flow of municipalities by increasing the quantum of specialised skills in project development, procurement, negotiating and overseeing of PPPs; streamlining the PPP approval process; and injecting more resources into initiatives that promote PPPs.

Land value capture possibilities for large cities

Evidence from a number of countries, both developing and developed, shows that land value capture (LVC) mechanisms are a major source of revenue for local governments. The study evaluated the appropriateness of various LVC mechanisms in the context of South Africa's large cities. It found that LVC can be a reliable and sustainable revenue source for many large cities in South Africa. Besides being efficient and equitable, LVC has the potential to generate substantial revenues from municipal land. The successful implementation of any LVC mechanism largely depends on its design, a clear legal framework, effective land use management systems, well trained and capacitated persons charged with its implementation, and an efficient, accurate and timely land valuation process that accurately identifies changes in land values.



CONCLUSION

Large cities face many challenges including rapid urbanisation, poverty, inequality, unemployment and huge infrastructure needs, which are increasingly becoming a major risk to the growth and development of the country. The ability of cities to deal with these challenges depends, to a large extent, on their ability to generate more own revenues. Evidence suggests that there is a large capital funding gap for large cities and evidence on the ground also shows that traditional own revenue and transfers cannot close this funding gap. Thus, large cities need to leverage non-traditional and innovative financing mechanisms to close the capital funding gap. Empirical evidence from the study summarised in this policy brief suggests that large cities should diversify and adopt new, innovative financing instruments which include mechanisms to enhance borrowing and public private partnership deal flows within large cities, and land value capture mechanisms. The following policy options should be considered to enable large cities to improve their revenue base:

1. National Treasury improves access to credit markets for large cities by:
 - a. allowing them to use their infrastructure grant funding allocations to leverage private capital;
 - b. establishing a credit rating mechanism for municipalities, with the Development Bank of Southern Africa as the most suitable public entity to lead the establishment of this process; and
 - c. requesting the Development Bank of Southern Africa to facilitate the creation of a special purpose vehicle to facilitate the pooling together of financial resources by large cities, for the purpose of joint bond issuance and lending to large cities.
2. The Public Private Partnership Unit at National Treasury improves public private partnership deal flows within municipalities by:
 - a. streamlining the PPP approval process, b subjecting only high value (above R100 million) and complex projects to rigorous feasibility studies;
 - b. using the Financial Management Grant to build capacity within large cities in specialised skills in public private partnership development, procurement, negotiating and monitoring; and
 - c. incentivising public private partnerships through adopting a national facility for financing feasibility studies in municipalities.
3. National Treasury creates awareness of land value capture fiscal instruments among large cities, and extends the scope of the Financial Management Grant, to cater for capacity building in the design and implementation of land value capture mechanisms.



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