Towards an Alternative Financing Model for Metropolitan Cities in South Africa

February 2017
Acknowledgements

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The report was compiled by Xavier Mac Master and Enrico Fourie of MKS Management Services
Executive Summary

Local government and in particular metropolitan cities globally and in South Africa continue to play a critical role in the economic and social development strategies and programmes of countries. Cities face a complexity of challenges around space, habitat, infrastructure, environment, technology and financing as a result of economic pressures and precipitous urbanisation. These challenges are exacerbated in the South African context given the country’s political and socio-economic history and its declared intents of redress and equity.

The South African Cities Network in collaboration with the City of Tshwane initiated an expert panel based study to explore potential innovations and alternatives in city financing that will address the perpetual gap and tension between fiscal space and development priorities. This draft report is therefore a consolidation of the initial work completed and is expected to inform further engagement, conversation and research towards potential policy and strategic changes around city financing.

The draft report contends that the strategic developmental agenda of cities needs a more rigorous financing model which integrates cross-cutting principles and fiscal instruments. This in turn lays the basis for a more effective and innovative configuration of fiscal options within alternative financing scenarios that will enhance the fiscal space for metropolitan cities. The process and report indicates that various alternatives are entirely possible, but the configurations of alternative financing models will have to be debated and discussed relative to the political and economic position of the country. The scenario-options tabled unpack the working assumptions, the impacts on cities stakeholders and the scenario outcomes together with implications for both shock-risk impacts and normal risks effects on cities thus extrapolating some possible configurations of crosscutting principles and fiscal instruments. This establishes the basis for a more detailed analysis of financing approaches available to metropolitan cities over time.

This is the key outcome of the AMFM study at this stage. However, it is acknowledged that the process to develop innovative financing alternatives are complex, nuanced, multi-faceted and will require the engagement of a wide range of stakeholders and methodologies.
# Table of Contents

Acknowledgements ........................................................................................................... 1

Executive Summary ......................................................................................................... 3

Acronyms .......................................................................................................................... 6

List of tables and figures .................................................................................................. 8

List of tables ....................................................................................................................... 8

List of figures ...................................................................................................................... 8

Introduction ......................................................................................................................... 9

Chapter 1: Context of Cities and Finances ....................................................................... 12

1.1 Global Context .............................................................................................................. 12
1.2 The South African context ......................................................................................... 13
1.3 Cooperative Government and Local Government Fiscal Relations Framework ......... 18
   1.3.1 Constitutional Vision and Principles .................................................................. 18
   1.3.2 Policy Objectives and Principles ........................................................................ 20
   1.3.3 Local Government Fiscal Framework ................................................................. 22
   1.3.4 Division of Nationally Collected Revenue .......................................................... 23
   1.3.5 Municipal Fiscal Instruments ............................................................................. 25
   1.3.6 Municipal Revenue Sources .............................................................................. 25
1.4 Key emerging issues and constraints within the LGFF ................................................ 27

Chapter 2: Future City Perspectives ................................................................................... 30

2.1 Global trends ................................................................................................................ 30
   2.1.1 Overview of macro trends .................................................................................. 30
   2.1.2 The impact of urbanisation on the cities globally ................................................. 31
2.2 What are the challenges for cities in this context? ..................................................... 32
2.3 What are the emerging trends for global cities? ......................................................... 32
2.4 Trends, impacts and potential outcomes ..................................................................... 33
   2.4.1 The centralisation/decentralisation trend ............................................................ 33
   2.4.2 The cities risks trends ......................................................................................... 33
   2.4.3 The cities urban socio-cultural trend ................................................................. 34

Chapter 3: The Case for Change ....................................................................................... 35

3.1 Summary of key arguments around constraints ....................................................... 35
3.2 Case for change in city financing models ................................................................... 36
   3.2.1 Changing global environment .......................................................................... 36
   3.2.2 Cities as engines of economic growth ................................................................. 37
   3.2.3 Equitable share (LGES) and devolution of powers ............................................ 37
   3.2.4 Constitutional mandate ..................................................................................... 37
   3.2.5 Infrastructure backlogs ...................................................................................... 38
   3.2.6 Undifferentiated local government policy ......................................................... 38

Chapter 4: City Financing Approaches and Principles .................................................... 39

4.1 Overview of city financing approaches and principles ............................................. 40
4.2 Cross-cutting approaches and principles .................................................................. 40
   4.2.1 Policy coherence ................................................................................................. 40
   4.2.2 City differentiation ............................................................................................ 41
4.2.3 Fiscal efficiency and effort .............................................................. 41
4.3 Fiscal instruments ............................................................................. 42
4.3.1 Own sources of revenue and local taxation ................................. 42
4.3.2 Intergovernmental Transfers ......................................................... 43
4.3.3 Capital financing ........................................................................... 44

Chapter 5: A Financing Model Supportive of Policy Objectives .................. 46
5.1 Policy objectives ............................................................................. 46
5.2 Links between financing and developmental outcomes ...................... 48

Chapter 6: Elements of an Alternative Metropolitan Financing Model .......... 50
6.1 Fiscal instrument components .......................................................... 50
6.1.1 Own sources of revenue and local taxation ................................. 51
6.1.2 Intergovernmental Transfers ......................................................... 55
6.1.3 Capital financing ........................................................................... 56
6.2 Potential impact of fiscal instrument scenarios on AMFM ...................... 57

Chapter 7: AMFM Scenarios ................................................................. 59
7.1 Fiscal instrument scenario options ................................................... 59
7.2 Aggregate AMFM Scenarios ............................................................ 60
Current City Financing Practice/Baseline ............................................... 61
A: Flat Scenario .................................................................................... 62
B: Step-Change Scenario ..................................................................... 63
C: Jump-Change Scenario ................................................................... 64
Overall scenario comparison ................................................................. 66
Scenario comparison – data table .......................................................... 67

Chapter 8: Summary of Recommendations ............................................. 68
Conclusion ............................................................................................. 71

Annexures ............................................................................................... 72
A. List of existing metropolitan city grants ............................................. 72
I. Metropolitan Cities – 2013/14 Operating and Capital Revenues ............. 73
II. Fiscal Efficiency Measures ............................................................... 74
III. Sound taxation principles and validation of local taxation options ....... 75
IV. Feasibility analysis of capital financing options ................................. 72

References ............................................................................................. 65
## Acronyms

<table>
<thead>
<tr>
<th>Acronym</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>AMFM</td>
<td>Alternative Metropolitan Financing Model</td>
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<tr>
<td>BWG</td>
<td>Bellagio Working Group</td>
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<tr>
<td>CIT</td>
<td>Corporate Income Tax</td>
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<td>CoT</td>
<td>City of Tshwane</td>
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<td>CSP</td>
<td>Cities Support Programme</td>
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<td>DoR</td>
<td>Division of Revenue</td>
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<td>EPWP</td>
<td>Expanded Public Works Programme</td>
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<td>ES</td>
<td>Equitable Share</td>
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<td>ESKOM</td>
<td>Electricity Supply Commission</td>
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<td>European Union</td>
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<td>Financial and Fiscal Commission</td>
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<td>FMDV</td>
<td>Global Fund for Cities Development</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>Gross Value Added</td>
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<td>IGTs</td>
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<td>ICDG</td>
<td>Integrated City Development Grant</td>
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<td>IUDF</td>
<td>Integrated Urban Development Framework</td>
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<td>JICA</td>
<td>Japan International Cooperation Agency</td>
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<td>LES</td>
<td>Local Equitable Share</td>
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<td>LG</td>
<td>Local Government</td>
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<td>LGBER</td>
<td>Local Government Budgets and Expenditure Review</td>
</tr>
<tr>
<td>LGES</td>
<td>Local Government Equitable Share</td>
</tr>
<tr>
<td>LGFF</td>
<td>Local Government Fiscal Framework</td>
</tr>
<tr>
<td>LGBER</td>
<td>Local Government Budgets and Expenditure Review</td>
</tr>
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<td>Local Business Tax</td>
</tr>
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<td>LVC</td>
<td>Land Value Capture</td>
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<td>MDB</td>
<td>Municipal Demarcation Board</td>
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<td>Municipal Funding Agency</td>
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</tr>
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<td>MFPPA</td>
<td>Municipal Fiscal Powers and Functions Act</td>
</tr>
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<td>Municipal Property Rates Act</td>
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<td>MTEF</td>
<td>Medium Term Expenditure Framework</td>
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<td>NDP</td>
<td>National Development Plan</td>
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<td>Neighbourhood Development Grant</td>
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</tr>
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<tr>
<td>PTDs</td>
<td>Property Transfer Duties</td>
</tr>
<tr>
<td>PTIG</td>
<td>Public Transport Infrastructure Grant</td>
</tr>
</tbody>
</table>
List of tables and figures

List of tables

Table 1: Local government service delivery mandates .......................................................... 19
Table 2: Municipal fiscal instruments, constitutional and legislative provisions ................. 25
Table 3: Re-assignment or sharing of existing tax revenues .................................................. 52
Table 4: New sources of tax revenues ..................................................................................... 52
Table 5: Possible new sources of revenues from city services and assets .......................... 54
Table 6: Intergovernmental transfers options ......................................................................... 55
Table 7: Capital financing options .......................................................................................... 56
Table 8: Potential impact of fiscal instruments on AMFM scenarios ................................ 58
Table 9: Fiscal instrument and fiscal efficiency scenario options ........................................ 59
Table 10: Aggregate scenario comparison data table ............................................................ 67

List of figures

Figure 1: AMFM study phases ............................................................................................ 10
Figure 2: Population growth (%), 1996-2011 and 2011-2018 ............................................. 14
Figure 3: Population density (number of people/km²), 1996, 2011 and 2018 ...................... 15
Figure 4: Household growth (%), 1996-2011 and 2011-2018 ............................................ 16
Figure 5: Employment (official definition), 1996 and 2011 ................................................ 16
Figure 6: GVA-R (constant 2005 prices, R1000’s), 1996, 2011 and 2018 .......................... 17
Figure 7: Policy objectives and principles of current municipal finance system ............... 21
Figure 8: Three spheres of government (CoT) .................................................................... 22
Figure 9: Local Government Fiscal Framework (LGFF) ..................................................... 23
Figure 10: 2013/14 National budget revenue ....................................................................... 23
Figure 11: 2013/14 national division of revenue .................................................................... 24
Figure 12: Major sources of operating revenue per type of municipality – 2012/13 .......... 26
Figure 13: SA Metros - Operating revenue by source .......................................................... 27
Figure 14: Population living in urban areas 1950-2050 (UN-Habitat, 2015) ....................... 31
Figure 15: DoRA - Changes in formula (City of Tshwane, 2015) ........................................ 35
Figure 16: DoR share for LG (City of Tshwane, 2015) ......................................................... 36
Figure 17: City financing approaches and principles ............................................................ 40
Figure 18: Main sources of revenue ...................................................................................... 42
Figure 19: Existing capital financing sources ....................................................................... 44
Figure 20: The circular nature of municipal finances (SACN, 2016) .................................... 46
Figure 21: Broad policy objectives to inform financing approach ....................................... 47
Figure 22: Alternative metropolitan city financing scenarios .............................................. 61
Figure 23: Current city financing practice/baseline ............................................................... 62
Figure 24: Flat scenario ........................................................................................................ 63
Figure 25: Step-change scenario .......................................................................................... 64
Figure 26: Jump-change scenario ........................................................................................ 66
Figure 27: Scenario comparison .............................................................................................. 66
Introduction

The strategic developmental prominence of South African cities, in particular metropolitan municipalities, within the local sphere of government and certainly nationally is emphasised by a dominant role in the country’s economy reflected by their contribution to the national gross value added and net job creation, higher concentrations of people residing in cities and the resultant scale of their social and economic challenges and infrastructure delivery needs. (South African Cities Network 2011; Department of Cooperative Governance 2014; Turok and Borel-Saladin 2015). This trend is similar to many other cities on the African continent, in other developing countries and globally becoming important centres and drivers of economic growth, job creation and social integration (Paulais 2012; World Bank 2013; City of Tshwane 2015; UN-Habitat 2015).

However, despite an evolving local and global consensus around the strategic developmental role of cities there is according to UN-Habitat (2015:8) ‘a widening gap between the availability of financial resources and municipal spending needs, which is significantly instigated by rapid urbanisation which creates ‘an ever-increasing demand for public services, new public infrastructure and its maintenance’. This assessment is resonated in the City of Tshwane’s study (2015) referring to the financial pressures of modern age city challenges and demands.

Within this context the South African Cities Network (SACN) in partnership with the City of Tshwane (CoT) convened an expert panel-based study on Alternative Metropolitan Financing Models (AMFM). The AMFM initiative emerged on the back of the SACN’s ongoing analysis and reporting on municipal finances in South Africa over a number of years, as well as a specific directive from its leadership and members. Subsequent to initial work by the SACN partners which has raised important questions about the challenges, constraints and sustainability of the current metropolitan municipal financing model, this initiative convened a panel of global and local experts in complementary and relevant fields to work on formulating and assessing possibilities for alternative metropolitan financing models for cities.

Within the context of this study the term “financing” broadly denotes the “means by which a government obtains financial resources to implement its policies, programmes and projects”¹ and “cities” refer to metropolitan cities or category A municipalities² in terms the Constitution of the Republic of South Africa of 1996.

² There are currently eight metropolitan municipalities, namely: Buffalo City, City of Cape Town, City of Ekurhuleni, City of Ethekwini, City of Johannesburg, City of Manguang, City of Tshwane and Nelson Mandela Bay.
In order to accomplish the above objective, the following core AMFM study questions were formulated to frame the execution of this initiative:

1) What are alternative models for the sustainable financing of South African metropolitan municipalities?
2) How could these be rendered feasible for implementation in the South African context?
3) What potential lessons can other countries or cities in Africa and the Global South learn from this process?

The AMFM study further included the following main implementation phases as depicted in figure 1 below.

- **Pre-Bellagio**  
  17 August - 20 September 2015  
  - Project initiation  
  - Preparatory research  
  - Conference design & facilitation  
  - Conference resources

- **Bellagio Convening**  
  22 - 25 September 2015  
  - Intensive facilitated sessions  
  - Explore & develop alternative financing scenarios/models

- **Post-Bellagio**  
  October 2015 - March 2016  
  - Conference reporting  
  - Further research  
  - Draft AMFM report  
  - Consultations  
  - Finalisation of outputs

**Figure 1: AMFM study phases**

- **Pre-Bellagio**  
  This phase included project initiation, preparatory research, identification of stakeholder groupings, detailed conference design, content-specific communication with panelists and preparation and collation of conference information and materials.

- **Bellagio Expert Conference**  
  The main aim of the conference was to provide an intensive, facilitated opportunity for local and international experts to collectively explore and interrogate the question of alternative financing models for cities.

- **Post-Bellagio**
Activities beyond the Bellagio conference included: Post-event reporting; further research in areas identified at Bellagio; on-going engagement of panelists; consultations with local stakeholders; and finalisation of the AMFM report, policy brief and roadmap.

This report is therefore a consolidation of the work undertaken and (1) outlines the current global and South African context of cities and city financing; (2) highlights the future city perspectives which will have a significant impact on metropolitan cities over the next 10 to 15 years; (3) discusses the key arguments and rationale for change; (4) examines the main approaches and principles to financing cities; (5) discusses the developmental policy objectives the alternative model will need to enable and support; (6) Presents and discusses potential alternative financing instruments (7) considers a package of new AMFM scenarios in the context of an alternative model; (8) suggests a road map for the contextualisation and implementation of the financing model over the short, medium and long term; and (9) provides a concise summary of the key recommendations and proposals contained in the report.

The AMFM study proposals and recommendations for an alternative metropolitan city financing model contained in this report provides a sound basis upon which to expand research and work towards arriving at an alternative funding model.
Chapter 1: Context of Cities and Finances

This chapter explores the current structure and context of South African cities and the local government sphere including the manner in which financing of cities has evolved around the following areas: the governing policy, legislation and constitutional framework underpinning the *modus operandus* of cities. By way of a current global context of cities this leads to the discussion around the features of and trends around current South African cities towards a conversation as to whether there is a need to relook at the financing scenario of South African local government sphere, in particular metropolitan cities. This with respect to what the emerging problems, limitations and constraints have been in order to be able to meet the obligations of the local government sphere as envisaged by the constitution.

1.1 Global Context

‘The fundamental problem confronting most local authorities, especially those managing cities in developing countries, is the widening gap between the availability of financial resources and municipal spending needs. One of the main reasons for this increasing fiscal gap is the rapid growth of urban populations, which creates an ever-increasing demand for public services, new public infrastructure, and its maintenance.’

‘In most countries, there are huge vertical imbalances at the sub-national level in terms of sharing responsibilities and available fiscal resources. Stated differently, many central governments refuse to pay the political and financial costs of the decentralization of roles and responsibilities.’

This report of UN-Habitat raises the question of the “fiscal gap” and its impact on local government regimes and cities. It has also raised two interconnected themes namely the level of administrative and politically autonomy in relation to the required level of fiscal autonomy for a local government systems future. In the current global context, there has been an accumulating literature on the contemporary global experiences of reforming local government and the cities’ financing models as a result of the inverse ratio of the increased demands on local government and cities and the declining level of revenues and resourcing for cities and local governments.

The Mckinsey Global Institute (GMI) which has the largest single global cities database of social, population and economic data has tabulated current cities’ context through four key current features:

- The rapid increase of the largest global cities contribution to GDP, greater than the rate of nation-states GDP rate, to overall GNP of countries and regions.

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3 UN-Habitat. 2015. The challenges of Local Government Financing In developing countries.
• The rapid rate of urbanisation in the developing countries cities as reflective of the steep increase in population growth, migration/ concentration, numbers of households in megacities; medium –sized and smaller cities and economic activity. The evolution of these pressures must also take into account and may reflect an inadequate level of forward planning and absence of specific regional and country vision around local government.

• The current complexity of resultant challenges arising from renewed urbanisation in global cities around elements of design, space, habitat, infrastructure and financing of cities across the globe.

• The centrality of cities as urban concentrations of economic activity to nation states and regional economies.

This landscape of global cities forms the backdrop to the South African Cities context and the current features of our local government sphere.

1.2 The South African context

It was in 1998 after the adoption of the 1996 Constitution that the South African White Paper on Local Government commenced the process of constructing policy and a legal framework for its third tier of government. The South African configuration of powers and fiscal relationships as derived form a relatively new constitutional dispensation is a well-crafted and progressive in global terms.

Between 1998 and 2004 this framework elaborated, transformed and deepened the focus and mandates of the local government system through inter alia the creation of metropolitan cities with differentiated classification of municipalities; the establishment of an operational and accountable legislative frame; the operationalisation of an intergovernmental fiscal (revenue) transfer system with a local government equitable share formula. More or less after the 2008-09 global crises together with increased demands on the South African local government system, a key conversation emerged around the future sustainability of the South African local government financing system.

This was in part driven since 2003/04 by a rapid urbanisation, population growth and density, together with the associated increase in the regional/ local/ economic activity and output around the metropolitan and secondary cities. This chapter also tabulates this growth in size and scale of South African Cities to illustrate the future pressures on the local government system. The LGFF had attempted to respond to this growth through an ad hoc menu of specific instruments and measures such as, inter alia, conditional and unconditional differential grants; changes to the LGES - to support the expansion of both the role and scope of Cities and municipalities.
South African Cities Socio-Economic Profiles

In distinguishing metropolitan cities from the other local government types it is a further motivation of the need for greater differentiation within the municipal fiscal system given their contribution to GDP and employment. Metropolitan cities economic performance has been sluggish in recent years, which has affected their revenue-raising capacity. At the same time these local economies have continuously grown faster than the rest of South Africa. City economies are thus expected to drive economic growth and prosperity in the country, which requires reliable, cost-effective economic infrastructure with spare capacity to accommodate the additional demands placed upon it. This position is articulated clearly in the Integrated Urban Development Framework (IUDF)\(^4\) and indicates the important links between this range of issues and city finance.

As part of tabling an argument for an alternative financing model 3 areas of comparison are explored via a key HSRC study around the social and economic profiles of metropolitan cities for two periods, namely 1996-2011 and 2011-2018.

Population growth and density

![Population growth graph](image)

*Figure 2: Population growth (%), 1996-2011 and 2011-2018*

*Source: IHS Global Insight database*

\(^4\) The Department of Cooperative Governance, working with various partners (including SACN), has recently released the Integrated Urban Development Framework (IUDF) which was approved by Cabinet in April 2016. “The IUDF is a policy framework on how the South African urban system can be reorganised, so that our cities and towns become more inclusive, resource efficient and good places to live, work, shop and play in, as per the vision outlined in the National Development Plan.”
The above Figure 2 confirms the rapid increase in the population of Metros especially the projection to 2018 in particular around the key Gauteng metropolitan cities compared to the rest of South Africa. Figure 3 above validates the picture of greater density in the cities and thus the growing pressures on infrastructure, habitat and space towards effective service delivery in terms of the 2018 projection.

**Household growth**

This Figure (4) below indicates the scale of household growth as compared to the rest of South Africa’s growth. Consonant with the population growth it is clear cities will experience greater pressures as urban concentration continues (even if at a declining rate) in cities greater than the rest of South Africa.
Economic growth and employment

This Figure (5) provides an overview of the levels of employment in each city compared to the rest of South Africa. Figure (6) provides a good indicator of the size and scope of the metro economies through the GVA-R measure. The Cities will produce slightly under double the GVA of the rest of the country (at constant 2005 prices) as projected to 2018. The divergence between local economic growth and the rest of SA’s growth (in GVA terms) is significant.
Figure 6: GVA-R (constant 2005 prices, R1000’s), 1996, 2011 and 2018

Source: IHS Global Insight database
1.3 Cooperative Government and Local Government Fiscal Relations Framework

1.3.1 Constitutional Vision and Principles

The Constitution of the Republic of South Africa of 1996 (Constitution) outlines the vision and determines the fundamental guiding and enabling principles for the country’s decentralised system of government and provides for the objects, developmental duties, establishment, functions and powers and funding framework of local government as part of a system of cooperative governance with the other spheres.

Chapter 3 of the Constitution describes the three spheres as being ‘distinctive, interdependent and interrelated’ and enjoins them to ‘cooperate with one another in mutual trust and good faith’. An important element of this cooperative relationship is that there needs to be a clear understanding of each sphere of government’s powers and functions to ensure that a sphere of government or organ of state ‘does not encroach on the geographical, functional or institutional integrity of government in another sphere’. In addition to the Constitution, various legislation governs or organises the system of intergovernmental relations. Among other things, the legislation formalises the roles and responsibilities of the different spheres regarding various functions and provides for a range of consultative structures.

Section 152 of the Constitution states that the five objects of local government are to:

a) Provide democratic and accountable government for local communities;

b) Ensure the provision of services to communities in a sustainable manner;

c) Promote social and economic development;

d) Promote a safe and healthy environment; and

e) Encourage the involvement of communities and community organisations in the matters of local government.

Section 152(2) directs municipalities to use their available resources to realise the object of local government and must do so “within its financial and administrative capacity”.

Section 153 of the Constitution sets out the developmental duties of local government and states that “a municipality must structure its administration and budgeting and planning processes to give priority to the basic needs of the community, and to promote

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5 BC: - As suggested, you may wish to reflect on the fact that the Constitutional, legal and institutional frameworks in SA are of a high standard, well thought through and largely fit for purpose.

6 Intergovernmental Fiscal Relations Act (1997); Municipal Structures Act (1998); The Municipal Systems Act (2000); Intergovernmental Relations Framework Act (2005)
the social and economic development of the community; and participate in national and provincial development programmes”.

Section 155 of the Constitution provides for the establishment of local government in South Africa by defining three types of municipalities, namely:

- **Category A (Metropolitan):** A municipality that has exclusive municipal executive and legislative authority in its area;
- **Category B (Local):** A municipality that shares municipal executive and legislative authority in its area with a category C municipality within whose area it falls; and
- **Category C (District):** A municipality that has municipal executive and legislative authority in an area that includes more than one municipality.

The metropolitan municipalities are responsible for all the local government functions within their respective areas of jurisdiction. Each district municipality includes several local municipalities, and the powers and functions assigned to local government in that area are shared between the category B and C municipalities.

Section 156 of the Constitution stipulates the powers and functions of local government with Schedules 4B and 5B of the Constitution specifying the matters on which the local sphere of government has executive and administrative authority.

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<tr>
<th>Schedule 4B</th>
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<tbody>
<tr>
<td>Air pollution</td>
<td>Beaches and amusement facilities</td>
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<td>Air pollution</td>
<td>Billboards and the display of advertisements in public places</td>
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<td>Building regulations</td>
<td>Cemeteries, funeral parlours and crematoria</td>
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<td>Child care facilities</td>
<td>Cleansing</td>
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<td>Electricity and gas reticulation</td>
<td>Control of public nuisances</td>
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<td>Municipal planning</td>
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<td>Municipal health services</td>
<td>Licensing and control of undertakings that sell food to the public</td>
</tr>
<tr>
<td>Municipal public transport</td>
<td>Local amenities</td>
</tr>
<tr>
<td>Municipal public works only in respect of the needs of municipalities in the discharge of their responsibilities to administer functions specifically assigned to them under this Constitution</td>
<td>Local sport facilities</td>
</tr>
<tr>
<td>Pontoonos, ferries, jetties, piers and harbours excluding the regulation of international and national shipping and related matters</td>
<td>Markets</td>
</tr>
<tr>
<td>Storm water management systems in built-up areas</td>
<td>Municipal abattoirs</td>
</tr>
<tr>
<td>Trading regulations</td>
<td>Municipal parks and recreation</td>
</tr>
<tr>
<td>Water and sanitation services limited to potable water supply systems and domestic waste-disposal</td>
<td>Municipal roads</td>
</tr>
<tr>
<td></td>
<td>Noise pollution</td>
</tr>
<tr>
<td></td>
<td>Pounds</td>
</tr>
<tr>
<td></td>
<td>Public places</td>
</tr>
<tr>
<td></td>
<td>Refuse removal, refuse dumps and solid waste disposal</td>
</tr>
</tbody>
</table>
In addition to the local government powers and functions listed in Schedules 4B and 5B of the Constitution, the national and provincial government in terms of section 156(4) must assign to a municipality, by agreement and subject to any conditions, the administration of a matter listed in Part A of Schedules 4 and 5 which necessarily related to local government. This assignment must be effected if that matter would most effectively be administered locally and the municipality has the capacity to administer it.

Section 227 entitles the local sphere to an “equitable share” of nationally raised revenue in order that it may “provide basic services and perform the functions allocated to it”. Municipalities may also receive additional grants from national or provincial government on a conditional or unconditional basis.

Sections 229 and 230 of the Constitution grant municipalities considerable taxation and borrowing powers, but subject these powers to national legislation and regulation. Municipal taxation powers are also limited in that they cannot “unreasonably prejudice” national economic policies and economic activities. Borrowing powers are limited by the requirement that borrowings do not fund budget deficits. This means that the Constitution effectively prohibits deficit budgeting at the local sphere.

Within the context of the Constitution, the White Paper on Local Government (1998)\(^7\) expands on the vision and guiding principles and establishes the policy framework and determinants for the country’s system of developmental local government and municipal finances outlined in the next section.

1.3.2 Policy Objectives and Principles

The White Paper on Local Government (1998:8) established the basis for the new system of developmental government, within the framework of the Constitution, which in turn premised on an explicit commitment to work with citizens, groups and communities to create sustainable human settlements providing a decent quality of life and holistically meeting the social, economic and material needs of communities.

According to the White Paper on Local Government the following policy objectives and principles must inform the restructuring of the municipal finance system in order to meet the above constitutional objectives. The policy objectives and principles for the new system of municipal finance are depicted in the diagram below.

<table>
<thead>
<tr>
<th><strong>Revenue adequacy and certainty</strong></th>
<th><strong>Sustainability</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Municipalities need to have access to adequate sources of revenue to enable them to carry out the functions that have been assigned to them and should be encouraged to fully exploit these sources of revenue to meet their developmental objectives.</td>
<td>• Financial sustainability requires that municipalities ensure that their budgets are balanced and set realistically by ensuring that services are provided at affordable levels and the costs of service delivery can be recovered.</td>
</tr>
<tr>
<td>• Municipalities should have reasonable certainty of revenue to allow for realistic planning.</td>
<td>• However, there is a need for subsidisation to ensure that poor households, who are unable to pay even a proportion of service costs, have access to basic services.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Effective and efficient resource use</strong></th>
<th><strong>Accountability, transparency and good governance</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>• Scarce economic resources should be used in the best possible way to reap the maximum benefit for local communities</td>
<td>• Municipalities should be held responsible and accountable to local taxpayers for the use of public funds</td>
</tr>
<tr>
<td>• Local residents must provide the necessary checks and balances.</td>
<td>• The fiscal system should be designed to encourage accountability</td>
</tr>
<tr>
<td>• Efficiencies in public spending and resource allocation will ultimately increase the access of the poor to basic services</td>
<td>• Municipal budgeting and financial affairs should be open to public scrutiny and community involvement</td>
</tr>
<tr>
<td><strong>Equity and redistribution</strong></td>
<td><strong>Macro-economic management</strong></td>
</tr>
<tr>
<td>--------------------------------</td>
<td>---------------------------------</td>
</tr>
<tr>
<td>• Municipalities must treat citizens equitably with regard to service provision and in turn, must be treated equitably by national and provincial government with regard to transfers</td>
<td>• Municipalities form an integral part of the public sector in South Africa, and their actions can substantially affect national policy</td>
</tr>
<tr>
<td>• Local and national government are jointly responsible for redistribution, with respect to subsidising the provision of basic services. The “equitable share” will be directed primarily at this purpose.</td>
<td>• Municipalities need to operate within the national macroeconomic framework and their financial activities should not be such as to destabilise macroeconomic fiscal policy.</td>
</tr>
<tr>
<td>• In addition to targeted subsidies to poor HHs, municipalities can cross-subsidise between high and low-income consumers, both within particular services and between services</td>
<td></td>
</tr>
</tbody>
</table>

**Figure 7: Policy objectives and principles of current municipal finance system**

Municipalities have access to a range of fiscal instruments in order to achieve the policy objectives outlined above and fund their service delivery mandate. These instruments are discussed in the next section of this chapter.
1.3.3 Local Government Fiscal Framework

The National Treasury (2011:27)\(^8\) states that “the constitutional assignment of powers and functions to local government has a direct bearing on the local government fiscal framework” (LGFF), established in 1998, “and should ideally provide municipalities with access to revenue sources that are commensurate with the services they are responsible for providing”. According to the Financial and Fiscal Commission (2012:8)\(^9\) the LGFF, can be broadly defined as the funding arrangement or framework required to ensure that municipalities are sufficiently financed to fulfil their constitutional mandates to render adequate services to communities.

This frames and defines the intergovernmental fiscal relations (IGFR) system and ultimately the LGFF which should promote *equity, democracy, fiscal accountability and economic efficiency*.

The LGFF is thus a multi-layered and complex system given that it operates within an interdependent regime towards fulfilling a complex mandate of delivery at local level. The following diagram captures the four components of the current local government system as well as the three sources of local government revenue: national transfers; own revenue and debt financing.

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In 1998, the National Treasury articulated a set of principles and objectives for the design of the LGES formula. Although these principles focused specifically on the LGES formula design, such principles can be applied to the current LGFF.

1.3.4 Division of Nationally Collected Revenue

The diagram below depicts the composition of national budget revenue for the 2013/14 national financial year.

![Figure 10: 2013/14 National budget revenue](image-url)
Personal Income Tax (PIT) at 34.5% is the main source of tax revenue, followed by Value Added Tax (VAT) at 26.4% and Corporate Income Tax (CIT) at 19.9%. Other minor tax sources include excise duties, fuel levy, customs duties, etc.

An analysis of the current division of nationally collected revenue illustrates that metropolitan cities are allocated 4.29% (incl. conditional grants and fuel levy allocation) of the total national tax base despite these jurisdictions being responsible for contributing almost 60% to GDP. The basis for such an allocation is that the metropolitan cities have greater revenue raising potential than other government institutions and thus are expected to be largely self-financing.

<table>
<thead>
<tr>
<th>Source of Revenue</th>
<th>National Revenue Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>PIC</td>
<td>34.5%</td>
</tr>
<tr>
<td>CIT</td>
<td>19.9%</td>
</tr>
<tr>
<td>VAT</td>
<td>26.4%</td>
</tr>
<tr>
<td>Other</td>
<td>19.2%</td>
</tr>
<tr>
<td>LG</td>
<td>439 661</td>
</tr>
<tr>
<td>Prov</td>
<td>439 661</td>
</tr>
<tr>
<td>National</td>
<td>491 368</td>
</tr>
</tbody>
</table>

Figure 11: 2013/14 national division of revenue

Sources: National Treasury (2015); SA Cities Network (2015)
1.3.5 Municipal Fiscal Instruments

The fiscal instruments that are available to municipalities to fund their expenditure responsibilities include own revenue (property taxes, user charges for municipal services rendered, surcharges on user charges and other local taxes), intergovernmental transfers (conditional and unconditional grants) from national government and municipal borrowing from credit markets (financial institutions) for capital expenditure. The table below sets out the main fiscal instruments at the disposal of municipalities and the applicable constitutional provisions and legislation governing it.

Table 2: Municipal fiscal instruments, constitutional and legislative provisions

<table>
<thead>
<tr>
<th>Municipal fiscal instruments</th>
<th>Constitutional provisions</th>
<th>Governing legislation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Municipal own revenue sources</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rates on property</td>
<td>Section 229 and 227(2)</td>
<td>Municipal Property Rates Act</td>
</tr>
<tr>
<td>Surcharges on fees for services provided by or on behalf of the municipality</td>
<td>Section 229 and 227(2)</td>
<td>Municipal Fiscal Powers and Functions Act</td>
</tr>
<tr>
<td>Service charges/ fees</td>
<td>Section 229 and 227(2)</td>
<td>Municipal Systems Act, Municipal Finance Management Act, Electricity Act and Electricity Regulation Act, National Water Act, Provincial land use planning ordinances</td>
</tr>
<tr>
<td>Other taxes, levies or duties</td>
<td>Section 229 and 227(2)</td>
<td>Municipal Fiscal Powers and Functions Act</td>
</tr>
<tr>
<td>Administrative fees</td>
<td></td>
<td>Municipal Systems Act</td>
</tr>
<tr>
<td>Fines</td>
<td></td>
<td>National Road Traffic Act</td>
</tr>
<tr>
<td>Credit control and debt collection</td>
<td></td>
<td>Municipal Systems Act</td>
</tr>
<tr>
<td>Borrowing</td>
<td>Section 230A</td>
<td>Municipal Finance Management Act</td>
</tr>
<tr>
<td>Transfers from national and provincial government</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local government equitable share of nationally collected revenues</td>
<td>Section 214 and 227</td>
<td>Intergovernmental Fiscal Relations Act, The annual Division of Revenue Act</td>
</tr>
<tr>
<td>Fuel levy sharing with metropolitan Municipalities</td>
<td>Section 229(1)(b)</td>
<td>Annual Taxation Laws Amendment Act</td>
</tr>
<tr>
<td>Conditional grants from national Government</td>
<td>Section 214(c), 226(3) and 227(1)(c)</td>
<td>Intergovernmental Fiscal Relations Act, The annual Division of Revenue Act, Annual National Appropriation Act</td>
</tr>
<tr>
<td>Conditional grants from provincial Government</td>
<td>Section 226</td>
<td>Annual Division of Revenue Act, Annual Appropriation Act of relevant province</td>
</tr>
</tbody>
</table>

Source: National Treasury. 2011. Local Government Budgets and Expenditure Review (LGBER)

1.3.6 Municipal Revenue Sources

The figure below shows the major sources of operating revenue across the various types of municipalities. It illustrates that metros rely more on own sources of revenue from property rates and service charges and are less dependent on intergovernmental
transfers compared to other types of municipalities such as rural and district municipalities who has a higher grant dependency ratio.

![Figure 12: Major sources of operating revenue per type of municipality – 2012/13](image)

Source: Presentation by B. Khumalo on Intergovernmental transfers at the inaugural convening of AMFM Expert Panel in Bellagio, Italy on 24 September 2015.

The next diagram shows the major sources of operating revenue for South African metropolitan cities over the last three financial years. Property rates, electricity and water service charges are the major sources of revenue for metros accounting for more than 70%, whilst intergovernmental transfers\(^\text{10}\) constituted around 13% of total operating revenues.

The substantial increases in bulk electricity tariffs by ESKOM over the past financial years have exhausted the historical municipal trading surpluses and cash reserves with adverse implications on the future financing of metropolitan cities as their ability to use electricity revenue as a general source of financing is rapidly diminishing. The possible amendments to the Municipal Property Rates Act, in respect of the rating of public infrastructure may also have an adverse effect on the revenue budgets of cities going forward.

\(^{10}\) See Annexure A for a list of existing metropolitan city grants
1.4 Key emerging issues and constraints within the LGFF

The constraints and barriers of the existing municipal fiscal framework discussed in this section will be categorised according to the major fiscal instruments and revenue sources of municipalities and cities as well as general issues. The constraints and barriers will be further analysed according to the issues identified by the AMFM Expert Panel during its inaugural meeting in Bellagio, the Final Report of the Financial and Fiscal Commission (2012) on the Review of the LGFF and the National Treasury 2011 LGBER. In addition, the findings from the DoR study by City of Tshwane (2015) will also be incorporated under the IGT section.

Own revenue and local taxation

<table>
<thead>
<tr>
<th>Expert Panel</th>
<th>Financial and Fiscal Commission</th>
<th>National Treasury</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Basket of services must be competitive</td>
<td>• Design of IGT system must recognise constraints on own revenue sources, such as sensitivities to global, national and local economic factors, increased urbanisation and growing poverty levels, over-regulation of municipal revenue sources, large increases in input costs, pressures on funding capex from own revenue</td>
<td>• Only the Minister of Finance may authorise a municipal tax by issuing regulations in terms of the MFPFA. The Minister of Finance, acting on his own initiative, may authorise new municipal taxes, or a municipality may apply for a new tax to be authorised. Such an application must be supported by various studies on the impact of the proposed tax.</td>
</tr>
<tr>
<td>• Budget to be ‘revenue’ driven</td>
<td></td>
<td>• Are municipalities using the ‘fiscal space’ available to them to raise their own revenue?</td>
</tr>
<tr>
<td>• Tariffs already at ceiling</td>
<td></td>
<td>• All municipalities, irrespective of fiscal capacity,</td>
</tr>
<tr>
<td>• Low growth in rates base</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• ESKOM electricity tariff increases crowding out space for municipal trading account surplus</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Minister in terms of the Municipal Fiscal Powers and Functions Act (MFPFA) deciding fiscal arrangements on behalf of a sphere of government is inappropriate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Implications of possible amendments to Municipal Property Rates Act (MPRA)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

SA Metros: Operating Revenue by source

![Figure 13: SA Metros - Operating revenue by source](image-url)
Inter-governmental transfers

<table>
<thead>
<tr>
<th>Expert Panel</th>
<th>Financial and Fiscal Commission</th>
<th>National Treasury</th>
</tr>
</thead>
</table>
| • Huge backlogs in service delivery  
• Free basic services  
• Current funding dispensation not aligned to constitution  
• Conditionality of grants and lack of differentiated approach for cities  
• Over-regulation of municipalities resulting in excessive reporting compliance to national and provincial departments – increasing the ‘cost of governance’  
• LGES at 9% compared to 43% increase in functions since 2004  
• Unfunded mandates  
| • Horizontal division of revenue: Inequities across municipalities  
• Infrastructure grants:  
  o Possible funding gap on municipal capital budgets  
• Conditional grants:  
  o Proliferation of grants and the compliance and reporting burden on municipalities  
| • Only a municipality’s fiscal capacity (and other issues mentioned in section 214(2) of the Constitution) may be taken into consideration when determining its equitable share or any other transfers from the national budget |

Capital financing

<table>
<thead>
<tr>
<th>Expert Panel</th>
<th>Financial and Fiscal Commission</th>
<th>National Treasury</th>
</tr>
</thead>
</table>
| • Adherence to national treasury norms and standards:  
  o gearing ratio not to exceed 45%  
  o debt to operating revenue not to exceed 8%  
| • Current financing structure sees banks as short-term lenders while the DBSA has a longer funding and development outlook.  
| • National government does not guarantee municipal borrowing, a municipality’s capacity to borrow is a function of sound financial management, sound own revenue management and choice of infrastructure projects. |

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11A common problem with fiscal systems is insufficient clarity in the assignment of local government expenditure responsibilities. Even where responsibilities are reasonably well defined in more advanced systems, expenditure challenges may be created by unfunded mandates from higher level governments and the lack of well-developed methodologies and practices to translate expenditure assignment responsibilities into quantifiable resource needs. Degrees of autonomy in expenditure decisions also vary widely. (UCLG, 2010:18)
## General constraints and barriers

<table>
<thead>
<tr>
<th>Expert Panel</th>
<th>Financial and Fiscal Commission</th>
<th>National Treasury</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Differentiation</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>• No differentiated approach to grant system</td>
<td>• It is paramount that the principle of differentiation be implemented in the functioning, financing and capacity support framework of local government based on the context and performance of municipalities</td>
<td>• How the local government fiscal framework provides for the funding of municipalities must be looked at holistically, taking into account the real differences between municipalities.</td>
</tr>
<tr>
<td><strong>Policy integration</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The dis-function of local government is equally the result of the failure of national and provincial sphere of government to effectively monitor, supervise and support municipalities</td>
<td>• How the local government fiscal framework provides for the funding of municipalities must be looked at holistically, taking into account the real differences between municipalities.</td>
</tr>
<tr>
<td><strong>Data constraints and unfunded mandates</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• The lack of frequent and useful data is not sufficient to support the design of a responsive and accurate LGFF</td>
<td>• National and provincial departments prefer to delegate functions through agency agreements because this enables them to retain control of the budget, while devolving responsibility for implementation to the municipality. The problem is that this separation of funding and implementation responsibilities often result in unfunded mandates being imposed on municipalities. (2011:35)</td>
</tr>
</tbody>
</table>
Chapter 2: Future City Perspectives

The purpose of this chapter is to describe and tabulate the importance of cities and their economic, social and administrative systems as they adapt to a changing global world. In the South African context, there is an increasing awareness of the cities’ importance to the overall social and economic growth. As part of sketching the current and future evolution of local government and metropolitan cities the UN-Habitat (2015:10) has described cities in the following way:

‘Local authorities in all parts of the world play an increasingly important role in the delivery of fundamental basic public services. But authorities also face great challenges.’
‘Cities are assets, solutions and drivers of economic and social development’

This chapter will thus consider the evolution of the urban dynamic and its trajectory as it shapes the conversation around innovative models with potential alternative scenarios for change.

2.1 Global trends

2.1.1 Overview of macro trends

The basis of the changes in city development has been successive waves of urban migration and development. The urban population in 2014 accounted for 54% of the total global population, up from 34% in 1960, and continues to grow.

The global urban population is also expected to grow approximately 1.84% per year between 2015 and 2020, 1.63% per year between 2020 and 2025, and 1.44% per year between 2025 and 2030. This has happened also in a context of globalization of communications, interplanetary systems and the digitalization of business processes through ICT globally. Globalisation has led to a blurring of boundaries between supranational, national and local control functions.
2.1.2 The impact of urbanisation on the cities globally

There are six dimensions that have had impact on cities globally:

- The emergence of greater uneven development around inefficient urban forms, habitat and space including the emergence of cyclical urban sprawl.
- There is increased pressure on the infrastructure system of cities globally which places pressures around three areas:
  - current demands versus backlogs in infrastructure
  - the future demands required for increased urbanisation and concentration in cities
  - The need for continuous evolving financial options.
- Increasing pressure on the natural resource base: land, water, energy, waste management system within cities.
- Increasing unemployment/underemployment, i.e. “jobless futures” – and therefore low/no affordability for housing and habitat.
- Permanence of informality (settlements, economy) in cities - “Informal as the new normal”.
- The changing use of technologies either enabling or disenabling city and citizens interface in the urban complexes.
- Increased urbanisation can also unlock more creativity and the benefits of the economies of scale and concentration.
2.2 What are the challenges for cities in this context?

- A key challenge for cities remains the inability to undertake and negotiate medium to long-term sustainable planning processes around managing the impacts of the urbanisation.
- There is a complexity of many urban socio-economic and political dynamic variables that are rapidly changing the governance and political environments of cities. These have an impact on the ability to chart a sustainable planning path for cities.
- There is an inverse proportion between the demand made for social services and social delivery and the resources available for cities and local governments. This places increased pressures on city management and governance structures.
- The emergence of uneven development has introduced greater future uncertainty in the key city operations.
- There is also an inability to find the appropriate administrative scale at which to formulate and implement industrial, social and infrastructure policies and devising the appropriate partnership mechanism with relevant private stakeholders towards this urban future.

2.3 What are the emerging trends for global cities?

- There is a trend to greater decentralisation from states and regional governments to cities and local governments. There have been cases cited in the EU context where there has been devolution of both administrative and financial powers. It is also a phenomenon in emerging economies across different constitutional regimes where there are variances in scale and scope of devolution. This appears to be a continuous trend.
- There is also the opposite trend dynamic of city centralisation and concentration from local governments and smaller cities. This trend is obvious in the phenomenon of mega cities and city-region states in both developing and developed countries. The cities of London and Paris are examples of greater centralisation and incorporation of powers and operations with changing local tax regimes. Many developing country cities such as Mumbai and Mexico City are further examples of this pattern as are cities in Africa and South Africa including the cities in the Gauteng Province, which are moving in that direction through the City Region formulation.
- With the increased urbanisation and migration there is a greater reliance and stimulation for own revenue generation in cities. This pattern is a response across city types to increased pressures on public finances and the increasing trend to underfund cities in both the south and north contexts form national governments.
• There is also the current trend of the emergence of differential global city and local government resourcing and planning models and concepts in both the north and south contexts. From the UN-habitat to the World Bank and global institutes, not least of all national governments, there is increasing awareness of cities as the key engines of global growth and human concentration for the next 15-20 years, which begs a more globally aligned framework together with norms and standards around city planning and financing. These do relate to different perspectives around current global issues, challenges and solutions.

2.4 Trends, impacts and potential outcomes

What are the current overarching trends and patterns if any of global cities that is effectively driven by the massive growth and concentration in urban complexes of space, habitat, design, economy, communications, layered governance, scale of functions and infrastructure, together with financing, over the next 15 to 20 years? Given that cities are located in differential regional and national socio-political contexts in both the North and South zones, every city will evolve both shaping national, regional contexts and in turn shaped by those specific contextual factors in a continuous and contiguous way. We offer three macro-trends that cities seem to be evolving towards.

2.4.1 The centralisation/decentralisation trend

The centralisation /decentralisation dichotomy between megacities or city-states/ city-regions and/or correlative smaller city units and city-counties, initially driven by the urban economic division of labour in countries/regions, as exhibited by both devolving or increasing, administrative, political and financial powers, is a complex phenomenon that will continue globally. There will be an increasing relative disjuncture between global mega-cities and/or smaller urban forms, across global regions and their nation-states, around appropriate political governance, economic and financial policy and strategies, urban space management and settlement, which will impact differentially on the future political, social and financial approaches.

The pattern of outcomes across global regions from this phenomenon and its impacts is still not fully discernible but early indications remain that there will be a wide differentiation across cities and local governments, around forms governance, policy and urban design, financing and administrative regimes, citizen incorporation and involvement.

2.4.2 The cities risks trends

All cities in their current regional and national socio-political contexts are also subject to
current global political, environmental and economic “shock” impacts and risks that have been part of the post 1970’s world. These impacts are defined as specific risks, different from evolving determinants of the socio-economic and political context of cities since they have direct cross-cutting effects on cities’ evolution. Three current risk areas that have and will also negatively shape future cities outside of their unilineal evolution:

- Climate change and its effects on resourcing, space, habitat, administrative management, infrastructure and financing;
- Political and governance regime change or regional / national wars;
- Economic crises (specific) and its effects on financing; administrative management and infrastructure.

Each of these impacts have different resultant effects given the specific historical narratives of cities. These effects have defined short term and long term costs for economies and financing of cities which is calculable for the specific context of that country and region.

2.4.3 The cities urban socio-cultural trend

This trend is characterised by the cluster of factors of how a city “comes together” around the configuration of social, cultural, educational, citizen involvement/ awareness, digital connectivity, population segments distribution and resource allocation across the city space and communities that shapes a city’s’ identity and its role. This can also be defined as the non-tangible but real cultural effects that define whether a city evolves effectively within the global knowledge economy with creativity for a future city sustainability.

This is often related to cities’ singular or multi-focus role and function within the urban economic division of labour of a region or country and takes on a particular social/ cultural identity that either alienates or integrates and coheres cities culturally into a future trajectory.

This trend has two broad impacts:

- The evolving level of innovation, creativity and city capability for future projections;
- The level of political and social and governance stability and equilibrium over time within a city context.
Chapter 3: The Case for Change

Given the South African and global scenarios sketched above there appears to be an overwhelming picture that the current financing model is inadequate to meet the medium to long term trajectory of local government and cities. This chapter focuses on what is the rationale for change in financing approaches.

3.1 Summary of key arguments around constraints

1. The local government equitable share formula (LGES) as the horizontal mechanism of share distribution has changed three times over the course of its existence. Throughout this however its configuration has been static and unresponsive to the changes in corresponding responsibilities and mandates. Below is a diagrammatic representation of the LGES formula.

2. The LGES also implies an undifferentiated approach to local government, i.e. not distinguishing the differential financing requirements between local government levels and classification. In this the social, administrative and economic importance of metropolitan cities is not inscribed into the LGES formula. From current studies and indicators 63% of the national GVA is generated by metropolitan cities and 58% of employment is in the metropolitan cities. It follows that if this is the scale of the cities impact on the economy, outputs and employment the LGES system must take account of this picture for a sustainable future of local government and cities.

3. The national DoR as the vertical picture of the split in transfers to the spheres of government as prescribed through the constitution has also been a static share of the national revenue despite the escalating importance and impact of cities. According to the CoT Study (2015) the Division of...
Revenue the level of mandates and high level responsibilities has increased by 43% between 2004 and 2014. In the 2012-2014 MTEF the local government share of the nationally raised revenue amounted to an average of 9%.

Figure 16: DoR share for LG (City of Tshwane, 2015)

4. The national grant system and its formulation for local government are also driven by national and provincial priorities and drivers. The grants (mainly conditional) are not sufficiently consolidated and given their volume and complexity is not sufficiently responsive to local government and Cities’ needs. The CoT (2015) study on the DoR argues that it has a paralysing effect on the ability of the constitution to meet its obligations (as an interdependent regime).

5. There is an inadequate equivalence between the devolution and autonomy of the three dimensions within local government: administrative; governance and financial. In the CoT study on the DoR also found despite being a interdependent system of government that there was, consistent with global trends, less devolution of financial powers in the LGFF compared to the other dimensions.

6. Our current LGFF does not articulate with the national planning and national programmes for the country overall growth trajectory. The NDP speaks to a national economic and social role for local government and cities.

3.2 Case for change in city financing models

The next section outlines the identified areas and related rationale for change.

3.2.1 Changing global environment

The contemporary global experience indicates that many cities have undergone the path of inadequate focus on local government and thus ineffective financing of development even if more than 50% of the GDP is contributed by Cities. The Global context has shifted as the massive population migration and social, economic urban concentration has taken place across the world. Cities are by current scenarios de facto ‘assets, solutions and
drivers of economic and social development’ (UN-Habitat, 2015: 10). The current financial approaches and model is unable to respond to this rapid shift globally. Both emerging and developed countries face the same problematic either through megacities, metropolitan and secondary cities.

3.2.2 Cities as engines of economic growth

The current financing approaches are unable to encompass and respond holistically to the growing trajectory of cities’ and local governmental roles and functions in both the global or sub-national economy. Current economic growth requires *inter alia*, greater urban-based skill sets and education; enhanced urban infrastructure investment; greater sub-national sectoral development and linkages. **Concomitantly it must be understood that economic growth is not automatic and will still depend on effective municipal efficiencies and capabilities.**

In the South African scenario, the current model is not sufficiently configured to enable greater stimulation of capital formation and business instruments together with labour market synergies within an overall sub-national and local economic approach. There is an inadequate sub-national/local view of cities and local government role in the economy even though cities account for up to 63% of the national GDP and up to 58% employment rate compared to the rest of the economy. An alternative financing model for local government and Cities will be able to unlock their full potential as engines and drivers of growth through more appropriate financing tools for increased projected tax revenue and GDP contribution over time.

3.2.3 Equitable share (LGES) and devolution of powers

The equitable share of the national revenue distribution has remained static and unresponsive post the adoption of the Constitution and the promulgation of the local government legislation. This has been a relatively flat rate of 9% of national revenue while there has been an increase of high level functions and mandates of 43% post the change in the LGES of 2004. This model is based on an assumption of greater reliance on ‘own revenue’ sources for local government and cities but the concomitant devolution of financial powers to local government and cities (within a differentiated cities’ framework) has not happened.

3.2.4 Constitutional mandate

Given the division of revenue fiscal gap of local government and cities, the current model hampers and paralyzes the constitution to be able to meet its full obligation, given the interdependent spheres of governance defined by the constitution. It is a constitutionally
defined precept that each sphere co-determines with the other to address and deliver effective services to the citizens as defined.

3.2.5 Infrastructure backlogs

There is a significant legacy backlog in the local government and cities infrastructure. While the system of grants emerged post 2004 to address various historic backlogs, addressing the current legacy is not formally inscribed into the financing arrangements of the division of revenue. This has the impact of undermining the ability to deliver effective services and efficiencies to both the regional/local economies and city and the active citizens.

3.2.6 Undifferentiated local government policy

The current model makes no distinction between urban complexes and the level of cities and councils in the determination of revenue transfers. This undifferentiated model undermines the ability of metropolitan cities to both continue to grow as sub national economies and efficient urban complexes and simultaneously contribute to the scale and scope of the national economy.

A new bold and visionary path is required given the above description of the challenges and inadequacy of the LGFF including that the last time policy changes were made was over ten years ago. This document thus further undertakes to table a set of cross-cutting city financing scenarios towards identifying a potentially feasible path of change for the local government fiscal situation.
Chapter 4: City Financing Approaches and Principles

Cities are playing an important role in realising the country's national development objectives and are increasingly becoming key drivers of economic growth, global competitiveness and social cohesion. City financing is also considered as a key enabler for city development within the context of the nationally-aligned and local service delivery priorities for cities.

The fiscal capacity (own revenue potential)$^{12}$ and fiscal space (financing available)$^{13}$ of cities should therefore be enhanced to ensure that they are financially self-sustaining and able to attract investment to ensure credibility and creditworthiness within the context of an integrated and coherent financing framework. According to Roy et al (2007) moving towards a fiscal framework that is development-centred (and not by any means less fiscally astute) from one that is grounded in a purely fiduciary logic, raises amongst other analytical issues, the issue of “fiscal space conjecture”$^{14}$ which explains why there continues to be a tension between the need to simultaneously secure both fiduciary and development outcomes.

This chapter will discuss the main approaches and principles to financing municipalities in general and specifically cities by propositioning a framework to ensure coherence in the appraisal of the various fiscal measures and instruments impacting on the fiscal capacity and space of cities and examine the suggested general and specific approaches and principles to the financing of cities.

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$^{12}$ **Dimensions of fiscal capacity**: Section 214(2) of the Constitution provides that when determining the equitable share of a municipality, government must give consideration to, among other things, ‘the fiscal capacity and efficiency of the ...municipalities’. It is important to note that fiscal capacity does not include the local government equitable share of nationally collected revenues or other transfers from national and provincial government, but rather the own revenue potential of the municipality. This emphasis on ‘own revenue potential’ is found in section 227 of the Constitution, which differentiates actual own revenue raised from fiscal capacity. The four components to municipal fiscal capacity include 1) the fiscal powers and functions of the municipality in terms of the Constitution and national legislation; 2) the own revenue potential of the municipality, given a specified set of fiscal powers and functions and the ability of its customer base to pay for services; 3) the community demand for the services that the municipality is responsible for funding. (National Treasury, 2011 Local Government Budgets and Expenditure Review, 2011:38)

$^{13}$ **Fiscal space** is “the financing that is available to government as a result of concrete policy actions for enhancing resource mobilisation and the reforms necessary to secure the enabling governance, institutional and economic environment for these policy actions to be effective for a specified set of development objectives” (Roy, R., Heuty, A & Letouzé, E. 2007. Fiscal Space for What? Analytical Issues from a Human Development Perspective. Paper for the G-20 Workshop on Fiscal Policy-Istanbul, June 30 – July 2, 2007. UNDP).

$^{14}$ The proposition that the greater the public good characteristics of public sector investment projects, the lower the precision and the predictability of their fiduciary payback calculations, but the higher the precision and predictability of their development payback calculation. (Roy, R and Hueuty, A. eds. 2009. Fiscal Space: Policy Options for Financing Human Development. UNDP. New York: Taylor & Francis)
4.1 Overview of city financing approaches and principles

The financing approaches and principles depicted in the following diagram and discussed below are best divided into two main conceptual categories, namely cross-cutting and fiscal instrument-specific. The three cross-cutting financing precepts and principles (*policy coherence, differentiation and fiscal efficiency*) are shown in the outside triangle as an indication of its overall influence on the three fiscal instrument areas (*own revenue sources, intergovernmental grants and capital financing*) displayed inside the inner triangle.

![Figure 17: City financing approaches and principles](image-url)

4.2 Cross-cutting approaches and principles

The following three cross-cutting financing approaches and principles for cities, as depicted in the outer triangle of the diagram above, have a direct and/or indirect impact on the fiscal capacity and space of metropolitan cities. Each one of the approaches and principles are concisely delineated below.

4.2.1 Policy coherence

The core aim of the AMFM initiative is to explore possibilities for alternative metropolitan
financing models for cities to effectively deliver on their strategic developmental agenda in South Africa (discussed further in chapter 5). It is thus critical that the financing or fiscal framework of cities and the analyses of alternatives must be examined within an integrated and coherent approach and framework. This implies that the linkages, interrelationships and balance among the different components and instruments must be fully considered and not viewed in a fragmented mode to avoid potential risks.\(^\text{15}\)

The objective of the policy coherent approach and principle should be to ensure that the fiscal capacity and space of cities must be enhanced through a consistent and integrated set of measures and instruments. **This will of necessity oblige planners and policy makers to take a longer planning time horizon at local government level, i.e. a 25-year minimum period.**

### 4.2.2 City differentiation

The differentiation approach and principle is motivated by the prominent role that metropolitan cities play in the country’s economy reflected by their contribution to the national gross value added (GVA) and net employment creation, higher concentrations of people residing in cities and the resultant scale of their social and economic challenges and infrastructure delivery needs, as highlighted in Chapter 1.

An extended differentiated approach within a coherent policy framework is essential for all areas impacting on the fiscal space and capacity of metropolitan cities and should be purposely enshrined in the devolution of functions and expenditure mandates, sharing in nationally raised revenues, other national and provincial transfers, the assignment of fiscal powers and functions and the range of capital financing options available for cities.

### 4.2.3 Fiscal efficiency and effort

There is a general understanding that, in order for metropolitan cities to enhance their fiscal space and capacity, it is essential that an alternative financing model should be buttressed by improved fiscal efficiency and effort. Cities need to manage existing revenue, expenditure, assets and liabilities (REAL) much better and strengthen institutional governance and accountability measures.

\(^{15}\) Focusing on generating more own source revenues from citizens without making sure this is linked to visible service delivery so that they feel they are getting value for money (revenue-service link); developing intergovernmental transfers that undermine own revenue generation; and advancing sources of capital finance and borrowing mechanisms without commensurate attention to the ability of cities to generate sufficient local revenues to repay such facilities.
However, this approach and principle must be developed further to ensure that measurable indicators are designed to assess the level of fiscal efficiency and effort of cities and the requisite performance improvements. The defined indicators must focus on specific dimensions of municipal fiscal health\textsuperscript{16} that influence the fiscal space and capacity of cities, such as the quality of revenue management capabilities, credibility of budget funding and spending, quality of annual audit outcomes, efficiency of supply chain management practices, adequacy of repairs and maintenance of existing infrastructure, degree of stability in administrative leadership, etc. Hence a specific tool must be developed to systematically measure the fiscal efficiency and effort of cities based on the National Treasury’s and other sector specific indicators, norms and standards\textsuperscript{17}.

The above cross-cutting approaches and principles have a direct and/or indirect impact on the fiscal capacity and space of metropolitan Cities and requires appropriate consideration in the design of possible alternative financing models.

4.3 Fiscal instruments

The fiscal instrument-specific approaches for cities, shown in the inner triangle of the diagram above, directly influence the fiscal space and capacity of metropolitan cities. Each one of the three approaches and principles are discussed briefly below.

4.3.1 Own sources of revenue and local taxation

\begin{figure}[h]
\centering
\includegraphics[width=0.5\textwidth]{main_sources_of_revenue.png}
\caption{Main sources of revenue}
\end{figure}

The significance of this fiscal instrument within the city fiscal space and capacity context is illustrated by the fact that own revenue from local taxes, service charges and other

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{16} National Treasury. 2014. The state of local government finances and financial management as at 30 June 2014 [online]. Available from \url{http://mfma.treasury.gov.za/}
\item\textsuperscript{17} See Annexure B for more information
\end{itemize}
\end{footnotesize}
sources on average constituted slightly over 80% of the total operating revenues of cities in the 2013/14 municipal financial year\(^\text{18}\). The two major sources of own revenue were electricity service charges (38%) and property taxes (19%). The significant impact of the ongoing and possible future threats to these two sources of revenue alluded to under section 1.3.4 above, also need to be reiterated.

The initial view articulated by the AMFM Expert Panel is that, complementary to the revenue management efficiency approach discussed under 4.2.3 above, metropolitan city revenue sources should be further diversified and extended. This should include the expansion of local revenue sources from households and businesses, service charges and taxes/levies, property based and income based sources. Additionally, several of the existing revenue sources currently vested in other spheres of government need to be re-assigned and transferred to cities in accordance with their associated expenditure responsibilities.

The diversification and extension of revenue sources to enhance the fiscal space and capacity of cities should be based on generally accepted principles of sound revenue management and taxation, which must guide the design of a coherent package of own revenue streams.

4.3.2 Intergovernmental Transfers

According to National Treasury transfers to local government, which constituted marginally under 18% of the total operating revenue of cities in 2013/14\(^\text{19}\), generally play three essential roles, namely (1) addressing the structural imbalance between revenues available to municipalities and the expenditure responsibilities assigned to them; (2) supporting national priorities as outlined through different sectoral policies; and (3) establishing incentives for good governance and building local government capacity (National Treasury, 2011:43).

The FFC (2012:15) inter alia pointed out that Intergovernmental fiscal transfers (IGTs) take the form of unconditional and conditional grants and support both operating and capital expenditures. Conditional grants are further subdivided between grants aimed at supporting municipal infrastructure and grants aimed at building institutional and administrative capacity within municipalities. The primary unconditional grant to local government is the LGES, which is a constitutional entitlement to municipalities as part of the DOR – the sharing of nationally raised revenues among the three spheres of government.

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\(^{18}\) SACN Database – City Audited Financial Statements: 2008/09 – 2013/14

\(^{19}\) SACN Database – City Audited Financial Statements: 2008/09 – 2013/14
government. The local government share of nationally raised revenue as indicated in the previous chapter averaged slightly under 9% for the 2012-2014 MTEF period.

It is important that the system of IGTs be further strengthened to enhance the fiscal space of cities by reviewing the horizontal and vertical division of nationally raised revenue (LGES), relaxing the numerous conditionality measures linked to conditional grants and ensuring that the assignment of national and provincial functions to local government are accompanied by the concomitant resources. This will ensure that constitutional functions and expenditure mandates of metropolitan cities are sufficiently and equitably funded in line with their expenditure mandates; that conditional grants are consolidated to focus more on substantive performance and outcomes; and that unfunded and under-funded mandates and any further devolution or assignment of functions to cities are fully funded.

### 4.3.3 Capital financing

The ability of a metropolitan city to raise long-term capital finance is largely dependent on its creditworthiness and financial position. In the 2013/14 municipal financial year, the capital funding sources of metropolitan cities comprised of mainly capital grants (52%), borrowings (25%), internally generated revenue (22%) and public contributions and donations (1%)

![Existing capital financing sources](image)

**Figure 19: Existing capital financing sources**

Essentially, the range of available capital financing instruments, in addition to capital grants and internally generated revenue, to expand the fiscal space and fund the requisite investment by cities in social and economic infrastructure need to be fortified and broadened. In this regard capital financing options, must be explored that will
enhance access to a mix of innovative and competitive instruments given the historical backlogs and new demands for social and economic infrastructure investment in metropolitan cities.

To enable cities to exploit the full benefits of potential financing options, it will be necessary to boost their collective technical financial advisory capacity on the structuring of financing deals whether it is through PPPs, borrowing, access to the bond market or even land value capture. A feasibility study to determine the most suitable business model to realise this vital initiative is imperative.

The fiscal instrument-specific approaches and principles discussed above provide the framing for alternative financing models for cities. The next chapter discusses the broad policy objectives within which financing approaches need to locate.
Chapter 5: A Financing Model Supportive of Policy Objectives

The State of Cities Report IV posits that cities are built how they are financed (SACN, 2016). There is thus a much closer relationship to developmental outcomes and the given municipal financing model than is acknowledged in the current discourse. An alternative financing model must take into consideration the broader policy objectives and intended outcomes that cities are attempting to move towards.

5.1 Policy objectives

If municipal finance is of a circular nature as illustrated in figure 21, (the revenue generated depends on the expenditure made, and the revenue source in turn influences the nature of expenditure) the following four broad policy objectives need to feature prominently in the discussion around an alternative financing model in the South African context:

**Productivity:** this point relates to the economic productivity of cities. A metropolitan municipal financing model needs to relate closely to the productivity output levels of a city. Is there indication that the manner in which a municipality raises revenue could incentivize investment and expenditure that promotes economic activity and business growth? What are the core components of a financing model that will promote economic activity?
**Inclusivity:** this point relates to the extent to which cities are reducing inequality. A metropolitan municipal financing model needs to relate closely to the provision of access and services. Are there elements within a financing model that can lead to and incentivise decisions that connect poorer people closer to the core of economic activity and allow for a greater equality in the access to urban amenity, services and opportunities?

**Sustainability:** this point relates to the extent to which cities are reducing the impact on the environment through their day to day operations and new or refurbed infrastructure investment. In what way does the financing model contradict or support these objectives? Are there alternate revenue raising opportunities associated with more environmentally sustainable growth?

**Spatial Transformation:** There is now a well-developed and relatively widespread consensus within South African policy that spatial transformation is a critical underpinning element to ensuring strong sustainable cities to carry South Africa into the future. The State of Cities Report IV (SACN, 2016) makes clear the critical importance for South African cities to make real strides in transforming the space economies of urban areas. Spatial transformation must be pursued with the aim of building more productive, inclusive and sustainable cities. The nature of the financing model relative to spatial transformation requires further interrogation and research.

![Figure 21: Broad policy objectives to inform financing approach](image)
5.2 Links between financing and developmental outcomes

There is limited literature globally that links financing sources at local government level to particular investment and development outcomes. This is an area that requires further interrogation and exploration. However, there is existing research to suggest that the link is critical as is suggested by Slack (2002:1):

‘The instruments cities use to raise revenues affect the nature and location of development. In some cases, municipal financial tools work in tandem with planning tools, but in other cases the two have opposite effects. For example, the application of some kinds of financial tools has the effect of increasing urban sprawl while planning tools are attempting to curb it. Yet relatively little has been written about how municipal revenue regimes can change the profitability of different types of development and influence the way in which a region develops.’

Testing the way particular financing arrangements encourage and incentivise decision making within a municipality relative to the broader growth and developmental objectives is important. There is enough insight to suggest a clear link between the way municipalities derive revenue and expenditure decisions (Slack, 2002). More work is required to bring the financial logic closer to local growth and development policies and strategies.

There have been some investigations on the link between financing and green infrastructure investment at local government level (Merk et al, 2012). In discussing these links Merk et al (2012: 8) argue that a systematic understanding of revenue sources is required:

‘Efforts to green urban revenue sources may have undesirable distributional consequences. These concerns should be addressed in the context of the entire tax and benefit system, rather than trying to ensure that each individual policy measure serves both environmental and equity objectives.’

The more systematic analysis that Merk (2012) advocates can arguably be thought about across all areas of finance and development. Currently such a systematic approach is lacking in the South African context. Many of the various instruments being discussed and explored are done so in an isolated and dislocated manner. Borrowing, bond issuances, Public Private Partnerships (PPP), project finance, pooled financing and land value capture are some of the financing options currently being promoted as innovative ways to finance cities. However, there is no systematic review of how each of these sources will come together to form a logical financing model that can move cities closer to broader policy objectives.

The spatial implications of financing approaches seem particularly important to consider. The financing of sprawl has been a topic of focus in North American discourse. The key question is whether an alternate financing model can incentivise different behaviour and
outcomes? In the United States context McGuire and Sjoquist (2002: 32) provide some opinion that might have relevance to South Africa:

‘The two most important market imperfections associated with sprawl are that the social value of open space may be greater than the private value and that the social costs of commuting may exceed the private costs. Policies to address the former include fees or taxes on development, subsidies to farmers, and public acquisition of land at the urban fringe or open land in the interior of the urban area. Congestion fees are the obvious response to the external costs imposed by drivers when they enter congested highway networks. State and local governments have all of these tools at their disposal. It can be argued that local government reliance on the property tax also contributes to sprawl both because the property tax results in less dense development than a land tax and because it results in average cost pricing of public infrastructure for new development. Shifting toward a land tax and imposing properly calculated impact fees would address these potential self-inflicted causes of sprawl.’

This analysis and opinion suggests that deeper questions need to be asked of the current reliance on property taxes across metropolitan municipalities in South Africa but also suggests that there are alternative financing logics that can support inclusive compact growth. In exploring alternative models to finance South African cities, greater attention will have to be paid to these linkages than is currently evident. The next chapter explores a range of potential financing tools and mechanisms.
Chapter 6: Elements of an Alternative Metropolitan Financing Model

According to the National Treasury (2011: 211), ‘South Africa has yet to find an appropriate model for effectively harnessing the potential of its cities to drive economic growth and redress the spatial patterns that continue to marginalise poor people’. While this statement was made within the context of an applicable model for efficient spatial planning to drive economic growth, a similar view can be expressed with respect of the paucity of a coherent financing model for cities that can effectively enhance the potential of cities to steer economic development and redress spatial and social inequities.

The city financing approaches and principles discussed in the previous chapter provides the basis for the alternative metropolitan financing model elements outlined in this chapter. The cross-cutting approaches and principles related to policy coherence, city differentiation and fiscal efficiency will implicitly apply to the respective model elements, whilst each of the specific fiscal instruments (own revenue, intergovernmental transfers and capital financing) will be outlined by providing a brief description of options, possibilities and potential limitations.

Chapter Six will therefore integrate the different elements of an alternative metropolitan financing model whilst the next Chapter Seven will discuss the possible new AMFM scenarios based on these model elements while taking a critical account of the policy outcomes discussed in the previous chapter.

6.1 Fiscal instrument components

The cross-cutting principles of policy coherence, city differentiation and fiscal efficiency discussed above are implicitly determinate to all three fiscal instruments. The specific fiscal instruments (own revenue, intergovernmental transfers and capital financing) are at the same time distinct from the scale and scope of determination of the cross-cutting principles, and will be outlined hereunder by providing a brief description, options, possibilities and potential limitations.
6.1.1 Own sources of revenue and local taxation

According to Bahl and Bird (2008: 1):

Both theory and experience in a variety of circumstances around the world suggest strongly that if fiscal decentralization is to produce sustainable net benefits in developing countries, subnational governments require much more real taxing power than they now have. In most developing countries, there are potentially sound and productive taxes that subnational governments could use: personal income tax surcharges, property taxes, taxes on the use of motor vehicles, payroll taxes, and even subnational value-added taxes and local “business value” taxes may all be viable options in particular countries.

The diversification and extension of revenue sources to enhance the fiscal space and capacity of cities should be based on generally accepted principles of sound revenue value chain management and taxation. This section will outline the sound local taxation principles, the re-assignment and sharing of existing revenues currently accruing to other spheres of government and the introduction of new revenue instruments.

6.2.1.1 Sound taxation principles

The decentralisation of expenditure and public functions is only one side of the coin of local public finance. Just as well it has to be settled how this delegation is financed and how independent the sub-national and local authorities are in their provision of public goods and services. A reasonable intergovernmental finance system has to consider the following principles:

- Revenue autonomy, subsidiarity and connectivity (local accountability)
- Transparency of the tax system and direct impact of the tax burden (benefit tax link)
- Reference to local circumstances and neutrality of the taxes with regards to the private sector
- Tax bases, which are not affected by economic fluctuation and are also viable
- Simplicity of tax system

Supplementary information on sound taxation principles is contained in Annexure C.

6.1.1.2 Re-assignment or sharing of existing tax revenues

This section outlines options for the re-assignment of existing tax revenues currently accruing exclusively to either the national or provincial sphere of government. Preliminary validation of the tax revenues below was undertaken (see Annexure C),

20 For detailed description see for example Spahn, 1995 as well as Werner, 2008.
however further in-depth research on the broader policy and specific technical implications is required.

Table 3: Re-assignment or sharing of existing tax revenues

<table>
<thead>
<tr>
<th>Options</th>
<th>Possibilities</th>
<th>Potential limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>a  Property transfer duties (PTDs) (linked to local property market)</td>
<td>Total devolution or revenue sharing arrangements</td>
<td>Broader policy and IGR impacts</td>
</tr>
<tr>
<td>b  Tourism levy (linked to use of municipal services)</td>
<td></td>
<td>Constitutional and other legislative amendments</td>
</tr>
<tr>
<td>c  Excise duties (tobacco, liquor, etc.)</td>
<td></td>
<td>City fiscal efficiency</td>
</tr>
<tr>
<td>d  Carbon taxes (linked to fuel levy sharing)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>e  Fuel levy for municipal roads</td>
<td></td>
<td></td>
</tr>
<tr>
<td>f  Vehicle license fees and public transport permits (linked to public transport function)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

6.1.1.3 New tax revenues sources

Opportunities for possible new sources of tax revenues are listed hereunder and are ranked based on the two-dimension of bureaucratic effort for tax administration and fiscal yield.

Initial validation of some of the associated principles and potential risks of these tax revenues was undertaken (see Annexure C), however further detailed analysis and exploration of the possible policy and technical implications are required.

Table 4: New sources of tax revenues

<table>
<thead>
<tr>
<th>Options</th>
<th>Possibilities</th>
<th>Potential limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>a  Personal income tax (PIT)</td>
<td>Surcharge to current tax</td>
<td>Broader policy and technical implications</td>
</tr>
<tr>
<td></td>
<td>Tax sharing</td>
<td>Constitutional and other legislative amendments</td>
</tr>
<tr>
<td></td>
<td>Piggyback tax</td>
<td>City fiscal efficiency</td>
</tr>
<tr>
<td>b  Corporate income tax (CIT)</td>
<td>Surcharge to current tax</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Payroll tax</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Tax sharing</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Piggyback tax</td>
<td></td>
</tr>
<tr>
<td>c  Property transfer duties (PTDs)</td>
<td>Surcharge to current duties</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sharing of duties</td>
<td></td>
</tr>
<tr>
<td>d  Tourism levies</td>
<td>Surcharge to current levies</td>
<td></td>
</tr>
<tr>
<td>Levies</td>
<td>Sharing of levies</td>
<td></td>
</tr>
<tr>
<td>--------</td>
<td>------------------</td>
<td></td>
</tr>
</tbody>
</table>
| e      | Local business tax (LBT) | Payroll tax  
          |                   | Tax on local turnover |
| f      | Wealth tax        | Surcharge tax    |
| g      | City congestion charge | Road tolling  
          |                   | Vehicle license surplus charge  
          |                   | Special permit zones |
6.1.1.4 New sources of revenue from city services and assets

The options below can be sources for both operating and capital revenue streams and represent a combination of existing practices that can be enhanced and new revenue opportunities for cities. Preliminary research that was undertaken to corroborate the principles and potential risks of these sources (see Annexure C) has to be augmented with a further investigation of policy and technical issues.

Table 5: Possible new sources of revenues from city services and assets

<table>
<thead>
<tr>
<th>Options</th>
<th>Possibilities</th>
<th>Potential limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>a Development Charges</td>
<td>Utility connection fees and bulk service contributions</td>
<td>Broader policy and technical implications</td>
</tr>
<tr>
<td>b Land Value Capture (LVC)²¹</td>
<td>Bulk infrastructure, area-based development and community development value</td>
<td>Constitutional and other legislative amendments, City fiscal efficiency</td>
</tr>
<tr>
<td>c Tax Increment Finance</td>
<td>Applicable to area specific infrastructure investment and close monitoring of land value increases</td>
<td></td>
</tr>
<tr>
<td>d New utility charges</td>
<td>Electricity distribution network fees or electricity wheeling for IPPs or off-grid developments</td>
<td></td>
</tr>
</tbody>
</table>

²¹ Land value capture in Germany (an international example) (Werner, 2016: 99)

Land value capture in Germany is a local fee, which is divided into technical development costs and traffic-related development costs. Technical development costs are costs incurred for the connection of land to supply and disposal networks. This includes electricity, gas, public water supply and sewage connection. Traffic-related development costs are costs for roads, sidewalks and lighting, public parks, children’s playgrounds, noise protection walls, telephone and cable television network.

A building permit will only be granted if the development costs for the property are secured or even paid. Private landowners pay in Germany a maximum of 90 % of the development costs and the remaining 10 % are covered by the municipality.

Development costs are distributed between private landowners on the basis of:
- the nature and extent of building / numbers of the floor, e.g. for a noise protection wall
- the size of the land, e.g. for a local road
- the land width, e.g. for a sidewalk

The lesson from Germany for the stakeholders in South Africa is that if they do not want to shift the development cost directly onto the private landowner, they should at least update the value of the newly constructed land property to guarantee a sufficient revenue flow from the local property tax.
6.1.2 Intergovernmental Transfers

This section will examine options for further strengthening the system of IGTs to enhance the fiscal space of cities. It will consider the options for the review of the horizontal and vertical division of nationally raised revenue, consolidation of conditional grants, relaxing the numerous conditionality measures linked to conditional grants and the assignment of national and provincial functions to local government.

<table>
<thead>
<tr>
<th>Options</th>
<th>Possibilities</th>
<th>Potential limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>Review of LGES formula (involving city differentiation)</td>
<td>Review formula for the horizontal division of nationally raised revenue</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Review formula for the vertical division of nationally raised revenue</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Consolidation of unconditional grants system</td>
</tr>
<tr>
<td>b</td>
<td>Review of conditional grant system (involving city differentiation)</td>
<td>Rationalisation of conditionality measures for conditional grants</td>
</tr>
<tr>
<td>c</td>
<td>Review powers and functions of Category A metropolitan municipalities (involving city differentiation)</td>
<td>Assignment of national and provincial government functions to cities must be fully funded</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Revision of schedules 4 and 5 of Constitution</td>
</tr>
</tbody>
</table>

Work currently been undertaken by the National Treasury\(^{22}\) and FFC\(^{23}\) pertaining to the review of Local Government Infrastructure Grants should be influenced to reflect the recommendations around policy coherence, differentiation and fiscal efficiency.


\(^{23}\) Financial and Fiscal Commission. 2013. Response to the Division of Revenue Bill 2013
6.1.3 Capital financing

This section outlines the different financing options that can be considered to expand the fiscal space of cities to fund their capital investment requirements and programmes. An initial feasibility analysis of the capital financing options was undertaken (see Annexure D), however a further in-depth exploration of the possible policy and technical implications will be essential.

Table 7: Capital financing options

<table>
<thead>
<tr>
<th>Options</th>
<th>Possibilities</th>
<th>Potential limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>a</td>
<td>Enhanced debt finance</td>
<td>Pooled financing24 Guarantees for city infrastructure finance by National Treasury25</td>
</tr>
</tbody>
</table>

24 Pooled financing – the Tamil Nadu Urban Development Fund in India (Werner, 2016: 96)

The Tamil Nadu Urban Development Fund (TNUDF) was established in 1996 and is mainly financed by the regional government of Tamil Nadu as well as the World Bank. The fund manager of the TNUDF is Tamil Nadu Urban Infrastructure Financial Services Limited (TNUIFSL). The regional government holds 49% shares of the TNUIFSL and remaining 51% shares belongs to three national banks. The daily management responsibility of this fund belongs to the ICICI Bank, which holds with 21% the biggest share of all three Indian banks.

Eligible Borrowers for the Tamil Nadu Urban Development Fund in India are on the one hand urban local bodies in India and on the other hand any private institutions that creates urban infrastructures in India. Moreover, the TNUDF uses - besides capacity development also the concept of pooled financing for the infrastructure financing. The idea of pooled financing means that several projects are pooled and lumped together in a bond issuance and this can provide a significantly reducing transaction costs and improving pricing. Especially for smaller and less creditworthy local authorities is this concept reasonable.

The lesson to be learned from the Tamil Nadu Urban Development Fund in India for the stakeholders in South Africa is that the local units should use the idea of pooled financing as much as possible to reduce their financing costs. Moreover, the urban metropolitan areas should not be blinkered as to the financial situation of their surrounding rural entities. To include those rural entities in a common pooled financing is in the long run surely cheaper for the metropolitan areas in South Africa, because if the infrastructure delivery gap between rural and urban entities is increasing, then the rural depopulation will also increase and the urban authorities have pressure on their own infrastructure.

Furthermore, the aspect of capacity development should be not underestimated, as financial institutions like commercial banks or pension funds from abroad expect very qualified dialogue partners.

25 United Kingdom guarantees scheme for infrastructure (Werner, 2016: 97)

The value of lending to new infrastructure projects in United Kingdom halved from £6 billion before the financial crisis to £3 billion in 2010.

In October 2012 the Infrastructure Act became law, allowing central government to issue guarantees to projects meeting a broad definition of infrastructure. Furthermore, the UK Treasury also aims to attract new sources of finance into infrastructure projects, such as pension and institutional investors.

More than 200 enquiries for guarantees were received by the UK Treasury. The first guarantee was issued in April 2013 and by December 2014 the Treasury had agreed guarantees with a value of £1.7 billion (excluding interest) to 7 projects (and 1 standby facility), with 39 more projects pre-qualified for a guarantee. The scheme has a limit of £40 billion in guaranteed lending (excluding interest) and is currently due to close in December 2016.
<table>
<thead>
<tr>
<th>Options</th>
<th>Possibilities</th>
<th>Potential limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Commercial and privately organised institution focused on municipal infrastructure</td>
<td>City fiscal efficiency</td>
</tr>
<tr>
<td></td>
<td>Land-based financing</td>
<td></td>
</tr>
<tr>
<td>b</td>
<td>Enhanced equity and bond finance</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Institutional investors with longer term horizon</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Boosting municipal bond market</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Project bonds</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Sovereign wealth funds</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Social Impact Bonds</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Public Private Partnerships (PPPs)</td>
<td></td>
</tr>
<tr>
<td>c</td>
<td>Municipal Funding Agency</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Develop technical financial advisory capacity of cities</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Facilitate innovative instruments, competitive financing costs, etc.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Involve donors, institutional investors, insurance funds, etc.</td>
<td></td>
</tr>
</tbody>
</table>

6.2 Potential impact of fiscal instrument scenarios on AMFM

The table below highlights the potential impact that the fiscal instrument options tabulated may have on potentially new AMFM scenarios. Other than the broad changes in the quanta of the LGES and grants over the last 15 years there has been no significant change in the fiscal instruments utilisation for enhanced fiscal space.

The potential impact of shifts in the fiscal instrument options in general are thus medium to high given this history. The approach has also been informed by a more medium to long term time-horizon of around the next 5-10 years in the way suggest reforms options are proposed.

The lesson from United Kingdom for the stakeholders in South Africa is that guarantees could be used in a similar way to bridge financing or to reduce the risk for private investors and make public infrastructure finance more attractive for them. However, the instrument of guarantees is often a politically influenced decision.
### Table 8: Potential impact of fiscal instruments on AMFM scenarios

<table>
<thead>
<tr>
<th>Fiscal instruments</th>
<th>Options</th>
<th>Potential impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>a Own revenue</td>
<td>Re-assignment of existing tax revenues</td>
<td>Medium – High</td>
</tr>
<tr>
<td></td>
<td>New tax revenue sources</td>
<td></td>
</tr>
<tr>
<td></td>
<td>New revenue sources from city services and assets</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>The impact is medium-high because of the relatively low base of ‘own revenue’ as a fiscal instrument historically in our taxation regime. Any shift in relative quantum has a significant effect on the fiscal space.</td>
</tr>
<tr>
<td>b Intergovernmental transfers</td>
<td>Review of LGES formula</td>
<td>High</td>
</tr>
<tr>
<td></td>
<td>Review of conditional grant system</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Review powers and functions</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>The impact of a small change in the LGES even without horizontal distribution together with a rationalization of grants will have a dramatic effect on the LG fiscal space given the low base of the 9% quantum (which is inclusive of conditional grants).</td>
</tr>
<tr>
<td>c Capital financing</td>
<td>Enhanced debt finance</td>
<td>Medium-High</td>
</tr>
<tr>
<td></td>
<td>Enhanced equity and bond finance</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Municipal Funding Agency (MFA)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>This instrument has found recent utilisation and its impact (between medium to high) will depend on whether cities continue to effect individual or collective capital financing processes.</td>
</tr>
</tbody>
</table>
Chapter 7: AMFM Scenarios

The fiscal instrument components of an alternative financing model discussed in the previous chapter potentially require different blends or mixing within in a range of possible aggregate scenarios. The aim of this chapter is to briefly outline the different fiscal scenario options that can be utilised to inform the building of aggregate scenarios and to provide a detailed illustration of the possible AMFM aggregate scenarios for metropolitan cities.

7.1 Fiscal instrument scenario options

The fiscal instrument scenario options outlined in the table below are based on the options and possibilities discussed in the previous chapter. It shows the range of possible quantification options for each of the fiscal instruments and fiscal efficiency measures that can be used as selected inputs in constructing the various aggregate scenarios in section 6.2 below.

Table 9: Fiscal instrument and fiscal efficiency scenario options

<table>
<thead>
<tr>
<th>Own Revenue and Local Taxes</th>
<th>Intergovernmental Transfers (IGTs)</th>
<th>Capital Financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>5-10% revenue efficiency gains (through increased consumer debtors collections; reduced non-technical distribution losses; and property rates optimisation)</td>
<td>5% real increase</td>
<td>Land Value Capture (LVC) And Development charges contributing between 10-20% of capital funding</td>
</tr>
<tr>
<td>5-10% expenditure efficiency gains (through the reduction in budget under-expenditure; wasteful and irregular expenditure; and improved grant spending)</td>
<td>10% real increase</td>
<td>5-10% increase in debt and bond finance (pooled financing, treasury guarantees, city bonds) linked to NT gearing ratio norm</td>
</tr>
<tr>
<td>Tax sharing and re-assignment of tax revenues (property transfer duties (PTDs)\textsuperscript{26}; tourism levies\textsuperscript{27};</td>
<td>15% real increase</td>
<td>Establishment of MFA to improve technical capacity in capital financing deals in terms of instruments and pricing</td>
</tr>
</tbody>
</table>

\textsuperscript{26} 2013/14 Property transfer duties amounted to R10,5bn (NT, 2015 Budget Review)

\textsuperscript{27} 2014 Tourism levies collected amounted to R121m (TOMSA, 2014 Levy Contributors Report)
The detailed outline of the fiscal instrument elements towards an alternative financing model potentially entail a wide range of permutations within different aggregate scenarios and thus the full impact can only be analysed through these combined configurations. The possible aggregate scenarios are discussed in the next section.

7.2 Aggregate AMFM Scenarios

The emerging trends, impacts and potential of cities, referred to in Chapters Two to Five of this report, forms the overall strategic thrust for the formulation of the aggregate AMFM scenarios discussed hereunder. It is argued that the significant realisation of the scenarios will enable cities to be “assets, solutions and drivers of economic and social development”.

Following the presentation of the current practice/baseline of metropolitan city finance three scenarios and their associated assumptions are examined below.

These scenarios are termed Flat, Step-Change, and Jump-Change. The flat scenario is situated in the current paradigm of financing assuming that urban conditions remain relatively unchanged and a continuation of ad hoc reforms and responses to financing pressures on cities. The other two alternatives move along a financial transformation spectrum with a view to moving towards future city conditions.

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28 2013/14 Total Excise duties amounted to R29,0bn (NT, 2015 Budget Review)
29 Provincial Motor Vehicle licences for 2013/14 amounted to R7,2bn (NT, PBER: 2010/11-2016/17)
30 2013/14 General fuel levy amounted to R43,7bn (NT, 2015 Budget Review)
31 PIC for 2013/14 amounted to R309,8bn (NT, 2015 Budget Review)
32 CIT for 2013/14 amounted to R177,3bn (NT, 2015 Budget Review)
Each of the scenarios will provide a sense of:

- The underlying assumptions and conditions;
- The share of national revenue allocated to cities;
- The breakdown and total metropolitan city revenue quantum to be potentially generated in terms of own revenue and taxes, IGTs and capital financing/borrowing;
- The envisaged system impacts on households, businesses, capital markets, and different spheres of government; and
- The probable outcomes in relation to future city developments.

**Current City Financing Practice/Baseline**

The current city financing practice or baseline does not reflect an explicit or stated model and is generally referred to by the National Treasury and FFC as the current LGFF (see *Chapter 1*). It includes a bias towards own revenue instruments with features of reforms in IGTs (capital grants and fuel levy sharing for cities) and limited borrowing mainly from traditional sources to finance capital investments.
It is becoming increasingly evident from the Draft AMFM Report and recent studies by the FFC (2012) and CoT (2015) that the current financing model has progressively increased the fiscal gap and is not adequate in enabling cities to perform optimally on their constitutional and developmental mandate.

A: Flat Scenario

This scenario features limited change in the socio-political space around institutional, legal and political developments. This approach to rethinking municipal financing is based on the notion of the continuation of ad hoc reforms in response to the financing pressures on cities. In a constrained medium term, economic outlook, cities are now more than ever being asked to maximise their own revenue potential to ease fiscal pressure across the governmental system. In this scenario fiscal efficiencies are at the core with some adjustments to the manner in which conditional grants are allocated to metropolitan cities. Increased borrowing is encouraged as another option to ease fiscal pressures and cities borrow more to fund infrastructure growth.
Key characteristics of the flat scenario:

- Same IGT quantum in real terms with a shift to greater consolidated grant structure;
- Fiscal efficiencies (assumes a 5% expenditure efficiency gain can be obtained through improved budget spending outcomes; rooting out fruitless and wasteful, irregular and unauthorised expenditure, and reducing non-technical water and electricity distribution losses) and a 5% increase in revenue efficiencies can be obtained through improved consumer billing and collections; and
- A moderate increase in borrowing is evident in cities finances.

![Figure 24: Flat scenario](image)

**B: Step-Change Scenario**

The step-change scenario is largely based on shifting the transfers allocated to metropolitan cities to a percentage in line with global trends and benchmarks and thus taking financing of cities onto a new level. The IGT quantum increases in real terms by 5% from 4.3% to 8.3%. This is justified on the basis that devolution has resulted in cities taking on additional functions and that cities are demonstrating better and consistently improving financial management practices across fiscal allocations. This is provided through a make-up of unconditional grants and equitable share.
Furthermore, in this scenario metropolitan cities gain a share of ‘easy’ taxes which impact their finances such as vehicle license tax, city congestion tax, tourism levy and excise duties (sin taxes). In this scenario cities improve on their efficiencies and are able to provide an additional 5% revenue gain through improved billing, collection rates and debt collection and expenditure efficiency gains through better budget spending outcomes and supply chain management practices. Borrowing features as a source of capital financing in a similar way to the flat approach and through pooled financing.

Key characteristics of the step-change scenario:
- IGTs increased to 8.3% of national revenue with increased unconditional grants;
- Cities access a share of ‘easy’ taxes; and
- Introduction of pooled financing with further borrowing.

In this scenario, there is a fundamental shift in the scale of financing to metropolitan cities as a result of an enhanced devolution of additional tax revenues to cities through surcharges on PIT and property transfer duties. Cities also implement a local business tax placing pressure on businesses which already have trust issues with government who argue that the tax space is being squeezed (this might require a tax space analysis to support).

**Figure 25: Step-change scenario**

**C: Jump-Change Scenario**

In this scenario, there is a fundamental shift in the scale of financing to metropolitan cities as a result of an enhanced devolution of additional tax revenues to cities through surcharges on PIT and property transfer duties. Cities also implement a local business tax placing pressure on businesses which already have trust issues with government who argue that the tax space is being squeezed (this might require a tax space analysis to support).
In the jump-change scenario the cities are also driven towards the financial markets and private sector to finance expenditure easing the pressure on the national fiscus – but introduces cost and risk increases. In this scenario a transversal MFA is developed to ensure cities have improved access to financial deal making capacity of the highest order to ensure that deal value is innovative, fair and maximised. Land value capture and PPPs feature prominently in this scenario as cities attempt to capture value from private sector investment more directly.

IGTs increase marginally to 10% of nationally collected revenue. Cities are persisting to maximise revenue collection (property rates value chain optimisation) and expenditure efficiencies (at an additional 10% of baseline revenue) in this scenario as their ability to access additional capital finance and DFI funding depends on it.

Key characteristics:

- Co-investment models (eases expenditure burden but increases cost and risk)
- Devolution of additional tax revenues through surcharges on PIT and PTDs (between 10-15%).
- Local business tax-take more to give more (new burden, threatens trust, affordability and payment concerns)
- IGT 10% including streamlined consolidated grants
- LVC and PPPs (funds 10% of capital expenditure)
- An array of other taxes contributes to city revenue such as sin taxes, city congestion taxes, etc.
**Overall scenario comparison**

**Assumptions**
- Significant and unprecedented economic growth
- Substantial changes to taxation regime
- Additional devolution of powers (ECD & PHC)
- Differentiated city incentives

**Metro revenue Make-up & Total quantum**

<table>
<thead>
<tr>
<th>Description</th>
<th>Baseline (Rbn)</th>
<th>Jump-change (Rbn)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Own revenue</strong></td>
<td>124.2</td>
<td>184.0</td>
</tr>
<tr>
<td>-Service charges</td>
<td>83.3</td>
<td>99.2</td>
</tr>
<tr>
<td>-Property taxes</td>
<td>29.0</td>
<td>35.0</td>
</tr>
<tr>
<td>-Other taxes and revenue</td>
<td>11.9</td>
<td>49.8</td>
</tr>
<tr>
<td><strong>IGTs</strong></td>
<td>38.4</td>
<td>90.0</td>
</tr>
<tr>
<td>-Equitable share</td>
<td>12.6</td>
<td>29.5</td>
</tr>
<tr>
<td>-Share of fuel levy</td>
<td>5.9</td>
<td>14.9</td>
</tr>
<tr>
<td>-Other operating grants</td>
<td>4.3</td>
<td>9.3</td>
</tr>
<tr>
<td>-Capital grants</td>
<td>15.8</td>
<td>38.3</td>
</tr>
<tr>
<td><strong>Capital financing</strong></td>
<td>7.6</td>
<td>32.6</td>
</tr>
<tr>
<td><strong>Total Metro Revenue</strong></td>
<td>170.2</td>
<td>306.6</td>
</tr>
<tr>
<td><strong>Increase in revenue quantum</strong></td>
<td>136.4</td>
<td></td>
</tr>
</tbody>
</table>

**System impacts**
- Testing financing scenarios against city future statements

**Scenario Outcomes**
- Significant shift in policy towards cities
- National economic boom period increasing fiscus
- Shock threats: Climate change
- Major public infrastructure investment

**Figure 26: Jump-change scenario**

**Figure 27: Scenario comparison**
Scenario comparison – data table

Table 10: Aggregate scenario comparison data table

<table>
<thead>
<tr>
<th>R'billion</th>
<th>IG Ts</th>
<th>Own revenue</th>
<th>Capital financing</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jump change</td>
<td>90.0</td>
<td>184.0</td>
<td>32.6</td>
<td>306.6</td>
</tr>
<tr>
<td>Step change</td>
<td>83.7</td>
<td>144.0</td>
<td>22.6</td>
<td>250.3</td>
</tr>
<tr>
<td>Flat</td>
<td>38.4</td>
<td>132.5</td>
<td>12.6</td>
<td>183.5</td>
</tr>
<tr>
<td>Baseline</td>
<td>38.4</td>
<td>124.2</td>
<td>7.6</td>
<td>170.2</td>
</tr>
</tbody>
</table>

The extent to which the various scenarios are closing the fiscal gap experienced by metropolitan cities has not been determined at this stage. Further research is required to develop a more scientific and robust methodology to calculate the estimated funding gap for cities inclusive of both capital investment and operating requirements and data. What the scenarios do suggest is that there are alternatives that can provide metropolitan municipalities with greater discretionary revenue. The scenarios further indicate that the alternatives will impact the source areas of revenue differently and further research and policy discussion is required to ascertain the impacts and their consequences.
Chapter 8: Summary of Recommendations

This report conclusively makes the case for why the current financing model is wholly inadequate for South African local government and metropolitan cities going into the future for the next 15 to 25 years. Given the current trend and profiles of South African cities including the current barriers and limitations in the fiscal framework there is a compelling case for introducing an alternative financing model that ensures a sustainable future path for metropolitan cities.

This report therefore recommends the following aspects towards an alternative model framework that deals with the fiscal gap or enhancing the fiscal space in a sustained manner for the continued evolution of Cities as important drivers of economic growth and development.

1. There is a need for a coherent conceptual model that integrates and aligns both cross-cutting principles and financing instruments in a holistic manner. This model framework diagrammatically represented as the alignment of two intersecting triangles.
   - the three cross-cutting principles: policy coherence; fiscal efficiency and differentiation; (outer triangle)
   - the three fiscal instruments: Own revenue; Capital financing; intergovernmental transfers. (inner triangle)

The deployment of a conceptual model for the alternative metropolitan city financing allows for innovation proposals as well as an approach from which to shape and define innovations over a medium to long term through the fiscal instruments while maintaining alignment given impacts across the local government fiscal framework.
2. The elements of an alternative financing model are to be found in both the cross-cutting principles and the fiscal instruments respectively.

(a) It is proposed that policy coherence is strengthened and enhanced for the medium to long term around ensuring integrated measures and instruments. This may involve greater formalisation and alignment of current local government processes and practices.

(b) It is proposed that the principle of fiscal efficacy and health through the formalisation of monitoring instruments and tools as indicators at sufficient granular level of current cities experiences.

(c) It is proposed that the principle of differentiation within and between local government and Cities is formalised and adopted into current policy within the local government sphere. This may involve certain policy and structural changes but opens up the possibilities of greater differentiated city scenarios around forms of governance, powers of devolution given the potential evolution of different city types and models.

3. Each of the fiscal instruments contain a cluster of recommendations and proposals that can have variable impacts either within that specific fiscal segment or across the instruments as a whole. The details for each, at another level of granularity is found in the body of the Chapter (5) around the mix of factors.

(a) Within the Intergovernmental transfers it is recommended that:
- A review of the LGES formula around a policy of city differentiation for both horizontal and vertical division of nationally raised revenue;
- A review and rationalisation of the conditional grants across the system; and
- A review of the powers and functions of local government.

(b) Within the own sources of revenue and local taxation instrument it is recommended that:
- In deliberating on new taxation approaches and measures the principles of sound taxation are applied to the framework of local taxation within the use of this fiscal instrument;
- Re-assigning and transferring existing revenue options be explored in an effective mix of options such as public transport and taxi permits, vehicle licencing, property transfer duties, etc.; and
- Reviewing and exploring new sources of tax revenues. This measure within the fiscal instrument will require greater analysis and scoping as per current contexts and factors.
(c) Within the Capital Financing instrument the following are the areas of recommended review:

- The establishment of a Municipal Funding Agency to enhance the municipal technical financial advisory capacity on the structuring of financing deals and channels;
- Exploring enhanced debt financing options and their applicability; and
- Exploring enhanced equity and bond financing for Cities borrowing.

4. This report also recommends that the fiscal instrument (underpinned by the crosscutting principles) options also be conceptualised as a mixed menu of options where a specific package of proposals containing measures from each instrument can be constructed over a time horizon and feasibility level within a roadmap scenario be adopted.

The alternative model thus defines three model scenarios:

- **The Flat scenario** is based on the concept of the continuation of ad hoc reforms and responses to the financing pressures on cities;
- **The Step-change scenario** which is based on shifting the local government sphere transfer and metropolitan cities to a percentage in line with global trends and benchmarks and thus taking financing of cities onto a new level;
- **The Jump-change scenario** is based on a fundamental shift in scale of financing to the local government and cities sphere as a result of a more enhanced fiscus through a potentially different taxation regime.
  - consolidated infrastructure grants thrusts over a rapid time period together with changing the content the LGES formula to be biased towards cities.
  - A further package could have a major focus on capital financing within a defined quantitative framework and blend this with fully funded mandates.
Conclusion

The draft AMFM report is a consolidation of the initial work completed and is expected to inform further engagement, conversation and research towards potential policy and strategic changes around city financing.

The draft report contends that the strategic developmental agenda of cities needs a more rigorous financing model which integrates cross-cutting principles and fiscal instruments. This in turn lays the basis for a more effective and innovative configuration of fiscal options within alternative financing scenarios that will enhance the fiscal space for metropolitan cities.

The scenario-options tabled unpack the working assumptions, the impacts on cities stakeholders and the scenario outcomes together with implications for both shock-risk impacts and normal risks effects on cities thus extrapolating some possible configurations of crosscutting principles and fiscal instruments. This establishes the basis for a more detailed analysis of financing approaches available to metropolitan cities over time.

This is the key outcome of the AMFM study at this stage. Furthermore, it acknowledges that the conversation and process to develop innovative financing alternatives are complex, nuanced, multi-faceted and will require the engagement of a wide range of stakeholders and methodologies.
## Annexures

A. List of existing metropolitan city grants

### Unconditional Grants

- Equitable Share
- Fuel Levy

### Conditional Grants

#### Capital Grants (National Transfers)

- Urban Settlement Development Grant (USDG)
- Integrated National Electrification Programme Grant (INEP)
- Public Transport and Infrastructure Grant (PTIG)
- Neighbourhood Development Partnership Grant (NDPG)
- Energy Efficiency and Demand Side Management Grant

#### Recurrent Grants

- Local Government Financial Management Grant (FMG)
- Water Services Operating Subsidy Grant
- Expanded Public Works Programme Grant (EPWP)
- Energy Efficiency and Demand Partnership Grant
- Public Transport Network Operations Grant
- Municipal Human Settlements Capacity Grant

#### Indirect Grants

- Integrated Electrification Programme (ESKOM) Grant
- Neighbourhood Development Partnership Grant (Technical Assistance)
- Regional Bulk Infrastructure Grant (RBIG)
I. Metropolitan Cities – 2013/14 Operating and Capital Revenues

A.1 Operating revenue

<table>
<thead>
<tr>
<th>2013/14 (R million)</th>
<th>CoJ</th>
<th>Cape Town</th>
<th>Mangung</th>
<th>Buffalo City</th>
<th>Ethekwini</th>
<th>Tshwane</th>
<th>Skukuza</th>
<th>NMB</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax and Other Own Revenue</td>
<td>10970</td>
<td>29.8%</td>
<td>7217</td>
<td>28.6%</td>
<td>1159</td>
<td>23.9%</td>
<td>952</td>
<td>22.0%</td>
<td>6245</td>
</tr>
<tr>
<td>Property rates</td>
<td>15490</td>
<td>20.5%</td>
<td>5542</td>
<td>22.0%</td>
<td>960</td>
<td>19.9%</td>
<td>673</td>
<td>15.9%</td>
<td>5299</td>
</tr>
<tr>
<td>Fines</td>
<td>1368</td>
<td>3.7%</td>
<td>729</td>
<td>3.0%</td>
<td>77</td>
<td>1.6%</td>
<td>6</td>
<td>0.1%</td>
<td>249</td>
</tr>
<tr>
<td>Other operating revenue</td>
<td>2053</td>
<td>5.6%</td>
<td>946</td>
<td>3.7%</td>
<td>113</td>
<td>2.3%</td>
<td>273</td>
<td>6.3%</td>
<td>697</td>
</tr>
<tr>
<td>Service charges</td>
<td>20107</td>
<td>54.7%</td>
<td>14063</td>
<td>55.7%</td>
<td>2637</td>
<td>54.3%</td>
<td>2199</td>
<td>50.8%</td>
<td>13077</td>
</tr>
<tr>
<td>Electricity</td>
<td>12398</td>
<td>33.7%</td>
<td>9313</td>
<td>36.9%</td>
<td>1701</td>
<td>35.0%</td>
<td>1383</td>
<td>31.9%</td>
<td>9422</td>
</tr>
<tr>
<td>Water</td>
<td>4130</td>
<td>11.2%</td>
<td>2185</td>
<td>8.7%</td>
<td>612</td>
<td>12.6%</td>
<td>325</td>
<td>7.5%</td>
<td>2296</td>
</tr>
<tr>
<td>Sewerage</td>
<td>2293</td>
<td>6.2%</td>
<td>1188</td>
<td>4.7%</td>
<td>201</td>
<td>4.1%</td>
<td>249</td>
<td>5.7%</td>
<td>471</td>
</tr>
<tr>
<td>Cleansing</td>
<td>1131</td>
<td>3.1%</td>
<td>837</td>
<td>3.3%</td>
<td>121</td>
<td>2.5%</td>
<td>229</td>
<td>5.3%</td>
<td>727</td>
</tr>
<tr>
<td>Other service charges</td>
<td>156</td>
<td>0.4%</td>
<td>540</td>
<td>2.1%</td>
<td>0</td>
<td>0.0%</td>
<td>12</td>
<td>0.3%</td>
<td>161</td>
</tr>
<tr>
<td>Interest earned</td>
<td>562</td>
<td>1.5%</td>
<td>666</td>
<td>2.6%</td>
<td>161</td>
<td>3.3%</td>
<td>27</td>
<td>0.6%</td>
<td>477</td>
</tr>
<tr>
<td>Government grants</td>
<td>5151</td>
<td>14.0%</td>
<td>3300</td>
<td>13.1%</td>
<td>902</td>
<td>18.6%</td>
<td>1155</td>
<td>26.7%</td>
<td>4103</td>
</tr>
<tr>
<td>Equitable share</td>
<td>4492</td>
<td>12.7%</td>
<td>1243</td>
<td>4.9%</td>
<td>650</td>
<td>12.5%</td>
<td>665</td>
<td>15.3%</td>
<td>1870</td>
</tr>
<tr>
<td>RSC levies / Fuel Levy</td>
<td>0</td>
<td>0.0%</td>
<td>1896</td>
<td>7.5%</td>
<td>0</td>
<td>0.0%</td>
<td>343</td>
<td>7.9%</td>
<td>1823</td>
</tr>
<tr>
<td>Operating grants</td>
<td>699</td>
<td>1.9%</td>
<td>161</td>
<td>0.6%</td>
<td>297</td>
<td>6.1%</td>
<td>147</td>
<td>3.4%</td>
<td>410</td>
</tr>
<tr>
<td><strong>REVENUE</strong></td>
<td><strong>36790</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>25246</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>4389</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>4333</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>23902</strong></td>
</tr>
</tbody>
</table>

A.2 Capital funding sources

<table>
<thead>
<tr>
<th>2013/14 (R'000)</th>
<th>CoJ</th>
<th>CT</th>
<th>MAN</th>
<th>BCM</th>
<th>ETH</th>
<th>TSH</th>
<th>EKU</th>
<th>NMB</th>
<th>Total</th>
<th>%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital transfers</td>
<td>3 094 028</td>
<td>2 855 771</td>
<td>856 282</td>
<td>542 869</td>
<td>3 103 857</td>
<td>2 219 779</td>
<td>1 813 793</td>
<td>4 197 068</td>
<td>15 835 877</td>
<td>51.9%</td>
</tr>
<tr>
<td>Borrowing</td>
<td>1 458 631</td>
<td>2 350 301</td>
<td>39 406</td>
<td>-</td>
<td>1 500 000</td>
<td>1 500 000</td>
<td>806 349</td>
<td>-</td>
<td>7 654 687</td>
<td>25.1%</td>
</tr>
<tr>
<td>Internally generated funds</td>
<td>3 147 604</td>
<td>978 161</td>
<td>338 454</td>
<td>163 759</td>
<td>867 996</td>
<td>591 912</td>
<td>247 121</td>
<td>492 681</td>
<td>6 827 688</td>
<td>22.4%</td>
</tr>
<tr>
<td>Public contributions &amp; donations</td>
<td>-</td>
<td>52 025</td>
<td>17 676</td>
<td>-</td>
<td>-</td>
<td>95 900</td>
<td>-</td>
<td>49 069</td>
<td>214 670</td>
<td>0.7%</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>7 700 263</strong></td>
<td><strong>6 236 258</strong></td>
<td><strong>1 251 818</strong></td>
<td><strong>1 006 628</strong></td>
<td><strong>5 471 853</strong></td>
<td><strong>4 407 591</strong></td>
<td><strong>2 867 263</strong></td>
<td><strong>1 591 248</strong></td>
<td><strong>30 532 922</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>
II. Fiscal Efficiency Measures

In order for cities to enhance their fiscal space and capacity they have to optimise efficiency gains through better management of existing city revenue, expenditure, assets and liabilities (REAL) better and strengthen institutional governance and accountability measures.

Some of the applicable measures of municipal financial health developed by the National Treasury have been used and this tool can be further expanded as a systematic basis to measure the fiscal efficiency of cities and any requisite improvements.

Table 11: City fiscal efficiency measures

<table>
<thead>
<tr>
<th>Measures</th>
<th>Possibilities</th>
<th>Limitations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improved revenue management</td>
<td>Percentage reduction in outstanding consumer debtors</td>
<td>Ineffective billing, credit control and debt collection systems/ Economic outlook and unemployment/ Bulk tariff increases</td>
</tr>
<tr>
<td></td>
<td>Percentage reduction in non-technical water and electricity distribution losses</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Improved assessment and collection of property rates</td>
<td>Aging infrastructure/ limited expenditure on asset renewal and operational repairs &amp; maintenance</td>
</tr>
<tr>
<td>[Total outstanding debtors (2013/14): R52,9bn</td>
<td>Total distribution losses (2013/14): Water-R2,6bn; Electricity-R3,5bn]</td>
<td></td>
</tr>
<tr>
<td>Improved credibility of budget funding and spending</td>
<td>Percentage reduction in underspending of operating budgets (opex)</td>
<td>Lack of project management capacity/ Delays in procurement</td>
</tr>
<tr>
<td></td>
<td>Percentage reduction in underspending of capital budgets (capex)</td>
<td></td>
</tr>
<tr>
<td>[2013/14 Opex under-spending: R8,7bn (6% of R149,5bn)</td>
<td>2013/14 Capex under-spending: R3,9bn (13% of R30,3bn)</td>
<td></td>
</tr>
<tr>
<td>Improved annual audit outcomes</td>
<td>Minimum achievement of unqualified audit opinion</td>
<td>Financial and non-financial audit qualifications originate in all city departments</td>
</tr>
<tr>
<td></td>
<td>[2013/14: 2 Qualified audit opinions (BCM; NMB)]</td>
<td></td>
</tr>
<tr>
<td>Improved SCM practices</td>
<td>Reduction in amount of fruitless &amp; wasteful, irregular and unauthorised expenditure</td>
<td>Non-compliance to SCM policies and procedures occur in all city departments</td>
</tr>
<tr>
<td></td>
<td>[2013/14: Total per audited AFS: R8,7bn]</td>
<td></td>
</tr>
<tr>
<td>Increased spending on conditional grants</td>
<td>Increased spending of conditional operating and capital grants [USDG unspent (2013/14): R500m (6% of R9,077bn)]</td>
<td>Compliance to numerous administrative conditions before grant funding becomes available/ Lack of project management capacity/ Delays in procurement</td>
</tr>
</tbody>
</table>

33 Other measures can include repairs and maintenance, credit ratings, etc.
34 National Treasury. State of Local Government Finances and Financial Management as at 30 June 2014
35 National Treasury. State of Local Government Finances and Financial Management as at 30 June 2014
37 National Treasury. State of Local Government Finances and Financial Management as at 30 June 2014
III. Sound taxation principles and validation of local taxation options

Besides their suitability to approximate the benefit principle, there are several properties for all taxes which are also desirable at the local government level: (a) being buoyant, with revenues roughly changing in proportion to the economic base; (b) being horizontally equitable: providing equal treatment to taxpayers in similar circumstances; (c) being relatively efficient, causing low distortions in economic activity; (d) being relatively low in administration and compliance costs; and (e) being politically acceptable.  

According to the National Treasury when setting property rates, service charges and other fees, municipalities need to have regard to two key principles of taxation, namely:

- **The benefit principle**
  This captures the idea that payments should be related to benefits. Customers need to have the sense that they are getting ‘value for money’ for the taxes and charges they pay. In this regard one needs to distinguish between individual benefit and general benefit. Individual benefit means that the amount an individual is required to pay for a public service should be more or less equal to the benefit that the individual derives from the consumption of that service. General benefit refers to a situation where beneficiaries of a particular public service do not necessarily derive individual benefits equal to individual costs; rather the benefits of all beneficiaries are equated with the cost to all beneficiaries.

- **The ability-to-pay principle**
  This captures the idea that beneficiaries pay taxes according to their income generating capacity, so as to foster greater social equity. It is customary to distinguish between horizontal equity and vertical equity. Horizontal equity is generally accepted to mean that those with the same incomes should pay the same amount of tax. By contrast, it is generally understood that vertical equity means that those earning higher incomes should pay proportionately higher taxes than those earning less income – i.e. the taxes should be progressive.

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<table>
<thead>
<tr>
<th>Local tax source</th>
<th>Notes</th>
<th>Sound taxation principles</th>
<th>Potential risks and issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Household and business taxes</td>
<td>Not limited to tax collected by the municipality, but could include funds collected by municipality (itself or on behalf of community based organisation, CID or NPO) for programmes to develop neighbourhood or implement place-making projects. SIBs offer municipalities a way of pursuing social programs that may take years to yield results. Usually, municipalities decide what problem to address and then enter a contractual agreement with an intermediary (bond-issuing organisation) responsible for raising capital from independent investors including banks, foundations, and individuals, and for hiring and managing service providers. If the project achieves its stated objectives, the municipality repays investors with returns based on the savings resulting from the program’s success. A neutral evaluator is hired to measure the outcomes and resolve any disputes.</td>
<td>Transparency in the purpose, allocation, expenditure and public value created. Clear accountability in partnership and contracting arrangements.</td>
<td>Most of these mechanisms are based on a relationship of trust between govt and citizens or business. The benefits of urban improvement or social gains are often difficult to measure and quantify.</td>
</tr>
<tr>
<td>1.1 Urban Improvement Precincts 1.1.1 Social Impact Bonds (SIBs)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.1.2 Voluntary contributions or membership fees</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.1.3 Crowdsourcing for campaigns</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.2 Local business tax</td>
<td>Business activities are assessed for tax purposes on the basis of local (gross or net) turnover, of local value-added, the local wage bill, local business capital, or local profits. In some cases the business tax is similar to a minimum tax on notional capital or notional returns.</td>
<td>Stability and predictability in the funding raised each year</td>
<td>Concentration of business activity in the big city regions (and head office factor) will drive regional disparities. Tax burden could reduce competitiveness of local businesses.</td>
</tr>
<tr>
<td><em>Harvard Magazine, Jul-Aug 2013</em></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local tax source</td>
<td>Notes</td>
<td>Sound taxation principles</td>
<td>Potential risks and issues</td>
</tr>
<tr>
<td>------------------</td>
<td>-------</td>
<td>--------------------------</td>
<td>---------------------------</td>
</tr>
<tr>
<td>1.3 Tourism levy</td>
<td>A levy collected by tourism businesses with the aim of contributing to the promotion of South Africa as the preferred tourist destination locally and internationally. This is a voluntary, private sector-led initiative, where tourism businesses collect a 1% levy or fixed rand amount from all confirmed accommodation, car rental or tour bookings, to contribute towards SA Tourism’s international profiling and marketing of destination South Africa. There is an option to devolve part of the funds raised to Local Tourism Organisations.</td>
<td>Transparency in the purpose, allocation, expenditure and public value created. Clear accountability in partnership and contracting arrangements.</td>
<td>The benefits of tourism marketing may be difficult to measure and quantify (because data collection is uneven and difficult). Administrative burden of enforcing 3rd party collection and payment.</td>
</tr>
<tr>
<td>2. Property rates</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2.1 Property rates</td>
<td>There are two ways that municipal rates policies can improve low-income households’ access to urban land. (a) by providing direct tax relief municipal rates policies can make land more affordable. (b) Through indirect means, municipal rates policies can create incentives for property owners to make land use decisions which increase the supply of available well-located land and the stock of low-income housing.</td>
<td>Support pro-poor and redistributive outcomes. Guide property development and investment (eg housing supply rebates or vacant land penalties). Incentivise desired construction standards (eg green building practices, transit oriented development densities or public space, access and interface design standards).</td>
<td>Rates rebates may work against value capture objectives. Administrative burden associated with complex rates policy (eg building inspectors may be required to verify standards).</td>
</tr>
</tbody>
</table>

*Source: SACN. 2009. Municipal rates policies and the urban poor.*
2.2 Land value capture mechanisms

There are three categories of value capture mechanisms: Bulk infrastructure, area-based development, and community development. Examples of tools for bulk infrastructure value capture include development impact fees or contributions, joint development agreements, and air rights. Area-based development value capture can be achieved through a betterment tax or special assessment, zoning tools, land value increment taxes, land banking or leaseholds, and tax increment financing. Community development value can be captured through business improvement district charges or special rating districts.

_Urban Landmark, Improving Access to the City Through Value Capture (2012)_

Value capture describes the process of extracting the additional value that accrues to a property as a result of some public investment such as public transport or a school. It is a public financing technique that ‘captures’ a part or all of the increases in private land values that result from new public investment, by imposing a tax on the property or requiring an in-kind contribution.

Value gains must be created before they are taxed. The revenue raised through value capture should be ring-fenced for spending that supports the retention of that value. For example, value capture revenue is often used to fund public transport operations.

The property rating system already captures some value gains because rates assessments are based on the value of land and improvements, and through bulk service contributions at the point of development approval.

There is a potential contradiction between value capture charges and other tax incentives that make certain geographic areas more attractive for property development.

Administrative burden associated with more regular and more complicated property valuations and projections.

2.3 Property transfer duty

SA Revenue Services Website _http://www.sars.gov.za/TaxTypes/TransferDuty/Pages/default.aspx_

There is an option to devolve all or part of the funding raised through property transfers to municipalities.

This should provide an incentive for municipalities to take action to support a healthy local property market.

Funding raised from property transfers should be earmarked for urban management, infrastructure maintenance or capital works (not general operating costs).
<table>
<thead>
<tr>
<th>Local tax source</th>
<th>Notes</th>
<th>Sound taxation principles</th>
<th>Potential risks and issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Service charges and levies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.1 Vehicle license fees</td>
<td>There is an option to devolve all or part of the funding raised through vehicle license fees to municipalities.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.2 Public transport and taxi operating permits</td>
<td>There is an option to devolve all or part of the funding raised through transport operating permits to municipalities.</td>
<td>User-pays principle.</td>
<td>Any addition to the fuel levy may be politically unpalatable.</td>
</tr>
<tr>
<td>3.3 Fuel levy for municipal roads</td>
<td>The national fuel levy is collected from oil refineries. A sub-national fuel levy will require a new collection system.</td>
<td></td>
<td>Affordability limits may be an issue.</td>
</tr>
<tr>
<td>3.4 Public amenity levies (parks, libraries, museums, sport facilities)</td>
<td>This could be levied as a one-off development charge at the point of town planning or building plan approval, or an annual charge could be levied as part of property rates accounts.</td>
<td>The cost-recovery principle may not be realistic, but perhaps capital works and facility upgrading projects could be funded in this way.</td>
<td></td>
</tr>
<tr>
<td>3.5 New utility charges (electricity distribution network fees or electricity wheeling)</td>
<td>Municipalities should consider setting tariffs for the use of electricity distribution infrastructure by independent power producers, and for developments or neighbourhoods applying to go off-grid (i.e they require a grid connection only for emergency demand).</td>
<td>Increase revenue by sweating the infrastructure assets.</td>
<td>Punitive charges for off-grid developments might be unpopular.</td>
</tr>
<tr>
<td>Local tax source</td>
<td>Notes</td>
<td>Sound taxation principles</td>
<td>Potential risks and issues</td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>3.6 City Improvement Districts</td>
<td>City Improvement Districts are geographic areas in which the majority of property owners determine and agree to fund supplementary and complementary services to those normally provided by the Local Authority in order to maintain and manage the public environment at a superior level and thus maintain or increase their investment. The Local Authority continues to provide normal services to a pre-agreed level. Legislation allows for CIDs to raise an additional levy to be charged on all property within the defined geographical area. Income from this levy is directed back to the defined area to finance a wide range of activities. Supplementary services might include safety and security patrol officers, pavement cleaning, litter collection, maintenance of public space, removal of illegal posters.</td>
<td>Good governance and clear accountability by the CID to residents paying compulsory contributions.</td>
<td>The value of urban management improvements is difficult to measure and quantify.</td>
</tr>
<tr>
<td>4. Development charges</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Local tax source</td>
<td>Notes</td>
<td>Sound taxation principles</td>
<td>Potential risks and issues</td>
</tr>
<tr>
<td>------------------</td>
<td>-------</td>
<td>----------------------------</td>
<td>---------------------------</td>
</tr>
<tr>
<td>4.1 Utility connection fees (electricity)</td>
<td>All customers make a contribution towards Eskom’s costs incurred in providing capacity on the distribution and transmission networks as well as the cost of providing a connection to these networks. This contribution is regulated by the National Energy Regulator of South Africa (NERSA) and is recovered by means of: a) Tariff charges such as network charges or Distribution Use of System (DUoS) charges which recover shared or pooled costs. b) Connection charges which recover dedicated and shared costs associated with the supply.</td>
<td>The customer pays for all dedicated costs. Dedicated costs will be based on the investment made to meet the customer’s capacity requirements at the minimum technical standards, as stipulated in the Network Code. In addition to the dedicated costs, customers will be allocated a standard R/kVA contribution based on replacement costs for shared upstream costs, whether new upstream investment is required or not. No actual upstream network strengthening costs are allocated to the customer. The costs allocated for a standard supply are rebated by the capital allowance included in the tariff. Municipalities must decide whether to subsidise new technology such as smart electricity meters or whether to pass these costs on to consumers.</td>
<td>The costs of compliant smart meters are currently prohibitive. The standards for smart meters must be reviewed by the regulator and Eskom in consultation with municipalities.</td>
</tr>
<tr>
<td>4.2 Bulk service contributions</td>
<td>Engineering Service Contributions (ESC) are required to fund “external” infrastructure that is necessary for the municipality to provide to mitigate the increased load on municipal services as a result of a proposed development. The contributions are also known as bulk service contributions, or payments for the provision of engineering services.</td>
<td>Cost recovery principle. Create a clear price distinction between charges for developments in CBDs and transit corridors and those in peripheral locations to incentivise compact city development. Incentivise affordable housing on well-located land by reducing bulk contributions.</td>
<td>Punitive charges may jeopardise the feasibility of some property developments.</td>
</tr>
</tbody>
</table>

*Eskom’s Electricity Connections Methodology*
[http://www.eskom.co.za/CustomerCare/TariffsAndCharges/Documents/Connection
documents/Connection_Services_Model_for_Metropolitan_Cities.2017.pdf](http://www.eskom.co.za/CustomerCare/TariffsAndCharges/Documents/Connection
documents/Connection_Services_Model_for_Metropolitan_Cities.2017.pdf)

*CoJ Policy for ESC for roads and stormwater*
<table>
<thead>
<tr>
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<th>Sound taxation principles</th>
<th>Potential risks and issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>5. Excise taxes</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5.1 Carbon tax</td>
<td>A carbon tax is an “upstream” tax on the carbon contents of fossil fuels (coal, oil and natural gas) and biofuels. A South African Carbon Tax has been proposed for business and industry at R120 per tonne of CO2e (carbon dioxide equivalent), the amount to be increased 10% per year from 1 January 2016. There is already a carbon tax for vehicles The tax on passenger vehicles’ CO² emissions is R90 for every gram of CO²/km above 120gCO²/km, and for double-cab bakkies it is R125 for every gram/km in excess of 175gCO²/km.</td>
<td>No space for local carbon taxes?</td>
<td></td>
</tr>
</tbody>
</table>

5.2 Vehicle and Road taxes

Vehicle Excise Duty (VED) (also known as vehicle tax, car tax and road tax), is a tax that must be paid for most types of vehicle which are to be used (or parked) on the public roads. Some countries require expensive vehicle permits (eg Singapore charges S$20 000 for a ten-year permit for a first vehicle, with a sliding scale of charges for every additional vehicle, penalties for imported vehicles and diesel vehicles, and a road tax with peak and off-peak distinctions). Differentiate between locally produced cars and imported cars. Encourage off-street parking by charging for on-street parking. Affordability limits and resistance to parking charges.
IV. Feasibility analysis of capital financing options

<table>
<thead>
<tr>
<th>External funding source</th>
<th>Notes</th>
<th>Pros</th>
<th>Cons</th>
<th>Potential risks and issues</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Summary of context presented by Shiva Makotoko in Bellagio**

- National Treasury estimates that around R43b is required for infrastructure across cities in the next 10 years, this compares to R28b currently spent.
- Commercial banks providing loans have limited ability to finance long-term projects, inhibited by regulations and liquidity constraints.
- Municipal bond accounts for 45% of city borrowing.
- High interest rates, short durations with no grace periods characterise the loan financing market.
- Long lead time and cumbersome procurement processes inhibit innovation and adaptability.
- The savings industry has an estimated R12b invested in municipal bonds, and R77b in direct infrastructure, eg housing (DBSA)

**Potential external funding sources to be explored (from Bellagio Report)**

- **Enhanced debt finance**
- Pooled metropolitan municipal loans
- Guaranteed lending schemes for infrastructure
- Commercial and privately organised institution focused on municipal infrastructure (to develop new blended financial instruments and leveraging / Hybrid loans with an explicit intention to adjust costs, duration and other benefits eg equity and short term debt tranches).
- Land and project-based financing
- **Enhanced equity and bond finance**
- Institutional investors with longer term horizons
- Boosting Municipal bond market: including project bonds. Develop infrastructure as an asset class, sufficient to attract private investment
- Sovereign wealth funds
- Social Impact Bonds
- PPPs
- **External grants**
  - Target donor funding to promote borrowing and facilitate risk mitigation strategies, e.g. guarantees, co-financing, Credit Enhancements, etc
<table>
<thead>
<tr>
<th>External funding source</th>
<th>Notes</th>
<th>Pros</th>
<th>Cons</th>
<th>Potential risks and issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Enhanced debt finance</td>
<td></td>
<td></td>
<td></td>
<td>Disproportionate benefit for poor performing municipalities. Pooled finance may cost more than ordinary loan finance for high performing municipalities.</td>
</tr>
<tr>
<td>1.1 Pooled municipal loan funds</td>
<td>Municipal Pooled Financing Mechanisms (PFMs) can be broadly defined as a cooperation between local authorities with a focus on local infrastructure investments financing through marked-based borrowing.</td>
<td>Increased access, flexibility and diversification in loan funding options available to municipalities. Averaging of credit-worthiness may reduce cost of finance.</td>
<td>Requires institutional reform - a municipal finance authority perhaps. Administrative burden to manage multiple loan agreements and ensure compliance by all municipal participants.</td>
<td></td>
</tr>
<tr>
<td>1.2 Guarantees for municipal infrastructure finance</td>
<td>An infrastructure guarantee scheme enables the Treasury to issue an unconditional and irrevocable guarantee to the lenders to infrastructure projects ensuring that scheduled interest and principal payments will be paid in full, irrespective of project performance. This transfers project risk to government, and ultimately taxpayers. The Scheme provides stronger protection to lenders than comparable European state schemes, which provide credit enhancement but not a full sovereign guarantee of principal and interest.</td>
<td>A guarantee scheme avoids delays to investment in infrastructure projects that may have stalled because of adverse credit conditions. The scheme can attract new sources of finance into infrastructure projects, such as pension and institutional investors.</td>
<td>The fee for guarantees might be prohibitive. Treasury is reluctant to issue guarantees so the cost-benefits will have to be clearly articulated.</td>
<td>Contingent liability may affect national rating if municipalities default.</td>
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<td>External funding source</td>
<td>Notes</td>
<td>Pros</td>
<td>Cons</td>
<td>Potential risks and issues</td>
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<td>1.3 Municipal Finance Institution</td>
<td>INCA website <a href="http://www.inca.co.za">http://www.inca.co.za</a></td>
<td>MFI to develop new instruments including securitisations, blended financial instruments and leveraging, hybrid loans with an explicit intention to adjust costs, duration and other benefits eg equity and short term debt tranches.</td>
<td>Can bring in institutional investors, insurance funds etc. Can facilitate lower interest rates, longer maturities and larger debt size than bank loans. Can lead to structured products including securitisations to reduce cost of finance.</td>
<td>Rating approach for Municipal Finance Institution may be a disadvantage. Limited profitability - may need an operating subsidy.</td>
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<td>2. Enhanced Equity and bond finance</td>
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<td>2.1 Longer term equity and bond instruments</td>
<td>Venu Prasath, 2013. <em>Credit Enhanced Infrastructure Bonds In Emerging Markets</em> <a href="https://books.google.co.za/books?id=MpnhBQAAQBAJ&amp;dq=long+term+equity+for+infrastructure+bonds&amp;source=gbs_navlinks_s">https://books.google.co.za/books?id=MpnhBQAAQBAJ&amp;dq=long+term+equity+for+infrastructure+bonds&amp;source=gbs_navlinks_s</a></td>
<td>Reduced repayments making repayments more affordable</td>
<td>Greater cost of finance over the borrowing period.</td>
<td>Longer term revenue projections are less reliable.</td>
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### External funding source

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<tr>
<th>2.2 Project bonds</th>
<th>Notes</th>
<th>Pros</th>
<th>Cons</th>
<th>Potential risks and issues</th>
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<tbody>
<tr>
<td>Deloitte website</td>
<td><a href="http://www2.deloitte.com/za/en/pages/finance/articles/project-bonds-an-alternative-to-financing-infrastructure-projects.html">http://www2.deloitte.com/za/en/pages/finance/articles/project-bonds-an-alternative-to-financing-infrastructure-projects.html</a></td>
<td>Recent surveys suggest that infrastructure is beginning to be viewed as an asset class of its own and the allocation to this investment class is expected to increase significantly. April 2013 saw the first listing and investment-grade rated infrastructure project bond, held entirely by institutional investors. The bond was issued by CPV Power Plant No.1 Bond SPV (RF) Ltd, a Soitec Solar GmbH affiliate. The proceeds were used to finance the construction of a 44 MWp Concentrated Photo Voltaic Plant. The plant, located in Touwsrivier in the Western Cape, will be the largest CPV plant in the world.</td>
<td>Project bonds are an alternative debt funding avenue. By accessing the institutional bond market, companies are potentially able to reduce the project funding cost. The use of bonds allows project developers to tap into R3 trillion worth of assets under management by South African institutional investors and Sovereign Wealth Funds. Project bonds offer an opportunity for institutional investors to participate in infrastructure projects through listed, tradable securities that can offer superior risk-adjusted returns.</td>
<td>The use of project bonds may be unattractive to investors with a lower appetite for risk. Local institutional bond investors, while happy to take on performance risk, generally are not prepared to take on any form of construction risk. Not all debt portions of these deals will be able to take advantage of this source of funding, but this mechanism will provide benefits to the project developers in the form of potentially enhanced returns due to the lower cost of capital.</td>
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<td>2.3 Sovereign Wealth Funds</td>
<td>Sovereign Wealth Funds are state-owned fund or entity created from balance of payments surpluses, official foreign currency operations, proceeds from privatisations, government transfer payments, fiscal surpluses, or receipts from resource exports. SWFs can invest directly in infrastructure projects.</td>
<td>Higher risk tolerance&lt;br&gt;Relatively low cost of finance</td>
<td>Competing requirements for this funding</td>
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<td>2.4 Social Impact Bonds (SIBs)</td>
<td>SIBs offer municipalities a way of pursuing social programs that may take years to yield results. Municipalities decide what problem to address and then enter a contractual agreement with an intermediary (bond-issuing organisation) responsible for raising capital from investors including banks, foundations, and individuals, and for hiring and managing service providers. If the project achieves its stated objectives, the municipality repays investors with returns based on the savings resulting from the program’s success. A neutral evaluator is hired to measure the outcomes and resolve any disputes.</td>
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<td>Most of these mechanisms are based on a relationship of trust between govt and citizens or business. The benefits of urban improvement or social gains are often difficult to measure and quantify.</td>
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<td>2.5 PPPs</td>
<td>PPPs gear private investment in big infrastructure projects and share risk</td>
<td>Sound governance and contracting arrangements because of regulated PPP process. Improved access to finance.</td>
<td>Limited capacity to initiate and prepare partnership projects. Might need project preparation facility to support municipalities. Administrative burden due to regulatory framework. (review)</td>
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References


http://media.wix.com/ugd/bfe783_ef32d0e158324c1986c0603bfad6a272.pdf

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40 This position paper was produced by The Global Taskforce of Local and Regional Governments facilitated by UCLG, in collaboration with Paul Smoke, Professor of Public Finance and Director of International Programs at New York University.


41 This book forms part of the Africa Development Forum Series created in 2009 to focus on significant issues relevant to Sub-Saharan Africa’s economic development. The series is sponsored by the Agence Française de Développement and the World Bank.

http://www.urbancenter.utoronto.ca/pdfs/elibrary/Slack_Mun-Finance-Urb-Growt.pdf


