Urban LandMark

making urban land markets work for the poor

Legislative and policy context for the application of value capture mechanisms by municipalities

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1. Introduction

When government upgrades existing or installs new transport infrastructure, the development may bring greater passenger loads, increased traffic, and improved exposure to the immediate area. As a result, local businesses may receive a boost, new businesses may wish to locate there, and more residents may wish to move to the area to benefit from more convenient, accessible transport. The resultant increase in the demand for nearby land often increases the property values. Such a process of value creation is not limited to transport infrastructure but may occur in any case of strategic infrastructure investment for urban development and growth.

Importantly, this potential increase in land value surrounding public infrastructure offers an opportunity for local government to accumulate some of the value created by using various 'value capture' mechanisms. Value capture is a public financing technique that 'captures' a part of, or all, 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, such as land or improvements. The additional revenue can be used to finance infrastructure for economic growth and urban development, or for poverty alleviation programmes. The infrastructure which is financed, in turn, leverages private investment in the area as it improves.

Despite these advantages, local authorities in South Africa have adopted few, if any, of these value capture mechanisms. Apart from the use of development charges, these revenue-raising avenues have been left unexplored, despite evidence of positive outcomes in other countries.

1.1. Background and Objectives

In 2009/10 Urban LandMark appointed African Development Economic Consultants (ADEC) to conduct research on transit-oriented development and value capture mechanisms. Specifically the ADEC report identified three case studies and analysed whether the installation of transport infrastructure increased the adjacent property values. The report then considered whether that value could be captured and used for poverty alleviation. The ADEC research included a local and international literature review with respect value-capture and made some recommendations about which value capture instruments would be best suited in the three case studies.

Urban Landmark now wishes to take this work one step further and to look more deeply into the opportunities and obstacles to the utilisation of value capture instruments by municipalities in South Africa.

Therefore the purpose of this short project is to further investigate the opportunities and limitations (e.g. institutional and legal constraints) of the value capture mechanisms identified in the ADEC Report in the South African context.

1.2. Report Structure

The first section of this report provide a brief overview of the current legislative and policy framework impacting on the use of value capture mechanisms in the South African context. The second section looks at the fiscal framework for local government budgets and thus sets the backdrop for the application of value capture mechanisms by municipalities.

The third section applies this framework to key various value-capture instruments, in order to identify which legislation authorises and regulates each instrument, and what legislative and policy space is available to purse these mechanisms. It also explores what the obstacles and challenges are, or would be, for municipalities in implementation.

The Conclusion offers recommendations on which VC mechanisms offer the best opportunities for application and what legislative, policy and fiscal changes would be required to allow for greater use of the identified value-capture mechanisms.

1.3. Scope

Table 1 briefly lists and defines the main value capture mechanisms highlighted in the ADEC report. This report will focus on a selected five instruments from this list: Betterment Taxes, Business Improvement Districts, Development Charges, Land Value Increment Taxes and Tax Increment Financing. These particular instruments have been highlighted because, while the other instruments are fairly well understood in the South African context, less is known about how these five instruments could be applied in South Africa and what the issues would be in their implementation.

Some of these categories overlap and definitions of terms may vary internationally and between municipalities in South Africa. For example, land value increment taxes, and tax increment financing are rather similar in that they typically use property rates to capture the increased value to that property due to public infrastructure investment in the area. However these instruments vary in the mechanism for calculating and collecting the tax, and the purpose for which the revenue is collected. Section 4 discusses some of these definitional issues further.

Table 1: Summary of Selected Value Capture Mechanisms

	Definition/description
Betterment tax or special assessment	A tax imposed by local governments to capture the increase in land value generated by private development that results from investment in infrastructure (including transport infrastructure).
Business Improvement Districts (BID)	An ad valorem tax or levy on property owners and/or businesses located within a specific area. The levy raises funds for the delivery of an added layer of service, above and beyond services provided normally within the city.
Development impact fees	Once-off fees levied by municipalities on developers to help recover the cost of the public infrastructure which is required to provide services to the developed properties. Fees are levied at the point at which developers are seeking land use approval.
Zoning tools	Use of zoning by-laws to direct the location, type, and scale of development. There are two main zoning tools: **Incentive zoning:** This tool rewards developers if they include certain public amenities in their development, or meet other public objectives. For example, incentive zoning can include density or floor-area bonuses, which allow a developer to build to greater densities so long as they include certain public amenities like parks and open space,that benefit the community at large. **Inclusionary zoning:** This tool requires housing developers to include a certain percentage of affordable units in their projects to create mixed income communities.
Joint development agreements	A type of public-private partnership where public and private organisations contribute to the costs of a transport facility, and share the revenues that come from commercial developments that take advantage of that facility.
Land Value Increment Taxation (LVIT)	A type of property taxation system in which the property rate is raised, based on the change in total assessed value of the property after the instalment of public infrastructure in the area.
Land banking and leaseholds	An instrument which local or provincial government uses to buy land around the planned transport interchange and hold it for sale once the infrastructure has been developed. The government then benefits from the increased land value,

	which is captured and ring-fenced for poverty alleviation projects such as housing, infrastructure services, etc.
Air rights	Air rights are designated to allow for development above public infrastructure and facilities such as railway or mass transit stations, highways, and other facilities.
Tax Increment Financing (TIF)	This instrument works on the principle that public infrastructure will increase the value of property around the infrastructure, and this will increase income from taxes on the property. This additional tax income can then be 'captured' within a specific part of the city, and used to pay the interest on money the municipality has had to borrow to pay for the infrastructure within that area.

Source: ADEC (2009).

It should be noted that this report is limited to desktop analysis of legislation and policy documents, and a single meeting with National Treasury officials 30 June 2011. Our analysis of institutional constraints to the greater use of value capture mechanisms in local authorities has therefore not benefited from interviews with LG officials and primary data gathering at local level. Such research would be an area for future enquiry and is discussed in the concluding section on recommendations.

2. Policy and Legislative Framework

Section 229 of the **Constitution** (Act 108 of 1996) on municipal fiscal powers and functions states that municipalities may impose other taxes, levies and duties appropriate to local government if authorised by national legislation (Section 229 (1)b). There are also limitations put on this power:

- Such taxes, duties and levies may not be exercised in a way that materially and unreasonably prejudices national economic policies, economic activities across municipal boundaries, or the national mobility of goods, services, capital or labour (Section 229 (2)a).
- They may be regulated by national legislation (Section 229 (2)b).

Based on Section 229, a suite of legislation has been developed, and is in the process of being developed, to provide a comprehensive framework to regulate municipal tax instruments and their application. Transfers to municipal government from nationally-raised revenue—the Equitable Share and conditional grants—make up a significant portion of most municipal budgets, and for smaller municipalities, is their main source of revenue. While the annual Division of Revenue Act (DORA) covers these intergovernmental transfers to local government, the other two main revenue instruments of local government are covered by other legislation: Property rates are authorised by the Municipal Property Rates Act (MPRA) while a collection of legislation regulates municipal tariffs on services. These pieces of legislation are reviewed below, in order to assess how they might enable or constrain the use of VC mechanisms by local authorities.

2.1 The Public Finance Management Act (PFMA), 1999

The Public Finance Management Act (Act 1 of 1999) covers financial management in the national and provincial spheres but does not cover local government. The PFMA applies to: departments, public entities, constitutional institutions and Parliament and the provincial legislatures (Section 3(1)). Chapter 5 of the PFMA covers public entities and spells out the responsibilities of their accounting officers and political heads. The public entities to which it applies---listed in Schedules 2 and 3 of the Act—include entities such as the ESKOM, the Land and Agricultural Bank of South Africa, Transnet and Airports Company of South Africa (ACSA). Such public entities which have large landholdings could potentially explore value capture mechanisms in the development of their land.

2.2 The Municipal Finance Management Act (MFMA), 2003

As the cornerstone of the legislative framework for municipal finance, the MFMA (Act No. 56 of 2003) provides a framework for sound, sustainable municipal financial management and sets out

Treasury norms and standards for local government. However it does not give detail on municipal taxes and levies.

When tabling the annual budget, municipalities must include draft resolutions imposing any municipal tax and setting any municipal tariffs as may be required (Section 17). Section 18 on the funding of expenditure states that an annual budget may only be funded from realistically anticipated revenues to be collect, cash-backed accumulated surpluses not committed for other purposes, and borrowed funds. Before approving a capital project, the Municipal Council must consider future operational costs and revenue on the project, including municipal tax and tariff implications (Section 19 (2)b).

Finally, Section 168 of the MFMA serves to strengthen the ties between the various Acts which together are intended to create a cohesive and comprehensive municipal fiscal legislative framework. In Section 20(1)(b), the MFMA gives the Minister of Finance, with the Minister of Local Government, the authority to prescribe uniform norms and standards concerning municipal tariff-setting. In addition, Section 168(1)(c) authorises the Minister to make regulations or guidelines for municipalities regarding a framework for regulating the exercise of municipal fiscal and tariff-fixing powers. These two sections are the links to the MSA which preceded it in 2000. Section 168 of the MFMA also provides the basis for the MFPFA which followed in 2007. These two key pieces of legislation—the MSA and MFPFA—are discussed next.

2.3 The Municipal Systems Act (MSA), 2000

The Municipal Systems Act (No. 32 of 2000), which preceded the MFMA, set out basic parameters for the application of municipal tariffs. Section 74 covers **tariff policy** and lays out the principles which must be reflected in a municipal tariff policy. Section 74 (1) states:

> *(f) provision must be made in appropriate circumstances for a surcharge on the tariff for a service;*
> *(g) provision may be made for the promotion of local economic development through special tariffs for categories of commercial and industrial users;*

Section 74 (3) permits tariff policies to differentiate between different categories of users, debtors, service providers, services, service standards, geographical areas and other matters as long as the differentiation does not amount to unfair discrimination.

Notably, Section 85 provides for the establishment of **internal municipal service districts** to facilitate the provision of a municipal services in that part of the municipality. It stipulates that the municipality:

- Must consult the community on the boundaries, service to be provided, method of financing, mechanism for providing the service
- Obtain consent of majority of the members

In order to finance the internal municipal services district, the municipality may:

> *(c) set a tariff or levy for the service in the district;*
> *(d) impose a special surcharge in the district on the tariff for the service; or*
> *(e) increase the tariff in the district for that service (Section 85(3))*

Section 85 also stipulates that the municipality must keep separate accounting records and establish a committee of community representatives to act as a consultative and advisory forum to the municipality for each internal municipal service district (Section 85(3)d&e).

2.4 The Municipal Fiscal Powers and Functions Act (MFPFA), 2007

Enacted 7 September 2007, the Municipal Fiscal Powers and Functions Act (MFPFA) gives effect to Section 229 of the Constitution and sets out the regulatory framework for municipal taxes including surcharges.[1] The MFPFA does *not* include property rates and user charges (tariffs).[2] Municipal user charges are addressed through the MFMA, Municipal Systems Act and sector legislation, while property rates are addressed in the MPRA.[3]

The MFPFA does not list particular taxes but sets out the processes and procedures necessary for the authorization of taxes, levies and duties that municipalities may impose under Section 229.[4] The Act:

- Provides for the process and procedure necessary for the authorisation by National Treasury of **taxes, levies and duties** that municipalities may impose under Section 229(1)b of the Constitution; and

- Regulates the exercise by municipalities of their power to impose **surcharges on user fees for services** under Section 229(1)a by empowering the Minister of Finance to prescribe norms and standards. [5]

The **municipal base tariff**, as defined by the MFPFA, is the fee necessary to cover the actual cost associated with rendering a municipal service. This includes: bulk purchasing costs; overhead, operation and maintenance costs; capital costs; a reasonable rate of return, if authorised by a regulator of or the Minster responsible for that municipal service (Section 1(1)). A municipal **surcharge**, as defined by the Act, refers to a charge in excess of the municipal base tariff.

Finally, the MFPFA made an amendment to the MFMA which made Section 43 (on tax and tariff capping on municipalities) not applicable to any municipal tax authorised in terms of the MFPFA. The MFPFA also repealed Section 86(1)d of the Municipal Systems Act which authorised the Minister of Finance to regulate the criteria to be taken into account by municipalities when imposing surcharges on tariffs for services. Both amendments serve to establish the MFPFA as the principal legislation concerning municipal taxes and surcharges on tariffs.

Application for and approval of a new municipal tax

A new tax can be proposed by: a municipality; group of municipalities; organised local government; and/or the Minister of Finance. Section 5 of the MFPFA specifies the information which must be contained in an application for a new municipal tax. Among other things, the application must identify:

- The purpose for which the revenue derived will be used

[1] The Provincial Tax Regulation Process Act, enacted in 2003, serves the same purpose on a provincial level.
[2] User charges and tariffs are used interchangeable. See Section 4.1 below for further explanation and discussion on the distinction between taxes and user charges.
[3] MFPFA Circular No. 1, pg. 3.
[4] MFPFA Circular No. 1, pg. 2.
[5] MFPFA Circular No. 1, pg. 2.

- The tax base
- The desired tax rate
- The persons liable for the tax
- Any tax relief measures or exemptions
- The tax-collecting authority
- The persons responsible for remitting the tax
- The methods and likely costs of enforcing compliance
- The compliance burden on taxpayers
- Procedures for taxpayer assistance
- Amount of revenue to be collected on an annual basis over three financial years following introduction
- The economic impact of individuals and businesses
- The impact on economic development

A municipality can only impose the new tax after the Minister of Finance has notified the applicant and the Minister responsible for local government in writing of his or her approval; and the Minister of Finance has "prescribed regulations regarding the imposition and administration of a municipal tax or taxes. The regulations will *inter alia* determine:

- the date from which the municipal tax may be imposed (which date must coincide with the start of a municipal financial year);
- the collecting agent of such tax;
- the tax base;
- as well as any limitations placed on such tax (Section 6 of the Act)." [6]

Notably, the regulations issued by the Minister may limit the purpose for which revenue derived from the collection of the municipal tax may be utilised, in respect of a specific purpose tax. Regulations can also specify that a certain percentage of the revenue derived from the collection of a specific purpose tax must be utilised for a specific purpose (Section6(d) i.e. ring-fenced.

Verification of existing municipal taxes

The MFPFA not only covers the approval of new taxes but also puts in a place a system for verifying and approving the continuation of existing municipal taxes. Municipalities were required to apply to the Minister of Finance by 7 September 2009 (two years after the enactment of the MFPFA) for authorisation to continue imposing any tax which existed prior to the enactment of the MFPFA.[7] The purpose of the verification process was to determine whether the existing tax met the necessary requirements. The National Treasury used the following criteria to assess existing municipal taxes:

- Must fit within the overall tax policy framework of Government and should not undermine national goals of macroeconomic stability and redistribution

- Must comply with the basic tenants of a good and sustainable tax instrument (and the trade-offs it sometimes implies), such as:
    - Efficiency
    - Equity (vertical and horizontal)

[6] MFPFA Circular No. 1, pg. 4.
[7] If a municipality failed to apply for such authorisation, then the tax automatically lapsed on 6 September 2009. If the Minister of Finance denied approval of an existing tax, then that tax lapsed 6 months after the Minister had informed the municipality that the application was not approved. MFPFA Circular No. 1, pg. 5.

- Administrative simplicity and certainty
- Revenue raising capacity and buoyancy
- Political acceptability/responsibility
- Reasonable overall tax burden
- Flexibility

In May 2011, Government gazetted the list of municipal taxes which had been approved for continuation. No other municipality can charge or impose taxes on the basis of this regulation, except those for whom the continuation of those taxes is approved. Table 1 lists the municipal taxes which were authorised for continuation along with the reason given by the Minister for the decision.

Table 2: Municipal Taxes Approved In Terms of 'Approval of Municipal Taxes Regulation' Gazetted 11 May 2011

Tax	Municipalities	Determination by Minister
Waterways Riparian Levy St Francis Bay	Kouga	These are well established taxes and most stakeholders supported the continuation of these taxes. Lukhanji Municipality indicated that once final approval has been obtained, this tax will be levied as part of property rates. Taxes in present format supported for continuation.
Community Levy	Lukhanji	
Fire Levy	Greter Kokstad	
Urban Development Charges	Breede Valley	Application supported until appropriate policy has been developed on how to deal with this charge in the longer term.
	Knysna	
	Cape Town	
	George	
	Overstrand	
	Kouga	
Rural Based Development Levies (in areas where property valuations not feasible)	Blouberg	Extends ability of poorly resourced municipalities to collect own revenues and improves accountability link with communities. Application supported until appropriate policy has been developed on how to deal with this charge in the longer term.
	Thulamela	

Source: Republic of South Africa Government Gazette. *Notice 289 of 2011. Municipal Fiscal Powers and Functions Act (12/2007): Approval of Municipal Taxes Regulation.* 11 May 2011.

Regulation of municipal surcharges

As noted above, the MFPFA empowers the Minister of Finance to prescribe norms and standards to regulate the exercise by municipalities of their power to impose **surcharges on user fees for services**.[8]

Such norms and standards have not yet been issued by National Treasury. The view of National Treasury is that municipal tariffs, which are currently inefficient and inconsistent, must first be regulated properly before regulations for surcharges on the municipal base tariff should be developed.[9]

Progress is being made on putting regulations and guidelines in place for municipal tariffs. NERSA is the regulator for electricity tariffs, from generation (Eskom) to retail (municipalities). In order to strengthen regulation of municipal electricity tariffs, NERSA is in the process of putting in place a regulatory electricity tariff setting manual for municipalities that will first be rolled out in metros and over time be phased-in to other municipalities. Simultaneously, the Department of Water Affairs is

[8] MFPFA Circular No. 1, pg. 2.
[9] Interview with National Treasury officials, 30 June 2011.

in the process of setting up an independent regulator for determining water tariffs (full service chain).[10]

Setting the **norms and standards for municipal surcharges**, as called for in MFPFA, will be a complex and difficult process. While avoiding penalties for large industry, such regulations must consider the macro-economic implications of surcharges, in terms of inflation. It will be necessary to establish different bands or categories of consumers, based on their ability to pay. However, given the recent large hikes in electricity tariffs, municipalities may be losing the scope for imposing surcharges on service fees.

2.5 The Municipal Property Rates Act (MPRA), 2004

As noted above, the authority of municipalities to levy property rates is governed by separate legislation for this purpose, the Municipal Property Rates Act, enacted in 2004. The MPRA reinforces the requirement that municipalities may not levy property rates which would 'materially and unreasonably prejudice: [11]

(a) national economic policies:
(b) economic activities across its boundaries; or
(c) the national mobility of goods, services, capital or labour.(Section 16(1))

Permissible and impermissible differentiations of ratepayers

The MPRA is explicit in stating how and in what cases municipalities can set different rates for different categories of properties and ratepayers:

- Section 19(1) stops municipalities from levying different rates on residential properties, except in cases of: phasing-in newly rateable property (Section 21), transitioning from the old to the new valuation roll (Section 89), and public service infrastructure (Section 11(1)b).

- With regard to non-residential property, municipalities may not levy rates that: exceed the prescribed ratio between residential and non-residential properties or which unreasonably discriminates between categories of non-residential property (Section 19(1)).

However Section 8(1)c permits municipalities to levy different rates for different categories of rateable property, according to the **geographical area** in which the property is situated, "subject to Section 19".

Special Rating Areas

Section 22 of the MPRA allows municipalities to set up **special rating areas (SRAs)** whereby groups of residents in a particular geographic area voluntarily come together to increase their levies in order to have additional services or infrastructure. The municipality may "differentiate between categories of properties when levying an additional rate for improving or upgrading that area." (Section 22(1)c). However Section 22(4) further specifies that SRAs must not be used to reinforce existing inequities and must be consistent with the Municipal IDP.

The Municipality must also indicate how the area is to be improved or upgraded by funds derived from the additional rate and establish separate accounting and other record-keeping systems

[10] Email correspondence with Wendy Fanoe, Chief Director: Intergovernmental Policy and Planning, National Treasury. 5 July 2011.
[11] The same limitations are contained in Section 229 of the Constitution and are echoed in Section 2(b) of the MFPFA.

regarding the revenue generated by the additional rate and the improvement and upgrading of the area (Section 22(3)).

Given that most municipalities are focused on establishing the new valuation roll and implementing the new rates policy, many have not included SRAs in their policies or have considered the idea but not yet developed specific SRA policies and by-laws. Cape Town, Johannesburg and eThekwini have SRA policies in place, while most of the other metros and secondary cities do not.[12]

2.6 The National Land Transport Act (NLTA), 2009

Apart from legislation related to the municipal finance exclusively, various sector legislation may also impact on the application of VC mechanisms. We look at that legislation relevant to transport infrastructure in particular. The NLTA (No. 5 of 2009) provides for the transformation and restructuring of the national land transport system. The Act sets out the responsibilities of each sphere of government. In addition to developing land transport policy and strategy within its area, based on national and provincial guidelines, the municipal sphere is responsible for:

> *(v) financial planning with regard to land transport within or affecting its area, with particular reference to transport planning, infrastructure, operations, services, maintenance, monitoring and administration, with due focus on rehabilitation and maintenance of infrastructure (Section 11(c)).*

The NLTA also requires that every municipality which is establishing an integrated public transport network must establish a **Municipal Land Transport Fund** (MLTF), which will hold money from: National, Province, user charges collected by the municipality, interest earned from the Fund, and donations and contributions from any other source (including foreign aid) (Section 27(1)).

The Fund is to be used for the transport function in terms of the NLTA or the municipality's integrated transport plan. The provisions of the MFMA apply to the Fund (auditing by the Auditor-General, regular reporting to Council, approval of payments by Council etc.).

Section 28 of the NLTA relates to public transport user charges and authorises a municipality which has established a Municipal Land Transport Fund (as per Section 27) to impose user charges which then accrue to the Fund, subject to the MFPFA.[13] There appears to be some confusion here by the drafters of the NLTA, in that the MFPFA does not apply to user charges. User charges are governed by the MFMA, the MSA and sector legislation. Regardless, because Section 28 of the NLTA stipulates that the imposition of such user charges is subject to the MFPFA, presumably NT approval would be required as per the processes for new municipal taxes set out in the MFPFA.

2.7 The Draft Spatial Planning and Land Use Management Bill, 2011

Apart from the NLTA, the current draft legislation in land use management is the second piece of sector legislation which may have a direct impact on the application of VC mechanisms by municipalities. In May 2011, the Department of Rural Development and Land Reform introduced the Spatial Planning and Land Use Management Bill (SPLUMB) for public comment. The Bill provides a

[12] Tshangana (2009), pg. 39.

[13] According to Section 28(1): such user charges "may differ from case to case, on—:

(a) *Specified classes of motor vehicles entering specified portions of its area at specified times;*
(b) *Land, buildings or other developments that generate the movement of passengers, including land or buildings of which the State is the owner, in its area; and*
(c) *The parking of motor vehicles in a building or on land in specified portions of its area;*
(d) *Parking places for, or the use of ranks, stops and terminals by, motor vehicles in such portions.*

framework for spatial planning and land use management, beginning with the identification of five key development principles: spatial justice; spatial sustainability; efficiency; spatial resilience; and good administration (Section 6).

The Bill sets out the requirements of national, provincial, regional and municipal SDFs. For the purposes of the Bill, municipal planning consists of: IDPs (including SDF and land use schemes) and the control and regulation of land use within the municipal area (Section 4). Among other content areas, the *Municipal* SDF must: [14]

- Identify the designated residential, business, commercial and industrial areas where national or provincial inclusionary housing and inclusionary economy policy or statutory requirements will be applicable (Section 20(i))

- Identify the designation of areas in the municipality where incremental upgrading approaches to development and regulation will be applicable (Section 20(k))

- Identify the designation of areas in which: more detailed local plans must be drawn up; and where shortened land use development procedures may be applicable and land use schemes may be so amended (Section 20 (l))

- Determine a capital framework for the municipality's development programmes (Section 20(n))

Chapter 7 of the SPLUM Bill deals with the provision of services and development charges. A land use applicant is responsible for the provision and installation of internal engineering services while the municipality is responsible for external engineering services (Section 46(2)(3)).

Section 47 of the SPLUM Bill states clearly that development charges are payable by the applicant to the municipality for the provision of installation of external engineering services. This is subject to any guidelines prescribed by the Minister of Rural Development and Land Reform and the Premier in terms of provincial legislation.

However the Bill allows for the applicant to install any external engineering service in lieu of paying a development charge, provided that it is done with the agreement of the municipality. "The fair and reasonable cost of such external services may be set off against development charges payable" (Section 46(5). In such cases where the applicant installs external engineering services instead of payment of development charges, the MFMA requirements around procurement and appointment of contractors are applicable (Section 46(6)).

Further, the applicant must pay development charges "in respect of the provision of land for the purpose of refuse sites" (Section 47(2)).

The Bill also includes a requirement that any application for residential use must include land for parks and/or open space. Section 48 reads as follows:

(1) The approval of a development application which provides for the use of land for residential purposes is subject to the provision of land for parks, or open space by the applicant.

[14] Emphasis added.

(2) *The land required for parks or open spaces must be provided within the land area which the development application refers or may be provided elsewhere within the municipal area at the discretion of the municipality.*

(3) *Where a development application is approved without the required provision of land for parks or open space, the applicant must pay a development charge to the municipality for the provision of such land.*

The Bill does *not* provide detail on the calculation or recovery of development charges. However it does allow for the Minister of Rural Development and Land Reform and Minister of Finance to prescribe guidelines which provincial guidelines and municipal tariff policies would subsequently need to adhere to (Section 49(1)). Provincial guidelines may also be issued by the MECs which must be consistent with the national guidelines and would apply to the collection of development charges by municipalities (Section 49 (2)).

2.8 Summary of Legislative Framework

Table 1 attempts to summarise the above sections on the legislative and policy framework by highlighting the main pieces of legislation which govern the different types of municipal revenue instruments. (Section 4 below discusses some of the definitional issues related to the labelling and categorisation of various municipal revenue-raising instruments.) Depending upon how value capture mechanism are defined—as surcharges, tariffs, taxes or property rates—they would be governed by different legislation.

When a municipality is considering the adoption of a VC mechanism, as a first step, it is therefore important that the municipality is clear on what it wants to achieve (e.g. revenue generation for infrastructure installation, debt financing) and then design an instrument which effectively serves those specific purposes. The local authority then needs to make an argument that the VC mechanism should be labelled under the appropriate category; that argument must be based on the *design features* of the revenue instruments, not its label or name per se. As this review of the legislative and policy framework has shown, the categorisation of the revenue instrument (as a tax, surcharge, or user charge) is critical because it determines the applicable legislation which will govern implementation.

Table 3: Legislative Framework for Municipal Revenue Instruments

Instrument	**Primary governing legislation**[15]	
Intergovernmental transfers	DORA	Provides for the equitable division of revenue raised nationally among the national, provincial and local spheres of government for each financial year. Covers equitable share and conditional grant transfers, as well as allocations-in-kind to provinces and municipalities.
User charges and tariffs	MSA	Section 74 covers tariff policy and sets out the principles which must be reflected in a municipal tariff policy. Section 85 provides for the establishment of internal municipal service districts to facilitate the provision of municipal services in that part of the municipality.

[15] Not all relevant legislation is listed for each instrument, for the sake of simplicity. For example, Section 229 of the Constitution governs all the instruments but is not listed here.

	MFMA	Section 20 (1)(b)gives the Minister of Finance, with the Minister of Local Government, the authority to prescribe uniform norms and standards concerning municipal tariff-setting. Section 168 (1)(c) authorises the Minister of Finance to make regulations or guidelines for municipalities regarding a framework for regulating the exercise of municipal fiscal and tariff-fixing powers.
	NLTA	Section 28 relates to public transport user charges and authorises a municipality which has established a Municipal Land Transport Fund (as per Section 27) to impose user charges which then accrue to the Fund, subject to the MFPFA.[16]
Property rates	MPRA	Regulates the power of municipalities to impose rates on property. Section 22 authorises Special Rating Areas.
Taxes, levies and duties	MFPFA	Provides for the process and procedure necessary for the authorisation by National Treasury of taxes, levies and duties that municipalities may impose under Section 229(1)b of the Constitution.
	SPLUM Bill	Sections 47 and 48 deal with the payment of development charges and the provision of land for parks and open space by land owners seeking development approval. Section 49 authorises the Minister of Rural Development and Land Reform to issue guidelines on development charges in consultation with the Minister of Finance.
Surcharges on municipal base tariff	MFPFA	Regulates the exercise by municipalities of their power to impose surcharges on user fees for services under Section 229(1)(a) of the Constitution, by empowering the Minister of Finance to prescribe norms and standards.

3. Fiscal Framework

This section looks at intergovernmental transfers to LG and other sources of municipal revenue, in order to put the discussion of municipal value capture instruments in the wider context of financing for local government.

3.1 Local Government's Share of Nationally-Raised Revenue

Local government receives the smallest slice of nationally-raised revenue, compared to national departments and provinces. In 2011/12, 47% of nationally-raised revenue went to national departments, 44.3% to provinces, and the remaining 8.7% to local government.

As shown in

Table 4, transfers to local government from national totalled R70.2 billion in 2011/12. The LG equitable share as a percentage of total transfers to LG has declined in recent years, as the fuel levy has kicked in. From 2009/10, general fuel levy sharing made up approximately 12% of total transfers to LG, while LG equitable share contributed 49% and conditional grants constituted the remaining 40% of total transfers to LG.

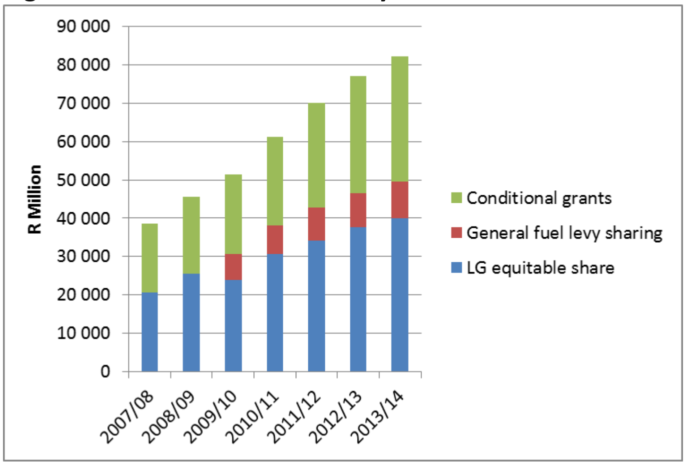
[16] As noted above, the NLTA inaccurately references the MFPFA in relation to user charges in Section 28. User charges are governed by the MFMA, the MSA and sector legislation—not the MFPFA.

Table 4: Transfers of Nationally-Raised Revenue to Local Government

	Outcome			Revised Estimate	MTE		
R million	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
LG equitable share	20 676	25 560	23 845	30 559	34 108	37 573	39 960
General fuel levy sharing			6 800	7 542	8 573	9 040	9 613
Conditional grants	17 806	19 928	20 892	23 051	27 490	30 416	32 743
Total transfers to LG	**38 482**	**45 488**	**51 537**	**61 152**	**70 171**	**77 029**	**82 316**

Source: National Treasury. 2011/12 National Budget Review, pg. 11.

Figure 1: Transfers of Nationally-Raised Revenue to Local Government (2007/08 – 2013/14)



Source: National Treasury. 2011/12 National Budget Review, pg. 11.Own calculations.

Municipal dependence on transfers from national as a share of total revenue varies dramatically between different municipalities, depending on their size and circumstances. Driven by economic growth in their urban areas, the Metros and larger secondary cities can rely upon user charges and property rates as their primary sources of revenue. In contrast, some smaller, more rural municipalities are almost completely dependent on national transfers, mainly the LG equitable share. The next two sections unpack the various sources of operating and capital budgets, besides transfers from national government.

3.2 Sources of Municipal Operating Revenue

As shown in Table 5, overall 43% of municipal operating revenue was sourced from service charges (mainly electricity and water) in 2009/10; 22% from government grants; and 19% from property rates.

Other municipal taxes, such as development charges, would fall under ‘Other own revenue’ which contributed 12.7% of operating revenue for municipalities in 2009/10.

Table 5: Sources of Operating Revenue for Municipalities (2003/04 – 2009/10)

R million	Outcome			Estimate	MTE		
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Operating Revenue							
Property rates	12 980	16 396	17 401	18 521	21 486	22 770	24 136
Service charges	36 146	38 735	40 201	44 498	49 223	51 549	54 777
RSL	4 983	7 009	7 604	386	95	2	
Investment revenue	1 673	2 115	2 357	2 970	3 845	3 818	4 133
Government grants	8 980	13 742	17 398	27 223	26 571	28 311	28 491
Public contributions and donations	44	588	664	695			
Other own revenue	8 025	8 784	10 375	11 763	17 184	16 260	16 167
Total operating revenue	**72 831**	**87 369**	**96 000**	**106 056**	**118 404**	**122 710**	**127 704**
As share of total operating revenue							
Property rates	17.8%	18.8%	18.1%	17.5%	18.1%	18.6%	18.9%
Service charges	49.6%	44.3%	41.9%	42.0%	41.6%	42.0%	42.9%
RSL	6.8%	8.0%	7.9%	0.4%	0.1%	0.0%	0.0%
Investment revenue	2.3%	2.4%	2.5%	2.8%	3.2%	3.1%	3.2%
Government grants	12.3%	15.7%	18.1%	25.7%	22.4%	23.1%	22.3%
Public contributions and donations	0.1%	0.7%	0.7%	0.7%	0.0%	0.0%	0.0%
Other own revenue	11.0%	10.1%	10.8%	11.1%	14.5%	13.3%	12.7%

Source: National Treasury. 2008 Local Government Budgets and Expenditure Review, pg. 23. Own calculations.

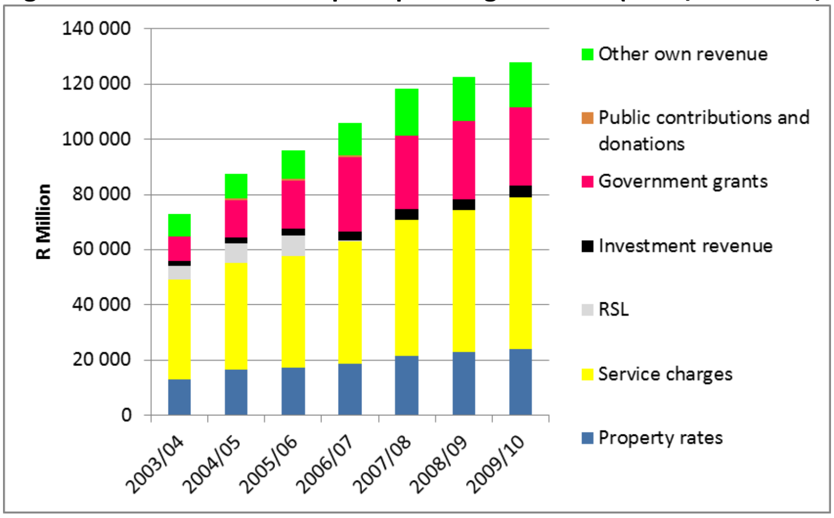
As reflected in Figure 2, after the discontinuation of the Regional Service Levies in 2006/07, property rates and service charges (as a share of total operating revenue) remained basically the same: 19% and 43% respectively. However government grants as a share of total operating revenue took up the slack, and rose to 26% in 2006/07. Over the 7-year period summarised in the *LG Budget and Expenditure Review*[17], government grants as a share of total operating revenue has increased steadily, from 12.3% in 2003/04 to 22.3% in 2009/10. This is largely driven by the contribution from the LG equitable share, which constituted 8.6% of the total operating revenue in 2003/04, rising to 17.5% in 2007/08. This increasing reliance on the equitable share by municipalities is a source of growing concern for National Treasury:

> *The growth in government transfers has occurred at a faster pace than the increase in own revenue generated by municipalities. This has created a situation where municipalities are increasingly dependent on grants to fund their operating costs. This is creating a dependency syndrome, which in future might be unsustainable.*[18]

Figure 3 compares the annual nominal growth rates of the major sources of municipal operating revenue. It shows how in 2006/07, when RSC levies were dropped, government grants jumped. Over the period, service charges have grown at a steady pace.[19] Similarly, property rates revenue has grown approximately 10% each year. Notably, revenue from 'other own sources' grew markedly from R11.7 million in 2006/07 to R17.2 million the following year—a jump of 46%.

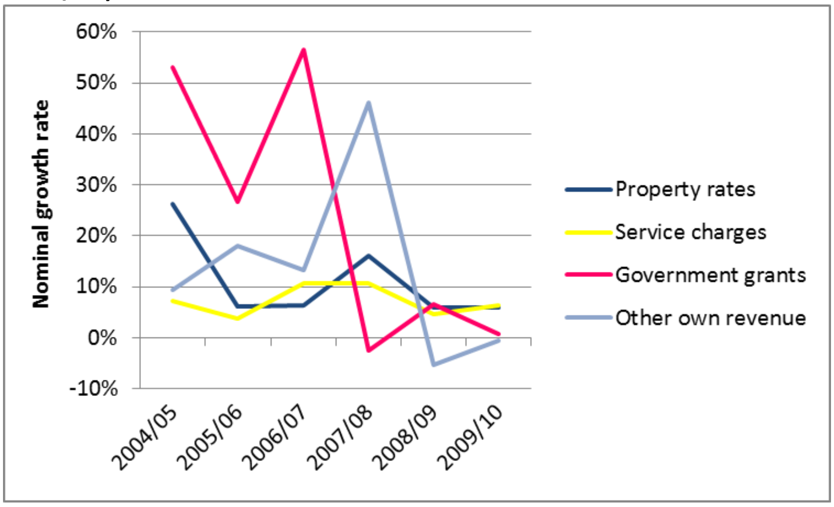
[17] The Local Government Budgets and Expenditure Review is produced by National Treasury periodically (approximately every 2-3 years). The next LGBER is due for release in November 2011.
[18] National Treasury. 2008 Local Government Budgets and Expenditure Review. Pg. 33.
[19] The 2008 LG Budgets and Expenditure Review only covers to 2009/10, and therefore predates the spikes in electricity charges in the most recent years.

Figure 2: Sources of Municipal Operating Revenue (2003/04 – 2009/10)



Source: National Treasury. 2008 Local Government Budgets and Expenditure Review, pg. 23. Own calculations.

Figure 3: Nominal Growth Rates of Selected Sources of Municipal Operating Revenue (2004/05 – 2009/10)



Source: National Treasury. 2008 Local Government Budgets and Expenditure Review, pg. 23. Own calculations.

3.3 Sources of Municipal Capital Revenue

Table 6 and

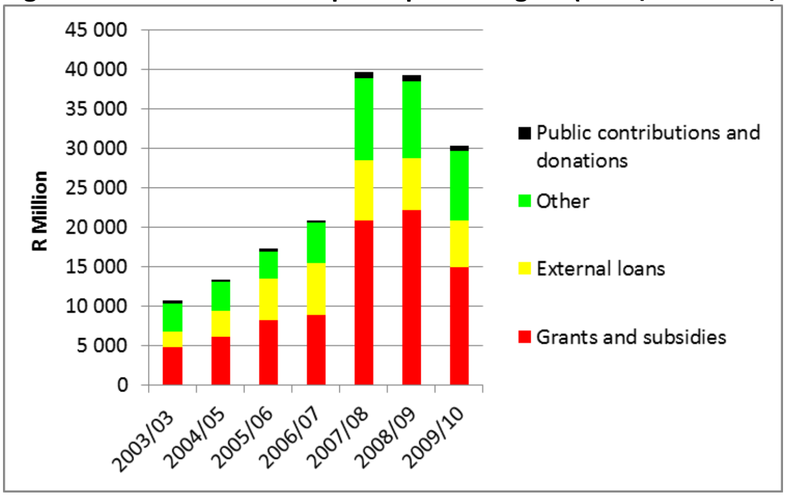
Figure 4 show the sources of capital funding from 2003/04 to 2009/10. On first glance, the percent shares of the capital budget for each source (shown in Table 6) appear to change rather erratically over the period. However municipal capital budgets received a large injection of funds for infrastructure in the run-up to the 2010 Fifa World Cup. If one removes this large capital supplement in 2007/08 and 2008/09 from the picture, an overall trend emerges whereby grants and subsidies contribute the largest portion (between 45% and 50%), followed by 'other' (25% to 30%), and external loans (approximately 20%).

Table 6: Capital Budget Sources for Municipalities (2003/04 – 2009/10)

R million	Outcome			Estimate	MTE		
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Municipal capital funding							
External loans	2 011	3 315	5 278	6 543	7 621	6 678	5 909
Public contributions and donations	371	248	301	287	838	786	701
Grants and subsidies	4 775	6 058	8 186	8 909	20 813	22 118	14 960
Other	3 539	3 702	3 467	5 153	10 464	9 670	8 767
Total capital budget	**10 696**	**13 323**	**17 232**	**20 892**	**39 736**	**39 252**	**30 337**
As share of total capital budget							
External loans	18.8%	24.9%	30.6%	31.3%	19.2%	17.0%	19.5%
Public contributions and donations	3.5%	1.9%	1.7%	1.4%	2.1%	2.0%	2.3%
Grants and subsidies	44.6%	45.5%	47.5%	42.6%	52.4%	56.3%	49.3%
Other	33.1%	27.8%	20.1%	24.7%	26.3%	24.6%	28.9%

Source: National Treasury. 2008 Local Government Budgets and Expenditure Review, pg. 27. Own calculations.

Figure 4: Sources of Municipal Capital Budgets (2003/04 – 2009/10)



Source: National Treasury. 2008 Local Government Budgets and Expenditure Review, pg. 27. Own calculations.

Revenue from development charges would be categorised under 'Public contribution and donations' on municipal budgets, in compliance with GRAP standards. Savage (2009)conducted an analysis of revenue performance from development charges and warned that the data in this category is of poor quality: often municipalities capture the revenue incorrectly or inconsistently, don't include development charges at all, or don't capture it for all years. He found that only 29 of 284 municipalities reported any annual income from DC, between 2004/05 and 2006/07.[20]

Assuming the entire category 'Public contributions and donations' is development charges, it appears municipalities collected a total of R287 million from this revenue source in 2006/07, or a mere 1.4% of their total capital budgets. Undertaking an analysis of DC revenue by municipal category (e.g. Metros, secondary cities, locals and districts), Savage concluded that approximately 60% of total revenue from development charges is collected in the 6 metros.

Based on the revenue received as a share of the value of all buildings completed in municipalities between 2003 and 2007, Savage calculated that the effective rate at which municipalities charged

[20] See Savage, D. "Evaluating the performance of Development Charges in financing municipal infrastructure investment". Discussion Paper: Second Draft 23 March 2009. This section draws heavily on Savage's work.

development levies averaged 2.1% over this period. Using different methods to calculate the difference between DC revenue needs and actual revenue, Savage estimated that the shortfall ranges between R482 million per year and R4.7 billion.[21] This suggests municipalities are significantly under-charging on development charges and thus under-recovering the investment costs related to infrastructure needed to provide services to new developments.

4. Application of Selected Value Capture Mechanisms

The discussion above has provided evidence that, although incomplete, the current legislative and policy framework does begin to address the application of value capture mechanisms by municipalities. However some legislative and regulatory gaps still exist. The discussion of the financial framework suggests that municipalities may be under-collecting on various instruments available to them, specifically development charges. The increased utilisation of value capture instruments may assist to alleviate the increasing reliance on national transfers which has been evidenced in the non-Metro municipalities in recent years.

Given the urgent need for additional financing sources for municipal infrastructure, and the potential for helping to meet that need through value capture mechanisms, this section looks at the challenges and obstacles to their application by local government. We first look at two general issues impacting on the use of value capture mechanisms by municipalities: how are these revenue instruments defined, and to what extent can revenue from these instruments be ring-fenced? We then look more closely at the legislative, technical and institutional issues associated with four main types of value capture instruments: development charges, Land Value Increment Taxation, Tax Increment Financing, and betterment taxes.

4.1 Definitional Questions

According to public finance theory, revenue instruments should be designed to adhere to the 'benefit principle', which states that the benefit of the service financed through fees or taxes should go directly to the taxpayer. Ideally, payment is levied in exact proportion to usage or benefit. In the case of the *individual* benefit principle, the individual paying benefits directly. With the *general* benefit principle, there is a still a link between the payer and the benefit, but the link is indirect and the benefit is not in direct relation to the payment.[22] The closer a revenue instrument adheres to the benefit principle, the greater its transparency and accountability.

The key distinction between taxes and user charges is that user charges adhere more closely to the benefit principle, compared to taxes which are typically used to generate general revenue for programmes or projects which provide benefits which are shared by a group of beneficiaries. In the case of user charges, tariffs are levied in proportion to usage or benefit received by the individual payer. With user charges, the amount charged should not exceed average cost of the good and/or service. The level of user charges and administrative fees should also be set taking into consideration beneficiaries' ability to pay. However, in the case of taxes, the amount may exceed cost recovery (i.e. the taxpayer is contributing more than the benefit which they directly receive). With taxes, a 'free-rider' problem also exists, whereby some individuals may receive benefits which exceed their contribution.

[21] The R482 million figure is based on revenue potential, using the average effective charging rate of municipalities over the period. The R4.7 billion figure comes from an expenditure needs approach which is based on estimates of infrastructure investment needs. See Savage (2009).

[22] National Treasury internal position paper for the development of guidelines on the imposition, amendment and appropriate application of levies, user charges and administrative fees. Received from Erwin Obermeyer (National Treasury: Tax Policy Unit) 10 July 2011.

The National Treasury developed an internal position paper for the development of guidelines on the imposition, amendment and appropriate application of levies, user charges and administrative fees, which they use to establish a clear basis for distinguishing taxes, duties and levies from user charges and administrative fees. Table 7 below sets out the defining features of each, as per the National Treasury document.

Despite these guidelines, there is still a fair amount of confusion around the definition of terms such as taxes, levies, user charges and fees, tariffs, and surcharges, and a fair amount of overlap between these categories, depending on interpretation.[23] For this reason, it is often useful to avoid labels and instead look at the characteristics and purposes of the revenue collection instrument. For example, in carrying out the Section 12 MFPFA process of assessing existing municipal taxes, NT found it works best to not look at the names or terms municipalities assigned to their tax applications but instead to interrogate the design features of the instrument.

Table 7: Distinction between Taxes and User Charges

	Defining elements
Taxes and levies	▪ Statutory or compulsory, enforced by legislation. ▪ Beneficiaries constitute a distinct group of individuals. ▪ No direct benefits accrue to individual beneficiaries in exchange for payments made (benefit principle only applies broadly). ▪ Government departments or agencies decide upon the purpose for which the revenue is spent. ▪ Normally used to mobilise general funding for programmes or services which provide general benefits shared by a group of beneficiaries. ▪ 'Free rider' problem exists, whereby some may receive greater benefit than others, or than their payment justifies.
User charges and administrative fees	▪ A marketable good (in the case of user charges) or a service (in the case of administrative fees) is provided to an identifiable beneficiary. ▪ Payment is required for the provision of those certain government goods and/or services. ▪ Direct benefits accrue to beneficiaries in exchange for payments (individual benefit principle). ▪ Voluntary; transactions take place in a willing buyer market. ▪ Revenues are earmarked or ring-fenced, by definition. ▪ Amount charged should not exceed average cost of the good and/or service. The level of user charges and administrative fees should also be set taking into consideration beneficiaries' ability to pay.

Source: National Treasury internal position paper for the development of guidelines on the imposition, amendment and appropriate application of levies, user charges and administrative fees. Received from Erwin Obermeyer (National Treasury: Tax Policy Unit) 10 July 2011.

Often revenue-raising instruments do not fall clearly into the category of a tax or user charge and instead have elements or characteristics of each, to more or less extent. For example, development charges share elements of user charges and taxes. Development charges are usually levied against a land-owner for a particular development and used to finance infrastructure which provides services for that development; by creating a direct link between the payment and the benefit, DC are similar to user charges. However the infrastructure may also benefit other areas and land owners, which gives DC some of the characteristics of a tax.

Although taxes (as noted in Table 7) typically raise revenue for services which benefit the broader population and cannot be tied back to the payer, it also possible for a tax or levy to be *earmarked* for a specific purpose. In these cases where revenue is ring-fenced, taxes begin to take on some of the

[23] National Treasury uses the terms 'levy' and 'tax' interchangeably.

properties of user charges. Similar to user charges, earmarked levies or taxes should not exceed the average cost of providing the service or investment it was intended to finance. Issues of ring-fencing revenue are explored further below.

4.2 Ring-fencing

The revenue collected via value capture mechanisms may be used for:

- the construction costs of infrastructure which directly benefit the immediate area where the public infrastructure investment is located;
- the construction costs of infrastructure installed in other areas in the municipality;
- debt service costs for private loans or bonds issued to raise funds for the public infrastructure projects;
- or broader developmental and poverty alleviation programmes.

While value capture revenue is most often used for urban regeneration or improvements and investment in low-income areas, municipalities may be tempted to apply it elsewhere, or simply to add it to general municipal revenue.

International practice has shown that capturing the value created from public infrastructure investment is best achieved by ring-fencing revenues collected within the particular district or area where the infrastructure is located.[24] In order to be a credible and justifiable policy from the perspective of developers and landowners, the benefits from the tax must be felt directly by those making the payment. The viability and success of value capture mechanisms therefore often depends on the ability to directly link the tax payment to the benefit received (infrastructure or service provided). [25]

For this reason, ring-fencing of the revenue is a critical element of many value capture mechanisms.[26] For example, tax revenue from TIFs is ring-fenced for specific uses. As will be discussed below, land value increment taxes ring-fence the revenue raised on the incremental increase in the value of land brought about by public investment (such as transport infrastructure).

However there are a number of other public policy arguments *against* the practice of ring-fencing:

- Ring-fencing undermines democratic principles in that it detracts from the Legislature or Council's authority and/or ability to set budget policy and priorities. As the body of elected citizen representatives, Parliament is meant to have final say in how taxpayers' funds are spent.
- Earmarked funds[27] are exempt from the scrutiny and requirements for justification which are part of the annual budget process. In this manner, ring-fenced funds lose the transparency, accountability, and efficiency gains that are created through the budget process.
- Extra-budgetary funding (as per value capture mechanisms) can set up alternate structures and funds which may not be subject to the same accountability and reporting requirements as regular revenue. In this sense, earmarked funds and accounts may be said to operate in the dark.

[24] ADEC (2009), pg. 49.
[25] ADEC (2009), pg. 37.
[26] In this sense, value capture mechanisms fall under the category of earmarked or ring-fenced levies or taxes.
[27] In this paper, the terms 'earmarked' and 'ring-fenced' are used interchangeably. Both refer to funds which have been authorised for use for a specific purpose only.

- When funds are earmarked for a specific purpose, over time a sense of entitlement may develop whereby the strength of the claim on the funds deepens, often despite the original purpose for the revenue collection expires.

For these reasons, National Treasury's general position is to avoid ring-fencing of budget allocations or tax revenue except in cases where there is sufficient transparency and accountability to make the practice effective and equitable. Because of the strong direct link between payment and benefit, user charges meet this criteria and therefore lend themselves naturally to ring-fenced expenditure.

NT's position has important implications for the design and application of value capture instruments by municipalities. As noted above, the MFPFA provides for the Minister of Finance, in issuing regulations governing a new municipal tax, to limit the purpose for which revenue derived from the collection of the municipal tax may be utilised. The regulations can also specify that a certain percentage of the revenue derived from the collection of a specific purpose tax must be utilised for a specific purpose (Section6(d).

Municipalities applying for approval to NT for a new municipal tax under the MFPFA should therefore take cognisance of the fact that, in order to approve the ring-fencing of revenue from the tax, NT will be looking for evidence of design features which enhance transparency and accountability: "The closer a fee or charge can be designed as a user charge, the more suitable it becomes for earmarking. The closer the design is to a tax, the less desirable earmarking becomes."[28]

National Treasury's position is that earmarked levies or taxes must:[29]

- Be used for purposes which are closely related to the interests of the persons primarily responsible for its payment;
- Be levied by a department or agency which adequately represents the views and interests of the persons primarily responsible for its payment
- Be levied by a department or agency which has adequate systems in place to account to such persons (stakeholders) regarding its receipt, expenditure and uses.

Should National Treasury regulations not support the ring-fencing of revenue from an approved municipal tax, it would still be within the purview of the Council to earmark revenue via municipal by-laws. Towards this end, Sections 27 and 28 of the NLTA which prescribe municipalities to set up a Land Transport Fund, also provide local authorities with a specific vehicle to ring-fence revenue from user charges for transport purposes.

4.3 Development Charges[30]

Development charges are the value capture instrument most in use in South Africa today, although there is great potential for more municipalities to adopt this instrument, given estimates of current under-collection.[31] At present there is not a clear legislative or policy framework to regulate and guide municipal development charges. However there are two initiatives underway to address this, which potentially may be in conflict. First, National Treasury has developed a *Policy Framework for*

[28] Personal correspondence with Erwin Obermeyer (National Treasury: Tax Policy Unit), 13 July 2011.
[29] National Treasury internal position paper for the development of guidelines on the imposition, amendment and appropriate application of levies, user charges and administrative fees.. Received from Erwin Obermeyer (National Treasury: Tax Policy Unit) 10 July 2011.
[30] This section draws heavily on work by David Savage on development charges (2009) as well as discussion with him on the *Policy Framework for Municipal Development Charges – Draft for Consultation, Version 6* developed by National Treasury. The author is indebted to him for his assistance and input.
[31] See Savage (2009).

Municipal Development Charges.[32] The Policy Framework, which is intended to be a guide for municipalities, needs to be preceded by a legislative framework and thus is still an unofficial document. Second, in drafting the SPLUM Bill, the Ministry of Rural Development and Land Reform included sections which govern development charges.

National Treasury Draft Policy Framework on Development Charges

The Policy Framework is intended to explicitly situate DC in the legislative framework for municipal finance. In the Explanatory Memorandum attached to the Framework, the argument is made to use the MFPFA to regulate DC instead of approaching them as user charges which would fall under the MSA. The draft *Policy Framework* defines DC as a "once-off infrastructure charges imposed by municipalities on a land owners as a condition of approval of a land development that will result in an intensification of land use and an increase in the use of or need for municipal engineering services infrastructure."[33] It is thus proposed that the MFPFA be amended to explicitly authorise municipalities to levy DC as per the Framework.

Section 8.4(b) of the Framework states that DC are to be considered as a municipal service fee as per Section 118 of the MSA and thus are subject to the credit control measures contained in that Act. By stating that DC fall under Section 118, it is ensured that developers must make the required payment before the transfer can be registered with the deeds office. Section 118 also includes surcharges on fees, property rates and other municipal taxes, levies and duties and therefore the labelling of the DC as a municipal service fee is not necessarily required in order for Section 118 to apply.

The Framework first sets out four key principles by which municipalities will design and underpin their system of DC. They are:

- **Equity and fairness**: DC are designed to recover the full and actual costs of infrastructure that results from new urban development. The DC can be used to cover either the costs of pre-installed infrastructure whose surplus is used to supply services to new development, or the costs of new infrastructure needed to supply additional services required by that new development. Notably, the Framework specifies that DC are *not* an additional revenue source which local government can use to rectify historical backlogs in access to services.

- **Predictability**: DC are to be treated as a formal commitment by the municipality to supply the infrastructure required to supply services to the new development. This predictability ensures the environment is more attractive for private investment.

- **Spatial and economic neutrality**: The Framework explicitly states that the primary purpose of DC is "to ensure the timely, sustainable financing of required urban infrastructure." It is *not* to be used as a tool to spatial planning policy instrument (to rectify segregation in cities inherited from the apartheid era). Nor are DC to be used to raise funds which are used to cross-subsidise services for the poor.

- **Administrative ease and uniformity**: The determination, calculation, and operation of DC should be administratively simple and transparent. It is suggested that although calculating the actual cost of needed infrastructure would be more accurate, it would also be more

[32] National Treasury. *Policy Framework for Municipal Development Charges. Draft for Consultation. Version 6.*
[33] National Treasury. *Policy Framework for Municipal Development Charges.* Section 1.

time-consuming, complex and expensive. As a trade-off, the Framework proposes the use of estimated standard unit costs (for each service) which are updated annually.

The funds collected are to be ring-fenced: "Cost recovered should be dedicated only to the purpose for which they were raised and where appropriate, charges should be levied on a sectoral or geographic scale to more accurately approximate costs within a specific impact area."[34] In this respect, the Framework includes a number of provisions intended to ensure an explicit and direct link between the DC collected, the actual cost of the infrastructure, and the delivery of that infrastructure as promised in the Master Infrastructure Plan of the municipality.

The net effect of these clauses is to cut off the opportunity for the municipality to use DC for: the operations and maintenance of existing infrastructure; cross subsidisation of services for the poor; the installation of infrastructure in other areas which does not directly benefit the new development; or accumulation of funds for non-specific infrastructure investment in the future. In addition to these specific exclusions, the Framework also sets limitations on the exemptions and subsidies which municipalities might grant as a means to attract investment by particular land owners, for particular areas, or for particular types of land use (Section 7).

Administrative procedures are also set out to provide for ring-fencing of DC revenue. Payments must accrue to the municipality's Public Contributions and Donations Reserve.[35] The municipality must establish, maintain and report on separate memorandum accounts which are set up for each impact zones it has designed in its approved policy framework for DC. Impact Zones are to be defined for each type of service e.g. for electricity, there would be an impact zone defined for each sub-station area (Section 6.2).

Revenue from DC can be used for the actual construction costs of that infrastructure or to cover the debt service costs of funds borrowed to install infrastructure. In many cases local authorities will have already installed infrastructure through debt financing and then would apply the DC receipts to repay that existing debt.[36]

Draft SPLUM Bill

The provisions in the draft SPLUM Bill on the basic purpose and scope of DC appear to be basically aligned with the contents of the NT Policy Framework on DC. As noted above, the SPLUM Bill states that development charges are payable by the applicant to the municipality for the provision of installation of external engineering services. (The developer may also install external engineering services in lieu of paying a DC, in agreement with the municipality). The Bill also includes a requirement that any application for residential use must include land for parks and/or open space.

The potential for legislative overlap and/or confusion lies in the authority the SPLUM Bill gives to the Minister to issues further guidelines on DC. The Bill empowers the Minister of Rural Development and Land Reform, after consultation with the Minister of Finance and 'the relevant authorities', to prescribe guidelines for the calculation and recovery of DC, which provincial guidelines and municipal tariff policies would subsequently need to adhere to (Section 49(1)). Provincial guidelines may also be issued by the MECs which must be consistent with the national guidelines and would apply to the collection of development charges by municipalities (Section 49 (2)). Given that the

[34] *Policy Framework for Municipal Development Charges,* Version 6. Section 3.1(c).
[35] Through this requirement, the Framework improves the accuracy and consistency of data which can be collected and analysed in the future, with regard to revenue performance of local government. See Section 3.3 above.
[36] One of the outstanding issues in the formula for the calculation of DC relates to how to deal with the costs of existing debt.

draft *Policy Framework* from NT sets out to define DC as a new municipal tax falling under the authority of the MFPFA, there is a possible conflict with the draft SPLUM Bill.

Unless clarity is achieved on whose portfolio DC fall under, there is a potential for overlapping and confusion legislation governing DC. A confusing legislative framework provides opportunity for developers to contest the levying by municipalities of DC and to tie up the process in lengthy and expensive legal processes. This vulnerability will likely dissuade municipalities from levying the DC in the first instance. One of the obstacles to the increased application of DC by municipalities is therefore the clarification of the legislative and policy framework. Such turf issues are best settled through intergovernmental forums as opposed to the courts.

4.4 Land Value Increment Taxation and Tax Increment Financing

When public infrastructure investment in a particular area lifts property values, the increased tax revenue from that heightened market value can be ring-fenced by municipalities. This is the basic principle behind both Land Value Increment Taxation and Tax Increment Financing.

The revenue garnered from these tax instruments can then be allocated to special projects or programmes which benefit that same area. For example, land value increment taxation might work as follows: if the value of a parcel of land increased by 100% before and after the public infrastructure investment in the area, then that additional increment could be taxed at a rate of 20%. If the land increased by a 200% increment, the additional value could also be taxed 20% or at a higher rate.

Similar to land value increment taxation, tax increment financing works on the principle that public infrastructure investment will increase the property values in that area. As a result of increased property values, income from property rates will increase. The municipality can then ring-fence that additional revenue to pay the debt service costs on a municipal bond issue which pays for the installation of the infrastructure in that area.

The key distinction between the two instruments is that tax increment financing is typically used to pay the debt service on municipal bonds issued to finance the infrastructure in that particular area, while LVIT is used to pay directly for the infrastructure. With TIFs, the local authority manages to leverage private investment by financing improvements to the area based on the future incremental revenue stream generated as a result of the private development.[37]

In essence, these two revenue instruments operate on similar basic principles of value creation and value capture, but may vary in terms of various *design features* (e.g. how the tax is calculated, the vehicle for levying the tax) and the *purposes* for which the funds are raised. As these practices have emerged around the world, they have also evolved into different permutations and have taken on different names or labels, which are not always used consistently. Because of their often overlapping forms and manifestations, we discuss these two instruments together.

Both LVIT and TIF appear straightforward in theory. However their implementation could be more complex, in terms of its technical and institutional arrangements. The following are three technical issues which arise in both instances:

[37] ADEC (2009), pg. 26.

Quantifying the land value appreciation

Quantifying the 'increment' or the difference between the market value of the property before and after the public infrastructure investment may be problematic. The MPRA requires municipalities to undertake a new municipal valuation role every 5 years. However it also allows for supplementary valuations which can be undertaken for any rateable property:

- "of which the market value has substantially increased or decreased for any reason after the last general valuation" (Section 78(1)d); or
- "that must be revalued for any other exceptional reason" (Section 78(1)f).

Presumably either clause could be used to justify a supplemental valuation to quantify the increase in property values in a specified area after the installation of public infrastructure (compared to the last general valuation).

However subsequent clauses in Section 78 create some confusion. Section 78(4)d) states that rates based on the supplementary valuations become payable on the date on which the event occurred which substantially increased or decreased the market value of properties in the area, as per Section 78(1)(d). In the case of public infrastructure investment which boosts property values in an area, Section 78(4)d would thus mean that the new rates based on the supplementary valuation would be effective from the date at which the public infrastructure was installed.

However Section 78(3)(a) earlier states that the supplementary valuation "must reflect the market value of properties determined in accordance with market conditions that applied as at the date of valuation determined for purposes of the municipality's last general valuation". Section 78(3)would therefore imply that the supplementary valuation should attempt to resurrect or model the value that the property would have had at the date of the last general valuation. In which case, this would mean the supplementary valuation cannot be used to reflect changes in market value due to public infrastructure development (as suggested in Section 78(4)(d)).

Defining the impacted area

Furthermore there would be questions of how widely to define the area impacted by the infrastructure investment. As discussed below, if the SRA mechanism under the MPRA is used, then the legislation requires the consent of the majority of landowners.

Sequencing revenue generation and expenditure

A further complication with the application of the land value increment tax instrument is the mismatch between the collection of revenue and the expenditure for which it is used. The municipality would only receive the tax revenue when the re-valuation of the property has been undertaken. However the financing for the new infrastructure is needed prior to the re-valuation. In the United States, this problem was addressed by raising municipal bonds to finance the new infrastructure i.e. tax increment financing. However if the municipality does not have a prior agreement with property owners (that they would pay), then there is not a guaranteed income stream which makes the bond credible and attractive in the market. The only available avenue currently available in the legislation would be the use of SRAs.

With these constraints and factors in mind, there are three broad scenarios for how such a tax could be calculated, levied and collected and used:[38]

Scenario 1: The municipality would consult with land-owners in the area and obtain their buy-in prior to the installation of the proposed public infrastructure. The land-owners would essentially agree to pay an additional levy for a specified time period to finance the cost of the infrastructure. The amount of the top-up would be linked directly to the cost of the infrastructure.

With the commitment from the land-owners in hand, the municipality then goes to the market to issue a bond to finance the infrastructure, leveraging the income stream from the top-up to pay the debt service costs. In this scenario, the tax takes the form of an annual levy instead of using the property rates mechanism. Therefore, the increased property value due to the infrastructure is relevant only because it persuades the land-owners to buy into the levy.

Scenario 2: The second option is similar to the first, except for two elements: Instead of the top-up being collected as a set annual charge for a specific time period, the revenue is collected as a differential rate on the increased land value due to the installation of the infrastructure. In order to achieve this, the municipality would need to use its rates policy to set differential rates for the specified area (defining it as an SRA). The regular Cent in the Rand rate would apply for the original value, while property rates payable on the incremental increase in value on the property would be levied at a higher rate, depending potentially on the size of the increment relative to the original value.

The property rates payable on the original value would be treated and used as regular property rates revenue is: for maintenance and operation of existing infrastructure and services. However the rates payable on the increment would be assigned to a separate fund set up to finance the costs of the public infrastructure in the area. (This separate fund can be set up as per Section of the NLTA, in the case of transport infrastructure). Because the SRA provision in the MPRA is used, the consent of the majority of the land-owners would be required, which would be part of the explicit commitment obtained from them up-front.

In contrast to the first option, in this scenario, the amount of revenue captured would be linked to the increase in land value (due to the installation of the public infrastructure) instead of to the cost of the infrastructure itself.

Scenario 3: In the third option, no additional levy or a differential property rate is applied to land in the area which benefits from the infrastructure investment. However the local authority decides internally to divide the regular property rates revenue from that area between 'core/existing' general municipal costs and the costs to provide the new infrastructure in that area. The additional re venue from the increased land value due to the infrastructure provision is ring-fenced to help to pay for new or upgraded infrastructure in the area. This approach can be undertaken without any consultation or notification of the land-owners presumably. The additional revenue could be used to offset the construction costs of the infrastructure *or* to leverage private loans for the capital costs of the infrastructure (i.e. pay the financing costs).

[38] The author is indebted to David Savage and Rob McGaffin for the development and discussion of these scenarios. In presenting these scenarios, we avoid labelling them as TIF or LVIT schemes due to the definitional questions discussed above.

In all of these scenarios, it is important to note that the success of TIF or land value increment taxation depends on the broader behaviour of the property market. While in most cases the installation of public infrastructure will increase the value of property in the area, this is not a given. Certain steps can be taken to maximise value creation, along the lines of better design, spatial planning, phasing etc. However, where the infrastructure creates negative externalities (such as traffic congestion, pollution or noise), property values may deteriorate instead of increase. Furthermore while the installation of public infrastructure in the area may have a positive effect, the effects of a broader economic cycles could outweigh its positive impacts and property values could remain the same or decline. Given that value capture instruments depend on value creation by public infrastructure, land value increment taxation is vulnerable to these dangers.

4.5 Betterment Taxes and Business Improvement Districts

The concept of special zones appears in multiple pieces of legislation related to local authorities: SRAs in the MPRA; internal service districts in the MSA; BIDs or CIDs in municipal zoning laws; and the Urban Development Zones tax incentive in the Income Tax Act. All of these mechanisms include the labelling of a specific geographic area for special tax treatment.

A betterment tax or special assessment involves the designation of a particular district where an additional tax is levied on property owners, the revenue from which is used to finance infrastructure projects. Typically betterment taxes are a once-off charge on properties which are set to increase in value with the change in their zoning.

In most cases, Business Improvement Districts are an ongoing additional levy in a particular area which is used to finance additional, ongoing services (e.g. greater security) for that specific district. In a BID or CID, an additional charge is levied on property owners within a specific portion of an urban area. Revenues are typically used to finance improvements which address crime and grime issues and thus improve the attractiveness and competitiveness of the area for businesses. Revenue from BIDs may also be used for various infrastructure improvements, such as signage, landscaping, surveillance cameras, marketing, management, and other services that benefit the property owners, businesses and residents of the designated area.[39]

All these schemes work on that same principle of collecting additional revenue from landowners in a defined area, in order to finance the provision of additional benefits to that area. The main differences relate to the purposes for which the funds are used (i.e. the type of special benefits provided in the area) and the vehicle for generating the revenue. The two basic options for revenue generation are:

- monthly or annual levy (levied for a set period of time, until the infrastructure is paid off, or on an ongoing basis, to pay for an ongoing service)
- surcharge of property rates via an increased Cent-in-the-Rand rate.

If betterment taxes, BIDs or CIDs utilise property rates to generate the additional revenue, then these schemes are essentially SRAs, as already provided for in the MPRA. However, Section 22(2)b of the MPRA only requires the written consent of a "majority of the members of the local community in the proposed special rating area who will be liable for paying the additional rate." This has been interpreted by most municipalities to be a simple majority (51%).[40] In order for SRAs to gain the required support, residents must see a direct benefit as a result of their increased payments.

[39] ADEC (2009), pg. 16.
[40] See discussion of SRAs in Tshangana (2009).

As discussed above, the MSA (Section 85) also provides for internal services districts. Provided there is consent from the majority of members of the area, the municipality can finance the additional service in that district by: setting a new tariff; setting a surcharge on an existing tariff; or increasing an existing tariff.

The two pieces of legislation different somewhat in their stipulations around the degree of required transparency and community input. For an SRA, a municipality **may** establish a committee representing the impacted community as a consultative and advisory forum on the improvement and upgrading of the area (according to Section 22(3) of the MPRA).[41] The MSA is more directive: the municipality **must** establish a committee of community representatives to act as a consultative and advisory forum to the municipality for each internal municipal service district (Section 85(3)d&e).[42]

5. Recommendations and Conclusion

An empirical analysis of the extent of the current use of VC mechanisms by local government (including the actual and potential revenue) is beyond the scope of this report. However it is safe to say that such mechanisms offer untapped potential for revenue generation at local level. Further, this paper has not included an analysis of the quantum of financing needed to support the necessary investment in public transport infrastructure in South Africa, and a comparison of current revenue and potential revenue from VC instruments. Yet it is clear that additional means of revenue generation by local authorities is vital to getting the necessary transport infrastructure in place in urban areas.

This paper has explored the legislative and policy framework and concludes that none of the VC mechanisms discussed in Section 4 would necessarily require an application by the municipality to the National Treasury for the approval of a new tax or levy, as per the process set out in the MFPFA. However a number of gaps or areas in the legislative framework need further clarification in order to create a more enabling environment for the increased uptake of VC instruments by LG:

- Although DC are already authorised in terms of provincial land use management ordinances and have been in practice for a number of years, amendments to the MFPFA and the approval of the draft policy framework developed by National Treasury would greatly facilitate the fair, transparent and effective use of development charges by more municipalities. The amendments to the MFPFA proposed in the Draft Policy Framework are needed to clarify the legal status, role and application of development charges.

- The Draft SPLUM Bill containing sections on DC raises a potential problem. Clarification on the roles and responsibilities of the two Ministries in regulating DC must be achieved, and these two documents must be properly aligned before their finalisation and political approval.

- As noted above, provisions for the establishment of special taxation zones appear in multiple pieces of legislation related to local authorities: SRAs in the MPRA; internal service districts in the MSA; BIDs or CIDs in municipal zoning laws; and the Urban Development Zones tax incentive in the Income Tax Act. Although this does not appear to have been a stumbling block as yet for municipalities, it could cause difficulties in the future if these

[41] Such a committee must be a subcommittee of the ward committee or committees in the area, if the municipality has a ward committee or committees in the area.
[42] The MPRA links directly back to the MSA: Section 22(5) of the MPRA also states that this section must be read with Section 85 of the MSA ‘if this section is applied *to* provide funding for an internal municipal service district established in terms of that section of the Municipal Systems Act.’

mechanisms are applied inconsistently. For example, at present, depending on the vehicle used, different levels of consent are required from potential taxpayers. The alignment of these pieces of legislation, and the potential need for national regulation of these tools, is another potentially important area for enquiry.

- As discussed above, at present its unclear whether the relevant clauses in the MPRA on supplementary valuation rolls would allow for their use as tools to assess land value appreciation. It may be that amendment to the MPRA is needed in this area in order to facilitate the use of LVIT and TIF schemes. This question needs further legal study.

- If it becomes clear that the SRA route could *not* be used to implement LVIT or TIF schemes, its possible the MPRA would need to be amended to allow for the permissible differentiation for rates on properties located within a special district.

Although the issues listed above represent possible legislative stumbling blocks for the municipal use of VC mechanisms, our analysis suggests that on the whole the greatest barrier to the use of VC mechanisms is not actually the current legislative framework, but municipal capacity. Most of these VC instruments entail complex planning and administrative processes which require technical skills e.g. the determination of the increment increase in land value. If the necessary systems and capacity are not present in the municipality, then these VC mechanisms will fail (not because the underlying principles have no basis).

The following are some of the most critical areas which need institutional strengthening in order to facilitate the use of VC mechanisms:

- The buy-in of land-owners to a TIF or LVIT scheme depends upon sound business models for the financing of the desired public infrastructure. Long term development plans must also be in place to demonstrate the rationale for the infrastructure investment. The municipality must be able to develop feasible models for project financing and demonstrate the financial logic which underpins the project. A successful bond issue also requires proper detailed market analysis.

- The additional levy must fall within the bounds of what land owners and developers are willing to pay, and not reduce their profit margin to the point where the project is no longer viable or attractive. In order to persuade developers and land-owners to pay an additional tax or levy, there must be sufficient evidence that their property values will increase due to the provision of the new infrastructure.

- The successful use of VC mechanisms also depends upon the proper costing of infrastructure projects. Given the difficulty municipalities are already experiencing with tariff-setting for services, its not guaranteed that skills for public infrastructure costing are sufficiently present in municipalities.

- Also from the municipality's perspective, the potential additional revenue must be compared to the overall costs of the new infrastructure and offset against the administrative costs (including legal costs and human resources) in levying the tax.

- Basic processes and systems for the efficient collection of revenue via existing instruments must be in place, before new instruments are introduced which piggy back on those systems. For example, LVIT depends upon a complete, accurate and credible valuation roll being in place. A well-functioning efficient tax administration system will ensure that the administrative costs of a new instrument will not overshadow the potential revenue gains.

- One of the common arguments against VC mechanisms such as betterment taxes is that affluent communities are more willing to pay this kind of tax. This can result in the concentration of infrastructure interventions in wealthier neighbourhoods. Given the apartheid spatial legacy, South Africa is particularly vulnerable to this danger. Public infrastructure projects and the VC mechanisms which are intended to finance them must therefore be incorporated into the municipality's long-term vision, SDF and IDP. This will ensure that the adoption of these mechanisms and the financing of infrastructure in certain areas will strategically benefit growth of the city as a whole, instead of exacerbating spatial inequalities.

The analysis from this report suggests that TIF and LVIT schemes, BIDs (or betterment taxes) and development charges are the VC mechanisms which offer the greatest potential for application in South Africa's municipalities. Further work to clarify and strengthen the legislative and policy framework will facilitate their application.

However the biggest barrier to their application at present remains municipal capacity and systems. Strengthening local government capacity and systems such as valuation rolls, billing systems, and credit control, is critical for two reasons. First unless proper systems are in place, the municipality will be unable to garner the maximum possible income from revenue instruments which are already in place, such as property rates, electricity charges, etc. Before adding new revenue instruments, municipalities would do well to improve the efficiency of current revenue instruments.

Second, the basics must be put in place—improved debt collection systems, better budgeting and accounting to reflect the true cost of providing services and infrastructure, and more accurate land valuation—to serve as the enabling engine for the successful application of VC mechanisms. These barriers are worth addressing because VC instruments offer great potential to relieve the shortfall in infrastructure financing needs of municipalities. At a more basic level, VC mechanisms can fortify the relationship between the consumer and the municipality by reinforcing the direct benefits experienced by taxpayers, thus ultimately enhancing accountability and improving service delivery.

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