



**Value Capture in South Africa –
A way to overcome urban
management challenges and
unlock development
opportunities?**

Prepared by Rob McGaffin, Mida Kirova,
Francois Viruly and Kathy Michell

UCT-Nedbank Urban Real Estate Research Unit

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UCT-Nedbank Urban Real Estate Research Unit
Department Construction Economics and Management
University of Cape Town
Private Bag X3
Rondebosch 7701
South Africa
Tel: +27 (21) 650 3443
Email: julie.thompsett@uct.ac.za
URL: www.ureru.uct.ac.za

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1. Introduction

South African cities face three broad challenges. The first is that the country is becoming increasingly urbanised and therefore cities need to equip themselves with the necessary services and facilities to accommodate this growth and to drive the economy. Secondly, our cities contain large concentrations of poverty and service provision backlogs. Lastly, the structure and form of our cities result in them being inequitable, inefficient, and environmentally and fiscally unsustainable. All three of these challenges require a sustained and innovative focus on how we manage our cities. Central to this management is the provision and maintenance of key infrastructure. This paper outlines the urban management problem relating to funding infrastructure and introduces a possible way in which this challenge can be addressed.

2. The infrastructure challenge

Due to its nature, infrastructure generally has to be delivered at scale, which means it is capital intensive and has to have long repayment periods. This form of delivery is unfortunately incongruent with the nature of property development, which tends to be delivered incrementally at a smaller scale over time, with much shorter repayment periods. To address this mismatch, the state has conventionally provided infrastructure and then recouped the capital and operational costs over time through development contributions, property taxes and user tariffs. However, this model is increasingly coming under strain for a number of reasons.

2.1 Fiscal squeeze

Firstly, there is an increasing squeeze on public finances resulting from declining revenues and increasing obligations to address backlogs and poverty. To appreciate the funding challenge facing municipalities, one needs to understand how public finance is sourced and spent.

2.1.1 Sources of municipal revenue

Broadly, municipalities are funded from their own revenue sources and national transfers (equitable share and grants) – see Figure 1. Own revenue sources include service charges (e.g. water, electricity etc.), property taxes, borrowings (e.g. municipal bonds etc.), and the share of the fuel levy and fines. The revenue generated from property rates is particularly important, as besides being one of the largest local sources of revenue, cities are able to allocate this revenue according to their priorities, unlike revenues from service charges that have to be ring-fenced to pay for those services.

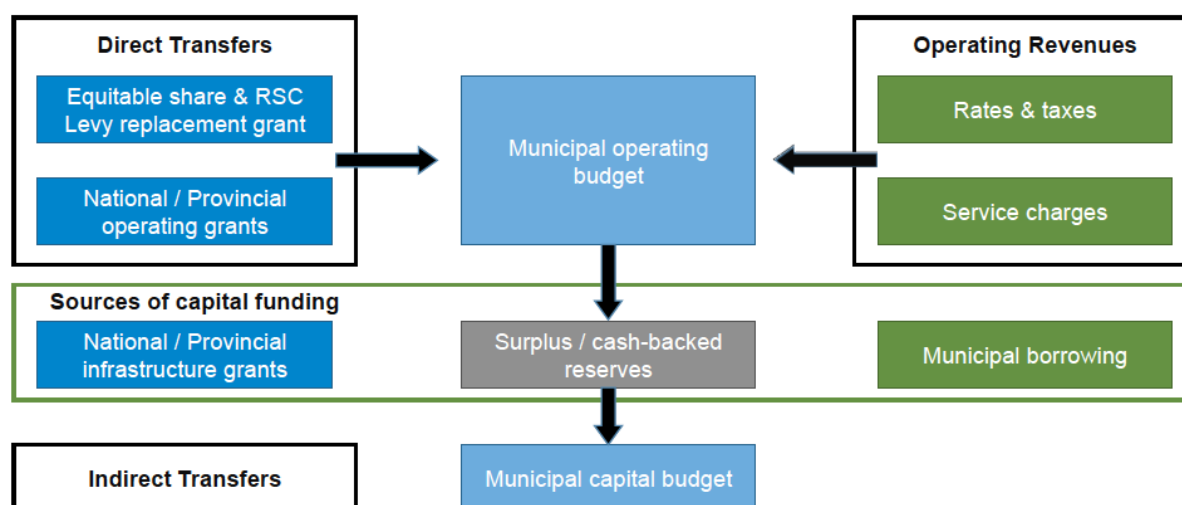


Figure 1: Funding of capital and operating budgets (SACN, 2015)

National transfers to provinces and municipalities are made based on their respective functions and responsibilities stipulated in the Division of Revenue Act (DORA) and take the form of the equitable share transfer and various conditional grants. The equitable share and conditional grant allocations to local government currently make up approximately 9% of the total division of revenue. The amount of the equitable share received by a municipality is based on their size and the developmental challenges they need to address. The intention is that this revenue pays for services to poor households and that non-poor residents are funded through revenues collected from property rates and service charges. However, conditional grants¹ must be spent on specified items such as transport and housing, and municipalities must meet certain criteria to receive them.

Moreover, the ability of national government to fund municipalities through national transfers is being constrained by the pressure on national revenue collection. For example, the gross tax revenue was revised downwards by R35-billion between

¹ The main city-specific conditional grants made available by government are:

- The Urban Settlements Development Grant. This grant is allocated only to the eight metropolitan municipalities. It replaced the Municipal Infrastructure Grant for cities (MIG Cities) in 2011/12 and is intended as supplementary funding that metros can use to fund informal settlement upgrades.
- Human Settlements Development Grant. This grant is used to fund the provision of subsidised housing.
- The Public Transport Infrastructure and Systems Grant. The grant aims to help cities create new and improve existing public transport (including provision of infrastructure for the bus rapid transport system) and non-motorised transport infrastructure.
- The Neighbourhood Development Partnership Grant. This grant aims to create a platform for third-party public and private investments to improve the quality of life in township urban hubs.
- The Integrated Cities Development Grant. This grant aims to incentivise the metros to integrate and focus their use of all available infrastructure investments to achieve a more compact and efficient urban spatial form.

Source: South African Cities Network, 2015

2015/16 and 2017/18 due to the steep decline in commodity prices and corporate income tax collection. As a result, the rise in infrastructure expenditure since the economic crisis in 2008 has been sustained by an ever-increasing dependence on debt, which is a concerning trend in a low growth environment with debt service costs being one of the fastest growing expenditure items on the budget. In response to this, the state is aiming to reduce the budget deficit from 3.9% of GDP in 2014/15 to 2.5% in 2017/18 and to stabilise the growth of debt as a share of GDP at 43.7% by 2017/18.

2.1.2 Municipal expenditure

Municipal revenue is spent on operating and capital items. Operating expenditure is related to running a city and includes amongst others, bulk purchases (e.g. water and electricity), employee-related costs, and repairs and maintenance. The operating budget is largely funded by internal sources of revenue, such as property rates and service charges.

Capital expenditure, on the other hand, includes the provision of new infrastructure, the majority of which is channelled towards investment in roads, water, electricity, and sewerage systems, and is funded from national and provincial transfers, internally generated revenue and municipal borrowing. It is important to note that while some of those capital investments translate directly into service charges, others such as roads do not. This has implications for the types of financing mechanisms that can be employed to finance them.

Numerous pieces of national legislation² govern how municipal revenue must be collected and spent, with regulations governing municipal rates, surcharges and other taxes, and how municipalities raise loans for capital or operating expenditure. As municipalities have to increasingly self fund their budgets, alternative sources of

² The following key pieces of legislation govern the various sources of municipal revenue:

- The Intergovernmental Fiscal Relations Act (97 of 1997) prescribes the process for the division of nationally raised revenues between the three spheres of government.
- The Municipal Structures Act (117 of 1998) provides for the establishment of different types of municipalities and the division of powers and functions between local and district municipalities.
- The Municipal Systems Act (32 of 2000) sets out the requirements with regards to integrated development planning, community participation, performance management, administration, service provision and debt collection.
- The Municipal Finance Management Act (56 of 2003) provides for the sustainable management of local government and sets out processes for municipalities to implement standardised budgeting, accounting and financial management practices.
- The Municipal Property Rates Act (6 of 2004) establishes a uniform property rating system across the country.
- The Municipal Fiscal Powers and Functions Act (12 of 2007) regulates the ways in which municipalities may impose surcharges on fees for services and provides for the authorisation of taxes, levies and duties that municipalities may impose.

revenue are being sought within the parameters of these complex pieces of legislation.

2.1.3 Municipal finance challenges

As infrastructure provision and maintenance demands escalate with rising levels of urbanisation and increasing pressure to stimulate economic growth, municipalities are faced with a number of challenges when it comes to financing their capital and operating budgets.

Firstly, municipalities are increasingly becoming dependent on national government transfers to fund their infrastructure investment, with 54% of capital financing for municipalities currently coming from national government grants. This dependence is particularly problematic in light of the decrease of national transfers over the medium term.

Secondly, additional responsibilities are being transferred from national to local government as processes are underway to devolve certain functions with respect to housing and transport to municipalities, which if not accompanied by the commensurate financing, pose the risk of compounding the current extent of unfunded mandates.

Thirdly, between 2008/9 and 2013/14, local government operating expenditure grew by a real annual average rate of 7.2%, primarily as a result of the increases in electricity bulk purchases and employee costs. As a result of these increases, cities have not been able to allocate adequate funds towards repairs and maintenance of existing infrastructure, which is likely to lead to further costs in the medium term.

Fourthly, while the 2015 budget maintained the baseline equitable share allocation, the baseline allocation for the conditional grants has been reduced by approximately R3.85-billion over the 2014 Medium Term Expenditure Framework.

Fifthly, although development contributions are a well-known levy imposed on developers to pay for infrastructure requirements resulting from additional and expanded land uses, they have often been implemented in an ad hoc and inconsistent manner resulting in confusion and inadequate revenue being raised. As a result, the National Treasury introduced a draft Policy Framework for Municipal Development Charges in 2011, but this has yet to be finalised and adopted.

Lastly, in some cases, municipalities are reaching their general obligation borrowing limits, which they cannot exceed without potentially negatively impacting on their credit rating and cost of capital.

2.2 Expenditure prioritisation

The second infrastructure challenge is that South African cities have to balance investing in new infrastructure to stimulate economic growth, maintaining existing infrastructure and correcting infrastructural backlogs resulting from historical under-provision in marginalised areas, all within a context of rapid urbanisation and an increasingly constrained fiscal environment. This is obviously a political, fiscal and economic juggling act.

2.3 Restructuring inequitable and inefficient cities

Thirdly, not only do municipalities have to address infrastructure backlogs but they also need to address the fact that South African cities are characterised by segregation, urban sprawl and low densities, which results in them being inequitable, inefficient and unviable. This in turn, causes high costs and hardships to households, communities, businesses and the state. As a result, municipalities are under pressure to bring about cities that are more integrated, dense and compact.

2.4 Risk

Based on the above challenges, it is broadly agreed that municipalities need to finance a greater share of their operating and capital expenditure from internally generated revenues. This creates the fourth infrastructure challenge facing municipalities. As a significant percentage of locally generated revenue is earned from property taxes, this source is vulnerable to the performance of local property markets.

For example, it is sometimes argued that municipalities should finance infrastructure expenditure by borrowing more on the back of their property rates base. However, as the property market is driven by numerous factors, there is no guarantee that the property market, and hence the rates base, will grow sufficiently to meet the debt repayment obligations. Therefore, it is questionable whether local government should take on this risk when it generally doesn't have the mandate, skill or capacity to manage the risks associated with the property market.

In response to the four infrastructure challenges outlined above, National Treasury, in partnership with local government, is intervening as follows:

- Putting in place programmes to build municipal financial capacity, focusing on improving the planning and implementation of infrastructure projects and streamlining local government spending of allocated infrastructure budgets, as well as providing support to municipalities in engaging with the private sector.

- Introducing a new capital budgeting framework over the medium term setting out a methodology for evaluating proposals for large infrastructure projects, ensuring value for money in service delivery.
- Reviewing local government infrastructure grants with a view to rationalising the number of grants that each municipality receives, including, seeking greater alignment with planning through the Built Environment Performance Plan process, introducing life-cycle asset management to sustain the functionality of existing infrastructure, strengthening administrative oversight in the allocation of grants, and standardising reporting to improve accountability.
- Exploring the use of “value-capture” mechanisms to raise additional locally generated revenue.

The remainder of this paper will define what value-capture is and discuss whether it can assist in overcoming the challenges outlined above.

3 Value capture as an approach to address the above challenges

3.1 Value capture defined

Value capture is a term used to describe the process of extracting (in different ways) the additional value that accrues to a property following different types of public investment (e.g. The Gautrain). The value extracted is therefore the value over and above the value the property would have had without the public investment. The additional value created by the investment is often termed the “value increment”. Since the additional value was created because of the state’s actions rather than the owner’s, it is arguably justifiable for the state to lay claim to this additional value through various mechanisms for some public purpose. In fact, it can be argued that a failure by the state to capture some of that value would equate to the public sector effectively transferring benefits to the private sector from the public fiscus, which is inequitable and inefficient. It is not a new concept and has been implemented in various forms across the world.

Essentially there are five main elements involved in the value capture process:

- i) The government investment that creates a value creation opportunity.
- ii) The realisation of the value creation opportunity usually through the application of private sector investment and expertise.
- iii) The calculation of what proportion of the overall value increase is attributable to the state intervention, changing market conditions and private investment. This exercise can be

contentious as it is often unclear what is deemed standard versus above normal investment by the state.

- iv) The actual ‘capture’ of some of the additional value by the state through a mechanism, which may include an in-kind contribution by the private sector.
- v) The investment of the captured value by the state. For example, to fund the original infrastructure implemented.

3.2 Key value capture mechanisms

Value capture mechanisms can be broadly categorised into two groups, namely: use-related mechanisms and income-related mechanisms. Although it is important to note that some mechanisms can be used to achieve objectives related to both use and income generation.

3.2.1 Use-related mechanisms

The objective of use-related value capture mechanisms is to achieve a non-financial public benefit usually related to urban regeneration or spatial transformation, financed directly from the private sector’s increased value. This is typically in the form of directing a certain land use to a specific location or achieving certain spatial outcomes, such as higher densities. Many use-related mechanisms tend to be regulation focused and include the following:

Table 1: Use-related value capture mechanisms

| | | |
|----|---------------------------------------|--|
| 1. | Density Bonuses | A zoning-based incentive aimed at encouraging developers to provide certain public amenities or to meet certain public objectives in exchange for allowing greater floor area and/or building height. The idea is that the additional revenue that the developer could generate from the sale of additional units would compensate for the inclusion of affordable housing or unprofitable public amenities. |
| 2. | Air-Rights | The granting of air rights above public infrastructure to the private sector could be aimed at encouraging the provision of public amenities, affordable housing, encouraging greater densities and increasing the City’s tax base. |
| 3. | Tax Abatement | This is a reduction or exemption from taxes for a specific period of time in a designated area, usually to stimulate investment in locations with lower demand. An example of this in South Africa is the Urban Development Zone. |
| 4. | Lease or Disposal of State-owned Land | Instead of maximising the market value of the land sale or lease, the state may choose to prioritise other policy objectives, such as affordable housing in well located areas. However, such leasing or disposal could also represent an income-generating opportunity. |
| 5. | Land-adjustment | Landowners pool their land together for reconfiguration and |

| | | |
|--|--|--|
| | | redevelopment, and contribute a portion of their land to raise funds to partially cover the public infrastructure development costs. Transit-Oriented Development land readjustments have been widely used in countries such as Japan to secure land, share infrastructure costs with the private sector, and to achieve a desired urban form. |
|--|--|--|

3.2.2 Income-related mechanisms

In contrast, income-generating mechanisms involve the recouping of financial benefits by the state, typically to finance capital investment, although some mechanisms are also suited to the generation of revenue for operating expenses. These types of mechanisms benefit from being able to leverage private sector demand and usually extract income from the value increment in the form of a user charge or tax and include the following:

Table 2: Income generating value capture mechanisms.

| | | |
|----|--|--|
| 1. | Development Charges | A well-known levy imposed on developers to pay for infrastructure requirements resulting from additional and expanded land uses |
| 2. | Business or City Improvement Districts (BIDS/CIDS) | These are delineated zones where an additional charge is levied on properties to finance top-up services to supplement the standard services provided by the state, often focused on security and cleansing. They often perform additional roles, such as area marketing, which together with the increased security and cleanliness, have demonstrably resulted in increased property values. |
| 3. | Tax Increment Financing (TIF) | TIF schemes enable municipalities to borrow against the future anticipated incremental tax revenue (property rates in South Africa) that would be generated within a specific geographic area as a result of the construction of large-scale infrastructure. |
| 4. | Special Assessment Districts (SAD) | These are similar to TIFs except that the income that is used to repay public funds or borrowings is in the form of a levy that has been agreed to upfront with the affected property owners within the SAD. This reduces the financial risk for the municipality, which instead is spread amongst the property owners. |

There is increased interest in Tax Increment Financing (TIF) in South Africa and therefore this mechanism is further elaborated upon. In summary a TIF works as follows:

- A site or precinct is identified that has (re)development potential.
- The property taxes payable as per the site's existing use are determined.
- Based on market conditions, the full development potential of the site is calculated.
- The infrastructure requirements to develop the site to this potential are determined and priced.

- The property taxes that would be paid if the site were developed to its full potential are calculated.
- The difference (the increment tax) between the existing property taxes and the potential property taxes are calculated.
- To compensate for the time lag between the infrastructure investment and the ability to extract the increment value from the rates and taxes, municipalities look to raise a public bond on the back of the expected increment income that would accrue as a result of the infrastructure investment.
- The size and phasing of the bond are determined based on the size of the increment tax generated.
- The increment tax is ring-fenced to pay for a TIF bond.
- The bond is issued and the proceeds used to fund the required infrastructure.
- Once the bond has been repaid, the increment tax is “unfenced” and is added to the general property tax revenue pool.

The question is why should municipalities and developers use such an instrument when it may be simpler for a municipality to rather issue a standard “general obligation” bond to fund some required infrastructure? The arguments in favour of using a TIF include:

- TIFs are often used to fund infrastructure needs that arise on the back of a development opportunity created by certain market conditions in certain parts of a city and this infrastructure investment may not have been budgeted for or be part of a short to medium term public expenditure priority.
- Following on from this, it may be difficult to justify using a municipality’s borrowing capacity (gearing level) to fund infrastructure that is not addressing basic need backlogs and other restructuring priorities. The use of a TIF overcomes this hurdle because, provided it is deemed to be off-balance sheet, it will not reduce the ability of a municipality to go to the market to raise general obligation funds to finance its budgeted for priorities.
- TIFs also potentially transfer some of the market risk to the private sector, which is much better equipped to measure and price it. Funding infrastructure through a general obligation bond, which is then repaid from the normal property taxes that arise on the development that results, can be a risky exercise for a municipality. This is because the municipality is reliant on the property values, and hence taxes, increasing sufficiently to meet its debt obligations. However, market conditions may prevent this from happening, resulting in the taxpayers having to partially foot the bill for a specific property development. By raising a ring-fenced TIF bond, the market risk is passed to, or at least shared with, the private-sector bondholders who stand to benefit from a successful property development.

3.2.3 Testing TIF in SA

Notwithstanding the abovementioned potential benefits of using TIFs, an investigation into their use in South Africa identified a number of challenges and issues:

- The provision of bulk infrastructure often occurs in standard units and sizes that come at a considerable cost but which also may exceed the requirements of the development. The question is, who funds this additional capacity or more importantly, how can the excess capacity be sold to third parties to assist in the payment of the infrastructure?
- Sites with multiple land-owners present a challenge in structuring and negotiating a deal and getting buy-in from everyone.

Furthermore, from a municipality's perspective, a number of issues exist:

- TIF is not expressly provided for in the existing legislation, which presents various uncertainties with respect to the TIF structure and process, including legal questions around billing systems, debt collection, the designation of the TIF district and requirements for public participation.
- TIF presents administrative risks as the skills and structures that are necessary to administer it effectively may not be in place. The administrative burden would be exacerbated by the need for regular supplementary valuation rolls in order to ensure that increases in property values are captured in increased rates.
- Of particular concern to the municipality is whether a TIF bond raised through a financial institution would be considered as an on- or off-balance sheet item on the municipal budget. An off-balance sheet structure would be preferable as it would not be considered as debt of the municipality by the lending institutions and would therefore not impact the municipality's credit rating.
- However, in terms of the South African government's current application of accounting standards, a bond issued by a municipality and secured only by incremental tax revenues would have to be an on-balance sheet structure with limited recourse. In terms of the current legislation, off-balance sheet status can only be achieved if an entity that is independent of the municipality, such as a Special Purpose Vehicle (SPV), issues and is responsible for servicing the bond. In that case, the municipality would have to rescind its rights and entitlement to the incremental tax revenue to the SPV, although the risks associated with the collection of the incremental tax revenue would pass to the SPV as well. However, the transfer of a municipality's rights in respect of property rates revenue presents complex legal issues that are not adequately covered by the MFMA or any other legislation regulating local government. There is an opinion that off-balance sheet status could only be achieved through a legislative amendment of the MFMA and an amendment of the existing accounting standards. Explicit national legislation providing for TIF would be a beneficial next step in promoting TIF as a funding mechanism for municipal economic development.

3.2.4 Pre-conditions for the successful use of value capturing mechanisms

Value capture mechanisms are often complex tools to structure and put in place, requiring extensive negotiations between the public and private actors involved. Furthermore, different variations of the same mechanism can occur when implemented in different economic, institutional and legal contexts. Nevertheless, there are a number of key principles that arguably apply across the board that should be observed to facilitate their successful implementation:

- The objectives and non-negotiables of both the public and private players must be clear, unambiguous and understood by all parties from the outset.
- Since value capture is complicated and can put a significant administrative strain on a municipality, it is important to ensure that an improvement of existing funding instruments could not achieve a similar outcome.
- Strong financial, administrative and legal systems and expertise, including project management, transaction structuring capability, effective revenue collection, comprehensive valuation rolls and sound fiscal management must be in place.
- Where income-generating mechanisms are utilised, it is important to distinguish between whether the income is collected as a tax or a user charge, as this will have implication for how the mechanism is structured and which enabling legislation applies.
- The majority of value capture mechanisms, particularly the income-generating ones, are only likely to be successful if the market and site conditions are conducive to value creation.
- It is important for all parties to demonstrate their long-term commitment in order to instill trust and confidence in the project and to diminish uncertainty. Equally important is for both the public and private players involved to be flexible to changing circumstances (which is arguably not common practice currently in South Africa), bearing in mind that value capture is sensitive to market conditions.

Although the South African legislation does not prohibit the use of many of the abovementioned mechanisms, they were not drafted with many of these instruments in mind. Consequently, for value-capture to be successful and for the full benefits to be realised, legislation such as the MPRA, MFPFA and MSA need to be reviewed, streamlined and where needed, a number of ambiguities removed. This is especially in the case of how tax districts are delineated and how and when increment values will be assessed. Encouragingly, the National Treasury is currently undertaking this review process.

Ring-fencing of revenue is another critical issue with regards to the use of value capture in South Africa. Since the viability and success, particularly of the income-generating mechanisms, depends to a large degree on the ability to directly link the user charge or tax to the benefit received, ring-fencing becomes a key element.

However, it can also be problematic as it may diminish a municipality's ability to set budget policy and priorities. Furthermore, the ring-fenced funds are often exempt from the reporting standards that are typically required from the annual budget process and therefore have a lesser degree of transparency and accountability. For these reasons, National Treasury prohibits ring-fencing for municipalities, although alternative approaches can be employed to a similar effect, such as through the creation of limited recourse vehicles.

The key question to be asked is whether the state has the necessary capacity and skills to negotiate and structure value capture instruments; whether the private sector has the awareness and appetite to partner with the state in this regard and whether the market conditions are conducive to the creation of value in the first place.

4 Can value-capture address the identified infrastructure challenges?

Clearly value capture mechanisms, particularly those that are income generating, have a role to play in addressing the infrastructure challenges outlined in this paper. To begin with, they can assist municipalities in raising local revenue. In addition, they can enable municipalities and the private sector to respond to development opportunities that are dependent on non-budgeted infrastructure investment. Similarly, they reduce the need for municipalities to make trade-offs between infrastructure investment needed for economic development and the redressing of historical imbalances and spatial transformation. Furthermore, under certain circumstances, they can increase the borrowing capacity of municipalities without impacting on their gearing limits and credit rating. Lastly, the risk associated with raising funds off the property market can be shared with the private sector that is often better equipped to assess and mitigate such risk.

However, for the potential of value capture to be realised, the preconditions for its success outlined above must be put in place by the state. There must be an appetite by the private sector to use value capture to finance infrastructure and the capital markets must invest in such instruments. Importantly, there are many unknowns associated with the use of value capture mechanisms in South Africa. Hence, a flexible, partnership-based approach is needed by both the state and private sector to engage with and address the issues and challenges that will emerge as these mechanisms are used. This will require a mind-shift by both parties and a more constructive working relationship, based on a better understanding of each other's obligations and constraints, to be cultivated.

5 Conclusion

The increasingly constrained fiscal environment in South Africa leaves local municipalities with little alternative but to become more creative in exploring different sources of revenue for infrastructure investment. Partnering with the private sector on value capture initiatives presents a possible way for the public sector to finance infrastructure and for the private sector to take advantage of development opportunities in areas where none would have existed otherwise. These arrangements will have to be embedded within a culture of shared responsibilities, with municipalities taking responsibility for raising funds, planning and implementation for infrastructure and service delivery; the private sector taking the lead in providing investment in exchange for fair returns; and national government for providing a stable and predictable fiscal regime.

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