Discussion Paper

Property Value Capture in South Africa –
On Property Rates and Tax Increment Financing

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Contents
Foreword ........................................................................................................................................... 2
A Basic Theory of Property Value Capture .................................................................................... 2
The Property Tax as the Basic Instrument ..................................................................................... 3
Related Cash- and Risk-Management .......................................................................................... 4
  Tax Increment Financing (TIF) as an Adapted Instrument ......................................................... 5
  A Portfolio of Management Options .......................................................................................... 6
Property Value Capture in South Africa ....................................................................................... 7
The Legal Framework for Property Taxation ............................................................................... 8
Empirical Evidence for South Africa ............................................................................................. 10
Tax Increment Financing in the USA ............................................................................................ 14
Summary and Conclusions ........................................................................................................ 16
References ....................................................................................................................................... 17
Foreword

In this discussion paper, I have – again – tried to follow the principles of “Action Research”\(^1\). Action Research aims at solving an acute social problem by guiding a reflective process of suitable knowledge creation in a system or community of practice. This type of research invites stakeholders to actively participate in a social change process. Hence, there are two processes in inter-connection and inter-action:

\[
\text{Knowledge creation} \leftrightarrow \text{social change.}
\]

The field of study that we are active in is that of funding local public infrastructure. The specific problems that we deal with are apparent or perceived lacks of volume, fairness, equity, efficiency or effectiveness in the funding. The main specific questions that we ask are:

- How can or should property value capture be a guideline for local public infrastructure funding in South Africa?
- How can or should property taxation be a related instrument?
- How can or should tax increment financing (TIF) be such an instrument?

This discussion paper has been developed in a cooperation between SALGA and GIZ. Other stakeholders have been included. – My thanks go to all of them.

Nevertheless, the posed problems have by far not yet been solved. The Action Research process thus should go on. All stakeholders are still cordially invited to participate.

A Basic Theory of Property Value Capture

The values of (real estate) properties depend on the infrastructure that they are connected to. The infrastructure enables owners or residents to get into exchange with each other – economically or socially. It thus increases their productivity or their cohesion.

Typically, infrastructure is a public good, which means that individuals cannot be excluded from its use; and in their use, they do not rival with each other. Therefore, it has become a government task to provide infrastructure. If the impact of a specific infrastructure item is local, then it is the task of the respective local government to provide it.

An inherent problem in the provision of public goods is free-riding. Individuals can basically use them without paying. To solve this problem, a government has got the power to tax. For the specific case of local public goods, the local government has got the power to tax

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\(^1\) For more see: Burns (2007); Greenwood/ Levin (2007).
property. Since (real estate) property is immobile, owners can hardly avoid to pay this tax. Hence, it is considered a very strong and effective government instrument.

In theory, one may affirm that the property tax is fair. The reasoning goes as follows, taking a park as an example:

If a local government invests into a park, then it has to bear the costs of this investment. In specific, it has to pay the gardeners that keep the park well-kept and attractive. However, it may not be efficient or fair to build a fence around the park and to demand an entrance fee from visitors. They thus could enter for free and socially engage and recover for higher productivity; and these are just two ways in which they benefit from the park. Normally, the visitors will be the property owners or residents out of the neighbourhood. They can freely benefit from the park because they live within its vicinity.

What thus happens is that the benefits from the park capitalize into the property values of the neighbourhood. The properties become more valuable because they also give access to a local public good – to a park that the local government has invested in.

The government’s claim to be compensated for its investment costs, based on the value that it has created for others, is called “value capture”.

The Property Tax as the Basic Instrument

The basic instrument for local government to execute property value capture is the property tax. This tax can be judged as fair in the sense of the “benefit principle”. Citizens pay for a public service to the degree that they (potentially) benefit from it. – The more property owners benefit from a park, the more these benefits capitalize into the values of their properties, the more they have to pay in property taxes.

Based on this theory, it seems rather easy to justify this type of tax. In practice, however, it has shown to be rather difficult to implement. The reasons for these difficulties lie in some special characteristics of (real estate) property; which are:

1. Real estate is immobile; it is bound to a specific piece of land. Each piece of land is unique – also in the benefit that it offers.
2. A real estate can be designed and created individually. It thus can get a very specific functionality.
3. A real estate is normally a long-term investment. However, the maximum duration of useful life depends on the initial quality of the structure and the investments in maintenance that are made.
4. A real estate is an extremely illiquid form of capital; which means that it cannot be transformed so easily into any other form.
5. The transaction of a real estate incurs relatively high specific transaction costs. Difficult parts of the transaction are in particular:
   a. To assess the quality of the real estate;
b. To include all relevant aspects into the contract;
c. To execute all the rights and obligations;
d. To monitor the execution;
e. To move tangible and non-tangible assets from one location to another.

Therefore, the (fair) value of a real estate is difficult to measure. To get as close as possible to that value, there are three basic approaches:

1. The “sales comparison approach”: The valuer compares the characteristics of the property to be measured with those of other properties that are similar and of which the values are already known, because they have been recently sold. She infers from these values to the searched value; with some corrections, due to the given differences in characteristics.
2. The “cost approach”: The valuer sets up a model in which the land is vacant. Then, she calculates what it would cost to:
   a. reproduce the same estate; or
   b. replace it by a different one which – nevertheless – offers the same benefit.
3. The “income approach”: The property is regarded as an investment object. The valuer predicts its cost and income streams and calculates its capital value out of them. As indicators, she may use, for instance, the Net Operating Income (NOI) or the Net Present Value (NPV).

Moreover, for the purpose of property taxation, in the sense of the benefit principle, it needs to be found out which is the share of the value that comes from local public services. To break down the value of a property into different value factors or contributors, one can use for instance a method called “hedonic pricing”. However, this method is also very demanding with respect to the assumptions, conditions, data and application. Altogether, the probability of error in measuring the property value share from local public services can become considerably high.\(^2\)

Because of all the difficulties in the implementation of property taxes, property owners tend to encounter their tax bills with special scepticism or aversion. To reduce this tendency, the local government should invite property owners to participate not only in the legislative but also in the implementation process. Participation might improve the valuation conditions, the collection of data, the valuation results and generate understanding, consensus or, at least, acceptance.

Related Cash- and Risk-Management

Further difficulties in the funding of infrastructure investment by property taxes lie in the generation and coordination of cash flows. As it is typically the case for investments, the investment into a local public good will first incur some cash outflows, before it generates

\(^2\) See Isaac/ O'Leary (2012).
cash inflows. – In our example of a park, the municipality first needs to pay for a fountain and its connections, its water and so on, before property owners benefit from it and the values of their properties rise.

What the municipality can do to coordinate its cash flows is to borrow money. A borrowing transaction typically generates a cash inflow, before it claims outflows. As a result of an optimal cash management, a cash outflow would always (exactly) be covered by an inflow – in time and amount.

Surely, the municipality will also pay a price for its cash management. If it borrows money, it will be in particular the interest rate. However, this price can be considered as a part of the investment; which generates a benefit and thus also is capitalized into the property values.

Nevertheless, in such an investment, funded by property taxes, the risk stays with the municipality. – If a storm destroys the roses in the park, then the municipality has to carry the loss.

**Tax Increment Financing (TIF) as an Adapted Instrument**

In order to distribute the risks from investments in public goods more equally, fairly or efficiently, a funding instrument has been developed, called: 

“*Tax Increment Financing (TIF)***”. 

TIF claims financial contributions to a public good investment from the beneficiaries in advance, based on their expected (incremental) benefit.

Their contributions may be in the form of:

1. A guarantee: Property owners pay instalments of the investment loan, if the municipality is unable to.
2. An advance tax payment:
   - The property owners pay once-off so that the municipality can pay out of a financial reserve.
   - The owners pay specifically with respect to forthcoming investment claims.

Thus, municipality and property owners make a form of credit arrangement; in which the latter:

- carry some of the investment costs, in advance;
- assume some of the investment risks;
- adopt further responsibilities;
- also get some additional rights of participation, in particular on:
  - the planning, execution, monitoring and evaluation of the infrastructure investment;
  - the financial management.
Hence, with TIF, opportunities and risks should become more equally distributed between municipality, property owners and capital markets.

In our example, this could mean:

The municipality and property owners decide together which types of flowers to plant in the park. The property owners then make an upfront tax payment. The municipality borrows further needed money on the capital market. It commissions a garden company to plant some special roses. The garden company delivers and invoices the municipality. Months later, a heavy storm hits the park and destroys the roses. The financial loss is born by the municipality and the property owners. They jointly decide on whether to make a new investment into roses.

A Portfolio of Management Options

Next, let us look at the cash- and risk-management options within property value capture in a broader perspective:

We define value capture as a government’s claim to be compensated for its investment costs, based on the benefits that it has generated for the specific beneficiaries. In the case of a local public investment in infrastructure, the beneficiaries are property owners. The basic instrument for property value capture thus becomes the property tax.

In its investment, the local government first has to face costs or expenditure, before it can generate revenue out of it, before it collects its property taxes.

In order to coordinate the cash-inflows with the outflows and to manage risk, the government has at least four options:

1. To borrow money on the capital market;
2. To practice TIF;
3. To exchange with other own revenues/ to (internally) cross-finance;
4. To get external transfers.

Ad 1.)

If a municipality borrows money to fund its infrastructure project, it brings in a third party. The lender wants to make sure that he is compensated for his service. Thus, he claims an interest and sureties. The height of the interest and the types and values of the sureties will depend on the borrower’s credit worthiness. The lower the credit-worthiness is, the higher the interest and the value of the sureties will have to be. One specific type of surety that the lender could claim is a priority right for certain revenue streams of the borrower. The municipality would, for instance, need to ring-fence or ear-mark its revenue from property rates and give it to the lender until the debt has been redeemed.

Ad 2)
With TIF, a municipality tries to involve those into its cash and risk management, for which the investment is meant: the community, or more specifically the benefiting property owners. Thus, it claims advance payments (in the form of property rates) or risk assumption from them. In a broader sense, these claims can be regarded as another type of borrowing, however, from the second party in the investment project, not a third one. Hence, the types and amounts of interest and sureties that the property owners will claim in exchange will typically differ from those of a third-party lender. The municipality might need to grant its property owners particular rights on:

- The transparency of and participation at its policy;
- The use of the tax revenue; in particular, the ring-fencing of and ear-marking to the infrastructure project;
- Tax imputation, in particular with respect to future property rates payments;
- Project planning and implementation standards and control.

Ad 3)

A municipality can also rely on its own overall revenue for its cash- and risk-management. Then, it seeks to equalize deficits from one project or service with surpluses of others. Services cross-subsidize temporarily and interchangeably. This type of cash-management can even work, if all the projects are just cost-recovering. Then, those older projects that are in the net-inflow phase could subsidize those newer ones that are still generating net-outflows. There would be thus an internal revolving system of infrastructure funding.

Ad 4.)

A municipality can also cover its cash-outflows by external transfers. According to the benefit-principle, it might be justified to get such transfers to the extent that there are beneficiaries of the local public investment outside of the local boundaries. Thus, there would be some inter-municipal value capture. This can be organized horizontally, with transfers coming from other municipalities, or vertically, with transfers from higher spheres of government.

Normally, the optimal cash and risk management of a local infrastructure investment will consist of a specific combination out of these four options. To find this combination, the local government needs to:

1. Create appropriate legal and technical conditions for the use of these options;
2. Analyse their specific strengths, weaknesses, opportunities and threats (SWOT);
3. Analyse their interactions.

Property Value Capture in South Africa
The Legal Framework for Property Taxation

The Constitution of the Republic of South Africa from 1996 empowers its municipalities to impose “rates” (taxes) on property (Section 229). The fundamental legal rules for property rates are stipulated in the:

“Local Government: Municipal Property Rates Act (MPRA), from 2004.”

In its preamble, the MPRA defines the following purposes of property rates:

- To be “developmental in nature”, which mainly refers to service delivery and economic and financial viability;
- To be a “sufficient and buoyant” source of revenue which helps to overcome historical injustices and imbalances.

Hence, the purposes go beyond value capture. They invite municipalities to think in their property rate policies also about the dynamics and distribution of economic and social capital, in space and time.

The Act’s rules leave a lot of room for conceptual differentiation and different treatment. Nevertheless, in particular, chapter 2, part 1, section 3 stipulates that:

“(3) A rates policy must—
(a) treat persons liable for rates equitably;
(b) determine the criteria to be applied by the municipality if it—
   (i) levies different rates for different categories of properties;
   (ii) exempts a specific category of owners of properties, or the owners of a specific category of properties, from payment of a rate on their properties;
   (iii) grants to a specific category of owners of properties, or to the owners of a specific category of properties, a rebate on or a reduction in the rate payable in respect of their properties; or
   (iv) increases rates;
   ...
   (f) take into account the effect of rates on the poor and include appropriate measures to alleviate the rates burden on them;
   (g) take into account the effect of rates on organizations conducting specified public benefit activities ...;
   (h) take into account the effect of rates on public service infrastructure;
   (i) allow the municipality to promote local, social and economic development;
   ...
”
In part 4 of the same chapter, the MPRA gives rules for the establishment of special rating areas:

“22. (1) A municipality may by resolution of its council—
(a) determine an area within that municipality as a special rating area;
(b) levy an additional rate on property in that area for the purpose of raising funds for improving or upgrading that area; and
(c) differentiate between categories of properties when levying an additional rate referred to in paragraph (b).

(2) Before determining a special rating area, a municipality must—
(a) consult the local community, including on the following matters:
   (i) the proposed boundaries of the area; and
   (ii) the proposed improvement or upgrading of the area; and
(b) obtain the consent of the majority of the members of the local community in the proposed special rating area who will be liable for paying the additional rate.

(3) When a municipality determines a special rating area, the municipality—
(a) must determine the boundaries of the area;
(b) must indicate how the area is to be improved or upgraded by funds derived from the additional rate;
...”

Here, the MPRA gives guidance for a special funding of a special development project. The link between the special rate and the special investment is, however, kept rather flexible. A municipality can, for instance, in coordination with the community, choose boundaries for a special rating area that deviate from the impact area of the infrastructure. Thus, redistribution may result from that deviation that goes beyond or even contradicts the principle of property value capture.

Chapters 4 to 8 determine how the municipality has to value property. As the general basis of valuation, chapter 5 sets the market value, which is defined as:

“46. (1) ... the amount the property would have realized if sold on the date of valuation in the open market by a willing seller to a willing buyer.”

This definition is very much in line with value capture. The value of a property finally arises out of the demand for it, because its use offers or promises to offer a certain benefit. A question with respect to TIF might just arise out of the “date of valuation”: Can it also be projected into the future?

About the valuation practices, methods and standards, the MPRA states:
“45. (1) Property must be valued in accordance with generally recognized valuation practices, methods and standards, and the provisions of this Act.

(2) For the purposes of subsection (1)—

(a) physical inspection of the property to be valued is optional; and

(b) comparative, analytical and other systems or techniques may be used, including aerial photography and computer-assisted mass appraisal systems or techniques, taking into account changes in technology and valuation systems and techniques.

…”

In part 2 of chapter 4, the required qualification, functions and conduct of municipal valuers, assistants and data collectors are described.

The MPRA thus sets standards for valuers and valuation that might build trust of property owners into them.

As a valuation process also might fail, property owners are given rights to appeal. In chapter 7, the functions of appeal boards are defined. For rights and options for the community to participate in the whole property taxation process, the MPRA also refers to the Municipal Systems Act. Altogether, the two Acts lay a solid foundation to lead a participation process that might generate more fairness, equity, efficiency, understanding and acceptance in value capture.

Empirical Evidence for South Africa

The two tables below show some empirical evidence on how South African municipalities fund their infrastructure and – vaguely – on how property value is captured.

For table 1, 4 out of 8 metros have been randomly selected, namely:

- Buffalo City (BUF);
- City of Johannesburg (JHB);
- Nelson Mandela Bay (NMB);
- City of Tshwane (TSH).

After a random selection of 6 out of 228 local municipalities, we have got in table 2:

- Breede Valley (WC025);
- Madibeng (NW372);
- Mhlontlo (EC156);
- Midvall (GT422);
- Steve Tshwete (MP313);
- Umzimkhulu (KZN435).

The relevant indicators that we could form for our purposes are:
Capital expenditure per household (Capex / HH);
Transfers recognised capital per capital expenditure (TrRC / Capex);
Borrowing per capital expenditure (B / Capex);
Internally generated funds per capital expenditure (IntGF / Capex);
Property rates revenue per capital expenditure (PRR / Capex).

The following evidence deserves to be highlighted:

- JHB made the highest capital investments (CAPEX) per household with nearly 6 000 Rand. Investment levels of metros were clearly higher than those of locals.
- The reliance on grants for capital investment was the highest in NW372 and in EC156, nearly 100%; it was below one third in: JHB, WC025 and MP313.
- Borrowing was only used in: JHB, TSH, WC025, GT422 and MP313; it covered between 29 and 44% of the capital investments.
- Internal generation of funds was significant in: BUF, JHB, NMB, WC025, MP34 and KZN435; the highest being in NMB with 41% of the CAPEX.
- The share of CAPEX potentially covered by property rates was the highest in GT422 (183%), followed by MP313 (174%). In the metros, these shares were on more similar levels than in the locals: between 90 (BUF) and 145% (TSH). Hardly any revenue from property rates was generated in EC156 and in KZN435.

Due to the differences in the terminology and categories between our theory on TIF and the data offered by NT, the small size of the samples and some other specific weaknesses of the empirical set-up, we can only draw very tentative conclusions on how property value is captured in South Africa. Nevertheless, we shall try with the following ones:

- Some municipalities – metros in particular – make considerable investments into their infrastructures.
- Some – metros or locals – have the financial potential to capture the benefits of their investments out of the property values.
- However, the property rates revenue is hardly allocated (ring-fenced or ear-marked) to infrastructure investments.
- Municipalities are hardly able to make self-sustaining investments, which means to generate enough funds by themselves.
- Many municipalities depend very much on transfers (grants) in their infrastructure investments.
- Only a few have the capacity or intentions to include borrowing into their funding.

Altogether, we can conclude that the principle of property value capture – at least in the strict sense of the benefit-principle – seems to be rather weakly followed. However, further, more specific study is needed to verify that conclusion and to elaborate on the reasons for it.
## Table 1:

<table>
<thead>
<tr>
<th></th>
<th>BUF</th>
<th>JHB</th>
<th>NMB</th>
<th>TSH</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of households (11)</strong></td>
<td>220 387</td>
<td>1 420 742</td>
<td>319 002</td>
<td>902 078</td>
</tr>
<tr>
<td><strong>Capital expenditure</strong></td>
<td>1 009 582</td>
<td>8 485 436</td>
<td>1 206 986</td>
<td>3 678 347</td>
</tr>
<tr>
<td><strong>Transfers recognised - capital</strong></td>
<td>614 312</td>
<td>2 424 507</td>
<td>669 097</td>
<td>2 278 478</td>
</tr>
<tr>
<td><strong>Borrowing</strong></td>
<td>-</td>
<td>3 740 529</td>
<td>-</td>
<td>1 085 586</td>
</tr>
<tr>
<td><strong>Internally generated funds</strong></td>
<td>395 270</td>
<td>2 123 602</td>
<td>499 939</td>
<td>159 212</td>
</tr>
<tr>
<td><strong>Property rate revenue</strong></td>
<td>908 992</td>
<td>7 890 598</td>
<td>1 608 280</td>
<td>5 316 306</td>
</tr>
<tr>
<td><strong>Capex / HH</strong></td>
<td>4580.95</td>
<td>5972.54</td>
<td>3783.63</td>
<td>4077.64</td>
</tr>
<tr>
<td><strong>TrRC / Capex</strong></td>
<td>0.6085</td>
<td>0.2857</td>
<td>0.5544</td>
<td>0.6194</td>
</tr>
<tr>
<td><strong>B / Capex</strong></td>
<td>0.0000</td>
<td>0.4408</td>
<td>0.0000</td>
<td>0.2951</td>
</tr>
<tr>
<td><strong>IntGF / Capex</strong></td>
<td>0.3915</td>
<td>0.2503</td>
<td>0.4142</td>
<td>0.0433</td>
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<tr>
<td><strong>PRR / Capex</strong></td>
<td>0.9004</td>
<td>0.9299</td>
<td>1.3325</td>
<td>1.4453</td>
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### Table 2:

<table>
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<tr>
<th></th>
<th>WC025</th>
<th>NW372</th>
<th>EC156</th>
<th>GT422</th>
<th>MP313</th>
<th>KZN435</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of households (11)</td>
<td>41 943</td>
<td>160 724</td>
<td>41 646</td>
<td>29 768</td>
<td>64 970</td>
<td>41 317</td>
</tr>
<tr>
<td>Capital expenditure</td>
<td>83 322</td>
<td>281 336</td>
<td>49 249</td>
<td>80 104</td>
<td>177 109</td>
<td>70 881</td>
</tr>
<tr>
<td>Transfers recognised - capital</td>
<td>24 830</td>
<td>271 658</td>
<td>45 106</td>
<td>34 189</td>
<td>50 526</td>
<td>50 919</td>
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<tr>
<td>Borrowing</td>
<td>27 807</td>
<td>-</td>
<td>-</td>
<td>27 722</td>
<td>64 733</td>
<td>-</td>
</tr>
<tr>
<td>Internally generated funds</td>
<td>30 685</td>
<td>9 678</td>
<td>3 824</td>
<td>6 639</td>
<td>61 851</td>
<td>19 962</td>
</tr>
<tr>
<td>Property rate revenue</td>
<td>103 565</td>
<td>292 796</td>
<td>11 486</td>
<td>146 376</td>
<td>308 610</td>
<td>10 384</td>
</tr>
<tr>
<td>Capex / HH</td>
<td>1986.55</td>
<td>1750.43</td>
<td>1182.56</td>
<td>2690.93</td>
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<tr>
<td>TrRC / Capex</td>
<td>0.2980</td>
<td>0.9656</td>
<td>0.9159</td>
<td>0.4268</td>
<td>0.2853</td>
<td>0.7184</td>
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<tr>
<td>B / Capex</td>
<td>0.3337</td>
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<td>0.0000</td>
<td>0.3461</td>
<td>0.3655</td>
<td>0.0000</td>
</tr>
<tr>
<td>IntGF / Capex</td>
<td>0.3683</td>
<td>0.0344</td>
<td>0.0776</td>
<td>0.0829</td>
<td>0.3492</td>
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<td>PRR / Capex</td>
<td>1.2430</td>
<td>1.0407</td>
<td>0.2332</td>
<td>1.8273</td>
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<td>0.1465</td>
</tr>
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</table>

Tax Increment Financing in the USA

Based on the idea of value capture, TIF has been widely used in the USA. The main power to regulate TIF is with the States. The first State to establish a specific legal framework for TIF was California in 1952, with its “Community Redevelopment Act”. By 2004, all other US States had followed in a more or less independent way. Hence, there exists a broad variety of models and practices, today. Nevertheless, one can also see some strong common tendencies in them.

As the main purpose of TIF, the States have defined the “(re-)development of blighted areas”. For such areas, a special benefit should be created by:

- Eliminating blight;
- Correcting negative market conditions and outcomes;
- Stimulating regional economic and social activity;
- Shifting costs from richer to poorer households;
- Leveraging given funds of municipalities;
- Adding funds to them.

To make such development projects more attractive to the municipalities, the States offer grants; which, however, are bound to conditions. Such conditions can be, for instance:

- Alignment to higher level development plans;
- Consent from public hearings;
- Rules to demarcate the tax increment district (TID);
- Land improvement measures;
- Targets for property value increment;
- Focus on business sectors;
- Targets for job creation;
- Elements or structures of project management;
-Administrational procedures.

The municipalities need to take a lot of highly complex measures to plan and realize TIF, adequately; of which some of the most relevant are:

1. Select an area for (re-)development;
2. Create a development plan, which includes:
   a. Development goals;
   b. Development measures;
   c. Impact study: scenarios/ projections;
   d. Estimation of project costs;
   e. Estimation of benefits;
3. Select a Tax Increment District (TID);
4. Create a Funding Plan, which includes:
   a. Basis projection of property values and taxes;
   b. Increment projection of property values and taxes;
   c. Other sources of funding, which can be:
      i. Service charges;
      ii. Interest from investments;
      iii. Local taxes;
      iv. Grants;
   d. Cash-flow projection;
   e. Risk-projection;
   f. Borrowing, regarding:
      i. Form of borrowing;
      ii. Types of creditors;
      iii. Maturities;
      iv. Interests;
      v. Credit enhancement;
      vi. Further terms and conditions;
5. Project compliance and eligibility check;
6. Stakeholder participation process;
7. Administrative tasks, resources and structure;
8. Project amendment rules.³

Hence, to take all these measures, adequately, it needs a lot of highly specified capacities. Based thereon, private service providers have offered support to municipalities in TIF. Such support has been highly demanded. Thus, a dynamic market of TIF planning and implementation has developed that also has changed the planning and implementation, themselves.

This, however, has not prevented TIF from being criticized – maybe often on the contrary. Some of the most often raised points of critique are:

- TIF-projects are not transparent and participative enough.
- Development plans make too strong assumptions and interfere too much into a well-functioning, beneficial market coordination.
- The demarcations of development and tax increment districts are not well enough justified.
- The focus on the development of blighted areas is not always adequate.
- The projections of property value increments are not convincing.
- The subsidization of TIF-projects sets wrong incentives. As a result, there is rent-seeking, favouritism, corruption, and so on.
- Competition between municipalities becomes biased.
- Competition between businesses becomes biased.

³ See Greifer (2007).
Summary and Conclusions

Local government has the task to provide infrastructure to its citizens. The benefits from infrastructure capitalize into the values of the properties that it connects or in other ways affects. The government’s claim to be compensated for its investment costs based on this capitalization is called “property value capture”. The basic instrument to execute this claim is the property tax. In theory, based on the benefit-principle, this instrument is easy to justify. In practice, however, it is difficult to use correctly.

A special disadvantage of property taxation is that it leaves liquidity and other risks to the municipality. In its infrastructure investment, it first faces cash-outflows, before cash-inflows can be generated. One instrument that can help a municipality to share such risks more equally, fairly or efficiently is TIF. TIF claims advance financial contributions from the property owners that will expectedly benefit from the infrastructure investment. Their contributions may be in the form of guarantees or different schemes of advance property tax payments.

TIF has been widely used by U.S. municipalities. As the main purpose, many U.S. State laws define the “(re-)development of blighted areas”. To promote the use of this funding instrument, the States also offer some conditional grants. Overall, the implementation process has become rather complicated. Many measures have to be taken that need highly specific capacities. Some of the measures are:

1. Selection of area for (re-)development;
2. Development plan;
3. Selection of a Tax Increment District (TID);
4. Funding Plan;
5. Risk Management Plan;
6. Project compliance and eligibility;
7. Stakeholder participation;
8. Administrative tasks, resources and structure;

The specific practices of TIF in the USA have also been object of criticism. The points of critique refer in particular to:

- Demarcation;
- Value measurement and projection;
- Transparency;
- Participation;

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4 See Kriz (2003) and Dye/ Merriman (2006).
• Influence on market process and outcomes;
• Incentive setting by grants;
• Administration costs.

In South Africa, the use of property rates is mainly regulated by the MPRA. As the main purposes of this instrument, the MPRA defines it as “developmental in nature” and a “sufficient and buoyant” source of revenue that also helps to overcome historical injustices and imbalances. Specific regulations cover among others:

• Differentiation of rates, with respect to categories of property or owners;
• Special rating area;
• Valuation practices, methods and standards;
• Participation.

In general, the MPRA seems to lay a solid legal foundation for municipalities to use property rates for property value capture. Nevertheless, the scope of it goes far beyond that principle. It also allows municipalities to use this tax instrument for widely redistributive or operational purposes.

Our rough empirical analysis could already indicate that South African municipalities use property rates in a sense rather different from value capture. Although some of the metros and locals generate enough revenue from property rates to cover CAPEX, they actually use a rather small fraction for that purpose. The share of CAPEX covered by IntGF was less than 40% in the whole sample. Borrowing was practiced only by a few of the municipalities. The specific share of coverage, however, was between 29 and 45%. Smaller municipalities in South Africa especially are still highly dependent on grants in their infrastructure investments.

The basic idea behind property value capture is that the municipality gets compensated for the value it creates – by infrastructure investment – for property owners, by the property owners. With property taxes, the compensation will be ex post, with TIF, ex ante. This idea and its related instruments are in theory highly convincing and the practical challenges can be mastered. Property value capture helps to improve local infrastructure funding, if it is discussed, planned and implemented in the right way. Thus, it might also become a stronger guideline for South African municipalities. The legal framework seems to allow them to have it. To date, municipalities still encounter very different economic and social conditions and have very different capacities to apply it. Before they start to use TIF, they should be certain to already master property taxation in that sense.

References


