Financing Expansion and Delivery of Urban Services in Rwanda

Mihaly Kopanyi[a]

[a] The World Bank (contact: mkopanyi@worldbank.org)

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International Growth Centre
London School of Economics and Political Science
4th Floor,
32 Lincoln's Inn Fields
Houghton Street
London WC2A 2AE
United Kingdom

For media or communications enquiries, please contact mail@theigc.org

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Rapid urbanization in Kigali and in the secondary cities in Rwanda has generated a growing demand for urban services and for the development of urban infrastructure. Timely, coordinated urban infrastructure development and increased service delivery is essential to avoid unplanned, informal development of the urban spaces. Given the current accelerated urbanization process, the Rwandan local governments need to address three priorities: i) allocate more resources for the development of urban infrastructure; ii) generate more local revenues by collecting more taxes and extracting private benefits created by urbanization; and iii) diversify infrastructure financing.

Rwandan local governments need to collect more resources

Rapid urbanization, especially in Kigali, increases the need for new infrastructure and for repair and maintenance of the existing one. Most immediate needs for Kigali are an adequate waste water network and treatment plant, reliable and affordable power, ecofriendly drainage systems, sanitary landfill, roads, social housing, and health and education facilities.

There is a growing difference between Kigali and the six largest secondary cities on the one hand, and the other districts on the other hand, in their generation of own-source revenues (OSRs). The share of OSRs is over 50% of local revenues (excluding donor funds) in some districts (e.g. Nyarugenge in Kigali) while less than 5% in Burera district (Northern Province)[2] with other districts falling in between. These differences are attributed to the diverse economic progress and also the shortcomings in collection capacity and efficiency.[3]

There are several options to raise more resources

Own financial resources are major tools for supporting decentralization[4] and the Government of Rwanda is committed to provide funds to the local governments.[5] Funds can be raised in different ways, on- and off- budget.[6] In Rwanda infrastructure developments are largely financed by *donor programs*.

[1] This brief is based on the policy paper prepared by Mihaly Kopanyi for the IGC "Financing Expansion and Delivery of Urban Services International Experiences and Rwanda Challenges" available on the IGC website [www.theigc.org/publications].

[2] World Bank Program Document, April 2013 (p. 45)

[3] Local Government Revenue Potential Study (LGRPS), International Center for Public Policy, Andrew Young School of Policy Studies, Georgia State University, November , 2013.

[4] Government of Rwanda: Decentralization Policy (p 43), 2012

[5] MINALOC: National Strategy for Community Development and Local Economic Development; www.minaloc.gov.rw

[6] For a comprehensive review of funding instruments for infrastructure projects, see M. Kopanyi (2014), "Financing Expansion and Delivery of Urban Services: International Experiences and Rwanda Challenges", IGC.

Even Kigali City, which collects the largest share of OSRs, heavily relies on donor funds and inter-entity transfers to finance infrastructures. The 2011/12 Kigali budget reports[7] show that OSR were less than a quarter of the total funds, but over half of the total budget was from donor funds. Other districts and secondary cities rely even more on transfers and donor grants. This trend needs to be reversed to ensure more sustainable funding.

Unutilized revenue potential should be tapped.

Substantial unutilized revenue potentials have been identified, including new shared taxes, local tax surcharges, and boosting land related taxes like land-lease fees, fixed asset taxes, betterment levies, and property transfer taxes.[8] Concerted actions are required at both national and local level to transform these potentials into actual budget revenues, including the revision of local tax policies, developing billing and collection capacities.[9] A recent decision to centralize the collection of property taxes by the Rwanda Revenue Authority (RRA) is a step in a good direction. However, it is vital to also encourage local actions for facilitating the revenue collection by timely updating of tax bases (e.g. capturing new properties, verifying taxable properties) hand in hand with the RRA.

Property taxation should be gradually increased.

Property taxation should be made more equitable and effective by fairly taxing land (accounting for improvements in land value that accrue from public investment), reducing exemptions, establishing a reliable fiscal cadaster (comprehensive register of real estate with taxable values), strengthening tax administration, and timely billing and collection. The property tax rate (fixed asset tax) is 0.1% of property value, about a tenth of the commonly levied international rates; thus a gradual increase of this rate towards the 1% benchmark in 5-10 years would increase local revenues substantially. The former area-based system (whereby taxation was based on the area, rather than market value, of a property) offers a good base for levying property tax: it is simple, easy for taxpayers to understand, and can fairly approximate market values provided that the demarcation of fiscal zones and level of unit taxes are kept updated to reflect important technical characteristics of improvements and the apparent real estate value zones of the cities.

Government should plan for and acquire land in peri-urban areas

Selling or leasing land is a major opportunity, given that land-lease fees are among the largest local OSR in most large Rwandan cities. However, land is a scarce resource and thus should be approached strategically. The master plan works strictly within the currently defined city boundaries, but land-lease or sale plans should strategically include the peri-urban areas to identify territories for further city expansion and to ensure the availability of public land for future public infrastructure development. Cities may need to acquire cheap agricultural land in peri-urban areas before the development spreads and increases the land prices. Rwanda cities may develop a land-asset register to support informed strategic decisions on land development, divestiture or acquisition. For instance, Kigali is assumed to

[7] MINECOFIN Budget reports; http://www.minecofin.gov.rw
[8] LGRPS study ibid pages 19-23
[9] Goodfellow, T.: Local taxation and institutional accountability in Rwanda's growing cities: the case of Kigali, IPAR Annual Conference, Kigali, December, 2011; http://eprints.lse.ac.uk

have a grave shortage of land, but about 65% of the land in the Gasabo District and about 60.8% in Ndera sector is developable.[10]

Land value appreciation should be adequately captured by the government.

The development of land induces enormous land-value appreciation and hence profits for private developers. Rwandan local governments should extract a fair share from these private profits (a share at least equal to the appreciation due to government investment) and use it to finance further local infrastructure. This major source of potential revenue will vanish as the time passes, and therefore should be levied and collected at the beginning of private development projects. To tap into private benefits of land-value appreciation, concerted actions are required including: clear policy and national legislation enabling cities to collect land-related revenues, the development of local analytic capacity and computerized databases to calculate land appreciation and the fair share for public revenues, market analysis to explore real factors and reference numbers for appreciation, and the local political support for adopting and enforcing land-revenue collection.

Developers should be taxed subject to adequate taxation.

Recent discussions on approaching land development projects suggest a lack of clarity about the best policy towards developers: should they be taxed or given subsidies? International experiences suggest that the land appreciation could be extremely high (ten or twenty fold increases are not uncommon) and that thus developers have room to contribute in funding respective infrastructure. Secondly, developers value the enabling environment (clear legal framework, fast and low-cost transactions, economic growth, reliability and predictability of rules and games) more than the issue of paying low taxes. Thirdly, any development subsidies should focus exclusively on supporting specific target groups such as “the poorest of the poor”, rather than other housing or commercial developments.

Land speculation gains should be tapped.

Urbanization, public infrastructure investments and private land development may generate windfall profits or even inspire land speculation. Land development fees or betterment levies are the appropriate instruments for extracting private benefits upfront at the time of issuing construction permit; they can be used to finance the adjacent urban infrastructure, which is also vital for the effective operation and sale of the new private developments. Extracting revenues from private benefits for public infrastructure thus has multiple advantages: a) it generates funds for infrastructure that would help further development and collection of more funds; b) it takes a fair share from the (rightful, but windfall) private gains; and c) it can reduce land speculation.

Capital gain tax can also reduce land speculation and provide money for the local budget. Capital gain tax is levied on both real and financial investments. In the case of land, it is levied on the net difference between the initial land purchase price and the sales price of developed land and structures, net of verified development expenses; it is usually levied with a rate of 20-30 percent if the land or structures are sold within ten years of acquisition. The recently improved land registers and well-identified land-parcels in Kigali and other cities offer the opportunity to develop computerized fiscal cadasters with reliable databases for fair, transparent and systematic taxation of properties and capital gains on land development. This also requires timely recording the real estate transactions and prices.

[10] Nsabimana, E. B.: Land Transactions in Peri-urban Areas of Kigali City, in IPAR 3rd Annual Research conference, November, 2013.

Property transfer should be taxed.

Property transfer tax also offers a good revenue source, with non-distortive taxation of private income of the sellers. The current charge on property transfers- a flat fee of RwF45,000- is on the one hand regressive,[11] and on the other hand provides only a miniscule revenue to cover administration. A transfer tax in the range of 1 or 2 percent of contracted sale value would be more equitable. Transfer tax could encourage misreporting of contract value; but the government can easily mitigate that risk by a) introducing the capital gain tax, and b) comparing reported sale prices to established market reference price and randomly assessing certain properties before levying the transfer tax.

Diversifying local infrastructure investments' financing

Diversifying financing instruments means that local governments should approach each planned project with openness to identify the most suitable on- or off-budget financing instrument. Adopting and institutionalizing a five year rolling Capital Improvement Program (CIP) would help prioritizing project ideas, communicating them with key stakeholders, and selecting the best financing instrument for each project in an iterative process where technical and financial modalities are harmonized and finalized, and then included respectively in the upcoming annual budget plan.

On- or off-budget?

On-budget financing, including current surplus and own capital income, capital transfers, and project grants from donors remains the main source of financing for Rwandan local governments in the medium term. The main reasons include: a) the availability of central government and donor funds, b) low capacities in structuring and managing complex off-budget projects, and c) the fact that urgent infrastructure projects are often better-served by on-budget financing. For instance, waste-water network and waste-water treatment plants are not only expensive, but should be financed from the budget, since ideally the operation and maintenance of these systems could be recovered from user fees; if necessary, land development fees or betterment levies could also be employed.

Debt-financing.

Kigali has sizable annual operation surpluses, which can be used for leveraging and servicing debt. Kigali has already borrowed from local **commercial banks** for development purposes. Some secondary cities might consider debt financing too. Borrowing from commercial banks seems to be an appropriate form of debt to start with, since it is simple, easy to structure, and fast. However, the very high commercial bank lending rate (around 15%)- fuelled by an exceptionally wide interest margin (around 10% to date)- makes loans unsuitable for financing long-term infrastructure.

Cities can pilot **bond issuance**, which no longer requires expensive transactions. The main benefits of bonds include: a) expanding the maturity from the current range of 5-10 years to the range of 15-20 years, more suitable for financing long-term infrastructure investments; and b) obtaining debt below the commercial bank lending rate with yields closer to the bank deposit rates. However, setting a benchmark interest rate for a bond is not easy, since there is no comparable market reference yield in

[11] The RwF45,000 is too high for low value land, while too low for high value land. With a 1% transfer tax, the RwF45,000 would be equivalent of taxing a RwF4.5 million land transaction. Thus it is charging too high for lower value land. So the flat administrative cost could be lowered in parallel with introducing a 1-2% property transfer tax.

Rwanda.[12] Furthermore, it should be tested if the potential investors are willing and able to buy a bond. A large volume of general obligation bonds that will be repaid from general revenues may overburden the local budget; thus it would be better to pilot bond issuance in the financing of ring-fenced development projects outside the city budget.

Municipal Development Funds (MDFs) are well-known specialized financial intermediaries established in about 70 countries around the world to support municipal infrastructure investments. MDFs can offer loans with much longer maturities than commercial banks; they could provide lower interest rates; and could combine the demand of the local governments and may issue bonds against this aggregate demand. In addition, MDFs often combine loan and grant financing, and often provide substantial technical assistance as part of the loan or grant agreement. It would be worth studying if, when, and how the development funds recently merged into the Local Development Authority (LoDA) could be transformed into an effective financial intermediary that could gradually assist Rwandan local governments also in debt financing. Positive experiences with MDFs suggest that this move could be a good step in supporting Rwandan local governments in piloting and gradually scaling up debt financing.

Ring-fenced debt financing could also be a good step in testing off-budget financing. Ring-fenced projects are a better way to start experiencing debt financing than is acquiring debt against a general obligation of the local budget. In fact it is advisable to finance off budget most or all the commercial service projects, such as office complexes, markets, inter-city bus terminals, or energy projects. A ring-fenced financing modality would be safer to the local budget and it would force the management to ensure financial viability in structuring the project, and in implementation and operation.

Establishing legally independent **municipal enterprises** for specific services is basically a variation on ring-fenced financing. The main difference is that the assets and the seed capital are transferred from the balance sheet and the budget of the local government to the enterprise, which becomes entirely independent.[13] Establishing independent municipal enterprises is worth testing in Kigali and some secondary cities. The benefits of a municipal enterprise include: a) higher operation efficiency, b) flexible management structure and market-based salaries for management and staff, c) market-based operation, and d) market-based financing.

Ring-fenced debt financing offers the opportunity to open up projects for **public-private partnerships (PPPs)**, as with some energy projects that are moving in this direction in Rwanda. PPPs are already also being tested in other fields in Rwanda, including the concession-based bus public transport services and contracting of private operators for solid waste collection and disposal. The operation of sanitary landfills as they would be constructed could offer another options for PPPs.

Way forward

Rwanda faces the substantial challenges, but also ample opportunities for its larger cities in expanding the scope, the sphere, and the financing capacities for developing local urban infrastructure and meeting the fast-growing demand for urban services. In order to well utilize these opportunities, some reforms are required in the legal and institutional framework. Furthermore, in addition to the existing initiatives and efforts cities should build reliable *fiscal databases*, establish *billing and collection*

[12] The current downward sloping yield curve is good for the country in general, but makes more difficult to price the bonds with long-term maturity (20 years).

[13] In contrast, the assets of a ring-fenced project remain in the municipal balance sheet; and only the revenue flow is ring-fenced.

capacities with remedies, and also good *communication programs* to involve and inform stakeholders on plans, taxes, charges, and levies. This road could be challenging–more analysis, careful steps, and courage are required -, but there is no other way to keep pace with the rapid urbanization.