Economic stimulus, infrastructure development and gearing

During tough economic periods one of the "go to" mechanisms for any government to stimulate economic activity, create jobs and attract new investment is to invest in new infrastructure. Properly planned and implemented infrastructure has numerous benefits for any economy. It is typically labour intensive (i.e. creates jobs). It (literally) lays the foundation for new (private sector lead) investments such as construction capacity (plant and equipment), property development, mining development and industrial development. It can have significant social development benefits – impacting and improving peoples' daily lives. Thus over the medium - to long term, investment in infrastructure development offers the prospect of significant gearing. This simply means that for every rand that government invests in infrastructure, the private sector will (over time) invest a rand (or more) in other investments – a second wave of investment so to speak. These investments create additional tax revenue that enables government to (partially) recoup its investment in the infrastructure. The term "gearing" that I use to describe the ratio between government's investment and the second wave of investment is very broad. So not to confuse it with a different form of gearing discussed later on I will rather use the term "investment gearing". Thus the way out of this current economic malaise seems obvious and it lies in significant infrastructure investment by government to achieve a high degree of investment gearing. Or is it?

South Africa faces a significant infrastructure backlog – that means that over the past 20 years government has invested too little in infrastructure and its maintenance. The frequent protests around poor service delivery, impact of drought on cities and towns, the state of disrepair of many roads and the environmental disasters such as raw sewage flowing into the Vaal River are all testimony to that. Unfortunately, significant wastage of money through ill-considered spending, poor planning, poor management and corruption in government as well as state owned enterprises during the Zuma-years has left government with little fiscal capacity to address the situation and to drive our economic recovery through investment in infrastructure. The economic stimulus and recovery plan announced by president Cyril Ramaphosa in September is more about eliminating bureaucratic bottlenecks and policy ambiguity in order to attract private sector investment than increasing government spend. This underlines the lack of fiscal capacity and this is robbing us of the investment gearing effect described above. Such investment gearing is critical to achieve meaningful economic growth rather than just a trickle effect. So, is there another way government can drive infrastructure development?

Yes, there is – through financial gearing. But that will require a major paradigm shift in the way government looks at infrastructure development and the financing thereof. In president Ramaphosa's economic stimulus and recovery plan there are some hints at this paradigm shift, but it is not yet clear if government is ready to go the "whole hog". How then can this financial gearing be achieved? To start answering this question, it is necessary to look at how infrastructure has been developed and financed at local level during the past 20 years. The term "local level" refers to municipalities – this is where the largest portion of the infrastructure backlog exists and where the most significant economic gains and financial gearing may be achieved.

Municipalities mostly rely on funding from central government for their infrastructure development. This funding is channelled through the Development of Revenue Act ("DoRA") – each municipality is (literally) awarded a slice of the tax and other revenue that government collects in a year. These funds are supplemented by municipalities from their own revenue collected – property rates, service charges etc. Municipalities may also supplement their available funds by borrowing in the market. To the extent that such borrowing increases the funds available for infrastructure development that constitutes financial gearing in my book. Unfortunately, most municipalities have a poor track record in collecting their own revenue. This obviously reduces the funding available for infrastructure development. Couple this with poor planning, poor management, lack of efficiencies and (of course) rampant corruption and the funding that is effectively spent on infrastructure development by municipalities is reduced to the proverbial drop in the ocean. The deteriorating financial position of municipalities detracts from their ability to borrow in the market. While there is some borrowing by the metros this is typically of a short-term nature rather than long-term borrowing that is suitable for infrastructure development. The net effect: there is virtually no financial gearing.

Let me clarify this statement. There is always some financial gearing at municipal level for the simple reason that central government supplements its own funds through borrowing in the market before determining the distributions to municipalities in terms of DoRA. Thus in the past when bemoaning the lack of primary gearing at municipal level, I have often encountered the argument that it doesn't matter, as financial gearing takes place at central government level. That is a valid argument if central government has the fiscal capacity to increase spending and/or gearing with the aim to drive the economic recovery through infrastructure development. But in our case, that fiscal capacity is simply not there. Central government thus have limited capacity for financial gearing, but even in the current economic climate, municipalities have significant capacity for financial gearing.

The key to significant financial gearing at municipal level lies in limited recourse project finance ("Project Finance"). In a recent article (Will the President's proposed Infrastructure Fund work?), I have highlighted this fact. Why can municipalities raise Project Finance? A significant portion of the infrastructure that are developed and which belongs to municipalities is infrastructure that generates revenue. This is typically infrastructure like water treatment and supply systems, sewage collection and treatment systems, electricity supply and distribution as well as solid waste collection and disposal systems. These are the things that we typically pay for on our monthly municipal accounts. The fact that these municipal assets generate revenue renders them suitable for financing through Project Finance. And through Project Finance significantly higher gearing can be achieved compared to other types of finance. In the article referred to above, I previously mentioned government's REIPPP program through which nearly R200 billion investment was secured against virtually no investment by government – thus infinite gearing through Project Finance. This is the type of financial gearing we should aim for at municipal level. And on the back of such significant investment in municipal infrastructure we will experience the second wave of investments in housing estates, schools, clinics, hospital, local businesses etc.

I have said previously that in the President's economic stimulus and recovery plan there are hints that government's paradigm on the development and funding of infrastructure is changing. To be sure the proposed Infrastructure Fund is a step in the right direction. What we lack is clarity on how government will achieve the required level of financial gearing through this fund. The budget policy statement of minister Tito Mboweni stated that: *"…the infrastructure initiative announced by the President builds on efforts to transform public infrastructure provision. It will support projects with 'blended' finance, combining capital from the public and private sectors, and development finance institutions*". All the right noises are there, but I would have liked to see a specific target for the level of financial gearing government wants to achieve. Let's put the R400 billion that government will invest in the fund over 3 years into context. For a starter, it is only twice the R200 billion raised through a single successful initiative: the REIPPP. Is R400 billion the type of quantum that will really kick start the economy? Definitely not!

Let me cite another example. There are around 980 sewage treatment works in this country – ranging from very small rural works to very large urban works. Estimates of the extent of funding required to get the 80 largest of these works (less than 10%) fully refurbished, upgraded and extended to do the job they are supposed to do range between R60 billion and R100 billion. If work on refurbishing and upgrading the relevant municipal sewage collection systems and sludge handling is included in these estimates they will more than double. It is clear that just getting our country's sewage handling and treatment facilities sorted (to remedy environmental and health disasters such as the Vaal River system) will rapidly wipe out the R400 billion. If government is able to gear the R400 billion with further contributions of R400 billion (*'blended' finance, combining capital from the public and private sectors, and development finance institutions*) will that be enough? Will such quantum of investment drive the economic recovery? Hardly.

In the twilight years of president Jacob Zuma's disastrous reign, the phrase "Radical Economic Transformation" was coined and bandied about. Ironically, that is exactly what the country now needs. The way to achieve it is by gearing the R400 billion that government will invest in the proposed Infrastructure Fund by a factor of (at least) 10. That is radical, but it is possible – through Project Finance. Investment of R4 400 billion in infrastructure over the next 5 to 10 years will make a significant difference – economically as well as socially. That is why I believe it is critical for the presidency to come out and confirm this radical vision. Once they do that, the critical next steps and building blocks that must be put in place to achieve such a radical vision differ significantly from what they will need to do to raise only another R400 billion. We will soon see where this is going. Hold your breath.