CHAPTER 10

The Funding Model for Local Rural Municipalities

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The Funding Model for Local Rural Municipalities

10.1 Introduction

Local government is facing a myriad of challenges that include poor economic growth, and high levels of unemployment and poverty. According to the Department of Cooperative Governance and Traditional Affairs (COGTA), a third of municipalities are dysfunctional and unviable (whatever the definition), while another third are at risk, and the remaining third are functional and viable. The majority of unviable municipalities are in rural areas and depend significantly on grants to fulfil their mandates. The government is aiming to minimise this dependency, as evidenced by the recent proposal by COGTA to amalgamate many municipalities to make them self-reliant.

The COGTA proposal suggests that a third of municipalities are dysfunctional and non-viable. Therefore, to correct for dysfunctionality and financial viability, the Minister of Cooperative Governance and Traditional Affairs proposed the redrawing of some municipal boundaries or the simple amalgamation of some municipalities. COGTA requested the Municipal Demarcation Board (MDB) to consider reviewing the boundaries of 34 municipalities in a proposal that affected 90 municipalities. The recent demarcations were motivated by a desire to eliminate dependency and improve municipal functionality. They provide an interesting case study because, for the first time in South Africa's history, demarcations were motivated by the desire to optimise the financial viability of municipalities. In the COGTA proposal, financial viability equates with self-reliance or self-sufficiency. Dependency on grants is considered an indicator of financial unviability and a problem that can be addressed through the demarcation instrument, i.e. dividing the country into spaces that have roughly even revenue bases. The assumption is that amalgamating municipalities will bring economies of scale and create functional municipalities that are large enough to deliver financially and technically on their mandates.

The COGTA request raises various research questions related to municipal viability and municipal functionality. In particular, what constitutes a viable municipality, and will the mergers proposed by COGTA create financially viable or self-reliant rural municipalities? If not, are there alternative funding models that could enhance the viability of the amalgamated rural municipalities? Furthermore, is there a link between functionality and boundary changes, and can a boundary change or amalgamation solve a municipality's managerial and delivery challenges?

10.1.1 Objectives

The main objective is to evaluate the funding model implied by the motivation underpinning the COGTA proposal for demarcations, using the recent wave of boundary changes as a case study. Other objectives include:

- To evaluate the implications of implementing the COGTA demarcation proposals.
- To examine whether current amalgamations will create "viable" or self-sufficient/self-reliant or functional rural municipalities.
- To recommend an appropriate funding model for amalgamated rural municipalities that are not financially self-sustaining.

10.2 Background

10.2.1 Historical context of municipal demarcation in South Africa

Demarcations and amalgamations in the local government sphere are not a new phenomenon in South Africa. Between 1948 and 1994, the country's decentralisation experience demarcated jurisdictions and organised governance on the basis of race, rather than on the basis of functional linkages or similar criteria (Van Ryneveld, 1996). The racially driven, decentralised governance system consisted of two main categories – white local authorities (WLAs) and black local authorities (BLAs). [45]

WLAs represented the earliest example of fiscal decentralisation in South Africa. Established in the early 1900s, they covered most of the country's urban areas, and were primarily responsible for providing services to urban white, coloured and Indian citizens living in areas outside of the homelands. Access to relatively wealthy sections of society meant that WLAs enjoyed a high degree of fiscal autonomy. In fact the notion of a viable municipality comes from the era of WLAs. WLAs were "viable" in the sense that they were self-sufficient. They had all the tax bases (property taxes and fees) and so relied entirely on own revenues but served only a small section of the population. In contrast, post-1994 municipalities have a fundamentally different mandate, do not have all the tax bases, rely significantly on transfers and cover entire populations, including rural areas. Therefore, it is difficult to subscribe to the same notion of viability.

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[45] The development of segregated local government bodies for coloureds and Indians followed a separate path from that for Africans. Under the Group Areas Amendment Act of 1962, provincial administrators constituted "Local Affairs Committees" or "Management Committees" in designated coloured and Indian areas. In their initial phases, these committees were intended to act in a purely consultative capacity in relation to WLAs, which retained administrative control over their areas. These committees would subsequently be granted full local authority status in terms of the criteria set out by provincial administrators in relation to a prescribed range of local issues. Despite their transformation into wholly elected entities, very few attained full local authority, as the status of the majority of the committees remained that of mere advisory bodies with few powers beyond granting trading licenses (Lemon, 1992).

Initially administered by adjacent WLAs, the BLAs evolved from the community councils that were introduced in response to the uprisings of June 1976. The BLAs enjoyed very little political legitimacy, as they were regarded as a facade set up by the apartheid regime to give some form of democracy to blacks, while entrenching segregation (Bahl and Smoke, 2003). The BLAs were unable to develop productive tax bases because of apartheid restrictions on economic development in black areas, insufficient socio-economic infrastructure that could generate service fees, and a lack of access to property, quality education and formal employment among black South Africans. As a result, BLAs generated very little own revenue, operated inefficient fiscal systems, and lacked the capacity to provide the necessary socio-economic services.

For much of the late 1980s and early 1990s, public anger over appalling service levels and attempts to impose rents and service charges in the BLAs led to violent rent boycotts, and fuelled the drive by civic organisations and activists to link local grievances to internal efforts to overthrow apartheid. As part of political efforts to end apartheid, a Local Government Negotiating Forum (LGNF) was established in 1992, and tasked with negotiating local settlements to rent and service boycotts, and amalgamating racially divided local authorities into a new local government system that would be more widely accepted. By 1993, negotiations at the LGNF resulted in the enactment of the Local Government Transition Act (LGTA) which outlined three phases – the pre-interim, interim and final phases as steps towards completing the formal role of local governments under a democratic dispensation (Smoke 2001; Powell 2012).

The pre-interim phase covered the period between the democratic election of 1994 and the first local government democratic elections held in 1995/96. In terms of the LGTA, local government was organised through locally negotiated transitional councils that were established via "negotiating transitional forums" within each municipal area. Representation on these transitional councils took the form of members being appointed in equal proportions from statutory institutions (such as the WLAs, BLAs and designated Indian and coloured local governments), and non-statutory bodies (mainly civic organisations, trade unions and previously unrepresented political parties). This phase concluded with the 1995/96 local government elections which ushered in the interim phase. A major prerequisite for the 1995/96 local government elections was to amalgamate the inherited apartheid-era local government structures. To facilitate this, the LGTA provided for the establishment of a Local Government Demarcation Board in each of the nine provinces, and granted these boards mainly advisory powers to make recommendations on matters relating to boundary and ward delimitations to their respective provincial Ministers of Local Government.

The process of boundary and ward delimitations for the interim phase led to the creation of three types of municipalities: metropolitan, urban and rural. The six large urbanised areas of the country (four in the Johannesburg–Pretoria area plus one each in Durban and Cape Town) were administered within a two-tier system consisting of transitional metropolitan councils (TMCs) and transitional metropolitan substructures, while transitional local councils (TLCs) were established to govern urban areas. For rural areas not included within TLCs, local governance structures took one of three forms: transitional representative councils, transitional rural councils (TRCs) and district councils (Cameron 2006; Schroeder 2003).

Chapter 7 of the 1996 Constitution made provision for three categories of municipalities: Category A municipalities (metropolitan councils) that exclusively covered large urban areas; Category B municipalities (local councils) that administer non-metropolitan areas, which vary in size and extent of urbanisation, and Category C municipalities (district councils).[46] The Local Government Demarcation Act (No. 27 of 1998) became the major policy instrument for dismantling locally segregated local government and ushering in the final phase of the local government transformation process. In line with Constitution, which stipulates that municipal boundaries are demarcated by an independent body, the Act merged the nine provincial demarcation boards into a single entity: the Municipal Demarcation Board (MDB). Unlike provincial boards, which had played a largely advisory role, the MDB was granted the status of the final decision-making body over matters of municipal demarcation and delimitation of municipal borders. [47]

In preparation for the 2000 local elections, which commenced the final phase of transforming the local government sphere, the MDB initiated two important changes to the composition of local governments. First, it established "wall-to-wall" municipalities, in accordance with the Constitution (1996) that called for municipalities to "be established for the whole of the territory of the Republic". Second, the MDB consolidated the former TLCs into a single local jurisdiction, which meant that a number of former TLCs would be included within the boundaries of Category B municipalities. As a result of the MDB's demarcation process, by the 2000 local elections, the complex system of 843 transitional municipalities had been consolidated into 284 municipalities. The country's six largest urbanised and industrialised centres made up the Category A municipalities. Outside the metropolitan areas, a two-tier structure was established with 231 Category B

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[46] These district councils succeeded joint structures between local authorities that had been established via the Regional Services Council Act of 1985 and named "Regional Services Councils (RSCs)" and "Joint Services Boards" (JSBs). The main function of the RSCs and JSBs was to operate a regional system for providing "bulk" infrastructure services in larger urban areas, especially poor black areas, as well as some rural areas.

[47] Where applicable, these powers were subject to a process that afforded any aggrieved parties or stakeholders the right to appeal decisions by the MDB, and for the MDB to consider such appeals.

municipalities falling under 47 Category C district councils. Then, in preparation for the 2006 local elections, the MDB consolidated the number of municipalities to 283. This reconfiguration resulted in the disappearance of cross-boundary municipalities. Ahead of the 2011 local elections, the number of municipalities was further reduced to 278: Category A municipalities increased from 6 to 8, while the number of local and district municipalities decreased to 226 and 44, respectively.

The motive underpinning the demarcations in the 1990s was to de-racialise municipalities that were segregated along apartheid spatial lines and, to an extent, redistribute resources from affluent municipalities to poor municipalities. White municipalities had clear tax bases, capacity and other resources but were only serving very small populations, whereas the black authorities consisted of mainly townships, tended not to have strong tax bases, and were characterised by a culture of non-payment for services and poor services. For example, in Cape Town, the main rationale for amalgamation in 1996 was to redistribute from rich municipalities to poor municipalities. The Western Cape Demarcation Board deliberately drew the boundaries of Cape Town to merge the former black and white municipalities. This resulted in a one-tier municipality with geographic boundaries that cover the economic region. However, amalgamating the previously black and white local authorities created problems, such as collapsing infrastructure (e.g. water and sewerage systems) because of the increasing number of people that now had to be serviced. Other challenges included financial stress due to increasing salaries, limited experience and lack of capacity.

In 2002, financial viability became a demarcation issue after The Presidential Coordinating Council (PPC) passed a number of resolutions on local government, mostly stemming from the need to build financially viable municipalities. The issue of municipal financial viability is not new but has still not been resolved 16 years after developing local government.

10.2.2 Demarcations in 2015

In 2015 the Minister of COGTA proposed further boundary changes that would see more municipalities becoming even larger. As noted above, the principal motivation for these changes was to ensure that municipalities are financially viable and functional. This study addresses the question of whether these amalgamations will result in viable (self-sufficient/self-reliant) or functional municipalities.

The 2015 boundary redeterminations reduced the number of municipalities by 21, from 278 to 257. Table 58 shows the distribution of municipalities affected by demarcations in 2016.

Table 58. Municipalities affected by boundary re-determinations in 2016

New Municipality	Affected municipalities (Amalgamations)
Eastern Cape	
EC101	Camdeboo LM, Baviaans LM and Ikwezi LM
EC129	Nxuba LM and Nkonkobe LM
EC139	Inkwanca LM, Tsolwana LM and Lukanji LM
EC145	Gariep LM and Maletswai LM
KwaZulu-Natal	
KZN212	Vulamehlo LM and Umdoni LM
KZN216	Ezinqoleni LM and Hibiscus Coast LM
KZN237	Umtshezi LM and Imbabazane LM
KZN238	Emnambithi/ Ladysmith LM and Indaka LM
KZN276	Hlabisa LM and The Big Five False Bay LM
KZN282	uMhlathuze LM and Ntambanana LM
KZN285	Mthonjaneni LM and Ntambanana LM
KZN436	KwaSani LM and Ingwe LM
Free State	
MAN	Mangaung Metro and Naledi LM
Limpopo	
LIM341	Musina LM and Mutale LM
LIM343	Thulamela LM and Mutale LM
LIM345	Makhado LM and Thulamela LM
LIM351	Blouberg LM and Aganang LM
LIM353	Molemole LM and Aganang LM
LIM354	Polokwane LM and Aganang LM
LIM368	Modimolle LM and Mookgopong LM
LIM476	Fetagomo LM and Gretaer Tubatse LM
Mpumalanga	
MP326	Umjindi LM and Mbombela LM
Northern Cape	
NC087	Mier LM and //Khara Hais LM
North West	
NW405	Tlokwe LM and Venterdorp LM

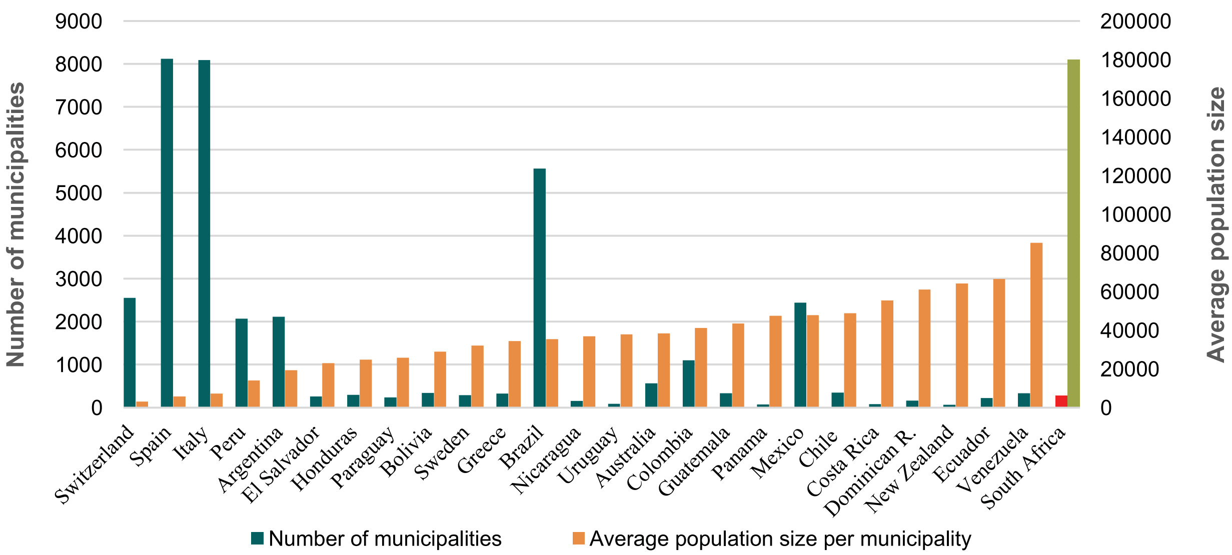
Source: MDB (2015)

10.3 Literature Review

10.3.1 South Africa's local government sector within a global context

With the reduction in the number of municipalities, from 278 to 257, a comparison with other countries is pertinent. International literature is clear that no standard size for a municipality exists, whether by geographical space, population size or political representation. However, compared to other countries, South Africa is at the extreme end of the spectrum for three characteristics: number of municipalities, average population size per municipality and number of citizens per local councillor. South Africa has one of the lowest number of municipalities and one of the highest average population sizes per municipality (Figure 79), as well as one of the highest number of citizens per councillor (Table 59). This has far-reaching implications for political representation, and democratic and governance accountability. When a local government structure is large, access to authority through public hearings, meetings, elections or direct contact is difficult; political representatives are far removed from the electorate; and citizen participation is weaker.

Figure 79. Number of municipalities and average municipal population sizes



Source: IMF (2010); World Bank (2014); Federation of Canadian Municipalities (2015)

Table 59. Number of citizens per councillor

	Number of councillors	Number of citizens per councillor
Republic of Ireland (2014)	949	4861
New Zealand (2000)	1892	2039
Philippines (2000)	2102	37075
Malaysia (2000)	2921	7654
Nepal (2000)	3344	7099
Australia (2000)	6637	2886
South Africa (2011)	9090	5671
Canada (2014)	19534	1819
Japan (2000)	62452	2031
China (2000)	653244	1933

Source: Drage (2001); IMF (2010); World Bank (2014); Morna and Mbadlanyana (2011); Federation of Canadian Municipalities (2015)

10.3.2 Why amalgamate municipalities?

Literature cites a number of reasons for amalgamations, including economies of scale, through, for instance, reducing the number of politicians and bureaucrats. Bigger municipalities are viewed as able to deliver services more effectively than smaller, fragmented municipalities. Larger municipalities result in improved productivity, cost savings, enhanced quality and mix of public goods, greater administrative and technical capacity and more effective lobbying with other spheres of government (Dollery and Robotti, 2008). They are able to provide a more extensive array of services than small, fragmented municipalities (Dollery et al., 2007; Slack and Bird, 2013).

The literature also has some strong arguments against amalgamations. When municipalities with different service levels and wage scales are amalgamated, operating costs may increase if the employees of the smaller municipality demand wage parity with their counterparts in the larger municipality. Salaries and benefits tend to equalise to the higher scale, thereby offsetting any cost savings (Slack and Bird, 2013). The advantage of having many smaller municipalities is that this can stimulate competition and be an incentive to be efficient, responsive and accountable to community needs (Faguet, 2004; 2011).

However, despite all the strong arguments for and against consolidation, empirical evidence is at best mixed (Lago-Penas and Martinez-Vazquez, 2013) and shows that there is no optimal municipal size (Bish 2000; Boyne, 1998; Dollery et al., 2012; Oakerson, 1999;). A review of research in the UK and USA found that "[o]verall, 29 percent of the empirical papers find evidence of U-shaped cost curves, 39 percent find no statistical relationship between per capita expenditure and size, 8 percent find evidence of economies of scale, and 24 percent find diseconomies of scale" (Byrnes and Dollery, 2002: 3). Cowley (2009) argues that high-density developments result in service delivery and administrative efficiencies, whereas spread-out, low-density developments are more costly to serve. Therefore, amalgamation may not achieve the hoped-for economies of scale but rather spread the operating costs of the insolvent municipality over a wider tax base (ibid).

Table 60 summarises this literature. The main message from this literature is that boundary changes can have either positive or negative fiscal consequences on municipalities as well as on their fiscal/financial viability.

Table 60. Summary of literature on the impact of municipal boundary changes

Author	Country	Findings
Dollery et al. (2007)	Australia	The study looked at the impact of municipal amalgamation on the financial viability of the South Australian Local Government, focusing on whether the size of a municipality improves its viability. The results indicate that there is no correlation between the municipal size and its viability. The study suggests that alternative methods to improve viability and effectiveness of local authority should be pursued.
Forsynth (2010)	America	This study asked the question: "Is a country's post consolidation (boundary change) economic development significantly better than reconsolidation development?" The study found that consolidations have a significant impact on the distribution of economic burdens within a county, but the impact on economic development is not significant and limited to social development. The study concludes that consolidating counties does not result in any efficiency gains.
Savitch and Vogel (2004)	America	The study tested the hypothesis that city-county consolidation promotes efficiency, equity and accountability. The study found that mergers reduce efficiency, but costs associated with transition and harmonising employment and wages increase, and inequities continue. They also result in minimal cost savings and make accountability problems worse.
Fleischmann (1986)	America	The study looked at the benefits and costs of local boundary changes and who the winners or losers were. Gains include new revenues sources (increased tax base), while areas that were poor before boundary changes benefited in the form of improved service delivery. The study also highlighted political and social costs/benefits, but found that the winners were largely the private actors.
Reingewertz (2012)	Israel	The study assessed the fiscal outcomes of municipal amalgamation using the "difference in differences" method. The results indicate that amalgamation leads to a decrease in municipal expenditures but, at the same time, causes no decrease in the quality of services provided. Based on this, the study concludes that amalgamation may have a positive impact on municipal viability.
Fritz (2011)	Germany	The study examined whether large-scale municipal amalgamations had an impact on the fiscal outcomes of municipalities in Germany, using the "difference in differences" approach. The results suggest that the effect is significant, with municipal amalgamation having a positive impact on debt per capita and expenditure per capita, but a negative impact on expenditure on administrative staff.

10.4 Methodology

According to COGTA, a third of municipalities are dysfunctional and unviable (whatever the definition) while another third are at risk, and the remaining third are functional and viable. The motivation underpinning the COGTA proposal is the elimination of dysfunctional and non-viable municipalities. This section explains how viability, functionality and revenue-raising capacity are evaluated.

10.4.1 Functionality

Functionality refers to how badly or how well a municipality operates, delivers services and accounts for the money it spends. The functionality of rural municipalities due for amalgamation in 2016 will be assessed by looking at the functionality indicators of management stability, fiscal stress levels and audit profiles.

10.4.2 Viability

The self-sufficiency or self-reliance (viability) of a municipality can be measured by its ability to raise own revenues to pay for basic public services (as per its constitutional mandate). One way of assessing the ability of demarcated municipalities to fulfil their constitutional mandate is to compare the gap between expenditure needs and revenue-raising capacity (Bandyopadhyay, 2013). This gap is often referred to as the need-capacity gap or fiscal gap. Expenditure needs refer to the amount of money needed to provide minimum acceptable levels of public goods (water, electricity, refuse removal, roads, etc.), while revenue-raising capacity refers to revenues that the municipality can raise from own sources (own revenues) when exerting a standard amount of effort.

A municipality's revenue-raising capacity depends on its fiscal capacity, which can be measured using many variables. These variables range from a municipality's tax and revenue base, to its socio-economic framework and all other political and legal constraints that may prevent its full revenue potential being realised. The most important component of a municipality's fiscal capacity is its economic base. Fiscal capacity will be assessed using the following measures:

- Per capita income (the wealth or income of a municipality divided by its population) captures a municipality's ability to handle a tax burden, or ability of individuals within a municipality to meet the financial needs of the community. The measure is simple and easy to understand.
- Per capita gross value added (GVA) captures the value of goods and services produced by a municipality over a given period. A higher per capita GVA value signifies a larger revenue base and greater ability to pay taxes.
- Employment (and unemployment) rates are indicators of a municipality's fiscal capacity. A higher employment rate implies a bigger tax base, as employed people pay taxes and fees, whereas a high unemployment rate means a smaller revenue base for a municipality.
- Property rates per capita are an important measure of fiscal capacity for local governments. These taxes are significant in many municipal governments. A municipality with many properties/estates is likely to raise more revenues. Similarly when property values increase, revenue yields are likely to increase.

10.4.3 Data

The data used in this paper is mainly secondary, and was sourced from National Treasury and Financial and Fiscal Commission databases.

10.5 Results

The purpose of this case study is to assess whether municipalities that were demarcated for the 2016 local government elections will be viable and functional, at least as per the COGTA definition of viability and functionality.

10.5.1 Amalgamation and municipal viability

In the COGTA proposal, viability refers to the ability of municipalities to fulfil their constitutional mandates using their own resources. In other words, demarcations will result in municipalities that are self-reliant and self-sufficient, have a strong fiscal base to support their constitutional mandates and minimum dependency on intergovernmental transfers. Fiscal capacity is crucial for a municipality to be viable/self-sufficient or self-reliant, and so the fiscal capacities of the demarcated municipalities was evaluated using a number of indicators, including revenue-raising capacity. As with other studies (Bandyopadhyay 2013; City of Fort Lauderdale, 2013; Yilmaz et al., 2007), all measures of fiscal capacity were indexed to the average, i.e. the average figure for South Africa was equated to 100 and used as a base against which to compare individual municipality indicators. These indicators are not measures of the fiscal health of a municipality but simply a relative gauge of whether or not a particular municipality can sustain all the assigned mandates using its own resources without intervention from national and provincial governments. Furthermore, the South African average is not necessarily the optimum but, in the absence of norms or standards, gives an indication of where an average municipality is operating in South Africa. The reader is also reminded that these measures evaluate a municipality's fiscal capacities relative to the national average, not their absolute fiscal capacities.

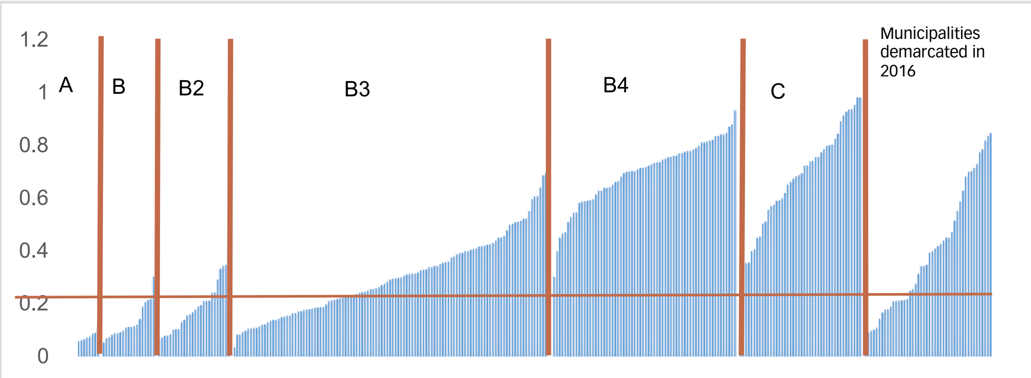
10.5.2 Dependency on transfers

Self-sufficient municipalities do not need to depend on transfers for their basic needs and are capable of delivering a range of services using own revenues. A simple dependency ratio (transfers/operating revenues) can reveal whether municipalities can sustain their mandates without significant assistance from national and provincial governments. The ratios used are: the local government equitable share (LGES) as a share of total municipal operating revenue and transfer capital funding as a percentage of total capital funding.

As Figure 80 shows, the dependency ratios vary widely, from metros (A municipalities) that derive less than 10% of their revenues from transfers, to district municipalities (C municipalities) that rely on transfers for almost 90% of their total revenues. The majority of rural municipalities (B3s and B4s) depend on transfers for more than 20% of their revenues, with most B4s relying on transfers for more than 50% of revenue. These municipalities are unlikely to be self-reliant and will always be dependent on transfers. In the case of the newly demarcated municipalities, the majority of them depend for more than 50% of their operational revenues on the LGES. A similar picture emerges for capital funding (Figure 81).

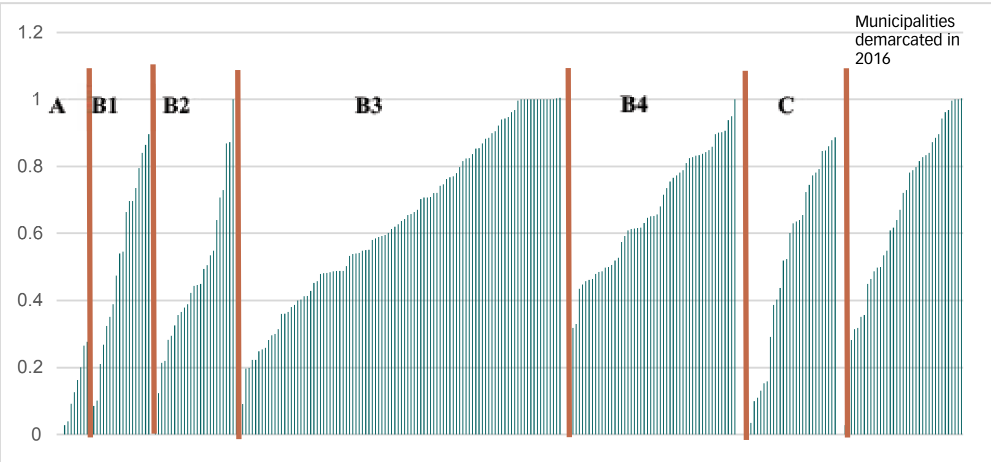
What Figure 80 and 81 show is that, given the present configurations, rural municipalities and the newly demarcated municipalities will never sustain their activities without transfers. Therefore, amalgamation will not make them self-reliant because of their limited revenue base and high levels of dependency. This implies that the funding model for rural municipalities and the newly demarcated municipalities should always consist of transfers.

Figure 80. LGES as a percentage of operating revenue



Source: Commission's calculations

Figure 81. Total transfer capital funding as a percentage of total capital funding



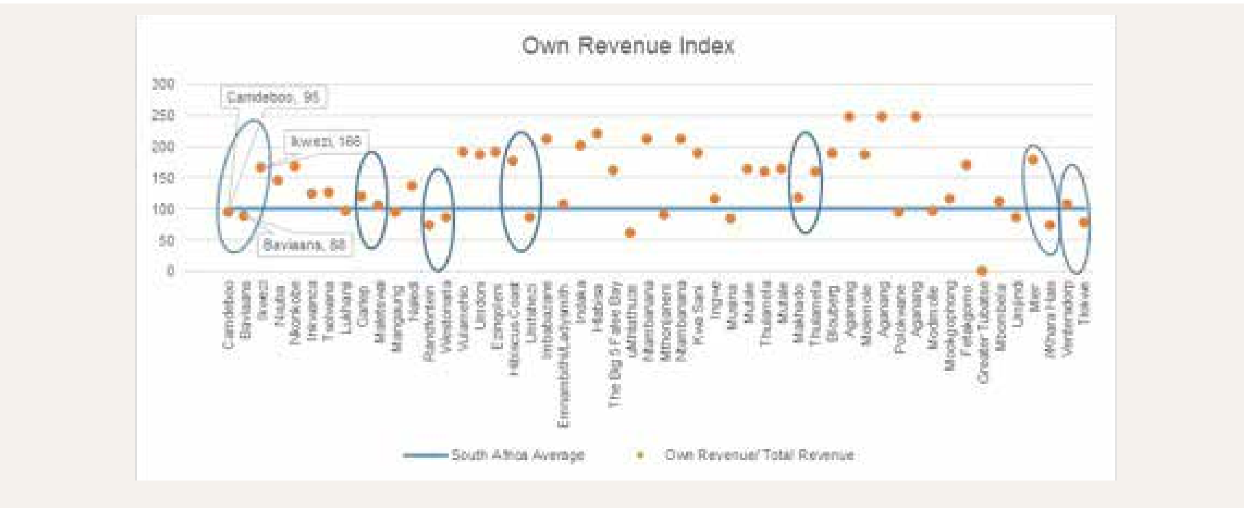
Source: Commission's calculations

10.5.3 Own-revenue index

The own-revenue index is generated from a ratio of own revenues to total revenues. According to the index, own revenue is the main source of income for over 70% of newly demarcated municipalities (they lie above the South African average).

The foregoing brief analysis on the degree of grant dependency of rural municipalities, and in particular the newly demarcated municipalities, shows that a significant number of individual municipalities and clusters will continue to be reliant on transfers. The amalgamations will not have an impact on the many municipalities that already have a high dependency on grants, while for some clusters, their dependency is likely to intensify. This means that transfers will continue to be the main funding window for rural and amalgamated rural municipalities.

Figure 82. Own-revenue index



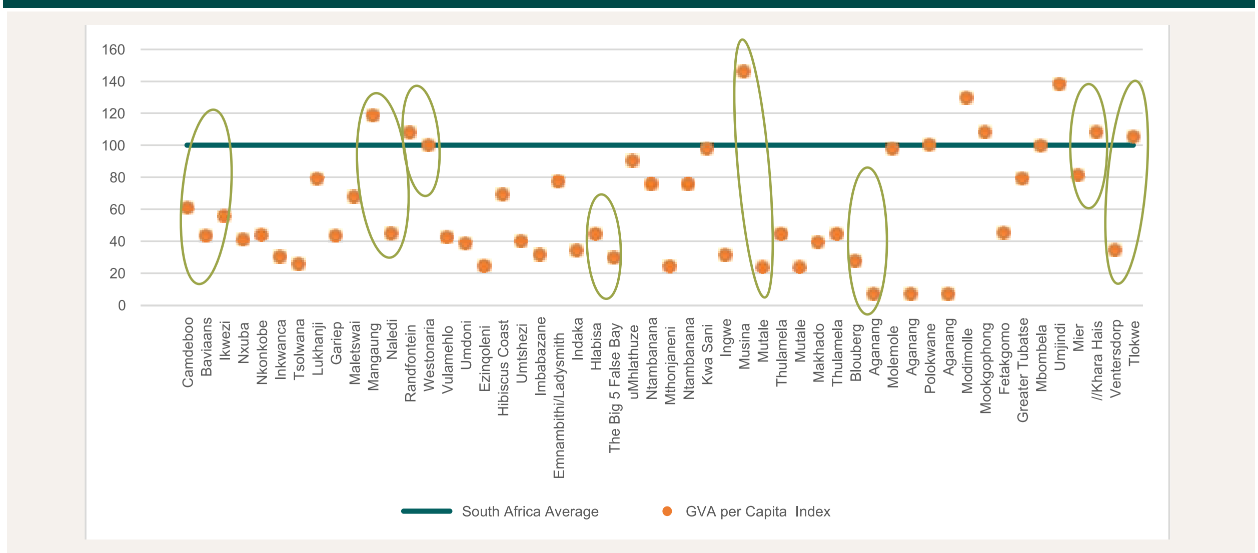
Source: Authors' calculations

10.5.4 Per capita GVA index

This indicator measures the value of goods and services produced by a municipality over a given period. A municipality with a higher per capita GVA value has a potentially larger revenue base and greater ability to pay taxes. All newly demarcated municipalities were compared to the average for all municipalities (Figure 83).

It is quite clear that the majority of municipalities demarcated in 2016 are below the South African average, and over 80% of them have a weak potential revenue base. Examples of amalgamations that consist of municipalities with GVA per capita indices below average include Camdeboo, Baviaans and Ikwezi; Hlabisa and The Big Five False Bay; and Blouberg and Aganang. This suggests that some of the proposed amalgamations will not necessarily result in municipalities with a better revenue base.

Figure 83. GVA Index

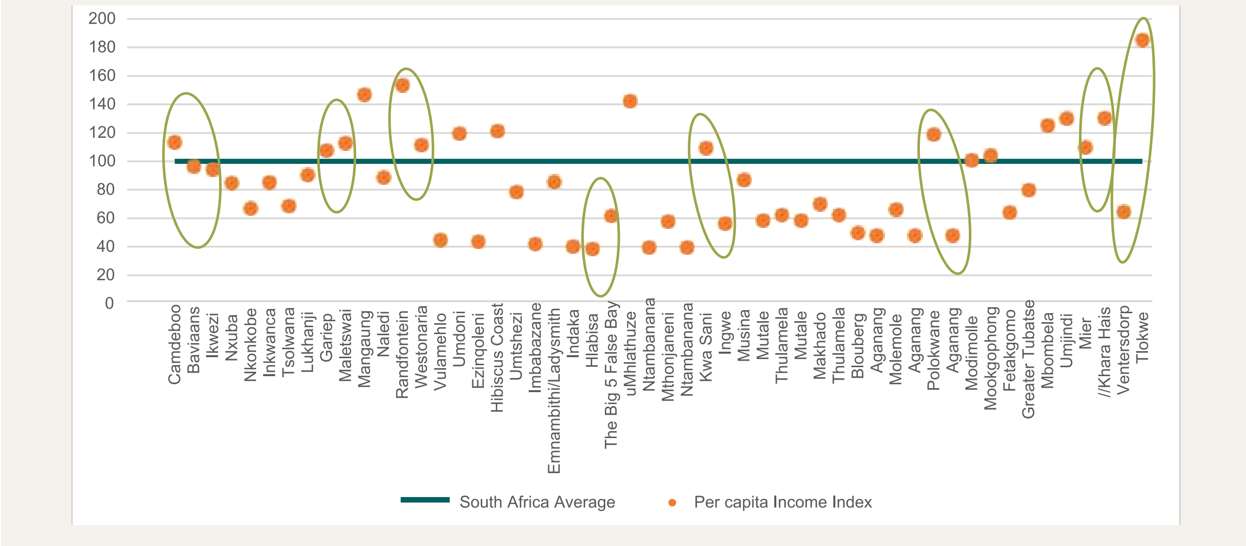


Source: Authors' calculations

10.5.5 Per capita income

Another well-known indicator of fiscal capacity is per capita income (Bandyopadhyay 2013; Tannenwald 1999; Yilmaz et al., 2006). Like per capita GVA, the per capita income measure captures the wealth or income potential of a municipality through a community's ability to meet its financial needs. As Figure 84 shows, around 70% of the municipalities demarcated in 2016 fall below the South African average for per capita income. This is a further indication that, other things being constant, the communities of such municipalities (e.g. the Hlabisa and Big Five False Bay amalgamation) would be hard pressed to meet their financial needs.

Figure 84. Per capita income index

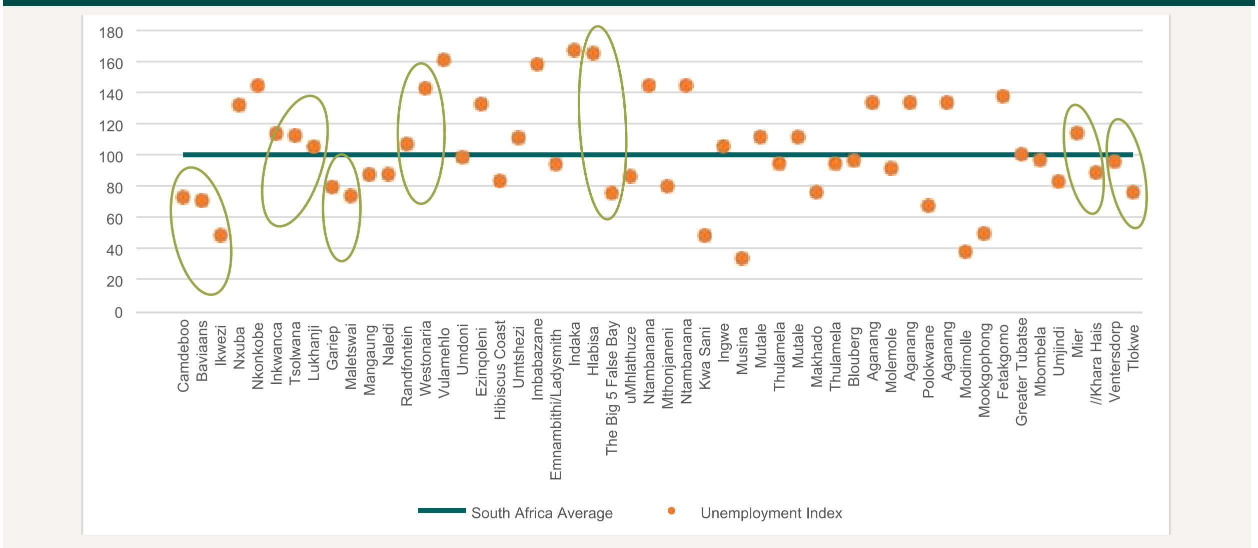


Source: Commission's calculations

10.5.6 Employment

A municipality's revenue base also depends on the employed population within its jurisdiction. The likelihood of a municipality generating a steady stream of revenues is high when a significant proportion of its population is employed. Conversely, the tax base is constrained when the unemployment rate is high. Figure 85 shows that almost half of the municipalities amalgamated in 2016 have below-average unemployment rates, indicating a weak revenue base. Clusters with above average unemployment rates include Camdeboo, Baviaans and Ikwezi; Inkwanca, Tsolwana and Lukhanji; and Ventersdorp and Tlokwe.

Figure 85. Unemployment index



Source: Commission's calculations

10.5.7 Poverty index

Poverty is another variable that explains a municipality's fiscal incapacity, with high levels of poverty implying a weak revenue capacity. Poverty levels for all the newly demarcated municipalities were compared with the average poverty level for all South African municipalities. Figure 86 indicates that over 60% of municipalities fall below the average poverty level. This suggests that for many municipalities (e.g. Hlabisa and The Big Five False Bay), the mergers will not improve their poverty levels nor their revenue base.

Figure 86. Poverty index

Source: Commission's calculations

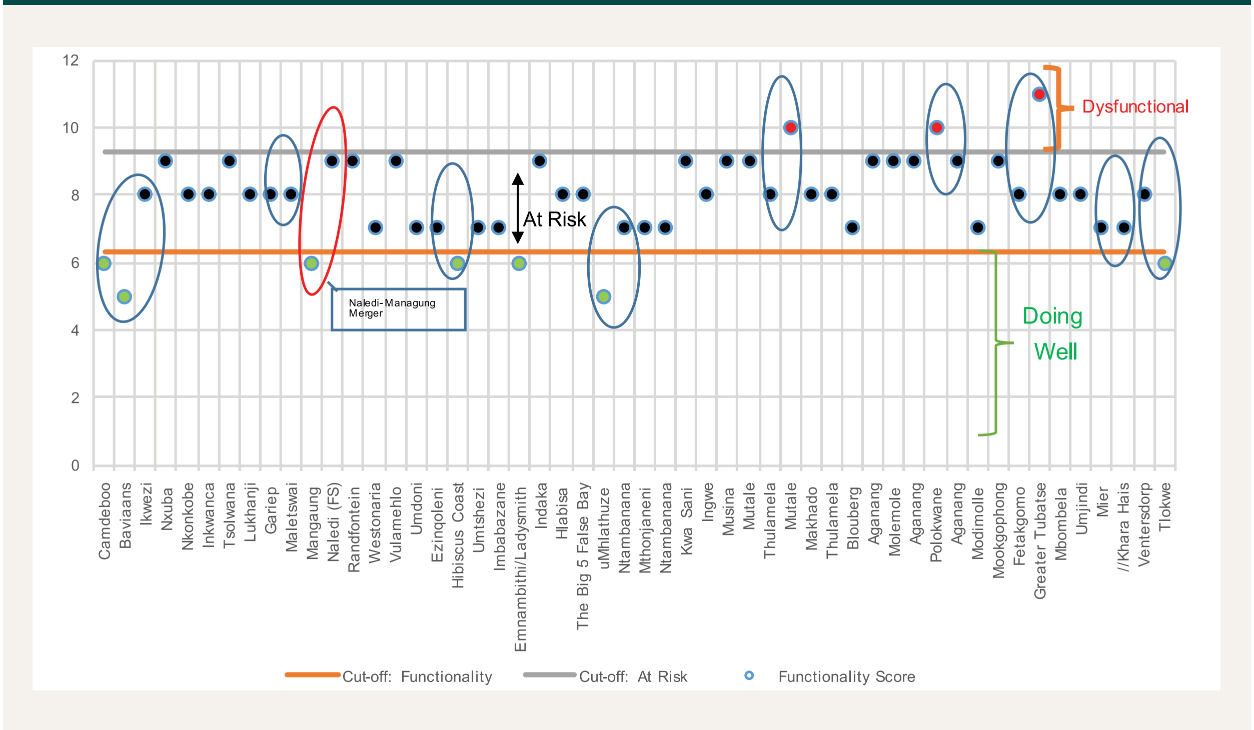
The above analysis suggests that a significant number of municipalities amalgamated in 2016 have weak revenue-raising capacities. This implies that amalgamations will not make many municipalities viable or self-sufficient or self-reliant. With weak revenue bases, most of the municipalities will continue to depend on transfers. Besides transfers, alternative revenue sources are required for such municipalities. The focus should be on increasing or developing tax bases through economic development rather than amalgamating municipalities.

10.6 Viability and Demarcation

10.6.1 Can amalgamations correct for municipal dysfunctionality?

The functionality of a municipality is a function of many factors, within and outside a municipality's control. The functionality of the municipalities amalgamated in 2016 were assessed using four factors: (a) institutional management, (b) financial management, (c) governance and (d) service delivery. Figure 87 shows that most municipalities (80%) are at risk of being dysfunctional and 6% are dysfunctional. Amalgamating municipalities that are at risk of being dysfunctional may actually worsen the problem. An interesting result concerns the amalgamation of a functional metro (Mangaung) and a dysfunctional rural area (Naledi). While this merger may achieve financial viability/self-reliance, two important elements of municipal viability – governance and democracy – may be compromised. With the amalgamation, political representation for marginalised communities in Naledi virtually disappear, and in many ways rural governance of these communities becomes less functional, as an urban core governs and administers rural areas. Although Naledi may not be able to be financially viable, it could serve a critical constitutional and democratic role.

Figure 87. Municipal functionality



Source: Commission's calculations

Given that many of the newly demarcated municipalities are not functioning well, the question is whether demarcation is the appropriate instrument for addressing their challenges and whether functionality can be a criterion for demarcating municipalities. In reality, many factors can cause a municipality to be dysfunctional. They include service delivery, institutional management, financial management, community satisfaction, and governance or political stability. Furthermore, such factors do not have a direct bearing on (or can be influenced by) boundary changes. For example, using demarcation to correct for financial mismanagement is akin to providing a patient with an incorrect pill, which may do more harm than good. The MDB's primary mandate is to demarcate municipal boundaries, delimit wards and carry out municipal capacity assessments, as spelt out in the Local Government: Municipal Demarcation Act (No. 27 of 1998). Correcting for dysfunctionality in municipalities is clearly not part of the MDB mandate, but that of national and provincial governments, which have a range of monitoring, support, regulatory and intervening powers at their disposal. As there are no apparent connections between municipal boundaries and municipal functionality, elevating the issue of functionality to a demarcation criterion may simply raise expectations that will never be fulfilled by demarcation. Furthermore, problems of dysfunctionality are often temporary and transient, and cannot be solved by a long-term drastic measure such as demarcation.

10.7 Conclusion and Recommendations

Government seeks to make rural municipalities self-sufficient and less dependent on transfers. In 2015, it proposed using demarcations to achieve financial viability or self-sufficiency, and to improve functionality among rural municipalities. However, an analysis of municipalities demarcated in 2016 found that amalgamations will not necessarily result in financially viable municipalities and may worsen the situation of some of the demarcated municipalities. The dependency ratio of many demarcated rural municipalities is too high to be reversed by amalgamations. Many rural municipalities will continue to be dependent on transfers, as their revenue bases are fragile and weak. Transfers will remain the mainstay of rural local government. The transfer system must also cater for the Constitution's acknowledgement of transfer-dependent municipalities (the Constitution sets no financial viability requirement for all municipalities but makes provision for some to be transfer-dependent). Some municipalities should exist to serve other equally important roles, such as ensuring that communities are politically and democratically represented. Amalgamations should carefully be studied, and benefits of amalgamations should be based on sound empirical evidence.

The study noted that elevating functionality to a demarcation criteria is problematic, as there is no direct or indirect link between functionality and municipal boundaries. Municipalities can be dysfunctional for a variety of reasons that have no relationship with boundary demarcation. Amalgamations are a long-term measure that cannot correct for short-term operational problems associated with municipal dysfunctionality.

The foregoing analysis has demonstrated that many rural municipalities will continue to depend on transfers. The analysis also suggests that demarcations are a weak instrument for pursuing the financial viability of rural municipalities and an incorrect one for improving the functionality of municipalities.

In light of the observations and findings above, it is recommended that:

- Rural municipalities with a low revenue base should be allowed to exist and be funded through the transfer system and not forced to amalgamate, as such municipalities could be serving other crucial constitutional imperatives such as democratic representation and community participation. The funding model should differentiate between rural municipalities, in terms of their revenue base.

- To achieve financial viability, government should focus on increasing or developing tax bases through economic development rather than amalgamating municipalities.

- Functionality should not be elevated to a demarcation criterion, as it has no direct or indirect link with boundary changes. Functionality should be corrected through legislative, policy and capacity-building measures rather than through amalgamations.

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