

CHAPTER 11

The Adequacy of Local Equitable Share and Conditional Grants for Rural Development

Mkhululi Ncube and Jabulile Monnakgotla

The Adequacy of Local Equitable Share and Conditional Grants for Rural Development

11.1 Introduction

South Africa requires a strong economy in order to tackle the triple challenges of poverty, inequality and unemployment. Nearly half (45%) of the population is poor, about a fifth live in extreme poverty and the Gini coefficient (a measure of inequality that reflects the income distribution in a country) was 0.69 in 2011. Underpinning a strong national economy is a strong local government with the resources to deliver the public services that communities need. The local government, as the sphere closest to people, plays a key role in facilitating development and improving living standards. Over the past two decades, transfers from national and provincial government to local government have increased steadily, in a bid to ensure that municipalities fulfil their constitutionally assigned mandate. Between 2000/01 and 2015/16, local government's share of the Division of Revenue allocations tripled, from R6-billion (3%) to about R100-billion (9%). However, the increase in resources has not translated into commensurate service-delivery improvements in the majority of municipalities. Many municipalities face the dilemma of expanding expenditure requirements and a shrinking fiscal space.

The Constitution and other legislation assign a range of functions to local government. Local government's mandate includes providing infrastructure and services (e.g. electricity, water and sanitation, refuse removal, roads) to local communities and developing local economic activities. To execute these functions, local governments rely on their own revenues, which are supplemented by transfers. Although own revenues fund on average 73% of municipal budgets overall, they constitute a small proportion of budgets of some (in particular rural) municipalities who depend on transfers for over 80% of their budgets.

To improve service delivery and the performance of rural municipalities, a number of interventions have been initiated, including the recent review of the local government equitable share (LGES) formula. The new formula, which was introduced in 2013 and is expected to be fully

phased in by 2017, seeks to address rural-urban imbalances by shifting allocations towards rural municipalities. However, despite this deliberate effort to shift resources, many rural municipalities continue to face poverty, deficient services and infrastructure, lending credence to claims that the funds directed to rural municipalities are insufficient to fulfil their constitutionally assigned mandate. The perception in many cases is that the challenges faced by many rural municipalities are a consequence of insufficient LGES and conditional grant funding.

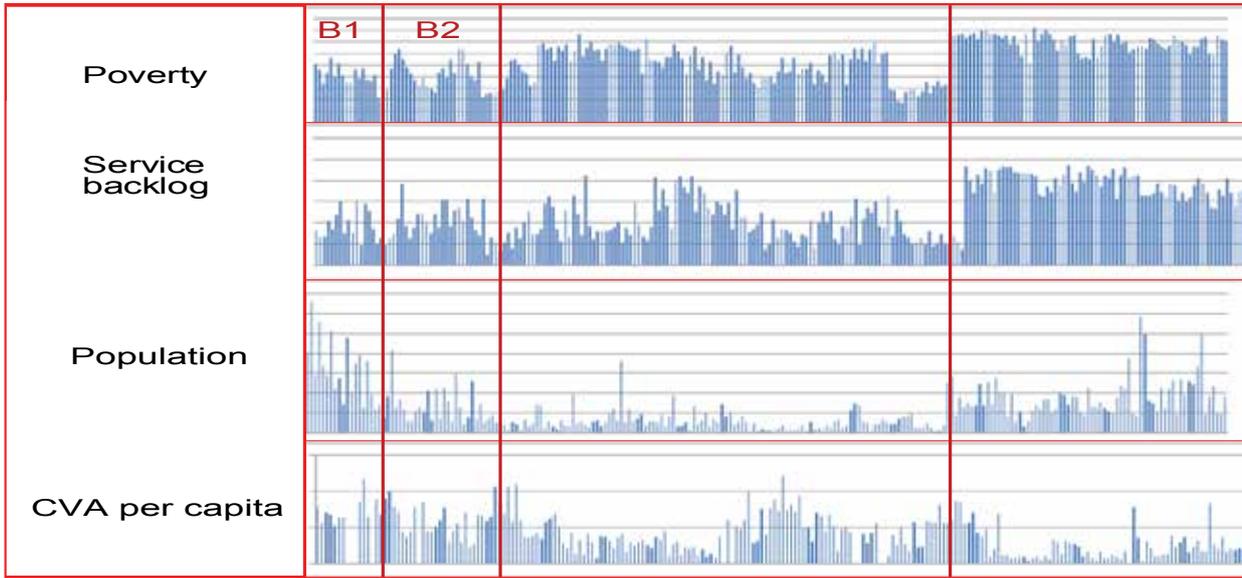
To date no independent empirical work has been carried out to investigate whether rural municipalities are sufficiently compensated for their lack of own revenues. Therefore, the main objective is to investigate whether the LGES and conditional grants compensate rural municipalities sufficiently (relative to their mandate) for their lack of own revenues. In addition, the study will investigate whether the new LGES formula has had the desired outcomes to date, and if not, why not, and how this can be remedied.

11.2 Background

Figure 88 shows that many municipalities have relatively high levels of poverty and service backlogs, especially in rural municipalities (B3s and B4s) where the GVA per capita is only R9 (compared to R76 in metros). This low economic activity translates into lower employment levels (13% on average in rural municipalities compared to 34% in metros and 29% in secondary cities), and points to rural municipalities having a limited own-revenue base.

Table 61 also shows the limited own-revenue base of rural municipalities, which rely on government grants for 70% of their funding and raise only 6% and 11% of their revenue from property rates and service charges, respectively. As these municipalities have such a limited revenue base, grants to them should be adequate to enable them to fulfil their mandate.

Figure 88. Characteristics of municipalities



Source: Commission's computations based on Global Insight data

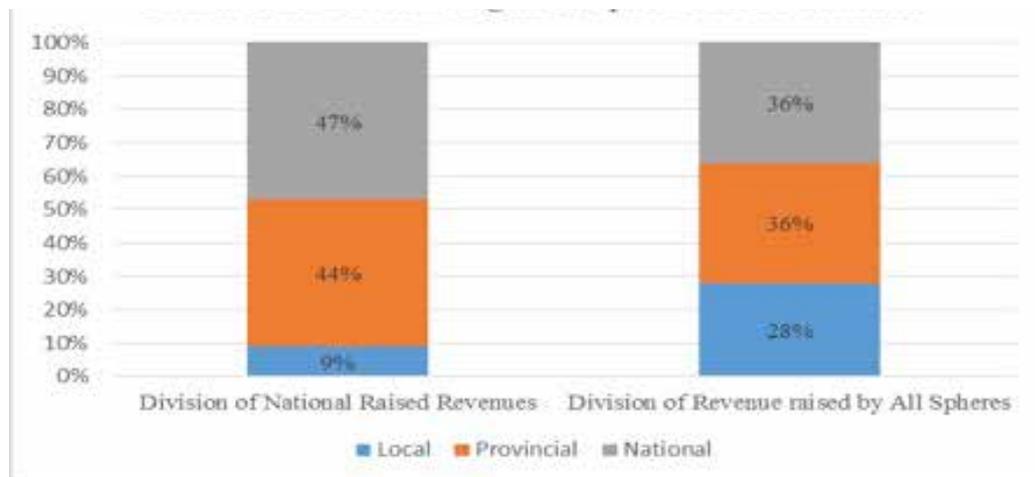
Table 61. Funding profiles of municipalities

| Type of municipality | Government grants | Investment revenue | Other | Property rates | Public contributions | Service charges |
|-----------------------------|-------------------|--------------------|-------|----------------|----------------------|-----------------|
| Metro | 24% | 2% | 9% | 18% | 0% | 48% |
| Secondary cities | 25% | 1% | 14% | 14% | 0% | 46% |
| Larger towns | 28% | 1% | 9% | 19% | 0% | 42% |
| Smaller towns | 40% | 1% | 10% | 11% | 0% | 37% |
| Rural municipalities | 70% | 1% | 12% | 6% | 0% | 11% |

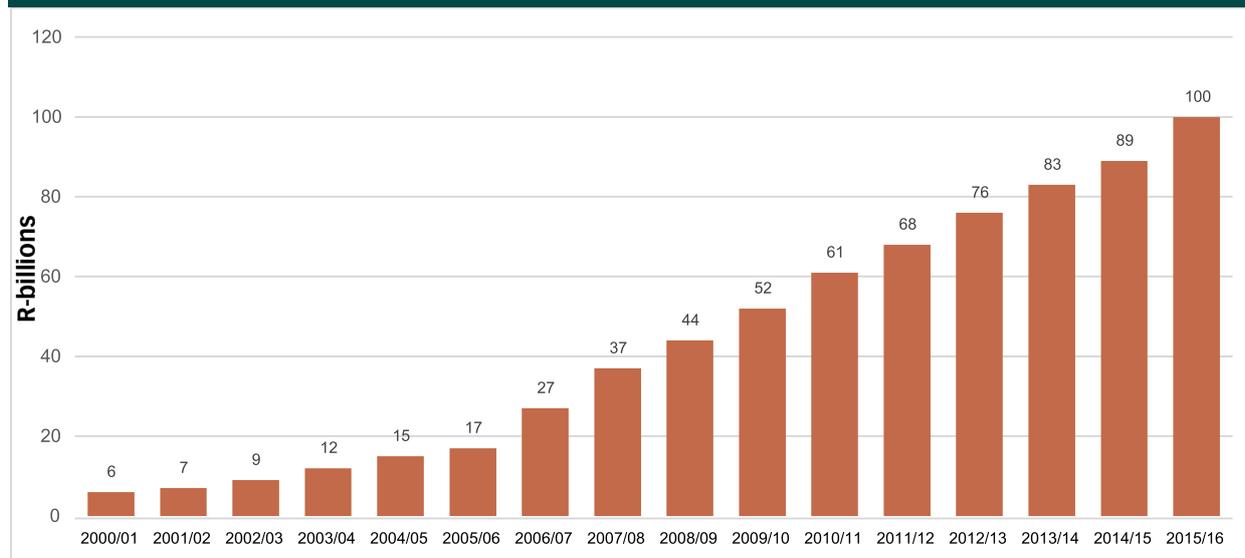
Source: Authors' calculations

Figure 89 shows the revenue allocations among the three spheres. The local sphere receives 9% of national raised revenues, compared to 44% and 47% for provincial and national spheres, respectively. When revenues raised by all spheres are considered, the local sphere receives 28%, compared to 36% apiece for national and provincial spheres. This imbalance has led to claims that the local sphere is unable to deliver on their mandate because it is not adequately compensated for the lack of own revenues.

As Figure 90 shows, transfers allocated to the local government have increased at a phenomenal rate, from R6-million in 2000/01 to R100-billion in 2015/16. Yet the increased resources have not led to an equivalent improvement in service delivery.

Figure 89. Division of Revenue among the three spheres of government

Source: Authors' calculations

Figure 90. Value of transfers to local government (2000/01–2015/16)

Source: Commission's computations based on National Treasury data

11.3 Related Literature: Adequacy of Funding

Despite various municipalities saying that resources are inadequate, the issue of adequate funding has not been scrutinised locally. The issue has also received little attention in international literature, with only a few international studies looking at the adequacy of funding of the local government sector in general. For example, Hancock (2002), found that funding for local government in Australia was adequate, despite continuous upward pressures on local government spending. Table 62 provides a summary of the findings

from international literature concerning the adequacy (or otherwise) of funding for local government across both developing and developed countries. Local governments appear to be adequately funded in developed countries but not in developing countries, implying that funding adequacy is probably linked to a country's level of development and affluence. This mixed evidence suggests that the issue depends on each country's context and circumstances, and needs to be evaluated through empirical evidence.

Table 62. Summary of literature on the adequacy of local government funding

| | |
|------------|--|
| India | Large urban local governments have adequate resources, but small urban and rural local governments are severely resource-constrained |
| Pakistan | Most local governments suffer harsh resource constraints |
| Australia | Local governments have sufficient resources for their responsibilities |
| Bangladesh | Resources of local governments are severely constrained |
| Nepal | Resources of local governments are severely constrained |
| Japan | Local government's current and capital resources are adequate |
| China | Local government resources are constrained, especially at the lowest level of government |
| Korea | Local government's current and capital resources are adequate |
| Thailand | Local governments have sufficient resources for their responsibilities |

Source: UCLG (2010)

11.4 Methodology

The question of whether the LGES and conditional grants sufficiently compensate the lack of municipal own revenues is essentially about whether the funds allocated are enough to cover the cost of a municipality's mandated services. In other words, whether the operational and capital funding allocations are sufficient. To establish whether funding for municipalities is sufficient, the cost of basic services were estimated using an Excel-based model developed by I@Consult on behalf of the Commission. A full description of the model can be found in FFC and SALGA (2015). Unlike the current Division of Revenue cost estimates of basic services, this robust model takes into account an elaborate array of cost-influencing factors, e.g.

- Topography (flat, rolling or mountainous terrain)
- Location (coastal or inland)
- Distance from economic centres
- Development status (number of settlements and densities)

The estimated costs of basic services were then compared with the LGES and conditional grants allocated to rural municipalities. Capital costs were determined through costing backlogs and new investments, while operational costs included: bulk purchases, contractual services, employee-related costs (salaries and wages), insurance, other materials, rent of facilities and equipment, repairs and maintenance and transport costs. Service access backlogs were based on the 2011 Census data, adjusted to 2015.

Additional key features of the model include:

- The municipal-specific factors are comprehensively profiled.
- The costs of municipal basic services are moderated individually, per category or in total, based on exogenous cost-influencing factors such as spatial characteristics, topography and geology.
- The model allows for temporal adjustments to variable base datasets (e.g. population size and number of households).
- Municipal inefficiencies are discouraged by establishing loss-limiting factors through a combination of quantification of demand based on national policy allowance and the setting of limits for unaccounted water and electricity.

11.4.1 Data

The costs of municipal services were based on actual costs, benchmark actual costs, average costs and a combination of the three mechanisms. Primary unit cost and benchmark data were sourced from a sample of 32 municipalities, i.e. 12% of the total 278 municipalities in South Africa. The sample cuts across all municipality categories: from metros to B4s, and includes municipalities in seven of South Africa's provinces. Secondary data, especially on municipalities, was sourced from the National Treasury, sector departments, Stats SA, the Municipal Demarcation Board, the Agricultural Research Council, audited municipal annual financial statements and budgets, Quantec, and the South African Local Government Association (SALGA).

11.5 Results

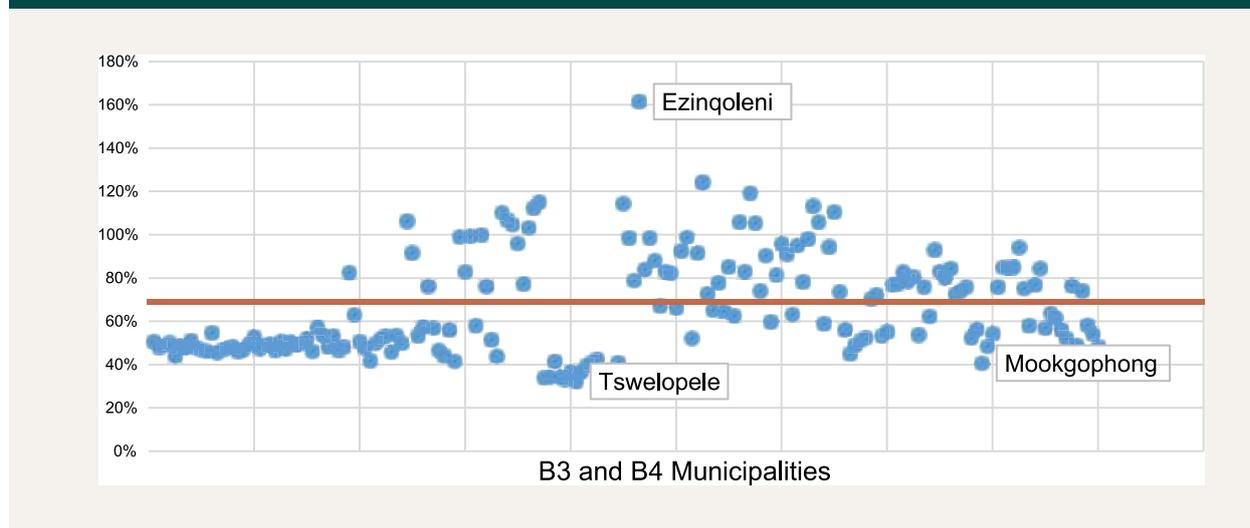
11.5.1 Does the LGES sufficiently compensate rural municipalities?

The Constitution is clear on the purpose of the LGES, stating in Section 227(a): “Local Government and each province is entitled to an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it”. In addition, Section 214(2)(e) says that the LGES has to achieve equity in the provision of basic services and must take into account the different levels of fiscal capacity of municipalities. This implies that the LGES is a useful instrument for compensating municipalities that lack fiscal capacity. Therefore, the effectiveness of the

LGES in compensating rural municipalities for lack of own revenue was tested, by comparing the operational costs calculated from the model with the LGES allocations for rural municipalities (Figure 91).

Given that own revenues account for almost 30% of rural municipalities’ budgets, the LGES would be expected to cover about 70% of their operational expenses. Using this rough guide, the LGES fully compensates about 40% of rural municipalities for their estimated operational expenses, and covers between 40% and 70% of operational expenses for the other 60% (Figure 91).

Figure 91. LGES vs. actual operational costs

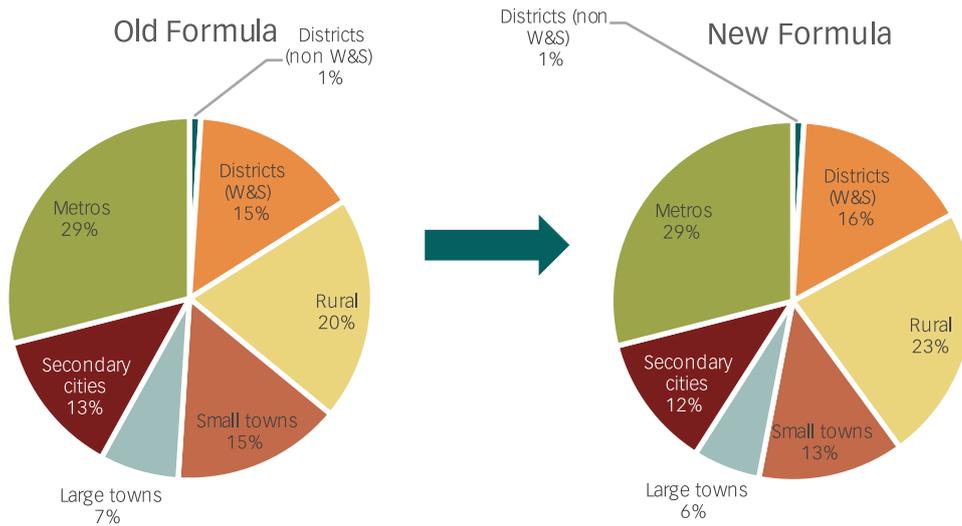


Source: Commission's calculations

The next step was to look at whether the LGES is achieving the desired outcomes since its review. In 2011, the review focused on redistributing LGES funding towards municipalities that lack own revenues. Figures 92 and 93 suggest that rural municipalities benefit more from the LGES, as

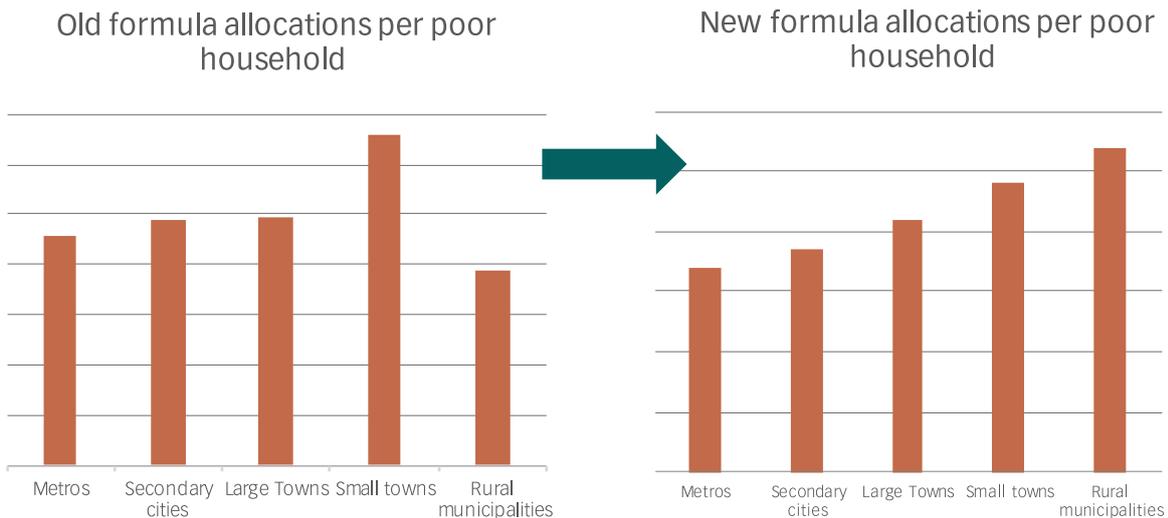
they receive more allocations per poor household. Poor households in rural municipalities are now receiving more through the LGES than households in metros, secondary cities, and large and small towns.

Figure 92. Impact of LGES



Source: Commission's calculations

Figure 93. Redistributive impact of LGES



Source: Authors' calculations

11.5.2 Do conditional capital grants sufficiently compensate rural local municipalities?

To determine whether conditional capital grants sufficiently compensate rural local municipalities, the capital grants for electricity, solid waste, roads and storm water, and water and sanitation were compared to the amount of investment required for each service. The costs of backlogs were estimated based on the assumption that municipalities are able to service 15% of the existing backlogs per annum. So for 2015, the costs of the backlogs will be equal to 15% of the existing backlogs.

Adequacy of funding for electricity

The assumption made is that all municipalities buy bulk electricity from Eskom, and so the extent of off-grid supply is not material. Hence generation infrastructure is excluded from the scope of infrastructure to be funded. The estimated capital investments required for electricity in 2015 by province are shown in Table 63.

Table 63. Estimated capital investments required for electricity per province (2015)

| Electricity | 1 | 2 | 3 | 4 |
|---------------|----------------------|--------------------------------|----------------------|---------------------------|
| | Growth 2015 | Backlog – 15% of total backlog | Total need (1+2) | Growth in poor households |
| Eastern Cape | 294 310 549 | 530 441 215 | 824 751 764 | 17 746 |
| Free State | 184 984 515 | 108 562 323 | 293 546 838 | 11 154 |
| Gauteng | 1 424 322 370 | 636 193 213 | 2 060 515 583 | 85 883 |
| KwaZulu-Natal | 767 689 091 | 1 058 842 304 | 1 826 531 395 | 46 290 |
| Limpopo | 516 472 892 | 248 804 607 | 765 277 499 | 31 142 |
| Mpumalanga | 386 219 374 | 200 604 221 | 586 823 595 | 23 288 |
| Northern Cape | 74 088 534 | 48 222 920 | 122 311 455 | 4 467 |
| North West | 316 562 139 | 228 124 857 | 544 686 997 | 19 088 |
| Western Cape | 393 772 403 | 113 890 031 | 507 662 433 | 23 743 |
| Total | 4 358 421 867 | 3 173 685 691 | 7 532 107 559 | 262 801 |

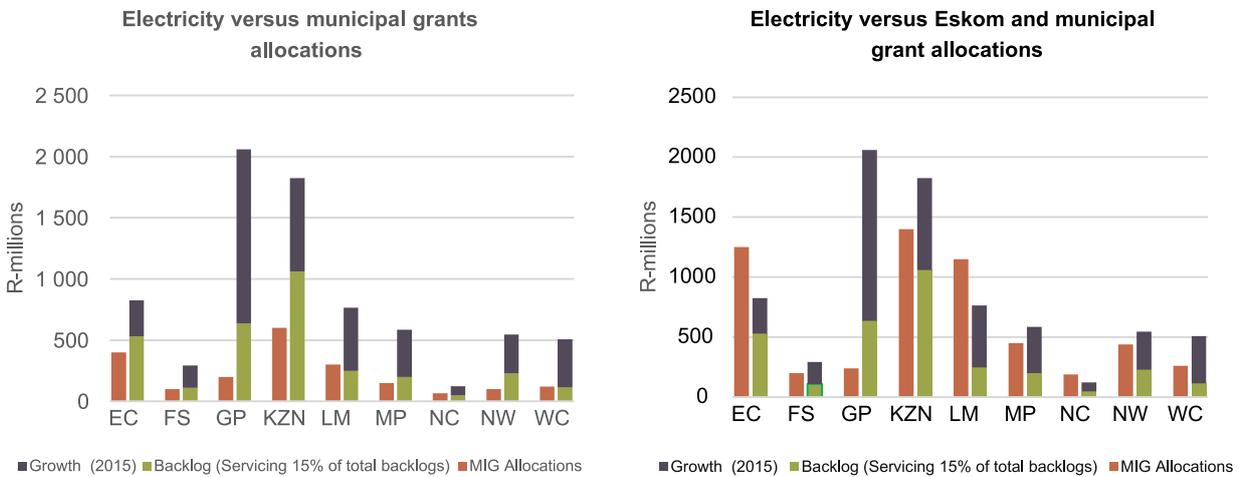
Source: Authors' calculations

Table 63 suggests that the capital investment required for electricity currently stands at R7.5-billion: R4.3-billion for new investment to cater for growth in poor households, and R3.1-billion to deal with 15% of the backlogs. The question is whether the grants are adequate to deal with this need.

Figure 94 compares the capital investments required for electricity and the grant allocations for electricity per province. The left graph shows clearly that in every province the Municipal Infrastructure Grants (MIG) alloca-

tions are far lower than the capital investments required. The largest shortfall is in Gauteng, where the MIG covers just 10% of the required electricity capital investment. As the Integrated National Electrification Programme (INEP) is channelled via Eskom, the graph on the right compares the sum of municipal and Eskom grants with the need on the ground. Together, the municipal and Eskom grants are adequate to service 15% of the backlogs and new infrastructure in the Eastern Cape, Limpopo and Northern Cape. Again, Gauteng has the largest shortfall, which is too wide to be closed by own revenues.

Figure 94. Estimated capital requirements

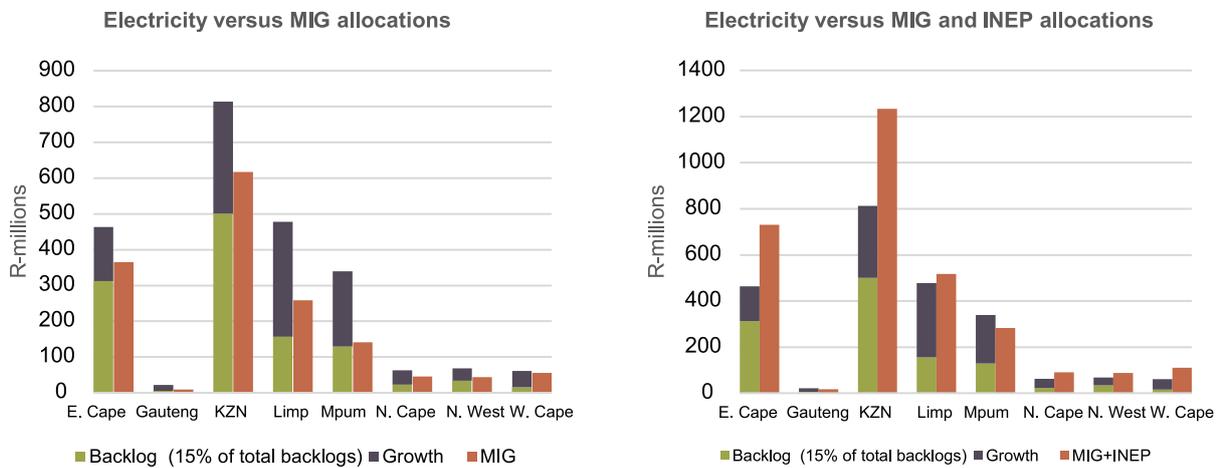


Source: Commission's calculations

The same comparison is done for rural municipalities only (Figure 95). As the left graph shows, MIG allocations are not enough to cover electricity costs. However, what is clear from the right graph is that when two funding streams

(MIG and, INEP) are combined, electricity is over-funded in all provinces, especially KwaZulu-Natal, Eastern Cape and Western Cape.

Figure 95. Capital investments required for electricity (2015)



Source: Commission's calculations

Solid waste

The main cost drivers of solid waste are garden refuse, land fill sites and transfer stations. The estimated total capital required to cover the need (backlogs plus growth) is about R659-million (Table 64).

Table 64. Estimated capital investments required for solid waste (2015)

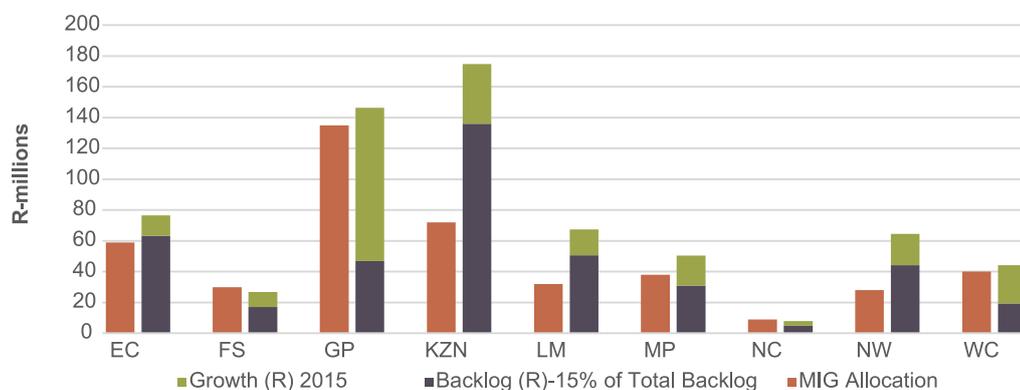
| Solid Waste | 1 | 2 | 3 | 4 |
|---------------|--------------------|--------------------------------|--------------------|---------------------------|
| | Growth 2015 | Backlog – 15% of total backlog | Total need (1+2) | Growth in poor households |
| Eastern Cape | 13 357 549 | 63 163 156 | 76 520 706 | 17 746 |
| Free State | 9 802 596 | 17 065 325 | 26 867 921 | 11 154 |
| Gauteng | 99 431 932 | 46 971 158 | 14 6403 090 | 85 883 |
| KwaZulu-Natal | 38 820 478 | 136 008 071 | 17 4828 549 | 46 290 |
| Limpopo | 16 835 861 | 50 650 857 | 67 486 719 | 31 142 |
| Mpumalanga | 19 474 437 | 30 974 776 | 50 449 213 | 23 288 |
| Northern Cape | 3 147 238 | 4 873 209 | 8 020 447 | 4 467 |
| North West | 20 307 331 | 44 144 162 | 64 451 494 | 19 088 |
| Western Cape | 24 814 050 | 19 335 415 | 44 149 465 | 23 743 |
| Total | 245 991 472 | 413 186 129 | 659 177 604 | 262 801 |

Source: Authors' calculations

Figure 96 compares the infrastructure needs for solid waste to the relevant part of the MIG allocated to municipalities. The MIG here represents 86% of the "Other" component in MIG, as case studies show that municipalities use on average 86% of the "Other" component of

MIG for refuse removal. The figure shows that the grants are insufficient to address needs in all provinces, except for the Northern Cape and Free State. The shortfall is largest (over 50%) in KwaZulu-Natal, Limpopo and North West.

Figure 96. Capital investments required for solid waste vs MIG allocations (2015)



Source: Commission's calculations

Roads and storm water

The main roads and storm-water capital spending include pavements, storm-water systems, public utilities, road furniture and public utilities. The estimated requirement for new infrastructure and servicing backlogs is R18.5-billion (see Table 65). The greatest needs are municipalities in

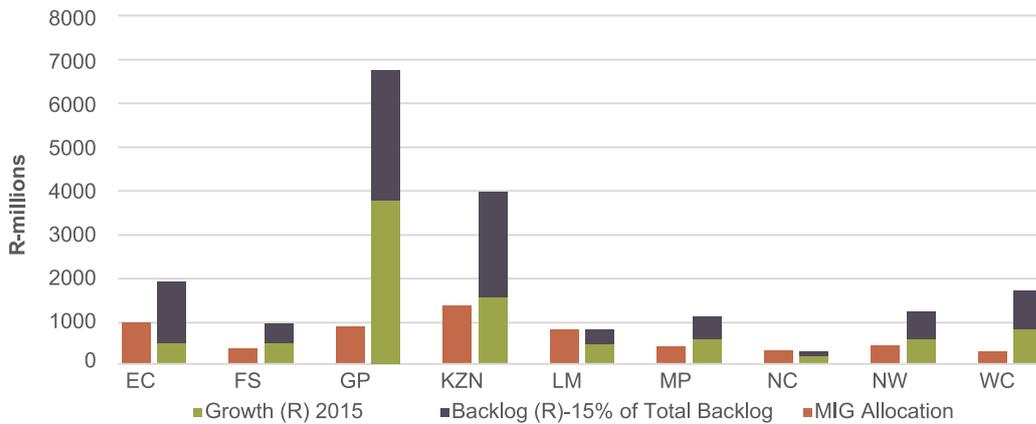
Gauteng followed by KZN. Figure 97 shows that the MIG will be insufficient to address all the needs (growth infrastructure plus 15% of the backlogs). The shortfall in funding is greatest in Gauteng and smallest in Limpopo.

Table 65. Estimated capital investments required for roads and storm water (2015)

| Roads Stormwater | 1 | 2 | 3 | 4 |
|------------------|----------------------|--------------------------------|-----------------------|---------------------------|
| | Growth 2015 | Backlog – 15% of total backlog | Total need (1+2) | Growth in poor households |
| Eastern Cape | 498 784 906 | 1 435 916 414 | 1 934 701 320 | 17 746 |
| Free State | 360 012 925 | 458 104 691 | 818 117 616 | 11 154 |
| Gauteng | 3 706 480 965 | 3 112 891 631 | 6 819 372 595 | 85 883 |
| KwaZulu-Natal | 1 395 909 926 | 2 626 505 694 | 4 022 415 620 | 46 290 |
| Limpopo | 573 908 683 | 269 656 473 | 843 565 156 | 31 142 |
| Mpumalanga | 632 243 030 | 475 053 104 | 1 107 296 134 | 23 288 |
| Northern Cape | 110 930 086 | 92 592 451 | 203 495 536 | 4 467 |
| North West | 644 419 353 | 563 762 812 | 1 208 182 165 | 19 088 |
| Western Cape | 914 526 109 | 637 975 833 | 1 552 501 942 | 23 743 |
| Total | 8 837 215 983 | 9 672 459 103 | 18 509 648 084 | 262 801 |

Source: Authors' calculations

Figure 97. Capital investments required for roads and storm water vs MIG allocations (2015)

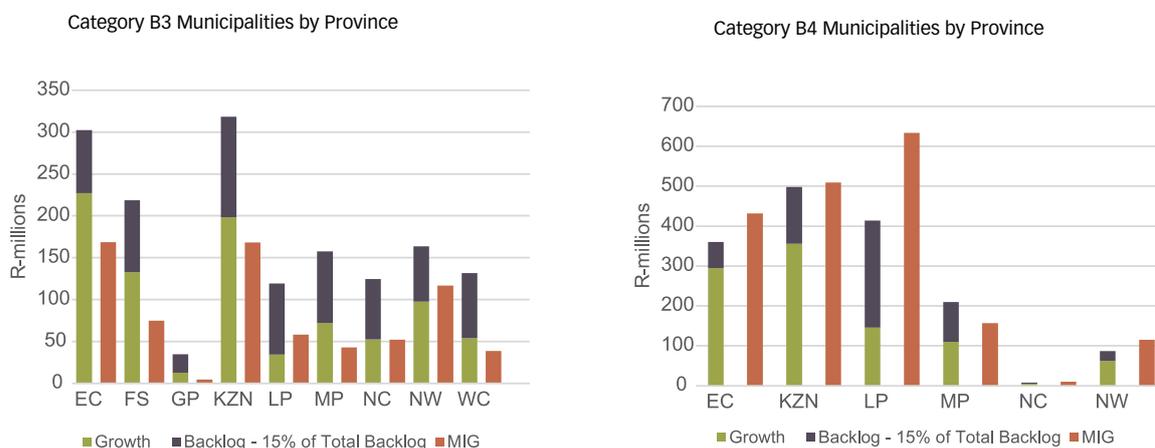


Source: Commission's calculations

Figure 98 compares roads and storm-water capital requirements with the MIG allocations for B3 municipalities (left graph) and for B4 municipalities (right graph). The MIG allocations alone are inadequate to cover roads and storm

water requirements in B3 municipalities but adequate for B4 municipalities in the Eastern Cape, Limpopo and North West.

Figure 98. Estimated capital requirements for roads and storm water



Source: Commission's calculations

Water

Water is examined separately from sanitation. The main components of water capital budgets are dams and boreholes, bulk mains, distribution, reservoirs, connections, pump stations and water treatment centres. The estimated capital investment requirements for water

amounted to R7.7-billion in 2015, with growth infrastructure accounting for R4.7-billion of this amount. The need for new infrastructure is greatest in Gauteng municipalities, while the need for servicing backlogs is largest in KwaZulu-Natal municipalities.

Table 66. Estimated capital investments required for water per province (2015)

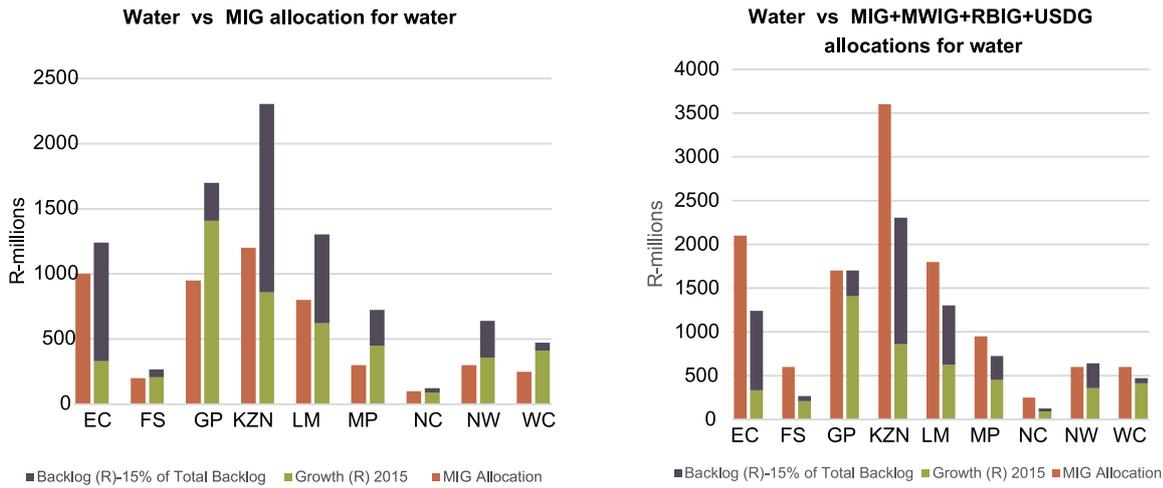
| Water | 1 | 2 | 3 | 4 |
|---------------|----------------------|--------------------------------|----------------------|---------------------------|
| | Growth 2015 | Backlog – 15% of total backlog | Total need (1+2) | Growth in poor households |
| Eastern Cape | 331 555 107 | 909 780 946 | 121 336 054 | 17 746 |
| Free State | 206 835 698 | 61 429 072 | 268 264 769 | 11 154 |
| Gauteng | 1 408 278 658 | 291 655 224 | 1 699 933 882 | 85 883 |
| KwaZulu-Natal | 858 357 297 | 1 446 612 926 | 2 304 970 223 | 46 290 |
| Limpopo | 622 504 299 | 680 988 239 | 1 303 492 539 | 31 142 |
| Mpumalanga | 449 530 147 | 273 886 610 | 723 416 757 | 23 288 |
| Northern Cape | 89 293 550 | 34 524 436 | 123 817 986 | 4 467 |
| North West | 357 891 624 | 282 934 412 | 640 826 037 | 19 088 |
| Western Cape | 411 783 839 | 60 403 076 | 472 186 915 | 23 743 |
| Total | 4 736 030 219 | 4 042 214 941 | 7 658 245 162 | 262 801 |

Source: Authors' calculations

In Figure 99, the infrastructure needs (that are identified in Table 66) are compared with the basic MIG grant to municipalities (left graph) and (right graph) with 50% of the total infrastructure grants, i.e. MIG + Municipal Water Infrastructure Grant (MWIG) + Regional Bulk Infrastructure Grant (RBIG) + Urban Settlements Development Grant (USDG),

as these grants are assumed to be split equally between water and sanitation. The basic MIG underfunds water infrastructure, whereas when all relevant grants are considered, water appears to be overfunded in all provinces except for the North West and (to a lesser extent) Gauteng.

Figure 99. Capital investments required for water vs MIG allocations (2015)



Source: Commission's calculations

Sanitation

The main components of sanitation budgets are outfall sewers, reticulation, connections, pump stations, waste water treatment works and VIP toilets. The estimated infrastructure needs for sanitation in 2015 stand at R10.5-billion

(Table 67), which is what the country requires to cover 15% of the existing backlogs and new sanitation infrastructure for 262 000 additional poor households.

Table 67. Estimated capital investments required for sanitation per province (2015)

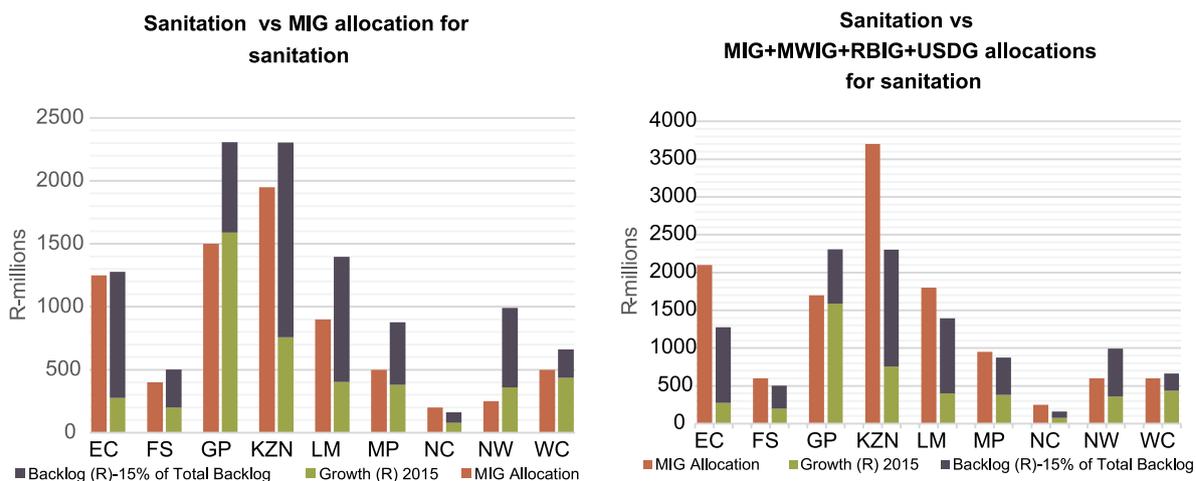
| Sanitation | 1 | 2 | 3 | 4 |
|---------------|----------------------|--------------------------------|-----------------------|---------------------------|
| | Growth 2015 | Backlog – 15% of total backlog | Total need (1+2) | Growth in poor households |
| Eastern Cape | 276 564 413 | 1 001 645 912 | 1 278 210 324 | 17 746 |
| Free State | 200 071 658 | 301 685 328 | 501 756 986 | 11 154 |
| Gauteng | 1 588 905 275 | 716 580 803 | 2 305 486 078 | 85 883 |
| KwaZulu-Natal | 757 530 895 | 1 545 710 449 | 2 303 241 394 | 46 290 |
| Limpopo | 401 298 802 | 994 077 845 | 1 395 376 647 | 31 142 |
| Mpumalanga | 380 078 374 | 496 891 038 | 876 969 412 | 23 288 |
| Northern Cape | 77 603 659 | 83 464 939 | 161 068 599 | 4 467 |
| North West | 358 765 553 | 633 123 976 | 991 889 529 | 19 088 |
| Western Cape | 435 058 295 | 2 270 03 481 | 662 061 776 | 23 743 |
| Total | 4 475 876 924 | 5 773 180 290 | 10 476 060 745 | 26 2801 |

Source: Authors' calculations

Figure 100 compares the infrastructure needs for sanitation with the MIG allocations (graph on the left) and with the 50% of the total infrastructure grants (MIG+MWIG+RBIG+USDG), as these grants are assumed to be split equally between water and sanitation (except for specific grants such as the bucket eradication). It shows clearly that the grants are insufficient to cover the required new infrastructure and

the eradication of 15% of the sanitation service backlogs. The gap is very small in municipalities in the Eastern Cape and widest in municipalities in the North West, Mpumalanga and Gauteng. When all capital grants for sanitation are taken into account, it should be possible to eradicate the backlogs at a higher rate than the assumed 15% per annum.

Figure 100. Capital investments required for sanitation vs MIG allocations (2015)

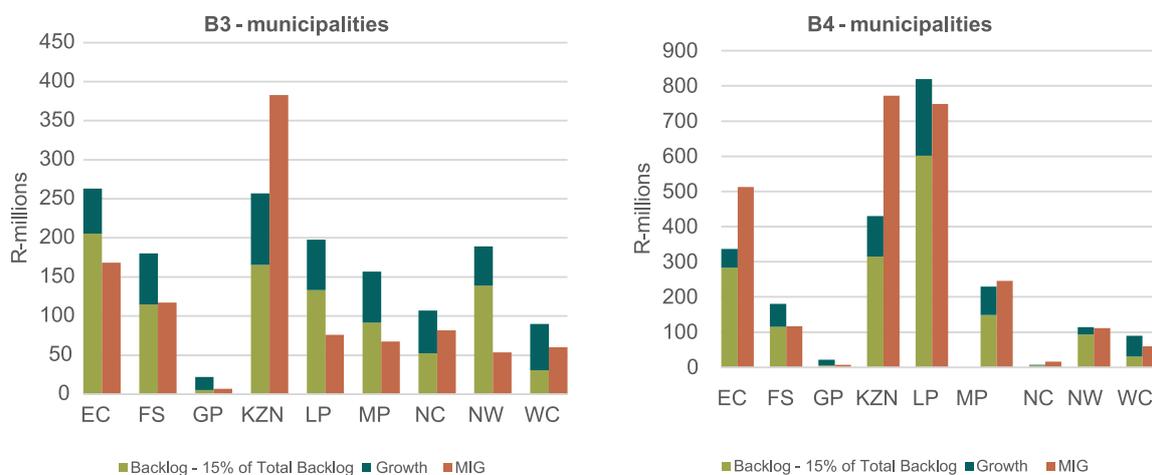


Source: Commission's calculations

Figure 101 shows the sanitation capital requirements for B3 and B4 municipalities separately. Apart from in KwaZulu-

Natal, B3 municipalities are not adequately funded, whereas B4 municipalities are adequately funded in all provinces.

Figure 101. Estimated capital requirements for sanitation



Source: Commission's calculations

11.6 Conclusion and Recommendations

The assessment shows that transfers adequately compensate rural local municipalities for the lack of own revenues in some services and not in others. This result implies that it is crucial to regularly review every transfer stream, so that needs and resources are always aligned, and it is important that objective cost estimates inform the allocations. The result also suggests that viewing a grant in isolation may lead to the impression that a service is being underfunded. However, when a holistic view of all grants is taken, a service may be fully funded. This suggests consolidating grants that are designed to achieve the same outcome. Therefore, the allocation of resources needs to be reviewed on a regular basis to avoid a situation where some services are over-compensated while others are not.

The following recommendations are in order:

- National Treasury should continue to consolidate grants (as previously recommended by the Commission) because viewing grants in isolation gives the impression that some services are underfunded, whereas services may be fully funded or overfunded when the grants are viewed holistically.
- National Treasury should ensure that the local government equitable share and conditional grants are informed by objectively derived cost estimates, without which the viability of rural municipalities will always be under threat.

11.7 References

FFC (Financial and Fiscal Commission) and SALGA (South African Local Government Association). 2015. Costing of Basic Services to Inform DORA Allocations, Final Report. Pretoria: FFC and SALGA.

Hancock J. 2002. Financing Local Government's Contribution to Community Development. Report Prepared for the Local Government Association of South Australia, University of Adelaide, South Australia.

UCLG (United Cities and Local Governments). 2010. Local Government Finance: The Challenges of the 21st Century. Second Global Report on Decentralization and Local Democracy. Barcelona, Spain: UCLG.