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CHAPTER 6: HOW EFFECTIVE, CREDIBLE AND SUSTAINABLE ARE LOCAL GOVERNMENT BUDGETS?

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6.1 Introduction

An integral part of South Africa's governance system, the local government sector is diverse and consists of 283 municipalities.[82] There are six metros, which contain 35% of the population, while secondary cities and local municipalities account for 38% and 26.8% of the population, respectively (StatsSA, 2007). Some municipalities have populations as small as 5,000 (e.g. Laingsburg) while at the other extreme, the City of Johannesburg is home to four million people. Over 80% of South Africa's gross domestic product (GDP) is generated in urban areas and, in 2002, the nine largest cities in South Africa contributed 63% to gross value added (GVA) and employed 51% of the country's total working population (SACN, 2004). Municipalities are also in control of infrastructural assets with a replacement value of over R720 billion (Boshoff, 2009). In 2008/9 the six metros accounted for 60.6% and 56% of total local government capital and operating expenditure respectively.

The local government sphere faces a myriad of challenges, including widespread poverty, unemployment (which in cities and towns ranges from 26% to 50%), and overstretched, sometimes inadequate infrastructure which affects service delivery negatively.

The local government sphere is at the coal face of service delivery, and is constitutionally assigned the responsibility of providing basic services to communities. However, many municipalities are failing to provide adequate basic services. Table 6.1 shows that, although the backlogs have improved, the number of households without access to refuse removal, sewage disposal, electricity and water remains high.

Table 6.1 Access to basic services

Basic Service	1996	2001	2007
Households with refuse removal by a local authority at least once a week	51.2%	55.4%	60.1%
Households with access to a flush toilet connected to a sewage disposal	n/a	49.1%	55.1%
Households using electricity as the main source of lighting	57.6%	69.7%	80.0%
Households with access to piped water	n/a	84.5%	88.6%

Source: StatsSA, 2007

In 2007, 40% and 45% of households had no access to adequate refuse removal and sewage disposal facilities. Of the four million households that received irregular or highly inadequate services, an estimated 2.2 million households had no access to any solid waste collection services at all (Savage, 2009). In 2007 the backlogs for electricity and water stood at 20% and 11% respectively.

The reasons for poor service delivery and other municipal failures are many and include:

- Inadequate and overstretched infrastructure.

79 Financial and Fiscal Commission.
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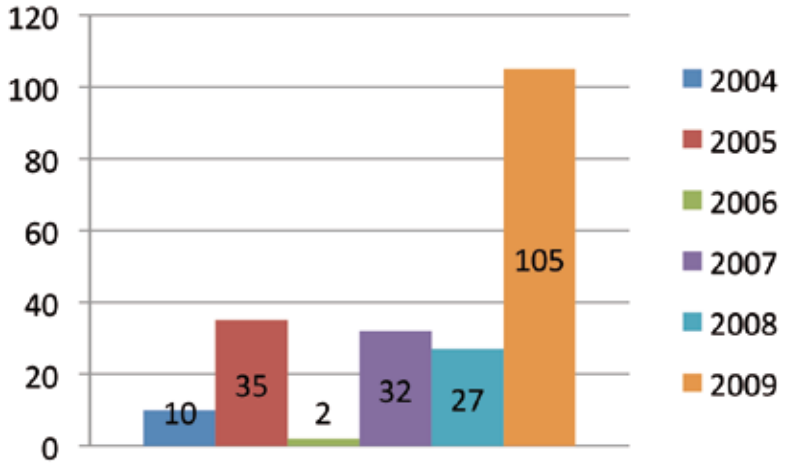
82 The re-demarcation process in 2011 reduced this number to 276 municipalities.

- Inadequate revenues versus unlimited expenditure needs.
- Limited opportunities to raise own revenues.
- Limited administrative, technical and managerial capacity and skills within the municipal workforce.
- Poor governance systems and structures, corruption and political meddling.

In recent years, poor service delivery has led to protests by residents across the country. These protests, by residents clamouring for improved service delivery, have emerged as one of the major threats to development and stability in the local government sphere. Service delivery protests have destabilised many municipalities and increased sharply around 2009 and 2010. Figure 6.1 shows the trends in service delivery protests.

Figure 6.1 Number of Service Delivery Protests in South Africa



Source: Karamoko (2011)

Reasons behind the protests include dissatisfaction with service delivery (such as water, electricity, toilets), unemployment, poverty, allegations of rampant corruption in local governments, and rising costs of utilities. The local government sphere is in difficulty, as the large numbers of qualified audit reports in municipalities proclaim (see Table 6.2). Municipalities submit their audit reports to National Treasury every year.

The table below shows audit reports between 2004/05 and 2008/09. Although the table below indicates some improvement in 2007/08 and 2008/09, the many incidences of audits with disclaimers, qualifications and adverse reports point to the challenges that municipalities face in meeting the grade. Reasons for the high incidence of these negative reports include capacity constraints and poor support infrastructure.

Table 6.2. Audit opinions

Audit opinions	2004/05	2005/06	2006/07	2007/08	2008/09
Unqualified	23%	18%	19%	33%	39%
Disclaimer	41%	45%	39%	33%	25%
Qualified	27%	22%	25%	19%	14%
Adverse	6%	9%	9%	3%	2%
Non-reported case	4%	6%	8%	13%	19%
Total	100%	100%	100%	100%	100%

Source: Author

To address poor service delivery in the local government sphere, the government has come up with the Local Government Turnaround Strategy (LGTAS), a comprehensive turnaround strategy (CoGTA, 2009a). LGTAS acknowledges the many challenges facing the sector and spells out a number of strategies to deal with them.

6.1.1 Problem statement

The performance of the economy is affected by many economic policies, for example monetary, trade, labour or industrial policies. Similarly, the government budget is one instrument or policy that has a significant impact on economic performance and can be used to influence the behaviour of economic agents and the economy at large. It spells out how the government mobilises, allocates and spends public resources, and how priorities are set and managed. It not only articulates the micro and macroeconomic policies of the government, but also fulfils the obligations and roles of the government to the population. Therefore, the effectiveness and efficacy of budgets in addressing national priorities needs to be constantly reviewed and evaluated in order to assess whether budgets continue to fulfil their main functions or whether they are deviating from national and local priorities.

Budget analysis is critical for local government, as municipalities can respond to local needs and priorities in a way that no other sphere of government can. By virtue of their proximity to the people, local governments are better placed and informed to understand the socioeconomic dynamics that exist within their communities.

In South Africa, municipalities are constitutionally mandated to ensure that their constituents have constant and high quality access to basic services such as water, sanitation and refuse removal. The local government sector is increasingly called upon to play a pivotal role in service delivery. Both the 2009 State of Local Government (CoGTA, 2009b) and 2009 LGTAS highlight the central role of local governments in changing the fortunes of the country, yet service delivery failures and community protests have increased in number and frequency (see Figure 6.1). For municipalities to maximise service delivery, sound financial practices are the key (Schoeman, 2011), as financial resources need to be used efficiently and effectively in order to maximise service delivery. For municipal budgets, this means fiscal credibility and sustainability, the main pillars of sound financial practices.

6.1.2 Rationale

This research will assist policy-makers, society and Parliament. It will help policy-makers to evaluate or formulate their budgets and related policy, contribute to the debate about how to turn around the fortunes of poorly performing municipalities and help assess whether more or less decentralisation is desirable to address service delivery challenges. As local governments are the custodians of public funds, analysing their budgets will benefit society, which needs to understand how its resources are utilised and which deep-seated budgetary challenges require urgent intervention. Parliament will also benefit, as the analysis will shed light on the allocation of scarce fiscal resources within the different spheres of government.

The Financial and Fiscal Commission (the Commission) is mandated with ensuring equitable sharing of fiscal resources and accountability of government agents. A systematic analysis of municipal budgets lays the foundation for building accountable local government institutions, which is one of the broad themes of the Commission's research strategy.

6.1.3 Methodology

Municipalities in South Africa are socially, demographically and economically diverse. Each municipality faces unique circumstances that either assist or hinder its ability to perform optimally. For instance, local governments in metros operate very differently from local governments in rural communities. Therefore, given these differences across municipalities, it is implausible to analyse local government in aggregate terms and infeasible to analyse every municipality in the country. Instead, municipalities will be categorised into relevant groupings as far as possible.

Section 155(1) of the Constitution recognises three categories of municipalities: A, B and C municipalities. However, the differences among municipalities within each category, particularly categories B and C, makes such grouping less attractive. For example, local (C) municipalities range from highly populated secondary cities such as Msunduzi (Pietermaritzburg) to sparsely populated rural municipalities such as Mbizana (Bizana). The asymmetric division of powers and functions between district and local municipalities also makes it difficult to compare category C municipalities in aggregate, as the nature of their budgets and expenditures differ.

Therefore, where possible, the budget outcomes will be evaluated using the categories in Table 6.3 and, if this categorisation is not possible, recourse will be made to the A, B and C groupings.

Table 6.3 Categorisation of municipalities

Category	No	Description
Metropolitan municipalities	6	As per the constitutional definition of category A municipalities
Secondary cities	21	Local municipalities with the highest operating budgets and a large urban spatial pattern
Large towns	29	Local municipalities that consist of a large town
Medium to smaller towns	111	Local municipalities that consist of several smaller urban settlements
Rural municipalities	70	Local municipalities that are largely rural with large sprawling settlements
District municipalities without major service powers and functions[83]	25	Category C municipalities without water and sanitation service powers and functions
District municipalities with major service powers and functions[84]	21	Category C municipalities with water and sanitation service powers and functions
Total	283	Local government sector

Source: CoGTA, 2009

Local government data has many gaps and deficiencies, which can hamper meaningful interrogation of budgets, and much of the information (such as the GVA or population of municipalities) is not up to date. Therefore, the data is sourced mainly from National Treasury databases (Local Government Budgets and Expenditure Review, various issues) up to 2008/09 which have been audited (National Treasury, 2010).

The objective of this chapter is to evaluate the performance of local government budgets, with particular emphasis on the implications of different spending patterns and revenue sources on service delivery challenges. The main issue is to evaluate the effectiveness of municipal budgets in fulfilling the main mandate of local governments, which is to maximise service delivery. In assessing the soundness of budget practices in the local sphere, the focus is on the fiscal credibility and sustainability of the sector's budgets.

A review of the macroeconomic environment and economic outlook for municipalities is followed by an analysis of spending, revenue trends and outcomes. After examining whether municipal budgets are sustainable and credible, recommendations are made to ensure a stronger and sustainable local government sphere.

6.2 Macroeconomic Environment and Economic Outlook

The macroeconomic environment in which municipalities operate affects their performance, especially their budgeting and spending processes. Like the rest of the world, South Africa's economy is slowly coming out of a financial and economic crisis. During the recession, South Africa's economy slowed, from a peak real GDP growth rate of 6% in 2006/07, to a negative real GDP growth rate in 2009/10.

The crisis was characterised by huge inflationary pressures, subdued domestic demand, weak export and tourism revenues, rising unemployment and poverty. As the engines of growth and development in many countries, urban centres found themselves in the deep end of this economic meltdown and were hit hard by unemployment, de-industrialisation, poverty and many other ills.

To reverse the downward spiral in economic activity, many economies introduced various stimulus packages, which in South Africa took the form of infrastructure investment, largely for the 2010 FIFA World Cup™.

83 Hereafter referred to as district municipalities without powers.

84 Hereafter referred to as district municipalities with powers.

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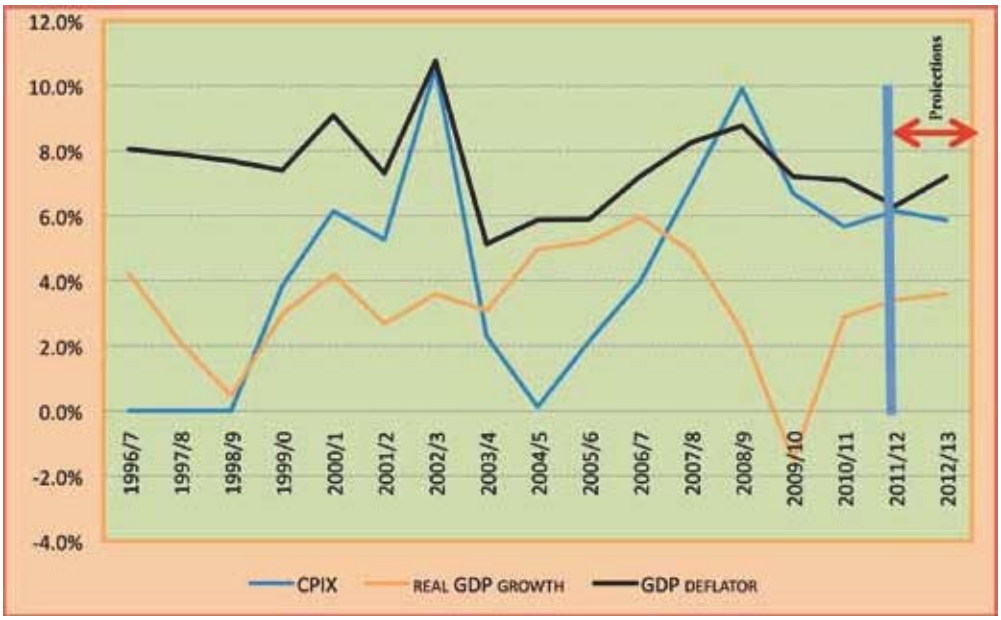
Figure 6.2 Macroeconomic indicators



Source: South African Reserve Bank (various)

Infrastructure investment helped to diminish what would have been deeper impacts of the recession. As Figure 6.2 shows, by the end of 2009 the economy was slowly rebounding and the outlook was promising. The rebound was spearheaded by manufacturing, mining, finance, wholesale and retail, and government sectors (see Table 6.4). In the manufacturing sector, the main growth impetus came from export-oriented sectors. Platinum prices drove spectacular growth in the mining sector of 4.6% in the last quarter of 2009 and 15.4% in the first quarter of 2010. Improvements in consumer confidence (attributable to the decline in inflation) and interest rates led to improved domestic demand and a boost in the retail sector. Spending associated with the 2010 FIFA World Cup™ also resulted in additional retail sales growth. The upswing was strongly correlated with the resurgence in capital inflows and recovery in global demand, particularly in East Asia, South Asia and sub-Saharan Africa (SSA), regions that account for the bulk of South African exports. The World Bank estimates that in 2011 and 2012, East Asian economies will grow by 7.8% and 7.7%, South Asian by 8.7% and 8.2%, and SSA by 5.1% and 5.4%. The euro area, which accounts for 35% of South African exports, is expected to grow by 1.3% and 1.8% in 2011 and 2012.

Table 6.4 Performance of key sectors of the economy

	2009Q1	2009Q2	2009Q3	2009Q4	2010Q1
Agriculture	-5.6	-15.8	-11.8	-7.6	3.0
Mining	-30.7	15.8	-5.8	4.6	15.4
Manufacturing	-25.5	-11.1	7.6	10.1	8.4
Electricity	-8.1	1.9	4.2	0.9	4.9
Construction	10.7	8.7	6.1	3.6	2.1
Wholesale & retail	-2.4	-5.9	-1.1	-0.7	3.3
Transport	-2.1	-1.0	1.2	1.9	2.4
Finance	-2.3	-4.3	-1.0	2.1	2.5
General government	2.1	4.1	4.4	5.1	2.8
Personnel services	2.7	3.3	3.5	3.1	2.0

Source: National Treasury, 2010

Although recovery prospects for the South African economy are strong, risks of all sorts may diminish the rate of economic expansion. On the domestic front, threats to sustained recovery will come from increases in electricity prices, strong currency, post-World Cup lull in economic activity, and strike activities in many sectors of the economy. On the external front the biggest threat to recovery comes from the sovereign debt crisis in the euro zone.

6.3 Local Government Budgetary Trends and Outcomes

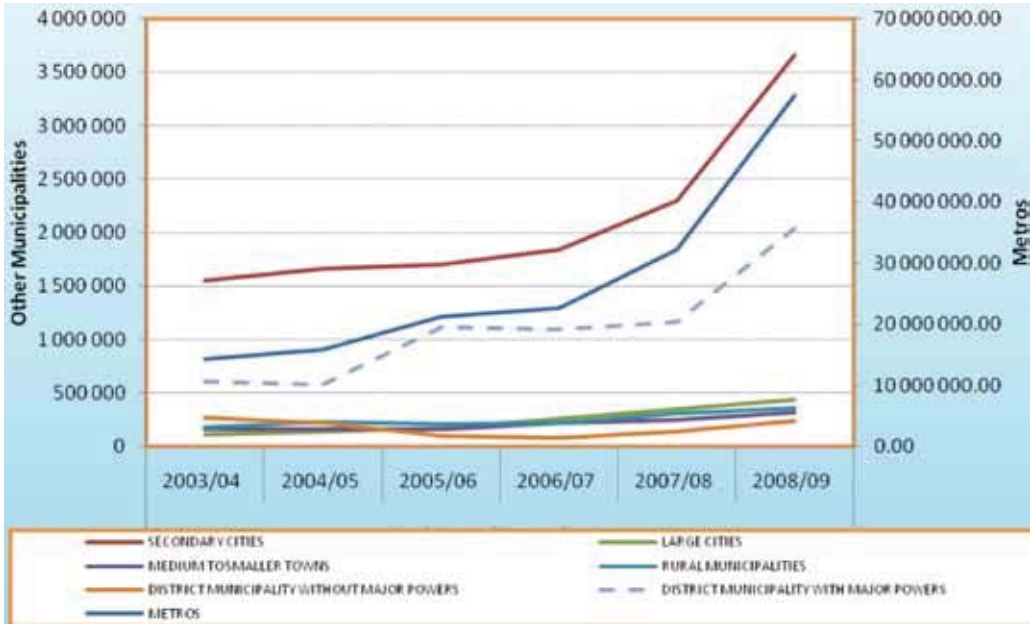
The two sides of the budget – expenditure and revenue – play equally important roles in the economy and social well-being, influencing the behaviour of many socioeconomic aggregates.

In the local government sphere, expenditure is broadly divided into capital and operating expenditures. Capital expenditure consists of long-term economic and social infrastructural investment, while operating expenditures constitute costs associated with the actual provision of services, e.g. input, capital and material costs. Across all municipal categories, municipalities generally devote at least 80% of their actual budgets to operational issues and 20% to capital expenditure.

6.3.1 Capital spending in the local government sphere

Figure 6.3 shows the real actual capital expenditures for the seven municipal categories for the period 2003/04 to 2008/09 (the series for metros is plotted on the 'secondary axis'). After 2007, capital spending increases sharply in metros, secondary cities and district municipalities with major powers and functions, but remains modest in the other municipality categories.

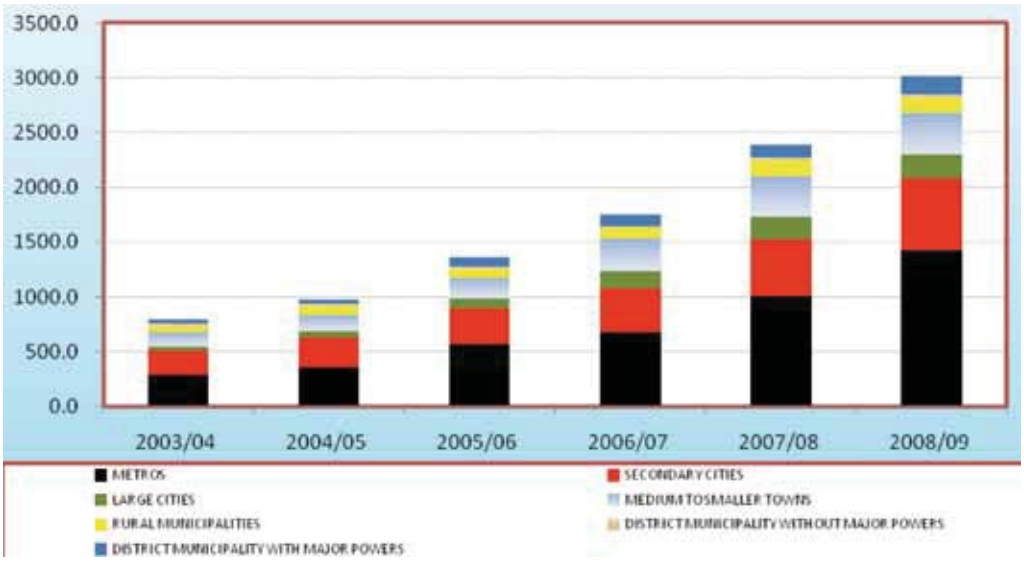
Figure 6.3 Real municipal capital expenditure (R'000)



Source: National Treasury, 2010

In Figure 6.4 the per capita capital expenditure trends are presented with the per capita spend in parenthesis.

Figure 6.4 Real per capita capital expenditure (rands)



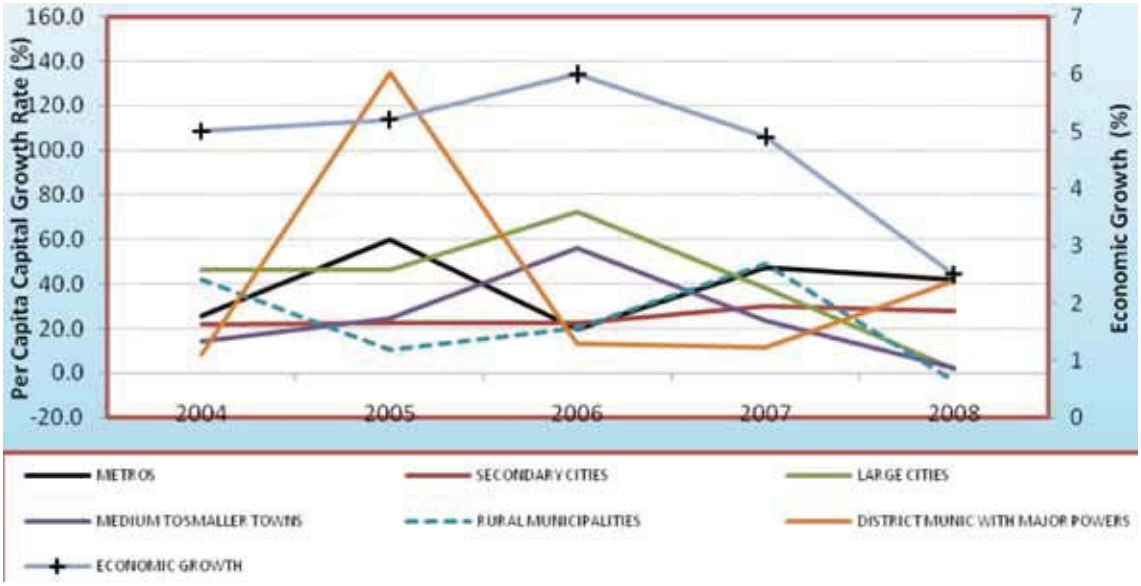
Source: National Treasury, 2010

Metros and secondary cities have the highest per capita spending, but all other municipalities show a modest increase in spending, which suggests that all municipalities are investing larger amounts in capital infrastructure.[85] Small investments by district municipalities are expected, as these municipalities have no powers to invest in infrastructure such as water and sanitation.

Although not shown here, when municipalities were grouped by province, per capita capital spend shows wide variation. The highest average per capita spending is in Western Cape municipalities (R6,235 per annum), followed by Gauteng (R6,029). At the lower end are municipalities in the Limpopo region (R1,492), Mpumalanga (R1,980) and the Eastern Cape (R2,204). Reasons for this variation are historical, demographical and economical.

Comparing per capita capital expenditure to economic growth rates (Figure 6.5)[86] reveals that the growth in per capita spend is inconsistent (districts with major powers are a good example) and exceeded the rate of inflation during the review period (except for district municipalities without major powers and functions). For most municipalities, there seems to be a close association between per capita spending and economic growth, implying that municipality spending is vulnerable to economic changes.

Figure 6.5 Per capita capital expenditure and economic growth rates (%)



Source: Own calculations from National Treasury Data (various years)

When evaluating public finances, it is critical to know where the money is spent (i.e. what are the budgetary outcomes). The Constitution mandates the local government sphere to provide basic services, while the LGTAS is clear that government's priority is to eradicate backlogs and ensure that the entire population has access to basic services such as water, sanitation and refuse removal. In order to assess whether sub-national spending is assisting national government to realise its goal of providing basic services to all, capital spending is examined by function.

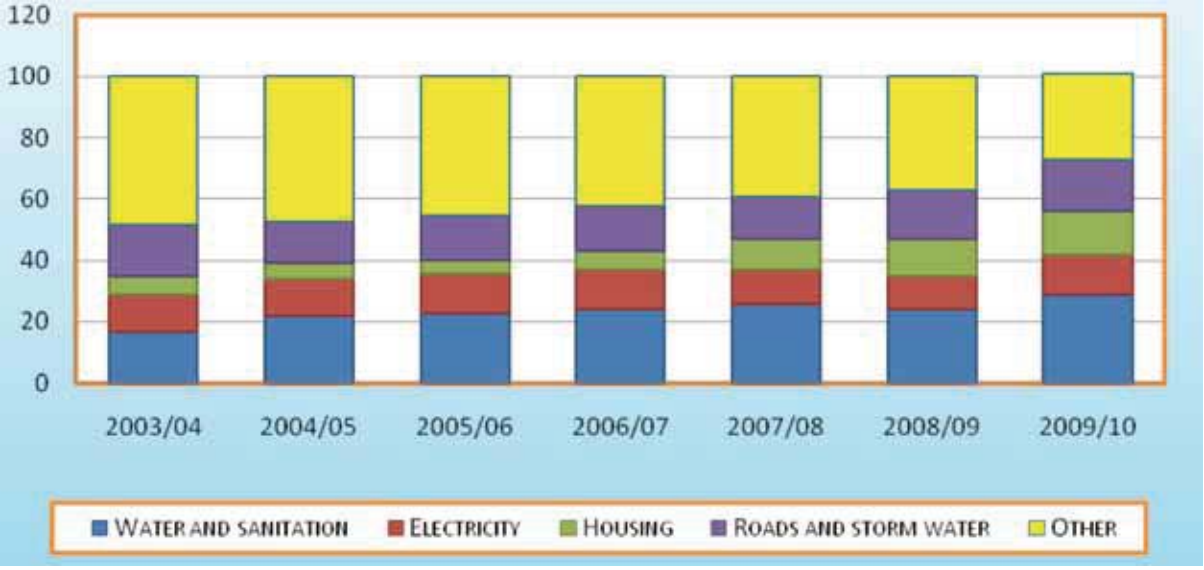
Water and sanitation, roads and storm water and 'Other' (see Figure 6.6) dominate local government capital expenditure. The 'Other' component refers to expenditures on land, buildings, vehicle fleets, and so on. However, caution must be exercised when interpreting information for district municipalities, which do not have water and sanitation service powers and functions. Interestingly, Figure 6.6 shows that water, sanitation and housing[87] have increased their share of the budget, which augurs well for the aim of providing all South Africans with basic services and is also in line with government's goal of achieving the Millennium Development Goals (MDGs) by 2014.

85 This point will be interrogated further in subsequent sections.

86 Municipalities without water and sanitation powers and functions are excluded from Figure 6.4.

87 Housing is mainly provided by metros, as housing is a provincial competency with implementation usually at the local level.

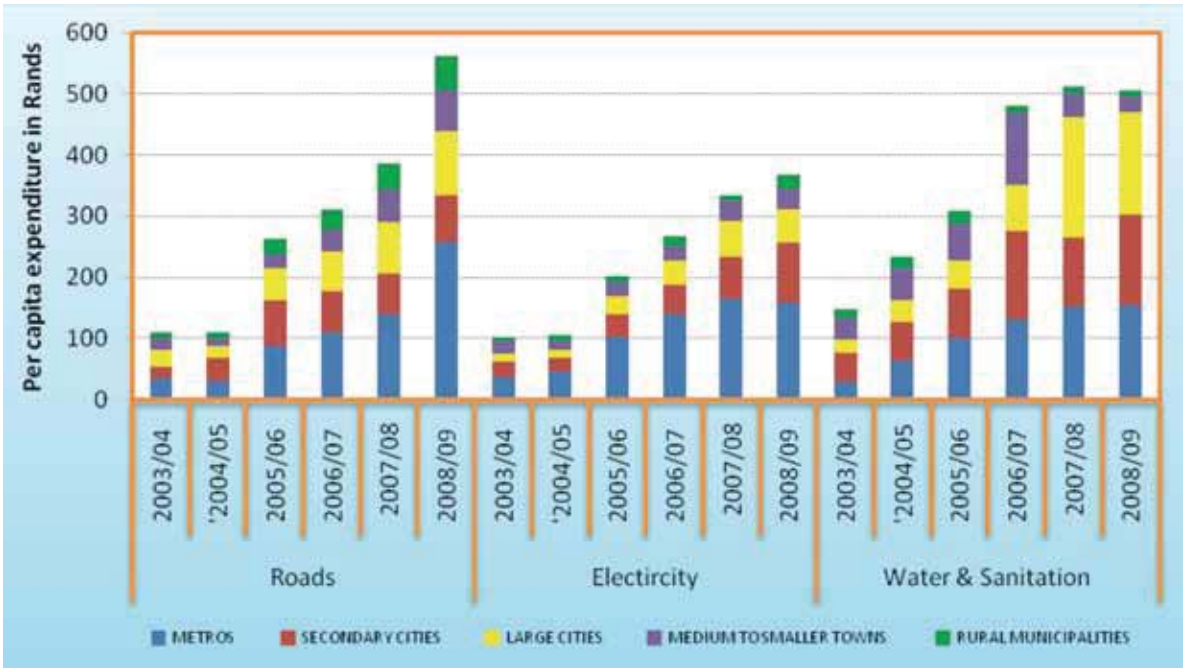
Figure 6.6 Capital expenditure shares for all municipalities (%)



Note: 'Other' refers to expenditure on land, buildings, fleet vehicles, etc.
Source: National Treasury, 2010

When the per capita capital expenditure is examined by function (Figure 6.7), large disparities appear for basic services by municipal type.[88] In general, metros spend the most per capita on infrastructure for all basic services and have increased their per capita expenditure. Large cities are also high per capita capital spenders on basic services, whereas rural municipalities and medium to smaller towns spend the least on road infrastructure. Of concern is the small and declining per capita capital spending by rural municipalities on water and sanitation. This implies that water and sanitation backlogs will persist in rural communities for the foreseeable future.

Figure 6.7 Per capita capital expenditure by function



Source: Own calculations from National Treasury Data (various years)

88 Note that all district municipalities have been left out because some do not have certain functions, such as water. It should be noted that some local municipalities do not spend on road infrastructure, as these functions are shared.

When examining spending patterns, the other issue is whether allocated resources are actually being spent. The expenditure analysis suggests extensive under-spending in capital budgets, which is of concern for service delivery. Under-spent capital budgets mean forgone infrastructural development, which translates into forgone jobs and economic development. Table 6.5 examines spending patterns of the conditional grants for infrastructure and capacity building, as capital spending largely comes from conditional grant revenues. The four major municipal, Schedule 6 grants are: Municipal Infrastructure Grant, Local Government Financial Management Grant, Municipal Systems Improvement Grant and the National Electrification Programme (Municipal) Grant. As Table 6.5 shows, these grants are widely under-spent.

Table 6.5 Spending on conditional grants

Conditional grant	2006/07	2008/09	2009/10
	Expenditure as % of allocation	Expenditure as % of allocation	Expenditure as % of allocation
Municipal Infrastructure Grant	90%	43.4%	78.9%
Local Government Financial Management Grant	34%	36%	110.9%
Municipal Systems Improvement Grant	67%	34.4%	94.3%
National Electrification Programme (Municipal Grant)	79%	53.4%	86.4%

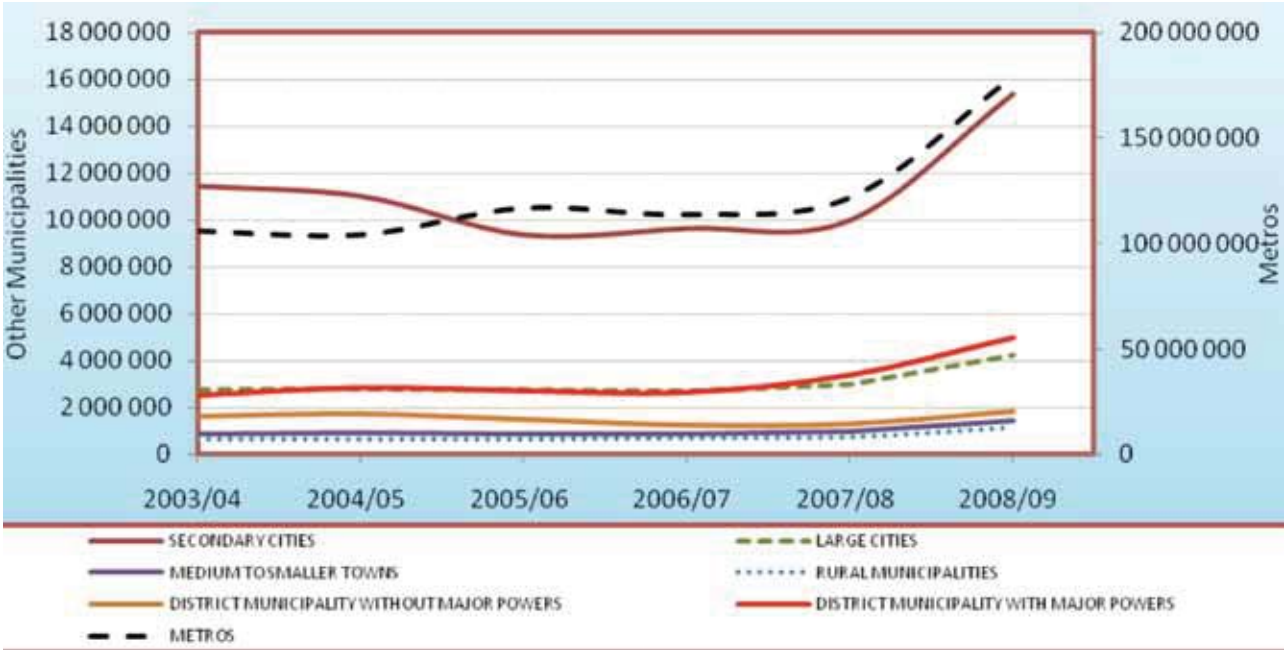
Source: Authors

Although the figures for 2009/10 show some improvement compared to 2008/09, the under-spending problem is widespread in capital budgets in general and in grants in particular. In 2009/10, all grants were under-spent, apart from the Local Government Financial Management Grant, which was overspent by 11%. Under-spending on the Municipal Infrastructure, Municipal Systems Improvement and National Electrification Programme (Municipal) Grants was 21%, 6% and 14% respectively. Consequences of under-spending fall disproportionately on the poorer communities and result in backlogs that are costly to eradicate. Under-spending on infrastructure not only affects employment, but also perpetuates poverty and hampers efficient and sustainable service delivery. Causes of under-spending include poor planning, poor infrastructure costing and lack of technical, project management and procurement capacity.

6.3.2 Operating expenditure

The bulk of local government expenditure goes on operating costs, which are associated with service provision. Figure 6.8 presents the operating expenditure trends (operating expenditures for metros were plotted on the secondary axis because of the large differences between the metros and other municipalities).

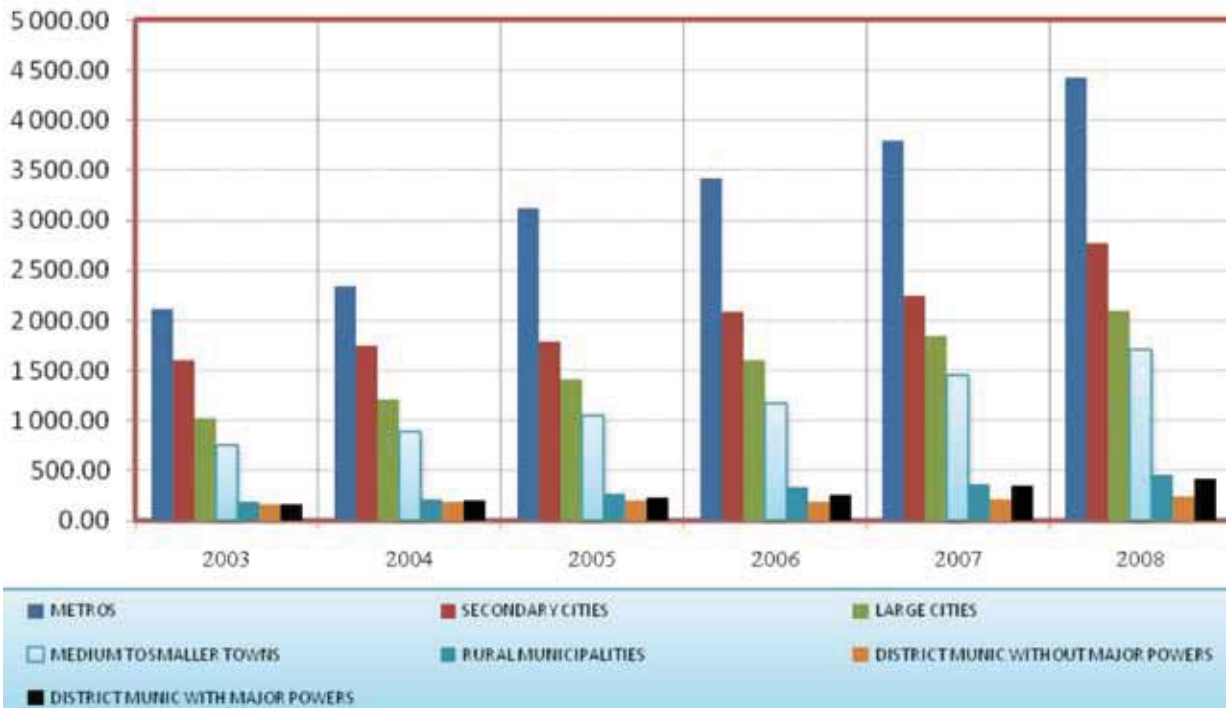
Figure 6.8 Real operating expenditure (R'000)



Source: National Treasury, 2010

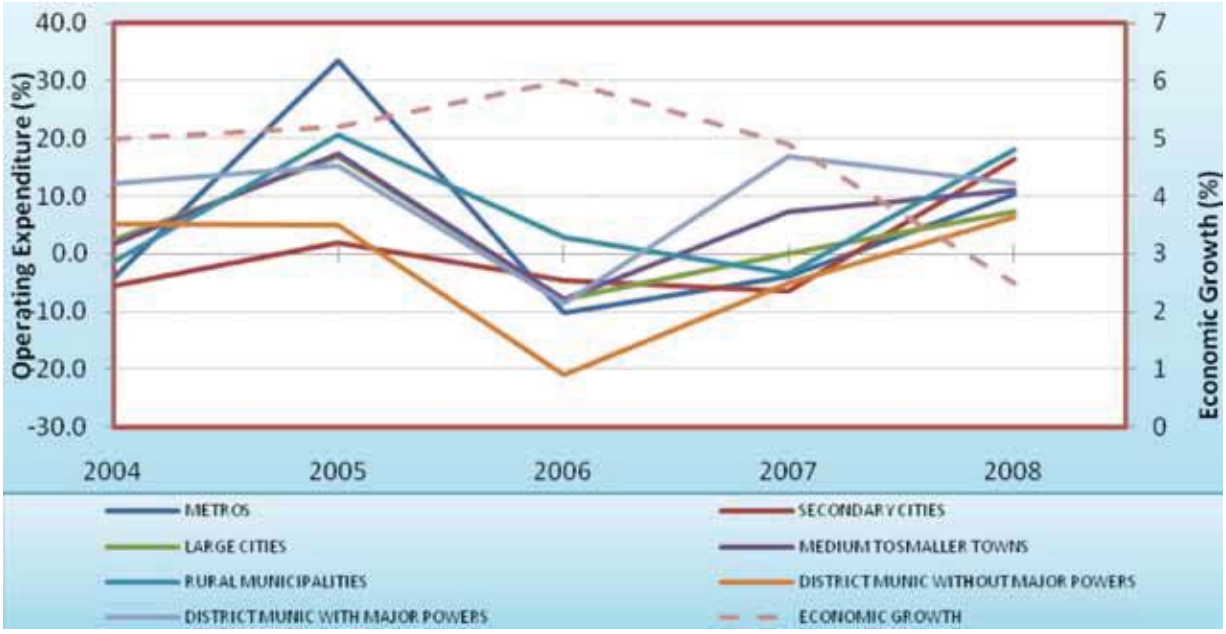
Operating expenditures in all municipalities decelerated between 2005/06 and 2007/08, but picked up in 2008/09. In per capita terms, operating expenditures increased steadily (Figure 6.9). However, when the growth in real per capita operating expenditures is plotted against economic growth (Figure 6.10), there appears to be no association.

Figure 6.9 Per capita operating expenditure (rands)



Source: FCC Calculations from National Treasury Data (various years)

Figure 6.10 Per capita operating expenditure and economic growth rates (%)



Source: FCC Calculations from National Treasury Data (various years)

Table 6.6 shows actual operating expenditures separated by functions. The main drivers, accounting for over 80% of total operating expenditures, are employee costs, material and bulk purchases and 'Other', which account for over 80% of total operating expenditures.

Table 6.6 Actual operating expenditure by function

Category		Actual Operating Expenditure							
		Employee costs	Depreciation & amortisation	Material & bulk purchases	Remuneration of councillors	Repairs & maintenance	Finance charges	Other	Total
2003	Metros	29%	4%	26%	0%	7%	6%	28%	100%
	Secondary cities	28%	5%	25%	1%	6%	4%	31%	100%
	Large cities	40%	1%	23%	1%	6%	6%	24%	100%
	Medium to smaller towns	40%	0%	19%	1%	6%	4%	29%	100%
	Rural municipalities	35%	0%	5%	6%	5%	2%	46%	100%
	District municipalities without major powers	43%	2%	5%	3%	2%	5%	41%	100%
	District municipalities with major powers	25%	1%	2%	3%	3%	3%	62%	100%
2004	Metros	28%	6%	24%	0%	7%	4%	31%	100%
	Secondary cities	30%	5%	23%	1%	6%	3%	31%	100%
	Large cities	35%	2%	22%	1%	5%	4%	28%	96%
	Medium to smaller towns	39%	1%	17%	1%	6%	4%	32%	100%
	Rural municipalities	36%	1%	5%	6%	4%	2%	46%	100%
	District municipalities without major powers	40%	3%	0%	4%	3%	4%	46%	100%
	District municipalities with major powers	27%	0%	2%	2%	4%	2%	63%	100%
2005	Metros	28%	6%	25%	1%	7%	4%	29%	100%
	Secondary cities	29%	6%	23%	4%	6%	4%	28%	100%
	Large cities	34%	4%	21%	2%	7%	3%	30%	100%
	Medium to smaller towns	37%	1%	17%	2%	6%	3%	33%	100%
	Rural municipalities	34%	1%	5%	8%	5%	2%	46%	100%
	District municipalities without major powers	40%	2%	1%	6%	4%	3%	45%	100%
	District municipalities with major powers	28%	1%	3%	2%	6%	1%	59%	100%

2006	Metros	31%	7%	25%	1%	7%	4%	25%	100%
	Secondary cities	29%	5%	23%	5%	6%	3%	29%	100%
	Large cities	35%	5%	19%	3%	6%	3%	30%	100%
	Medium to smaller towns	37%	2%	16%	4%	5%	2%	34%	100%
	Rural municipalities	31%	2%	2%	11%	5%	2%	47%	100%
	District municipalities without major powers	42%	2%	0%	6%	5%	3%	42%	100%
	District municipalities with major powers	29%	3%	7%	3%	5%	1%	52%	100%
2007	Metros	30%	6%	24%	1%	8%	3%	28%	100%
	Secondary cities	28%	8%	23%	4%	6%	3%	27%	100%
	Large cities	34%	5%	18%	3%	6%	2%	31%	100%
	Medium to smaller towns	35%	4%	14%	3%	5%	2%	37%	100%
	Rural municipalities	33%	3%	3%	11%	4%	1%	46%	100%
	District municipalities without major powers	41%	3%	0%	5%	5%	2%	44%	100%
	District municipalities with major powers	28%	4%	5%	2%	5%	1%	54%	100%
2008	Metros	28%	8%	25%	1%	7%	4%	28%	100%
	Secondary cities	26%	8%	23%	4%	6%	4%	28%	100%
	Large cities	33%	6%	19%	2%	6%	2%	31%	100%
	Medium to smaller towns	33%	4%	16%	4%	5%	2%	37%	100%
	Rural municipalities	32%	4%	3%	10%	5%	1%	44%	100%
	District municipalities without major powers	40%	4%	0%	6%	4%	2%	44%	100%
	District municipalities with major powers	26%	6%	6%	2%	5%	1%	54%	100%

Source: National Treasury, 2010

Two components described in Table 6.6 that warrant further analysis are employee costs and repairs and maintenance.

Employee/Personnel Costs

Expenditure on salaries is driven by the need for labour, as an input to provide services and run the municipal administration efficiently and effectively. Municipalities also maintain the political structures in terms of remunerating councillors. A disaggregated analysis of personnel expenditure by municipal category reveals that spending on personnel tends to be larger in municipalities with less service-level responsibilities. This means that rural and district municipalities have (1) the largest shares of personnel expenditure to total operating expenditure, and (2) relatively larger real growth rates for personnel costs.[89]

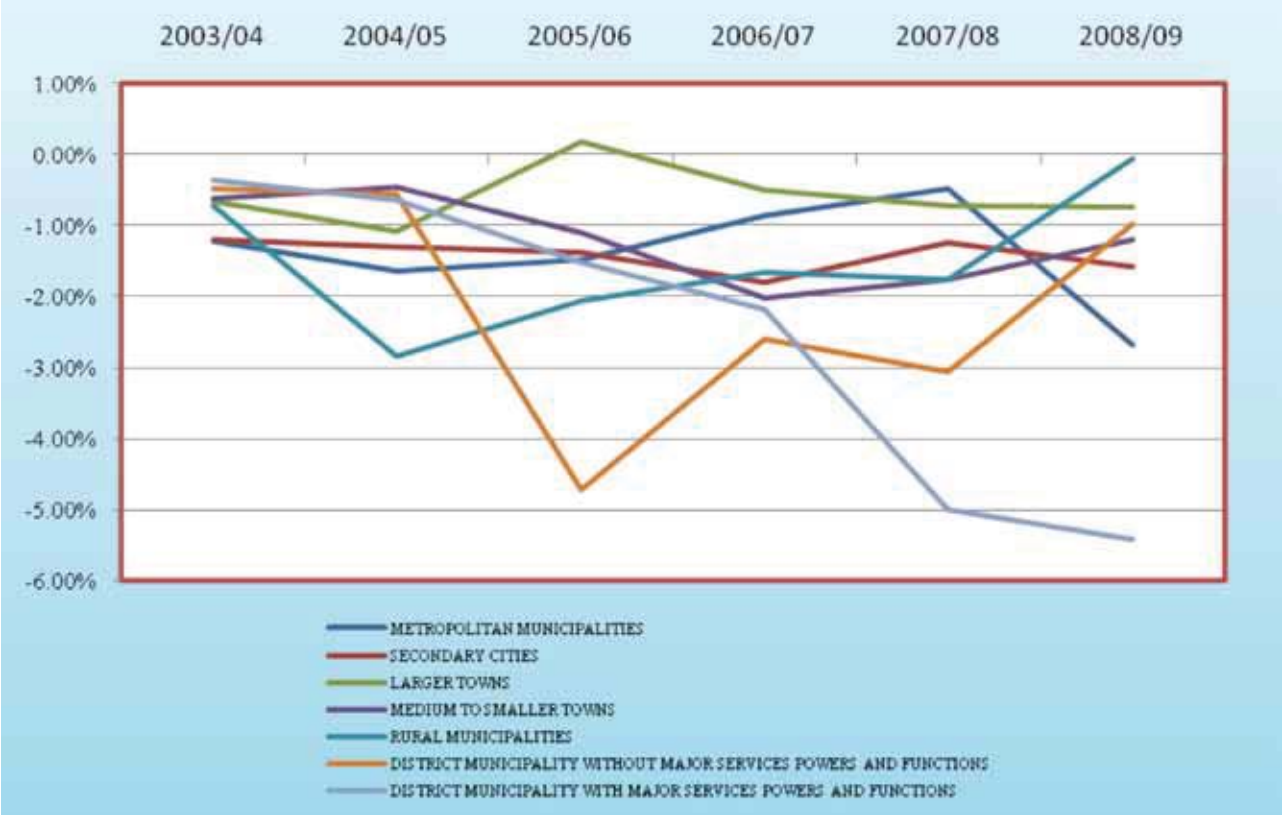
89 For example, expenditure on personnel increased on average by 16% in districts with major powers, compared to just 3% and 4% in metros and secondary cities respectively. In rural municipalities, real personnel expenditure increased, on average, by 16% over the period under review.

Furthermore, compared to other types of municipalities, rural municipalities spend the highest proportion of operating budgets on councillor remuneration. This trend is surprising because the salaries of councillors are governed by the Independent Commission for the Remuneration of Public Office Bearers,[90] and higher numbers of councillors are found in larger municipalities, which receive more funds via the local equitable share (LES) for remuneration of councillors. However, most of the municipalities in question have no, or limited service powers and functions (relative to metros), which means that more labour-intense service delivery processes are not a possible explanation for the trend. One possible reason is that these municipalities are simply paying excessive salaries. Another is their location in poorer, rural areas of the country, which means that they are obliged to pay excessive salaries in order to attract appropriate skills. If either of these two reasons explains the trend, the implication is that service delivery is being compromised in the municipalities, as resources required for the delivery of services are being diverted to pay large salaries.

Repairs and Maintenance

To ensure sustainable delivery of quality services, it is crucial that new and existing municipal infrastructure is adequately maintained. Although National Treasury recommends that 8%–10% of municipal operating budgets be allocated to this line item, ideally repairs and maintenance should be planned and executed relative to the existing municipal asset base. However, Figure 6.11 shows that performance on repairs and maintenance is extremely poor, regardless of the size, capacity or characteristics of the municipality. In fact, over the period under review, none of the municipalities fully spent their budgeted amounts for repairs and maintenance (with the exception of large towns in 2005/06).

Figure 6.11 Actual expenditure on repairs and maintenance relative to budgeted amounts 2003/04–2008/09



Source: Own calculations based on National Treasury Local Government Database, 2010

As poor spending on repairs and maintenance is found in all municipal categories, the underlying reasons must go beyond fiscal, planning and budgeting capacity. One possible reason could be that municipal services are not cost reflective, which means that tariffs do not reflect the cost (incorporating a reasonable return on investment) of providing the services. Repairs and maintenance of infrastructure should be funded via the tariff charged for a service, as required

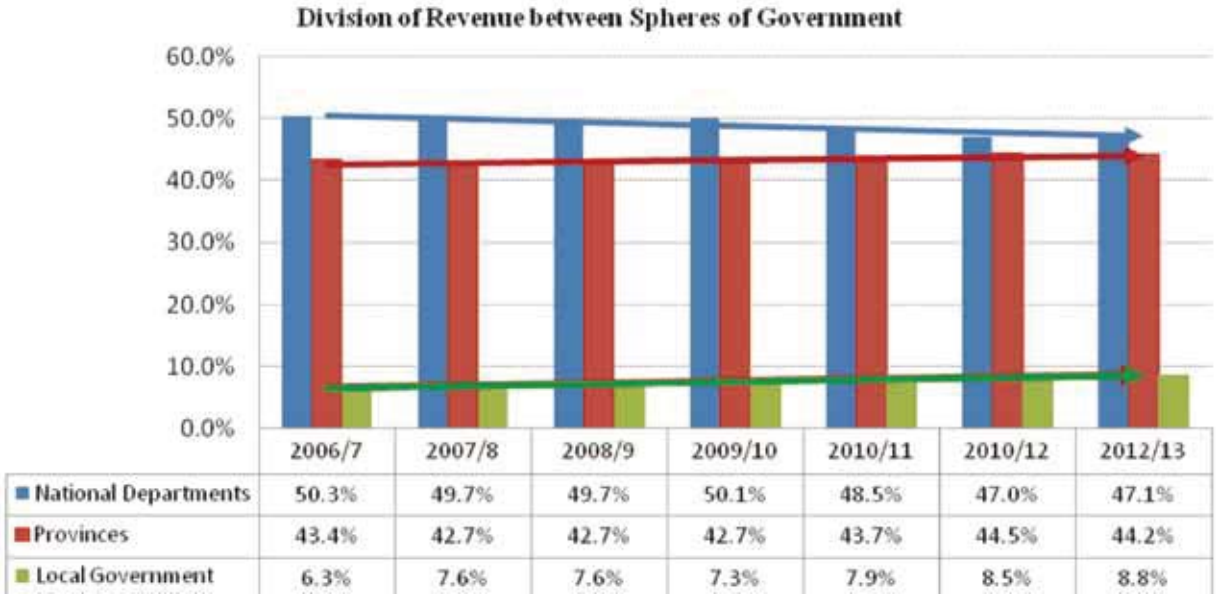
90 See the Independent Commission for the Remuneration of Public Office Bearers Act of 1997.

under Section 74(2) of the Municipal Systems Act, No. 32 of 2000. However, municipal tariffs have a long history of not being cost reflective, and government is considering a review of municipal tariff structures. When assessing the funding requirements of repairs and maintenance, it is important to distinguish between social and economic infrastructure. Consumers can be charged a tariff for the use of economic infrastructure, but social infrastructure is the infrastructure required to deliver a basic service to a household, specifically poor households, and a return on investment is unlikely. Therefore, to lessen the strain on municipal resources, the maintenance of social infrastructure should be supported via an operating subsidy from national government, such as the LES.

6.3.3 Local government revenues

An analysis of the performance of revenues begins with an overview of the division of revenue between the three spheres of government. Figure 6.12 shows that the share of local government has remained at less than 10%. The trade-off between the local government share and the national share is clear: as the former increases gradually, the latter shows a steady decrease. The provincial share has remained somewhat constant at between 43% and 44%. One plausible reason for the increase in the local government share is the realisation that local government is closer to the community and the best channel for dealing with local socioeconomic deficits.

Figure 6.12 Division of revenue between spheres of government



	2006/7	2007/8	2008/9	2009/10	2010/11	2010/12	2012/13
National Departments	50.3%	49.7%	49.7%	50.1%	48.5%	47.0%	47.1%
Provinces	43.4%	42.7%	42.7%	42.7%	43.7%	44.5%	44.2%
Local Government	6.3%	7.6%	7.6%	7.3%	7.9%	8.5%	8.8%

Source: National Treasury, 2010

Capital revenues

Like expenditures, revenues are divided into capital and operational revenues. Table 6.7 shows actual capital revenue shares for the seven municipality categories between 2003/04 and 2008/09. As the table shows, grants and subsidies and 'Other' revenues drive capital revenues, while external loans feature quite strongly for metros and secondary cities.

Conditional grants and subsidies dominate capital revenues of all municipalities, but especially rural municipalities and district municipalities with major powers. In 2008/09 these two categories of municipalities received grants and subsidies representing 73% and 74% respectively of their capital revenues. The overwhelming dependence on grants and subsidies for infrastructural funding takes away the autonomy of municipalities to choose their own capital projects, as the grants are mainly conditional.

Metros are increasingly becoming major players in the credit markets. As Table 6.7 shows, between 2003/04 and 2008/09, external loans as a proportion of capital revenues of the six metros increased from 28% to 38%. Secondary cities are also major players, although the share of external loans in total revenues is declining. There is some evidence of a trade-off between grants and external loan revenues in rural municipalities and medium to smaller towns, which suggests that national transfers may be crowding out own-revenue efforts such as borrowing. The 'Other' component is

the internal, own income of municipalities and represents a significant portion of total capital revenues for all municipalities. This is a positive development, as own revenues gives municipalities the autonomy and leeway to decide on where and how to spend their capital revenues. However, for district municipalities with major powers, the share of the 'Other' component has declined sharply since 2004/5. It seems the decline was being compensated by an increase in grants.

Table 6.7 Actual capital revenue

Actual capital revenue						
	Category	Grants & subsidies	External loans	Public contributions & donations	Other	Total
2003	Metros	29%	28%	8%	34%	100%
	Secondary cities	47%	15%	0%	38%	100%
	Large cities	52%	7%	0%	40%	100%
	Medium to smaller towns	51%	10%	1%	38%	100%
	Rural municipalities	55%	2%	0%	43%	100%
	District municipalities without major powers	36%	9%	0%	55%	100%
	District municipalities with major powers	31%	0%	0%	64%	95%
2004	Metros	45%	29%	1%	24%	100%
	Secondary cities	51%	17%	5%	27%	100%
	Large cities	59%	14%	1%	27%	100%
	Medium to smaller towns	50%	9%	2%	38%	100%
	Rural municipalities	41%	2%	0%	57%	100%
	District municipalities without major powers	31%	6%	3%	61%	100%
	District municipalities with major powers	26%	7%	0%	67%	100%
2005	Metros	43%	31%	1%	26%	100%
	Secondary cities	46%	22%	6%	27%	100%
	Large cities	50%	17%	5%	28%	100%
	Medium to smaller towns	58%	7%	1%	34%	100%
	Rural municipalities	50%	1%	0%	49%	100%
	District municipalities without major powers	19%	5%	5%	71%	100%
	District municipalities with major powers	55%	2%	0%	43%	100%
2006	Metros	35%	36%	0%	29%	100%
	Secondary cities	49%	13%	2%	36%	100%
	Large cities	46%	11%	0%	43%	100%
	Medium to smaller towns	62%	8%	1%	28%	100%
	Rural municipalities	58%	0%	0%	42%	100%
	District municipalities without major powers	17%	6%	0%	77%	100%
	District municipalities with major powers	68%	2%	0%	30%	100%
2007	Metros	35%	40%	0%	24%	100%
	Secondary cities	43%	14%	1%	41%	100%
	Large cities	45%	10%	3%	42%	100%
	Medium to smaller towns	66%	8%	1%	25%	100%
	Rural municipalities	65%	1%	2%	32%	100%
	District municipalities without major powers	21%	4%	0%	76%	100%
	District municipalities with major powers	81%	1%	0%	18%	100%
2008	Metros	41%	38%	1%	20%	100%
	Secondary cities	42%	12%	2%	45%	100%
	Large cities	42%	6%	1%	50%	100%
	Medium to smaller towns	66%	3%	2%	29%	100%
	Rural municipalities	73%	2%	2%	24%	100%
	District municipalities without major powers	29%	5%	0%	66%	100%
	District municipalities with major powers	74%	2%	0%	24%	100%

Source: FCC Calculations from National Treasury Data (various years)

Operating revenues

Table 6.8 shows the sources of local government operating revenues, which are dominated by service charges, property taxes, grants and other incomes. These four revenue sources account for over 80% of total municipal operating revenues.

Table 6.8 Actual operating revenues shares

	Category	Service charges	Gov grants	Invest-ments	Property rates	Donations	RSL	Other Income	Total
2003/4	Metros	54%	6%	3%	22%	0%	7%	8%	100%
	Secondary cities	51%	10%	1%	16%	0%	0%	22%	100%
	Large cities	54%	13%	1%	22%	0%	0%	10%	100%
	Medium to smaller towns	45%	26%	1%	12%	0%	0%	15%	100%
	Rural municipalities	10%	68%	2%	7%	1%	0%	12%	100%
	District municipalities with major powers	6%	23%	6%	0%	0%	46%	19%	100%
	District municipalities without major powers	13%	51%	4%	0%	0%	18%	15%	100%
2004/5	Metros	49%	9%	3%	22%	0%	9%	8%	100%
	Secondary cities	51%	15%	2%	17%	1%	0%	14%	100%
	Large cities	51%	14%	1%	23%	0%	0%	11%	100%
	Medium to smaller towns	44%	27%	1%	12%	0%	0%	15%	100%
	Rural municipalities	10%	72%	2%	6%	1%	0%	10%	100%
	District municipalities with major powers	2%	29%	4%	0%	1%	48%	15%	100%
	District municipalities without major powers	10%	58%	2%	0%	0%	20%	10%	100%
2005/6	Metros	47%	9%	3%	22%	1%	9%	9%	100%
	Secondary cities	46%	17%	2%	17%	1%	0%	17%	100%
	Large cities	47%	19%	1%	22%	1%	0%	11%	100%
	Medium to smaller towns	42%	30%	1%	12%	0%	0%	14%	100%
	Rural municipalities	8%	76%	2%	5%	2%	0%	7%	100%
	District municipalities with major powers	1%	33%	4%	0%	0%	51%	10%	100%
	District municipalities without major powers	10%	64%	2%	0%	0%	15%	9%	100%
2006/7	Metros	47%	19%	3%	20%	1%	0%	10%	100%
	Secondary cities	48%	21%	2%	15%	0%	0%	13%	100%
	Large cities	40%	23%	2%	22%	1%	0%	12%	100%
	Medium to smaller towns	40%	33%	2%	13%	0%	0%	13%	100%
	Rural municipalities	8%	76%	2%	6%	1%	0%	8%	100%
	District municipalities with major powers	2%	71%	5%	1%	0%	4%	17%	100%
	District municipalities without major powers	11%	78%	2%	0%	0%	1%	8%	100%
2007/8	Metros	44%	24%	3%	20%	1%	0%	8%	100%
	Secondary cities	47%	23%	3%	16%	0%	0%	10%	100%
	Large cities	39%	24%	2%	23%	1%	0%	12%	100%
	Medium to smaller towns	35%	39%	2%	12%	0%	0%	13%	100%
	Rural municipalities	6%	78%	2%	5%	0%	0%	8%	100%
	District municipalities with major powers	2%	80%	6%	0%	0%	0%	12%	100%
	District municipalities without major powers	11%	78%	4%	0%	0%	0%	8%	100%
2008/9	Metros	45%	26%	3%	18%	0%	0%	9%	100%
	Secondary cities	48%	24%	3%	15%	1%	0%	10%	100%
	Large cities	39%	28%	2%	21%	0%	0%	11%	100%
	Medium to smaller towns	34%	40%	2%	11%	0%	0%	13%	100%
	Rural municipalities	7%	79%	3%	5%	0%	0%	7%	100%
	District municipalities with major powers	2%	80%	7%	0%	0%	0%	10%	100%
	District municipalities without major powers	9%	77%	4%	0%	0%	0%	10%	100%

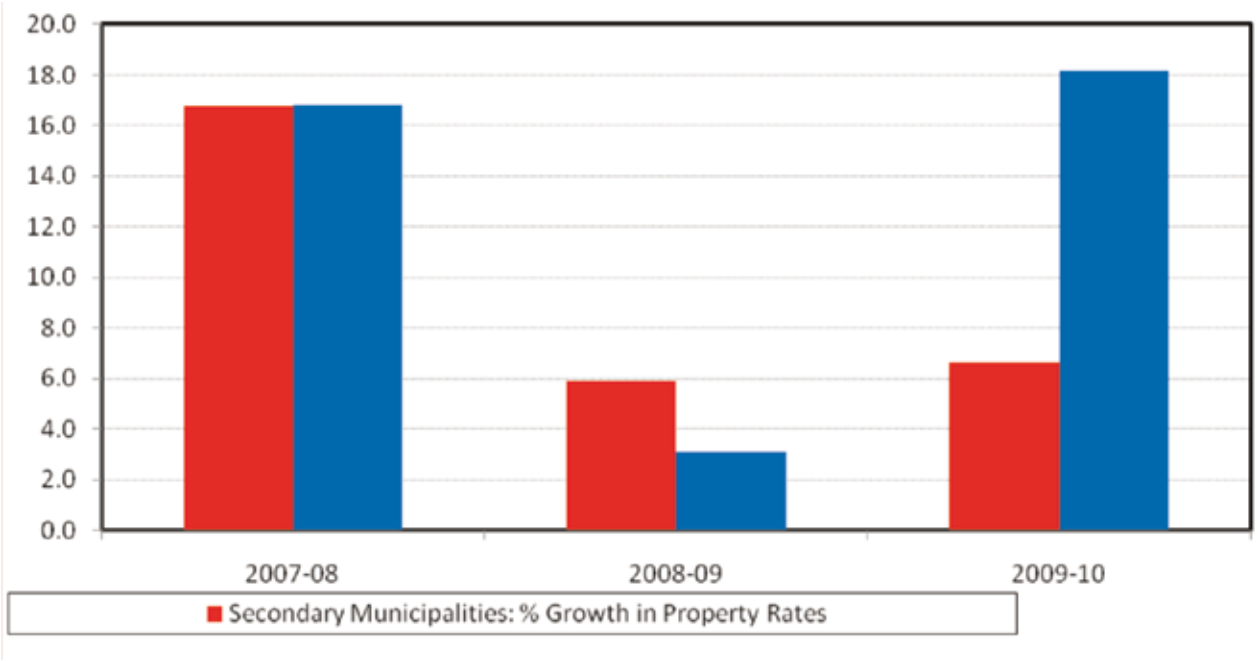
Source: Own calculations from National Treasury Data (various years)

Service charges are the main source of operating revenue for metros, secondary cities, large cities and medium to smaller towns. However, as rural and district municipalities have limited services to levy, most of their operating revenue comes from government grants, which may lead to grant dependency. As noted earlier, employee and councillor remuneration represents a significant share of operating expenditure, which implies that grant revenues are being channelled into personnel-related costs instead of services that will improve the livelihoods of the population. Over-dependency on

grants could also take away the accountability of local government officials and councillors to their communities. Grant dependency can give rise to the soft budget problem, where municipalities overspend because even if their budgets do not balance up, the bail outs will flow from the upper spheres of government (Schoeman, 2011). Lastly, transfer dependency may actually stifle the efforts and creativity of municipalities to raise their own revenues.

Between 2003/04 and 2008/09 metros' revenues from service charges declined from 54% to 45%, but the grant component of operating revenues increased from 6% to 26%. Large cities exhibited a similar pattern, which may be due to pressures from the economic crisis. The trade-offs between grants and service charges are cause for concern, suggesting that these two municipality categories are becoming more dependent on transfers, at the expense of own-revenue sources.

Figure 6.13 Growth in property rates



Source: National Treasury, 2010

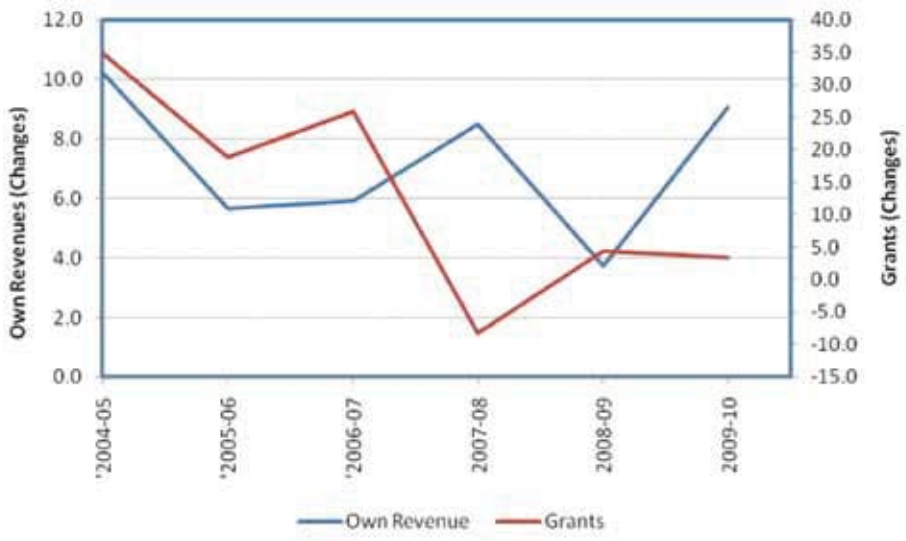
In 2008/09 the proportion of property rates declined slightly for some municipality categories (e.g. metros, secondary cities, large cities and medium to smaller towns). This decline in rates can partially be explained by the financial crisis of 2008, which affected the property market. Figure 6.13 shows that the growth in revenues from property rates for both metros and secondary municipalities was subdued during the recession period.[91] The decline in revenues from service charges and property rates suggest that municipal own revenues are vulnerable to economic shocks.

As noted above, grants are a significant component of municipality revenues. Grants are divided into conditional and non-conditional components: conditional grants are mainly for capital expenditure, while unconditional grants are part of operating expenditures. The possible trade-off between grants (both conditional and unconditional) and own revenues has been observed in some municipality categories.

In order to assess whether the increase in grants is crowding out municipal own revenues, the growth rate in total municipal own revenues is plotted in Figure 6.14. The discord in the trends of the two series suggests some trade-off between own revenues and grants.

91 Please note that the 2009/10 data is unaudited and so caution must be exercised in interpreting this result.

Figure 6.14 Growth rate of grants and own revenue (%)



Source: Own calculations from National Treasury Data (various years)

Grants play a significant role in financing the activities of municipalities and may have detrimental effects on a municipality's efforts to raise its own revenues (the 'crowding-out' effect). On the other hand, grants may have a 'crowding-in' effect whereby they help stimulate efforts by municipalities to raise their own revenues.

The hypothesis that grants crowd out own revenue has been tested in developed countries using local government data (Zhuravskaya, 2000; Dahlberg *et al*., 2007). In the developing world, Mogues *et al*. (2009) tested this hypothesis on Ghanaian local government data, using an econometric model, and found that external transfers to the local government sector tend to crowd out local government's own revenues.

They concluded that crowding out results in the loss of equity and efficiency gains associated with decentralisation. Using a discontinuous grant rule model to identify the effect of grants on local taxes and spending in Sweden, Dahlberg *et al*. (2007), found strong evidence of crowding in, where federal grants are shifted to more local spending, but not reduced local tax rates. In the South African context, Amusa *et al*. (2008) tested this hypothesis, which is also known as the 'flypaper effect' and did not find any crowding out.

For the purpose of this research, the following model[92] is used to test the hypothesis that grants are crowding out the own-revenue raising efforts of municipalities, using a panel data set:

$$lnOR_{it} = \beta_1 lnGR_{it} + \beta_2 lnEXP_{it} + \beta_3 X_i + \beta_4 LG_i + \varepsilon_{it}$$

Where, OR_{it} denotes own revenues for municipality i during period t, $GRit\text{-}1$ is grant revenues, EXP_{it-1} are past expenditures, X_i is a vector of economic and demographic municipality variables, and LG_i are the dummies to control for municipality-specific effects. The relationship between OR and GR is of particular interest, as it sheds light on the crowding-out effects of transfers from upper tiers of government on local government's efforts to raise own revenues.[93] The crowding-out phenomenon is tested on a sample of 176 municipalities that had complete data for the above own-revenue drivers (municipalities with inadequate data were eliminated). The exogenous variables for the above model are:

Expenditure requirements. Expenditure requirements are another key driver of own revenues in municipalities, as an increase in spending requirements will encourage municipalities to find other sources of revenues.

Access variables. Access variables imply that residents of a municipality are more likely to pay their dues when they have access to basic services, which are water and electricity in this model.

Socio-demographic variables. The variables used are population size in a municipality and number of councillors, which

92 This model is a modified version of that used in Mogues et al. (2009).

93 RSL will be omitted in the estimation, as it has the potential to distort or bias the results.

are simple proxies for the size of a municipality. An increase in population size or number of councillors is expected to boost a municipality's own revenues.

Four panel data modelling techniques are used: the generalised least squares random effects model, maximum likelihood fixed effects model, and the ordinary least squares (OLS) fixed effects model with time and group-specific effects. Table 6.9 presents the estimates of the above equation. The random effects and the maximum likelihood models give more robust results than the other two. In a nutshell, the results indicate that the key drivers of own revenue are population size and access to water and electricity. In addition, the last model indicates the importance of time and group effects. These effects simply control for effects that are specific to each municipality group or specific to a time period.

Three of the four models suggest that national government transfers are instrumental in explaining municipality own-revenue raising efforts. In all four models, the relationship between grants and own revenues is positive, although insignificant in the fourth model. This finding (of a positive relationship between transfers and own revenues) refutes the hypothesis that in South Africa, national government transfers crowd out efforts by municipalities to raise own revenues. The result underscores the importance of the transfer system in stimulating economic development in sub-national governments. In other words, grants provide additional opportunities and are enabling mechanisms for municipalities to generate extra revenues. The implication is that the government should always strive for a stable and predictable transfer system to avoid the undesirable consequences of crowding out.[94]

Table 6.9 Testing for crowding-out effects (independent variable: municipal own revenue)

Variable	Coefficient (T-value)	Coefficient (T-value)	Coefficient (T-value)	Coefficient (T-value)
Constant	4.1862 (4.38)	4.0480 (4.08)	-7.9619 (-4.69)	8.3220 (2.09)
No of councillors	0.0003 (0.01)	0.0018 (0.01)	-0.0003 (-0.01)	0.0251 (1.25)
Access electricity	0.0564 (2.73)	0.0539 (2.65)	0.0251 (1.22)	0.3549 (4.77)
Grant	0.3170 (4.62)	0.3301 (4.82)	0.0748 (2.73)	0.0121 (0.39)
Population size	0.6494 (7.68)	0.6453 (7.34)	8.5023 (5.25)	0.3824 (3.21)
Access to water	0.0522 (2.17)	0.0508 (2.15)	0.0426 (1.91)	0.1536 (7.42)
	Wald X^2 (5)=319.6 (0.000)	R^2 Within = 19%; Between = 51%; Overall = 50% LR X^2=(5) =234.8(0.000)	R^2 Within = 23%; Between = 48%; Overall = 47% F(5,523)30.7 (0.0000)	**Time-specific effects** *Yr* 2006 0.0671 (5.75) *Yr* 2007 -0.6468 (-16.0) *Yr* 2008 -1.1536 (-15.2) **Municipality specific effects** District 0.315(5.62) Rural 0.402(6.87) Med-small 0.988(18.2) Largetowns 1.02(12.9) Secondary cities 1.68(20.1)
				R^2 56%

Source: Own estimates

6.4 Budget Analysis

To fulfil the main mandate of local governments, which is to maximise service delivery, municipalities are required to have budgets that are fiscally credible and sustainable. The credibility of budgets and spending plans are especially important, as infrastructure investment stimulates local economic development.

6.4.1 Budget credibility

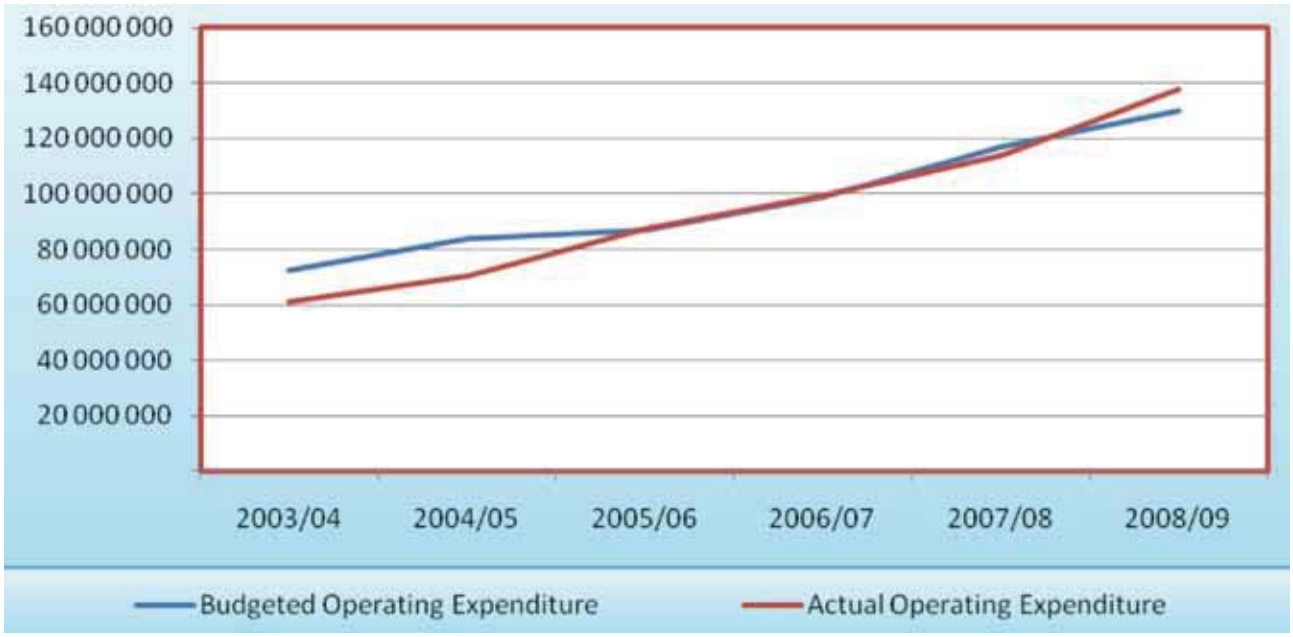
A credible budget ensures the funding of all approved items, not unapproved items. In other words, a credible budget ensures that "the budget out-turns regularly and, with little deviation, matches the budget approved" (Fölscher, 2006). A credible budget is implemented as planned, accurately reflects a country's priorities and must be an effective financial management instru-

94 Please note that this analysis will be improved once data has been updated to take care of lagged effects.

ment (Schiavo-Campo, 2008). A credible budget is anchored in sound, timely and reliable information on spending and service delivery, diligent and robust macro and fiscal revenue projections, realistic costing of government activities and a feasible and transparent planning process. Without these elements, budget out-turns are likely to deviate from approved budgets.

For the purpose of this research, budget credibility is represented by the extent to which budgeted and actual expenditures coincide. If the resulting credibility measurement is less than 100%, the actual amount (or outcome) is smaller than the budgeted amount, meaning that the budget is under-spent. The reverse is also true: if the measurement is greater than 100%, the budget was exceeded. Ideally, the deviation between budgeted and actual amounts should be minimal or zero, which is rarely the case. The Department of Co-operative Governance and Traditional Affairs (CoGTA) has defined a credible budget as "one with a variance of less than 20 per cent" (CoGTA, 2009:62). Variations between budgeted and actual amounts can occur for many reasons, including increases in unemployment, poverty and/or general economic downturns. Nevertheless, while municipalities may not have control over these factors, in their planning processes they are expected to be sensitive to extenuating factors and revise budget/spending projections appropriately.

Figure 6.15 Aggregate operating expenditure, budgeted versus outcomes, 2003/04–2008/09 (R'000)



Source: National Treasury Data, 2010

In Figure 6.15, the budgeted operating expenditure and actual expenditure seem to be moving together, with very little variability. Operating expenditure is much less flexible than capital expenditure, as it includes employee remuneration, a budgetary item that allows for very little or no variation at all. As a result, municipalities find it easier to cut back/under-spend on items such as capital or maintenance than personnel.

Whereas Figure 6.15 provides an aggregate picture of budgeted versus actual operating expenditure, Table 6.10 disaggregates municipalities according to the seven categories and provides a credibility ratio for each from 2003/04 until 2008/09.

Table 6.10 Credibility of operating expenditure disaggregated by municipal category, 2003/04–2008/09

Category	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Metros	75.6%	75.3%	94.8%	94.0%	90.4%	100.3%
Secondary cities	103.7%	99.3%	97.0%	104.1%	99.1%	109.8%
Large towns	96.9%	103.2%	107.3%	106.2%	105.3%	103.9%
Medium to smaller towns	92.2%	96.5%	108.6%	105.6%	115.6%	110.7%
Rural municipalities	98.4%	96.7%	112.2%	111.5%	105.7%	119.6%
District municipalities without powers	76.5%	78.1%	155.4%	136.6%	114.9%	109.9%
District municipalities with powers	96.0%	90.1%	157.6%	147.7%	136.2%	160.8%
TOTAL	84.3%	83.9%	100.7%	100.5%	97.4%	106.1%

Source: National Treasury, 2010

Table 6.10 shows that operating budgets and spending can be described as credible for metros, secondary cities, large towns, medium to smaller towns, and district municipalities without powers, as the variation between what was originally budgeted for and the actual operational expenditure differs by less than 20%.

Metros in particular show marginal differences between budgeted and actual operating expenditure in 2008/09, which underlines the fact that these municipalities are employing good planning techniques, and that other municipalities have much to learn from these types of municipalities.

Rural municipalities, and to a greater extent district municipalities with powers, display large variances between amounts budgeted and actual operating expenditure. District municipalities seem to have become progressively worse relative to 2003/04, which indicates poor planning processes, as these municipalities appear to be significantly under-budgeting their expenditure and risk overspending.

The credibility of budgeted versus actual revenue from service charges (including payment for services such as electricity, water, sanitation, refuse removal) is assessed in Table 6.11.

Table 6.11 Budgeted versus actual revenue derived from service charges, 2003/04–2008/09 (in %)

Category	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Metros	77.2%	75.7%	97.9%	102.2%	102.9%	102.4%
Secondary cities	93.5%	94.0%	89.7%	101.4%	103.8%	106.9%
Large towns	103.4%	103.3%	108.4%	101.6%	97.7%	97.4%
Medium to smaller towns	92.3%	101.2%	98.4%	98.4%	97.8%	99.6%
Rural municipalities	67.6%	85.9%	101.3%	101.1%	75.3%	100.0%
District municipalities without powers	261.9%	95.1%	119.7%	134.8%	119.1%	43.5%
District municipalities with powers	89.7%	70.1%	86.4%	97.8%	82.6%	75.7%
TOTAL	83.5%	83.2%	96.9%	101.7%	101.5%	102.1%

Source: National Treasury, 2010

On aggregate, the local government sphere appears to be performing relatively well with regard to credibility of budgeted revenue relative to actual revenue from service charges. Since 2003/04 progress has been made, with budgeted versus actual amounts mimicking each other very well.

However, district municipalities with, and to a greater degree those without, powers are displaying particularly poor performance. In 2008/09 district municipalities without powers[95] over-budgeted expected revenue from service charges by more than 50% (R194 billion was originally budgeted, but only R84 billion was collected in service charges).

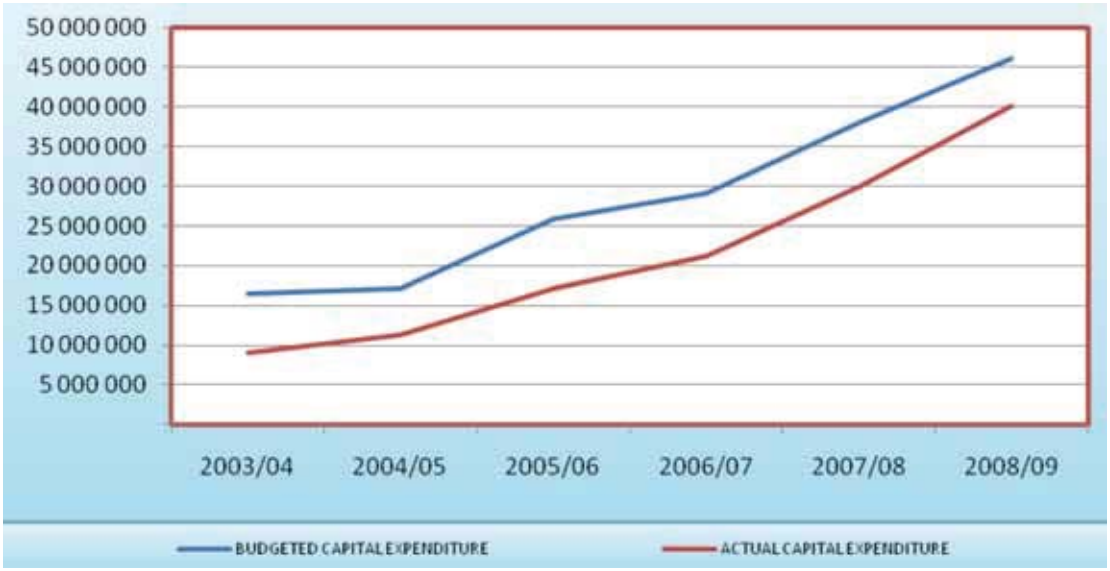
As they have no water or sanitation powers and functions, these municipalities are expected to collect less revenue. Yet they continue to table unrealistic plans, going from gross under-budgeting in 2003/04 (when actual service-charge revenues were more than the budgeted amount) to a situation in 2008/09 where revenue budgeted for from service charges far exceeded actual service charges collected.

Capital expenditure is the final aspect of credibility to be assessed. Figure 6.16 shows that municipalities struggle to align budgeted and actual capital expenditure. Over the entire period reviewed, actual capital expenditure is less than anticipated. One reason for this variation is that budgeting and spending on capital projects differ from operational items. In many cases the municipality's budget is based on simply dividing the projected cost of a capital project by the estimated number of years to completion.

The reality is that capital projects are multi-year undertakings and often show increases or spikes in spending towards the end of the project life cycle. To ensure that under/over-spending does not occur, municipalities need to have sound project and financial management in place, but instead suffer from capacity constraints. In South Africa, under-spending of capital budgets is pervasive, particularly in municipalities, which Figure 6.16 confirms.

95 While district municipalities without the water and sanitation function do not provide services to their local municipalities, they do provide all municipal services to District Management Areas (DMAS). DMAs are not part of a local municipality, but are areas that the district municipality directly controls and are usually national parks or areas with low population density.

Figure 6.16 Credibility of budgeted versus actual capital expenditure, 2003/04–2008/09 (in R'000)



Source: National Treasury, 2010

Decomposing the aggregate picture according to the seven municipal categories highlights the challenge with respect to the credibility of capital spending, as Table 6.12 illustrates.

Table 6.12 Budgeted versus actual capital expenditure by municipal category, 2003/04–2008/09

Category	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Metros	55.4%	64.8%	70.8%	85.1%	96.9%	110.5%
Secondary cities	70.0%	78.2%	66.1%	65.4%	69.3%	72.1%
Large towns	48.6%	54.7%	78.8%	69.3%	72.3%	65.7%
Medium to smaller towns	57.0%	72.8%	56.1%	64.7%	59.1%	66.4%
Rural municipalities	52.6%	63.1%	48.6%	51.1%	75.9%	67.2%
District municipalities without powers	63.7%	104.4%	43.0%	24.2%	58.7%	43.1%
District municipalities with powers	35.7%	51.0%	66.5%	68.2%	47.3%	55.1%
TOTAL	55.1%	66.3%	66.6%	72.7%	78.7%	87.0%

Source: National Treasury, 2010

Table 6.12 shows that all categories of municipalities, except for metros, have problems with capital spending, deviating by more than the 20% benchmark/acceptable variance set by CoGTA. Under-spending on capital projects is particularly dire in district municipalities without powers and rural municipalities.

Based on this brief analysis of budget credibility, better-resourced municipalities, such as the metros and large towns, tend to show greater alignment between budgeted and actual revenue/expenditure. In all probability, this is because better-skilled human capital is available to these municipalities, which means that they are able to plan and project spending/revenue trends more accurately. This suggests that there is room for skills transfer from well performing to poorly performing municipalities. The challenge of credible capital spending requires urgent attention.

6.4.2 Budget sustainability

Sustainability is about financial efficiency, but the concept of sustainability is fluid and not easily operationalised (Dollery *et al*., 2007: 119–120). No generalised measure of sustainability exists, although the National Treasury often measures sustainability by computing the ratio of personnel costs to operational costs. The measure may be a rather simplistic way of analysing sustainability, but it captures the notion that budgets cannot sustain their basic functions if personnel costs are substantial relative to operational expenditure.

The Australian Local Government Association (ALGA), through the Productivity Commission of Australia, has come up with a number of possible measures of sustainability (ALGA, 2007), including:

- Minimal (or negative) growth in revenue.
- Cost growth which exceed revenue growth.
- Tendency to operate deficits.
- Limited access to rate revenues due to small or declining population bases.

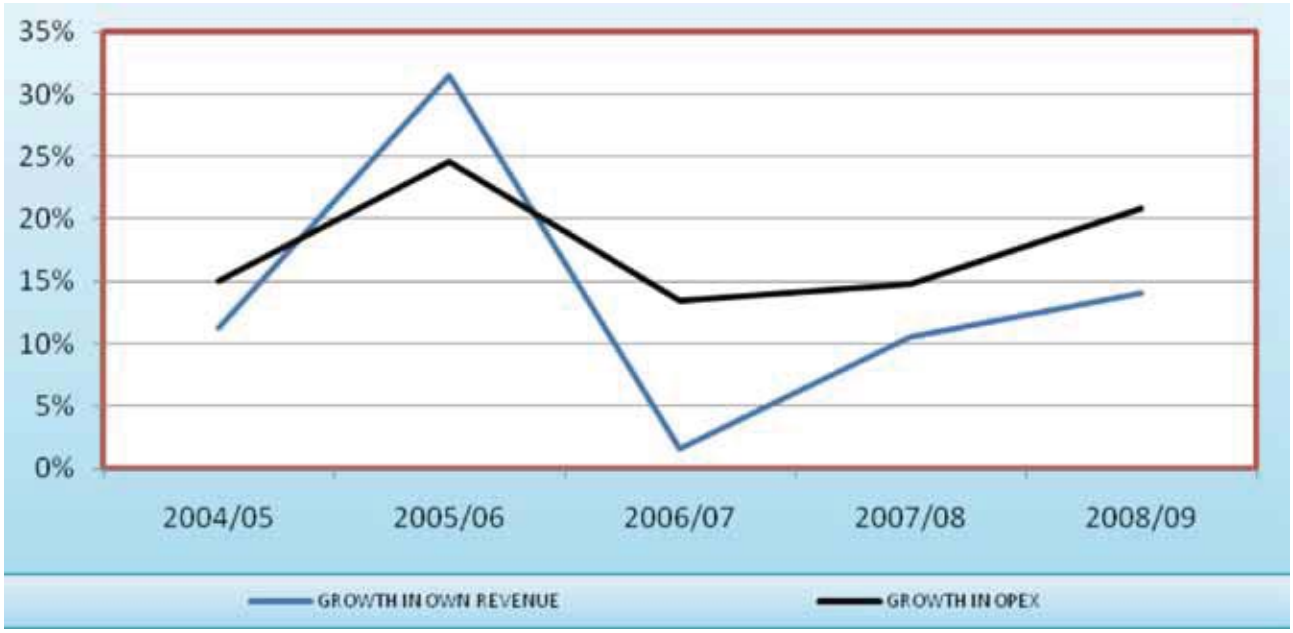
In 2006, an enquiry into the issue of sustainability in North South Wales identified various conditions that municipalities have to meet in order to be declared financially healthy (Dollery *et al*., 2007:119–120). These include:

- Borrowing or debt should make up a small proportion of the total capital invested in infrastructure/capital assets.
- The council (municipality) should be running an operating surplus, not a deficit.
- The municipality should exhibit a small infrastructural renewal backlog, and spending on infrastructure renewal/replacement should be approximately at the same level as depreciation expenses.

An important conclusion from the Dollery study is that flexibility is needed when devising sustainability indicators to measure municipal performance. A one-size-fits-all approach may be too inflexible to capture the diverse contexts experienced by different types of local government authorities (Dollery *et al*. 2007).

Several indicators can be used to measure sustainability, and for the purpose of this exercise, operating expenditure and own-revenue growth rates are used. The long-term financial sustainability of the municipality may be threatened if municipal input costs are increasing at a higher rate than own revenue. In such a case, greater intergovernmental fiscal transfers would be needed to sustain the demand for services from communities. Figure 6.17 gives the aggregate picture for local government in South Africa.

Figure 6.17 Expenditure and own-revenue growth rates



Source: National Treasury, 2010

In general, expenditure responsibilities appear to be increasing faster than own revenues. However, the drivers of the increase in expenditure need to be factored in. If the increase in expenditure is larger than the increase in input costs or demand for services, then the financial sustainability of municipal own revenues would be of concern.

However, intergovernmental fiscal transfers are likely to have grown substantially, which would in turn allow municipalities to increase their non-discretionary or non-essential expenditures. Table 6.13 disaggregates this analysis per category of municipality.

Table 6.13 Sustainability ratio per municipal category

Municipality	2004/05	2005/06	2006/07	2007/08	2008/09
Metros	-2%	10%	-12%	-2%	-8%
Secondary cities	-3%	10%	-10%	-1%	-9%
Large towns	-8%	-2%	-3%	-5%	-3%
Smaller towns	-3%	-7%	-4%	-9%	-1%
Rural municipalities	-3%	-19%	-2%	-10%	0%
District municipalities without powers	-15%	3%	-52%	-30%	-5%
District municipalities with powers	-12%	-17%	-17%	-37%	-7%
Grand Total	-4%	7%	-12%	-4%	-7%

Source: Own calculations

Table 6.14 calculates a sustainability ratio, which is the difference between the growth in municipal own revenues and expenditure responsibilities. This ratio is shown per financial year but can be aggregated per period (for example five years). A negative ratio indicates that expenditure responsibilities are increasing at a higher rate than own revenues, suggesting that these municipalities are financially unsustainable in the long run. Most of the categories of municipalities have negative sustainability ratios, which is of concern for the long-term financial sustainability of these municipalities. One explanation may be that municipalities are not maximising own revenues. For instance, revenue collection is poor, the local tax base is eroding, changes in local economic environment mean that potential revenue sources are not being maximised, or intergovernmental fiscal transfers are crowding out own revenues.

To further examine the sustainability of budgets, the ratio of personnel expenditure to total operational expenditure is computed. However, as there is no benchmark ratio, any ratio above the average will indicate an unsustainable budget. As Table 6.14 shows, the average sustainability ratio for all municipalities was 28% in 2008/09. The smaller and rural municipalities have ratios above the average of 28%, which suggests that these municipalities have, to some extent, unsustainable budgets and therefore need interventions (e.g. building capacity and monitoring of budgetary processes).

Table 6.14 Sustainability ratio per type of municipality

Municipality	2004/05	2005/06	2006/07	2007/08	2008/09
Metros	30%	28%	28%	29%	28%
Secondary cities	28%	28%	28%	28%	28%
Large towns	37%	34%	33%	34%	32%
Smaller towns	37%	36%	35%	34%	31%
Rural municipalities	31%	32%	31%	29%	30%
District municipalities without powers	23%	24%	24%	29%	29%
District municipalities with powers	20%	20%	21%	22%	22%
Average ratio for all municipalities	30%	29%	28%	29%	28%

Source: National Treasury, 2010

6.5 Conclusion and Recommendations

In evaluating the performance of local government budgets, the emphasis was on the effectiveness of budgets in dealing with challenges facing municipalities, in particular service delivery. The chapter assessed the soundness of budget practices in the local government sphere, focusing on fiscal credibility and sustainability of budgets.

Analysis of the expenditure and revenue suggests that:

- Budgets for municipalities are vulnerable to external economic shocks.
- Spending on personnel costs, including the remuneration of councillors, is excessive, especially for smaller municipalities. Such expenditure takes resources away from much needed service delivery needs.
- Repairs and maintenance spending is generally low in local government, which gives rise to backlogs, unemployment, retarded economic growth, poverty and other service delivery challenges.
- Some municipalities depend heavily on transfer revenues, which could have negative effects. Although the modelling re-

sults suggest that grants have no negative effects on own-revenue raising efforts, the negative effects on accountability and lack of enthusiasm to balance budgets cannot be discounted. Municipalities should be incentivised to find creative ways of raising their own revenues. The model estimates suggest that grants have some crowd-in effects, which means that grants spur economic activity in municipalities which translate into improved revenue bases. In this regard a predictable transfer system is important.

- Under-spending, of capital budgets in general and grants in particular, is very widespread. Such under-spending implies forgone jobs and economic growth and increases in backlogs and service delivery challenges. The underlying causes of this under-spending are capacity and skills constraints, poor planning and costing of infrastructural projects.

When assessing budget credibility from an aggregate viewpoint, municipalities appear to be performing well, particularly with respect to operational expenditures and service charges. However a disaggregation of credibility ratios by category of municipality presents a different picture. Medium to smaller towns and district municipalities, with and without powers, register poor credibility scores over the period reviewed. The lack of alignment between capital budgets and actual expenditure is glaring and is a challenge faced by all categories of municipalities, albeit to a lesser extent for metros.

Many municipalities are clearly not financially sustainable. In all categories, municipalities are increasing their expenditure at a higher pace than their own revenues. These expenditures are driven mostly by higher input costs and demand for services by communities.

6.5.1 Recommendations

The above analysis yields the following recommendations:

- Municipalities should be encouraged and assisted to find new revenue sources. Government should explore building incentives into the distribution of intergovernmental transfers to promote own-revenue maximisation and punish poor revenue performance.

- Municipalities need to budget adequately for repair and maintenance.

- Spending almost half of operational expenditure on salaries and wages should be discouraged. A thorough analysis of the reasons for this needs to be done, and proper mechanisms put in place to get such expenditures to reasonable and acceptable levels. Costs related to councillor remuneration in smaller municipalities also need to be examined.

- Robust monitoring of municipality budgets is necessary, to ensure that municipality budgets pay attention to service delivery challenges and backlogs.

- Municipalities should prioritise essential expenditures and cut back on 'nice to haves'. Municipalities should also strive for technical and distributive efficiency in order to maximise their service-level outputs with low average input costs and to optimise the welfare of their communities.

- Poorly performing municipalities need to leverage the experience and best practice methods of municipalities that have budget credibility, particularly with respect to capital budgeting and spending.

- Appropriate disincentives should be attached to municipalities that do not plan adequately (especially for capital and grant spending), so that actual figures are not significantly over or underestimated.

- In cases where municipalities lack technical expertise to plan and budget adequately, provincial and national treasuries should provide technical support. For smaller municipalities, sharing technical expertise may be considered as well. Capacity-building efforts need to be strengthened, while fragmented interventions need to be minimised.

- Increases in municipal funding should be based strictly on past spending performance and available human-capital capacity so that additional resources are absorbed and effectively spent.

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