

# Chapter 3

## ANALYSIS OF LOCAL GOVERNMENT REVENUE AND EXPENDITURE

### 3.1 Introduction

Like most aspects of South African society, municipalities are diverse and operate in unique social, demographic and economic spaces. These characteristics have a significant impact on municipal performance and the subsequent strategies required to ensure a well-functioning local government sphere. Chapter 3 analyses the trends and performance of municipal revenues and expenditures against the unique spatial, social and economic characteristics of the various municipalities. To this end, municipalities were grouped according to their spatial characteristics, as depicted in Table 6, which appropriately distinguishes between the economically vibrant urban centres and the sparsely populated rural areas of the country.

Table 6. Categorisation of municipalities used in analysis

Category	Number	Description
<b>Metropolitan Municipalities</b>	6	As per the constitutional definition of category A municipalities. Large metropolitan cities
<b>Secondary Cities</b>	21	Local municipalities with the highest operating budgets and a large urban spatial pattern
<b>Large Towns</b>	29	Local municipalities that consists of a large town
<b>Medium to smaller Towns</b>	111	Local municipalities that consists of several smaller urban settlements
<b>Rural Municipalities</b>	70	Local municipalities that are largely rural with large sprawling settlements
<b>District municipalities without major powers</b>	25	Category C municipalities without the water and sanitation service powers and functions
<b>District municipalities with major powers</b>	21	Category C municipalities with the water and sanitation service powers and functions
<b>Total</b>	283	Local government sector

Source: *Local Government Turnaround Strategy (2009)*

The two sides of the budget – revenue and expenditure – play equally important roles in the country's economy and social well-being. Therefore, this chapter carefully examines the revenue and expenditure performance of municipalities between 2003/04 and 2008/09. Data was sourced from a wide range of sources – in particular National Treasury's Local Government Database for 2009/10. With respect to revenue, special emphasis is placed on revenue performance and the challenge of municipal consumer debt. On the expenditure side, the drivers of municipal expenditure are assessed alongside the efficiency with which local authorities are spending limited resources.

### 3.2 Overview of Municipal Revenue Trends

To fund constitutionally mandated expenditure responsibilities,<sup>24</sup> municipalities rely on two main sources of revenue: own revenue and intergovernmental fiscal transfers. With respect to own revenue sources, municipalities are constitutionally accorded an array of fiscal instruments. These revenue instruments include property rates, user charges for municipal services rendered and other local taxes.<sup>25</sup> Local government in South Africa is generally self-financing, deriving

<sup>24</sup> As detailed in Part B of Schedules 4 and 5 of the Constitution.

<sup>25</sup> In addition, it should be noted that under Section 230 of the Constitution, municipalities are also assigned borrowing powers, which are an important source of revenue particularly for infrastructure.

an average of 73.4% of total real operating revenues from own revenue collection over the period 2003/04 to 2008/09. Due to economic inequalities across the country, certain municipalities have less own revenue resources. Therefore, intergovernmental transfers play an important role in bridging these inequalities to ensure that all municipalities are well funded to fulfil their service delivery mandates. Over the period under review, intergovernmental fiscal transfers contributed on average 26.6% to total municipal revenue.

As Table 7 shows, total municipal revenue grew by a real annual average rate of 13.2% between 2003/04 and 2008/09. This growth was driven largely by strong increases in intergovernmental transfers to enable, among other things, greater access to basic services, the replacement of the Regional Service Council (RSC) levy<sup>26</sup> and preparations for the 2010 FIFA World Cup™.

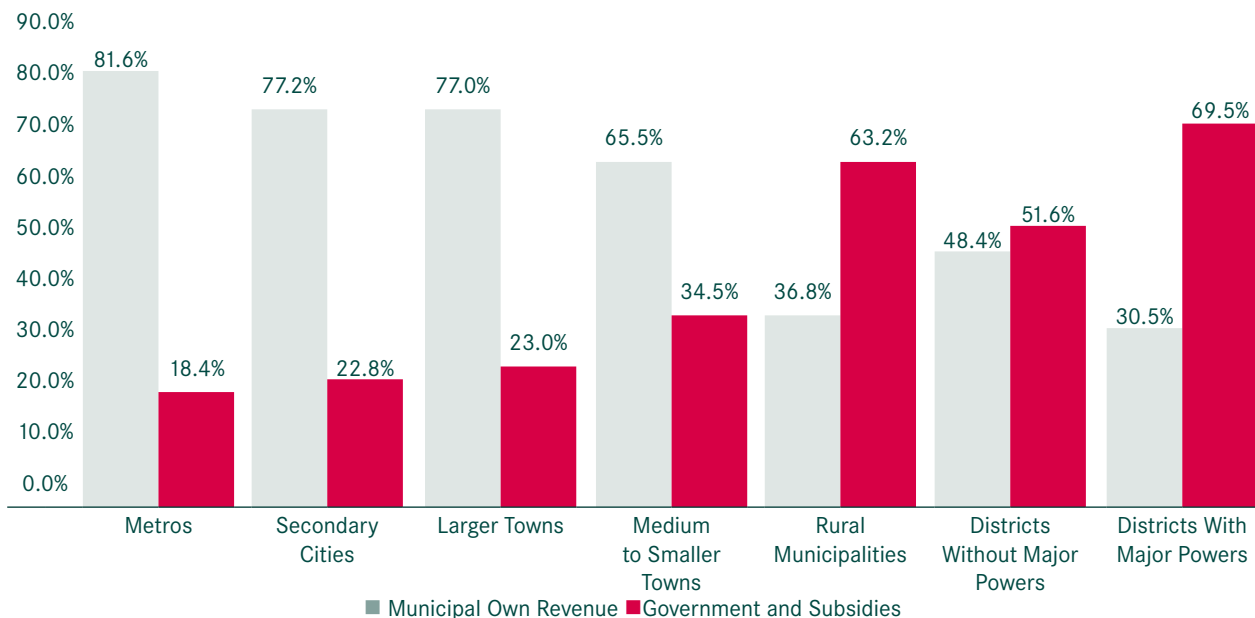
Table 7. Performance of municipal revenue over the period 2003/04 to 2008/09

	Outcome (R'million)						Real Annual Average Growth
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2003/04-2008/09
<b>Total Municipal Own</b>	66,426	70,037	86,780	84,830	89,486	94,921	7.4%
<b>Total Government</b>	13,492	18,900	25,106	35,200	44,638	53,882	31.9%
<b>Total Municipal</b>	79,919	88,937	111,887	120,031	134,125	148,803	13.2%

Source: FFC calculations based on National Treasury Local Government Database, 2010/11

Figure 20 illustrates the real average contribution of own revenue versus intergovernmental transfers to total municipal revenue per municipal category. On average the revenue bases of metros, secondary cities, larger towns and medium to smaller towns are dominated by own revenue (derived mainly from property rates and user charges), whereas rural municipalities and districts tend to rely heavily on intergovernmental transfers.

Figure 20. Real average contribution of main revenue sources to total municipal revenue over the period 2003/04 to 2008/09



Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

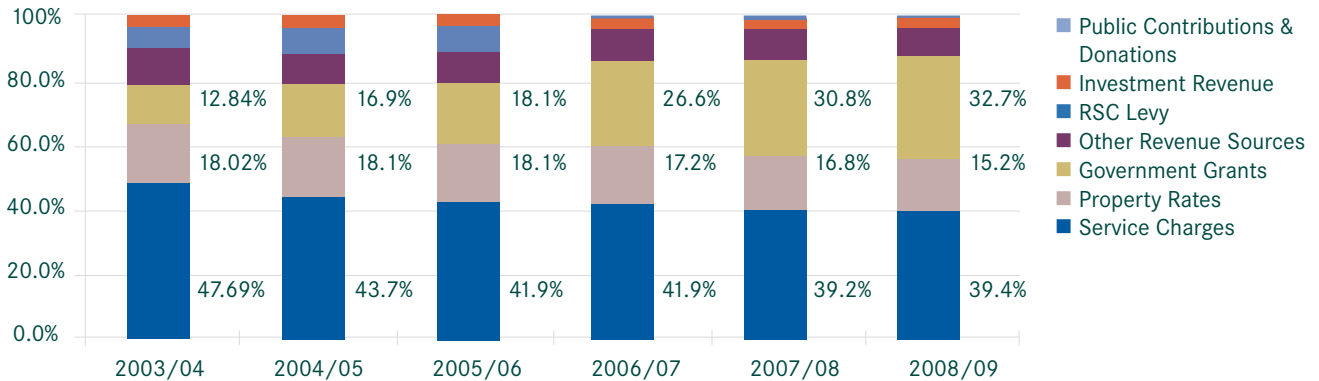
26 The RSC levy was a local government tax afforded to category A and C municipalities and was abolished from the 2006/07 financial year. It was replaced by an interim grant up until 2009/10; whereupon Category A municipalities were given a share of the general fuel levy (also supplemented by the VAT zero-rating of municipal property rates), and the grant continues for Category C municipalities.

Total municipal revenue can be subdivided into two broad categories, operating and capital revenue.

### 3.2.1 Municipal Operating Revenue

As at 2008/09, total municipal operating revenue recorded real annual growth of 7.7%, which is slower growth relative to the 8.3% of the previous year. Municipal operating revenue is comprised of several components: service charges, government grants and subsidies, property rates, other revenue sources, RSC levies, investment revenue and contributions and donations from the public. Figure 21 illustrates the contribution of these various items to total operating revenue.

Figure 21. Contribution of main revenue sources to total municipal operating revenue over the period 2003/04 to 2008/09



Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

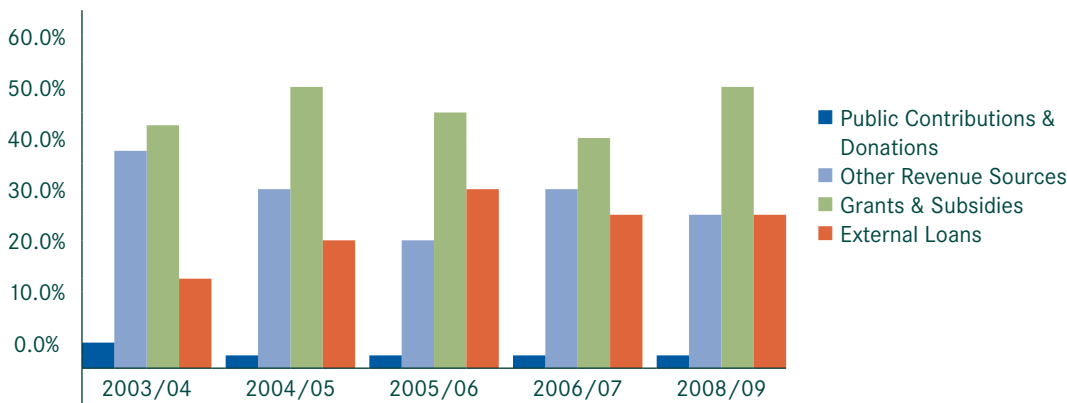
Revenue derived from services charges made up the largest component of operating revenue, particularly for metros, secondary cities, larger towns and medium to smaller towns. In 2003/04, service charges generated over half the total operating revenue within these four municipal categories. As at 2008/09, the proportion contributed by service charges had declined, alongside strong increases in intergovernmental transfers. As explained in Section 3.2.3 below, non-payment for municipal services, particularly water, may be one cause for the decline in service charges. The decline in own revenue generation can also be partially explained by the financial crisis of 2008. On the other hand (and as noted in Section 3.2 above), increases in intergovernmental transfers is largely the result of government's drive to ensure greater access to basic services, the replacement of the RSC levy and preparations for the 2010 FIFA World Cup™. In the case of rural and district municipalities, government grants, specifically the local government equitable share (LES) allocation, are the dominant operating revenue source. District municipalities have limited services to levy, and thus national transfers are the main source of operating revenue.

Metros and local municipalities (secondary cities, larger towns and medium to smaller towns) are allowed to levy property rates. This item contributed, on average, 17.2% to total municipal operating revenue over the period under review. During 2008/09, the contribution of property rates to total operating revenue declined slightly. This can partially be explained by the financial crisis of 2008, when the property market took a knock from the crisis, and alludes to the vulnerability of municipal property revenues to economic shocks. Other revenue sources also made a significant contribution to total municipal operating revenue. For the sake of transparency, municipalities need to be specific about what exactly comprises "other revenue".

### 3.2.2 Municipal Capital Revenue

In aggregate terms, funding for capital increased by a real annual average of 26% between 2003/04 and 2008/09. One of the primary reasons for this strong real growth was increased funding to municipalities in preparation for the hosting of the 2010 FIFA World Cup™. Capital revenues are derived from four main sources: government grants and subsidies; other own revenues; external loans; and public contributions and donations. Figure 22 illustrates the contribution of these various revenue sources to aggregate municipal capital revenue.

Figure 22. Real composition of total municipal capital revenue



Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

The contribution of grants and subsidies to capital revenue is significant across all municipal categories but is most pronounced for districts with major powers, rural and medium to smaller municipalities. For example, in 2008/09 government grants and subsidies contributed 86.0%, 70.2% and 57.7% respectively to total capital revenue in these municipal categories. On the other hand, metros are increasingly making use of the borrowing powers at their disposal.<sup>27</sup> Over the period under review, external loans contributed on average 33% to total capital revenue in metros. The “other” component constitutes own income of municipalities and contributes a significant portion to total municipal capital revenues across all municipal categories. As with municipal own revenue, municipalities need to be more transparent as to what the term “other” entails.

### 3.2.3 Performance of Revenue Collection and the Challenge of Municipal Consumer Debt

Municipal consumer debt refers to non-payment of property rates, fees/charges for services provided by municipalities (for example water, sanitation, electricity and refuse removal) and various other financial obligations to municipalities (including, for example, traffic fines and rental housing payments). Non-payment emanates mainly from households, businesses and government. A fourth group is categorised as “other”, and its contents varies from municipality to municipality; an example of what might be listed in this category is debt from insolvent estates. It should be noted that the practice of using “other” is contrary to the reporting format prescribed by National Treasury, one of the aims of which is to improve clarity and accessibility of information. Essentially poor consumer debt collection constrains municipal own revenue and, specifically, the operating component of own revenue.

As noted in Section 3.2.1, municipal contributions to total operating revenues have shown evidence of slower growth. In addition, the contribution of key municipal revenue drivers to total operating revenue – service charges and property rates – have both declined significantly over the review period. Part of this decline can be explained by non-payment.<sup>28</sup> (The decline in the share of property rates can partially be explained by the financial crisis of 2008, as the property market was particularly affected by the crisis). The Commission’s analysis of consumer debt is based on a six-year database (2004/05 to 2009/10).<sup>29</sup> For each of the six years covered in this database, the number of municipalities reporting was different and consistently increasing.<sup>30</sup> To account for the year-on-year improvements in reporting, and to get a sense of whether actual consumer debt was increasing over and above the increases in the number of municipalities reporting, the reporting variances were controlled for by averaging out the debt figures by municipal category.

The Commission’s analysis of municipal consumer debt over the review period reveals that municipalities are making in-roads with respect to this challenge. The key message in Table 8 is that consumer debt is generally declining across

27 As provided for in Section 230 of the Constitution.

28 Non-payment and its causes have received significant coverage in the literature: see for example, Booysen (2001), Botes and Pelsler (2001), Burger (2001) and Fjeldstad (2004).

29 Please note that the analysis on municipal consumer debt is based on a slightly different review period – it covers six years starting from 2004/05, up until 2009/10 – as opposed to the revenue and expenditure analysis, which runs from 2003/04 up until 2008/09.

30 Differences in the number of municipalities reporting in each year should not be viewed unfavourably, as the important point is that there have been consistent increases in reporting since 2004.

the majority of municipal categories. Secondary cities and districts with major powers recorded real increases between 2008/09 and 2009/10; however, growth was significantly slower in 2009/10 in districts with major powers.

Table 8. Real average municipal consumer debt per municipal category, 2004/05 to 2009/10

Municipal Category	R'million					
	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
<b>Metropolitan Municipalities</b>	4,423	3,431	4,187	3,772	3,826	3,715
<b>Secondary Cities</b>	286	499	287	306	352	404
<b>Larger Towns</b>	56	1,368	106	124	127	111
<b>Medium to Smaller Towns</b>		173	38	39	51	42
<b>Rural Municipalities</b>	10	116	49	21	27	25
<b>Districts Without Major Powers</b>	7	37	7	5	17	4
<b>Districts With Major Powers</b>	11	41	63	43	61	70
<b>Real Year on Year Growth (%)</b>						
<b>Metropolitan Municipalities</b>		-22.4%	22.0%	-9.9%	1.4%	-2.9%
<b>Secondary Cities</b>		74.5%	-42.5%	6.6%	15.0%	14.8%
<b>Larger Towns</b>		2342.9%	-92.3%	17.0%	2.4%	-12.6%
<b>Medium to Smaller Towns</b>			-78.0%	2.6%	30.8%	-17.6%
<b>Rural Municipalities</b>		1060.0%	-57.8%	-57.1%	28.6%	-7.4%
<b>Districts Without Major Powers</b>		428.6%	-81.1%	-28.6%	240.0%	-76.5%
<b>Districts With Major Powers</b>		272.7%	53.7%	-31.7%	41.9%	14.8%

Source: FFC calculations based on National Treasury data, 2009 and 2010/11.

Table 9 assesses consumer debt relative to municipal operating revenue and confirms that the picture is indeed improving. The key point is that consumer debt, as a proportion of municipal operating revenue, is on a downward trend. Districts with major powers show marginal increases from 2007/08 onwards.

This issue may be something to monitor, as districts with major powers are one of the two categories that exhibit real increases in municipal consumer debt. Between 2006/07 and 2009/10, the proportion of consumer debt to operating revenue has remained generally constant. Again, as consumer debt in secondary cities has shown real increases, in the region of 15% in two consecutive years (2007/08–2008/09 and 2008/09–2009/10), this is definitely a municipal category that should be monitored to ensure that consumer debt does not start to affect the financial health of these municipalities.

Table 9. Real average municipal consumer debt as a proportion of real average operating revenue, 2004/05 to 2009/10

Municipal Category	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
<b>Metropolitan Municipalities</b>	10.9%	26.6%	7.5%	6.1%	5.9%	4.7%
<b>Secondary Cities</b>	4.1%	8.1%	1.9%	1.9%	2.0%	1.9%
<b>Larger Towns</b>	15.9%	283.3%	2.4%	2.6%	2.0%	1.4%
<b>Medium to Smaller Towns</b>		6.0%	1.1%	0.7%	0.6%	0.5%
<b>Rural Municipalities</b>	12.2%	3.8%	5.5%	1.1%	0.8%	0.6%
<b>Districts Without Major Powers</b>	3.5%	5.6%	0.7%	0.3%	0.7%	0.2%
<b>Districts With Major Powers</b>	5.7%	40.2%	3.0%	1.1%	1.3%	1.6%

Source: FFC calculations based on National Treasury data, 2009 and 2010/11.

Despite progress made, consumer debt remains a challenge. For example, metros are still faced with, on average, just under R4 billion worth of consumer debt. However, this analysis indicates that the severity of this challenge is weakening. Policy-makers therefore need to reflect accurately on the consumer debt challenge and acknowledge the progress that has been made.

The Commission also considered reasons for non-payment from households, businesses and government.<sup>31</sup> Across all three groups, the inadequacy of municipal billing systems (largely with respect to inaccuracy) was emphasised. Other factors were: for households, poor metering systems and recipients being unable to afford to pay for services; and for businesses, unhappiness with services and high tariffs. Concerns persist around affordability and poor municipal billing systems, which indicate that despite decreases in the severity of the consumer debt challenge, the root causes of non-payment are not being effectively addressed. Based on these reasons, the following aspects that require improvement are highlighted:

*(a) Management of debtors*

The accounting treatment of debtors varies across municipalities. The issues range from the recognition of revenue,<sup>32</sup> to the inadequate writing off of irrecoverable debt (thereby artificially inflating the amounts outstanding) and making inadequate provision for bad debt. There is also little uniformity with respect to the level of interest charged on outstanding amounts.<sup>33</sup> While these aspects are at the discretion of municipalities and their councils and should be location-specific, formal debt management guidelines for different categories of municipalities could assist government in getting a handle on this challenge. This could be done in terms of Section 168 of the Municipal Finance Management Act (MFMA), which allows for the Minister to establish national regulations or guidelines applicable to municipalities.

*(b) Accurate accounting for indigents*

Due to unemployment and poverty, there are households/citizens that are unable to access or pay for basic services – this grouping is referred to as indigent (DPLG, 2005). According to the Free Basic Service (FBS) Policy of South Africa, indigents are exempt from having to pay for basic services below a certain threshold.<sup>34</sup> The roll-out of FBS within municipalities is funded through the LES allocation and municipal own revenue. As a result, the issue of indigents is intricately related to non-payment, as non-payment reduces the amount of own revenue at a municipality's disposal, which affects its ability to extend access and deliver FBS to the poorest of the poor.

Municipalities target indigents in a variety of ways. In the case of water, which is the service where most non-payment accrues, the majority of municipalities use what is referred to as the targeted approach.<sup>35</sup> The indigent register is an important management tool<sup>36</sup> that is used to keep track of indigent households. The problem is that municipalities do not regularly update this information and so indigents may be included among those that have been listed as (illegal) defaulters, thus inflating the extent of consumer debt. Accurate information on those eligible for FBS (versus those who should pay for services) is essential to devise credible revenue and expenditure estimates. It is therefore suggested that regular updating/maintenance of indigent information be recognised as an integral component of revenue management and be included as part of Section 64 of the MFMA. More weight should be attached to the quality and accuracy of data and information on indigents, as this type of information is valuable for addressing a range of challenges, from better targeting the poorest of the poor, to assisting to quantify consumer debt better, and contributing to more credible revenue and expenditure estimates.

*(c) Affordability of basic services*

Related to the issue of indigents is the need to monitor the affordability of basic services (water, electricity, sanitation, refuse removal). Although a national benchmark establishes [income] baselines for those households eligible for FBS,

31 Reasons driving non-payment emanating from households, businesses and government were arrived at as follows: for households, the main area of non-payment is water. The key reasons for this type of non-payment were derived from annual General Household Surveys which contain questions on the non-payment of water. For businesses, Business Unity South Africa (BUSA), the umbrella body for business in South Africa, provided information while reasons for non-payment on the part of government departments, were sourced from provincial treasuries, particularly treasuries in provinces where the metros are located.

32 This refers to some municipalities adhering to Generally Recognized Accounting Practice (GRAP) 9 versus others that comply with International Accounting Standards (IAS) 36 and IAS 39. With GRAP 9 the rendering of a service to an indigent does not increase debtors. The opposite is true for those municipalities who adhere to IAS 36 and IAS 39 – these municipalities recognise services delivered to indigents and these are then reflected as debtors and provision for bad debts need to be made (see Salga Input to Budget Forum, 2010 for more information).

33 In some municipalities, interest is pegged to the prevailing prime rate, whereas in others the rate charged is at the discretion of the chief financial officer.

34 For example, in the case of electricity, the FBS threshold is 50 kilowatt hours per household per month. For water, the FBS amount is 6,000 litres per formal connection per month.

35 The targeted approach refers to cases where the municipality identifies which households are indigent (according to a determined income threshold) and then supplies these households with FBS.

36 See Non-Financial Census, 2008/09

municipalities are at liberty to increase this threshold.<sup>37</sup> During economic recession or periods of higher than average tariff escalations, municipalities should be sensitive to the impact on households that fall below the threshold or are close to the margins.<sup>38</sup> Affordability indicators need not be complicated.

For example, to monitor affordability, municipal policy-makers can use consumption-related indicators (such as percentage of total household expenditure devoted to a commodity or per capital consumption/expenditure on a commodity), price-related indicators (for example unit prices paid for a commodity), or payment-related indicators (such as the use of arrears statistics, use of alternative payment schemes and disconnections owing to debt) (Milne, 2004, 5). Such indicators can assist municipalities to be more sensitive to potential increases in consumer debt and/or the need to adjust municipal indigent thresholds.

#### *(d) Billing and collection*

As recent reports indicating public discontent with the poor billing practices of, for example, the City of Johannesburg proves, poor billing/collection is specific not only to smaller, less resourced municipalities.<sup>39</sup> Improvements in billing and collection have the potential to bring about immediate enhancements to the revenue bases of municipalities. Instead, as households, business and government confirm, issues around incorrect billing continue to affect negatively the integrity of local authorities. Poor performance can result in paying customers being categorised as defaulters and can, in certain instances, exacerbate unwillingness to pay.<sup>40</sup> Achieving and maintaining accurate and efficient billing and collection processes are based on a number of factors. These include accurate customer databases, effective and regular metering of service consumption, adequate staff capacity and convenient facilities for customer payments (World Bank, 2008). Of the reasons driving household non-payment, poor/irregular metering systems were particularly emphasised (StatsSA, 2005, 2006, 2007, 2008). In this instance, wider use of prepaid meters may be a possible solution.<sup>41</sup>

Some municipalities successfully implement creative measures to improve billing and collection. eThekweni Municipality, for example, has developed a geographic information system to facilitate enhanced management of water and sanitation services. The system uses aerial photographic surveys carried out annually to produce maps that indicate, for example, recently constructed properties and can show the precise location of all connected and unconnected properties (World Bank, 2008). This municipality also employs dedicated staff to recover debt from government and the largest debtors. The City of Cape Town employs a similar strategy, establishing a dedicated section to focus on the top 1,000 debtors in the City. Theewaterskloof municipality places particular emphasis on the use of customer profiling and regular updating of its indigent register.

In addressing the billing and collection problem, municipalities need to determine the root cause of poor performance. In instances where municipalities do not have the financial and human capital resources to upgrade and employ more sophisticated administrative and billing systems, consideration should be given to either outsourcing the function (this is permissible in terms of Section 76(b) of the Municipal Systems Act) or establishing an internal municipal service district to facilitate improved performance (permissible in terms of Section 85 of the Municipal Systems Act). In less severe cases, municipalities should leverage the experience of their counterparts who are capably managing their billing and collection functions. Finally specific key performance indicators could be included in the performance contracts of municipal managers, to attach appropriate weight to the role of sound and efficient billing and collection processes in municipalities. These should include, for example, reducing the average time between meter reading and invoicing, increasing metered consumption (if metering is chosen over the use of prepaid systems) and improving the average time between complaints being lodged and (partially or fully) addressed.

37 According to the 2005 "Guidelines for the Implementation of the National Indigent Policy", R1,600 is cited as the monthly household income threshold for determining indigent status.

38 For example, according to Eskom's multi-year price determination for the period 2010/11 to 2012/12, the cost of electricity is to increase by just under 26% annually. Municipalities often have little choice but to pass these increases on to consumers.

39 The City of Johannesburg recently spent R580 million on Project Phakama, an upgraded system described on the municipality's website as a system that will "ensure greater functionality in the areas of metered services, billing, collections, customers' service options and payment process" (Mungoshi, 2010).

40 Political interference that prevents officials from collecting arrears or applying pressure to defaulters is another factor that can entrench a culture of non-payment (See Lubbe and Rossouw, 2010).

41 The use of prepaid meters carries with it certain disadvantages, most notably a false sense of progress with respect to access to basic services as a result of self-disconnection. However, if indigent thresholds are sensitive to changes in affordability and are appropriately adjusted, the advantages of using prepaid meters may outweigh the negatives.

(e) Municipal power to recover unpaid amounts

In instances of good debt management, the government can consider extending more punitive recovery measures, by taking a differentiated approach to expand the powers of municipalities. This differentiated approach should not be based merely on municipal category, but rather on individual municipal performance with respect to consumer debt. To this end, a range of factors – from general management of debt to regular updates of indigent information – should be considered.

Relative to 2004/05, municipalities are showing progress with respect to this challenge. However this does not imply that municipalities should not try and further contain consumer debt. Municipalities can choose from an array of revenue instruments to finance their constitutional mandate and related service delivery responsibilities. However, they need to spend these scarce resources effectively and efficiently so as to ensure that outcomes are achieved and services to communities are maximised and sustained. In this regard, the next section analyses the expenditure decisions, outcomes and performance of municipalities in South Africa.

### 3.3 Overview of Municipal Expenditure and Outcomes

Municipal expenditures can be divided into two categories: operating expenditures and capital expenditures. Table 10 provides an aggregate picture of these two types of expenditure across the local government sphere. As a proportion of the total, operating expenditure far exceeds capital expenditure, but capital spending was the fastest growing component. This trend is probably the result of government’s drive to eradicate service backlogs and substantial investment in infrastructure related to the 2010 FIFA World Cup™.

Table 10. Total municipal expenditure, 2003/04 to 2008/09

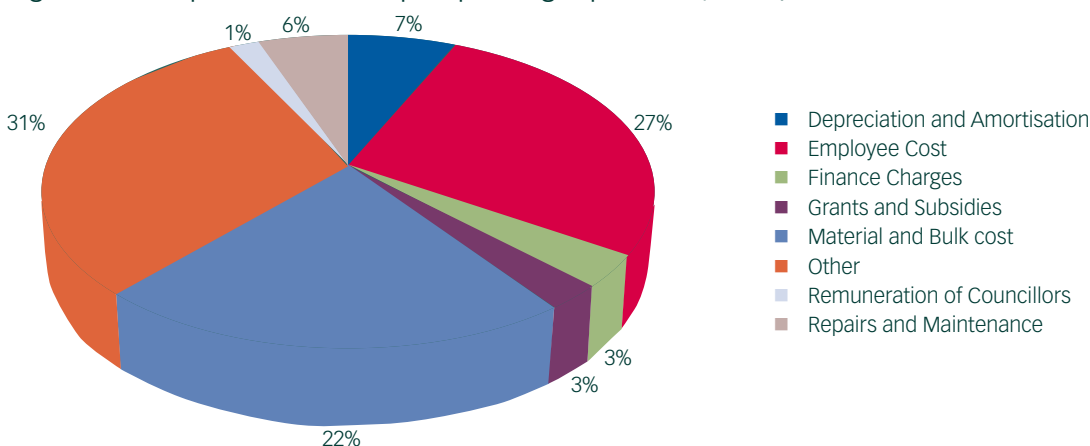
R Millions	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Municipal Operating Expenditure	79 548	85 615	86 237	91 261	96 764	107 399
Municipal Capital Expenditure	11 311	13 952	16 933	19 472	25 395	31 312
<b>Total Municipal Expenditure</b>	<b>90 859</b>	<b>99 567</b>	<b>103 170</b>	<b>110 734</b>	<b>122 159</b>	<b>138 711</b>
Real Year on Year Growth		2004/05	2005/06	2006/07	2007/08	2008/09
Municipal Operating Expenditure		7.6%	0.7%	5.8%	6.0%	11.0%
Municipal Capital Expenditure		23.3%	21.4%	15.0%	30.4%	23.3%
<b>Total Municipal Expenditure</b>		<b>9.6%</b>	<b>3.6%</b>	<b>7.3%</b>	<b>10.3%</b>	<b>13.5%</b>

Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

#### 3.3.1 Municipal Operating Expenditure

Municipal operating expenditure represents the recurrent costs that a municipality incurs in providing constitutionally mandated basic services to its communities. Figure 23 below looks at the composition of total municipal operating expenditure for the 2008/09 financial year.

Figure 23. Composition of municipal operating expenditure, 2008/09



Source: FFC calculations based on National Treasury Local Government Database, 2010/11.



As Figure 23 shows, total municipal operating expenditure is driven by seven components. Two of the components – employee costs and repairs and maintenance – warrant further analysis.

(a) Employee/personnel costs

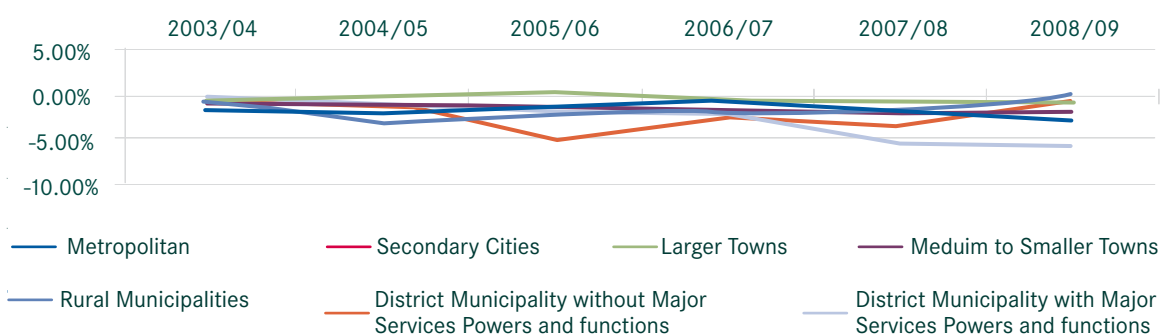
Expenditure on salaries is driven by the need for labour, as an input to provide services and run the municipal administration efficiently and effectively. A disaggregated analysis of personnel expenditures by municipal category reveals that spending on personnel tends to be larger in municipalities with fewer service-level responsibilities. As a result, rural and district municipalities have the largest shares of personnel expenditure to total operating expenditure, and relatively larger real growth rates for personnel expenditure.<sup>42</sup> Various hypotheses can be driving this trend: (1) these municipalities are perhaps simply paying excessive salaries to their staff; (2) service delivery processes of these municipalities are possibly more labour intensive. While these two hypotheses would explain the above trends, most of the municipalities in question have no or limited major service powers and functions, relative to metros. (3) Building from the first hypothesis, it could be possible that these municipalities, which are largely located in poorer, rural parts of the country, have to pay excessive salaries in order to attract appropriate skills.

In the case of the first and third hypotheses, a possible conclusion is that these municipalities and their communities are in dire straits, as resources required for the delivery of services appear to be diverted to pay large salaries. Service delivery is perhaps being compromised in these areas. Therefore, extensive research is required to understand the fundamentals and drivers of municipal personnel expenditure in the South Africa, particularly in more rural municipalities.

(b) Repairs and maintenance

Adequate maintenance of new and existing municipal infrastructure is pivotal for ensuring sustained delivery of quality services and preventing service delivery failures due to poor maintenance. Although National Treasury recommends that 8–10% of municipal operating budgets be geared towards this expenditure item, ideally expenditure on repairs and maintenance should be planned and executed relative to the existing municipal asset base. As illustrated in Figure 24, spending performance on repairs and maintenance is extremely poor, regardless of the size, capacity or characteristics of municipalities. In fact, over the period under review, all municipalities failed to spend fully their budgeted amounts for repairs and maintenance (except for larger towns in 2005/06).

Figure 24. Actual expenditure on repairs and maintenance relative to budgeted amounts per municipal Category, 2003/04 to 2008/09



Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

As poor spending on repairs and maintenance cuts across all municipal categories, it is likely that the reasons underlying such trends go beyond general capacity issues and are more the result of poor management and performance. One possible reason for such poor expenditure performance could be because municipal services are not cost reflective. In essence, repairs and maintenance of infrastructure should be funded via the tariff charged for a service, which is a requirement legislated in Section 74(2) of the Municipal Systems Act (South Africa, 2000). However, municipal tariffs have

42 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.

a long history of not being cost reflective. To correct this, the government is planning to undertake a review of municipal tariff structures.

Based on the discussion above, poor expenditure on repairs and maintenance can be equated to poor planning by municipalities in terms of their spending performance and tariff determination. Although a precedent should not be created where national government will bail out poor municipal performance, it is important to distinguish between social and economic infrastructure when considering the funding of repairs and maintenance. Whereas a tariff can be charged to consumers for the use of economic infrastructure, social infrastructure<sup>43</sup> is the infrastructure required to deliver a basic service to a household, specifically poor households, and no return on this investment is likely. In South Africa, municipalities receive the Municipal Infrastructure Grant (MIG), which is a conditional grant that primarily funds infrastructure to households not connected to services. Although municipalities use own revenues to invest in infrastructure, in most cases the MIG accounts for large amounts of the capital budgets. Since MIG-related infrastructure serves poor households, who in turn receive free basic services, a return on these investments is unlikely. This creates an expenditure item that is not readily funded or needs to be funded from other sources. While certain municipalities have the ability to cross-subsidise such expenditures, municipalities containing large proportions of poor households are unlikely to be able to fund repairs and maintenance. Such issues should be considered as part of the review of the local government fiscal framework.

#### (c) Factors influencing operational expenditure

Municipal expenditures are informed by implicit and explicit factors. Implicit factors can include municipal expenditure efficiency, planning and budgeting decisions, all of which are within the control of municipalities. Explicit factors that impact on the size and nature of municipal operating expenditures tend to be subject to the unique social, economic, demographic and spatial nature of the municipalities and are thus beyond their control. To identify and quantify these factors, a fully specified cross-sectional model is used.<sup>44</sup> Knowledge of these factors is expected to aid internal planning and expenditure processes and assist in the design of intergovernmental transfers, to ensure that the expenditure needs of municipalities are captured and appropriately subsidised through the various grant mechanisms. However, severe data constraints limit the scope of this analysis and, as a result, important variables are excluded, which impacts on the overall fit of the model. Such variables include mostly supply-side factors, such as wage rates across municipalities and geographic and topographical variables, which are extremely difficult to obtain per municipality in South Africa. Despite these constraints, the exercise yielded interesting results. Some of the factors<sup>45</sup> that were found to have a significant and positive effect on municipal expenditures are:

- *Access to basic services.* The more households connected to services, the higher the expenditures required to serve these households
- *Greater economic activity.* This captures the demand for services from business, which results in positive impacts on expenditures,
- *Institutional arrangements.* Municipalities with powers and functions for services spend more due to these greater service responsibilities,
- *Population density.* General theory suggests that the denser the settlements, the lower the service costs. However, the population density variable has positive effects on operating expenditures, which is possibly explained by the additional costs associated with denser settlements, such as increased crime prevention efforts and the need for additional infrastructure.
- *Household income.* Higher disposable income of households results in greater purchasing power, which likely results in a greater demand for quality services,
- *Poverty rates.* The social role that municipalities play in offering support to poor households in the form of FBS is apparent: the more poor households in a municipality, the higher the operating expenditures.

43 In this context, social infrastructure refers to infrastructure required to provide basic services to communities, particularly poor households and would include, for example, water and electricity.

44 The cross-sectional model was estimated for the 2007/08 financial year for all 283 municipalities, using mainly 2007 Community Survey data. Municipal operating expenditure was analysed in per capita terms.

45 Please make reference to the technical report for a detailed list of variables and how they were measured.

An assessment of the share of total population across the different types of municipalities between 1996 and 2009 highlights the extent of urbanisation in the country, especially migration between the largely rural municipalities and the six metros. A similar trend is also apparent between secondary cities and smaller towns. This suggests that urban municipalities face an annual increase in demand for services from new households being established within their jurisdictions. The impact of migration on municipal operating expenditures was tested in the model. The migration variable comes out as significant in explaining the variation in operating expenditures but has a negative effect on such expenditures. This suggests that municipalities are finding it difficult to cope with the increased pressures of migration and the quality of service provision is negatively affected.

In terms of the design of intergovernmental transfers, the LES is the primary operating grant for municipalities. This grant adopts a formula-driven equalisation framework. Therefore, the formula needs to estimate accurately the expenditure need of municipalities relative to their fiscal capacity to determine allocations. Based on the analysis and results described above, several factors clearly have an impact on municipal operating expenditures. Therefore, the assumptions that inform the expenditure estimations in the model must reflect the different factors that can have an impact on the costs of providing services. Furthermore, the current LES formula is based on 2001 census data, and so migration patterns, population movements and service-related dynamics over the past ten years are not accounted for in the formula. Thus, it is possible that funds from this grant are not being appropriately distributed relative to the demand for services and concentration of poor within local government. Such considerations should be factored into the review of the LES formula, which the government is currently undertaking.

#### *(d) Performance of municipal operating expenditure*

One way of assessing the performance of local government operating expenditures is to calculate the efficiency<sup>46</sup> with which municipalities use their resources to generate appropriate service delivery outputs. This was estimated, using the Free Disposable Hull (FDH) approach,<sup>47</sup> for a sample of 129 municipalities that are authorised to and provide all basic services. The efficiency scores should be interpreted as the use of resources (input) to generate services (outputs).<sup>48</sup> Municipalities with a score of 100% are fully efficient in using their given resources relative to the sample, whereas a municipality with a score of 0.85 uses 15% less resources to produce the same amount of services. This exercise is significant because it is a relatively new method that can be used to identify and benchmark best practice in local government in South Africa.

Over the period, four municipalities remain constantly efficient: Thembisile in Mpumalanga, Polokwane in the Limpopo province, Mangaung in the Free State and eThekweni in Kwazulu-Natal. The average efficiency score ranges from 0.30 in 2005/06 and peaked at 0.39 in 2007/08 and decline to 0.35 in 2008/09. This suggests that, on average, municipalities in the sample can obtain the same level of services with at least 60% to 70% less resources. In the 2005/06 financial year, a total of 11 municipalities were computed as efficient, decreasing to just seven in the 2008/09 financial year. Then, in order to further gauge the factors that have an impact on municipal efficiency, an estimation was undertaken against a range of factors that could theoretically affect efficiency.<sup>49</sup> The key results are described below:

The more fiscally capacitated a municipality, the more inefficient the use of resources.

- The financial capacity<sup>50</sup> and experience of municipal managers has a positive impact on efficiency. This finding confirms the importance for municipalities to adhere to the minimum skills requirements for employing senior officials, such as the Municipal Manager and Chief Financial Officer, as stipulated in the Municipal Regulations on Minimum Competency Levels.<sup>51</sup>
- Outsourcing refuse removal services improves efficiency, while outsourcing water and electricity does not result in any significant impacts on efficiency.

46 The technical efficiency of municipalities was assessed in this exercise. Technical efficiency is defined as the optimum use of given resources to produce a certain level of services. In other words, inputs are minimised and outputs maximised.

47 The Free Disposable Hull approach is a technique that identifies "benchmark" municipalities that use resources efficiently within the sample and thereafter computes efficiency scores for the remaining municipalities as a percentage relative to the efficient municipality.

48 Inputs were measured as total operating expenditure per capita to capture the costs of labour, capital and materials to provide municipal services. Outputs were captured by computing service indices of all major services provided by municipalities, which were averaged into one output index.

49 A cross-sectional tobit estimation, based on the FDH efficiency scores generated for the 2008/09 financial year was undertaken - the analysis was done for the 129 sampled municipalities.

50 In terms of the modelling, financial capacity was indicated by skills and experience of the Chief Financial Officer and audit outcomes, among others, as considered in the financial classification system of the MFMA.

51 For more detail, see Government Gazette Volume 504, No. 29967.

- Of the several policy methods used to implement FBS in South Africa, the most common are the technical,<sup>52</sup> broad-based<sup>53</sup> and self-targeting<sup>54</sup> approaches. When assessed against the efficiency scores generated, municipalities that used the technical approach were the most efficient in providing free basic electricity. The targeted approach was identified as the most efficient in terms of providing water and sanitation.

### 3.3.2 Performance of Municipal Capital Expenditure

Municipal capital expenditure constitutes a municipality's investments in (social and economic) infrastructure projects. As such, this type of expenditure plays an important role in the social development of communities and the economic growth of the country. Local government capital expenditure is dominated by three items: water and sanitation, roads and storm water and 'other'.<sup>55</sup>

Performance of capital expenditure is defined here as deviations in planned from actual capital expenditure.<sup>56</sup> As is evident in Table 11, municipalities experience severe challenges aligning the budgeted and actual capital expenditure. Over the entire period reviewed, actual capital expenditure is less than what was planned. When the aggregate picture is decomposed according to the various municipal categories, all categories of municipalities (except for metros) are experiencing problems with capital spending. Apart from metros, every other category show deviations in excess of the 20% benchmark/acceptable variance set by the Department of Cooperative Governance. One of the reasons for this variation is that budgeting and spending for capital projects differ from operational activities. In many cases, municipalities simply divide the projected cost of a capital project by the estimated number of years to completion and budget on this basis. The reality is that most capital projects are multi-year undertakings with increases or spikes in spending towards the end of the project life cycle. This calls for sound project and financial management on the part of municipalities to ensure that under/overspending does not occur.

Table 11. Budgeted vs. Actual capital expenditure by municipal category, 2003/04 to 2008/09

Municipal Category	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
<b>Metros</b>	55.4%	64.8%	70.8%	85.1%	96.9%	110.5%
<b>Secondary Cities</b>	70.0%	78.2%	66.1%	65.4%	69.3%	72.1%
<b>Larger Towns</b>	48.6%	54.7%	78.8%	69.3%	72.3%	65.7%
<b>Medium to Smaller Towns</b>	57.0%	72.8%	56.1%	64.7%	59.1%	66.4%
<b>Rural Municipalities</b>	52.6%	63.1%	48.6%	51.1%	75.9%	67.2%
<b>Districts without Major Powers</b>	63.7%	104.4%	43.0%	24.2%	58.7%	43.1%
<b>Districts with Major Powers</b>	35.7%	51.0%	66.5%	68.2%	47.3%	55.1%
<b>TOTAL</b>	<b>55.1%</b>	<b>66.3%</b>	<b>66.6%</b>	<b>72.7%</b>	<b>78.7%</b>	<b>87.0%</b>

Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

The Commission has consistently raised the issue of poor capital grant spending at local government level. With the tabling of the 2010 Medium-Term Budget Policy Statement (MTBPS), the poor conditional grant spending was highlighted by the R1.8 billion in rollovers from the previous financial year. Past spending performance and access to adequate human capital capacity and technical capacity of municipalities should be considered when determining allocations, particularly in the case of municipalities that perennially under-spend on their grant allocations. The potential benefits of increased funding to municipalities could be lost should ineffective spending and/or under-spending persist due to inadequate capacity.

### 3.3.3 Outcomes Related to Municipal Expenditure

Ultimately, the core responsibility of municipalities is to ensure that their communities receive a sustained and high

52 The technical approach to free basic electricity includes the use of prepaid meters, where a portion of the service is provided free of charge and thereafter the household has to pay for any extra usage.

53 With the broad-based approach, all households receive a portion of electricity free, with households that use more than the stipulated free amount paying more to cross-subsidise poorer households.

54 In terms of the targeted approach, the municipality needs to identify a household as indigent and then supply this household with a portion of electricity free.

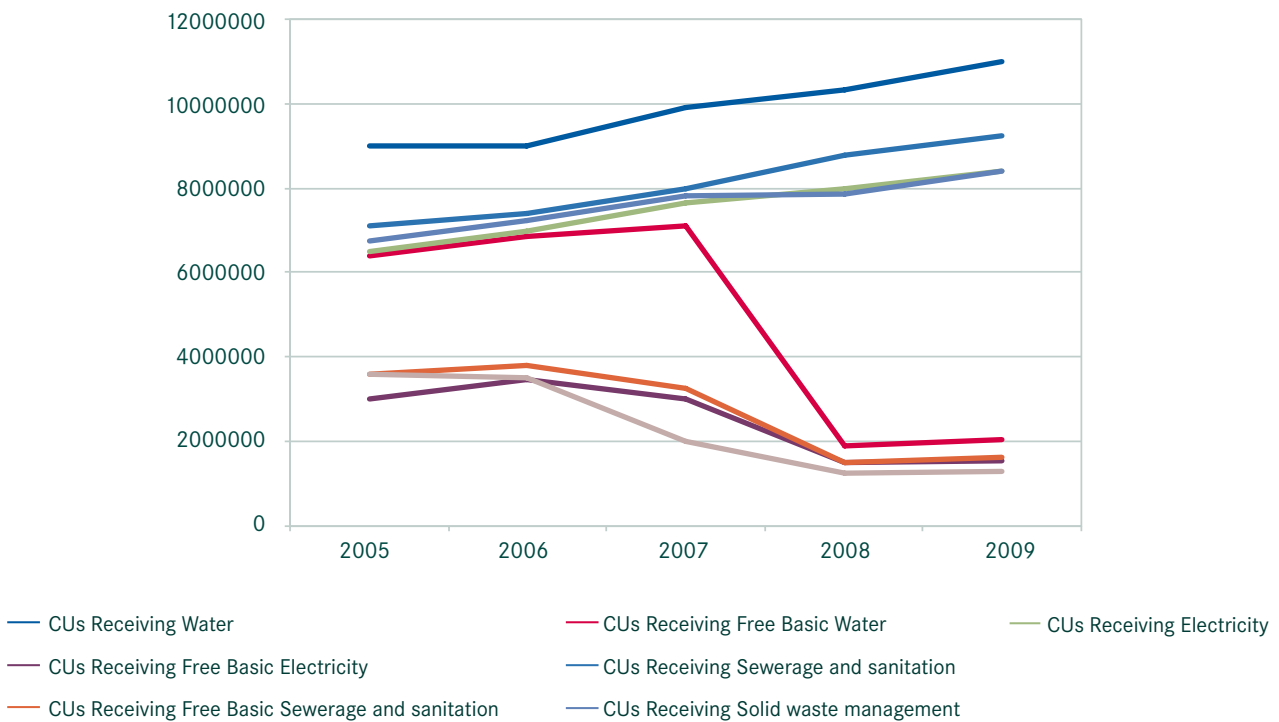
55 In this case 'other' refers to expenditures on land, buildings, vehicle fleets, etc.

56 As opposed to operating expenditure, the technical efficiency of capital expenditure was not assessed due to the dynamic nature of this type of expenditure.

quality of service. Municipalities are also required to provide sufficient social support to indigent households and to promote economic development within their jurisdictions. In terms of the former, municipalities are responsible for the provision of FBS, a government policy that affords households deemed as indigent, a portion of basic services free of charge.

Figure 25 illustrates growth in the average number of consumer units (CUs)<sup>57</sup> receiving basic services and FBS in South Africa. It clearly shows a gradual increase in the number of CUs receiving services, which correlates well with the increases in operating expenditure over this period. In 2005, just over six million CUs were receiving the electricity, sanitation and refuse services, while almost nine million CUs were receiving the water service. In 2009, this increased to well over eight million for all services, with over ten million CUs receiving the water service. It is clear that the increasing demand for services from consumers is being accommodated by municipalities, and that there is a certain degree of achievement in terms of rolling out services.

Figure 25. Growth in number of consumer units receiving basic services and free basic services (FBS), 2005 to 2009



Source: StatsSA, 2005 to 2009.

Turning to capital expenditure and basic services backlogs, Table 12 illustrates the proportion of households with access to the four basic municipal services. These trends constitute substantial progress in extending services to previously disadvantaged and poor households by government in 13 years of democracy. However, backlogs in access to sanitation and, especially, refuse removal are considerably high. These figures are a concern, as the Millennium Development Goals dates approach.

Table 12. Basic services backlogs

Basic Service	1996	2001	2007
Percentage of households where there is refuse removal by a local authority at least once a week	51.2%	55.4%	60.1%
Percentage of households with access to a flush toilet connected to a sewerage disposal	Not available	49.1%	55.1%
Percentage of households using electricity as the main source of lighting	57.6%	69.7%	80.0%
Percentage of households with access to piped water	Not available	84.5%	88.6%

Source: StatsSA, 2007.

57 A consumer unit is defined as the point at which a service is charged i.e. the entity that receives a municipal bill. This would therefore include households and business.

### 3.4 Recommendations

With respect to local government revenue and expenditure assessment, it is recommended that:

- National and provincial treasuries' efforts to improve the credibility of municipal budgets through annual benchmarking exercises should continue to be supported, the results of these evaluations be reported to Parliament and provincial legislatures, and placed in the public domain. This may incentivise effective financial management among municipalities.
- National government should specifically enforce the provisions set out in Section 74(2) of the Municipal Systems Act, such that the basis of municipal tariffs accurately reflects the cost of providing the specific service, as well as conforms to the National Treasury expenditure guidelines for repairing and maintaining municipal infrastructure. This will improve planning and funding of repairs and maintenance.
- National and provincial government should require and assist municipalities to identify the primary cause of poor performance in their billing and revenue collection functions and use the information to design appropriate remedial strategies. Subsequently, municipalities should establish municipal service districts to facilitate improved performance
- As an interim measure, government should establish and publish guidelines for municipalities on the management of municipal consumer debt in terms of, but not exclusive to, interest charges, debt impairment and writing off of bad debts.
- Section 64 of the Municipal Finance Management Act (No.56 of 2003) should be amended to require the regular collation and updating of information on the indigent residents of a municipal area, as an integral component of municipal revenue management practices.
- National and provincial government should develop and support peer learning and support programmes that assist poorly performing municipalities to leverage the experience and best practices of well-performing municipalities, particularly in relation to spending performance, efficiency in using resources, proper debt management and the achievement of desired developmental outcomes.
- Data available at local government level should be reviewed so as to ensure appropriate surveys or alternatives are available to account accurately for changes in demographics and other factors at municipal level. This recommendation is a reiteration of previous recommendations on data requirements for the local government fiscal framework made by the Commission.