LOCAL GOVERNMENT IN A SYSTEM OF INTERGOVERNMENTAL FISCAL RELATIONS IN SOUTH AFRICA

A Discussion Document

27 July 1997

Foreword

The Financial and Fiscal Commission (FFC) was appointed in terms of the Interim Constitution on 25 August 1994. During the latter half of 1994 and early 1995 the FFC's office infrastructure was established, including a small research staff complement.

From May 1995 to mid-1996 the main focus of the FFC was on the establishment of the fundamental principles of a system of intergovernmental fiscal relations, and associated provincial and national financial issues. Due largely to the nature of the constitutional process and the resultant sequencing in establishing the institutions of governance, the provincial and national spheres of government were dealt with in the first phase of the Commission's work program, the outcome of which was the design of a provincial formula for the allocation of financial resources to the national and provincial governments.

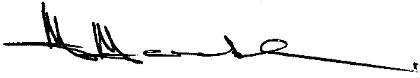
During 1996, once the structures and responsibilities of the local government sphere had been resolved in terms of the interim phase for local government, the FFC found it possible to focus on this sphere of government. In doing so, the FFC has taken cognisance of the Local Government White Paper process, which may influence the existing socio-economic rationale of local government, its structures, functions and political system. Although some changes are expected, our estimation is that most of the fundamental features are likely to remain largely unaltered.

The FFC has now reached a point in its work where it can now present its initial thinking on the local government financing regime for general discussion and debate. These are contained in the discussion document: "***Local Government in a System of Intergovernmental Fiscal Relations in South Africa".*** It is anticipated that all role players and interested parties in civil society in general, will respond to this draft submission and thereby assist in developing a sound and sustainable system of local government in South Africa.

As far as the process is concerned, the discussion document is to be disseminated as widely as possible, with a particular focus on municipalities and to both provincial and national departments responsible for local government matters, and to appropriate legislative forums. It is requested that comments and suggestions be submitted to the FFC by the end of October 1997. The Commission is also going to schedule presentations and discussions with the institutions mentioned above to facilitate the consultative process.

As the Chairperson of the Financial and Fiscal Commission, I extend an invitation to each person and institution, able to make a contribution to the development of an effective system of intergovernmental fiscal relations for local government in South Africa, to submit your comments and suggestions.

Greetings



Murphy Morobe
Chairperson: ***Financial and Fiscal Commission***

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FINANCIAL RESOURCES FOR LOCAL GOVERNMENT & MUNICIPALITIES

1. Introduction

This Synopsis highlights the key principles and arguments which the Financial and Fiscal Commission develops in the full discussion document. For the sake of clarity, the section on the core recommendations is presented in the Synopsis in its entirety. This particular section also forms part of the FFC's report, *Comments and Recommendations: The Allocation of Financial Resources to National, Provincial and Local Government* which is to be submitted to the Budget Council and Chairperson of the Joint Standing Committee on Finance, in Parliament.

2. Constitutional provisions

Section 155 of the Constitution determines that there are three categories of municipality: category A comprises municipalities that have exclusive municipal executive and legislative authority in their areas; category B comprises municipalities that share municipal executive and legislative authority in their areas with a category C municipality within whose area it falls; and category C comprises municipalities that have municipal executive and legislative authority in an area that includes more than one municipality. National legislation must define the types of municipality that may be established within each category and the appropriate division of powers and functions between category B and C municipalities.

In Chapter 13 of the Constitution it is stated that the local government sphere is entitled to an equitable share of revenue collected nationally. Furthermore, provision is made for municipalities to raise own revenues and to raise loans subject to certain conditions.

3. Local Government Transition Act

Section 26 of Schedule 6 of the Constitution, dealing with transitional matters, determines that, despite the above-mentioned sections of the Constitution, the provisions of the Local Government Transition Act of 1993 (LGTA), as may be amended from time to time by national legislation consistent with the new Constitution, remain in force until 30 April 1999 or until repealed, whichever is sooner. This period is referred to as the local government "interim phase".

Despite the delineation envisaged in the Constitution, the Local Government Transition Act currently distinguishes between two main categories of local government, viz. urban and rural local governments. Urban local governments may be metropolitan councils, their constituent metropolitan local councils, or local councils. Rural local governments may consist of district councils, rural councils, representative councils, local councils or local area councils, all of which appear to be consistent with the Constitution.

4. A partial two-tier system

Although the existing local government system encompasses an enormous range of disparities in terms of physical size and economic capacity, it lends itself analytically to a further (albeit incomplete) two-part characterisation. The first of these parts is a two-tier group of local governments consisting of categories B and C municipalities, into which many, especially rural, municipalities fall. In the major urban areas, the upper tier of this two-tier group consists of metropolitan councils, and the lower tier the constituent metropolitan substructures; in the rural areas, district (or regional or services) councils form the upper tier and a variety of substructures is to be found on the lower level. The second part of the characterisation, referred to above, consists of category A municipalities that form a single-tier. Many of the municipalities that fall into this category are towns that do not have metropolitan status (but do fall within the geographical borders of a district council).

5. Local government functions

In terms of section 156 of the Constitution a municipality has executive authority in respect of, and has the right to administer, the matters listed in parts B of schedules 4 and 5. Examples of the former are building regulations,

electricity and gas reticulation, fire-fighting services, municipal planning, municipal health services, municipal public transport, and water and sanitation services. Examples of the latter are beaches and amusement facilities, cemeteries, cleansing, local amenities, markets and abattoirs, municipal parks and roads, refuse removal, street lighting, traffic and parking.

6. Sources of revenue

In contrast to the provinces, the so-called traditional municipalities in former white areas have historically been able to finance a significant proportion of their expenditures from own revenues. This was not necessarily the case in Black, Indian and Coloured townships in the former RSA, TBVC-states and self-governing territories. As a consequence of the demarcation of new municipal boundaries in 1995, whereby former Black, Coloured, Indian and White areas have been amalgamated, the above-mentioned historical patterns have ceased. Moreover, important disparities exist between the municipalities themselves, both in terms of fiscal capacities and levels of service provision.

The main revenue sources of the upper-tier municipalities (i.e. metropolitan councils and district, regional or service councils) are the (payroll, turnover and fuel) levies of the former regional services councils (and joint services boards), cost recovery fees, and, in the case of the metropolitan councils, surcharges on their constituent metropolitan local councils' revenues. The main revenue sources of the remaining (urban) municipalities are property rates; "surpluses" made on trading in electricity, water, solid waste collection and sewerage; and other sources such as licences and fees.

7. Intergovernmental transfers

The local government sphere is constitutionally entitled to an equitable share of revenue collected at the national level. In the past, intergovernmental (grants) transfers were paid to some (former black) local authorities to cover operating expenditures. In addition, in some cases "subsidies" were paid by provincial governments to local governments for performing agency functions; allocations were made to the so-called "R293 towns"; and certain grants were made for financing capital expenditure by various national government departments, most of which have now been consolidated into the Municipal Infrastructure Programme.

8. The importance of own revenues and payments for services received

Despite the relative significance of intergovernmental transfers for some jurisdictions, it is important that all municipalities should generate own revenue and maximise their tax effort.

If a sector of government is required to raise (part of) its revenue, its accountability is increased, because of the resulting obligation to justify to its electorate the taxes it raises in terms of the services the revenue will pay for. This process also enhances efficiency and effectiveness, because taxpayers tend to be critical of expenditure programmes when their own money is involved. Similarly, consumers only use services efficiently by weighing up the costs of the resources they use, if they are required to pay for them.

In principle, therefore, municipalities should raise as much own revenue as possible by, *inter alia,* charging fees for the services they provide and levying the taxes to which they are constitutionally entitled. There is the obligation on service recipients to pay for the services rendered. Long term sustainability of service provision is not possible without high levels of cost recovery from service recipients. However, in reality the tax capacity of a jurisdiction moderates cost recovery, especially where service recipients are simply unable to pay for even basic services.

9. Vertical and horizontal equity

In addition to the general principles contained in the previous paragraph, many sound reasons exist for making intergovernmental transfers to municipalities under certain circumstances. Firstly, while some municipalities are able to meet all their obligations out of their own revenues, many are unable to do so. This is because their revenue sources do not match the services they are required to deliver. In such cases, intergovernmental transfers are necessary to ensure vertical equity between the different spheres of government.

Secondly, in the interests of horizontal equity, persons in different jurisdictions should receive reasonably comparable levels of public services at reasonably comparable levels of tax effort. In order to achieve this under current circumstances, where disparities are severe, intergovernmental transfers are also required.

10. Minimum levels of service provision and spillovers

Equity in the sense used in the previous paragraph means that certain minimum levels of service provision must be attained for all citizens. In this regard, sections 214 and 227 of the Constitution refer to "basic services", which in the case of municipalities are generally regarded to be access to clean water within a reasonable distance of one's dwelling, basic sanitation, and in some cases, limited access to electricity and roads with storm water drainage.

The level at which the minimum provision of each of these services is defined, is influenced by the "spillovers" that arise from each. Spillovers are the indirect benefits or costs that other persons get from the use of the services by their neighbours. For example, the absence of clean water or adequate sanitation, leading to disease, would clearly affect not only those too poor to afford those services, but would also expose other members of the community to the danger of infection. Similarly, in an urban setting, the absence of electricity and the consequent use of open fires or paraffin stoves for cooking and heating by the those individuals and communities without access to electricity would adversely affect that section of the community which has access to electricity by subjecting them to the pollution of the former's smoke and fumes.

In their own interest, the relatively rich communities should ensure that the poorer neighbourhoods receive sufficient services to meet the minimum standards described above. This they should do, if necessary, by subsidising the levels of service consumption in their vicinities. Nevertheless, in some cases the attainment of the minimum levels of service provision will require assistance to the local community in the form of intergovernmental transfers.

The question therefore becomes one of identifying firstly which communities would qualify for transfers, secondly the level at which this assistance should be given, and thirdly how the transfers should be determined.

11. Which communities qualify for transfers?

The principles referred to above (namely that transfers should not undermine accountability and that efficiency requires services to be priced and paid for), suggest that transfers should only be made available to those communities that are unable to afford the minimum levels thought to be necessary. Furthermore, the analysis of spillovers brings one to the conclusion that, as far as possible, communities should be prepared to cross-subsidise the relatively less wealthy communities so as to maximise their own benefits.

Taken together, these results imply that, in general terms, the subsidies made available for municipalities from national revenues should be calculated after taking into account the circumstances of each municipality as a total entity, rather than those of the poor communities within a (possibly rich) municipality. In other words, the tax capacity of each municipality must be one of the major determining factors in the calculation of intergovernmental transfers to municipalities, even if the allocations are made subject to the rationale that they be used for providing minimum levels of basic services to specific poor members of those municipalities.

12. At which administrative level should the assistance be given?

Several options could be considered for the point at which the intergovernmental transfers could be given: namely, the provincial level, the metro or district council level, or the primary municipal level. The Financial and Fiscal Commission recommends that the allocations be directed at the metro or district council level (in the medium term). The reasons for this are as follows.

Municipal transfers should not be directed at the provincial level, unless they are made conditional upon being transferred to those municipalities specifically identified as recipients. The Constitution establishes three spheres of government, namely national, provincial and local, each of which is entitled to its own "equitable share of revenue collected at the national level" and each of which is entitled to a reasonable level of independence. Therefore, even if the municipal allocations were to be channelled through the provinces, this would have to be done in the form of conditional grants and the provincial treasuries would be no more than conduits. Section 226 of the Constitution specifically states that revenue allocated through a province to municipalities in that province is a direct charge against that province's revenue fund. Secondly, the spillovers that are relevant at the local government level accrue to the local communities themselves and should be evaluated in light of the tax capacity of each community in determining whether allocations should be made. This cannot be done at the level of aggregation implied by provincial transfers. Furthermore, the allocation of funds can be done more efficiently at lower levels (such as municipalities rather than provinces), where the specific needs and constraints of local communities can be evaluated more accurately. These arguments imply that the transfers should flow directly to the local government sphere.

The transfers (and grants) should be directed at the metro or district council level rather than at the primary level for a number of reasons. Firstly, although in principle allocations should be devolved to the lowest possible level, they are blunt instruments that cannot currently be targeted at the primary municipal level from the central fiscus with sufficient accuracy. In contrast, metro and district councils have sufficiently intimate knowledge of local conditions within their jurisdictions to be able to reflect local priorities with a justifiable degree of confidence. Secondly, Schedule 2 of the Local Government Transition Act confers redistributive powers on metropolitan councils, whereby the principle of and mechanism for allocations at the second municipal tier have already been established; and thirdly, the current dearth of relevant data at the primary level makes the direct formula-funding of such municipalities difficult at this stage.

13. How should the allocations be determined?

In line with its proposals for the financing of the provinces, the FFC recommends that a funding formula be adopted to determine allocations to the metro and district councils, for both operating and capital expenditure.

The **allocations for operating expenditures** should be distributed to the primary municipalities according to the metro and district councils' knowledge of local conditions, taking into account the constitutional rationale for all citizens to have access to "basic services". Although the FFC proposes that these transfers, based on the revenue-sharing principle, should be unconditional, it would clearly be contrary to the criteria, used to calculate the transfers, and to the spirit of the Constitution, if funds were allocated on the basis of dissimilar equity criteria or used for purposes other than subsidising "basic services". The allocation formula will enable the sum allocated to the local government **sphere** to be calculated, from which the vertical division can be deduced, and subsequently the horizontal division amongst the second-tier municipalities determined .

Three approaches to these issues can be adopted. The first is to base operating transfers (inversely) on the revenue-raising potential, or **tax capacity**, of a municipality; the second is to use the **expenditure needs** of a jurisdiction for this purpose; and the third is to apply a **combination of these two**.

The third option is the one advocated by the FFC. It is argued above that tax capacity should be an integral part of the formula. In addition, expenditure needs should be accommodated by taking into account the current expenditures necessary to meet the minimum standards for those who qualify.

As far as **capital allocations (grants)** are concerned, the FFC recommends that these should be conditional grants **allocated by national government** to local government and municipalities. Such funds would fit into the policy imperatives of national government and be allocated on the basis of a formula to metropolitan councils and district councils. The **existing backlogs** in the provision of basic infrastructure are **the criteria** used to determine these grants.

14. The vertical division

A number of possibilities for determining the vertical division exists, ranging from the quantification of the present transfers to municipalities to a detailed calculation of municipalities' needs. Each of these possibilities has particular political, financial and data implications. On the one hand, overall financial constraints and the requirements of the other spheres of government make it impossible to increase the total amount flowing to the local government sphere rapidly; on the other hand, the political consequences of long delays in delivering services to those who have been promised them, must be considered.

The FFC recommends that, as an initial step, the coefficients of its horizontal division formula be set so that the annual total transfers generated equal the amount(s) of the present transfers. The second step, which is inherently political, is to evaluate the time period, derived from the first step, for eliminating backlogs in the provision of basic services to all citizens. The third step is to consider the implications of increasing the transfers to the local government sphere, thus decreasing the time required to eliminate the backlogs.

In terms of the FFC's proposals for the revenue-sharing (operating) component, the sum of the transfers to the local government sphere will be in the local government vertical division share of nationally collected resources. For the national government's capital grants to municipalities, the sum of these amounts will be in the national government component of the vertical division. This separation allows conditions to be set for the capital grant in terms of section 214(1)(c) of the Constitution.

15. The formula for the horizontal division (nationally and locally)

The FFC's proposals for the funding of municipalities are based on the use of a formula for the horizontal division of the transfer to local government amongst the metropolitan councils and district councils. The use of a formula will ensure both revenue stability and objective allocations. The proposed formula takes into consideration both indicators of need and tax capacity for operating transfers and infrastructure backlogs for capital grants.

The transfers are based on a two-part formula with three components:

(i) a conditional capital grant (which is dealt with horizontally in the national government share);
(ii) an unconditional operating transfer (which is dealt with horizontally as part of the local government share); and
(iii) a tax capacity (equalisation) component, related to (ii).

Both the capital and operating "grants" are designed to address the basic needs of the poorest section of the population. On the one hand, the capital grant is aimed at eliminating backlogs in the provision of basic municipal services; on the other hand, the operating transfer is to enable the poor to purchase the minimum quantities of certain essential services, such as clean water, adequate sanitation, suitable roads and/or electricity.

One of the most commonly-stated rationales for the use of transfers, and of particular relevance to South Africa, is the need to address inter-jurisdictional fiscal disparities. This must be done in a fiscal context where there are simply not enough public resources to allocate funds for these basic services to all indiscriminately. Therefore, the funds generated by the first two transfers are tempered by the criteria discussed at length above: if a jurisdiction has the capacity to raise its own revenue and should therefore itself be capable of addressing the needs of its inhabitants, the money made available to it through the transfer system, is reduced. The FFC recommends that at present only the revenue-sharing transfers be adjusted according to a jurisdiction's tax capacity.

15.1 Capital Grant

(Sections 214(1)(c) & 227(1)(b) transfers)

The capital grant is seen as a **conditional grant from national government to local government**. In terms of the vertical division, this amount would be calculated as part of the national government component so that the condition that these funds must be used for addressing infrastructural backlogs can be set. In line with national government policy objectives of developing local government infrastructure to ensure that all South Africans have access to basic services, national government will be able to apply such grants to address these capital expenditure requirements. The Constitution requires that the actual disbursement of these grants must be based on equity.

In the interim, a very crude measure of "access to basic services backlogs" has been adopted to formulate the capital expenditure component of the formula. Mainly because of the inadequacy of other data, the measure focuses on the provision of two basic services - water and sanitation.[1] Weights are attached to the two services to derive a composite index of backlog/need. The assumption underlying the choice of variables making up the composite index, is based on backlog/need, not on financial implications. In other words, although municipalities are responsible for providing a number of services, some of which could be self-financing, for example water and electricity, it is necessary to identify those services which could be indicative of backlogs/need. For this reason, the lack of water and sanitation, combined into a single index (I), are chosen as being **indicative** of backlog/need. They must not be seen as excluding other basic services.

The total allocation for capital expenditure (G_i) to a municipality is calculated on the basis of the cost to provide infrastructure to the qualifying population (i.e. the number of individuals or households below a defined poverty line)[2] that do not have access to basic services. This is weighted by a combined index "I" in order to determine the allocation to each metropolitan council or district council. The real cost of providing basic infrastructure services needs to be spread out over a period of time, say 10 years, since it would be impossible to provide the total amount in one year.

[1] *Although two services are used to "slice the cake" and are regarded as sensible proxies for a package of basic services, sight is not lost of the importance of other services such as solid waste removal, roads and storm water drainage and electricity.*

[2] *The poverty line is defined in terms of relative poverty i.e. the poorest 40% of households (ranked by adult equivalence) in the country. This definition is taken from an October 1995 RDP report.*

The allocation of grants for capital expenditure, G_i, to the ith MC or DC is as follows:

Capital Grant (G_i) = $\{1 - I_i / \sum(1 - I_i)\} * 1/n(x * H_{qi})$;

Where:

I_i = combined index for i[th] MC or DC
x = real average cost per household of providing infrastructure for basic services
H_{qi} = qualifying number of households in i[th] MC or DC
n = number of years (phasing)

The composite index "I" will be constructed following the methodology used by CSIR in the construction of its Development Indicators Monitoring System (DIMS) index. Observations for each variable will be scaled from 0 (the worst-off) to 1 (the best-off). For example, if the percentage of the population without access to the minimum level of water ranges between 20% and 60%, a place with 20% of the people having no access to water would have an index score of 0 while a place with 40% of the people having no access to water would receive an index score of 0.5. The composite index will then be calculated on the basis of a linear scale transformation of the average of the index scores for all variables. It will range in value from 0 (greatest need) to 1 (least need).

The composite index can be broken up as follows:

- Level: MC or DC

- Values: Absolute (based on absolute numbers of housing units in need)
  Relative (based on relative proportion of housing units in need)

- Categories: Water
  Sanitation

- Indicators: Water: (number of housing units without access to on-site water)
  Sanitation: (number of housing units without access to adequate sanitation)

The definition of basic services and values will be developed in greater detail as more adequate data become available so that more comprehensive indices can be constructed.

The real average cost per household of providing basic infrastructure services, "x", will be calculated on the basis of how much it would cost to install bulk and connector infrastructure for basic services in the different jurisdictions under consideration. At present, the only information available is from the EMIP which uses the Combined Services Model from the DBSA to calculate infrastructure costs for urban and rural areas.

Once each MC and DC has received its capital allocation, it will be responsible for redistributing the funds to municipalities within its boundaries or for metro-/district-wide capital expenditure purposes. The distribution procedure followed would be application-driven, with individual municipalities submitting applications for projects. Stringent criteria need to be applied to ensure that the funds are equitably distributed by the MCs and DCs. An effective monitoring system also needs to be put in place to ensure that conditional funding is appropriately applied by the spending agencies.

15.2 Operating Transfers (Revenue Sharing)

(Sections 214(1)(a)& 227(1)(a) transfers)

The allocation for current expenditure is intended for subsidising access to basic services for those who cannot afford to pay for these services. At this stage, the two basic services under consideration are water and sanitation.[3] The operating grant is based on the cost to the qualifying consumer (i.e. a household below the poverty line) of the minimum amount of water needed for annual consumption and the operating cost of providing the basic level of sanitation.

[3] *Similar to the capital grant, only two services are used as indicative of needs. This does not imply that transfers are applied to these two services but for any service which is included in the definition of "basic services".*

(*The minimum levels of water and sanitation need to be defined. The cost to the qualifying consumer would be based on the average price per unit of household water consumption across jurisdictions. A similar process will be used to estimate the cost of sanitation.*)

$$RS_i = (a*p_w + b*c_s)*H_{qi};$$

Where:

a = minimum household annual water consumption;
p_w = unit price of water;
b = minimum level of sanitation;
c_s = unit cost of sanitation
H_{qi} = qualifying population in i^{th} MC or DC

Here again, once each MC and DC has received its operating transfers allocation, it will be responsible for distributing the funds to the primary municipalities.

15.3 Tax Capacity Equalisation Component

As mentioned earlier, fiscal equalisation encompasses both equalisation of expenditure need and of tax capacity. The first aspect is dealt with in the allocation for operating and capital expenditure. The latter deals with the revenue-raising capacity of the jurisdictions under consideration and uses measures such as personal income, property taxes and other standard municipal taxes.

Of critical importance is that the tax capacity measure (even if it is a proxy measure) has to be part of the operating transfer formula. A core principle in any system of intergovernmental fiscal relations is developing incentives for all governments to maximise the use of their own resources. The corollary to this is that governments should not be "subsidised" in such a manner that their tax effort is less than their tax capacity. If this component of the formula were not to be implemented, then the latter condition could prevail, which would be ineffective, unfair and unconstitutional.

In the case of South Africa, tax capacity at the MC and DC level could be reflected in a representative tax system through a combined index which takes account of personal income, property taxes and RSC levies (and possibly other tax/revenue sources as data systems develop). At present, there are severe data restrictions with regard to both personal income and property taxes. While data for personal income are available at the national level, it is extremely difficult to disaggregate the data to the MC or DC levels currently. With regard to property valuations, the data is both dated and incomplete in its geographical coverage and property valuation methods are not uniform across jurisdictions. If no national norms are imposed for property taxation it would be well-nigh impossible for this source to be used as a tax capacity measure, on its own or in combination with other sources.

As stated above, the tax capacity measure is directly related to the operating or current transfer component. With reference to the operating expenditure formula, "RS_i" what is measured is the relative cost to an MC or DC of providing a minimum level of service to that target population needing financial assistance due to poverty. What the tax capacity component does is to measure the relative ability of the MC or DC to "subsidise" its own "poor". If the "wealth profile" of the MC or DC is of such a nature that relative wealth fully compensates for the relative need then it will receive no operating transfer. In other words, if the aggregate wealth is equal to or more than the aggregate need of the jurisdiction, then that jurisdiction is considered able to provide for its own needs.

Clearly, as the profile's balance changes to reflect a relatively poorer jurisdiction, then the operating transfer becomes positive. The tax capacity component must be constructed in such a manner that it would not result in a negative amount large enough for the MC or DC to forfeit its own revenues in contravention of section 227(2) of the Constitution. Thus, while T_{Li} may be ≤ 0, $(RS_i + T_{Li}) \geq 0$.

The tax capacity of each MC or DC (X^i_{t-1-}) would be calculated using property taxes and RSC service and establishment levies. The tax capacity for each component will be calculated by applying a normative national average tax rate to each tax base to give the *per capita* yield for each tax. These will be converted into *per capita* tax capacity figures and then aggregated to get each MC or DC's actual tax capacity, X^i_{t-1}. The national average tax capacity, X^*_{t-1}, will then be calculated from the aggregates.

The entire tax capacity formula would be:

$T_{Li} = \alpha (X^*_{t-1} - X^i_{t-1}) P_i$

which can be written:

$T_{Li} = [(X^*_{t-1} / X^i_{t-1}) - 1] (\alpha^*. X^i_{t-1})P_i$

subject to the additional constraint that $\Sigma T_{Li} = 0$ and $(RS_i + T_{Li}) \geq 0$

Where:

T_{Li} = the tax capacity transfer to the ith MC or DC
α^* = the proportion of the tax capacity to be equalised
X^*_{t-1} = the norm/national average tax capacity *per capita* in year t-1
Xi_{t-1} = the ith MC or DC's actual tax capacity *per capita* in year t-1
P_i = the population of the ith MC or DC

Of course, in the short run, it will not be possible to calculate the tax base for property taxes due to the data limitations described earlier. Personal income may have to be used as a proxy. In the absence of reliable personal income figures at the MC or DC level, it may be necessary to use only the RSC levies to estimate the tax base for each MC and DC.

In order to fulfil the condition that $RS_i + T_{Li} \geq 0$, it may be necessary to have equalisation only to a certain proportion, α^* , of each MC or DC's *per capita* tax capacity. This means that the *per capita* tax capacity of each richer MC or DC will be reduced to the proportion α^* of the national average while that of each poorer MC or DC will be raised to α^* of the national average, where $0 < \alpha^* \leq 1$.

The allocation of revenue sharing transfers for current expenditure (**RS_i**) adjusted for tax capacity to the ith MC or DC is as follows:

$\mathbf{RST_i = RS_i + T_{Li}}$

Where:

RS_i = Allocation for Current Expenditure; and
T_{Li} = Tax Capacity Equalisation Component

15.4 The Combined Formula

The combined formula would be:

$\mathbf{IGT_i = G_i + RS_i + T_{Li}}$

Where:

IGT = Intergovernmental Transfer;
RS + T = RST = Revenue Sharing Transfer;
G = Capital Grants; and
T = Tax Capacity Component.

16. The conditions applicable to the transfers

The intergovernmental transfers to municipalities should be subject to a number of conditions and guidelines. The capital (conditional) grant may only be used for financing the construction of infrastructure necessary for delivering

basic services. The allocation of capital should be on the basis of scientific appraisals of infrastructural projects to address backlogs in basic service provision.

Metro and district councils will be expected to adhere to the general guidelines that the operating transfers are to subsidise "basic services" within the set of services defined as "basic". The needs and priorities of each jurisdiction will determine which service or services will be subsidised. More specific guidelines than this cannot be prescribed as this would undermine the unconditional nature of the operating transfers. If services cannot be provided, because of the absence of infrastructure, the operating allocations could also be used temporarily to add to the capital grants.

17. Data requirements

The data required for the application of the FFC's proposals are not currently available. However, they will become so once the national census returns have been processed and the forthcoming municipal census conducted. This means that the vertical division, which is required by mid-1997, will have to be made on an incremental basis as a transitional measure; the horizontal division, which is required before the commencement of the new municipal financial year which begins in July 1998, may have to be done on the basis of the October Household Survey data if the processing of the municipal census has not been completed in time.

18. The FFC's Recommendations *vis-a-vis* the development of a White Paper on Local Government

The on-going development of national policy on local government issues implies that the current state of local government may be temporary. Thus, there could be changes to structures and related matters. The FFC recognises the fluidity in these matters and has attempted to develop an approach which would be able to accommodate most of the envisaged changes. In fact, some desirable changes such as rationalising structures would ease some of the problems the FFC faces at present.

The Financial and Fiscal Commission's Constitutional Mandate *vis-à-vis* Local Government

1.1 **Introduction**

Government in South Africa is made up of three distinctive yet interdependent and interrelated spheres of government, one of which is local government.

On the revenue side, local government is entitled to an equitable share of revenues raised at a national level. Also, municipalities may receive grants from the revenues allocated to national government.

Both the revenue shares and grants flowing to local government are intended to supplement municipal own revenues for the provision of basic services and fulfilling functions assigned to the local government sphere.[4]

The equitable allocation of nationally collected revenues to local government (and any other additional allocations to local government or municipalities from national government) must be provided for in an Act of Parliament. This Act may only be enacted after "…organised local government and the Financial and Fiscal Commission have been consulted, and any recommendations of the Commission have been considered."[5]

The legislation governing these fiscal flows is required to take into account a number of factors:

(a) "the national interest;
(b) any provision that must be made in respect of the national debt and other national obligations;
(c) the needs and interests of the national government, determined by objective criteria;
(d) the need to ensure that the provinces and municipalities are able to provide basic services and perform the functions allocated to them;
(e) the fiscal capacity and efficiency of the provinces and municipalities;
(f) developmental and other needs of provinces, local government and municipalities;
(g) economic disparities within and among the provinces;
(h) obligations of the provinces and municipalities in terms of national legislation;
(i) the desirability of stable and predictable allocations of revenue shares; and
(j) the need for flexibility in responding to emergencies or other temporary needs, and other factors based on similar objective criteria."[6]

The functions and responsibilities of local government are set out in Schedules 4 and 5 of the Constitution, and also in other national and provincial legislation.[7]

It is important that the funding of local government from nationally collected resources is dealt with in the overall context of a system of intergovernmental fiscal relations. Thus this aspect of the FFC's recommendations is not a distinctly separate matter but an integral part of the comprehensive recommendations on resource allocations, own resources, borrowing and functions and responsibilities of all spheres of governments.

1.2 **The role of the Financial and Fiscal Commission in recommending allocations to local government and municipalities**[8]

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[4] *Sections 40 and 227 of the Constitution of the Republic of South Africa, Act No. 108 of 1996. While some the financial provisions of the Constitution may come into Effect as late as 1 January 1998, these recommendations apply to the 1998/99 financial year which commences for local government in July 1998 and other spheres of government in April 1998.*
[5] *Sections 214 (1) and (2) of the Constitution.*
[6] *Section 214 (2)(a) to (j) of the Constitution.*
[7] *The Local Government Transition Act, 1993 (Act 209 of 1993), and the subsequent regulations and amendments are national legislation.*

Firstly, the FFC is required to recommend to Parliament what the local government share of national resources should be, and also which grants national government should provide to the local government sphere. This it needs to do in conjunction with its recommendations concerning the other two spheres' shares of revenues and national government grants to provinces. The determination of these relative amounts relate to the vertical division and vertical balance aspects of intergovernmental fiscal relations.

In making such recommendations the FFC is required to take into account the ten criteria listed above, points (a) to (j) in Section 1.

These criteria can be summarised as follows: The relative functions, needs, capacities and efficiencies of each sphere have to be estimated to ensure that these are matched with nationally collected resources in line with national imperatives.

Secondly, the references to "municipalities" in the criteria referred to above imply that the FFC is required to recommend to Parliament what the allocations to municipalities should be, from the general allocation to local government calculated in the first step. This is the horizontal division aspect, in which, the FFC believes, equity can best be achieved through the use of a formula. In addition, as far as grants from national government to municipalities are concerned, the FFC is required to recommend which conditions should apply.

1.3 **The Constitutional Context of FFC's recommendations**

There are several role-players (including local government and municipalities) who must be considered in the design of the system of intergovernmental fiscal relations.

In national government there are two departments responsible for local government matters, Finance and Constitutional Development (DoF and DCD). Although DoF is the executive arm of government ultimately responsible for preparing financial legislation, the technical and procedural recommendations of the FFC should be taken into account as draft legislation is prepared. If it chooses not to implement any (or some) of the FFC's recommendations, the executive should be required to explain such a decision to Parliament (legislatures) and implicitly civil society.

Both provinces and local government also have roles to play in the decision-making about resources they receive from national collections. This they do via both executive and legislative forums, such as the National Council of Provinces, ministerial forums (MINMECs), technical committees, organised local government, and both local government and provincial government "representation" on the FFC.

In essence, there are two parallel processes. The one involves the executive departments (DoF and DCD) which undertake technical work and prepare legislation. The other is the work of the FFC which culminates in submissions to Parliament. Although these are parallel processes dealing with the same issues and may suggest unnecessary duplication, they are part of the system of "checks and balances" for which the FFC was created, as a sound feature of decentralised democratic government.

However, these two simultaneous processes should not occur in total isolation of each other. There has to be some mutual understanding of the ideas and approaches which the different institutions follow and also about base data and information. It would be highly inefficient for the system as a whole if there was no mutual attempt by the executive and the FFC at least to recognise each others' work, prior to the submissions to Parliament.

Independent of all of the above-mentioned processes, the FFC has the constitutional obligation to submit its recommendations to Parliament. Such recommendations should include not only "bottom line" figures but also issues of process.

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[8] *Reference to local government is to the sphere, and to municipality is to the individual jurisdictions within local government.*

Any technical and procedural involvement between the FFC and the executive could lead to the FFC being "co-opted" by one of the executive branches, resulting in its roles of being a check and balance and an independent legislative advisor being undermined. Therefore, the trade-off between efficiency in the system and possible co-option requires that efficiency be promoted while possible co-option be managed properly.

Without effective liaison between the FFC and the executive during the design and development of the intergovernmental fiscal relations system (and the design of the formulae that go into the system) the legislatures could receive two potentially very different inputs, making it difficult to assess their relative merits. As budgets are tied to discrete time-frames which cannot easily be changed, it would be untenable for major changes to be made to budget legislation at the eleventh hour, which could be the case if the responsible parties were to work in total isolation of each other.

The FFC's recommendations must be introduced as early as possible into the legislative process to enable Parliament to assess them effectively together with any other submissions. If all submissions are not co-ordinated properly, the FFC's inputs would become irrelevant, with regard to influencing the forthcoming fiscal year.

1.4 **Problems faced by the FFC in fulfilling its mandate**

The FFC is a technical advisory institution and thus its core work, research and recommendations are dependent on appropriate and credible information and data. As the FFC is not a primary data collection agency it is dependent on having access to official information and data. Where such information and data are not accessible for whatever reason, the Commission is unable to fulfil its constitutional mandate.

While it is accepted that during the short run there will have to be solutions to the data problem, it is important that plans are put in place for ensuring the FFC has access to all the information and data it requires. Section 6 in Part IV deals extensively with this matter.

Section 2

The Current State of Local Government

2.1 **Introduction**

Local government is currently in the so-called Interim Phase, which will end after the next general or nation-wide local government elections in 1999. The representative structures of local government are considered to be "transitional" until the end of the Interim Phase.

The transition is characterised by a range of simultaneous changes to the political and socio-economic bases of local government: the related structures, powers, functions, responsibilities, revenue bases and other aspects are in the process of being reconsidered.

2.2 **Structures**

Nevertheless, the current structure of local government is illustrated in terms of a set of categorisations and attributes:

- Every geographic part of South Africa is (newly) under the authority of a municipality.
- Broadly there are two "categories" of municipality:
    - Urban; and
    - Rural.
- Urban local government/municipalities comprise(s):
    - Metropolitan Councils (MC) ;
    - Metropolitan Local Councils (MLC); and
    - Local Councils (LC).
- Rural local government/municipalities comprise(s) :
    - District Councils (DC);
    - Rural Councils (RC);
    - Representative Councils (REPC);
    - Local Councils; and
    - Local Area Councils (LAC).

- The municipalities still use the former local government "grading" scheme, which graded municipalities from 1 to 15, to determine organisational structure and staff remuneration levels.

2.3 **Functions, Powers and Responsibilities**

- The different jurisdictions do not all have the same functional responsibilities. The divisions are as follows:
    - MCs and DCs have similar functions but also particular differences. The analogy that DCs are the rural version of MCs is limited;
    - MLCs and some LCs have similar functions, but again there are differences. There are some LCs which are so small that they are in essence rural jurisdictions that are hardly comparable with MLCs;
    - RCs, REPCs and LACs are comparable in some cases but there are as many differences as there are similarities.

- On the revenue side, the revenue sources of the different jurisdictions are again not uniform; for example:

    - RSC/JSB levies: MCs and DCs;
    - Property rates: MLCs and LCs (so-called primary municipalities);
    - Trading surpluses: generally MLCs and LCs;
    - MLC contributions (to): MCs; and
    - Licenses and fees: MLCs and LCs.

The prevailing revenue sources are traditional ones for local government and are consistent with the former tax regime for local government. The universally traditional local government revenue source, property rates, together with the surpluses on trading accounts, continue to be the most important items of local government revenue.

What is changing for these revenue sources is their coverage (property rates are being extended into areas formerly excluded) and possibly their structure (new costing policies in the electricity industry will require trading surpluses to be replaced with excise taxes). Both of these dynamics have serious implications for the ways in which municipalities have financed their expenditures in the past. If, for example, municipalities were no longer responsible for electricity distribution and thus not able to charge fees that generate surpluses, local government would forfeit about 30% of its revenues in aggregate.[9] It is clear that the loss of these revenues would have to be made good in some other way.

Issues which require attention are: (i) the basis of property valuations (tax base), (ii) the regularity of valuations, (iii) manipulation of property rates "simply to balance the books" rather than setting rates in terms of standard tax principles (iv) valuations in "informal" townships, (v) property (land) taxes in rural areas (and on communal land), and (vi) replacing electricity surpluses with an explicit tax.

Currently, municipal relationships with each other and with both national and provincial governments are all in transition too. Most municipalities are characterised by a mixture of old relationships with new, in addition to different interpretations of what the new relationships should be.

For example, in the metropolitan areas some MCs are developing (by design) into distinctive "strong" municipalities, while others subscribe to the "weak" MC model. The strong versus the weak model refers to the extent of functions and powers which the MC takes up in relation to the MLCs. The distribution of functions and powers between MCs and the MLCs influences the relationships which develop, especially with regard to financial flows and intra-municipal redistribution.

While the FFC is concerned with the allocation of nationally-collected resources, such allocations have to take into account the respective functions and responsibilities of each jurisdiction, thus influencing the nature of financial relationships. Because the transition is characterised by function shifts and the assignment of new functions, the nature of the inter-jurisdictional relationships is in flux. Similarly, the relationships between local, provincial and national government are in an embryonic stage with function shifts, affecting financial flows, taking place between spheres.

2.4 **Intergovernmental "Transfers"**

For these reasons the current state of "grants" and "subsidies" to local government from both national government and provincial government is not clear, but could be described as follows.

- **"Intergovernmental grants" (IGGs) for operating expenditures ("bridging finance"):**
    - For the 1997/98 fiscal year the national government's transfer to local government, based on the apartheid-era bridging finance to former black local authorities (and passed through provincial government budgets), is to remain fixed at the 1996/97 value of R800 million. This is regarded as a "holding" position (temporary approach) while the broader matter of intergovernmental grants to local government is dealt with for the 1998/99 fiscal year. Refer to Table 2-1 which illustrates this form of funding from 1987/88 to 1997/98.
    - While the total "IGG" amount to local government is set at the same level for 1997/98 as it was for the previous year, the allocations to individual provinces and municipalities may differ. This is due

[9] *The figure of 30% is an estimate based on estimated total revenues for all municipalities. Data available from the Department of Finance do not include the MCs of Durban and Cape Town, nor capital funding or the DCs.*

to the use of different methods (formulae) for calculating the individual transfers. Table 2-2 illustrates the allocations to individual provinces from 1994/95 to 1997/98. Data earlier than this are based on the former subnational/regional jurisdictions and thus not relevant to the current system. What is reflected in the table are the "conditional" transfers to provinces for allocation to municipalities.
- It is evident that only a handful of individual municipalities actually receive this type of allocation. The reason for this, as referred to above, is that these amounts were designed as bridging finance for some former black local authorities in the former RSA area of jurisdiction. The allocations to individual municipalities have also changed significantly over the past number of years due to different criteria being applied by provinces and the fact that while some provinces have received considerably more or less than in previous years.

- **"Subsidies" from provincial government for performing agency functions:**
  - Some municipalities have received or are receiving what are referred to as subsidies for a number of functions, such as provincial health services, ambulance and fire fighting services and libraries.
  - Although the aggregated amounts for all municipalities have not been calculated (or defined) accurately, it would seem that the amount was of the order of R1.5 billion in 1996/97.[10]

- **Financial support for "R293 Towns" by certain provincial governments:**
  - Formerly, regional governments provided services directly to and/or financed so-called R293 Towns. These were towns which did not function as conventional municipalities, having little or no tax base or administrative capacity of their own.
  - These amounts are currently in the budgets of provincial governments but are not readily identifiable as such.
  - The FFC has not been able to quantify these amounts to date, but a report by Ernst & Young has illustrative figures for three of the five provinces which have R293 Towns, a total of R209 million for 1996/97.

- **"Grants" and "subsidies" for capital expenditures:**
  - There has been a gamut of fiscal flows to municipalities for a variety of capital expenditures. These include funds for housing and external and internal bulk infrastructure (water, roads, drainage, etc.).
  - A feature of this funding is that it has often been uncoordinated at each level. In the past few years such funding has flowed from national government to provincial governments, the size being determined by means of a formula, and thence to municipalities on an application basis.
  - There has been considerable work done during the past year or so to consolidate this funding under the umbrella of the Municipal Infrastructure Programme (MIP).
  - In this connection the intention has been that the capital allocations to provinces would be determined on a formula basis. Municipalities are in turn required to apply individually to their provincial government (department responsible for local government) for funding for specific capital projects. A disadvantage to this approach is that often there is an inverse relationship between the capacity of a municipality to prepare an application and its need for funding, which places poorer jurisdictions at a disadvantage.
  - The total amount of capital transfers to local government is not known currently. For the 1997/98 fiscal year an amount of R500 million has been earmarked for the MIP, with a formula designed by the DCD being used to disburse the funds to provinces.[11]

Table 2-1: *"Bridging Finance" to LG: 1987/88 - 1997/98*

YEAR	AMOUNT (R'000) [Nominal]	AMOUNT (R'000) [Real-1990 base]	Existing IGGs: As % Nat. Budget	IGGs: If 3% Nat. Budget were allocated (R'000)

[10] *FFC estimate.*
[11] *The FFC has submitted comments to the DCD on their formula.*

[1]	[2]	[3]	[4]	[5]
1987/88	373,800	542,010	0.742%	1,510,785
1988/89	460,300	569,851	0.755%	1,829,949
1989/90	518,800	584,169	0.679%	2,291,892
1990/91	644,000	644,000	0.791%	2,441,409
1991/92	903,700	855,804	0.965%	2,808,456
1992/93	791,800	543,967	0.687%	3,458,349
1993/94	955,800	534,292	0.697%	4,112,625
1994/95	709,900	305,257	0.517%	4,120,911
1995/96	802,300	236,679	0.510%	4,720,803
1996/97	800,000	144,000	0.461%	5,209,782
1997/98	800,000	131,760	0.429%	5,593,404

Notes:
[5] Column [5] illustrates what the aggregate size of IGGs would be if 3% of the national budget were earmarked for such a purpose. (Three percent is not used in a normative sense.)

Table 2-2: *"Bridging Finance" (Current IGGs) Allocated to Provinces for LG: 1994/95 - 1997/98*

Province	Annual Amounts (R'000)			
	1994/95	1995/96	1996/97	1997/98
[1]	[2]	[3]	[4]	[5]
Western Cape *	67,502	132,061	82,692	82,692
Eastern Cape *	65,164	91,9874	128,778	128,778
Northern Cape	13,263	27,301	25,132	21,824
KwaZulu-Natal *	56,509	86,695	151,000	151,000
Free Sate	82,136	73,922	62,895	65,530
North West	33,429	37,167	68,000	68,000
Gauteng	333,421	298,020	156,343	156,343
Mpumalanga *	50,281	45,318	59,095	60,695
Northern Province	8,204	9,881	74,222	74,000
Total	709,909	802,352	808,157	808,862

Notes:
"Bridging finance": Refer to the above definition of this item.
[2] "State of local government finance", Department of Finance, 1995, p. 22.
[3] The budgeted amount was just over R700 million, as presented in the document, "Intergovernmental transfers to local governments, 1995/96", Department of Finance, 1995. Due to higher actual expenditure an additional R100 million was added to some provincial budgets.
[4] "Report: Financial assistance to local authorities (1997/98 and 1996/97), Ernst & Young, 1997.
[5] "Report: Financial assistance to local authorities (1997/98 and 1996/97), Ernst & Young, 1997, adjusted by FFC.
[5] & [*] Data accessed from the Ernst & Young Report and the Department of Finance's Budget Review for 1997/98 (Tables 1 to 6 and Table 6.5 respectively) appear to have inconsistent data for time series comparisons. To enable meaningful comparisons to be made the FFC has adjusted all the 1997/98 provincial allocations for local government. This has been done in the context of the general Budget Council position that the overall amount for local governments within the aggregate provincial allocations should remain the same for 1997/98 as it was in 1996/97, namely about R800 million.

Table 2-3: *"Intergovernmental grants" to local government: 1987/88 TO 1997/98 [Bridging Finance & Illustrative values*]

YEAR	Amount (R'm) [Nominal]	AMOUNT (R'm) [Real]	% Change Nominal	IGG % Nat. Budget	IGG per Capita (R)(i)	IGG for New Target Population [R'm] (i)	IGG for New Target Population [R'm] (ii)	IGG for New Target Population [25%] [R'm]	New IGGs as % Nat. Budget [15]	IGGs: 3% of Nat. Budget
[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]	[11]
1987/88	373.80	542.01		0.742%	62.54	2,214	2,128	1,929	3.83%	1,511
1988/89	460.30	569.85	23.14%	0.755%	74.98	2,723	2,611	2,376	3.89%	1,830
1989/90	518.80	584.17	12.71%	0.679%	82.28	3,065	2,932	2,678	3.51%	2,292
1990/91	644.00	644.00	24.13%	0.791%	99.44	3,799	3,627	3,324	4.08%	2,441
1991/92	903.70	855.80	40.33%	0.965%	135.96	5,327	5,075	4,667	4.99%	2,808
1992/93	791.80	543.97	-12.38%	0.687%	116.06	4,664	4,434	4,092	3.55%	3,458
1993/94	955.80	534.29	20.71%	0.697%	136.50	5,626	5,337	4,943	3.61%	4,113
1994/95	709.90	305.26	-25.73%	0.517%	98.78	4,176	3,952	3,673	2.67%	4,121
1995/96	802.30	236.68	13.02%	0.510%	108.77	4,716	4,454	4,154	2.64%	4,721
1996/97	808.00	145.44	0.71%	0.465%	105.67	4,677	4,429	4,241	2.44%	5,210
1997/98	808.00	133.08	0.00%	0.433%	102.95	4,557	4,416	4,025	2.16%	5,593

Notes:
[2] Actual & budgeted amounts for "IGGs". (Sources are not consistent for these figures.)
[3] Column [2] figures in real terms with 1990/91 as the base year.
[4] Nominal changes for the figures in column [2].
[7] The relative size of "IGGs" compared to the national budget (nominal figures).
[9i] The *per capita* figures relate to that portion of the black population which fell below the poverty threshold of R5000 household income *per annum*.
[7] & [8] The "new target" populations include all households. Columns i and ii use slightly different thresholds.
[9] Here the original target population is increased by 25%, which is an illustrative estimate of the "additional poor" incorporated into the new municipalities.
[10] This column illustrates the relative size of "IGGs" to national budget, based on column [9].
[11] If 3% of the national budget were allocated for "IGGs" then the amounts in column [11] would be relevant. The use of 3% is illustrative.

Section 3

Theoretical Framework for Intergovernmental Fiscal Allocations/ Transfers[12] to Municipalities.

3.1 Introduction

The efficient and equitable provision of public services in a country depends crucially on the assignment of taxing, spending, and regulatory functions among different levels of government and on the structure of intergovernmental fiscal relations.

In general, the FFC has argued that each sphere of government should raise (a portion of) its own revenue and determine its own level of expenditure (in terms of functions assigned to it) so as to enhance its accountability and efficiency. (Refer the FFC's *Framework Document for Intergovernmental Fiscal Relations*, 1995) In many countries, however, subnational spheres of government find that it is impossible to raise enough revenue to finance the functions assigned to them. Systems of intergovernmental transfers are therefore necessary to overcome these and related problems.

Intergovernmental transfers are the main source of revenue for subnational governments in many developing countries. For example, central transfers finance about 75% of subnational expenditures in South Africa, 67% to 95% of state-local expenditures in Nigeria and 70% to 90% of expenditures in less prosperous states in Mexico (Shah, 1994). In fiscal year 1996/97, about 76% of all government revenues in South Africa were raised at the national level, 2% by provincial government and 24% by local government. During the same period, the share of expenditures was, respectively, 43%, 36% and 21%.[13] As a consequence of the fiscal gap resulting from the disjunction between tax assignment and expenditure responsibilities there is the need for a system of transfers from nationally collected resources to each of the spheres of government.

3.2 The design of intergovernmental transfers

In designing a system of intergovernmental transfers, one needs to keep in mind both the allocation of the divisible pool between the different spheres of government and the way in which allocations are made among the subnational governments in each of the spheres. The former has to do with the vertical fiscal balance between national and subnational governments while the latter deals with the horizontal fiscal balance among subnational governments.

Three basic approaches to determining the vertical division between the tiers of government can be identified: (i) allocating a specified share of national tax revenues to lower-tier governments; (ii) an *ad hoc* approach to the amounts to be transferred; or (iii) reimbursing budgeted expenditure amounts. The first of these, based upon the functions each sphere of government is required to fulfil, is the preferred option.

The division of the pool for a particular sphere, derived from the vertical division and referred to as the horizontal division, among recipient governments can then be made on either a systematic or on an *ad hoc* basis. Two types of systematic methods can be identified: (i) derivation, whereby funds get allocated on the basis of where the taxes were collected; and (ii) a formula approach, which requires decisions to be made about the variables that are to be used to determine transfer amounts.

[12] To reiterate a point made in Section 1 above: Although there is general reference to "grants" from national government to local government in these recommendations and elsewhere, this is not the terminology used in the Constitution and could obscure the underlying constitutional principles. The Constitution envisages revenue sharing of the nationally collected revenues amongst the three spheres of government. Thus, these revenues are not national government (or partly provincial government) revenues to be allocated to local government. Local government has the inalienable right to an "equitable share" of these nationally collected revenues. For the sake of consistency the terminology "intergovernmental fiscal transfers" or just "transfers" is used where reference is made to revenue sharing.

[13] Data from the Department of Finance's Budget Review, 1997/98.

A derivation principle of revenue-sharing requires that some percentage of a tax collected from a subnational jurisdiction be returned to it, possibly with the higher level of government deducting a fee for collection. Under this system, the subnational government has no say in determining the tax rate or base. The reasons for a shared tax include: (i) the perception on the part of national government that subnational governments do not have the administrative capacity or political will to mobilise sufficient resources from local tax bases; and (ii) the desire by national government to retain fiscal control, while simultaneously trying to achieve a better vertical fiscal balance.

A formula-based allocation is primarily motivated by the desire to equalise tax capacity and/or to reduce disparities in service provision across jurisdictions. Typical factors used in developing a formula include: (i) indicators of tax capacity such as personal income, the tax base of a single tax or a combination of taxes or the theoretical concept of "utility"; (ii) indicators of need such as population, land area, population density and the extent of roads; and (iii) indicators of tax effort, such as the ratio of tax collections to tax capacity.

The third category is designed to stimulate local resource mobilisation, the aim of which is to incorporate an incentive for the recipient jurisdiction to increase or at least maintain tax effort. In this case, the degree of control that the national government exercises over the recipient government depends on whether the grants are conditional or unconditional, matched or unmatched.

In line with its proposals for the provincial sphere of government, the FFC recommends that formulae be used as basis for the division of local government's share of the revenue collected at the national level amongst municipalities. Once agreement on the nature of a formula is achieved, this approach ensure stability in intergovernmental fiscal relations and avoids *ad hoc* decisions.

The aspects mentioned briefly in the preceding paragraphs are developed more fully in the following subsections.

3.3 **Rationale for intergovernmental fiscal transfers**

The Constitution provides for two forms of intergovernmental fiscal allocations. The first, found in section 214(1)(a), is revenue sharing, which is in the form of unconditional "block grants", and the second, found in section 214 (1)(c), is "other allocations" or grants (which may be *ad hoc*, systematic, conditional, unconditional, matching or unmatched or any combination). The FFC's interpretation of these provisions is found in Section 1 and in footnote 9.

The recommendations contained in this chapter of the report deal with both revenue sharing and grants (as defined above). The former are specifically intended for operating (or current) expenditure and the latter are for capital projects.

Intergovernmental transfers of this nature are usually justified on the following grounds: firstly, to overcome fiscal disparities amongst the different tiers of government, in order to achieve vertical fiscal balance; secondly, to attain horizontal equity amongst different jurisdictions on the same level through ensuring certain minimum levels of service provision; and thirdly, to correct for spillovers. Of course, there are often overlaps between these objectives.

In addition, in South Africa there are massive backlogs in municipal infrastructure which need to be addressed. Without some form of revenue redistribution from the national level it would be difficult to ensure that redress and equity are achieved.

The proper design and administration of a system of intergovernmental transfers is crucial to achieving any of the above-mentioned objectives.

3.4 **Vertical fiscal balance**

The first general justification for intergovernmental transfers to local government is the need to address the vertical fiscal imbalance amongst the national, provincial and local government spheres.

Table 3-1: *Revenues, Expenditures & Fiscal Gaps per Sphere: 1996/97*

Sphere	Rev (Rb)	Exp (Rb)	Diffs: Rev-Exp	Own Rev % Own Expe	Own Rev % Total Rev	Own Exp % Total Exp	Fiscal Gap (Rev - Exp)/Rev	Fiscal Gap (Exp-Rev)/Exp	% GDP [Rev]	% GDP [Ex]	% GDP [Deficit]
[1]	[2]	[3]	[4]	[6]	[7]	[8]	[9]	[10]	[11]	[12]	[13]
Local	43.0	48.0	-5	90%	22%	21%	-12%	10%	6.9%	7.7%	-0.8%
Provincial	3.2	80.8	-78	4%	2%	36%	-2425%	96%	0.5%	12.9%	-12.4%
National	147.0	96.7	50	152%	76%	43%	34%	-52%	23.5%	15.4%	8.0%
Total	193.2	225.5	-32	86%	100%	100%	-17%	14%	30.8%	36.0%	-5.2%
GDP	626.67										

From Table 3-1, it is clear that the position of local government differs markedly from that of the provinces. Whereas the provinces as a whole in 1996/97 were only able to finance about 4% of their expenditures out of own revenues, municipalities were, on average, able to finance approximately 90%[14]. From these figures, one can draw two conclusions. Firstly, the vertical imbalance between the different spheres of government in South Africa is considerably greater between the national government and the provinces than between the national and local government spheres. Secondly, in the case of the local government sphere, the vertical gap cannot be filled by the provinces (in the form of grants), because they do not have sufficient own revenue. The problem will have to be addressed via nationally-collected revenues, in the form of revenue sharing and grants from national government.

The figures in the table disguise significant disparities amongst the municipalities themselves. Although some of the established municipalities would be able to fund reasonable levels of basic services to their communities without any transfers, others currently scarcely have sufficient revenue to retain their core staff or in some of the newly created municipalities (specifically in rural areas) even to employ staff at all. It is, therefore, obvious that the design of a system of intergovernmental transfers must take due cognisance of the tax capacity of each and every jurisdiction, an aspect that is addressed in greater detail below.

3.5 **Horizontal equity**

Horizontal equity may refer to interpersonal equity and/or inter-jurisdictional equity. In the former context horizontal equity is usually considered to exist where persons in different jurisdictions receive reasonably comparable levels of public services at reasonably comparable levels of tax effort. The importance of this criterion is apparent in the provincial sphere because of the dominance of education, health-care and welfare. In the local government sphere, there is equally a need to provide equitable levels of service for the provision of water, sanitation, roads, storm water drainage, solid waste removal and electricity, irrespective of neighbourhood. Where this cannot be done from the resources of the local community, intergovernmental transfers are necessary. In the latter context equity focuses on the jurisdiction, be it provincial or municipal, and the ability of each jurisdiction to provide similar services at similar levels of tax.

In practice, there is considerable overlap between the various reasons listed above for intergovernmental transfers to municipalities. The overlap between the need for horizontal equity and minimum standards of

[14] *The fiscal imbalance (fiscal gap) for local government illustrated here hides certain historical anomalies. The budget data on which these relationships between revenue and expenditure are made largely relate to the former "white" local governments in the former RSA. In these jurisdictions there were high levels of service provision across a considerable range of services, financed by an extensive tax base. Therefore, the fiscal gap was small. In the rest of South Africa there were very low levels of service provision for few services and a concomitant meagre tax base. It could be argued that the fiscal gap here was also small. However, if one combines these two very disparate situations and assumes a significantly higher level for a greater range of services for the formerly excluded sector (i.e., a more equitable service level for all), without an equivalent increase in the tax base, then the fiscal gap would certainly be of a greater magnitude than illustrated here, and thus closer to the fiscal gap between national and provincial spheres.*

service delivery, and the need to compensate for spillovers is particularly strong. These issues are pursued further below.

3.6 **Service charges, payments and property rights**

The design of a system of intergovernmental transfers must take the incentives that are induced into account so as to ensure that the results are not only equitable but also that society's scarce resource are used efficiently.

Economic resources that are limited are **always** used at a cost. Even if they appear to be "free", opportunity costs are involved. If the cost is not made explicit in the form of a price, there are no incentives to use the resources efficiently. Examples abound: if there is no charge for the use of water, taps are left running and leaking toilets are not repaired; if electricity is not priced, heaters are left on all day. No developing country can afford to overlook such obvious examples of waste; consequently, all services should be provided at a price. Even though the requirements of the poor must always be kept in mind, care must be taken that the grant system does not result in inefficiencies by creating incorrect incentives.

Because of the positive incentives involved, marketable goods are usually provided more efficiently by private producers, who are subject to the pressures of competition, than by public sector monopolies. However, markets only operate if the commodities being traded are priced. In addition, markets require the clear definition of property rights so that the ownership of the goods being traded are not ambiguous and buyers are assured of the rights (and obligations) they are purchasing. Where this is not the case, inefficiency results. Examples are easy to find: access roads leading to more than one property are usually badly maintained; tribal land may be poorly utilised; public facilities are often dirty.

In principle, therefore, the efficient provision of marketable goods and services, for example those generally provided by municipalities, depends upon appropriate prices and clearly defined property rights. Furthermore, in the cases of water, sewerage or electricity reticulation, it would clearly be feasible to exclude anyone who was unwilling to pay for the services; which in principle makes it possible to charge everyone who benefits, even if only indirectly. Once again therefore, it is important that the grant system should strengthen and not weaken these properties: subsidised municipal services should be designed so as not to undermine pricing mechanisms and property rights. In general, this is achieved best by specifically targeting subsidies in the form of matching grants at those who need them, rather than by using subsidies to alter the general level of service fees.

The question of access to facilities by the poor is addressed below in greater detail; nevertheless, it is appropriate to note that land invasion violates both parts of this general principle and is therefore likely to retard rather than expedite solutions to the problem of housing the poor. Similar disincentives for those who provide important services arise from rent boycotts and the non-payment of service fees. Finally, it should be recorded that, if these conditions are fulfilled, contracting private sector firms to deliver many of the traditional local government services is a viable option.

3.7 **Spillovers and minimum levels of service provision**

Although the analysis of the previous section is valid, it can also be argued that there are circumstances where the rationale is not clear-cut. Furthermore, the argument must be expanded to account for the "spillovers" that many public sector services generate. For example, up to some level of provision, these services display "public good properties" by generating public benefits or "spillovers" that warrant subsidisation. In general, when people purchase goods or services, they only take their own benefits from doing so into account and ignore those of other persons, who may also benefit (indirectly) from their actions. The result can be that less of the particular service is purchased than would be optimal from the public's point of view. One way of correcting for this is for the public benefits, or spillovers, that are not taken into account by the purchaser to be subsidised so that the particular service is used up to the point which is optimal for society as a whole.

Examples of local government services that fall into this category are the provision of water and sanitation, but possibly also, under certain circumstances, electricity. General standards of health depend significantly upon the availability of "adequate" clean (potable) water and "minimum" levels of sanitation and refuse removal. In their absence, negative consequences, such as poor health, could ensue for the broader public, which shift these issues from the private to the public domain. A similar argument may be advanced for electricity, where its provision would reduce the levels of pollution caused by wood and coal fires considerably. There is also the impact which these factors have on productivity levels and consequently economic growth prospects.

It is undeniable that these arguments are applicable in many communities in South Africa. To illustrate them, examples can be drawn from the Greater Johannesburg Metropolitan Council (GJMC), where relatively rich communities are to be found juxtaposed with poor communities: one of these is the case of the Eastern Metropolitan Local Council (EMLC) (a wealthy jurisdiction) and the Southern MLC. The residents of the SMLC do not take the benefits of the EMLC residents into account when deciding whether or not to purchase electricity, for instance. Yet the consequences of the decisions taken in the SMLC are clearly felt by their (relatively rich) neighbours in the form of pollution: there is no doubt that the EMLC residents would benefit from the electrification of the substantial former black townships in the SMLC jurisdiction and the avoidance/banning of open fires. However, to achieve this result, it may be necessary for a (government) transfer of resources to the SMLC to ensure that the levels of service provision (in this case, electricity) are adequate to compensate for the spillovers. These spillovers are even more acute when one considers the prevailing intra-jurisdictional inequalities. The example of Sandton and Alexandra, both within the EMLC of the GJMC, is particularly important.

Although spillovers occur at all intergovernmental fiscal levels, municipal services, and the spillovers they cause, are by nature limited to the local and neighbouring residents and do not benefit others further afield. It could therefore be argued that there is no reason why the local communities (as opposed to those further afield) should not be expected to pay for them, albeit collectively. For example, if municipalities' boundaries encompass both rich and poor communities, the rich community should be willing to finance the benefits it receives from the spillovers deriving from the poorer area's consumption of basic services. Only where this would place too heavy a burden on a particular community should alternatives be sought in the form of intergovernmental transfers to address the vertical disparities that remain.

3.8 **Disparities amongst municipalities**

The following conclusion can be drawn from the preceding discussion. The subsidisation of minimum levels of local government services is necessary for a number of reasons. These are primarily centred around the need to achieve vertical and horizontal equity and to compensate for the spillovers resulting from requiring minimum consumption levels of these services. However, careful distinctions must be drawn between cases where the imbalance between a jurisdiction's functions and its fiscal resources requires intervention in the form of vertical intergovernmental transfers and cases where equity can be achieved satisfactorily in a horizontal way within the community itself (through subnational redistribution). The factor determining whether or not the latter is the case, is the jurisdiction's tax capacity.

This conclusion is important for the construction of grant mechanisms. It suggests that local communities should take responsibility for providing services and alleviating poverty in their own areas, because they themselves will benefit from doing so. Furthermore, it means that subsidies should not be paid to a community simply because it has poor groups within its midst. Subsidies are only required if a municipality is unable to raise the resources necessary to fulfil its functions, i.e. if its tax capacity is low. Therefore, a tax capacity term must be included in the revenue sharing and grant formulae developed for the local government sphere.

In broad terms and using tax capacity as a measure, one could distinguish between two polar categories of municipality for these purposes. The first is where municipalities are large and diverse enough to include both rich and poor areas, in which case they should be able to address or alleviate their problems by applying redistribution through cross-subsidies within their own areas, thus limiting the need for interventions by other spheres of government. In terms of the analysis used above, the primary issue in such cases should be seen as one of horizontal equity and not one of vertical imbalance. Because of the preponderance of urban and peri-

urban areas, a significant part of the country's population will fall into local government jurisdictions in this category.

The second polar case is where municipalities serve uniformly poor areas and do not have adequate revenue sources. The problem therefore becomes one of vertical imbalance. This situation is likely to be prevalent in former black rural areas that are not attached to (former white) towns and which have, in addition, inherited large infrastructural backlogs that impede the delivery of services. The problem is exacerbated by some newly created (rural) municipalities' lack of legislative authority to implement rates on the properties within their jurisdictions. Until corrective measures have been taken to address these issues and reasonable revenue bases established for all jurisdictions, subsidies on the basis of vertical imbalance will be imperative.

In the (major) urban areas, the argument that the prevailing problem is one of achieving horizontal equity appears to have been the logic behind the new municipality boundaries, which have been drawn so as to combine disparate communities into single municipalities. Although ultimately this line of reasoning should prevail and each municipality, comprising a set of interdependent communities, should be able to internalise its own spillovers through developing a system of redistributive, in many cases, as already indicated above, the present disparities are so great as to require intervention in the form of transfers to achieve equity.

Finally, the constitutional provision that the local government sphere is entitled to an equitable share of revenue collected at the national level, and to grants from national government must be seen in the light of this analysis. Insufficient resources are available at the centre for all municipalities to be allocated national funds, irrespective of need and their abilities to raise their own revenues. For this reason, measures to estimate needs and tax capacities are explored in detail below.

3.9 **Intergovernmental transfers for capital expenditure**

With respect to the provision of funds for capital expenditure and in the light of the analysis conducted earlier, the following general principle holds. The basic facilities sufficient to generate the public benefits, considered essential by the community, should be financed from the public purse; those that exceed the minimum should be borne by the persons that stand to benefit from them. For example, the funds to provide safe electricity connections to poor communities may have to be subsidised, but those for extravagant houses should not be.

Providing funding for capital projects of this nature depends upon the extent of the existing facilities and backlogs. Each situation or specific project must therefore be evaluated on its own merits, making it imperative for the formula funding of capital, which is not project based, to be at a level of aggregation higher than that of primary municipalities, e.g. at the MC/DC level. Because these allocations are intended for the provision of infrastructure, they should also be made as conditional transfers, which is what the FFC recommends.

The introduction of the government's Municipal Infrastructure Programme (MIP) complies with these principles and must therefore be welcomed. Care must nevertheless be exercised in its implementation to ensure that the minimum standards are applied uniformly and that strongly disadvantaged communities are not forgotten through their lack of expertise to present the merits of their own projects for evaluation.

The primary goal of the MIP is the provision of basic municipal services for all citizens within 10 years. A system of intergovernmental transfers that provides funds for meeting the capital costs of infrastructure for basic services has been designed by the Department of Constitutional Development. For the 1997/98 fiscal year, R500 million has been earmarked for the MIP. The DCD has suggested a poverty-based formula for allocating these funds to the provinces. The FFC has expressed its concern that a formula of this nature is conceptually more suited for operating grants and that, at present, the formula for capital grants should be based upon indicators of need to reflect infrastructural backlogs, besides taking tax capacity into consideration. The FFC's proposals in this regard are to be found in section 5 below.

Under the previous system, funds were allocated to the RDP and thence to municipalities directly or through the provinces from line departments. Under the current system, a Municipal Infrastructure Fund (MIF) has been

established for bulk and connector infrastructure to consolidate all capital grants into a single funding channel. Presently, while provinces have a role in the allocation of funds, transfers are conditional, based on standardised criteria. The MIF comprises three windows, namely: (i) new and upgraded infrastructure (70% of funding); (ii) rehabilitation (20%); and (iii) special cases (10%). The funds for the first two are formula-funded to each province which then disburses the funds to municipalities on a project basis, based on business plans produced by the latter. Projects are selected and prioritised according to defined criteria.

Municipalities may use the funds as equity to raise money from the DBSA or the private sector. However, unlike the RDP, no municipality is obliged to raise its own money as matching funds. The project must be financially sustainable, i.e. municipalities must be able to sustain the operating and maintenance costs. The capital cost for the basic level of service provision has been estimated at R3 000 per eligible household.

As the benefits flowing from capital facilities are normally spread over the life-span of those facilities, capital projects could be financed through borrowing (as indicated in the previous paragraph). This will result in the annual interest and redemption costs of the loans being spread equitably across all the present and future beneficiaries, instead of being borne by the present beneficiaries alone. As interest and redemption charges are recurring items, this principle suggests that capital subsidies will only be needed until the existing backlogs have been eliminated. Thereafter, they could be merged into the recurrent expenditure formula and based upon a poverty indicator.

3.10 **Intergovernmental transfers for current expenditure**

Subsidising current expenditures presents a different set of problems to that of subsidising capital projects. As was pointed out above, the major problem is that incentives to use the scarce resources efficiently are reduced if recurrent costs are subsidised. In general, people should pay for the units of the services that they consume, even if the facilities are provided “free” by the authorities. (Fees should equal marginal costs, even when the fixed costs are excluded.) In this way, wastage will be kept to a minimum.

Clearly, there are at present many cases where hardship would ensue if this principle were to be applied without moderation. The criteria identified above suggest that an additional set of intergovernmental transfers must be designed to prevent this possibility from occurring. If the poor are prevented from using the facilities provided for them (and necessary for the public good) by the tariffs they are required to pay, the remission of fees may be necessary to ensure compliance with the minimum standards that have been set.

This, in turn, raises the complicated issue of tariff policy. One option is to introduce a two-part tariff to encourage people to use the minimum levels of service considered important for policy purposes. If this is done by zero-rating the first number of units used by a household or, preferably, charging very low tariffs for the first number of units, all consumers including the rich will benefit. It may therefore have to be done initially by differentiating between geographical areas according to their ability to pay i.e. between rich and poor neighbourhoods on the basis of their fiscal capacities. Once administrative systems are sufficiently sophisticated to meter the consumption of services by separate households, it should be done by differentiating between rich and poor consumers on the basis of income. Credits on the municipal accounts of those who have been identified as poor (in the form of matching grants), rather than the lowering of the prices of services in general would be preferable and avoid distorting incentives. However, as pointed out above, whether or not the existence of low-income households in a municipality warrants the payment of subsidies depends upon the tax capacity of the region.

3.11 **Fiscal equalisation**

At various points in the arguments presented above it has been stated that fiscal capacity should be a determining factor in deciding whether or not a municipality should receive transfers and grants. Indeed, one of the most commonly stated rationales for the use of transfers, and of particular relevance to South Africa, is the need to address inter-jurisdictional fiscal disparities. Fiscal equalisation, as a concept, attempts to address the fiscal disparities among jurisdictions.

As regards what it is that has to be equalised, there are two views. The first view states that the capacities of municipalities to finance comparable levels of service provision across jurisdictions have to be similar. This view would focus on the revenue-raising capacity of the jurisdictions and then seek to equalise these based on some notion of the national average or other norm. A second view states that expenditure needs should be the focus of redistributive grants. The emphasis of the expenditure needs approach to equalisation is on service provision rather than financial capacity.

As far as the first of these is concerned, criteria for equalising fiscal capacity are not easy to determine in South Africa at this stage. As mentioned earlier, fiscal capacity measures could be income-based, tax-based or utility-based. Each approach entails a trade-off between theoretical validity and empirical feasibility.

Theoretically, the personal income approach ignores tax exportation if income is taxed at source, and empirically, in South Africa, it suffers from lack of data at the local level: the data that are available on personal income are inconsistent with subnational jurisdictions.

Ideally, tax-based equalisation should be based on a representative tax system; however, none of the South African taxes that could be combined into a representative system, are without problems in this regard. The difficulties with income tax have already been mentioned. Using the VAT tax base falls short theoretically because in many cases the consumption of the poor would result in a distorted picture of fiscal capacity emerging; empirically, this too has problems with availability of data at the local level. Problems would also be encountered if the property tax base were to be used unaltered: data on property valuations are dated, incomplete and inconsistent and would therefore present an inaccurate reflection of revenue-raising capacity at the local level.

The third method is the utility-based approach which is theoretically unsatisfactory because it uses national-average values for selected taste variables (thus assuming identical preferences across provinces) and because it assumes that each province is maximising its utility (when, in reality, provinces may be using sub-optimal resource allocations). In addition, these criteria are difficult to quantify in South Africa both because of lack of data and because of unresolved decisions about the definitions of basic needs and norms and standards for basic levels of services.

A possible tax-based solution for the local government sphere is to use the property values within a geographical region, calculated on a mass valuation basis, for determining tax/fiscal capacity for the purposes of a transfer programme. This would require acceptance of a uniform procedure for evaluating properties country-wide, but may be feasible if done on an aggregated basis. A difficulty is that such a procedure could have been done more easily if each area had been homogeneous. Ironically, the new municipalities , which have specifically been designed to incorporate a combination of disparate areas into single municipalities, will complicate this process.

The alternative to estimating tax/fiscal capacity is to develop some measure of need with respect to current expenditure on municipal services. International experience shows that expenditure needs are usually more difficult to define and measure than tax capacity. The measurement of expenditure needs for a service or category of expenditure requires a definition of an equalisation standard based on the differential costs of service provision. The differential costs of service provision may be due to taste, inherent cost disabilities, policy decisions, and strategic decisions made by the sub-national governments. It is necessary to distinguish between these cost differentials; this has in most cases proven to be a formidable task.

The variables that are to be used for the needs-based approach should provide sufficient information regarding those factors which primarily influence expenditure need. Variables such as age structure, race, ethnicity, growth rates, population density, types of roads, personal income, existing level of services and basic level of service are all relevant in this regard. However, in order to restrict the number of variables, thereby reducing confusion, a composite variable/index, which captures a number of variables, could instead be calculated and used. Similarly, some variables may only result in marginal differences and adjustments(close correlation), thereby not justifying their inclusion, for the sake of simplicity.

Even though cost data on expenditure needs are not readily available, other needs-based data are available in the form of the October Household Survey undertaken by the Central Statistical Service (CSS) (See section on data limitations for an evaluation of these data). Furthermore, since these transfers are for the provision of basic services, the focus is on expenditure needs.

Means tests are, in addition, useful instruments for distinguishing the needs of the poor from other "needs". Through using a means test, funds are only provided to subsidise the municipal services of those who qualify.

Finally, a more complete system of equalisation is one that attempts to equalise both the tax capacity and the expenditure needs of the sub-national governments. Despite the present data problems in South Africa, this is the method used in section 5 below.

In section 5 it is recommended that the magnitude of the municipal grant for recurrent expenditure should be related to the number of inhabitants with incomes below a specified level. Nevertheless, in line with the reasoning used above, namely that cross-subsidisation should occur within regions, additional measures are called for. Regions that can raise sufficient funds to solve their own problems should be required to do so. Therefore in principle, even if current constraints delay implementation in practice, estimates of tax capacity are essential. When implemented, these measures should result in the reduction of transfers to regions with relatively high tax capacities.

3.12 **The administrative level at which assistance should be given**

The final question to be addressed in this section is that of the level at which local government subsidies should be given. Several options could be considered, namely, the provincial level, the metro or district council level, or the primary municipal level. The analysis in the previous subsection leads one to the conclusion that the upper-tier municipal level is the correct one.

Theoretically, there are two reasons for this conclusion. The first is related to the arguments in the previous subsection; the second to efficiency. Additional support for this approach is to be found in the provisions of the Constitution and the Local Government Transition Act.

It was argued above that national funds (in the form of subsidies, grants or revenue sharing) should only be given to those communities that are unable to address their problems horizontally by means of cross-subsidies. Because the spillovers from municipal services are localised and do not affect those far afield, local residents should address their effects themselves. A "vertical" solution should only be sought if the local community does not have the necessary resources to do this on its own.

This implies that neither the provincial nor the primary local governments would be optimal levels for giving financial assistance. The degree of aggregation implied by the provincial level would make it too difficult to differentiate between the needs of different municipalities adequately and necessitate a second distributive mechanism to do so. On the other hand, if one were to target national funds at the primary level, and thereby effectively "ring fence" primary municipalities, the opportunities for meaningful redistribution, as described in the previous section, would be severely diminished. Both these problems would, however, be overcome if national funds were allocated to the upper-tier municipalities, which are sufficiently disaggregated to enable adequate distinctions to be made between them, but which in many cases are simultaneously sufficiently large to encompass wide enough income spectrums within their boundaries for horizontal solutions to many problems to be found.

The second argument in support of allocating local government's share of the revenue collected nationally to the upper-tier municipalities, is that of efficiency. In general, the specific allocation of funds can be done more efficiently at lower levels where the detailed needs and constraints of local communities can be evaluated more accurately. Provinces, being further removed from the communities within each municipality, are not highly conscious of or responsive to community preferences, problems and priorities. Additional costs must be incurred to obtain and administer the information necessary for detailed allocations under these circumstances. In

contrast, metro and district councils have the intimate knowledge of local conditions within their jurisdictions to be able to judge local priorities with a justifiable degree of confidence.

An additional efficiency argument is that, at present, distributing block grants (as constitutionally required for the revenue sharing component) by formula directly to the approximately 850 existing municipalities would be both impracticable and inefficient. This is due to insufficient reliable data at the municipal level to be able to use a formula mechanism for distributing the funds and the lack of technical and administrative capacity in many of the smaller municipalities.

Consequently, the FFC recommends that the higher-tier municipalities, i.e. regional, service or district councils and metropolitan councils should be the recipients of the funds. They would thereafter have the responsibility of transferring the money to the municipalities in their respective jurisdictions. In this way the number of distribution points would be reduced from approximately 850 to 48 and the assessment of need would be on a regional basis rather than on the basis of each lower-tier municipality.

Support for this approach is to be found in the current constitutional and legal provisions. The Constitution establishes three spheres of government, namely national, provincial and local, each of which is entitled to its own "equitable share of revenue collected at the national level" and each of which is entitled to a reasonable level of independence. Furthermore, in terms of section 226 (3), revenue allocated to local government through a province is a direct charge against the province's revenue fund. Therefore, even if municipal allocations were to be channelled through a province, this would have to be done as conditional grants (from the province's perspective) and the provincial treasuries would be no more than conduits.

In addition**,** Schedule 2 of the Local Government Transition Act, 1993, Second Amendment Act 1996, assigns redistributive powers to metropolitan councils to receive, allocate and distribute transfers in accordance with an objective formula. The implications of the FFC's proposals are that, although the district councils are not rural carbon copies of metropolitan councils, district councils be assigned similar functions.

As always in economics trade-offs are involved. The first is that using aggregated data from the lower-tier jurisdictions could conceal the intra-regional disparities that may exist. It is also recognised that the distribution of transfers by the metropolitan and district councils to municipalities in their regions needs to be closely monitored on the basis of the criteria established in section 214 (2) (a)-(j) of the Constitution. Guidelines and a monitoring mechanism must be established. Nevertheless, as mentioned before, the "upper-tier" of local government is much closer to its constituency than the province and is in a better position to know its needs and to distribute funds. This attribute also implies a greater level of accountability to the electorate than at the provincial level. Furthermore, the Councils of the higher-tier bodies are made up of representatives from the entire jurisdiction, who therefore are able to voice their opinions on priorities and relative allocations, based on the criteria accompanying the transfers.

3.13 **The role of provinces in transfers to local government**

From section 4 above it is clear that there is a range of fiscal flows to local government from nationally collected revenues, national government, national government departments, provinces and provincial government departments. At present there is no coherent system of intergovernmental fiscal flows into local government. Neither the source of the flows nor their extent is known with any certainty, as stated earlier. Clearly therefore, there is an urgent need to develop a new system for the local government sphere which complies with the accepted framework that has recently been established for the other two spheres and also with generally accepted norms for intergovernmental fiscal relations. Attempts to revise the existing grants are unlikely to be successful.

It has been argued above that in principle transfers to the local government sphere should be made to the upper-tier municipalities. In contrast to this, in the budget process for 1997/98, the transfers and grants to local government for current expenditure were included in the global amount going to the provinces. (Refer to Tables 2-1 and 2-2 above.) To date, there are no provisions for the earmarking of these funds for the exclusive use of local government. With regard to capital expenditure, grants have been allocated through the Municipal

Infrastructure Programme (MIP) and the Extended Municipal Infrastructure Program (EMIP), as well as capital subsidies through other programmes.

As is evident from the discussion above on the relevant constitutional provisions, allocations to local governments through provinces will be direct charges against the provincial revenue funds in future. Therefore, transfers (revenue sharing) to local government that flow through the budgets of provinces, will have to be earmarked from the 1998/99 financial year onwards, This does not, however, imply that local government funds must flow through the provinces: local government's equitable share of the revenue raised nationally, as well as additional grants from the national government, may be allocated directly from national government to municipalities on the basis of the equitable criteria listed in section 214. As pointed out earlier, the FFC recommends that the allocation of funds to municipalities be done through the use of objective formulae. In this respect it is envisaged that the same set of formulae be used for the whole local government sphere. Although not recommended by the FFC, an alternative procedure, that would give provinces a more prominent role in allocating funds to municipalities in their geographical areas, could also be considered. This would be to establish mechanisms for dividing each province's local government share separately. Each of these allocation mechanisms would have to comply with the provisions of section 214 of the Constitution. Depending upon the interpretation given to subsection 214 (2), each provincial division may require a national Act of Parliament. (As pointed out above, the FFC believes that the reference to "municipalities" in subsection (2) implies that this would be the case.) In effect, this alternative would amount to establishing nine provincial bodies, similar to the FFC, to effect the provincial divisions. Although there are examples of similar systems elsewhere in the world, the FFC believes that the constitutional distinction between the local and provincial government spheres would be blurred by using this alternative approach. Its use is accordingly not recommended.

Section 4

Local Government & The Vertical Division

4.1 **Introduction**

To reiterate, local government is entitled to an equitable allocation of nationally collected revenues (revenue sharing) and grants from national government. A key question is: How much are these amounts, both the equitable allocation and the grants, or rather, how much should they be?

These questions refer to the matter of the vertical division. Although it was mentioned in Section 2 that currently there are a variety of fiscal flows between national government and local government, they are remnants from the former political environment and are not necessarily part of the envisaged intergovernmental fiscal relations system. Thus, an obvious answer to the first of the questions would be based on the sum of these above-mentioned allocations. This would also be consistent with the method applied to the national government/provincial government vertical division, where the historical nexus between regional expenditures, transfers and own revenues has formed the basis for the vertical division.

A fundamental question which is critical for deciding on the vertical division is: *What are these revenues and grants for or what should they be for?*

In essence, the objectives of intergovernmental transfers influence the design of the system of intergovernmental allocations. The basic objectives of transfers in most fiscal systems are:

(i) political imperatives;
(ii) closing the fiscal gap;
(iii) equalisation (horizontal balance);
(iv) compensating for externalities; and
(v) maximising the benefits from the national budget.[15]

The aggregate size of the transfers is also influenced by its intended purposes. Revenue transfers and grants to local government in South Africa are intended for two purposes, namely,

(i) to ensure that municipalities are able to provide "basic services"; and
(ii) that they are able to perform the functions assigned to them (and these cover both current and capital transfers).

4.2 **Options for dealing with the vertical division**

There are clearly several options with regard to how one deals with the relative sizes of the vertical division shares. The various options are discussed briefly below.

Option I: It is theoretically possible to determine the normative size of intergovernmental grants to local government by costing the functions of local government, calculating the needs and backlogs and then juxtaposing this with its tax capacity and effort.

There are two major problems associated with this option. Firstly, the data needs for such calculations are enormous, and in the South African case unavailable in the medium term. Secondly, even if such calculations were possible, it is quite probable that the needs and backlogs components would result in a massive "over demand" on fiscal resources. In order to bring the demand into line with available resources it would be necessary to scale the aggregate amount down to an "affordable" level.

[15] *Bird, R M., Threading the Fiscal Labyrinth: Some Issues in Fiscal Decentralisation, National Tax Journal, Vol. No. 2, p. 218, (date and publisher unknown).*

This scaling effect undermines the original rationale for determining the normative quantum. Thus this option does not appear to be useful.

An alternative to the scaling procedure is to raise additional revenues at the national level, which is unlikely at present with the commitment to a constant tax revenue/GDP ratio of around 25%. In addition, this sort of rationale for additional revenues could be used by almost all spending agencies, which would add further pressure on the aggregate tax burden.

Option II: In this option one could attempt to quantify the current aggregate allocations to local government ("bridging finance" + subsidies for health, ambulance, fire, library services, etc. + R293 towns + directly funded local government services by provinces [former TBVC-states] + the plethora of capital grants).

The advantage of this option over the first is that all these funds are in some existing budget. Each of the mentioned components would have to be identified, taken out of the existing budgets (municipality, provincial and/or national) and then relocated in either the revenue sharing component or the national budget item "Intergovernmental grants to local government". This option clearly avoids the probability of exceeding the budget referred to in Option I.

A similar problem to the data issue identified in Option I is evident here. There is no (accurate) data on what the aggregate transfer to local government is. There are "guestimates" made by a number of institutions but such data should only be used with great circumspection.

A further question to be answered is whether this aggregate amount, if it could be calculated, is "equitable or reasonable". The former system of transfers to local government was a feature of the race-based policies of separate development. As a consequence, the fiscal transfers to local government were perhaps adequate for the white urban areas (which did not really have great needs due to their adequate tax bases) but clearly inadequate for all other areas. Thus rural areas in general and other race groups' townships were relatively underfunded.

To use these former fiscal flows as the basis for a new equitable system would be incorrect and also send wrong messages about the merits and rationale of the new system.

The question of how to deal with operating as opposed to capital grants is a feature of this option, although also relevant for all the other options.

Another moot point is whether "subsidies" from provincial departments to municipalities for agency functions, e.g., health-care, should be factored into the grants. These subsidies are actually agency fees and not grants. If such an argument is valid, one will have to omit these amounts from any calculations to aggregate current financial flows between provincial and local governments.

Option III: In this case the historical "bridging finance" allocation is used as the base figure.

Table 2-1 illustrates what these amounts have been for the past number of years. As discussed elsewhere in Part IV, these amounts have no bearing whatsoever on the prevailing political context. It would be an absolute travesty of justice and equity if this figure were to be regarded as the base amount for the new system of intergovernmental fiscal relations.

This option places no demands on data requirements but is clearly not a credible option. In addition, these transfers were only for operating expenditure.

Option IV: An alternative to Option III is using the historical "bridging finance" allocation, but extrapolating the amount to match the "new" qualifying population for the country as a whole.

Whereas the original amounts related to a small portion of the black population in some of the former RSA black townships, the current rationale for the transfers and grants is to subsidise basic services and infrastructure where the tax base does not match the need. Consequently, the entire population would have to be surveyed to determine the new qualifying population.

If a number of assumptions were agreed to, it is practically possible to calculate a reasonable set of figures for this option.

These amounts would be for operating grants only. The capital grants component would have to be dealt with separately.

Option V: This is a variation on some of the previous options whereby the local government transfer is exogenously determined as a percentage of the national pool. A conservative percentage could be set on the assumption that it would grow at a predetermined rate, depending on inflation and the economic growth rate.

The exogenously determined percentage could be informed by factors such as those referred to in other options, e.g., relative powers, functions and fiscal capacities of "spheres"; and national government priorities.

4.3 **Problem areas**

Apart from the problems and challenges identified for each of the options discussed above there are problems which are generic.

- The variations for dealing with the vertical division need to be considered in terms of operating and/or capital expenditure. Questions which are addressed elsewhere in this chapter, are: should there be two separate formulae (one for each type of grant), two different sets of institutions at different levels receiving and administering the grants, and should capital grants be formula-funded to the spending agency or disbursed from a "higher" level, on the basis of application?

- The vertical division itself may be considered in two ways. There could be a vertical division in series or in parallel. In the former option the "first" vertical division would be the national/provincial division. The local government allocation would be included within the provincial allocation. There would then be a subsequent vertical division between the provincial allocation and the local government allocation. The alternative is to have a national three-way vertical division. Although there would be no difference in the amounts allocated in these two approaches, the latter approach would appear to be the preferable one from a constitutional perspective. As argued in the previous section, local government is not a function of provincial government but an independent sphere in its own right.

- As is the case for the national/provincial vertical division, the national/local vertical division is a politically loaded issue.

- Perhaps the most fundamental question is: what are these transfers for? How are basic services to be defined? Are they only transfers for the poor, and how does the capital grants component factor into the system of transfers as a whole?

- In determining the vertical division, how does one take account of the capacity of local government to borrow for capital expenditure? It would seem that there is considerable capacity within metro and district councils to borrow. These councils were designed to address backlogs by focusing on redistribution through capital expenditure. If there is potential for gearing current revenues for borrowing at this level it is imperative that this should be done. Each government has to exploit all its potential resources to the full, including its potential to borrow.

Section 5

Intergovernmental Transfers to Local Government in South Africa

5.1 **Introduction**

It is apparent from Section 3 that, due to the fiscal imbalance in South Africa, intergovernmental transfers are very important for funding both provincial and local government. Such funding is important for both capital and recurrent/operating expenditures.[16]

5.2 **The formula for the horizontal division (nationally and locally)**

The FFC's proposals for the funding of municipalities are based on the use of a formula for the horizontal division of the transfer to local government amongst the metropolitan councils and district councils. The use of a formula will ensure both revenue stability and objective allocations. The proposed formula takes into consideration both indicators of need and tax capacity for operating transfers and infrastructure backlogs for capital grants.

The transfers are based on a two-part formula with three components:

(i) a conditional capital grant (which is dealt with horizontally in the national government share);
(ii) an unconditional operating transfer (which is dealt with horizontally as part of the local government share); and
(iii) a tax capacity (equalisation) component, related to (ii).

Both the capital and operating "grants" are designed to address the basic needs of the poorest section of the population. On the one hand, the capital grant is aimed at eliminating backlogs in the provision of basic municipal services; on the other hand, the operating transfer is to enable the poor to purchase the minimum quantities of certain essential services, such as clean water, adequate sanitation, suitable roads and/or electricity.

One of the most commonly-stated rationales for the use of transfers, and of particular relevance to South Africa, is the need to address inter-jurisdictional fiscal disparities. This must be done in a fiscal context where there are simply not enough public resources to allocate funds for these basic services to all indiscriminately. Therefore, the funds generated by the first two transfers are tempered by the criteria discussed at length above: if a jurisdiction has the capacity to raise its own revenue and should therefore itself be capable of addressing the needs of its inhabitants, the money made available to it through the transfer system, is reduced. The FFC recommends that at present only the revenue-sharing transfers be adjusted according to a jurisdiction's tax capacity.

5.3.1 **Capital Grant**

(Sections 214(1)(c) & 227(1)(b) transfers)

The capital grant is seen as a **conditional grant from national government to local government**. In terms of the vertical division, this amount would be calculated as part of the national government component so that the condition that these funds must be used for addressing infrastructural backlogs can be set. In line with national government policy objectives of developing local government infrastructure to ensure that all South Africans have access to basic services, national government will be able to apply such grants to address these capital expenditure requirements. The Constitution requires that the actual disbursement of these grants must be based on equity.

[16] *This statement does not imply that subnational governments cannot or should not borrow for capital expenditure. In Section 2 above the point is made that it would appear that certain categories of municipalities are very under-borrowed. The implication is that they are not exploiting all their resources effectively.*

In the interim, a very crude measure of "access to basic services backlogs" has been adopted to formulate the capital expenditure component of the formula. Mainly because of the inadequacy of other data, the measure focuses on the provision of two basic services - water and sanitation.[17] Weights are attached to the two services to derive a composite index of backlog/need. The assumption underlying the choice of variables making up the composite index, is based on backlog/need, not on financial implications. In other words, although municipalities are responsible for providing a number of services, some of which could be self-financing, for example water and electricity, it is necessary to identify those services which could be indicative of backlogs/need. For this reason, the lack of water and sanitation , combined into a single index (I), are chosen as being **indicative** of backlog/need. They must not be seen as excluding other basic services.

The total allocation for capital expenditure (G_i) to a municipality is calculated on the basis of the cost to provide infrastructure to the qualifying population (i.e. the number of individuals or households below a defined poverty line)[18] that do not have access to basic services. This is weighted by a combined index "I" in order to determine the allocation to each metropolitan council or district council. The real cost of providing basic infrastructure services needs to be spread out over a period of time, say 10 years, since it would be impossible to provide the total amount in one year.

The allocation of grants for capital expenditure, $\mathbf{G_i}$, to the ith MC or DC is as follows:

Capital Grant (G_i) = $\{1 - I_i / \sum(1 - I_i)\} * 1/n(x * H_{qi})$;

Where:

$\mathbf{I_i}$ = combined index for i^{th} MC or DC
x = real average cost per household of providing infrastructure for basic services
$\mathbf{H_{qi}}$ = qualifying number of households in i^{th} MC or DC
n = number of years (phasing)

The composite index "I" will be constructed following the methodology used by CSIR in the construction of its Development Indicators Monitoring System (DIMS) index. Observations for each variable will be scaled from 0 (the worst-off) to 1 (the best-off). For example, if the percentage of the population without access to the minimum level of water ranges between 20% and 60%, a place with 20% of the people having no access to water would have an index score of 0 while a place with 40% of the people having no access to water would receive an index score of 0.5. The composite index will then be calculated on the basis of a linear scale transformation of the average of the index scores for all variables. It will range in value from 0 (greatest need) to 1 (least need).

The composite index can be broken up as follows:

- Level: MC or DC
- Values: Absolute (based on absolute numbers of housing units in need)
  Relative (based on relative proportion of housing units in need)
- Categories: Water
  Sanitation

[17] *Although two services are used to "slice the cake" and are regarded as sensible proxies for a package of basic services, sight is not lost of the importance of other services such as solid waste removal, roads and storm water drainage and electricity.*
[18] *The poverty line is defined in terms of relative poverty i.e. the poorest 40% of households (ranked by adult equivalence) in the country. This definition is taken from an October 1995 RDP report.*

- Indicators: Water: (number of housing units without access to on-site water)
  Sanitation: (number of housing units without access to adequate sanitation)

The definition of basic services and values will be developed in greater detail as more adequate data become available so that more comprehensive indices can be constructed.

The real average cost per household of providing basic infrastructure services, "x", will be calculated on the basis of how much it would cost to install bulk and connector infrastructure for basic services in the different jurisdictions under consideration. At present, the only information available is from the EMIP which uses the Combined Services Model from the DBSA to calculate infrastructure costs for urban and rural areas.

Once each MC and DC has received its capital allocation, it will be responsible for redistributing the funds to municipalities within its boundaries or for metro-/district-wide capital expenditure purposes. The distribution procedure followed would be application-driven, with individual municipalities submitting applications for projects. Stringent criteria need to be applied to ensure that the funds are equitably distributed by the MCs and DCs. An effective monitoring system also needs to be put in place to ensure that conditional funding is appropriately applied by the spending agencies.

5.3.2 **Operating Transfers (Revenue Sharing)**
(Sections 214(1)(a)& 227(1)(a) transfers)

The allocation for current expenditure is intended for subsidising access to basic services for those who cannot afford to pay for these services. At this stage, the two basic services under consideration are water and sanitation.[19] The operating grant is based on the cost to the qualifying consumer (i.e. a household below the poverty line) of the minimum amount of water needed for annual consumption and the operating cost of providing the basic level of sanitation.

(*The minimum levels of water and sanitation need to be defined. The cost to the qualifying consumer would be based on the average price per unit of household water consumption across jurisdictions. A similar process will be used to estimate the cost of sanitation*.)

$$RS_i = (a*p_w + b*c_s)*H_{qi};$$

Where:

a = minimum household annual water consumption;
p_w = unit price of water;
b = minimum level of sanitation;
c_s = unit cost of sanitation
H_{qi} = qualifying population in i^{th} MC or DC

Here again, once each MC and DC has received its operating transfers allocation, it will be responsible for distributing the funds to the primary municipalities.

5.3.3 **Tax Capacity Equalisation Component**

[19] *Similar to the capital grant, only two services are used as indicative of needs. This does not imply that transfers are applied to these two services but for any service which is included in the definition of "basic services".*

As mentioned earlier, fiscal equalisation encompasses both equalisation of expenditure need and of tax capacity. The first aspect is dealt with in the allocation for operating and capital expenditure. The latter deals with the revenue-raising capacity of the jurisdictions under consideration and uses measures such as personal income, property taxes and other standard municipal taxes.

Of critical importance is that the tax capacity measure (even if it is a proxy measure) has to be part of the operating transfer formula. A core principle in any system of intergovernmental fiscal relations is developing incentives for all governments to maximise the use of their own resources. The corollary to this is that governments should not be "subsidised" in such a manner that their tax effort is less than their tax capacity. If this component of the formula were not to be implemented, then the latter condition could prevail, which would be ineffective, unfair and unconstitutional.

In the case of South Africa, tax capacity at the MC and DC level could be reflected in a representative tax system through a combined index which takes account of personal income, property taxes and RSC levies (and possibly other tax/revenue sources as data systems develop). At present, there are severe data restrictions with regard to both personal income and property taxes. While data for personal income are available at the national level, it is extremely difficult to disaggregate the data to the MC or DC levels currently. With regard to property valuations, the data is both dated and incomplete in its geographical coverage and property valuation methods are not uniform across jurisdictions. If no national norms are imposed for property taxation it would be well-nigh impossible for this source to be used as a tax capacity measure, on its own or in combination with other sources.

As stated above, the tax capacity measure is directly related to the operating or current transfer component. With reference to the operating expenditure formula, "RS_i" what is measured is the relative cost to an MC or DC of providing a minimum level of service to that target population needing financial assistance due to poverty. What the tax capacity component does is to measure the relative ability of the MC or DC to "subsidise" its own "poor". If the "wealth profile" of the MC or DC is of such a nature that relative wealth fully compensates for the relative need then it will receive no operating transfer. In other words, if the aggregate wealth is equal to or more than the aggregate need of the jurisdiction, then that jurisdiction is considered able to provide for its own needs.

Clearly, as the profile's balance changes to reflect a relatively poorer jurisdiction, then the operating transfer becomes positive. The tax capacity component must be constructed in such a manner that it would not result in a negative amount large enough for the MC or DC to forfeit its own revenues in contravention of section 227(2) of the Constitution. Thus, while T_{Li} may be ≤ 0, $(RS_i + T_{Li}) \geq 0$.

The tax capacity of each MC or DC (X^i_{t-1}) would be calculated using property taxes and RSC service and establishment levies. The tax capacity for each component will be calculated by applying a normative national average tax rate to each tax base to give the *per capita* yield for each tax. These will be converted into *per capita* tax capacity figures and then aggregated to get each MC or DC's actual tax capacity, X^i_{t-1}. The national average tax capacity, X^*_{t-1}, will then be calculated from the aggregates.

The entire tax capacity formula would be:

$$T_{Li} = \alpha (X^*_{t-1} - X^i_{t-1}) P_i$$

which can be written:

$$T_{Li} = [(X^*_{t-1} / X^i_{t-1}) - 1] (\alpha^*. X^i_{t-1})P_i$$

subject to the additional constraint that $\Sigma T_{Li} = 0$ and $(RS_i + T_{Li}) \geq 0$

Where:

T_{Li} = the tax capacity transfer to the ith MC or DC
α^* = the proportion of the tax capacity to be equalised
X^*_{t-1} = the norm/national average tax capacity *per capita* in year t-1
X^i_{t-1} = the ith MC or DC's actual tax capacity *per capita* in year t-1
P_i = the population of the ith MC or DC

Of course, in the short run, it will not be possible to calculate the tax base for property taxes due to the data limitations described earlier. Personal income may have to be used as a proxy. In the absence of reliable personal income figures at the MC or DC level, it may be necessary to use only the RSC levies to estimate the tax base for each MC and DC.

In order to fulfil the condition that $RS_i + T_{Li} \geq 0$, it may be necessary to have equalisation only to a certain proportion, α^* , of each MC or DC's *per capita* tax capacity. This means that the *per capita* tax capacity of each richer MC or DC will be reduced to the proportion α^* of the national average while that of each poorer MC or DC will be raised to α^* of the national average, where $0 < \alpha^* \leq 1$.

The allocation of revenue sharing transfers for current expenditure (**RS_i,**) adjusted for tax capacity to the ith MC or DC is as follows:

$$\mathbf{RST_i = RS_i + T_{Li}}$$

Where:

RS_i = Allocation for Current Expenditure; and
T_{Li} = Tax Capacity Equalisation Component

5.3.4 **The Combined Formula**

The combined formula would be:

$$IGT_i = G_i + RS_i + T_{Li}$$

Where:
IGT = Intergovernmental Transfer;
RS + T = RST = Revenue Sharing Transfer;
G = Capital Grants; and
T_i = Tax Capacity Component.

5.4 **Data Limitations**

There are several problems with regard to implementing the formula proposed above. In the first place, as already mentioned, population data at the local government level are extremely deficient. Secondly, there are severe problems with the existing data on basic services needed to compile the composite index. The figures available from the 1995 October Household Survey are also regarded, even by the CSS themselves, as being of too poor a quality to use for purposes of determining financial transfers. Due to errors with regard to the sampling frame, these data are not reliable at the magisterial district level. At best, they could be used at the provincial level. Aggregation to any lower level (such as MC or DC) would increase the margin of error considerably.

With regard to services cost data, there are many problems. In the first place, capital costs of providing basic infrastructure differ markedly for urban and for rural areas and even between urban areas and rural areas themselves.

The problems regarding data are dealt with in detail in Section 6.

Data Requirements for the Design & Implementation of Formulae for Revenue Sharing

6.1 Introduction

The major stumbling block that the FFC faces in fulfilling its mandate of making recommendations to Parliament on the allocation of nationally-collected revenues to local government and municipalities is the absolute lack of data in general, but specifically with regard to its relevancy, reliability and accuracy.

This situation prevents the FFC from making credible and informed recommendations on how nationally-collected resources should be distributed to and amongst the three spheres of government. The FFC is not a primary collector of data and has to rely on data collected by other institutions, such as the CSS, to carry out its mandate. However, no single institution or combination of institutions has all the data that the FFC (or any other institution which has a similar mandate, such as the Department of Finance) needs and most of what is available is either outdated, inconsistent, inappropriately aggregated or disaggregated.

The above-mentioned information and data problems are of a short-to-medium-term nature as there are a number of initiatives to collect appropriate information and data. In the long term it is a matter of principle that the FFC will use officially sanctioned information and data, provided by institutions such as the CSS and SARB.

In the short to medium term, the only option is to use "surrogate" (proxy) information and data from diverse sources. This option is beset with problems which may not be manageable and could also have long-term implications for the system of intergovernmental fiscal relations as a whole. Even if one of the possible problems, the contentious nature of some of the proxy data, is overcome by obtaining consensus amongst the various stakeholders, this may not be optimal. It is important for the FFC and for the system which is designed that all stakeholders accept its work and methods and the resulting system.

The second option in the short to medium term is to design the system and the formulae but not assign any data until appropriate data are available. This option has significant system and technical advantages but may have negative political consequences.

6.2 Data Requirements

The allocation of resources to local government has two components: the vertical and horizontal divisions. Firstly, the vertical division determines the aggregate, equitable amount of nationally collected revenues that should accrue to local government. The horizontal division refers to the division of the aggregate amount amongst the municipalities. As stated earlier, the FFC recommends that this amount be allocated to the 'upper tier' of local government, namely district councils (DCs) (or their equivalents) and metropolitan councils (MCs). The DCs and MCs will in turn allocate the amounts they receive to the municipalities within their areas of jurisdiction.

In addition to the vertical and horizontal divisions, there has to be clarity about the nature of the allocations in terms of the recommended capital, operating and tax capacity grants and the relationship between the three.

- **The Vertical Division**

To determine the aggregate amount that should accrue to local government one needs to look at the intended purposes of the various grants to local government. The intended purpose for the allocation to local government is to ensure that municipalities are able to provide "basic services" and that municipalities are able to perform the functions assigned to them.

Five options are suggested in Section 4 to determine the relative sizes of allocations to the three spheres of government. Data requirements for the five options are summarised in Table 6-1 below.

Table 6-1: *Data Requirements: The Vertical Division*

Option	Data Requirements [medium-term availability[20]]
I: Share determined normatively.	• identifying the target population at the municipal level, i.e. that portion of the population within each municipality which does not have access to basic services and/or is unable to pay a full cost recovery fee[21] [NA]; • average cost of (i) basic services infrastructure (capital) and (ii) actual service provision (operating) for a single household or dwelling unit or individual (adult or adult equivalent) [NA]; • costing of infrastructure backlogs for basic services;[???] • measurement of municipal tax base(s) (property valuations, personal income tax, and RSC levies) [NA]; and • measurement of tax capacity and tax effort - how much should be collected and how much is actually collected [NA].
II: Share based on current aggregate fiscal flows.[22]	• "bridging finance"; • subsidies, delegated and non-delegated functions (for health, housing, social services, environment & culture & sport & recreation); • funding of R293-towns ; • funding by former TBVC-states to their municipalities [[NA], if ever]; • various capital grants and subsidies; and • other grants [NA].
III: Share based on historical "bridging finance" to some former BLAs in former RSA.	• actual "bridging finance" allocations made to some former BLAs in former RSA and carried through to nation-wide "grant" allocations thereafter.
IV: Share based on original "bridging finance" concept (Option II), but scaled up to include target population previously excluded.	• Option III requirement; • "new" & former qualifying populations [NA]; • a measurement of needs and/or backlogs, e.g., a needs or poverty index [NA].
V: Share set exogenously as percentage of the nationally collected resources.	• a "macro-feel" for the relative powers, functions & responsibilities of the three spheres, juxtaposed with their relative tax capacities.[23]

Data needs for Option I are too numerous and involved and cannot be addressed in the short term. A problem with Option II is that there are no accurate data on the aggregate amount of transfers to local government.[24] It may, however, be possible (and offer some advantages) to apply the figures available, but scaled up somewhat for the inherent inaccuracies in the data. This assumes that the inaccuracies result in conservative figures.
Option III has the least data requirement, but as stated before, it is not a credible option and excludes capital allocations.

[20] *NA denotes not available in the short-term (mid-1997 to end-1997).*
[21] *A number of key concepts and categories, such as, "household", "household unit, "individual", "adult & adult equivalent", "minimum level", "basic services" and "poverty line", have to be defined*
[22] *An item which is not included in the list is the share of the fuel levy (one cent in the rand) which accrues to district councils and metropolitan councils. This item is "tax sharing" rather than a subsidy. This position is contrary to the one taken by Ernst & Young who prepared a report for the Departments of Finance and Constitutional Development. They have factored the shared fuel levy into aggregate fiscal flows to municipalities.*
[23] *In essence, the determination is made on the basis of each sphere's relative fiscal capacity, where fiscal capacity is defined in its broad context as having both revenue (tax) and expenditure sides.*
[24] *The Ernst & Young report cited above concludes that on account of different methods of resource allocation amongst provinces, and poor record keeping and poor data systems in general, the results of their investigation are* ***unreliable.*** *(Ernst & Young, Report: Financial Assistance to Local Authorities (1997/98 and 1996/97), February 1997.*

Option IV's data needs could be met in the short term but the reliability and accuracy of the data are questionable. Another problem with this option is that it only deals with operating allocations, the allocation of capital grants would have to be dealt with separately.

Option V is not an objective way to allocate resources and might result in local government not getting its equitable share. Unlike Option I where the share is determined normatively, this option involves making an "educated" value judgement.

To reiterate what has been stated in Section 4 on the vertical division, this particular component of the intergovernmental fiscal relations system is a politically loaded one and, no matter how accurate the technical calculations are the vertical division has to be an informed political decision . It is the intention of the FFC to inform the political decision-making in this regard as best as is technically possible.

- **The Horizontal Division**

Data for the horizontal division should be disaggregated down to the DC/MC level and it is critical that these data be comparable across jurisdictions. The FFC has developed a formula that will determine the allocation of nationally-collected resources to each DC and MC for the 1998/99 fiscal year. The DCs/MCs will then allocate these funds to the municipalities within their geographical area by using a given set of criteria/ guidelines.

The formula has three components: capital expenditure, operating expenditure and fiscal capacity. Table 2-6 illustrates data needs for each of the components in order for the formula to be implemented.

Table 6-2: *Data Requirements for the Horizontal Division*

Type of Data	Data Requirements [& availability]

Capital Expenditure	• Qualifying population:
	  ◦ Urban vs. rural;
	  ◦ Number of households or housing units or individuals (adult equivalents) without access to the minimum amount of water;
	  ◦ Number of households or housing units or individuals (adult equivalents) without access to the minimum level of sanitation;
	  ◦ Number of households or housing units or individuals (adult equivalents) earning below the poverty line;
	• Real average national cost of providing infrastructure for minimum levels of water and sanitation ;
	• Quantify backlogs, in housing units; and
	• Jurisdictional boundaries.

Operating Expenditure	• Qualifying population (income below the poverty line); • Income levels (*per capita*, per household unit, etc.); • Real (national) average operating costs for providing minimum levels of basic services; and • Price to the consumer for receiving a minimum level of basic services.
Tax/Fiscal Capacity	• Personal income tax base per municipal jurisdiction; • Personal income • Property valuations/ rateable value of property; • RSC levies (payroll & turnover) base; and • National, average or "norm" rate to calculate tax/fiscal capacity.

Unfortunately, the FFC formula cannot be implemented in its entirety in the short term because most of the required data are not available anywhere, let alone from official sources such as the Central Statistical Service (CSS) and the Department of Finance. (Refer to Table 6-3.)

Data, including population, number of housing units, households' access to basic services, such as water, sanitation and electricity, are available from the October Household Survey (OHS) that is carried out by the CSS. The most recent data are available from the 1995 OHS, which covers both urban and rural areas, but are not consistent with the new municipal jurisdictions. While the data are compatible with magisterial districts, these jurisdictions do not coincide with the district and metropolitan council boundaries. Further work will have to be carried out to correlate the data between magisterial district boundaries and district and metropolitan council boundaries. A further problem with this data set is its lack of reliability due to confusion between old and new enumerator areas.

The capital and operating components of the formula could be implemented in the short-term by making use of the updated 1993 National Electricity Liaison Forum (NELF) data base. The NELF database was compiled by Economic Analysis Systems (EAS), a private firm, from the 1991 Census and the census for TBVC-states. This database contains data on services (electricity, water and sanitation), number of housing units, population and population growth rates. The data were compiled according to geographical areas that can be aggregated to magisterial district. The only drawback with this database is that it has not been updated (with the exception of electricity) since it was set up in 1993 and all the demographic, political and jurisdictional dynamics are not reflected in the database.

The tax/fiscal capacity component cannot be implemented fully in the short to medium term for the following reasons:

- personal income tax data are only available at a national level and it is impossible to disaggregate them to DC/MC level at present; and
- data for the property tax base are not complete across or within municipal jurisdictions.

Most of the FFC's data needs will be met in the medium to long term by the CSS Local Government Census to be conducted in September 1997 and the 1996 Census results. Preliminary Census 1996 results, which include data on population size using gender and race categories only, might become available at the earliest by the end of June 1997.

In an attempt to bridge this data gap, the FFC is undertaking a sample survey of municipalities across South Africa to collect data, assess the state of municipal finances, the dynamics of the transition, and the need for revenue sharing. Section SS 7 of Part IV details this programme.

Table 6-3: *List of data requirements, sources & availability at municipal level*

Variable	Disaggregation Level	Data Sources	Availability Imm.	LTA	Formula Component
Capital Grant (G_i)					*(G_i)*
Boundaries	DC/MC [TLC] MD-level	CSIR/ PMT DBSA DCD	Y N ?	Y Y Y	
Total population size	DC/MC [TLC] MD-level	Census "96 DIB	N Y	Y ?	
Number of housing units Per jurisdiction Backlogs	MD-level	Dept. Housing DIMS OHS Municipalities	? Y N Y/?	? ? Y ?	*(H_{qi})*
Number of households Per jurisdiction *(Obtain the definitions from the various Institutions)*	MD-level	Dept. Housing ? DIMS OHS Municipalities	? Y N ?/Y	? ? Y ?	*(H_{qi})*
Energy Source Electricity within unit No access Min. level Cost of providing Price to consumer	MD-level	NELF/DIMS OHS Municipalities DME ESKOM	Y N Y ? Y/?	Y/? Y Y ? ?	*(I)* *(x)*
Water Tap within unit Tap on erf Communal tap No access Min. level Cost of providing Price to consumer	MD-level	DWAF DIMS OHS Municipalities	?/Y Y N Y	?/Y N Y Y	*(I)* *(x)*
Sanitation/Sewerage Waterborne Septic tank Pit-latrine Communal No access Min. level Cost of providing Price to consumer	MD-level	DWAF DIMS OHS Municipalities	?/Y Y N Y	?/Y N Y Y	*(I)* *(x)*

[ ] = Long term
Imm = Immediate availability
LTA = Long term availability

Variable	Disaggregation Level	Data Sources	Availability Imm.	LTA	Formula Component
Operating Grant (RS_i)					*(RS_i)*
Boundaries	DC/MC [TLC] MD-level	CSIR DBSA DCD	Y N ?	Y Y Y	
Total population size	DC/MC [TLC] MD-level	Census '96 DIB	N Y	Y ?	
Population below the poverty line (*Define)*	MD-level	SALDRU OHS	? N	? Y	*(H_{qi})*
Energy Source Electricity within unit No access Min. level Cost of providing Price to consumer	MD-level	NELF/DIMS OHS Municipalities DME ESKOM	Y N Y ? Y/?	Y/? Y Y ? ?	
Water Tap within unit Tap on erf Communal tap No access Min. level Cost of providing Price to consumer	MD-level	DWAF DIMS OHS Municipalities	?/Y Y N Y	?/Y N Y Y	*(a)* *(H_w)*
Sanitation/Sewerage Waterborne Septic tank Pit-latrine Communal No access Min. level Cost of providing Price to consumer	MD-level	DWAF DIMS OHS Municipalities	?/Y Y N Y	?/Y N Y Y	*(b)* *(c_s)*
Tax Capacity Equalisation Component (T_{li})					*(T_{Li})*
Property evaluations	TLC DC/MC	Municipalities	Y/?	Y	X_i
Personal Income Tax	DC/MC [TLC]	Receiver of Rev. (SARS)	N	Y	X_i
Personal Income	DC/MC [TLC]	SARS Census '96 OHS	N N Y/?	Y Y Y	Xi
RSC Levies	DC/MC	SARS DCs	Y	Y	X_i

[ ] = Long term
Imm = Immediate availability
LTA = Long term availability

Section 7

FFC Visits to Selected Municipalities

7.1 Background

A core theme in the local government chapter of the FFC's 1998/99 Recommendations to Parliament (Part IV), and also a stumbling block to the fulfilling of the FFC's constitutional obligations, is the absence of appropriate, credible and up-to-date data and information, in general, but specifically at the disaggregated level of municipalities.[25] This situation results from both the political transition and the apartheid legacy of a state which was not geared to collecting data for the purposes of effective and democratic policy development, planning, budgeting and resource allocation. There is thus no single public sector institution which at present has the sort of information and data which the FFC must have to fulfil its functions.

There are currently plans to acquire appropriate, credible and up-to-date data and information, such as the 1996 Population Census and the 1997 census on local government finances and non-financial matters, which will only be available during the latter half of 1997 and during 1998.

Apart from the data issues there is no nationally accessible information about the nature of the transition itself and how local government jurisdictions are dealing with the practical matters of governance. These matters are potentially so diverse from one jurisdiction to the other that it is difficult to appreciate them from afar.

As a consequence of these information and data problems and the imperative for establishing the new system of intergovernmental fiscal relations, inclusive of local government and municipalities, the FFC has embarked on an information and data collection programme of its own. Although it is recognised that it is not a function of the FFC to be a primary data collection agency, it is regarded as an important interim measure to facilitate the establishment of an effective system of intergovernmental transfers for local government and municipalities specifically, but also for government as a whole.

This programme is also intended to develop the institutional relationship between the FFC and local government and municipalities, which is an important collateral objective of the FFC's functions.

7.2 The Programme

As far as was possible, all stakeholders were consulted about this programme. Our consultation included the national Department of Finance, provincial departments of finance and local government and municipalities themselves. In addition, individuals with expertise in local government matters were also asked for their inputs.

The various aspects of the programme are presented below.

- **Objective**

The formulae-driven approach to determining intergovernmental transfers is a heavily data dependent approach. As a consequence of appropriate data not being readily available to the FFC it was decided to collect representative appropriate primary data from municipalities' themselves.

In addition, as the FFC has developed a working relationship with provinces and national government, it is important that the FFC develops a relationship with the other sphere, local government. In developing this relationship it is important for the FFC to inform itself of the "soft" information pertaining to municipalities, which are not found in any data set.

[25] *The details of this situation are dealt with in Section 6.*

- **Approach**

The approach to collecting the data was based on a representative sample of municipalities.[26] The sample approach took account of the following sorts of factors:

- although the FFC proposals must be well-informed and fully inclusive, the time-frame for accessing local government data was (and is) rather limited;
- the knowledge that agencies responsible for primary data collection would have appropriate data available in the longer run and that in essence what was to be done by the FFC, as far as data is concerned, would be for "bridging" the period where data is not available.

- **The Sample**

The representativeness of samples and the application of any outputs are always contentious. Although researchers took the utmost care to ensure reasonable representativeness it is acknowledged that making any definitive recommendations based on the outputs derived is not possible, especially as only three provinces have been visited to date and only 45% of the sample has been completed.[27]

- the sample was selected so as to be representative of different categories of municipalities nationally and within each province. (Where possible, provincial departments of local government were also consulted prior to finalising the sample);
- a total of 90 municipalities were selected, ranging in size from "Health Committees" comprising four staff members with a budget of about R140 000 per year to metropolitan councils and "sub-structures" with thousands of employees and budgets of billions. The former municipal grading system was also used to provide an indication of size variations;
- not only was size taken into account but also the rural vs. urban context;
- in almost all cases the primary municipality was linked to the district council or metropolitan council; i.e., if a LC was targeted then the corresponding DC would also be part of the sample; and
- another factor which was included was that of mixing "traditional" municipalities which existed in the former RSA with those local jurisdictions which existed in the TBVC-states.

- **Research Method**

As stated previously, the approach used was to identify a sample of municipalities which the FFC researchers (and Commissioners where possible) would visit.

The disadvantages of surveys done by postal or faxed questionnaires led the FFC to decide on using a "check list" of issues for discussion.

FFC researchers were responsible for compiling the check list and subsequently visiting the municipalities.

Prior to the visits municipalities were given some idea of the FFC mandate, the programme envisaged and the officials with whom it would be useful to have discussions.

In general, half a day was set aside for discussions with key municipal staff, in most cases these were the CEO, the City or Town Treasurer (or designated substitute), the head of planning and/ or engineering and the City or Town Secretary.[28]

[26] *Refer to Table 7-1 which lists the municipalities in the sample.*
[27] *It should be noted that due to the nature of the program, requiring researchers to visit municipalities is a time-consuming process and FFC staff available for such visits are limited resulting in the program having to be spread out over a few months. Thus at the time of compiling this interim report only a portion of the municipalities have been visited.*
[28] *All targeted municipalities' mayors were informed about the program but were not asked to attend the meetings. However, in a number of cases, the mayors or chairpersons of councils and councillors also attended meetings.*

Prior to the visits as much information as was available on each jurisdiction was collected and analysed by the FFC. The national Department of Finance was helpful in supplying summary budget information for individual municipalities. In addition, many jurisdictions provided budgets, financial statements and other information prior to being visited.

- **The Check List (Questionnaire)**

The discussion items in the form of a check list are divided into two general categories, namely, socio-economic and demographic information and data. These items are directly related to the objectives of the Programme, namely, in the short-run to access primary information and data from municipalities which will enable the FFC to begin to comply with its constitutional mandate on local government, and on an on-going basis to establish a relationship with municipalities.[29]

The financial data include issues such as:

- budgets for 1996/97 and financial statements for 1995/96 (audited or unaudited);
- of particular interest are items such as administrative and personnel expenditures, main revenue sources, state of property taxation across the jurisdiction, tax and tariff rates (and rebates, exemptions and differentials);
- the state of borrowings;
- receipts of grants, subsidies and transfers from other governments;
- capital versus operating expenditure; and
- compliance rates.

The non-financial data include:

- geographic parameters of the municipal jurisdiction, i.e., what is the extent of the jurisdiction, the current constituent parts, the former constituent parts and location in or contiguity with magisterial districts;
- range of services and standard of services provided to different communities;
- privatised services;
- agency services provided or received;
- consumption levels by sectors of trading services;
- personnel numbers per remuneration category;
- demographic profile;
- number of households;
- numbers of dwellings by type;
- income levels (household and/or *per capita*);
- unemployment rate;
- general human capacity issues within the administration;
- financial implications for the new jurisdictions;
- financial and other relationships with provinces, national departments (Health, Finance Constitutional Development and CSS), and related municipalities (MCs with MLC, DCs with LCs and DCs with RCs and LACs); and
- financial and service implications for the municipality if a restructured electricity industry absorbs electricity surpluses.

7.3 **Preliminary Findings**

[29] *This Program has contributed towards giving the FFC an understanding of what type of information and data are required to enable it to fulfil its role of making recommendations on the transfer of resources from national revenues and the national government. This has also assisted the task team which has been involved in compiling the two questionnaires for the local government censuses.*

To reiterate, the FFC Programme of visiting a sample of municipalities is to date only partly complete. It is thus inappropriate to draw even tentative conclusions about any of the matters which relate to the objectives of the programme. However, with this position in mind, it is possible to highlight some of the themes or inclinations which may be developing.

- Budgets:

  Due to the recent changes in municipal jurisdictions and the first all-inclusive elections at local government level there was a decision by the FFC that the 1996/97 budgets would form the base year. Any time-series comparisons prior to this fiscal year would not be consistent.

  Although the budgets for local government run from July to June and there are also set time-frames for the submission of budgets to the national Department of Finance (end July 1996 for the 1996/97 fiscal year) not all budgets were available at the time of visiting. This would appear to be due largely to the late elections in some areas, jurisdictional changes and capacity problems.

  In a jurisdiction like the Cape MC and its related MLCs the former two factors seem to be the prime reason for the delay in budgets being compiled in terms of normal schedules.

  In other jurisdictions where municipalities have been "created" anew a contributing factor for incomplete budgets is one of capacity. In some of these jurisdictions it would appear that lack of capacity would be a long-term factor and that if seen as such the structures of local government require reviewing.

  Although there is a general uniformity in the way budgets are presented there would appear to be scope for making them less cumbersome and easier to analyse across jurisdictions. This statement is not intended to detract in any way from the work done by the IMTA and other institutions to develop certain commonalties but seeks to highlight the requirement of the new Constitution for budgets to subscribe to national prescriptions.

- Financial Statements

  Financial statements, being *post facto*, are available (if so) for the 1995/96 fiscal year only. Although these documents are useful for gaining insights into a range of issues, they relate to a fiscal year which precedes the base year and thus the current jurisdictions. As argued above, this factor limits their usefulness for assessing any matters over time.

- The Revenue Budget

  Particular interest and discussion has centred around the major revenue sources of municipalities. There have been no surprises here: in general the most important (in terms of yield) are assessment rates (rates on property), surpluses on the trading of electricity and water and sewerage.

  There are large variations amongst individual municipalities (in terms of a range of factors, not just revenue sources) and it is thus inappropriate to treat municipalities in terms of an aggregated solution or view. It is regarded as an important feature of local government that local differences and preferences should be recognised and accommodated to the fullest extent possible. A view different to this one undermines the democratic principle of responsive government being closest to the people.

  It is possible to venture some findings and opinions on a number of revenue source issues:

  i. Property rates.

The current state of property taxation is characterised by the following. (a) Only certain sectors of the urban jurisdictions have been subject to property taxation and to a large extent this is still the case. (b) Where property taxation has not been imposed before there are generally plans afoot to include all properties on valuation role in urban areas. (c) Where property taxation has been imposed previously there is very little consistency in dates of last valuation, rates imposed, deductions, exemptions and sectoral rate differentiation. (d) The Constitution provides for all municipalities to impose rates on property, which includes rural jurisdictions to impose a rural version of property taxation, namely, "land taxation". This matter is still in the jurisdiction of the Commission of Inquiry into certain aspects of the Tax Structure in South Africa. It is the position of the FFC, as submitted to the above-mentioned commission, that all government jurisdictions are required to exploit effectively all the revenue sources at their disposal, which would include a rural "land tax". (e) Last, but certainly not least, is the matter of ability to pay and subsidisation in the context of property taxation.

For those municipal jurisdictions which are able to impose property tax at present (MLCs and LCs, for example) many, if not most, seem to use this revenue source as a budget-balancing item. The procedure seems to be as follows: (a) A calculation is made of the budgeted (desired) expenditure (within the parameters set by the national Department of Finance), followed by the calculation of the aggregate revenue sources' yield, excluding property taxation. (b) The difference between budgeted expenditure and revenue estimation is the amount which property taxation should yield. (c) In the absence of a revised valuation role the property tax rate is then set at that level which will yield the desired revenue to ensure a "balanced budget". Where the budget cannot be balanced due to the magnitude of the rate increase required, it seems as if other revenues are increased or the budgeted expenditures are decreased.

It would seem that there needs to be a systematic appraisal of property taxation, both within the context of local government and the overall tax regime. The commission investigating tax matters referred to above has not researched this tax, although there have been other investigations by other institutions, such as the former Permanent Finance Liaison Committee (PFLC) which was chaired by the national Department of Finance. The FFC has committed itself to undertaking a comprehensive study of property taxation and will complete this during the course of 1998.

ii. Surpluses on the supply of electricity.

In aggregate, the surplus on electricity is the largest source of revenue for local government, although the inter-municipal range is considerable.[30]

The experience and insights gained so far include the following:

- There is no uniformity amongst municipalities in terms of revenues generated, sources of bulk purchasing, reticulation, metering systems, size of electricity departments and administrative capacity, tariffs and rebates and the role of utilities in service provision. For this reason cross-jurisdictional comparisons are not only difficult but offer little value.
- In aggregate, and for most individual municipalities, any loss of revenues from electricity distribution and/or reticulation, without a concomitant alternative source, would cripple the institution of local government. In addition, if the alternative source of revenue is not offset by a reduction in the consumer cost of electricity then the aggregate tax-cost to consumers would be higher by as much as 40% in some areas.[31]
- There would be administrative and human capacity implications for municipal administration in general if the electricity departments were closed or moved out from their control. The reasons for these consequences are that in many cases the electricity departments of municipalities are

[30] Figures released by the national Department of Finance indicate that the gross yield from this source is in the order of 40% of total revenues. From a small sample of budgets reviewed by the FFC the net yield (profit) on electricity is considerably smaller, around 10% for larger municipalities.

[31] There are a number of permutations to the problems and possible solutions. The investigations by the Electricity Regulator into a range of electricity and related matters is going to pay particular attention to the issues of municipal revenues derived form electricity.

relatively large with considerable technical capacity and they also perform functions for other departments.

There is clearly a considerable range of issues that need to be addressed with regard to the electricity industry as a whole. As mentioned, there has been a Cabinet decision to institute a dedicated research programme on the matter. It is the FFC's view that until this programme has been completed it would be senseless for the FFC to pre-empt its work or findings.

iii. Surpluses on the supply of water.

Like electricity, water provision is a trading service which earns surpluses for municipalities. In relative terms the surplus on water is on average about the fourth largest revenue source.

There is a wide range with regard to water supply, revenues generated, levels of service, service providers and tariffs. The outstanding characteristic, as was the case for electricity supply, is the lack of uniformity in almost every feature of this service. For the FFC, and other institutions, the inability to make credible cross-jurisdictional comparisons is a severe impediment to designing an intergovernmental fiscal system.

iv. Other services.

Services, such as sanitation (sewerage and solid waste removal) are generally the fourth or fifth largest in terms of gross revenues generated.

Solid waste removal has become the primary service for "privatisation" or "outsourcing". This activity is labour intensive and there appear to be numerous benefits to "outsourcing"

Another outstanding feature of local government service provision is the range of services which are provided and their related revenue generating or absorbing characteristics. In some jurisdictions which have LC status the LC itself provides few services and at low standards. In the larger LCs and of course the metropolitan councils the range of services is enormous, from all of the "basic services" to sport and recreation facilities, municipal police forces, public transport services (bus and train), electric power stations and libraries.

7.4 **Further Work**

The FFC realises that this research certainly does not cover all the matters related to local government finances. Most of the work done thus far has been around revenue issues. Further work needs to be carried out on expenditure issues, both operating and capital budgets, and related matters. This will be done in due course, when all the data from the sample has been collated and analysed.

Acknowledgements

*The FFC recognises that it is only one of a gamut of institutions which inundates municipalities with requests for meetings and information. Despite this additional burden on local government, the co-operation and assistance which the FFC received from the vast majority of municipalities is **sincerely acknowledged and appreciated**. This, in essence, is the practice of co-operative governance. The few municipalities that have not been co-operative have certainly not undermined the general spirit which has prevailed.*

Table 7-1: *Sample of municipalities identified for visits by the FFC*

Municipality	Province	Visited or Pending
[2]	[3]	[5]
Germiston LC	Gauteng	13/1196
Eastern Gauteng Services Council (DC)	Gauteng	05/12/96
Greater Cullinan LC	Gauteng	09/12/96
Pretoria City Council MLC	Gauteng	13/12/96
Centurion Town Council MLC	Gauteng	17/12/97
Westonaria LC	Gauteng	14/01/97
Akasia Town Council MLC	Gauteng	15/01/97
Western Gauteng Services Council	Gauteng	16/01/97
Greater Pretoria MC	Gauteng	27/01/97
Port Shepstone LC	KwaZulu-Natal	28/01/97
Ugu Regional Council (DC)	KwaZulu-Natal	28/01/97
Mzinyathi Regional Council	KwaZulu-Natal	29/01/97
Hattingspruit LC	KwaZulu-Natal	29/01/97
Indlovu RC	KwaZulu-Natal	30/01/97
Ulundi LC	KwaZulu-Natal	31/01/97
Zululand RC	KwaZulu-Natal	31/01/97
Uthungulu	KwaZulu-Natal	03/02/97
Inyala/Mathubatuba	KwaZulu-Natal	04/02/97
Pietermaritzburg	KwaZulu-Natal	04/02/97
Durban Metropolitan Council & Six Metro Local Councils	KwaZulu-Natal	June 1997
City of Cape Town	Western Cape	10/02/97
Kuils River	Western Cape	11/02/97
Helderberg	Western Cape	11/02/97
Blaauberg	Western Cape	12/02/97
Constantia	Western Cape	12/02/97
Tygerberg	Western Cape	13/02/97
Cape Town Metro	Western Cape	13/02/97
Bree River	Western Cape	24/02/97
Prince Alfred Hamlet	Western Cape	24/02/97
Clanwillaim	Western Cape	24/02/97
West Coast	Western Cape	24/02/97
Robertson	Western Cape	25/02/97
Overberg	Western Cape	25/02/97
Winelands	Western Cape	25/02/97
Paarl	Western Cape	25/02/97
Caledon	Western Cape	26/02/97
Franschoek	Western Cape	26/02/97
Southern Cape	Western Cape	27/02/97
George	Western Cape	27/02/97
Bloemfontein LC	Free State	P
Bloemfontein DC	Free State	P
Harrismith LC	Free State	P
Eastern Free State DC	Free State	P
Bothville LC	Free State	P
Gold Fields DC	Free State	P

Villiers LC	Free State	P
Northern Free State DC	Free State	P
Bethlehem LC	Free State	P
Port Elizabeth LC	Eastern Cape	P
Western Region DC	Eastern Cape	P
Port St Johns LC	Eastern Cape	P
Kei DC	Eastern Cape	P
Middelburg LC		P
Stormberg DC	Eastern Cape	P
Lady Grey LC	Eastern Cape	P
Drakensberg DC	Eastern Cape	P
Pietersburg/Polokwane LC	Northern Prov	P
Northern DC	Northern Prov	P
Nylstroom LC	Northern Prov	P
Bushveld DC	Northern Prov	P
Ellisras LC	Northern Prov	P
Thohoyandou LC	Northern Prov	P
Kimberly LC	Northern Cape	P
Diamantveld DC	Northern Cape	P
Garies LC	Northern Cape	P
Namaqualand DC	Northern Cape	P
Port Nolloth LC	Northern Cape	P
Hannover LC	Northern Cape	P
Upper Karoo DC	Northern Cape	P
Kakamas LC	Northern Cape	P
Lower Orange DC	Northern Cape	P
Nelspruit LC	Mpumalanga	P
Lowveld & Escarpment DC	Mpumalanga	P
Dullstroom LC	Mpumalanga	P
Highveld DC	Mpumalanga	P
Standerton LC	Mpumalanga	P
Eastvaal DC	Mpumalanga	P
Balfour/Siyathemba LC	Mpumalanga	P
Mmabatho LC	North West	P
Central Region DC	North West	P
Ventersdorp LC	North West	P
WestVaal DC	North West	P
Vryburg LC	North West	P
Huhudi DC	North West	P
Hartebeesfontein LC	North West	P
Eastern Region DC	North West	P

LOCAL GOVERNMENT IN A SYSTEM OF
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IN SOUTH AFRICA

A Discussion Document
Prepared and Issued by the Financial and Fiscal Commission

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