FINANCIAL AND FISCAL COMMISSION

POLICY BRIEF

1/2013

Rural municipalities struggle to maximise their limited tax base - Current own revenues insufficient to support service delivery mandates in rural municipalities

EXECUTIVE SUMMARY

The high levels of poverty and unemployment, and low levels of economic activity affect the ability of rural municipalities to fulfil their service delivery mandates. Compared to their urban counterparts, rural municipalities generate and collect low levels of revenue. This is because rural municipalities have a much weaker property rates tax base and collect about half of the potential rates revenue. Low levels of economic activity and demographic factors explain the limited tax base in rural areas, while social issues and high levels of income inequalities affect a municipality's ability to collect revenues. To ensure the successful development of rural economies will require a concerted effort from all spheres of government. National and provincial governments should help weaker rural municipalities to improve their revenue and expenditure performance. Grant funding needs to be linked to capacity-building initiatives, so that municipalities can improve their ability to collect revenues and their quality of spending. In the long term, rural municipalities should explore greater collaboration with district municipalities and neighbouring local municipalities to pool resources and to share best practices.

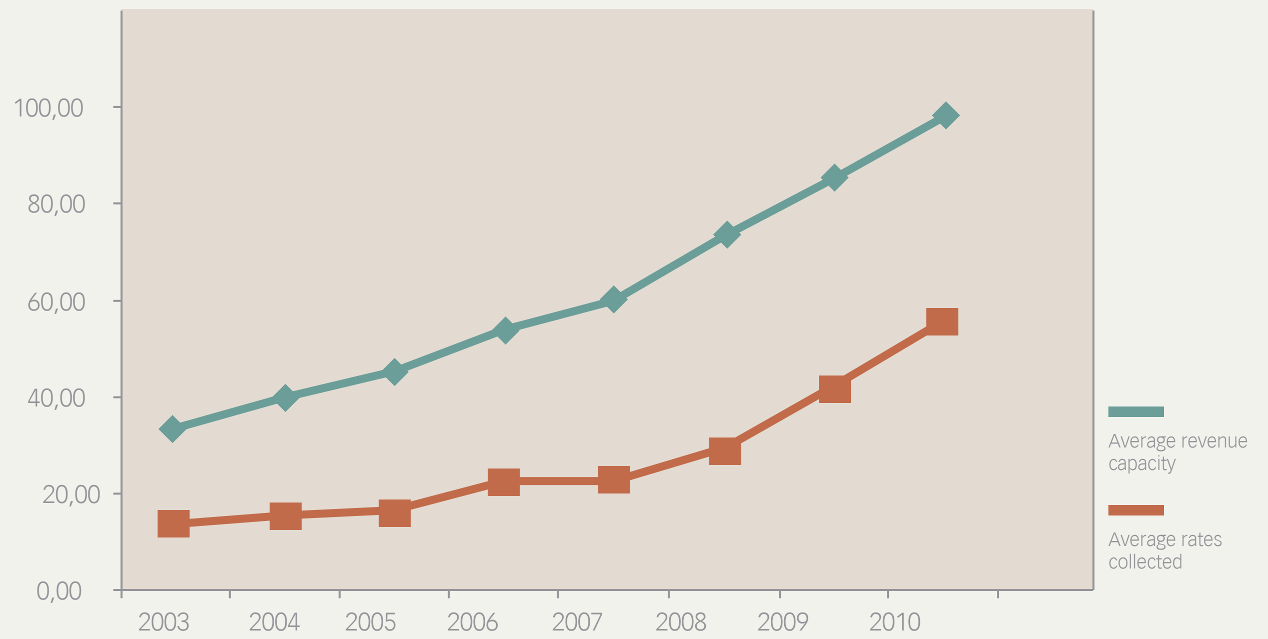
BACKGROUND

South African society is characterised by high social and economic inequalities, especially between urban and rural areas. Rural areas have high levels of poverty and unemployment and low levels of economic activity, which can affect the ability of municipalities to fulfil their service delivery mandates. Compared to their urban counterparts, rural municipalities generate/collect low levels of revenue, but the primary driver is difficult to explain. It could be because of structural problems (i.e. limited or non-existent tax bases) or administrative problems (i.e. weak revenue effort – poor performance in collecting revenues owed to the municipality). A study[1] by the Financial and Fiscal Commission (the Commission) examined the dynamics of the rural municipal tax base and the financial viability of rural municipalities.[1]

FINDINGS

Figure 1 shows the municipalities' revenue capacity (i.e. the ability to generate revenues from the rural property rates base) and their effectiveness in collecting the property rates.

Figure 1: Property Rates Revenue Capacity versus Actual Property Rates Collected (2003–2010)



Source: The Commission's Calculations

During 2003–2010, revenue collected from property rates was much lower than the potential revenue. In 2010/11, rural municipalities collected only R56 out of a potential R99 per person, or just over half the potential revenue. Although performance has improved since 2003, rural municipalities still collect far less than the predicted property rates revenue.

[1] For the full study, see Mahabir, J and Vacu, N. 2013. Understanding the dynamics of rural tax bases and its influencing factors, Chapter 7 in Financial and Fiscal Commission (2013). 2014/15 Submission for the Division of Revenue Technical Report, Midrand, South Africa.

The property rates tax base is much weaker in rural areas than in urban areas. For example, in 2003/04 metros collected on average R647 per person compared to the potential to generate R34 per person in rural municipalities. This is the metros' revenue effort (not capacity) for property rates. To emphasise, in 2009 the average revenue effort of metros was R1,075 per person, whereas the average revenue potential of rural municipalities was R85 per person. The rural tax base for property rates is clearly constrained relative to urban areas.

Local economic activity and demographic factors determine a municipality's ability to generate revenues (revenue capacity – the blue line in Figure 1); for instance, the proportion of people over the age of 65, who benefit from property tax rebates because they cannot afford to pay, and unemployment levels. Certain factors have a positive impact on revenue capacity, such as proximity to urban areas, specific economic activities and a coastline. However, overall the tax base in rural areas is limited due to the low levels of economic activity, especially in deep-lying rural areas.

Social issues affect a rural municipality's effectiveness in collecting revenue (revenue effort – the red line in Figure 1). Revenue collection is better in areas where residents have higher levels of disposable income, indicating that people who can afford to pay are willing to pay for property rates. Municipalities with high levels of income inequalities among their communities have a lower ability to collect revenues due. This is likely due to social issues that result in local communities not being willing to pay taxes and services or municipalities using richer households to cover for debt not paid by poor households.

Interestingly, municipalities with higher levels of traditional households have a lower ability to collect revenues due. However, this is not a statistically robust finding, which is surprising, given the complexities of traditional leadership in respect to revenue collection in these areas. The other factors described above appear to be more significant in explaining revenue effort. Another interesting variable is the local government equitable share (LES) allocations to rural municipalities. A positive and significant relationship was found between the LES allocations and revenue effort in collecting property rates. One explanation could be that municipalities are using this funding to improve their billing and collection efforts.

CONCLUSION

The fundamental factor constraining rural tax bases is depressed economic activity. In addition, rural municipalities use their limited existing revenue base inefficiently, collecting only half the potential revenue. A concerted effort is required from all spheres of government to ensure the successful development of rural economies.

With respect to **developing rural revenue capacity**, the Commission recommends that:

In the short term:

- National and provincial governments support weaker rural municipalities to ensure improved revenue and expenditure outcomes. This should be done through:
  - Improved assistance in formulating and implementing budgets, IDPs, LED, debtor management and credit control policies.
  - More effective capacity-building initiatives, which deal holistically with governance, systems and business processes, as well as recruitment, retention and the development of requisite skills.
- National and provincial governments ensure that grant funding to rural municipalities is linked to capacity-building initiatives and structured assistance, so that systems are built to improve the municipality's ability to collect revenues due and increase the quality of spending.
- Municipalities ensure that revenue-enhancement strategies are sensitive to broader constraints, such as inequality, unemployment, local politics and land tenure issues so that revenue effort is maximised.

In the long term:

- Given the skills and resource shortages in rural areas, municipalities explore greater collaboration with district municipalities, neighbouring local municipalities and provinces to pool resources in order to ensure greater regional planning and investments. Where rural municipalities are adjacent to better performing municipalities, best practice methods should be shared through peer learning arrangements among municipalities.

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