Financial and Fiscal Commission Options Analysis Report

25th May 2012

Executive Summary

Introduction

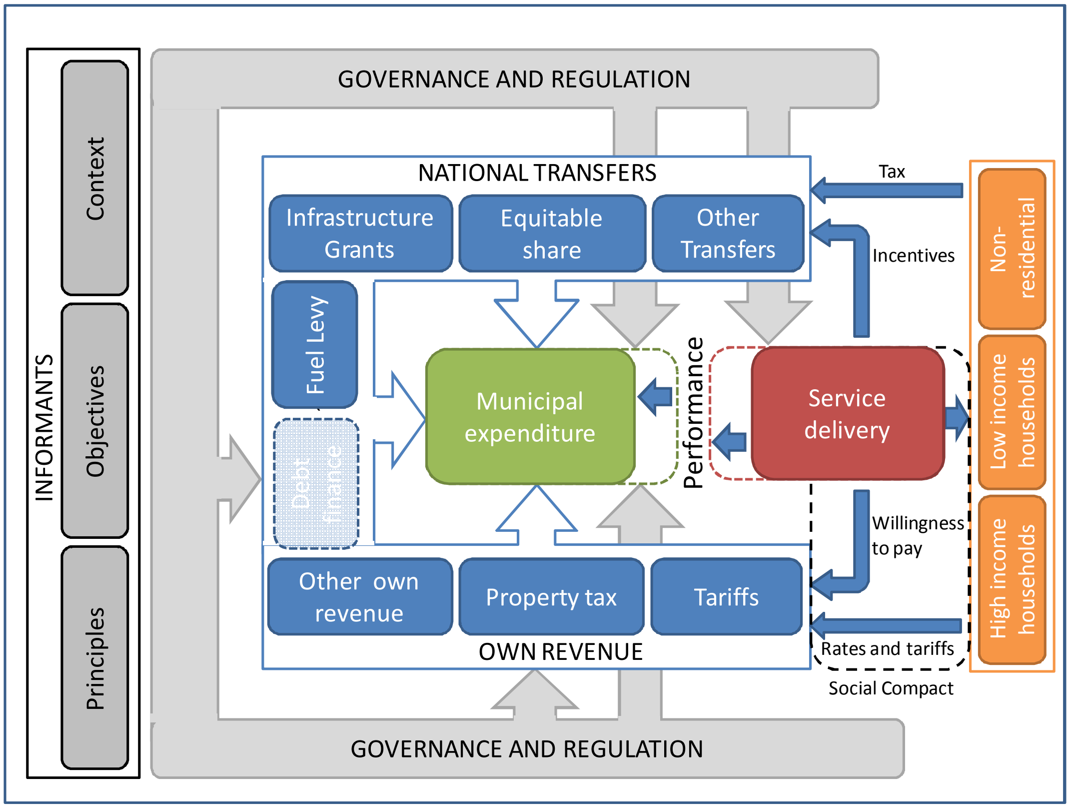
Local Government Fiscal Framework (LGFF) lies at the heart of the local government sector. It needs to cater for the needs of municipalities with the ultimate aim of ensuring that consumers of municipal services get universal access to good quality services at a reasonable price, with provision for free basic services to the poor. At the same time it needs to be dynamic enough to account for changes within the sector and to meet current challenges and policy priorities, including those associated with economic development. To better understand these issues and to explore more effective and efficient alternatives, the Commission released a draft problem statement on the financing of municipalities and the requirements of the LGFF. The problem statement document originated at public hearings on the LGFF held on 3rd and 4th October 2011.

This document follows on the problem statement, providing an analysis of options for improving the effectiveness of the LGFF. It is intended to serve as a discussion document at a second round of public hearings to be held 4th and 5th June 2012.

In facilitating the public hearings on the LGFF, the FFC recognises the current initiative of National Treasury and DCoG to review the LGFF and it is understood that this document, and the discussions at the hearings, may serve as information to be used in this initiative.

Defining the LGFF

There have been various definitions or 'structures' for the LGFF in the past. Given the current priorities of Government, these have been reviewed and a new structure for the LGFF is proposed as illustrated in the diagram below:



The structure provides for the basic requirement of balancing expenditure and revenue in municipalities but also places emphasis on the informants of the LGFF, the regulatory and governance framework, incentives to improve performance while minimising costs and on the role of consumers as the ultimate beneficiaries of the municipal service and the funders of the municipality which serves them.

Municipal context

Consumers and their experience of services

In considering the 'consumers' of municipal services, the LGFF needs to respond to the social mandate of providing services to poor households and the economic mandate of providing services to high income households and the enterprises which rely on municipal services to function and hence drive economic development. Yet there is still much to be done in this regard: 6.5% of people to not have access to basic water supply, 19% to basic sanitation and 27% to electricity. But the challenge is greater than that reflected through these figures: the functionality of this infrastructure is a concern, particularly in rural areas; in many situations it is dysfunctional, meaning, for example, that while a household may have a tap within 200 metres of their dwelling, there is often no water in the tap.

Local government institutional and organisational aspects

The current structure of local government, with two tiers outside the metros, has been in place for a decade but it is not yet functional. Perhaps the biggest concern is the role of district municipalities with arguments that those districts which have major service provision responsibilities are ineffective in providing these services, and provide poor value for the funding they receive from the national fiscus. Those that do not have major service obligations are faced with a similar the criticism that they do not deliver value for money, considering the high level of their overheads. New models for two tier local government are being considered with changes likely to bring greater efficiency.

The governance and management arrangements for municipalities are another concern which is receiving increasing publicity. Although there are some shortcomings in metros and secondary cities, the biggest problem exists in smaller municipalities and primarily those serving mostly rural areas. The lack of skills to manage infrastructure is particularly severe in these areas. Capacity building efforts to improve this situation have not had notable success and new initiatives are needed. The establishment of the Municipal Infrastructure Support Agency (MISA) is one such initiative, but it has limited committed funding and cannot cover the cost of a capacity building initiative of a scale which is needed.

Partnerships with other organisations: public entities, private sector and civil society represent an important way to improve service delivery. However, there are rather ambiguous views about the commitment to involving the private sector in this work and community based organisations are underutilised. National public entities are, however, fully engaged with municipalities, with Eskom being the biggest player both because of its role as a suppler of bulk electricity and because it is a distributor of electricity to some 40% of electrified households in the country. Water boards are next in line, providing some 50% of the bulk water in the country; and PRASA plays a central role in terms of providing commuter rail service in metro areas increasingly integrated with municipal road-based transport systems.

Regulation of municipal performance

A functional system of local government requires a sound regulatory structure in order to ensure that municipalities meet their service provision obligations. This applies to governance and administration, service provision (individual sectors) and financial arrangements. Current regulatory arrangements with regard to service provision are highly variable in terms of their impact: DWA has a relatively engaged relationship with local government, with access to information from most municipalities which are water service authorities. DoT, on the other hand, plays virtually no role with regard to municipal roads and nationally consistent information on these roads is generally poor.

Aside from the obvious benefit that regulation brings in terms of improving service provision, it also provides information on the performance of municipalities which is a key component to any financial intervention which relates to performance, including funding for capacity building and possible incentive based transfers.

Services and governance benchmarking

Benchmarking – the sharing of information relating to municipal performance - has an important part to play in promoting efficiency in the way services are provided, a goal shared with the LGFF. There have been substantial efforts to promote benchmarking in the water services sector and the Municipal Demarcation Board undertakes a 'capacity' survey at regular intervals which has provided useful information. But much remains to be done if benchmarking is to live up to its potential as an important influence over the performance of municipalities.

Summary: the state of local government

Overall, the picture which emerges is one of highly variable performance of municipalities combined with highly variable performance of the organisations which support and regulate local government. At the one extreme metros and secondary cities are relatively functional, with some exceptions. At the other extreme there are many smaller and more rural municipalities which are performing poorly and not delivering services effectively to the consumers they are supposed to serve. While demarcation may have led to financially unviable municipalities, the difficulty of making changes to established municipalities at local level are recognised.

Further, the importance of fiscal measures in improving performance need to be recognised and this reaffirms the critical linkage between the LGFF, municipal context and non-fiscal measures to improve performance.

Finally, the role of national departments in supporting local government needs to be acknowledged with these concerns raised at the LGFF hearings:

- Intergovernmental coordination is failing resulting in inefficiencies and unfunded mandates.
- Slow progress on policies (e.g. housing accreditation, transport and the failure to restructure the electricity distribution industry) creates uncertainty and expenditure pressure.

Local Government financial context

The LGFF as it exists at present

While it may not exist currently as a framework which is recognised as such by all stakeholders and described in a single document to guide these stakeholders, the LGFF does exist, largely in the form of a set of transfers and the policies which guide them. In a sense the Division of Revenue Act, and the documents which are published annually as part of the Division of Revenue Bill, represent the LGFF. The need for a review is recognised, with National Treasury currently participating with DCoG in a combined initiative to do this. This FFC initiative is seen to be complementary to the NT/DCoG initiative.

Revenue and expenditure patterns

The many analyses of revenue and expenditure patterns which have been done over the last few years place strong emphasis on the high degree of variability across the spectrum from metro to 'mostly rural' local municipalities. At the one extreme –metros and secondary cities – the data illustrates the full range of services which are provided by these municipalities and a relatively low level of expenditure on GAPD expenditure. At the other, local municipalities serving mostly rural areas, (with their district partners, which are typically assigned service provision obligations) spend a large proportion of their budgets on GAPD. It is difficult be very specific on the extent to which expenditure is undertaken efficiently, due to lack of data, the strong indication is of inefficient expenditure in the more rural municipalities (B4s) and, to a lesser extent, smaller municipalities serving small towns and commercial farming areas (B3s).

With regard to revenue the picture below shows the high degree of dependency on transfers in mostly rural areas (65% for local municipalities and 75% for their district municipality partners).

On the capital account, all municipalities are heavily reliant on transfers but with metros and secondary cities also having the ability to finance half of their own capital requirements through debt finance, use of reserves and other 'own sources' of capital. At the other extreme, mostly rural municipalities rely on transfers from the national fiscus to fund 80% of their capital expenditure.

Expenditure and expenditure trends

The costs of municipal services, both with respect to operating and capital costs, are strongly dependent on the package of services which need to be provided. This, in turn, governs the basis upon which transfers are made to cover specific costs either wholly or partially. At the one extreme, metros typically provide a full package of municipal services and are faced with escalating expenditure on housing and public transport as they take on more responsibility for these services. At the other, a rural local municipality typically does not provide electricity (done by Eskom) or water and sanitation services (done by the district) with roads and municipal public services being rudimentary.

Trends with regard to operating costs is a big concern currently, primarily because those municipalities which provide electricity are faced with rapidly increasing bulk electricity costs. Bulk water costs are also escalating, driven primarily by increases in the cost of raw water. Metros and secondary cities also have to cope with 'unfunded mandates' to provide primary health care, libraries and housing related services. Furthermore, metros are taking on increasing costs associated with public transport.

With regard to capital costs, overall expenditure is increasing rapidly to construct both new infrastructure and rehabilitate existing infrastructure, which has reached the end of its useful life. The former is driven mainly by economic growth and by the need to provide services to households who are currently not adequately served. The requirement for rehabilitation expenditure, related to the condition of assets, is building, driven partly by poor maintenance or historical neglect of rehabilitation. Capital expenditure trends are also influenced by the need to service increasingly remote areas (most notably in rural areas), by political and consumer demands for higher service levels and increasing construction costs.

Revenue sources

Considering 'own sources' of operating revenue, these are primarily property rates and tariffs. These revenue sources are becoming relatively well understood and well practiced by most municipalities. Nonetheless, smaller municipalities still face problems and districts face a special problem in that several of them do not have functional billing systems. Then there is a significant gap in the property rates system in rural areas with communal tenure, as property rates to not apply in these situations. This largely explains the low property rates revenue figure for mostly rural (B4) municipalities. Looking at trends, larger municipalities have historically generated surpluses on their electricity, water and sanitation trading accounts, which has allowed them to cover some of the municipality's 'general' expenditure from this source. These surpluses are facing new limitation partly due to regulatory measures (electricity specifically), and partly due to affordability constraints, as consumers of electricity and water are facing high increases in tariffs which have a significant impact on household budgets.

Capital finance position

As noted above, municipalities finance their capital through transfers (mainly infrastructure grants), use of reserves, debt finance, developer charges and other minor sources. Structurally the existing LGFF is set up for own source finance to cover a substantial part of capital expenditure even in the most economically underdeveloped municipalities[1]. However, although there is an upward trend in use of debt finance in metros and secondary cities, there are very low levels of borrowing in the remainder of

[1] Grant funding is generally intended to be targeted at infrastructure for the poor and not all consumers in a municipality are poor.

municipalities, leading to a structural gap in the system. There is not nearly enough finance to close the capital finance gap, as discussed below.

Assessing the 'fiscal gap'

The 'fiscal gap' can be seen both from a 'structural' point of view: what it is with a properly functioning municipality, and an 'actual' point of view: what the municipality actually spends less the money it raises itself, before transfers are applied. This can be applied to both the operating and capital account.

The '*structural fiscal gap*[2]' is an important concept for the LGFF as it defines a 'target' for applying transfers in an attempt to close this gap. It can be defined as the difference between the costs incurred in providing services at a reasonable level of expenditure, for a properly managed service, less the revenue raised from 'own sources.' This assumes that all the revenue due to the municipality is raised at appropriate levels from all consumers who are not eligible for free basic services. The revenue in this case is referred to as '*fiscal capacity*'. On the capital account the 'structural fiscal gap' can be referred to as the difference between the costs of providing an adequate package of services to consumers, taking national standards into consideration, less the finance which the municipality can raise from 'own sources,' assuming that it makes the best possible effort to raise this finance.

The '*actual fiscal gap*', on the other hand is based on whatever the municipality spends less the amount of revenue it actually raises. It is therefore associated with a certain level of '*fiscal effort*' which may be less than that associated with the best possible effort.

A quantitative estimate the structural fiscal gap is a necessary part of the LGFF. This needs to take the differentiated nature of municipalities into account. Currently the best available estimates of this gap come from the financial analysis undertaken as part of the Municipal Infrastructure Investment Framework (MIIF). This analysis provides estimates of the structural fiscal gap on both the operating and capital account.

The gap after the application of existing transfers

Using the MIIF analysis on the operating account, the indication is that the fiscal gap can be closed with the current system of transfers aimed at the operating account (the local government equitable share (LGES)). This implies that the LGES is functioning as a gap filling measure taking the structural fiscal gap into consideration. This assessment has been confirmed in the case of metros through recent work done for them: they are under pressure on their operating accounts but can manage this and the problems they are having with raising sufficient capital. In the case of municipalities at the other end of the spectrum, mostly rural (B4) municipalities and their district partners, there is a consistent call for more LGES funding, but almost always this call is from a situation where fiscal effort is well below what it should be. No evidence based research using sound financial modelling has been located to suggest that the LGES is not sufficient.

With regard to the capital account the situation is completely different: the grant arrangements do not close the structural fiscal gap and all categories of municipality are facing shortages of capital, which is hindering them in removing backlogs with service provision and in rehabilitating aging infrastructure.

Summary of the problem statement with respect to the financial aspects of the LGFF

[2] Definitions still to be checked against those on FFC documentation.

Informed by the LGFF problem statement hearings and the above analysis the problem statement with respect to the LGFF is summarised as follows:

a) Differentiation and the horizontal division: the hearings placed considerable emphasis on the problems of responding to a differentiation, the different concepts for differentiation and the way this impacted on the horizontal division of transfers.

b) Fiscal capacity: the importance of fiscal capacity is recognised but the measurements of actual fiscal capacity are inadequate.

c) Attention is focused on new infrastructure rather than maintenance and rehabilitation of exiting infrastructure.

d) Performance and capacity: the lack of incentives to improve performance in the LGFF is leads to lowered impacts of transfers. Inadequate attention to capacity building meant that one option for improving performance was underutilised.

e) Access to data: The lack of data hampers the effectiveness of the LGFF

f) Equitable Share: while it is recognised that the LES is adequate to fill the fiscal gap on the operating account, there are problems with the way it is calculated.

g) Other transfers: the plethora of conditional grants is problematic, with some needing to be removed and some reconsidered such as fuel levy sharing.

Review of the LGFF: structure, objectives and options

In reviewing the LGFF, the context described above is a key informant, as are the objectives and principles which provide a basis for the framework.

Expanding on the objectives of the LGFF

The following objectives of the LGFF are put forward for discussion:

a) Ensuring access to basic services for all South Africans.

b) Promoting performance of municipalities in terms of quality and cost of service.

c) Ensuring the financial viability of municipalities.

d) Promoting quality of life through functional and efficient human settlements.

e) Promoting economic development.

f) Promoting environmental sustainability.

Principles to be applied

A set of principles have also been identified, based on previous LGFF initiatives, with the most important ones listed below:

a) Equity in the way resources are allocated to benefit the poor.

b) Efficiency.

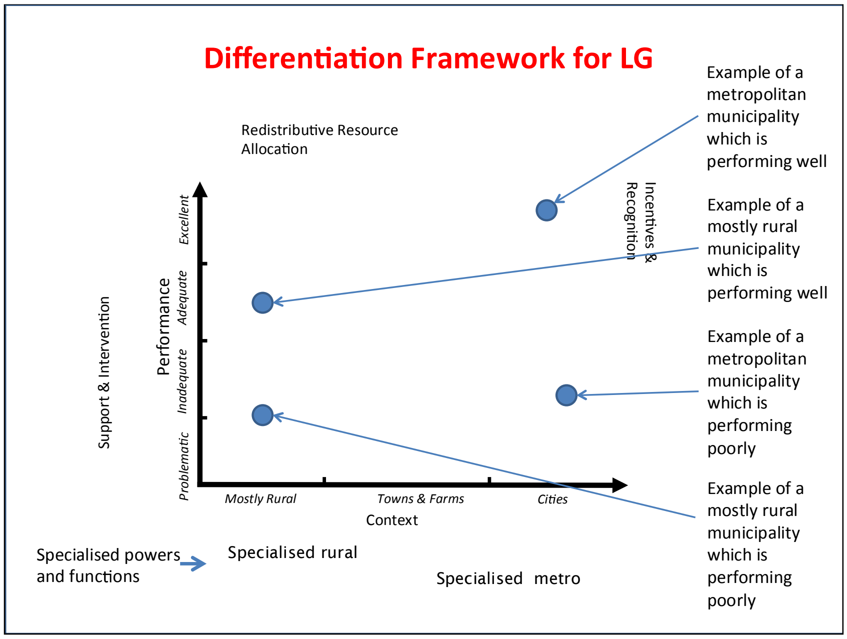
c) Avoidance of spill-over effects.

d) Facilitating democracy.

e) Transparency.

System for differentiation

In designing a revised LGFF, consideration needs to be taken of the high degree of variability which exists across municipalities, in terms of their economic, social and spatial contexts and in terms of their performance. There is new thinking in this regard which is reflected on the structure shown on the diagram below, which forms the basis of a DCoG differentiation system.



The diagram illustrates the spectrum of contexts on the horizonal axis and the spectrum of performance on the vertical axis. The way powers and functions and redistributive resource allocation happens is demonstrated horizontally and the way support, intervention and perfromance based incentives happen is shown vertically. Looking at the arrangement vertically there is an important implication for the LGFF: as performance increases the financial resources which could possibly be allocated to a municipalities differentiatlly shift from support (typically capacity building) towards incentive based allocaitons.

The vertical structure of the differention framework also guides the nature of interventions as follows:

- Problematic municipalities are faced with legal interventions.
- Those with inadequate performance receive 'hands-on' support which is largely imposed on them.
- In the case of adequate performance the emphasis is on more hands-off support and advice.
- Where the municipality's performance is 'excellent' the emphasis is on oversight and regulation.

Integrating objectives into an overall structure of the LGFF

Taking the objectives and principles of the LGFF into consideration and informed by the existing municipal services context, there are a range of options for a high level conceptual structure for the LGFF. This requires debate but, in order to inform such debate two options are proposed which represent substantially different approaches:

- *A gap-filling approach with an emphasis on transfers*. This option is veru simlar to the one which has existed in past years in South Africa where the emphasis is on the design of transfers to fill gaps in expenditure in a municipality as a whole or in specific systems.

- *A performance-based approach with an emphasis on incentives.* This option requires a mix of interventions or activities including the support for good governance and management, consumer action through a 'social compact', regulation, benchmarking and incentive-based transfers.

These two options inform the instruments which are the 'nuts and bolts' of the LGFF and are dealt with below.

An assessment of the instruments which make up the LGFF

A range if instruments are considered in the main report. They are summarised in the table below with a tentative attempt to assess their applicability in relation to the two main conceptual options. There are also instances where the application of a particular instrument should be mandatory. This table is intended only as a set of ideas to inform discussion.

Instrument	**Notes**	**Impact**	**Difficulty**	**Priority for inclusion in a revised LGFF (1 is highest priority)**		
				Man-datory	**Gap filling**	**Perf based**
Non-fiscal instruments associated with improving service delivery	While it is an informant of the LGFF, the LGFF also substantially influences municipal performance with respect to service provision. Perhaps this is not an 'instrument' but a fundamental part of any LGFF.	High	High (involves many stake-holders).	Y		
Operating expenditure regulation and incentive measures	Main activities, using potential benefit as a criterion, are cost benchmarking and regulation of bulk service providers.	High	Moderate (some of this is there already)		5	2
Incentives associated with capital expenditure	Includes investment planning to assess affordability of service and service levels, project scale regulation and benchmarking.	High (SA is short of capital finance and costs are 'out of control')	Moderate (requires new way of working by munis)			2
Regulation of own source operating revenue	Tariff and property rates regulation.	Moderate	Easy (mostly in place but not water tariffs)	Y		
Debt finance regulation	Primarily controlled through MFMA and NT regulations. Indicators are an important element.	Moderate	Low (mostly in place).	Y		
LGES (formula based).	The current formula with reforms to the way each window is calculated and the secondary vertical split	High	Low (data exists, just change to		1	2

Instrument	Notes	Impact	Difficulty	Priority for inclusion in a revised LGFF (1 is highest priority)		
				Man-datory	Gap filling	Perf based
	between LMs and DMs .		calcs)			
Operating grants associated with the LGES	RSC levy replacement and new councillor remuneration grant.	Moderate (impact mainly on C1 districts)	Low (requires change to formulae but will be resistance from districts).		2	3
Incentive window to LGES formula or new incentive grant	Consistent with the differentiation framework an incentive is required to reward performance. Detail design not yet available but could be part of ES (new window) or separate grant or part of MIG.	High	High (new concept to be 'sold' politically)		0	5
MIG	MIG formula and calculations require review. Recommendations made in 2009. Include incentive based option.	Moderate (biggest need is for more funding)	Low (change formula and calcs)		2	3
Other infrastructure grants	Require reform to avoid continued fragmentation	Moderate (will shift horizontal division; total quantum of grants remains biggest issue)	Moderate (requires engage-ment with national depts.		2	3
Possible new debt finance mechanisms	Includes bond pooling, MIF proposals, gearing arrangements etc.	High	High		1	1
Transfers aimed at capacity building	Consistent with the differentiation framework, there is a requirement to fund large scale capacity building initiatives focused on under-performing municipalities. Current arrangements poorly targeted.	High (high multiplier effect)	Moderate (design of mech-anism to be finalised and budget obtained).		3	1
Fiscal interventions with environmental objectives	Review of demand side interventions and water conservation incentives required. New arrangements to be considered.	Moderate (some up and down side for municipal account)	Moderate		3	2
Fuel levy sharing	Policy as currently applied has been questioned but no proposals are available	Moderate (metros only)	Low (easy to change)		5	2

Instrument	Notes	Impact	Difficulty	Priority for inclusion in a revised LGFF (1 is highest priority)		
				Man-datory	Gap filling	Perf based
	for making changes at present.					
New local business tax	Strong motivation from metros and SALGA for new tax.	Moderate (benefits for cities mainly)	High (requires new systems etc)		2	4

Summary of options (integration)

Having the benefit of the individual instruments assessment with a suggestion as to how they fit with the two options, the options are compared in the table below:

Criteria for comparison	Primary emphasis on gap filling	Primary emphasis on performance
Overall financial impact	Higher draw on national budget, less service delivery per Rand of funding transferred.	Potentially large gains in terms of promoting improved service delivery, decrease in costs and increase in revenue to municipalities. Capital requirements reduced due to greater efficiency, better incentives and lower rehabilitation expenditure.
Overall political and organisational impact	Limited change; politically saleable as it has a pro-poor 'feel' to it. Limited improvement in organisational performance of municipalities.	Requires a change in thinking, considerable organisational effort and inter-governmental coordination. But potential for big gain in organisational efficiency of municipalities.
Environmental impact	Small	Potentially substantial.
Economic impact	Limited change to what is happening currently. Stronger draw on the national fiscus.	As the focus is on improved services per unit of payment made for the service this has a significant impact on improved performance of businesses. Potential to stimulate debt finance market and draw in other private partners to municipal service provision.
Cost of implementation (systems etc)	Low cost as this builds on existing arrangements.	Relatively high cost to provide new systems and build a belief in a different approach.
Cost to national fiscus in terms of transfers	Not focused on incentive for municipalities to perform hence emphasis moves towards arguments for unconditional transfers. This is relatively high cost in relation to performance based approach.	Important benefit in that is reduces the call on the national budget for the same impact in terms of service delivery.
Cost to municipalities	Limited change in relation to what is happening now.	Increase in expenditure on systems but higher gains in terms of cost efficiency. Increased revenue. More efficient use of capital.

Making it happen: regulatory and administrative interventions

It is not possible to be specific about institutional interventions without knowing what will happen in terms of the LGFF options discussed above. The emphasis of this report remains on assessing options. However, there are some things which are necessary under any LGFF option.

Regulatory structures

The emphasis here is on performance regulation with the following interventions proposed for discussion:

a) Greater coordinating effort with DCoG having a central role to play.

b) Strong intervention mechanisms for 'problematic' municipalities including a willingness to remove control over equitable share funding from the municipality.

c) Much greater role of national sector departments, with DoT requiring most attention.

d) Continuing role for NT on financial regulation with increased integration of financial data into other systems.

e) Coordinating structure for information flowing from municipalities is required.

Powers and functions

While the 'performance based' option may imply a marginally more emphasis on devolution of functions, this is really a requirement under all options with the objective of improving accountability and integrating expenditure and revenue efforts at metro or local municipality level. Districts need to have a much reduced mandate both to promote effectiveness and to allow better targeting of transfers to them.

Public entities

There is all-too-often a conflictual relationship between municipalities and the public entities with serve them or provide municipal services to consumers on their behalf. This is partly associated with bulk tariffs which need to have greater scrutiny, particularly in the case of water where regulatory arrangements are underdeveloped. But there also needs to be an improved commitment at the highest level for public entities to be more cooperative.

Central decision-making on application of LGFF instruments including transfers

The proliferation of transfers over the last five years is a matter of concern and it is argued that there needs to be better coordination in the way these transfers are designed and integrated into the LGFF.