Sustaining Municipal Finance: Making Local Government Work

For an Equitable Sharing of National Revenue

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Foreword

The fiscal challenges facing the local government sphere are not new: fundamental inherent flaws have existed ever since the sphere was officially established in 1998. In 2011, the Financial and Fiscal Commission (the Commission) hosted a series of public hearings on the Local Government Fiscal Framework (LGFF), as part of its focus on disseminating research and engaging with stakeholders. The aim was to ascertain the challenges facing the LGFF from the perspective of a wide range of stakeholders. This was the first time that the Commission had held public hearings of this nature and is an innovative contribution to the current local government debate. Public hearings are seldom held to discuss technical issues such as the LGFF, despite the LGFF's far-reaching consequences for service delivery at local level and financial sustainability of municipalities across the country. By bringing together representatives from all government spheres and a range of other critical stakeholders, the Commission has gained a more nuanced understanding not only of the problems within the LGFF, but also the underlying drivers. This understanding, validated by stakeholder input, together with the research and data gaps identified in the public hearing process, will help shape the Commission's local government research agenda going forward.

This Report is a summary of the problem statement, processes and feedback that emanated from the public hearings. It also highlights the principles and research gaps in the system that will inform an appropriate response from the Commission and a second set of public hearings.

It is my view that recent protests emanate from, among others, the slow pace of service delivery, which highlights the urgency of this process and the need to ensure the proper funding of municipalities in the country. All stakeholders must make a concerted effort to ensure a proper functioning local government sphere.

As the Acting Chairperson and Chief Executive Officer of the Financial and Fiscal Commission, I wish to thank all the participants in this initiative for their enduring commitment to the local government cause and unbridled dedication in solving the challenges facing this important sphere. In particular, I would like to thank the Limpopo Provincial Treasury officials and their MEC for their support in hosting the hearings and the members of the Portfolio Committee on Department of Cooperative Governance for their contribution. I hope that all your thoughts, insights and perspectives are appropriately captured in this document. I would also like to thank my fellow Commissioners for their support and dedication in ensuring the reputation of the Commission is maintained and enhanced. Lastly, I would like to convey a very special thanks to the administrators and researchers of the Secretariat of the Commission for their efforts in ensuring that this process was, and will continue to be, a success.

Dated in Midrand on this 31st day of January 2012

Bongani Khumalo (Mr)
Acting Chairperson/CE

Acronyms

DBSA	Development Bank of Southern Africa
DCOG	Department of Cooperative Governance
DOR	Division of Revenue
EDI	Electricity Distribution Industry
FBS	Free Basic Services
GAPD	Governance, Administration, Planning and Development
IDP	Integrated Development Plan
IGFR	Intergovernmental Fiscal Relations
IGR	Intergovernmental Relations
INEP	Integrated National Electrification Programme
LBT	Local Business Tax
LES	Local Government Equitable Share
LGFF	Local Government Fiscal Framework
MDB	Municipal Demarcation Board
MFPFA	Municipal Fiscal Powers and Functions Act
MIG	Municipal Infrastructure Grant
MPRA	Municipal Property Rates Act
MSA	Municipal Systems Act
NERSA	National Energy Regulator of South Africa
RRP	Research and Recommendations Programme
RSC	Regional Service Council
SALGA	South African Local Government Association
SOEs	State Owned Enterprises

Executive Summary

As municipal service delivery failures become more apparent, numerous service delivery protests by communities are plaguing the local government sphere and could threaten the social and political wellbeing of the country. One of the challenges afflicting service delivery is the general perception that the current structure of the Local Government Fiscal Framework (LGFF) results in inappropriate funding of certain municipalities. The LGFF lies at the heart of the local government sector and needs to be flexible enough to cater for the needs of municipalities and dynamic enough to account for changes within the sector and to meet current challenges and policy priorities.

The differences among municipalities affect the LGFF, as the ability of municipalities to generate their own revenue varies markedly. Urban municipalities (represented by the metros and secondary cities) have greater levels of economic activity, employment and a 'richer' demographic profile, which means that they are able to collect more own revenues. In contrast, poor, mainly rural municipalities are characterised by high levels of unemployment and poverty and low levels of economic activities, making them more dependent on grants from National Government. In addition to revenues, the expenditure functions and powers assigned to different types of municipalities vary, with metros and secondary cities having greater decision-making powers for planning housing and transport infrastructure.

Municipalities fund their expenditure responsibilities using own revenues, supplemented by intergovernmental transfers from National Government and private financing via credit markets. Local government revenues consist of own sources, such as property rates, user charges (e.g. for water), unconditional grants, conditional grants and municipal borrowing. The major unconditional grant is the equitable share transfer, which distributes the pooled local government equitable share (LES) across municipalities using a formula based on demographic, poverty and service delivery characteristics. The initial formula operated from 1998 to 2004 but contained several flaws. After a review, the current formula was adopted from the 2005/06 financial year. In addition to unconditional grants, municipalities receive conditional grants, which are destined to a specific purpose. They are usually divided into infrastructure-related grants and capacity building-related grants. Lastly, municipalities are legally authorised to borrow from credit markets.

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 draft problem statement was presented for discussion at a public hearing, which was held on 3 and 4 October 2011 at the Protea Hotel Ranch Resort, Polokwane, Limpopo Province and attended by 75 stakeholders from across the three spheres of government and the country. This is just one mechanism that the Commission has at its disposal to execute its mandate, with the aim of contributing to the mainstream policy debate. Submissions from a broad range of stakeholders (including the three spheres of government) on the draft problem statement are included in this final document.

Dimension of the problem

The main issues affecting the financing of the local government sphere are: differences among municipalities, in their revenue-raising ability as well as their expenditure responsibilities (especially related to infrastructure investment); the LES formula, in particular whether it takes sufficiently into account municipalities' different levels of expenditure and revenue; and the effect of increased transfers to local government on municipal own-revenue effort (for instance, the LES's share of nationally raised revenue has been growing faster year on year relative to national and provincial government's share).

Stakeholders recognised that municipalities have different underlying characteristics, including spatial factors, population density, topography, level and type of economic activity and historical redress. Therefore, **a differentiated approach is needed for municipal funding**, either based on a continuum (as is currently the case with the LES formula) or across groups based on criteria such as capacity or performance. What also needs to be taken into account is the different cost of providing services in urban areas compared to rural areas.

A review of the horizontal and vertical divisions of revenue is required, especially in light of the decline in own-revenue funding of local government expenditure. Withdrawn own-revenue instruments (e.g. RSC levies) were replaced by alternatives not under the control of municipalities. Examples were given of small rural municipalities that receive clean audits (hence have reliable financial data) and make every effort to collect revenues due to them, and yet they do not have a sustainable revenue base to meet basic service delivery demands in their jurisdiction.

All stakeholders agreed on the inadequacy of using 2001 census data to calculate the current LES. **Updated census-quality data is essential** for planning, as substantial demographic change takes place within a decade. This view concurs with the concerns raised by the Commission, especially as it is no longer possible to generalise that rural areas are poor and urban areas are rich.

In line with some of the concerns raised by the Commission in 2009, stakeholders argued for a **review of the LES formula component,** to address the lack of clarity and transparency over the data used and the allocation to different municipalities. In particular, when allocating LES funding equity in funding is prioritised over equity in level of service, and yet the minimum cost of service delivery could differ markedly across municipalities, which affects the actual level of services delivered. Stakeholders described the current basis on which funds are distributed as inadequate, in need of revision and linking to social sector data. The LES formula also needs to take into account service backlogs that perpetuate apartheid planning, the funding of services such as roads and street lighting and social and community services (instead of just municipal health).

Conditional grants are used to address backlogs and repair existing municipal infrastructure. However, stakeholders explained that **working with a plethora of conditional grants is administratively intensive**, and prevents municipalities from proper capital budgeting and from having collateral to pledge when borrowing. One suggestion made was to consolidate grants in the form of the Municipal Infrastructure Grant (MIG). If necessary, capacity support should accompany conditional grant allocations, so long as local government is part of setting the agenda. Also, major capital investments should not be made without ensuring that operations are running efficiently. Some stakeholders proposed monitoring and rewarding the performance of conditional grants and including incentive-based measures in the LGFF, although others felt that this would increase the already heavy administrative burden on municipalities.

Stakeholders agreed that a sustainable local revenue base with local accountability is critical. However, **financial constraints in both urban and rural areas must be evaluated fairly**, as urban areas may have a larger rates base than rural municipalities to draw upon but also face a difficult trade-off between economic development and social infrastructure. What is important is to **review the sources of own revenue and their regulation**. An alternative is needed to the RSC replacement grant, which was described as not sustainable; a local business tax was one suggestion. Some stakeholders felt that own-revenue sources are overregulated, while others pointed out that municipal own revenues have legislative constraints and regulation prevents abuse of tax payers. Also highlighted was the challenge of the **lack of a social compact over service delivery**, as shown by organised rates boycotts by the rich and service delivery protests by the poor. Municipalities need to ensure greater community consultation and participation, although the problem of having to provide services to the poor (consumers who are not creditworthy) was also mentioned.

Municipal planning, operations and reporting are frustrated by fragmented funding and a lack of coordination among other spheres of government, regulators and state-owned enterprises. A particular problem is the limited municipal control over the setting of electricity and water tariffs, which account for a large percentage of most municipalities' operating revenue. Therefore, any **review of the LGFF should be informed by a review of the institutional framework**, which would include looking at sharing of powers and functions across the three spheres of government and the role of district municipalities. **Municipalities are facing increasing cost pressures**, arising from poorly managed intergovernmental relations and policy uncertainties. Functions and assets are often devolved from provinces to municipalities without a clear understanding of the cost implications, and the cost of infrastructure projects do not always include repairs and maintenance cost. Municipalities also face other expenditure pressures over which they have little control, e.g. migration from rural to urban areas and the failure of government departments to pay municipal debts. The central focus has become compliance rather than service delivery and governance. This has had a crippling effect on smaller municipalities, in particular in rural areas, as compliance requires significant resources in addition to other day-to-day operational commitments.

Principles guiding the Commission's response

In 2000, the National Treasury identified four central policy objectives for the intergovernmental transfer system and seven additional policy objectives/principles. Input from stakeholders indicated that, while some of the principles had been satisfactorily adhered to, much less progress has been made on others. The Commission highlights the need to focus on not only the equity and efficiency of grant allocations but also grant incomes and their development impact. Therefore, in framing its recommendations on the problem statement, the Commission will take into account the following considerations:

1. A better understanding of the dynamic between fiscal capacity and fiscal effort needs to inform any revision of the fiscal framework.
2. A LGFF should ensure that incentives created in the IGFR system are compatible with policy intent.

3. Mindful of the three re-demarcation stages undertaken by the Municipal Demarcation Board (MDB), the fiscal criteria for re-demarcation should be clarified when demarcating municipalities.
4. The design of a new LGFF must be predicated on a clear understanding of the redistributive and growth-enhancing roles of local government.
5. The Commission supports the core dimensions of the LES design as an unconditional grant. However, the adequacy of the LES allocations must be reassessed in relation to powers and functions, expenditure needs, cost disabilities and revenue capacity of municipalities, and a revised LES must be aligned with the broader developmental role of local government, over and above the basic constitutional assignment of functions.
6. Local government is embedded within whole-of-government performance.
7. Conditional grants are supposed to trigger behaviour change in order to engender outcomes, implying performance measurement.
8. The focus should be on the linkages between urban and rural areas within functional economic regions rather than categorisation into rural and urban municipalities.
9. All elements of the LGFF should be transparent to all stakeholders, including the elements of the formula and underlying variables for distributing LES allocations as well as conditional grants.
10. Backlogs should be taken into account explicitly in determining the LGFF, coupled with closer link between capital grant funding and operational funding in relation to maintenance and rehabilitation.

Research Gaps

The public hearing identified areas that require thorough and systematic research. The research gaps identified are not exhaustive but warrant further investigation.

1. Develop a rigorous costing framework for basic services in municipalities that will also enable tariffs to be set that ensure sustainable delivery of services.
2. Define, contrast and measure fiscal capacity and fiscal effort in the context of the South African local government sector, as they are important in the design and implementation of the LGFF.
3. Evaluate the efficacy, efficiency and fairness of the fuel levy, in order to design an instrument that conforms to the basic principles of a good local tax.
4. Establish the extent to which fiscal sustainability is considered part of the demarcation criteria and the impact of demarcation on the intergovernmental transfer system, and the viability and fiscal sustainability of municipalities.
5. Assess the technical and allocative efficiency of municipalities in using municipal resources, to ensure that public funds are not wasted and that the welfare of the poorest of the poor is enhanced. (The Commission has already developed some suitable methodology in this area.)
6. Review the entire tariff setting regulatory framework in the local government sector and among utilities that supply services to the sector, with a view to making tariff setting transparent, cost reflective, cost effective, equitable and ensuring sustainable service provision.
7. Evaluate the capacity of municipalities to do property evaluations and the methods used, with the aim of providing guidelines on how to value properties.
8. Look at existing criteria and principles underpinning different methodologies used to classify municipalities, in order to design objective criteria and principles for differentiating municipalities.

9. Examine the lending and borrowing value chain, in light of the massive infrastructure requirements and limited own revenues for many municipalities, looking at how municipalities can access private and quasi-public capital.
10. Investigate the best funding models and incentive instruments to encourage investment in infrastructure maintenance and rehabilitation.
11. Define performance, establish objective criteria for measuring performance and recommend a system of rewarding performance within the local government sector.
12. Identify local government data gaps and their implications, and identify ways of bridging data deficits.

These areas fit well within the Commission's five-year research strategy, which emphasises "the impact of the intergovernmental system and the allocation of public funds on service delivery outputs and community development". Priority will be given to areas in which the Research and Recommendation Programme is conducting research or has developed some methodologies. The possibilities of joint research with other institutions, for example with the Municipal Demarcations Board, are also being explored. The Department of Cooperative Government, the National Treasury, SALGA, the Development Bank of South Africa, NERSA and other key stakeholders will also be engaged in responding to the challenges identified in this problem statement.

Based on the principles articulated in this document, the Commission will identify an initial set of policy options and recommendations which will be considered at a second public hearing. It is hoped that this research will help precipitate urgent action by policy-makers to respond to vulnerable municipalities in fiscal distress and to sustain improvements in extending access to and quality of basic services. The structuring of the LGFF lies at the very heart of the constitutional vision of developmental local government and the day-to-day quality of life of ordinary South African citizens.

Chapter 1: Introduction

1.1 Rationale for the Public Hearings

The Financial and Fiscal Commission (the Commission) has a legislative mandate to make recommendations on financial and fiscal matters across all three spheres of government in terms of Section 214(1) of the Constitution, the Financial and Fiscal Commission Act of 1997, the Intergovernmental Fiscal Relations Act of 1997, and the Money Bills Amendment Procedure and Related Matters Act of 2009). In terms of the Financial and Fiscal Commission Act 99 of 1997, the Commission held a special public hearing on the financing of municipalities and requirements of the Local Government Fiscal Framework (LGFF) on 3 and 4 October 2011, at the Protea Hotel Ranch Resort, Polokwane, Limpopo Province.

The local government sphere is dynamic and continuously evolving. Therefore, the fiscal framework that finances the sphere must be equally flexible to cater for the needs of municipalities. National government, in particular the National Treasury and the Department of Cooperative Governance (DCOG) constantly review the LGFF, which is defined in the Money Bills Amendment Procedure and Related Matters Act of 2009 as the aggregate revenue arrangement or funding framework of local government relative to the aggregate expenditure mandates and responsibilities of the sphere. Related to this, the National Treasury and DCOG have proposed a Summit to review the intergovernmental fiscal system in 2012. The Commission has agreed to play an active role in these discussions while at the same time running its own processes, thereby maintaining its objectivity and role as an independent player in the general IGFR arena. The Commission's process should therefore be considered as complementary to Government initiatives. Participating actively in these debates falls within the Commission's constitutional role as an advisory body. The Commission is thus assisting the overall policy debate environment and better serving the needs and requirements of all its stakeholders.

1.2 Process

The hearing process followed in this project is intended to stimulate public debate on policy options across key stakeholder groups. It also aims to create momentum for changes to the LGFF, by using the Commission's powers and profile more fully.

The objective of the public hearings was to discuss a draft problem statement document, which the Commission released in order to strengthen analysis of the challenges at hand. In considering the stakeholders' perspectives on the challenges in the LGFF, the Commission has arrived at a final problem statement, which is presented in this document. In addition, the report outlines the principles, which will guide the Commission's response, and the areas identified for future research.

The Commission will then produce a draft report, containing an initial set of policy options and recommendations, which will be considered at a second public hearing. Thereafter, the Commission will finalise the technical report, which will inform a structured research agenda and provide policy options for the issues raised based on sound research. In so doing, the report will contribute meaningfully to the debate on the LGFF.

1.3 Why This Project Is Important

As part of a system of cooperative governance, the Constitution provides for the establishment, expenditure responsibilities and funding framework of local government. To fund these expenditure responsibilities, municipalities command an array of fiscal instruments assigned in terms of section 229 of the Constitution. These include own revenues, or money that the municipality generates itself through property rates, user charges for municipal services rendered, surcharges on user charges and other local taxes. The own revenues are supplemented by intergovernmental transfers from National Government, to ensure that municipalities are able to fulfil service delivery obligations to communities and to meet national policy goals and priorities. These transfers are in the form of unconditional and conditional grants: unconditional grants may be used at the discretion of the recipient provincial government or municipality (the primary unconditional grant is the equitable share grant, which gives the provincial government or municipality its share of the nationally collected revenue), whereas conditional grants may only be used for specific purposes as set out by the transferring department. Other legislation (such as the Municipal Finance Management Act of 2003) also enables municipalities to leverage private financing via credit markets. These various revenue instruments form the general fiscal framework of local government.

There is a general perception among stakeholders that the current structure of the LGFF results in certain municipalities not being funded appropriately. However, it is the Commission's view that concerns about the LGFF have the potential to detract attention from non-fiscal issues, such as capacity constraints and weak accountability systems, which result in municipal failures. Nevertheless, as the context of local government changes, the LGFF needs to evolve continuously; its design must be dynamic enough to account for the changes in local government while ensuring that current challenges and policy priorities are funded so their constitutional mandates can be fulfilled.

As municipal service delivery failures become more apparent to communities, numerous service delivery protests have plagued the local government sphere and could threaten the social and political wellbeing of the country. The recent local government elections reiterated such concerns and highlighted several fiscal and non-fiscal challenges facing municipalities. The Commission's problem statement details some of these challenges, including differences across municipalities, the local government equitable share (LES), conditional grants and municipal own revenues.

1.4 Objective

The objective of this report is to present the final problem statement, the Commission's formal statement that captures the Commission's understanding of challenges confronting the LGFF, having considered stakeholder input at the hearing in Limpopo. In addition, the report outlines the principles guiding the Commission's response and identifies areas requiring future research. This report also presents consolidated views expressed by stakeholders during the plenary and group discussions. The 75 stakeholders represented were drawn from Parliament, the three spheres of government, the South African Local Government Association (SALGA), the Public Service Commission and consultants (a full list can be found in Annexure 2). The LGFF draft problem statement, the stakeholder submissions and group feedback presentations are on the Commission's website (http://www.ffc.co.za/index.php/media-a-events-interactive/public-hearings.html).

Chapter 2: Problem Statement

This section identifies some of the key challenges confronting the local government sphere and the LGFF in particular. The purpose is to introduce debate around these and related issues, and to distinguish between the manifestations of these challenges and their underlying causes or drivers.

2.1 Differences across Municipalities

Section 155 of the Constitution establishes local government in South Africa by defining three types of municipalities:

i. Category A: A municipality that has exclusive municipal executive and legislative authority in its area.
ii. Category B: A municipality that shares municipal executive and legislative authority in its area with a category C municipality within whose area it falls.
iii. Category C: A municipality that has municipal executive and legislative authority in an area that includes more than one municipality.

Prior to 2000, South Africa contained 843 municipalities, which included several transitional councils in former homeland areas. In 2000, the country was re-demarcated into 284 wall-to-wall municipalities[1], followed in 2005 by a further demarcation process aimed at aligning district and local municipalities to a particular province. This resulted in a total of six category A (metros), 231 category B (local) and 46 category C (district) municipalities. Following the 2011 local government elections, a further amalgamation reduced the total to 278 municipalities and included two additional metros.

While a structured set of criteria informs the categorisation of municipalities in the Constitution and the demarcations processes, no other official categorisation of municipalities exists. Yet section 155(2) of the Constitution and the Municipal Systems Act (MSA) explicitly provide for a categorisation of municipalities in addition to the constitutional categorisation described above. Unofficial categorisations exist which are based on the different socio-economic, spatial or settlement patterns or on capability or performance (e.g. high or low capacity). The most popular categorisation in use expands the one in the Constitution by adding certain social and economic variables to emphasise the differences among municipalities (see Table 1).

Table 1 Social, economic and demographic differences across municipalities

[1] Historically municipalities in South Africa were centred around towns, and their borders did not extend significantly beyond the edge of those towns. Large, predominantly rural areas of the country effectively had no municipal-level of government. The Constitution requires that the local government sphere consists of municipalities established for the whole area of the country, introducing for the first time, wall-to-wall municipalities so that the full territory of the country is covered by municipalities.

Type of Municipality	Total population	Total households	Total gross value added per capita	% of people employed	% of households earning below R3200pm	Average population density	Operating expenditure per capita	Revenues from local taxes per capita
Metropolitan municipalties	16,974,424	4,714,021	75.67	34%	46%	1388	3,789.48	*3,279.51*
Secondary cities	8,233,208	2,207,004	50.80	29%	59%	221	2,242.55	*1,940.00*
Larger towns	3,985,216	1,074,513	40.83	27%	62%	87	1,843.08	*1,513.82*
Smaller towns	6,906,926	1,808,666	29.16	22%	69%	19	1,466.46	*988.70*
Rural municipalities	12,331,695	2,673,914	9.44	13%	80%	81	370.49	*120.77*
Total/average	**48,431,469**	**12,478,118**	**41.18**	**25%**	**63%**	**359**	**1,942.41**	**1,568.56**

Source 2007 Community Survey, 2009 Local Government Turnaround Strategy

Urban municipalities in the country (represented by the metros and secondary cities) have greater levels of economic activity, employment and a 'richer' demographic profile, which affect expenditure responsibilities, as shown by the higher per capita expenditure. Rural municipalities are characterised by high levels of unemployment and poverty and low levels of economic activities. Urban municipalities have denser settlements, while rural municipalities are relatively more sparsely populated. These differences have an impact on the minimum costs of providing services and suggest that these unique environments require unique planning decisions. The differences also affect the fiscal framework itself, as the ability of municipalities to generate their own revenues varies markedly, and certain municipalities are very dependent on transfers from National Government. Table 2 shows the funding mix across the various types of municipalities, highlighting these differences.

Table 2 Source of operating income across types of municipalities 2008/09

Type of Municipality	Government Grants	Property Rates	Service Charges	Investment Revenue	Other	Total
Metropolitan Municipalities	25%	18%	45%	3%	9%	**100%**
Secondary Cities	26%	14%	47%	3%	10%	**100%**
Larger Towns	27%	21%	40%	2%	10%	**100%**
Smaller Towns	37%	12%	36%	3%	12%	**100%**
Rural Municipalities	70%	6%	14%	3%	7%	**100%**
Districts without P&F	79%	0%	2%	8%	11%	**100%**
Districts without P&F	80%	0%	8%	4%	8%	**100%**
Total	**34%**	**15%**	**39%**	**3%**	**9%**	**100%**

Source National Treasury Local Government Database

The greater levels of economic activity and favourable demographic profiles of metros and urban municipalities clearly enhance their ability to generate own revenues. In 2008/09, local own revenues funded 75% of the operating budgets of metros and secondary cities, whereas rural municipalities and district municipalities depended heavily on grants. This dependency ranges from 70–80% and suggests that the ability to generate revenues in these areas is minimal.

In addition to revenues, the expenditure functions and powers assigned to different types of municipalities vary. Metros and secondary cities, which operate in the urban space, have greater decision-making powers for planning housing and transport infrastructure, to enhance the development and funding of the built environment.

Furthermore, it is argued that the MDB's current methodology for determining municipal boundaries results in the establishment of financially unviable municipalities. In other words, certain municipalities are demarcated around poor rural areas, which means that these administrations have a limited tax base and are over reliant on intergovernmental fiscal transfers to fund their operations. Such exogenous factors have an impact on the LGFF's performance in appropriately funding municipalities.

Issues for Discussion

Based on this preliminary analysis, the local government landscape is clearly diverse and the fiscal capacity of municipalities varies substantially. Urban municipalities are able to collect more own revenue because of higher levels of economic activity and richer households within their jurisdictions. However, poor, mainly rural municipalities are more dependent on grants to fund their expenditure responsibilities. In the context of the LGFF, the issues to consider are:

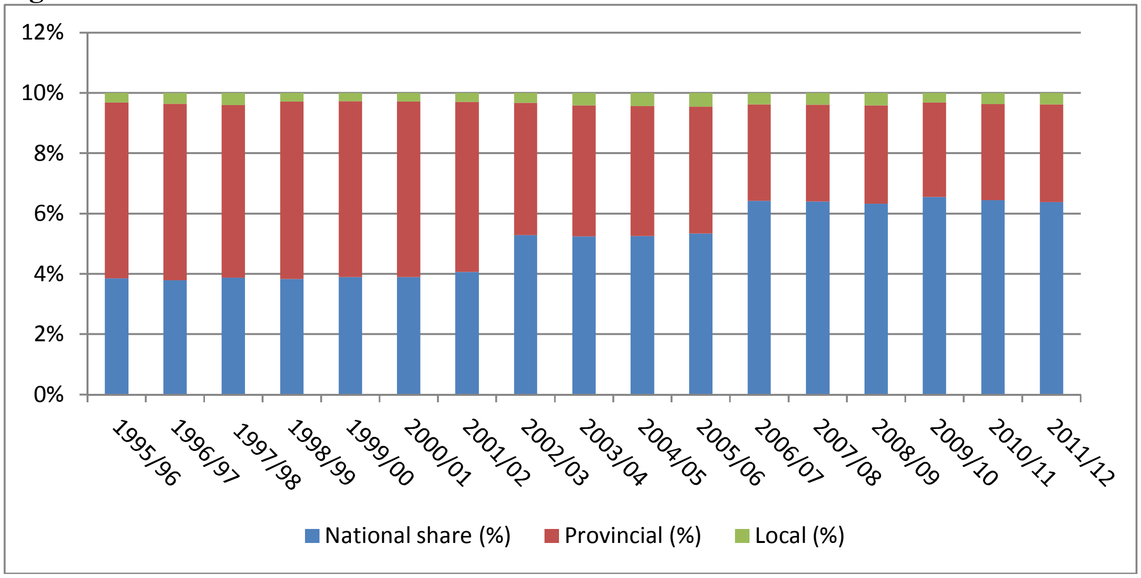
i. Should a more explicit differentiated approach to the funding of municipalities be adopted? Is there sufficient differentiation in the current system?
ii. Should urban municipalities be encouraged to maximise their own revenues and be given extended taxation powers to become largely self financing, in view of their better socio-demographic and economic situation?
iii. Should intergovernmental transfers play an equalisation role, by being directed mainly at rural municipalities without an economic base?
iv. How should the regulation and implementation of municipal taxes account for such differences?
v. How should grants account for the different expenditure needs across municipalities? How should the urban built environment be funded? Are the costs of services different in rural areas than in urban areas (and what about the semi-urban and semi-rural municipalities)?
vi. What funding mechanisms should be developed to ensure that urban municipalities can fund their increased responsibilities? The devolution of greater expenditure responsibilities (specifically for public transport and housing) to metros and other urban municipalities can enhance their capacity and ability to plan their built environment and promote integrated human settlements, but should be accompanied by appropriate funding mechanisms.

2.2 Local Government Equitable Share and Conditional Grants

Local government revenues consist of own local taxes such as property rates, user charges (e.g. for water and electricity), unconditional grants, conditional grants and municipal borrowing. The LES is the major unconditional grant that accrues to municipalities.

Figure 1 traces the share of nationally raised revenue across the three spheres of government since 1995/96. Across the spheres, the equitable share to local government is the smallest, which is due partly to the greater fiscal powers decentralised to the sphere. However, this share has been growing faster year on year relative to national and provincial government.

Figure 1 Vertical Division of Revenue 1995/06 – 2011/12



Source National Treasury

The total share of nationally collected revenue accruing to the local government sphere in the 'vertical division of revenue'[2] is further split among the individual municipalities in the 'horizontal division of revenue'[3] using a formula. The LES distributes the LES pool across municipalities using a formula based on demographic, poverty and service delivery characteristics. The initial formula operated from 1998 to 2004 but contained several flaws. Following a review process, the current formula was adopted from the 2005/06 municipal financial year and is depicted as follows:

$$\textbf{LES = BS + I + D – RRC ± C}$$

Where:	BS	=	Basic Services Component
	I	=	Institutional Component
	D	=	Development Component
	RRC	=	Revenue Raising Component
	C	=	Correction Component

The components of the formula are described briefly hereafter. A full description can be found in Annexure 4.

- Basic Service Component assists municipalities in providing basic services to poor households and in meeting municipal health service needs for all.
- Institutional Component assists municipalities in meeting administrative and governance requirements costs.
- Development Component is currently inactive.

[2] Vertical division of revenue is when the total pool of revenue is divided into national, provincial and local government share and is a political judgment.
[3] With horizontal division of revenue, formulae are used to split the amount available to provincial government among the individual provincial governments and the amount available to local government among the individual municipalities.

- Revenue-raising Component is aimed at achieving greater horizontal equity in the allocation system and acknowledges that smaller municipalities face revenue-raising constraints.
- Stabilisation, or Corrective, Component accounts for the guarantee mechanism applied that ensures consistency and predictability in allocation,s to support proper municipal planning and budgeting.

The Commission plays a significant role in developing and continually improving the formula. Following a review of the current formula in 2009, the Commission raised the following concerns:

i. Subsidies in the formula do not reflect the different cost pressures faced by municipalities.
ii. The LES should consider subsidising all services that are an expenditure pressure for municipalities.
iii. The current application of the RRC component is unconstitutional.
iv. Frequent data updates that track changes in demographics and service levels are lacking.
v. The R800 per month per household used to measure poverty is an arbitrary figure.
vi. Continued tinkering by government further complicates the distribution of resources across municipalities.

Electricity and water prices also affect the LGFF and local government's ability to provide services to communities. Eskom's recent electricity price hikes led to an increase in the cost of providing free basic electricity. Furthermore, municipalities are likely to absorb some of price increases, therefore diminishing their ability to cross subsidise services. Additional revenues generated from electricity sales are also squeezed, which could jeopardise municipal cash flow. To a lesser extent, these effects are likely to be mirrored in the prices of bulk water sold to municipalities.

Issues for Discussion

Taking into consideration the concerns raised by the Commission and stakeholders, the current formula raises the following questions:

i. Is the general structure of the formula aligned with theoretical and legal principles and reflective of National Government's policy priorities?
ii. Is the current formula technically effective at ensuring that the needs of the different types of municipalities are catered for?
iii. Does the current basket of municipal services funded through the formula fully reflect the constitutionally mandated basic services?
iv. Do the current subsidies reflect the costs of providing services, given the differences in the spatial, social and economic circumstances of municipalities across the country?
v. Does the current formula account sufficiently for the greater fiscal capacities and revenue-raising abilities of metros and other urban municipalities, so that the LES funds are equitably shared and distributed? Should the LES take into account the fiscal capacity of municipalities?
vi. How can the LES formula account for changes in service levels, demographics and migration patterns, given the lack of data at the local government level?

2.3 Conditional Grants

The Constitution allows other spheres of government to provide municipalities with grants (that have specific conditions) to enhance and promote national policy goals. These conditional grants are usually directed at infrastructure development and capacity building. The transfers can either go directly to the municipality or be an in-kind allocation to the municipality that will be spent on their behalf by a third party. Table 3 summarises the transfers to municipalities.

Table 3 Transfers to local government

R million	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
	Outcomes			Revised estimate	Medium-term estimates		
Direct Transfers	**38 483**	**45,487**	**51,538**	**61,152**	**70,171**	**77,029**	**82,317**
Equitable share	**20,676**	**25,568**	**23,845**	**30,559**	**34,108**	**37,573**	**39,960**
General fuel levy sharing with metros	**-**	**-**	**6,800**	**7,542**	**8,573**	**9,040**	**9,613**
Conditional grants	**17,807**	**19,927**	**20,893**	**23,052**	**27,490**	**30,416**	**32,743**
Infrastructure	16,290	18,562	18,812	20,972	25,596	28,642	30,774
Capacity building and other	1,517	1,365	2,081	2,080	1,894	1,774	1,969
Indirect transfers	**1,884**	**2,307**	**2,997**	**3,095**	**3,992**	**4,445**	**4,734**
Infrastructure	1,334	1,928	2,754	2,947	3,892	4,445	4,734
Capacity building and other	550	379	243	148	100	-	-
Total	**40,367**	**47,794**	**54,535**	**64,247**	**74,164**	**81,474**	**87,051**

Source 2011 DOR Bill

The Commission has undertaken several reviews of the intergovernmental transfer system and conditional grants to municipalities. Some of the concerns raised include:

i. The criteria used to allocate conditional grants should be more transparent.
ii. Infrastructure grants should be differentiated and cost reflective.
iii. Outcomes of conditional grants should be made explicit, and tracking improved via the collection of non-financial performance data.
iv. There should be better guiding principles for the introduction and termination of conditional grants, to prevent a continuous proliferation of grants and confusion over national policy objectives, to signal when the original objectives of a grant have been achieved, and to allow for an orderly exit strategy.

Issues for Discussion

The current intergovernmental transfer system, specifically related to conditional grants, raises the following questions:

i. Do conditional grants generally emerge as and when a priority arises? Is their design sufficiently rigorous?
ii. Is there an implicit or explicit link between conditional grants and the LES? Should such a link exist?
iii. Should conditional grants have a greater differentiation, in addition to the differentiated approach introduced for cities receiving the municipal infrastructure grant (MIG)?
iv. Is the performance of conditional grants being appropriately measured and evaluated? Should performance be a measure to determine grant allocations?

v. Should individual infrastructure grants to local government be consolidated under the MIG?

vi. What is the future of the Integrated National Electrification Programme (INEP) Grant for the eradication of backlogs, given the failed restructuring of the Electricity Distribution Industry (EDI)?

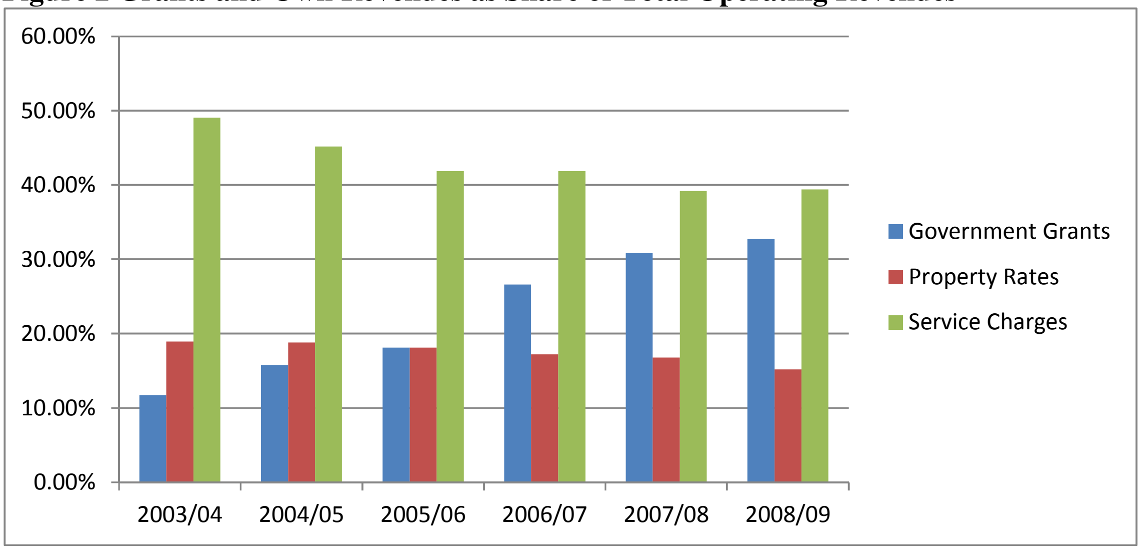
2.4 Municipal Own Revenues

Unlike provinces, municipalities have an array of revenue instruments, as set out in section 229 of the Constitution. The largest sources of own revenues are municipal user charges and property rates. Some developments and concerns pertaining to municipal own revenues are highlighted below.

Are Grants Crowding Out Municipal Own-Revenue Efforts

Transfers to local government, particularly in the form of the LES, have been increasing substantially over the years, as Figure 2 shows.

Figure 2 Grants and Own Revenues as Share of Total Operating Revenues



Source National Treasury Local Government Database

Figure 2 confirms that government grants (largely in the form of the LES) are funding a greater proportion of municipal operating budgets. Such a trend raises concerns that local government may be becoming more grant reliant, which may be eroding municipal efforts to maximise their own revenues.

Evolution of the Legislation Regulating Municipal Own Revenues

Supporting section 229 of the Constitution are several pieces of legislation that govern municipal own-revenue sources. The Municipal Property Rates Act (MPRA) of 2004 regulates local government's ability to impose property rates, while the Electricity Act of 1987 and the National Water Act of 1998 govern service charges and tariffs specific to the sector. The most recent legislation regulating municipal revenues is the Municipal Fiscal Powers and Functions Act (MFPFA) of 2007. This Act regulates all municipal taxes (excluding property rates), including a municipality's ability to apply a surcharge on a tariff.

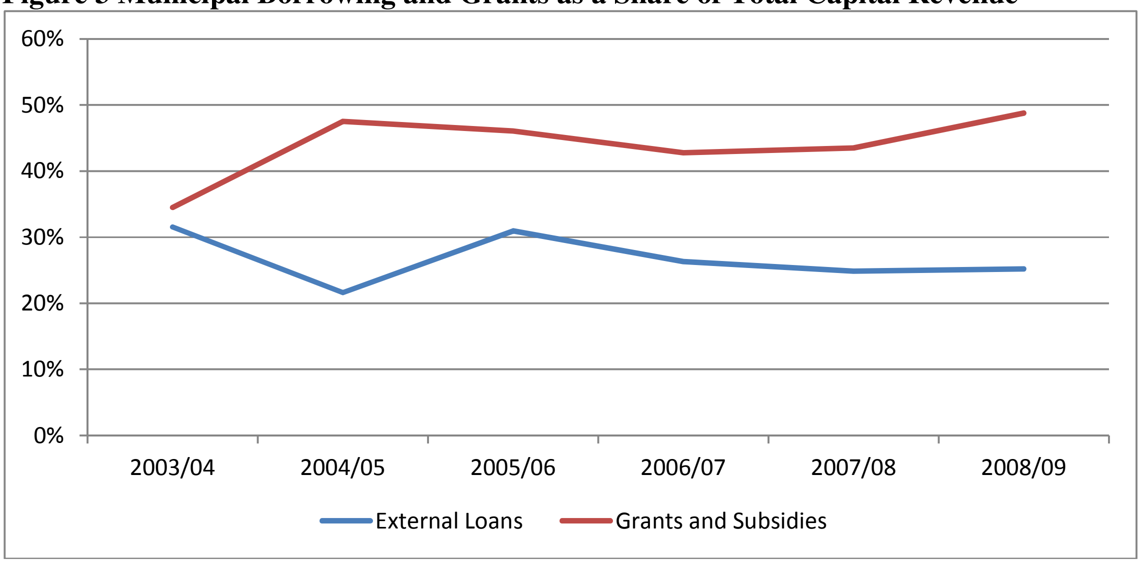
Importantly, section 5 of the Act allows for a municipality, a group of municipalities or organised local government to apply for a new tax.

In a unitary state, all spheres are interrelated and interdependent, and so it is important to protect the greater macro economy and policy priories. Therefore, the main question for discussion is whether the legislation has resulted in the over-regulation of municipalities' ability to levy taxes and encroached on municipal fiscal autonomy.

Municipal Borrowing

Although municipalities tend to finance the operating budget mainly from own revenues, local governments are also legally authorised to borrow from credit markets for capital expenditure such as infrastructure. Section 230 of the Constitution empowers municipalities to borrow, while the Municipal Finance Management Act regulates such powers. The concern is that some municipalities are not taking full advantage of their ability to borrow, while other municipalities have limited access to borrowing from capital markets. Figure 3 illustrates the portion of municipal capital budgets financed by borrowing and by infrastructure grants. On average, municipalities fund their capital expenditures with infrastructure grants. Municipal borrowing has been steady but has declined, which is possibly due to the impacts of the recession in 2008/09.

Figure 3 Municipal Borrowing and Grants as a Share of Total Capital Revenue



Source National Treasury Local Government Database

The Regional Services Council (RSC) Levies, Sharing of General Fuel Levy and Local Business Tax

Up until 2006/07, the RSC levy was a major revenue source for local government, accounting for approximately 8% of total municipal operating revenues. A tax levied by metros and district municipalities, the RSC levy was abolished in the 2006/07 municipal financial year because of several economic, legal and administrative deficiencies. To protect municipal budgets from the loss of revenue, National Government introduced an RSC levy replacement grant as an interim measure until a suitable replacement for the former tax was identified and implemented.

In 2009/10 the sharing of the general fuel level (a national tax) was implemented as the official replacement for the RSC levies for metros (along with the VAT zero rating of municipal property rates[4]). Metros were entitled to an approximate 23% share of the revenues from the general fuel levy, which was an amount equivalent to the RSC levy replacement grant and shared proportionally among the metros according to total fuel sales within their respective jurisdictions. The Commission raised concerns about the buoyancy[5] of the new instrument, its link to economic activity and the continued lack of a replacement levy for district municipalities. As the sharing of the fuel levy is based on total fuel sales per metropolitan municipality, a concern was that it could encourage more fuel sales within the municipality, which is counter to the government's transport policies aimed at promoting greater use of public transport.

Before of the introduction of the general fuel levy, most parties preferred to replace the RSC levy with a Local Business Tax (LBT). The LBT is similar to the RSC levy, as it is linked to economic activity, but improves on the RSC levy's administrative failures. More importantly, unlike the RSC levy replacement grant or the fuel levy, the LBT would give municipalities a measure of control over a revenue source. Recently, municipalities (the metros in specific and organised local government in general) are looking into applying for a LBT via section 5 of the MFPFA.

Issues for Discussion

The current concerns around the raising of local municipal taxes are:

i. Should intergovernmental transfers account for the difficulties in accessing revenues in rural areas governed by traditional authorities and communal tenure systems?
ii. Are municipal own-revenue sources currently over-regulated, and should they be regulated?
iii. How much fiscal discretion is local government given in the context of the interdependence and interrelatedness of the spheres?
iv. What are the real impacts of grants on municipal own revenues? Are increasing transfers to municipalities resulting in a lack of effort to maximise existing revenue sources? Or is decreasing fiscal capacity, rather than fiscal effort, driving grant dependency?
v. Have the RSC and Joint Services Board levies been appropriately replaced? Is the sharing of the general fuel levy a buoyant revenue source?
vi. What potential avenues for increasing local taxes are provided by Section 5 of the MFPFA?
vii. What are the views regarding the proposed LBT? Should the LBT be implemented only in metros? How can it be implemented at a local municipal level, given the social, demographic and economic differences across municipalities?
viii. How should district municipalities be funded in the future? What are the options for replacing the RSC levies, and should the RSC levy be replaced for these municipalities?

[4] VAT is changed at 0% on property rates but is invoiced and reclaimed or retained by the municipality

[5] Tax buoyancy is a measure of how rapidly the actual revenue from a tax rises (including that due to any change in the tax law) as the tax base rises. As revenues from a tax should ideally *automatically* grow in proportion to the growth in expenditure needs, there should be no need to make frequent adjustments to the tax.

ix. Should additional taxation powers be afforded to local government seeing that most municipalities fail to maximise current revenue instruments because of high levels of outstanding consumer debt?
x. Is local government taxation viewed in a holistic manner relative to the general tax burden being placed on businesses and individuals at the national level?
xi. Is there scope for municipalities to increase their borrowing sustainably?
xii. Should institutions like the Development Bank of Southern Africa (DBSA) focus their lending initiatives on middle-income municipalities thus allowing metros and larger urban municipalities, which have greater collateral, to borrow more from private institutions?

2.5 Other Issues

Some other pertinent issues to consider for the review of the LGFF include:

i. The impact of migration (specifically urbanisation and the lack of data available at local government level).
ii. Intergovernmental coordination failures that result in unfunded mandates
iii. Slow progress on policies, which creates uncertainty and expenditure pressure for local government. These include housing accreditation, transport and the failure to restructure the EDI.
iv. Low expenditure on municipal repairs and maintenance of existing and new infrastructure, largely due to the poor tariff determination by municipalities (tariffs do not reflect the costs of providing services). The repairs and maintenance of social infrastructure are not readily funded through the LES as the formula does not accurately reflect the costs of services and subsidies.
v. Municipalities often interact with state-owned enterprises (SOEs), particularly Eskom and water boards, which sell bulk electricity and water to municipalities. Therefore, the interface between SOEs and municipalities needs to be efficient and effective, in order to limit administrative failures that compromise the financial positions of municipalities and ultimately their ability to roll out services to communities.

Chapter 3: Summary of the Stakeholder Views on the Problem Statement

3.1 Stakeholder Views on Differences across Municipalities

The principle of differentiation is agreed upon, but the basis thereof is contested

Stakeholders recognised that the underlying characteristics of municipalities are different, as identified in the problem statement. These include spatial factors, population density, topography, level and type of economic activity and historical redress. Stakeholders also agreed that a differentiated approach is needed for municipal funding. However, the basis on which differentiation should occur was contested: whether differentiation should take place across a continuum, as is currently the case with the LES formula, or across groups based on criteria such as capacity, costs or performance.

Some stakeholders argued that the formula basis of LES means that further differentiation is not required, while others felt that differentiation needs to be further embedded within the LGFF to respond to municipalities with differing capacities. It was argued that different municipalities require different technical and financial capacity-building support. In this case, if formulas are used to distribute funds and include a capacity component, how capacity is defined and measured would need to be clarified.

Another theme in the stakeholder submissions was the need to take into account the different costs of providing services in various contexts. One stakeholder cautioned against generalising urban and rural cost differences and said that, for the same level of service, in certain cases urban costs are higher and in other cases rural costs are higher. It was argued that there is room for an urban/rural differentiation based on the different approaches to service levels in these areas.

Finally, some stakeholders argued for considering a performance approach to differentiation, which might include once-off performance awards, rewarding compliance, determining fiscal effort[6] and spending efficiency, while ensuring that perverse incentives[7] are avoided.

3.2 Stakeholder Views on the Local Government Equitable Share (LES)

Review both the horizontal and vertical division of revenue

The problem statement indicated that the LES receives the smallest proportion of nationally collected revenue in the vertical division of revenue (see Figure 1) but the proportion has been growing faster year on year relative to national and provincial government. Stakeholders pointed out that both the horizontal and vertical divisions of revenue are important. The

[6] Fiscal effort measures the actual performance in collecting revenues billed by a municipality.
[7] Perverse incentives refer to the unintended consequences of a particular grant design, where the municipality has more information than the transferring department. For example, linking grant allocations to performance based only on number of houses built could lead to lower quality houses.

vertical division of revenue divides the total pool into national, provincial and local government shares and is a political judgment. The horizontal division uses formulae to split the amount available to the provincial sphere among the individual provincial governments and the amount available to local government among the individual municipalities (LES). The vertical division is critical in the light of declining local government fiscal capacity, as own-revenue instruments have been withdrawn (e.g. the RSC levies) without being replaced by viable alternatives that are true local government taxes under the control of municipalities. In 2003/4 local government financed in aggregate 90% of its expenditures from own revenues, but this has declined to 75%. Escalations in water and electricity pricing also affect the vertical division.

Examples were given of small rural municipalities that were receiving clean audits (and hence had reliable financial data) and were exerting maximum effort to collect revenues due to them, but do not have a sustainable revenue base to meet the basic service delivery demands in their jurisdiction. While some municipalities do not collect sufficient revenue from the available tax base (e.g. not metering or billing properly), stakeholders emphasised that small, mainly rural municipalities, which were optimising revenues at their disposal, are in a precarious financial position. For these cases urgent action was requested.

Conduct a transparent review of LES formula components

In line with some of the concerns raised in 2009 by the Commission regarding the current formula, stakeholders argued that the application of various components of the formula should be reviewed. There was a perception that "similar municipalities" seem to be getting different LES allocations, and the lack of transparency and clarity regarding the data used to calculate the LES was problematic. The observation was also made that the allocation of LES funding is done in such a way that equity in funding is prioritised over equity in level of service. In other words, while each municipality may get equitable budget allocations, the minimum cost of service delivery could differ markedly across municipalities, which could result in different actual level of services being provided to citizens of different municipalities.

Some stakeholders argued that funding should be provided based on municipal expenditure obligations, adjusted for the revenues that the municipality could expect to raise on their own. However, other parties queried whether the revenue-raising component of the LES was indeed constitutional.

Currently, funds are distributed based on a poverty measure, which is defined in a way that stakeholders described as inadequate. Stakeholders thought it should be revised in line with the current context and linked to social sector data. Another perspective was that the funding mechanism should recognise that the impact of increased poverty thresholds is different for rural and urban municipalities.

Stakeholders also argued that the formula does not:

- recognise current levels of backlogs in municipalities, which perpetuates apartheid spatial planning;
- provide adequately for governance, administration, planning and development facilitation (GAPD), which was calculated in such a way that the amounts distributed were too low;
- fund roads, street lighting, storm-water management and fire-fighting services;

- incorporate social and community services, which are an important part of what municipalities do and a big expenditure item. Yet, municipal health is included, which is a low expenditure item and not really a service.

Update data for improved insight into demographic profile of municipalities

Stakeholders unanimously agreed on the inadequacy of using 2001 census data for calculating the current LES. They argued that essential for planning is census-quality data, updated more frequently than every 10 years, as substantial demographic change takes place within a decade. This view concurs with the concerns raised by the Commission in the problem statement. In the past it was possible to generalise that rural areas were poor and urban areas were rich, but in recent years urbanisation has led to poverty becoming concentrated in cities as well. It was also suggested that the economic linkages between urban and rural areas should be examined, to ascertain whether they were exploitative or mutually beneficial. The development and implementation of a national urbanisation policy need not contradict government's support of rural areas.

3.3 Stakeholder Views on Conditional Grants

Challenges posed by a plethora of conditional grants

In response to infrastructure backlogs and deterioration in the condition of existing municipal infrastructure, various sector departments issue conditional grants. Stakeholders explained that working with such a plethora of conditional grants is administratively intensive and is contrary to integrated infrastructure planning. In addition, this ad-hoc approach prevents municipalities from proper capital budgeting and from pledging capital grants as collateral for borrowing. Stakeholders mentioned that consolidating grants in the form of the MIG could reduce the number of conditions that municipalities need to comply with.

Capacity support to accompany conditional grant allocations where necessary

Stakeholders argued that, if necessary, sector departments should provide capacity support as part of the conditional grant allocation. In addition, support for low-capacity municipalities should focus on setting up sound systems and growing management capabilities. For example, operations should be funded, to ensure that the management systems are running efficiently, before making any major capital investments in water conservation and demand. However, other stakeholders were concerned about a "top-down approach", and felt that local government should be central to setting the agenda for any capacity-building programmes.

Recognise and reward performance

Some stakeholders proposed that the performance of conditional grants should be monitored and results rewarded. This suggests putting in place a performance management system and including incentive-based measures in the LGFF. Suggestions included recognising municipal performance based on the amount of revenue collected relative to potential revenue, and giving once-off rewards. However, other stakeholders argued that conditional grants already pose a significant, costly and time-consuming reporting burden on municipalities.

3.4 Stakeholder Views on Municipal Own Revenues

Fairly evaluate financial constraints in both urban and rural areas

There was general agreement by stakeholders on the need to incentivise municipalities to generate their own revenues, and that benchmarks would ensure that transfers do not discourage municipalities from collecting own revenues. However, some stakeholders from the cities pointed out the misconception that urban areas have large untapped sources of revenue. While metros do have a rates base to draw on, large cities experience significant fiscal stress from economic development and infrastructure pressures. These stakeholders mentioned the difficult trade-off between investing in economic and in social infrastructure.

Stakeholders described inadequate property valuations of traditional, non-bondable and rural properties as a challenge for municipal revenue. It was argued that the communal tenure in traditional areas means that municipalities cannot raise revenue based on property rates and should therefore be compensated. However, a counter argument made was that the low sanitation costs in these areas (because of their 'on-site' nature) balance the low revenue from property rates.

Review true own-revenue sources and their regulation

Stakeholders mentioned that the local business tax, or a new business tax, should be considered given the complaints about the RSC levy replacement grant, which was described as inequitable. For stakeholders, a viable replacement of own revenue is important for local government fiscal autonomy. A review of the local business tax revealed that businesses would be willing to pay a local tax provided its objectives were economic and not social, so that a direct benefit can be seen.

This was contrary to the view expressed by some stakeholders that there was limited fiscal space for further metro taxes. Stakeholders also argued that municipal own revenues have legislative constraints, for example, rates ratios in the MPRA, the National Energy Regulator of South Africa (NERSA) tariff structures, and norms and standards on surcharges that will be developed in terms of the MFPFA. Some stakeholders felt that own-revenue sources for municipalities are overregulated, while others considered that regulation was important to prevent abuse of tax payers.

Many municipalities do not have the required alienable collateral (i.e. transferrable assets) to borrow money. However, stakeholders provided another perspective, based on case studies in the Western Cape, that the current approach to borrowing is too conservative and so national borrowing rules need to be reviewed. Some stakeholders described own-revenue instruments such as the local business tax as essential to allow them to borrow on capital markets.

Have a social compact over service delivery

An important objective described by stakeholders is a sustainable local revenue base with local accountability. However, also discussed was the lack of a social compact over service delivery, as highlighted by the organised rates boycotts by the rich and service delivery protests by the poor. Stakeholders' reasons for service delivery protests include fraud and corruption (and/or the perception thereof); over-promising and under-delivering instead of managing expectations down to affordable levels and using resources responsibly and prudently; and effectively communicating to citizens which functions are core and non-core (and will therefore be referred to the relevant sector departments). Stakeholders mentioned that, through the Integrated Development Plan (IDP) process, municipalities need to ensure greater community consultation and participation by residents for property valuations and rates and spending revenue. Municipalities mentioned the challenge of not being able to refuse the provision of services to consumers who are not creditworthy – the only way is to restrict consumption to the free basic service using prepaid meters, and only after proper consultation and provided it is included in the municipal by-laws.

3.5 Stakeholder Views on Other Issues

Local government challenges require a whole-of-government response

Local government problems, which are often symptomatic of government-wide issues such as national and provincial policy incoherence, require a whole-of-government response. However, other government spheres often lack the experience required to support municipalities effectively and may have their own capacity problems.

Fragmented funding and a lack of coordination, cooperation and planning among departments, spheres, regulators and SOEs are frustrating municipal planning, operations and reporting. One of the most significant themes to arise from the public hearings was stakeholders' frustration with the limited municipal control over the setting of electricity and water tariffs. For example, in most municipalities electricity accounts for between 30% and 50% of operating revenue. However, although municipalities provide services in Eskom supply areas, surcharges are not transferred to them, which results in significantly lower collection rates. Also, in Eskom-supplied areas, municipalities cannot disconnect the electricity of households in debt, which has a substantial impact on municipal revenue.

LGFF review should be informed by a review of the institutional framework

Stakeholders argued that the funding framework would only be effective if aligned to a sound institutional framework that clearly sets out the roles and responsibilities of the individual organisations or organisational groupings involved. The sharing of powers and functions across the three spheres of government and two tiers of local government is problematic in certain cases. For example, the shared national and local function of water resources can result in non-optimal resource management, which lead to funding and management difficulties. Another example is the shared provincial and local function of road provision which, because of the lack of a national roads classification system, leaves many district and local municipalities uncertain about which roads they are responsible for and makes financing of roads difficult. Stakeholders recognised the significance of the provincial and local government review currently taking place, which they argued must result in permanent assignments or, in the case of municipal functions, authorisations. In particular, the role and function of district municipalities need to be clarified.

Municipalities are facing increasing cost pressures

A significant theme was the increasing cost pressures felt at the municipal level, which arise, among others, from poorly managed intergovernmental relations, policy uncertainty, and infrastructure and compliance costs. Functions and assets are often devolved from provinces to municipalities without a clear understanding of the cost implications. Stakeholders expressed the need for policy certainty during the review of the LGFF, including finalising issues such as the restructuring of the EDI and housing accreditation processes. For example, stakeholders argued that a higher level of responsibility (together with funding to make expenditure decisions) should be devolved to high-capacity municipalities so that they can plan their built environment.

The costs of infrastructure projects should be worked out based on the entire lifecycle of the infrastructural asset, so that the repairs and maintenance costs are included in the funding and linked to asset management in municipalities. Evaluating costs based on an asset's lifecycle avoids taking a short-term view although may mean adjusting the service level provided.

Stakeholders unanimously agreed that compliance, rather than service delivery within a good governance framework, has become the central focus and had a crippling effect on smaller and more rural municipalities in particular. Compliance requires significant resources in addition to other day-to-day service delivery and operational commitments. While many practitioners felt that municipalities are over-regulated, which restricts creativity and innovation, others felt that the data generated from the regulated reporting processes were very useful for analysing local government from a provincial and national perspective and enabled better insight and action. However, the amount of non-financial data required needs to be rationalised.

Municipalities face other expenditure pressures and do not have control over many of the factors driving up the costs e.g. migration from rural to urban areas, unfunded mandates, escalating fuel prices, contracted services and poorly managed contractors that cost local government a lot of money, as well as the failure of government departments to pay municipal debts.

Chapter 4: Principles Guiding the Commission's Response to this Problem Statement

Local government fiscal framework challenges need to be resolved with a sense of urgency. Not all municipalities are financially sustainable in terms of their own revenues and intergovernmental grant allocation, which disrupts service delivery. However, it should be borne in mind that not all dysfunctions of local government have their origin in the fiscal domain. Fiscal responses therefore have to be supported by other solutions which address poor performance within the sphere (ensuring managerial and technical skills competence and broader capacity and governance improvement).

A fundamental review of the LGFF has to assess and evaluate the current design, implementation and impact of the framework in relation to the policy objectives and related principles of transfer design originally articulated by the National Treasury in 2000. The policy document *Introduction of an Equitable Share of Nationally Collected Revenue for Local Government* identifies four central policy objectives for the intergovernmental transfer system and seven additional policy objectives/principles, as summarised in the table below:

CENTRAL POLICY OBJECTIVES	
Equity: Intergovernmental transfers should promote the constitutional and governmental goal of ensuring that all South Africans have access to basic services.	In effect, this means the provision of subsidised basic services to the poor. Transfers should also treat jurisdictions fairly and according to a uniform set of criteria.
Efficiency: A new transfer system should promote allocative efficiency by ensuring that interjurisdictional fiscal competition is an effective check on fiscal performance.	This in turn requires that, where possible and appropriate, uniform equalisation measures should be introduced to ensure that local tax rates vary because of variations in local service costs rather than because of disparities in tax bases.
Spillover effects: A new transfer system needs to introduce a way of funding projects which have strong spillover effects.	The provision of some public goods generates negative or positive externalities which may spill over into neighbouring jurisdictions. While the costs of providing public services with spillovers accrue to a single jurisdiction, the benefits are enjoyed by other jurisdictions as well. Thus, any local authority could be expected to undersupply such public goods..
Facilitating democracy: A new transfer system needs to enable local authorities to build or acquire a minimum level of institutional and physical infrastructure to discharge their fundamental administrative, functional and political responsibilities to their residents.	However, there is a certain minimum efficient scale for local authorities, and transfers should not be made available to entities falling below this level. In such cases, rationalisation and administrative restructuring are necessary.
ADDITIONAL BASIC PRINCIPLES	
Rationality	The level and distribution of transfers must be grounded in well-articulated arguments showing how they promote goals such as equity, economic growth and efficiency, and so on.
Unintended consequences should be limited.	In particular, the new system of transfers should create no perverse incentives.
Transfers should be ***predictable.***	Without predictability, budgeting and borrowing becomes difficult and expensive.
Transfers should promote ***accountability.***	Without accountability on the part of recipient governments, valuable national resources will be wasted, through inefficiency or corruption.
Transfers need to be ***politically acceptable.***	They should support institution-building at the local level.
Transfers should be as ***simple*** and ***transparent*** as	

possible.	
The current system of ***RSC levies*** (payroll and turnover taxes) is not economically efficient nor conducive to labour intensive economic growth.	In the long term consideration should be given to replacing the levies with a more appropriate form of taxation. In the short term, however, the system needs to remain intact.
The bulk of the ***redistributive*** effort intrinsic to the equity objective stated above should be funded by the central fiscus.	First, for reasons of economic fairness, economic efficiency and sound fiscal management, national equity standards should be financed by national taxation on all citizens and enforced uniformly across the country. Second, it is not constitutionally possible for central government to reallocate locally raised revenues from one Metropolitan or District Council jurisdiction to another. Third, the potential impact of any alternative needs also to be considered.

Source: National Treasury (2000)

Input from stakeholders at the Commission's public hearings on the LGFF have indicated that, while some of these principles (such as predictability) have been adhered to satisfactorily, much less progress has been made on achieving other principles (e.g. adequacy of transfers in the interests of equity and redistribution). In reviewing the orientation of the LGFF, the Commission highlights the need to focus on the developmental impact and grant outcomes (second generation concerns) over and above equity and efficiency of grant allocations (first generation concerns). Similarly, first generation concerns (such as predictability, stability, avoiding perverse incentives) need to be supplemented by a focus on second generation concerns, related to creating incentives for behaviour change and performance, promoting accountability and ensuring long-term sustainability.

In framing its recommendations, the Commission will take into account the following considerations:

1. A better understanding of the dynamic between fiscal capacity and fiscal effort[8] needs to inform any revision of the fiscal framework. In balancing expenditure needs with revenue sources, a distinction needs to be made between lack of fiscal effort vis-à-vis fiscal capacity and the policy response needs to be appropriate to the underlying causes. For instance a section 139[9] may be appropriate in the case of poor financial management but cannot solve structural fiscal capacity problems inherent in the skewed distribution of underlying economic activity. The assertion that there is a lot of untapped fiscal capacity in cities needs to be tested objectively.

2. A LGFF should ensure that incentives created in the IGFR system are compatible with policy intent. Performance is inadequately rewarded, whereas non-performance is often perversely rewarded. This emphasis on performance is closely aligned with the principle of accountability, which has been insufficiently embedded in local government financing to date. It includes not only ensuring that actual spending is consistent with planned expenditure, but also that the conditional grant achieves the outcomes delineated in its framework.

[8] Fiscal capacity is defined as "the amount of revenue a particular municipality can raise using the revenue instruments that it has at its disposal and applying a standard set of rates" (Reschovsky, 2003), while fiscal effort measures the actual performance in collecting revenues billed by a municipality.

[9] Section 139 of the Constitution empowers a provincial executive to intervene in the affairs of a municipality in certain circumstances: when a municipality cannot or does not fulfil one or more of its executive oblications, or when there is a financial crisis.

3. Mindful of the three re-demarcation stages undertaken by the Municipal Demarcation Board, *the fiscal criteria for re-demarcation should be clarified* when demarcating municipalities. Re-demarcation of municipal boundaries may improve the sustainability of individual municipalities, but cannot be a systemic solution because it does not necessarily redistribute fiscal capacity, which ultimately reflects the underlying skewed distribution of economic activity.

4. The design of a new LGFF must be predicated on a clear understanding of the redistributive and growth-enhancing roles of local government. This is critical in understanding the vertical division of revenue. Any change in the mandate of municipalities must be accompanied by associated funding (e.g. public transport, housing accreditation) so that “finance follows function”.

5. The Commission supports the core dimensions of the LES design as an unconditional equalisation grant. However, as this role has evolved over time, it is not clear whether the grant instrument’s design and implementation currently support this aim. The Commission re-iterates the principles of grant design submitted for the 2003/04 review of the LES, in particular focussing on the following:

    a. *The adequacy of the LES allocations must be reassessed in relation to powers and functions, expenditure needs, cost disabilities and revenue capacity of municipalities.* The purpose of the LES has shifted over time from equalisation as a substitute for local government’s own revenues to a finance mechanism for free basic services (FBS): poverty alleviation through assuring minimum standards of service delivery. The LES formula allocates funding proportionally on the basis of variables which attempt to capture underlying relative expenditure needs, with some rescaling in order to fit the total available resource pool. While this ensures relative equity and aggregate fiscal discipline, it also means that equitable share allocations are dislocated from the absolute costs of service delivery. (i.e. financial equity vs technical service equity). Variables such as the poverty threshold of R800 are arbitrary and require updating. The revenue raising component of the formula still does not pass constitutional muster.
    b. *A revised LES should be aligned with the broader development role of local government, over and above the basic constitutional assignment of functions.* While a development component was mooted initially, its non-activation is symptomatic of the lack of consensus on the objectives of the LES.

6. Local government is embedded within whole-of-government performance. Inadequate policy coherence and lack of implementation support from national government have exacerbated dysfunction within the local sphere. This includes the impact of regulators such as NERSA, state-owned entities such as ESKOM, ports authority etc.

While local government has an IDP, there is often inadequate effort by other spheres of government to ensure alignment, especially spatially and financially.

7. Conditional grants are supposed to trigger behaviour change in order to engender outcomes. However the performance of conditional grants in terms of their desired impacts is seldom measured, and reasons for their inception and phase-out are poorly articulated.

8. Instead of focusing on categorisation into urban and rural municipalities, the focus should be on the linkages between urban and rural areas within functional economic regions. This is critical in the light of increased migration and concentrations of poverty and inequality in both rural and urban localities. There needs to be a clearer understanding of how the economies of localities interact with the broader economy.

9. All elements of the LGFF should be transparent to all stakeholders, including the elements of the formula and underlying variables for distributing LES allocations as well as conditional grants. Disturbingly, many IGR practitioners do not understand the division of revenue formula, and the probability of councillor and communities understanding them is even more remote.

10. Backlogs should be taken into account explicitly in determining the LGFF, coupled with closer link between capital grant funding and operational funding in relation to maintenance and rehabilitation.

Chapter 5: Research Gaps

The public hearings on the LGFF identified a number of areas that require thorough and systematic research. The identified research gaps cover four thematic areas:

a) The LES and conditional grants
b) Revenue sources and borrowing
c) Intergovernmental fiscal coordination and interface with municipalities
d) A differentiated approach to the funding of municipalities

These research areas are discussed in the paragraphs below, followed by a discussion on areas that can be done in-house by the Commission or in partnership with other stakeholders.

5.1 Costing of Basic Services in the Local Government sector

In many municipalities, important decisions and policy actions are taken without a proper costing framework. The absence of a systematic costing framework for goods and services hampers optimal service delivery, elimination of backlogs and equitable resource allocation. Similarly, the LES grant, an important mechanism for allocating resources to the sphere, is not based on any comprehensive, objective costing framework and points to inherent weaknesses in the allocation process. The same applies to tariff setting and expenditure decisions that are not founded on an objective and proper costing framework. In the absence of such a framework, many tariff-setting decisions are largely arbitrary, resulting in many municipalities charging tariffs that may not fair, equitable, cost effective or cost reflective.

Participants at the public hearings identified the need for research that contributes to the development of a rigorous costing framework for basic services in municipalities which will also enable tariffs to be set that ensure sustainable delivery of services. The results of such research will benefit, in particular, the design of the LES grant, municipal tariff setting processes and expenditure decisions.

5.2 Understanding Fiscal Capacity and Fiscal Effort in the Context of the South African Local Government Sector.

The design of the LGFF needs to distinguish between the concepts of fiscal capacity and fiscal effort. Fiscal capacity is defined as "the amount of revenue a particular municipality can raise using the revenue instruments that it has at its disposal and applying a standard set of rates" (Reschovsky, 2003), while fiscal effort measures the actual performance in collecting revenues billed by a municipality. In certain instances, municipalities are demarcated such that most of the area covers rural areas characterised by poor households and low economic/business activity. In these areas, the scope for municipalities to generate revenues from their constituents is very limited. Intergovernmental fiscal transfers need to be sensitive to such factors and ensure that these municipalities are adequately compensated for a lack of revenue generation capabilities or fiscal capacity. In contrast, in areas with richer households and higher levels of business activity, municipalities can potentially generate substantial own revenues. In such cases, a municipality that fails to collect the revenues because of administrative failures and institutional constraints suffers from a lack of fiscal effort.

In the context of local government in South Africa; defining, contrasting and measuring fiscal capacity and fiscal effort is important in the design and implementation of the LGFF.

5.3 Optimal Allocation and Design of the Fuel Levy

In 2006, the RSC levies were abolished, and an interim RSC replacement grant for metros and district municipalities was introduced. In 2009/10 the general fuel levy replaced the RSC levy replacement grant. The general fuel levy, which is a tax levied at the pump on mainly fossil fuels (petrol and diesel) is shared among the metros. The criteria for sharing the fuel levy among metros have been fraught with controversy. Stakeholders, including the Commission, have argued that the fuel levy departs from the norm of a local tax, as there is no relationship between the economic activity within a metro and the revenues that the metro receives. The levy's design defies some basic principles of a good local tax, e.g. fiscal autonomy, as the metros have no influence over the rate of tax or the tax base. The fairness of the way in which the fuel revenues are shared has also been questioned. Therefore, the efficacy, efficiency, and fairness of the fuel levy needs to be empirically evaluated, with a view to designing an instrument that conforms to the basic principles and objectives of a good local tax. In addition, it is critical that options for a true local tax implementable in the medium to long term are investigated.

5.4 The Impact of the Demarcation of Municipal Boundaries on the Fiscal Base and Fiscal Sustainability of Municipalities

Municipal demarcations should ideally result in viable and sustainable municipalities. The question is whether the existing demarcations promote fiscally sustainable municipalities or whether fiscal sustainability for each municipality is indeed possible, given the extremely spatially skewed distributions of underlying economic activity and concentrations of wealth and poverty! These questions have become more relevant with the recent re-demarcations that resulted in the numbers of municipalities being reduced from 283 to 278.

The recent demarcations will definitely have an impact on the intergovernmental transfer system: *inter alia* the LES, conditional grants, fuel levy sharing, etc. In addition, what is not well understood is the impact of demarcations on the fiscal base of municipalities and the cost of demarcations to municipalities. As many municipalities lack a sound revenue base to sustain their activities, a serious empirical scrutiny is required of the demarcation criteria and the demarcation's impact on the transfer systems, fiscal sustainability and fiscal base of municipalities. Underpinning the proposed research will be to establish (a) the extent to which fiscal sustainability is considered part of the demarcation criteria and (b) the impact of demarcations on the intergovernmental transfer system, and viability and fiscal sustainability of municipalities.[10]

5.5 Understanding Allocative and Technical Efficiency at a Local Government Level

One of the fundamental principles supporting a decentralised system of governance is the perceived efficiency gains of such an arrangement. The theory is that lower levels of governments are better placed to deliver certain services and to administer certain fiscal powers. South Africa has such a decentralised system of governance, with nine provinces and

[10] This study will also examine the principles and constitutionality of the demarcation process.

278 municipalities. Provinces are constitutionally authorised to provide social services such as education and health (concurrently with national government), while local government are mandated with basic services such as water, sanitation, electricity and refuse removal.

Local government clearly plays a critical role in uplifting and sustaining communities in the country, but in recent years the local government sphere has been plagued with numerous community protests, as service delivery failures are becoming more frequent and apparent. Such incidents question the perceived efficiency gains according to the decentralisation theory and raises concerns that public funds are being wasted, used inefficiently and diverted through corruption.

Municipalities are required to be technically efficient[11] in the use of public resources, so as to enhance and provide optimally service delivery. Municipalities must also be allocative efficient.[12] As the comprehensive social security system of the country confirms, the South African government's policy is to alleviate poverty, reduce inequality and target intensively the poor. Municipalities are directly involved in this system, as they implement the FBS policies. Therefore municipalities need to target their services (FBS in particular) so as to reach those sections of the community in greatest need of the services (the poor). Distribution efficiency is an important component of welfare economics, which postulates that goods and services are efficiently distributed to sections of the community that gain the most utility from it. The role of municipalities in this regard cannot be over emphasised.

Since the establishment of local government in South Africa, few studies have attempted to test the technical and allocative efficiency of municipalities, to ensure that public funds are not wasted and that the welfare of the poorest of the poor is enhanced. In the current environment of fiscal consolidation, substantial increases in the LES pool are unlikely and so the local government sphere will have to do more with less. Therefore the Commission needs to undertake research in these areas and has already developed some suitable methodology.

5.6 A Review of the Regulatory Framework for Tariff Setting in the Local Government

The challenges of under spending or overspending that sometimes characterise the local government sector can be traced to, *inter alia,* the problem of tariffs that do not correspond to the cost of providing a particular service.[13] The lack of proper costing (despite the legislative requirement in the MSA) also gives rise to arbitrary tariff setting, tariffs that are not fair and reasonable in sustaining supply, or tariffs that do not balance properly the interests of consumers, service providers and the broader economy. Consumers need affordable tariffs, whereas service providers require tariffs that guarantee investment in both rehabilitation and growth infrastructure. Sometimes tariff setting in the local government sphere is not guided by the widely known basic principles of fairness, equity, efficiency, transparency and sustainability. Sometimes tariffs are set way below the cost of providing the services for political reasons, thereby clouding the degree of cross subsidisation. In some situations, the main objective is to raise revenue (to allow cross subsidisation).

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[11] Technical efficiency refers to a situation where maximum output is achieved with the minimum level of input.
[12] Allocative efficiency refers to an optimal distribution of goods and services.
[13] To some extent this is deliberate since tariffs are often the vehicle for cross subsidisation, and tariffs on the private good element of services are often set to cover public good elements as well. To some extent this is because the long run lifecycle costs of asset management are poorly understood.

The picture painted above suggests some weakness in the regulatory framework that underpins tariff setting in the local government sector. In other words, the arbitrary tariff setting shows that the existing regulatory framework is not properly designed and implemented to guide tariff setting in the sector. Therefore, a review is urgently needed of the entire tariff setting regulatory framework in the local government sector and among utilities that supply services to the sector, with a view to making tariff setting transparent, cost reflective, cost effective, equitable and ensuring sustainable service provision.

5.7 Optimising Revenues from Properties in the Local Government Sector

Municipalities generally suffer from a revenue base that is not changing at the same pace as their obligations. The limited revenue alternatives are jeopardising service delivery and investments in infrastructure. One alternative that remains under-utilised is property revenues. Anecdotal evidence suggests that revenues from properties are not fully exploited because of a number of factors including:

- *Skills*: inadequate capacity to do evaluations in the local government sector. As valuation skills are limited, the quality and quantity of evaluations, as well as the revenues generated, are weakened.
- *Different valuation methods*: banks and municipality property valuations methodologies differ.
- *Traditional areas*: traditional leaders sometimes resist valuations, and so properties in these areas cannot be optimally valued without alienating traditional leaders. In addition, ill-defined tenure rights in rural areas result in lower property revenues in predominantly rural municipalities.

The Commission proposes research into these issues that will:

- Evaluate local government's capacity to do property evaluations and examine the support mechanisms that national and provincial government make available to local government.
- Examine evaluation methods used in local government, with a view to producing a framework that would guide municipalities in carrying out property evaluations within their jurisdictions.[14]
- Provide guidelines on how to value properties in traditional areas optimally.

5.8 What is the Best Way of Differentiating Municipalities?

The 278 municipalities in South Africa face different socio-economic and political challenges and have different capacities for dealing with these challenges. In this regard different departments use many classifications to group municipalities. The Constitution (1996) provides for three categories: A (metropolitan municipalities), B (local municipalities) and C (district municipalities).

The Municipal Infrastructure Investment Framework follows the constitutional categorisation and has seven categories that are based on, *inter alia*, spatial characteristics, size of institution and budget, and population variables. The categories are:

[14] For example computer guided valuations.

- A: Metropolitan municipalities,
- B1: Local municipalities with largest budgets, also referred to as the secondary cities
- B2: Local municipalities with large towns at their core
- B3: Local municipalities with small towns and relatively small populations
- B4: Local municipalities that are mainly rural with communal tenure
- C1: District municipalities that are not water service authorities
- C2: District municipalities that are water service authorities:

National Treasury separates municipalities using economic, demographic and performance characteristics. The variables are: access to basic services, poverty rate, municipal viability, staff vacancy, municipal debt, population density and size of the municipality's economy (gross value added, or GVA). National Treasury has come up with six performance groups: Very high, High, Medium high, Medium low, Weak and Very weak.

The DCOG's "Municipal Spatial Classification System" has four classes that are driven by functionality, socio-economic profile and backlog status:[15] Class 1: Most vulnerable; Class 2: Second most vulnerable; Class 3: Second highest performing; Class 4: Highest performing. The Auditor General and the Municipal Demarcation Board also have different classification criteria.

The different classifications methodologies highlighted above recognise that municipalities have different underlying characteristics, which need to be considered when making decisions. However, the motive for differentiation is not always clear, and some classifications are not useful for making decisions or allocating resources. Sometimes the categorisation depends on the policy purpose and often detracts from looking at the linkages between municipalities e.g. rural and urban. Furthermore, some classifications try to recognise performance, while others do not. Overall, the high number of classification methodologies undermines coordinated decision making and intervention strategies. The proposed study will look at existing criteria and principles and design objective criteria and principles for differentiating municipalities.

5.9 Municipal Borrowing: Principles and Challenges

Over the next 10 years, South African municipalities will need to invest an estimated R500 billion in infrastructure.[16]

Table 4 South Africa's infrastructure investment needs over the next 10 years

	New infrastructure	Backlogs	Rehabilitation	Total
Metros & secondary	R 120.9 billion	R 25.5 billion	R 125.2 billion	R 271.6 billion
B2s & B3s municipalities	R 32.3 billion	R 14.4 billion	R 51.6 billion	R 98.3 billion
Rural municipalities	R 26.8 billion	R 40.7 billion	R 64.1 billion	R 131.6 billion
Total	R 180.0 billion	R 80.6 billion	R 240.9 billion	R 501.5 billion

Source: World Bank (2010)

[15] Department of Cooperative Government and Traditional Affairs (2009) Local Government Turnaround Strategy (LGTAS), http://www.info.gov.za/view/DownloadFileAction?id=118277

[16] World Bank (2010) *Municipal Infrastructure Finance Synthesis Report,* Washington, DC: World Bank

In total, municipalities will require R241 billion just for rehabilitating infrastructure. Many municipalities are not capable of raising such revenues from own sources or from intergovernmental transfers,[17] and so borrowing becomes an important option. Only metros and secondary municipalities have exploited this opportunity, and to varying degrees. The town-based municipalities (B2s and B3s) have found accessing capital markets very challenging and are not receiving loans from development finance institutions which are supposed to support them. Anecdotal evidence suggests that this market segment borrows on a scale that makes lending more expensive or has poor financial management skills that make them a credit risk for any lender.[18] The B2s and B3s have limited own revenue-raising capacity and lack alienable (or transferrable) assets to serve as collateral. Borrowing is not a viable option for rural-based municipalities (B4s), which are virtually excluded from the capital markets, as their own-revenue bases are too limited to attract private capital and legislation limits their ability to pledge future equitable share allocations against borrowing obligations. This makes them almost entirely dependent on intergovernmental transfers. However, in the face of rising expenditure needs, growing government transfers may not be sustainable, especially in times of economic slowdown and recessions.

The massive infrastructure requirements and limited own revenues for many municipalities, especially the B2, B3 and B4s, means a rethink of the entire lending and borrowing value chain and the regulatory framework that excludes many municipalities. The Commission is proposing a study that will shed light on these issues and answer some of the questions raised by stakeholders at the LGFF hearings. These included: Why are many municipalities not able to access private and quasi-public capital? How can municipalities with the potential to access capital markets sustainably be identified and assisted to access the credit markets? Is the regulatory framework a constraint to borrowing by these municipalities? How can private and public institutions (e.g. DBSA) be incentivised to lend to these municipalities?

5.10 Infrastructure Maintenance and Rehabilitation in the Local Government Sector: Funding Models and Incentives

Maintaining existing infrastructure is important to ensure availability and quality of services such as water and electricity to existing consumers and provide the backbone for extending these services to new consumers. The municipal level of government is closest to people and is where service delivery challenges are experienced first-hand. Inadequate infrastructure maintenance undermines sustainable service delivery, contributes to increased backlogs and places a strain on public finances. Evidence on the ground shows a significant mismatch between the repair and maintenance requirements and the resources being injected into infrastructure rehabilitation. As already stated, the World Bank (2010) estimates that a total of R500 billion is required for municipal infrastructure investment, of which almost half is for repairs and maintenance. Yet, municipalities invest on average 5% of total operating expenditures on infrastructure rehabilitation, which is well below the National Treasury guidelines of 8–10% and the World Bank estimated requirements. Furthermore, in hard times, a soft target for cuts is spending on infrastructure repairs and maintenance, which are not immediately visible and politically less sensitive. This is particularly prevalent in non-metro municipalities. While deferring maintenance may improve cash flow problems in the

[17] For purpose of examining borrowing capacities and constraints, municipalities are subdivided into three broad categories; (i) Metros and secondary cities, (ii) Town-based municipalities and (iii) Rural municipalities.
[18] National Treasury (2011) Local Government Budgets and Expenditure Review: 2006/07–2012/13

short term, the long-term costs wipe out any benefits, as the assets will eventually need to be rehabilitated or replaced. Stakeholders were united in their view that poor maintenance of infrastructure in the local government sector is cause for concern and a major factor in sub-optimal service delivery. However, what remains in contention is the best way to fund infrastructure maintenance and rehabilitation. In addition, it is not clear how municipalities can be incentivised to quantitatively and qualitatively increase their investments in infrastructure maintenance. A study is proposed that will investigate the best funding models and incentive instruments to encourage investment in maintaining and rehabilitating infrastructure.

5.11 Defining, Measuring and Rewarding Performance in Municipalities

The South African intergovernmental fiscal system does not have a uniform framework for measuring and rewarding performance. In its annual benchmarking exercises, the National Treasury measures municipal performance using various indicators but not based on any formal framework. It is therefore proposed that research be done to define performance, establish some objective criteria for measuring performance and recommend some system of rewarding performance within the local government sector.

5.12 Data Gaps in the Local Government Sector

The Commission has previously pointed out data gaps in the local government sector that have implications for efficient and effective decision making, resource allocation and intervention strategies. The stakeholders at the LGFF hearings also underscored the negative implications of data deficiencies in the sector. For example, many IGFR resource allocation decisions are still based on the 2001 census data. Although new census data is expected in 2013, the same problem is likely to occur between censuses. The questions that need answering are: What can be done to bridge data gaps in the local sector? Should the frequency of censuses be changed? Should data collected by municipalities be subjected to the South African Statistical Quality Assessment Framework (SASQAF)?[19] The Commission and stakeholders at the LGFF proposed a study that would identify local government data gaps and their implications, and identify ways of bridging data deficits.

5.13 Conclusion

The above list of research gaps is not exhaustive but indicates some of the key areas in the local government finances that warrant further scrutiny. All the identified research areas fit well within the Commission's five-year research strategy, which emphasises "the impact of the intergovernmental system and the allocation of public funds on service delivery outputs and community development". Thus, although all these areas are important, priority will be given to areas in which the Research and Recommendations Programme (RRP) is already conducting research or has developed some methodologies, including the following projects:

- Understanding fiscal capacity and fiscal effort in the context of the South African local government sector.
- Understanding allocative and technical efficiency at a local government level
- Data gaps in the local government sector

[19] In terms of the Spatial Planning and Land Use Management Bill, the Department of Rural Development should do this.

The Commission is discussing an memorandum of understanding with the Municipal Demarcation Board (MDB) that will cover a number of issues. One of the proposals is for the Commission and the MDB to jointly commission a project on *"The Impact of Demarcations on the Fiscal Sustainability of Municipalities"*. The possibilities of joint research with other institutions, for example with the Municipal Demarcations Board, are also being explored. The Department of Cooperative Government, the National Treasury, SALGA, the Development Bank of South Africa, NERSA and other key stakeholders will also be engaged in responding to the challenges identified in this problem statement.

The RRP has in-house expertise to undertake research in other areas, and projects that can be started in the new research cycle include:

- Municipality borrowing: principles and challenges
- Infrastructure maintenance and rehabilitation in the local government sector: funding models and incentives

The last set of projects requires the Commission to partner or collaborate with other technical advice institutions and includes:

- Costing of basic services in the local government sector
- A review of the regulatory framework for tariff setting in local government
- Optimal allocation and design of the fuel levy
- Optimising revenues from properties in the local government sector
- Defining, measuring and rewarding performance in municipalities
- Examining the best criteria/way of differentiating municipalities?

Chapter 6: Conclusion

Through a complementary process to the DOR submission, the Commission held a special public hearing on the financing of municipalities and current LGFF arrangements. The purpose of the hearing was to discuss the draft problem statement released by the Commission and to get stakeholders' perspectives on the challenges in the LGFF. A final problem statement, which captures the Commission's formal position after considering input from the 75 stakeholders at the hearing, is presented in this document.

The Commission's formal problem statement describes the wide range of interrelated challenges confronting the LGFF, and begins to analyse their underlying causes or drivers. One challenge is that municipalities are very different. Their fiscal capacity varies substantially, as urban municipalities have greater levels of economic activity and employment, a more affluent demographic profile and higher per capita expenditure, compared to rural areas. In addition, the expenditure functions and powers assigned to different types of municipalities vary. Another challenge is that the municipal ability to raise local taxes (own revenue), has decreased over the past decade, raising the concern that government grants may crowd out municipal efforts to generate own revenue, which is not sustainable.

This problem statement has largely been validated by stakeholder input at the Commission's public hearing on the LGFF. However, while there are areas of broad stakeholder consensus, how to structure the LGFF remains a contested terrain. The many data and research gaps also constrain evidence-based policy-making in this area. The research gaps cover four thematic areas: the LES and conditional grants; revenue sources and borrowing; intergovernmental fiscal coordination and interface with municipalities; a differentiated approach to funding of municipalities.

Based on the principles articulated in this document, Commission research will identify an initial set of policy options and recommendations which will then be considered at a second public hearing.

The Commission's sincere hope is that this research will help to precipitate urgent action by policy-makers in responding systematically to vulnerable municipalities in fiscal distress and to sustain improvements in extending access to and quality of basic services. Far from being a technical exercise in intergovernmental fiscal relations, the structuring of the LGFF lies at the very heart of the constitutional vision of developmental local government and the day-to-day quality of life of ordinary South African citizens.

Appendix 1: Glossary

Allocative efficiency	Given the limited resources available, an allocatively efficient mix of public goods and services yields the maximum possible social welfare
Conditional grant	intergovernmental transfer that may only be used for specific purposes as set out by the transferring government department.
Fiscal capacity	The maximum potential amount of revenue that a municipality could raise if it fully utilised all revenue sources legally available to it. A municipality's actual revenues may fall below its fiscal capacity when fiscal effort is not exerted.
Fiscal effort	the actual performance in collecting revenues billed by a municipality.
Horizontal DOR	formulae are used to split the amount available to the provincial government sphere among the individual provincial governments and the amount available to local government among the individual municipalities.
LGFF	the aggregate revenue arrangement or funding framework of local government relative to the aggregate expenditure mandates and responsibilities of the sphere (as defined in the Money Bills Amendment Procedure and Related Matters Act of 2009).
Own revenues	money that a municipality generates itself through property rates, user charges for municipal services rendered, surcharges on user charges and other local taxes.
Perverse incentives	the unintended consequences of a particular grant design, where the municipality has more information than the transferring department. For example, linking grant allocations to performance based only on number of houses built could lead to lower quality houses.
Tax buoyancy	a measure of how rapidly the actual revenue from a tax rises (including that due to any change in the tax law) as the tax base rises. As revenues from a tax should ideally *automatically* grow in proportion to the growth in expenditure needs, there should be no need to make frequent adjustments to the tax.
Technical efficiency	a situation where maximum output is achieved with the minimum level of input use.
Unconditional grant	intergovernmental transfer that may be used at the discretion of the provincial government or municipality.
Vertical DOR	the total pool of revenue is divided into national, provincial and local government share and is a political judgment.
Wall-to-wall municipalities	historically municipalities in South Africa were centred around towns and their borders did not extend significantly beyond the edge of those towns. Large, predominantly rural areas of the country effectively had no municipal-level of government. The Constitution requires that the local government sphere consists of municipalities established for the whole area of the country, introducing for the first time, wall-to-wall municipalities so that the full territory of the country is covered by municipalities.

Appendix 2: List of Stakeholders

	Name	Institution
1.	Mike Richardson	City of Cape Town
2.	Joshua Ngonyama	City of Tshwane
3.	Helen Shube	DCOG
4.	Zanele Ndlaleni	DCOG
5.	David Savage	Financial and Fiscal Commission
6.	Tania Ajam	Financial and Fiscal Commission
7.	Muthotho Sigidi	DCOG
8.	Mohammed Hassan	Eastern Cape Provincial Treasury
9.	Pumla Silinda	Ekurhuleni Metro Municipality
10.	Hannes Dednam	Ekurhuleni Metro Municipality
11.	Lovedalia Selabe	Ekurhuleni Metro Municipality
12.	Vongani Machimana	Ekurhuleni Metro Municipality
13.	Gerald Groenewald	Emakhazeni Municipality
14.	Mrs. Groenewald	Emakhazeni Municipality
15.	Sam A Khumalo	Emakhazeni Municipality
16.	Mashumi K Mzaidume	Financial and Fiscal Commission
17.	Bongani Khumalo	Financial and Fiscal Commission
18.	Ramos Mabugu	Financial and Fiscal Commission
19.	Jugal Mahabir	Financial and Fiscal Commission
20.	Vincent Makinta	Financial and Fiscal Commission
21.	Sasha Peters	Financial and Fiscal Commission
22.	Marina Marinkov	Financial and Fiscal Commission
23.	Mkhululi Ncube	Financial and Fiscal Commission
24.	Lydia Ntenga	Financial and Fiscal Commission
25.	Sabelo Mtantato	Financial and Fiscal Commission
26.	Tebogo Makube	Financial and Fiscal Commission
27.	Nomonde Madubula	Financial and Fiscal Commission
28.	Donald Sibanda	Financial and Fiscal Commission
29.	Henry Eksteen	Financial and Fiscal Commission
30.	Conrad van Gass	Financial and Fiscal Commission
31.	Leigh Berg	Financial and Fiscal Commission
32.	Floyd Abrahams	Free State Provincial Treasury
33.	Reggie Chetty	Free State Provincial Treasury
34.	Joey Krishnan	KwaZulu-Natal Provincial Government
35.	Farhad Cassimjee	KwaZulu-Natal Provincial Treasury
36.	Arvin Soopal	KwaZulu-Natal Provincial Treasury
37.	N Ngoepe	Limpopo Provincial Treasury
38.	Sandra Sooklal	Limpopo Provincial Treasury
39.	Sydwell Sibanda	Limpopo Provincial Treasury
40.	Nerulal Ramdharie	Limpopo Provincial Treasury

Appendix 3: Stakeholder perceptions of principles that should drive solutions and knowledge and data gaps

A3.1 Stakeholder perceptions of principles that should drive solutions

Stakeholder perceptions of principles to drive solutions regarding the LGFF included:

(a) Any differentiated approach to municipal funding should encourage and not discourage fiscal effort and efficient spending by municipalities. Further, performance should be monitored, rewarded and incentivised. Where necessary, technical capacity and system development support should be provided to improve performance.

(b) Clarity is required on what the Constitution envisages for the LES, and any adjustments to the variables in the formula should be transparent. In addition, the data used to calculate the LES should be easily accessible and available so each municipality can clearly see how their share is calculated.

(c) The design, allocation and management of the LES and conditional grants should be predictable and well communicated. In addition, enforceable three-year budgets would help ensure that spending does take place.

(d) Local government should have its own true revenue sources. Municipal revenue raising should be affordable for residents, and the process by which rates are determined should have a greater degree of consultation and participation.

(e) Municipalities must aim to be viable, and borrowing should be sustainable and only occur for assets that will yield a stream of revenue to enable repayment and continuous maintenance and operations. In addition, a better understanding of asset lifecycle costs is required in order to make informed infrastructure investment decisions, and to set appropriate tariffs.

(f) The role and mandate of local government should be recognised as equal to that of national and provincial government, and all three spheres of government should be striving towards better intergovernmental cooperation. Effort should be exerted to make existing structures work rather than duplicating efforts and resources. Once a review of institutional arrangements has taken place and powers and functions have been clarified, municipalities should be funded for those services they are responsible for providing based on proper costing of municipal services.

A3.2 Stakeholder perceptions of knowledge and data gaps

Knowledge and data gaps identified by stakeholders included:

(a) Clarity on municipal demarcation and what constitutes a viable municipality.

(b) Various approaches to differentiation should be researched, such as differentiation based on costs and performance. Better understanding of cost and revenue differentials across local government would help in considering a funding approach based on these, and research into a performance approach to differentiation was also suggested.

(c) Stakeholders suggested consistent reviews and improvement of the data informing the LES, such as the poverty data. In addition, further research into some formula components was mentioned, such as the development component of the LES along with what indicators might be used for this.

(d) How rural properties could be valued and valuation rolls improved, and better understanding of how traditional and municipal councils function in practice in terms of property rating and service charging.

(e) Research into what levels of consultation would be required to preserve the social contract; what levels of cross-subsidisation of property, electricity and water rates are feasible, and whether local government should indeed be responsible for cross-subsidisation.

(f) The impact of existing local government revenue instruments on municipal revenue should be explored as well as the design, transparency and allocations in terms of sharing the fuel levy, and whether removal of the RSC levy exacerbated a pre-existing fiscal gap.

(g) A review of the regulatory framework for borrowing mechanisms.

(h) Future research should be conducted on the impact of intergovernmental relations, SOEs and regulators on local government. In addition, how unfunded mandates can be avoided by proper costing of legislation, regulations and implementation plans to ensure that funding arrangements can be made for these before they are passed by Parliament and the Provincial legislatures.

(i) A review of powers and functions, specifically provincially mediated functions, should be conducted along with section 84 of the Municipal Structures Act which sets up responsibilities of district municipalities and SALGA review of section 78 of the Municipal Systems Act in terms of implications for institutional arrangements for water services.

(j) Information on costs, backlogs and access to infrastructure were raised as areas for further research. A fuller understanding of infrastructure costs on a lifecycle basis was essential to enable cost-benefit analyses. In addition, research into the introduction of operating and maintenance components of capital grants should be conducted. How infrastructure backlogs can be quantified in order to determine grant funding was raised, and it was suggested that an interface between Stats SA and municipal GIS systems be built in order to obtain reliable information about access to infrastructure for planning purposes.

Appendix 4: Detailed components of the Local Government Equitable Share (LES) formula

The detailed specification of the LES formula is outlined in Appendix W1 to the annual Budget Review, which is an explanatory memorandum to the DOR. The individual components of the formula are discussed in detail below:

The basic services component
The purpose of this component is to assist municipalities in providing basic services to poor households and with meeting municipal health service needs for all. For each subsidised basic service there are two levels of support: a full subsidy for poor households that are connected to municipal services, and a partial subsidy of 45% for poor households that are not yet connected to municipal networks.

The characteristics of the basic services component are:

- Supporting poor households earning less than R800 per month in 2001 prices.
- Distinguishing between poor households connected to services and those that are not connected to services and may be provided with alternatives.
- Recognising water reticulation, sanitation, refuse removal and electricity reticulation as core municipal services.
- Providing for municipal health services to all households (through funding allocated to district and metropolitan municipalities).

The basic services component
BS = [water subsidy 1*poor with water + water subsidy 2*poor without water] + [sanitation subsidy 1*poor with sanitation + sanitation subsidy 2*poor without sanitation] + [refuse subsidy 1*poor with refuse + refuse subsidy 2*poor without refuse] + [electricity subsidy 1*poor with electricity + electricity subsidy 2*poor without electricity] + [municipal health services*total number of households]

The development component
This component is currently inactive. The review of the local government fiscal framework which will commence in 2011 will consider how best the formula can respond to the development needs of the different types and categories of municipalities.

The institutional support component
The average low- or medium-capacity municipality (typically in rural areas or small towns), spends more than half of its own revenue on administrative and governance costs, leaving a reduced portion available for the provision of basic services to residents. Given the existing capacity challenges in these municipalities, the institutional support component of the equitable share formula offers assistance in meeting some of these requirements, providing a supplement to augment, but not fully cover, institutional costs.

The institutional support component
I = Base allocation + [allocation per councillor * number of seats] * [poverty factor]

Where the values used in the formula are:
I = R550 000 + [R54 000* councillors] * [% of households in poverty + 17%]

The base allocation is an amount that will go to every municipality. The second term of this formula recognises that administrative costs go up with the size of a municipality and the ability of a municipality to fund these costs from their own revenue is lower the greater the proportion of its residents that are poor. This second term incorporates two elements; an allocation per councillor that reflects the relative size of a municipality (councillor numbers are determined by the population of a municipality) and a poverty factor calculated as the proportion of poor households in a municipality (poor households divided by total households). The municipality with the highest proportion of poor households receives a poverty factor of 100% (the poorest municipality has 83% of its households below the R800-a-month poverty line according to 2001 prices), so 17% is added to the proportion of poor households in each municipality to calculate the poverty factor. The number of seats that will be recognised for purposes of the formula is determined by the Minister of Cooperative Governance and Traditional Affairs for elections and composition.

The revenue-raising capacity correction
To account for the varying fiscal capacities of municipalities, the formula must account for each municipality's ability to raise revenue for the purposes of fulfilling its constitutional mandate. This component therefore takes into account income from property rates and the fuel levy sharing with metropolitan municipalities. In the absence of proper information on property valuation rolls across the spectrum of municipalities and as an interim measure, previous property rate collections between 2004/05 and 2006/07 have been used as a basis for determining future capacity to collect income from this source.

In order to achieve greater horizontal equity in the allocation system and to acknowledge the revenue-raising constraints faced by smaller municipalities, a differentiated "revenue correction" rate on property rates income is applied. The applicable revenue correction rate for a municipality is based on the level of per capita own operating revenue (based on 2004/05 to 2006/07 figures), and own operating revenue is the difference between past actual total operating revenue and income from grants and subsidies. The revenue correction rates range from 1% for municipalities with the lowest operating revenue per capita to 7% for those municipalities with the highest operating revenue per capita. The correction rate applied to each municipality's predicted revenue from property rates is calculated using the following formula (with a 7% maximum cut-off for municipalities with operating revenue per capita above R2 500):
"Revenue correction rate" = 1 + 6/2500 * [Operating revenue per capita]

The application of revenue-raising capacity correction in the local government equitable share formula means that municipalities are expected to use between 1% and 7% of the revenue they raise from property rates to top-up the funds provided through the equitable share.

District municipalities do not collect property rates, so the revenue-raising capacity correction component of the formula is applied as a flat "tax" of 6% of the value of the regional services council RSC / Joint Services Board (JSB) levy replacement grant, allocated to each district. This grant is an unconditional allocation that replaces the major source of own revenue for district municipalities prior to 2006.

There have been two changes in this component of the formula for the 2011 MTEF. The previous stepped taxation structure for property rates (in which municipalities were placed into eight bands with one revenue correction rate applying to all municipalities in each band) has been replaced with the smoothed curve structure described above. This is fairer to municipalities that were on the outer edges of the bands in the previous formula, as they will now have their own revenue correction rate. In addition, the rate of revenue correction has been reduced for all municipalities. Previously, this rate ranged from 1.5% to 9.5%, and now it ranges from 1% to 7%.

Stabilising constraint

With the publication of three-year budget allocations, a guarantee mechanism is applied to the indicative outer-year baseline amounts with the aim of ensuring that municipalities are given what was indicated in the previous MTEF, as far as this is possible, given overall budget constraints and the need to amend the formula to increase allocations to poorer municipalities. In the 2010 MTEF, the applicable guarantees on the allocations are 100% for 2010/11 and 90% for 2011/12. In the schedules of the 2011 Division of Revenue Act, the applicable guarantees are 100% for the 2011/12 allocations, 90% for the 2012/13 allocations, with no guarantee on the indicative 2013/14 allocations published.

To deal with these constraints, municipalities are divided into two groups: municipalities that require a "top-up" in order to meet the stabilising constraints and those that do not. The total size of the top-up is calculated and deducted from those that do not require a top–up amount in proportion to the "surplus." All district management areas (DMAs) have been incorporated into local municipalities as part of the re-demarcation of municipal boundaries that comes into effect with the 2011 local government elections. Previously, district municipalities received the equitable share funds allocated on the basis of households in the DMAs. As these district municipalities are no longer responsible for providing services in the DMAs, the guarantees on their equitable share allocations (described above) were applied after subtracting the amounts previously allocated to them for the DMAs.

Other considerations in applying the formula

The formula outlined above has to be rescaled to make allowance for intricacies in the allocation process. In particular, powers and functions must be taken into account, and the overall budget must balance.

Powers and functions

Local government is divided into categories A, B and C.1 The division of powers and functions between local and district municipalities differs – and this is also true between the different local municipalities within the same district. In order to deal with these differences, the formula has to ensure that the allocations made in terms of the basic services component go to the municipality that is authorised to perform that function. To enhance transparency in the budget process, local government equitable share and municipal infrastructure grant (MIG) allocations to district municipalities are published per unauthorised local municipality in the relevant district municipality.

Balancing allocations

The horizontal division of allocations made between municipalities depends on the size of the overall allocation made to the local government sphere, usually decided through a separate consultative process to determine the equitable share of nationally raised revenue for each of the three spheres of government (the vertical division). As there is no guarantee that allocations made in terms of the horizontal division add up precisely to the amount allocated to the local government equitable share, such allocations need to be adjusted to fit within the constraints outlined above.

Rescaling of the BS, D and I components

The simplest way of making the system balance is to rescale the BS, D and I components to the available budget, and the formula actually becomes:

Grant = adjustment factor*(BS + D + I) – R ± C

This adjustment factor is calculated to ensure that the system balances.

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