FINANCIAL
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Policy Brief

The Incentive Effects of Intergovernmental Grants: Empirical Evidence from South Africa's Municipalities

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EXECUTIVE SUMMARY

South Africa has implemented a programme of measured fiscal consolidation aimed at narrowing the budget deficit and stabilising public debt levels. This will be achieved through tax policy measures to raise additional revenue on the income side, and on the expenditure side, the lowering expenditure ceilings through reducing the operating budgets of national departments, as well as lowering transfers to public entities and sub-national governments. For sub-national governments, particularly municipalities, the reduction in transfers (equitable share and conditional grants) raises a key policy question: do lower transfers facilitate increased independence from national government and innovation in revenue autonomy, or do they worsen service delivery functions and exaggerate regional disparities?

These issues are particularly important given that municipalities are expected to use their assigned fiscal functions as the main tool with which to address significant historical inequities in the distribution of, and access to socio-economic infrastructure and resources. In this regard, the Financial and Fiscal Commission (the Commission) carried out research to provide empirical evidence on the effects of intergovernmental transfers. The findings show that metropolitan areas and secondary cities are less dependent on transfers to drive expenditure and revenue. For smaller and rural municipalities, transfers significantly correlate with the financing of capital and operating budgets. The Commission thus recommends that in a fiscally constrained environment, fiscal balance is achieved by reducing transfers on the one hand, and on the other, stimulating capital expenditure funding in fiscally vulnerable municipalities with conditional grants. A differentiated approach that takes cognisance of the fiscal structure of particular categories of municipalities is thus recommended.

Background

In the aftermath of the 2008 financial crisis, South Africa's economic growth has steadily weakened due to a combination of factors including infrastructure constraints (particularly electricity and logistics), moderate growth in the global economy, and domestic policy uncertainty. In the face of lower growth and substantial revenue under-collection, South Africa has implemented a programme of measured fiscal consolidation aimed at narrowing the budget deficit and stabilising public debt levels. This is being achieved through tax policy measures to raise additional revenue, and expenditure measures such as cutting the operating budgets of national departments and lowering transfers to public entities and sub-national governments. As a result of fiscal consolidation measures, R14 billion, mainly in direct local government grant allocations, will be cut from national transfers to local government over the 2018 MTEF (National Treasury, 2018). In the context of a sustained real decline in intergovernmental transfers compared to those prior to 2009, this is a significant cut.

The introduction of consolidation measures in a fiscally constrained environment has generated debate around the possible long-term effects of lowering the overall envelope and constraining the growth of intergovernmental transfers to local government. This debate is largely centred on two competing views about the budgetary influence of transfers. The first is that increased reliance on central or intergovernmental transfers compromises local government's autonomy to set policies in accordance with local preferences, while promoting overreach by central government in local decision-making processes. The second view is that inadequate revenue bases and failure to take into account the full expenditure needs of mandated functions, particularly in smaller and mainly rural municipalities, has negatively impacted the capacity to deliver adequate levels of critical socio-economic services. In this case, fiscal constraints on resource vulnerable municipalities should not be allowed to worsen interregional disparities and undermine efforts to enhance the ability of local administrations and institutions to respond to the needs of local citizens in a timeous and adequate manner.

Given these opposing views, the Commission examined whether reducing intergovernmental transfers in a fiscally constrained space promotes independence and innovation in revenue autonomy, or worsens service delivery functions and regional disparities.

Research Findings

Using a unique FFC dataset on South Africa's municipalities, this policy brief examines the responsiveness of municipal expenditures and revenues to the main intergovernmental transfers.

The analytical tool developed by the Department of Cooperative Governance (DCoG) to classify municipalities in terms of their spatial characteristics has been used. Its definitions and characteristics are depicted in Table 1.

Table 1. Classification of municipalities

Class	Characteristics
Category A	All metropolitan municipalities
Category B1	Previously referred to as 'secondary' cities, now referred to as 'emerging' cities: All local municipalities referred to as secondary cities
Category B2	Large towns. All local municipalities with an urban core. These municipalities have large urban dwelling populations, but the size of their populations vary hugely.
Category B3	Small towns. Municipalities without a large town as a core urban settlement. Typically they have relatively small populations, of which a significant proportion is urban and based in one or small towns. Rural areas in this category are characterised by the presence of commercial farms because these local economies are largely agriculture-based. The existence of such important rural areas and agriculture sector explains why they are included in the analysis of rural municipalities.
Category B4	Mostly rural. Municipalities that contain no more than one or two small towns and are characterised by communal land tenure and villages or scattered groups of dwellings and are typically located in former homelands.

Source: Department of Cooperative Governance and Traditional Affairs

The main findings of the empirical analysis are:

- For **Category A** municipalities, conditional grant transfers provide incentives for enhancing own-revenues of metropolitan municipalities and generate increased funding of capital outlays. On the other hand, increased unconditional grants are associated with lower capital and operating expenditures.
- For **Category B1**, equitable share[1] allocations positively correlate with own revenues while negatively impact on operating expenditure.
- For **Category B2**, unconditional grants benefit municipal own revenues and expenditure per capita. Conditional grant allocations induce lower per capita outlays on capital and operational goods.
- For **Category B3** municipalities, unconditional grants are beneficial for own revenue and different components of municipal spending, while conditional grants incentivise municipalities to raise per capita spending on capital and operational goods and services.
- For **Category B4** municipalities, unconditional grants are beneficial for own revenue and different components of municipal spending, while conditional grants tend to lower capital expenditure.

The findings highlight that intergovernmental transfers are a critical component of the revenues that are used by municipalities to fund expenditure. These transfers are especially important for mainly rural municipalities that lack both internal capacity and a tax base to generate adequate own revenues. Such municipalities are financially weak and unable to attract qualified staff or purchase equipment to implement the technical aspects of budgets and raise capacity to collect taxes and fees. All municipal types rely on financial transfers from the national government to fund their provision of mandated basic public services, which, in turn, raises the levels of local revenues through promoting voluntary tax compliance.

[1] Equitable share and unconditional grants are synonymous and used interchangeably.

In terms of expenditure, the findings indicate the extent to which municipal expenditures depend on grant types.

- For metropolitan municipalities (Category A) that generate the bulk (over 70%) of revenue from own sources, the results suggest that such municipalities are more dependent on conditional than unconditional grants to finance their capital and operating budgets. This suggests that own revenues and conditional grants drive capital and operating expenditure.
- Emerging cities (Category B1) are less dependent on increasing levels of unconditional transfers as a source of funding operating costs.
- With increased intergovernmental transfers, the capital and operating budgets of large towns (Category B2) are more dependent on unconditional grants and less dependent on conditional grants.
- For small towns (Category B3), higher levels of both conditional and unconditional transfers are associated with increased capital and operating expenditures.
- Finally, rural municipalities (Category B4) tend to depend more on rising unconditional transfers as a source of funds for capital and operating expenditure.

Conclusion

In an environment of slow growth and efforts to consolidate public finances, the reliance on intergovernmental grant transfers to finance the capital and operating budgets of municipalities is welcomed. This is particularly so for Category A (CG), B1 (LES) and B2 (LES) municipalities that generate a significant share of revenues from own sources. However, for mainly rural Category B3 (CG & LES) and B4 (CG & LES) municipalities, transfers play a key role in their budgets. There is thus a need to focus on efficient use of funds and on overcoming the capacity challenges that have resulted in underspending of grants in these municipalities. In terms of revenue, conditional grants incentivise higher levels of own revenues in Category A municipalities, while for Categories B1-B4 municipalities, higher unconditional grant allocations are positive incentives for own revenue collections.

Recommendations

In light of the research findings, the Commission makes the following recommendations:

1) *That the Minister of Finance, through National Treasury, gives municipalities (particularly those in categories B3 and B4) greater flexibility in the use of conditional grants to encourage innovative approaches to resolving local problems.*

2) *That a fiscal capacity component be introduced to the equitable share formula to make it more efficient and incentivising. The component should incorporate two aspects that (**a**) recognise the revenue-raising effort of municipalities, and (**b**) incorporate the redistributive element of addressing horizontal imbalances.*

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