POLICY BRIEF

FINANCIAL AND FISCAL COMMISSION (2023)

Investigating the Local Government Fiscal Framework and Spatial Inequalities

FINANCIAL AND FISCAL COMMISSION

EXECUTIVE SUMMARY

Significant spatial inequalities across different types of municipalities limit the municipal tax base and hamper their ability to raise their own revenues. Smaller, rural municipalities continue to rely heavily on the intergovernmental transfer system. However, even urban local municipalities struggle to meet the objectives of the 1998 White Paper and National Treasury's assumption of a 75-25 split between own revenues and transfers, respectively. Due to internal and external weaknesses within the local government fiscal framework, basic infrastructure delivery continues to be severely constrained by underspending, undermining the important role of local government to drive Local Economic Development (LED).

BACKGROUND

Post-1994, local government was placed at the forefront of the developmental agenda. Not only do municipalities improve the living standards of citizens by providing essential services to communities, but they are also envisaged to fulfil a developmental role by investing in infrastructure and creating an enabling environment for fostering LED.

Sections 229 and 230 of the Constitution grant municipalities a range of taxation and borrowing powers. Property rates are a substantial source of taxable income to municipalities, whilst trading services (electricity, water and sanitation) contribute the bulk of municipal revenue. The White Paper on Local Government (1998) sets out the framework within which the municipal financial system functions. The policy objectives of the White Paper are threefold: firstly, to address the underlying causes of financial problems at the municipal level; secondly, to balance programmes aimed at eradicating poverty and fostering equity with strategies to enhance growth, job creation and competitiveness; and thirdly, to empower municipalities to fulfil their constitutional mandates.

RESEARCH FINDINGS

1. Municipal revenue sources

To function sustainably, municipalities require a solid revenue base to cover their operating expenditure and deliver services to their communities. However, municipalities have vastly different revenue-generating capabilities, given their socioeconomic, geographic and

THE FINANCIAL AND FISCAL COMMISSION

The Financial and Fiscal Commission is a body that makes recommendations and gives advice to organs of state on financial and fiscal matters. As an institution created in the Constitution of the Republic of South Africa, it is an independent juristic person subject only to the Constitution itself, the Financial and Fiscal Commission Act, 1997 (Act No. 99 of 1997) (as amended) and relevant legislative prescripts. It may perform its functions on its own initiative or at the request of an organ of state.

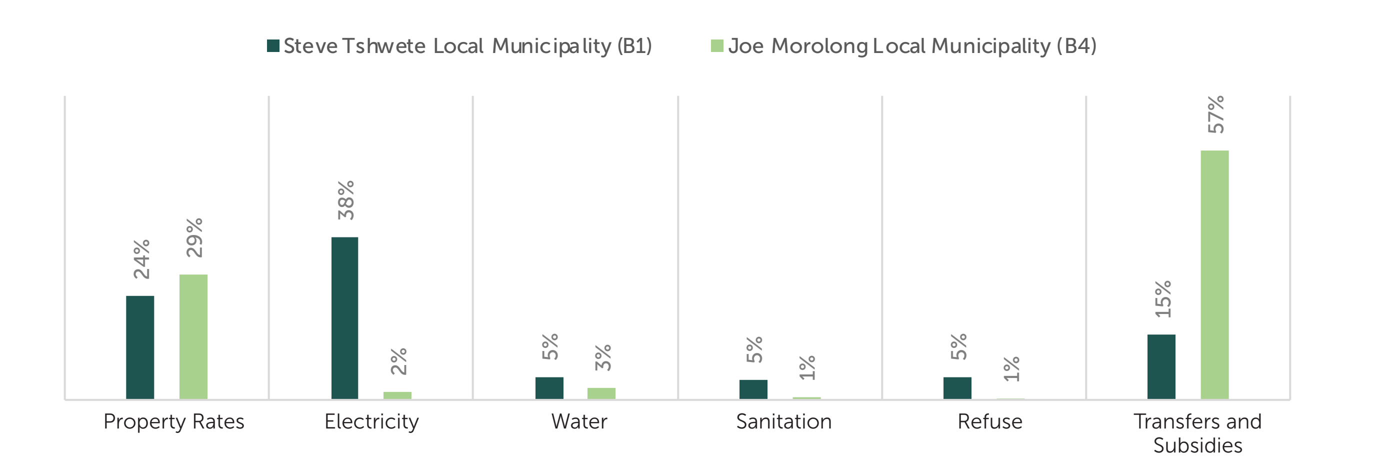
The vision of the Commission is to provide influential advice for equitable, efficient and sustainable intergovernmental fiscal relations between national, provincial and local spheres of government. This relates to the equitable division of government revenue among three spheres of government and to the related service delivery of public services to South Africans.

Through focused research, the Commission aims to provide proactive, expert and independent advice on promoting the intergovernmental fiscal relations system using evidence-based policy analysis to ensure the realisation of constitutional values. The Commission reports directly to both Parliament and the provincial legislatures, who hold government institutions to account. Government must respond to the Commission's recommendations and the extent to which they will be implemented at the tabling of the annual national budget in February each year.

The Commission consists of Commissioners appointed by the President: the Chairperson and Deputy Chairperson, three representatives of provinces, two representatives of organised local government and two other persons. The Commission pledges its commitment to the betterment of South Africa and South Africans in the execution of its duties.

demographic circumstances. Figure 1 shows that for Steve Tshwete (Category B1), a more economically developed municipality with a stronger revenue base than Joe Morolong (Category B4), sales from electricity make up almost 40 per cent of its total revenue, and only 15 per cent of total revenue comes from intergovernmental transfers.

Figure 1: Key revenue components across Steve Tshwete and Joe Morolong, 2020/21



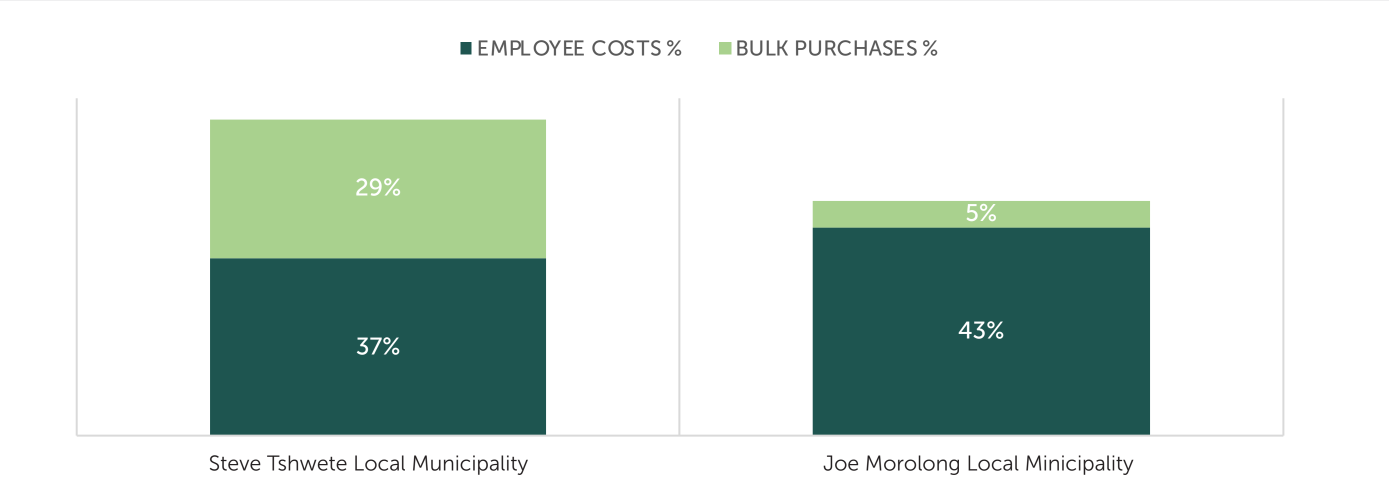
Source: National Treasury Section 71 reports 2020/21

On the other hand, 57 per cent of Joe Morolong's total revenue came from transfers and electricity sales only contributed 2 per cent. Joe Morolong is a rural municipality with a lower population than Steve Tshwete and is much more transfer dependent. Property rates across both municipalities make up a significant portion of total revenue, despite their varying geographical profiles and socio-economic status.

2. Key operating expenditure

The graphs in Figure 2 compare two key expenditure items, bulk purchases and employee costs, across two local municipalities. In Steve Tshwete, a secondary city, bulk purchases amounted to 29 per cent of total operating expenditure. In Joe Morolong, a rural municipality, bulk purchases consumed only 5 per cent of total operating expenditure in 2020/21. Such underspending on bulk services of key municipal services, such as water and electricity, severely constrains a municipality's ability to fulfil its service delivery mandate. Section 153 of the Constitution requires municipalities to prioritise basic services and socio-economic development in their budgets.

Figure 2: Key expenditure components as a percentage of total operating expenditure: Steve Tshwete and Joe Morolong, 2020/21



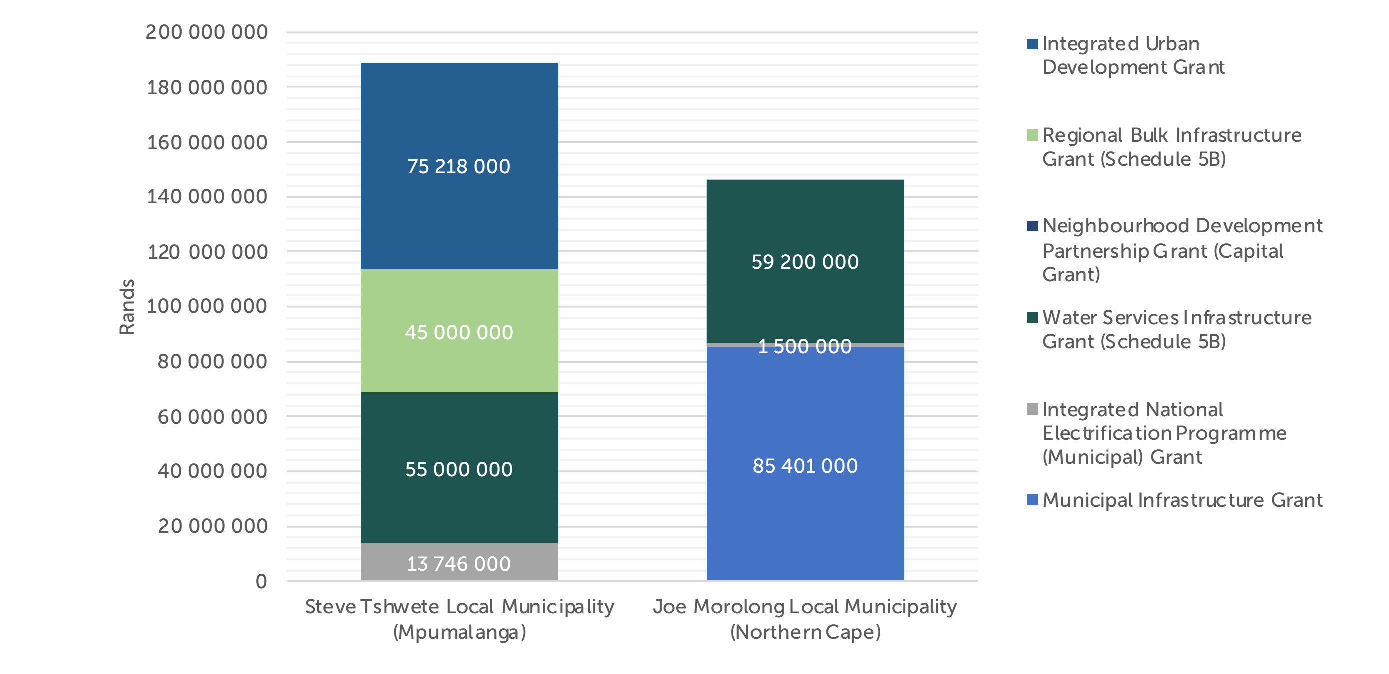
Source: National Treasury Section 71 Reports 2020/21

Figure 2 shows that employee costs consumed a significant proportion of operating expenditure, which amounted to 43 per cent in Joe Morolong and 37 per cent in Steve Tshwete. Both municipalities, especially Joe Morolong, spent a high proportion of their budget on personnel costs, which is an administrative function. The FFC has previously stated that there is an unhealthy balance between core and non-core municipal services (Financial and Fiscal Commission, 2019).

3. Infrastructure investment by local government

Investment in infrastructure is a crucial pillar of the state's economic policy response to the COVID-19 pandemic and its detrimental impact on economic activity (Economic Recovery and Reconstruction Plan, 2021). Despite financing provided by the national sphere of government to municipalities in the form of infrastructure grants, these grants are not effectively utilised at the municipal level and continue to underperform. Figure 3 shows the amount of infrastructure-related grants received by Steve Tshwete (B1) and Joe Morolong (B4) disaggregated by grant type.

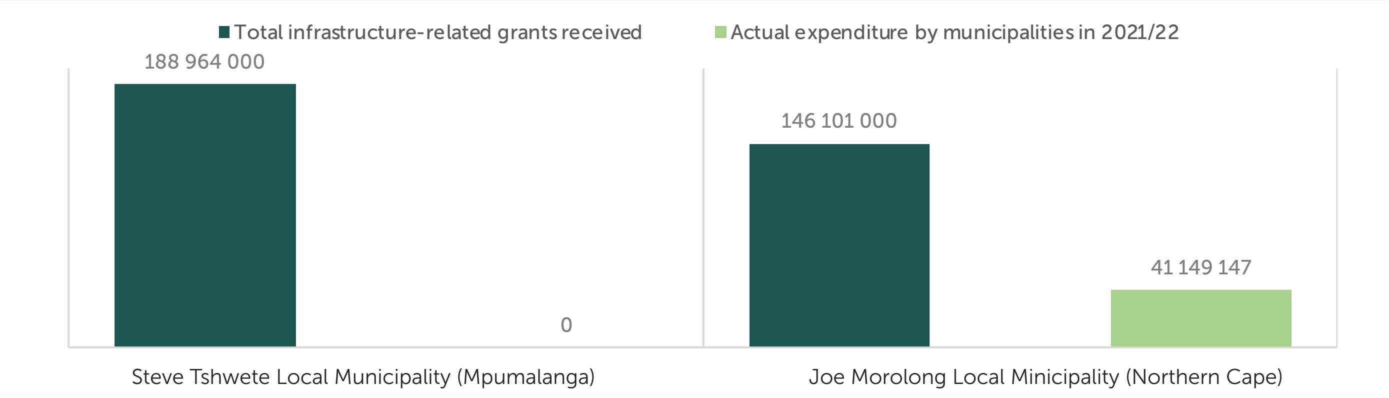
Figure 3: Infrastructure grant composition across two local municipalities, 2021/22



Source: National Treasury Section 71 reports 2021/22

What is apparent from the figure is that Joe Morolong mostly receives funding to address backlogs in service delivery and water infrastructure, while Steve Tshwete receives funding for a much wider scope of local developmental objectives. This points to a lack of coherence in policy priorities in the local government sphere, particularly regarding the objectives of LED, since a wider scope of funding appears to be granted to local municipalities that already have greater revenue-generating capabilities.

Figure 4: Infrastructure grant spending, 2021/22



Source: National Treasury Section 71 reports 2021/22

Actual grant spending by Joe Morolong and Steve Tshwete is captured in figure 4 below. From Figure 4 it is clear that mere financial assistance provided to municipalities is insufficient due to capacity-related constraints that persist at the local government level. The graphs indicate that Steve Tshwete received approximately R188.9 million in infrastructure-related grants. Yet, due to either spending inefficiencies or missing data (or both), no infrastructure grant spending was recorded for the 2020/21 financial year. In Joe Morolong, R146.1 million was received, and only R41.1 million was spent.

CONCLUSION

While the 1998 White Paper acknowledged the key role that intergovernmental fiscal transfers would play in assisting less affluent and more rural municipalities in fulfilling their mandates, the policy did not foresee that decades on, municipalities would still be struggling financially. Many municipalities still lack the critical infrastructure to provide essential services and where funds are available, they spend them inefficiently.

The level of economic activity municipalities can attract influences their ability to generate sufficient revenue streams. Large spatial inequalities mean that smaller, more rural municipalities are unable to achieve the objectives of the 1998 White Paper. The findings from the two case studies illustrate transfer dependency amongst smaller, rural municipalities such as Joe Morolong. In contrast, larger local municipalities with secondary cities can generate a substantial portion of their revenue from electricity sales. However, property rates are an important source of revenue for both municipalities, despite their socioeconomic differences. Furthermore, the analysis of expenditure reinforces the view that the bulk of municipal spending is administrative, on employee compensation rather than prioritising basic services.

Underspending on infrastructure grants allocated is significant due to varying capacity constraints across municipalities. Underspending and improper spending of municipal infrastructure grants continue to occur due to a variety of internal and external weaknesses, such as poor planning and contracting, poor project management, lack of technical capacity, inefficiencies in the procurement system and lack of intergovernmental coordination in managing and delivering infrastructure projects (Financial and Fiscal Commission, 2019). Funding for LED appears to be geared towards larger, more urbanised municipalities with greater revenue-generating capacity, while smaller, rural municipalities receive funding mostly for backlogs in service delivery. Continuing this trajectory will only deepen spatial inequalities.

Overall, the policy objectives of the local government fiscal framework have not been realised. The framework is not sufficiently differentiated and thus does not adequately accommodate the unique challenges faced across different types of municipalities, hampering their ability to invest effectively in infrastructure and deliver basic services.

RECOMMENDATIONS

The Commission makes the following recommendations:

1. *The Commission recommends that, to overcome persistent challenges municipalities face in the context of the rapidly changing economic environment, the Minister of Cooperative Governance and Traditional Affairs (COGTA) and the Minister of Finance should critically review the local government fiscal framework. A differentiated approach is needed to ensure the policy is well-tailored to overcome unique issues individual municipalities face. To achieve this, the fiscal framework may need to be radically, rather than incrementally, reconfigured.*

2. *The Commission is of the view that careful attention must be given to the funding mechanism of conditional grants. The Commission thus recommends that COGTA and National Treasury develop an appropriate funding mechanism or funding plan in a targeted and phased approach, which enhances the capacity of municipalities to spend conditional grants effectively and in a manner consistent with local government's developmental role.*

ENQUIRIES:

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