Review of Local Government Fiscal Framework Public Hearings

Problem Statement and Policy Issues

16 September 2011

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For an Equitable Sharing of National Revenue

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1. Problem Statement

The Local Government Fiscal Framework (LGFF) 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. In essence, the LGFF is the funding arrangement required to ensure that local government and individual municipalities are financed sufficiently to fulfil their constitutional mandates so that adequate services are rendered to communities. The current local government configuration and system is relatively young, with the financing framework for municipalities only established in 1998. The Constitution provides for the establishment, expenditure responsibilities and the funding framework of local government as part of a system of cooperative governance with all other spheres.

There have been several changes to the LGFF since 2000. Some key developments in this period have been:

i. The general consolidation and growth in the number and quantum of grants to local government. This was followed by pressures that have given rise to the proliferation and fragmentation of the various grants
ii. A general stagnation in own revenues and poor performance in maximising own revenues
iii. Increasing expenditure requirements placed on municipalities
iv. Changes and a lack of progress in certain policies. These include the failed policy position on the electricity distribution industry and the slow accreditation of municipalities for housing
v. A greater need to differentiate municipalities based on widening variations in contexts and challenges

There is a general perception that the current structure of the LGFF results in certain municipalities not being appropriately funded. In addition, under-funding is often cited as a possible explanation for municipal service delivery failures and general poor performance *However, not much research has been undertaken to justify this viewpoint.* Some problems around the LGFF have also masked the non-fiscal constraints that give rise to failures by municipalities to effectively deliver services. These constraints include capacity and weak systems of accountability. In addition, the local government sphere has recently been plagued by numerous service delivery protests. Municipal service delivery failures are becoming more frequent and with far reaching consequences on the social and political wellbeing of the country. The LGFF needs to be designed so as to address these identified problems. The main question to be discussed is whether as just framed, these are indeed the overarching problems confronting Local Government?

If they are, then the general questions are around whether the different types of municipalities in the country are financially and fiscally well resourced to fulfil their constitutional mandates. Is the LGFF in its current form, adequately and effectively catering for the different needs and developments in different municipalities? How can the current LGFF be configured to appropriately fund the various needs and developments in different types of municipalities? Furthermore, is the local government fiscal framework robust and dynamic enough to cater for a continuously evolving local government system? As part of its mandate, the Financial and Fiscal Commission seeks to contribute to this debate as well as finding possible solutions to challenges affecting the local government sector. The Commission seeks to achieve these twin goals through this public hearing process.

2. The Public Hearing Processes

The public hearing discussions will be framed around a set of questions that are highlighted in this paper. Public hearings will provide a rare opportunity for stakeholders to reach a consensus on research and policy issues pertaining to the LGFF in order to develop a structured research agenda going forward. The research agenda will seek to provide policy options to the issues raised via sound research.

How Do These Hearings Complement Other Processes

The local government sphere is dynamic and continuously evolving. Therefore, it is important that the fiscal framework that finances the sphere is equally robust to cater for the needs of municipalities. Given these dynamics, the LGFF is continuously being reviewed by the national government, in particular the National Treasury and the Department of Cooperative Governance (DCOG). Related to this, the National Treasury and DCOG are proposing a Summit to review the intergovernmental fiscal system in 2012. It is important that the Commission plays an active role in these discussions while at the same time running its own processes that maintains its objectivity and role as a unique player in the general policy arena. Therefore this process should be considered as a complementary process to Government initiatives. The role of the Commission is to actively participate in these debates and contribute to the intellectual environment within its constitutional role as an advisory body.

3. Issues in the Local Government Sphere

This section identifies some challenges that confront the local government sphere and the LGFF in particular. The purpose is to introduce debate around these and related issues.

Differences across Municipalities

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

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, there were 857 municipalities in the country. These included several transitional councils in former homeland areas. In 2000, 284 wall to wall municipalities were established. In 2005, a further demarcation process resulted in a municipality being disbanded. This resulted in a total of 6 category A (metros), 231 category B (local) and 46 category C (district) municipalities. Following the 2011 local government elections, 2 additional metros where established, with further amalgamation processes resulting in a total of 278 municipalities in the country.

While there is a structured set of criteria that informs categorisations of municipalities in the Constitution and the demarcations processes, the suggested range of criteria does not exist in practice. Apart from the categorisation in the Constitution, there is no official categorisation of municipalities. However, section 155(2) and provision in the Municipal Systems Act explicitly provide for a categorisation of municipalities in addition to the constitutional categorisation highlighted above. The most popular categorisation used defines municipalities based on their spatial characteristics. These are highlighted in table 1 below which also includes certain social and economic variables to emphasise these differences.

Table 1 Social, Economic and Demographic Difference across 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

The urban municipalities in the country (represented by the metros and secondary cities) have greater levels of economic activity, employment and a “richer” demographic profile. These factors impact on their expenditure responsibilities, as shown by higher per capita expenditures in these municipalities. Due to low levels of economic activities rural municipalities are characterised by high levels of unemployment and poverty. Urban municipalities have more compact settlements while rural municipalities are relatively more sparsely populated. These differences impact on the costs of providing services and suggest unique planning decisions around these unique environments.

These differences impact also on the fiscal framework itself, indicated by the varying ability of municipalities to generate own revenues as well as the dependence of certain municipalities on transfers from National Government. Table 2 highlights these differences by providing the funding mix across the various types of municipalities.

Table 2 Source of Operating Income across the 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%	2%	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	33%	15%	39%	3%	9%	100%

Source National Treasury Local Government Database

It is clear that the greater levels of economic activity and favourable demographic profiles of metros and urban municipalities greatly enhances their ability to generate own revenues. In 2008/09, 75% of the operating budgets of metros and secondary cities were funded by local taxes. On the other hand, rural municipalities and district municipalities are heavily dependent on grants. This dependency ranges from 70%-80%, suggesting that the ability to generate revenues in these areas are minimal

In addition to revenues, the differences across municipalities are also reflective in the expenditure functions and powers assigned to different types of municipalities. Given the urban space that metros and secondary cities operate in, the development and funding of the built environment is being enhanced by providing greater planning decisions in terms of housing and transport infrastructure.

Issues for Discussion

Based on this preliminary analysis, it is clear that the local government landscape is diverse. This impact on the fiscal capacity of municipalities, with urban municipalities having a greater ability to collect own revenue due to greater levels of economic activity and richer households within their jurisdictions. On the other hand, 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 a differentiation in the current system?
ii. Should urban municipalities ideally be encouraged to maximise own revenues and have their taxation powers be extended to be largely self financing, given their better socio-demographic and economic situation?
iii. Should intergovernmental transfers play an equalisation role in terms of being directed to mainly 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 service different in rural areas as opposed to urban areas? What about the semi-urban and semi-rural municipalities?

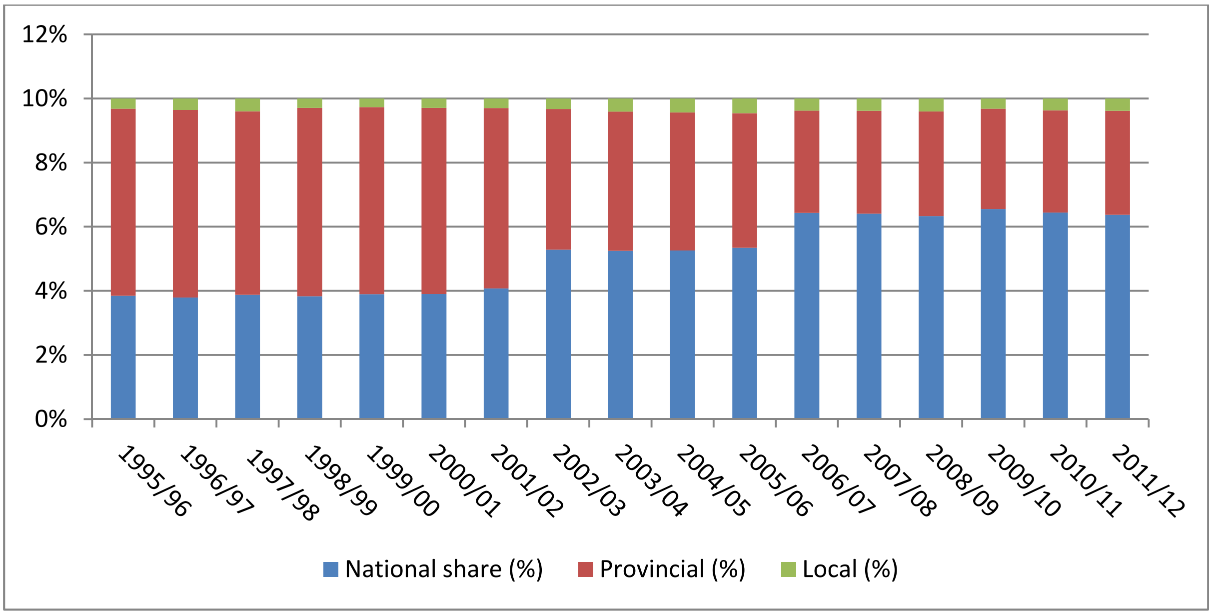
vi. Recent policies have resulted in greater expenditure responsibilities being devolved to metros and other urban municipalities, in specific that of transport and housing. This is related to their capacity and ability to plan around their built environment. What are the appropriate funding mechanisms that should be developed to ensure that these municipalities can fund these expenditures?

Local Government Equitable Share

Local government revenues consist of revenues from their own local taxes, unconditional grants, conditional grants and municipal borrowing. The major unconditional grant that accrues to municipalities is the local government equitable share (LES)

Figure 1 traces shares of nationally raised revenue across the 3 spheres from 1995/96. The equitable share to local government is the smallest across the spheres, 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 LES formula came into effect in 1998 when it was distributed across municipalities using a formula based on demographic, poverty and service delivery characteristics. Following several flaws in an initial formula that operated from 1998 to 2004, a review process resulted in the adoption of the current formula from the 2005/06 municipal financial year. The current formula is depicted as follows:

$$LES = BS + I + D - RRC \pm C$$

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

The FFC played a significant role in development and continued improving of the formula. Following a review of the current formula in 2009, the FFC raised the following concerns:

i. Subsidies in the formula not being reflective of the different costing pressures faced by municipalities
ii. The LES should consider subsidising all services that is an expenditure pressure for municipalities
iii. The unconstitutionality of the RRC component
iv. The lack of frequent data updates that track changes in demographics and service levels
v. The use of R800 per month per household to measure poverty
vi. Continued tinkering by government that further complicates the distribution of resources across municipalities

Issues for Discussion

i. Is the general structure of the formula aligned with theoretical and legal principles as well as reflective of the policy priorities of national government?
ii. Is the current formula technical effective in ensuring the needs of the different types of municipalities are catered for?
iii. Are the current basket of municipal service funded through the formula fully reflective of the expenditure pressures faced by municipalities
iv. Are the current subsidies reflective of 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 such that the funds from the LES is equitable shared and distributed? Should the LES account for fiscal capacity of municipalities?
vi. How can the LES formula take account of changes in service levels, demographics and migration patterns, given the lack of data at the local government level?

Conditional Grants

The Constitution allows for other spheres of government to provide grants to municipalities with specific conditions to enhance and promote national policy goals. Conditional grants to municipalities are usually divided into infrastructure related grants and capacity building related grants. These transfers can also go directly to the municipality or can be an in-kind allocation to the municipality that will be spent on their behalf by a third party. Table 3 summarises the conditional grants that accrue to municipalities.

Table 3 Transfers to Local Government

R million	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
		Outcome		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**	**25 560**	**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 FFC has undertaken several reviews of the intergovernmental transfer system and conditional grants that accrue to municipalities. Some of the issues raised include:

i. There should be transparency in the criteria used to allocate conditional grants
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 nonfinancial performance data
iv. There should be better guiding principles to introduce and terminate conditional grants to prevent a continuous proliferation of grants and confusion over national policy objectives

Issues for Discussion

i. Is there a general proliferation of conditional grants as and when a priority arises?
ii. Is there an implicit or explicit link between conditional grants and the LES? Should there be such a link?

iii. Should there be a greater differentiation in conditional grants in addition to the differentiated approach introduced in the MIG with the MIG cities
iv. Is the performance of conditional grants being appropriately measured and evaluated? Should performance be taken as a measure to determine grant allocations?
v. Should the MIG be a consolidation of all infrastructure grants to local government
vi. Given the failure in the restructuring of the Electricity Distribution Industry, what is the future of the Integrated National Electrification Programme (INEP) Grant for the eradication of backlogs

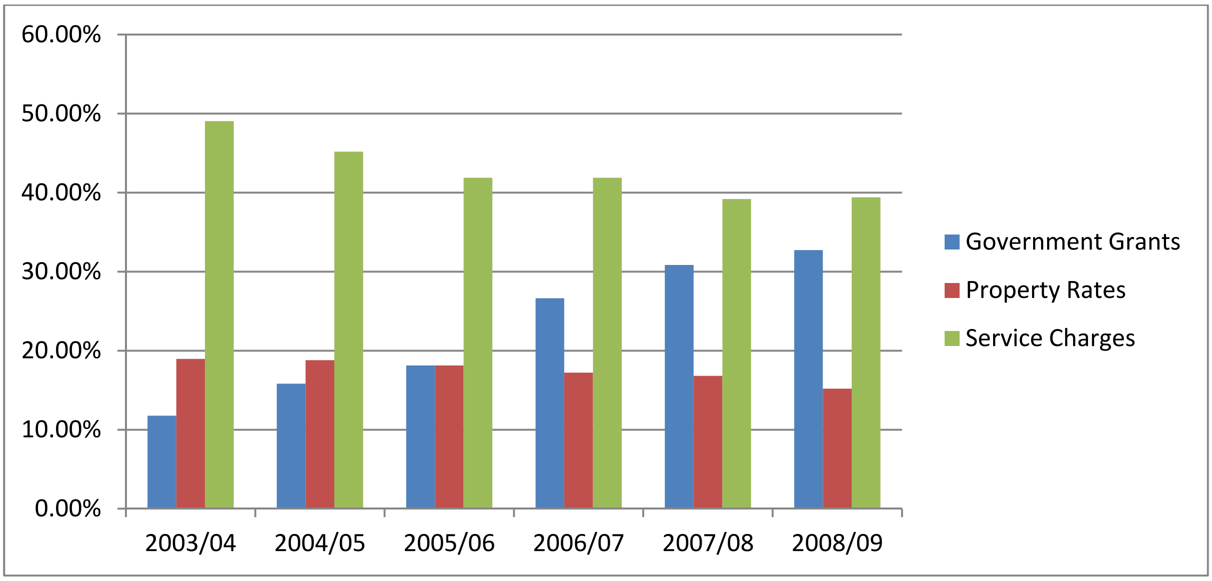
Municipal Own Revenues

Unlike provinces, local government has an array of revenue instruments. Section 229 of the Constitution gives effect to these revenue instruments. Municipal user charges and property rates are the largest sources of municipal own revenues. 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. Figure 2 illustrates the gradual impact of this trend.

Figure 2 Shares Grants and Own Revenues of Total Operating Revenues



Source National Treasury Local Government Database

Figure 2 confirms that government grants (largely in the form of the LES) increasingly comprise more of municipal operating budgets. Such a trend raises concerns that local government is becoming more grant reliant and that municipalities effort to maximise own revenues is eroding due to this. Is this indeed the case?

Evolution of the Legislation Regulating Municipal Own Revenues

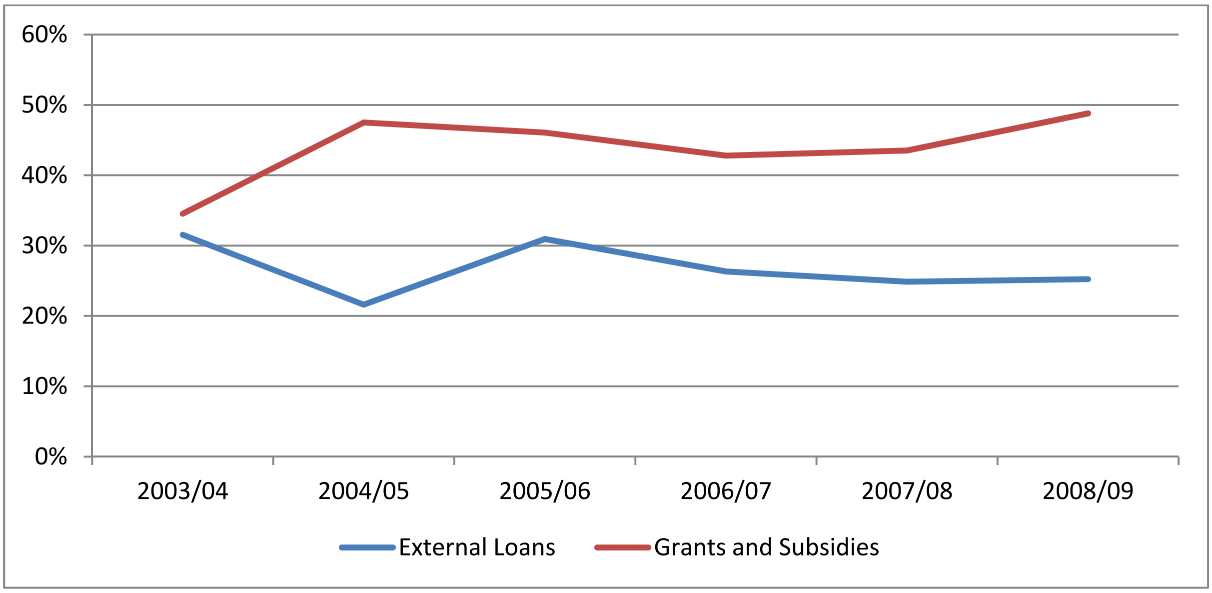
Section 229 of the Constitution empowers local government with an array of revenue sources. However, there are several pieces of supporting legislation that governs municipal own revenue sources. The Municipal Property Rates Act of 2004 regulates local government's ability to impose property rates. In terms of service charges, acts such as the Electricity Act and the National Water Act govern 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, 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.

Mindful of the fact that in a unitary state where all spheres are interrelated and interdependent, it is important that the greater macro economy and policy priories are protected, the main question for discussion is whether the nature of all these pieces of legislation has led to over regulation of municipalities' ability to levy taxes and an encroachment on municipal fiscal autonomy?

Municipal Borrowing

Although most of a municipality's revenues from taxation are spent on the operating budget, local governments are also legally authorised to borrow from credit markets. Section 230 of the Constitution empowers municipalities to borrow, while such borrowing powers are regulated by the Municipal Finance Management Act (MFMA). There is a concern that most municipalities are not taken full advantage of their ability to borrow, while other municipalities are being constraint to access borrowing markets. Figure 3 illustrates the extent of municipal capital budgets that are 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 due possibly 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 RSC levies, Sharing of General Fuel Levy and Local Business Tax

RSC levies were a major revenue source for local government, accounting approximately 8% of total municipal operating revenues. It was a tax levied by metros and district municipalities. As of the 2006/07 municipal financial year, the RSC levies were abolished due to several economic, legal and administrative deficiencies in the taxation instrument. In order to protect municipal budgets from the loss of revenue, national government introduced an RSC levy replacement grant that was to continue until a suitable replacement for the former tax is identified and implemented.

In 2009/10, the sharing of the general fuel levy (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). Metros were entitled to a 23% share of the revenues from the general fuel levy, which equated to the previous quantum of the RSC levy replacement grant, and was shared proportionally amongst the metros according to total fuel sales. The FFC raised concerns over the buoyancy of the new instrument, its link to economic activity and concerns over the continued lack of a replacement for district municipalities. As the fuel levy is shared using total fuel sales per a metropolitan municipality, such a sharing mechanism would encourage more fuel sales within their jurisdiction, which counters transport policies of promoting greater use of public transport.

Prior to the introduction of the sharing of the general fuel levy amongst metros, most parties preferred the implementation of a Local Business Tax (LBT) to replace the RSC levy. This was due to the similarities between the proposed LBT and the RSC levies in terms of its links to economic activity, but improving on the administrative failures of the latter. Recently, municipalities (the metros in specific and organised local government in general) are exploring applying for a LBT via section 5 of the MFPFA. There are a host of issues to discuss including the (tax) principles – why is LBT better than any other possibility (what is the basket of possibilities?), the issue of local autonomy in relation to the tax base and tax rate administration as well as whether all municipalities should receive this tax?

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 traditional areas
ii. Is there currently an over regulation of municipal own revenue sources? Should there be a regulation of such sources?
iii. How autonomous is local government given the interdependence and interrelation between spheres?
iv. Are increasing transfers to municipalities resulting in a lack of effort to maximise existing revenue sources? What are the real impacts of grants on municipal own revenues?
v. Has the RSC and JSB levies being appropriately replaced? Is the sharing of the general fuel levy a buoyant revenue source?
vi. What potential avenues of increasing the array of local taxes are provided by Section 5 of the MFPFA?
vii. What are the views over 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. What is the future over the funding of district municipalities? What options are there for replacing the RSC levies for this type of municipality? Should the RSC levy be replaced for these municipalities?
ix. Should additional taxation powers be afforded to local government given that most municipalities fail to maximise current revenue instruments due to the 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?
xii. Should institutions like the DBSA focus their lending initiatives to middle income municipalities thus allowing for metros and larger urban municipalities, with greater collateral, to borrow more from private institutions?

Other Issues

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

i. The impacts of migration (urbanisation in specific) and the lack of data available at the Local Government level
ii. Issues of intergovernmental coordination failures that result in unfunded mandates

iii. Slow progress on policies that creates uncertainty and expenditure pressure for local government. This includes housing accreditation, transport and the failure in the restructuring of the EDI
iv. Poor municipal expenditure in repairs and maintenance on existing and new infrastructure. This is due largely to the poor tariff determination process in municipalities such that tariffs are not reflective of the costs of providing services. The repairs and maintenance of social infrastructure is not readily funded through the LES as services and subsidies are also not cost reflective in the formula

4. Questions for Consideration and Deliberation at Public Hearings

This section summarises questions to kick-start discussion during the public hearings. The list of questions is not exhaustive and only intended to provide a guide on some of the questions that affect the LGFF.

i. **Is the proposed problem statement for LGFF appropriate and the most pressing one?**
ii. **Is the current local government fiscal framework catering for the needs of all municipalities in the country given the diverse social, demographic and economic characteristics of municipalities?**
    a. Appropriately empowering urban municipalities to manage the built environment?
    b. Devolution of additional powers and functions to urban municipalities?
    c. Ensuring rural municipalities are well capacitated to roll out a decent quality of basic services to communities?
    d. Is the current intergovernmental transfer system accounting for the difference inherent across the local government sphere?
    e. Are certain municipalities underfunded?
iii. **What are the factors inherent in the current policy and fiscal environment that are hindering the appropriate funding of municipalities?**
    a. Increased roll out of social infrastructure puts additional expenditure pressures on municipalities in terms of providing services to new households and maintaining infrastructure?
    b. The impacts of FBS policies on municipal expenditure pressures?
    c. The prolonged policy issue on housing accreditation?
    d. Issues around the roles and responsibilities of district municipalities?
    e. The continued existence in the system of unfunded mandates?
iv. **Is the current legislative framework governing local government fiscal matters, in specific to the financing and division of expenditure power and functions of municipalities, impacting negatively or positively on municipal performance?**
    a. Over regulation of municipal taxes?
    b. Issues around the asymmetric division of power and functions between local and district municipalities?

v. **What other issues in the local government and, in general, the intergovernmental fiscal relations systems weaken the performance of municipalities?**
   a. The future of the EDI and the role of Eskom in electricity distribution?
   b. Poor efforts from municipalities in terms of enhancing existing revenue sources?
   c. Poor expenditure on repairs and maintenance of existing and new infrastructure?
   d. Poor tariff determination and implementation processes

vi. **Does the fiscal framework achieve an appropriate balance between equity concerns and providing appropriate incentives for effective, efficient and accountable governance?**

vii. **Are current revenue instruments afforded to municipalities sufficient, well designed and appropriately implemented?**
   a. The role, design and targeting of the local government equitable share formula?
   b. Issues on the conditional grants afforded to municipalities?
   c. Reviewing the municipal borrowing frameworks and generally the scope for certain municipalities to borrow?
   d. Protecting and enhancing own revenue sources of municipalities?
   e. Appropriately balancing the need to protect municipal autonomy while ensuring national priorities are met?

viii. **Is the current local government fiscal framework robust and dynamic enough to gradually cater for the continuous evolution of the local government sphere?**
   a. Increased migration and urbanization?
   b. Improvements in technologies and access to services?

ix. **What changes or improvements that you or your department/municipality would like to see in the local government fiscal framework? Explain why these changes are being proposed?**

x. **What other aspects should be catered for in the local government fiscal framework?**