Submission to the FFC on the local government fiscal framework

Prepared by PDG
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Introduction

This submission to the FFC is made by PDG (formerly Palmer Development Group) motivated by the interest and commitment we have to the public sector in South Africa and informed by the work we have done on research, policy and management support in this sector over the past 21 years. As almost all this work has been done on behalf of specific public organisations we must acknowledge that the outputs from this work are effectively owned by the wide range of organisations we have worked for. But we see this work as a cooperative effort between ourselves and our clients and, benefiting from this effort, we believe we are well placed to thread together some key findings from this body of work which are relevant to the LGFF.

Structural issues impacting on the LGFF

Linking the LGFF to the institutional framework

A fiscal framework can only be effective if it is aligned to a sound institutional framework which clearly sets out the roles and responsibilities of the individual organisations or organisational groupings involved. In South Africa we do have a relatively well developed institutional framework but it does have some shortcomings which have created problems in the past, notably:

a) The variability across municipalities has not been properly catered for. However, current evidence is that there is full commitment to a 'differentiated approach' and a considerable amount of work has been done on planning for this. But this has not been implemented to date (more on this below).

b) Uncertainty continues to exist about the role of district municipalities.

c) The sharing of powers and functions across the three spheres of government, and the two tiers of local government, is problematic in some cases, specifically:

   National to local service provisions interfaces

   i. Considering ***water supply systems***, some infrastructure is typically required which makes water resources available, such as a dam or wellfield. This links to the next part of the water supply value chain: the bulk water supply system. There is an institutional divide here as water resources is a national competency and water supply is a LG competency. It is important for the resource development and water supply systems to be treated as a whole, where possible, and particularly for small to medium sized systems which are locally managed. But the divide continues to exist and causes considerable difficulty in some cases both with funding and management.

ii. In the case of ***sanitation*** there has been a shift in part of the function from Water Affairs to Human Settlements. The motivation for this is difficult to understand and it creates a specific set of difficulties for the fiscal framework.

iii. In the case of ***electricity*** the alignment between the national function of bulk electricity and electricity transmission with electricity distribution (or reticulation as it is called in the constitution) is less problematic as most electricity if generated by national scale power stations. But there are issues associated with alternative generation arrangements and with identifying the point in a network at which national (Eskom) responsibility ends and LG responsibility starts.

Provincial to local government devolution

iv. The progressive devolution of ***housing and public transport*** functions to local government, specifically cities, is delayed. While the situation with PT has become much clearer with the publication of the National Land Transport Act, in both these cases the devolution should take place as an assignment and not a delegation, with sector legislation aligned with this position.

v. In the case of ***primary health, libraries and museums***, these are provincial functions but many municipalities, cities specifically, provide these services. Legally these are ‘delegations’ but they are typically poorly structured and not properly financed. The problems of coordination of primary health care services, provided by two separate spheres of government in one municipal area needs to be resolved. Overall it is important to move away from delegation to permanent assignment.

vi. The ***roads sector*** has particular problems which originate from lack of nationally consistent information on lower level roads (Class 3 and below) and a lack of attention nationally to a roads classification system. This leaves many municipalities with uncertainty as to which roads they are responsible for and creates a very difficult situation with regard to financing of roads.

Sharing of functions between district and local municipalities – nationally mediated functions

vii. With regard to ***water services***, there has been a properly implemented process to authorise many LMs to be the ‘authority’. This has been generally accepted that the fiscal framework aligns with this position. There are ongoing concerns about the effectiveness of DMs which are responsible for this function which may require further authorisations. One of the biggest problems with this situation is that districts typically do not have billing systems. This splitting of revenue sources – own revenue on the one hand and transfers on the other – is problematic.

viii. The 'authority' for ***electricity*** is a patchwork at the moment with this shared between LMs (mostly urban areas) and DMs (mostly rural areas) in many municipalities. This needs to be rectified.

ix. ***Municipal health*** is primarily environmental health and is not, strictly speaking, a service but a regulatory activity primarily aimed at regulating businesses. It is currently the responsibility of DMs but where it is provided effectively this is being carried out by LMs. It should be an LM function.

Sharing of functions between district and local municipalities – provincially mediated functions

x. With regard to sharing the ***roads*** function between DMs and LMs this is highly problematic. As mentioned above this relates primarily to lack of information and an associated classification system nationally. There are initiatives underway currently to improve this, using the Rural Transport Infrastructure and Systems Grant. The extent to which this leads to a nationally consistent GIS-based roads system, including municipal roads, remains to be seen.

xi. The ***solid waste management (refuse) and fire fighting provisions*** in the Municipal Structures Act lead to a split authority for the function (planning at a district level and implementation at a local level) which is problematic.

What is to be done about this?

- There should be a substantial national initiative to review ***nationally mediated powers and functions*** aimed primarily at housing, public transport, roads, primary health, municipal health, libraries and electricity. This should result in permanent assignments or, in the case of municipal functions, authorisations. Legislation places the responsibility for these assignments and authorisations under the Minister of Cooperative Governance and Traditional Affairs.
- The ***Municipal Demarcation Board*** currently has an important new project running to review powers and functions under its control and gather new information on local government. This will lead to recommendations on powers and functions and, more specifically, action in the case of ***provincially mediated functions***.
- ***Section 84 of the Municipal Structures Act***, which sets up the responsibilities of DMs, requires review.
- The outcome of the ***SALGA*** review of the way ***Section 78 of the Municipal Systems Act*** has been applied will provide important insights into the future institutional arrangements for water services.

The necessity of having a LG performance management system in place

If the LGFF is to include incentive-based measures, it is important to have a good LG performance management system in place. Although there has been work at national level on setting up such a system for local government, this is currently not effective.

However, provinces are taking some action in this regard. For example, KZN has set up a web-based performance management system which is based on a consistent set of indicators and is proving to be useful.

Information requirements

There is a recognition of the need to have census quality information at intervals of less than 10 years. In addition to this, the following is important:

- Aligning expenditure functions applied in the National Treasury budget survey with provisions in legislation and with the capacity survey carried out by the MDB.
- Carrying though recommendations made as part of the Municipal Infrastructure Investment Framework to link infrastructure access information to dwelling points identified by Stats SA. This requires an interface between Stats SA and the municipal GIS systems. The result will be a reliable measure of access to infrastructure while, at the same time, supporting the development of information management systems at local level.
- Clarifying LG KPIs and setting up a national web-based LG information system which manages this information. This can be done without too much difficulty (KZN LG performance system, 'Blue and Green Drop' systems and current SALGA/WRC initiative to set up national web-based water services info system).
- Have a once off, year long project to identify all the roads in the country on a single GIS and apply a classification system to this information[1].
- Strengthen current Stats SA surveys to get customer satisfaction information which is statistically relevant at municipal level.

LG capacity

An understanding of capacity is important for the LGFF as there are options for formulas distributing funds to include on 'capacity' features and because a specific capacity building initiative may need to be funded.

The capacity classification system developed by DCoG which provides for three groups of municipality needs to be implemented. In reality this is being implemented through the high capacity economically strong municipalities now incorporated under the City Support Programme. DCoG also have plans for support to the middle and low capacity groups, primarily dependant on the establishment of the Municipal Infrastructure Support Agency (MISA). However, the activities, at least for the low capacity grouping, have not been implemented. It has been argued in several policy position papers that an intervention for lower capacity municipalities can only be successful if it is aligned with a transitional grant aimed at funding private sector and water board management contracting arrangements which, in turn, are aimed at setting up sound systems and supporting the growth of management capabilities within municipalities.

Key factors impacting on the financial viability of municipalities

An important feature of the LGFF is that it should incentivise cost efficient local government performance. In order to do this it is important to understand what these costs are and what influences these costs into the future. This is best done through

[1] It is notable that private GIS systems such as 'Tracks for Africa' already have national roads info down to track level captured.

modelling and this work has been done over the past decade using the Municipal services Finance Model. The most recent set of models done for the country as a whole, and taking differentiation into account, was undertaken in early 2010. The results show that a ‘benchmark’ municipality in each of the categories identified in the FFC problem statement document can be viable on the operating account with the levels of transfers available currently. However, it is notable that this is a complex situation that this is influenced by many factors, additional costs related to unfunded mandates being one. Of particular concern for the fiscal framework is the existence in some areas of high cost systems (costs well above the benchmark). This may relate to management inefficiency, service levels which have been set too high or geographical circumstances, with high water resources development cost being the most significant example of the latter. Should this be provided for with high levels of transfers? The answer is ‘probably not’ as this is likely to create economic and organisational efficiency disincentives.

On the capital account side the modelling shows that there is not enough capital available to provide for the economic and social development objectives of Government. This requires new sources of capital to be sought with one option being higher levels of transfer.

Issues for discussion

Each of the issues identified in the FFC Problem Statement document are addressed below.

Differentiation across municipalities

Key issue to be discussed	***Thoughts on this point***
Should a more explicit differentiated approach to the funding of municipalities be adopted? Is there a differentiation in the current system?	The great advantage of the current LGFF is that it does not require differentiation in the case of formula based allocations. Formulae provide for different circumstances through the parameters and this is good in principle, although parameters may need review. As Non-formula based, application based, allocations inherently imply some form of differentiation by the implementing department. There is one particular case where differentiation is considered sound: in the allocation of a transitional grant aimed at capacity building for the low capacity group of municipalities.
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?	Yes. The way the RSC levy has been ‘removed’ without a long term solution to replace it has caused problems.
Should intergovernmental transfers play an equalisation role in terms of being directed to mainly rural municipalities without an economic base?	No, there should not be a special case made for mainly rural municipalities. The transfer system needs to recognise municipalities as a continuous spectrum. The one important exception is capacity building where low capacity municipalities – which happen to be mainly rural – require specific financial support as mentioned later in this submission.
How should the regulation and implementation	Not sufficient knowledge to comment.

Key issue to be discussed	*Thoughts on this point*
of municipal taxes account for such differences?	
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?	The current grant system provides for needs across municipalities, with some qualification mentioned in this submission. With regard to costs this is not a big factor: in some cases urban costs are higher for the same level of service and in some cases, rural, for the same service level. What is more important is to provide for differentiated service level and the proposals in the MIG policy review do provide for a separation of urban and rural in the calculations. There is an argument for this to be applied to the LES as well.
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?	Provisions made in MIG Cities and now the City Support Programme provide for this: there needs to be greater integration of grants with more responsibility devolved to higher capacity municipalities to make expenditure decisions, taking the need for greater settlement integration into consideration. With greater integration of grants the options to improve access to debt finance increase.

The LG Equitable Share

Overall, our impression is that the LGES conforms to international best practice and has worked effectively in SA to date. However, this is not to say that improvements cannot be made.

PDG has done work on the LGES for National Treasury in 2005 when a review of the municipal fiscal framework was undertaken. At that time a model was constructed to allow ES policy decisions to be tested. It is not certain whether this model has been applied subsequently by NT.

Note that the comments below do not include for the RSC levy replacement grant which is covered in this submission separately below the table.

Key issue to be discussed	*Thoughts on this point*
Is the general structure of the formula aligned with theoretical and legal principles as well as reflective of the policy priorities of national government?	The general structure is fine. The shortcomings relate to the way the components are applied. In this regard there are two primary approaches to be considered: a) Distribute funds based on a measure of the un-served poor (current approach). b) Distribute funds based on a broader view of municipal expenditure obligations and then apply a 'theoretical' gap in financing municipal services after 'own source' revenues have been considered (favoured).
Is the current formula technical effective in ensuring the needs of the different types of municipalities are catered for?	There is likely to be criticism of the formula from municipalities as many of them are under financial stress and see transfers as a way out. However, overall the formula is sound and if the approach described as Option b) above is taken the inconsistencies will be less acute.

	As implied in the introductory section to this submission, the LES should not be designed to fund high cost systems, in relation to a benchmark, as this can create perverse incentives.
Are the current basket of municipal service funded through the formula fully reflective of the expenditure pressures faced by municipalities	No, the basket of services has several major anomalies: • Provision for Governance, Administration, Planning and Development Facilitation (GAPD) has historically been calculated on amounts which are too low. • Roads are not included. • Social and community services which are a big expenditure item, and an important part of what municipalities do, are not included. • Municipal health is included which is strange as it is a low expenditure item and not really a service (as described in the institutional section of this submission).
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	The costs can be improved and there is room for an urban/rural differentiation mainly associated with the differing approach to service levels.
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?	The formula provides for this, correctly, and the extent to which provision for revenue raising is adjusted can be tuned over time. This implies that fiscal capacity is included, and should be.
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?	The data problem is addressed in the introductory section of this submission. It is fine for figures to be adjusted on a five yearly basis. What we have experienced recently is a 10 year gap in a stage of quite substantial demographic change and this is problematic.

RSC levy replacement grant

This is not really a conditional grant and sits somewhere between the LES and conditional grants.

The way it is being applied at present is problematic as it boils down to an unconditional transfer to districts which have higher levels of economic activity in their area of jurisdiction, thus being highly inequitable:

- It gives those ‘C1’ districts who have little service delivery obligation a fairly large sum to ‘hand out’.
- In the case of C2 districts which have and water services responsibilities and a B1 LM in their midst it does, at least, allow the relatively large RSC levy replacement grant to be used for service provision in surrounding rural areas.
- C2 districts with no large urban centres in their midst are the poorest and have the highest service provision obligation and yet get the lowest level of grant allocations.

This situation has to be changed but taking the implications of the losses to the first category of C2 districts mentioned above into consideration. In the case of C1 districts the consequences of reducing their revenue are not as great.

Conditional grants

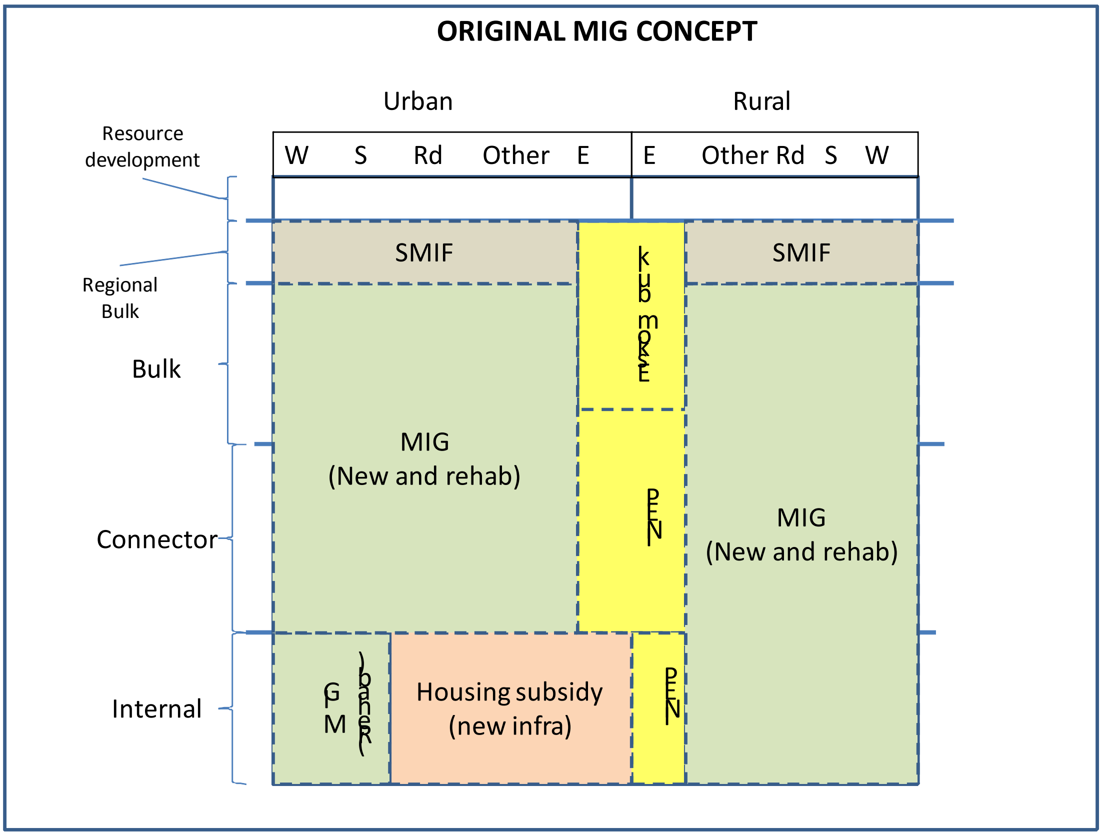
With regard to capital grants the first point to make is that the total aggregate capital funding – including grant funding – is not sufficient as mentioned earlier in this submission. This has three primary implications:

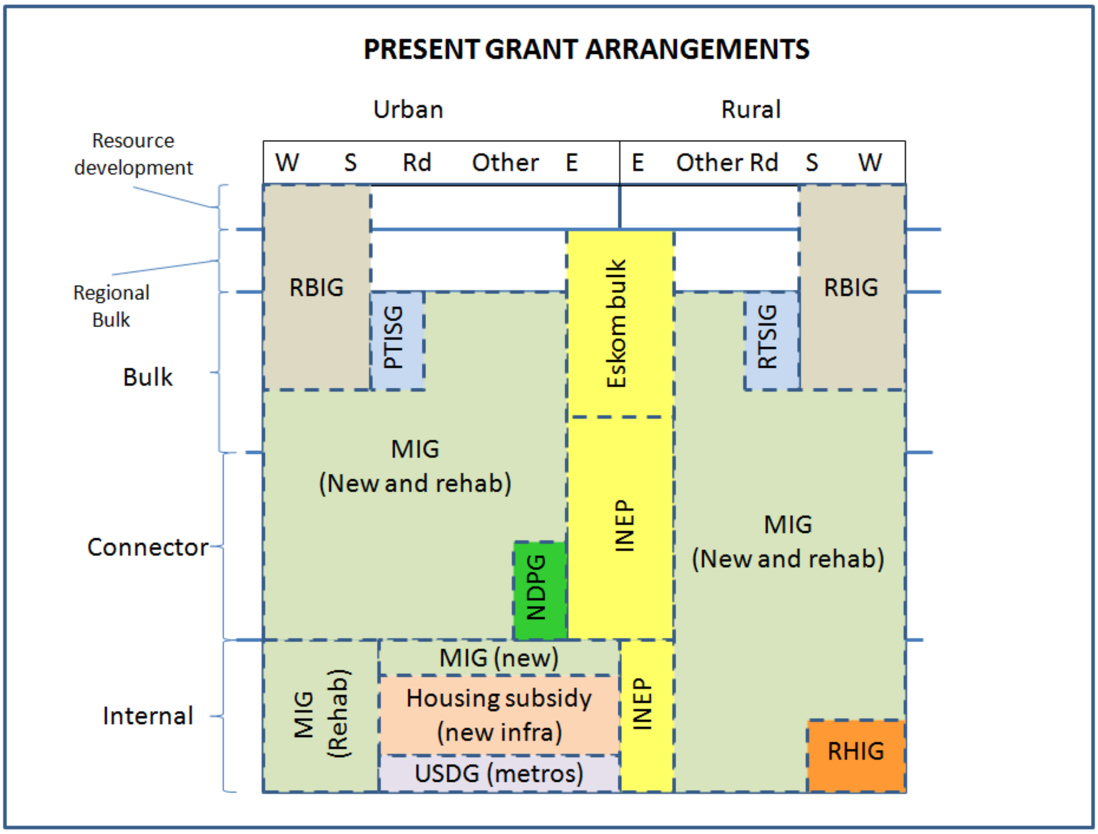
- National targets cannot be met.
- The condition of municipal infrastructure is in decline in many areas.
- National line departments respond to this by trying to get allocations through sector based grants to solve problems with 'their' sectors without enough attention to issues of integration across sectors.

Key issue to be discussed	***Thoughts on this point***
Is there a general proliferation of conditional grants as and when a priority arises?	Yes there is a proliferation (see figures below) and this is not considered to be good practice for several reasons: • It makes life for municipalities really difficult as they can't do capital budgets properly, they can't use grants for gearing and they have a multitude of application procedures to deal with. • It promotes a 'top down' delivery mind-set. • It acts against integrated planning.
Is there an implicit or explicit link between conditional grants and the LES? Should there be such a link?	There must obviously be a link between all operating transfers (including LES) in order to promote a holistic approach to the operating budget. Similarly with capital grants. But the logic for capital transfers and operating transfers is different and does not need to be explicitly linked.
Should there be a greater differentiation in conditional grants in addition to the differentiated approach introduced in the MIG with the MIG cities	Ideally the grants should be based on a common set of principles which does not require differentiation, but there are some instances where this is necessary (see new issues below).
Is the performance of conditional grants being appropriately measured and evaluated? Should performance be taken as a measure to determine grant allocations?	No, there should be better performance management. This is addressed in the notes at the start of this submission and in the 2009 MIG review proposals where a move towards a performance-based component of MIG was proposed.
Should the MIG be a consolidation of all infrastructure grants to local government	It will not be possible to exclude all other grants but, yes, the original concept of MIG as an integrated grant is sound.
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.	Ideally INEP should be included in an integrated grant system such as MIG, which can also be used to gear debt finance. Currently INEP is not sufficient to build all the new electricity infrastructure required and rehabilitate that which is nearing the end of its useful life. But any change should be considered as part of a holistic assessment of infrastructure funding requirements.
Is the level of grant funding enough? (New issue)?	National modelling indicates that it is not enough and this creates a perverse incentive for sector departments to motivate for new grants to cover the shortcomings for their sector, as mentioned above.

Key issue to be discussed	***Thoughts on this point***
If the principle is towards grant integration how do the existing capital grants fit with this concept?	The use of RBIG for non-'regional' infrastructure, as well as RTISG and RHIG (see diagram below) appear to create fragmentation with little benefit other than giving control over to national departments. RHIG is now a 'Schedule 7' grant and funds the most basic level of infrastructure which can easily be done by municipalities if they were given the same level of funding.
How can grants promote capacity building and resource efficiency?	It has been argued in the Bulk Infrastructure Fund proposals, and elsewhere, that in order to get the transition required in capacity of low capacity municipalities, a grant is required to fund private sector and water board interventions in the form of management contracts, for a transitional period. There is also a strong argument for water conservation and demand management interventions to be funded before major capital interventions are implemented. Both of these proposals are based on the maxim: get the operating system right before shifting to building major new infrastructure (although some of this will always have to happen in parallel).
How can the lack of funding for water resource infrastructure development be improved?	There is a serious gap in the funding framework relating to small to medium scale water resource infrastructure. This is Nominally DWA responsibility but they are not able to make the necessary capital funding available and, in any event, this needs to be blended with debt finance. This means that either a specific grant needs to be introduced for this infrastructure or the MIG has to be adjusted to take this into account. (Note that while this is being addressed as part of DWA's Institutional Realignment project, there are no firm conclusions on this yet).
Financing regional water supply and sanitation infrastructure	The concept of having a grant for regional water supply and wastewater infrastructure is valid. This should include regional water resource infrastructure. Responsibility is likely to vest with water boards (or their future restructured version) and thus this grant would go to them primarily. (Again, DWA is investigating this option but there is no firm position from DWA on this matter at this stage).
Is the MIG formula working and, if not, what can be done to improve it?	There are some major shortcomings with the MIG formula which have been identified in the DCoG MIG policy review in 2008/09 but which have not been implemented yet. Perhaps the greatest concern is the lack of attention to rehabilitation and to district roads in the formula. In the latter case the MIG also does not do the splitting between district and local responsibilities well.
How well do capital grants align with housing subsidies?	The capital grant system was designed to align with housing at a time when a housing package was assumed to include services to the site. With the politically motivated shift to have housing subsidies applied only to 'top structure' this has left a gap in the fiscal framework.

With regard to the 'proliferation' of capital grants a diagrammatic comparison of the grant structure at the time MIG was implemented (circa 2004) - as a way of consolidating grants - and currently, is shown below.





Municipal own revenues

Key issue to be discussed	*Thoughts on this point*
Should intergovernmental transfers account for the difficulties in accessing revenues in traditional areas	We are not certain why specific mention is made of 'traditional areas'. But perhaps it relates to the fact that these areas have communal tenure and, therefore, do not present a source of property rates revenue. In this case, yes, transfers do need to compensate for this as these municipalities do incur costs which are typically covered by 'rates and general' revenue. A counter to this is that sanitation costs in these areas are low as they relate to 'on-site sanitation. Currently this probably acts as a balancing factor in relation to low property rates revenue. But there is definitely no argument to compensate them for lower income from trading services. Municipalities must set up effective systems to raise revenue from consumers who use above the free basic provision of water and electricity.
Is there currently an over regulation of municipal own revenue sources? Should there be a regulation of such sources?	Different levels of regulation are appropriate. But what is more important is creating incentives to raising 'own source' revenue.
How autonomous is local government given the interdependence and interrelation between spheres?	The institutional framework needs to deal with this. But autonomy inevitably declines as the capacity of the municipality declines. A municipality needs to prove its ability to act autonomously. Those that have lower capacity will be more reliant on support and conditionality of grants is more appropriate.
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?	Yes, we have to get some relationship between transfers and 'own source' revenue in place so that raising the latter becomes more incentivised. Benchmarking of 'own source' revenues is important.
Has the RSC and JSB levies being appropriately replaced? Is the sharing of the general fuel levy a buoyant revenue source?	Comment on the RSC levy replacement grant as this applies to districts which do not get the fuel levy is given above. We do not have sufficient knowledge to comment on the fuel levy as a transfer. But we would strongly suggest that outside metros it should go to LMs not DMs.
What potential avenues of increasing the array of local taxes are provided by Section 5 of the MFPFA?	We, PDG, have been participating with Hunter van Ryneveld on making recommendations on behalf of the metros to National Treasury for a new business tax. We defer to the approach to be presented as part of this initiative.
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?	See above.
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?	It is essential that the funding of district municipalities be completely overhauled. Partly this relates to the need to resolve the inequities of the RSC levy replacement grant, as described above, partly this relates to the poor targeting of existing conditional grants and partly it relates to the poor performance of districts in raising 'own source' revenue. In considering options for the future it is difficult to do this without knowing what the structure of district municipalities will be but the following principles can be considered: • Remove the powers and functions anomalies as

Key issue to be discussed	*Thoughts on this point*
	mentioned in the institutional section of this submission. • Make sure that there is only one billing system either to be managed by LM or DM. • Align payments of operating grants (including LES) to level where billing takes place so that the incentives to collect revenue can be properly applied. • On the capital side urgently improve the roads information system so that MIG can be properly split between LM and DM. • Accept that it will be either the LM or DM serving a particular area that should be able to borrow so as not to fragment the debt finance opportunities.
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?	No comment on this one.
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?	Based on PDG financial modelling work it is evident that high income households and businesses contribute a high level of 'cross-subsidy' to the poor through the trading accounts, through paying far above cost for the services they receive, and through the 'rates and general' account. However, evidence gained through the local business tax review process is that businesses will be willing to pay a local tax, providing it is focused on local economic, and not social, objectives. In other words, if they can see a direct benefit emanating from the tax they are paying they are willing to do this, particularly as the amounts in relation to their overall value added are not large.
Is there scope for municipalities to increase their borrowing?	Gearing up municipal borrowing is critically important. PDG has been working with DCoG on a project to develop recommendations for a Municipal Infrastructure Fund which is aimed at blending grant funding (MIG) with loan funding with the aim being to make debt finance more accessible to municipalities below metros in size. It also appears that the nationally applied 'rules' for limiting borrowing need to be reviewed. In case study work done in the Western Cape there the indication is that the approach to borrowing is too conservative.
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?	Yes, DBSA should be oriented primarily at opening up new markets in the municipal lending field. One option is to facilitate the Municipal Infrastructure Fund.