

Financial problems in local government assignment



1 LOCAL GOVERNMENT'S FINANCIAL CHALLENGES A fresh look at local government's deliver obligations and resource requirements is needed. HILDEGARDE FAST makes the case for a differentiated approach. It is common knowledge that many municipalities in South Africa are financially in dire straits. In the public discourse, the focus is often on operational issues such as poor revenue collection, unsustainable debt burdens, and lack of financial management capacity.

In seeking to understand the financial challenges facing municipalities, it is important first to take a step back and ask broader questions, namely: What is local government required to do? Where should the resources come from? And is there a need to change the current intergovernmental fiscal system to ensure that local government can do its job?

Constitutional mandate Municipalities are given five over-arching tasks in Chapter 7 of the Constitution: to govern in a democratic manner, to ensure the provision of basic services, to promote social and economic development, to promote a safe and healthy environment, and to encourage community participation in local government. The specific functions assigned to municipalities are subsequently listed in part B of schedules 4 and 5 of the Constitution.

Delivering on these mandates invariably has financial implications. Whether it is extension of infrastructure for basic services or promotion of economic development, municipalities require resources to perform their constitutional functions. Revenue sources Municipalities have two main sources of revenue, namely own revenue and intergovernmental transfers. Own revenue consists

primarily of revenue from property rates and surpluses generated on electricity and water accounts.

It is important for municipalities to balance these revenue sources appropriately. A recent study undertaken by the Financial and Fiscal Commission (FFC) has shown that some municipalities do not maximise some revenue sources while simultaneously over-utilising others. This can result in economic distortions. For example, some municipalities collect relatively little from property rates but have high electricity tariffs, which may discourage businesses that rely heavily on electricity from investing in that municipal area.

Municipalities need to understand the crucial link between decisions on revenue sources and their attempts to promote local economic development. In considering intergovernmental transfers, the imperative to redistribute resources and alleviate poverty needs to be taken into account, given the historically unequal development of South Africa. It is appropriate for redistribution to be funded primarily from the centre, since municipalities have different levels of poverty and thus varying fiscal capacity to address poverty.

There are three general categories of intergovernmental transfers to municipalities, and each is evaluated below in terms of the prerogative to target resources to historically under-resourced areas. The first category is the equitable share transfer, which is local government's entitlement to revenues that are collected nationally. Currently, the equitable share 2 for

local government is distributed according to a formula that has two components, namely a Services (“ S”) grant and an Institutional (“ I”) grant.

The S grant makes up more than 90 per cent of the overall equitable share transfer and is calculated according to the number of poor households in each municipality. This means that municipalities with high numbers of low-income households receive a greater proportion of the equitable share than municipalities with relatively few poor people. The local government equitable share requires careful consideration. Some question whether the portion allocated to municipalities is sufficient for municipalities to deliver at least basic services to residents.

The difficulty lies in answering this question: it requires detailed knowledge of the expenditure implications of municipal functions, and this data is currently not available. The FFC is currently engaged in a project that seeks to understand the various components of municipal service costs. Gaining insight into service delivery costs is only half of the task. It is also necessary to measure the extent to which municipalities are able to raise revenue locally, which is closely related to their economic base.

It is important to choose a revenue-raising measure that will encourage municipalities to maximise their revenue sources. A further conceptual issue with the equitable share is its relationship to infrastructure transfers. The equitable share is intended for operating expenditure, although due to its unconditional nature it can be used for capital infrastructure projects. If only a minority of residents in a municipality have access to water and sanitation

services and electricity supply, then the operating expenditure needs of such a municipality will be relatively low.

The equitable share currently does not take account of this. The solution lies either in encouraging municipalities with substantial backlogs to use a significant portion of their equitable share for capital infrastructure, or to ensure that the equitable share and municipal infrastructure formulas relate to one another. The second and third categories of transfers are infrastructure and capacity-building transfers. The current trend with both types of transfers is to consolidate the numerous grants into one funding stream.

It is important that the consolidated infrastructure grant strikes the right balance between conditionality and flexibility. National government wishes to ensure that national priorities are addressed through stipulating conditions for grant use. On the other hand, municipalities require the flexibility to respond to local priorities. For example, if a condition of the grant is that a given percentage of the grant must be spent on a particular service (such as roads), a municipality may not be able to use those funds to address what it sees as a more pressing need.

It is crucial for municipalities to ensure that they identify an appropriate level of service delivery for municipal infrastructure, as prohibitive operational costs will impact negatively on the delivery of other services. In Mangaung, for example, expenditure on sanitation services increased from 13.9 per cent of municipal expenditure in 1994/5 to 23.5 per cent by 2001/2. Most of

this increase was owing to significant investment in water-borne sewerage systems.

The increased expenditure on sanitation resulted in a squeezing out of expenditure on other services such as health and safety and security. When infrastructure transfers are compared to levels of poverty, it is evident that infrastructure transfers are generally redistributive in nature. However there is room for improvement, and it will be important in future to ensure that the consolidated 3 infrastructure grant accurately targets areas with the greatest infrastructure backlogs.

At the same time, the infrastructure programme should provide incentives for all municipalities to utilise infrastructure funding efficiently. The capacity-building grants of various national departments are also in the process of being amalgamated. It is important for this grant stream to identify priority areas of funding. The experience of recent years has demonstrated that there is particularly a dearth of financial management capacity. Strategic planning skills are also in short supply. An Integrated Development Plan (IDP) is unlikely to be successful if a municipality does not have leaders with vision and the ability to translate that vision into reality. Cities and poverty reduction Intergovernmental transfers are therefore directed to a significant extent to areas with high rates of poverty. Indeed, there has been some concern that greater attention needs to be paid to the role that “wealthier” municipalities play in the economy. Over 80 per cent of South Africa’s economic activity is concentrated in 15 urban centres.

While these cities have larger revenue bases than other municipalities, their expenditure needs are also proportionately greater. For example, cities require sophisticated transport infrastructure to provide access and mobility to large numbers of people. Poverty-targeted subsidies are meant to alleviate poverty. However, the long-term goal is poverty reduction, and this will only be brought about by sustained economic growth. With so much economic activity concentrated in urban centres, it is likely that this is where most economic growth and job creation will take place.

One of the ways in which to ensure that major urban centres can underpin economic growth is to provide them with local taxes that are related to economic activity. While regional services levies are problematic in some ways, they are closely related to economic activity. Metropolitan municipalities retain all their levy income, but levy income in the large non-metropolitan urban centres (or “secondary cities”) is collected by district municipalities and spent mostly in the rural hinterland.

Metropolitan municipalities therefore have access to a source of revenue related to economic activity while secondary cities do not. This inconsistency needs to be addressed. It is important to ensure that all major urban centres have access to a second major source of revenue (besides property rates) that can be used to invest in the infrastructure that is required to underpin economic activity and growth. Two systems for non-metropolitan areas In the past two years there has been considerable confusion in non-metropolitan areas regarding which functions should be assigned to district and local municipalities.

The process of clarifying this is almost complete, and municipalities will soon be legally authorised to perform specified functions. Although the authorisations are still to be published, it is clear that very different situations will prevail throughout South Africa. Generally speaking, district municipalities will be responsible for delivering services such as water and sanitation in ex-homeland areas, while local municipalities will perform these functions in “ old 4 South Africa” areas. This implies that two systems of governance will operate in nonmetropolitan areas.

There is no doubt that many local municipalities have a serious shortage of capacity, with some not even having bank accounts. It is appropriate for districts to deliver services in this context for the time being. Yet the authorisations are permanent, which means that district municipalities that are authorised to deliver services on the ground will do so indefinitely. If authorisations remain permanent, there is little incentive for district municipalities to build capacity within local municipalities, as envisaged in the Local Government White Paper.

Furthermore, the majority of district councillors are indirectly elected (that is, elected by Local Councils). Accountability for the delivery of certain services will therefore not be located locally throughout much of South Africa. Need for differentiated approach In the long term, ours should not be a municipal system of “ two South Africas”, the one consisting of municipalities that are relatively functional and fiscally strong, and the other of municipalities that struggle to fulfil their constitutional mandates and depend heavily on on-going subsidies from the centre.

At the heart of the long-term vision is the constitutional imperative for all municipalities to govern democratically and deliver services efficiently. This means that the current situation should not be accepted as static, and that the intergovernmental system should encourage all municipalities to improve their management of resources and to grow their revenue bases. To promote a dynamic system that sees continuous improvement in service delivery, there needs to be a recognition that municipalities are faced with different realities.

With respect to local government borrowing, municipalities in South Africa can roughly be grouped into three categories: those who have access to capital markets at relatively favourable rates; those who struggle to obtain loan finance and pay significant risk premiums when they do; and those who simply cannot obtain loans owing to their weak fiscal capacity and/or poor human resource capacity. There should be an approach that recognises these differences. For example, the Development Bank of Southern Africa (DBSA) could play a key role by extending loans at concessionary rates to municipalities that could otherwise not be able to borrow money. It could thereby “coach” such municipalities to a position where they can obtain loan finance directly from capital markets. One may wish to consider how such an approach could be applied to other areas such as expenditure responsibilities and revenue sources. For example, a study commissioned by the Department for Provincial and Local Government (DPLG) suggests that one option for the reform of regional levies is for some district municipalities to retain this as an “own revenue source” and for others with weak fiscal capacity to receive intergovernmental grants.

In this scenario, there would be room for districts to move from grants to an own revenue source once certain conditions have been met. The Municipal Systems Act and the Municipal Finance Management Bill are providing a uniform basis for democratic governance and efficient financial management. This needs to be complemented by a framework that recognises the different circumstances of municipalities and provides mechanisms that encourage 5 them to improve their ability to perform their constitutional functions within existing constraints.

In summary, the following are some of the key financial challenges for the local government sphere: sources are neither over nor under-utilised; choices have long-term financial implications; costs of municipal service delivery and that a reliable revenue-raising capacity measure be developed; should ensure that municipalities have sufficient flexibility in utilising the funds; recognised by ensuring that they have access to a second major source of revenue; and capacities of municipalities and encourages them to improve their ability to deliver on their constitutional mandates.

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