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BRIEFING NOTES

26 August 2008

2008 Local Government Budgets and Expenditure Review
Overview and Chapter Summaries

BACKGROUND:

1. The National Treasury is once again publishing the *Local Government Budget and Expenditure Review*. This is the second time National Treasury has published this document. This year the *Review* covers municipal spending and budgets for 2003/04 to 2009/10.
2. This *Review* improves on the 2006` publication in that it:
   a. Covers all 283 municipalities' audited financial outcomes from the 2003/04 to 2006/07 years and the 2007/08 budgets and the medium term forecast until 2009/10. It thus covers information for a seven-year period, whereas the 2006 publication only covered three-years of budget figures for only 58 municipalities.
   b. Includes six additional chapters dealing with the socio-economic context for local government, metropolitan finances, intergovernmental transfers, municipal borrowings, the built environment and roads and public transportation.
3. The municipal expenditure and budget information used to compile this *Review* is the best available dataset covering all 283 municipalities. You are referred to the *Technical Notes* at the beginning of the *Review* for more details. In order to facilitate oversight and encourage further analysis, National Treasury has published the *Review* and the entire dataset on its website: www.treasury.gov.za

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OVERVIEW OF CHAPTERS:

1. The *2008 Review* is made up of twelve chapters that are divided into four parts. The first part looks at the context for local governance, and consists of just chapter
    a. *Chapter 2: The socio-economic and fiscal context for local government*, highlights the wide variation in social and economic contexts among South Africa's 283 municipalities. It outlines the key components of national government's fiscal policy stance and highlights important opportunities for municipalities that arise from these policy choices.
2. The second part looks at the key issues in financing local government:
    a. *Chapter 3: Revenue and expenditure trends in local government* provides a broad overview of the financial performance of municipalities. It highlights four issues - the under-pricing of services, growing reliance on national transfers, inadequate maintenance expenditures by municipalities and the high level of consumer debtors.
    b. *Chapter 4: Metropolitan finance* focuses specifically on the financial performance of the six metropolitan municipalities. It notes the effects on municipal budgets of expenditure related to the 2010 FIFA World Cup and the specific challenges of rapid urbanisation.
    c. *Chapter 5: Intergovernmental transfers* tracks the reforms to the system of transfers and begins to evaluate the performance of transfer programmes. It identifies problems in the design of programmes and co-ordination between transfer programmes. It also raises concerns about the potentially negative effects of growing municipal reliance on grants
    d. *Chapter 6: Leveraging private finance*, notes the huge demands placed on municipalities for responding to local social and economic needs. It highlights the limited use of partnerships with the private sector in financing infrastructure, relative to the potential that exists.
3. The third part investigates municipal performance in the delivery of major services:
    a. *Chapter 7: Water and sanitation* highlights emerging challenges in the water and sanitation sector, specifically those related to system losses arising from inadequate maintenance. Importantly, it highlights emerging problems in the pricing of water services.
    b. *Chapter 8: Electricity* outlines the structure of the electricity sector and some of the challenges. Asset maintenance and pricing are highlighted as key challenges facing the electricity distribution industry. Ongoing uncertainty about the pace and direction of reforms to the electricity distribution industry continues to disrupt the sector.
    c. *Chapter 9: Roads and public transportation*, considers the current demand for municipal investment in roads and public transport in the context of limited public expenditure on the sector and an environment of institutional overlap and uncertainty.
4. The final part considers three cross-cutting issues that are critical to the ability of municipalities to manage the local development processes:
    a. *Chapter 10: Managing the built environment*, describes the rapid growth in demand for public investment and the responses by municipalities. It shows municipal approaches to asset management are being exposed as inadequate. Further concerns relate to the current framework for spatial planning and the poor co-ordination of public investments.
    b. *Chapter 11: Financial management and MFMA implementation*, reviews progress made with the implementation of financial management reforms in municipalities over the last four years. Key issues include improving audit outcomes and stabilising senior municipal management positions.
    c. *Chapter 12: Managing municipal personnel*, highlights the modest contribution that municipalities make to overall employment. It notes that between 2005 and 2006, the number of employees declined, despite an increase in the number of available positions. Personnel expenditure has been growing strongly, but the average cost of employment and the average minimum wage have grown even faster. In effect these gains are being "paid for" by the shedding of low level jobs – facilitated by mechanisation and outsourcing.

CHAPTER SUMMARIES:

Chapter 1
Introduction

Overview and background

1. Local government has emerged from a prolonged transition to face a second generation of challenges, namely:
   a. The growing economy has resulted in increased demand for economic infrastructure;
   b. Ageing assets are increasingly requiring upgrading, rehabilitation or replacement; and
   c. Urbanisation means the location and nature of poverty are changing.
2. While there are many examples of exceptional efforts and remarkable successes by individual municipalities, the local government system does not, at present, appear to be responding to these challenges very effectively.
3. The evidence suggests that, in aggregate, the demands of a growing economy are no longer being met by the levels of municipal investment. Asset maintenance and life-cycle management are very weak as the low levels of maintenance expenditure reflect. Governance and spatial planning responses tend to be both fragmented and delayed.
4. The strategies to address service backlogs for previously ignored communities, while successful in the past, are now coming up against significant cost pressures that partially result from inappropriate decisions by municipalities on the level of service to be provided. Balancing the tough choices of investing in social infrastructure to meet the targets of the Millennium Development Goals with investing in infrastructure that would stimulate and support local economic development is becoming increasingly harder.
5. The result of these trends is that the limited provision of strategic infrastructure and a declining quality of service are growing constraints to economic growth and poverty reduction. If this trend is not arrested it might undermine the future sustainability.
6. A shortage of national funding is an inadequate explanation for these trends. Significant real increases in resources have been transferred to local government. In addition, government has introduced a range of reforms to support municipalities in addressing the challenges they face. In this regard, financial management reforms have begun to improve the transparency, credibility, timeliness and usefulness of municipal financial information.

Data issues

7. The *Review* is based on the best available data set of municipal spending and budgets for the period 2003/04 to 2009/10. Nevertheless, there are shortcomings in the data. These are discussed in the *Technical Notes* at the beginning of the *Review.*
8. In the interests of transparency, to facilitate better oversight and wider debate on local government finances, the *Review* is complimented by the publication of all the supporting financial data on National Treasury's website. This means that, for the first time, all 283 municipalities spending and budget information is being made publically available in one place.

Main themes for the 2008 Review

9. The *Review* explores the following issues:
   a. Local government's role in supporting economic growth.
   b. The performance of local government in combating poverty.
   c. The progress that has been made in strengthening the financial management capacity of municipalities.

Key issues identified

10. The *Review* identifies at least two related trends:
    a. Municipal responses to demands for additional or improved infrastructure and services resulting from sustained economic growth have been constrained in a number of ways, including:
        i there is growing evidence that municipal services are under-priced relative to the cost of production
        ii municipalities have been wary of actively leveraging private sector finance, which suggests that municipalities continue to face capacity constraints in conceptualising and implementing developmental spending programmes
    b. Municipalities reliance on transfers from national government to fund their activities has grown markedly, particularly in larger urban municipalities
11. The *Review* proposes several appropriate responses:
    a. First, in order to better support economic growth, municipalities need to free up additional local resources to invest in infrastructure provision and service delivery.
    b. Second, in order to combat poverty more effectively, municipalities need to reconceptualise their current programmes to ensure that there is more universal access to basic infrastructure and services.
    c. Third, to improve the capacity of municipalities to perform their functions, municipalities urgently need to stabilise their senior management cadre and ensure appropriate technical skills are put in place.
    d. Finally, there should be space for greater asymmetry in the fiscal regime for different types of municipalities, where the more capable municipalities are able to exercise more discretion in the way they pursue their developmental mandates

---*Please read the chapter at www.treasury.gov.za*---

Chapter 2
The socio-economic and fiscal context for local government

Overview and background

1. South Africa's 283 municipalities operate in a wide range of social and economic contexts. The priorities of fiscal policy, such as poverty alleviation or job creation, present them with different challenges and opportunities.
2. Regardless of their specific contexts, all municipalities must play a central role in supporting economic development and alleviating poverty. The services they provide, such as water, sanitation, refuse removal and electricity, are critical inputs to social wellbeing and economic activity. The availability, price and reliability of these services impact on local economic performance and can significantly affect the quality of life of poor households.
3. Municipalities can also guide private investment decisions through the spatial location of their own infrastructure investments and their powers to regulate spatial development.

Local government and the national economy

4. Between 2003/04 and 2007/08, expenditure by the local government sphere amounted to an average of 6.9 per cent of South Africa's gross domestic product (GDP). However, this understates the importance of municipalities since the infrastructure and services they provide are essential ingredients to the functioning and growth of other economic sectors.
5. On average, local government accounted for 24 per cent of total public sector infrastructure expenditure between 2004/05 and 2007/08.

Variations between municipalities

6. The current demographic trends are reshaping the contexts for service delivery and governance in most municipalities in strikingly different ways:
   a. The Community Survey 2007 reports that 52 per cent of South Africans live in metropolitan areas and secondary cities. The proportion of the population in mostly rural municipalities has declined since the Census 2001. This reflects the strong growth in the population of the metros, which rose by 5.7 per cent per year between 2001 and 2007.
   b. The drop in the average size of households is a common trend across all categories of municipalities. In larger urban areas this is associated with an increase in the absolute number of households.
   c. The processes of urban population growth and the reduction in the average size of households create significant fiscal challenges for all municipalities.
      i In more rural jurisdictions it means the number of persons reached by each household service connection is falling, while simultaneously adding to backlogs in the urban centres.
      ii In larger urban areas, each infrastructure connection installed and operated serves fewer people in a household, but the absolute number of connections required increases as the number of households rises.
   d. The HIV and AIDS pandemic has also begun to fundamentally alter the definition of household units, with an increased prevalence of child-headed and multi-family units that have lost their primary income earners to illness or death. Most directly, this presents municipalities with more of a challenge when it comes to implementing their indigent policies and generating revenue.
7. As regards economic differences between municipalities:
   a. There is a strong bias in most economic sectors towards larger, more urban municipalities and the contrasting weak economic base of mostly rural municipalities. This results in the revenue

base of rural municipalities being constrained and the need for high levels of grant support from national government.

   b. Mostly rural municipalities and small towns are predictably reliant on agriculture, fishing and forestry activities, while other economic sectors are more dominant in metropolitan areas. The mining and quarrying sector is most dominant in secondary cities.

8. Poverty levels and access to services differ across municipalities:
   a. Reliance on social grants is highest in mostly rural municipalities, reflecting the weak economic base of these areas. Unemployment is highest in metropolitan areas. Both these factors constrain the own revenue potential of municipalities.
   b. There are high residual service delivery backlogs in the mostly rural municipalities which continue to pose a serious institutional challenge. Despite significant increases in transfers to these municipalities and a declining share of population, they have been unable to make a significant dent in backlogs. Metros, on the other hand, face significant population growth. As they have addressed existing backlogs, new demand has emerged.

The economic outlook and local government

9. The economic advances of the past five years have benefited all South Africans through higher employment, rising public spending, strong welfare gains and substantive investments in productive capacity. However, the economic outlook in the short term is clouded by a deteriorating global economy, rising inflation and supply constraints.
10. Two specific factors are of relevance to local government:
    a. First, wide variations in growth trends between different sectors of the economy place different pressures on individual municipalities, depending on the sectoral make-up of their local economies. In municipalities with economies based in higher growth sectors, growth has led to an expansion in demand for municipal infrastructure and services.
    b. Second, economic developments are creating pressures for an increase in municipal taxes and user charges. Municipalities need to address capacity constraints through increasing the supply of local infrastructure and services (through infrastructure investment and refurbishment), as well as through measures to moderate the growth in consumption. Both of these requirements have significant price implications for local services. Infrastructure investment requires additional resources, while demand management is most effective when transmitted through pricing signals to consumers.
11. The major challenge facing municipalities is to reconcile the need for price increases with the imperative of ensuring that services remain affordable to consumers.

National fiscal policy and local government

12. National government's fiscal policy has four implications for local government:
    a. The growth in government spending and its bias towards increased transfers to local government will result in additional resources being made available to municipalities.
    b. Transparent and responsible fiscal policy has created a comparatively stable economic and fiscal environment for municipalities to operate in.
    c. The prudent fiscal stance of national government provides room for increased borrowing by sub-national entities, including municipalities.
    d. The rapid real growth in capital spending by public corporations and, to a lesser extent, by other spheres of government poses severe co-ordination challenges for public investment in the built environment.

---*Please read the chapter at www.treasury.gov.za*---

Chapter 3
Revenue and expenditure trends in local government

Overview and background

1. Weaknesses in revenue and expenditure management could constrain the ability of a municipality to contribute to poverty reduction and economic development. They are also likely to reflect the existence of other governance challenges.
2. Simply reviewing the size of municipal revenues or expenditures provides little insight into the challenges that face municipalities, nor does it reveal much about the efficiency or effectiveness of a municipality.
3. Rising expenditures related to the delivery of a particular service may reflect an expansion of services to more citizens or increasingly difficult technical conditions, such as a dispersed population or a municipality reaching a specific stage in the life-cycle of its assets. But it may also reflect higher than average personnel costs or administrative overheads, weak expenditure control systems or inappropriate service standards.
4. Inefficiencies in service delivery might also quickly translate into increased expenditures and perhaps even reduce the availability of resources to address the core objectives of poverty reduction and economic development

Local government in the system of public finance

5. Municipalities are largely self-financing. This means that the bulk of their resources are raised from own revenue sources such as taxes and service charges. This principle is an important feature of any democratic local government system as it ensures that municipalities are directly accountable to local residents for the functions they perform and the services they provide. However, in South Africa there are two important dimensions to this basic principle:
   a. First, there is a structural imbalance between available local revenue sources and the expenditure functions that are assigned to local government.
   b. Second, not all municipalities have the same capacity to raise revenues, as levels of poverty vary considerably and are particularly high in mostly rural municipalities.
6. This means that while national government must provide financial support to all municipalities, such support needs to be directed to ensuring all citizens have access to basic services.

Revenue trends

7. Total operating revenue of municipalities (including government grants) grew by 7 per cent annually for the period between 2003/04 and 2006/07 and is projected to further increase by 1.1 per cent per year over the medium-term. This growth is driven largely by increases in national transfers targeted at stepping up funding access to pro-poor basic services, increased funding for 2010 FIFA World Cup commitments and the replacement grant for the Regional Services Levies (RSC) which was abolished in 2006/07.
8. Property rates as a percentage of GDP remain constant at about 1 per cent. Revenue raised from rates grew by R4.5 billion or 4.2 per cent in real terms between 2003/04 and 2006/07 and is expected to grow further by 3.8 per cent over the medium term. This is largely due to the implementation of the new rating system, where municipalities will charge households according to the market value of both the land and any improvements to it.
9. The equitable share grant is the largest national transfer to municipalities. The total equitable share grant for municipalities has grown by R11.7 billion between 2003/04 and 2006/07 and is set to increase by another R12.1 billion over the medium-term. The rapid growth in local government's equitable share is largely due to increases in the allocations for indigent households.
10. The distribution of the equitable share has increasingly favoured metros over local municipalities. In 2003/04, metros received only 20 per cent of the equitable share, while local municipalities received 64.2 per cent and district municipalities the remainder. In 2006/07, 40.7 per cent of the

total grant went to metros, 37.3 per cent to local municipalities and 22.1 per cent to the district municipalities. The bias towards the metros is a result of both their large and growing poor populations and the introduction of the RSC levy replacement grant, which is transferred through the equitable share mechanism.

Capital funding

11. Municipalities fund their capital expenditure from external loans, own revenue and grants.
    a. Grants for municipal infrastructure averaged about 45.1 per cent of the capital funding of municipalities for the period 2003/04 to 2006/07, with real annual growth averaging 16.8 per cent. The upswing in the grants between 2007/08 and 2008/09 is because of additional grants allocated to municipalities hosting the 2010 FIFA World Cup. Another reason for the increase in grants over the medium-term is the R1.8 billion set aside for the development of regional bulk water services.
    b. Only 26 out of 283 municipalities use external loans to fund capital expenditure.

Outstanding consumer debts

12. As at December 2007, municipalities were owed a total of R44.2 billion:
    a. Metros are owed the biggest portion of the debt, amounting to R25.4 billion. While this is high, it does represent a decrease of about R2.8 billion from December 2006. This is mainly due to debt write offs by municipalities like Ekurhuleni, the City of Tshwane and the City of Johannesburg, as part of debt management strategies, rather than this revenue actually being collected.
    b. Local municipalities' outstanding consumer debts have increased by nearly R3 billion between December 2006 and December 2007

Expenditure trends

13. Actual expenditure by all categories of municipalities has been increasing annually by 14.3 per cent from R85.9 billion in 2003/04 to R128.1 billion in 2006/07 and is set to increase by 6.9 per cent to R156.5 billion over the medium-term.
14. Analysing municipal expenditure in terms of per capita spending by each municipality reveals great variations.
    a. The highest per capita spending in 2007/08 is in George at R6 632 per person, while the lowest is Madibeng (Brits: North West) at R1 830 per person.
    b. Municipalities in Western Cape spend the highest amount per capita, at R6 334 for 2007/08, while Gauteng municipalities spend on average R5 665 per capita.
    c. The lowest municipal per capita spending is in Limpopo, where R1 903 was spent in 2007/08.
15. It would seem that trends in per capita spending are mostly determined by the demographics, the socio-economic context and the powers and functions in a particular municipality. It is also influenced by the history of local government in a particular area and consequently the maturity of the municipality.
16. Municipalities' actual operating expenditure increased in real terms by 4.6 per cent annually from 2003/04 to 2006/07 and is estimated to grow by 4.1 per cent in the medium-term.
    a. Personnel costs account for the largest component of operating expenditure, averaging 29.4 per cent of total operating expenditure.
    b. Bulk purchases (mainly of water and electricity) take up almost 21.8 per cent of municipalities' operating expenditure and have remained stable over the seven-year period.
    c. Expenditure on repairs and maintenance has grown from R4.5 billion in 2003/04 to R8.5 billion in 2007/08 and will be increasing by R1 billion over the medium-term. Yet maintenance expenditure remains low, constituting only 6.6 per cent of total expenditure since 2003/04.

17. Spending on municipal infrastructure has increased from R10.7 billion in 2003/04 to R20.9 billion 2006/07 and is set to increase by nearly R10 billion over the medium-term. In real terms this amounted to an average annual growth of 18.5 per cent between 2003/04 and 2006/07. However, the real growth rate is set to decline to 7.6 per cent over the medium-term.

Key issues in municipal budgets

18. *Growing grant dependenc*e: the growth in government transfers has occurred at a faster pace than the increase in own revenue generated by municipalities. This has created a situation where municipalities are increasingly dependent on grants to fund their operating costs. This is creating a dependency syndrome, which in future might be unsustainable.
19. *Inadequate maintenance expenditure:* ideally allocations to repairs and maintenance should be directly linked to the life-cycle management of municipal assets. However, in most municipalities expenditure on maintenance tends to be reactive, rather than proactively determined
20. *Outstanding consumer debts:* if municipalities had collected half of their outstanding debts, they would have had about 18 per cent more revenue with which to fund the delivery of services. The increase in outstanding consumer debts highlights possible governance problems.
21. *Under-pricing of services:* the over reliance by municipalities on national grants points to the possibility of under-pricing of services. This is more so even in services that have the potential to finance themselves.

---*Please read the chapter at www.treasury.gov.za*---

Chapter 4
Metropolitan finance

Overview and background

1. South Africa's six metropolitan municipalities (metros) are eThekwini, City of Cape Town, City of Johannesburg, Ekurhuleni, Nelson Mandela Bay and Tshwane. By virtue of their share size they are playing an important role in supporting economic growth and combating poverty:
    a. Metros contribute 58.6 per cent to the national economy in terms of value of goods and services produced, the gross value added (GVA).
    b. The combined budgeted expenditures of the metros comprise 57.5 per cent of all municipal budgets for 2007/08. This is expected to increase to 59.1 per cent in 2009/10.
    c. 36.8 per cent of the country's households resided in the metros in 2001. This increased to 37.8 per cent in 2007.
    d. The share of the metros' population in the country has increased from 32.7 per cent in 2001 to 35 per cent in 2007.
    e. Metros employ 49.2 per cent of all municipal personnel.
2. Despite their many similarities, there are also important differences among metros.
    a. The economies of the metros differ markedly and are subject to different pressures.
    b. Social pressures and poverty levels are changing at different rates.
    c. Service delivery mechanisms vary between municipalities as do their sources of revenue.
3. Strategies to address the pressures of social and economic change must, therefore, be developed within the specific socio-economic context of each metro. Metros cannot be conceived of as a homogenous block. Each one requires the institutional capacity unique to its developmental objectives and priorities.

Regulatory environment and functions

4. Section 155(1)(a) of the Constitution classifies metros as category A municipalities and assigns them the exclusive executive and legislative authority within their areas of jurisdiction. Parts B of schedules 4 and 5 of the Constitution specify the functional competencies of municipalities. Essentially, the functions metros are responsible for are service utilities.
5. A key challenge for metros, but also other municipalities, has been to model and operate the service utilities functions as separate and identifiable "businesses". The benefit of operating the service utilities as businesses is that it becomes less cumbersome to plan and manage the infrastructure investments and related maintenance. Better still, tariffs could be set so that both the capital and operating expenditure associated with the functions could be recouped and adjusted over the economic lives of the infrastructure assets.

Social and economic context

6. The number of households in the six metros has increased by 593 000 or 14.4 per cent between Census 2001 and Community Survey 2007. This growth is primarily driven by inward population migration, decreasing household size and faster household formation.
7. The City of Johannesburg has the highest GVA (a measure of municipal economic activity at the local level) of 18.1 per cent, followed by the City of Cape Town (11.2 per cent), eThekwini (10 per cent), City of Tshwane (9.2 per cent), Ekurhuleni (7.1 per cent). The lowest is Nelson Mandela Bay, at 2.9 per cent.

Financial analysis and trends

8. Operating revenue increased from R43.7 billion in 2003/04 to R61.8 billion in 2006/07.

a. Revenue from service charges grows slowly (1.2 per cent per year in real terms) between 2006/07 and 2009/10, mainly due to growing outstanding consumer accounts, increases in water and electricity losses and the under-pricing of utility services.

b. Outstanding consumer debtors are a major constraint on metros revenue. At the end of December 2007 consumer debtors owed metros R25.4 billion. This is down by R2.8 billion compared to the previous year. This decline is mainly due to credit control policies and limited write-offs instituted by metros, rather than the actual collection of the debt. Further, more attention has been given to indigent policies and their alignment to budgets.

9. Property rates revenue is projected to grow due to the expansion of cities and the gradual implementation of the Municipal Property Rates Act (2004).

10. Operating budgets of metros account for 83.3 per cent of their total budgets. Operating expenditure increased in real terms by 4 per cent annually between 2003/04 and 2006/07 and is budgeted to increase annually by 5.8 per cent in real terms between 2006/07 and 2009/10.

a. The share of personnel expenditure of the total operational budget is around 27 per cent.

b. Metros are gradually prioritising repairs and maintenance; spending nearly doubled from R2.9 billion in 2003/04 to R5.2 billion in 2007/08 and is set to grow further over the medium-term. However, the share of spending on repairs and maintenance remains low at around 6 per cent of total metro budgets. Spending on repairs and maintenance is particularly low in the City of Johannesburg.

11. Capital budgets of metros have more than doubled from R5.7 billion to R12.2 billion between 2003/04 and 2006/07, a real increase of 48.6 per cent per year.

12. Data on spending per household shows that the City of Cape Town has remained at around R12 000 per household between 2001 and 2007, while the rest of the metros experienced large spending growth. This is mainly due to a faster rate of growth in revenue in the other metros and rapid inward migration into the City of Cape Town. The rest of the metros' budgets grew faster than household growth.

Indicators of financial performance

13. The *Review* presents a selection of key indicators of financial performance for the metros. These indicators are of particular interest to institutions that either lend or are contemplating lending to municipalities. For further information please refer to Chapter 4.

Four-year trend on audit outcomes

Table 4.11 Audited outcomes by metro, 2003/04 – 2006/07

	2003/04	2004/05	2005/06	2006/07
Audit outcome				
City of Cape Town	Unqualified	Unqualified	Unqualified	Unqualified
City of Johannesburg	Disclaimer	Disclaimer	Qualified	Unqualified
City of Tshwane	Qualified	Qualified	Qualified	Qualified
Ekurhuleni	Qualified	Qualified	–	Qualified
eThekwini	Unqualified	Unqualified	Unqualified	Unqualified
Nelson Mandela Bay	–	Qualified	Qualified	Qualified

Source: Auditor-General report

14. The main issues identified by the Auditor-General include long outstanding consumer debtors, water and electricity losses, employee benefit schemes, not meeting deadlines in terms of accounting standards reforms, for example, standards on property, plant and equipment and non-compliance with legislative requirements, such as the Municipal Systems Act with regards to performance management. Detailed information is contained in the audit reports of the relevant financial years.

---*Please read the chapter at www.treasury.gov.za*---

Chapter 5
Intergovernmental transfers

Overview and background

1. This chapter reviews the reforms made to the system of transfers to municipalities and begins to evaluate the performance of transfer programmes. Key issues identified include:
   a. Problems in the design of programmes and co-ordination between transfer programmes.
   b. Concerns about the potential negative effects of growing municipal reliance on grants.
   c. The increasing equalization of the transfers between municipalities based on their socio-economic profiles.
2. In practice, transfers from national and provincial government are made through a range of different mechanisms and instruments. The most basic distinction is between those that are directly transferred to municipalities as cash, either on a conditional or unconditional basis, those that are transferred indirectly in the form of assets or in instances where other spheres of government perform functions or services on behalf of a municipality and those transfers that are made as agency payments to reimburse municipalities for expenditures incurred on behalf of other spheres of government.
3. Generally, transfer programmes play three roles, namely:
   a. addressing the structural imbalance between revenues available to municipalities and the expenditure responsibilities assigned to them
   b. supporting national priorities as outlined through different sectoral policies, in particular those focused on providing universal and sustainable access to services
   c. establishing incentives for good governance and building local government capacity within a sound fiscal framework.
4. The system of national transfers to local government has adapted well to rapid real increases in resources being transferred from national government. This is largely due to the establishment of two flagship grant instruments, the equitable share and the MIG and the emergence of a new generation of grant programmes supporting economic development. Ongoing progress is evident in the contribution of these programmes to supporting the objectives of economic growth, combating poverty and strengthening municipal capacity.

The vertical and horizontal division of revenue

5. National government transfers to local government have continued to grow strongly in real terms since 2003/04. This has led to an adjustment in the structure of the vertical division of resources between the spheres of government. Compared to the other spheres of government, the local government share has risen at the fastest rate, averaging 21.3 per cent annually since 1995/96. This means that local government is getting a rapidly rising proportion of nationally raised revenue. This indicates the priority government is giving to programmes such as provision of basic services like water, sanitation and electricity.
6. The increases to the local government's share of nationally collected revenues result from growth in three programmes areas.
   a. First, the allocation to the local government equitable share grows due to the abolition of the Regional Services Council levies and the introduction of a temporary replacement grant and the special contribution towards the councillor remuneration grant.
   b. Second, the municipal infrastructure grant grows rapidly to support municipal expenditures on infrastructure.
   c. Finally, a new set of grants has been introduced to support the 2010 FIFA World Cup and encourage township development, as well as scale-up spending on regional bulk infrastructure.

7. National government support through transfers should be complemented by municipal own revenue. However, in practice municipal own revenue is growing substantially more slowly than national transfers, indicating increasing grant dependence.

Grant performance.

8. In terms of the municipal grant performance, the equitable share and Municipal Infrastructure Grant have been showing some excellent spending performance over the period between 2003/04 to 2006/07. This indicates the efficacy of formula-based and outcomes focused programmes in ensuring that funds are transferred to municipalities. In comparison, other direct infrastructure programmes reported far lower expenditure levels from 2003/04 to 2006/07.
9. Indirect infrastructure transfers report very volatile expenditure patterns, with overspending of allocations by almost 40 per cent in 2003/04, but under-spending by 14 per cent the following year and the programmes continue to report a low overall expenditure figure. This reflects poor planning by the national departments responsible for the grants.
10. Capacity building programmes report the lowest spending levels. Collectively, they spent only 38.7 per cent of their allocations in 2003/04, although this rose to almost 54.5 per cent for the capacity building category in 2006/07.
11. On the non-financial performance side, the infrastructure programmes have made a significant contribution to combating poverty through expanding access to basic services. Nearly 2.9 million households have been serviced through completed MIG projects since the inception of programme in April 2004. In addition, the MIG funded the eradication of 121 228 bucket toilets by the end of 2006/07.
12. An average of almost 200 000 connections have been made every year over the last four years through the electrification programme administered by both the department of Minerals and Energy and Eskom. The average cost of a single connection over the period has been R5 006, but this has begun to rise dramatically. In 2006/07, the average cost of connections was R7 014, due to both significant growth in the cost of materials and the costs associated with servicing outlying areas.

Challenges

13. A number of issues are beginning to emerge and will have to be addressed within the system of transfers over time:
    a. First, co-ordination between programmes remains weak. For example, delays in housing implementation, which is a provincial function, can slow down the rate of infrastructure investment by municipalities. The proliferation of indirect infrastructure transfers further complicates co-ordination arrangements.
    b. Second, transfers continue to weaken local democratic accountability. The grant conditions often replace local oversight of municipal performance with complicated reporting requirements to national departments.
    c. Third, weak programme design, implementation and evaluation procedures limit the impact of grants on the development outcomes sought by government.
        i Smaller grant programmes, in particular, continue to under spend and produce sub-standard information on their impacts.
        ii Although a number of grant programmes have been phased out on completion of their design lives, this has not been accompanied by exit evaluations. Many others continue regardless of their performance.
    d. Finally, programmes to strengthen the capacity of municipalities remain fragmented and are difficult to evaluate. This is a significant problem, given concerns over capacity constraints in municipalities.

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Chapter 6
Leveraging private finance

Overview and background

1. Municipalities are facing challenges to keep up with the growing economy and the expanding population while sustaining and improving their services. Investment in infrastructure becomes critical to enable municipalities to provide services in a sustainable manner. There is therefore a need for municipalities to explore optimal leveraging of private finance as alternative financing mechanisms to address much needed investment in infrastructure.
2. It is estimated that for the three years to the end of 2009/10, an average of only 18.5 per cent of the value of all capital budgets will be financed from external loans, compared to 27.6 per cent over the four years up to the end of 2006/07.

The financing needs of municipalities

3. Investment needs of municipalities arise from spending pressures associated with the growing economy, replacement of assets and the need to address poverty.
4. The growth in the value of building plans for residential and non-residential buildings completed since 2003, have been on average higher than municipal capital expenditure. This indicates that municipalities are not keeping up with the needed infrastructure that will complement economic growth such as providing access roads, water, sanitation and electrification.
5. Infrastructure spending needs to be supported by adequate provision for repairs and maintenance in municipal budgets to maintain the reliability of municipal services and to prevent system failures such as damaged roads and water leakages. It is estimated that around R7 billion per annum would be needed to address the normal maintenance costs of municipalities.
6. Moreover, the total cost for the eradication of all infrastructure backlogs is estimated to be around R70 billion. The eradication of backlogs in water and sanitation, electricity and waste management in low income areas is a national priority.
7. Given these needs, municipalities need to explore alternative financing instruments in order to finance new infrastructure.

Sources of infrastructure financing

8. There are a number of alternative financing instruments that municipalities could use to finance infrastructure:
   a. *Development charges* are an off-balance sheet source of finance for capital projects. A municipality would typically enter into an agreement with property owners or developers that allows it to recoup some of the cost of infrastructure development from the individual property owners who will benefit directly from the infrastructure.
   b. *Public private partnerships* (PPPs). There are different types of PPPs that involve different models for risk sharing between the municipality and its partners. In many cases the private party is in a better position to raise debt and equity to finance a project
   c. *Long-term loans.* Over the years, municipalities have preferred long-term loans over bonds. This is partly because loans are less complicated to administer and only a few municipalities can absorb the high initial transaction costs associated with bond issues. Municipalities also may not have the technical capacity to issue bonds. Long-term loans amount to approximately 73 per cent of total local government debt.
   d. *Municipal bonds* are an ideal instrument for financing large capital projects. They address the shortcomings of loans as the period of tenure of bonds can go up to more than 30 years and the issuer (municipality) is able to negotiate the interest rate payments and the repayment period to meet its own and investors' needs. With bonds, there is a diverse pool of investors involved, whereas only two parties are involved in bank loans.

9. For a successful bond issue, a municipality must have a good revenue collection and revenue growth rate, as this serves as an indicator of the ability of a municipality to meet its bond repayment obligation.
10. The City of Johannesburg and the City of Cape Town have successfully launched bonds totalling R5.7 billion and R1 billion respectively. They are the only municipalities to have done so recently.

Lending institutions

11. The Development Bank of Southern Africa (DBSA) is the largest public lender to municipalities, with a 46 per cent share of total municipal debt in June 2007.
    a. Although DBSA is lending to all municipalities, its bias in favour of the metros. This tends to crowd out private sector lenders.
    b. The DBSA should be providing more assistance to municipalities that are not creditworthy so that they reach the stage where commercial banks develop an interest in funding them. Such interventions would ensure that the DBSA crowds in private sector finance in the local government environment.
12. The Infrastructure Finance Corporation (INCA) is a significant private lender in the market. It accounted for R3.6 billion or 23 per cent of municipalities' outstanding long-term loans as at 30 June 2007.
13. Banks and other financial institutions play an important intermediary role of linking the supply of capital with demand. They provide both short and long-term debt to municipalities. They accounted for R2.2 billion of outstanding long-term loans in June 2007.

Managing credit risk

14. All market-based financing arrangements carry risk. There are however ways of managing these risks, such as credit enhancements and obtaining proper credit ratings.
15. The regulatory framework governing municipal borrowing provides for the rights and duties of all parties lending to municipalities. The Municipal Finance Management Act, Borrowing Framework and various regulations introduce important budgetary and financial reforms that are designed to stabilise municipal finances and improve the scope for borrowing.

Constraints to leveraging private finance

16. Despite the efforts of various capacity-building programmes, municipalities are still under spending national transfers. This suggests their capacity to absorb further funds from borrowing is limited.
17. The municipal infrastructure grant (MIG) has grown by an annualised rate of 24 per cent between 2003/04 and 2009/10, external loans grew by 16 per cent for the same period and are set to decline from 2007/08. It is evident that the growth in the MIG provides an incentive for municipalities not to borrow.

Conclusion

18. Municipalities that are well positioned for more investment by the private sector, such as metros and the large secondary cities, should diversify their finance mix into bonds and PPPs. This will free-up significant resources that national government can use to assist struggling municipalities that will always be grant dependent.

---*Please read the chapter at www.treasury.gov.za*---

CHAPTER 7
WATER AND SANITATION

Overview and background

1. Although renewable, water is also a finite yet significant resource. South Africa is classified as a water scarce country, with water sources limited in certain areas of the country. Due to water being unevenly distributed throughout the country, Government has divided the country into a number (19) of catchment-based water management areas to ensure that water resources are equitably allocated to all water users, including domestic, agriculture, commerce, industry and the environment. Five catchment areas have already been established.

The management of water resources

2. Future growth in water requirements will largely be in the main metropolitan areas, which need to be balanced with rural water needs, particularly agriculture. Substantial investments in infrastructure development and rehabilitation in water resources management will be made over the next few years, including the De Hoop Dam project.
3. Legislation is currently being processed which recommends the establishment of a National Water Resources Infrastructure Agency, which will be wholly owned by the state and responsible for the efficient and effective operation of the country’s water resource infrastructure.

The institutional arrangements in the water services sector

4. Water boards are intermediaries between the raw water supply and reticulation functions by providing bulk water to municipalities within their respective service areas as their primary function. Currently, 22 district municipalities and 123 local municipalities are responsible for the provision of the water services function to end consumers.
5. The two-tiered local government system, where either a local (category B) or a district (category C) is authorised for the provision of the water and sanitation functions, may be contributing to some of the difficulties currently being experienced in providing the service, including ensuring that fiscal resources are appropriately targeted towards these services. The Department of Provincial and Local Government will as part of its review of the White Paper on Local Government, among others, also deal with a number of issues related to the two-tier local government system.

Access to water and sanitation

6. Municipalities are responsible for increasing access to water and sanitation services to households that are currently not connected as well as improving and maintaining existing connections.
7. The 2007 Community Survey has indicated that access to piped water has increased by 4.1 per cent in South Africa since 2001. Western Cape Province recorded the highest performance (98.9 per cent) and Eastern Cape recorded the lowest performance of 70.4 per cent which is below the national average of 88.6 per cent. However, the most significant improvement in water backlog eradication has occurred in the Eastern Cape, where access to basic water increased by 7.2 per cent. This trend is also reflected in other provinces with low levels of access in 2001, such as KwaZulu-Natal and Limpopo. Government has therefore been making good strides in providing and increasing the access of water, which is one of the most significant and basic necessities, to all South Africans and consequently improving the quality of life.
8. The eradication of sanitation backlogs and providing people with adequate and acceptable levels of sanitation has been a major policy priority of government. National and local government worked extensively to eradicate the bucket system, with only 2.2 per cent of households in 2007 (in terms of Community Survey) still utlising this method of sanitation. Overall access to flushed toilets increased by 6 per cent from 2001 to 2007 while the percentage of households that had no toilet facilities declined by 4.4 per cent during the same period. Eastern Cape remains the province with the highest percentage of households (23.5 per cent) without any toilet facilities, followed by Limpopo Province (12.4 per cent).

9. Municipalities also play an important role in poverty alleviation by providing free basic water and sanitation and subsidised basic water and sanitation services to poor households. National Government Policy sets the amount of water that is to be provided for free at 6 kilolitres to all poor households per month. As from 2006, approximately 7 million households received free basic water and 3.8 million received free basic sanitation. Free basic services have been a government priority as such initiatives improve the quality of the life of the poor.

10. The quality of water supplied needs to be at an appropriate standard for human consumption and other social usage. Although South Africa is well known for its high quality of water, there have been recent instances of disease outbreaks due to quality standards not being maintained. One of the major causes of the substandard quality of water is purification works not functioning at optimal levels.

11. National government has initiated several policy processes to prevent excessive pollution and promote the efficient use of South Africa's water resources. The need to invest in new and existing water infrastructure is also necessary to maintain, not only the quality of water, but also the security of water supply.

Factors influencing the efficient provision of the water services function.

12. There are a range of factors that impact on the efficiency of the provision of the water and sanitation service by municipalities.

    a. The extent of water losses is one of the major factors that hinders service efficiency and in the process is costing municipalities greatly. Water losses are caused mainly by transmission leakages due to poor infrastructure maintenance. The importance of improving and maintaining existing infrastructure is an essential measure to improve the efficiency and the quality of the water and sanitation service.

    b. Other factors that contribute to water losses are illegal connections, low revenue collection rates and incorrect billing.

13. Administrative capacity and efficiency needs to be improved in local government. Municipalities should ring fence the water and sanitation service which will lead to improved costing of the water service and appropriate tariff-setting, maintenance of infrastructure, and so forth.

14. In order to improve the quality and efficiency of the water services sector, national government is initiating a number of reforms that will focus on municipalities in areas where there is insufficient capacity and skills to provide the water service, including advising municipalities on the most appropriate institutional options applicable for that service provision area.

---*Please read the chapter at www.treasury.gov.za*---

Chapter 8
Electricity

Overview and background

1. Electricity is currently a major issue in South Africa. Electricity generation shortages have affected the everyday lives of South Africans by way of the widespread blackouts during the early part of 2008 as a result of the load shedding initiatives of Eskom. Due to South Africa's good economic growth in recent years, electricity demand has increased, but crucial decisions to invest in additional generation capacity were not taken timeously.

Current and future developments in the electricity supply industry

2. Various initiatives have been launched to address these generation capacity shortages. Eskom has accelerated its investment programme to ease the current capacity constraints. This is set to run from 2009 until 2013 and will cost an estimated R343 billion. The 2008 Budget provides for a R60 billion loan over three years to the utility to support the financing of this programme. Building sustainable generation capacity in the long term will also be assisted by expanding the role of independent power producers (IPPs), a policy also endorsed by government.
3. The announcement of the National Energy Regulator of South Africa (NERSA) on 18 June 2008 has provided certainty in terms of electricity pricing, which will ensure that the tariff is equalised to the long-run cost of producing electricity over the next few years. This has the benefit of ensuring the sustainability of the electricity supply industry and encourages energy efficiency in industry and households. Cognisant of the current economic hardships faced by many of our people, NERSA provided the necessary protection to low-income and poor households by limiting the price increase to these customers to 14.2 per cent.
4. As part of a multi-pronged approach to address the current electricity shortages, the building of new power generation capacity is complemented by demand side management strategies and power conservation procedures and guidelines to assist the public so as to reduce the extent of load shedding and the impact on the macro-economy and society.

The current composition of the electricity distribution sector

5. Local government plays a major role in the electricity industry in South Africa as it is responsible for the provision of electricity to end consumers. Municipalities distribute electricity to more than half of all electricity customers in South Africa, with Eskom (who are also responsible for electricity generation and transmission) distributing to the remainder.

Electrification and free basic electricity

6. Municipalities (along with Eskom) are responsible for increasing the access to electricity to households that are currently not connected as well as improving and maintaining existing connections.
7. The 2007 Community Survey has indicated that access to electricity has increased overall by 10 per cent, with the largest improvement in electrification being in Limpopo, where backlogs decreased by 18 per cent, the Eastern Cape by 17 per cent and Northern Cape 15 per cent. This indicates that some of the provinces which previously had the lowest levels of households with access to electricity have worked extensively to remedy this problem and improve the quality of life of South Africans.
8. Municipalities also play an important role in poverty alleviation by providing free basic electricity and subsidised basic electricity to the poor. National government policy sets the level of electricity to be provided for free at 50kWh per month. As of 2006, approximately 3.4 million households received free basic electricity from municipalities, with Eskom providing free basic electricity, on behalf of municipalities, to a further 1.3 million households. This adds up to 4.7 million poor households receiving free basic electricity, as government strives to target and assist poor people.

9. The Department of Minerals and Energy has recently extended its free basic electricity programme to include alternative sources such as paraffin, coal, liquefied petroleum gas (LPG) and bio-ethanol gel. Free basic alternative energy is intended to provide indigent households with alternative energy where electricity is not available and could significantly improve the quality of life of less fortunate South Africans.

Factors influencing the efficient provision of the electricity distribution function.

10. A range of external and internal factors impact on the ability of municipalities to render the electricity distribution function.
11. Concern has been expressed regarding the lack of investment by some municipalities in repairing and maintaining existing infrastructure. This function is pivotal as aging electricity assets make the security of electricity supply unreliable, contributing to major supply disruptions. Spending trends show that maintenance of existing networks has not kept pace with growing demand for electricity, which will put a strain on these networks.
12. The extent of electricity losses is another major factor that is proving costly to municipalities. Non-technical losses result from illegal connections and incorrect billing among others, issues that municipalities need to address in order to increase the efficiency of their provision of electricity mandate. By addressing these issues pro-actively, there could be substantial spin-offs. These include investing appropriately in both the progressive roll-out of social infrastructure as well as existing infrastructure that underpins economic development. As access to electricity increases, investment in new and existing infrastructure needs to keep pace with the increase in demand.
13. Recent legislative developments have sought to provide a more coherent legislative framework for the municipal electricity reticulation function. National Energy Regulator of South Africa (NERSA) is the lead role player in this area. The legislation includes the Electricity Regulation Act of 2006 and the Electricity Regulation Amendment Act of 2007. The ring-fencing of electricity budgets, a new requirement introduced through the Electricity Regulation Act (as amended) will bring about institutional efficiencies that will yield many benefits, including a more correctly costed service and tariff setting that is more appropriately aligned with the actual cost of providing the service. Other complimentary legislation includes the Municipal Fiscal Powers and Functions Act (MFPFA) which gives national government the power to regulate municipal surcharges on the electricity reticulation service.
14. Future developments in the electricity distribution industry (EDI) include the restructuring of the sector and the establishment of wall-to-wall regional electricity distributors, which incorporates the distribution capabilities of municipalities and Eskom into six publicly owned electricity distribution companies. Concerns have been raised around the pace at which the restructuring of the electricity distribution industry is occurring, with several issues still unresolved. The uncertainty of the electricity distribution industry restructuring process among municipalities and other agents restricts the efficiency of planning and consequently the efficiency in providing and maintaining electricity distribution. National government has acknowledged this concern and is currently dealing with the outstanding EDI policy and legislative issues in this regard.

---*Please read the chapter at www.treasury.gov.za*---

Chapter 9
Roads and public transport

Overview and background

1. The demand for road transport services in South Africa is increasing, consequently there is a continuing high demand for transport infrastructure investment.
2. In analysing municipal roads infrastructure budgets, it is clear that the increase in demand has not been matched by investment or maintenance of either roads or public transport. As such, road construction and maintenance must continue to be prioritised in the period ahead.

Institutional arrangements

3. The national Department of Transport plays a largely facilitative and regulatory role in respect of roads and transport. Provincial roads and traffic are exclusive Schedule 5A provincial functions. Municipal roads, traffic and parking are exclusive Schedule 5B municipal functions. Public transport is a concurrent Schedule 4A national and provincial function.
4. Despite these constitutional assignments, the de facto functional assignment of roads and public transport functions between spheres of government has been confusing and fragmented.

Municipal road infrastructure

5. As at 2007, the South African road network comprised some 741 100 km of proclaimed roads and streets. However, the national public road inventory is out of date according to the national Department of Transport, which is responsible for compiling it. The department attributes this to the fact that it is reliant on provinces and municipalities to supply information based on their monitoring of roads.
6. To remedy the situation, the national Department of Transport is currently undertaking studies aimed at reclassifying the entire road network in South Africa and clarifying responsibilities for individual roads.
7. Municipalities are responsible for the construction and maintenance of roads and streets within their jurisdiction. Metropolitan transport advisory boards govern urban areas which have been declared metropolitan transport areas.

Number of vehicles and impact on roads

8. One effect of economic growth has been an increasing number of vehicles on the roads. Between 2004 and 2007, nearly 2.5 million new vehicles were sold in South Africa. This is on top of the 1.5 million vehicles sold between 2000 and 2003. Currently, South Africa’s vehicle population is over 8.2 million.
9. The average annual growth rate of 7 per cent contributes to congestion and puts pressure on the maintenance of the country’s road network. The challenges of increasing congestion are compounded by problems associated with the behaviour of road users.
10. There are essentially three ways in which municipalities (and government) can begin to mitigate the costs associated with rising private vehicle usage.
    a. First, in the short term extend, enhance and maintain the existing road network.
    b. Second, encourage a shift away from private vehicle usage to public transport.
    c. Third, over the medium term encourage more integrated and sustainable human settlement patterns.

Trends in expenditure on roads

11. In 2005/06, total provincial and municipal roads infrastructure expenditure was R11.1 billion. Of this, municipalities spent R3.5 billion or 31.9%, and provinces spent R7.6 billion or 68.9%. Metropolitan municipalities account for 60% of the aggregated municipal roads infrastructure budgets and the 21 secondary cities account for 30%.

12. For the period under review, metro roads infrastructure budgets increased by 4.6% annual nominal growth, from R1.4 billion in 2003/04 to R1.6 billion in 2006/07 and are set to decrease by 3.2% annually to R2.3 billion by 2009/10. Adjusted for inflation, aggregated metropolitan municipalities' roads infrastructure budgets grew by 2.1 per cent in real terms from 2003/04 to 2006/07. This means they have not kept up with escalating costs in the construction industry and levels of motor vehicle registration.

13. The roads infrastructure budgets for the 21 secondary cities increased rapidly (32% annually) from R281 million in 2003/04 to R651 million in 2006/07, but are then set to decrease by 4.6 per cent annually to R876 million by 2009/10. While most of these municipalities list roads and storm-water upgrading as their number one priority in their IDPs, roads infrastructure budgets over the MTEF period are actually decreasing.

Trends in expenditure on roads maintenance

14. Metropolitan municipalities' roads maintenance budgets increased by 6.2% annual nominal growth, from R776 million in 2003/04 to R930 million in 2006/07 and are set to grow by 13.3% annually to R1.5 billion by 2009/10. Adjusted for inflation, roads maintenance budgets grew at an average annual growth rate of 4.6%.

15. The 21 secondary cities' roads maintenance budgets increased by 16.8% annual nominal growth, from R213 million in 2003/04 to R339 million in 2006/07, and are set to marginally increase by 3.1% annually to R386 million by 2009/10. In both metros and the secondary cities roads maintenance budgets have not kept up with inflation and growth in motor vehicle registrations.

Preparations for 2010 FIFA World Cup

16. Over the current MTEF, an additional R2 billion will be added to public transport networks, specifically bus rapid transit systems, in addition to the transport infrastructure investment of R11.7 billion since 2005/06. The funding is aligned with the 2007 public transport strategy.

Public transport system and the system to allocate grants

17. National Department of Transport is responsible for the national transport plan for the 2010 FIFA World Cup. Since 2005/06 the department has transferred more than R2 billion to host cities and feeder municipalities, the South African Rail Commuter Corporation and Cross-Border Road Transport Agency for public transport infrastructure. The public transport infrastructure and systems grant has been allocated R1.8 billion in 2007/08, R3.5 billion in 2008/09 and R2.8 billion in 2009/10.

Public transport developments

18. Taxi Recapitalisation Programme has progressed significantly since its implementation in October 2006. To date, a total of 13 415 old and un-roadworthy minibus taxis have been scrapped.

19. Metrorail intends opening new lines in the next two years, while improving the service of existing ones, especially those dealing with high passenger volumes.

20. Public transport developments in Cape Town: The development of public transport lanes and infrastructure on Symphony Way (linking Philippi and the south east part of Cape Town with Bellville), the N1, and the R27 / Koeberg Road is a priority.

21. Durban's People Mover: In 2007 Durban's People Mover began transporting passengers in the inner city and to the city's beaches.

22. Joburg's rapid bus transport system: In November 2006, the City of Johannesburg launched 'Rea Vaya' (We are Going); the new system will have 325 kilometres of special public transport lanes and intersections, and 40 transport interchange nodes, where commuters can switch from one form of transport to another.

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Chapter 10
Managing the built environment

Overview and background

1. Public investment in built environment takes place across a number of sectors and across all spheres of government. These public investments are intended to support economic activity and address basic community needs. The diverse nature of needs among communities calls for the coordination of sectors to guide the blending of public and private investments. The effectiveness of public sector investment is influenced by the capacity of institutions to manage their assets, provide guidance on spatial development and coordinate investments.

Expanding economic infrastructure

2. The growing economy has created demand for the extension and expansion of municipal infrastructure services. Economic growth has also resulted in the rapid growth of higher income housing developments and thus, additional demand of infrastructure within the city and on the periphery. The failure of municipalities to keep pace with the infrastructure needs has resulted in the over-utilization and deterioration of the existing infrastructure.

Maintaining infrastructure assets

3. Infrastructure maintenance differs between sectors, depending on the utilisation rates and the initial quality of the infrastructure that is installed. Nonetheless, the need for asset management remains a function of where the municipality is in terms of its asset management cycle. This requires the maintenance of proper asset management systems Failure to do this will inevitably lead to the erosion of asset values and a decline in the quality of services.

Challenges arising from demands for municipal infrastructure

4. The government has recognized the financial implications of infrastructure demands and has assisted by providing a policy framework, national grants and a framework for leveraging private sector funding. However, three additional challenges remain:
   a. First; the demand is shifting to large urban centers, characterized by an increase of poorer households who are less able to pay for the services.
   b. Second, there is a need for effective and efficient spatial planning systems to guide the investments in the built environment.
   c. Third, effective coordination of these investments is essential to achieving developmental outcomes of safe, liveable and dynamic communities, and to providing a consistent guide to fixed investments by households and firms.

Sources of infrastructure finance for municipalities

5. Various sources of finance are available to municipalities. The Municipal Infrastructure Grant (MIG) is the largest contributor. Alignment of MIG to other programs including the housing and human settlement grants is essential for integrated human settlement outcomes.
6. Although municipal expenditure grew at an average rate of 26.9% over the past six years, it was set to grow by a massive 92.3% between 2006/07 and 2007/8, largely due to 2010 FIFA World Cup projects.

Progress in addressing backlogs

7. Significant progress has been made in addressing backlogs but there is still considerable work to be done to meet targets. Sector departments are faced by the challenge of inadequate capacity, maintenance and modification of systems and inadequate bulk infrastructure. The backlogs remain stark in the rural areas and less capacitated municipalities. The effects of these challenges are under-spending and over-utilization of exiting assets.

Spatial planning

8. Since 1994, the government has been grappling with the fragmented, incoherent and constraining regulatory framework for planning. The regulatory framework has failed to redress the segregated, unequal and dysfunctional patterns of apartheid cities.

9. Overall, the planning and property development approval processes have had the effect of both increasing the cost of investment and enabling lobbies opposed to investment to delay and prevent new property development projects. This regulatory environment has a negative impact in the following ways:

   a. *Economically*: it impedes investment in land development and fails to establish sufficient certainty in the land market.

   b. *Spatially*: it fails to address the segregated and unequal spatial patterns inherited from apartheid.

   c. *Environmentally*: it does not balance the country's socio-economic needs with those of environmental conservation and sustainability.

   d. *Procedurally*: the planning regulatory system has not only added to bureaucracy, but also increased the incentives for corruption of officials vested with the power of approving applications.

10. The reasons for the regulatory framework having this effect include:

    a. The fragmented nature and definition of planning functions means that the concept of planning is understood differently in different sectors and between spheres of government.

    b. There is little co-ordination of forward planning between sectors and uncertainty as to the manner in which forward planning should relate to the day-to-day management of land development.

    c. There are no procedures to review planning decisions every 10 years, to ensure that previous decisions are updated to take into account new realities.

    d. Administrative mechanisms to deal with objections and appeals are weak or non-existent, leaving judicial processes to deal with objections, often resulting in lengthy and costly delays.

    e. Preventative and management mechanisms to minimise risk of corruption and delay in approving planning applications are weak.

    f. The current situation puts considerable strain on the processes and instruments of co-operative governance in an area in which co-operation is especially important.

Coordination of public investments in the built environment

11. The public sector makes significant investments in the built environment. Complex sets of relationships exist in all three spheres of government relating to different infrastructure sectors. There is a potentially excessive demand for inter-governmental coordination especially in the housing departments.

12. Alignment is required between housing and infrastructure conditional grants which would lead to gradual re-assignment of the housing function to municipal level. This alignment should include the fiscal instruments supporting the development of the built environment as this has potential to improve local government's ability to deliver on its service delivery mandates. Improved certainty of grant allocations in the Division of Revenue Act (DORA; 2008) will enable the municipalities to plan ahead.

13. The problem of weak information flows is evident in the reporting system where the focus is purely on the expenditure performance with information gaps on the medium term targets.

---*Please read the chapter at www.treasury.gov.za*---

Chapter 11
Financial management and the MFMA implementation

Overview and background

1. The Municipal Finance Management Act is the legal framework that aims to modernize budget and financial management practices by placing local government finances on a sustainable footing in order to maximize the capacity of municipalities to deliver services to all its residents, customers, users and investors. It also aims to put in place a sound financial governance framework, by clarifying and separating the roles and responsibilities of the mayor, executive and non-executive councillors and officials.
2. This chapter provides an aggregate view of progress made in a range of areas covering municipal finance reforms. Implementation of the reforms commenced four years ago and was undertaken in a phased and sequenced manner recognizing the capacity constraints and the changes that were needed to fully implement the reforms. Although progress has been made in certain areas, the chapter points to a number of challenges that still remain and require focused attention of oversight structures, policy and decision makers.
3. With the full commitment of all stakeholders, the basic building blocks have been laid and with the ongoing commitment and support of all role-players assuming direct responsibility for the reforms, it is possible to achieve the goal of sustainable financial management practice that is based on democratic accountability, effective and efficient use of public resources.

How the budgeting, planning and reporting processes are being strengthened

4. This chapter gives an overview of the implementation of the reforms focusing on the management, budgeting and planning processes, meeting deadlines for tabling and approving budgets, covering the strategic orientation in budgeting, raises the key aspect to address the credibility of budgets.
5. The MFMA facilitates the establishment of a clearly defined three-year budget cycle that seeks to achieve the best allocation of scarce resources to address the most important needs of a community. Evidence referred to in the chapter indicates a steady improvement in municipalities tabling and approving budgets on time. The progress in linking budgets with integrated development plans (IDP) is slow and performance is sub-optimal. Where the original budget and estimated actual expenditures showed a variance of greater than 20%, the budget was regarded as not credible, evidenced by the poor levels of capital spending.
6. It provides information on in-year reporting and discusses the status of annual financial statements and annual reports in municipalities. The chapter also discusses the relevance of the audit outcomes and describe the various types of outcomes, whilst providing information on the establishment of internal audits and audit committees.

The strengthening of oversight through improved transparency and reporting practices

7. A cornerstone of the reforms is the progressive and constant improvement in quality of information made available to the Council and the general public to promote accountability and to encourage public participation in municipal activities. The tabling in council and the publication of relevant financial information coupled with service delivery related performance forms part of the package of reforms envisioned.
8. Reforms are also be implemented in supply chain and information contained in the chapter point to the adoption of policies, implementation of delegation, establishment of the various committees and training to support the reforms.
9. An aspect of public finance that required further analysis related to the institutional models used to delivery municipal services. The research into the number of municipal entities and the functions they perform on behalf of municipalities have provided insight into these alternative institutions. This research has also led to closer examination of the operations of such entities, their establishment, roles and responsibilities.

The strengthening of the regulatory environment for municipal financial management

10. The chapter also provides information on the interventions undertaken by provinces in municipalities and points to the common areas needing attention, namely, revenue collection, budgeting, internal controls and strengthening of governance arrangements for effective decision making.

Institutional strengthening and capacity building.

11. Over the past four to five years, major support has been provided through various capacity building efforts, ranging from financial support in the form of grant allocations, technical support through the placement of technical experts, support rendered through a graduate internship programmes to encourage new entrants into the field of municipal finances.

12. Some of the detailed analysis suggests that there has been a noticeable improvement in management arrangements between the years 2004/05 and 2005/06. Despite this largely positive self-assessment by municipalities, there was an increase in the number of municipalities reporting vacancies for municipal managers and chief financial officers. Research results also indicate that the 2006 local government elections impacted on senior management especially in the low capacity municipalities. This trend impacted on the pace at which financial management reforms had been implemented.

13. The MFMA requires a number of financial and non-financial reports to be prepared, tabled in council and published on municipal websites in order to strengthen oversight and improve management arrangements. While improvements against all submission indicators are evident between the 2004/05 and 2005/06 financial years, this trend reversed in 2006/07. Poor planning, weak management and the inability of officials to prepare financial statements to the required standards are a feature of the municipal landscape. Further skills audits on financial management capacity are being undertaken in many municipalities and initial findings suggest that a back to basics policy coupled with targeted training programmes will assist in addressing the fundamental weaknesses in financial management in many municipalities. A co-ordinated programme of action, with regional based universities and specialist trainers is planned for roll out during 2008, 2009 and 2010.

14. Further measures will also have to be considered on how best to enforce compliance with the legal framework and to build on key principles espoused to promote good governance, public accountability and transparency in the use of public resources. A sustainable future depends on focused efforts and unwavering commitment to effective and efficient government through accountable and transparent finance management.

---*Please read the chapter at www.treasury.gov.za*---

Chapter 12
Managing municipal personnel

Overview and background

1. Municipal employees and the skills they bring to the workplace are a critical input in the delivery of all services a municipality delivers. The objective of managing municipal personnel is therefore not necessarily to minimise the "wage bill", but rather to ensure that people with the required skills are recruited, retained and appropriately deployed.
2. Generally, expenditure on personnel is notoriously difficult to restructure, even over the medium-term. Therefore any interventions aimed at changing the way a municipality manages its employees and allocates its personnel budget, need to be thoroughly thought through, as such interventions typically have long-term impacts on municipal finances, delivery and the livelihoods of individuals and households.

Trends in local government employment

3. In 2006, municipalities employed some 200 000 people and contributed 1.6 per cent to employment (official definition). In the 70 mostly rural municipalities, municipal employment contributed only 0.7 per cent to employment. This is substantially less than in the metros, secondary cities and towns. This would seem to contradict the received wisdom that in small towns and rural areas municipalities are the primary employers.

Growth in local government employment

4. Personnel spending by municipalities has increased significantly over the past five years. However, 2 532 fewer people were employed by municipalities in 2006 than in 2005. In other words, the increase in personnel spending between 2005 and 2006 did not translate into increased employment. Some of the job losses can probably be attributed to increasing mechanisation of service delivery systems – a trend which is discussed in greater detail below.

Vacancies in local government

5. "Lack of capacity" is one of the perennial explanations for shortcomings in municipal service delivery. Core to this capacity problem are the very high vacancy rates in local government, which are aggravated by the job losses noted above.
6. In 2005, there were 256 885 positions in local government, of which 50 619 or 19.1 per cent were vacant. In 2006, the number of positions increased to 260 744, of which 57 010 or 21.9 per cent were vacant. However, vacancy rates need to be interpreted with care:
   a. First, a vacancy only has meaning in the context of an up-to-date organisational structure that has been approved by its council. However, in most instances the municipal organisational structures are outdated or inadequate.
   b. Second, a municipal council may approve an organisational structure, but invariably may only be able to fund a certain percentage of the positions. Those positions that are funded but not filled are referred to as funded vacancies, while the remainder are unfunded vacancies; on aggregate just over 20 per cent of the approved positions in municipalities are unfunded.
   c. Lastly, about 28 per cent of municipal employees are appointed to non-existent positions, i.e. positions not reflected on the municipality's organisational structure. The practice appears to be very widespread among municipalities in Mpumalanga, where more than 60 per cent of municipal employees are appointed to positions not reflected on organisational structures.

Getting the personnel mix right

7. A municipality needs sufficient workers and the right skills mix to deliver services effectively. The fact that there are on average only about 7 municipal workers per 1 000 households in Limpopo and about 11 and 12 in Mpumalanga and North West respectively, does suggest that staffing levels among the municipalities in these provinces may be inadequate.

Employment trends in key sectors

8. Nationally, about 32 per cent of municipal staff are directly involved in delivering the key services of electricity, water and sanitation and waste removal. A further 14 per cent are involved in financial administration, much of which is closely linked to the effective delivery of these key services.
9. In 2006, over 25 per cent of the 10 226 staff employed by district municipalities were in financial administration, which at the time would have involved the administration associated with the regional services council levies. It would be important to track what has happened to this staff component since the scrapping of these levies. More broadly, it must certainly raise questions about the institutional efficiency and even the continued relevance of category C municipalities.

Trends in personnel expenditure

10. Total municipal expenditure on personnel increased from R22.2 billion in 2003/04 to R29.3 billion in 2006/07 and is projected to increase to R38.4 billion by 2009/10. In other words, personnel expenditure increased at an annual rate of 9.8 per cent between 2003/04 and 2006/07 and is set to increase by an average annual 9.5 per cent over the MTEF period. This is consistent with the growth in total expenditure by municipalities.

Personnel expenditure versus other inputs

11. Aggregate municipal expenditure on personnel as a percentage of operating expenditure has remained almost constant around 30 per cent since 2003/04.
    a. For the metros, the ratio is set to decline to a level around 26 per cent over the MTEF period.
    b. For category B municipalities this ratio has been increasing consistently from 32.8 per cent in 2004/05 and is set to reach 35.9 per cent in 2009/10.
    c. For category C municipalities this ratio increases from 22.5 per cent in 2003/04 to an expected 40 per cent in 2009/10.
12. It is difficult to reconcile the trend among category B municipalities with the observed decline in employment numbers for these municipalities. What it points to is that higher wages appear to correlate directly with a decline in the number of jobs, rather than attracting more people to work for municipalities. Or stated differently, average wages are increasing at the expense of jobs.
13. A number of municipalities have personnel to operating expenditure ratios in excess of 60 per cent. There have to be serious doubts about the financial viability of such municipalities, especially if there is little prospect of them being able to increase their budgets with internally generated revenues.

Average cost of employment

14. The average cost per employee in most instances are increasing at rates well above inflation. This points to the possibility that many of the jobs shed between 2005 and 2006 were lower income jobs, which suggests that municipalities are either adopting less labour intensive approaches to deliver services, or they are outsourcing labour intensive services to the private sector. Either way municipalities are employing fewer low skilled workers directly.

Are municipalities supporting job creation?

15. By providing indigent households with access to free or subsidised services, municipalities contribute directly to alleviating poverty. However, where municipalities choose to use labour intensive approaches their contribution to combating poverty is even greater. By extending formal and temporary employment opportunities, particularly to those with limited skills, municipalities are, in essence, providing people with fishing rods and not just fish.
16. Many activities performed by municipalities lend themselves to providing job opportunities for low and unskilled labour. Yet, municipalities' involvement in the EPWP is very limited. Only 20 of the 283 municipalities participated in the programme in 2005. This increased to 33 in 2006 and 2007. Nevertheless, although less than 10 per cent of the total number of EPWP projects were by

municipalities over the last three years, these projects have created over 20 per cent of the work opportunities.

17. Why do municipalities appear to be becoming more capital intensive in their approach to service delivery? A standard economic answer to this question is that the cost of labour has increased relative to the cost of capital within the municipal sphere of activity. And so municipalities are behaving rationally (economically speaking) when they replace labour with machines – labourers digging ditches with ditch diggers. After all, a municipality's primary aim is to maximise the output of services to communities given available resources. Hence, if a capital intensive approach is more cost effective than a labour intensive approach it is incumbent on a municipality to mechanise. Or is it?

18. The average minimum wage for municipalities and utilities has increased from 12 per cent above the national average for all sectors in 2005 to 41 per cent above the national average in 2007. Given the relatively modest wage settlements in these years, this points to a reduction in the proportion of jobs at the lower end of the wage spectrum within municipalities.

19. In summary, jobs are being lost, the average cost per employee is increasing and the higher minimum wages are being "paid for" by the shedding of low level jobs – facilitated by mechanisation and outsourcing.

Conclusion

20. The above analysis highlights the relatively modest contribution that municipalities make to overall employment. It shows that between 2005 and 2006 the number of municipal employees declined, despite an increase in the number of available positions. Together, these factors have contributed to rising vacancy rates. Although the aggregate vacancy rates are on average lower in the key sectors of electricity, water and sanitation and waste removal than in other areas of service delivery, they are worryingly high among the metros.

21. Personnel expenditure has been growing strongly. However, the average cost of employment and the average minimum wage have grown even faster. In effect these gains are being "paid for" by the shedding of low level jobs – facilitated by mechanisation and outsourcing.

22. Indeed many of the trends point to a bias in favour of mechanisation and against labour intensive approaches to delivering services. This needs to be reversed if municipalities are to make a meaningful contribution to job creation and to combating poverty.

23. Lastly, there is an urgent need to improve the scope and quality of information pertaining to municipal personnel so that it can be used to analyse the nature of the problems facing local government and so assist developing interventions that go to the core of the capacity challenges faced by the sector.

---Please read the chapter at www.treasury.gov.za---

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