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Introduction

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Local government has emerged from a prolonged transition to face a second generation of challenges. A growing economy and urbanisation have resulted in increased demand for economic infrastructure, ageing assets are increasingly requiring upgrading, rehabilitation or replacement and the location and nature of poverty are changing. Yet the context and pressures of individual municipalities differ widely. Levels of economic activity and poverty are markedly different: large urban municipalities are coping with rapid demographic and economic growth, while more rural municipalities face huge challenges in addressing backlogs in basic services.

Local government has emerged from a prolonged transition to face a second generation of challenges

Municipalities are the custodians of public funds, whether raised from their own revenues or received through intergovernmental grants. They are tasked with using these resources to respond to the needs of their communities for infrastructure, local services such as water, electricity and refuse removal and enabling and guiding the spatial development of their localities.

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. 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. While they were successful in the past, the strategies to address service backlogs for previously ignored communities are coming up against significant cost pressures that partially result from

The demands of a growing economy are no longer being met by the levels of municipal investment 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. 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 of everything.

Municipal revenue collection has begun to fall as greater reliance is placed on transfers as a revenue source

A shortage of national funding is an inadequate explanation for these trends. Significant real increases in resources have been transferred to local government and proportionate to the location of poverty. This has resulted in growing under-spending and unclear value for money in outputs. Municipal revenue collection has begun to fall as greater reliance is placed on transfers as a revenue source. Indeed, the growth in transfers may impact on the ability of municipalities to respond to local contexts, as local needs may increasingly diverge from the requirements that other spheres of government impose through the grant conditions.

Government has introduced a range of reforms to support municipalities in addressing the challenges they face. To encourage better planning, government has legislated that municipalities must produce integrated development plans (IDPs). These plans are supposed to interface with the provincial growth and development plans and the national spatial development perspective to provide an overarching plan of how infrastructure services are to be provided within the local geographic area. However, this is only true in theory. While some municipalities have come a long way, integrated planning in the true sense is not sufficiently recognised by the existing institutional and financing arrangements.

Financial management reforms have begun to improve the transparency, credibility, timeliness and usefulness of municipal financial information. This process began in 2004 in larger municipalities and is now being rolled out to smaller municipalities. The reforms are intended to empower both municipalities and citizens. Municipalities are more able to respond to local demands for infrastructure, services and the facilitation of spatial development through allocating available public resources in an effective and sustainable way. Communities are increasingly able to hold their municipalities to account for their expenditure choices and performance. Collectively, this helps municipalities to realise value for money in the use of public resources.

Uses of this publication

The main target audiences for this Review are people in local government: councillors, practitioners and citizens. The Review should help them form an aggregate picture of local government and to situate them in the context of the developmental role that this sphere of government is expected to play. However, policy-makers in other spheres of government will also find the information and analysis to be extremely valuable. Provincial and national legislatures will find useful information for strengthening their oversight of government at all levels, through the comparative and historical data on financial performance and, where possible, associated outputs. National and provincial departments sharing functional concurrency with the local government sphere could enjoy similar benefits. Researchers, analysts and investors will find a wealth of information on individual municipalities, categories of municipalities and the sphere as a whole.

Objectives of this publication

The Review focuses on the impact of municipalities on their socio-economic environments

The 2008 Local Government Budget and Expenditure Review is National Treasury's second publication dedicated to local government financial and fiscal issues. The 2006 Review described the basic fiscal and financial position of the local government system, based on the limited data that were available at the time. This Review marks a shift in National Treasury's analysis of local government from focusing largely on the finances and financial management of local government, to a focus on the impact of municipalities on their socio-economic environments. After all, municipalities are institutions of democratic local governance that exist to provide basic services to the communities that are living and working in these environments.

Data issues

Data limitations continue to restrict the scope and depth of the focus on the developmental outcomes of local government, but it is anticipated that the analysis begun in this Review can be deepened and broadened in the future. For example, information on what municipalities actually produce is not adequate, which limits the evaluation of municipal performance. Services such as solid waste management are not covered, despite being an important function that can have important environmental, social and employment effects. Analytical and policy research on the role of development charges in financing infrastructure investment is only beginning now.

National Treasury intends to complement the information presented here with increasingly greater public access to its own databases. This will be rolled out as part of a broader exercise to rationalise and improve the quality of data available on local government. Hopefully, this will encourage empirically driven public interest analysis and debate on issues in local governance and basic service delivery.

For more information on the different data sources used and their reliability, please refer to the Technical Notes at the beginning of this Review.

Main themes for the 2008 Review

This Review focuses on the impact of municipalities on their environment through exploring three main themes:

The Review investigates the performance of local government in supporting economic growth

First, the Review investigates the performance of local government in supporting economic growth. It collates available and often new, information on the growth in demand for municipal infrastructure. It assesses the extent to which municipal expenditures have kept pace with these demands and whether the quality of services provided is adequate to meet the needs of a growing economy. It investigates trends in municipal capital spending relative to these priorities and provides an initial assessment of the performance of regulatory and development planning functions by municipalities.

The Review assesses the performance of local government in combating poverty

Second, the Review assesses the performance of local government in combating poverty through investigating progress towards meeting targets for the elimination of basic service backlogs. It introduces an analysis of the employment effects of municipal service delivery programmes that will be expanded on in later publications.

The Review assesses the financial management capacity of municipalities

Third, it reviews the progress that has been made in strengthening the financial management capacity of municipalities, which must lie at the centre of any programme to improve their overall operational capacities. It identifies the significant challenges that remain, particularly in stabilising the senior management cadre in municipalities that is responsible for implementing these reforms.

Key issues identified

The Review identifies at least two related trends that are impacting on the performance of municipalities in combating poverty, supporting economic growth and in strengthening their own governance and service delivery capacity.

Municipalities have been wary of actively leveraging private sector finance

First, municipal responses to demands for additional or improved infrastructure and services resulting from sustained economic growth have been constrained in a number of ways. There is growing evidence that municipal services are under-priced relative to the cost of production and this may be exacerbated by current inflationary pressures. Municipalities have also been wary of actively leveraging private sector finance, through debt, PPPs and development charges (that are paid by property developers for obtaining connections to infrastructure networks), despite a conducive economic and regulatory environment. This suggests that municipalities continue to face capacity constraints in conceptualising and implementing developmental spending programmes.

Municipalities have become more reliant on transfers from national government

Second, the increasing reliance of municipalities on transfers from national government to fund their activities has grown markedly, particularly in larger urban municipalities. This partially reflects the priority accorded to combating poverty through providing universal access to basic services. However, it also reflects limited own revenue effort and a lack of commitment to leverage private finance. This undermines the effectiveness of government's poverty alleviation efforts as these revenue sources are not being optimally utilised. Ultimately, this trend may reduce the autonomy of municipalities as they become increasingly dependent on national transfers.

The Review proposes several appropriate responses by all spheres of government. These span the three dimensions of supporting growth, combating poverty and strengthening municipal capacity.

Municipalities need to free up additional local resources

First, in order to better support economic growth, municipalities need to free up additional local resources to invest in infrastructure provision and service delivery. A careful balance will need to be struck between a structural adjustment to taxes and tariffs to cover the full, long term costs of service delivery and improved expenditure efficiencies. Managing necessary price increases will require a long term view (based on new tariff setting models) and sensitivity to growing pressures on household budgets. Price increases will thus need to be substantially offset by improved expenditure efficiencies that increase productivity in the major trading services. Most municipal expenditure is in major utility trading services such as water, electricity and refuse collection, that need to be managed efficiently and according to sound business principles. The institutional form of these local utilities needs to be clarified as a precursor to improved asset management and the pursuit of lower unit costs. Also, creditworthy municipalities need to explore opportunities for leveraging private finance for the expansion and delivery of services, especially those that support local economic development. Levels of borrowing are relatively low, while the use of PPPs for the development of infrastructure has been very limited. There is considerable scope for expanding the use of development charges to finance infrastructure investment, based on the principle that direct beneficiaries of services should shoulder the largest burden of the associated costs.

Municipalities need to reconceptualise their current programmes for combating poverty

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. Here, effective spatial planning and land use regulations governing development are crucial. While improving the access of poor households to the urban economy requires better use of strategically located urban land, municipal infrastructure investment decisions can be used creatively to guide private sector responses. For example, the location of bulk infrastructure obviously influences the private sector's decisions about where to invest and set up their businesses within a municipal jurisdiction. However, municipalities will only be able to guide private sector investments towards efficient and pro-poor development outcomes if they are able to spatially co-ordinate public investments across housing and infrastructure sectors. This needs to be done in ways that improve the access of poor households to economic opportunities as well as public services.

Municipalities need to generate more employment

There is also considerable scope for municipalities to generate more employment through their activities. A range of opportunities for labour intensive capital programmes and service delivery practices have not been adequately explored. Domestic solid waste and public cleansing activities, in particular, seem to provide good opportunities for using comparatively unskilled labour. This could contribute significantly to government's job creation objectives without undermining the financial position of municipalities.

Municipalities need to stabilise their senior management cadre

Third, to improve the capacity of municipalities to perform their functions, municipalities urgently need to stabilise their senior management cadre. Appropriate technical skills need to be in place. Evidence suggests that, in some instances, senior management positions have become tools in local political power plays, with unacceptably high turnover and vacancy levels, particularly around election times. This seriously disrupts the implementation of critical reform programmes and destabilises municipal administration.

More inputs are required from national government to improve municipal capacity

More inputs are also required from national government to contribute to the improvement of municipal capacity. The following technical functions require particular attention: sewerage and water treatment plant operators, road maintenance supervisors, health inspectors and planning and project managers. In particular, there needs to be better co-ordination between policy instruments. For example, grants may be squeezing out borrowing and community/user contributions and undermining sound asset management practices. Greater emphasis needs to be placed on the self-financing of services, the transparent operation of subsidies and clear incentives for municipal performance. Capacity support programmes have been fragmented and often un-strategic in their orientation and may have undermined municipal accountability for performance.

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.

A summary of the chapters

The 2008 Review is made up of twelve chapters that are divided into four parts. The first part of the Review looks at the context for local governance, the second part considers the financing of local government, the third part investigates trends within the major services provided by municipalities and the final part discusses some key themes in managing local development.

The first part consists of just one chapter. *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 that address the major social and economic trends and highlights important opportunities for municipalities that arise from these policy choices.

The second part looks at the key issues in financing local government. *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. *Chapter 4: Metropolitan finance* focuses specifically on the financial performance of South Africa's six metropolitan municipalities. In addition to the points raised in Chapter 3, it notes the effects on municipal budgets of expenditure related to the 2010 FIFA World Cup and the specific challenges associated with coping with high levels of urbanisation. *Chapter 5: Intergovernmental transfers* tracks the reforms introduced in the system of transfers to municipalities 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 for municipal accountability to communities. *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.

The third part investigates municipal performance in the delivery of major services. *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. *Chapter 8: Electricity* outlines the structure of the electricity sector in South Africa and some of the challenges it is facing. Again, issues of asset maintenance and pricing are highlighted as key challenges facing the electricity distribution industry if it is to continue to contribute to growth and development. Ongoing uncertainty about the pace and direction of reforms to the electricity distribution industry continues to disrupt efforts to reverse the declines in the sector. *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.

The final part considers three cross-cutting issues in municipal finance that are critical to the ability of municipalities to manage the local development processes. *Chapter 10: Managing the built environment*, describes the rapid growth in demand for public investment in the built environment and analyses trends in investment responses by municipalities, in the context of overall public investment in the built environment. It notes that while municipalities have made significant progress in addressing historical backlogs in basic infrastructure, shifting patterns of demand – to urban areas and to support economic growth – are currently outstripping the investment capacity of municipalities. Municipal approaches to asset management are increasingly being exposed as inadequate. Underlying this problem are concerns about the current framework for spatial planning and weaknesses in mechanisms for the co-ordination of public investments. Considerable work is still required to refine policy and implementation frameworks for both spatial planning and public sector co-ordination. Without this, the efficiency and developmental effectiveness of public investments will continue to be undermined. *Chapter 11: Financial management and MFMA implementation*, reviews progress made with the implementation of financial management reforms in municipalities over the last four years. These reforms underpin the process of democratic accountability. It notes that while a firm foundation of financial management systems and capacity has been laid down, considerable work remains. Key issues include improving audit outcomes and stabilising senior municipal management positions. *Chapter 12: Managing municipal personnel* considers trends in municipal employment. It highlights the modest contribution that municipalities make to overall employment and notes 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. 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. Indeed many of the trends point to a bias in favour of mechanisation. This needs to be reversed if municipalities are to make a meaningful contribution to job creation and combating poverty.

Conclusion

The environments in which South Africa's 283 municipalities operate differ considerably. The varied demographic and social trends and the varying spatial implications of national fiscal policy will all require vastly different policy responses from individual municipalities.

All municipalities must reconcile the need to fund service improvements, through price increases, with the imperative of ensuring that household bills remain affordable. Short term price increases seem to be unavoidable for the major municipal services. Over the medium term, however, municipalities will need to consider mechanisms to improve the efficiency of their expenditures. This will not only support local economic development, but also provide scope for more aggressive programmes to combat poverty.

National fiscal policy gives municipalities the space to respond appropriately to this challenge. Increased grant resources can fund the cost of necessary institutional reforms to improve expenditure efficiencies of municipal trading services. The scope for more municipal borrowing will allow municipalities to fund investments up front, while spreading their financing over the life of these assets.

The ability of municipalities to rise to these challenges will ultimately be determined by the quality of their governance and administrative practices. Stronger, more participatory governance practices will, however, only have a meaningful effect if municipalities provide stable and attractive work environments. Ultimately, councils must ensure that they have the right people in the right places to lead their municipal administrations and provide the technical expertise required to deliver services.