2

The socio-economic and fiscal context for local government

Introduction

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. Demographic trends vary significantly between large urban municipalities and their smaller rural counterparts, making very different demands on municipal budgets. Economic activity in some municipal areas is predominantly agricultural, while in others it is more concentrated on manufacturing or financial services. Different sectors have different requirements from local government. National government policy attempts to address structural disparities between municipalities, through distributing nationally raised resources to areas of greatest need, while other aspects of fiscal policy create opportunities for some municipalities to leverage private sector finance or facilitate economic development.

South Africa's municipalities operate in a wide range of social and economic contexts

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. Municipalities can also guide private investment decisions through the spatial location of their own infrastructure investments and their powers to regulate spatial development. The location of major roads, for example, can determine which areas become preferred locations for private investment. These spatial choices can also significantly influence the accessibility of

All municipalities must play a central role in supporting economic development and alleviating poverty poor households to economic opportunities and thus to productive livelihoods.

Municipalities must remain responsive to challenges and opportunities presented by social and economic trends and by fiscal policy. A key justification for a system of local governance is that it is better able, than national or provincial governments to respond to local trends, needs and priorities.

This chapter gives an overview of:

- local government and the national economy
- variations between municipalities
- economic outlook and local government
- national fiscal policy and local government.

Local government and the national economy

Between 2003/04 and 2007/08 the actual contribution of municipalities to GDP was relatively low

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). The infrastructure and services provided by municipalities are essential ingredients to the functioning and growth of other economic sectors. Municipal services are delivered predominantly to households, which provide the labour force for the economy. Water, electricity and refuse collection are critical inputs into all productive processes, while local road networks are essential to the delivery of goods and services to consumers. On average, local government accounted for 24 per cent of total public sector infrastructure expenditure between 2004/05 and 2007/08. The share of local government is, however, set to decline in response to more rapid growth in infrastructure expenditure by provincial government and public enterprises.

Variations between municipalities

There is considerable variation in the social and economic contexts and trends between municipalities. Trends in the social and economic contexts, the scale of service backlogs and the rate at which they are being addressed vary markedly.

Demographic trends

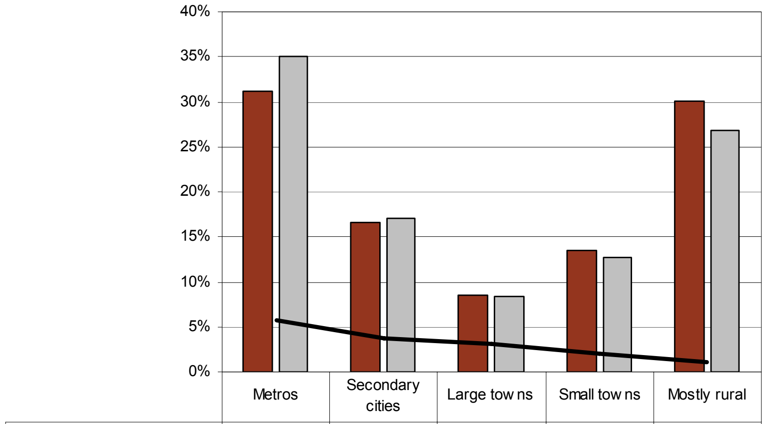
The current demographic trends of urbanisation and a reduction in the average size of households impact differently on individual municipalities

The current demographic trends of urbanisation and a reduction in the average size of households are reshaping the contexts for service delivery and governance in most municipalities in strikingly different ways[1]. 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

[1] The reduction in household size is known as "household decompression" and appears to have been driven by out-migration from rural areas and the greater availability of urban housing and basic services.

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.

Figure 2.1 Share of population and annual growth rate by category of municipality, 2001 – 2007

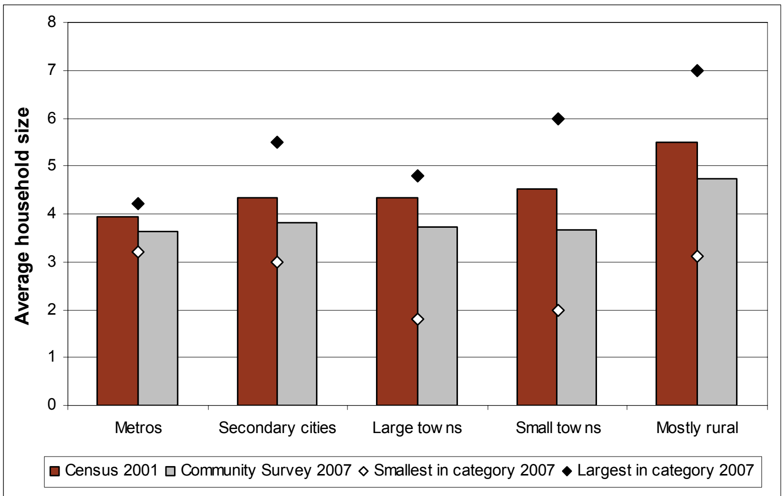


	Metros	Secondary cities	Large tow ns	Small tow ns	Mostly rural
Census 2001	31.2%	16.6%	8.5%	13.6%	30.2%
Community Survey 2007	35.0%	17.0%	8.4%	12.7%	26.8%
Annualised grow th rate (2001–2007)	5.7%	3.8%	3.1%	2.0%	1.0%

Source: Stats SA, Census 2001 and Community Survey 2007

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. But, due to out-migration, this process of household decompression is most marked in small towns and mostly rural municipalities, where the variation in average household sizes between individual municipalities is also greatest.

Figure 2.2 Average household size by municipality, 2001 – 2007



Source: Stats SA, Census 2001 and Community Survey 2007

Urban population growth and smaller households are creating significant fiscal challenges for all municipalities

The processes of urban population growth and the reduction in the average size of households create significant fiscal challenges for all municipalities. In more rural jurisdictions the out-migration of individuals to urban areas has been accompanied by falling average household sizes. This reduces the number of persons reached by each household service connection while simultaneously adding to backlogs in the urban centres. Also, while it is likely that new household formation has been limited, significant backlogs in access to basic infrastructure persist.

In larger urban areas, the process of rapid population growth and falling household size combine to extend the service delivery challenge facing these municipalities. In essence, 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.

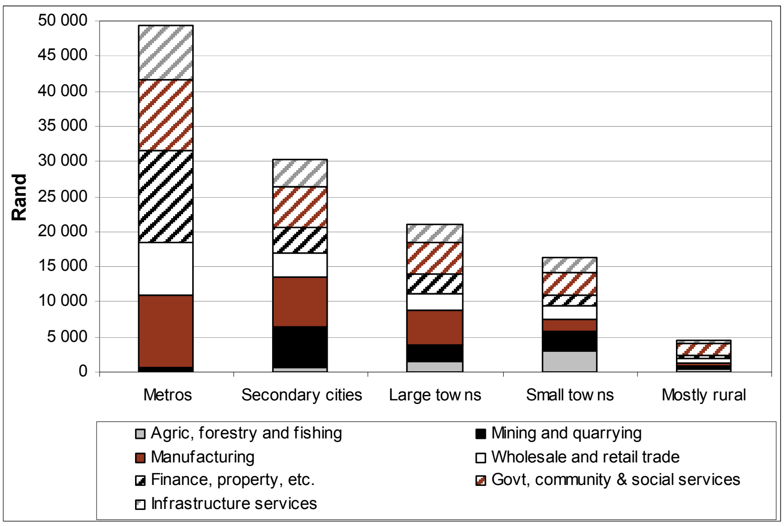
In addition, the HIV and AIDS pandemic has begun to fundamentally alter the definition of household units, with an increased prevalence of child-headed and multi-family units that have lost their primary income earners to illness or death. Most directly, this presents municipalities with more of a challenge when it comes to implementing their indigent policies and generating revenue.

Economic activity

There is also significant variation in the level and nature of economic activity across different municipal contexts.

Figure 2.3 demonstrates the 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.

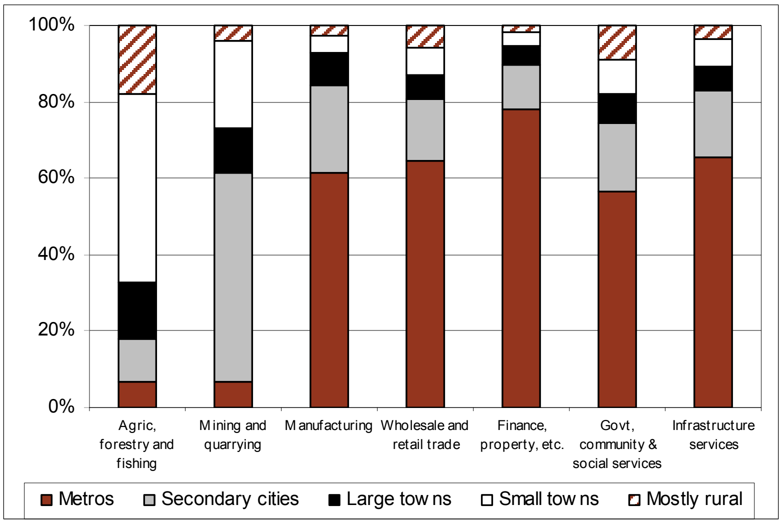
Figure 2.3 Gross value added (GVA) per capita by type of municipality, 2004



Source: National spatial development strategy

Figure 2.4 shows that 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, reflecting both the location of these activities and their significant contribution to the national economy. These differences underscore the need for individual municipalities to pursue vastly different infrastructure investment and service delivery strategies.

Figure 2.4 Municipal types and share of GVA by economic sector, 2004



Source: National spatial development strategy

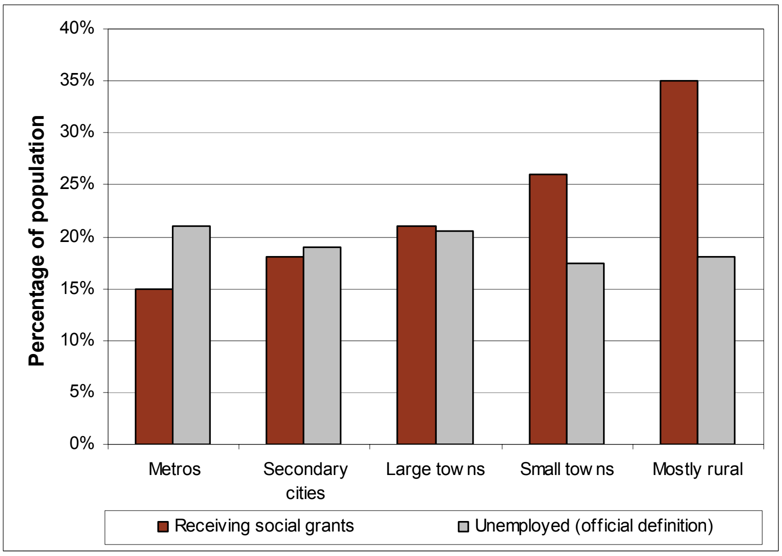
Poverty levels and access to services

There are wide variations in levels of poverty and access to services

There are wide variations in levels of poverty and access to services between the different categories of municipalities and individual municipalities within the same category. 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. High levels of poverty limit the ability of residents in more rural municipalities to pay for even basic services and constrain the ability of these municipalities to introduce significant cross-subsidies between richer and poorer consumers. Although metros do have the capacity to generate consumer cross-subsidies, they must ensure resources are effectively targeted to those in need in order to limit the overall size of the subsidies that are required.

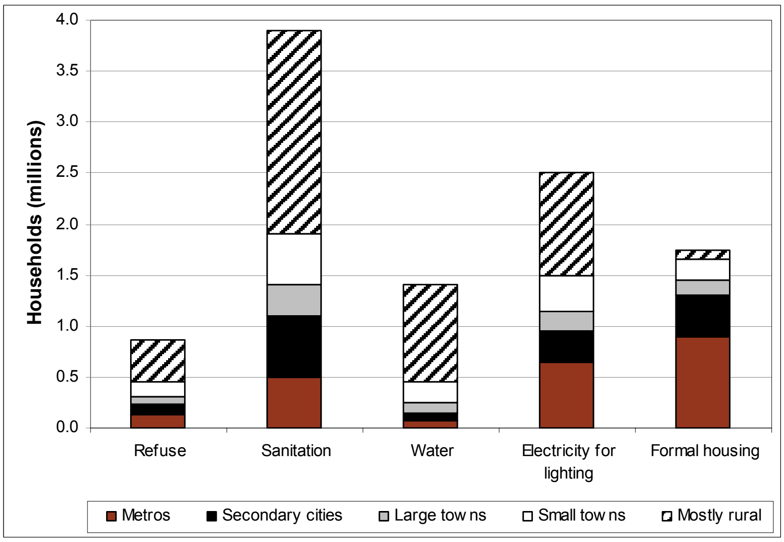
Backlogs in access to basic levels of services are most significant in the sanitation sector. Again, the mostly rural municipalities face the most significant absolute backlogs in access to services, while metros report high levels of backlogs in access to electricity for lighting and formal housing.

Figure 2.5 Proxies of poverty by municipal location, 2007



Source: Stats SA, Community Survey 2007

Figure 2.6 Households without access to basic services and housing by municipal location, 2007



Source: Stats SA, Community Survey 2007

Other chapters in this publication explore these issues in greater depth. At a broad level it is important to note the variations in contexts between municipalities and consider the implications of how municipalities respond. In particular, the high residual backlogs in the mostly rural municipalities 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. This volatility in demand requires municipalities to improve their long-term planning.

The economic outlook and local government

The 2008 Budget Review provides a more detailed analysis of the current economic outlook. It notes that 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.

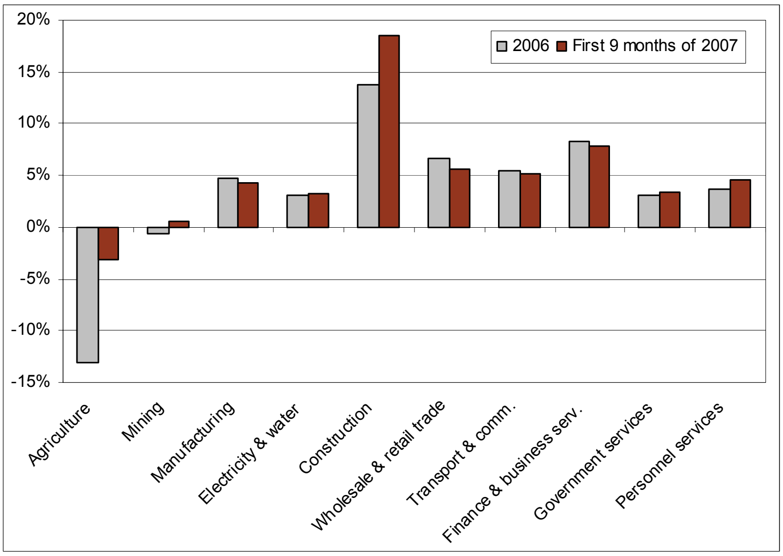
The short term economic outlook is clouded by a deteriorating global economy, rising inflation and supply constraints

The economic outlook in the short term, however, is clouded by a deteriorating global economy, rising inflation and supply constraints. Economic growth is projected to slow from 5 per cent to 4 per cent in 2008, rising to about 4.6 per cent by 2010. Gross fixed capital formation reached 21 per cent of GDP in 2007 and the pace of investment is expected to remain robust. Public sector infrastructure spending is increasing rapidly to alleviate capacity constraints and congestion in various network industries.

Two specific factors are of relevance to local government. 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.

Construction, financial services, transport and communication and wholesale and retail trade continued to grow at rates above 5 per cent, while the agriculture, forestry and fishing sector contracted by 3.1 per cent in the first nine months of 2007 compared with the same period in 2006. The mining sector grew at a sluggish pace in the first three quarters of 2007, with gross value added rising by only 0.5 per cent compared to the same period in 2006.

Figure 2.7 Sectoral growth, 2006 and 2007

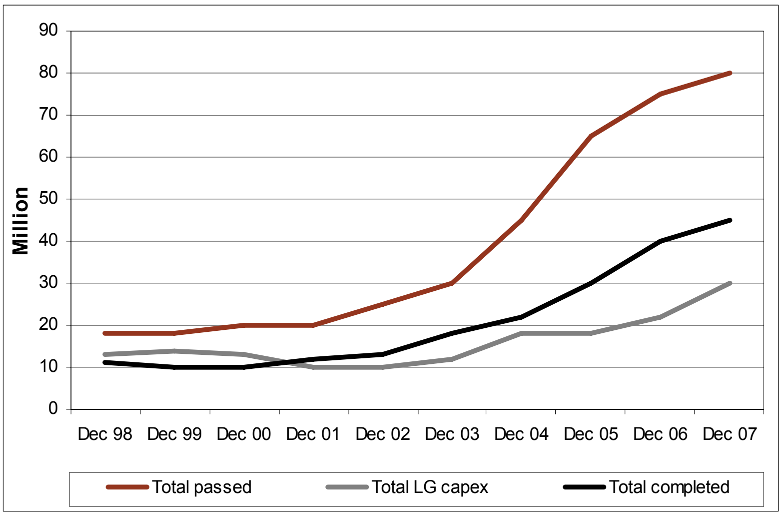


Source: 2008 Budget Review

Mostly rural municipalities tend to have a greater reliance on agriculture and related sectors, while secondary cities are largely reliant on the mining sector. Growth in these sectors can have knock-on effects for local economies and particularly for household spending, which ultimately impacts on municipal revenues.

In municipalities with economies based in higher growth sectors, growth has led to an expansion in demand for municipal infrastructure and services. Figure 2.8 shows the widening gap between municipal capital expenditure and the value of buildings completed, which serves as a proxy for demand for municipal infrastructure.

Figure 2.8 Nominal value of building plans passed and buildings completed and local government capital expenditure, 1998 – 2007



Source: Stats SA and National Treasury local government database

As reported in the 2008 Budget Review, this trend mirrors the declining share of gross fixed capital formation by general government between 2000/01 and 2006/07 (of which municipalities contributed approximately 36 per cent). This was due to the rapid expansion in investment by the private sector and public corporations. The municipal share of public infrastructure expenditure by general government is projected to fall from 38.2 per cent in 2007/08 to 33.4 per cent in 2010/11.

Economic developments are creating pressures for an increase in municipal taxes and user charges

Economic developments are creating pressures for an increase in municipal taxes and user charges, even as growth in some sectors is showing signs of slowing due to capacity constraints, rising interest rates and more moderate household spending. 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.

Municipalities need to manage price increases while ensuring that services remain affordable to consumers

The major challenge facing municipalities is to reconcile the need for price increases with the imperative of ensuring that services remain affordable to consumers, in an environment where household budgets are tightening. In this environment, price increases will need to be balanced with efforts to improve internal cost efficiencies.

Expenditure side productivity improvements remain largely unexplored in municipalities. Most municipalities do not operate their trading services as full cost centres with applied business logic. Few municipalities operate coherent or effective public works programmes.

Ancillary measures by municipalities to reduce the costs of doing business in their jurisdictions, through streamlining by-laws and development approvals, may provide some scope for offsetting the negative effects of price increases without expenditure side reforms, but this cannot be the only solution.

National fiscal policy and local government

In the face of economic developments, the core priorities of public policy and the 2008 Budget are focused on investment in sustainable long-term growth and progressively raising living standards. The fiscal stance enables government to raise public spending in key areas – increasing fixed investment, creating jobs, boosting export capacity, fighting poverty and improving public services – while providing a cushion against global volatility. Rising fixed investment, together with further microeconomic reforms, will raise the competitiveness of the economy, while reducing constraints in key areas, such as electricity.

National fiscal policy recognises that municipal expenditure contributes to poverty alleviation and economic development

National fiscal policy has long recognised that municipal expenditure makes a significant contribution towards alleviating poverty and economic development. Municipalities contribute to providing a social wage through providing free basic services to poor households. Municipal infrastructure investment contributes to total fixed capital formation by the public sector and the provision of associated services is critical for economic activity and household welfare.

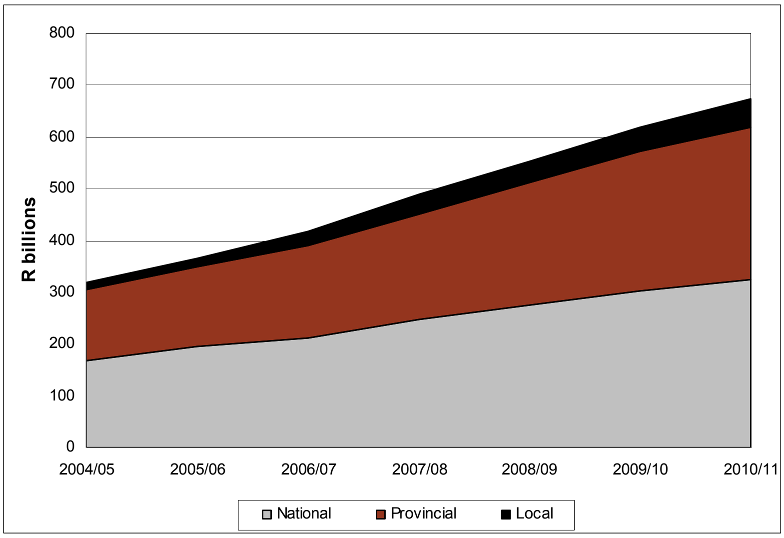
National government's fiscal policy has four implications for local government:

Local government's share of nationally collected revenues increases relative to the national and provincial spheres

First, the growth in government spending and its bias towards increased transfers to local government will result in additional resources being made available to municipalities. The broadly equitable nature of the distribution of these resources ensures that all municipalities benefit fairly and will experience significant real growth in national financial support over the medium-term. Local government's share of nationally collected revenues increases relative to the national and provincial spheres. This suggests that fiscal policy recognises the important role of local government and the need to channel more resources to it.

However, these resources are intended to contribute to the capital and operating costs of providing basic services to poor households, rather than as a general subsidy to municipal operations. The costs of providing infrastructure and services to non-poor households and firms must continue to be fully financed from local taxes and service charges. But municipal own revenue collection has declined as a portion of total revenue, with service charges in particular having grown at the slowest pace of all revenue sources. As a result, municipalities have become increasingly reliant on grants, indicating that there may be significant leakage of national resources to non-poor households.

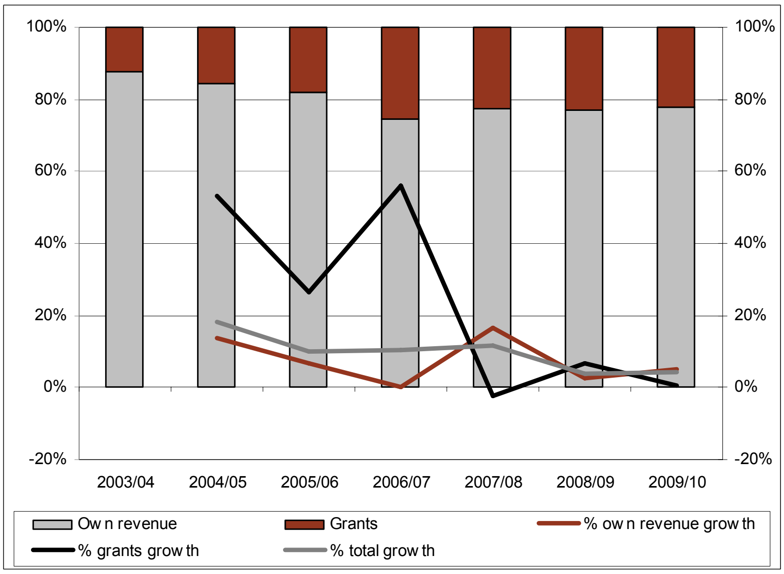
Figure 2.9 Historical nominal vertical division of revenue, 2004/05 – 2010/11



Source: 2008 Budget Review, National Treasury database

Second, transparent and responsible fiscal policy has created a comparatively stable economic and fiscal environment for municipalities to operate in. Current trends in national transfers to local government are sustainable over the medium-term. In turn, this stability enables more accurate planning and financial management by municipalities. Regulatory reforms to planning and budgeting processes have provided the legal basis on which municipalities can take advantage of this trend.

Figure 2.10 Revenue trends by major source, 2003/04 – 2009/10

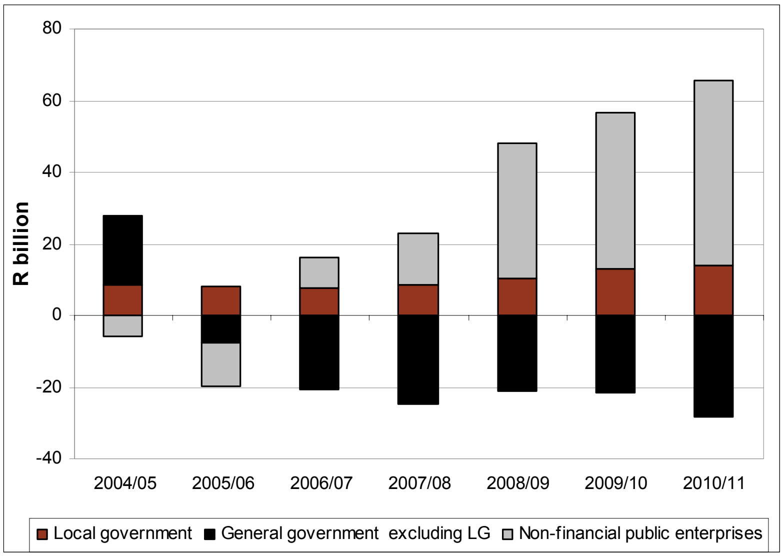


Source: National Treasury local government database

Third, the prudent fiscal stance of national government provides room for increased borrowing by sub-national entities, including municipalities. However, although not all municipalities are able to access private capital markets, those that can have not shown much initiative.

National government's prudent fiscal stance provides room for increased borrowing

Figure 2.11 Public sector borrowing requirement, 2004/05 – 2010/11



Source: 2008 Budget Review

Finally, 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. For municipalities, expanded public spending by other public entities places pressure on development planning and control systems. In addition, it extends demands for municipal infrastructure. For example, a new school or a shopping mall will require infrastructure such as local roads, water, electricity and sanitation. Effective mechanisms to co-ordinate and sequence public investments are thus required. These issues are considered in more detail in the next chapters of this Review.

Conclusion

Considerable variation exists between municipalities across South Africa. The impact of the differing demographic and social trends and fiscal policy will 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 and their jurisdictions remain competitive investment destinations. Short-term price increases appear unavoidable for the major municipal services. Over the medium-term, however, municipalities will need to increasingly consider mechanisms to improve the efficiency of their expenditures.

National fiscal policy provides important breathing space for municipalities to address this challenge. Increased grant resources can fund the cost of the required institutional transition, which is already supported strongly by legislation. The scope for increased municipal borrowing will allow municipalities to fund investments up front, while spreading their financing burden over the life of these assets.