**National Treasury**

**Republic of South Africa**

# Local Government Budgets and Expenditure Review, 2008

## Executive Guide

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# Contents

# 1. Introduction

### A new generation of challenges for municipalities

Municipalities in South Africa face a new generation of challenges. Having undergone a challenging transition from being racially segregated to new democratic structures that serve the development needs of communities, municipalities should be ready to deliver services effectively. The transition involved the establishment of new governance and management systems that will ensure an improved system of local government.

Municipalities are mainly responsible for providing basic services, such as water, sanitation, refuse removal, roads, public transportation and electricity to all residents within their boundaries. However, since 1994 a new generation of challenges has emerged to confront municipalities. Two main factors have changed the environment that municipalities operate in.

### Municipalities are now operating in a different environment

Firstly, the size of South Africa's population has increased, and where people live is changing. An increasing number of people have moved from rural areas to large cities. As a result the population of large urban municipalities has grown, while more rural municipalities have seen a decline in their population size. The size of small towns and secondary cities has remained largely stable. However, all municipalities have more households than they did in the past, as people now live in smaller family groups. This means that municipalities have a lot more customers to provide services to than they did in the past.

Secondly, South Africa's economy has grown strongly over the past few years. However, this growth has been focused in particular parts of the economy and in particular places in the country. This means that not all municipalities have benefited equally from economic growth, and not all municipalities face the same challenges that this growth brings with it. Large urban municipalities are the home to most economic activity in South Africa. As the economy grows this creates pressure for these municipalities to spend money to deliver more services (for example, collecting more refuse) and to extend or improve infrastructure, such as roads and electricity networks.

**Urban and rural areas have different infrastructure requirements**

Municipalities in large urban areas have not been able to build enough infrastructure to cope with the demands of both a growing population and a growing economy. Levels of municipal investment in infrastructure have consistently fallen behind the level of private sector investment in buildings. The gap between private investment and municipal investment grows bigger every year. This means that there is a significant backlog of municipal infrastructure needed to keep the economy growing.

Rural areas that have not benefited much from economic growth are less pressured and face fewer demands for increased levels of infrastructure investment. Thus, this category of municipalities needs to take care not to invest in infrastructure that may not be required in the future. However, their challenge remains the provision of basic services to communities.

**Despite support from national government, many municipalities are still ineffective**

National government has provided extensive support to municipalities over the past few years as a way of helping this sphere of government function better. This has been in the form of more money, targeted support programmes, improved policy and laws. Unfortunately, despite this support many municipalities still do not address issues effectively.

Very few municipalities have analysed their particular changing social and economic conditions in relation to the impact on their service delivery responsibilities. Many still do not have asset registers that would allow them to properly manage the assets they have. Others have not fully complied with the new budgeting and financial management rules set out in legislation. There are also many municipalities that have outdated and ineffective spatial development plans (also known as town plans), and inefficient development control systems that result in long delays in getting residential, business and factory developments approved. This means developments that would have created jobs are either delayed or never happen.

While there are still huge backlogs in access to basic infrastructure, many municipalities contribute to future and on-going challenges because of failure to adequately maintain existing infrastructure. For instance, if a municipality fails to maintain its sewerage works, it is more likely to breakdown and spill raw sewerage into nearby rivers.

**The issues that municipalities need to address now**

The points raised above suggest that municipalities must shift their focus away from internal issues and instead focus on improving their performance in delivering services. Major issues that municipalities should immediately attend to include:

- Responding to the rising demand for services, through increasing their capital and maintenance budgets, while at the same time limiting the amount they spend on operating costs, such as administration.
- Dedicating themselves to collecting all the money owed to them, while at the same time being sensitive to the difficulties experienced by the poor. Municipalities should aim to ensure that their own revenues grow at the same rate as the revenues they receive from national or provincial grants.
- Reviewing the price of municipal services; to ensure that they cover the full cost of producing the service, particularly in sectors such as water and sanitation as well as electricity and refuse removal.
- Removing institutional inefficiencies that result from bad human resource management, such as regular changes to senior managers, inadequate staffing of technical functions and a lack of commitment to effective relationships with national and provincial government.

**The purpose and uses of the Review**

This guide provides an overview of the main themes and issues in the *2008 Local Government Budgets and Expenditure Review* which covers the financial years 2003/04 to 2009/10. It however, does not cover all the issues in the main document.

The *Review* is published every two years by National Treasury to provide an assessment of the major trends and issues in local government. This allows the progress and performance of municipalities over the last four years to be measured, and an assessment to be made on whether municipalities are contributing to a "better life for all". In particular, the *Review* assists the reader in assessing whether government policies have realised the policy goals they were meant to achieve.

The *Review* also indicates programmes where municipalities have allocated and spent public funds. This allows the reader to assess whether these choices have been in line with developmental priorities that the municipality set out in its Integrated Development Plan, and whether the intended outputs (such as improved access to sanitation) have actually been achieved, and whether these outputs have made a contribution to national development through supporting growth or combating poverty.

The 2008 *Review* is different from previous versions in that it does not provide a basic description of the system of local government. Rather, it focuses on the major trends and issues that municipalities must begin to address. In particular, for the first time, the *Review* compares the performance of municipalities with activities and circumstances in the "real world" outside of municipal administrations and the public sector. In doing so, the *Review* takes account of the very different conditions and challenges that face different types of municipalities.

The *Review* can be used by many different stakeholders. National and provincial policy-makers can use the information and analysis to assess the effectiveness of policy towards local government. Local government representatives and managers can use the *Review* to compare the performance of their municipalities to that of the local government sector as a whole, or to other similar municipalities. Citizens can use the information to compare the performance of their municipality with that of others, and to hold their municipal representatives to account.

Specific information on individual municipalities is not presented in the Review. It is, however, available on National Treasury's website (www.treasury.gov.za). Researchers, municipal representatives or officials may like to compile this information on their municipality in a format that is comparable to the *Review* and table this as a report before their municipal council to facilitate public discussion about the issues raised in the document.

## The contents of this Guide

The rest of the Guide looks at:

- the context of local government
- issues in the financing of local government
- issues in service delivery
- cross-cutting issues and debates affecting local government

Each section ends with some questions for readers to consider, and that could be useful in assessing the actual performance of municipalities and the particular challenges each municipality faces.

# 2. The context of local government

### Municipal services are essential for people, the economy and combating poverty

Municipalities are an important part of the South African economy. Their combined expenditures amount to almost 7 per cent of South Africa's gross domestic product (GDP). Moreover, the infrastructure and services provided by municipalities are absolutely essential to the functioning of the economy. Water, electricity, roads, refuse and other services are essential inputs into most productive activities in the economy, be it in agriculture, manufacturing or financial services.

It is important to note that the largest 27 municipalities are home to almost 80 per cent of the national economy, when measured by their contribution to GDP. The performance of these municipalities is therefore very important to the overall performance of the South African economy. If this set of municipalities fails to deliver adequate services job creation and poverty reduction will be negatively affected.

Municipalities are responsible for 24 per cent of the total spending by the public sector on infrastructure every year (this includes the spending by large public enterprises like Eskom and Transnet). This means that municipalities are responsible for managing a very significant part of public infrastructure assets.

### Huge differences between municipalities across South Africa

There are big differences between municipalities across South Africa, mainly because of the massively different environments that they work in. Small, largely rural municipalities have large poor populations but little economic activity, whereas large urban municipalities have rapidly growing populations, and experience rapid economic growth. Municipalities based in medium sized towns tend to have stable populations and levels of economic activity. These differences have a big impact on what each municipality needs to do in order to support the development of its area.

In large urban areas there are more unemployed people than those who receive social grants, whereas in rural or small town municipalities more people receive social grants than those who are officially counted as being unemployed. This means that there are proportionately more young and elderly people in the more rural areas than in urban areas. When rural municipalities develop their plans and budgets they need to be mindful of this aspect. Similarly, large urban municipalities need to design plans and budgets that address the needs of young job seekers.

**National government policy creates an enabling legal and financial environment**

National government has introduced a policy and legal environment that assists municipalities in working out how to respond to their own unique social and economic situations.

The amount of money transferred to local government has risen dramatically. Local government now receives a far larger portion of national government's resources than at any point in the past. Its share has grown faster than that of both national and provincial government and has increased every year. This helps municipalities to plan and budget more effectively. These resources should assist municipalities to respond to their particular circumstances, and should not simply replace revenues that were raised from local sources in the past.

In addition, prudent financial management by national government has reduced the amount of money that it needs to borrow from private capital markets. Municipalities who have good financial management capabilities (usually measured by a "credit rating") should explore other means of supplementing their revenue sources such as borrowing - provided they are able to obtain favourable terms. Moreover, as national government is no longer competing with municipalities for these resources, and has put in place a good legal framework for municipal borrowing, these resources should be cheaper for municipalities than ever before.

| Some questions to consider | |
|---|---|
| **National level** | **Local level** |
| Does national policy on local government adequately distinguish between the vastly different contexts that municipalities must operate in?<br><br>Does national policy sufficiently support large urban municipalities in coping with both a growth in levels of poverty and in economic activity?<br><br>To what extent should restraints be imposed on small rural municipalities to prevent them building infrastructure that may not be needed in future? | What social and economic changes have occurred in your municipal area, and how does this compare to the national average, or to similar municipalities?<br><br>How has your municipality responded to these specific changes? How could it respond better?<br><br>To what extent has your municipality been able to take advantage of the opportunities provided by national fiscal policy, such as predictable and growing financial contributions to local government and an increased opportunity to borrow from private capital markets? |

# 3. Issues in the financing of local government

### Good financial management in municipalities is crucial

Financial management in local government deals with municipal revenue sources, how these resources are spent, how municipal budgets are developed, implemented and monitored.

In 2007/08 municipalities raised R118 billion in revenues, mainly from user charges, property rates and grants. They also raised almost R40 billion in resources to finance infrastructure investment, mainly from national grants and private loans. Total municipal spending accounted for over 23 per cent of total public spending in 2007/08.

National government's approach to financial management in municipalities is generally known as the fiscal framework for local government. This framework deals with the relationship between different revenue sources, including items such as grants from national government and borrowing from the private sector. It also identifies service delivery areas that municipalities must spend money on, and how they must budget for these services.

### Municipalities raise their own revenue and receive transfers from national government

Municipalities, unlike provinces, are largely self-financing. This means that they raise most of the resources that they need from local taxes and user charges. The power of municipalities to directly raise revenue, as opposed to relying on national grants, is an important part of their direct, democratic accountability to residents in their areas.

However, not all municipalities have the same ability to raise their own revenues. For example, while on average municipalities spent R3,538 per person in 2007/08, municipalities in Western Cape spent R6,334 per person, while those in Limpopo spent R1,903 per person. This is mainly because levels of poverty are lower in the Western Cape than in Limpopo, and therefore residents are better able to pay municipal taxes and other charges in the Western Cape than in Limpopo.

Also, no municipality is able to raise all of the revenues that it needs, mainly because of the high levels of poverty in most municipal areas. For this reason, national government makes various different kinds of financial transfers to municipalities.

The transfers made by national government to municipalities have grown dramatically in size over the past few years, and are increasingly made in ways that allow municipalities to plan for and use the resources effectively. These transfers are also increasingly directed to those municipalities that have large numbers of poor people. However, despite these important and positive changes there are two problems that remain.

**Some municipalities are becoming too dependent on grants from national government**

Firstly, the rapid increase in national transfers has reduced the proportion of revenues that municipalities raise from their own local sources. In some instances municipalities have stopped making serious attempts to collect their own revenues, for example by not collecting money owed to them by customers who can afford to pay. As a result municipalities are becoming more reliant on grants. In the long term this will result in municipalities becoming more accountable to national government than to their own residents. This has also contributed to municipalities not charging consumers for the full cost of the services that they use, such as water and refuse services. In December 2007, customers owed municipalities over R44 billion.

**Some grant programmes are not performing well**

Secondly, the performance of some of the smaller conditional grants programmes has not lived up to expectations. In particular, grants to strengthen municipal capacity are fragmented, overlapping and generally lacking coherence. This severely limits efforts to improve municipal performance, despite sufficient funds being available.

**Capital expenditure: municipalities are not spending enough on infrastructure**

The capital budgets of municipalities have grown at 16 per cent a year since 2003/04. However, this is not enough to meet the demands of either communities or the economy. Despite progress made since 1994, backlogs in accessing services remain high. Demands from the economy for more municipal infrastructure have also grown much faster than municipal capital budgets. In addition municipalities have also not been spending enough on maintaining existing infrastructure. For each year that a municipality does not spend enough on new infrastructure or maintenance the total accumulated backlog grows. Consequently, this will begin to prevent future economic growth, as basic municipal infrastructure will either not be available or will have fallen into disrepair.

Municipalities have chosen to rely on national grants to fund their infrastructure programmes.  Borrowing from the private sector accounted for less than 28 per cent of capital financing between 2003/04 and 2006/07, and this is set to decline to 18 per cent by 2009/10.

**Municipalities need to explore new sources of finance for investing in infrastructure**

Borrowing from the private sector to finance infrastructure investment allows municipalities to speed up the construction of infrastructure while paying it off over the useful life of the assets that are built. Thus borrowing should be a key source of capital funding for the stronger municipalities. The reduction in borrowing by national government has created a lot of scope for municipalities to explore this revenue source, alongside other ways of accessing private finance such as development charges and public-private partnerships (PPPs).

Unless municipalities begin to take the lead in exploring new sources of finance for infrastructure investment it is likely that they will be unable to stop the decline in the quality of services they provide.

**Financing issues in the six metropolitan municipalities**

The financing of metropolitan municipalities deserves a special mention. The metros account for over 57 per cent of all municipal spending, and this is continuing to increase. They are home to nearly 38 per cent of South African households and produce nearly 59 per cent of all goods and services in the economy. The capacity and performance of metropolitan municipalities has improved steadily and significantly over time, as shown by improvements in basic financial indicators and in their audit outcomes. However, metros are also facing many challenges. These include a growing reliance on grants, extremely high levels of consumer debt, and - in many metros – the lack of a business oriented approach to the delivery of their major trading services.

| Some questions to consider | |
|---|---|
| **National level** | **Local level** |
| Is there a need to slow down the growth in national grants to local government in order to encourage municipalities to raise their own revenues from citizens and the private sector? | Has your municipality managed to increase local revenues at the same pace as national grants have increased? How does your municipality compare to the national average and to similar municipalities? |
| Why have some capacity building grants performed so badly? What can be done about this? | Has capital investment by your municipality kept pace with the demand for new infrastructure from businesses and households? Are you able to measure the backlog? |
| How can municipalities be encouraged to seek finance from the private sector? | Is existing municipal infrastructure in your municipality well maintained? Are you able to measure the maintenance backlog? |
| | What scope exists to access additional resources from the private sector in your municipality? Why have these avenues not been fully explored in the past? |

# 4. Issues in service delivery

**Many more people have greater access to basic services**

The number of South Africans who have access to basic municipal services has increased significantly since 1994. This is a major achievement, in which municipalities have played an important role. Municipalities have also been able to provide free basic services to a significant number of poor households.

The number of households with access to water has increased by 4.1 per cent since 2001, while those with flush toilets has increased by 6 per cent, and those with access to electricity increased by 10 per cent over the same period.

The number of households receiving free basic services has increased dramatically. Over 650,000 new households received free basic water in 2006 alone, while 264,000 also received free basic sanitation and 360,000 received free basic electricity for the first time.

**Spending on water and sanitation, and electricity**

Big increases in municipal spending have driven the growth in accessing basic services. While capital expenditure accounts for most spending on sanitation, it is operating expenditure that takes up most spending in water and electricity. Capital expenditure in sanitation has declined over time. This underlines the important choice that must be made on the level of sanitation services to install. Flush toilets cost considerably more to operate than ventilated improved pit latrines, although both produce more or less the same developmental improvements to a households' quality of life. Operating expenditures increased at a faster rate than capital expenditures in the electricity sector, while the opposite occurred in the water sector.

It should be noted that the vast majority of spending in all these sectors occurs in the largest 27 municipalities. These municipalities account for 69 per cent of water expenditure, 61 per cent of sanitation expenditure and 84 per cent of electricity expenditure.

The water and sanitation sector and the electricity sector face considerable challenges that are not confined to municipalities alone. The *Review* discusses these challenges in detail. However, as with other municipal assets the lack of attention being paid to maintaining existing infrastructure remains a challenge. This is reflected in how under-priced these services are. In effect, municipalities have kept the user charges at unrealistically low levels. It is also reflected in the growing number of challenges with water quality, and increasing water and electricity distribution losses through leakages and theft.

Although the water services and electricity sectors operate under different legal frameworks, it is evident that municipalities must take urgent steps to improve the efficiency and effectiveness of their operations. This can be done by increasing user charges for water and sanitation, and electricity. This will allow municipalities maintain and upgrade infrastructure. However, it must be realised that households are under increasing pressure, due to the rising cost of living. Municipalities must therefore also seek new ways to manage these services more efficiently. In particular, there is an urgent need to adopt a more business oriented approach to the management of services, through the financial and organisational ring-fencing of each of these trading services.

**Spending on roads**

Municipal roads are also coming under increasing pressure as a result of continued high levels of economic growth. A significant portion of the national roads network is managed by municipalities, yet their investment in and maintenance of road and public transport infrastructure has fallen well behind the growth in demand. For example, the growth in the number of new cars on South Africa's roads has far exceeded the growth in municipal expenditure on roads functions. This is particularly severe in large urban municipalities.

**Need to clarify functional responsibilities**

In many instances there is no clarity regarding ultimate responsibility for ensuring that services are provided and this negatively affects service delivery. In the water services sector there is no clarity about whether local or district municipalities will have the final responsibility for service delivery. In some areas this has been formally assigned to districts, but the service continues to be provided by local municipalities. In electricity, the timetable for, and future of the regional electricity distributors (REDs) has resulted in municipalities slowing down their investment programmes in electricity infrastructure. In the roads and public transport sector, there have been delays in the establishment of transport authorities, and there is confusion over whether provinces or municipalities are responsible for public transport functions. These issues need to be clarified so that the delivery of services is not hampered.

| Some questions to consider | |
|---|---|
| **National level** | **Local level** |
| Which municipalities have not been able to achieve the national average for increasing access to basic services? Why is this?<br><br>Do subsidies from national government definitely go to improving access to services, either through infrastructure investment or free basic services? Is there a need for tighter control of the generation of municipal own revenue?<br><br>Why can most municipalities not provide accurate data on the value and condition of their major assets?<br><br>Should national government force municipalities to invest more in asset maintenance, or should it emphasise the creation of appropriate organisational structures, such as municipal entities to do this?<br><br>How can the assignment of functions between spheres and agencies of government be improved? | How has your municipality performed in increasing access to services, relative to the national average and to similar municipalities?<br><br>What percentage of the full cost of each service provided by your municipality is recovered through user charges? How is the difference made up?<br><br>How do you monitor the quality of services provided by your municipality? Has this improved or become worse over time?<br><br>Can your municipality provide recent, comprehensive data on the age, value and condition of its major assets? Is expenditure on the maintenance of these assets adequate? |

# 5. Cross-cutting issues and debates affecting local government

The *Review* explores in some detail three cross-cutting and strategic issues in local government. These issues concern the management of the built environment, financial management and personnel management. The way in which these issues are addressed, in both policy and practice, are likely to have far reaching effects on the long term success of the local government system.

**The built environment**

Municipalities have a critical role to play in managing the built environment. This includes issues of infrastructure, housing, transportation and land use management and control. What is clear is that despite growing municipal spending on built environment functions there is a huge demand that is not being met. This is beginning to constrain the rate of economic growth and poverty alleviation. Issues related to the failure of municipalities to raise additional sources of finance for their investment and maintenance programmes have already been discussed. However, two additional challenges are evident:

- Firstly, the system of spatial planning is not working effectively. Many different agencies in national, provincial and local government all play a role in taking planning decisions; from environmental approvals, zoning and building control. These powers are governed by a complex and confusing set of laws from the apartheid period and thereafter. This creates opportunities for parallel (and often corrupt) processes of development approval to be pursued by developers, in some cases to secure the most favourable outcome for themselves. This can result in the public sector having to bear the long term cost of these decisions.
- Secondly, investments in the built environment by all spheres of government are currently poorly co-ordinated. This is because provincial and local governments have a shared responsibility for many aspects of the built environment, particularly in the housing and public transport sectors. This often creates unworkable demands for “co-ordination. As a result, different agencies in government prioritise delivery on their own mandates, at the long term expense of other agencies. For example, low-income housing that is located far from the urban centre may result in the cheap and speedy construction of houses (due to low land costs) but increases the cost of infrastructure investment and creates a long-term need for transport subsidies for residents in these areas to commute to work.

## Reforms in financial management

Encouraging progress has been made with implementing reforms to the system of financial management in municipalities, as required by the Municipal Financial Management Act (2003). These reforms emphasise and strengthen municipal accountability for financial management through requiring greater transparency, timeliness, reporting and consultation in the financial management process.

Improvements have been seen across all of these areas, with audit outcomes gradually improving, budgets being prepared earlier and reports being submitted on time. The support programme managed by National Treasury has been particularly successful in this regard, and will be expanded to the low capacity municipalities in its next phase.

However, progress with the implementation of reforms has been undermined by the high turnover of senior managers in municipalities, and the ongoing failure by municipalities to fill these posts with appropriately qualified officials on a permanent basis. Frequent changes in senior management destroy continuity in municipal management and can quickly undermine the budget process, and ultimately service delivery.

## The people working in municipalities

The people who work in municipalities are often the “unsung heroes” of service delivery. Without their dedication and commitment, the difficult local government transition process would not be nearing completion, the rollout of basic services would not have been achieved, and municipalities would not be able to sustain the delivery of services. Over 200,000 staff work in municipalities and their salaries account for 30 per cent of total municipal operating expenditures. While expenditure on personnel has been increasing, data from 2005 and 2006 shows that the number of staff being employed has fallen. The number of vacancies in municipalities has also risen. The average cost of an employee has risen faster than average wages, which suggests that municipalities are employing people on higher salary scales than in the past.

Municipal personnel policies require careful ongoing management. Given their importance municipalities should pay attention to four areas to ensure that problems do not emerge:

- Firstly, key management and technical positions must be filled at all times with competent officials, with vacancy rates carefully monitored and kept to an absolute minimum.

- Secondly, municipalities must make sure that they have an appropriate personnel mix, both in terms of the skills they require and in terms of the number of staff needed to deliver services.
- Thirdly, municipalities must take steps to support job creation in the way they choose to deliver services. Municipal services have a strong potential to create lasting jobs if they are designed in a labour intensive way. Solid waste collection services, for example, provide an excellent opportunity to create a large number of unskilled jobs. Municipalities must carefully assess the extent to which mechanisation of services can be avoided.
- Fourthly, municipalities need to manage the costs of employment carefully. Higher minimum wages may result in the mechanisation of service delivery and the shedding of low-level jobs. These trends need to be openly discussed.

<table>
<tr><th colspan="2">Some questions to consider</th></tr>
<tr><th>National level</th><th>Local level</th></tr>
<tr><td>Can the co-ordination of public investment ever be achieved with the current division of responsibilities for the built environment?<br><br>How can the system of spatial planning be better monitored?<br><br>What can national government do to encourage municipalities to stabilise senior management appointments?<br><br>Are enough steps being taken to ensure that labour-intensive service delivery methods are used in municipalities?</td><td>How long does it take to get development plans approved in your municipality?<br><br>What are the current vacancy and turnover rates in your municipality? What steps have been taken to ensure that critical management and technical positions are permanently filled?<br><br>In your municipality what are the trends regarding the cost of employment? How does this compare with the national average and with similar municipalities?<br><br>What is the ratio of capital assets to labour in the major municipal services provided by your municipality? What trends can be seen in this ratio and how does it compare with other municipalities?<br><br>What steps have been taken by your municipality to make its operations more labour intensive?</td></tr>
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