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## Introduction

### ■ Introduction

To meet South Africa's development needs, government has developed a new growth path that has employment creation as its central focus. There is general agreement that job creation makes economic growth more inclusive, and facilitates faster poverty reduction and income redistribution. Local government has a crucial role to play in the new growth path and the realisation of many of government's recently articulated 12 outcomes.

*Local government has a crucial role to play in the new growth path*

The *2008 Local Government Budgets and Expenditure Review* highlighted the fact that municipalities faced a range of challenges arising from the high levels of economic growth and urbanisation that characterised the period 2001 to 2008. These challenges remain: the increased demand for economic infrastructure, ageing assets that require upgrading, rehabilitation or replacement, and changes in the location and nature of poverty. However, the economic and fiscal context to address these challenges has changed. Due to the recession, municipal revenues are growing slowly; which makes it all the more important to ensure that spending is prioritised appropriately, and implementation is effective and efficient. Good governance is critical in this regard.

*Municipalities continue to face a number of challenges*

While there are many examples of councils, mayors and municipal managers striving to provide effective leadership and making progress with strengthening governance, there are instances where serious governance shortcomings remain. The systems that are under greatest pressure are procurement, billing and revenue collection, staff appointments and the planning and zoning functions.

The period ahead will see continuing efforts to improve the effectiveness and efficiency of local government so as to ensure that the legislative and fiscal framework is appropriately structured to

facilitate the functioning of municipalities in different contexts. While the current system does provide for significant differentiation in the fiscal arrangements of municipalities, these are being further strengthened to ensure that rural municipalities receive a greater share of the funds flowing to local government from the national revenue fund. A separate regulatory framework for urban municipalities is under consideration. The aim is to give them greater autonomy to plan, co-ordinate and manage urban development.

*Since 2008, National Treasury has taken further steps to improve the transparency, credibility, timeliness and usefulness of municipal financial information*

Since 2008, National Treasury has taken further steps to improve the transparency, credibility, timeliness and usefulness of municipal financial information. Key initiatives include the introduction of the Municipal Budget and Reporting Regulations, strengthening of the Section 71 quarterly financial reporting processes, improved monitoring and enforcement of the Division of Revenue Act and the publication of a wider range of municipal financial information on National Treasury's website. Collectively, these initiatives aim to help municipalities realise better value for money in the use of public resources. They also provide councils and communities with key information for holding their municipalities to account.

### **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. Given the timing of the release of the *Review*, it will assist the new councillors elected on 18 May 2011 to get to grips with many of the challenges confronting them. Policy-makers in other spheres of government will also find the information and analysis useful. Provincial and national legislatures will be able to use the information to strengthen 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**

*This Review explores some of the key context differences between rural and urban municipalities*

The 2011 *Local Government Budgets and Expenditure Review* is National Treasury's third publication dedicated to local government financial and fiscal matters. The 2006 *Review* described the basic fiscal and financial position of the local government system, based on the limited data available at the time. The 2008 *Review* focused largely on the impact of municipalities on their socio-economic environments – given that municipalities are institutions of democratic local governance that exist to provide basic services to the communities that are living and working in these environments. This *Review* explores some of the key context differences between rural and urban municipalities – highlighting the different kinds of

developmental challenges they face, and the need for the regulatory and fiscal frameworks to respond to these differences.

### **Data issues**

Since the *2008 Review*, there have been a number of key improvements in the scope and detail of data available on local government – primarily driven by the coming into operation of the Municipal Budget and Reporting Regulations. However, it is still going to take a number of years for the benefits afforded by these regulations to flow through to provide a consistent multi-year local government financial dataset. Indeed, the full benefits will only be realised when the standard chart of accounts for local government gets introduced. Nevertheless the improvements that have occurred have facilitated better analysis of municipalities’ finances.

National Treasury routinely publishes on its website municipalities’ adopted budgets, Section 71 quarterly financial information and their annual financial statements. The logistics of managing data from 283 municipalities are very challenging – but gradually municipalities are beginning to take these reporting processes seriously. The aim continues to be that this should be part of a broader exercise to improve the quality of data available on local government and rationalise the number of data requests that are sent to municipalities. In addition, it is hoped that 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*.

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## **■ Main themes for the 2011 Review**

This *Review* focuses on the role municipalities need to play in supporting the new economic growth path and the realisation of government’s outcomes through exploring three main themes:

First, the *Review* investigates the performance of local government in supporting economic growth. It updates previous information on the growth in demand for municipal infrastructure. It assesses the extent to which municipalities have used the opportunity afforded by the recent slower economic growth to address some of the infrastructure backlogs that had arisen and whether municipal infrastructure plans and the quality of services provided is adequate to meet the needs of the new growth path. It analyses trends in municipal capital spending relative to these priorities and provides an initial assessment of a range of services that are important to supporting economic growth.

*What is the performance of local government in supporting economic growth?*

Second, the *Review* highlights the different development challenges facing rural and urban municipalities when it comes to fulfilling their development roles – particularly the provision of basic services in support of the government’s outcomes. It explores the very different contexts within which rural and urban municipalities operate, and how these different contexts impact upon the finances of rural and urban municipalities, the kinds of service delivery challenges they face, and the choice of technology and service levels appropriate to the rural

*What are the different development challenges facing rural and urban municipalities when it comes to fulfilling their development roles?*

and urban contexts. This analysis highlights the need to provide for greater differentiation in the design of the local government fiscal framework, and the need for a differentiated approach to the assignment of functions to municipalities, based on their individual capacity to effectively manage them.

*Good governance and accountability are critical to ensuring the effective and efficient stewardship of municipal resources*

Third, the *Review* focuses on the importance of good governance and accountability in ensuring the effective and efficient stewardship of municipal resources, and the ongoing challenges of ensuring that proper and ethical standards of governance and administration are upheld. It highlights the further steps taken to improve the quality and usefulness of municipal financial information. It also re-emphasises the significant challenges that exist with the capacity of municipal Budget and Treasury Offices, and the importance of stabilising the senior managements of municipalities.

## ■ Key issues identified

This *Review* identifies the following trends that are impacting on the performance of municipalities in combating poverty and supporting economic growth:

*The quality of leadership and governance is critical to how a municipality performs*

First, the quality of leadership and governance is critical to how a municipality performs. Effective leadership and good governance contribute enormously to ensuring a municipality makes positive progress in delivering services and extending infrastructure. To improve the capacity of municipalities to perform their functions, there is an urgent need to stabilise the senior management cadre of municipalities. Appropriate technical skills need to be in place.

*The municipal budget must be funded in accordance with legal requirements to ensure it remains a going concern able to sustain and extend services*

Second, to ensure municipalities remain going concerns, able to sustain existing services and progressively extend services, they need to ensure that the municipal budget is funded in accordance with the legal requirements set out in the Municipal Finance Management Act (2003). If a municipal budget is unfunded, it is not a credible budget – either the revenue projections are unrealistic, the operating expenditures are too high, or the capital budget is too ambitious. In most instances there are problems in all three areas. Correcting these problems involves going back to basics – and ensuring that the municipality only budgets to spend what it will realistically collect in revenue, eliminates all non-priority spending and has adequate cash reserves to back its existing obligations.

*A major part of the challenge is to get the basics of cash management and revenue management right*

A major part of the challenge is to get the basics of cash management and revenue management right. This means understanding the relationship between financial planning and effectively managing municipal cash resources and ensuring regular bank reconciliations of municipal accounts are undertaken. In respect of revenue management it means paying attention to the integrity of billing information, the accuracy of bills and having dedicated managers able to build administrative implementation systems that integrate each component of the revenue value chain. In addition, a careful balance will need to be struck between adjusting 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. Such increases will also need to be mitigated by improved expenditure efficiencies that increase productivity in all services.

Third, there is an urgent need for all municipalities to pay greater attention to maintaining their existing assets. Systems of asset management and levels of spending on repairs and maintenance need to be improved. To assist in financing this spending it is important that tariffs for the trading services are cost reflective, incorporating all the input costs associated with the production of those services. The clarification of the institutional responsibility for electricity distribution should lay the foundation for improved management of electricity assets.

*All municipalities need to pay greater attention to maintaining their existing assets*

Fourth, municipalities need to revisit how they fund their capital budgets. Generally, national capital grants are intended to finance the rollout of infrastructure for addressing service delivery backlogs and extending access to basic services. Municipalities are still expected to fund the on-going development and extension of infrastructure related to the economic and trading services for which they are responsible. To do so, municipalities need to examine the balance between their operating budgets and capital budgets, and ensure they structure their operating budgets so as to generate the surpluses required to fund infrastructure. 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. 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 associated costs.

*Municipalities need to revisit how they fund their capital budgets*

Fifth, in order to combat poverty more effectively, municipalities need to reconceptualise their current programmes to ensure greater 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 provide appropriate incentives to the private sector. 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. It is within this context that the devolution of the housing and public transport functions to municipalities is very important.

*Municipalities need to reconceptualise their current programmes for combating poverty*

There is also considerable scope for municipalities to generate more employment through their activities. A range of opportunities for labour intensive programmes and service delivery practices have not

*Municipalities need to generate more employment*

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.

*More inputs are required from national government to improve municipal capacity*

Sixth, 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 the trading services, the transparent operation of subsidies and clear incentives for municipal performance. It is hoped that the steps that national government has taken to restructure the capacity support programmes to local government will ensure better targeting of support.

Finally, ways of extending the differentiated approach to the local government fiscal framework need to be pursued so that the more capable municipalities are able to exercise greater discretion in the way they pursue their developmental mandates, and municipalities with low fiscal capacity are equitably supported.

## **■ A summary of the chapters**

The 2011 *Review* is made up of thirteen 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 and key financial management issues, the third part investigates trends within the major services provided by municipalities and the final part looks at the contextual and developmental differences between rural and urban municipalities, and the need to adopt a differentiated approach to the local government fiscal framework in respect of these municipalities.

The first part consists of two chapters. *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, highlights the importance of adopting differentiated policies to local government and the importance of getting municipal governance right to ensure greater effectiveness. *Chapter 3 Intergovernmental relations and the local government fiscal framework* explains local government's position and role within South Africa's system of intergovernmental relations, describes the key elements of the local government fiscal framework and how it relates to municipalities' service delivery responsibilities, and highlights the

important role municipal councils play in ensuring the effective management of municipal resources.

The second part consists of four chapters that look at the financing of local government and key financial management issues. *Chapter 4 Revenue and expenditure trends in local government* provides a broad overview of intergovernmental transfers and the financial performance of municipalities. It highlights five issues – the need to get the basics right in relation to revenue management and the collection of consumer debtors, under-pricing of services, inadequate maintenance expenditures by municipalities and the need to curb spending on non-priorities. *Chapter 5 Financial management and MFMA implementation* focuses on continuing initiatives to reform municipal financial management, particularly measures to strengthen the framework for aligning municipal plans and budgets, initiatives to strengthen oversight through improved transparency and reporting practices, and national government programmes to support institutional strengthening and capacity building. *Chapter 6 Leveraging private finance* notes the huge demands placed on municipalities for responding to local social and economic needs. It highlights initiatives to strengthen the municipal borrowing markets, including the bond market and the opportunities afforded by development charges, land leases and public private partnerships. *Chapter 7 Managing municipal personnel* considers trends in municipal employment. It highlights the modest contribution that municipalities make to overall employment. Personnel expenditure has been growing strongly, but with little noticeable impact on services. This raises questions about the effectiveness of municipal performance management systems.

The third part investigates municipal performance in the delivery of major services. *Chapter 8 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 9 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. *Chapter 10 Roads* considers the current demand for municipal investment in roads in the context of limited public expenditure on the sector and an environment of institutional overlap and uncertainty. *Chapter 11 Solid waste services* provides an overview of institutional arrangements and financing for the provision of solid waste services, access to solid waste services and the challenge of waste minimisation, recycling and energy recovery.

The final part consists of two chapters that explore the service delivery contexts of smaller municipalities versus those of the metros and the secondary cities. *Chapter 12 Delivering municipal services in rural areas* explores the distinguishing features of rural municipalities and some of the specific challenges they face when delivering services and raising own revenues. *Chapter 13 Cities and the management of the built environment* reviews the demographic, economic and spatial

challenges that confront South African cities and the challenges in current fiscal and institutional arrangements that complicate the ability of city administrations to manage the built environment. It also reviews public expenditure on public transport, housing and community assets.

## ■ 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 services. Exploring alternative funding mechanisms will enable municipalities to leverage their development potential and facilitate more rapid expansion of services.

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.