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Intergovernmental relations and the local government fiscal framework

■ Introduction

South Africa has an intergovernmental system that is based on the principle of cooperation between the three spheres of government – local, provincial and national. While responsibility for certain functions is allocated to a specific sphere, many other functions are shared among the three spheres. However, the Constitution specifically envisages that as municipalities develop the necessary capacity, the administration of many functions that are currently the responsibility of national and provincial government will be assigned to municipalities. While this has been taking place, very often the devolution has only been partial – with municipalities not being given the necessary funds, scope of responsibilities or without their being subject to clear forms of accountability for their performance. Over the medium term, government is planning for more functions to be devolved to municipalities. There is therefore a need for clear principles to guide such assignments to ensure that there are appropriate incentives, funding and accountability arrangements.

The assignment of functions to local government has a direct bearing on the local government fiscal framework. Ideally, the framework should provide municipalities with access to revenue sources that are commensurate with the powers and functions that they are responsible for. In this regard, it is important to keep in mind that the *whole* local government fiscal framework is designed to fund local government, and not just the transfers from national government.

The assignment of functions to local government has a direct bearing on the local government fiscal framework

It is also important to understand the relationship between the allocation of functions and the fiscal framework, the fiscal effort the municipality makes to collect revenues, the appropriate allocation of

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those revenues to services, the responsible management of service delivery processes and the effective delivery of services.

The revenue-service link between municipalities and residents is key to fostering greater accountability. This suggests that requiring poor households to pay even very small amounts for services may deepen local democracy and municipal accountability.

Municipal councils, mayors and municipal managers are responsible for ensuring that available revenues are collected, resources are allocated appropriately and procurement and service delivery processes are economical, efficient, effective and equitable.

This chapter examines these issues under the following headings:

- intergovernmental relations and the role of local government
- the local government fiscal framework
- services and the local government fiscal framework
- municipal councils' role in the management of resources.

■ Intergovernmental relations and the role of local government

Chapter 3 of the Constitution describes the three spheres as being 'distinctive, interdependent and interrelated' and enjoins them to 'cooperate with one another in mutual trust and good faith'. An important element of this cooperative relationship is that there needs to be a clear understanding of each sphere of government's powers and functions to ensure that a sphere of government or organ of state 'does not encroach on the geographical, functional or institutional integrity of government in another sphere'.

In addition to the Constitution, various legislation governs or organises the system of intergovernmental relations (see text box below). Among other things, the legislation formalises the different spheres' roles and responsibilities with regard to various functions and provides for a range of consultative structures.

Legislation that organises intergovernmental relations

Intergovernmental Fiscal Relations Act (1997) – This Act sets out the process for the division of nationally raised revenues between the three spheres of government. It establishes the Budget Forum, in which local government issues are discussed as part of the national budget process. It also requires that a Division of Revenue Bill is tabled annually, setting out (among other things) the amounts to be transferred to each municipality.

Municipal Structures Act (1998) – This Act provides for the establishment of different types of municipalities and the division of powers and functions between local and district municipalities. It also regulates the internal systems, structures and roles of office bearers of municipalities.

The Municipal Systems Act (2000) – This Act sets out detailed requirements in relation to community participation, integrated development planning, performance management, administration, service provision and debt collection. It also regulates the publication of by-laws and determines the role of national and provincial government in setting standards and monitoring local government. The Act also governs the assignment of functions to a municipality from another sphere of government.

Intergovernmental Relations Framework Act (2005) – This Act provides a framework for the establishment of intergovernmental forums and mechanisms to facilitate the settlement of intergovernmental disputes.

The South African system of intergovernmental relations is complex and continues to evolve as better modes of cooperation and coordination emerge and as functions are shifted between the spheres.

The following key elements and principles underpin the intergovernmental system:

- *Accountability*: Each sphere has specific constitutionally defined powers and responsibilities, is accountable to its legislature or council, and is empowered to set its own priorities. The power of national government to intervene in provincial and local government matters, and provincial governments to intervene in local government matters, depends on whether the relevant sphere fails to carry out an executive obligation.
- *Transparency and good governance*: Accountability of political representatives to the electorate and transparent reporting arrangements within and between spheres is at the heart of the intergovernmental system. While political executives are responsible for policy and outcomes, the accounting officers are responsible for implementation and outputs.
- *Mutual support*: National and provincial governments have a duty to strengthen the capacity of municipalities. Spheres of government must also act cooperatively towards each other, for instance through avoiding legal action until all other mechanisms have been exhausted.
- *Redistribution*: The three spheres all have important roles to play in redistribution, but because inequalities exist across the country, the redistribution of resources is primarily a national function. Where provinces and municipalities undertake redistribution, the challenge is to do this in line with their fiscal capacity and not to undermine economic activity and their financial viability. Redistribution among the three spheres is achieved through the vertical division of revenue. Redistribution among provinces and municipalities is effected through their respective equitable share formulae.
- *Vertical division*: Determining allocations to each sphere of government inevitably involves trade-offs that are made in the course of a comprehensive budget process driven by political priorities, and which covers all aspects of governance and service delivery. Separate and ad hoc requests for funds fragment the coherence of the budget and undermine the political process of prioritisation.
- *Revenue-sharing*: The fiscal system takes into account the fiscal capacity and functions assigned to each sphere. Provinces and municipalities are funded from own revenues, equitable share allocations, and conditional and unconditional grants. The grant system must be simple and comprehensive and not compensate provinces and municipalities that fail to collect own revenues.
- *Broadened access to services*: The Constitution and current government policy prioritises broadening access to services. The responsible spheres are expected to design appropriate levels of

service to meet customer needs in an affordable manner, explore innovative and efficient modes of delivery, and leverage public and private resources to fund infrastructure.

- *Responsibility over budgets:* Each sphere of government has the right to determine its own budget and the responsibility to comply with it. To reduce moral hazard and ensure fairness, national government will not bail out provinces or municipalities that mismanage their funds, nor provide guarantees for loans.

Intergovernmental forums

The intergovernmental system depends on well-coordinated policy, planning, budgeting, implementation and reporting

The intergovernmental system depends on well-coordinated policy, planning, budgeting, implementation and reporting. This is necessary both within spheres and between spheres and is effected through technical, executive and legislative consultative forums.

Municipalities are generally represented on the national intergovernmental structures by ‘organised local government’ in the form of the South African Local Government Association (SALGA). At the provincial level, municipalities are either represented directly or through the provincial local government associations.

The following intergovernmental forums play an important role in cooperative governance and in shaping policy and resource allocation decisions:

- *Extended Cabinet:* This is made up of the national cabinet, premiers of provinces and the chairperson of SALGA. It is the highest cooperative governance mechanism, advising the national cabinet when it finalises the fiscal framework and the division of revenue on which MTEF budgets are based.
- *The President’s Coordinating Council:* This is chaired by the President and comprises the nine provincial premiers, the chairperson of SALGA, the mayors of the metros and the national ministers responsible for cross-cutting functions such as provincial and local government affairs, public service and administration, and finance. Other national ministers may be invited to participate.
- *The Budget Council and Budget Forum:* These are established under the Intergovernmental Fiscal Relations Act (1997). The Budget Council consists of the Minister of Finance and the members of the executive council (MECs) responsible for finance in each of the provinces. The national and provincial spheres consult on any fiscal, budgetary or financial matters affecting provinces as well as any legislation that has financial implications for provinces. The Budget Forum consists of the members of the Budget Council plus representatives of SALGA. It provides a forum for discussing financial matters relating to the local government fiscal framework.
- *MinMECs:* These are sectoral policy forums made up of the national ministers responsible for concurrent functions and their provincial counterparts. SALGA represents local government on a number of these forums.

- *Various technical intergovernmental forums:* These consist of senior officials who provide technical support to the political forums. There are also forums that involve officials from municipalities such as the City Budget Forum.
- *The Financial and Fiscal Commission:* This is an independent constitutional institution that provides recommendations to Parliament and the provincial legislatures on the division of nationally collected revenues between the three spheres of government.

Allocation of roles and functions between spheres

The Constitution delineates public functions into two categories: those that are concurrent (shared among different spheres) and those that are exclusive (performed by one sphere only).

Concurrent functions

A function is concurrent if more than one sphere of government is responsible for making policy, legislating, administering or monitoring performance in relation to that function.

Concurrent functions are shared among different spheres and exclusive functions are performed by one sphere only

Schedule 4 of the Constitution lists the ‘functional areas of concurrent national and provincial legislative competence’. Functions in Part A of Schedule 4 include school education, health services, social welfare services, housing and agriculture. In relation to these functions, national government generally takes the lead in formulating policy, determining regulatory frameworks, setting norms and standards and monitoring overall implementation. Provinces, on the other hand, are mainly responsible for implementation in line with the nationally determined frameworks. This division of responsibilities means that provincial budgets for these functions are far larger than the budget of the relevant national department.

All local government functions listed in Parts B of Schedules 4 and 5 of the Constitution (see detail below) are concurrent functions. This is because, in all instances, either national or provincial government may regulate how municipalities exercise their executive authority in relation to these functions.

Exclusive functions

A function is exclusive if only one sphere of government is responsible for making policy, legislating, administering or monitoring performance in relation to that function. The Constitution does not define the exclusive functions of national government because it is responsible for all government functions that have not been specifically assigned to either provincial or local government. National government is therefore exclusively responsible for national defence, national fiscal policy, foreign affairs, the criminal justice system (safety and security, courts), higher education and certain administrative functions. These take up a large portion of national government’s budget. Provinces have exclusive legislative competence over the functions listed in Part A of Schedule 5 of the Constitution, which include provincial roads, ambulance services and provincial planning. However, national government may legislate in these ‘exclusive’ provincial functions if it is necessary to maintain essential national standards or for reasons of national security.

A function is exclusive if only one sphere of government is responsible for making policy, legislating, administering or monitoring performance in relation to that function.

Municipal by-laws may not conflict with either national or provincial legislation

There are very few, if any, local government functions that can be described as exclusive. In nearly all instances, there is either national or provincial framework legislation. Nevertheless, municipalities do exercise a high degree of autonomy when making by-laws and administering these functions within the prescribed national or provincial frameworks. It is important to note that municipal by-laws may not conflict with either national or provincial legislation.

The Constitution and local government's responsibilities

Section 152 of the Constitution sets out the 'Objects of local government' as follows:

152. Objects of local government

1. The objects of local government are -
 - a. to provide democratic and accountable government for local communities;
 - b. to ensure the provision of services to communities in a sustainable manner;
 - c. to promote social and economic development;
 - d. to promote a safe and healthy environment; and
 - e. to encourage the involvement of communities and community organisations in the matters of local government.
2. A municipality must strive, within its financial and administrative capacity, to achieve the objects set out in subsection (1).

The purpose of section 152(2) is to direct municipalities to use their available resources to realise the objects of local government. However, a municipality must do so 'within its financial and administrative capacity'.

Section 153 of the Constitution sets out the 'Developmental duties of municipalities' as follows:

153. Developmental duties of municipalities

A municipality must –

- a. structure and manage its administration and budgeting and planning processes to give priority to the basic needs of the community, and to promote the social and economic development of the community, and
- b. Participate in national and provincial development programmes.

The Constitution requires municipalities to prioritise the delivery of basic services

There is thus a constitutional requirement that municipalities *prioritise the delivery of basic services* in the way their administrations, planning and budgeting are structured and managed.

Section 156 of the Constitution sets out the 'Powers and functions of municipalities' as follows:

156. Powers and functions of municipalities

1. A municipality has executive authority in respect of, and has the right to administer –
 - a. the local government matters listed in Part B of Schedule 4 and Part B of Schedule 5, and
 - b. any other matter assigned to it by national or provincial legislation.
2. A municipality may make and administer by-laws for the effective administration of the matters which it has the right to administer.
3. ...
4. ...
5. A municipality has the right to exercise any power concerning a matter reasonably necessary for, or incidental to, the effective performance of its functions.

As noted above, section 153 of the Constitution refers to ‘giving priority to the basic needs of the community’. Similarly, section 227 of the Constitution specifies that local government is ‘entitled to an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it’. It is widely accepted that *basic needs* and *basic services* refer to the same set of functions/services. This set of services is by general agreement regarded as being: water, electricity, sanitation and refuse removal.

Water, electricity, sanitation and refuse removal make up basic services

The Municipal Demarcation Board has divided municipal functions into three categories according to its assessment of their relative priority.

Table 3.1 Priority functions of local government

Priority 1 functions	Priority 2 functions	Priority 3 functions
Water (potable)	Air pollution	Municipal parks and recreation
Electricity reticulation	Beaches and amusement facilities	Local sport facilities
Sanitation	Cleansing	Public places
Refuse removal	Control of public nuisance	Local tourism
	Fencing and fences	Local amenities
Cemeteries	Sell food to the public	Municipal airport
Fire fighting	Noise pollution	Licensing of dogs
Municipal health services	Pontoons and ferries	Child care facilities
Municipal planning	Pounds	Sell liquor to the public
Municipal roads	Street lighting	Markets
Storm water	Street trading	Burial of animals
Traffic and parking	Trading regulations	Municipal abattoirs
Building regulations		
Municipal public transport		

Source: Municipal Demarcation Board, 2005, National Report on Local government Capacity: MDB Capacity Assessment Period 2004/05

Note: National Treasury regards 'building regulations' and 'municipal public transport' as priority 1 functions

The Municipal Demarcation Board’s ranking of functions provides a useful framework and municipalities ought to prioritise the priority 1 functions in the way their administrations, planning and budgeting are structured and managed. Nevertheless the specific circumstances within a municipality should also inform the ordering of the priorities and the consequent allocation of resources.

The municipal planning function

Municipalities are responsible for municipal planning, which encompasses planning related to the spatial, economic and social development of the municipality. Planning is a powerful tool if it informs priorities, budgets and the actual delivery of services.

The main instrument of municipal planning is the five-year integrated development plan (IDP). Each municipal council is required to approve a new IDP in the first year following an election, and then update it on an annual basis. The IDP should be based on long term spatial, infrastructure and finance plans. It should set the priorities for budgets, capital investments and service delivery over the plan’s five-year lifespan. The IDP must not simply be a wish list; it should clearly set out what can realistically be achieved given the capacity and resource constraints facing a municipality.

The main instrument of municipal planning is the five-year integrated development plan

Roles of different categories of municipalities

The Constitution provides for three types of municipalities: category A (metros), category B (local municipalities) and category C (district municipalities).

The metros are responsible for all the local government functions within their respective areas of jurisdiction. Each district municipality includes several local municipalities, and the powers and functions assigned to local government in that area are shared between the category B and C municipalities.

The provincial MEC for local government, after receiving advice from the Municipal Demarcation Board, decides which municipalities are authorised for which functions in a particular province. The current division of responsibilities between district and local municipalities needs to be urgently reviewed because it is creating coordination problems and undermining accountability for service delivery.

National government transfers are made to the municipality that is legally responsible for the function, which is not necessarily the municipality that delivers the service

There are districts in which some local municipalities are authorised to perform a particular function such as water. In others, the district municipality performs this function and local municipalities are not authorised for the function but provide the service to households under an agency arrangement with the district. The fiscal framework has to be aligned with the legal framework. Hence, national government transfers are made to the municipality that is legally responsible for the function, which is not necessarily the municipality that delivers the service. Most often, it is the district municipalities that have been allocated the function and are receiving the funds. While they are expected to pass the funds on to the local municipalities that perform the functions, very often they fail to do so. Consequently, funds do not follow function. As a result, service delivery is undermined.

Devolving functions to local government

Functions can be devolved from national and provincial government to local government by delegation or assignment.

When national or provincial government delegates a function to a municipality, it is given responsibility for implementing the function under the authority and direction of the delegating authority. The municipality has to act strictly within the confines of the service level or agency agreement. Provinces often delegate the administration of libraries, clinics, emergency medical services and the implementation of housing projects to municipalities.

Assignment is a more complete way to devolve a function. It can be done either through legislation or by executive decision, and can be to all municipalities or to a specific municipality. The processes set out in sections 9 and 10 of the Municipal Systems Act (2000) are intended to ensure that sufficient funding and capacity building initiatives are made available to municipalities to enable them to successfully carry out assigned functions.

Section 156(4) of the Constitution provides that wherever the decentralisation of the administration of a function to a municipality would facilitate better service delivery, it must be done.

156 Powers and functions of municipalities

- (4) The national government and provincial governments must assign to a municipality, by agreement and subject to any conditions, the administration of a matter listed in Part A of Schedule 4 and Part A of Schedule 5 which necessarily relates to local government if –
- (a) that matter would most effectively be administered locally, and
 - (b) the municipality has the capacity to administer it.

The legislative authority remains with national and provincial government, while the administration of the function is assigned to the municipality. This means that the municipality is fully responsible for deciding how to carry out the function, the allocation of resources to the function and the actual execution of the function. The municipality is not simply being contracted to do things on behalf of national or provincial government as in the case of a delegation.

To date, few functions have been assigned to municipalities, largely because there has been a perception that assignments have to be done uniformly to all municipalities at once, instead of adopting a differentiated approach as specific municipalities develop the necessary capacity. In addition, national and provincial departments prefer to delegate functions through agency arrangements because this enables them to retain control of the budget, while devolving responsibility for implementation to the municipality. The problem is that this separation of funding and implementation responsibilities often results in unfunded mandates being imposed on municipalities.

It also means that the advantages of coordinating implementation at the local level are not being fully realised. For example, municipalities are responsible for developing integrated public transport systems while provinces are responsible for licensing public transport operators and subsidising buses, and national government is responsible for passenger rail services. This makes municipalities' task of planning and developing integrated public transport systems exceptionally difficult. Another example is the housing function. Provinces use municipalities as developers for housing projects, but have not assigned the housing function to them. This is despite the fact that well-capacitated municipalities are best placed to plan for the integrated delivery of housing, basic services and transport within the broader spatial development plan of the municipality.

Going forward, there is a need to give proper effect to section 156(4) of the Constitution and ensure that functions are assigned to municipalities that have the capacity to administer them effectively. In this regard, government has already indicated that the public transport and housing functions will be assigned to municipalities that have the necessary capacity.

Capacity support and interventions

An integral part of the intergovernmental system is the responsibility that section 154 of the Constitution places on national and provincial government to support and strengthen the capacity of municipalities to manage their own affairs. There are various national and provincial support initiatives, some of which are described in *Chapter 5 Financial management and MFMA implementation*. In addition,

The separation of funding and implementation responsibilities often results in unfunded mandates being imposed on municipalities

Well capacitated municipalities are best placed to plan for the integrated delivery of housing, basic services and transport

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Section 139 of the Constitution provides that the provincial executive can intervene in a municipality where it fails to fulfil an executive obligation

section 139 of the Constitution provides that the provincial executive can intervene in a municipality when it fails to fulfil an executive obligation. The same section provides that the provincial executive, or the national executive, *must intervene* in a municipality when it fails to approve a budget or any revenue raising measures necessary to give effect to the budget, or when there is a crisis in its financial affairs. Interventions may include instructing the municipal council to take certain actions, taking over responsibility for particular functions and dissolving the municipal council and appointing an administrator.

■ The local government fiscal framework

The constitutional assignment of powers and functions to local government has a direct bearing on the local government fiscal framework. Ideally, the local government fiscal framework should provide municipalities with access to revenue sources that are commensurate with the services they are responsible for providing. Table 3.2 sets out the main sources of local government funding:

Table 3.2 Sources of local government funding

Source of local government funding	Constitutional provisions	Governing legislation
Municipal own revenue sources		
Rates on property	Section 229 and 227(2)	Municipal Property Rates Act
Surcharges on fees for services provided by or on behalf of the municipality	Section 229 and 227(2)	Municipal Fiscal Powers and Functions Act
Service charges/ fees	Section 229 and 227(2)	Municipal Systems Act Municipal Finance Management Act Electricity Act and Electricity Regulation Act National Water Act Provincial land use planning ordinances
Other taxes, levies or duties	Section 229 and 227(2)	Municipal Fiscal Powers and Functions Act
Administrative fees		Municipal Systems Act
Fines		National Road Traffic Act
Borrowing	Section 230A	Municipal Finance Management Act
Credit control and debt collection		Municipal Systems Act
Transfers from national and provincial government		
Local government equitable share of nationally collected revenues	Section 214 and 227	Intergovernmental Fiscal Relations Act The annual Division of Revenue Act
Fuel levy sharing with metropolitan municipalities	Section 229(1)(b)	The annual Taxation Laws Amendment Act
Conditional grants from national government	Section 214(c), 226(3) and 227(1)(c)	Intergovernmental Fiscal Relations Act The annual Division of Revenue Act The annual National Appropriation Act
Conditional grants from provincial government	Section 226	The annual Division of Revenue Act The annual Appropriation Act of the relevant province

Source: National Treasury

A balance between own revenues and fiscal transfers

There is a widespread perception that municipalities are supposed to be self-sufficient or at least largely 'self-funded' and that, therefore, certain poor rural municipalities are 'non-viable'. However, the fiscal arrangements set out in chapter 13 of the Constitution provide that local government is 'entitled to an equitable share of revenue raised nationally' and may also receive additional conditional transfers from national and provincial government. In addition, the Constitution also

requires that municipalities raise their own revenues from service fees, property rates, surcharges and other taxes, levies and duties.

The *whole* local government fiscal framework is designed to fund local government, and not just one component of it such as own revenues or the equitable share. How the local government fiscal framework provides for the funding of municipalities must be looked at holistically, taking into account the real differences between municipalities.

Section 227(2) of the Constitution spells out the relationship between a municipality's entitlement to an equitable share, other transfers and its obligation to raise own revenues:

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227. National sources of provincial and local government funding

1. Local government and each province –
 - (a) is entitled to an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it; and
 - (b) may receive other allocations from national government revenue, either conditionally or unconditionally.
2. Additional revenue raised by provinces or municipalities may not be deducted from their share of revenue raised nationally, or from other allocations made to them out of national government revenue. Equally, there is no obligation on the national government to compensate provinces or municipalities that do not raise revenue commensurate with their fiscal capacity and tax base.

The Constitution expects municipalities to show fiscal effort to raise revenue commensurate with their fiscal capacity. On the other hand, section 214(2) of the Constitution provides that when determining the equitable share of a municipality, the government must give consideration to, among other things, 'the fiscal capacity and efficiency of the ... municipalities'. Thus when determining a municipality's equitable share of nationally collected revenues, government:

- must have regard for the fiscal capacity of a municipality – i.e. municipalities with low fiscal capacity should get a more generous share than municipalities with high fiscal capacity (all other things being equal)
- may not favour a municipality that does not raise own revenue commensurate with its fiscal capacity and tax base – i.e. municipalities that fail to show fiscal effort cannot look to national government for additional funding
- may not discriminate against a municipality that shows fiscal effort, and collects own revenues in line with or even exceeding normal evaluations of its fiscal capacity.

The Constitution differentiates between actual 'revenue raised' and 'fiscal capacity' (see text box). These concepts are often mistakenly conflated when discussing whether a municipality or group of municipalities have access to sufficient funding.

The dimensions of municipal fiscal capacity

Section 214(2) of the Constitution provides that when determining the equitable share of a municipality, government must give consideration to, among other things, *'the fiscal capacity and efficiency of the ... municipalities'*. It is important to note that fiscal capacity does not include the local government equitable share of nationally collected revenues or other transfers from national and provincial government, but rather the *own revenue potential of the municipality*. This emphasis on 'own revenue potential' is found in section 227 of the Constitution, which differentiates actual own revenue raised from fiscal capacity.

So fiscal capacity does not equal actual own revenue raised. Similarly, the failure to raise own revenue does not equate to a lack of fiscal capacity. In practical terms this means that a municipality's fiscal capacity needs to be determined independently of its *fiscal effort*.

Fiscal capacity also needs to be determined in context. There are four components to municipal fiscal capacity:

1. *The fiscal powers and functions of the municipality.* A municipality is only allowed to raise own revenues from the revenue sources given to the municipality by the Constitution and national legislation. It follows that any nationally imposed restrictions on municipalities' fiscal powers and functions reduce municipal fiscal capacity.
2. *The own revenue potential of the municipality, given a specified set of fiscal powers and functions.* A municipality can only raise revenues commensurate with the incomes of the individuals, households, businesses and other institutions that fall within its area of jurisdiction. The municipality's customer base's *ability to pay* is thus a critical variable in evaluating municipal fiscal capacity.
3. *The powers and functions of the municipality.* A municipality may only raise service charges and surcharges in relation to the functions it is empowered to deliver. Metros, districts and local municipalities have all been allocated different sets of powers and functions – therefore they do not have the same service delivery responsibilities, nor the same fiscal capacities.
4. *The community demand for the services that the municipality is responsible for funding.* The extent of a municipality's service delivery obligations provides the context within which the revenue potential of the municipality derives meaning. The demand for each service is related to the extent of backlogs and the number of indigent households, other households, businesses and other institutions requiring the service. Other variables that impact on the cost of delivering particular services in different geographical locations, such as population density, terrain or rainfall, are also relevant.

Households' *ability to pay* (not households' *willingness to pay*) is relevant to calculating fiscal capacity. This can be a contentious issue. Are there circumstances when the risks and difficulties associated with enforcing payment effectively reduce a municipality's fiscal capacity? For instance, many rural municipalities point to difficulties raising property rates on non-poor households living on traditional land. When does a municipality need to approach the courts to enforce payments?

The fact that municipalities' fiscal capacities differ underpins the rationale for the differentiated approach used to divide the local government equitable share and certain conditional transfers between municipalities. Government, however, recognises the need to provide for greater differentiation in the local government fiscal framework based on municipalities' differing fiscal capacity.

Municipalities with low fiscal capacity will receive a higher proportion of their funding from national transfers

Thus, according to the Constitution, a municipality's fiscal capacity needs to be determined independently of its fiscal effort; and only the municipality's fiscal capacity (and the other issues mentioned in section 214(2) of the Constitutions) may be taken into consideration when determining its equitable share or any other transfers from the national budget. Municipalities with low fiscal capacity therefore receive a higher proportion of their funding from national transfers than municipalities with high fiscal capacity. However, all municipalities, irrespective of their fiscal capacity, are expected to show fiscal effort and collect the own revenues that *are* available to them. Together, these different sources of revenue are intended to ensure that all municipalities have access to resources commensurate to their service delivery responsibilities.

The fact that the local government fiscal framework allocates significant own revenue sources to municipalities means that they

have greater control over the income side of their budgets than do provinces. However, this also means that municipalities need to pay particular attention to revenue management. If they don't, they will not collect the cash they need to fund their expenditures. This will result in cash-flow problems – as many municipalities have experienced.

Section 18 of the MFMA requires a municipal budget to be funded by 'realistically anticipated revenues to be collected', cash-backed accumulated reserves or borrowings (but only for capital). This means that a municipality must limit its expenditures to its available revenues, and if those revenues are not collected, then expenditures have to be cut. As indicated above, national government will not bail out municipalities that fail to collect own revenues or mismanage their funds.

National government will not bail out municipalities that fail to collect own revenues or mismanage their funds

Municipal own revenues

Section 229 of the Constitution deals with municipal fiscal powers and functions. It provides that municipalities may impose rates on property and surcharges on fees for services provided by the municipality or on behalf of the municipality. It also provides that a municipality may impose other taxes, levies and duties, if authorised by national legislation. In addition, municipalities may charge for the services they provide (service charges and administration fees).

When setting property rates, service charges and other fees, municipalities need to have regard to two key principles of taxation, namely:

- *The benefit principle:* This captures the idea that payments should be related to benefits. Customers need to have the sense that they are getting 'value for money' for the taxes and charges they pay. In this regard one needs to distinguish between individual benefit and general benefit. Individual benefit means that the amount an individual is required to pay for a public service should be more or less equal to the benefit that the individual derives from the consumption of that service. General benefit refers to a situation where beneficiaries of a particular public service do not necessarily derive individual benefits equal to individual costs; rather the benefits of all beneficiaries are equated with the cost to all beneficiaries.
- *The ability-to-pay principle:* This captures the idea that beneficiaries pay taxes according to their income generating capacity, so as to foster greater social equity. It is customary to distinguish between horizontal equity and vertical equity. Horizontal equity is generally accepted to mean that those with the same incomes should pay the same amount of tax. By contrast, it is generally understood that vertical equity means that those earning higher incomes should pay proportionately higher taxes than those earning less income – i.e. the taxes should be progressive.

Property rates

The levying of property rates is governed by the Municipal Property Rates Act (2004). Only metros and local municipalities may raise

revenue through property rates. In terms of the Act, they are required to adopt property rates policies. They must also put in place and maintain a property valuation roll. The valuation roll needs to comply with the ‘horizontal equity principle’ in that similar properties should have similar valuations.

Property rates are intended to fund municipal services such as municipal roads, storm water systems, street lighting and street cleansing

Property rates are intended to fund the economic services provided by the municipality, such as municipal roads, storm water systems, street lighting and street cleansing. The consumption of these services is non-exclusive (i.e. they cannot be limited to specific consumers) so they are funded through a general tax on all potential consumers, namely the owners of property within the municipality’s jurisdiction. The structure of rates should take account of the ‘ability to pay’ principle, and so should be progressive. The level of rates should cover the cost of providing a defined basket of economic services efficiently and effectively, and so should be set at a level where the benefits of the collective beneficiaries are commensurate with the cost imposed on those beneficiaries, i.e. the level of rates charged should comply with the ‘benefit’ principle.

The Act provides that the Minister of Cooperative Governance and Traditional Affairs, after consulting with the Minister of Finance, may regulate various aspects of property rates, including the provision of exemptions, maximum levels of rates and rates ratios between categories of property. The aim is to ensure that property rates are equitable, do not stifle economic growth, and that they support certain national policy objectives.

Service charges and administration fees

A municipality is expected to charge for the services it provides to specific, identifiable customers that derive ‘individual benefit’ from the consumption of those services. Examples include water, electricity, sanitation, refuse removal, planning and building permissions and the hiring out of municipal facilities.

Section 74(2) of the Municipal Systems Act (2000) prescribes that a municipal council must adopt and implement a tariff policy on the levying of fees for municipal services:

A tariff policy must reflect at least the following principles, namely that

- (a) users of municipal services should be treated equitably in the ‘application of tariffs;
- (b) the amount individual users pay for services should generally be in proportion to their use of that service;
- (c) poor households must have access to at least basic services through –
 - (i) tariffs that cover only operating and maintenance costs;
 - (ii) special tariffs or life line tariffs for low levels of use or consumption of services or for basic levels of service; or
 - (iii) any other direct or indirect method of subsidisation of tariffs for poor households;
- (d) tariffs must reflect the costs reasonably associated with rendering the service, including capital, operating, maintenance, administration and replacement costs, and interest charges;
- (e) tariffs must be set at levels that facilitate the financial sustainability of the service, taking into account subsidisation from sources other than the service concerned;

- (f) provision may be made in appropriate circumstances for a surcharge on the tariff for a service;
- (g) provision may be made for the promotion of local economic development through special tariffs for categories of commercial and industrial users;
- (h) the economical, efficient and effective use of resources, the recycling of waste, and other appropriate environmental objectives must be encouraged;
- (i) the extent of subsidisation of tariffs for poor households and other categories of users should be fully disclosed.

These principles create an enabling framework for establishing financially sustainable service charges. While the principles require that ‘ability to pay’ should inform the structure of tariffs, the Act does not place a legal obligation on municipalities to provide free basic services. It would seem that when Parliament passed the Act, the intention was that all households should always make some payment (no matter how small) for the municipal services they receive, as in each instance there is reference to poor households getting access to services on the basis of a tariff. The requirement that the extent of any subsidisation of tariffs for poor households and other categories of users be fully disclosed is also rarely complied with by municipalities. This lack of transparency means municipal councils and households are not aware of the revenue cost of the free benefits given/received, and consequently there are ongoing demands for greater subsidies and more ‘free’ services.

The principles underpinning a municipality’s tariff policy create an enabling framework for establishing financially sustainable service charges

It is also worth noting that tariffs must reflect the costs reasonably associated with rendering the service, including capital, operating, maintenance, administration and replacement costs, and interest charges. This is particularly important in relation to water, electricity, sanitation and refuse removal. These trading services are expected to operate according to good business principles and be largely self-financing. To facilitate this, municipalities are required to ring-fence these functions where appropriate.

Tariffs must reflect the costs reasonably associated with rendering the service, including capital, operating, maintenance, administration and replacement costs

The Electricity Regulation Act (2006) empowers the National Energy Regulator of South Africa (NERSA) to issue electricity distribution licences to municipal distributors. Such licences may be made subject to conditions relating to, among other things, the setting and approval of prices, charges, rates and tariffs. Section 15 of the Act sets out tariff principles that must be adhered to when NERSA approves municipal electricity tariffs. These principles are fully aligned with those in the Municipal Systems Act (2000). Of specific importance is section 21(5)(c), which provides that a municipality may terminate the supply of electricity to a customer if that customer has contravened the payment conditions of that licensee (municipality). In other words, if a municipality wants to use electricity cut-offs as a debt management tool, its tariff policy or debt collection policy must specify that this is permitted. This has been tested in court on a number of occasions, and each time the courts have ruled in favour of municipalities provided they have the necessary policies in place.

The Water Services Act (1997) empowers the Minister of Water Affairs (with the concurrence of the Minister of Finance) to issue regulations setting norms and standards in respect of municipal tariffs for water services. Regulations in this regard were issued in 2001, but

while setting norms and standards for water tariffs, there is little monitoring of compliance. This means that there is no oversight of municipalities' water tariffs. The concern is that in many instances municipalities are getting their water tariffs wrong, usually by significantly under-pricing the service, thus placing its sustainability at risk. Consequently, the need for a dedicated regulator in the water sector has been raised.

Some municipalities have already developed the necessary policies to impose development charges

Extensive work has been done in relation to municipal *development charges*. These charges should be structured to ensure that the cost to the municipality of providing new municipal service infrastructure to new private developments gets properly factored into the cost of those developments. Some municipalities have already developed the necessary policies to impose these charges. In time, these will need to be aligned to the framework National Treasury is currently developing that will set norms and standards to ensure that these charges facilitate (and do not stifle) new property developments.

Surcharges, other taxes, levies and duties

The Municipal Fiscal Powers and Function Act (2007) regulates municipal surcharges and municipal taxes, other than property rates. Only the Minister of Finance may authorise a municipal tax by issuing regulations in terms of the Act. The Act also requires municipalities to get authorisation for all existing municipal taxes – which process still has to be concluded. The Act also empowers the Minister of Finance to prescribe norms and standards for municipal surcharges.

The Minister of Finance, acting on his own initiative, may authorise new municipal taxes, or a municipality may apply for a new tax to be authorised. Such an application must be supported by various studies on the impact of the proposed tax. Since the Act came into effect, no new municipal taxes have been authorised.

The possibility of introducing a local business tax as a new municipal tax, particularly for the metros and large cities, has been raised. Various studies have been undertaken in this regard. However, before any new tax can be considered there needs to be clarity regarding the need for such a tax, the equity of any proposed tax and how the tax is going to be administered. In addition, before a new tax can be considered, the municipalities wanting the new revenue source need to demonstrate that they are optimizing revenues from all the existing sources available to them, that their tax expenditures (rebates) are not overly generous, their indigent policies are appropriately structured and efficiently managed and that service tariffs are cost reflective. Furthermore, the municipalities should be able to demonstrate that their billing system is complete, accurate and reliable, and that their collections and debt management policies are being effectively implemented.

Other own revenues

Municipalities also collect revenue from traffic fines, penalties for by-law contraventions, licence fees and permits, agency payments, and interest. These sources, while a lot smaller than other sources, are still significant as in most instances they contribute to the pool of revenues

that the municipality can use for redistributive and local economic development purposes.

Transfers to local government

In general, transfer programmes play three roles:

- addressing the structural imbalance between revenues available to municipalities and the expenditure responsibilities assigned to them
- supporting national priorities as outlined through different sectoral policies, in particular those focused on providing expanded access to basic services
- establishing incentives for good governance and building local government capacity.

The value of national transfers to local government, and the specific allocations to particular municipalities are determined through the division of revenue process and the national budget process. Annexure W1 to the Division of Revenue Act, which is published on the National Treasury website, describes the structure of the different transfers to local government for 2011/12.

Transfers to local government can be in the form of unconditional transfers, conditional grants and allocations in-kind

Transfers from national and provincial government may be direct or indirect in nature. Most transfers entail the funds being directly transferred to municipalities, either on a conditional or unconditional basis. Indirect transfers usually take the form of asset transfers or may be services provided by another sphere of government on behalf of the municipality.

Unconditional transfers

The vertical division of nationally collected revenues determines the pool of funds to be transferred to local government as unconditional transfers. Currently, there are three streams of unconditional transfers that flow to local government.

The local government equitable share is the main unconditional transfer

- *The local government equitable share:* This transfer is intended to balance the unequal distribution of fiscal capacity between spheres of government and across municipalities. It redistributes funds from the national fiscus to help fund municipalities. The division of the local government equitable share between municipalities takes account of the different needs and responsibilities of municipalities relative to their fiscal capacity, and so is the primary redistributive mechanism between municipalities. While the local government equitable share is an unconditional transfer, there is nevertheless a constitutional expectation that municipalities will prioritise its use to fund the provision of basic services within the broad policy framework defined by national government. The aim is to subsidise the cost of providing these services to poor households, and to contribute to the funding of core administrative functions.
- *RSC levies replacement grant:* Before 2006, district municipalities raised levies on local businesses through either a Regional Services Council (RSC) levy or Joint Services Board (JSB) levy. These taxes were abolished because they were

regarded to be ‘bad taxes’ when measured against generally accepted principles of sound taxation, namely equity among taxpayers, efficiency, certainty, simplicity and ease of administration. This source of revenue was replaced in 2006/07 with the RSC levies replacement grant, which was allocated to all district municipalities and metros based on the amounts they had previously collected through the levies. This grant is allocated together with the equitable share.

When the RSC levies replacement grant was introduced, there was a firm intention to introduce alternative own revenue sources for municipalities as soon as possible. This has been accomplished in respect of the metros’ portion of the grant (see below). However, finding a suitable replacement for the district municipalities’ portion of the grant is proving to be difficult. Consequently, the process has been postponed until such time as the future roles and responsibilities of the district municipalities have been clarified.

- *General fuel levy sharing with metros:* The sharing of the general fuel levy with the metros was introduced in the 2009 Budget as the primary replacement for the former RSC levies, in addition to the VAT reforms introduced in 2006. The sharing of the general fuel levy is a direct charge and is formalised annually through the Taxation Laws Amendment Act.

Conditional grants

The biggest conditional grant is the municipal infrastructure grant

Direct conditional grants are transfers that municipalities may only spend on particular purposes as set out in the conditional grant frameworks. Collectively, these grants are worth almost as much as equitable share transfers. The biggest conditional grant is the municipal infrastructure grant (MIG), which provides funding for municipal infrastructure, principally for extending access to water and sanitation to poor households. Other grants fund electrification, public transport infrastructure, local economic development projects and capacity building programmes in municipalities.

Allocations in-kind

Allocations in-kind provide a way for departments in other spheres of government to spend funds on providing goods or services in a municipality without having to transfer funds to the municipality. These grants are used in cases where municipalities do not have the capacity to spend the funds themselves, or where there are economies of scale that can be achieved by implementing a project across several municipalities, such as with the regional bulk infrastructure grant that builds dams that supply several municipalities with water.

Municipal borrowing

A municipality’s capacity to borrow is a function of sound financial management, sound own revenue management and choice of infrastructure projects

Municipalities may borrow funds from the financial markets to finance part of the economic infrastructure portion of their capital budget. Given that national government does not guarantee municipal borrowing, a municipality’s capacity to borrow is a function of sound financial management, sound own revenue management and choice of infrastructure projects. It is envisaged that the metros and the

secondary cities should borrow primarily from private capital markets on the strength of their credit ratings, while the Development Bank of Southern Africa (DBSA) will increasingly play its developmental role by lending to the poorer municipalities. See *Chapter 6 Leveraging private finance* for more details.

Own revenue and accountability

The local government fiscal framework is deliberately designed to raise municipalities' level of accountability to residents. The fact that most municipalities receive the majority of their revenue from service charges and property rates means that they need to ensure that:

- residents receive the trading services (so that the municipality can earn income off them)
- the general level of municipal services is adequate to maintain property values (so as to maintain the municipality's rates base)
- residents are generally satisfied with the municipalities' services (so that they are willing to continue paying their rates and service charges).

This revenue-service link means that there is potential for a strong alignment between the municipality's revenue interests and the service delivery interests of residents that pay rates and service charges.

However, providing free services to indigent households does not generate municipal revenues through service fees. Poor households also do not typically pay rates. This means that there is little or no revenue-service link between these residents and the municipality, which means that the revenue interests of municipalities are not aligned with the service interests of poor residents. Consequently, the municipality's incentive to service these customers is reduced.

The presence or absence of this revenue-service link may partly explain how different groups of residents choose to engage with municipalities. Ratepayer associations are increasingly using their power as taxpayers and paying consumers to leverage greater accountability on the part of municipalities and municipal councils; whereas poorer residents appear to be engaging increasingly in service delivery protests, and so exercising their political power, as well as their power to disrupt.

The power of this revenue-service relationship in fostering more accountable municipalities highlights the need to bring more residents into the municipal revenue base, even if at very low levels. When residents pay for municipal services it empowers them by establishing a direct, reciprocal link to the municipality. If the municipality does not provide services to these customers, it will not earn any revenue. There is thus a strong incentive for the municipality to ensure services to paying customers are not interrupted.

Residents who do not pay for their services can only hold the municipality accountable indirectly, via service delivery protests or once every five years through the ballot box.

Also, municipalities that are highly dependent on transfers will tend to be more accountable to the source of the transfers and less

The local government fiscal framework is deliberately designed to raise municipalities' level of accountability to residents

The financial interests of municipalities are not aligned with the service interests of poor residents

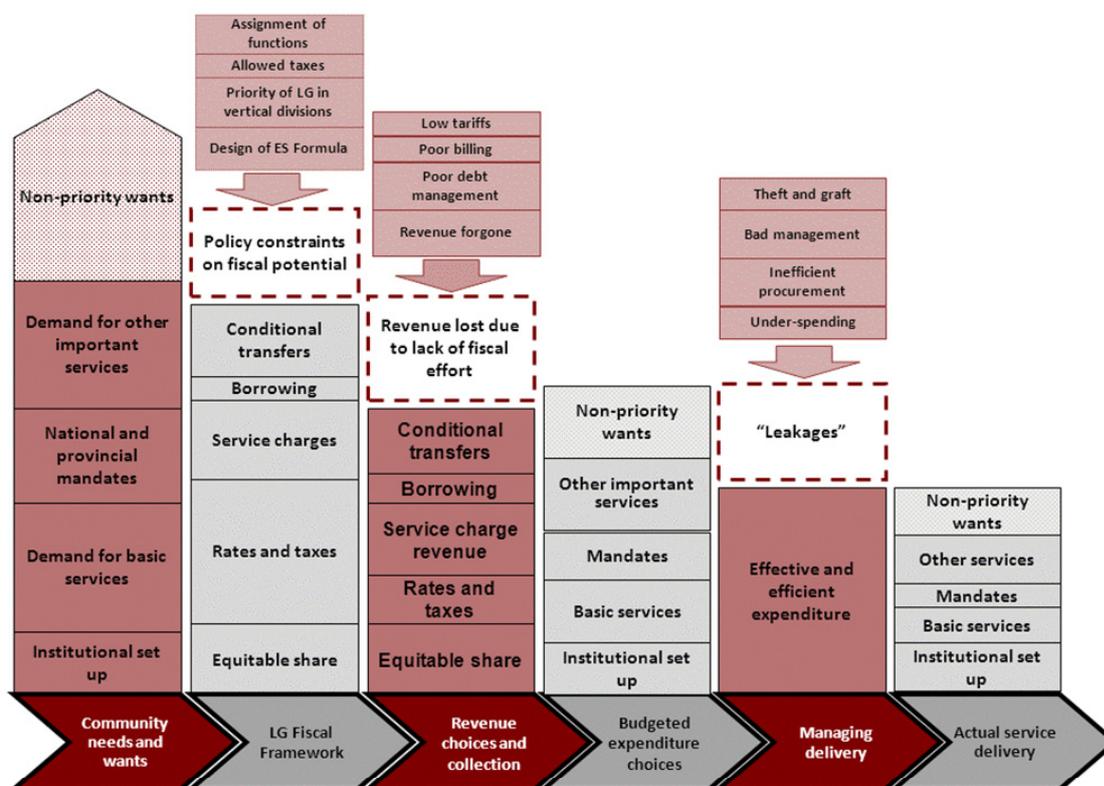
Poorer households use service delivery protests to engage with municipalities, while wealthier households organise themselves through ratepayer associations

accountable to residents due to the lack of the revenue-service link between them. However, national and provincial oversight of the smaller municipalities is comparatively weak, and not an effective substitute for local oversight by rate-paying residents. This may partly explain why increasing grant dependency seems to be correlated with a lack of accountability for the use of municipal funds in many poorer, more grant dependent district and local municipalities.

Services and the local government fiscal framework

The following figure provides a conceptual framework that shows how the local government fiscal framework relates to a municipality’s service delivery responsibilities.

Figure 3.1 A model of municipal service delivery and finances



Source: National Treasury

There are five components to this relationship between municipal finances and service delivery:

The first component in the relationship is between the community’s demand for services that a municipality is responsible for providing versus the local government fiscal framework. As noted, the Constitution allocates particular functions to local government. In addition, national and provincial legislation may assign further functions to local government. Then there is the actual community demand for each of the services that fall within these functions. Against this there is the local government fiscal framework, which sets out what sources of revenue are potentially available to a municipality to fund these

services and functions. Key questions are: Is the local government fiscal framework broadly aligned with the service responsibilities of municipalities? Are there any constraints on the fiscal capacity of local government that arise from certain policy choices?

Ideally, the local government fiscal framework should provide municipalities with access to revenue sources that are commensurate with the powers and functions (or services) that they are responsible for performing.

- The second component in the relationship is between the local government fiscal framework and the actual revenues collected by a municipality. The key issue is whether municipalities are using the ‘fiscal space’ available to them to raise their own revenues. Or are municipal tariffs too low? Are the billing systems inaccurate? Is there poor debt management? Is the council giving away excessive free services, especially to non-poor households? In sum, is the municipality showing ‘fiscal effort’? Or are municipalities simply relying on and dependent on transfers from national and provincial government?
- The third component of the relationship relates to how each municipality chooses to use its available resources. This is generally reflected in the municipal budget. Key questions in this regard are: Is the municipality prioritising the delivery of basic services? What functions and services does the municipality prioritise? What is the balance between the operational budget and the capital budget? Is the municipality budgeting sufficient for repairs and maintenance? How much gets allocated to non-essential, non-priority items?
- The fourth component in the relationship relates to the municipality’s governance and management systems to implement the budget and manage service delivery. Are these systems effective and efficient?
- The fifth component relates to what actually gets delivered by the municipality. Are ratepayers getting value for money? Which communities benefit most from the services provided by the municipality? Is there an equitable distribution of services? Is the level of service being provided taking into account the ‘benefit principle’ and are any cross-subsidies sustainable?

Councillors, mayors and municipal managers are encouraged to use this framework to examine the performance of their municipality in the course of their oversight duties.

Municipalities’ role in the management of resources

Very often the debate around municipal finances only looks at the relationship between the needs in the community and the resources available to meet those needs. This approach fails to recognise that municipal councils, mayors and municipal managers are responsible

Municipal councils, mayors and municipal managers are responsible for managing the resources of a municipality

for ensuring that available revenues are collected, that resources are allocated appropriately, and that for ensuring that available revenues are collected, that resources are allocated appropriately, and that procurement and service delivery processes are economical, efficient, effective and equitable. In addition, they are responsible for ensuring that the municipality raises own revenues in line with its fiscal capacity.

The municipal council, mayor and municipal manager are responsible for ensuring that the revenues of the municipality are allocated correctly

Second, the municipal council, mayor and municipal manager are responsible for ensuring that the revenues of the municipality are allocated in a manner that prioritises basic needs, and the social and economic development of the community. They should evaluate all budget allocations and actual expenditures with a view to identifying all non-essential, fruitless and wasteful expenditure.

Third, the municipal council, mayor and municipal manager are responsible for ensuring that the municipality has sound financial management policies and systems in place. The municipal audit outcomes show that over half of municipalities' financial systems and governance and financial information are deficient. These widespread weaknesses leave municipalities vulnerable to financial mismanagement.

The municipal council, mayor and municipal manager are responsible for ensuring that service delivery is economical, efficient, effective and equitable

Last, the municipal council, mayor and municipal manager are responsible for ensuring that the municipality has sound and competent management in place to ensure that service delivery is economical, efficient, effective and equitable.

■ Conclusion

The intergovernmental system is continually evolving as contexts change, better approaches to cooperative governance emerge and ways of resolving particular problems are identified. Key areas that need to be addressed are the allocation of functions between district and local municipalities, and the assignment of the housing and public transport functions to municipalities.

All municipalities need to pay particular attention to improving revenue management. While the *whole* local government fiscal framework is designed to fund local government, the existence of national and provincial transfers does not absolve any municipality from showing the necessary fiscal effort – and collecting the own revenues available to it.

The revenue-service link between municipalities and residents is key to fostering greater accountability. This suggests that requiring more households to pay even very small amounts for services may deepen local democracy and municipal accountability.

Clearly, in assessing the relationship between the service delivery responsibilities of municipalities and the local government fiscal framework, issues of good governance are exceptionally important. Mayors, councillors and municipal managers have fiduciary responsibilities to ensure that public funds are safeguarded and only used for the benefit of the community.