REVIEW OF THE

Local Government Fiscal Framework

In 2009, SALGA recommended to the Local Government Budget Forum that there should be a review of many aspects of fiscal policies in relation to municipal finances. This year SALGA proposed a comprehensive review of the local government fiscal framework (LGFF). While there have been some ad hoc policy changes over the past few years, many remain incomplete or unattended to. In SALGA's view, the review of the LGFF should address the fundamental structural challenges, rather than introducing minor ad hoc adjustments, if it is to improve operational efficiency in the short and long term.

While there have been some attempts to introduce a differentiated approach to local government finance, SALGA recommends that the proposed comprehensive review of the LGFF should outline a long-term vision for sustainable local government finance. This entails a differentiated approach to all the main elements of the LGFF configuration, which include expenditure assignment, revenue assignment, the vertical division of revenue, the local government equitable share (LGES) formula, conditional grant design, infrastructure funding and borrowing powers.

Policy constipation

As far as the powers and functions of local government and its associated expenditure responsibilities are concerned, a number of protracted national policy processes have been initiated, but not concluded from a revenue assignment perspective. The processes of establishing regional energy distributors to consolidate electricity services and of introducing a single public service have not been finalised. The process of municipal housing accreditation has been painfully slow, and clarity is still lacking about the funding of urban public transport in the wake of the new National Land Transport Act (Act 5 of 2009).

The Provincial and Local Government Policy Review, initiated by the Department of Cooperative Governance and Traditional Affairs in July 2007, has not yet been concluded. One of the objectives of this exercise was to clarify the roles and responsibilities of district and local municipalities.

A differentiated approach to revenue assignment is therefore essential. This will allow significant own revenue instruments to be allocated to municipalities so that those with sufficient fiscal capacity are able to finance investment in infrastructure to lay the foundations of economic growth and to ensure that ageing core infrastructure is maintained. To this end, SALGA is exploring the modalities of implementing a local business tax, particularly benefitting larger cities and metros.

Municipalities with high concentrations of poverty and low fiscal capacity (mainly S3 municipalities) will unfortunately have to continue relying on intergovernmental grant funding. National and provincial government departments will need to commit resources to provide intensive implementation support to build the capacity of these municipalities to spend effectively and efficiently.

All municipalities, including those heavily dependent on grant funding, should exert the maximum effort to collect their own revenues, even though these may be limited. SALGA will continue to strongly encourage its members to do so by improving metering, billing, credit control and other dimensions of revenue management. This is a concern in light of indications that municipal revenue may be declining, due, for example, to the limitation of ratios of non-residential to residential property categories as part of the implementation of the Municipal Property Rates Act.

Review of the local government fiscal framework

A review of the LGFF should systematically reassess the appropriateness of the baselines that underpin the vertical division of revenue, in order to establish whether the local government sphere is receiving adequate revenue to fund its broader development mandate, not just free basic services. The substantial increases in the prices of bulk electricity and water anticipated over the medium term need to be factored in as well.

There is ample evidence that the LGES is deeply flawed and will need to be reconceptualised in its entirety rather than through minor adjustments to parameters. The basic services component omits critical municipal services such as municipal roads, street lighting, storm-water management, and fire fighting services. The institutional component for rural S3 municipalities with virtually no own-revenue sources is inadequate, relative to their salary, wage and allowance commitments. The development component has also not been activated. The revenue-raising component as currently implemented (using actual revenues as a proxy for revenue-raising capacity) is probably unconstitutional. The formula is not sensitive enough to target poor municipalities effectively. Overall, the formula is seen by some SALGA members as overly complex and non-transparent, yielding allocations which some believe favour urban centres.

The data underpinning the LGES formula is now severely outdated and out of touch with the dynamically changing municipal service delivery context (migration patterns, etc). The data from Census 2011 will only be available about two years later. In the interim, a credible mechanism is needed to update the LGES data. These issues need to be explored further in the comprehensive review of the LGFF.

Municipalities with sufficient fiscal capacity (mainly S1 and S2 municipalities) will be able to fund economic infrastructure extension through their own revenue instruments, such as the proposed local business tax. The implementation of development charges should also be encouraged. In addition, own revenue instruments will enhance the ability of these municipalities to leverage financing from private capital markets. The existing infrastructure funding envelope can then be channelled to poorer municipalities. To this end, a capital-raising capacity component should be considered for the municipal infrastructure grant (MIG).

In poorer municipalities, the expansion of infrastructure to poor communities through the MIG has resulted in greater pressure on operating and maintenance budgets. The comprehensive LGFF review should explore ways in which to link the LGES explicitly to the MIG. After 1994, the main policy thrust was on new infrastructure to enable service extension to previously underserved communities. However, it is now clear that ageing core infrastructure in many municipalities requires considerable investment in rehabilitation because the infrastructure has deteriorated beyond the point at which routine maintenance can keep it functioning. The current fiscal framework does not adequately address the issue of operating and maintaining infrastructure.

Last year SALGA outlined the challenges in the existing system of conditional grants that the comprehensive LGFF review should address. These included

- insufficient coordination between grants, eg the municipal systems improvement grant, the financial management grant and Siyenza Manje;
- little account of the impact of the grants, especially on smaller municipalities;
- the heavy reporting burden on municipalities, which is costly and time-consuming;
- the fact that local government is not central to setting the agenda for capacity-building programmes; and
- delays in the gazetting and transfer of provincial allocations.

Unfunded mandates continue to exist across many services, including libraries, museums, primary health care and hostels (linked to the issue of housing accreditation). For instance, in 2009/10, in the Western Cape, the community service library service grant amounted to only 10.7% of municipal expenditure on libraries. EThekwini municipality has quantified its annual unfunded mandate in respect of libraries, museums, hostels and formal housing at R191.2 million, R261.7 million, R26.9 million, R224 million and R25 million respectively, totaling R728.8 million per annum.

Local business tax

The abolition of the regional services council levies sharpened SALGA's long-standing concerns regarding municipal revenue

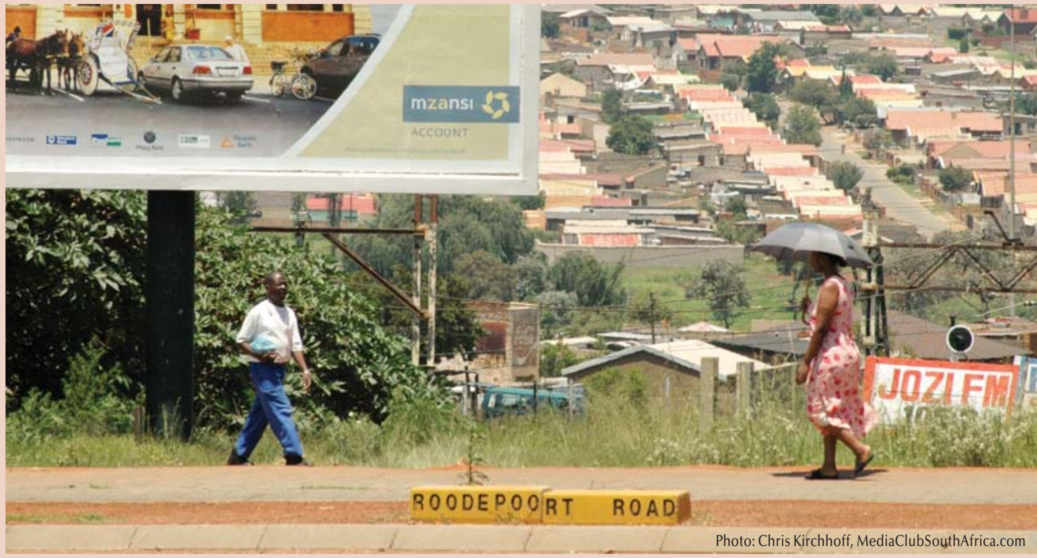

Photo: Chris Kirchhoff, MediaClubSouthAfrica.com

sources, and the organisation embarked upon a two-year process to develop a position on the future funding sources of local government. SALGA investigated 14 potential alternative sources of revenue (including a local business tax) which could be implemented within the framework of the Constitution. The local business tax envisaged is a levy payable on all factors of production used by business in the course of its activities. The SALGA 2009 National Members Assembly supported the idea of a local business tax and resolved that SALGA should do the necessary lobbying.

In October 2009, SALGA submitted to the Budget Forum a proposal to introduce a local business tax as a second general tax revenue source for local governments. Specifically, SALGA proposed that

- steps be taken to implement a local business tax to increase municipal responsiveness to the local economy and local accountability generally, and to increase municipal fiscal capacity, so that municipalities are better able to provide the infrastructure services required for economic development and growth; and
- appropriate adjustments be made to the overall intergovernmental fiscal structure, in particular by reviewing the basis for distributing the LGES to make it more redistributive.

SALGA, together with the Institute of Municipal Finance Officers and some of the larger cities, has further developed this proposal, outlining the need and modalities of a local business tax. An additional revenue source in the form of a local business tax is needed because municipalities face a significant fiscal gap between their expenditure responsibilities and their revenue resources, the nature of which varies according to the circumstances of the municipality. In the cities and some other municipalities, much of the gap relates to the requirement to provide infrastructure and services for economic growth and development, and specifically public transport infrastructure and operations. For many other municipalities the gap still consists largely of a basic service standards backlog. Some, but not all, of this fiscal gap is the responsibility of municipalities themselves. Municipalities must make determined and ongoing efforts to improve revenue collection and increase expenditure efficiency.

SALGA and the metros will be developing a formal proposal, in terms of the Municipal Fiscal Powers and Functions Act (Act 12 of 2007) (MFPFA), advocating a local business tax for economic infrastructure and services for economic growth and development to ensure a greater focus by municipalities on supporting long-term growth and development.

The MFPFA requires that any application for a new tax must comply with the requirements of section 5 of the Act, which requires, among other things, reasons for the imposition of the proposed tax, the purpose for which the revenue will be utilised and the outcomes of consultation with stakeholders.

Recommendations

SALGA recommended to the Budget Forum that it support the rapid implementation of a more comprehensive review of all the elements of the municipal fiscal framework over the medium term. It also recommended the speedy resolution of a number of protracted national policy processes that are precluding the finalisation of a long-term, sustainable municipal fiscal framework configuration. Finally, it also proposed that an independent commission be appointed to ensure maximum stakeholder participation and transparency in order to arrive at long-term solutions that are sensitive to the wide variations in municipal delivery contexts.

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