South Africa
Local Government Financial Reform Project

Final Report

10 September 2001

Report on Additional Work Undertaken by Local Government Financial Reform Project Team

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SA LOCAL GOVERNMENT FINANCIAL REFORM PROJECT:
Local Government Finance Reform Project Advisory Work

Report on Additional Work Undertaken by Local Government Financial Reform Project Team

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Prepared by Peter Vaz

RTI INTERNATIONAL

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for the Department of Provincial and Local Government, South Africa

REPORT ON ADDITIONAL WORK UNDERTAKEN BY LOCAL GOVERNMENT FINANCIAL REFORM PROJECT TEAM

10 September 2001

In addition to the work formally required by our scope of work under the Local Government Financial Reform (LGFR) Project, we have provided some valuable assistance to the South African government on intergovernmental fiscal relations.

1 INTERGOVERNMENTAL FISCAL RELATIONS FRAMEWORK PAPER

Roy Bahl, Pundy Pillay, and Paul Smoke have, at the joint request of DPLG and the National Treasury, prepared an intergovernmental fiscal relations framework paper (see Annex 1) that attempts to chart a common understanding of how to approach intergovernmental fiscal reform and consider how the various elements of the intergovernmental fiscal system should fit together. Neither department has formally adopted this paper, but it has stimulated some productive interdepartmental dialogue on a number of issues and could eventually serve as the basis for further cooperative efforts on intergovernmental fiscal reform policy work.

2 DPLG ADVISORY WORK

We have been assisting with a variety of urgent policy matters that have arisen in the course of the project time frame. Roy Bahl, Andy Reschovsky, Larry Schroeder and our resident advisor, Peter Vaz, have been working closely DPLG on a number of tasks not explicitly in our terms of reference.

Roy Bahl has assisted DPLG with comments on the Property Rates Bill (see Annexes 2 a, b). He also assisted National Treasury with reviewing a terms of reference for a local consultant to provide an implementation strategy for taking forward the RSC Levy reform work (prepared under the LGFR project). He hosted a study tour in Atlanta in July 2001 on property rates for representatives from DPLG, SALGA, and the Local Government Portfolio Committee.

Andy Reschovsky has been a key player in assisting Wendy Fanoe and Vusi Mkhonta with decisions about the horizontal allocation of the equitable share to municipalities. He reviewed the formula that was in place in 2000/01 and made recommendations for how the formula should be changed to take account of fiscal capacity and the demarcation process. In addition, he provided recommendations for updating key variables used in the formula (see Annexes 3a, b, c). He prepared an equitable shares model (at the same time as the local consultants appointed by DPLG) for determining 2001/20002 allocations to municipalities (see Annex 4). He has reviewed and critiqued the equitable shares model prepared by the local consultants (see Annex 5).

Larry Schroeder has assisted DPLG in preparing a Cabinet memorandum (see Annex 6) that formed the basis for legislation on a policy framework for the adjustment of division of powers and functions between municipalities. The legislation was passed on July 12, 2000 in a Schedule titled "Policy Framework for the Adjustment of Division of Functions and Powers between District and Local Municipalities."

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Peter Vaz has assisted DPLG with the following issues:

1. **Work with the Municipal Demarcation Board (MDB) on the demarcation process**: Peter has worked closely with the MDB from the time he began working on the LGFR project. He served on the MDB Coordinating Committee from February to December 2000. During this period, he was also a member of the MDB Finance Working Group, which researched the viability of the newly demarcated municipalities. He liaised with MDB staff to assist them with developing indicators of administrative and financial capacity. During this period, he worked closely with Coceko Pakade and Myron Peters from DPLG and Dave Savage from National Treasury.

2. **Assistance with the DPLG policy framework and implementation strategy for free basic services (FBS)**: Peter has been an active participant in DPLG's efforts to develop a policy framework for FBS. He has worked with DPLG and National Treasury staff to help identify key issues that need to be considered in developing this framework. He has assisted Vusi Mkhonta of DPLG in developing a terms of reference for consultants to prepare the policy framework and interim guidelines to municipalities for implementing FBS. He has attended meetings with DPLG staff and the consultants (Richard Tomlinson and Burgert Guildenhuys) to take the terms of reference forward and to critique the work of the consultants.

3. **Assistance with reviewing comments on and redrafting the Property Rates Bill**: Peter has assisted Myron Peters and Mbulelo Tshangana of DPLG and Matt Glasser (DPLG-Treasury policy advisor) with reviewing comments on the Property Rates Bill. He has participated in meetings with DPLG, National Treasury and sectoral ministries in the redrafting process. He has been present at meetings between DPLG and NEDLAC to review and answer questions on the Bill. The Bill is currently in the process of going to the Cabinet for submission to Parliament.

4. **Additional work on Division of Powers and Functions**: Peter has served as Co-coordinator (with Chris Heymans) of the DPLG-Treasury Interdepartmental Task Team on Powers and Functions. He has prepared two papers (see Annexes 7a,b) representing DPLG and Treasury's viewpoint on a policy framework for the division of powers and functions. In the course of preparing these papers, he has chaired meetings within DPLG and solicited opinions and comments from DPLG staff, including Jackie Manche, Coceko Pakade, Fanie Louw, Derek Powell, Wendy Fanoe, Louise Muller, Mbulelo Tshangana and Vusi Mkhonta. He has prepared a terms of reference (see Annex 8) for local consultants to assist DPLG with determining more specific recommendations (than those that emerge from the LGFR project) on the appropriate division of powers and functions using a case-study methodology to understand the situation beyond the limited sample covered by the project.

5. **Assistance with Cabinet and Technical Minmec Submissions**: Peter has assisted Jackie Manche and Wendy Fanoe with editing a Cabinet memorandum (See Annexes 9 a, b) to highlight the need and develop support for a study on determining the once-off and incidental costs of the demarcation process and for the creation of a transition fund for municipalities to cope with the amalgamation process required by the new demarcation. He has also summarized the paper on RSC Levy reform options

(prepared by Roy Bahl and David Solomon under the LGFR project) for submission to Technical Minmec (see Annex 10).

6. **Assistance with Equitable Shares formula**: Peter has assisted Wendy Fanoe and Vusi Mkhonta of DPLG with reviewing the current equitable shares formula and determining the horizontal allocation of the equitable share to municipalities for the 2001/02 financial year. He has attended meetings between DPLG, National Treasury, and StatsSA on updating variables, including income and poverty, in the formula. He has assisted DPLG with reviewing the 2001/02 equitable shares model.

7. **Participation in DPLG-Treasury bilaterals and other Treasury work**: Peter has participated in several monthly bilaterals between DPLG and National Treasury dealing with the above and other issues. He has also worked with Treasury officials in reviewing and critiquing proposed legislation, papers and/or terms of reference on the Municipal Finance Management Bill, RSC Levy, municipal debt policy, municipal database, electricity restructuring, and other issues.

This general policy advisory role is critical for DPLG and the project relationship with them. Although some of these “extra” tasks are not directly related to the project’s scope of work, they are critical for the development of the broader intergovernmental fiscal system, and thus affect the efficacy of specific recommendations that emerge from the project.

In addition, by involving DPLG staff on a regular basis in our project activities, we have contributed to the development of greater understanding of and capacity in local government financial reform in DPLG.

ANNEX 1
MUNICIPAL FINANCE AND FISCAL DECENTRALIZATION: A FRAMEWORK FOR REFORM

Municipal Finance and Fiscal Decentralization:
A Framework for Reform

Prepared by Roy Bahl, Pundy Pillay and Paul Smoke

I. Introduction

Intergovernmental fiscal reform is a challenging and complex exercise. Reform efforts in most countries are partial and fragmented, a problem that South Africa shares to some extent. An integrated approach is preferred because local revenue reforms that are not conceived as part of a larger fiscal system often do not work well and cannot be sustained. In addition, desirable reforms are often difficult and time-consuming to implement, but their implementation strategy typically receives inadequate attention in designing reform programs.

The problem is particularly complicated in South Africa because of the evolving political, economic, institutional and fiscal situations and the weak financial condition of some local governments. There are wide disparities between urban and rural local governments in terms of their capacity to raise revenues and deliver services. At the same time, local governments are being restructured under the Municipal Demarcation Board, and both the Department of Provincial and Local Government (DPLG) and the National Treasury are developing legislation that will affect the way local government functions. Underlying the entire situation are tensions between those who feel the need for central control to support macroeconomic policy and maintain service standards, and those who prefer greater fiscal decentralization. For all these reasons, it is essential that South Africa chart its broad intergovernmental fiscal course carefully.

In an "ideal" world, the South African government might develop the system in a series of logical steps. The first step would be to determine the priority level of fiscal decentralization relative to other competing national objectives. The types of taxes selected for local governments and the way they are structured depend largely on the degree to which the central government supports genuine increases in local fiscal autonomy.

The second step would be to match revenue requirements to expenditure needs. The purpose of a local government is to provide services, not simply to raise revenues. Fiscal reforms should, therefore, initially focus on what local governments should do and how much this will cost. Prioritizing the expenditure side does not preclude immediate reforms of important local taxes, but it would provide a basis for a more sensible, longer-term, revenue-generation strategy.

The third step would be to consider local revenue sources in relation to each other when trying to determine a sensible set of local own-source revenues. There must be decisions about which sources should be used for general purposes, and which should be used as benefit-like taxes dedicated to particular types of services. In determining the composition of local revenues, the government must try to balance the efficiency and equity effects of individual sources, such that the overall system meets broader national goals.

The fourth step would be to design intergovernmental transfer systems in a way that meets Constitutional objectives and helps to offset revenue shortfalls of the municipalities relative to their expenditure responsibilities. Consideration needs to be given to how transfer system design affects national redistributive goals, incentives to generate local revenues, and municipal decisions about borrowing for investments, options for which need to be enhanced.

The reform path being taken by South Africa is less systematic than this suggested approach. This is not surprising given the national context and international experience. Local government must function while the broader system is developed and reformed, so some degree of partial and ad hoc reform is needed. At the same time, the government can develop a clearer vision for how components of the intergovernmental fiscal system fit together and how each reform can be instituted in a way that supports the development of an integrated system. The next three sections consider local government tax structure, intergovernmental transfers and local government borrowing. The paper concludes with suggestions for moving forward.

II. The Local Government Tax Structure

The theory on fiscal federalism provides some broad guidelines with regard to which taxes can be appropriately assigned to subnational governments. In practice, however, many countries at similar levels of development have in many cases chosen different solutions. One of the main reasons for this is that the historical, ethnic, geographical and constitutional character of each country does affect the choice and range of feasible tax policies.

Nevertheless, some lessons may be drawn from actual country experiences. First, a decentralized fiscal system cannot function satisfactorily without the necessary administrative capabilities at the subnational level. In other words, the design of tax systems should be clearly be adapted to the level and quality of administrative resources at the provincial/state and municipal levels. Second, experience indicates that a decentralized system will work satisfactorily only if provincial and local governments are given at least one major source of own revenue over which they have autonomy. Only then can a decentralized system of government promote accountability and ultimately economic efficiency. Finally, there are potential gains as well as risks associated with decentralizing taxing powers. The gains include improved mobilization of revenue sources and potential efficiency gains. The risks relate to the increased vulnerability of central government with respect to its ability to conduct effective fiscal stabilization policies.

What are the best sources of local government revenue for South Africa? There are no unambiguous answers to this question. International practice and economic and political theory suggest that there are many options. The right choice for South Africa will depend on what objectives are emphasized by the government. Several objectives are particularly critical.

The amount of revenue generated by the tax should be *adequate* to cover budgetary needs. There should be a balance between needs based on expenditure assignment, and the combined amount of local taxes, charges and intergovernmental transfers. The percentage of own source revenues in the financing structure will depend on the amount of fiscal autonomy that the central government wants local governments to have. Moreover, the own-source

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revenue share of urban governments may be considerably higher than that of rural local governments.

Revenues from a local tax should be *income elastic*, automatically growing in proportion to the growth in expenditure needs. If revenues grow more slowly than needs and the difference is not made up by elastic intergovernmental transfers, local government will always have to return to voters or to the center to ask for discretionary increases or look for “gimmicks” to cover their shortfalls. Fiscal gimmicks (extra-budgetary revenues, nuisance licenses or taxes, short term borrowing to cover current expenditures, etc.) are almost always harmful to the economy because they tend to distort microeconomic resource allocation and/or cause “rent-seeking” and steer social energy towards lobbying.

Taxes should be *equitable*. Vertical equity is concerned with whether local taxes imposed treat individuals at different income levels according to the norms that are acceptable to the country. For example, is the overall national system meant to be proportional or progressive, and does the local component contribute to that equity goal? Horizontal equity—whether equally situated individuals (or enterprises) are treated the same—is another dimension to consider. The difficult task here is to define what constitutes “an equally situated” individual or enterprise.

There should be a *correspondence* between those who bear the burden of the tax, and those who enjoy the benefits of the expenditures financed by the tax. If a local government tax is exported to other jurisdictions, the taxing jurisdiction will have an incentive to overspend because its residents do not pay the full price of services they consume. Moreover, it is unfair for residents of small towns to pay for some of the services consumed in larger cities.

Local taxes should be structured to give the local government a desired degree of *fiscal autonomy*. In a decentralized system, local voters hold elected officials responsible for the quantity and quality of services provided. For this to happen, some minimal conditions must be met. The local government must have some control over tax rates, the tax must be large enough to burden the local population significantly, and it should be visible enough for voters to recognize it as a levy placed on them by their elected local government.

A good local tax will be *administratively feasible*. It should be simple enough to be understood by voters, and administrative costs should be reasonable. Local governments and the central government should resist the temptation to achieve multiple objectives with local taxes (e.g., equity objectives achieved by deductibility from central income tax, special features to encourage land development or substitution of labor for capital, schemes that use the property tax to promote VAT compliance). Broad-based local taxes with flat rates ought to be the rule. Complex systems tend to encourage corruption, favouritism, and the use of social energy for special pleading.

Local taxes should be *neutral* with respect to market decisions. Violations of neutrality are common. Turnover taxes contain a “tax on tax” element which could lead to higher market prices. Payroll taxes bias the choice between capital and labor in favor of the former. Deductibility of property taxes from business income tax liability lowers the tax rate on businesses to below the rate levied on individuals. There are no completely neutral taxes, but it is good practice to stay away from taxes that significantly distort economic decisions.

Finally, local taxes must be *politically acceptable*. No one likes taxes, but some taxes are less objectionable to voters than are others. One rule of thumb is that less visible taxes tend to be more acceptable, i.e.; people like the illusion of not knowing how much tax they are actually paying. Taxes collected directly from businesses are examples of this. Taxes paid in small amounts (sales taxes) seem preferable to those paid in large installments or annually, perhaps because the taxpayer is less aware of the total amount of tax paid. Such an approach, however, may be seen to undermine the revenue-expenditure linkage that is considered to be a principal benefit of local government. There is also a “certainty” element to political acceptability, because taxpayers like to understand the taxes they must pay.

The Local Revenue System in South Africa

South African government local revenues include Regional Services Council (RSC) levies (turnover and payroll taxes), property rates, and various user charges. Each of these is briefly considered below in terms of the criteria outlined above.

RSC Levy

The RSC levy has good revenue adequacy and elasticity, especially the turnover tax. However, the levy generally fares less favorably in terms of other principles outlined above. There is not a good correspondence between where tax burdens are borne and expenditure benefits are realized. The turnover tax burden on firms that sell in national markets is exported to other jurisdictions. The payroll tax is borne where taxpayers work, but it also fails the exporting test if firms that sell nationally pay their full liability to the jurisdiction where their headquarters are located or if there is significant cross-jurisdiction commuting to work. The RSC levy does not support local autonomy or promote administrative ease. The tax rate and base are set centrally with little local control. Proper tax administration would be complex for the turnover tax (if branch plant or outlet turnover were separated) and easier for the payroll tax (if collected from withholdings), but potentially costly audit is required for both components.

In terms of equity, the turnover tax is likely to be regressive because it is passed forward to consumers, but the payroll tax fares better if it is not levied on low-income wage earners. Uneven administration may contribute to inequity, but limitation of exemptions contributes to horizontal equity. Efficiency distortions are a major concern. The payroll tax discriminates against labor and at the margin discourages employment. The turnover is imposed at each stage of production, distribution and consumption, leading to higher prices and favoring vertically integrated firms.

In summary, the RSC levy has strong revenue benefits and seems to be politically acceptable, at least for now. The major question is whether these benefits and the low rate of taxation outweigh the considerable negative aspects of the tax.

Property Rates

The property tax is an important source of local revenue, but its buoyancy is problematic. Although it should grow with economic development and land values, politically sensitive rate increases and/or revaluations (also administratively burdensome) are necessary to realize growth potential. Arguably the best feature of the property tax is significant local autonomy.

Local governments may within limits choose the tax rate and even the tax base, and may grant exemptions. Property rates fare well on equity grounds. That portion levied on land (on residences, rented premises or non-residential property) is likely borne by the (generally higher income) owners of land. The remainder may fall heavily on middle class residences and on business owners, leading to a distribution of tax burdens probably no worse than proportional. A further positive feature is that, as a wealth tax, it is probably least distortionary of resource allocation. On grounds of neutrality, the property tax gets a mixed review. A site value tax has a neutral effect on real estate development. A capital value tax on land and improvements does discourage property investment at the margin, but the magnitude of displacement is uncertain.

The property tax is politically controversial because voters are subjected to an assessment procedure that they do not understand, and they are taxed on accrued rather than realized income. The biggest drawback however, is that rates are difficult and costly to administer fairly. Administration requires identification of taxpayers, assessment, record keeping, collection, and audit/appeals. These are major tasks beyond the financial and technical capability of many local governments.

In summary, the tax on property rates is the most “locally controlled” tax in the system, generates significant revenue, and probably contributes to the overall equity of the South African tax system. Its major failings are the difficulty of administration and the arbitrariness that sometimes results from poor administration, and the difficulty in making revenue growth from the property tax keep up with growth in the economy.

User Charges

Ideally, a user charges cover the marginal cost of service provision, and an additional surcharge or excise tax can be levied to recover social costs necessary to support a service provider. In principle, user charges can, if properly set, score high on a number of local revenue criteria. They can realize substantial revenue, promote efficiency, and grow in response to revenue needs. User charges may fall more heavily on lower-income service users, but adjustments can be made to offset such effects.

User charges for electricity, water, sanitation, and solid waste collection are a major source of revenue in some urban jurisdictions in South Africa. Local governments also charge for other services, such as transport, clinics, and recreation, but these rarely generate much revenue. Limited evidence suggests that charges for trading services sometimes exceed expenditures, essentially functioning as local taxes, while charges for most other services rarely cover costs.

There are different views about the role that central government ought to play in local user charges. For urban governments, the center might simply insist on full cost recovery and enable an excise tax to cover social costs. Under a more interventionist scenario, the center would exercise more control over user charge practices. In this case, there are two concerns. First, the government does not know enough about the structure and effects of most types of user charges to set guidelines intended to improve efficiency and equity. Second, there have been recent proposals to regionalize or privatize some services that currently generate trading surpluses used to fund general expenses. Reforms that take surplus-generating services away from local governments could have profound impacts on their overall financial viability.

Such "hidden taxes" may be inefficient, but they can generate significant revenues. Their replacement will require careful analysis and crafting of alternative revenue enhancement measures.

In summary, user charges are a critical element of urban government finance in South Africa, and they are likely to remain important no matter what types of reforms are adopted. More systematic study of user charges and the services for which they are collected is required before recommendations can be made for the future.

Other Revenue Sources

At present, there are no other highly significant sources of local government revenue in South Africa. Some that may merit consideration include motor vehicle registration, motor fuel tax, excise taxes on electricity and telephone services, and extension of user charges to additional services. Such sources would have to be evaluated on the basis of the criteria outlined above before their adoption could be seriously considered.

III. Intergovernmental Transfers

Because local own-source revenues generally do not cover local government expenditure responsibilities, virtually all countries have intergovernmental transfers. These serve multiple, often interrelated purposes, three of which are particularly important. First, they help to cover *vertical fiscal imbalances*, supplementing inadequate local own-source revenues to improve the ability of local governments to meet their expenditure responsibilities. Second, they can be used to meet national *redistributional objectives*, helping to offset fiscal capacity differences among local governments. Third, they can be used to encourage (discourage) local expenditures on particular goods and services that exhibit positive (negative) *externalities* (spillovers) or are considered to be basic needs. Most transfer systems are intended to meet some or all of these objectives.

There are several typical issues and problems involved with transfer programs. First, different types of transfers are appropriate to meet different objectives. Unconditional grants, for example, are best for inter-jurisdictional redistribution purposes, while conditional grants are a more effective and cheaper way of encouraging expenditures on target services or spill-over correction. If designed properly, both types can help to encourage local resource mobilization and to ensure over time the provision of a basic minimum of services regardless of local fiscal capacity.

Second, fiscal equalization grants are often a priority, but they are difficult to design because of the technical and political complexities involved in defining an "optimal" distribution of income across jurisdictions and in determining a fair way to raise the revenues to be redistributed. Equal resources do not guarantee equal results, and there are often inequalities within recipient jurisdictions that may not be alleviated by transfers. In spite of these problems, redistributive grants can generally be designed to improve on the status quo.

Third, macroeconomic problems can be created if too large a percentage of central resources are guaranteed to local governments each year. The importance of this problem depends on the intended size of the local public sector. In cases where it is a real issue, the potential dangers must be weighed against the value of providing local governments with a stable revenue base and the potential microeconomic gains of decentralized service delivery.

In the South African context, while it is undoubtedly true that undisciplined local governments can add to macroeconomic instability problems, this is probably not a big concern given present levels of local government fiscal activity. Moreover, if national government were to impose a hard budget constraint such a concern could be further alleviated. All national governments feel that they need to control the major instruments of tax and expenditure policy in order to have the flexibility to shape macro-stabilization policy. In South Africa, for example, the national government has set a 26% tax burden ceiling and a ceiling on domestic credit, and its great concern would be that it could control neither of these if it gave taxing and borrowing powers to local governments. In the final analysis the national government has to make a trade-off, namely greater autonomy for local governments will lead to less flexibility on macroeconomic policy, and vice versa. The national government has to choose how much of a trade-off it is willing to make.

Fourth, if local governments lead public investment choices with grant funding, there will be a bias towards projects with predominantly local benefits. This would be considered undesirable by those who support the need for central governments to set public facility standards and those who believe that priority for social capital should go to the types of infrastructure characterized by regional externalities.

Fifth, transfer programs may collectively have inconsistent or unintended results. For example, an equalizing grant may be offset by conditional grants that go to wealthier areas. Careful research can help to understand and minimize, as appropriate, such effects. Grants may also substitute for rather than stimulate local tax effort, thereby failing to increase spending as much as expected. A local-tax-effort variable in a transfer allocation formula can alleviate, but not eliminate, this problem. Finally, multiple transfer programs with different allocation criteria for a particular sector can confuse local officials and provide incentives for unproductive competition and strategic behavior. Consolidation and simplification can reduce such problems.

Sixth, transfer programs need to be simple and transparent. A transfer system needs to be simple, easy to understand, and easy to administer. Examples of transfers that do not match these criteria are:

- Grants with complicated formulae;
- Conditional grants with many conditions that must be monitored and complied with;
- Derivation-based sharing where the “headquarters problem” must be accounted for;
- “Hidden grants” such as (a) deductibility of property tax from income tax liability, and (b) RSC levy. These give the appearance of being something other than transfers, but in fact they are transfers (i.e. the center determines the amount and the allocation formula for distribution among local governments); and
- Vertical shares determined on an ad hoc basis.

In the final analysis, there are no absolute standards for evaluating intergovernmental transfers. The structure of transfers should be expected to vary across countries depending on national objectives, the extent of service and revenue functions assigned to local governments, local fiscal capacity, and the extent of inequalities across local governments.

Intergovernmental Transfers in South Africa

The South African constitution requires the establishment of democratic local governments that are expected to provide basic services and perform the functions allocated to them. Most urban jurisdictions raise substantial amounts of revenue and provide a number of key services. In contrast, most rural jurisdictions provide few services - some lack even rudimentary administrative structures -and have weak revenue capacity. Given the limited amount of own-source revenue raised by many local governments, the constitutional mandate for local governments to provide basic public services, and the extremely unequal income jurisdiction, intergovernmental revenues must play an important role in the financing local governments.

The transfers to the local government sphere comprise the following (see also Table 1):

a. An **Equitable Share** of nationally-collected revenue whose primary purpose is to enable municipalities to provide basic services. The formula for distributing the equitable share between municipalities comprises a municipal basic services transfer and a municipal institutional transfer. The basic services component enables poor municipalities to deliver basic municipal services to households, while the institutional component provides support to those municipalities that lack administrative capacity and basic infrastructure.

b. **Conditional Grants.** These currently comprise (1) grants to the R293 towns in the former Bantustans for staff salaries, for subsidization of electricity and water services and to provide incentives for the transfer of staff to local governments; and (2) a local government support grant to fund management support and capacity-building initiatives in smaller municipalities. In addition, two new grants have been introduced. The financial management grant assists the metropolitan, district, and large Category B municipalities to build capacity for financial planning and budgeting. A restructuring grant will assist eligible municipalities whose 'financial difficulties pose a significant threat to national economic development'.

c. **Agency Payments:** These include grants made through the Consolidated Municipal Infrastructure Programme (CMIP) for basic infrastructure, the community based public works programme for job creation and the 'grant-in-kind payments' for the community water supply and sanitation programme for rural areas and bus subsidies to assist low-income commuters.

The National Treasury is proposing the consolidation of all capital grants into an unconditional transfer. This is a good idea in principle, yet one that will take a long time to implement across all municipalities. Greater local control over capital resources at present would be appropriate for the larger and more well-resourced local governments but others may need to evolve towards this situation from a CMIP style approach as their capacity improves.

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Table 1:
Transfers to Local Government

R, million	1998/99 Actual	1999/2000 Revised Estimate	1999 Budget	2000 Budget	2001/02 Estimate	20002/03 Estimate
Local govt. allocation	2 156	2 327	2 480	2 830	3 030	3 233
Equitable Share	1 024	1 673	2 480	1 867	1 997	2 130
Conditional Grants	1 132	654		963	1 033	1 103
Total Shared	158 865	170 702	176 652	184 963	197 947	207 674
Local Govt. share (%)	**1.4**	**1.4**	**1.4**	**1.5**	**1.5**	**1.6**
Agency payments		3 505		3 879	4 265	4 510
Total		**5 832**		**6 709**	**7 925**	**7 743**

Source: Budget Review, 2000. Note: Agency payments: CMIP, Community-based public works, Community water and sanitation, SDIs, bus subsidies.

How does the existing transfer system perform? The existence of the equitable share and capital grants programs recognizes vertical imbalances. The equitable share is redistributive, and the capital transfer programs largely target basic services for disadvantaged citizens. Some services create spillovers that transfers can help to correct for. Thus, the system is designed to meet the key objectives noted above, but empirical evidence on actual effects is limited.

Fiscal Imbalance

The extent to which the fiscal imbalance is alleviated by the present transfer system is unclear. Some analysts suggest that the vertical imbalance is small because revenues raised by local governments cover 90 percent of their operating expenditures, but it is inappropriate to use actual expenditures and actual revenues to determine the size of the fiscal imbalance. This is particularly true in South Africa, where, except in former "white" areas, local governments provided few services and raised little revenue. The correct approach is to develop a normative indicator of fiscal need that measures the gap between local expenditures required to provide mandated services at a minimum standard and local revenue-raising capacity. Although various capital and recurrent transfer programs help to fund local service provision that would otherwise not occur, the extent to which needs are being met cannot be determined without better data. The documented lack of local services and the small size of the equitable shares program, suggest that more needs to be done to alleviate vertical fiscal imbalance, but it is equally unclear how much more revenue local governments should raise from their own sources.

It must also be recognized that the demand for local services will grow in the future. As the economy develops and local capacity increases, there will be increased pressure for local governments to provide a broader range of services. Local revenue-raising capacity will also be growing, but it will probably lag behind the growth of expenditure needs. First, the institutional capacity of many local governments to raise own-source revenue is limited and will take time to develop. Second, some key local taxes tend to grow slowly or require political and/or administrative action to keep buoyant. Third, there are limits on the development of local taxes and user fees. Raising them too high would be politically difficult, may place a heavy burden on residents, in some cases especially the poor, and may discourage local economic development.

In summary, it is evident that the great challenge facing national government in the intergovernmental fiscal relations arena relates to the vertical division of nationally-collected revenue and in particular, the share accruing to the local government sphere. In pondering this challenge, national government may wish to consider the following important issues:

- First, it is clear that the size of the local government sector in the South African economy, i.e. relative to GDP, is small. Meaningful decentralization would suggest a strong case for increasing the vertical share of local government.

- Second, the contentious issue, of course, is "what should the vertical share be?" Drawing from the literature on fiscal federalism and the actual experience of countries suggests that the share should match expenditure assignment and some notion of minimum expenditure standards.

- Third, it is vital that the process of determining the vertical share be transparent. If local governments do not know what they may count on, how can they efficiently plan their budgets or maintain a fiscal balance?

- Fourth, it is evident that there is a growing gap between expenditure requirements based on assignment and revenues. Up to this point in time expenditure and revenue issues have rarely been considered together in South Africa. There is overwhelming theoretical and practical support for the notion that a proper intergovernmental system must be guided by the principle that finance follows function, and not the reverse.

These arguments—which require further documentation—suggest that the aggregate need-capacity gap of local governments could grow in the future and that the local vertical share of national revenues probably needs to increase. At the same time, the restrictions the Treasury wishes to place on the overall size of the public sector will probably limit the local share. In addition, the Treasury and DPLG understand that local governments must have adequate capacity, financial discipline, and local accountability to use resources provided to them responsibly. Ultimately, the decisions about how to vertically divide nationally-raised revenue and how this should evolve over time requires weighing the capacities and competing demands of the three levels of government.

Fiscal Disparities

Differences in the need-capacity gaps of individual local jurisdictions provide an indication of the fiscal disparities across local governments. Some relatively rich municipalities will have revenue capacity in excess of expenditure needs, while other less prosperous places will face large need-capacity gaps. Fiscal disparities result in horizontal inequities, and their existence can lead to economic inefficiencies if individuals and businesses chose locations on the basis of municipal fiscal condition rather than to minimize private or social costs. In addition, municipalities with large need-capacity gaps will not, in the absence of substantial intergovernmental grants, be able to provide their residents with adequate basic services. Funds to reduce fiscal disparities and to guarantee that every municipality has enough resources to provide minimum services must come from the national government.

Recent research compared the grants to local governments in 1997-98, the year before the first equitable share allocation, to an estimate of the grants that will occur when the institutional grants are fully phased in and the historical allocations are completely phased out. With the exception of Gauteng, where rural incomes are relatively high, the horizontal distribution of the equitable share will result in large grant increases to rural jurisdictions and decreases to urban jurisdictions. In the poorest local authorities, equitable share revenue dominates the budget, while this revenue is relatively trivial in the wealthier local governments. Thus, there is some genuine redistribution occurring. If own-source revenues cannot be substantially increased, however, there will be growing pressure to distribute the equitable share in a way more favorable to urban and metropolitan jurisdictions. There is little information available about the distributional effects of capital grants. Before steps can be taken to improve the redistributional effects of transfers, more work needs to be done on how to best measure local fiscal capacity and the differences across local governments in South Africa.

Spillovers

As democratic local governments in South Africa become more fully established and take on larger service roles, residents will play an increasingly more important role in determining the level of local services. This is desirable in some respects, but it can lead to the under-provision of some services from the national perspective if voters fail to take account of the benefits they confer on neighboring communities, particularly in metropolitan areas where local governments are in close proximity. A solution is for the national government or provincial governments to design matching grants for local services with benefit spillovers, where the matching rate is set to encourage the appropriate level of expenditure. It is not clear that any existing transfers in South Africa are explicitly designed to correct for externalities, but it may be appropriate to develop a well-targeted system of matching transfers as part of overall transfer system redesign. Some portion of the existing transfers could be devoted to this purpose.

Other Issues

The above discussion suggests a clear need to better document the size of the vertical fiscal imbalance, the nature and extent of interjurisdictional fiscal disparities, and the overall effects of the present set of transfers, including the capital grant programs that have not been extensively studied. In addition, a number of other critical issues should be considered as government determines what to do with the intergovernmental transfer system in the future.

- What kind of balance does the government wish to maintain between pure redistribution/local autonomy in the use of transfers and encouraging local governments to spend on certain services that meet national priority objectives and/or involve interjurisdictional spillovers?

- How will new boundaries under the demarcation affect the need for transfers and the way they should be distributed? Will new (larger) local authorities be more fiscally viable and independent? Will the institutional component of the equitable share need to be maintained? How will reforms to be phased in as the new municipal boundaries take effect?

- How can a measure of local revenue effort be included in transfer formulas to ensure that the transferred resources do not undermine local tax effort?

- Should transfers go to primary municipalities or the districts? Should the mechanism differ by type of transfer or capacity of the primary municipalities?

IV. Local Government Borrowing

Local governments in many developing countries get most of their capital budget from transfers, but some decentralized governments, typically provinces and large cities, are able to borrow. Where local borrowing occurs, often through some type of municipal credit institution, it is normally subsidized, and local repayment is often inadequate. Municipal bonds are used in a few countries, but they are not common.

The development of borrowing mechanisms for local governments is often inhibited by a number of realities. First, there has been a pervasive belief that subsidization through transfers would improve service delivery equity, a key objective of governments and donors. Second, if local governments can readily get transfers for infrastructure development, their incentive to borrow is undermined. Third, the fiscal performance and creditworthiness of local governments is often weak, so that borrowing is not a serious possibility.

It is now clear that subsidization through transfers to local governments does not always primarily benefit those in need. Thus, central governments may be subsidizing those who can afford to borrow. In addition, many countries can no longer afford to subsidize either local governments that can afford to borrow or poorly performing municipal lending institutions. There is an increasing tendency to adopt objective appraisal techniques, charge closer-to-market interest rates, and enforce repayment. Some central governments are even trying to develop a municipal bond market.

These changing realities have raised the recognition that some local governments in many countries can afford to borrow, and that capacity building can enhance creditworthiness. Thus, an effective fiscal decentralization program needs to develop an appropriate *spectrum* of options to finance capital investment, from grants and subsidized loans for poorer local governments and non-self-financing projects, to various types of loans and bonds for fiscally sound local governments and self-financing projects. As with grants, the approach that a country takes towards enhancing local government access to loans depends on the fiscal context, as does the extent to which these efforts pose any danger to macroeconomic stability.

In the South Africa case, some local governments have borrowed in the past, and others will hopefully be able to borrow in the future. The DOF's Municipal Financial Management Bill outlines a regulatory framework for local government borrowing.

Loans account for over half the capital budget of South African metropolitan and other urban municipalities, which is very high compared to other developing countries. Historically, the largest source of loans has been government institutions and especially the National Housing Fund, which lends money to municipalities at subsidised rates for the provision of public housing. In addition, South Africa has a financial sector that is capable of raising and allocating capital to projects involving known risks. With the advent of the reform process to amalgamate municipalities (in some cases, rich and less well-endowed ones), investors however, have become more doubtful about the borrowing capacity of municipalities.

A well-developed capital market is desirable as a source of municipal revenue, and thus proper budgeting and sound financial management procedures, including firm credit-control measures, are needed. An important issue around demarcation is whether or not new municipalities will be able to tap into private markets to raise revenue. Should demarcation result in a loss of creditworthiness for a municipality, it will need to rely on the CMIP for funds for infrastructure investment. However, demarcation can also result in certain municipalities increasing their access to capital markets. Because the national government will not provide sovereign guarantees of municipal debt, there needs to be greater clarity with regard to the security of loan investments in order for the private sector to lend to municipalities.

The National Treasury has released a municipal finance management bill for comment. This document states that municipalities should be able to determine their own debt levels, but cannot borrow to fund current deficits. It also states that National Government will not establish municipal credit limits and will not act as a guarantor or lender of last resort. The extent of borrowing will be the decision of the municipality. Short-term borrowing will be limited to the amount required to bridge operating cash shortfalls and long-term borrowing will be limited to funding capital investment in property, plant and equipment. Full disclosure will be enforced to ensure that investors can fairly assess risk.

As efforts are made to improve local government creditworthiness and access to loan financing, it is critical that the linkages to the rest of the intergovernmental fiscal system are recognized. Improved generation of local own-source revenues (to enhance repayment capacity) is a prerequisite to local government borrowing (the purpose of which should be for long-term investments), and intergovernmental transfer mechanisms should not be designed in a way that undermines local government incentives to borrow.

V. Moving Forward with Reform

The South African government has made impressive gains in intergovernmental fiscal reform. At the same time, a number of outstanding issues remain. First, it is evident from the above discussion that there are many unanswered questions about specific aspects of the intergovernmental fiscal system, and it is not always clear that the various aspects of the system—own-source revenues, transfers, and loans—are being considered in an integrated way.

Second, the local government system in South Africa is complex and evolving. The Constitution requires the national government to specify powers, functions and structures of the various types of local governments and to clarify their interrelationships under the two-tier system. The government is making progress on these matters, but it will take some time to sort out the details and implement the "final" system, particularly with the new demarcation.

Third, despite the strength of the Constitution on local government matters, there remains at the central level a lack of clear consensus on intergovernmental fiscal reform. Some analysts feel the need to maintain significant fiscal centralization to support macroeconomic stability, to adequately redress inequities, and to protect the integrity of service delivery by maintaining service standards. Others prefer greater fiscal decentralization in the belief that it will improve allocative efficiency and accountability. This lack of consensus influences the direction, strength and consistency of local fiscal reforms.

Fourth, moving forward with fiscal decentralization requires considerable information and capacity. While substantial capacity exists at the central level, specific skills required to define and implement local reform are somewhat short in supply, and lack of information is an enormous constraint. At the local level, there are wide disparities among municipalities in terms of their capacity to deliver services and administer taxes, their fiscal capacity, and the degree of accountability to and the political sophistication of their citizens. These disparities exist across and within types of local governments. Thus, uniform devolution of fiscal powers to all local governments or all councils of a particular type is likely to result in uneven fiscal performance.

Fifth, several central departments with different agendas and inadequate cross-departmental channels of communication have a role to play in local government fiscal reform. To date, coordination and conflict resolution have been primarily ad hoc and bi-departmental. The principal focus of the "coordinating" ministries, DOF and DPLG, has been on the revenue side, and there appears to be only modest understanding of sectoral decentralization activities and detailed municipal expenditure requirements. These coordinating departments and their sub-departments have pursued various reforms to local government own-source revenues, the intergovernmental transfer system, and local government credit access mechanisms. Individual sectoral departments have pursued service-specific reforms independently, sometimes without regard to the financial capacity of local governments. Some of these reforms have been only marginally related and coordinated, raising concerns that such reforms might work at cross purposes and/or overwhelm the capacity of some weaker local governments.

Given the institutional and political complications involved in fiscal decentralization, various types of local level disparities, and poor information on local government demographics and finances, careful deliberation and strategic incremental implementation of fiscal reforms are required. In South Africa, such a strategy would have at least the following elements.

First, South Africa needs a process to resolve outstanding debates on how far decentralization should go and the specific form it should take. Some remaining policy decisions are required on all aspects of intergovernmental and local government financial reforms. These include service responsibilities of local governments; local own-source taxes; shared taxes; intergovernmental grants; local government credit mechanisms; institutional and procedural reforms; governance development; and supporting capacity building efforts (technical assistance and training). There is considerable guidance on many of these matters in the Constitution and various laws, but numerous matters remain open to detailed interpretation.

Second, it would be useful to differentiate among local governments on a more objective and thorough basis than is currently the case. Improved local government information would help to do this and would allow local government financial and other decentralization reforms to be better tailored to the specific circumstances of individual local governments. This system could also serve as the basis for targeting of technical and financial support from higher levels, as well as continued monitoring of local government circumstances and performance. This would provide the system with information to respond in an appropriate manner as local governments become ready for additional responsibilities or fall into financial trouble and require assistance.

Third, South Africa needs a more developed and coordinated strategy for how to proceed with reform of finance and other aspects of local government functions. An interministerial process/mechanism could provide an institutional vehicle for developing this strategy. As many types of reforms cannot be implemented in all local governments at once, this mechanism could determine, based on recommendations of research on local capacity and performance, how to proceed. The involvement of a coordinating body in implementation design and oversight would help to improve the consistency of central departmental activities and to ensure that basic reforms that are a prerequisite to more advanced reforms in local finance will be undertaken first.

In summary, it may be useful to list some of the key issues for reform with respect to municipal finance and fiscal decentralization. These must include the following:

- Deciding on the degree of autonomy for local government, specifically with respect to the degree of fiscal independence allowed, and the extent to which fiscal discipline will be a goal of the intergovernmental fiscal system;

- Formulating a clear expenditure assignment so that there is greater clarity on the role of local government;

- Determining the appropriate share for the local government sphere;

- Formulating a clear and realistic human resource development plan to enable local governments to govern themselves;

- Establishing an effective monitoring and information system for use by the center in leading the decentralization process including considering the creation of an intergovernmental policy unit at the central government level to guide, monitor and evaluate the new fiscal decentralization program;

- Ensuring appropriate and adequate sources of local government own-source revenue; and

- Determining the extent to which there can be asymmetric decentralization, so that those municipalities that are relatively well-developed with respect to financial, human and other resources can move along the decentralization path at a faster pace than those that are not. The experience of the South African schooling sector with asymmetric decentralization may be worth noting in this regard.

Consolidating a strategy for intergovernmental fiscal reform is a great challenge in any environment. South Africa has already undertaken reforms that are moving the system in the right direction and beginning to meet key national goals. In spite of such positive developments, several factors complicate and inhibit development of a more effective intergovernmental fiscal system. The benefits of greater clarity on the details of local government structures and functions, better information on which to make decisions and design reforms, improved coordination of the various actors involved, and a more fully articulated but flexible implementation strategy would be substantial. Together, these elements would further the development of a politically acceptable, institutionally appropriate, and fiscally sound system of local government with the capacity to contribute to South Africa's considerable development challenges.

ANNEX 2A
COMMENTS ON DRAFT 10 OF PROPERTY RATES BILL

Prepared by Roy Bahl
November 17, 2000

I have read through this a few times and made notes. But my eye will not catch things the way a wily old valuer or treasurer will. What we all have learned is that big legal loopholes are a significant enemy of good policy. So, tight wording with an eye on the loopholes is so very important. That said, here is what I pick up.

Good Things That I See

1. We do have a draft of the Legislation, and that is a first and very important step. It is long past time to get on with it.

2. A local government can choose to tax land or tax land and improvements, or to use a split rate. I like that.

3. There is provision for special assessments (page 7). This is very good. This means that in designated areas, we can charge a special property tax for new public improvements (e.g., sewers or roads), and this money must be spent in the areas where the tax was paid. This is important and good policy. However, it is not clear what it means that the municipal government must "consult the people".

4. Page 13. If someone does not pay up, the government can collect the rent from the tenants and keep it. Good, but I do not see any other penalty on the landlord, e.g., that he cannot sell the property until he settles up, or he owes a collection fee to the government, penalty, etc. Also, this puts the government in the landlord business, and that can be costly.

5. Page 14. Revaluation every five years at most, four years is the legal norm. This is probably reasonable, and I see there is provision to update the roll in the intervals if new property comes on, etc. However, what I do not see is a statement about what happens to the local government if it does not get its roll done in four years. What incentive do they have? Why not withhold a portion of the equitable share, or deny borrowing privileges, or something? Otherwise there can be little revenue growth and more asking for grants.

6. Page 17. Good job of letting the courts know that all of the modern techniques of valuation will be acceptable to the law. Hurrah. (However, who is going to train the judges?) Also good is that the valuation of improvements does not have to be in current use – at least that is the way I read this. Or have I read it wrong?

7. Page 14. Monitoring valuation quality is a welcome part of the law. This is very good idea. Now the valuers can tell us if it has appropriate teeth. Who will take on this new responsibility?

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8. Those who appeal must pay the amount they owe while the appeal is being decided, right? Even businesses, right?

Things That Did Not Make Me Jump With Joy

1. I think, on page 5, they make provision for a classified property tax, whereby different types of properties can be taxed differently. This flies in the face of fairness. Why not let the different values of land be reflected in good assessment, and then let a uniform rate apply to all properties. Surely this is a better way to discriminate among properties of different types. Otherwise, it is a very subjective matter and lends itself to political bargaining. Get it right in the law and politicians are protected from the special interest groups, whether they want to be or not.

2. On page 7, it says that the Minister may limit the rate or the rate increase. This is not the way to enhance local self-government. At present the Minister of Finance has capped the RSC levy, thereby turning it into a grant. The same could happen to the property tax. What is wrong with letting the local governments tax themselves as much as they want, especially the big cities? Otherwise they will just turn to the center to make up the difference in grants. Also, think about borrowing capacity. In order to enter markets, the local governments must be able to show that they can raise revenue to cover the debt service, without asking permission. Finally, does this provision mean that the minister can limit the rate on each municipality, individually?

3. I think it says that government property cannot be taxed. Actually, government (national and provincial) use up property that is potentially valuable and crowds out private use thereby reducing local government revenue. Moreover, they use general local services, such as streets and traffic control, street cleaning, and they hire employees who are products of the local education system, etc. So, why not make them pay at least a contribution in lieu of property tax. In effect, this is a negative grant to the local government. Not good policy, I think.

4. Page 18, I think, says that land values must be established in current use only. This is very wrong. The whole idea of a land value tax is to stimulate owners to move from lower to higher value uses, and this provision actually rewards one who has underutilized the land. Suppose I own property in a high rent commercial district, but I have a one level dilapidated parking garage on it. I am just speculating and waiting until the price is right. The property tax in this regime should value the site in its highest use, and should ignore what improvement is on the property. This is really a world class bad idea.

5. Page 19. The law says that only taxable properties should be included on the valuation roll. I think all properties should be shown, This way one can readily calculate a tax expenditure associated with exempts, relieved, etc. and learn more about the cost of these exemptions.

6. For the valuation board, they stop short of stating the qualifications of the four valuers who are members. Why not use the same language as above when the stated the quals of the municipal valuers?

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7. Page 30. Now for the biggie. Strict penalties for non-payment are not included. The "max" is R5000 and 6 months in jail. A better route would be (a) pay tax plus interest with latter tied to market rate, and pay penalty, and (b) have provision for seizure of property. Did I miss this? Stating the penalty in absolutely rand amount makes non-compliance a better deal for big businesses and high-income people!

Things That I Am Confused About

1. Who gets to decide on exempts and rebates?

2. Is the tax to be deductible for businesses from their income tax liability?

3. What about church; and charitable?

4. On page 7, must land or land and improvements be assessed. If a place chooses to tax only land, would it still have to assess improvements? If so, it seems like a lot of administrative cost for the purpose of gathering data to measure fiscal capacity.

5. On the phasing in discussion on page 7-8. I am a little unsure about whether an interest charge is levied here? If not, it does not seem fair to those who pay promptly. Does this phasing in option, give the municipal officials a lot of discretion in relieving property tax? In rural areas where they rely heavily on grants, this may be a mighty temptation.

6. On rebates and exemptions discussed on page 11, it seems that the field is open? It is significant that there is no mention of a required fiscal note, i.e., if I exempt Fred, I need to show the amount of revenue loss and how I will make it up.

7. What about rural property and agricultural property in urban or semi urban areas?

8. Who will handle the work that needs to be done in the Ministry to oversee the new property tax?

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ANNEX 2B
COMMENTS ON DRAFT 11 OF SOUTH AFRICA PROPERTY RATES BILL

Prepared by Roy Bahl
August 6, 2001

In general, I think the bill in its preset draft form is pretty good. There will always be disagreements, but I think this version is very professional and very defensible. There are, however, some things that I would quibble with as maybe being not the best for South Africa. So, in the following, I have concentrated on what I think to be the problems, and not on the strong points and the very, very good work in this document.

<u>The bill seems to call for a classified property tax</u>, wherein different types of property may be taxed at different rates. In my opinion, this is not good public policy, and a uniform rate is the better way to go. I would make the following arguments:

The different assessed value of the property already differentiates between high and low valued properties. If a commercial property is worth more, it will pay more tax at a uniform rate in the rand. There is no need for an additional rate differentiation.

Why impose a differential higher rate on certain properties (presumably, commercial and industrial)? If you do, this is shifted on, either to consumers of the products in the form of higher prices, or to workers at the establishment in the form of lower wages, or to owners of the business in the form of lower returns on their investment. If we want to tax wages or profits or consumer purchases, let us do it directly so we know what is going on! (But mostly, let us get away from the notion that businesses somehow pay taxes.)

If we tax one use of property more favorably than another, we are artificially changing the relative prices/profits of these activities. This means we believe that the government bureaucracy knows better than the market, what is “best” for the local economy. Unless there is a compelling reason to tax such properties at higher rate (e.g., they make extraordinary use of government services), better not to do it.

When we allow for the differential taxation of certain types of property, we invite politicians to do what they think is popular, no matter how harmful this is to the economy. For this reason, “classified” property taxes, in the form of differential rates or differential assessment ratios, are a very bad idea. A better law for South Africa would call for a uniform rate and let the differentiation in tax bills come exclusively from the valuation process.

The “categories of property” listed in the bill should be unnecessary.

<u>On the amount of the tax rate</u>. The bill says that the minister(s) will be able to regulate the allowable rate increase. This is a good way to exert control over the finances of local governments. It restricts locals from imposing inordinate increases in the property tax rate, which may be unpopular. It also lets the center regulate the overall national tax burden.

However, such central control also has some very negative features. It limits local autonomy at exactly a time when the government is attempting to promote decentralization. It shifts accountability of local councils: away from accountability down to voters, toward accountability up to the central government. Consider the following: the local government wants to increase service levels, or to make provision to repay debt. The decentralist would say "Let them fight the proposed tax rate out with their voters, and let their accountability be down to voters". If instead, the responsibility is passed up to the Minister, then local councils are no longer making their own decisions and local voters will not hold them accountable.

Also, why would a prospective bondholder feel comfortable with this provision? Certainly, it limits the discretion of the local government to meet the repayment obligations when times are tough. This should lead to lower ratings and higher interest costs to compensate for the additional risk.

Finally, there is the issue of history. Exactly the same provision is now in effect for RSC levy where the rates are now frozen. Why would we expect this would not be done in the case of the property tax?

This provision also lets the minister cap rates for certain types of property. What a temptation, and what pressure certain interest groups will bring, and what a way to introduce politics into the process.

I think a better route, if decentralization is a government objective, is to let the locals set the rate, as they do now. Let the councils be accountable to voters. If there must be a control, then let it be an overall limit, with considerable tax room, where the local government can increase the rate to that limit without asking permission. Not to do this, is for the central government to put itself in a position of having to bail out the local governments when they cannot meet needs.

<u>Tax rates and valuation rolls</u>. As I understand it, the tax roll is put in place for a period of 3 to 5 years. The tax rate to apply to that roll is more or less fixed for this period. There are two very big problems with this.

First, there will be little growth in the valuation roll (only new property and new buildings). No "natural" growth will be allowed. The rates may only be increased in the interim with the permission of the minister. This means little elasticity to the property tax, i.e., revenue growth will be limited. But expenditure growth will continue (with inflation, demand for new services, mandates, etc.). How will the gap be covered? By central government transfers?

Among the alternatives, one could build in an inflation adjustment each year, or allow the local government to increase the rate of tax. But, presently, the bill effectively imposes a slow growth on the property tax, and this means that the central government will need to find a way to fill the gap.

Second, when the tax on a property is held constant for four or five years (even though values have grown), the results of a revaluation come as a shock to ratepayers. In fact, political resistance is almost guaranteed, and there will always be pressure for transition plans or for rollbacks. So, an inflation adjustment in the years between revaluation, or better yet, an ability to increase rates, could ameliorate this problem.

On recovery of rates from tenants and occupiers. This bill makes provision for recovering from tenants, rates that are unpaid by landlords. I am not sure about the wisdom of this. It makes perfectly good intuitive sense, but implies a big administrative cost to government. Now the government will be in the landlord business. It must collect, it must collect the right amount, it must deal with delinquent ratepayers, etc. How about disrepair of buildings with landlords, who do not pay tax, will government deal with this as it negotiates with tenants? This is really a non-starter. A better route will be to take the property and sell it at auction. Or, appoint a property management firm to handle the property in the interim. But government itself should not be in the landlord business to collect unpaid taxes by landlords.

On exemptions. I think the right thing to do is for the bill to prescribe the blanket exemptions. Obviously, government property is the big issue. The reasons to tax "other " government property are persuasive: they are users of services and they crowd out other taxable uses of property. If a property does not use local government services or uses only partial services, then maybe a contribution in lieu or exemption is appropriate. This is done all over the world. If a land use does crowd out anther private use (e.g., a government office building) then it ought to be taxed. A national park, Table Mountain, is another issue. In general, with the exception of those exemptions specifically prescribed in the bill, then the local government should have the exclusive right (without seeking approval) to tax or not tax. [That is the position that would be taken by a "decentralist".]

On the tax base. Is it to be uniform, and levied on the value of land and improvements? This is a tough issue, and the following might be considered.

The present system lets the local governments decide what they will tax. A few countries do this. It is consistent with decentralization. The fact that South African local governments do in fact choose all three bases [site, improved and differential], tells you that preferences are in fact different around the country. Why does one want to impose uniformity and take away this choice?

Uniformity would give some advantages. The nominal rate would be lower than if only land value was taxed, making the system more acceptable to voters. People understand the notion of valuing the whole property whereas land valuation alone is a bit mysterious. South Africa apparently has some good total property value data. Finally, if all locals were required to value the same base, then we would have an objective measure of fiscal capacity that we might use for other purposes where we need to measure fiscal capacity.

But, uniformity and the taxation of total property value also have some significant disadvantages that might suggest the taxation of sites to be a better route. Local governments could have more autonomy/choice in a non-uniform system. The taxation of buildings discourages an optimal use of land, whereas a land tax does not. The assessment of every building in South Africa, and updating all improvements (every building permit), implies some additional administration duties. This could be costly. A tax on land probably falls on landowners, which makes it more progressive than a tax on land and improvements, which falls on both landowners and renters. So, a uniform tax on land and buildings is probably less equitable than a tax on land alone. I know this seems counter-intuitive, but it is by now widely accepted and I think a correct conclusion.

So, the choice of a uniform tax on land and improvements is not an easy one, and there are important pros and cons to consider.

Also on valuation. What is the plan for farmland located on the fringe of urban areas? Will it be valued at highest and best use or will it be valued at actual use. The law would seem to imply the former, but it is not clear. This will be an important issue.

8. What about penalties? I am told this will go in another act, but I wonder …. . The penalties and sanctions for non-payment of property tax could include confiscation of land and sale at auction. I wonder if this is not different enough from other tax penalties to warrant something very separate?

ANNEX 3A
DPLG LOCAL GOVERNMENT FISCAL REFORM PROJECT

INTERNAL PROJECT MEMORANDUM
Prepared by Andy Reschovsky
August 18, 2000

Issues Surrounding the Horizontal Allocation of the Local Government Equitable Share for Financial Year 2001/02

Introduction

Local government in South Africa is in a period of transition. As a result of the demarcation process the existing 843 local governments will be replaced later this year by 284 newly demarcated local governments. A number of these new local governments will also be assigned new powers and functions. The drafting of a property rates bill and active discussion within Government of possible reforms of the RSC levy suggest that in the near future the revenue-raising capacity of local government may change. As local governments mature as democratic institutions and as their financial management capacity increases, their service delivery responsibilities will almost certainly expand.

Equitable share allocations play an important role in the financing of local government public services. In this period of transition to newly demarcated local governments, it is important that to the extent possible, the basic structure of equitable share transfers remain as stable as possible. It is also important for the allocation process to be transparent. With these goals in mind, DPLG and the National Treasury would like to announce equitable share allocations based on the Medium Term Economic Forecast period (MTEF). Whether estimated allocations for the second and third year of the current MTEF period can be released along with the 2001/02 allocations will depend on the availability of the appropriate data.

The transition to the newly demarcated local governments raises a number of issues concerning the formulas used to allocate equitable share transfers. The purpose of this memorandum is to discuss the major issues that must be dealt with before the local government equitable share allocations for the 2001/02 financial year can be calculated, and to suggest a number of alternative policy options. A detailed analysis of these issues will need to await the completion of a database for the newly demarcated local governments that will allow simulation of alternative equitable share allocations.

As a prerequisite for a discussion of the issues involved in determining the 2001/02 equitable share allocations, the next section will provide a summary of the formulas currently used to allocate the equitable share to local government.

The Current Equitable Share System

The Equitable Share was distributed to local government for the first time during the 1998/99 financial year. Starting with that fiscal year, two formulas have been used to determine each municipality's equitable share allocation, the Municipal Basic Services Transfer (the S grant) and the Municipal Institutions Transfer (the I grant).

I Grants

The purpose of I grants is to guarantee that every eligible municipality has available sufficient funds to finance the basic operations of a local government. The I grant is thus an institution building grant for newly created democratic local governments. The I grants are designed so that they will fill in the gap between the funds needed to "...provide and maintain basic facilities for the operation of local government" (Department of Finance, 1998; p. 13) and the amount of money each local jurisdiction is expected to raise from local resources. Although local government are not permitted to tax the income of residents, average per capita income within each municipality is used as a measure of the revenue-raising capacity of municipalities. Among municipalities of any given population size, municipalities with higher levels of average income receive smaller I grants. Relatively high-income municipalities are considered to have sufficient revenue-raising capacity to finance the basic operations of government on their own, and hence they do not receive an I grant. Because municipalities with very low populations are considered too small to provide efficient public services, eligibility for I grants is limited to those municipalities with populations in excess of 2,000 people.

The formula used to allocate the I grant is designed so that the resulting distribution of grants has the following characteristics:

- Holding population size constant, smaller I grant allocations are made to municipalities with higher levels of average monthly per capita income.
- Holding per capita income constant, *per capita* I grant allocations decline as population size increases.
- For any given income level, I aggregate grant allocations increase in size as population size rises up to a *population threshold*. Above the threshold, the size of the I grant allocation declines as population rises, with the thresholds being higher for lower-income jurisdictions.

The I grant is allocated using the following formula:

(1) $I_i = I^* P_i^{\gamma} - 0.05 * (y_i - 180) * P_i$

Where I_i = the I grant allocation to municipality i (with no grant allocated in cases where the formula yields values less than zero),
I^* = a per capita I grant parameter that serves to determine the total amount of money allocated through the I grant,
P_i = the population in i,
γ = a scale parameter that could take any value > 0 and ≤ 1, but has been set at 0.25,
y_i = average monthly income per capita in municipality i. For values of y_i below R180, the term $(y_i - 180)$ is set equal to zero.

To get a better picture of how the I grant operates, the formula in (1) can be written in per capita terms as shown in (1'):

(1') $I_i/P_i = I^* P_i^{\gamma-1} - 0.05*(y_i - 180)$

For the 2000/01 financial year, approximately R206 million is being distributed through the I-grant formula. Given that γ has been set at 0.25, the I grant budget was achieved by setting I^* equal to R61,750. Note that as long as γ is defined to be less than one, the exponent to P is negative, implying that larger population size leads to smaller per capita grants. The expression $0.05*(y_i - 180)$ represents a measure of each municipality's ability to raise revenue, where revenue-raising ability is measured as five percent of the municipal residents' average monthly per capita income in excess of R180. The formula defines the norm for revenue raising effort by municipalities as five percent of income. Both this income percentage and the R180 poverty line represent explicit policy decisions taken by the Government.

S Grants

The largest portion of the equitable share payments to local governments is allocated in the form of S grants. According to the Government, the purpose of these grants is "to ensure that low income households in all municipal jurisdictions receive access to basic municipal services" (Department of Constitutional Development, 1999). The approach is to provide each government with a block grant that is equal to the estimated costs of providing "basic services" to all residence living in poor households, where, for purposes of this grant, poverty has been defined as household income below R800 per month. Specifically, an S grant to municipal jurisdiction i (S_i) is calculated using the formula below:

(2) $S_i = \alpha\beta\, L\, H_i$

where α = a phase-in parameter with $0 < \alpha \leq 1$,
β = a budget-adjustment parameter, set to adjust the size of the grants to the available budget,
L = an estimate of the annual per capita cost of providing basic public services, and
H_i = the number of people living in poverty as measured by the number of people living in households with household incomes of less than R800 per month.

Because rural municipalities will in general require a longer period of time to develop the capacity to provide a full range of basic services, the S grants will be phased in over a seven year period for rural jurisdictions and a five-year period for urban and metropolitan governments. α was set at 0.1 for the 1998/99 financial year and at that time was scheduled to increase annually by 0.15 for the next six years. For urban and metropolitan jurisdictions, α was set equal to 0.6 for the 1998/99 financial year and was scheduled to increase by 0.1 over the remaining four years of the phase-in period. Thus, for the 1999/2000 financial year, α was set at 0.25 for rural municipalities and 0.7 for urban and metropolitan municipalities. These values were retained for the 2000/01 S-grant allocations.

For the purposes of determining S grant allocations, L, the per capita annual cost of basic electricity, water, refuse, and sanitation services has been set at R252. Under the assumption that there are on average 4.1 people living in each household, R252 is equivalent to R86 per month per household. The R86 per month number comes from a cost estimate made several years ago by the Development Bank of South Africa. Although an updated study has not been undertaken, R86 per month is almost certainly an underestimate of the current user costs associated with these four basic services.

The current budget allocation for the S grant is below the amount of money necessary to provide municipalities with R86 per month for each poor household. To reflect these budgetary constraints, β, the budget adjustment parameter, is set at less than one. The National Treasury has estimated that full funding of the S grant (i.e. $\beta = 1$) would require an annual equitable share transfer of R5.6 billion.

"Guaranteed Allocations"

To prevent or at least minimise potentially serious disruptions in municipal services in municipalities that faced substantial declines in transfers as a result of the implementation of the equitable share system, the Government decided to phase out the "historical" aid allocations over a period of seven years by guaranteeing that during this period every jurisdiction receive *at least 70 percent* of the transfer amount it received in the previous year. Thus, the actual equitable share allocation going to each municipality is the sum of the formula-determined S and I grants or 70 percent of the previous year's allocation, whichever is greatest.

Issues Surrounding the 2001/02 Local Government Equitable Share Allocations

There are five major issues that need to be addressed as a prerequisite for determining the equitable share allocations for financial year 2001/02. These are discussed below.

1. What Future for the I grant?

If the I grant formula with the current parameter values is used to calculate I grants for the 2001/02 financial year, there is good reason to believe that total I grant allocations will be substantially reduced. As per capita I grants are smaller for larger municipalities, and average municipality size will increase substantially with the conversion to the newly demarcated boundaries, average I grant allocations will be reduced. It is also possible that the average incomes calculated for the new municipal jurisdictions will result in smaller I grant allocations.

The current I grants are intended to help small, poor municipalities establish basic institution of governance and financial management. As a result of demarcation, most of the municipalities currently receiving I grants will be merged with larger, more established municipalities. The need for I grants may thus be reduced.

There appear to be several policy alternatives.

- Retain the current I grant formula and the current values of the I* and γ parameters. As this option will result in fewer rand being distributed through the I grant formula, allocate these newly available funds through the S grant formula.

- Continue to allocate approximately R200 million through the I grant formula by appropriately adjusting the I* and γ parameters. Given the nature of the I grant formula, this option would result in I grants being allocated to the smallest and poorest of the newly demarcated municipalities.

- Allocate the funds currently being distributed through the I grant formula through a new formula (perhaps using a different name) which targets transfers to those newly demarcated municipalities that include substantial numbers of residents who are not currently served by well-established local governments. The purpose of this new grant would be to assist newly established Category B municipalities in expanding the institutions and infrastructure necessary for the delivery of services to that portion of their population not currently benefiting from well established local government. The grant formula might be designed so as to target poor local governments with a high proportion of their residents living in rural areas within the municipal boundaries. As the purpose of these new I grants would remain institution building, the formula for the distribution of these grants should be structured so that the total allocation through the formula is phased out over a period of several years. Presumably, as these new I grants are phased out, the available revenue would be used to increase the funding available to distribute via the S grant.

- Replace the existing I grant with a new grant targeted to Category C municipalities (more on this below).

2. *Should the a, the Urban-Rural Parameter in the S Grant Formula, Be Modified?*

The purpose of the α in the S grant formula is to reflect existing differences in the capacity of rural and urban municipalities to efficiently and effectively utilize S grants. For example, to the extent that local governments use their equitable share allocations to subsidize electricity and water services for poor households, rural local governments that lack water and electricity capital infrastructure will be unable to utilize their S grants for the intended purpose. Over time, as municipal capacity for service delivery increases, equitable share allocations will be increased in line with the increase in the value of α.

In reducing the number of municipal governments in South Africa, the Municipal Demarcation Board has in many cases combined existing urban and rural municipalities into a single jurisdiction. It will thus be no longer possible to categorize many municipalities as being *rural* or *urban*. As differences among the newly demarcated local governments in their ability to deliver services will remain, the challenge is to decide whether to establish a new mechanism for phasing in equitable share allocations. Here are three possible options:

- Eliminate the α's from the S grant formula. If it is determined that the differences in the capacity for public service delivery of the new municipal governments have been substantially reduced, then it may be reasonable to eliminate α from the S grant formula.

- Adapt the α's to reflect the six-way classification of local government capacity developed by the Municipal Demarcation Board. As this classification scheme is designed to reflect differences among municipalities in capacity, it may, if the classification is deemed reasonably accurate, provide a good basis for differential phase-in of the S grant.

- Use census data on settlement patterns (calculated at the enumeration district level) to calculate the percentage of the population of newly demarcated local governments that are classified as rural and urban, and use these data to define a value to α for each municipality. Local governments with a relatively high proportion of their population classified as rural will be assigned a lower α value.

It should be noted that in the past, increases in the values assigned to α where not explicitly linked to the total money available to distribute through the S grant formula. If increases in the value of α are not reflected in a corresponding increase in the total equitable share budget, the increases in allocations to rural jurisdictions will be largely funded by decreases in the allocations to urban local governments, regardless of their fiscal condition.

3. Should Category C Municipalities Receive Equitable Share Allocations?

Only Category B municipalities receive equitable share allocations. It has been argued that Category C municipalities can fulfill their public service responsibilities by relying on own-raised revenues, mainly RSC levies.

As a result of the demarcation process, 40 Category C jurisdictions will be created. These jurisdictions, which are either metropolitan or district councils, will all be assigned new planning functions. In some cases, where their underlying Categories B municipalities are deemed not to have the capacity for the delivery of services, Category C municipalities will be mandated to provide these services for the Category B municipalities within their boundaries.

One important issue is the extent to which Category C municipalities have sufficient revenue-raising capacity to fulfill the powers and functions assigned to it as a result of the demarcation process. The constitutional implications of the assignment of functions to Category C municipalities also needs to be assessed.

There are several policy options:

- Establish a new equitable share grant that is targeted to Category C jurisdictions. The purpose of this new grant would be to facilitate the provision of Category C functions. As some Category C local governments already have substantial reserves, the allocation formula should favor jurisdictions with limited capacity to raise RSC levies. The practical problem is one of developing an operational measure of RSC levy capacity. Funding for this new grant could conceivably come from the funds currently being allocated to the I grant (see above).

- Category C jurisdictions that are in fact assigned substantial Category B functions could be given a portion of S-grant allocations that are currently being allocated to all Category B municipalities. In cases where Category C municipalities effectively provide most Category B public services, most, if not all, the S-grant allocations to those Category B jurisdictions could be transferred to the overlapping Category C jurisdiction on an agency basis in return for the direct provision of public services of by the Category C governments.

4. *Is It Possible to Improve the Measure of Poverty Used in the S-Grant Formula?*

The S grant allocation to each local government is proportional to an estimate of the number of its residents living in poverty. The calculation of S grants is thus highly sensitive to the measurement of poverty. The major issues involve first deciding below what level of economic well-being a person is to be considered poor, and then determining an accurate count as possible of the number of poor persons residing in each municipality.

During the three financial years over which the equitable share has been distributed to local governments, the Department of Provincial and Local Government and the National Treasury did not have available to them income distribution data at the municipal level from the 1996 census. Instead, they relied on a quite complex method for estimating the distribution of income in each municipality. This method was based on the assumption that the underlying distribution of income could be described in all municipalities by a cumulative log-normal function, where the standard deviation of income varied only by province and urban/rural status.

During the past year, Statistics South Africa (STATS SA) in collaboration with the World Bank, has been evaluating the accuracy of the income information provided in the census. The 1996 census asked each individual about his or her income. By contrast, STATS SA's Income Expenditure Survey asks each household a set of detailed questions about both their income and their expenditures. Their (as yet, unpublished) findings suggest that census income provides a substantial underestimate of household income and consequently an overestimate of the rate of poverty in South Africa. Of even greater significance, they conclude that the overestimate of poverty differs systematically by place of residence, being higher in rural areas (former homelands) and in formal urban areas.

Economists generally agree that data on household expenditures provides, particularly for households with limited economic resources, a better measure of total income (or, more generally *ability to pay*) than data on cash income. In South Africa, expenditure data are available from STATS SA's Income and Expenditure Survey. An analysis of these data by a team from STATS SA and the World Bank indicate that poverty rates calculated using expenditure data are lower than poverty rates based on census income data.

By combining the Income and Expenditure Survey with the October Household Survey, STATS SA estimated a statistical relationship between household expenditures and a set of economic, social, and demographic characteristics. They proceed to show how this statistical relationship (different for each province) can be used to impute household expenditures to households in the 1996 census, and to provide an estimate for small geographical areas of the number of individuals living below any given poverty line (defined in terms of expenditures). They argue that their methodology is particularly well suited for providing poverty counts for local governments.

As a means of improving the quality of the poverty data used in the S grant formula, one of the following strategies could be pursued.

- Request STATS SA to provide a count for each newly demarcated municipality of the number of residents living in households with household incomes below the poverty line, where the income data come directly from census data on incomes. These poverty counts should be calculated for several alternative definitions of the poverty line. In providing these counts STATS SA should adjust 1996 census income data for increases in income and in population that have occurred between 1996 and 2001.

- Ask STATS SA to provide an estimate for each newly demarcated municipality of the number of residents living in households with household expenditures below the poverty line. These estimates should be based on the new methodology developed by STATS SA and the World Bank. These poverty counts should also be calculated for several alternative definitions of the poverty line defined in terms of monthly household expenditures. The poverty counts estimated by STATS SA should be based on estimated household expenditures for the year 2001.

To make a decision of whether to base poverty counts on income or expenditures, it would be useful for DPLG and National Treasury to convene, as soon as possible, a joint workshop (or reference group) on this issue. In addition to DPLG and National Treasury officials, it would be very helpful if representatives from STATS SA, the World Bank, and appropriate academic experts were asked to participate.

Independent of which of the above alternative is chosen, a decision must be made about the level of income (or expenditure) at which to draw the poverty line. Note that the poverty level (expressed as monthly household income) used in the S grant formula during the past three years is R800. This number apparently comes from a 1993 study, and has not been adjusted for inflation since then.

One reason the poverty line has not been adjusted is that with a given equitable share budget (in any year), an increase in the number of poor individuals (H_i in formula 2) will require that the budget adjustment parameter is adjusted downward. An increase in the poverty line will, however, result in larger S grants going to municipalities that have a relatively large proportions of population with income (or expenditure) just above R800.

In order to calculate estimates of the equitable share allocations for local government for the second and third year of the 2001/2004 MTEF period, STATS SA will have to provide estimates of population, poverty counts, and average monthly per capita income for the years 2002 and 2003.

It should be noted that the measurement of *ability to pay* using expenditure rather than census income will result in a lower poverty rate for any given poverty line. Thus, a constant average poverty rate could be maintained by combining a switch to an expenditure-based measurement of ability to pay with an increase in the poverty line.

5. How Should the Existing "Guaranteed Amounts" be Allocated to the Newly Demarcated Jurisdictions?

As currently defined the guaranteed amounts only exist for the existing municipalities, not for the newly demarcated jurisdictions. The issue is to develop a methodology for assigning a guaranteed amount to each newly demarcated municipality. In cases where the newly demarcated municipalities are made up of several complete existing local governments, the guaranteed amount for 2001/02 equitable share allocations could be defined as 70 percent of the sum of the 2000/01 allocations going to all the component municipalities.

For newly demarcated local governments that are composed of parts of existing municipalities, the guaranteed amounts would need to be determined by splitting the 2000/01 allocations between more than one newly demarcated jurisdiction, with the division of the guaranteed amount being proportional to the population split of the existing municipality among the new jurisdictions. Preliminary data indicate that this procedure will only have to be undertaken in about 15 percent of the newly demarcated local governments.

ANNEX 3B
MEMORANDUM

TO: Wendy Fanoe

FROM: Andrew Reschovsky

DATE: January 23, 2001

RE: Parameter Choice for I Grant Formula

You asked for some advice on parameters to use in the I grant formula. I don't have much time this week as this is the very beginning of the semester, but I did find a little time to look at a few I grant simulations. Here is what I learned:

I made the following three assumptions: (1) the amount of money allocated through the I grant formula would remain at about R206,800,000, (2) no jurisdiction with a population below 2,000 would be eligible for an I grant, and the "fiscal capacity" element of the formula would be defined as average monthly per capita income in excess of R300. With these assumptions I ran nine different simulations. Remember that with a fixed budget there is only one degree of freedom. In other words, if one chooses a value for I*, γ is automatically determined, or visa versa, any chosen value of γ, implies a value for I*. Here are the parameter values for the nine simulations:

	I*	γ
1.	9,875	.485
2.	25,600	.402
3.	35,600	.373
4.	74,750	.308
5.	96,250	.285
6.	107,750	.275
7.	124,650	.262
8.	199,450	.220
9.	301,000	.183

The first thing to note that is under most of the simulations, 160 Category B municipalities receive I grant allocations. The exceptions are as follows: under simulation 1, 156 municipalities receive allocations, under simulation 2, 161, and under simulation 8, 162.

Second, as the value of I* is increased, per capita allocations to small municipalities grow and per capita allocations to larger places get smaller. Thus, the average per capita I grant in municipalities with population below 10,000 is R49.5 in simulation 1 and 163.3 in simulation 9. At the same time, the average grant is R4.6 in simulation 1, but only R2.4 in simulation 9.

Third, as the value of I* is increased, the value of the average I grant to poor municipalities is (to a small extent) diminished. Thus, the average per capita grant in municipalities with average monthly per capita income below R500 is R14.9 in simulation 1 and R11.6 in simulation 9.

Fourth, the various different parameter values make almost no difference in the distribution of per capita I grants across the provinces and across municipalities characterized by percentage of urban population.

As the rationale for the I grants is to assist municipalities in fundamental institution building, if we had more time, it would make sense to use information we are gathering in Tasks 1 and 4 to identify newly demarcated municipalities that appear to be in particular need of institution building and then look which set of parameters does the best job of targeting those municipalities.

ANNEX 3C
MEMORANDUM

TO: Wendy Fanoe

FROM: Andrew Reschovsky

DATE: January 29, 2001

RE: National Treasury Proposal for Updating Poverty Data for 2001/02 Equitable Share Allocations

Peter Vaz sent me a copy of Vusi's Friday email to Pieta at StatsSA in which Vusi asks StatsSA to update income and expenditure data (and poverty counts) using provincial-level inflation data. Vusi's email indicates that the National Treasury did not accept the updating method proposed by DPLG, namely, basing changes in the number of poor on the changes in employment by industry (i.e., the method developed by the HSRC).

Although you have not requested my advice, I wanted to let you know that at first glance it seems to me that basing changes in the poverty rate on provincial differences in inflation rates makes little sense. If I understand correctly, using provincial inflation rates to update household incomes and expenditures implies (1) no change in the relative distribution of incomes within provinces and (2) larger increases in income (or expenditures) and hence larger declines in poverty, in provinces with above-average inflation rates. Are these reasonable conclusions? An alternative interpretation is that since by definition, provincial-level inflation measures differences in price levels, not differences in income (however measured), an above-average increase in the cost of living (as measured by the inflation rate) would reduce households' ability to purchase basic goods and services and would thus **increase** poverty. If this interpretation holds, then using the provincial inflation rate to update 1996 income and expenditure data would result in increases in relative poverty in provinces with above-average inflation rates.

Which of these two interpretations best explains the relationship between the inflation rate and the poverty rate in South Africa? The answer to this question depends, at least in part, on the reasons why the inflation rate differs across provinces. If, as seems likely, inflation is higher in some provinces than in others because of supply or cost considerations, such as fuel shortages or drought conditions, then higher inflation will be correlated with **above-average** increases in poverty. In order for above-average inflation rates to result in reductions or **below-average** increases in poverty, inflation would have to reflect excess demand for goods and services resulting presumably from the combination of rapid growth in employment and incomes **and** some sort of impediment to the increase in the supply of goods and services. It seems highly unlikely that this set of conditions would hold in the South African economy with its high rate of unemployment. Furthermore, for demand-driven inflation to result in lower poverty rates, income growth would have to be strong among low-skilled (and hence, low-income) workers. There is no reason to believe that such conditions existed in South Africa over the past few years.

Although the HSRC methodology is not perfect, it seems to me that it will result in a much more accurate estimate of the number of poverty households than any methodology based on inflation.

In any case, if you go ahead with the use of inflation data, I would be glad to update the ES model to account for the new poverty counts. Just send me the appropriate data sets.

ANNEX 4
MEMORANDUM

TO: Wendy Fanoe

FROM: Andrew Reschovsky

DATE: December 20, 2000

RE: Local Government Equitable Share Simulation Model (LGESSM)

I am attaching to this message an Excel spreadsheet, which contains an equitable share simulation model. The model is meant as a tool to facilitate the evaluation of alternative formulas and parameters values. The model has been explicitly designed to help you address the five issues identified in my August 18th memo "Issues Surrounding the Horizontal Allocation of the Local Government Equitable Share for Financial Year 2001/02."

The basic structure of the two equitable share formulas, for the S and the I grants, remains unchanged. The model however allows one to address the following issues:

- The form and the value(s) of the phase-in (alpha) parameters used in the S grant formula.
- The underlying data used to measure household poverty.
- The rand amount below which a household is counted as *poor*.
- The parameter values to be used in the I-grant formula.
- The use of and the value of a "guaranteed amount".

The model is structured so that it is very easy to conduct alternative simulations and to compare the distribution of equitable share allocations generated by each set of parameters. The top worksheet is a control sheet. As indicated, there are just two steps to follow in conducting a simulation. First, define the parameter values in any way you like, and second, adjust the S-grant budget parameter, beta, until the number in the instruction box becomes zero. Then, switch to the third worksheet, the one marked "Tables" and you will find a ready-to-print table. The table has been set up to show the average value of the per capita amounts of the I grant, the S grant, and the actual equitable share allocation, by municipal population size (divided into seven categories) and by monthly per capita income (divided into six categories). The bottom panel of the table indicates the parameter values used in generating the current equitable share simulation. By printing out the table after each policy simulation (i.e. a choice of a different set of parameter values), one can easily observe--by comparing tables, the impact of changing parameter values on the distribution of per capita equitable share amounts.

Other analysis tables might be useful and can very easily be added. For example, the average per capita grant amounts by province and the average grant by percentage of urbanization might both be useful additions. Time permitting, I will add these tables.

The data can be found on the 2nd worksheet (*Calculations_0102*). Note that there are 259 rows of data, one for each Category A or B municipality. As you know, the original data sets from StatsSA and the updated data from HSRC consist of 359 rows of data. These extra data reflect the fact that there is more than one row of data for some municipalities. Multiple rows occur in cases when a newly demarcated municipality is divided between multiple Category C municipalities. The data in the spreadsheet are appropriate municipality totals or averages for these split municipalities.

Although the structure of the model is complete, it cannot yet be used for actual policy evaluation. As you are probably aware, there are problems with the data on the 2000/01 equitable share allocations (to the newly demarcated municipalities). Presumably, after the holidays, the folks from Argil will provide us with a corrected set of data. The corrected series should then replace the data currently in column V of worksheet: *Calculations_0102*.

You mentioned that you would like to explore the impact of measuring poverty using an average of income- and expenditure-based poverty counts. As it is currently constructed the model does not automatically allow this kind of combination, although it would not be technical difficult to adapt it to combine the two poverty measures. In my view, combining the two ways of measuring poverty makes no sense. The paper by Harold Alderman et al. in Statistics South Africa's recent publication *Measuring Poverty in South Africa* makes a very convincing case that an expenditure-based measure gives a much more accurate measure of true household resources than a measure based on the income question in the census. Although I don't find it convincing, the best argument for using an income-based measure is that it was used in the past. One disadvantage of using a combined measure is that it will be very difficult to explain to municipal officials and will tend to undercut the argument that expenditure-based data provides a more accurate measure of household resources and household poverty.

As a starting point, the set of parameters I chose were intended to allocate approximately the same amount of money through the I grant as in the current year, i.e. R206 million. Note that I also raised the per capita income floor in the I-grant formula from R180 to R300. This adjustment reflects an increase that is about equal to the estimated increase in per capita income in South Africa between 1996 and 2001. Note that if the I-grant formula parameters were left unchanged from their current values, the total amount of money distributed through the I-grant formula would be reduced to a mere R14.2 million.

Note also that the model I have sent you is only for the 2001/02 financial year. It would however be very easy to create parallel models for 2002/03 and 2003/04. Basically, all that is involved is updating the basic data using the estimates provided by HSRC.

In addition to the spreadsheet containing the model, I am attaching a Word version of this message, and two Excel tables, one listing the total number of households classified as poor in 2001 under the six policy options, and the other that categorizes municipalities by the percentage of their populations that is classified as urban.

ANNEX 5
MEMORANDUM

TO: Wendy Fanoe

FROM: Andrew Reschovsky

DATE: April 1, 2001

RE: 2001/02 Local Government Equitable Share Allocations

This memo is divided into two parts. In the first part, I will discuss a couple problems I see with the WEFA Equitable Share Allocation Model (ESAM) version 3. In the second part, I will briefly discuss several policy issues related to the 2001/02 equitable share allocations to local government.

ESAM Version 3

I want to start by saying that I was very impressed by Martin's modeling efforts. With a couple exceptions, documented below, I think he has done a fine job, and has produced a model that will be provide a useful tool for DPLG in its ongoing work on equitable share allocations.

First, I'd like to reiterate my concern expressed in an earlier email that Martin has used an incorrect definition of the "guaranteed amount". The ESAM is programmed so that in any municipality where 70 percent of last year's equitable share allocation is greater than the sum of the formula-based S and I grants, that municipality is not to receive any S or I grant. Instead, their entire allocation is classified as a guaranteed amount. It makes much more sense to argue that every municipality receives an S and I grant allocation as calculated by the official formulas, and in those municipalities where the sum of the S and I allocations are less than 70 percent of their previous year's total equitable share allocation, a supplemental allocation is awarded equal to the difference between 70 percent of the previous allocation and the sum of the S and I grant allocations. This supplemental amount is called the *guaranteed* allocation.

This might seem like merely an issue of how we label different kinds of grants. Given the way the model works, however, the labeling makes a difference in the actual allocations. The sum of the I grant allocations have been fixed at R260,000,000. To reach this target amount, the formula parameter values must be adjusted. If the I grant allocations for some municipalities (those with guaranteed allocations) are set to zero, then the parameters values must be changed in order to reach the R260 million target. Changing the parameter values, obviously changes individual I grant allocations. Changing the ESAM to reflect my definition of guaranteed allocations (which, by the way, is the definition used by DPLG in previous years), involves only a minor change in the existing model.

The basis of the guaranteed amounts are the equitable share allocations for the 2000/01 financial year. With considerable effort, you produced a file that lists all the 2000/01 allocations for the 262 newly demarcated municipal governments. With the following exceptions, the ESAM uses your numbers. The ESAM sets the 2000/01 equitable share allocations equal to R14,286 in 21 of the 25 District Management Areas (DMAs). For the remaining four DMAs, the ESAM uses your numbers, namely zero for the three DMAs with no population and R1,407,074 for WCDMA04. Your data indicate that the 2000/2001 allocations greatly exceeded R14,286 in most of the DMAs. I should note that as long as the DMAs are allowed to receive S and I grant allocations, these guaranteed amounts are irrelevant, as in every case the sum of the formula allocations exceed 70 percent of last year's actual equitable share allocations.

Equitable Share Policy Issues

The ESAM produces some very useful reports. I would like to supplement these reports with a couple tables that display the 2001/02 **per capita** equitable share allocation to municipal governments characterized by population size and by average monthly expenditure per capita. Table 1 is based on a simulation that is very similar to Martin's. In line with the discussion in the previous section, my simulation reflects a different definition of the guaranteed amount. *Control sheet A* is used to generate the simulation upon which the tables are built. The starting point is a total local government equitable share allocation to municipal governments of R2,259,877,000. Using the specified model parameters that amount is divided as follows:

S grant:	R 1,836,233,529
I grant:	R 260,000,000
Guaranteed amount:	R 163,643,470

Of the 262 municipalities (including DMAs), 192 receive an I grant allocation and 49 receive a guaranteed allocation.

Table 1 displays average per capita allocations for the I grant, the S grant, and the total equitable share allocation. It is important to emphasize that all averages in the tables are *population weighted* averages. This means that per capita grant amounts in large municipalities count more heavily in the calculation of the averages than per capita amounts in small municipalities. Using weighted averages instead of straight arithmetic averages makes a big difference when, as in the case of I grants, some small municipalities receive very large per capita I grant allocations. Thus, the weighted average I grant in municipalities with fewer than 10,000 people is R216 per capita, the corresponding unweighted average is R1,692 per capita!

Table 1 indicates that as expected, per capita I grants decline as municipal population size rises. In general, per capita I grants are also reduced as average municipal per capita income (or expenditure) grows. The relatively large per capita I grants growing to the small number of rich municipalities reflect the fact that these municipalities get relatively large per capita grants because of their small size. One could reduce the grants to relatively rich municipalities by increasing the size of the revenue-raising effort parameter. For example, if

Table 1:
Per Capita Equitable Share Allocations, Financial Year 2001/02*
By Population Size and Average Per Capita Monthly Household Income

Population Size of Municipality	Number of Municipalities	Average Per Capita I Grant	Average Per Capita S Grant	Average Per Capita Equitable Share	Percentage Change from '00/'01
Less than 10,000	27	216.0	64.2	281.9	471.4%
10,000-24,999	25	77.0	63.5	140.5	63.4%
25,000-49,999	45	32.3	61.2	97.6	46.3%
50,000-99,999	50	11.7	52.6	65.8	34.0%
100,000-199,999	62	9.1	42.8	54.8	30.8%
200,000-499,999	39	3.0	44.7	55.9	19.4%
500,000 and more	14	0.0	34.8	36.7	26.7%
Total/Average	262	5.9	41.7	51.3	17.3%
Monthly Expenditure Per Capita	**Number of Municipalities**	**Average Per Capita I Grant**	**Average Per Capita S Grant**	**Average Per Capita Equitable Share**	**Percentage Change from '00/'01**
Less than R500	79	13.1	56.3	71.9	41.9%
R500-R749	76	8.0	44.5	60.0	33.6%
R750-R999	53	4.6	43.3	54.8	2.3%
R1,000-R1,499	42	0.6	30.5	32.3	26.3%
R1,500-R1,999	8	10.7	43.4	63.3	12.8%
R2,000 and more	4	26.6	31.2	72.0	19.5%
Total/Average	262	5.9	41.7	51.3	17.3%

Total S grant allocation	R	1,836,233,529
Total I grant allocation	R	260,000,000
Total historical allocation	R	163,643,470

Number of municipalities receiving an I grant allocation = 192
Number of municipalities receiving "guaranteed amounts" = 49

*Grant simulation based on the following assumptions:

1. Expenditure-based poverty measure
2. Households are categorized as poor if monthly income or expenditures are less than R 1,100
3. S-Grant: Monthly per household cost of "basic services" (in rand) R 86
   - Phase-in parameter (")—urban/metro = 0.80
   - Phase-in parameter (")—rural = 0.40
   - Budget parameter ($) = 1.5688136590
4. I-Grant parameters: I* = R 155,371
   - γ = 0.250
   - Average monthly per capita income floor R = 250
   - Minimum population for I grant allocation: 0
   - Revenue-raising effort: 0.05
5. "Guaranteed amount" as a percentage of last year's ES allocations: 70%
6. District Management Areas (DMA) receive ES allocations: Yes
7. Minimum Equitable Share allocation: R 10,000

the parameter were raised from 5 percent to 7.5 percent, the average per capita I grants by monthly expenditure per capita class would look like:

Monthly Expenditure Per Capita	Avg. Per Capita I Grant
Less than R500	13.8
R500 - R749	7.8
R750 - R999	4.0
R1,000 - R1,499	0.5
R1,500 - R1,999	9.4
R2,000 and more	19.4
Total/Average	5.9

(In order to maintain the total R260 million allocation, the I* parameter has been raised from 155,371 to 185,495.)

Note also that the per capita S grant is generally larger in small municipalities and in poorer municipalities. The final per capita equitable share allocations (including the guaranteed amounts), are inversely related to municipal population size, and with the exception of a few relatively rich municipalities are also inversely related to the average monthly expenditure per capita of municipal residents.

The last column of Table 1 indicates the average percentage change in total equitable share allocation between financial year 2000/01 and 2001/02. Recall that the 2000/01 numbers are constructed figures, representing grant payments to the old municipalities that have been allocated to the newly demarcated municipalities. The data indicate that in percentage terms equitable share allocation will grow the most in small and in poor municipalities.

Dealing with District Management Areas

The base ESAM simulation and the simulation summarized in Table 1 both distribute equitable share allocations to all DMAs. The three DMAs with zero population (EDCMA14, ECDMA44, and MPDMA32) are each allocated R10,000 as a guaranteed amount. Table 2 displays the allocations to all 25 DMAs ranked by population size. The two smallest DMAs would receive very large per capita allocations, R14,793 and R10,988. In fact, 8 DMAs receive per capita allocations over R1,000. The smallest per capita equitable share allocation to a DMA is R152, an amount that is over three times the national average per capita equitable share allocation. The last column of Table 2 illustrates that all DMAs would receive very large percentage increases in equitable share allocations, with 15 DMAs benefiting from over 500 percent increases in allocations.

Table 2:
District Management Area Equitable Share Allocations, 2001/02
(All DMAs are ineligible for S and I grants. There is no minimum equitable share allocation)

Category C or B Name	LG Number	Estimate 2001 Population	Percent Urban	S Grant Allocation	S Grant p.c.	I Grant Allocation	I Grant p.c.	S + I Grant	2000/01 Equitable Share Allocation	2001/02 Equitable Share Allocation	2001/02 Equitable Share Per Capita
Oviston Nature Reserve	ECDMA14	0	0.0%	0	0.0	0	0.0	0	0	0	0.0
O Connors Camp	ECDMA44	0	0.0%	0	0.0	0	0.0	0	0	0	0.0
DMA Lowveld	MPDMA32	0	0.0%	0	0.0	0	0.0	0	0	0	0.0
Highveld DC	MPDMA31	23	0.0%	0	0.0	0	0.0	0	1,007	705	30.7
Highveld DC	CBDMA3	34	0.0%	0	0.0	0	0.0	0	1,823	1,276	37.6
Indlovu Regional Council	KZDMA22	113	0.0%	0	0.0	0	0.0	0	3,922	2,746	24.4
Overberg DC	WCDMA03	145	0.0%	0	0.0	0	0.0	0	7,181	5,027	34.7
Stormberg DC	ECDMA13	164	0.0%	0	0.0	0	0.0	0	16,878	11,815	71.9
Rustenburg TDC	NWDMA37	289	0.0%	0	0.0	0	0.0	0	5,469	3,828	13.3
Thukela Regional Council	KZDMA23	622	0.0%	0	0.0	0	0.0	0	19,557	13,690	22.0
Eastern Free State DC	FSDMA19	654	50.0%	0	0.0	0	0.0	0	18,347	12,843	19.6
Indlovu Regional Council	KZDMA43	1,443	0.0%	0	0.0	0	0.0	0	50,028	35,019	24.3
Namaqualand DC	NCDMA06	1,533	0.0%	0	0.0	0	0.0	0	149,727	104,809	68.4
Western Gauteng Service Council	GTDMA41	3,047	0.0%	0	0.0	0	0.0	0	96,929	67,850	22.3
Northern DC	CBDMA4	3,648	0.0%	0	0.0	0	0.0	0	422,568	295,797	81.1
Diamandveld DC	NCDMA09	4,756	0.0%	0	0.0	0	0.0	0	163,878	114,714	24.1
Upper Karoo DC	NCDMA07	4,823	0.1%	0	0.0	0	0.0	0	533,157	373,210	77.4
West Coast DC	WCDMA01	5,007	30.0%	0	0.0	0	0.0	0	305,215	213,650	42.7
Overberg DC	WCDMA02	7,013	0.0%	0	0.0	0	0.0	0	100,647	70,453	10.0
Western Region DC	ECDMA10	7,113	15.6%	0	0.0	0	0.0	0	815,955	571,169	80.3
Sentrale Karoo DC	WCDMA05	7,331	75.7%	0	0.0	0	0.0	0	559,264	391,485	53.4
Kalahari DC	NCDMACB1	8,839	4.5%	0	0.0	0	0.0	0	725,688	507,982	57.5
Lower Orange DC	NCDMA08	9,060	0.0%	0	0.0	0	0.0	0	557,361	390,153	43.1
uThungulu Regional Council	KZDMA27	10,006	0.0%	0	0.0	0	0.0	0	353,908	247,735	24.8
South Cape DC	WCDMA04	14,536	45.1%	0	0.0	0	0.0	0	1,407,074	984,952	67.8

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I have not been involved in any of the discussions concerning the DMAs and I am obviously unaware of many of the issues involved. I would however like to mention that the S and I grants are designed to provide unconditional grants to local governments, with the I grant designed to help facilitate the building of the institutions of democratic governance. If DMAs don't have locally-elected governing bodies and aren't directly involved in the provision and financing of municipal services to residents, I find it hard to understand how the receipt of equitable share payments would be justified.

In Table 2, I report on the results of a simulation where DMAs are not entitled to receive equitable share allocations. Not surprisingly, the main impact of this simulation is on the average per capita allocations to the smallest class of municipalities, those with populations of fewer than 10,000. The average I grant per capita in these small municipalities is now R43.8, compared with R216 when DMA allocations were included. Overall allocations to the smallest group of municipalities (including DMAs) would decline relative to financial year 2000/01, rather than increased by nearly 500 percent. It should be noted that if DMAs were not permitted to receive S or I grants, but would still be eligible for guaranteed allocations (equal to 70 percent of last year's allocation), the average per capita equitable share allocation would be R101, and on average equitable share allocations would increase by 17.8 percent among municipalities with fewer than 10,000 inhabitants.

The Definition of Beta

The S grant allocation to each municipality is based on an estimate of the costs of providing basic municipal services to a poor household (L) times the number of poor households. On the basis of a DBSA study conducted in the mid-1990s, the average cost of services per household was set at R86 per month. Because not enough money was available to fully fund the S grant formula, a budget adjustment parameter (beta) was added to the S grant formula a couple of years ago. If only 75 percent of the needed resources were available, beta would be set at 0.75.

Because the adoption of a new and more accurate measure of the number of poor households and because the local government equitable share allocation has grown, the budget adjustment parameter for 2001/02 has a value of around 1.6. This implies that during the 2001/02 financial year, the S grants can finance 160 percent of the cost of basic services. This statement makes little sense in light of data produced by both the National Treasury and DPLG which indicates that the average costs of basic municipal services substantial exceeds R86 per household. I would suggest that a more realistic estimate of the monthly cost of basic services be chosen and the budget parameter be adjusted appropriately. If a good estimate of the current costs of basic services is not available, an upward adjustment of the R86 figure to reflect inflation might be used. As an example, on the assumption that all DMAs are entitled to S grants, increasing L from R86 to R136 would require a beta of 0.992044. Increasing L to R160 would require a beta of 0.843237. It should be emphasized that these changes would in no way change the allocation of S grants among municipal governments. This change would only make it easier to explain the S grant formula and enhance the transparency of the equitable share allocation process.

ANNEX 6
GUIDING PRINCIPLES FOR DIVISION OF FUNCTIONS AND POWERS

Prepared by Larry Schroeder
May 17, 2000

In accord with the objectives of local government as prescribed in the Constitution (Chapter 7, Section 152), the underlying principle for the division of functions and powers of local government should be the concept of *Subsidiarity*. This means that services should be assigned in a manner that places the responsibility for providing public services as close as possible to the people the services are meant to serve.

The underlying rationale for this principle is that such service provision arrangements are most likely to lead to an efficient level and supply of public services.

There are, however, acknowledged reasons to limit subsidiarity. Among these is the possibility that certain services are subject to economies of scale or that certain services create either positive or negative effects on residents who live outside the locality. Where economies of scale characterize the production of certain services, larger local governments can produce the services are more efficiently than can small jurisdictions. Likewise, if non-residents of a locality bear some of the costs of a local service or derive some of the benefits, the local governments are expected to provide more or fewer of those services than are socially optimal. Again, assigning such services to larger governments can overcome these inefficiencies.

A third, more practical limitation to subsidiarity is capacity. Capacity relates to the resource – human and financial – available to the local government. Without an adequate revenue base, a local government will be entirely dependent on others to provide the financial resources necessary to provide the efficient level of public services. Total reliance on others for financial resources

Human resources are the key to effective management of the delivery of local public services. Similarly, for services that require considerable technical skills for proper planning and execution, lack of those skills can result in ineffective service delivery. Thus, in cases where management and/or technical skills are unavailable, assignment of service delivery functions may have to be allocated to larger jurisdictions. (This does not, however, mean that all local public services need to be assigned to larger jurisdictions since at least some local public services are not technically sophisticated.)

While these features characterize the overall guiding principles for assignment of services, there remains a question of how to operationalize them. The creation of larger, more populous “B” municipalities should have the effect of decreasing all of the listed problems. Larger municipalities may better be able to take advantage of economies of scale and lessen the likelihoods of jurisdictional spillovers of benefits and costs. Furthermore, a smaller number of top management personnel and technical department heads will be necessary now that the number of jurisdictions have been substantially cut.

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In line with the above, it is reasonable for "C" Municipalities to provide bulk services and, where necessary to avoid negative or to enhance positive interjurisdictional spillovers, to coordinate the provision of such services.

Nevertheless, the condition of local governments in South Africa is probably as diverse as anywhere in the world and what applies at the local level in one area or locality of the country is unlikely to be applicable in most other areas. This means that there are likely (and should be) differential arrangements in different locations. There can and should be B municipal councils functioning in all demarcated B jurisdictions. And those councils will need to be ultimately responsible for the provision of local services.

[For that reason it is not reasonable for the DP&LG to mandate a particular assignment of services beyond that which is already specified in the Constitution.]

ANNEX 7A
A POLICY FRAMEWORK FOR THE DIVISION OF POWERS AND FUNCTIONS BETWEEN SOUTH AFRICA'S NEW MUNICIPALITIES

Prepared by Peter Vaz
March 20, 2001

Introduction

This document flows from discussions between Treasury and DPLG regarding a conceptual framework for the division of powers and functions between South Africa's new local governments. Two papers have been drafted so far: 1) A Framework for Allocating Powers and Functions to South Africa's New Local Governments by National Treasury and 2) Issue paper on the discussions between the National Treasury and DPLG regarding the powers and functions of municipalities (prepared by National Treasury and edited by DPLG).

This document attempts to develop a common approach to the policy framework, based on the above two documents and discussions held at the bilateral of February 23, 2001. The need for such a framework derives from the evolving set of relationships between the spheres of government in South Africa and the changes required against the backdrop of municipal demarcation.

The Fiscal Framework

Government policy in respect of the municipal fiscal and financial system is outlined in a series of public documents. These include the Constitution, the 1998 Local Government White Paper, recent Budget Reviews, the 1999 and 2000 Intergovernmental Reviews and The Introduction of an Equitable Share of Nationally Raised Revenue for Local Government published in 1998. Read together, this policy provides a coherent and integrated framework that needs to form a key point of departure for the municipal demarcation process.

The basic points of departure of this policy framework for local government finances are:

- Local government is an autonomous and accountable sphere of government, with clear revenue and expenditure responsibilities, as established in the Constitution. The role of national government in municipal finance is to provide an enabling regulatory environment within which municipalities can manage their financial affairs responsibly.

- Local government needs to fulfill the developmental role envisaged for it in the White Paper. This role involves both capacitated Category B and C municipalities. Category B municipalities would need to play a more direct service delivery role and address local challenges while Category C municipalities would need to play a greater role in addressing regional challenges and assisting in the development of local municipalities. While it is acknowledged that redistribution is primarily a national government function, District Councils have a strong redistributive role to play within their local jurisdictions. There is a need to distinguish between interjurisdictional redistribution (which is regarded primarily as a national function) and intrajurisdictional redistribution. This distinction is particularly important in South Africa. Its apartheid legacy, which created huge disparities in wealth and in service provision across and within jurisdictions, calls for the

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Category A and C municipalities to play a strong redistributive role. Category C municipalities also have a major role to play in district-level integrated development planning. District IDPs need to provide guidelines for local development objectives of each municipality and for planning and programmes of departments with decentralised field offices in their area of jurisdiction.

- Local governments need to operate in a fiscally disciplined manner, in line with requirements set or implied by the Constitution and other legislation. This means that budgeted and actual revenues and expenditures should match. Municipalities should thus deliver services commensurate with their revenues from the sources that are currently available to them, and without any operating deficit.

- Municipalities require access to adequate resources and budgetary powers to fulfill their constitutional functions. On average, municipalities have sufficient revenue raising powers to fund the bulk of their expenditure, and finance 90% of their recurrent expenditure out of own revenues. These are, however, aggregate figures and hide the fact that there are great variations between municipalities across the country. Rural municipalities fund far less of their expenditure from own revenues and are more reliant on intergovernmental transfers than urban municipalities. The major source of own revenue is derived from utility services (water, sanitation, and electricity). Other sources of revenue include intergovernmental transfers and borrowing, and the RSC levy for Category C municipalities.

- Municipal access to capital markets should be enhanced. This will extend the financial resources available to municipalities to deliver infrastructure, enhance fiscal discipline, spread the burden of funding for capital investment equitably over generations, and promote efficiency in the financing of infrastructure and the allocation of capital to productive uses. During the apartheid era, South Africa had an active municipal bond market and municipalities also borrowed from private institutions. However, the reform process, with its newly amalgamated municipalities (both in 1996 and in 2000) has made investors more doubtful about the borrowing capacity of municipalities. For these reasons, although a few big municipalities have managed to establish creditworthiness and are able to borrow from the private sector, the majority of municipalities are not able to do so.

Key Considerations

Existing Functions and Powers

The Constitution and the White Paper on Local Government provide the basic framework for the powers of local government. They treat local government as an independent and accountable sphere of government, with clear revenue and expenditure responsibilities. Its powers and functions revolve around ensuring the delivery of affordable basic services and promoting economic and social development.

General Powers and Functions

As regards general powers and functions, Section 152 of the Constitution expects local government to:

- Provide democratic and accountable local government for local communities
- Ensure the sustainable provision of services to communities
- Promote social and economic development
- Promote a safe and healthy environment
- Encourage community involvement in local government matters.

Important municipal services include the provision of water, sanitation (and sewage disposal systems), roads, storm water drainage, refuse removal (including solid waste removal) and electricity reticulation. Bulk functions demonstrate scale economies at regional level whereas reticulation functions do so at local level.

Fiscal Powers

Section 229(3) of the Constitution deals with the specific question of dividing fiscal powers in cases where two municipalities operate in the same area. This is clearly relevant to the B/C allocation. The criteria that need to be taken into account are:

- Compliance with sound principles of taxation
- Each municipality's powers and functions
- Each municipality's fiscal capacity
- The effectiveness and efficiency of raising taxes, levies and duties
- Equity.

The Constitution assigns revenue sources to local government and designates municipal fiscal powers and functions. The main sources of revenue for Category B municipalities are rates on property and fees (or surcharges on fees) for services provided by or on behalf of the municipality, while Category Cs get their revenue from RSC levies and fees for bulk services.

Possible Guiding Principles

Apart from the above constitutional and policy principles, the policy framework for the adjustment of division of functions and powers between district and local municipalities (Notice 2592 of 2000), derived from the White Paper on Local Government, also points towards a number of basic principles to guide any transformation interventions. These have as their objectives:

(i) equitable, efficient, affordable, economical and sustainable access to basic municipal services by all consumers;
(ii) the placement of responsibility of providing municipal services as close as possible to the communities the services are meant to serve;
(iii) minimizing costs of services to consumers or customers;
(iv) achieving economies of scale in the delivery of services;
(v) minimizing interjurisdictional spillovers;

(vi) benefiting the greatest number of residents;
(vii) causing the least disruptive effect on the delivery of services;
(viii) promoting a safe and healthy environment;
(ix) promoting efficient, effective and accountable public administration;
(x) promoting co-operative government; and
(xi) addressing the historical inequities in society.

Problem Statement

The functional division of powers between different categories of municipalities is one of the major issues that face local government in the wake of the 2000 demarcation process. It is not much of an issue as far as metros are concerned, as they will have one tier of government that will be responsible for all aspects of the functions under their jurisdiction.

However, the division of powers and functions is highly important for the new District Councils (Category C) and Category B municipalities. The basis for this division is indicated in Sections 84 and 85 of the Municipal Structures Act. Recent amendments to these sections enable the Minister and the relevant MEC – after consulting the Demarcation Board – to "authorise" municipalities to perform certain functions. However, in principle, most functions are being moved to the district level and it is only upon such authorisation that Category B municipalities will be made responsible. This marks a shift from the approach that prevailed in the Act before the amendments, where the underlying principle was that District Councils will only take responsibility for functions if local capacity did not exist or where the functions were performed for the district as a whole.

The current fragile state of local governments underscores the need to preserve whatever capacity does exist. While transformation inevitably means that consolidation, integration and reorientation of municipal administrations must receive attention, these processes should never destroy capacities. It cannot be assumed that new capacities will simply arise from amalgamation of earlier ones.

It makes sense to allocate functions to district municipalities in cases where Category B authorities have limited capacity. Category C municipalities should supplement the administrative capacity of Category B municipalities in these areas by providing financial and administrative capacity where it is lacking, or directly providing municipal services where they are required. However, a more complex challenge arises where the latter do have sufficient capacity. Should any changes be considered, their implications for the continuity of services must be carefully thought through. Furthermore, governance considerations are important. Category B municipalities are directly elected; Cs are not. To make service delivery accountable, the responsibility for reticulated services is best placed at the B level. A placement of these functions with District Councils removes the space for communities to directly hold their elected officials accountable for services. Finally, given Government's stance that the access of municipalities to capital markets must be advanced, the implications of changes to the powers of Category B municipalities must be carefully considered. If capacities are dispersed and weakened, potential private investors will find local governments unattractive.

The redrawing of municipal boundaries and Structures Act's reallocation of powers and functions between Category B and C municipalities also raise the question of the

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reassignment of fiscal powers and functions between them. In keeping with the principle that finance must follow function, the final allocation of fiscal powers must be aligned to the expenditure powers and functions designated to each type of municipality.

As they stand, the current legislative arrangements are out of sync with the fiscal arrangements. The services linked to Category C powers that the minister could authorise for Bs are mostly cost recoverable, i.e., from user charges. However, most of those that MECs may assign do not generate own revenue, and ought to be funded from general taxation i.e. the property tax. If these are located at Category C level, the municipalities will not have the fiscal powers to support the services. Appropriate revenue-sharing arrangements between B and C municipalities would, therefore, need to be determined. Consideration would have to be given to special arrangements, whether they be surcharges, agency payments etc. The challenge is to reconcile the fiscal powers with the general powers and functions allocated between the different types of local governments.

Optimal Use of Local Capacity

The crucial role of local government in service delivery requires that capacity be nurtured and that as much stability as possible is ensured to assist municipalities in their attempts to mobilise resources and apply them effectively in the service of their communities.

Given this, a blanket shift of powers and functions away from Category B towards Category C municipalities may be counterproductive. The primary consideration is the viability of municipalities, which revolves essentially around the ratio between poorer and wealthier consumers, the strength of the local economy, settlement density, capacity of the municipality (primarily management capacity), existing service levels and access to subsidies.

The issue of management capacity is particularly important at this stage of the transition as it can be influenced in the restructuring process. Further, in dividing powers and functions, the ability of the municipalities to manage the functions assigned to them is a central consideration.

Management capacity is essentially located in the structures with roots in urban areas, particularly in larger former transitional local councils. Category C municipalities have focused their attention to date primarily on resource allocation, planning, and contracting capital works. They, thus, at this stage have limited service provider capacity.

A recent study undertaken for DPLG identifies a number of key institutional and organisational issues in approaching the allocation of powers and functions:

- Separation of the functions of *service authority* (primarily governance, planning and regulatory aspects) and *service provision* (actual provision of the service).

- The importance of *settlement level responsibility*: a large component of service provider activity cannot be carried out remotely from consumers and needs to be based in settlements. As local authority structures are becoming geographically larger, this places a new demand on new municipalities. For settlement level responsibility to be exercised effectively, two options have been identified: use of *community based organisations* as service providers or use of *area based management*.

- *Types of service provider*: a range of service providers can be appointed, including other spheres of government, parastatal organisations, community based organisations and private sector bodies.

- *Split responsibility:* A single service (water supply, for example) may be run by two services providers, one providing bulk services and one retail. Another form of split responsibility occurs where a locally based service provider is provided with support from one based at regional level. Support can include treasury functions, project implementation, procurement, mentoring or major maintenance.

- *Internal organisational arrangements:* As municipalities get larger both in terms of staff numbers and geographic areas, they will need to pay greater attention to organisational structure.

It is important to stress that the consideration of these issues in the division of powers and functions must be accompanied by the appropriate division of fiscal powers.

Models for New Municipal Arrangements

Subsequent to the relevant amendments to the Structures Act in 2000, it was decided to immediately re-allocate – by regulation – the major municipal functions to Category B municipalities. The current plan is to retain this situation until such time that the District C municipalities are ready to take over those functions without major disruption. Under the circumstances, this approach of essentially maintaining the status quo in the short-term will secure as little disruption as possible. The shifting of functions between municipalities is always a complicated exercise, and almost always has financial implications. It is therefore important to adopt a cautious approach that builds on existing capacities.

However, this leaves the situation fluid, and creates uncertainty for municipalities in terms of their budgets and planning activities. Medium-term budgets and effective integrated development plans cannot be drawn up until clarity is achieved. The prevailing situation also gives little comfort to private sector investors whose planning horizon extends well beyond the two-year transitional period. It creates uncertainty and is hence likely to impede both existing and future lending arrangements. It is, therefore, important that the division of powers and functions be resolved soon, and in a manner that causes minimum disruption as well as upholds the principles intended by government in the first place.

The practical implementation of powers and functions involves the assigning of the following municipal responsibilities appropriately to local and district municipalities or to other services providers. The key roles in this regard are:

- Service authority, possibly separated for different services.
- Service provider, possibly separated into bulk and retail components.
- Support services.

It seems appropriate to base the allocation of such responsibilities on capacity, and to show a preference for duly enabled local governments as close as possible to the consumers. Only where no capacity exists at the local level or where there are clear economies of scale or interjurisdictional spillovers that extend beyond Category B boundaries should powers and functions be assigned to Category C municipalities. This approach allows the fiscal burden on national and provincial government towards these municipalities to be reduced, releasing resources for investment in poorer areas of the country. Moreover, it is consistent with s156(4) of the Constitution, which states that national and provincial government must assign those functions to a municipality that are most effectively administered locally, where that municipality has the requisite capacity to perform them. The October 2000 amendments to the Municipal Structures Act tend to transfer major service delivery functions to Category C municipalities across the board, which is at odds with the hybrid approach suggested here.

In general, for a *local municipality with a large town as core*, the current arrangement where they retain full service authority and service provider functions is preferable, from their own perspective. The arguments for moving away from this relate primarily to the desire by districts and province to share the capacity of the existing TLCs over a wider area and cross-subsidise from large town cores over the whole district. Where there are some management efficiency arguments to run some services at a district level, it will be best to do this with the service provider (perhaps a district municipality) contracted to the local municipality which will be the authority. It is urgent to identify such cities and towns that may qualify for aspirant-metro status. The National Treasury has already in this regard started some analysis to look at councils with relatively larger budgets.

From the perspective of a *local municipality with a small to medium sized town as core*, the arrangements need to be considered internally and externally. Internally, it is considered best for retail service provider capacity to be located at local (settlement) level, as far as possible. However, such service providers need to be supported by a good support and bulk service function. Often this is best located at the district level as capacity can be shared across the district.

With regard to *local municipalities with no town as core (all rural)*, the conclusions are similar to that for the previous case. For the internal arrangements, a strong preference is indicated for service provider activity to be delegated to settlement level as far as possible. However, the extent to which this is done is strongly dependent on the type of service. With regard to higher level skills, these are typically absent at local municipal level currently. It then becomes more obvious that these should be shared across the district.

The implications are that Category C municipalities should essentially have a planning and monitoring function across the boundaries of the municipalities within their jurisdictions. Their direct service delivery role should be confined to bulk services, or to areas where no local capacity exists, or where economies of scale or interjurisdictional externalities extend beyond Category B boundaries.

Related Issues

A related issue deals with the devolution of certain national and provincial functions to the local government sphere. Such a process should adopt similar guiding principles, listed above, for the transfer of such functions. As a result of the current legislation, it would appear that some health and transport functions would be transferred to Category C municipalities. The addition of these functions to the current workload of Category C municipalities will add considerable management and funding pressure for the latter as well as significant transfer of staff and assets. It is, thus, incumbent on DPLG and National

Treasury to ensure that any such transfers happen in line with the guiding principles and with available capacity. In principle, national and provincial departments should retain the functions for the immediate future, and any transfer should be phased in over time with the consent of DPLG and National Treasury after due consideration of relevant institutional and financial factors.

Conclusion

The division of powers and functions between municipal structures is one of the major challenges facing local government at the moment. A number of uncertainties currently affect the functioning of municipalities in terms of planning and budgeting and also undermine their creditworthiness in the eyes of the capital markets. It is, therefore, necessary to clarify the key issues and adopt appropriate approaches that would support the functioning of the new municipalities. The key issues concern the general approach to where powers and functions should be placed, how fiscal powers are to be related to that general division of powers and functions, and how these approaches are dealt with in legislation.

In dividing powers and functions, the approach should be to build on current strengths and to minimise institutional disruption that could compromise service delivery. It is, therefore, advisable, to retain powers and functions where they are institutionally well-serviced. Given the importance of accountable service delivery, the general approach should also be to empower Category B municipalities so that they could deliver services effectively, with sensitivity and in line with the needs of local residents. Recent changes to the Structures Act that tend to bolster the powers of Category C municipalities, should, therefore be reviewed and the necessary amendments made to facilitate a local delivery strategy that builds on established capacity.

There are three particularly prevalent implications of these principles and approach:

- Generally, Category B municipalities should retain their powers with regard to direct service delivery, with the role of Category C municipalities seen as one focused on planning, co-ordination and monitoring, and as supportive to Bs or taking over functions where capacities are absent. These measures will support the guiding principles mentioned above.

- Systematic cost/benefit analysis is necessary for any major changes to the division of powers and functions. This entails the division between Bs and Cs, and also in the case of sector transformation as is planned for electricity and water sectors. Such costs must be measured in the context of priorities.

- The programme for establishing a framework for division of powers and functions must be expedited. By 30 April 2001, a cabinet memorandum should have been completed and submitted that spells out the basic approach and the overall division of powers and functions on both the expenditure and revenue sides.

The implications for legislation are as follows:

- The legislation may be amended to reflect the arrangements originally envisaged in the Municipal Structures Act before the October 2000 amendment.

- Alternatively though, the regulation maintaining the status quo could be extended for a reasonable time frame in the interest of greater certainty. A thorough investigation of powers and functions would need to be conducted over the next year to determine the appropriate division, using the guiding principles mentioned above.

ANNEX 7B
DEALING WITH POWERS AND FUNCTIONS

Prepared by Peter Vaz
June 14, 2001

Problem Statement

The functional division of powers and functions between different categories of municipalities is one of the major issues that face local government in the wake of the 2000 demarcation process. It is not much of an issue as far as metros are concerned as they have one tier of government that will be responsible for all aspects of the functions under their jurisdiction. It is, however, highly important for the new District Councils (Category C) and Category B municipalities.

The Legislative Framework

The basis for the division of powers and functions between Category B and C municipalities is indicated in Sections 84 and 85 of the Municipal Structures Act. Recent amendments to these sections enable the Minister and the relevant MEC – after consulting the Demarcation Board – to "authorise" municipalities to perform certain functions. In principle, however, most functions are being moved to the district level and it is only upon such authorisation that Category B municipalities will be made responsible. This marks a shift from the approach that prevailed in the Act before the amendments, where the underlying principle was that District Councils will take responsibility for functions if local capacity did not exist or where the functions were performed for the district as a whole. This is consistent with the White Paper on Local Government which, while recognizing the need for a measure of consistency across all district governments, called for a measure of flexibility with regard to their roles and responsibilities. It envisaged a variable district government system in which districts exercise different sets of powers vis-à-vis their areas and the local municipalities that comprise them, depending on local circumstances and the differences in capacities of District Councils.

Guiding Principles

Based on the Constitution, the policy framework for the adjustment of division of functions and powers between district and local municipalities (Notice 2592 of 2000), and the White Paper on Local Government, a number of basic principles should guide any transformation interventions:

- Equitable, efficient, affordable, economical and sustainable access to basic municipal services by all consumers;
- The placement of responsibility of providing municipal services as close as possible to the communities the services are meant to serve;
- Minimizing costs of services to consumers or customers;
- Achieving economies of scale in the delivery of services;
- Minimizing inter-jurisdictional spillovers;
- Benefiting the greatest number of residents;
- Causing the least disruptive effect on the current delivery of services;

- Promoting a safe and healthy environment;
- Promoting efficient, effective and accountable public administration;
- Promoting co-operative government; and
- Addressing the historical inequities in society.

Redistribution

One of the most pivotal aspects of the debate on powers and functions concerns the roles of different spheres of government in redistribution. Redistribution is primarily a national government function, with taxes collected at the centre and national government targeting part of it to low-income individuals. The redistribution that occurs at the local level is of an entirely different nature. Category A and C municipalities collect the RSC levy from within their geographical jurisdiction and channel the funds primarily towards infrastructure throughout the jurisdiction. This is different from the welfare role played by national government. Category C municipalities also have a major role to play in district-level integrated development planning (IDP). District IDPs need to provide guidelines for local development objectives of each Category B municipality within their jurisdictions and for planning and programmes of departments with decentralised field offices in their area of jurisdiction.

Synchronising Functions and Fiscal Powers

The redrawing of municipal boundaries and the Structures Act's reallocation of powers and functions between Category B and C municipalities raises the question of the reassignment of fiscal powers and functions between them. In keeping with the principle that finance must follow function, the final allocation of fiscal powers must be aligned to the expenditure powers and functions designated to each type of municipality. Before the amendment to the Structures Act, municipal functions and service responsibilities were aligned with municipal fiscal powers. The current legislative and fiscal arrangements are yet to be aligned. The services linked to Category C powers that the minister could authorise for Bs are mostly cost recoverable, i.e., from user charges. However, most of those that MECs may assign do not generate own revenue, and ought to be funded from general taxation, i.e., the property tax. If these are located at Category C level, the municipalities will not have the fiscal powers to support the services. Appropriate revenue-sharing arrangements between B and C municipalities would, therefore, need to be determined. Consideration would have to be given to special arrangements, whether they are surcharges, agency payments etc. The challenge is to reconcile the fiscal powers with the general powers and functions allocated between the different types of local governments. In allocating powers between Category B and C municipalities, both expenditure and revenue powers must be taken into account, and the fiscal gap between the two should not be allowed to increase. In resolving this issue, the Fiscal and Financial Commission (FFC) must be consulted, as determined in Section 229 of the Constitution. Section 229 (3) and (4) of the Constitution recognize the need for an optimal assignment of fiscal powers and functions or revenue sharing mechanisms when two municipalities have the same fiscal powers and functions with regard to the same area. National legislation in this regard has yet to be enacted.

Institutional Perspectives

The current draft framework draws extensively on analysis done in some case studies. On that basis, the institutional approaches to the allocation of powers and functions suggest:

- a separation of the functions of service authority (primarily governance, planning and regulatory aspects) and service provision (actual provision of the service)
- institutional arrangements that enhance settlement level responsibility
- use of a range of service providers, including other spheres of government, parastatal organisations, community based organisations and private sector bodies
- split responsibility between bulk and retail services, reflecting economies of scale and accountability considerations.

Capacity Considerations: The current fragile state of local governments underscores the need to preserve whatever capacity does exist. It is acknowledged that transformation should not compromise capacity, and that aspects of the system that function well, should be used as the basis for a new system. While transformation inevitably means that consolidation, integration and reorientation of municipal administrations must receive attention, these processes should never destroy existing capacities. It cannot be assumed that new capacities will simply arise from amalgamation of earlier ones.

It therefore makes sense to allocate functions to Category C municipalities in cases where Category B authorities have limited service provider capacity. Category C municipalities should supplement the administrative capacity of Category B municipalities in these areas by providing financial and administrative capacity where it is lacking, or directly providing municipal services where they are required. However, a more complex challenge arises where the latter do have sufficient capacity. This should not be construed to mean that, irrespective of other considerations and objectives, Category B municipalities that have capacity should not expect any changes. Local government is in a stage of transformation and big changes could, in fact, occur. If so, major efforts would have to go into building capacities at the required levels, or in fact, other innovative arrangements, such as management contracts, would have to be entered into.

Governance and accountability: Category B municipalities are directly elected; Cs are in part directly elected, but some councilors are nominated by municipalities within the District Council's jurisdiction. A placement of functions around reticulated services with District Councils therefore reduces somewhat the space for communities to directly hold their elected officials accountable for services.

Access to private capital: Given Government's stance that the access of municipalities to capital markets must be advanced, the implications of changes to the powers of Category B and C municipalities must be carefully considered. Uncertainty about service delivery responsibilities is likely to have a negative impact on both availability and price of long-term credit for B and C municipalities alike until their powers and functions have been finally resolved.

Interim Arrangements

In the run-up to the election, in order to ensure that the provision of services was not disrupted and the transfer of staff was kept to a minimum, functions and powers were allocated by the Minister and MECs along the following lines: Category B municipalities were authorised to perform the functions of former TLCs and TRCs and Category C municipalities were authorised to perform former District/Regional Services/Services Council functions. These authorisations have become known as maintaining the *status-quo* in respect of the four national functions (potable water supply systems, bulk supply of electricity, domestic waste-water and sewage disposal systems, and municipal health services) and the other Section 84 (1) functions (excluding the four national functions) as well as the Section 84 (2) functions.

The result of maintaining the *status-quo* is that where a disestablished local municipality performed a function (say water) within its area, the newly established local municipality continues to perform that function, but only for the disestablished municipal area. This has resulted in a situation where in areas of certain newly established local municipalities, specific water functions are being performed by different entities such as the new local municipality, the new district municipality, or a water board.

Although it is acknowledged that this situation is not ideal, it has resulted in the uninterrupted provision of services and disruption has been restricted to a minimum.

The authorisations have resulted in a state of uncertainty due to the fact that municipalities are anticipating, and in certain instances insisting, that the division of powers and functions be adjusted in compliance with Section 84 of the Structures Act. This resultant uncertainty makes it difficult for municipalities to prepare a proper IDP or a budget for the long term. It also complicates a number of transformation issues such as the finalisation of organograms, and has an adverse effect on the creditworthiness of councils seeking to access private sector funding for capital expenditures.

In order to resolve these issues, an incremental transformation approach is suggested. This will allow that some capacity would be developed at the district council to absorb the functions in 2002, that municipalities without functions will be authorised accordingly, and that some Category B municipalities who are currently delivering services under the *status-quo* would begin delivering services to all residents within their jurisdiction.

Models for New Municipal Arrangements

The institutional approach suggested earlier revolves around three service roles in the municipal sphere: service authority, service provider (possibly separated into bulk and retail components), and support services. In proposing institutional models, the framework bases the allocation of such responsibilities on existing capacity, and attempts to enable service delivery by local governments as close as possible to the consumers.

The role envisaged here for Category C municipalities is significant. It focuses on important strategic functions like planning, monitoring and co-ordination, financial management, rural development, and delivery of bulk services or, in cases where capacity is inadequate in Category B municipalities, of reticulated services. It is inaccurate to understand this stance as one that proposes “strong Bs and weak Cs”. The strategic role of Category C municipalities would be a powerful one, while allowing local councils to focus on service delivery. Powers and functions should be shifted to Category C municipalities where no capacity exists at the local level and there is no reasonable expectation that such capacity could be created in the near future; where there are clear economies of scale or inter-jurisdictional spillovers that extend beyond Category B boundaries; or where there is no possibility of an agreement by consensus to shift functions through an agency arrangement.

This approach allows the fiscal burden on national and provincial government towards these municipalities to be reduced, releasing resources for investment in poorer areas of the country. Moreover, it is consistent with Section156(4) of the Constitution, which states that national and provincial government must assign those functions to a municipality that are most effectively administered locally, where that municipality has the requisite capacity to perform them.

The institutional models suggested are:

- Local municipalities with a large town as core should retain full service authority and service provider functions, as well as responsibility for local planning. Where there are some management efficiency arguments to run some services at a district level, it will be best to do this with the service provider (perhaps a district municipality) contracted to the local municipality which will be the authority.

- In a local municipality with a small to medium sized town as core, it is considered best for retail service provider capacity to be located at local (settlement) level, as far as possible. However, such service providers need to be supported by a good support and bulk service function. Often this is best located at the district level as capacity can be shared across the district.

- In local municipalities with no town as core (all rural), the conclusions are similar to that for the previous case. For the internal arrangements, a strong preference is indicated for service provider activity to be delegated to settlement level as far as possible. However, the extent to which this is done is strongly dependent on the type of service. With regard to higher level skills, these are typically absent at local municipal level currently. It then becomes more obvious that these should be shared across the district.

Further Considerations

A misplaced debate about strong or weak Bs and Cs: Casting the debate on powers and functions as one over whether Category B or C municipalities should be strong or weak, is a misnomer. In fact, this draft document does not make such a distinction – it merely envisages different roles. Category C municipalities are envisaged to essentially have a planning and monitoring function across the boundaries of the municipalities within their jurisdictions, and are poised to play a major role in rural development. Their direct service delivery role, or regulatory role in the case of Municipal Services Partnerships (MSPs), should be in the realm of bulk services, or in areas where no local capacity exists, or where economies of scale or inter-jurisdictional externalities extend beyond Category B boundaries. There are ample opportunities to engage them to provide services where Category B municipalities lack capacity. This does not suggest at all that they should be 'weak' – in fact, this strategic role is inherently a very powerful one, and it will be money well spent to direct resources at building the capacity of District Councils to this end.

Transferring national and provincial functions to local government: There have been suggestions that the role of some local governments in respect of certain services might be expanded, with current national and provincial functions, like health and transport, being devolved to the local sphere.

The addition of current provincial and national functions to the workload of Category C municipalities will add considerable management and funding pressures for the latter. It will also require significant transfers of staff and assets. A challenge would thus be to contain the instability such changes could imply for the operations of local government. It is therefore necessary to approach changes in this regard systematically, based on sound research, and with a clear plan of action. Transfers of functions and powers to the local sphere must thus be carefully sequenced, and local requirements must be preferenced.

Various departments have an interest in this issue, but it is incumbent on DPLG and the National Treasury to provide policy guidance and to ensure that any such transfers of responsibilities and powers happen in line with available capacity. In principle, national and provincial departments should retain the functions for the immediate future, and any transfer should occur only with the consent of DPLG and the National Treasury, after due consideration of the relevant institutional and financial factors. The issues around capacity and fiscal ability are complex, and it is necessary to phase in any such transfers over time while municipalities develop the required vision statements, resource plans and strategies, means for implementation and monitoring mechanisms.

The Way Forward

- DPLG and Treasury must provide guidance to departments, provinces and municipalities regarding the allocation of municipal powers and functions.

- It is thus proposed that the conceptual framework developed by the two departments be finalised and submitted as a cabinet memorandum by the middle of July.

- A detailed analysis should be undertaken as a matter of urgency, of the capacities of municipalities, and the functional and fiscal requirements that should guide their powers and functions.

- The transfer of national and provincial functions to municipalities should be delayed until the latter clearly have the necessary capacity.

- Ministerial and departmental meetings with SALGA and other stakeholders should help to enlighten this crucial policy process.

ANNEX 8
TERMS OF REFERENCE FOR ANALYSIS OF CAPACITIES OF MUNICIPALITIES TO GUIDE DETERMINATION OF POWERS AND FUNCTIONS

Prepared by Peter Vaz
June 7, 2001

Background

The division of powers and functions between Category B and C municipalities is one of the major issues facing local government in the wake of the 2000 demarcation process. The basis for this division is indicated in Sections 84 and 85 of the Municipal Structures Act. Recent amendments to these sections enable the Minister and the relevant MEC – after consulting the Demarcation Board – to "authorise" municipalities to perform certain functions. However, in principle, most functions are being moved to the district level and it is only upon such authorisation that Category B municipalities will be made responsible.

Section 83 of the MSA provides that all municipalities have the functions and powers assigned to them in terms of Sections 156 and 229 of the Constitution. Section 84 of the MSA (as amended) divides the functions and powers referred to in Section 83 between district and local municipalities. Subsection (1) of Section 84 contains a list of the functions and powers allocated to district municipalities and subsection (2) allocates all the Section 83 (1) functions and powers to local municipalities, excluding those functions and powers vested in district municipalities in terms of Section 84 (1).

The Minister has an unfettered discretion (except for a consultation requirement with the relevant line function Minister and the MEC) to authorise a local municipality to perform a function and exercise a power with regard to potable water supply systems, bulk supply of electricity, domestic waste-water and sewage disposal system, and municipal health services. The MEC for local government in a province has the legislative ability to authorise a local municipality to perform certain other functions and powers allocated to district municipalities in Section 84. In addition, the MEC may authorise a district municipality to perform certain functions and powers of a local municipality.

In order to ensure that the provision of services was not disrupted and the transfer of staff was kept to a minimum, the Minister and MECs decided to maintain the status-quo. This means that Category Bs were authorised to perform the functions of TLCs and TRCs and Category C municipalities were authorised to perform District/Regional Services/Services Council functions. This has resulted in a situation where, in areas of certain local municipalities, specific functions are being performed by different entities, such as the new local municipality, the new district municipality, or some other service provider (such as a water board).

A number of problems have arisen with these authorisations. These include difficulty in a municipality's ability to prepare a proper IDP or a budget for the medium to long term, complications with a number of transformation issues such as the finalization of organograms, and adverse effects with regard to the creditworthiness of municipalities. The Municipal Demarcation Board (MDB) has undertaken a capacity assessment to determine which of the municipal functions that the provincial MEC has authority over should go to different Category B and C municipalities. A capacity assessment needs to be undertaken for the four "national" functions over which the Minister has authority as well as related "provincial" functions over which the MEC has authority.

Requirements

The Department of Provincial and Local Government (DPLG) requires a dedicated, short-term study to research these issues and explore various alternative options and approaches that would mitigate some of the evident problems. The outputs of this study would provide DPLG, and other local government stakeholders with adequate information to effectively engage in the transition from the old to newly demarcated municipalities.

Outputs

Three key outputs are required from this task:

1. Detailed definition of the four "national" powers and functions over which the Minister has authority.
2. A methodology for assessing the "capacity" of Category B and C municipalities in respect of the four "national" functions as well as related "provincial" functions over which the provincial MEC has authority.
3. Recommendations for the division of powers and functions between Category B and C municipalities with regard to the four "national" functions, based on the above methodology and substantiated through a set of detailed case studies. Detailed recommendations would be provided for the case study municipalities – the top 20 Category B municipalities and the Category C municipalities within whose geographical boundaries they fall. More general recommendations would be provided for the remaining municipalities. The recommendations should not only suggest reassignment possibilities but also explore the fiscal implications of this reassignment.

Resources Required

Skills

It is anticipated that one local specialist will be required to fulfill these tasks. This individual or firm should have experience in the field of local government service management and/or municipal finance. Some economic or financial background would be a pre-requisite if appropriate technical outcomes were to be achieved (such as modelling). A sound knowledge of service delivery reform agendas both locally and internationally, but with specific emphasis on South Africa, is highly desired.

Timing

The study must be completed in six months, given the limited time that is available to respond to these matters.

Reporting

The specialist team would report to a reference group consisting of DPLG, DWAF, DME, DoH, and National Treasury, who will provide a more detailed briefing of work required, ongoing support and direction for the work of the team, and resources necessary to accomplish the tasks. If necessary, parties represented on the reference group may request dissenting views to be explored and documented by the team. Day-to-day management of the team would be undertaken by DPLG.

ANNEX 9A

Memorandum

DEPARTMENT OF PROVINCIAL AND LOCAL GOVERNMENT

MINISTER

CABINET MEMORANDUM ON FUNDING THE RESTRUCTURING OF THE LOCAL SPHERE OF GOVERNMENT

Purpose

To inform Cabinet of the intention of the Department of Provincial and Local Government to quantify the costs of restructuring local government.

Background and Discussion

Various stakeholders, such as SALGA, have indicated the need for a transitional fund to assist municipalities with the restructuring costs related to the demarcation process.

It is acknowledged that the restructuring of municipalities will place enormous strain on them. It is, accordingly, critical that a costing of the transformation process be done to quantify the incidental and once-off costs involved in transforming local government in order to determine whether or not there is a need for a transitional fund to assist municipalities during the process.

The purpose of the Cabinet memorandum is to inform Cabinet of the process that will be followed by the Department in determining the transitional costs involved in financing the restructuring of municipalities. A follow-up submission will be made to Cabinet as soon as the survey has been completed and the once-off and incidental costs of the demarcation process have been quantified in order to motivate for the introduction of a transitional fund to local government, if necessary.

Recommendation

That the attached memorandum be submitted to Cabinet to inform it of the process that will be followed by the Department in determining the transitional costs involved in financing the restructuring of municipalities as a result of the demarcation process.

ACTING CHIEF DIRECTOR: LOCAL GOVERNMENT FINANCE
(MR C PAKADE)
Date:

ACTING DEPUTY DIRECTOR GENERAL: LOCAL GOVERNMENT
(MS J MANCHE)
Date:

DIRECTOR GENERAL
(MR Z TITUS)
Date:

Report noted / or

MINISTER FOR PROVINCIAL AND LOCAL GOVERNMENT
(MR F S MUFAMADI)
Date:

ANNEX 9B
DEPARTMENT OF PROVINCIAL AND LOCAL GOVERNMENT

CABINET MEMORANDUM NO OF 2000
DATE:
FILE NO.:

Subject

Funding the restructuring of the local sphere of government.

Purpose

To inform Cabinet of the intention of the Department of Provincial and Local Government to quantify the costs of restructuring local government.

Summary

The redrawing of municipal boundaries is one of the most important tasks that will be undertaken in the transformation of local government. Although this will enable the creation of viable and sustainable local government in the long term, it will place enormous pressures on municipalities in the short term. The restructuring will, amongst other things, result in re-organising service networks in different ways, transfers of staff and integrating administrations, dividing assets and liabilities, and bringing together different budgeting, planning and development systems, and so on.

This restructuring will place enormous strains on municipalities. It is accordingly critical that a costing of the transformation process be done to quantify the incidental and once-off costs involved in transforming local government in order to determine whether or not there is a need for a transitional fund to assist municipalities during the process.

The Department of Provincial and Local Government will undertake a survey of selected municipalities which will be used as a basis for projecting/estimating the total transformation costs (taking into account the new demarcated boundaries) of all municipalities. The results of the survey will be used as a basis for informing Cabinet of the once-off and incidental costs of the demarcation process and to motivate for a transitional fund to local government, if necessary.

Discussion

In 1995, approximately 1 260 local government bodies across the country were amalgamated to create 843 municipalities. After these elections, municipalities spent a lot of time, energy and money adjusting to these new boundaries. However, further restructuring is needed for a number of reasons, many of them arising from weaknesses in the existing system. Although municipalities are functioning as best as they can within the given boundaries, these boundaries have often contributed to their difficulties. For example, a number of councils are simply not financially viable because their boundaries were not drawn widely enough to cover a tax base that can sustain their administration.

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The process of institutionally restructuring the system of local government is nearing completion. The promulgation of the Demarcation Act and the Municipal Structures Act established a framework for realising the institutional arrangements for a developmental local government. These reforms are necessary to ensure that local government can deliver services efficiently to all its constituents.

One of the most important tasks in the transformation of local government is the drawing of new municipal boundaries. Of course, new boundaries will not suddenly solve all the problems faced by municipalities. Much work needs to be done, in addition to demarcation, to ensure that municipalities have stable and adequate sources of revenue, have administrations that are properly organised, and so on. Demarcation will set the structural conditions within which these other processes of transforming and developing local government can occur.

Almost all municipalities have their boundaries re-drawn, or demarcated. Therefore, local government is being completely restructured from its current format. New municipal boundaries will result in re-organising service networks in different ways, transfers of staff and integrating administrations, dividing assets and liabilities, and bringing together different budgeting, planning and development systems, and so on.

The above local government reforms will enable the creation of viable and sustainable local government in the long term. However, enormous pressures will initially be placed on municipalities during the restructuring process. The complexities of transformation will require massive efforts and resources of the local government role-players. It, therefore, becomes imperative for national government to re-position local government through a stabilized administrative and conducive policy environment to implement the broader mandate of local government and to ensure the smooth transition to the new local government system.

It is critical that the costing of the transformation process be done in order to determine the incidental and once-off costs involved so as to determine whether or not there is a need for a transitional fund to assist municipalities during the process.

The Department of Provincial and Local Government will undertake a survey which will be used as basis for informing Cabinet of the once-off and incidental costs of the demarcation process. The survey will focus on the following types of municipalities to determine all incidental and once-off costs which are directly related to the restructuring process:

- 6 metropolitan councils (Category A municipalities);
- 10 larger urban municipalities (Category B municipalities); and
- 10 district councils, including smaller and urban municipalities falling under these structures (Category C municipalities).

All legal, institutional, financial and practical matters relating to the dis-establishment of the old municipalities and the establishment of the new municipalities need to be identified and quantified. Some of the issues that will be addressed include:

- Costs of re-organising service networks to provide services aligned to the new municipal boundaries, i.e. creating new billing, metering systems, etc.;

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- Costs related to the transfer and re-organising of staff, i.e. development of legal framework for transferring staff, establishing new organograms, salary structures, etc.;

- Costs of integrating administrations, dividing assets and liabilities, and bringing together different budgeting, planning and development systems, infrastructure systems, etc;

- Determining the length of the periods during which these costs must be borne;

- Using these costs as a basis for projecting/estimating total costs (taking into account the new demarcated boundaries) of all municipalities;

- Determining appropriate criteria for allocating the transitional fund as a means of financial support to those municipalities that cannot afford to pay for the transitional costs; and

- Any additional tasks identified by the Department in this regard.

The outputs of the survey will be:

- A detailed report indicating all incidental once-off costs related to the restructuring process of municipalities, including its impact on the sample municipalities and a reasonable timeframe for the process; and

- A recommendation on the total amount the national fiscus should set aside as a transitional fund and proposed criteria for the allocation of such a fund in financing the transformation process; and

- A detailed implementation plan to implement the re-organisation of local government.

The activity will be undertaken as soon as possible and should be completed by May 2000. The envisaged period of completing this activity is two months.

Other Departments/Bodies Consulted

Consultation will need to take place with other relevant stakeholders. These may include:

- Organised local government associations (SALGA and provincial associations)
- Other national government departments (e.g. DWAF and DoF)
- Institute of Municipal Finance Officers (IMFO)
- Municipal Demarcation Board
- National Electricity Regulator (NER)

Organisational And Personnel Implications

None. Donor funding will be secured in order to obtain the services of approximately two top level South African advisers to undertake the above-mentioned costing exercise and to prepare a detailed report to inform government of the need for funding these costs.

Financial Implications

The establishment of a transitional grant to assist municipalities with the incidental and once-off costs during this demarcation process will enable the smooth transition to the new local government system. The actual costs of the transformation will be quantified and communicated to Cabinet as soon as the study has been completed.

Communication Implications

None.

Constitutional Implications

None.

Recommendation

It is recommended that Cabinet notes the steps being taken by the Department of Provincial and Local Government to determine the once-off and incidental costs of the demarcation process and to motivate for a transitional fund to local government, if necessary.

Contact Person

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APPENDIX 10
THE REGIONAL SERVICES COUNCIL LEVY: EVALUATION AND REFORM OPTIONS

Summarized by Peter Vaz
June 7, 2001

Problem Statement

The Regional Services Council (RSC) levy is a revenue-productive tax that supports the finances of metropolitan and district councils. It has two components – (1) a turnover tax levied on the gross sales of businesses and (2) a payroll tax levied on the gross payrolls of businesses. The former accounts for about two-thirds of revenue.

The RSC levy has two problems:

1. It fails most of the maxims for a "good tax". The norms for a good tax include: revenue adequacy, income elasticity, equity, administrative feasibility, neutrality, and political acceptability. The norms for a good "local" tax include correspondence between those who bear the burden and those who enjoy the benefits, fiscal autonomy, and fiscal equalization. No single tax will satisfy all these criteria so the decision to be made is which norms should receive priority. Accordingly the decision to be made is whether to live with the significant flaws in the RSC levy in order to capture the benefits that the RSC levy offers. The one thing to note here is that the RSC levy is levied at such a low rate that its flaws do not have much impact.

2. Legal strictures have constrained the assessment and collection of the RSC levy. Businesses simply declare and pay what they think is "right". Metropolitan and district councils may neither issue an assessment nor examine the books of a company thought to be under-reporting tax liability. They may not penalize a delinquent nor may they call a non-payer for an examination of accounts. The SARS collector may issue an assessment on behalf of the metropolitan or district council, or may examine the books of account, or may pass information regularly to the metro and district councils, but this does not appear to be a common practice. Thus, the RSC levy operates more like a donation by businesses than as a tax.

Evaluation Of The RSC Levy

The RSC levy can be evaluated in terms of the following:

1. **Revenue Performance**: In 1998/99, the RSC levy yielded R3.1 billion, equivalent to 1.9 percent of total national government tax revenues and 0.4 percent of GDP. The income elasticity of the RSC levy over the period 1995/96 to 1998/99 was 1.7 i.e. for every 10 percent increase in revenue over the period, RSC revenue increased by 17%. The GDP elasticity in 1998/99 was 0.94, compared to 0.9 for individual income tax and 0.7 for the VAT. Thus, despite the poor administration of the tax, some combination of increased registrations and increased declarations of turnover and payrolls led to a growth that nearly kept pace with GDP and did as well as individual income tax and VAT.

2. **Revenue Importance**: At the local level, the RSC is a significant revenue source. In the metropolitan councils, it accounts for between 7.7 % to over 40% of total local revenue. In the district councils, it often accounts for almost all of district council revenue. This leads to the conclusion that the RSC levy would be a very difficult revenue source to replace.

3. **Equity**: The turnover and payroll taxes have different incidence. Since the turnover tax is likely to be passed forward by businesses in the form of higher prices, regressivity is a concern because consumption taxes tend to fall more heavily on low-income people. Because payroll taxes fall primarily on formal sector employees, who are relatively well off in the national income distribution, they could be considered progressive. However, since the payroll component of the RSC levy is a flat rate tax, it is not progressive within the target group. This leads to the conclusion that the RSC levy probably adds an element of regressivity to the tax structure. However, since it accounts for only about 0.5% of GDP, it does not have a significant effect on the overall distribution of tax burdens.

4. **Horizontal Equity**: "Fairness" in taxation requires that people/businesses in the same circumstances be treated the same. In this regard, the RSC levy is more horizontally fair than the VAT or the income tax. By law, the tax is very broad-based and covers virtually all sales transactions and all wage, salary and fringe benefit payments. However, in practice, the RSC levy introduces horizontal inequities in three areas: (a) a worker in the informal sector is not as likely to be subject to the payroll tax as a worker in the formal sector, even if the two earn the same wage; (b) a transaction in the informal sector is not as likely to be taxed as an identical transaction in the formal sector; and (c) a vertically integrated firm pays less gross receipts tax than does a non-vertically integrated firm. In addition, the arbitrariness of assessment and collections contributes to horizontal inequities in the distribution of tax burdens because some delinquent taxpayers, and some who are deemed to underreport, are singled out for the attention of collectors.

5. **Neutrality**: The RSC levy does not fare well in this regard. First, there is an incentive for a firm to vertically integrate some of its production and distribution processes so as to avoid paying the turnover tax at some stages of production. Second, an employer will find labour more costly because of the payroll tax and have an incentive to substitute capital for labour at the margin.

6. **Administration Costs**: Because there are no data on the true tax base for either the turnover or payroll components of the RSC levy, it is not possible to estimate how much of the tax is not collected. It is reasonable to assume that, due to the low probability of a delinquent being detected and the small penalties assessed if detected, the percent of true tax liability is very small. This leads to the conclusion that collection costs are high. However, due to the poor administration of the levy, a narrow view of the collection rate (the administrative costs as a percentage of the actual amounts collected) leads to an estimate of the collection cost at somewhere between 2% and 20% of collections. Compliance costs are also low because compliance is poor. Both collection and compliance costs would be much higher if the RSC levy were better administered.

7. **Fiscal Disparities**: There are wide disparities across district councils in the yield of the RSC levy. Over half of total collections takes place in the metropolitan areas. The per capita collection of RSC levies varies from a high of R1848 to less than R10, with a mean of R145. This leads to the conclusion that the RSC levy significantly accentuates fiscal disparities between rich and poor provinces. Metropolitan councils, which have higher levels of income, raise more RSC revenue on a per capita basis, even if they do not levy a higher tax rate.

8. **Benefits and Burdens**: Businesses pay their turnover taxes at their headquarters location. Those metro and district councils with large concentrations of headquarters firms can export their taxes to other places. The metros collect about 57% of all turnover taxes but their residents are burdened with only 48% of this tax, thus exporting about 9%. In general, big rich municipalities are tax exporters and small, poor ones are tax importers. The payroll tax is not as susceptible to the exporting problem because the tax is generally collected by the employer at the place of work and paid to that jurisdiction.

9. **Political feasibility**: There is no great complaint from business or from individuals to abolish the RSC levy. Most individuals probably do not realize that the tax is passed on to them by business. The tax rates are very low and the tax is not seen as onerous. The poor administration of the tax contributes to its acceptability. If the tax were fully and properly administered, voters may find it objectionable. It would be viewed as regressive, exerting a bias against labour, and introducing significant collection and compliance costs. So, if administration of the tax is tightened, the following objections might become points of contention: (a) the constitutionality of the tax – it is unconstitutional for local government to levy a sales or income tax; (b) businesses do not have representation on the district councils or metros; and (c) the benefits of the tax are not clear to taxpayers.

10. **Legal implications**: There are three issues of concern here: (a) the constitutionality of the tax – as it stands, the constitutionality has not been challenged because of the low rate (that has not changed since 1996) but may become an issue if the tax rate is increased; (b) the rights of local government to invade the financial privacy of taxpayers may be questioned if administration is improved by enacting legislation to permit this; and (c) the behaviour of some private collectors who are not regulated or closely monitored.

Options For Reform

There are several options for reform of the RSC levy. These can be divided into:

1. **Decentralized solutions:**

(i) Leave the tax alone.
(ii) Convert the tax to a true local tax and make proper provision for administration.
(iii) Leave the tax structure as it is but turn administration over to SARS.
(iv) Abolish the RSC as it now exists and replace it with a piggyback on the payroll tax.

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2. **Centralized solution:**

(v) Convert the tax to a VAT-based grant.

3. **Mixed solution:**

(vi) Abolish the tax and replace it with a mixed system.

(i) Leave the tax alone

Arguments in favour include:
(a) It is the primary local own-source source for district councils.
(b) It is revenue productive and will be hard to replace.
(c) It is currently accepted by the public.
(d) It has low administrative and compliance costs.
(e) It is a relatively elastic revenue source.
(f) Despite its problems, its low rates minimize the distortions that it creates.
(g) Timing for reform may be bad – there are enough shocks to the system currently with demarcation, the property rates bill, electricity restructuring, and so on.

Arguments against include:
(a) Administration is bad and unfair.
(b) Its revenues are more localized in the big cities because so much of the tax is paid at the headquarters location.
(c) The turnover tax is distorting and could be seen to duplicate VAT at the local level.

(ii) Convert the tax to a true local tax and make proper provision for administration

Arguments in favour include:
(a) Local rate-setting would encourage local accountability.
(b) Metros and district councils would have an incentive to increase revenues and improve administration.
(c) Consistent with decentralization.

Arguments against include:
(a) Local rate setting might lead to increases in already-existing rate differentials across jurisdictions and increase tax exporting by richer jurisdictions.
(b) Administrative costs would rise.
(c) Major changes in the legal structure of the tax and its administration would be required and this would raise both timing and political issues.
(d) A constitutional amendment would be needed to allow metros and district councils to collect the tax (which is, in effect, both an income and sales tax).

(iii) Leave the tax structure as it is but turn administration over to SARS

Arguments in favour include:
(a) Administration to do this is in place and a costly duplicative local government administration could be avoided.

(b) Taxpayers could submit the tax as part of their VAT or income tax return, thereby minimizing compliance costs.
(c) A greater revenue yield could be expected since there would be sanctions and an inspection threat and since SARS could do regular crosschecks against VAT and income tax records.
(d) Consistent with local rate setting, allowing for fiscal autonomy and local accountability.

Arguments against include:
(a) Since it would leave the turnover tax in place, SARS would be collecting both a turnover tax and a VAT tax from each VAT-registered taxpayer.
(b) Poor incentive for SARS to collect the tax because it would receive little of this revenue
(c) District councils are not harmonized with tax districts.
(d) Question of whether SARS has the capacity to take on this additional administrative burden.

(iv) Abolish the RSC as it now exists and replace it with a piggyback on the payroll tax

Arguments in favour include:
(a) Metros and district councils would choose a tax rate on payrolls within limits prescribed by national government, providing some amount of local autonomy.
(b) Eliminates the turnover tax and would consequently be more progressive than the current RSC levy in terms of the distribution of tax burdens.
(c) Promotes administrative efficiency because national government collects the tax and compliance costs would be lowered.

Arguments against include:
(a) It is a tax on labour in a labour-surplus economy and another payroll tax has recently been introduced.
(b) Capital income will be excluded from the tax base.
(c) It may not be horizontally equitable in that it will tax labour income but, for administrative reasons, will likely miss most self-employed income.
(d) It will take up some "tax room" in national government's 27% effective tax rate ceiling.
(e) Question of legality of a local payroll tax.

(v) Convert the tax to a VAT-based grant

This option would take the form of a grant based on a surcharge on the VAT. A revenue-neutral surcharge would require an increase in the VAT from 14% to 15%. An amount equivalent to 1% of the VAT would be dedicated to a "local government fund" as a replacement for the RSC levy. There are three options for distributing this fund to metros and district councils:

(a) Derivation: This has the advantage of providing a significant base of revenue support to more urbanized metros and district councils but has the disadvantage of being counter-equalizing.

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(b) Needs-based formula: This has the advantage of being equalizing but has the drawback of channeling significant revenues to district councils that may not have the capacity to spend the funds.
(c) Ad-hoc conditional grants: This has the disadvantage of not being consistent with a decentralization policy of providing local autonomy.

Arguments in favour include:
(a) It eliminates the turnover tax with its potential regressive effects.
(b) It gives metros and district councils access to a productive and elastic revenue source i.e. the grant pool will grow as fast as VAT collections.
(c) It would be administratively more efficient and would impose no additional compliance costs.
(d) Because the VAT surcharge is better administered than the RSC levy, it can raise the same amount of money with a lower effective rate than is currently faced by most firms who pay the RSC levy.

Arguments against include:
(a) Since it is a grant, it will be a step away from local autonomy and will remove one major revenue source from metro and district councils.
(b) The distribution of the revenue pool could be contentious. If distribution is done on a derivation basis, it will favour big cities and keep in place the headquarters problem. If distribution is done on a needs-based formula basis, it will favour rural areas that may not have the capacity to spend the money.
(c) An increase in the VAT may take "tax room" away from national government.
(d) The "flypaper effect" (money sticks where it hits) may occur i.e. national government may not distribute a fair share back to metros and district councils. National emergencies or new priorities may come up as significant reasons for diverting the funds.

(vi) Abolish the tax and replace it with a mixed system

Recognition of the differential taxing and spending capacities of the newly-established metros and district councils may necessitate an asymmetric approach to the reform of the RSC levy. The more capacitated metros and district councils could be given taxing powers while the less capacitated ones would be given grants in lieu of the RSC levy. One variant of this approach is as follows:

(1) Group 1: More capacitated metros and district councils would be given the power to levy a payroll tax and could set the rate up to some specified limit. SARS would collect the tax along with its usual payroll tax and remit the money to the local jurisdiction.
(2) Group 2: Less capacitated metros and district councils would receive a general-purpose grant. The size of the grant pool would be fixed at some amount greater than the difference between the level of previous RSC revenues and the amount previously raised by those local jurisdictions who would be given the power to tax. The distribution would be according to a needs-based formula. The jurisdictions in this group would be able to graduate to Group 1 once they meet certain conditions. Once a Group 2 jurisdiction joins Group 1, it could not return to the grant system.

Arguments in favour include:

(a) The turnover tax, with its potential regressive effects, would be eliminated and tax exporting would no longer be a problem.
(b) The administration of the RSC levy would no longer be an issue because SARS would collect the payroll tax.
(c) This approach would provide decentralized taxing powers to more capacitated metros and district councils, promoting local accountability.
(d) More capacitated councils would have an income-elastic revenue source.

Arguments against include:

(a) It is a tax on labour in a labour-surplus economy and another payroll tax has recently been introduced.
(b) Capital income will be excluded from the tax base.
(c) It may not be horizontally equitable in that it will tax labour income but, for administrative reasons, will likely miss most self-employed income.
(d) It will take up some "tax room" in national government's 27% effective tax rate ceiling.
(e) Question of legality of a local payroll tax.
(f) The less capacitated Group 2 local jurisdictions are not decentralized. They would not receive any additional taxing powers. In fact, in future years, they may be at the mercy of national government in terms of the determination of the vertical share of the grant pool.
(g) The provisions for graduating from Group 2 to Group 1 could be complex.

Conclusion

The RSC levy is not the best choice for a decentralized system of local government but it is known and accepted. Its shortcomings are forgiven because the rate is low and the problems are softened by poor administration. With so much going on currently – demarcation, property tax reform, electricity restructuring, sorting out of powers and functions, and so on – it may not be the optimal time to introduce a new, major change to local government finances. However, in the interests of decentralization, the reform of the RSC levy needs to be considered. The way forward might be to get through the next year or two while planning the transition of the RSC to something that supports national government's decentralization strategy and working out the implementation of the new program. Decentralization objectives would be best supported by either converting the tax to a true local tax or piggybacking it onto the payroll tax or replacing it with a mixed system of a local tax and grant.