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## Integrating Fiscal Decentralization Reforms and the Challenge of Implementation

Authors	Smoke, Paul;Bahl, Roy W.;Reschovsky, Andrew;Schroeder, Larry;Vaz, Peter
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# Restructuring Local Government Finance in Developing Countries

Lessons from South Africa

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*Edited by*

Roy Bahl, Georgia State University, USA  
and

Paul Smoke, New York University, USA

STUDIES IN FISCAL FEDERALISM AND STATE-LOCAL FINANCE

**Edward Elgar**

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## 7. Integrating Fiscal Decentralization Reforms and the Challenge of Implementation

**Paul Smoke, Roy Bahl, Andrew Reschovsky, Larry Schroeder, David Solomon, and Peter Vaz**

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### INTRODUCTION

South Africa's struggles with an ambitious and complex fiscal decentralization program are presented in detail in the first six chapters of this book. In this chapter, we summarize our key findings and turn to a discussion of the way forward with the assignment of powers and functions, the development of local sources of revenue, and the redesign of the intergovernmental transfer system. We give special emphasis to the interrelationships among the pieces of the fiscal decentralization system. We also briefly consider two dimensions of the system – development transfers to support capital investment and municipal borrowing powers – that are not discussed at length in the previous chapters.

Our approach particularly highlights implementation, a critical aspect that is often de-linked from the analysis of fiscal decentralization policy. Given the large number of reforms that need to be undertaken, the heterogeneity of local governments, the need for substantial capacity building in many local governments, and the fragmentation of responsibility for decentralization across national agencies, implementation may be seen as the most challenging aspect of decentralization. We believe that implementation must follow policy, but we also know that the actual policy impacts are to a very great extent determined by the effectiveness of the implementation. If the implementation strategy is not carefully conceived, the likelihood of

realizing a sustainable fiscal decentralization is not high.<sup>1</sup> Throughout the discussion, we highlight the relevance of the South African model for other developing countries.

## SUMMARY OF THE SOUTH AFRICAN REFORM CONTEXT

South Africa's entire three-sphere system of government – national, provincial, and local – has been undergoing major changes since the fall of apartheid in 1993 and the finalization of the new Constitution in 1996. This book focuses primarily on the local government sphere, which has been the target of particularly ambitious reforms in the past decade.

As discussed in Chapter 2, the Constitution and the Local Government Municipal Structures Act (1998) consolidated a complex system of urban and rural transitional governments, such as transitional local councils (TLCs) and transitional rural councils (TRCs), into three municipal categories. Metropolitan municipalities (category A, or 'metros') exclusively cover large urban areas. Local municipalities (category B) cover non-metropolitan localities, which vary in size and degree of urbanization. District municipalities (category C) geographically encompass several B municipalities, provide services to areas within their boundaries not served by B municipalities and coordinate integrated development planning for the entire district. In 2000, the Municipal Demarcation Board reorganized and consolidated municipalities in South Africa, resulting in a reduction in their number from 843 to 284.

Local governments in South Africa are given substantial powers and functions by the Constitution and various laws. The most important municipal services are water, sanitation (including solid waste), roads, stormwater drainage, and electricity. The actual distribution of responsibilities, however, varies widely within and among types of local governments, especially between urban and rural areas, and there is still a lack of clarity about the division of responsibilities between category B and C municipalities. Local governments are granted a number of sources of revenue by the Constitution, and they are also given the right to borrow, except to finance a recurrent deficit. The main sources of revenue are property rates and surcharges on fees for services provided by, or on behalf of, the municipality, with electricity

being particularly important. Other sources, such as the Regional Service Council (RSC) levy, a combination payroll and turnover tax, are also allowed. Property rates are available only to category A and B municipalities, while the RSC levy is available only to category A and C municipalities. The Constitution further entitles the local governments to an 'equitable share' of national revenues, which is provided as an unconditional transfer, and to other types of grants. Local governments raise over 90 percent of their revenues from own-sources, but there is wide variation, ranging from the largely self-sufficient metros (category A) to very poor category B municipalities that depend heavily on transfers.

The Constitution gives higher levels of government some oversight and control powers over local governments. Assignment of certain powers and revenues to local governments is at the discretion of the national government and, to an extent, the provinces. The center develops national objectives and guidelines and ensures coordination among all levels of government. The center also designs and administers the intergovernmental transfer system. Particularly important players are the Department of Provincial and Local Government (DPLG) and the National Treasury. Finally, the national and provincial levels monitor municipal affairs – and can intervene as necessary – to ensure that basic standards of good governance, service provision, and financial discipline are being met.

There are many unresolved questions regarding the structure and operations of the local government system in South Africa and various reforms are still in process. Major effort is now being directed to determining how to assign powers and functions to local governments, particularly with respect to category B and C municipalities. There are also plans for improving local government own-source revenue and intergovernmental transfer systems. DPLG continues to work on implementing the Local Government Municipal Systems Act (2000), which regulates internal municipal arrangements, focusing on support of economic development, establishing participatory mechanisms, and reforming human resource management and service delivery arrangements. The National Treasury is developing the Local Government Municipal Finance Management Bill (2002), which includes provisions about municipal financial management systems, municipal debt, and monitoring municipal fiscal condition.

## ASSIGNMENT OF POWERS AND FUNCTIONS

Among the key choices to be made as the South African government attempts to craft a system of effective local government, none is more critical than assigning powers and functions between category B and C municipalities. Without well-defined responsibilities and revenue entitlements certain functions may be duplicated in some areas and not provided in others. In this section, we summarize the basic framework detailed in Chapter 2 for considering the assignment of municipal powers and functions, briefly summarize key empirical results that are relevant for evaluating assignment choices, and close with an evaluation of alternative approaches to developing assignment arrangements.

### **Framework for Analyzing Functional Assignments**

The assignment of powers and functions to local governments is complicated because a long list of objectives are desirable, but no single package of functional assignment can satisfy all of them. Thus, a first step is for the South African government to prioritize its objectives.

In this context, it is important to remember that policy making can take a short- or long-term perspective. A long-term perspective considers what the local government system should look like when it has matured, whereas a short-term perspective is concerned with what is feasible today. The advantage of the shorter-term view is that it focuses pragmatically on how to get the system working now, but a key disadvantage is that changing rules for assigning powers and functions at a later time can be difficult because municipalities and political groups who lose power will resist reform. Using a long-term perspective may reduce political disputes later, but a system based on pre-requisites of a mature local government system is unlikely to succeed in the short run. A compromise is to define a system that initially focuses on realizing short-term achievements but is structured in a way that will allow it to 'grow' into a mature system.

There also is the question of sequencing. A basic principle of fiscal decentralization is that finance should follow function – the revenues assigned to a municipality should be consistent with its functional responsibilities. Beginning the process with revenue assignment creates the risk of some municipalities being assigned expenditure responsibilities that exceed available revenues whereas others may have

excess revenue potential that can lead to wasteful spending. If function follows finance, then the goal of establishing a hard budget constraint for sub-national governments will not likely be realized.

A set of municipal functional assignment objectives was issued by the South African Department of Provincial and Local Government (2000). The numerous and partially redundant objectives, which are detailed in Chapter 2, are common in fiscal decentralization programs worldwide. They are fraught with difficult conflicts. One particularly important objective in South Africa is to redress the substantial historical inequities that were institutionalized in the apartheid era, but this goal may undermine other stated objectives. Redressing inequities implies redistributive cross-subsidies from those who historically benefited from government policies to the historically deprived. This is consistent with ability-to-pay equity, but it conflicts with the principle that payments should be in line with benefits received. It may also be non-sustainable if those on whom taxes are levied resist compliance because substantial portions of their payments are benefiting others.

Given such tradeoffs, the South African government will need to decide which of its objectives are more critical. In our analysis, we attempt to make explicit the various objectives that are likely to be attained or ignored under a particular set of assignments.

### **Recent Fiscal Status of Municipalities and Future Needs**

The decision regarding assignment of powers and functions to municipalities should recognize their current fiscal status. Furthermore, it is helpful to know the types of challenges that will have to be met if municipalities are to realize service delivery expectations. This subsection reviews highlights of our empirical work on service delivery arrangements (detailed in Chapter 2) in order to shed light on the task of assigning powers and functions.

Data gathered from a small national sample of pre-demarcation TLCs and TRCs in three districts illustrates major differences in the fiscal activities of these two types of transitional governments. Approximately 70 percent of total TLC revenues in 1998–1999 were derived from tariffs for electricity, water, sanitation, and refuse collection services. On a per capita basis these revenue sources amounted to approximately R1,200 per TLC resident. Property rates contributed another 12 percent or so of total recurrent TLC revenues. Thus, the TLCs raised a substantial portion of their revenues from own-

sources and were not heavily dependent on intergovernmental transfers. They also provided many basic services, at least to some residents in more urbanized areas. Nearly all TRC revenues, on the other hand, were derived from transfers and, unlike the TLCs, their expenditures focused on administrative expenses rather than basic service delivery.

Now that the TRCs and TLCs have been joined to form category B municipalities under the 2000 demarcation, there are likely to be some situations where these amalgamations have resulted in fiscally stronger jurisdictions. There could also be some cases in which the opposite is true. In either case, our analysis suggests that a key challenge of the assignment task will be to improve the flow of resources and services to the poorly served non-urbanized areas of new B and C municipalities.

Districts (category C municipalities) mobilize resources primarily from the RSC levy and intergovernmental transfers. Approximately 40 percent of total district revenues (including revenues provided for agency functions) in 1998–1999 were raised from the RSC levy in our sample. Per capita district RSC levy revenues averaged approximately R50, but ranged from about R5 to nearly R160.

Based on three district case studies, we determined how, prior to the creation of newly demarcated municipalities, powers and functions were divided between districts and former TLCs and TRCs. Although small, the sample was sufficiently large to indicate that current arrangements were far from uniform. Some districts restricted their expenditures primarily to capital investment fund allocations to local municipalities, which accounted for nearly half of total district revenues in 1998–1999. Others made substantial recurrent expenditures for service delivery. The assignment task must recognize this diversity in choices about how to use resources.

In addition, it must be emphasized that in spite of the public expenditures that were being made by transitional local governments, substantial portions of the population outside metropolitan areas are not well served. Urbanized areas tended to have reasonable service coverage (in terms of the proportion of households served) in five key service areas – water, sanitation, electricity, solid waste removal, and roads. Outside the urban areas, however, the majority of households were not adequately serviced in two of the three districts studied. Since services such as water and electricity require capital investments (particularly in ‘scattered settlements’ where population densities are low), considerable development resources along with substantial increases in recurrent revenue sources will be necessary before

adequate services can be made available to these rural residents. In addition to tariffs, rates imposed on property that is currently not a part of the tax base, as discussed in Chapter 4, will help to meet these needs. Reliance on tariffs, however, may be at least partially limited by the South African government's new 'free basic services' policy, and it is unlikely that extended property rates will be a significant revenue source in the near term because developing a property tax is costly and time-consuming.

The bottom line is that the present system is one of great service deficiencies in many, particularly rural, parts of the country. Present levels of resources seem unlikely to be able to come close to meeting this need. In terms of service assignments and how to finance them, the South African government is faced with an important but critical choice – introduce new, more revenue-productive local tax instruments, enhance the flow of capital transfers to municipalities, or lower expectations concerning how soon basic services will be available to all South Africans. We will return to this overarching choice later, but we first consider service assignment options in more detail.

### **Analysis of Alternative Assignments of Powers and Functions**

The functional assignment objectives and empirical findings summarized above provide a basis for us to evaluate several different alternatives regarding assignment of powers and functions to the B and C municipalities. The empirical results document that municipalities are highly diverse with respect to their economic and population bases, fiscal, managerial and technical capacities, and current service delivery performance. This suggests that, at least in the short to intermediate run, service responsibilities should be assigned asymmetrically. While the Constitution allows asymmetric treatment, it does not provide clear guidance on the basis for imposing it.

To carry out the analysis of illustrative options, certain assumptions were made concerning expenditures and revenues within the South African context. Among the ones we used are the following:

- A service need not be provided by the legal service authority entity. The actual service provider can be the authority holder or any agent that is authorized to act on behalf of the legal authority, including other public agencies, private firms, or non-governmental organizations.

- A number of public services and authority over them can be divided into their constituent parts. For example, some public service production processes consist of separable bulk and reticulation activities. Separation in practice, however, could involve non-trivial transaction costs.
- The B municipalities can be objectively categorized according to settlement pattern and economic base. We distinguish among three different types in our analysis – B1, containing a small city or large town as the economic core; B2, containing one or more small towns; and B3, primarily rural or with scattered settlements.
- The menu of potential own-source revenues is limited to the existing set, namely the RSC levy, property rates (with a new statutory basis), and user charges. We also assume that the RSC levy can, in spite of legislative restrictions, be used for both capital and recurrent spending, which reflects current practice.
- Assignment of revenue-raising powers is subsidiary to the assignment of functional responsibilities, so the municipality with functional authority over a service should receive revenues related to it. That municipality, however, may transfer revenue authority to another organization to which it delegates service provision responsibility.

Based on a review of the existing situation, consideration of the constitutional and legal framework, and discussions with key policy makers, our analysis considers four different arrangements for dividing powers and functions among the B and C municipalities. Briefly they include:

1. All powers and functions other than planning and capital infrastructure investments would be granted to the B municipalities, with the planning/investment function and RSC levy revenue powers reserved for the districts (category C).
2. B municipalities with large towns constituting their population/economic base (category B1) would be granted powers, functions, and revenue bases comparable to the metros (category A). Districts would retain all service authority over all other B municipalities.
3. There would be asymmetric treatment of both municipalities and services. The authority for some services would be assigned

exclusively to the district, others would be assigned to a combination of the district and more 'urban-like' category B municipalities, and detailed service provision arrangements would be determined on a case-by-case basis. Districts would retain RSC levies, and the Bs would retain the property tax, but sharing arrangements would be needed to reflect service responsibilities.

4. Districts (category C) would be granted all service authority and all local revenue powers but would contract with B municipalities to be local service providers on a case-by-case basis.

The *first alternative* provides for the greatest amount of decentralized authority while retaining the planning and investment decision function for the districts. This may be the most appropriate arrangement for a 'mature' system of local government in South Africa, but it ignores current weaknesses in many B municipalities. Although unlikely to be attainable in the short run, this arrangement could be considered a target for the longer run.

The *second alternative* essentially treats more urbanized Bs as metros (category A municipalities). A key advantage is its recognition of the RSC levy as an urban-based tax (as are property rates at present), and it would best achieve the objective of linking revenue burdens to service benefits. This option promotes fiscal decentralization (at least in more urbanized B municipalities), although less effectively than the first option. It would, however, require a significant re-orientation of intergovernmental transfers because districts would lose substantial portions of the RSC levy to urbanized Bs. In addition, although B municipalities can now collect the property tax, they will need time to extend it into areas that have not previously used it. Thus, little own-source revenue would be available to non-urban Bs or their overlying districts. With municipalities having just endured a long period of redefining systems and boundaries, substantially altering the transfer system to deal with this situation may be politically difficult.

The *third alternative*, unlike the second, does not alter the current definition of B and C municipalities. It does, however, segment B municipalities into three mutually exclusive groups – B1, B2, and B3 municipalities (where the B1 are most highly urbanized and B3 are basically rural in nature) – to allow more fine-tuned assignment of individual service responsibilities. With this option, the district would be the service authority for planning and would retain authority over local health services (to maximize coordination with the Ministry of

Health). For all other services there would be an asymmetric division of functions between the B1 municipalities and the B2 and B3 municipalities. The district can, however, on a case-by-case basis according to a set of guidelines that would require articulation, negotiate with individual B2 and B3 jurisdictions to allow them to act as providers of certain services. In particular, at least some B2s would likely be able to assume functional responsibilities similar to those assigned to the B1s. Chapter 2 provides a detailed rationale for the division of service responsibilities in each major sector.

On the revenue side, the third option retains the current assignment of property rates and the RSC levy, i.e., the former to B municipalities and the latter to districts. The RSC levy would again be intended primarily as a local source of funds for infrastructure to support district planning. By keeping the RSC levy a district source, there could be some redistribution to redress historical inequities (although some districts have little to redistribute). At the same time, this alternative does not conceive of property rates as a main source of district-level redistribution, thus preserving the property tax link between revenues paid and benefits received in urban areas.

The third alternative has many positive features, but there are also potential disadvantages that must be recognized. For example, it assumes that all districts can take primary responsibility for many local services, which may not be true where districts have weak capacity. It also implicitly assumes that agreements between service authorities (districts) and service providers (B2 or B3 municipalities) involve minimal transaction costs, which is unlikely.

The revenue aspects of this alternative may be problematic, particularly in the short run. Until property rates are implemented in previously untaxed areas, the more rural Bs will be strapped for revenues. Their only own-source alternative is service tariffs, but these can only be collected if service delivery facilities exist. Even where they exist, poverty and the emerging national policy on free basic services may limit collection levels. If services are being delivered and tariffs do not cover recurrent costs, the equitable share can be designed to help, and some portion of the district RSC levy could be used if necessary. If B2 and B3 municipalities do not deliver services, their equitable share allocations will have to be channeled to the overlying C municipality that provides services on their behalf. This arrangement could leave many B2 and B3 municipalities with no recurrent revenues to support even basic overhead expenditures. As this is likely to be

politically unacceptable, rules will be needed to divide the category B equitable share grant between the district and B municipalities. It should also be noted that the use of a portion of the RSC levy to support recurrent spending would mean that less would be available to invest in new district capital facilities. In addition, as the RSC levy is the only local revenue source available to the C municipalities, increased administrative responsibilities at the district level will also have to be financed from this source unless additional revenue sources or grants are created.

The *fourth alternative* shares some common features with the arrangements adopted by the 2000 Amendment to the Municipal Structures Act (discussed in Chapter 2) in that it strengthens the role of the districts. The main advantage of this alternative is simplicity; it transfers all revenue powers and spending responsibilities to the district. The B municipalities may, after negotiation, become service providers; however, they would have no independent service authority or direct revenue-raising powers. This option may redress historical inequities (since all revenues accrue to the overarching districts), minimize benefit spillovers and capture scale economies. It clearly, however, moves local government farther from the people, as district municipalities are geographically large and their councilors are not all directly elected. Furthermore, this option does not closely tie revenue burdens to service benefits. Thus, it would likely weaken the accountability of local government officials to their electorates. This option is the least decentralizing of the four options.

Clearly, none of the four alternatives considered here is 'optimal' in terms of being capable of achieving the full set of objectives desired by the South African government. This underscores the need for the government to make hard choices that are based on its priorities. Our view is that some variation of the third option may be the most reasonable next step given the current heterogeneity in B municipalities and the possible political infeasibility of further redefining basic local government roles in the near term. The third option pragmatically recognizes the current lack of capacity in many B municipalities. At the same time, it permits those Bs that are currently providing services to continue to do so (and to expand those services into their less urbanized hinterlands) with less disruption than the other alternatives. A situation of this nature, in which there is great variation in the capacity of local governments to deliver services and collect taxes, is not uncommon in developing countries.

This third option could be viewed as an interim approach. A system with asymmetric assignment of functions may be reasonable now but transition must be planned if the eventual objective is to develop a more mature system of local government similar to those embodied in alternatives one and two. Assigning property rates to the B municipalities will enhance their fiscal independence, and capacity-building efforts can improve their administrative and technical skills over time. As capacities develop, functions assigned to the districts could be transferred to previously dependent B municipalities. Because districts may resist losing power, clear rules and incentives will have to be established to induce them to give up responsibilities and to redirect equitable share grants to B municipalities that demonstrate adequate capacity. In this view of the world, there is not a single, once-and-for-all assignment of municipal powers and functions, but there must be a relatively clear vision of where the system should be heading. The initial system would evolve over time, and revenue assignments and the structure of the equitable share transfer would develop with it.

### **Current Status of Reforms**

The type of system outlined above would not be easy to design and implement, especially with the responsibility for assignment of municipal powers and functions divided between the DPLG and the provincial MEC for local government, as explained in Chapter 2. Progress, however, is being made. The draft policy framework under discussion in South Africa in late 2002 recommends three scenarios for the division of powers and functions between category B and C municipalities:

- Where 'strong' category C municipalities have essentially all 'nationally' (DPLG) and 'provincially' (MEC) authorized local government functions, with constituent category B municipalities having no functions other than governance, Cs would have access to most of the equitable share, along with the property tax and RSC levies. Bs would receive a limited portion of the equitable share for basic governance.
- Where 'strong' category B municipalities have essentially all local government functions, with category C municipalities having no functions other than municipal health and governance, the Bs would have access to the equitable share and property tax,

while the Cs would retain the RSC levy and receive a limited portion of the equitable share for municipal health and basic governance. The service delivery function of a district municipality would be affected in this scenario, but not its broader district-wide developmental role, which would be funded through the RSC levy and the equitable share.

- In mixed cases, where the bigger Bs ('secondary cities') are responsible for essentially all nationally allocated functions except municipal health within their own jurisdictions, and where the category C municipalities are responsible for most nationally allocated functions elsewhere, the secondary city Bs would have access to the equitable shares and property tax within their jurisdiction, including areas outside the secondary city.

These scenarios are a useful starting point, but they still need to be operationally defined. There have already been some concrete decisions, as noted in Chapter 2, on how to divide certain service responsibilities between category B and C municipalities, but the specific criteria for assignment in cases where asymmetry is to be allowed have not yet been fully identified. In addition, there have to date been no concrete provisions for altering or sharing local revenue powers.

Clearly, the South African government is seriously rethinking the assignment of local government powers and functions, as well as the need to link municipal revenue assignments with municipal powers and functions. The scenarios envisaged and actions taken to date do not correspond precisely to the assignment options we detailed in Chapter 2, or go far enough towards doing what needs to be done. The key principles embodied in our options, however, are generally consistent with the government's emerging approach to reform.

## MUNICIPAL REVENUES

South African local governments have considerably more revenue raising authority than is the case in most developing countries, but the system is not without problems. There is presently an active discussion of options to reform it. Three choices highlighted in Chapter 1 and elaborated in Chapter 3 are particularly important here – the degree of municipal autonomy in choosing tax rates and bases; the correct

balance between local revenues and intergovernmental transfers; and the degree of asymmetry acceptable in assigning revenue-raising powers. Decisions on these policy choices are crucial, because they affect both the degree to which elected local councils are accountable to their constituents (for financial prudence and service levels/quality) and the degree of equalization present in the fiscal system.

We begin this discussion with a very brief review of the principles of good local taxation and an evaluation of the South African system against these principles (see also Chapter 3). We then consider some possible reforms regarding a number of key existing or potential sources of municipal revenue. We focus particularly on the property tax and the RSC levy. More detail on these two sources is provided in Chapters 4 and 5.

### **Framework for Evaluating Revenue Options**

Five important principles could guide choices about municipal revenue reforms. First, *there should be a proper correspondence between the cost of providing a minimum level of local services and the level of local revenues expected from all sources*. Once expenditure assignment and minimum expenditures are determined, an expected level of locally raised revenue for each municipality can be estimated by applying a 'normal' tax rate to the local fiscal base. Intergovernmental transfers can then be determined as a residual between expected revenues and minimum expenditures, as elaborated in Chapter 6. This 'finance follows function' approach results in a proper fiscal correspondence, with the likely outcome of heavier urban dependence on local revenues and heavier rural dependence on grants. In the South African case, we cannot assess with certainty the degree of fiscal correspondence. Minimum local expenditures and expected local tax revenues have not been determined, relevant data are generally scarce, and a target level of equalization has not been defined. (Some limited ideas/evidence on these matters from our research is presented in Chapter 6.) We can, however, say that since both revenue structure and expenditure assignment are under review, finding a proper fiscal correspondence may be high on the decentralization policy agenda.

A second guideline for selecting local taxes is that *the growth of the revenue base should be adequate to match the growth of local service provision costs, including resources required to help reduce service level deficiencies*. This guideline will be difficult to accomplish in

South Africa. The size of the revenue pool for equitable shares and conditional grants is determined by Parliament in an ad hoc way. This makes the long-run elasticity of transfers uncertain and suggests a need to develop an elastic local revenue base. Even if this can be realized, there will be great inter-jurisdictional differences in revenue base growth, especially between urban and rural municipalities. There is, however, some buoyancy in the revenue bases presently assigned to municipalities. The RSC levy and the property tax growth rates have been relatively comparable to those of national taxes in recent years, and there is some evidence that the same is true of the surplus revenues from electricity undertakings. However, proposals for reforming all three of these major municipal revenue sources are under consideration, with uncertain implications for the overall elasticity of the local government revenue base.

Third, *local government revenue choices should be made with full recognition of the great variation among municipalities in their ability to assess and collect local taxes.* For many municipalities in South Africa, effective administration of modern taxes is still beyond reach. The staff skills and practical experience required for assessing and collecting taxes are simply not in place in many municipalities outside of the metros and larger urban areas. A number of the currently proposed reforms for property rates and the RSC levy do not take account of such differences in administrative and tax capacity, and some would propose a uniform financing system for all municipalities. If uniformity is chosen, there is an urgent need to upgrade municipal administrative infrastructures, especially those in rural jurisdictions, but this cannot occur instantly. Thus, decisions must be taken about what to do under current circumstances, what the desired system should ultimately look like, and how to make the transition to the desired system over time.

Fourth, *local government revenue sources should be structured so as to minimize disincentives to revenue mobilization and give municipalities some control over local tax rates.* In this respect, grant formulae based on objective measures of need, matching grants, and grants that require minimum tax effort are good practice. Deficit (bailout) grants, grant formulae based on actual expenditures, and heavy central control of local taxing powers are less desirable practices in that they may not encourage increased tax effort by municipalities. The present system of local government finance in South Africa gets a mixed review on revenue incentives. On the one hand, the equitable

share grant is based on objective (if somewhat flawed) measures of need and is distributed in a transparent way, and municipalities may adjust property tax rates and user charge levels without seeking central approval. On the other hand, bailout-like grants have been used by the national government, raising the moral hazard issue. Moreover, local governments are not allowed to raise the RSC levy rate, and legislation under consideration is likely to circumscribe their discretion over the property tax rate.

The final principle is that *municipalities should not be given authority to levy taxes whose burden can be shifted significantly to residents of other jurisdictions*. If the burden can be exported, then the taxing jurisdiction may overspend because its voters do not bear the full cost of local services. Payroll and property taxes, as well as user charges generally pass this test – those who bear their burden (workers, renters, and property owners) are generally local residents and service beneficiaries. Turnover taxes, income taxes on businesses, and income taxes on non-labor personal income do not pass this test. For example, consumers who live in other jurisdictions may ultimately pay gross business sales taxes because they are reflected in higher consumer prices. In South Africa, the biggest problem in this respect is the turnover tax component of the RSC levy. The analysis in Chapter 5 estimates that category A municipalities (metros) receive 58 percent of revenue from the turnover tax component of the RSC levy, but metro residents bear only 48 percent of the burden. Through tax shifting, residents of rural and smaller urban areas are financing part of the services provided in large metros.

## **Individual Sources of Municipal Revenue**

### **Property rates**

By international standards, South Africa is a heavy user of the property tax. As discussed in Chapter 4, municipalities in South Africa have historically been given greater than typical discretion in choosing the tax rate and the tax base. At present, some local councils tax improved value, some tax site value, and some levy a differential rate on land and improvements. The property tax is a revenue source available to the A and B municipalities but not the district municipalities.

Clearly, property rates should be a major source of local government revenue in South Africa. This tax passes the tests for a good local revenue source, though it does impose some significant administrative

challenges. The major questions for the government to answer about this tax are how much of the local government-financing burden it should carry, and how adequate revenue growth can be assured.

Property rates will almost certainly be reformed in the very near future. A bill in an advanced stage of preparation will be considered soon by Parliament, and the general outline of the new system is coming into focus. The latest draft of the bill suggests that the national government will exert more control over property rates in the future. The tax base is expected to be mandated as uniform, i.e., all municipalities will be required to tax the improved value of property. In addition, the national government is expected to have discretion to cap the percentage increase in the property tax rate. While there are good arguments for such restrictions, they would limit the degree of local autonomy in taxing decisions.

There are, however, some more clearly positive features of the proposed property tax reforms. These include a broadening of the tax net, instituting mandatory revaluation at an interval that should improve the buoyancy of the tax, and allowing municipalities some discretion regarding the implementation of the tax, including extending the base to heretofore untaxed properties and defining policies on exemptions. The draft bill also recognizes the need for developing a strategy for a scheduled implementation of the tax rather than an adoption of all reforms simultaneously in all local governments.

### **The RSC levy**

The RSC levy is a revenue-productive tax that finances a significant share of the services provided by metropolitan (category A) and district (category C) municipalities. It is levied at a flat rate on the gross sales and payrolls of businesses, with the turnover tax component accounting for about two-thirds of revenue. The base is set by the national government, which has frozen rates since 1996.

Legal strictures have so flawed the assessment and collection of the RSC levy that it is doubtful that it actually taxes either gross sales or payrolls. Municipalities may neither issue an assessment nor examine the books of a company thought to be under-reporting liability. They may not penalize an outright delinquent, nor may they examine accounts of non-payers. Businesses simply declare and pay what they consider to be acceptable. The RSC levy resembles a donation as much as it does a tax.

The six metros account for about 55 percent of all collections. For

smaller urban and rural districts, the RSC levy is not as revenue productive, but it is usually the dominant source, often accounting for as much as 90 percent of revenue. As only metros and districts have access to the RSC levy, changes in expenditure assignment between districts and B municipalities may necessitate a change in RSC levy assignment, as discussed in Chapter 2.

The RSC levy in its present form fails most of the maxims for a 'good tax'. The pyramiding that characterizes the turnover tax component distorts final market prices and favors vertically integrated firms, while the payroll tax component offers a disincentive to employment in a labor-surplus economy. Neither the payroll nor the turnover component reaches the informal sector very well, indicating another source of horizontal inequity. On a more positive note, the cost of the administrative apparatus required to collect the present RSC is a modest 2 percent of revenues received. If those taxes that are legally due but not actually paid are included, however, collection costs are quite large. The RSC levy accentuates the significant disparities in fiscal capacity across districts. Per capita collections range from over R1000 to less than R10. On average, a 10 percent higher level of per capita gross product is associated with an 8.9 percent higher level of per capita collections. As the intergovernmental fiscal system evolves, an equalizing grant will have to compensate for the counter-equalizing influence of the RSC levy distribution unless the RSC levy itself is reformed. This is yet another reason why the government needs to evaluate and reform the local revenue system in its entirety.

Despite its substantial flaws, certain virtues of the RSC levy must be addressed by any proposals to reform it. Perhaps the key advantage is that it is levied at such a low rate that its flaws do not have much impact. A tax more visible to the public and levied at a higher nominal rate would likely raise political objections. Another advantage is that the levy generates major revenue, so that any replacement would have to make up for a significant income loss. Finally, the RSC levy is known – taxpayers understand it and have factored its effects into their decision-making. Any replacement tax will have to be accompanied by an education program to make the general public comfortable with the change.

There are many reasonable options for RSC levy reform that meet one or more important goals. The right choice depends on what goals the government most wants to achieve, how it chooses to define municipal powers and functions, and what other sources of revenue are

made available to municipalities. A particular issue is the level of government commitment to fiscal decentralization, i.e., to make municipalities more accountable by giving them independent taxing powers and imposing a hard budget constraint on them.

If fiscal decentralization is a priority objective, then a piggyback payroll tax may be the best option to replace the RSC levy, assuming that obstacles to municipal taxation of income posed by Section 229 of the Constitution can be dealt with. A flat rate tax on payrolls could be collected by the South African Revenue Service (SARS) as an add-on to the income tax. A payroll tax would have advantages. It would be revenue productive, particularly for urban municipalities, and eliminating the turnover tax component of the RSC levy would minimize the possibility of tax exporting from richer to poorer jurisdictions. Although SARS may not welcome complicating its income tax return, a piggyback local payroll tax would be administratively feasible. Municipalities could be allowed to choose the tax rate, within limits, giving a significant decentralization feature to the reform. The disadvantages are that a tax on labor in a labor surplus economy might be problematic, and rural districts would not fare any better with revenue yield than under the present system.

A second viable reform option, also a decentralization strategy, is a combination payroll tax and grant. The payroll tax would be levied by urban municipalities (metros and perhaps, depending on service and revenue assignments, more urbanized and capable category B municipalities) and would operate as described above. The grant would fund the more rural municipalities, and could be distributed like the present equitable share grant. The cost to the national government would be relatively small. Under this asymmetric scheme, 'rural' municipalities could at least initially (again depending on service assignments) include some of the weaker Bs as well as the Cs. These weaker municipalities could graduate from the grant to the tax when they meet clearly articulated conditions, such that grants would eventually go primarily to districts to fund services that could or should not be provided by the Bs. Under such an approach, the revenues raised locally will shift from districts to urban municipalities, and rural local governments would be dependent primarily on transfers from the national government.

If the national government is less interested in emphasizing fiscal decentralization, then it could introduce a grant program to fully replace the RSC levy. This grant would be revenue neutral if funded from a 1

percent add-on to the VAT rate (raising the overall rate to 15 percent). It could be distributed among municipalities on a derivation (where-collected) basis, but this would significantly advantage the metros and the urban districts. Alternatively, the grant pool could be distributed on an equalizing-formula basis, in which case the urban municipalities would be faced with the issue of how to close the revenue gap that would result. Either way, local councils would have no say in tax base or tax rate decisions. The viability of either of these approaches to grant allocation will depend on expenditure assignments.

There is a tension between pragmatism and good policy in making a decision about the future of the RSC levy. The easiest political course is to 'leave it alone', not because there are such great virtues to the present RSC levy, but because any replacement proposal will initiate a new and unwanted debate as well as involve significant transition costs. Yet, the RSC levy is a poor revenue choice to support decentralization. It is more a donation than a local tax and may not be collectable at higher rates. It is regressive, distortive and unfair, accentuates fiscal disparities, and provides little fiscal autonomy for municipalities. In the long run, it will not help South African municipalities take their appropriate place in a well-functioning, decentralized fiscal system. Eventually it will be abolished or restructured. Before the options outlined here and detailed in Chapter 5 can be properly evaluated, however, expenditure needs and assignments must be more clearly identified.

#### **A tax on utility consumption**

At present, many larger municipalities are heavily dependent on revenue surpluses earned from the sale of electricity. Reforms now underway will result in the removal of electricity as a local government function, and as a result, the loss of this source of local government revenue. The national government has indicated its intention to replace the lost revenue.

The likely option is to enact a tax on electricity (and possibly other utilities) consumption. There is much to say in favor of this tax. It would give the municipalities access to a large and growing tax base. It is equitable in the sense that consumers pay according to the benefits of services received. Such a tax would be easy to administer and have low compliance costs, requiring little or no additional record-keeping. The proposed excise tax would also be relatively robust with respect to the changing governance structure of the electric utilities. The results of

ongoing deliberations about the electrical industry as regards ring-fencing, ownership, appropriation of surpluses, or market territories would have little impact on the base of the proposed tax.

There are also drawbacks to this proposal. It can be argued that user charges on utilities impose a heavier burden on low-income versus high-income families. The result may be resistance to timely and full payment, although low-income families could be exempted or favorably treated. Estimates provided in Chapter 3 indicate that the *ad valorem* tax rate necessary to replace the revenues from current arrangements is between 8 and 16 percent. There also is an issue of equalization. As in the case of all locally imposed taxes, revenues would accrue more heavily to the more developed municipalities. Finally, there is the issue of how this reform impacts the balance between expenditure assignment and revenue assignment, i.e., which class(es) of municipalities would be given authority to levy this excise tax.

#### **Motor vehicle taxes**

Another good choice for a local government revenue source is the taxation of motor vehicle ownership and use. A number of tax bases might be considered, including annual vehicle licenses, restricted licenses to enter congested areas (e.g., central business districts), parking taxes for off-street parking, a motor fuel tax, and tolls.

There is much to be said for considering this family of taxes as revenue sources for South African municipalities. Motor vehicles impose significant public sector costs, such as those related to roadways and traffic control, and revenues from motor vehicle taxes could partially compensate for these costs. Moreover, imposing a higher tax on those who contribute to congestion and pollution could be justified on efficiency grounds, especially if urban municipalities were allowed to impose a higher nominal rate of tax. Motor vehicle taxes can be revenue productive and in most cases are relatively easy to collect.

There are also drawbacks. Motor vehicle taxes, especially those on motor fuels, are often politically sensitive. Another drawback is that the national government may be loath to reduce its claim on this lucrative tax base. Finally, the merit of assigning motor vehicle taxes to municipalities depends on the assignment of expenditure responsibility between provincial and the various types of local government.

### **The mix of local own-source revenues**

The South African government may elect to adopt some or all of the above revenue reforms, or perhaps others. Whatever decisions are taken, it is important to consider local revenue sources not just individually, but as a group in relation to expenditure assignments and needs. Following such an approach to fiscal decentralization will lay a foundation for the development of an appropriate intergovernmental transfer system.

## **INTERGOVERNMENTAL TRANSFERS**

Municipal revenues allowed by the Constitution and legislation are expected to play an important role in the financing of assigned local public services, but the Constitution recognizes that local revenues are unlikely to be sufficient to meet municipal expenditure needs and specifies that the local government sector is entitled to an equitable share of nationally raised revenue. Until recently, legislation assigned this equitable share exclusively to category A and B municipalities, but recent reforms have extended a portion of the equitable share to the districts (category C).

In this section we summarize a simple framework for thinking about the allocation of the equitable share. We then offer a brief evaluation of the present system. Finally, we consider how to improve the equitable share and how to approach the challenge of developing it for the longer term as the local government system matures. Full details on our analysis of the equitable share are provided in Chapter 6.

### **Framework for Analyzing the Equitable Share**

The equitable share transfer should play a central role in ensuring that local governments are able to fulfill their constitutional obligations to provide basic municipal services to all residents. All municipal governments are expected to make a reasonable effort to raise revenues on their own. Equitable share transfers, however, need to be available when municipalities have insufficient revenues to meet the recurrent costs of providing basic municipal services.

The Constitution points toward a system of unconditional local government transfers but does not provide details on its basis. In principle, the size of each municipality's allocation could be set equal

to the difference between the amount of money needed to perform assigned functions at basic levels, and the amount of money it could be expected to raise from local sources at a 'normal' revenue effort. With the implementation of such a system, the equitable share would guarantee that all South African municipalities would have sufficient resources to meet basic responsibilities without having to place extraordinary fiscal burdens on their residents.

To operationalize a system of transfers that can achieve this goal, we propose the direct calculation of needs-capacity (or fiscal) gaps, where the gap for each municipality is defined as the difference between its expenditure needs and revenue-raising capacity. In Chapter 6 we demonstrate the feasibility of calculating such an index. The critical requirement for the definition of each municipality's needs-resources gap is that it should reflect only factors outside municipal control. Thus, for example, the calculation of a municipality's expenditure need should be based on an objective measure of the costs of providing a set of basic services, determined by national norms and standards, rather than by current municipal expenditure levels. Likewise, a municipality's revenue capacity should provide an objective measure of its tax base, and not reflect its current decisions about tariff levels and tax rates.

By summing up the needs-capacity gaps of all municipalities, it is possible to determine the extent to which aggregate municipal expenditure needs exceed the aggregate municipal revenue-raising ability. The resulting gap provides a measure of the vertical fiscal imbalance that exists in the intergovernmental fiscal system. This gap describes the claim of local governments on national government revenues and defines the total amount of equitable share grant. Note that this amount can be readily changed to accommodate the national government budgetary position. For example, the identified gaps could be used to define relative, rather than absolute claims on national resources. In addition, 'basic' service levels could be raised or lowered, and 'normal' levels of tax effort could be reset.

### **The Current Local Government Equitable Share**

Starting with the 1998–1999 fiscal year, the equitable share grant has been allocated using a formula with two components, the S grant and the I grant. The purpose of the S grant is to finance recurrent costs of basic municipal services to poor households, while the I grant is

designed to finance the development of basic institutions of democratic governance in small, poor municipalities. In order to safeguard municipalities from large year-to-year drops in their equitable share allocations, each is guaranteed the larger of the sum of their formula-generated S and I grants or 70 percent of their allocation in the previous year. This system has provided a way to gradually phase out the old system of intergovernmental grants developed under apartheid. The phase out of the old system is essentially complete. For the 2002–2003 fiscal year, around 90 percent of the equitable share allocation is being distributed through the S grant formula.

Although both components of the formula have undergone a number of modifications since 1998–1999, the local government equitable share system for the 2002–2005 Medium-Term Expenditure Framework (MTEF) period is very similar to the original formulation. Our analysis of the distribution of the 2001–2002 per capita S and I grant allocations shows that both components favor smaller and poorer municipalities. Given that local government in South Africa has been in transition, and given the limited availability of appropriate data, the current formulation of the S and I grants has served South Africa quite well. There has been a minimum of political interference in the allocation process and outcomes. In the future, however, the system will need to change as local government matures.

I grants were designed to help municipalities fund the development of basic institutions of democratic governance and financial management. Over time, as municipalities become well established, the I grant will no longer be necessary. This does not mean that municipalities will not require central assistance to build capacity, which is an ongoing process. The initial ‘set-up’ goals of the I grant, however, will have been largely fulfilled, an achievement that should be assisted by the boundary consolidation under the 2000 municipal demarcation. The phasing out of the I grant implies that in the future the S grant formula will determine the distribution of the local government equitable share. When the formula is fully phased in, equitable share allocations will be proportional to the number of poor households in each municipality.

We have argued that a central role of the equitable share in a mature system of local government is to ensure that municipalities have sufficient revenues to provide their residents with basic services. Designing an intergovernmental transfer system that meets this goal requires a distribution of grants that is proportional to the fiscal

condition of municipalities as measured by their needs-capacity gaps. We demonstrate in Chapter 6 that the number of poor households – the basis for the allocation of the S grant – is not an appropriate indicator of these fiscal gaps. The current S grant formula provides a weak measure of expenditure needs and takes no direct account of the revenue-raising capacity of municipalities.

### **Looking Forward**

The development of the equitable share transfer as the intergovernmental fiscal system matures requires a more sophisticated approach to defining the needs-capacity gap. The data required to measure needs-capacity gaps for all municipalities do not yet exist. However, based on data from several case studies we were able to estimate expenditure needs, revenue-raising capacity, and hence, fiscal gaps, for ten newly demarcated category B municipalities situated in KwaZulu-Natal, Eastern Cape, and Mpumalanga provinces, as detailed in Chapter 6.

It is important to note that the starting point for the measurement of expenditure needs is to determine exactly how basic services are defined in each municipality. The process of doing so is quite complex. Different types of municipalities and different parts of individual municipalities may require different sets of services and different levels of the same service. In rural areas, for example, ventilated improved pit latrines are an adequate means of providing basic sanitation services. At the same time, in cities and dense urban areas, waterborne sewer systems are essential to prevent the spread of diseases, and therefore in those settings, these systems define basic sanitation services. For reasons of public health and public safety, the list of basic services in urban municipalities will probably be more extensive than the list of basic services in rural areas and in villages. For example, stormwater management and street lighting should probably be considered basic municipal services in most dense urban areas, while both of these services would be (presently) either unnecessary or categorized as luxuries in South Africa's scattered rural settlements and villages.

The next step in calculating expenditure needs is to determine the expected costs of basic municipal services. These costs are the minimum amount of money needed to provide the desired service levels. This amount depends on the technology available to provide the service and the environment in which the service is to be delivered.

The costs of operating and maintaining a simple waterborne sewage system, for example, will be higher than the costs of a pit latrine. In addition, the topology of the land and the density of the settlement patterns can have large impacts on the costs of delivering any given service to a household. The estimation of such costs is a task within the reach of government fiscal planners.

Based on population projections by settlement type (farmland, villages, urban, etc.), data on costs, and assumptions about national government norms for basic services, we estimated expenditure needs in our ten sample municipalities for the year 2009 based on two alternative assumptions about costs. The results indicate that expenditure needs per household vary substantially across municipalities. Per household needs in the sample range from R1,913 to R2,790 under moderate cost assumptions and from R2,776 to R4,420 under high cost assumptions. (All figures are expressed in 1999 rand). In general, we found expenditure needs, as expected, to be highest in large urban municipalities and lowest in rural areas.

In projecting the revenue capacity of the ten sample municipalities for 2009, we made two sets of assumptions, one pessimistic, the other optimistic, as detailed in Chapter 6. Not surprisingly, there is a wide range in revenue capacity per household, ranging from R685 to R4,475 under pessimistic assumptions, and from R1,236 to R5,159 under optimistic assumptions. Revenue capacity, like expenditure needs, was generally highest in large urban areas and lowest in rural areas.

Given our two alternative sets of assumptions about service costs and two alternative estimates of revenue-raising capacity, we generated four different sets of estimates of fiscal gaps in the ten case study municipalities. Under the most optimistic of the four estimates, positive fiscal 'gaps' (an excess of expenditure needs over revenue capacity) would exist in only four of the ten municipalities. These include three rural and one small urban municipality, with the largest positive gap per household being R677. Under the most pessimistic case, positive fiscal gaps existed in all but one of the ten municipalities, with the largest gaps, exceeding R2,000 per household, existing in rural areas. Large positive fiscal gaps are, however, not exclusively a rural phenomena. Gaps over R1,500 per household were also found in two larger urban municipalities. It is also interesting to note that under the pessimistic case, the current year S grant allocations per household in nine of the ten municipalities are substantially smaller than our projected fiscal gaps.

On the basis of calculations made for the sample category B municipalities, we can conclude that, unless the most optimistic – and probably most unlikely – scenario is realized, many municipalities will face substantial fiscal gaps in the future. The methodology we used in calculating expenditure needs and revenue-raising capacity allows us to predict that many other municipalities throughout the country (with characteristics similar to our sample municipalities) are also likely to face large fiscal gaps. The absence of data for category A municipalities and the non-random nature of our sample prevent us from making a quantitative estimate of the national aggregate fiscal gap for South Africa at the present time. A reasonable proposition, however, is that this gap would likely represent a significant share of the national government budget.

Despite the large fiscal gaps we found in some communities and evidence that the existing system of S grants does a poor job in filling them, it may be preferable over the current MTEF period that the equitable share formulas remain basically unchanged. Municipalities are in a period of extreme flux as they attempt to adjust to their newly demarcated boundaries and other reforms. Having a stable and predictable revenue source over this challenging period will facilitate the adaptation process. Delaying reform will also provide a window in which to develop better data to measure the fiscal gaps more accurately.

In the longer run, the current equitable share system based on the S and I grant components could be transformed to a system based on a formula that accounts for the expenditure needs and revenue-raising capacities of municipalities. The development of such a formula will take time. In order to design and implement a formula, the government will need to make a number of policy decisions, including the exact definition of ‘basic’ services to be included in the calculation of expenditure needs and the level of fiscal effort to be required of local residents and businesses. On the basis of these decisions, a fiscal gap for each municipality could be calculated. Equitable share transfers would be allocated in proportion to the size of each municipality’s gap, and the government must also decide whether all municipalities, or only those in the weakest fiscal condition, would be entitled to these grants.

A particularly challenging task will be the updating of the allocation formula as expenditure assignments and service coverage evolve, the municipal tax system is reformed, and fiscal conditions change. Both tax bases and the unit cost of providing basic services will change from year to year. So, too, will the size of the client population.

Government-determined levels of basic services and normal tax effort, however, should probably remain fixed for a period of years.

A final important point is that substantial capital investments will be required before all South Africans can be guaranteed access to basic municipal services. Recurrent costs associated with basic service provision will occur only after the necessary investments occur. Thus, the system of national grants for infrastructure investment must be explicitly coordinated with the allocation of the local government equitable share. This is a complicated issue, but without coordination, equitable share allocations are likely to be highly inefficient. In some cases, transfers would go to municipalities without the facilities needed for delivering basic services, thus wasting resources. In other jurisdictions, equitable share allocations may be inadequate to allow for the operation and maintenance of existing infrastructure facilities.

In the long run, municipal fiscal gaps must be filled by providing equitable share grants, reducing expenditure needs, or increasing revenue-raising capacity. Failure to do so will result in an inability of municipalities to fulfill their obligation to provide their residents with basic municipal services. This situation will both dampen economic development potential in the less urbanized areas and exacerbate national inequities in access to local public services. Local revenue-raising is important, but for the foreseeable future, the equitable share will play the major role in filling the fiscal gap for less-developed and rural local governments.

## ADDITIONAL ELEMENTS OF FISCAL DECENTRALIZATION

This research has focused on assignment of powers and functions, recurrent revenue sources, and intergovernmental transfers to support municipal recurrent budgets. Remaining and important dimensions of fiscal decentralization include intergovernmental development transfers and local government borrowing for capital expenditures. These are particularly important in a country like South Africa, where the existing quality of the public infrastructure is very uneven.

### **Development Transfers**

The South African government provides capital-purpose grants to both

provinces and municipalities. Conditional provincial infrastructure grants appear to generally go to targeted sectors and poorer provinces, but there has been a problem with failure on the part of some national departments to make these transfers in full and a failure by some provinces to spend them in full.<sup>2</sup> These delays have been attributed both to micro-management by mistrustful national government departments and to weak capacity on the part of provincial governments.

There is limited information available about the success of local government capital grants in meeting their objectives.<sup>3</sup> The existing programs do target priority sectors, such as job creation, water, roads, housing, electricity, and transport, but a number of problems have been identified.<sup>4</sup> First, there has been a lack of demand responsiveness, resulting from resources being targeted to particular types of infrastructure regardless of a community's perceived needs. Second, the current framework does not adequately deal with the issue of service sustainability since the responsibility for capital spending and that for operations and maintenance are not always held by the same organization. Third, the programs are ad hoc and highly fragmented, and their allocation and disbursement mechanisms are often project-based and centralized. Fourth, there is great variety across programs in conditions for accessing funds and reporting on their use, and disbursements are often delayed. Fifth, some recent internal work conducted by the National Treasury raises concerns that the distribution of some municipal infrastructure transfers has not been targeted to areas of greatest poverty.

These problems have collectively undermined investment coordination, limited the predictability of transfers, reduced financial accountability, and constrained the responsiveness and sustainability of infrastructure investments. The many different programs targeting different sectors in unduly inconsistent ways, and the common delays in fund disbursement, create serious planning and budgeting challenges for national departments and municipal managers.

The National Treasury is proposing the consolidation of all capital grants into a single Municipal Infrastructure Grant (MIG).<sup>5</sup> The proposed grant would allocate funds primarily by formula, and the recipient municipalities would be expected to use these funds for attaining priority sector outputs and outcomes. There would be a small window for supporting innovation and regional investments. The grant mechanism would be phased in over three years to allow existing

commitments to be honored. Objective grant conditions and performance objectives would be tied to the grant to ensure appropriate utilization, but municipalities would be given discretion to identify, select, approve, and commission capital projects in accordance with a broad nationally prescribed policy framework. The MIG would be a multi-department fund but it is proposed that DPLG would administer it subject to oversight by a board and the Cabinet.

The consolidated MIG is a good idea in principle to support demand-responsive service delivery in autonomous municipalities, but some of the national sectoral departments have legitimate concerns that a lack of sector-specific conditions on the use of these resources could undermine their ability to ensure the delivery of basic services guaranteed by the Constitution. This is familiar decentralization debate worldwide, and there is no unambiguously correct answer to how a transfer system can best balance legitimate national priorities and local autonomy. Whatever decision is ultimately made about the degree of discretion local governments will have over capital grants, it will probably take a long time to fully implement a system that allows all local governments more substantial discretion. Even with the presumably greater local government viability under the demarcation, there is significant variation in the capacity of municipalities to take independent responsibility for infrastructure development, and there may be continued resistance from some national-level actors. As with some other areas of reform, this may be an appropriate area for asymmetric treatment. Greater local control over capital resources would be most suitable for the larger and more capable municipalities, while others may need to evolve towards this situation as their capacity develops.

### **Sub-national Borrowing**

Provincial governments are empowered by the Constitution to borrow, but they have not yet done so except to secure bridging finance. On the other hand, loans have historically accounted for a substantial portion of the capital budget of South African metropolitan, and some other urban, municipalities. The largest source of loans has been government institutions and especially the National Housing Fund, which lends money to municipalities at subsidized rates for the provision of public housing. Some larger municipalities, however, have also borrowed on the capital market.

South Africa has a developed financial sector that is capable of raising and allocating capital to local government development projects. However, with the consolidation of municipalities that came with the 2000 boundary demarcation (in some cases, rich with less well-endowed ones), investors have become somewhat more doubtful about the borrowing capacity of certain municipalities.<sup>6</sup> In fact, the recent growth in municipal borrowing in South Africa has been increasingly for short-term debt, while the long-term municipal debt market has, according to National Treasury, 'all but dried up'.<sup>7</sup>

A well-developed capital market is desirable as a source of local government revenue, especially where there is such a large backlog of infrastructure needs and where some municipalities have borrowing potential. In order to revitalize the local debt market, proper budgeting and sound financial management procedures, including firm credit-control measures, are needed. The national government is developing a regulatory framework for sub-national governments.<sup>8</sup> As discussed in Chapter 1, the National Treasury has drafted a Local Government Municipal Finance Management Bill. This document prohibits municipalities from borrowing to fund current deficits, but it does establish their right to borrow for development activities. It also states that the 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 potential investors can make lending decisions on the basis of a fair assessment of risk. In 2001, a constitutional amendment to improve the environment for municipal borrowing was passed.<sup>9</sup>

The various ongoing and planned efforts of both the National Treasury and the Department of Provincial and Local Government to build the financial and overall capacity of local governments should improve the prospects for borrowing by South African municipalities. As more creditworthy municipalities are able to go to the market for their investment needs, the national government can target its limited infrastructure grant resources to the municipalities that genuinely need subsidization.

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 pre-requisite to local government borrowing, and intergovernmental transfer mechanisms should not be designed in a way that undermines local government incentives to borrow.

## THE CHALLENGE OF IMPLEMENTATION

Fiscal decentralization and municipal fiscal reform are complex and challenging undertakings. Throughout this book we have outlined reform options that the South African government might consider. In this section, we summarize key issues in the context of the framework outlined in Chapter 1. The focus of this discussion is on implementation.

### **Returning to the Basic Choices**

Although South Africa has a developed legal and policy framework for guiding local government reform, it is not specific enough on fiscal issues to provide operational guidance on system design. Some progress has been made, but complete positions have yet to be taken on some of the basic decentralization choices. Some major questions remain unanswered. To what extent is asymmetry in the treatment of municipalities acceptable? How much autonomy should municipalities have in making local expenditure and revenue decisions? How much income redistribution activity should local governments undertake and how should this be funded and managed?

From our perspective, asymmetric treatment of municipalities is necessary in South Africa, and recent policy debates indicate that the national government supports such an approach. Variations in local government needs and capacities are too great, both across and within municipal categories, to justify uniformity. Some category B and C municipalities are weak, while others are relatively capable. Asymmetry, however, must be defined on the basis of transparent standards so as to minimize arbitrariness, and it need not forever trap municipalities into a particular set of powers and functions. In fact, as suggested throughout this volume, municipalities could be given incentives to 'graduate' to a different status according to concretely defined rules. For example, weak B municipalities meeting certain

well-defined conditions could be given additional responsibilities over time. Similarly, we suggest the possibility of an asymmetric approach to reforming the RSC levy that would provide incentive for qualified municipalities to move from a grant intended for the weaker ones to the regular RSC levy used by the stronger ones.

With respect to autonomy, the maximum degree feasible is desirable because local government fiscal discretion is required for the benefits of decentralization to be realized. There are, however, two caveats. First, some centrally issued and objective guidelines on certain services and revenue instruments are appropriate to ensure that key national goals are met and to prevent extreme variations in local fiscal policies that may have effects beyond individual municipal borders. Second, there is merit to an approach whereby weaker municipalities would, to some degree, 'earn' autonomy by meeting basic capacity and/or performance standards. Significant autonomy given to weak and unaccountable municipalities is a recipe for poor performance.

Redistribution to redress historical inequities is one of the fundamental goals of decentralization in South Africa. This is a sensible policy. Through the provision of basic services, local governments are in a position to have a significant impact on the quality of life in poor households. At the same time, the funding of redistribution is primarily a national government responsibility. The national government has a greater revenue-raising capacity and the wherewithal and mandate to reduce disparities in fiscal capacity among municipalities. The creation of larger, presumably more fiscally viable municipalities under the 2000 demarcation should improve intra-jurisdictional redistribution capacity, but there will be limits to the willingness of wealthy taxpayers to bear higher local tax burdens designed to finance services for the less well off. Grants could be allocated on an equalizing basis and carry conditions for redistributive expenditures, but this might be accomplished at a cost of reduced local government fiscal autonomy. Clearly, redistribution poses complex challenges.

### **Implications for Intergovernmental Fiscal System Design**

Our research findings and positions on the basic policy choices outlined above have a number of implications for the further design of the intergovernmental fiscal system in South Africa. As detailed in Chapter 2, differential treatment of municipalities can be clearly justified, and it should take into account the status quo. It makes no sense, for example,

to give responsibilities to category C municipalities that cannot adequately manage them or to take responsibilities away from category B municipalities that are effectively providing them.

Divisions in service responsibility can, and should, be fine-tuned where this would be productive and feasible – service authorities versus service providers, investment versus operation, separating components of service delivery (e.g., bulk supply versus distribution), etc. Different public and private sector actors can be given responsibility for different functions as appropriate. Our illustrative approach outlined above and detailed in Chapter 2 indicates some ways to think about such differentiation in service assignment. Given the potential complications and transaction costs involved in changing responsibilities, however, it is necessary to consider these options in more detail on a sector-by-sector basis.

Within the constraints of capacity, services should be assigned to the jurisdiction that is closest to voters unless there are economies of scale or spillovers. For this reason, there was initially concern about the 2000 amendment to the Municipal Structures Act that broadly assigns key expenditure functions to the category C municipalities. Certain functions may legitimately be considered in the domain of category C municipalities, and it does make sense for them play a role in coordinating district-wide infrastructure planning and investment. To empower them with primary responsibility for all or most local service delivery, however, does not support a decentralization agenda. Nor is it pragmatic or efficient in an environment where some Bs have been providing services effectively and some Cs have little capacity. Fortunately, the policies that appear to be emerging in South Africa in 2002 and 2003, as outlined above, recognize these realities and embrace a flexible interpretation of the amendment.

On the local own-source revenue side, there is obviously a need to ensure that municipalities expected to provide services are given some independent resources to do so. Urban municipalities – whether large or small – will generally need a broader range of revenue instruments than rural municipalities. This does not mean that rural municipalities do not need dedicated resources, but they are always likely to be more dependent on transfers than urban areas. At least in the short run, some creative sharing of revenues may be in order. If, for example, category C municipalities need to provide for some functions on behalf of weak category B municipalities under their jurisdiction, they might be entitled to some of the property tax or equitable share entitlement of the

category B municipality. Similarly, in cases where category B municipalities are providing services that are the formal responsibility of their associated district (C municipality), some portion of the RSC levy revenues accruing to the C could be shared with them. Again the South African government seems to accept this general approach, but the details of such arrangements cannot be worked out until further concrete decisions are made on the desired longer-term structure of municipal expenditure and revenue assignments and a strategy for implementing them over time.

In terms of specific local revenue sources, proposed property tax reforms are already in an advanced stage of discussion. As has been argued above, it is crucial that the property tax be strengthened for the category B municipalities. As detailed in Chapter 4, there are legitimate concerns about making the property tax unduly standardized. Thought should be given to minimizing the number of restrictions on local autonomy in tax administration included in the legislation. The present draft of the Local Government Municipal Property Rates Bill is not highly problematic in this regard.

Political realities may require that the RSC levy be left alone in the near term. In the medium-term, as the intergovernmental system evolves, it might be replaced with an asymmetric model that combines a payroll tax and grant (see Chapter 5). Stronger, more urbanized municipalities would levy the payroll tax, while the formula-distributed grant would fund weaker, particularly rural, municipalities. Under this asymmetric scheme, weaker municipalities would be able to graduate from grant to tax when they meet certain conditions. This type of scenario, which should be seen only as an indicative illustration of how to proceed with reform, is consistent with the emphasis here on giving municipalities independent sources of revenue, treating them differentially when appropriate, and supporting their evolution towards greater autonomy. Exactly how to define RSC levy reform, however, again depends on the decisions that will be made about the assignment of functions and about other revenue sources.

Perhaps the most pressing local revenue issue is how to ensure the replacement of funds that many municipalities will lose from electricity sales surpluses when this service is reorganized. A reasonable option would be a tax on electricity consumption. This would provide a large, buoyant tax base that directly relates benefits to payments. Challenges in structuring such a tax include potential regressivity, the high rates that may be needed to replace the former trading surpluses, and the

likely bias of this tax in favor of more developed municipalities. The Department of Provincial and Local Government, the National Treasury, the Financial and Fiscal Commission, and the South African Association of Local Governments have this potential revenue source under study.

Exploration of motor vehicle taxes and charges as a local government revenue source should also be on the reform agenda. These have potentially positive yield, equity, and efficiency benefits, and can be relatively easy to administer. As with the electricity consumption tax, there are potential concerns, including their suitability for local (as compared to provincial and national) use and political sensitivity. The potential benefits, however, combined with significant and growing municipal revenue needs, recommend this base for further consideration.

The equitable share grant has, given the shifting context of the local government system, done a reasonable job of meeting certain goals of the South African government. It has funded local governments that have limited taxable capacity, and the overall level of funding has been stable. The allocation among municipalities is based on transparent and objective criteria, and the transition to this system from the old apartheid system has been relatively smooth. The time has come, however, to move the equitable share transfer to another level.

First, a vertical share (entitlement) of the local government sector needs to be established with the same objectivity that underlies the horizontal sharing. Second, the allocation formula needs to develop concurrently with the overall intergovernmental fiscal system and the availability of better information. There is some serious concern at the national government level, particularly at the National Treasury, about using a cost-based, fiscal-gap approach for the analysis of the equitable share, because of the potentially major implications for the national budget and possible misinterpretation or misuse of information by the public. These are understandable concerns. Our projections, however, suggest the high likelihood of a significant gap between municipal expenditure needs and fiscal capacity, and a great variation among municipalities in the size of this gap. This reality cannot be ignored.

Clearly, intergovernmental transfers are not the complete solution to local government financing shortfalls. As emphasized throughout this book, there are other ways to close the local government fiscal gap, including increasing locally raised revenues, decreasing service levels, and improving the efficiency of local government operations. The

South African government may decide to use one or all of these instruments. Any combination is potentially appropriate and viable if fair processes and objective rules are used, but action to correct existing problems cannot be taken unless the relationship between needs and capacity is better understood. Once the government decides how to proceed, we believe that the pool of resources devoted to the local government equitable share should be defined in a transparent way that ensures an adequate degree of buoyancy, in contrast to the present situation in which the pool is determined more on an ad hoc basis.

We underline the importance of development grants for capital investment. The validity of many of our recommendations is contingent on the appropriate reform of the infrastructure financing system. Productive steps have already been taken in developing mechanisms to support municipal infrastructure investment. First, the National Treasury is developing a local government borrowing framework that should enhance the ability of creditworthy municipalities to secure loans in the future. Second, DPLG has been implementing a variety of efforts to support municipal infrastructure planning and development. Third, the National Treasury is working on a proposal to consolidate the complex and fragmented set of local government conditional transfers.

These are steps in the right direction, but they will not immediately help all municipalities, many of which have few reliable resources and inadequate capacity to develop infrastructure. The equitable share formula is aimed at financing the recurrent costs of providing services to poor households. The allocations of the equitable share, however, are made whether or not the infrastructure (or capacity) to provide those services exists. Thus, equitable share allocations designed to help finance basic service delivery end up being used to pay for basic administrative expenses that the municipality has no other way to support. Moreover, the lack of infrastructure also deprives municipalities of the opportunity to deliver revenue-generating services.

This situation represents a kind of low-level equilibrium trap from which there is no obvious escape without concerted and well-coordinated national government efforts to develop infrastructure and related local government capacity and revenue sources. Some in the national government might prefer to do this by strengthening the category C districts rather than category B municipalities, the approach embodied in the 2000 amendment to the Municipal Structures Act. As noted above, however, an unduly district-centered approach could undermine the development of a local government system that would be

grassroots enough to be responsive to citizens and thereby capture the expected benefits of decentralization.

### **Strategically Approaching Transition**

The above discussion of the intergovernmental fiscal system design takes us back full circle to the assignment of powers and functions. As has been emphasized repeatedly, the proper sequence of policy formulation is that finance should follow function. Until some basic decisions are taken on certain unresolved aspects of municipal functions, it will be difficult to consider in an adequately informed way many decisions that need to be made on other aspects of the fiscal system. Without some basic rules on expenditure assignment, even if incrementally defined in a longer-term implementation framework, it is not possible to fully design a desirable revenue structure. If revenue side reforms are adopted independently and too hastily, they may have to be changed later as expenditure assignments change, perhaps at considerable political expense. It may even be impossible to effect later rounds of desired reforms if the early ad hoc policies become institutionalized.

Neither expenditure assignments nor other aspects of municipal finance get settled overnight. Transition strategy is a critical element of planning the implementation of fiscal decentralization. There are questions regarding exactly what reforms to make, when to initiate them, and how many to undertake at one time. In fact, much has happened recently in local government reform and much more is on the table, including boundary changes, new structures and procedures, the announcement of 'free basic services', property rates and RSC levy reform proposals, the restructuring of electricity-delivery mechanisms, etc. These developments raise substantial concerns about how much 'policy shock' the municipalities can absorb at one time, how quickly they can climb the required learning curve, and what the national government can afford in the short term and beyond. Ongoing and potential reforms often mandate completely new systems and procedures. Demanding too much at once, especially if uncoordinated and/or unsupported by adequate capacity building, may prevent municipalities from adopting reforms successfully, damaging economic development and social well being.

In order to minimize these transition problems, the total reform

program needs to be sequenced in a well-planned way over a period of years. There are several dimensions to such an approach. The first step is to define a concrete starting point in terms of expenditure assignments. As suggested above, the best starting point may be to maintain the status quo in terms of the division of functions between category B and C municipalities, at least to the extent that this minimizes the disruption of service delivery that is presently functioning at an adequate level. But there could be some tinkering at the margins or a few bolder steps early on, trying to move certain services to more appropriate type of municipality. The starting point, however, should be framed in the context of a longer-term, and more normatively ideal, structure of responsibilities (and specific service standards) that the South African government would like to see eventually prevail. The definition of a starting point on the expenditure side also provides an entry point for thinking about the revenue side and how the present structure of own-source and intergovernmental revenues compares to needs under the initial functional assignments envisaged.

A second key transition issue is to understand and plan the development of the capacities and skills a municipality needs to have in order to meet its desired fiscal responsibilities. Administrative and managerial structures and procedures have been defined by the South African government in the Municipal Structures Act, the Municipal Systems Act, and the Municipal Finance Management Bill. Some implementing regulations have been defined and others will follow, spelling out much of the detail about what is expected of local government officials. Almost certainly there will be management, accounting, treasury, and tax administration responsibilities that are beyond the reach of many local governments. In particular, the capacity needs that are implied by sectoral decentralization have not been clearly defined. Many types of local services require particular types of skills and expertise, and norms for service provision are sector specific. National sectoral ministries have not fully worked out the roles of municipalities, what they should be providing, and the capacities they need to meet these responsibilities.

A third key task is operationally defining any asymmetric treatment that is adopted, i.e., allowing for municipalities with varying capacities to start at different points in the reform process. The weakest municipalities could be assigned limited minimal responsibilities and revenues, but targeted for technical assistance. As they meet established

requirements, they could be rewarded with additional responsibilities and resources. The most capable municipalities could be more or less left alone to do their jobs independently, as some are now, although they would still face limited types of national guidelines and monitoring, as is presently the case. Obviously, the details of such an approach – how various interrelated components of intergovernmental fiscal reform would be phased-in – need to be more fully examined and defined. The transition process needs to be structured in as simple and transparent a way as possible, or there could be great uncertainty introduced into the local government system and the potential benefits of an asymmetric approach to decentralization could be undermined.

A fourth key concern has to do with the need for effective capacity building mechanisms to bring municipalities up to required skill levels. As the South African local government system has been evolving, a variety of capacity-building efforts have already been undertaken. The national government, however, needs a more developed capacity building system, complemented by incentives for good municipal behavior to support the maturation of the system. Options for how to meet capacity-building needs, including possible development of a municipal training program or institution, need to be explored.

Fifth, most national agencies themselves require capacity-building in policy analysis and the skills needed to monitor and support municipalities as per regulatory requirements. This is an important and often overlooked element of the transition plan. In the final analysis, the success of a fiscal decentralization program will depend on the skill of the national government to lead it. Strong fiscal analysis units in DPLG, National Treasury, and FFC, charged with developing the intergovernmental system, and supported by a comprehensive database are essential. These national agencies have improved their capacity and databases considerably in the past few years, but they are not yet where they need to be.

A sixth aspect of the decentralization transition, manageability, relates to even the most capable municipalities. The strong municipalities may not need substantial supervision and heavy capacity building as reforms proceed, but they cannot be expected to manage the administrative and political demands, for example, of simultaneously implementing new accounting codes, meeting new cost standards in many sectors, adopting potentially major property rates and RSC levy reforms, etc. Thus, decisions must be made about the relative importance and the most effective sequencing of these policies, so that

reform programs can be sequenced in an efficient way.

The eventual goal of the decentralization transition process would be to get most municipalities, the more advanced and the weakest, to a point where they are able to deliver their assigned services in a quality and fiscally responsible way. If this goal were achieved, fiscal disparities and historical inequities would be reduced and national priorities would be advanced. At the same time, municipalities would become more accountable to their constituents.

### **Support Structure for Further Developing and Implementing Reform**

Two critical support mechanisms should be in place to lead the further development of decentralization policy and the implementation of this policy. First, it is essential to develop an adequate municipal information and monitoring system. Better information is needed about expenditure levels and needs, revenue levels and capacities, and fiscal performance. Understanding these matters better, would allow the design of appropriately asymmetric treatment of municipalities in assigning responsibilities, measuring fiscal capacity, and targeting intergovernmental transfers and capacity-building. A good information system would also give the national government and citizens a mechanism for continuously monitoring local government performance. The municipal database recently piloted by DPLG<sup>10</sup> and efforts by National Treasury to develop better municipal budget systems are important steps in this regard, but neither of these efforts is complete.

Second, mechanisms for integrating and coordinating the various aspects of fiscal decentralization are needed. Several national government departments, with different agendas and inadequate cross-departmental channels of communication, play a role in local government fiscal reform. To date, coordination and conflict resolution have been ad hoc and bi-departmental. The principal focus of the 'coordinating' ministries, the National Treasury and DPLG, has been on the revenue side, particularly with respect to local governments. There has been only modest attention by these departments to the expenditure side and to sectoral decentralization activities. These coordinating departments and their sub-divisions have pursued various reforms related to local government own-source revenues, the intergovernmental transfer system, and the local government borrowing framework. It is, however, not always clear that the various aspects of

the system – own-source revenues, different types of transfers, and loans – are being considered in an integrated way or that the coordinating ministries are fully aware of each other's activities in a timely manner. Individual national sectoral departments have also pursued service-specific reforms. Some of these reforms have been only marginally related and coordinated, raising concerns that they might work at cross-purposes and/or overwhelm the capacity of some weaker local governments.

South Africa, like most countries in transition, needs a more coordinated approach to reform of intergovernmental fiscal system. A formalized inter-ministerial process/mechanism at a higher level than any single ministry, perhaps based at the Office of the President, could provide a vehicle for developing this approach. The Office of the President could avoid 'turf' issues more easily than could individual ministries. Because many types of reform cannot be implemented in all municipalities at once, this mechanism could determine, based on recommendations of research on local capacity and performance, how to proceed with local government reform. The Municipal Demarcation Board had tried to play a role in this regard, but it does not appear to command the necessary authority. The involvement of a stronger coordinating body in implementation design and oversight would help to improve the consistency of national departmental activities and to ensure that basic reforms are properly sequenced. Given the great interdependencies among the components of sub-national government finance, coordinated action is critical in all countries pursuing fiscal decentralization.

### **Further Work**

The work discussed in this book is only a first step towards understanding how to proceed with fiscal decentralization in South Africa. There is a great need for further applied research. First, in order to develop more comprehensive recommendations on the assignment of municipal powers and functions, additional empirical fieldwork is needed. Our sample of municipalities is too small to give reliable estimates of the impacts of the reform options we developed. Moreover, while our examination of service delivery arrangements covers a range of options, we cannot be certain that the mechanisms we documented are adequately representative of the spectrum of arrangements in South Africa. Service provision arrangements that

involve community organization and private sector partnerships are not well documented in our work, and we have not been able to definitively evaluate which mechanisms and arrangements are clearly superior under particular conditions.

Second, it is important to better understand the magnitude of the vertical fiscal gap, both for individual municipalities and in the aggregate. This requires further study of municipal expenditure needs and revenue capacities. Without this information, the South African government cannot understand the choices it needs to make in terms of enhancing local own-source revenues, increasing intergovernmental revenues to municipalities, or reducing expectations regarding service coverage and levels. The empirical approach we took to documenting expenditure needs and revenue capacity should be extended to a broader range of municipalities for this purpose.

Third, additional work will be needed to examine in more detail the possible impact of various options for reforming existing local taxes, adopting new municipal revenue sources, and evolving the intergovernmental transfer system. For some local revenue sources we were able to do a thorough enough analysis of costs and benefits to evaluate reform options. In other cases we were not. Even though the methodologies developed here can serve as a solid basis for the additional work required, much remains to be done.

Fourth, it would be useful to take more careful stock of the numerous government-wide efforts related to decentralization. For example, there are already many types of capacity-building programs in place, and there are also plans to develop new programs – at DPLG, National Treasury, and some of the sectoral ministries. Are they working effectively? Are they complementary or redundant? Are they potentially in conflict with each other? Are different types of capacity building initiatives being coordinated to maximize their impact? Only when these questions are answered can the government devise an effective strategy for comprehensively developing municipal capacity in a way that supports the attainment of the potential benefits of fiscal decentralization that South Africa desires. Similar questions could be asked for a number of areas, e.g., the development of information systems, privatization and contracting out, project evaluation, and capital facility financing.

Finally, even with our stated focus on fiscal matters, we must recognize more explicitly the political nature of decentralization. There is a need to keep government as close as possible to the people and to

ensure adequate local government autonomy. This is a complex issue that requires further investigation, and existing and planned work on it should be better tied to the work on fiscal reforms. Most of the alleged benefits of fiscal decentralization can be realized only if local governments are able to develop a genuine accountability to their constituents. Bringing about this accountability will not occur rapidly, particularly in areas where the concept and practice of democratic governance are new.<sup>11</sup> It typically involves a gradual process while trust is being built between local government officials and their constituents.

How well are South African municipalities faring in developing mechanisms to ensure accountability? What is the role of higher spheres of government in this regard? How has the recent demarcation, which was intended to create fiscally more viable municipalities, affected municipal councilors' interaction with the people who elected them? How does this, in turn, affect the service delivery performance of the system and the satisfaction of citizens with their local government? These questions, which are at the very core of decentralization, merit considerable attention in South Africa.

## SOME BROAD CONCLUDING LESSONS

Many of the challenges of fiscal decentralization facing South Africa are also being faced in other developing countries. This prompts us to ask: 'What can other countries learn from the South African experience?'

A first general lesson has to do with the study methods necessary to evaluate decentralization proposals. Our work places a heavy emphasis on gathering detailed information and defining viable reform options as the basis for making informed decisions on the structure of the intergovernmental fiscal system. In addition, we have highlighted the importance of understanding the relationships among the various elements of fiscal decentralization. We have noted the typical differences of opinion among key actors about how to approach decentralization reform and the need to build some degree of consensus among them before making major decisions on system structure. Many of the detailed approaches and methodologies we have used to examine and evaluate expenditure assignment, local revenue development, and intergovernmental transfers in South Africa should be useful and adaptable in many other countries. The type of broad-brush analysis

typically used in designing fiscal decentralization programs is likely to be much less useful.

A second lesson has to do with the complexity of the expenditure assignment issue.<sup>12</sup> Decentralization cannot simply be a matter, for example, of assigning 'water service delivery' to local governments. The level of service required will vary across and within local governments with diverse characteristics, as will the appropriate technology to produce it. In addition, formal local government institutions may not be the best managers of certain service delivery activities for which they are assigned responsibility. Some complex urban services may benefit from participation by the private sector and/or by community groups. The involvement of non-governmental actors may be desirable not only because improved efficiency could be realized under certain conditions, but also because local governments in developing countries often do not have the capacity needed to meet their service responsibilities on their own. In short, effective expenditure assignment is very much a sector-specific exercise, and the precise nature of assignments and service-delivery mechanisms may also need to vary across local governments in a particular country. Unless such realities are carefully taken into consideration, little meaningful, systematic progress can be made with the assignment of powers and functions.

Third, there are also lessons on the revenue side.<sup>13</sup> Throughout this book we have returned to the old rule that 'finance follows function' in pointing up to necessity of identifying expenditure assignments before restructuring local revenue systems. Many developing countries begin fiscal decentralization programs with revenue-side reforms, jeopardizing the achievement of fiscal correspondence and risking the institutionalization of revenue instruments that may have to change when expenditure assignments eventually get sorted out. To some extent, such adjustments are inevitable, but they can be minimized and made less disruptive if revenue-expenditure linkages are carefully thought through from the start. Another key concern is the balance between developing local revenue sources that can support local redistribution and those that provide a clear link between the benefits and costs of service delivery. The former type support important public goals, albeit ones that many experts view as better tackled by national government, but the latter is the basis for the efficiency gains attributed to fiscal decentralization. Still another revenue-design concern is how to ensure an adequate degree of local autonomy in local tax policy,

which is a critical element of local governments being able to respond to the demands of their constituents. This is often resisted by national governments worried about macro-economic control. Even with its problems, South Africa is an interesting example of the 'workability' of giving local governments a significant amount of revenue-raising authority.

Fourth, with respect to intergovernmental transfers, we highlight the need to move as closely as possible to a 'needs-resources gap' approach in which a local government's entitlement to transfers is based on the difference between a normatively defined measure of recurrent expenditure needs and a normatively defined measure of local own-source revenue-raising capacity. Many students of intergovernmental transfers in developing countries have recommended this approach, but the difficulties of implementation are substantial. A few countries have tried to use needs and resources measures in their allocation formulae, and the former Soviet states calculated expenditure 'norms' as a basis for revenue distributions. It would not be a stretch to say that the worldwide experience has not been satisfactory.<sup>14</sup> For a sample of South African municipalities, we demonstrate that such an approach may be administratively possible and is an improvement over the present formula allocation. We also show, however, that the measurement of a needs-capacity gap requires governmental judgments about levels of basic service needs and tax effort, and must be supported by a comprehensive data base. The latter in particular may be beyond the immediate reach of many developing countries.

Finally, the South African case also points to the important lesson that the capital and current sides of local government budgets need to be linked more than they typically are. Many local governments in South Africa (and in many developing countries) do not have the basic facilities required for service delivery. Without them, service assignment is not very meaningful, and both locally raised revenues and intergovernmental transfers may be wasted. Thus, the development of an appropriate transfer system for capital expenditures and a framework for local government borrowing are critical for a successful local government fiscal system.

## BEYOND THE ELEMENTS OF FISCAL DECENTRALIZATION

The conventional approach to fiscal decentralization focuses primarily on designing the structure and basic elements of the decentralized system – an enabling framework, expenditure and revenue assignments, and intergovernmental relations (including fiscal transfers, technical support, and local performance incentives). Under this conventional approach, it is essentially the responsibility of local governments to meet the defined requirements, presumably under democratic pressure from their residents and ‘carrot and stick’ incentives defined and enforced by the national government. This type of ‘sink-or-swim’ approach, however, particularly in the extreme, tends to favor more competent local governments. Weaker local governments often have great difficulty meeting the basic requirements of the system because they have not reached some threshold level of capacity.

Given these concerns, especially in the context of the substantial historical inequities in South Africa, our work incorporates elements of what might be called a ‘developmental’ approach to fiscal decentralization. Just as in the conventional approach, we argue the case for good information, empirical analysis, and rules. But we also emphasize the need for an implementation process in which the various features of an effective decentralized system are developed together gradually and individually tailored to the conditions and capacities of local governments with appropriate support from higher levels of government. This approach explicitly recognizes that a strong framework, even if consensus-based, is simply not enough to ensure that decentralization will work in practice. Most students and practitioners of fiscal decentralization have participated in or observed efforts in which well-researched, apparently politically acceptable and normatively desirable decentralization reforms are never realized because they are undertaken without adequate attention to implementation. Attempts are often made to do too much too quickly and too uniformly – in ways that end up creating conflicts among concerned agencies at the central level, overwhelming the capacity of weaker local governments, and failing to account for limits on the political tolerance for decentralization reforms. Such an approach often invites failure.

Accordingly, we have highlighted the critical need for developing a fiscal decentralization strategy in South Africa. An effective strategy in

South Africa (and in many other cases), would have three key dimensions. First, there should be appropriately differentiated treatment of municipalities, sectors, and revenue sources. Some local governments have more capacity than others, some sectors are far more complex to decentralize than others, and some revenue sources are more suitable for certain areas and uses than for others. Recognizing these differences allows reforms to be designed and targeted in ways that maximize the probability that they will succeed. In short, we argue for an asymmetric approach.

Second, the sequencing of local fiscal reforms should be strategic and gradual. Initial efforts should be made to move forward as quickly as possible with reforms that are not particularly contentious, and/or relatively easy to implement, and/or absolutely essential. Moving step by step allows for simple successes that build a basis for further achievements and enhance the credibility of the reform effort. In addition, careful sequencing provides an opportunity for integrating reform components, for example, the adoption of new local sources of revenue may be tied to intergovernmental transfer or loan reforms. Reform bundling and strategic sequencing also create a basis for changing behavior and building capacity. For example, a reform process that requires local governments to adopt new financial management procedures in conjunction with receiving a project or training grant helps to institutionalize important new skills. Future reforms can then build, according to clear but appropriately flexible guidelines and processes, on the modest ones that are put into place at earlier stages. In developing these rules and processes, it is important to carefully balance the need for some local autonomy with legitimate national priorities. Local governments that have demonstrated adequate capacity and fiscal responsibility can be exempted from some or all steps of the reform process.

Third, a system and procedures must be developed for monitoring the progress of local governments in performing their routine functions and in adopting new reforms. Only with such a system can the national government be sure that local governments are meeting basic requirements and that the goals of reform programs are being realized. In addition, a monitoring mechanism can help to ensure that local governments ready to move on to the next reform step can be identified and treated consistently and fairly. Public access to such information on local governments can also facilitate accountability.

There are potentially legitimate concerns about this type of

'developmental' approach to fiscal decentralization. It requires non-trivial central government capacity and resources, can become excessively bureaucratized and easily manipulated, and may be taken over by centralists in the national government who want to prevent genuine decentralization. There is also a danger that the responsibilities of local governments will be fixed and based on their present capacities, with no possibility of movement forward. Perhaps the greatest challenge is how to ensure that the reform implementation process is transparent and dynamic, so that as local government capacity improves, greater service responsibilities are assigned. Similarly, as local governments catch up with infrastructure investment backlogs, they could be expected to provide additional services at higher standards. The phasing-in of responsibilities has important implications for revenue requirements, the appropriate structure and allocation of intergovernmental transfers, and the development of better local government access to credit.

This way of thinking about fiscal decentralization may seem unworkably complex to some observers. It is certainly more demanding than the conventional approach, i.e., defining a legal framework, normatively desirable expenditure and revenue assignments, and an equalizing transfer system, and then leaving the local governments to 'sink or swim'. The developmental approach also requires the central government to think more strategically about how to phase in the implementation of fiscal decentralization, and it may require a degree of inter-agency, and where relevant, international donor coordination that many developing countries find difficult to achieve. We do not support a tedious and potentially paralyzing bureaucratic process, and we strongly believe that local governments should be left substantially on their own as quickly as is feasible. We also understand that there is often heavy pressure to move forward with decentralization reforms, so that a central government cannot focus excessive attention on gathering ideal information and developing perfect implementation mechanisms without taking action. And we would certainly not pretend to make fully generalizable recommendations about exactly how to approach fiscal decentralization in any developing country.

We are, however, confident in asserting that the reality of most developing countries – great differences in needs and capacities among local governments – requires an asymmetric and gradual approach to fiscal decentralization. Building an integrated intergovernmental fiscal reform program is a complex and time-consuming effort that requires

not only good information and an appropriate framework, but also an implementation strategy and adequate coordination. More attention to implementation would undoubtedly result in better fiscal decentralization programs in many developing countries.

## NOTES

1. Recent attempts to consider the strategic design and implementation of fiscal decentralization programs include: Smoke and Lewis (1996); Litvack, Ahmad and Bird (1998); Bird and Vaillancourt (1998); Bahl (2000a); Smoke (2000); and Smoke (2001).
2. National Treasury (2000) and National Treasury (2001a); National Treasury (2001b).
3. Department of Finance (2000a); National Treasury (2000); Financial and Fiscal Commission (2001); and National Treasury (2001a).
4. National Treasury, 2002.
5. National Treasury, 2002.
6. For an overview of municipal borrowing in South Africa see Research Triangle Institute (1999); Department of Finance (2000b); and Financial and Fiscal Commission (2001).
7. National Treasury (2000, p. 106).
8. A draft of this framework is contained in Research Triangle Institute (1999).
9. In 2001 Parliament approved and the President signed into law an amendment that added a new section (230A) to the Constitution to govern municipal borrowing. The amendment authorized legislation empowering municipal councils to legally bind the municipality over the long term and to make commitments in connection with future budgets and revenues. Prior to this amendment, the weight of legal opinion was that a municipal council could not make such a binding commitment, which obviously would limit willingness to invest in long-term municipal debt. This amendment is contained in Section 17 of the Constitution of the Republic of South Africa Amendment Act No. 34 of 2001.
10. Liner and Vaz (2001).
11. See Smoke (2003).
12. For more information on international experience with service assignment, see, for example, Dafflon (1992); Shah (1994); Ahmad (1995); Ahmad, Hewitt, and Ruggerio (1997); Martinez-Vazquez (1999); and Andrews and Schroeder (2003).
13. For more information on international experience with local government revenues, see, for example, McLure (1983); Bahl and Linn (1992); Norregaard (1997); Vehom and Ahmad (1997); Bird and Vaillancourt (1998); McLure (1998); and Bahl (2002).
14. For more information on international experience with intergovernmental transfers, see, for example, Schroeder (1988); Bahl and Linn (1992); Shah (1994); Bahl (2000b); Bird and Smart (2002); and Schroeder and Smoke (2002).

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