LOCAL RESOURCE MOBILIZATION IN DEVELOPING COUNTRIES:  
THE CASE OF SOUTH AFRICA

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ABSTRACT

The efficient and equitable provision of public services in a country crucially depends on the allocation of taxing, spending, and regulatory functions among different governmental levels and on the structure of intergovernmental transfers. Using fiscal-federalism, economic-efficiency, and equity principles, I identify appropriate measures for restructuring these intergovernmental fiscal arrangements in developing countries and apply them to a single case, South Africa.

My central research question is: Given that South Africa is undergoing a shift from a high degree of centralization to decentralization, what is the “proper” design of this decentralized system and how can the government implement it under particular legal, institutional, administrative, and political constraints? Throughout my study, I focus on the key concept of equity -- an important constitutional objective in South Africa in designing this system.

Local government has major responsibility for the provision of basic services. The recent geographic decentralization in South Africa aims at enabling municipalities to generate sufficient revenue for providing these services equitably to their constituents. I analyze the historical and current structure of local government, and recommend its reform so that it is feasible from a fiscal and administrative viewpoint, while simultaneously fulfilling democracy and representation objectives.

I examine the options that the newly amalgamated and created municipalities could use to achieve incremental local-revenue enhancement for establishing sustainable service delivery. Specifically, I first estimate the capital and operating costs of providing different levels of service. I then consider the implications of these costs, together with nationally set policies, for municipalities in terms of the choice of service level as well as the available financing mechanisms.

Although South Africa basically follows the fiscal-federalism principles of efficiency and equity in assigning revenue responsibility to local government, it needs to consider the reform of existing revenue sources in order to exploit their potential fully.
Given that municipalities cannot meet the existing fiscal gap by reducing expenditures or increasing revenues in the short run, they need a well-designed system of intergovernmental transfers. I evaluate the present transfer system and develop alternative models that the national government can consider for the system of operating and capital transfers needed as it phases in local-revenue enhancement.

The main contribution of my study is to provide an integrated approach to looking at decentralization system design in the context of a single country — to which little attention has been paid. Most analysts focus separately on the different system-design components — local government structure, expenditures, revenues, and intergovernmental transfers — without discussing the linkages among them.

Using South Africa as a case study, I demonstrate the importance of viewing system design as an integrated piece. In addition, I conduct an initial examination of the implementation process, which has also received very little attention in the literature. Thus, I highlight the need for a comprehensive decentralization reform strategy that prioritizes reforms, is phased in gradually so as to gain political acceptance and not overwhelm local government capacity, coordinates the various agencies involved with the process, and pays heed to implementation.

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ACRONYMS

BLA Black Local Authority
CEO Chief Executive Officer
CMIP Consolidated Municipal Infrastructure Programme
COSATU Congress of South African Trade Unions
CSM Combined Services Model
CSS Central Statistical Service
DBSA Development Bank of Southern Africa
DC District Council
DCD Department of Constitutional Development
DLA Department of Land Affairs
DOF Department of Finance
DWAF Department of Water Affairs and Forestry
EMIP Extension of Municipal Infrastructure Programme
FFC Financial and Fiscal Commission
GTZ Gesellschaft fur Technische Zusammenarbeit
IMFO Institute of Municipal Finance Officers
LC Local Council
LGTA Local Government Transition Act
MC Metropolitan Council
MHLG Ministry for Housing and Local Government
MIIF Municipal Infrastructure Investment Framework
MIP Municipal Infrastructure Programme
MLC Metropolitan Local Council
NCOP National Council of Provinces
NEDLAC National Economic Development and Labor Council
OPCAS Office of Policy Co-ordination and Advisory Services
RC Representative Council
RDP Reconstruction and Development Programme
<table>
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<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tbody>
<tr>
<td>RSC</td>
<td>Regional Service Council</td>
</tr>
<tr>
<td>SALGA</td>
<td>South African Local Government Association</td>
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<tr>
<td>SANCO</td>
<td>South African National Civics Organization</td>
</tr>
<tr>
<td>TBVC</td>
<td>Transkei, Bophutswana, Venda, Ciskei</td>
</tr>
<tr>
<td>TLC</td>
<td>Transitional Local Council</td>
</tr>
<tr>
<td>TRC</td>
<td>Transitional Rural Council</td>
</tr>
<tr>
<td>USAID</td>
<td>U.S. Agency for International Development</td>
</tr>
<tr>
<td>VAT</td>
<td>Value-Added Tax</td>
</tr>
<tr>
<td>VIP</td>
<td>Ventilated Improved Pit Latrine</td>
</tr>
<tr>
<td>WLA</td>
<td>White Local Authority</td>
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CHAPTER 1
THE FISCAL FEDERALISM MODEL AND ITS APPLICABILITY IN DEVELOPING COUNTRIES

1.1 INTRODUCTION

The efficient and equitable provision of public services in a country depends crucially on the allocation of taxing, spending, and regulatory functions among different levels of government and on the structure of intergovernmental transfers. The theory of fiscal federalism, developed by Oates (1972), offers general conceptual guidance for nations attempting to reform or restructure their fiscal relations. It provides economic guidelines for dividing public-sector responsibility for stabilization, distribution, and allocation among different levels of government. Although there are certain problems with attempting to apply the fiscal-federalism model (conceived in the context of developed countries) directly to developing countries, many of the basic principles of the model, qualified by the special circumstances of these countries, can be used to analyze and evaluate the role of local authorities in developing countries (Smoke, 1994).

The issue of fiscal decentralization in developing countries has received renewed attention since the 1980s, owing to several factors. First, there have been significant changes in economic conditions that have resulted in tighter central government budgets at a time when demand for government services is growing rapidly. This has led central governments to reduce the growth and scope of their own activities (Bird, 1993; Smoke, 1994; Tanzi, 1995). Second, political and political economy developments in specific countries have prompted a reassessment of the intergovernmental relations and multilevel
finance. These include the demand for more independence by provinces in Canada, the transition from a command economy to a market economy in Eastern Europe and the former Soviet Union, the desire to break away from the legacy left by colonialism in Africa, and the move from an apartheid to a democratic system in South Africa. (Tanzi, 1995; Shah, 1997; Litvack, Ahmad, and Bird, 1998). The judicial systems in some countries, such as India and South Africa, are also providing the impetus for change by providing a broader interpretation of basic rights of citizens and requiring national and subnational legislation to conform to these rights (Shah, 1997). Third, there has been an increasing realization that local governments may be underutilized and could be potentially productive in raising resources, providing services, expanding rural-urban linkages, stimulating private investment, and implementing national development policies (Esman and Montgomery, 1982; Mahwood, 1983, 1987; Bendavid-Val et al., 1988; Gramlich, 1993; Smoke, 1994). Finally, multilateral development agencies (the World Bank, in particular) and bilateral aid agencies strongly support this broader role for local government, evidenced by their research work and lending policies (World Bank, 1988, 1991a; UNDP, 1992; Smoke, 1994; Tanzi, 1995).

The assignment problem, or the allocation of expenditure and tax functions to various levels of governments, is the most fundamental fiscal issue in a country (Shah, 1994b). Using fiscal-federalism, economic-efficiency, and equity principles (outlined in the next section) as an evaluative framework for the assignment problem, I identify appropriate measures for restructuring existing intergovernmental fiscal arrangements in developing countries and apply them to the case of a single country, South Africa.
My central research question is: Given that South Africa is undergoing decentralization, what is the “proper” design of this decentralized system and how can it be implemented in South Africa, given particular legal, institutional, administrative, and political constraints. In essence, I examine the main aspect of fiscal decentralization: system design (which follows from the fiscal-federalism literature). In this context, I attempt to identify what the decentralized system in South Africa would look like in a normatively "correct" sense, i.e., what services should the local organs of government provide, and to whom, and what revenue should they collect, and from whom. In conjunction with this, I examine the extent to which this normative model can be applied in South Africa, given existing legal, institutional, administrative, and political conditions. I also propose options for how this system of allocation of expenditure and revenue functions could get phased in, given that there will be some shortfall between revenues and expenditures, at least in the short run. In this context, I consider alternative models for the system of transfers that needs to be put in place in order to meet the gap between revenues and expenditures. My overall research objective is to provide a framework for looking at these options that can be used by the newly amalgamated local municipalities to achieve the incremental local-revenue enhancement needed to establish sustainable service delivery in South Africa.

I concentrate on the fiscal dimension specifically to ascertain design criteria (taking into consideration the balancing of the objectives of efficiency and equity) for local revenue enhancement and specific operational instruments for strategy implementation. I also briefly examine the implementation process to identify the degree
of institutional reform (administrative and legislative) necessary to achieve the above fiscal improvements.

The main contribution of my study is to provide an integrated approach to looking at system design in the context of a single country -- to which little attention has been paid so far. Most analysts focus primarily on the different components of system design separately -- local government structure, expenditures, revenues, and intergovernmental transfers -- without discussing the linkages among them. Using South Africa as a case study, I demonstrate the importance of looking at system design as an integrated piece. In addition, I conclude with directions for future research with regard to implementation, which has also received very little attention in the literature. In recent years, some authors (Smoke and Lewis, 1996; Shah, 1997; Litvack, Ahmad, and Bird, 1998) have begun to stress the importance of paying careful attention to the institutional setting in which the design of decentralization policies are implemented as a vital criterion for the success of these policies.

In the remainder of this chapter, I first discuss the fiscal-federalism model and its applicability to developing countries. Second, I present a brief background of African countries, identifying the problems faced by them in local-revenue mobilization and indicating the gaps in the literature that I intend to fill in my study. I then detail the methodology used in conducting my fieldwork. Finally, I outline the organization of my study.
1.2 THE FISCAL-FEDERALISM MODEL

Oates' (1972) basic theory of fiscal decentralization, known as fiscal federalism, deals with assigning public-sector responsibility for the following three public-sector functions of government (attributable to Musgrave, 1959): (1) stabilization, (2) distribution, and (3) allocation. As will be seen, some of the arguments about these three functions support centralization and others support decentralization. Here, I briefly review the theory behind these functions, paying special attention to the allocation function, which is the focus of local public finance theory and of this study. I also discuss the applicability of the fiscal-federalism model in the context of developing countries.

1.2.1 Stabilization

The first justification for government intervention in a market economy is that public management of fiscal and monetary policy is needed because market economies are not self-regulating. The fiscal-federalism literature has traditionally reached a broad consensus that the central government should be primarily responsible for this stabilization function because such activities are considered to be essentially macroeconomic (Oates, 1972; Musgrave, 1983). A monetary policy must be managed at the national level because of the problems that would arise if subnational units had their own money supply and/or control over monetary policy. In addition, fiscal policy must also be managed at the national level because, owing to the generally open nature of local economies, leakages from a marginal dollar of private spending would likely be substantial, resulting in a dissipation of the expansionary effects of local fiscal policy into
other jurisdictions. These arguments have been recently restated by Prud’homme (1995) and Tanzi (1996), among others.

Some authors (Gramlich, 1987, 1993; Smoke, 1994; Ter-Minassian, 1997; Shah, 1998; Spahn, 1998) have challenged the above views. According to them, the theoretical case for centralization of stabilization policies rests on a number of unrealistic assumptions, including regionally symmetric shocks, a closed economy, segmented capital markets, lack of supply-side effects of local fiscal policy, neglect of built-in stabilizers, non-cooperative behavior by subnational governments, and unconstrained and undisciplined local borrowing. I summarize below some of their arguments as to why these assumptions are violated.

There is no clear rule for fiscal policy in the presence of regionally asymmetrical shocks that cancel out at the national level. In addition, now that national economies are increasingly open, any national fiscal stimulus would be offset by an exchange-rate change. An appropriate state fiscal response to regionally varying, but zero-sum shocks, could be neutral as to the exchange rate and still exhibit significant employment effects. With regard to segmented capital markets, the view that decentralized fiscal policy is more costly (due to high borrowing costs for regional governments) does not have merit for an economy where there are free capital markets and unrestricted access to international financing. With regard to supply-side effects of fiscal policy, the regional incidence of the supply effects is more evident at the local than at the central level for local public investment programs. Local governments are better equipped than the central government to cope with local unemployment because they have easier access to
relevant information, can respond more quickly to local needs, and can control appropriate policy instruments for immediate implementation. With regard to built-in stabilizers, fiscal stabilization is largely automatic through built-in elements of the tax-transfer system. These are, however, not confined to the central government but can work at all levels of government.

Given that the traditional assumptions for centralization of the stabilization function have been challenged, there is a case for the central government to involve subnational governments in macroeconomic management and to make them share responsibility for the achievement of national economic objectives.

1.2.2 Distribution

The second justification for government intervention is to affect the distribution of income in order to maximize social welfare. Mainstream fiscal-federalism analysts (e.g., Oates 1972; Musgrave and Musgrave, 1973; Prud'homme, 1995; Ter-Minassian, 1997) argue for distribution to be placed in the hands of the central government mainly because local redistributional programs would drive out the rich and attract the poor, undermining the redistributive base. Other analysts (e.g., Pauly, 1973; Tresch, 1981; McLure, 1994), however, argue for decentralization of such efforts, suggesting that taxpayers should and will try to raise the incomes of the poor primarily in their own areas (either for altruistic reasons or because of the fear of negative externalities, such as increased crime) since income redistribution may raise the utility of higher-income people (due to the reduction of poverty in their area). Still others (e.g., Boadway, 1992) argue that, although the center may assume a dominant role in income redistribution,
Subnational governments need to be involved in implementing specific redistributive programs in order that such programs are tailored to meet individual jurisdictions' circumstances. In the United States, state governments have been playing a greater and more successful role in implementing redistributive policies (Gramlich, 1993). One should note that this may not necessarily be a conscious attempt by state governments to influence distribution; some of this is by federal mandate. More recently, Sewell (1996) argues that regulatory policies, such as land use and rent controls, allocated to subnational governments have distributional implications. Ahmad and Craig (1997), citing the United States as an example, posit the view that there is a role for state-level redistribution because within-state variations in incomes and service levels often exceed across-state variations. Shah (1998) argues that the new economic environment of globalization and localization will polarize the distribution of income in favor of skilled workers, thus accentuating income inequalities. Under these conditions, since the national government may not be able to deal with this social policy fallout, subnational governments would need to devise strategies for dealing with this emerging crisis.

1.2.3 Allocation

The third justification for government intervention is to correct for market failure in order to achieve an efficient allocation of resources. The fiscal-federalism model envisages a substantial role for decentralized levels of government in the allocation function because the demand for many public goods and services is unlikely to be uniform over space. Given this, resources would be misallocated if uniform levels of service were provided across large geographic areas. Decentralization would enhance
welfare gains, because residents in smaller jurisdictions could articulate their preferences for the optimal mix of public goods and taxes through the process of voting. In such a framework, a fragmented pattern of jurisdictions is preferable to a system of large, all-purpose authorities not only because of preference differentiation, but also because expenditure decisions are related more closely to real resource costs in smaller jurisdictions. (Oates, 1972)

In addition, Israel (1992) argues that a decentralized system can become a competitive surrogate, thus increasing allocative efficiency. Tanzi (1995) postulates another potentially important advantage of decentralization -- when there are a large number of decentralized governments, there is likely to be greater experimentation and innovation in the provision of local public goods, contributing to improvements in overall resource productivity. Shah and Qureshi (1994, p. xv) advocate the decentralization of various functions with the argument that accountability brings responsibility:

“Accountability is promoted through a clearer and closer linkage of the benefits of local public services with their costs.”

There are, however, important economic considerations, such as economies of scale, economies of scope, and interjurisdictional externalities, that may preclude decentralizing to maximize efficiency in service provision. For example, it is more efficient to provide services, such as utilities and transport, which exhibit economies of scale, at a relatively centralized level or through a cooperative agreement of local authorities than at a decentralized level. In the case of water supply, whose provision generates interjurisdictional externalities, resource allocation may be more efficient when
it is provided centrally, cooperatively, or with central coordination than when it is
decentralized (Khellaf, 1992). Also, in the case of administrative and compliance costs,
where centralized administration may reduce such costs associated with financing certain
public services, some degree of central control or compensatory grants may be warranted
(Smoke, 1994; Prud'homme, 1995).

1.2.3.1 The Assignment Problem

At the heart of the allocation function lies the assignment problem, which deals
with three issues: (1) the allocation of expenditure functions to various levels of
government; (2) the allocation of tax functions to various levels of government; and (3)
other sources of revenue, including intergovernmental transfers and borrowing.

With regard to the first aspect -- the allocation of expenditure -- the four basic
principles enunciated in the fiscal-federalism literature for delineating expenditure
responsibilities among levels of government relate to: (1) Efficient provision of public
services; (2) Fiscal efficiency; (3) Regional (horizontal) equity; and (4) Provision of
quasi-private goods. (See Appendix 1 for elaboration)

With regard to the second aspect -- the allocation of tax functions -- the criteria of
equity (consistency of revenue means with expenditure needs) and efficiency
(minimizing resource costs) have traditionally been used to suggest broad principles for
tax assignment, which constitutes the division of revenue sources among federal and
subnational governments (Musgrave, 1993). A similar framework for tax assignment
would use the criteria of: (1) efficiency in tax administration, i.e., the level of government
likely to have the best information on a tax base should have the responsibility for
levying taxes on that base; and (2) fiscal needs, i.e., matching revenue means to revenue needs so that tax instruments that advance particular policy objectives should be assigned to the level of government responsible for providing the service (Shah, 1994b).

The third aspect concerns the role of intergovernmental transfers, which are the main source of revenue for subnational governments in developing countries. For example, central transfers finance 85% of subnational expenditures in South Africa, 67 to 95% of state-local expenditures in Nigeria and 70 to 90% of expenditures in less prosperous states in Mexico (Shah, 1994b).

Rationales for intergovernmental grants are classified into two categories: (1) economic justifications, where one can show that the central government could have efficiency, equity, or stabilization objectives that have certain implications for local governments; and (2) political or institutional justifications, where local governments are viewed as agents of central government policy (Gramlich, 1977). Whatever the rationale, a system of grants is a step in the direction of fiscal decentralization in that it finances local government services; what determines the autonomy it gives to local governments is the way in which it is structured.

1.3 RELEVANCE OF THE MODEL FOR DEVELOPING COUNTRIES

Several analysts argue that the fiscal-federalism model is of limited relevance to developing countries, primarily because it cannot explain the actual intergovernmental arrangements in them, nor does it provide the framework for solutions. For example, Bird (1993, p. 217) laments the fact that the traditional literature on fiscal federalism
"both fails to explain most of the transfers found in the real world and makes impossible informational demands." Rondinelli et al. (1989, p. 58) explain that the approach based on economic theory alone cannot offer "... comprehensive theoretical and methodological solutions to determine how decentralization should be carried out."

Smoke (1994, p. 45) indicates that although many of the basic principles of the fiscal-federalism model universally apply, "A number of critical assumptions of the theory, both explicit and implicit, are violated, and various local conditions affect the way the theory should be interpreted."

I examine each of the three public-sector functions viz., stabilization, distribution, and allocation, in turn, to assess the suitability of the basic theory for application to developing countries, in general, and to South Africa, in particular.

**1.3.1 Stabilization**

In general, analysts (McLure, 1994; Smoke, 1994; Prud’homme 1995) agree that the case for assigning stabilization responsibility to the central government in developing countries is stronger than in industrialized countries for several reasons. First, developing countries tend to have more severe macroeconomic fluctuations (especially agricultural economies which are subject to climate variations and are dependent on other countries for basic production inputs), necessitating careful planning and central coordination.

Second, local governments in many developing countries play only a small decision-making role in the economy so that the impact of their fiscal behavior is limited. Prud’homme (1995) says that stabilization policies can only be undertaken at the margin and will be small if the whole is small. Finally, local governments in some developing
countries are more sensitive than the central government to economic fluctuations because they rely on less stable source of revenue related to economic activity (such as agricultural taxes and business license taxes) than on more stable wealth-based taxes (such as land rates) and user charges.

How do these issues relate to the case of South Africa? First, the South African economy is relatively open so that macroeconomic policies, even at the national level, are likely to be ineffective in stabilizing output and employment, and are reflected more in the rate of inflation and the exchange rate. Second, local government spending accounts for over 20% of total government expenditure (Financial and Fiscal Commission, 1997), as a result of which arguments about the small impact of subnational stabilization policies at the margin become less convincing. In this regard, though, McLure (1994) argues that subnational governments have limited ability to issue or retire debt -- one of the stabilization policy instruments. Finally, urban local government in South Africa does have access to stable sources of revenue, such as the property tax and user charges. For these reasons, Gramlich's (1993) recommendation to grant subnational governments the ability to operate limited fiscal stabilization policies could be considered in South Africa. I discuss these issues in greater detail as I present my case study.

McLure (1994) draws attention to the potential conflict between the fiscal autonomy of local government and the assignment of sole responsibility for stabilization policy to the national government in South Africa. In the interest of overall macroeconomic stability, the national government monitors and sets general guidelines for the budgets of provincial governments and municipalities. The exercise of more
specific control over the details of subnational budgets, although not essential for the
conduct of macroeconomic stability, might compromise the fiscal autonomy of
municipalities and should be allowed only under strict non-partisan external supervision.

1.3.2 Distribution

Again, it is generally agreed that distribution is best left to the central government
in developing countries but for different reasons than in developed countries. Smoke
(1994) argues that, first, even though domestic mobility is likely to be less significant for
rich people (because there are few major cities that provide the level of services and
amenities to which they are accustomed) in developing countries, many municipalities
have a limited resource base and inadequate capacity to administer major
intrajurisdictional redistributional programs. Second, there may be greater political
resistance to local redistributional programs in developing countries because prominent
wealthy residents may be able to exert a greater influence on local politicians.

Both McLure (1994) and Smoke (1994), however, suggest an alternative means of
local redistribution -- for municipalities to be reasonably progressive in the way they
finance local services. Taxes or user charges paid by the better-off citizens can be used
to finance public services for the poor in the same jurisdiction. Making this fairly
standard practice across the country can discourage domestic mobility.

The argument of limited revenue bases and inadequate administrative capacity is
ture for rural, but not for many urban, municipalities in South Africa. The issue of
political resistance as a result of local influence can also be questioned, at least in the
short run, because of the radical change in government, both at the national and local
levels, after the apartheid system was brought down in 1994. The new administration has set forth the mandate of a “one city, one tax base”, according to which municipal boundaries have been redrawn to amalgamate the former white areas and the black townships. The taxes and excess user charges paid in the former white areas (as well as those in the former black areas) are being used to finance services and service backlogs in the former black areas within the same municipal jurisdiction. This has its problems, which I discuss in greater detail in the following chapter. Another intrajurisdictional redistributional tool that is used in South Africa is the Regional Service Council levy, which I discuss in Chapter 4. I also discuss the issue of taxes and user charges in that chapter.

1.3.3 Allocation

The significant role envisaged by the fiscal-federalism model for decentralized levels of government in the allocation function, and the exceptions to it that call for greater centralization (economies of scale, economies of scope, and interjurisdictional externalities), need to be carefully examined in the context of specific economic, cultural, legal, institutional, and political factors in developing countries. Many of the basic assumptions of the model may be violated as a result of these factors.

First, with regard to economic considerations, certain services generate interjurisdictional externalities that are unique or pervasive in developing countries. For example, Smoke (1994) argues that veterinary services in Kenya call for greater involvement of officials familiar with local conditions to combat the externalities, such as infection of imported livestock breeds by untreated local breeds, involved with infectious
diseases. This runs counter to the traditional fiscal-federalism view that
interjurisdictional externalities may call for more centralized provision of the service.

Second, with regard to legal and institutional factors, the assumption is that the
decentralization of revenue and expenditure functions is based on a clear contract
between central and subnational governments (to ensure accountability), and the
existence of sufficient resources and capacities in the latter to carry out their functions.
This is often not the case in many developing countries (Bahl and Linn, 1992; Olowu and
Smoke, 1992; Smoke, 1994; Tanzi, 1995; Shah, 1997; Litvack, Ahmad, and Bird, 1998).
Formal rules and oversight mechanisms, that are the main channels for accountability in
developing countries, are often ineffective because of poor information and monitoring
systems. In addition, the assumption of articulation of preferences through voting to
ensure local accountability and achieve welfare gains does not hold in many developing
countries. Opportunities for “voice” and “exit” are limited due to weak institutions,
democratic systems are frail, and the use of strong local participation to counter weak
formal election systems is compromised by the presence of powerful elites.
(Prud’homme, 1995; Litvack, Ahmad, and Bird, 1998)

The South African Constitution provides the key legal framework for the
decentralization initiatives underway in the country. I discuss its implications for
decentralization in Chapter 2. I also analyze the structure and institutions of local
government in this chapter. I discuss issues of local accountability in Chapter 7.

Khellaf’s (1992) study of local public services in Tunisia illustrates the case of
centralization of the sewerage service owing to the deficiencies of municipalities in terms
of institutional structure and legal base. She concluded that “... the division of responsibilities between levels of government in Tunisia is determined by the desire to produce the service effectively rather than by the search for economic efficiency as suggested by the economic model of allocation of function, known in the fiscal-federalism literature.” (Khellaf, 1992, p. i) Her conclusions bring home the point that there is a difference between allocative and production efficiency that needs to be understood to sort out the most appropriate service delivery role for local governments. Prud’homme (1995) points out that the centralization of sewerage services in Tunisia was successful in terms of production (or supply) efficiency but not in terms of allocative (or demand) efficiency. The Office National de l’Assainissement (ONAS), the centralized agency, has not provided sewerage services in all parts of the country, and some smaller cities have not benefited from the system. Thus, one must be careful when interpreting Khellaf’s conclusions -- one needs to weigh the tradeoffs between production and allocative efficiency when deciding whether to produce a service at a more centralized as opposed to a decentralized level. One also needs to recognize that there is a difference between provision of a service (i.e., having responsibility for it) and actual production of it.

With regard to political factors, the assumption behind experimentation and innovation in service provision to achieve enhanced resource productivity is that the central government is willing to share power with the subnational governments. Smoke (1994) argues that central governments in developing countries may take control over certain services that may be provided more efficiently at the local level in order to
achieve power consolidation goals. Even if local governments are sufficiently empowered, efficiency in service provision can be undermined if local politicians indulge in nepotistic behavior or award contracts and positions in return for political favors. Prud’homme (1995) and Tanzi (1995) both believe that corruption may be a more common problem at the local level than at the national level, especially in developing countries. They argue that corruption is often stimulated by contiguity, and this is more prevalent in the case of local than national bureaucrats because the former are more likely to spend their careers in the same location while the latter tend to move from place to place. In this regard, Bardhan (1997) points out that centralized corruption is likely to have less damaging consequences for efficiency than decentralized corruption, because the bribee will internalize some of the distortionary effects of corruption in the former case.

As mentioned earlier, the focus of my study is on the allocation problem. I will, therefore, discuss the relevance of the above-mentioned allocation issues to South Africa in detail in the next few chapters. In the next section, I provide a brief background of local governments in African countries in an attempt to identify some of the common problems faced by them in the context of local-revenue mobilization and to indicate the gaps in the literature that I intend to fill in my study. This sets the stage for an in-depth analysis of my case-study country, South Africa.
1.4 BRIEF BACKGROUND OF SUBNATIONAL GOVERNMENTS IN AFRICAN COUNTRIES

African cities have been characterized by a low degree of political and fiscal autonomy. At the same time, the decentralization process has now been accelerated by the on-going political changes, such as the desire to shed the vestiges of colonialism and the advent of multi-party political systems, in many African countries (Madavo, 1989, Smoke, 1993; Shah, 1997; Litvack, Ahmad, and Bird, 1998). They are embarking on institutional reforms leading to greater democracy, particularly at the local level, and moving towards a market-oriented economy. However, the decentralization process and administrative reforms currently underway remain incomplete and result in various degrees of autonomy at the local level.¹

Local authorities in urban areas of African countries are plagued by chronic fiscal gaps between the rising demand for urban services and the rather stagnant local fiscal bases under their jurisdiction. As the available resources (and thus expenditures) have fallen, so have both the quality and quantity of many essential facilities and services (Stren, 1989). Their problems have been further compounded by the financial difficulties of the central governments (in West Africa, particularly after the recent CFAF devaluation, and in South Africa as a result of apartheid). Fiscal crisis at the central level has led to massive reductions in both intergovernmental fiscal transfers and direct public

¹For instance, in countries such as Ghana, Benin, and Burkina Faso, municipalities have legal and financial autonomy but lack any elective elements. In most of the other African countries, such as Guinea and Cameroon, legislative bodies, led by a mayor who is appointed by the central government, are elected. This has led to a "dual function" of local leadership, in which the local head acts as the representative of both central and local authorities. In some exceptional cases, into which Senegal and Côte d'Ivoire fall, both legislative and executive representatives are elected at the local level.
investments at the local level (Madavo, 1989). The deteriorating fiscal situation is exacerbated by the tendency for the central government to usurp from local governments their most buoyant and productive sources of revenue (Lalaye and Olowu, 1989).

In many of the African countries, however, the share of urban-service responsibilities that are assigned to local authorities has substantially increased during the course of the current decentralization reform, but this transfer has not been generally accompanied by a corresponding transfer of authority and matching fiscal resources (Lalaye and Olowu, 1989, Smoke 1994). This is the problem of "unfunded mandates" and has generated distrust from the local levels that have received added responsibilities and contributed to ever-widening urban fiscal gaps.

The following are the main problems that arise at the local level:

(1) Local authorities are often restricted in their revenue-raising authority to income-inelastic fiscal bases, such as property taxes, specific excises, and user charges.

(2) Central governments, which are often uncommitted to granting autonomy, maintain control over key appointments, the budget, procurement, and revenue generation, thus seriously undermining the administrative and economic efficiency of local authorities (Smoke, 1994).

(3) In many African countries, operating surpluses are nonexistent and local authorities are barely able to meet current expenditures for basic administrative tasks and responsibilities. Many rely heavily on deficit financing. (Olowu and Smoke, 1992). Due to the local authorities' limited credit worthiness, borrowing has played a marginal role.
Considering the current fiscal situation at the central level, a substantial increase in the amount of revenues transferred from higher-level government might not be a feasible solution to fill the urban fiscal gap. At the same time, considering the current low level of public investment in the urban areas of these countries and the increased need for urban-service provision for the current and ever-growing urban population, a reduction in local public expenditures is not a justifiable solution (Stren, 1989). Another solution would be an increase in the local efforts to raise revenue in the face of unchanged revenue-raising authority. As Olowu and Smoke (1992, p. 9) have indicated, "Although it appears that even successful local authorities have fairly narrow revenue bases, they have at least been able to tap a few sources very effectively. There is, however, evidence, that the yield from virtually all local sources of revenue can be improved." This suggests that there is considerable scope for local authorities to improve the use of fiscal resources currently available to them in a more efficient and effective manner. In order to do this, they need to improve collection and enforcement procedures and this requires the building of local institutional capacity.

From the discussion in the previous paragraph, it appears that an enhancement of the locally assigned authority to raise revenue is inevitable in order to fill the current urban fiscal gap. Also, the World Bank's past empirical studies on urban public finance strongly indicate that increases in locally raised resources appear to have determined the ability of an urban local authority to expand its services (Bahl and Linn 1992, p. 48). Their examination of changes in local government finance during the late 1960s to the 1980s indicated that where locally raised revenues fared badly, urban expenditure
suffered; where they did well, urban expenditure thrived. Intergovernmental fiscal transfers and local borrowing were less important either way.

Recent studies (Israel, 1987; Ostrom, Schroeder, and Wynne 1993) have identified an inherent limitation on the possibilities to enhance local institutional capacity through internal administrative reform. The performance of local authorities is substantially influenced (positively and negatively) by regulatory and fiscal controls of the central government. Therefore, local resource mobilization appears to be a problem that cannot be fully solved by taking the current institutional framework as given and attempting to enhance the performance of local authorities within the current institutional constraints.

At the very least, the current momentum of decentralization has set the stage for further institutional reform. Because decentralization has introduced a high degree of fluidity into the structure of intergovernmental relations, it presents the governments in African countries with an opportunity to promote fundamental reforms that have not been possible in the past (World Bank 1994a). At the same time, it is important to note that the current decentralization is not necessarily undertaken according to a carefully designed sequence of reforms; it arises in response to a complex set of pressures for change as varied in nature as the country contexts in which it takes place (Dillinger, 1994). This is also the case for African countries, as documented in the proceedings of workshops (held in Italy in 1989) by the World Bank on strengthening local government in Sub-Saharan Africa. In order to gain a better understanding of the current decentralization initiatives, the degrees of further institutional reform needed, and
operational instruments to materialize a streamlined reform, a country-specific analysis is very essential. My research examines such initiatives in the context of South Africa.

Although the normative theory of ideal allocation of fiscal functions between the central and local governments and descriptions of the current status of decentralization in these countries are relatively abundant, studies on operational and effective instruments for incremental expansion of local fiscal functions are still limited. Most of the decentralization initiatives frequently encounter the same kind of problems, such as: how can an incremental decentralization program be successfully initiated?; how can local fiscal resources be gradually expanded?; and what major setbacks and bottlenecks should officials designing these programs anticipate during the incremental expansion of local authorities?

I undertake an in-depth and systematic analysis of intergovernmental fiscal relations in South Africa to identify the current institutional bottlenecks and to propose incentive structures to improve the performance of local authorities.

1.5 FIELDWORK AND METHODOLOGY

The data and information for my study were gathered during two field trips to South Africa: from June 1996 to December 1997, and from June 1998 to January 1999. During the first trip, I was based at the office of the Financial and Fiscal Commission (FFC) in Midrand, and during the second, at the office of the Department of Constitutional Development (DCD) in Pretoria. During the first trip, I undertook visits to sample municipalities in order to obtain both detailed budget data as well as qualitative
information regarding revenue sources, service provision, intergovernmental transfers, relationships with other governmental organizations, capacity issues, and the like. At the time, detailed budget data for the whole country were not yet available.

The sample of municipalities visited was broadly representative of the different types of municipalities nationally and within each province. At the time of sample selection, there were 850 municipalities in the country. The sample of 90 municipalities ranged in size from a former “Health Committee” (now incorporated as a municipality) comprising four staff members with an annual budget of about R140,000 to metropolitan and local councils with thousands of employees and budgets of billions of rands. In almost all cases, the primary municipality was linked with the district or metropolitan council, i.e., if a local council was selected, the corresponding district or metropolitan council within whose geographical area it fell was also selected. I intended to cover all nine provinces, but, at the time of this writing, I have visited only the municipalities in three provinces, covering only 45% of the intended sample visits in total. My focus was on urban local councils in the metropolitan areas, although both urban and rural municipalities were visited as part of a larger study by the FFC. The three provinces (Gauteng, KwaZulu Natal, and the Western Cape) I visited are the ones in which all the six metropolitan areas are located.

In general, I set aside half a day for discussions with key municipal staff, including the CEO or Town Clerk, City or Town Treasurer, the heads of planning and engineering, and the City or Town Secretary. Prior to the visits, I sent a checklist of items to each municipality, and the FFC requested as much information as was available
In advance. I collected the rest at the time of the visit. The checklist contained questions relating to socio-economic and demographic information and data. Financial data included financial statements and budgets for the 1995/96 and 1996/97 financial years. Non-financial data included geographic boundaries of the municipal jurisdiction, range and standard of services provided to the community, by whom and on whose behalf, demographic profile, human capacity issues within the administration, relationships with national and provincial departments and other municipalities, among others.

In addition to collecting information directly from the municipalities, I also contacted the relevant provincial department in the Ministry of Local Government, the national Departments of Finance, and Constitutional Development and obtained summary budget and other information for the municipalities in the sample. I also held in-depth interviews with officials from these departments. All these efforts resulted in the collection of various types of quantitative and qualitative information, including observations and opinions based on personal experience.

During my second visit, detailed budget data were available for the whole country from the Department of Finance. Consequently, I have used the 1996/97 detailed budget data and not the financial data collected from the individual municipalities to conduct my analysis. I have made use of the qualitative data obtained from the sample municipalities to make general observations about certain issues, such as the relationship between the municipalities and other governmental departments, capacity issues, and so on.
1.6 OUTLINE OF STUDY

In order to gain a better understanding of the decentralization process that is underway in South Africa, it is crucial to get a sense of both the apartheid system under which local government operated and the current system. I present this in Chapter 2. In addition, I examine the key constitutional and government policy reform issues that relate to decentralization to provide an initial understanding of what is constitutionally required in South Africa, what are the current reform objectives of the government, and how these relate to what is normatively correct versus what is actually possible.

In Chapter 3, I discuss expenditure requirements for the provision of basic services -- a major local government function in South Africa. I first deal with the legal role of local government in the provision of these services and relate this to the development of norms and standards for them. I then estimate the capital and operating costs of providing basic services. This sets the stage for Chapter 4, in which I relate these costs to what local government can raise by itself to finance these services and what is needed from other sources, including intergovernmental transfers, borrowing, and private-sector equity in infrastructure. In the process, I describe the main revenue sources for local government, analyze some of the problems with the existing sources as well as their revenue potential, and make recommendations for their reform.

Chapters 5 and 6 go into detail on the current system of intergovernmental transfers that are given to local government to meet the shortfall between revenues and expenditures for the provision of basic services. In Chapter 5, I first examine the theoretical rationale for intergovernmental transfers. Next, I describe the current system
of transfers. I then undertake both a theoretical and empirical evaluation of the current system. This leads into Chapter 6, in which I present an alternative model of operating and capital transfers to local government, taking into account the problems faced with the existing system, and keeping in mind the need to encourage local government to become more self-reliant in its efforts to provide basic services.

Having discussed the major issues related to the design of fiscal decentralization in South Africa, I then turn to the often-neglected implementation strategy. In the final chapter, I first summarize the major findings of my study. I then outline an implementation strategy to take into account the political, institutional, legal, and administrative reality, in which I make recommendations for prioritizing reforms and building local government capacity. I conclude with lessons for other developing countries that are attempting to develop decentralization reform programs.
CHAPTER 2

THE STRUCTURE OF LOCAL GOVERNMENT IN SOUTH AFRICA

2.1 INTRODUCTION

In this chapter, I provide an in-depth analysis of the historical structure of local government in South Africa and make recommendations for its reform. I first detail the former apartheid system and its implications for local government finances. The system of local government that existed in South Africa under apartheid was characterized by:

1. fragmentation along racial lines;
2. exclusion of Africans from Parliament;
3. inequitable provision of services.

The Black Local Authorities (BLAs), and the Indian and Colored Management Committees were controlled by the White Local Authorities (WLAs) and provincial and central authorities, and they had fiscal problems. I highlight the fact that, although the local government system was characterized by a proliferation of units (due to the formation of the BLAs, Indian and Colored Management Committees under the 1983 Constitution), this type of system should not be confused with one in which power is decentralized.

With this as a background, I analyze the attempts to decentralize the current system of intergovernmental fiscal arrangements in South Africa. The Local Government Transition Act (1993) has provided for revised interim measures for restructuring local government through two phases: (1) pre-interim and (2) interim, which have already been completed. My research focuses on the post-interim phase, which deals with system redesign and implementation issues, which have not really been dealt with in the Act. Now that the municipalities are in place, it is crucial to analyze their administrative and
fiscal position and capacity in order to assist them in their mandate to provide services to their constituents. Previously, there were only four provinces; under the new Constitution of 1996, there are nine. As a result, municipal boundaries have been redrawn and new municipalities have been formed. Some of them are amalgamations of the former WLAs and the former BLAs or Indian and Colored Management Committees. Others are newly formed urban or rural municipalities. In addition, Metropolitan Concils have been created in the urban areas. Thus, the present system of local government is also characterized by a proliferation of units.

The local sphere of government consists of urban and rural municipalities that number over 850. Three key points characterize the system. First, in both urban and rural areas, a two-tier system of local government exists, while, in certain urban areas, a single-tier system exists; this has constitutional and policy implications for intergovernmental fiscal relations. I highlight the main aspects of the three spheres of government that relate to decentralization. Second, the amalgamation of the former black townships and white cities has implications for equity and the provision of basic services. I discuss this and other contextual factors that limit the extent to which the normative model of fiscal federalism can be applied in South Africa and complicate the implementation of desired policies. Third, the powers and functions of local government affect its potential sources of revenue. This is intrinsically related to expenditure needs for the provision of basic services, and leads into the next two chapters on expenditure requirements and revenue sources for this purpose. To show the importance of the local government today, I first provide a brief review of the earlier system.
2.2 THE FORMER SYSTEM OF LOCAL GOVERNMENT IN SOUTH AFRICA

The system of local government that existed in South Africa under apartheid was defined under the 1983 Constitution and was jurisdictionally fragmented along racial lines: Whites had their municipal councils, Coloreds and Indians their management committees, and Africans their Black Local Authorities (BLAs). The first three were "own affairs" institutions (under the control of the respective Minister of Local Government in Parliament), while the last were "general affairs" institutions (under the control of the government-appointed provincial government). The White Local Authorities (WLAs) were municipal bodies that provided services, levied and collected tariffs and taxes, and invested and borrowed on the capital market. They were, however, subject to control under statutes that ordained what revenues they could collect and on what they spent these revenues. The Colored and Indian Management Committees were administratively and financially under the direct supervision of the WLAs. Their fiscal responsibility was limited to the allocation of housing and business licenses, leasing of immovable property, and levying of certain fees and taxes. Theoretically, the BLAs were fully independent and autonomous units with corporate status and powers similar to the WLAs. In reality, however, the BLAs were subject to intervention and tight controls from the provincial and central authorities.

According to Christianson (1993), the presentation of BLAs as an African self-government was a ploy by the government to justify the exclusion of Africans from parliament. Given that it was built on the underlying apartheid framework, right from its
inception, the system of the BLAs suffered from a lack of political legitimacy from its constituents. An additional problem faced by the BLAs was their limited revenue base (which included only rent and service charges). Their fiscal problems were heightened with the rent boycott, beginning in 1984, when township residents boycotted rent payments to protest rent increases. The most traditional and profitable source of revenue for township administration, liquor retailing, had been privatized by the time the BLAs came into existence (Christianson, 1993).

The fragmentation of local authorities along jurisdictional lines made it difficult to provide certain services (such as electricity, transport, water and sewerage) that are metropolitan in nature. Recognition of this problem led to the creation of Regional Service Councils (RSCs) in 1985. The national government viewed them not as a separate tier of local government but as instruments of horizontal cooperation with the local units. The RSCs were defined as multi-racial decision-making bodies with a mandate to: (a) provide additional sources of revenue for local authorities; (b) upgrade infrastructure in areas of greatest need; and (c) provide "hardware" services, such as electricity, transport, water and sewerage, to all local authorities. The RSCs' two major sources of revenue were a levy based on turnover (0.25% of profit) and a levy based on payroll (0.1% of payroll), both on businesses. For the 1991/92 budget, 66% of the RSCs' revenue was generated from the turnover levy, 28% from the payroll levy, and 6% from other sources, including user charges for services provided (Croeser, 1991).

Although the system of local government under apartheid in South Africa was characterized by a proliferation of units, it should not be confused with a decentralization
of power. Both the RSCs and the BLAs were under the jurisdiction of the appointed provincial administrators. In 1986, a system of government-appointed councils replaced elected provincial councils (for whites). The provincial authorities were, thus, accountable not to the provinces but to the national government, making the goal of "devolution of power" a mockery (Cameron, 1992). Moreover, despite the fact that the RSCs were multi-racial decision-making structures, they had limited autonomous powers and were controlled by an underlying system of racially separated units of local government, thus subjecting them to the same vulnerability and opposition as the BLAs.

2.3 THE CURRENT SYSTEM OF LOCAL GOVERNMENT IN SOUTH AFRICA

The Interim Constitution of 1993 set the stage for the current system of local government in South Africa. It established a republic with three levels of government: national, provincial, and local. It provided for the creation of nine provinces. Although the Interim Constitution proclaimed the establishment of local government, it was the Local Government Transition Act (LGTA) of 1993, passed in January 1994, which set the tone for restructuring the former system. By the end of January 1995, there were 700 transitional metropolitan, local, and rural councils established throughout South Africa. They were charged with the mandate of maintaining services, collecting revenues, and beginning the process of amalgamation of the so-far racially divided structures and functions of municipal governments (Office of the President, 1995).

In light of the earlier discussion of the system prior to 1993, it is clear that the legacy of apartheid had created an untenable system of local government, plagued by lack
of political legitimacy and a limited revenue base, contributing to financial problems. The LGTA thus provided for revised interim measures for restructuring local government through the establishment of committees, forums, and councils. As noted earlier, it provided for two phases: (1) pre-interim; and (2) interim, which have already been completed. In the pre-interim phase, Provincial Committees for local government were set up and negotiating forums for restructuring local government were established. In the interim phase, transitional metropolitan and local councils were established, areas of jurisdiction were delimited, and local elections were held. The post-interim phase has not really been dealt with in the Act and is the focus of my research.

The Constitution of the Republic of South Africa was adopted by the Constitutional Assembly in May 1996 and amended in October 1996. Like the Interim Constitution, it also provides for nine provinces: (1) Eastern Cape; (2) Free State; (3) Gauteng; (4) KwaZulu Natal; (5) Mpumalanga; (6) Northern Cape; (7) Northern Province; (8) North West; and (9) Western Cape. The local sphere of government consists of municipalities, which are established for the whole territory of the Republic.

2.3.1 Types of Local Government

Currently, there are over 850 urban and rural municipalities in South Africa. Figure 2.1 shows the structure of local government. As mentioned earlier, either a two-tier or a single-tier structure characterizes the urban municipalities. There are six metropolitan areas in the whole of the Republic: (1) Cape Town; (2) Durban; (3) Johannesburg; (4) North-East Rand; (5) Pretoria; and (6) Vaal. These areas have a two-tier structure of local government: Metropolitan Local Councils (MLCs) at the primary
FIGURE 2.1
LOCAL GOVERNMENT STRUCTURE

Source: The author
tier and Metropolitan Councils (MCs) at the secondary tier. The other urban areas all have a single-tier structure of Local Councils (LCs). The local councils in several areas are composed of amalgamated combinations of former WLAs, BLAs, and Indian and Colored Management Committees.

The rural areas are characterized by a two-tier structure with Local Councils (LCs) or Representative Councils (RCs) at the primary tier and District Councils (DCs) at the secondary tier. The DCs are all some form of the former RSCs (i.e., their geographical boundaries are either contiguous with the former RSCs or are a portion of a former RSC). Single-tier urban LCs (that do not have metropolitan status) are located within the geographical area of DCs.

2.3.2 Powers and Functions of Local Government

The Constitution entrusts municipalities with provision of democratic and accountable government for local communities. It also mandates sustainable provision of services to communities, promotion of social and economic development and a safe and healthy environment, and encouragement of participation of communities in local governance.

Section 156 of the Constitution lists the powers and functions of municipalities. They have executive authority over all local government matters listed in Part B of Schedule 4 and Part B of Schedule 5 (see Appendix 2 for the Schedules) and any other matter assigned to them by national or provincial government. Among the most important local government functions are the provision of water and sanitation, refuse removal, electricity and gas reticulation, roads, and stormwater drainage.
Section 229 of the Constitution details municipal fiscal powers and functions. A municipality may impose rates on property and surcharges on fees for services provided by it or on its behalf. It may also impose other taxes, levies, and duties authorized by national legislation with the exception of income tax, value-added tax, general sales tax, or customs duty. These fiscal powers and functions have to be consistent with national economic policies, economic activities across municipal boundaries, and the national mobility of goods, services, capital, and labor, and they may be regulated by national legislation. If two municipalities have the same fiscal powers and functions with regard to the same area, national legislation must authorize an appropriate division of these powers and functions. A municipality may raise loans for capital expenditure and for bridging purposes for current expenditure (repayable within twelve months) in accordance with conditions determined by national legislation. In all instances, organized local government and the Financial and Fiscal Commission (FFC) need to be consulted. National legislation may be enacted only after any recommendations of the FFC have been considered.

As it stands, the different rural and urban, primary (LCs or RCs), and secondary (MCs and DCs) tier municipalities have different service responsibilities as well as fiscal powers and functions, depending on their structure.

With regard to service responsibilities, MLCs perform different functions in different metropolitan areas, with some assuming a wider range of service delivery functions. Generally, MCs and DCs are responsible for the bulk service functions (e.g., provision of bulk and connector infrastructure and for water, sanitation and electricity) of
the old RSCs, while the LCs are responsible for internal service functions (e.g., delivery of water, electricity, and sanitation directly to the household). However, the LGTA allowed for a negotiation process to define the allocation of powers and functions between the MCs and MLCs, as a result of which some MCs provide municipal services directly to the public. The same holds true for DCs, which provide services to the public in some rural areas. In other rural areas, this function is performed on an agency basis by either the LC or by another service provider, e.g., a water board. Although rural LCs are constitutionally authorized to perform the same functions as their urban counterparts, very few have the fiscal capacity or even the institutional and administrative structure to carry out their functions.

With regard to municipal fiscal powers for MCs and DCs, the LGTA Second Amendment Act, 1996, authorizes them to collect both the regional services and establishment levies (i.e., levies on payroll and on turnover, respectively). In addition, MCs and DCs may claim agency fees from an LC for a service provided on the latter’s behalf. The MCs may also claim an equitable contribution from all MLCs. They may also receive, allocate, and distribute grants. The latter two provisions of the Act do not hold for DCs. By providing financial support to LCs, both MCs and DCs play a redistributive role in that they act as regional mechanisms for redistributing wealth from affluent areas to disadvantaged areas under their jurisdiction.

In urban areas, MLCs and single-tier LCs impose property rates and user charges for the provision of basic services. Rural LCs exist largely in name with little or no fiscal capacity, and they have representation on the DC under whose jurisdiction they fall.
They have a very small economic base, and therefore a small tax base. This is exacerbated by the fact that there is no property or land tax collected in rural areas. The DC performs all the fiscal functions assigned to its rural LCs on their behalf.

The fiscal and financial powers of local government are inextricably linked to its structure as well as to its powers and responsibilities. Thus, these should not be determined in isolation of one another, and the “appropriate model” should be one that is optimal from the structural, functional, and fiscal points of view. Given the diverse nature of municipalities and their peculiarities, this option should not be cast in stone. Moreover, variants of the option should be allowed in the different provinces. I discuss the prescribed system as well as the rationale for its choice in Section 2.5.

2.4 CONSTITUTIONAL AND REFORM IMPLICATIONS OF INTERGOVERNMENTAL FISCAL RELATIONS

What are the key constitutional and reform issues in the roles of the spheres of government in South Africa? How do they relate to decentralization? How do these impact on the application of the normative fiscal federalism model in South Africa? The Constitution has created three spheres of government that are distinctive, interdependent, and interrelated: national, provincial, and local. Local government is no longer purely a creature of provincial legislation, but an autonomous sphere of government with its own constitutionally mandated powers and responsibilities. The three spheres, although autonomous, do not enjoy equal status. The national government has a variety of roles that relate to macroeconomic stability, the development of norms and standards, and national functions (such as national security, transport, and higher education) such that its
influence, by definition, will extend over all provinces and municipalities (Pillay, 1997).
In addition, the Constitution defines the legislative and executive authority of national and provincial government to regulate the performance of municipalities.

The Constitution charges both national and provincial government with supporting municipalities in the management of their affairs, the exercise of their powers and the performance of their functions. Each provincial government must supervise the execution by municipalities of their functions and promote the development of local government capacity to enable municipalities to perform these functions.

The creation of municipal government as a separate function has important implications for intergovernmental relations. The Constitution restricts the national government’s and provinces’ authority over local government to a monitoring role. This has important implications for fiscal as well as for institutional development issues.

Insofar as the Constitution limits the legislative power of provinces, the division of powers and fiscal responsibilities between different levels of government are also importantly affected. The crucial issue here is decentralization and devolution of functions versus delegation of functions. In the following chapters, I analyze issues relating to the “appropriate fiscal model” needed for the country to achieve the level of decentralization mandated by the Constitution.

The Constitution stipulates that local government is entitled to an equitable share of nationally raised revenue to enable it to provide basic services and discharge its duties. This is a crucial fiscal issue in the whole decentralization process. To this end, the following issues need to be clarified: what are these “basic” services?; what are the
minimum standards for these services (should a national norm be applied or should they be differentiated by province)? and how are these services to be paid? This is the topic of discussion in Chapters 3 and 4. Other issues in this regard involve: what is this equitable share?; and how is it to be divided among the 850 municipalities? I discuss these in Chapters 5 and 6. It is important to note that the national government has interpreted the "equitable share" to be an unconditional operating transfer that goes to local government. In order to comply with this, the current transfer system has two separate components: (1) an unconditional operating transfer, administered by the Department of Constitutional Development; and (2) a conditional capital transfer administered through the Consolidated Municipal Infrastructure Program. This has important implications for the redesign of the transfer system, which I elaborate on in Chapters 5 and 6.

Local government is in transition, and all its structures are considered to be transitional until the new elections in the year 2000. In this period, lots of changes to the political as well as the socio-economic bases of local government are expected. Local government structures, powers, functions, responsibilities, revenue bases, and other aspects are in the process of being restructured. For example, some of the metropolitan areas are considering moving in the direction of becoming "mega cities." This will affect redistribution as well as the entity to which local government transfers will flow. Any recommendations for reform, therefore, need to be carefully considered in light of these changes. The whole issue of phasing in reforms to adapt to changes affects both the
design of a system of transfers and implementation issues, which I deal with in Chapters 6 and 7.

The White Paper on Local Government is a key policy document in the transition process and provides the basis for most of the current policy reform. The first issue to consider with regard to the White Paper is the type of municipality. As noted earlier, the interim system comprises a two-tier system in rural and some urban areas and a single-tier system in most urban areas. The White Paper calls this system into question. With regard to the two-tier system in urban areas, there is considerable variation in the size of the current areas of jurisdiction of both MCs and MLCs, as well as the number of MLCs within each metropolitan area. MLCs perform different functions in different metropolitan areas -- some of them have assumed a wider range of service delivery functions than others. In addition, the allowance in the LGTA for a local negotiation process to define the allocation of powers between MCs and MLCs has resulted in different allocations in each area. The current lack of clarity regarding the specific powers and duties of each tier in metropolitan areas has resulted in confusion and inefficiency, and in some cases has strained relations between the MC and MLCs. By the same token, in rural areas, there is variation in the size and capacities of the DCs and LCs in rural areas. The LGTA has not provided for clear powers for DCs -- these are determined instead by provincial proclamations that differ from province to province; thus DCs play different roles in different provinces. The single-tier system of LCs that prevails in most urban areas is also characterized by major variations in the size and capacities of municipalities. While municipalities in cities and larger towns face
problems of poverty and uneven development, most of them have relatively solid administrative and financial capacity. In contrast, many small-town municipalities do not have these capacities to adequately provide services and governance without external support. As a result, DCs provide this support to the smaller urban municipalities on an agency basis. (White Paper on Local Government, pp. 5 and 6).

In light of this discussion, it is clear that the current institutional structure of local government needs to be reconsidered. Should the two-tier system be allowed to continue to exist? Is there a need for so many small municipalities that exist in name only or can these be rationalized into larger municipalities? Or would it be better to still have so many municipalities that fulfill an important political role (in terms of democracy and participation) but have a different division of powers and responsibilities from the point of view of fiscal and administrative capacity? All these issues must be considered in the design of an appropriate decentralized local government system in South Africa.

The amalgamation of the former WLAs with former Indian and/or colored areas and/or former BLAs further complicates the issue. The aim was to have a “one city, one tax base” system so that the injustices inherited from the apartheid system in terms of the delivery of services could be redressed. However, the fiscal situation that the amalgamated municipalities have inherited is unstable. They are faced with huge backlogs in infrastructure and housing in some areas and with ensuring proper maintenance of existing levels of infrastructure. At the same time, the tax bases of municipal areas have not increased in the same proportion as the geographical areas increased in size. This is mainly due to the fact that households in the former black areas
did not have private property rights, so that there was no property market; consequently, there was no basis for determining a rate for property tax. (Thornhill, 1997). Given that it will be almost impossible to redraw municipal boundaries without serious political repercussions, any recommendations with regard to institutional and fiscal reform must take into account the above-mentioned problem.

The whole issue of intra-regional redistribution is also very complex in South Africa. Both MCs and DCs are responsible for redistribution within their areas of jurisdiction. This primarily occurs through the allocation of RSC levies that are collected by MCs and DCs. Powerful special interest groups often compromise the mechanisms for intra-regional redistribution. From a fiscal point of view, the RSC levies themselves have problems. However, they account for a substantial portion of MC and DC own-source revenue and it would be politically very difficult to terminate them. I discuss this issue in greater detail in Chapter 4.

2.5 REFORMING THE STRUCTURE OF LOCAL GOVERNMENT

As is evident from the earlier discussion, the current structure of local government needs to be re-examined. The Constitution empowers all municipalities with certain basic functions. We have seen that the types of municipalities that exist have different administrative and fiscal capacities to perform the basic functions assigned to them. The basic issue that needs to be analyzed as South Africa continues to implement its Constitutionally mandated decentralization is: What is the appropriate system that will make sense from a fiscal and administrative point of view, while at the same time
considering important political imperatives of democracy and representation? In this regard, I analyze the existing two-tier system in urban and rural areas, and the single-tier system in urban areas. (See Table 2.1 for a summary).

2.5.1 Analysis of the Existing Two-tier System

The two-tier system of local government exists in both rural and urban areas but each of them has its own particular issues. In rural areas, the representative and rural councils that exist either do not have any service-delivery functions, legislative power, and administrative support or, if they do, they have no fiscal capacity and an inadequate tax base. The DCs perform most of the functions assigned to their rural or representative LCs that are not done by other agencies, such as the water boards, ESKOM, and development service boards (in the case of KwaZulu Natal). Thus, from a fiscal and administrative point of view, it would make sense for the DCs to continue to serve the rural LCs within their jurisdiction in the short to medium term (with continuing financial support from the national government) until the latter build enough capacity to begin performing some of the functions assigned to them. Rural LCs have elected Councilors, who are accountable to their electorate. Each DC, in turn, has representatives from every rural LC on its Executive Committee. Thus, even though they may not presently perform any service-delivery functions, their existence facilitates democracy and representation.

In the longer term, I suggest that the rural LCs be combined with each other into larger structures that are administratively and financially viable. The long-term goal is for them to operate as autonomous municipalities. This will be facilitated if their tax base is
## TABLE 2.1

REFORMING THE STRUCTURE OF LOCAL GOVERNMENT

<table>
<thead>
<tr>
<th>Local Government Structure</th>
<th>Political Viability for Representativeness and Democracy</th>
<th>Fiscal and Administrative Viability for Service Delivery and Revenue Generation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>EXISTING</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Two-tier Rural</td>
<td>Local Council</td>
<td>District Council</td>
</tr>
<tr>
<td></td>
<td>District Council</td>
<td>District Council</td>
</tr>
<tr>
<td>Two-tier Urban</td>
<td>Metropolitan Local Council</td>
<td>Metropolitan Local Council</td>
</tr>
<tr>
<td></td>
<td>Metropolitan Council</td>
<td>Metropolitan Council</td>
</tr>
<tr>
<td>Single-tier Urban</td>
<td>Local Council</td>
<td>Local Council</td>
</tr>
<tr>
<td><strong>PROPOSED</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Two-tier Rural</td>
<td>Local Council</td>
<td>Amalgamation of Local Councils into larger autonomous entities</td>
</tr>
<tr>
<td></td>
<td>District Council</td>
<td>District Council</td>
</tr>
<tr>
<td>Two-tier Urban</td>
<td>Metropolitan Local Council</td>
<td>Metropolitan Local Council</td>
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<td></td>
<td>Metropolitan Council</td>
<td>Metropolitan Council</td>
</tr>
<tr>
<td>Single-tier Urban</td>
<td>Local Council</td>
<td>Amalgamation of Local Councils into larger autonomous entities or</td>
</tr>
<tr>
<td></td>
<td></td>
<td>with fiscally and administrative capable Local Council</td>
</tr>
</tbody>
</table>

Source: The author
widened through the introduction of appropriate taxes such as a property or land tax. Their administrative capacity could be enhanced by harnessing the human and financial resources of agencies, such as the development services boards in KwaZulu Natal.

In urban areas, MCs, and their corresponding MLCs in the six metropolitan areas, are all modeled differently. Some have a “strong metro” form of government, while others have a “weak metro” system. The strong versus the weak model refers to the extent of powers and functions that the MC takes up in relation to the MLCs. The exclusive powers and functions of each tier as well as the shared functions between them are not defined clearly (the Western Cape has made some progress in this regard). There is also no clear framework to regulate the fiscal relationships between the two tiers of metropolitan local government. As a result, there is always a struggle between the MC and its MLCs in terms of the allocation of resources and provision of services.

As mentioned earlier, the White Paper on Local Government suggests a mega-city concept as one possible option for metropolitan areas. The main advantages of this concept in metropolitan areas are that economies of scale can be reaped in the provision of certain services, such as water and electricity, and that the administration may become more efficient, with fewer staff responsible for the whole metropolitan area. However, with regard to economies of scale, these are currently already being achieved, because the MCs and DCs are responsible for the bulk provision of these services. In some instances, they perform this function themselves, and in others, this function is performed on their behalf by water boards and other agencies. The dangers with having a mega-city are (1) that accountability may be undermined because the electorate is further away; and (2) the
intrajurisdictional redistributive role of the secondary tier of local government may also be undermined because the mega-city may focus its financial resources on the city at the expense of the fringe areas.²

Given these dangers and given that most of the MLCs currently have sufficient fiscal and administrative capacity to perform the basic functions assigned to them by the Constitution, I would recommend that the status quo be maintained in metropolitan areas. The major advantage of the South African two-tier metropolitan system is that it is the optimal system for redistribution at the local level. Despite conventional public-finance wisdom about redistribution being ideally a national government function, the particularities of the South African system necessitate some amount of redistribution at the local level. The apartheid system has created massive inequalities within jurisdictions, and the fiscal arrangements at the local government level could be effectively used to allow for some redistribution to take place at the secondary-tier level. MCs and DCs could use some of the RSC levy income received by them to subsidize the costs of infrastructure in areas with a weaker tax base. They could also use the grants (for both operating and capital expenditures) from national government to ensure an equitable provision of services across their jurisdictions. Thus, it would be wise to retain the two-tier metropolitan system with some modifications. MCs should still retain their fiscal powers with regard to collection of levy income, and their functions with regard to the bulk provision of basic services. MLCs should retain their fiscal powers, with regard

² Durban is a case in point where the administrations of the metro, the North Central, and South Central councils are run by the same team; consequently, the focus is on the development of the city at the expense of the other local council areas.
to the collection of property rates and user charges, and their functions, with regard to
the provision of services internally. There needs to be a clear division of both functions
as well as fiscal powers between the two tiers. Currently, this is not the same in all
metropolitan areas — it depends on consensual agreement between the two tiers in the
different areas. I suggest that this be retained because the capacities of the MCs and
MLCs differ in the different metropolitan areas — in this regard, local autonomy can also
be enhanced.

2.5.2 Analysis of the Existing Single-tier System in Urban Areas

With regard to single-tier urban local government, some of the existing stand-
alone urban municipalities are large enough to be financially viable. Others are far too
small and perform very few of the functions traditionally assigned to municipalities,
relying on larger entities to provide these services on an agency basis. I would use the
same argument that I advocated for the rural municipalities — allow the latter to exist for
reasons of democracy and representation but to have fiscal and administrative
responsibility for them at a different level. Some of the smaller municipalities should be
combined with the larger municipalities, or with each other, so that they can have a wide
tax base and be able to perform the basic functions effectively and efficiently themselves.
In the former case, the municipalities will have sufficient capacity, but in the latter case,
there will have to be strong capacity-building programs targeted at these amalgamated
municipalities. I discuss this in Chapter 7.
2.6 SUMMARY

The South African Constitution entrusts municipalities with certain service responsibilities (the most important of which are the provision of basic services) and fiscal powers (mainly the imposition of property rates, user charges, and RSC levies). At the same time, however, the various municipalities have different fiscal and administrative capacities. Given this reality, I recommend the restructuring of local government so that it works from a fiscal and administrative viewpoint, while simultaneously fulfilling democracy and representation objectives.

With regard to the two-tier system of local government in metropolitan areas, the main question is whether or not to have a mega-city. Due to the fact that a mega-city would undermine accountability to the electorate and the intrajurisdictional redistributive role of the MCs, the status quo should be maintained. The primary issue with regard to both the two-tier system and single-tier system of local government is the presence of small municipalities that do not have the administrative support, fiscal capacity, or an adequate tax base to perform Constitutionally mandated service delivery functions. Their existence facilitates democracy and representation but, on their own, they are administratively and fiscally unviable. Thus, in the short term, they should be served by the DC in whose jurisdiction they fall, and, in the longer term, they should be combined with each other into larger structures that have fiscal and administrative responsibility for them. In order for them to function as autonomous entities, they will need to have strong capacity-building programs targeted at them.
These recommendations have important implications for both the expenditure and revenue functions of local government. Combining the smaller municipalities into larger fiscally and administratively viable entities would move them in the direction of both performing their service-delivery functions and having a wider tax base to finance these functions. I turn next to a discussion of expenditures and revenues in Chapters 3 and 4, respectively.
CHAPTER 3

THE ROLE OF LOCAL GOVERNMENT IN THE PROVISION OF BASIC SERVICES IN SOUTH AFRICA

3.1 INTRODUCTION

In this chapter, I examine the role of local government in the provision of basic services to which citizens are entitled, with a particular focus on fiscal implications. The basic question I answer is: What are the capital and operating costs to municipalities for providing at least the basic level of services? This, then, relates to Chapters 4, 5, and 6 in terms of what local government can raise by itself to finance these services and what is needed from other sources, including intergovernmental transfers from other spheres of government, borrowing, and private-sector equity in infrastructure.

The five key issues in local government involvement in the provision of basic services are: (1) the legal role of local government in providing these services; (2) the role of national government in defining and enforcing minimum standards for these services; (3) the cost requirements for the provision of these services; (4) the financial capabilities of municipalities for providing these services (discussed in Chapter 4, which looks at local revenues); and (5) capacity-building to enable efficient provision of these services (discussed in Chapter 7, which deals with reform issues). I use the Combined Services Model (see Appendix 4 for description), developed by the Palmer Development Group for the Development Bank of Southern Africa (DBSA), to estimate the capital and operating costs (defined in Section 3.4) of providing different levels of service.
3.2 LEGAL ROLE OF LOCAL GOVERNMENT IN PROVISION OF BASIC SERVICES

As mentioned in Chapter 2, Section 156 of the Constitution lists the powers and functions of municipalities, the most important of which are the provision of water, sanitation (including solid waste removal), roads, stormwater drainage, and electricity. In 1996/97, municipalities budgeted for a total expenditure (operating and capital combined) of more than R48 billion. This represents about 7.5% of South Africa’s gross domestic product, and it is equivalent to 21% of the country’s total public sector budget.

Metropolitan councils (primary and secondary tier combined) budgeted for 53% of the total expenditure (R25.3 billion), other urban municipalities for 40% (R19 billion), and district councils for 8% (R3.8 billion). The data are available only for metropolitan and other urban councils and for district councils, but not for rural local councils. About 60% of South Africa’s population lived in areas covered by the data.

An in-depth analysis of 1996/97 budget data provides an overview of municipal expenditures and revenues. The major operating expenditure line item in metropolitan areas was salaries -- accounting for 25% of total operating expenditure -- followed by trading services\(^3\) -- 22% (Figure 3.1). These accounted for 30% and 29%, respectively, of total operating expenditure in other urban areas (Figure 3.2). District councils’ budgets are not broken down into operating and capital. Local authority functions were the main expenditure item (45%), followed by regional functions (34%) and administration (11%).

How do these fit in with the allocation of expenditure functions proposed by the

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\(^3\) Electricity, water, sanitation, and refuse removal -- which are generally called utilities -- are referred to as trading services in South Africa.
FIGURE 3.1
OPERATING EXPENDITURE IN METROPOLITAN MUNICIPALITIES
1996/97

Source: Based on 1996-97 budget data provided by the Department of Finance.
FIGURE 3.2
OPERATING EXPENDITURE IN URBAN MUNICIPALITIES
1996/97

Source: Based on 1996-97 budget data provided by the Department of Finance.
normative model of fiscal federalism? In Chapter 1, we saw that the fiscal federalism model advocates decentralizing to the lowest geographic level possible in order to internalize benefits and costs of service provision, except when there are economies of scale, economies of scope, or interjurisdictional externalities. Using such a framework, Shah (1994b) argues that the services that should generally be provided at a local level include (but are not limited to) water supply, sanitation, electricity, local roads, fire protection, police protection, street maintenance, refuse collection and disposal, local transit, and traffic management. (See Appendix 3 for a comprehensive list).

The allocation of expenditure functions mandated by the South African Constitution thus indicates that South Africa basically follows fiscal-federalism principles for assigning expenditure responsibility to local government. What remains to be seen is whether or not municipalities are able to finance the costs of service provision and have the capacity to provide these services. I elaborate on these issues in Chapters 4 and 7.

The Bill of Rights, contained in Chapter 2 of the Constitution of the Republic of South Africa, lists 27 rights to which citizens are “entitled.” These include the right to equality, to human dignity, to life, to a healthy environment, to housing, to health, food, water, and social security, and so on. Section 152 of the Constitution lists the provision of services to communities and promotion of a safe and healthy environment as two of the objectives of local government. The rights that relate to the provision of “basic” services by municipalities are the following:
Environment: Everyone has the right to an environment that is not harmful to their health or well-being; (Section 24)

Health care, food, water, and social security: Everyone has the right to have access to health care services, and sufficient food, water, and social security. (Section 27)

What are the implications of these rights for the provision of basic services? First, I define the concept of basic services in the South African context. The general definition is those services that are the simplest or lowest in level needed for survival. I focus on basic services because of the Constitutional requirement for local government to receive "... an equitable share of revenue raised nationally to enable it to provide basic services ..." (Section 227 (1) (a)). In the South African context, relating this to the Bill of Rights and to the RDP, relevant White Papers and other government policy documents (such as the MIIF), basic services are those services that ensure the minimum standards of health and well-being of all citizens. With particular regard to local government functions, the municipal services that generally are (or should be) considered basic are water, sanitation (including solid waste), roads, stormwater drainage, and electricity.

I relate each of these services to the issue of the environmental right of every person, viz., the right to an environment that is not harmful to their health or well being, to illustrate my point.

1) Water, Sanitation, and Solid Waste: Inadequate access to water and sanitation results in increased risk of disease, of which diarrhea is the most prevalent worldwide both in terms of morbidity and mortality (Sanders and Groenewald, 1996, pp. 1-2). Waste accumulating on a plot or within a neighborhood generates odors and serves as
a breeding ground for rodents and flies. It may also block stormwater drainage channels and pollute local sources of water (MIIF1995, p. 16)

2) **Roads:** In the case of roads, the association with particular disease categories is more tenuous, and their health implications are consequently difficult to disaggregate. Nevertheless, Sanders and Groenewald (1996, p. 10) argue that road dust contributes to particulate pollution, which is linked to respiratory diseases; unpaved and unlit roads contribute to unsafe, insecure travel; pedestrian deaths are higher in areas with poor transport infrastructure, substandard roads, and poor safety enforcement.

3) **Stormwater Drainage:** Many disease vectors thrive in areas where there is poor drainage (Sanders and Groenewald, 1996, p. 6). Improper drainage can also lead to flooding and erosion (Himlin, p. 1).

4) **Electricity:** Lack of access or incomplete conversion to electricity results in the use of “dirty” fuels, such as coal, wood, and paraffin for heating and cooking, and the use of candles for lighting. These result in high indoor air pollution that has been shown to affect respiratory health negatively. In addition, the close proximity of the stove or fire to the ground when using these fuels is associated with a high rate of burns and scalds. Paraffin spills and the uses of candles for lighting are important causes of catastrophic house-fires in informal settlements, with high-burn fatalities (Sanders and Groenewald, 1996, pp.6-7).
3.3 THE ROLE OF NATIONAL GOVERNMENT IN DEFINING AND ENFORCING STANDARDS FOR SERVICE PROVISION

If one accepts the definition of basic services stated in the previous section, the next question is: What is adequate or proper? This relates to the issue of appropriate standards for service provision. In order for a municipality to provide adequate or proper service, there needs to be a set of norms or standards in place for that service. The Green Paper on Transforming Public Service Delivery (1996) sets the stage for the development of service standards as one of the key principles of public service delivery. “Users and consumers of public services should be told what level and quality of service they will receive (from public funds) so that they are aware of what to expect.”(p. 4) From the end of 1997 onwards, national departments and provincial administrations will be required to publish standards for the level and quality of services they provide. The Green Paper also says that these standards must be relevant and meaningful to the individual user and must be precise and measurable, so that users can judge for themselves whether or not they are receiving what was promised (p. 5).

The above discussion raises the issue of “levels” of service, which relates to the way the service is experienced by the user: the more convenient to the user, the higher the level of service (Office of the President, 1997, p. 5). Thus, water provided in-house entails a higher level of service than by means of a yard tap while that from a communal standpipe entails a lower level of service.

What, then, constitutes a “basic level of service”? It is a level that meets the minimum standards for provision of a service. There is a question of whether or not standards should be uniform across rural and urban areas. Let us consider the case of
water supply. The standard set for basic water supply in the Water and Sanitation White Paper (in line with the short-term aim of the RDP) is 25 liters of potable water of acceptable quality per person per day within 200 meters of his/her dwelling. This standard can obviously be applied universally to both rural and urban areas because it is a goal for all citizens. What comes into question is the appropriate level of service -- ranging from unreticulated source (well, borehole, spring, or river) to house connections. There is generally a direct correlation between the level of service and the cost, both in terms of initial capital and operation and maintenance. Thus, although the standard set for water supply is the same for both rural and urban areas, the basic level of service may differ, i.e., basic for rural areas may be communal standpipes, while basic for urban areas may be yard tanks. Or, in the case of solid waste, refuse removal from the site may be considered basic in urban areas, whereas on-site disposal may be appropriate in the case of farms or in less densely settled areas.

The next question that comes to mind is who should set standards for services -- the national or subnational government? Howse (1996) provides the following rationales for having national standards (as opposed to standards set at subnational levels): (1) the race to the bottom; (2) portability and mobility; (3) equity; and (4) accountability.

(1) **Race to the bottom**: If there is no national floor below which the level of service provided by subnational government cannot fall, there is the inherent danger that provinces or municipalities will compete with each other to lower levels of service. This may encourage migration to jurisdictions where service provision is of a higher level and the jurisdiction may be forced to abandon its higher standards.
(2) **Portability and mobility**: A national standard would ensure a minimum level of service beyond which local jurisdictions can provide more if they wish, possibly stimulating some mobility (and improving efficiency because people's preferences are being better catered to) in a Tiebout world.

(3) **Equity**: The disbursement of funds from national government to subnational governments is done partly on the basis of fiscal equalization (bringing the fiscal capacity of jurisdictions with a weak tax base up to a national norm or average). However, fiscal equalization is a necessary, but not sufficient, condition for assuring that services are actually delivered or are of reasonable quality throughout the country; equalization of tax revenue does not prevent jurisdictions from delivering highly variable levels of service. A national standard in conjunction with a fiscal equalization grant would, thus, ensure that a minimum acceptable level of service would be provided in every jurisdiction.

(4) **Accountability**: National standards can be used as a means by which national government can make national spending on subnational programs accountable in terms of the actual results achieved. For example, if the national government provides a conditional grant to a local government for building capital infrastructure for the provision of water, it can monitor the results in terms of a nationally set standard for water provision to which each citizen is entitled.

In accordance with the RDP, White and Green Papers, MIIF, and other government policy documents, the following can be considered guidelines for national standards for the provision of basic services in South Africa:
**Water Supply:** In the short term, 25 liters of potable water per person per day within 200 meters of his/her dwelling, the quality of water being in accordance with currently accepted minimum standards with respect to health-related chemical and microbial contaminants. In the medium term, an on-site supply of 50 - 60 liters per person per day of clean water, with water supply to nearly 100% of rural households.

**Sanitation:** "Adequate" sanitation is defined as the provision and ongoing operation/maintenance of a method of disposing of human excreta, waste water, and household refuse, which is acceptable and affordable to the users (National Sanitation Policy, 1996, p. 3). In the medium term, improved on-site sanitation and an appropriate household refuse collection system, provided to at least 75% of all rural households.

**Roads:** In urban areas, a road network that improves mobility and accessibility, especially for disadvantaged communities (A Framework for Urban Development, 19??). In rural areas, access to roads of an adequate standard for buses and minibus taxis to operate at reasonable levels of service in terms of reliability, safety, comfort, and cost (White Paper on Rural Development, 1996).

**Electricity:** The guideline set for electricity by the RDP is an accelerated and sustainable electrification program to increase access to about 72% of all households (compared to 36% in 1990) by the year 2000, using both grid and non-grid power sources (p. 23).

A typology with regard to levels of service provision is provided in Table 3.1. In Table 3.2, I then translate this typology, in conjunction with national standards, and modified to take into account externalities involved in the provision of infrastructure services, into a classification of levels of service. For some services (such as water,
### TABLE 3.1: TYPOLOGY OF SERVICE LEVELS

<table>
<thead>
<tr>
<th>Sector</th>
<th>Service type</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Water Supply</strong></td>
<td>Unreticulated source: well, borehole, spring or river</td>
</tr>
<tr>
<td></td>
<td>Communal standpipe, 200 m walking distance</td>
</tr>
<tr>
<td></td>
<td>Yard tank</td>
</tr>
<tr>
<td></td>
<td>Yard tap</td>
</tr>
<tr>
<td></td>
<td>House connection</td>
</tr>
<tr>
<td><strong>Sewerage</strong></td>
<td>Unimproved pit, bucket or nothing</td>
</tr>
<tr>
<td></td>
<td>Ventilated Improved Pit (VIP) latrine</td>
</tr>
<tr>
<td></td>
<td>Low Flow On Site (LOFLOS) system</td>
</tr>
<tr>
<td></td>
<td>Septic tank</td>
</tr>
<tr>
<td></td>
<td>Full waterborne</td>
</tr>
<tr>
<td><strong>Solid Waste</strong></td>
<td>No service or intermittent collection</td>
</tr>
<tr>
<td></td>
<td>Central landfill point where burial on site is not possible</td>
</tr>
<tr>
<td></td>
<td>Communal collection point, regular collection</td>
</tr>
<tr>
<td></td>
<td>Curbside collection, at least once weekly</td>
</tr>
<tr>
<td></td>
<td>Curbside collection; at least once weekly, with compactor</td>
</tr>
<tr>
<td><strong>Roads</strong></td>
<td>Rough road or track</td>
</tr>
<tr>
<td></td>
<td>All weather access to within 500 meters of dwelling</td>
</tr>
<tr>
<td></td>
<td>Access to each site with graded or gravel road</td>
</tr>
<tr>
<td></td>
<td>Good gravel road</td>
</tr>
<tr>
<td></td>
<td>Narrow paved road</td>
</tr>
<tr>
<td><strong>Stormwater Drainage</strong></td>
<td>No drainage</td>
</tr>
<tr>
<td></td>
<td>Drainage along distributor roads</td>
</tr>
<tr>
<td></td>
<td>Unlined or partially-lined drainage channels along access roads</td>
</tr>
<tr>
<td></td>
<td>Partially-lined, open-channel drainage</td>
</tr>
<tr>
<td></td>
<td>Piped, underground drainage</td>
</tr>
<tr>
<td><strong>Electricity</strong></td>
<td>No managed energy source</td>
</tr>
<tr>
<td></td>
<td>Access to biomass source at least, or 5-8 Amp</td>
</tr>
<tr>
<td></td>
<td>Access to electricity, either 5-8 Amp or non-grid source; street lighting</td>
</tr>
<tr>
<td></td>
<td>20 Amp grid electricity supply; probably pre-paid meter</td>
</tr>
<tr>
<td></td>
<td>60 Amp electricity supply</td>
</tr>
</tbody>
</table>

*Source:* Office of the President, 1997, p. 6
### TABLE 3.2: SERVICE-LEVEL CLASSIFICATIONS

#### URBAN:

<table>
<thead>
<tr>
<th></th>
<th>Basic</th>
<th>Intermediate</th>
<th>Full</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Water</strong></td>
<td>Communal standpipe</td>
<td>Yard tap linked to wet core</td>
<td>House connection</td>
</tr>
<tr>
<td><strong>Sewerage</strong></td>
<td>VIP latrines</td>
<td>Low-flush, full waterborne</td>
<td>Full waterborne</td>
</tr>
<tr>
<td><strong>Solid Waste</strong></td>
<td>Communal</td>
<td>Curbside collection</td>
<td>Curbside collection</td>
</tr>
<tr>
<td><strong>Roads</strong></td>
<td>Graded/gravel</td>
<td>Surfaced (bus/taxi and access)</td>
<td>Normal paved</td>
</tr>
<tr>
<td><strong>Stormwater Drainage</strong></td>
<td>Earth-lined open channel</td>
<td>Open channel, partially lined</td>
<td>Piped systems</td>
</tr>
<tr>
<td><strong>Electricity</strong></td>
<td>5 Amp supply</td>
<td>20 Amp supply</td>
<td>60 Amp supply</td>
</tr>
</tbody>
</table>

#### RURAL:

<table>
<thead>
<tr>
<th></th>
<th>Basic</th>
<th>Intermediate</th>
<th>Full</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Water</strong></td>
<td>Communal standpipe</td>
<td>Yard tap</td>
<td>House connection</td>
</tr>
<tr>
<td><strong>Sewerage</strong></td>
<td>VIP latrines</td>
<td>50-50 septic tank/low-flush waterborne sanitation</td>
<td>Full waterborne</td>
</tr>
<tr>
<td><strong>Solid Waste</strong></td>
<td>On site</td>
<td>Communal</td>
<td>Curbside</td>
</tr>
<tr>
<td><strong>Roads</strong></td>
<td>Graded/gravel</td>
<td>All-weather access roads within 500 meters of site</td>
<td>Normal paved</td>
</tr>
<tr>
<td><strong>Stormwater Drainage</strong></td>
<td>Earth-lined, open channel</td>
<td>Open channel, partially lined</td>
<td>Piped systems</td>
</tr>
<tr>
<td><strong>Electricity</strong></td>
<td>5 Amp supply</td>
<td>85-15% 20 Amp supply/non-grid</td>
<td>60 Amp supply</td>
</tr>
</tbody>
</table>

**Source:** The author
stormwater drainage, and electricity), the classifications are the same in both rural and urban areas, while they differ for others (sewerage, solid waste, and roads). With sewerage, for example, while the definition of a basic and full level of service is identical in rural and urban areas, an intermediate level of service is defined differently. This is because the topography in some rural areas makes low-flush waterborne sanitation an unviable option. This difference in the definition is reflected in the capital-cost estimates for providing this level of service (which I discuss in the next section).

In Table 3.3, I present service levels for the country to illustrate the backlogs in the provision of basic services and the difference in need between urban and rural areas. It is clear that rural areas face much greater backlogs in service provision. The figures are aggregates and hide disparities in service provision across the nine provinces. For example, inadequate water provision ranges between 1% and 11% in urban areas, and between 3% and 48% in rural areas. The corresponding range for sewerage is 2% to 14% in urban, and 37% to 86% in rural areas; and for electricity, 9% to 62% in urban, and 26% to 91% in rural areas. The data do not provide figures for solid waste, roads, and stormwater drainage.

The discussion in this section highlights the importance of national standards for the provision of basic services in South Africa. At the same time, however, it must be remembered that local preferences play an important role in making local decisions -- a basic tenet of the fiscal federalism model for decentralization of expenditure functions in terms of allocative efficiency. The national government provides conditional non-matching block grants to local government for infrastructure provision to meet minimum
<table>
<thead>
<tr>
<th>Service</th>
<th>Inadequate</th>
<th>Basic or Better</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Water:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rural</td>
<td>35%</td>
<td>65%</td>
</tr>
<tr>
<td>Urban</td>
<td>2%</td>
<td>98%</td>
</tr>
<tr>
<td><strong>Sewerage:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rural</td>
<td>74%</td>
<td>26%</td>
</tr>
<tr>
<td>Urban</td>
<td>7%</td>
<td>93%</td>
</tr>
<tr>
<td><strong>Electricity:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rural</td>
<td>79%</td>
<td>21%</td>
</tr>
<tr>
<td>Urban</td>
<td>18%</td>
<td>82%</td>
</tr>
</tbody>
</table>

*Source:* Adapted from 1994 October Household Survey Data.
standards for basic services through the Consolidated Municipal Infrastructure Programme (CMIP). Shah (1994b) points out that such grants can ensure that the funds are spent on the national government's priorities without distorting local priorities among alternative activities or inducing inefficient allocations in that expenditure area. This is because no conditions are set on how the money is to be spent; rather, the agreement is on meeting the national objective of minimum standards of service and access to basic services. Local autonomy is, thus, not compromised. I elaborate on this issue in Chapter 4 when I consider the implications of the costs of providing basic services for municipalities in terms of the choice of service level as well as the financing mechanisms.

3.4 COST REQUIREMENTS FOR PROVISION OF BASIC SERVICES

As mentioned earlier, the relevant basic services are water, sanitation (including solid waste), roads, stormwater drainage, and electricity. The issue that arises here is the bifurcation between the service component, governed by economic criteria, and the political component, concerned with equity, of the provision of municipal services (Pammer, 1992). This bifurcation is caused by the conflict between democratic principles (embodied equality and freedom) implicit in entitlement of services and bureaucratic norms (upholding principles of efficiency, hierarchy and rules) for these services. In essence, a balance has to be struck between what levels of service should be provided and the costs associated with their provision. The financing of service
provision, both in terms of capital and operating costs, is thus a crucial issue for municipalities in both the policy-making and implementation arenas.

In the analysis that follows, I use the DBSA Combined Services Model (CSM) (Appendix 4) to estimate the capital and operating costs of providing different levels of service. I then consider the implications of these costs for municipalities in terms of the choice of service level as well as the financing mechanisms.

Table 3.4 shows the capital costs of providing the different levels of service in urban and rural areas. These are divided into (1) costs for internal service infrastructure (on-site infrastructure such as piping and taps from the edge of the site to the house); and (2) costs for internal bulk (e.g., local water reservoirs) and connector (e.g., water pipes linked to reservoirs) infrastructure. It must be remembered that these costs are based on national averages and that a variety of local conditions will affect these estimates.

Although the definition of a basic level of service is the same in urban and rural areas, capital-cost estimates for internal bulk and connector infrastructure are higher in rural areas for even a basic level of service because factors, such as distance from the source of supply, density of the settlement, and economies of scale, affect the costs. In addition, the difference in the definition of an intermediate level of service in urban and rural areas are reflected in the differences in the capital cost estimates for both internal services as well as bulk and connector services.
## Table 3.4

### Capital Costs of Service "Packages" (per household)

#### Internal Services

<table>
<thead>
<tr>
<th>Service</th>
<th>Basic</th>
<th>Intermediate</th>
<th>Full</th>
<th>Rural Basic</th>
<th>Intermediate</th>
<th>Full</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Water</strong></td>
<td>R 900</td>
<td>R 1,400</td>
<td>R 1,900</td>
<td>R 600</td>
<td>R 1,400</td>
<td>R 3,100</td>
</tr>
<tr>
<td><strong>Sewerage</strong></td>
<td>R 1,900</td>
<td>R 3,727</td>
<td>R 4,200</td>
<td>R 1,900</td>
<td>R 3,364</td>
<td>R 3,727</td>
</tr>
<tr>
<td><strong>Electricity</strong></td>
<td>R 1,500</td>
<td>R 2,600</td>
<td>R 2,600</td>
<td>R 1,500</td>
<td>R 3,330</td>
<td>R 3,500</td>
</tr>
<tr>
<td>Roads &amp; Stormwater</td>
<td>R 2,013</td>
<td>R 4,238</td>
<td>R 7,970</td>
<td>R 1,380</td>
<td>R 2,700</td>
<td>R 7,500</td>
</tr>
<tr>
<td>Solid Waste</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
<td>N/A.</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>R 6,313</td>
<td>R 11,965</td>
<td>R 16,670</td>
<td>R 5,380</td>
<td>R 10,794</td>
<td>R 17,827</td>
</tr>
</tbody>
</table>

#### Internal Bulk and Connector

<table>
<thead>
<tr>
<th>Service</th>
<th>Basic</th>
<th>Intermediate</th>
<th>Full</th>
<th>Rural Basic</th>
<th>Intermediate</th>
<th>Full</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Water</strong></td>
<td>R 297</td>
<td>R 392</td>
<td>R 1,471</td>
<td>R 748</td>
<td>R 1,048</td>
<td>R 3,592</td>
</tr>
<tr>
<td><strong>Sewerage</strong></td>
<td>R 100</td>
<td>R 527</td>
<td>R 1,296</td>
<td>R 100</td>
<td>R 1,103</td>
<td>R 2,006</td>
</tr>
<tr>
<td><strong>Electricity</strong></td>
<td>R 0</td>
<td>R 0</td>
<td>R 0</td>
<td>R 0</td>
<td>R 0</td>
<td>R 0</td>
</tr>
<tr>
<td>Roads &amp; Stormwater</td>
<td>R 1,383</td>
<td>R 1,383</td>
<td>R 1,383</td>
<td>R 2,450</td>
<td>R 2,450</td>
<td>R 2,450</td>
</tr>
<tr>
<td>Solid Waste</td>
<td>R 20</td>
<td>R 20</td>
<td>R 20</td>
<td>R 0</td>
<td>R 20</td>
<td>R 20</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>R 1,799</td>
<td>R 2,322</td>
<td>R 4,170</td>
<td>R 3,298</td>
<td>R 4,621</td>
<td>R 8,068</td>
</tr>
</tbody>
</table>

### Total

<table>
<thead>
<tr>
<th>Source</th>
<th>Basic</th>
<th>Intermediate</th>
<th>Full</th>
<th>Rural Basic</th>
<th>Intermediate</th>
<th>Full</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Internal</strong></td>
<td>R 6,313</td>
<td>R 11,965</td>
<td>R 16,670</td>
<td>R 5,380</td>
<td>R 10,794</td>
<td>R 17,827</td>
</tr>
<tr>
<td><strong>B&amp;C</strong></td>
<td>R 1,799</td>
<td>R 2,322</td>
<td>R 4,170</td>
<td>R 3,298</td>
<td>R 4,621</td>
<td>R 8,068</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>R 8,112</td>
<td>R 14,287</td>
<td>R 20,840</td>
<td>R 8,678</td>
<td>R 15,415</td>
<td>R 25,895</td>
</tr>
</tbody>
</table>

**Source:** The author

**Notes:** N/A.: not applicable

- a: The connector costs for electricity are R0 because the model calculates them in the costs for internal services.
TABLE 3.5

OPERATING COSTS (Rands/household/month)

<table>
<thead>
<tr>
<th></th>
<th>URBAN</th>
<th>RURAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Basic</td>
<td>Intermediate</td>
</tr>
<tr>
<td>Water</td>
<td>16.00</td>
<td>14.60</td>
</tr>
<tr>
<td>Sewerage</td>
<td>4.00</td>
<td>14.16</td>
</tr>
<tr>
<td>Electricity</td>
<td>12.13</td>
<td>42.82</td>
</tr>
<tr>
<td>Roads &amp; Stormwater</td>
<td>12.72</td>
<td>14.02</td>
</tr>
<tr>
<td>Solid Waste</td>
<td>5.80</td>
<td>10.00</td>
</tr>
<tr>
<td>TOTAL</td>
<td>50.65</td>
<td>95.60</td>
</tr>
</tbody>
</table>

Source: The author

Table 3.5 shows the operating costs of different levels of service provision. These include operations and maintenance costs and, in the case of water and electricity, bulk purchase costs (purchase by the municipality of bulk water and electricity from external bodies). In general, for the same level of service, operating costs are higher in rural areas than in urban areas for two reasons: (1) consumers are more widely spread out in rural areas, which implies that the size of systems is larger, and travel and communications are more difficult; and (2) there is less capacity to manage infrastructure well in rural areas (MIIF, 1995). Again, because the definition of an intermediate and full level of service is different in urban and rural areas, the operating costs do not follow this general pattern. It must also be noted that the rural operating costs are very rough estimates.

3.5 FUTURE RESEARCH AND POLICY FORMULATION

Local government has a daunting task ahead of it in terms of the provision of basic services to ensure that it complies with the constitutional requirements set out in the
Bill of Rights. Each citizen is entitled to a healthy and safe environment that can be assured by municipalities through the provision of water, sanitation, electricity, roads, stormwater, and solid waste disposal of adequate standard. The costs associated with the provision of these services are the responsibility not only of the municipalities but also of the citizens. There has to be a recognition from the citizens that these services need to be paid for and appropriate tariff structures should be put in place by municipalities, based on each individual's ability to pay. The Water and Sanitation White Paper, the RDP, and the MIIF all talk about tariffs in a very broad sense. Further research needs to be done on the structuring of tariffs in each sector, and municipalities need to consider the issue of "lifeline" tariffs for basic services. I discuss this issue in Chapter 4.

The discussion in Section 3.3 has raised the issue of standards for services. At present, there are general guidelines for standards mentioned in different government policy documents but clear standards need to be established for each of the basic services provided by the three spheres of government. The Green Paper on Transforming Public Service Delivery (1996) reiterates the need for the development of these standards. At the same time, the national government must make provisions for ensuring funding of nationally set standards to avoid the problem of unfunded mandates. I discuss the different funding mechanisms in the next three chapters.
CHAPTER 4

SOURCES OF REVENUE FOR LOCAL GOVERNMENT IN SOUTH AFRICA

4.1 INTRODUCTION

Shah (1994b) points out that once an expenditure assignment has been agreed upon, a tax assignment and the design of intergovernmental transfers are crucial in matching expenditure needs to revenue means at the different governmental levels. To this end, in this chapter, I focus on the major sources of municipal revenue on both the operating and capital accounts. I analyze what local government actually collects from the different sources and discuss some of the issues involved with each source: the property tax, Regional Service Council (RSC) levies, user charges, loans, and transfers. I use the criteria of efficiency and equity to examine how the tax assignment in South Africa corresponds to what is suggested by the normative model of fiscal federalism.

I focus on five major issues: (1) the differential administrative capacity of municipalities to collect revenues, a common issue for all revenue sources; (2) equity considerations with regard to the introduction of a land tax in rural areas; (3) the question of uniformity of the property rating system so that the fiscal capacity of a municipality can be determined; (4) the appropriateness of the RSC levy as a local revenue source; and (5) the possibility of municipal borrowing as an additional revenue source. I relate these to the previous chapter in terms of the revenue potential of municipalities for meeting the expenditure requirements for the provision of basic services. This provides the basis for the next two chapters on intergovernmental transfers in terms of what is needed to bridge
the gap between expenditures and revenues. Finally, I consider recommendations for reform of each of the major revenue sources.

4.2 REVENUE SOURCES FOR LOCAL GOVERNMENT

There are two sources of operating revenue for local government: (1) “own revenue,” which includes taxes and user charges; and (2) transfers from the other spheres of government, which include both an “equitable share of revenue collected nationally” and grants. There are four sources of capital revenue: (1) “own revenue,” which includes both local taxes and the services and turnover levies collected at the secondary level; (2) grants from the other spheres of government; (3) borrowing; and (4) private-sector equity in infrastructure provided by municipalities. (Vaz, 1997)

Figures 4.1 to 4.4 show the major sources of urban and metropolitan revenue on the operating and capital accounts of South African municipalities. How do these revenue figures compare with revenues generated in other developing countries? Bahl and Linn (1992) estimated that between 60 and 90% of local expenditure in developing countries is financed from local sources, with a median share of 70%. On average, South African municipalities finance about 90% of their expenditure from own revenue (FFC, 1997). These are, however, aggregate figure and hide the disparities that exist between municipalities -- I discuss this further in Chapter 5. Bahl and Linn further indicated that, on average, property taxes dominate the revenue structure, accounting for 40% of total revenue, while user charges account for about 33%. South African municipalities raise between 17 and 22% of total revenue from the property tax and between 54% and 65% from user charges. Thus, South Africa municipalities fare much
better than the average city in developing countries in terms of cost recovery of service provision but worse in terms of the property tax. In Bahl and Linn’s study, loan financing on the capital account was the smallest revenue source -- less than 10% of total local financing. South African municipalities, on the other hand, rely heavily on loans for capital financing; the majority of these are subsidized loans from government institutions. I discuss this and its implications for infrastructure financing in greater detail in Section 4.3.4.

Figures 4.1 and 4.2 show that the major source of urban and metropolitan revenue on the operating account is own-source revenue from trading services -- 54% in metropolitan areas and 65% in other urban areas. Although user fees are a substantial source of revenue for urban municipalities, operating expenditure on trading services is far less (22% in metropolitan areas and 29% in other urban areas), implying that the bulk of revenue generated from trading services is being used to fund salaries and other operating expenditure items. I discuss this issue in greater detail in Section 4.4 in terms of its implications with regard to municipal financing of basic services.

Property rates are the major source of tax revenue in urban areas -- accounting for 22% and 17% of revenue in metropolitan and other urban areas, respectively. On the capital account in metropolitan areas, loans are the major source of finance (62%), followed by national and provincial grants and subsidies (17%), contributions from revenue and special funds (8%), grants from the regional councils (7%) and RDP funds (6%) (Figure 4.3). In urban areas, the corresponding figures are 37%, 16%, 8%, 11%,
FIGURE 4.1
SOURCES OF REVENUE FOR METROPOLITAN MUNICIPALITIES
(OPERATING ACCOUNT)
1996/97

Source: Based on 1996-97 budget data provided by the Department of Finance.
FIGURE 4.2
SOURCES OF REVENUE FOR URBAN MUNICIPALITIES
(OPERATING ACCOUNT)
1996/97

Source: Based on 1996-97 budget data provided by the Department of Finance.
**FIGURE 4.3**

**SOURCES OF REVENUE FOR METROPOLITAN MUNICIPALITIES**

(CAPITAL ACCOUNT)

1996/97

**Source:** Based on 1996-97 budget data provided by the Department of Finance.
and 28%, respectively (Figure 4.4). The major source of district council income was RSC levies, accounting for 39% of 1996/97 revenue.

Intergovernmental transfers (for operating expenditure) accounted for only a small share of the total operating budget -- 2.8% in metropolitan areas and 3.5% in other urban areas. However, these are aggregate figures and hide the variations among provinces. For example, intergovernmental transfers to the metropolitan areas in KwaZulu Natal represented 1.8% of the total operating budget compared with 6.6% in the Western Cape. The corresponding figures in other urban areas were 8.6% in KwaZulu Natal compared with 0.5% in the Western Cape.

Intergovernmental transfers (for capital expenditure) accounted for almost 30% of the total capital budget in metropolitan areas and almost 55% of the capital budget in other urban areas. Again, there are variations among the provinces -- they accounted for over 40% of the total metropolitan capital budget in KwaZulu Natal and the Western Cape but only 15% in Gauteng. The corresponding figures in other urban areas were over 70% in the Eastern Cape and the Free State, but less than 40% in the Northern Cape and Northwest.

### 4.3 MAJOR SOURCES OF REVENUE

How does the allocation of tax functions in South Africa correspond to the normative principles espoused in the fiscal federalism model? As mentioned in Chapter 1, Musgrave (1993) identifies two broad criteria for tax assignment: efficiency and equity. Using these criteria, Shah (1994b) concludes that pollution taxes, poll taxes, user
FIGURE 4.4
SOURCES OF REVENUE FOR URBAN MUNICIPALITIES
(CAPITAL ACCOUNT)
1996/97

Source: Based on 1996-97 budget data provided by the Department of Finance.
charges, or benefit taxes are suitable for imposition by all levels of government; income
taxes, profits, production and output taxes, value-added taxes, and customs duties should
be assigned to the national government; single-stage sales taxes, and certain “sin” taxes,
such as excises on alcohol and tobacco, should be assigned to the national or state
government; business taxes, motor vehicles taxes, and driving licenses should be
assigned to the state government; and property taxes and frontage charges should be
assigned to the local government. (See Appendix 5 for a comprehensive list of
assignment of tax functions)

The South African constitution basically follows fiscal-federalism principles in
assigning revenue responsibility to the three levels of government. The major departure
is with the Regional Service Council (RSC) levy which is assigned to local government
and which conventional public finance wisdom dictates should be the responsibility of
the national government. I discuss this and each of the other major sources of revenue
next in order to elaborate on the five main issues (listed in Section 4.1) involved with
each of them.

With regard to the common issue, administrative capacity, a United Kingdom
study on optimization of local government revenues (DCD, 1997) sets out evidence
related to income collection. It reports that there is an absence of reliable data regarding
collection. The fieldwork conducted by the investigating team suggests that around 81%
of accounts are in regular payment with average collection rates of 85%; but the range is
50% to 95%. Factors contributing to poor collection include inability to pay, the
“culture of non-payment”, and poor administrative capacity to render bills or enforce
payment. Potential solutions of the collection problem include strong enforcement powers, improved billing and collection systems, better customer care, and increased numbers of high-quality staff. I elaborate on these issues when I discuss capacity building in Chapter 7.

4.3.1 Revenue from Trading Services

Cost recovery is an important principle to ensure efficient and effective delivery of trading services. If municipalities are unable to recover at least the operating costs of providing these services, they will be unable to maintain the infrastructure created for this purpose. Services need to be self-financed as far as possible at the local level. As discussed earlier, own-source revenue from trading services accounts for over half the operating revenue in urban and metropolitan municipalities. Thus, it is evident that, on the whole, revenues from trading services are greater than operating expenditures on these services. In aggregate, it might appear that services are self-financing. However, the reality in South Africa is that these aggregate figures hide the widespread variations in municipal budgets. In addition, these figures are for urban areas only.

An analysis of 15 sample municipalities indicates that cost recovery (sales as a percentage of bulk supply costs) in the form of user charges ranges from 94% to 146% for water, from 65% to 128% for electricity, from 79% to 213% for sanitation, and from 65% to 110% for refuse services (DCD, 1997). This implies that, although some municipalities are able to self-finance basic services and use the surplus for other expenditures, others have to finance basic services partly from the general operating
account (i.e., from a mixture of property rates and intergovernmental transfers). I discuss this issue in greater detail in Section 4.4.

4.3.2 Property Tax

As mentioned above, the property tax is the major source of municipal tax revenue. Currently in South Africa, it is levied only in urban areas. Until recently, only areas under the former WLA were levied. The newly amalgamated municipalities are in the process of extending the property tax base to formerly unrated areas as well as complying with the constitutional requirement of a "uniform structure" for all taxes, tariffs, and duties levied throughout the jurisdiction of any local government council (Franzen, 1997).

During the apartheid era, since local government was primarily a provincial government function, each of the former four provinces levied a property tax in the former WLA areas under its jurisdiction in terms of its own ordinances. Under Section 229 of the Constitution, these ordinances will remain in force until repealed or amended. Thus, municipalities in different provinces are subject to different legislation with regard to the tax base, assessment, tax rates, exemptions, collection and other aspects of the property tax. The national government is in the process of drafting a property rates bill that aims at achieving some level of legislative uniformity across municipalities.

Under current legislation in South Africa, municipalities have a choice of the following tax bases: (1) site rating: rating the unimproved value of the land; (2) flat rating: rating the improved value of the land; or (3) composite (differential) rating: rating both land and improvements, but at different tax rates. In Eastern Cape, Free State,
Gauteng and Northern Cape, the vast majority of municipalities use site rating; in Mpumalanga, Northern Cape, North West and Western Cape, the preferred system is flat rating, while in KwaZulu Natal, the composite rating method is favored.

In all provinces, land values are based on market value, and a property is assessed in terms of the comparable sales method (i.e., the estimated amount it would fetch if sold on the open market on the date of valuation). The value of improvements is typically calculated by subtracting the site value from the improved land value (except in KwaZulu Natal where improvements are valued at replacement cost -- the cost of erection at the date of valuation -- less depreciation). Thus, in South Africa, land is valued at market value in all provinces but there is some variation in the treatment of buildings (when at all taxed).

Current legislation mandates that revaluation must be done at least once every five years. However, according to a study, the periodicity of valuations ranges from three years to ten years (DCD, 1997).

Current legislation allows municipalities considerable leeway in setting property rates (although this power may be regulated by national legislation). As a result, property tax rates (expressed in terms of cents per Rand) vary widely among municipalities, even within provinces. Indeed, only a handful of provinces have prescribed a maximum rate. Generally, flat (uniform) rates are used within a municipality with differential rates being used only for land held for very specific uses, e.g., agricultural landholdings or land held under a mining authorization. (Franzen, 1997)
Although the property tax is an annual tax, municipalities normally collect it in monthly or biannual installments for the sake of convenience. Municipalities charge and collect interest on arrears. While collection rates of the property tax in former WLAs exceeded 95% in many jurisdictions, collection levels of flat rent (in lieu of the property tax) and service charges were extremely low in the former BLAs, especially since 1986 when the formal boycott of these charges was initiated. The “culture of non-payment” for municipal services (used as a political tool in the townships during the apartheid era) still persists in the newly amalgamated municipalities. A national effort -- the Masakhane campaign -- was launched in February 1995 to educate the citizens in an attempt to end the rent and service charges boycott. So far, it has met with limited success. (Franzen, 1997; Verbrugge, 1994)

In terms of enforcement, unless the municipality issues a clearance certificate (stating that the property tax has been paid), ownership of a ratable property registered in the Office of the Registrar of Deeds cannot be transferred. If rates are in arrears for over three years, a municipality can seize the property and sell it at a public auction. Municipalities have not used this latter legal enforcement mechanism for political reasons.

The following are some of the concerns deriving from this situation:

1. Should rural areas be subject to the property tax? The Katz Commission is investigating the introduction of an agricultural land tax at the local level. Van Zyl and Wink (1997) have shown that the possible yield from a land tax would make only a small contribution to the revenue problems of municipalities. At the same time, there are
associated problems of administration and affordability. However, any addition to the coffers of the state is welcome, no matter how small, as long as the yield outweighs the costs. The land tax appears to be a successful source of revenue for local governments, particularly those in Latin America. Indeed, the potential for land taxation in financing valorization projects (e.g., irrigation projects) is excellent because the benefits of the tax are readily available and because the owners of the land are likely to benefit economically from the improvements (Skinner, 1994).

This option needs to be clearly evaluated from a political perspective as well; however, in the interest of equity and fairness, it may make sense to introduce an agricultural land tax. In order to ensure equity between urban and rural areas, the property tax could be extended to rural areas. For example, commercial properties in urban areas must pay property taxes; thus, to ensure interjurisdictional equity, commercial farming properties in rural areas should also be subject to the property tax.

(2) Should all municipalities be subject to the same rating system with regard to the tax base, assessment, and rates? Currently, there are variations in the laws relating to valuation, and different municipalities follow different practices with regard to exemptions, reliefs, and discounts. Although there may be some benefit to standardization of these matters in terms of national equity, experts suspect that the growth in the net tax product obtained thereby would be insufficient to warrant the erosion of local autonomy that would be entailed (DCD, June 1997). However, although this may be true for determination of rates and issues of exemptions, reliefs, and rebates, this is not the case for valuation. It would be much more practical for valuation to be
standardized across municipalities so that the fiscal capacity of a municipality can be
determined. This is an important issue that I will elaborate on further when discussing
the design of a system of intergovernmental transfers in Chapters 5 and 6.

4.3.3 Regional Service Council Levies

The Regional Service Council (RSC) levy is an important source of revenue for
MCs and DCs. It has two components (1) a regional services levy, which is a payroll tax
based on a percentage of the wage bill; and (2) a regional establishment levy, which is
based on a percentage of turnover. The RSC levy was traditionally used for the
establishment, improvement, and maintenance of infrastructural services and facilities.
However, in some areas, the RSC income was used to deal with the deficits in the
operating budgets of the former BLAs. (Van Reyneveld, 1996)

Smoke (1998) highlights four key issues with regard to the RSC levy in South
Africa:

(1) Despite their wide usage internationally, the potential effects of the two components
of the RSC are somewhat controversial. Payroll taxes raise the relative costs of labor and
this may have employment effects. This is a particular concern in South Africa because
of the fear that the cost of labor is already high relative to potential international
competitors. Turnover taxes are cascading and raise prices that are already subject to the
value-added tax (VAT) in South Africa. Both components are difficult and expensive to
administer. Finally, the equity effects of the two components are not clear. Because
payroll taxes fall primarily on formal sector employees, who are relatively well off within
the South African national income distribution, they could be considered progressive.
However, since the payroll tax in South Africa is a flat rate tax, it is not progressive within the target group. Because turnover taxes are likely to be passed forward in the form of higher prices, regressivity is a concern because consumption taxes tend to fall more heavily on low-income people.

(2) In its present form, the RSC levy is structured more like a grant than a local tax. The national government defines the bases of its two components, sets a ceiling on the tax rates, and does not allow municipalities legal recourse. At the same time, though, there are some variations in rates (since the national government reviews and approves requested rates but does not mandate a single, uniform rate).

(3) In terms of deciding whether or not to give municipalities more autonomy in the administration of the RSC levy, there is an inherent conflict among the different goals of the national government, such as macroeconomic stability, economic growth, decentralization, redistribution, meeting backlogs in infrastructure caused by apartheid, and so on. Because greater local autonomy could lead to higher and more variable rates across municipalities and a greater overall tax burden on the citizens, it could jeopardize macroeconomic stability and reinforce or exacerbate existing inter-municipal inequalities. However, if the national government continues to control the RSC levy, it may constrain the ability of municipalities to meet growing demands for service provision placed on them by Constitutional imperatives and better-informed citizens.

(4) Because the RSC levy has become an important source of revenue for the MCs and DCs in South Africa, it is neither practical nor desirable to abolish it unless it can be replaced with a revenue source that provides a comparable yield.
The points raised by Smoke are all crucial in determining the future of the RSC levy in South Africa. I discuss this in greater detail when talking about reform issues in Section 4.5.

4.3.4 Municipal Borrowing

As mentioned earlier, loans account for over half the capital budget of South African metropolitan and other urban municipalities, as compared with less than 10% of total local financing in other developing countries (Bahl and Linn, 1992). The largest source of loans has been government institutions, especially the National Housing Fund, which lends to municipalities at subsidized rates for public housing provision (Office of the President, 1997).

South Africa has a fairly sophisticated financial sector that is capable of raising and allocating capital to projects involving known risks. During the apartheid era, it had an active municipal bond market and municipalities also borrowed from financial institutions. However, the reform process, with its newly amalgamated municipalities, has made investors more doubtful about the borrowing capacity of municipalities. In addition, the increasing use of subsidized government loans as a form of fiscal transfer has undermined the creditworthiness of municipalities. For these reasons, although a few big municipalities have managed to establish creditworthiness and are able to borrow from the private sector, the majority of municipalities are not in a position to do so. (Office of the President, 1997; Peterson and Hammam, 1997) Thus, although a well-developed capital market is desirable as a source of municipal revenue for infrastructure financing, it will remain very limited in the short-to-medium-term.
4.3.5 Intergovernmental Transfers

Although intergovernmental transfers only account for no more than 4% of the total operating budget in metropolitan and other urban municipalities, they form a large part of municipal capital budgets. As noted with other revenue sources, these aggregate figures hide the variations within municipalities. There is a wide variation between individual municipalities in the percentage of the total operating budget income that comes from own revenue (DCD, 1997). While some municipalities are fairly self-sufficient and hardly rely on operating transfers, others scarcely have enough revenue to retain their core staff. The situation is more severe in rural areas, which have hardly any access to the traditional revenue sources available to urban municipalities (White Paper on Local Government, 1998).

The national government has made some efforts to solve this problem. It has redesigned the system of intergovernmental transfers to local government with the aim of subsidizing the operating costs of basic services to indigent and low-income households (White Paper on Local Government, 1998). I discuss this in greater detail later and in Chapters 5 and 6.

In the earlier discussion on intergovernmental transfers in Section 4.2, I clearly show that grants and subsidies from national and provincial government form a substantial portion of finance on the capital account of municipalities. In order to meet the backlogs in infrastructure created by the apartheid system, the national government has provided a capital grant package -- the Consolidated Municipal Infrastructure
Programme (CMIP) -- to assist municipalities in meeting the capital costs of internal bulk and connector infrastructure.¹ I elaborate upon this issue next and in Chapters 5, and 6.

4.4 FINANCIAL CAPABILITIES OF MUNICIPALITIES FOR PROVIDING BASIC SERVICES

How are municipalities to finance the capital costs of providing at least the basic level of services? As noted earlier, there are four sources of capital finance available to local government: (1) own-source; (2) grants from the other spheres of government; (3) borrowing; and (4) private sector equity in infrastructure provided by municipalities.

From the discussion in Section 4.2, it is evident that municipalities currently do not rely on own-source revenue for capital expenditure. The bulk of capital expenditure is financed through loans and grants from the national and provincial government. Municipal bond markets are currently very undeveloped in South Africa and Project Viability (a special project undertaken by the Department of Constitutional Development to monitor municipal budgets) indicates that the majority of municipalities are not creditworthy and would have difficulty raising money in the debt market. The issue of public-private partnerships is currently being debated, and the national government is drafting legislation to provide a regulatory framework for what it terms “municipal service partnerships.”

¹The CMIP divides infrastructure into five main components: (1) on-site infrastructure (e.g., piping and taps from edge of site to house); (2) reticulated project level infrastructure (e.g., streets and water pipes common to a housing project); (3) connector infrastructure (e.g., bus routes linked to a freeway, or water pipes linked to reservoirs); (4) internal bulk infrastructure (e.g., arterial roads and freeway off-ramps maintained by municipalities, or local water reservoirs); and (5) external bulk infrastructure (e.g., proclaimed roads maintained by provinces, or bulk water supplied by water boards).
In terms of intergovernmental transfers, currently, a housing subsidy of up to R15,000 per qualifying household is available to cover internal services as well as the cost of land and top structure in urban areas. In addition, the CMIP provides urban municipalities with R3,000 per household for new bulk and connector services. (Office of the President, 1997). Assuming that at least R10,000 of the housing subsidy is retained for land plus top structure, a maximum of R8,000 is left for infrastructure. Thus, urban municipalities can just about afford the capital costs of providing a basic level of service within this funding framework. However, financing an intermediate level of service for all qualifying households would use up almost R15,000, leaving very little for land and top structure, and a full level of service is unaffordable. It would be possible, however, for urban municipalities to provide an appropriate mix of basic, intermediate, and full levels of service. This mix will have to be determined in terms of people’s ability to pay for the operating costs of these services.

In rural areas, the housing subsidy is also theoretically available, but there are difficulties, particularly associated with tenure, resulting in little delivery. A land and settlement grant is available from the Department of Land Affairs for those who wish to farm. The CMIP applies to rural areas as well, and a sanitation grant of R600 is also available to them. (Office of the President, 1997, p. 27). Just as urban municipalities can barely meet the capital costs of providing a basic level of service for all qualifying households through these funding mechanisms, the same holds for rural municipalities; further, an intermediate or full level of service is unaffordable.
The MIIF, however, points out that the R15,000 housing subsidy and R3,000 CMIP grant may make little sense in rural areas as these arrangements have been inherited from urban areas and proposes the application of a single subsidy of about R6,000 for all infrastructure (bulk, connector, and internal). This would not even allow for subsidization of, at most, a basic level of service in rural areas.

How are municipalities to finance the operating costs of providing at least the basic level of service? The two main sources of income mentioned earlier are: (1) “own revenue”; and (2) transfers from the other spheres of government.

As is evident from the analysis of 1996/97 budget data in Section 4.2, the majority of municipal revenue is own-source revenue from trading services and property rates. However, municipal spending on basic services is far less, which means that the bulk of revenue generated from trading services is used for funding salaries and other operating expenditure items. Unless municipalities reprioritize their spending, they will still have to rely on transfers from national and provincial government for financing the operating costs of basic services for those who are unable to pay for these services.

Currently, there are two main channels of operating subsidies to local government for this purpose: (1) R1.2 billion in the form of “equitable share” transfers (flowing directly to urban municipalities and indirectly to rural municipalities through the district councils); and (2) R2 billion in direct spending by provincial and national departments (such as the Department of Land Affairs and the Department of Water Affairs and Forestry) to provide local government services directly where municipalities either do not
exist or do not have the capacity to provide these services (e.g., Development Services
Boards in KwaZulu/Natal).

If, based on capital affordability constraints, municipalities provide a basic level
of service, the operating costs per household per month are R51 in urban areas and R42
in rural areas. The MIIF proposes an operating real subsidy of R50 per month for every
household with an income below R1000 (approximately 40% of all urban and 70% of all
rural households). Thus, municipalities would be able to cover the operating costs for
these households, but they would need to recover the operating costs from other
households through appropriately structured tariffs. If an intermediate level of service
were affordable in terms of capital expenditure, the additional amount that would have to
be paid per month by the poor households would be R47 in urban areas and R29 in rural
areas. However, the available capital funding from national government would not allow
this, and municipalities would have to leverage additional funds for capital expenditure to
provide a higher level of service.

From the above discussion, and due to the lack of available data to estimate the
revenue potential of local government revenue sources in South Africa, it is clear that the
intergovernmental grant system remains an important mechanism for financing the
operating and capital costs of municipal provision of basic services. The best link to
revenue potential that can be made at this time is to use a crude measure of fiscal capacity
in the transfer system and to use as many conditional grants as possible so that
municipalities deliver services to meet the basic needs of their citizens. In this regard, I
discuss and evaluate the current transfer system in the next chapter and make recommendations for its redesign in Chapter 6.

Another important issue that arises in the context of the national subsidization of investments in basic services is whether or not municipalities actually spend the money as the national government intended. This is a very difficult question to answer in South Africa at present. The provincial governments are supposed to monitor the CMIP allocations to municipalities and report back to the national government. Until recently, however, there has been no stringent monitoring of these allocations. I was unable to obtain the necessary information either from the provincial ministries of housing and local government (responsible for this function at the provincial level) or from the Department of Constitutional Development (DCD -- responsible for this function at the national level). The DCD has recently mandated monthly and quarterly reporting requirements and devised a set of forms for this purpose (DCD, 1998). Time will tell whether or not the provinces and the municipalities will adhere to these reporting requirements.

4.5 REFORM OF REVENUE SOURCES

Bahl and Smoke (1998) caution that attempts to identify and strengthen local government revenue sources must be considered in terms of the broader intergovernmental fiscal situation in order to maximize the chances of their adoption and sustainability. In South Africa, in particular, all structures and institutions of local government are considered transitional until the next elections in the year 2000. I have
already pointed out that there are wide disparities between urban and rural municipalities in terms of their fiscal, administrative, and service-delivery capacities. There is also tension between those in the national government (particularly in the Department of Finance) who feel the need to retain tight control of local government in order to pursue stabilization objectives, those (particularly in the national sectoral departments and in the provincial ministries) who feel the need to protect service delivery by keeping infrastructure standards centralized, and those (particularly in the Department of Constitutional Development, in the NGO sector, and in local government itself) who prefer to implement the Constitutional mandate of moving functions and financing closer to the population. I elaborate on this tension in Section 7.2. Thus, even before working on specific policy reforms, the various sectoral ministries of the national and provincial governments must work together to decide on a broad fiscal decentralization strategy.

The first major issue with regard to revenue sources concerns how they are related to expenditure requirements -- it is crucial to determine what it will cost local government to perform its assigned functions for the discussion of local revenue mobilization to have any meaning. If not, local government will be operating in a vacuum. In Chapter 3, I have used the DBSA Combined Services model to arrive at cost estimates for the provision of basic services. In the interest of time and because of the paucity of data, I have made some simplifying assumptions in terms of the costs for urban and rural municipalities. There needs to be more research done in this area, because it would enable costs to be estimated more accurately and the appropriate level of transfers for both operating and capital expenditure to be determined. Studies on expenditure
requirements should not have to preclude immediate reforms of crucial local taxes -- they should go hand-in-hand.

Second, what are the major issues that need to be considered with regard to the reform of revenue sources? As discussed in Chapter 2, the Constitution details the types of revenue that local government is empowered to raise -- the major ones that are currently being exploited are property taxes, RSC levies, user charges for the provision of basic services, and loans. The national government needs to chart a broad reform strategy that will consider both these as well as possible new revenue sources. It must realize, however, that these cannot be undertaken simultaneously and that the reforms must be phased in gradually. It should, thus, undertake detailed studies of the existing sources of revenue, as well as the intergovernmental transfer system, before it considers new sources of revenue (such as a land tax in rural areas, pollution charges, and valorization taxes). I discuss this issue of prioritization and sequencing of reforms in Section 7.3.

4.5.1 Revenue from Trading Services

As seen in Section 4.2, this is the major source of municipal revenue on the operating account and needs to be carefully investigated. The whole issue of tariff structuring is crucial for the functioning of municipalities -- this is a source of local revenue that is most directly tied to expenditure requirements. Although the trading services are largely self-financing in some South African municipalities, others finance them out of general revenue and intergovernmental grants. A study needs to be undertaken to identify these two groups of municipalities and help the latter to structure
appropriate tariffs that will help to recover operating costs in each sector and reduce dependence on intergovernmental transfers, while at the same time solving equity concerns.

A framework of principles, which would serve as a guideline for all municipalities (both urban and rural) and other service providers (such as ESKOM) to determine tariffs for basic services, needs to be developed. As seen in Chapter 3, the Bill of Rights "entitles" every citizen to a basic level of services. Some national departments (e.g., Department of Water Affairs) have interpreted this constitutional right to be the responsibility of municipalities, thus raising the issue of "lifeline" tariffs (zero tariffs for a minimum consumption of basic services and charges beyond that). This raises the question of "unfunded mandates" -- national government mandates that local government is responsible for certain centrally determined policies without providing the funding for them, or even determining if the local government has the capacity to fund them. Policy-makers at the national level must weigh these issues very carefully before making promises to the citizens.

4.5.2 Property Tax

As seen in Section 4.2, the property tax is the major source of tax revenue for South African local government. In order to make informed key policy decisions about property-tax reform, the South African government needs to undertake a detailed study of the following issues:

(1) The revenue yield and the revenue potential in each municipality: This is an important issue because it will help the government to identify how much municipalities actually
raise versus how much they can raise. There is much talk about the “culture of non-payment.” By studying the reasons for the shortfall (if any) between revenue potential and revenue yield, the government can actually determine whether or not this is the major cause for inadequate revenue yield. If this is the case, the national government needs to continue its Masakhane program of instilling a “culture of payment.” It is entirely possible that some municipal collection and enforcement systems are not up to a standard, and this may need to be the impetus for reform in certain municipalities. Although a broad national policy reform in needed for the overall system, it is essential to target the main causes for poor performance in different municipalities and apply differential strategies.

(2) The uniformity of the tax base: This issue is important because it relates both to how revenues in certain municipalities will be affected by changes in the tax base as well as to how this could provide data for calculation of municipal fiscal capacity. The first question that needs to be answered is whether the tax base should be land or should it be land and improvements? Because there are variations in the tax base across municipalities, a nationally legislated uniform tax base might cause some municipalities to suffer revenue losses. This must be weighed against the advantages of being able to determine fiscal capacity for the purposes of redesigning the system of intergovernmental fiscal transfers -- an issue that I deal with in Chapters 5 and 6.

(3) The introduction of a land tax in rural areas: This issue is crucial in evaluating the potential for raising revenue in rural areas. The two main factors to consider are: (1) equity between rural and urban areas; and (2) whether the benefits of increased revenue
outweigh the costs of administration and affordability. I have already discussed the benefits of the rural land tax in Section 4.3.2 -- its introduction is needed to ensure interjurisdictional equity, any addition to revenue (no matter how small) is welcome, and it could be used to finance valorization projects. However, the introduction of this tax is a politically contentious issue in South Africa and would have to be weighed very carefully. Given the upcoming local government elections in the year 2000, it is possible that even if it is found to be a viable source of rural local revenue, its introduction should be timed properly.

4.5.3 RSC Levy

As discussed in Section 4.3.3, although the RSC levy has certain undesirable economic effects, such as cascading, excess taxes on wage income, and horizontal inequity, it is a major source of municipal revenue. Thus, it is not practical to abolish it unless it can be replaced by a comparable revenue source. It would appear that in the short term, at least, the RSC levy will remain. Given this, the following need to be determined:

(1) A complete study of the administration of the RSC levy to understand the variations in administrative practice and efficiency between rural and urban municipalities. Are municipalities exploiting this source of revenue to the fullest in terms of assessment, collection, and enforcement? What administrative reform is needed to enhance revenue mobilization of this tax?

(2) A study of the interjurisdictional redistributive effects of the tax to determine whether or not it should remain in the hands of MCs and DCs. Bahl and Smoke (1998) have
pointed out that the tax is employment-based, while many service needs are residence-based. This undermines the efficiency link that is a main rule in local public finance. In South Africa, this is especially problematic in metropolitan areas because not everyone who works in the metropolitan area lives there -- this means that the tax paid by people in rural areas is used to meet the service needs of people in urban areas. Should the RSC levy then be administered by the national government in the interests of interjurisdictional redistribution?

A longer-term reform option would be to replace the RSC levy with an alternative revenue source. Bahl and Smoke (1998) have suggested an “equal yield” share of value-added tax revenues collected by the national government and redistributed to municipalities on a formula basis. A thorough study of this option needs to be undertaken in terms of its revenue impact, administrative costs and efficiencies, and effects on local discretion.

4.5.4 Municipal Borrowing

In Section 4.3.4, I discussed the reasons why municipal borrowing in the open capital market is not a feasible option in the short-to-medium term -- the creditworthiness of most municipalities is in doubt because (1) they rely increasingly on subsidized government loans; and (2) the former WLAs have been amalgamated with former black BLAs, and Indian and Colored Management Committees that had severe fiscal problems.

This is, however, an area that could be developed over the longer term. In order for municipalities to establish creditworthiness, they need to develop proper budgeting
and sound financial management procedures, including establishing firm credit control measures and affordable infrastructure investment programs. Because the national government will not provide sovereign guarantees of municipal debt, there needs to be greater clarity with regard to the security of loan investments in order for the private sector to be more comfortable with lending to municipalities. The national government could do this by developing a framework for monitoring the financial position of municipalities and establishing rules for intervention in the event that a municipality experiences financial difficulty. The national government’s Project Viability program is a step in this direction. I discuss these issues in Chapter 7. The issue of grant-loan linkages is another area that is linked to both municipal borrowing and intergovernmental transfers, which I turn to in the next chapter.

4.6 CONCLUSION

The allocation of tax functions in South Africa basically follows the fiscal federalism principles of efficiency and equity in assigning revenue responsibility to local government. The notable exception is the RSC levy, that is collected by the secondary tier of local government and that conventional public finance principles assign to the national government. The legacy of apartheid, which created disparities in wealth and service provision across jurisdictions in South Africa, calls for the MCs and DCs to play a intrajurisdictional redistributive role, and they partly achieve this by their collection and redistribution of the RSC levy.
Because revenue sources are inextricably linked to expenditure requirements, it is imperative to determine how much it costs local government to perform its service-delivery functions. At the same time, the national government needs to consider the reform of existing revenue sources, such as the property tax, user charges, and the RSC levy, with the aim of exploiting their potential more fully. Local government capacity -- in terms of rendering accounts and enforcing payments -- needs to be strengthened in order to improve collection. The national government also needs to consider new revenue sources (such as an agricultural land tax and municipal borrowing) as longer-term reform options. The proper design of a system of intergovernmental transfers -- the other revenue source, to which I turn next -- is crucial for bridging the fiscal gap between revenues and expenditures.
CHAPTER 5
CURRENT SYSTEM OF INTERGOVERNMENTAL FISCAL TRANSFERS

5.1 INTRODUCTION

Given that local revenues are insufficient to meet South Africa's basic service needs in the short run, the proper design of a system of intergovernmental transfers is a critical element for matching expenditure needs to revenue means. In this chapter, I evaluate the current system of intergovernmental fiscal transfers to local government in South Africa. I first examine the rationale for an intergovernmental transfer system, including a discussion of three key principles that need to be considered in the design of such a system. These are: (1) vertical fiscal balance; (2) horizontal fiscal balance; and (3) correcting for spillovers. I then describe the present system of transfers to local government in South Africa and evaluate it in light of these principles (such as, what are the problems with it?, does it meet some of the principles that government claims as objectives and local finance norms would support?, and so on). This provides the basis for the next chapter in which I propose an alternative model of intergovernmental transfers from national to local government.

5.2 THEORETICAL RATIONALE FOR INTERGOVERNMENTAL TRANSFERS

In general, fiscal theorists (including Oates, 1972; Bird, 1993; Shah and Qureshi, 1994; Tanzi, 1995) indicate that each sphere of government should raise (a portion of) its own revenue and determine its own level of expenditure (in terms of functions assigned
to it) so as to enhance its accountability and efficiency. In most countries, however, subnational spheres of government find that it is impossible to raise enough revenue to finance the functions assigned to them (Bahl and Linn, 1992; Shah, 1994b). Systems of intergovernmental transfers are therefore necessary to overcome these and related problems.

Intergovernmental transfers are the main source of revenue for subnational governments in many developing countries. For example, Shah (1994b) points out that central transfers financed about 85% of subnational expenditures in South Africa, 67% to 95% of state-local expenditures in Nigeria and 70% to 90% of expenditures in less prosperous states in Mexico. In fiscal year 1996/97, about 76% of all government revenues in South Africa were raised at the national level, 2% by provincial government, and 22% by local government. During the same period, the share of expenditures was, respectively, 43%, 36%, and 21% (Financial and Fiscal Commission, 1997).

There are three ways to fill the fiscal gap resulting from the disjunction between tax assignment (and subsequent collection) and expenditure responsibilities: (1) reducing total expenditures; (2) local revenue mobilization (either from existing revenue sources or from new revenue sources); or (3) transfers to provincial and local government from nationally collected resources. With regard to local government, we saw in Chapter 3 that the national government has prioritized the provision of basic services to redress the backlogs in infrastructure provision caused by apartheid. Thus, a reduction in expenditures is not feasible in the short run. In Chapter 4, we concluded that the options of better exploitation of existing revenue sources and exploring new sources need to be
part of a broader reform strategy that will take time to operationalize. In the short run, therefore, there is a need for a well-designed system of transfers to meet the fiscal gap. I focus on this issue in this and the next chapter.

Intergovernmental transfers are usually justified on the following three grounds: (1) to overcome fiscal disparities, resulting from a disjunction between tax assignment and expenditure responsibilities, among the different tiers of government, in order to achieve vertical fiscal balance; (2) to attain horizontal equity among different jurisdictions on the same level by ensuring certain minimum levels of service provision; and (3) to correct the inefficiencies from spillovers (Bird, 1993; Shah 1994b). Of course, there are often tensions between these objectives -- the first two are intended to promote equity and the third to promote efficiency. The proper design and administration of a system of intergovernmental transfers is crucial to achieving an appropriate balancing of the above-mentioned objectives. I discuss each of these in turn next.

The concept of vertical fiscal balance refers to the need to balance funds among the different spheres of government due to their differential ability to finance expenditures out of own revenue. Bird (1993) reminds us that the vertical fiscal gap may be closed by transferring revenue-raising power to local governments, by transferring expenditure responsibility to the central government, or by reducing local expenditures or raising local revenues. There is, however, a sufficient mismatch between revenues and expenditures in all countries to warrant assigning an important balancing role to intergovernmental fiscal transfers.
Shah (1994a) defines horizontal fiscal imbalance as the imbalance between expenditure needs and revenue means among jurisdictions within the same governmental sphere (i.e., among provinces or among municipalities). Boadway and Flatters (1983) term a “broad based” view of horizontal fiscal balance to mean that the national government should ensure that all its citizens are treated equally regardless of where they live. Thus, the fiscal system should be locationally neutral, i.e., individuals with similar incomes across jurisdictions should receive the same net benefits (imputed public service benefits less tax costs). In the local government sphere, there is a need to provide equitable levels of service for the provision of basic services, irrespective of locality. Where this cannot be done from the resources of the local community, intergovernmental transfers are necessary.

The strongest economic rationale for intergovernmental transfers is to correct for spillovers in the provision of public services (Bird, 1993). Spillovers usually occur because the benefits of a locally provided good or service spill beyond the local jurisdiction to benefit those not contributing to the costs (e.g., air and water pollution control) and because the services provided are enjoyed by nonresidents (e.g., parks, recreational, and transportation facilities). Because subnational governments consider only their own benefits in planning and administering such public services, they generally underprovide these services. Intergovernmental transfers are often the most practical means of correcting the inefficiencies from spillovers (Shah, 1994b).

Bahl and Linn (1992) identify three basic methods to determining the vertical division between the spheres of government: (1) allocating a specified share of national
tax revenues to lower-tier governments; (2) an ad-hoc approach to the amounts to be transferred; or (3) reimbursing budgeted expenditures. According to the first method, the total amount to be given to subnational governments is determined as a fixed percentage of a national tax (e.g., income tax, sales tax, and so on). With the ad-hoc method, the size of the divisible pool is determined annually by the national government and the distribution is made on some subjective basis. The choice between these two methods depends on the extent of control the national government wishes to retain over the division of revenues between the spheres of government and the degree of confidence it has in the ability of lower-tier governments to absorb the money effectively. The ad-hoc method is preferred if the national government wants to exert more control and has less faith in the capacity of lower-tier governments. The third method -- reimbursing budgeted expenditures -- uses either a specified share of a national revenue source or an ad-hoc method to fix the size of the pool if a limit on the total reimbursed costs is desired. If not, all eligible expenditures (eligibility being determined by the national government) can be reimbursed.

Bahl and Linn (1992) further define the following four approaches to the division of the pool for a particular sphere, derived from the vertical division and referred to as the horizontal division, among recipient governments: (1) a derivation principle, whereby funds get allocated on the basis of where the taxes are collected; (2) a formula approach, which requires decisions to be made about the variables that are to be used to determine transfer amounts; (3) ad-hoc; or (4) reimbursing costs.
A derivation principle of revenue-sharing requires that some percentage of a tax collected from a subnational jurisdiction be returned to it, possibly with the higher level of government deducting a fee for collection. Under this system, the subnational government has no say in determining the tax rate or base. The reasons for a shared tax include: (1) the perception on the part of the national government that subnational governments do not have the administrative capacity or political will to mobilize sufficient resources from local tax bases; and (2) the desire by the national government to retain fiscal control, while simultaneously trying to achieve a better vertical fiscal balance. (Bahl and Linn, 1992)

A formula-based allocation is primarily motivated by the desire to equalize tax capacity and/or to reduce disparities in service provision across jurisdictions. Typical factors used in developing a formula include:

(1) indicators of tax capacity, such as personal income, the tax base of a single tax or a combination of taxes, or the theoretical concept of “utility”;
(2) indicators of need, such as population, land area, population density and the extent of roads; and
(3) indicators of tax effort, such as the ratio of tax collections to tax capacity.

The third category is designed to stimulate local resource mobilization, the aim of which is to incorporate an incentive for the recipient jurisdiction to increase or, at least, maintain tax effort. In this case, the degree of control that the national government exercises over the recipient government depends on whether the grants are conditional or unconditional, matched or unmatched. (Bahl and Linn, 1992)
The main disadvantage of formula funding in many countries, including South Africa, is that the choice of formula is partly constrained by the availability of data at the subnational level. Another problem is finding operational measures of tax capacity and need. For example, the property tax base comes to mind as a measure of tax capacity. Unfortunately, as discussed in the previous chapter, there are variations across municipalities in the laws relating to property valuation in South Africa so that this is currently not a viable option.

However, the advantages of using formula funding should be stressed. The first advantage is its relative objectivity when compared to other funding mechanisms or processes that are open to manipulation by politicians, civil servants, and other policy makers. Second, this mechanism ensures certainty of revenue for governments, which is vital to any development planning that national and subnational governments may wish to undertake.

5.3 RATIONALE FOR INTERGOVERNMENTAL TRANSFERS IN THE SOUTH AFRICAN CONTEXT

The system of intergovernmental transfers to subsidize the operating costs of local government was started in 1977/78 as a short-term crisis measure to help fund a few of the more volatile black urban areas outside the old homelands, and they were paid out as loans (referred to as “bridging finance”). It was used exclusively to fund recurrent costs in former black townships. In 1990 government accepted that the Black Local Authorities (BLAs), as then structured, were not financially viable and needed ongoing financial assistance in the form of grants. From fiscal year 1991/92, the transfers to
BLAs were appropriated as intergovernmental grants, and not as loans. In terms of a Finance Act passed in June 1993, the funds previously appropriated and classified as loans were reclassified as grants. (Van Reyneveld, 1996)

At the same time, funds were flowing from the national government to municipalities, either directly or through the provinces, to perform certain agency functions, such as health, social services, sports, and recreation. Also, in the previous self-governing territories and former TBVC states dispensation, monies were specifically provided on the budgets of these areas for the management of so-called R293 towns.

From the 1993/94 to 1996/97 financial year, intergovernmental transfers to municipalities fluctuated from year to year, and it is not possible to determine whether intergovernmental transfers have significantly decreased or fallen as a percentage of national expenditure in real terms over the last few years. Provinces used their own criteria to allocate these funds to municipalities. There is, however, a concern that monies previously provided for R293 towns and delegated functions might also not have found their way to municipalities due to provincial budgetary constraints.

The first general justification for intergovernmental transfers to local government is the need to reduce the vertical fiscal imbalance among the national, provincial, and local government spheres. From Table 5.1, we see that, although the national

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5 The TBVC (Transkei, Bophutatswana, Venda, and Ciskei) and the six self-governing territories (Gazankulu, Lebowa, Kangwane, KwaNdebele, KwaZulu, and QwaQwa) were part of the old homeland areas, which had no local authorities and were administered by the “central government” of the territories, viz., traditional leaders (Van Reyneveld, 1996). These have now been incorporated into the provinces.

6 R293 towns are towns that were established under Provincial Proclamation R293 and did not function as conventional municipalities. They were administered by the province, which provided services and financed them. (FFC, 1997). Provinces still provide services directly to some R293 towns while municipalities provide services to others. The eventual aim is to have all service responsibilities for R293 towns transferred to municipalities.
### TABLE 5.1
**REVENUES, EXPENDITURES, AND FISCAL GAPS BY GOVERNMENTAL LEVEL IN SOUTH AFRICA: 1996-97**

<table>
<thead>
<tr>
<th>Level of Government</th>
<th>Own Rev (Rb)</th>
<th>Own Exp (Rb)</th>
<th>Diff: Own Rev-Own Exp (Rb)</th>
<th>Own Rev as % of Own Exp (%)</th>
<th>Own Exp as % of Total Exp (%)</th>
<th>Fiscal Gap (Exp-Rev)/Exp (%)</th>
<th>Rev as % of GDP (%)</th>
<th>Exp as % of GDP (%)</th>
<th>Diff as % of GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Local</td>
<td>43</td>
<td>48</td>
<td>-5</td>
<td>90</td>
<td>22</td>
<td>10</td>
<td>7</td>
<td>8</td>
<td>-1</td>
</tr>
<tr>
<td>Provincial</td>
<td>3</td>
<td>81</td>
<td>-78</td>
<td>4</td>
<td>2</td>
<td>96</td>
<td>1</td>
<td>13</td>
<td>-12</td>
</tr>
<tr>
<td>National</td>
<td>147</td>
<td>97</td>
<td>50</td>
<td>152</td>
<td>76</td>
<td>43</td>
<td>-52</td>
<td>24</td>
<td>15</td>
</tr>
<tr>
<td>Total</td>
<td>193</td>
<td>226</td>
<td>-33</td>
<td>86</td>
<td>100</td>
<td>14</td>
<td>31</td>
<td>36</td>
<td>-5</td>
</tr>
<tr>
<td>GDP</td>
<td>626</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Source:** Adapted from FFC Discussion Document on Local Government, 1997.

**Notes:**
- Rev: Revenue
- Exp: Expenditure
- Rb: Rand billion
- Diff: Difference
- GDP: Gross Domestic Product
government is able to finance all its expenditure out of own revenue, there is a total budget deficit for the three spheres of R33 billion. Of the total deficit of R83 billion (-R78 billion at the provincial level and -R5 billion at the local level) at the subnational levels, R50 billion comes from national government revenue and the remaining R33 billion from domestic and foreign loans taken out by the national government (Department of Finance, 1998). From Table 5.1, it is also clear that the position of local government differs markedly from that of the provinces. Whereas the provinces as a whole in 1996/97 were only able to finance about 4% of their expenditures out of own revenues, municipalities were, on average, able to finance approximately 90%.7 From these figures, two conclusions can be drawn. First, the vertical imbalance between the different spheres of government in South Africa is considerably greater between the national government and the provinces than between the national and local government spheres.8 Second, in the case of the local government sphere, the provinces cannot fill the vertical gap (in the form of grants) because they do not have sufficient own revenue.

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7 The fiscal imbalance (fiscal gap) for local government illustrated here hides certain historical anomalies. The budget data on which these relationships between revenue and expenditure are made largely relate to the former "white" local governments in the former Republic of South Africa. In these jurisdictions, there were high levels of service provision across a considerable range of services, financed by an extensive tax base. Therefore, the fiscal gap was small. In the rest of South Africa, there were very low levels of service provision for few services and a concomitant meager tax base. It could be argued that the fiscal gap here was also small. However, if one combines these two very disparate situations and assumes a significantly higher level for a greater range of services for the formerly excluded sector (i.e., a more equitable service level for all), without an equivalent increase in the tax base, then the fiscal gap would certainly be of a greater magnitude than illustrated here, thus closer to the fiscal gap between national and provincial spheres. (FFC, 1997).

8 The reason for the large vertical fiscal gap between the national and provincial governments is that provinces in South Africa are assigned significant expenditure responsibility for education, health, housing, and welfare, but very little revenue responsibility. Their main sources of revenue are from levying taxes on casinos, gambling, lotteries, and betting. Although provinces absorb the vast majority of intergovernmental grants from national government in South Africa, I will not discuss the issue here because my focus is on local government. The relationship between the national and provincial governments is a complex topic that would be the subject of a whole other study.
problem will have to be solved either through local revenue mobilization (better exploitation of existing revenue sources or exploring new forms of revenue generation) or through nationally collected revenues, in the form of revenue sharing and grants from the national government, or by reducing total expenditures.

The figures in the table disguise significant disparities among the municipalities themselves. This provides the second rationale for intergovernmental transfers, i.e., the need to solve horizontal fiscal imbalance. Although some of the established municipalities would be able to fund reasonable levels of basic services to their communities without any transfers, others, currently, scarcely have sufficient revenue to retain their core staff, or, in some of the newly created municipalities (specifically in rural areas), even to employ staff at all. The Department of Finance (1997) has documented that in 1996/97, the 6 metropolitan areas of the country (comprising 30 metropolitan and local councils) accounted for over 49% of all expenditure; the 513 local councils accounted for 44% of all expenditure; and the 42 district and 236 rural or representative councils accounted for about 7% of all expenditure of local government. The White Paper on Local Government (1998) reiterates that “municipal budgets vary enormously, from metropolitan areas with budgets of several billions, to small rural councils with negligible revenues” (p. 109). A study (DCD, 1997) showed that there is a wide variation between individual municipalities in the percentage of total operating budget income that comes from own revenues. For example, for the 1996/97 fiscal year, own revenue accounted for only 2.4% of total operating income in Ulundi (KwaZulu-Natal) while the figure for Hankey (Eastern Cape) was 26.1% and for Mafikeng (North West) was 48.3\%.
It is, therefore, obvious that the design of a system of intergovernmental transfers must take due cognizance of the tax capacity of each and every jurisdiction, an aspect that is discussed in greater detail below.

5.4 CURRENT SYSTEM OF TRANSFERS TO LOCAL GOVERNMENT IN SOUTH AFRICA

Section 227 of the Constitution stipulates that local government and each province (1) is entitled to an equitable share of revenue collected at the national level to enable it to provide basic services and perform the functions allocated to it; and (2) may receive other conditional or unconditional allocations from national government revenue. In accordance with the legal interpretation of the Constitution, equitable share transfers cannot be conditional.

Currently, there are two types of transfers that flow from national to local government: (1) unconditional operating transfers that form the equitable share to which local government is entitled; and (2) conditional capital transfers.

5.4.1 Unconditional (equitable share) operating transfers

The “equitable share” has been defined as “... the sum of unconditional transfers (formula-based and historical/discretionary) flowing to local government.” (Department of Finance, 1998, p. 25) As of fiscal year 1998/99, the equitable share of nationally collected revenues flowing to local government (in the amount of R1.01 billion) is intended to be distributed according to a four-component formula developed by the Department of Finance (DOF): (1) a municipal basic service (S) transfer; (2) a tax-base equalization (T) transfer; (3) a municipal institutions (I) transfer; and (4) a spillover
matching (M) transfer. The quantum of these transfers (approximately 0.7% of national
government revenues to be shared among the three spheres of government after debt
service and other provisions) was determined to equal the amount (in real terms) of
transfers flowing to local government in the previous financial year.

(1) Municipal basic service (S) transfer: The objective of this transfer is to ensure that
poor residents in all municipalities receive access to basic services.

\[ S_i = \alpha L H_i \]

where
\( S_i \) = service transfer to municipality \( i \);
\( L \) = annual cost of providing basic services per person;
\( H_i \) = population living in households with incomes less than R800 per month; and
\( \alpha \) = coverage parameter with \( 0 \leq \alpha \leq 1 \).

(2) Tax-base equalization (T) transfer: The objective of this transfer is to promote the
efficient allocation of households, capital investment, and labor within the major
economic centers of South Africa. The intention is to counter the unbalanced pattern of
past development by promoting equalization of tax-base distortions. Only within-
metropolitan area equalization (i.e., transfers between metropolitan local councils within
the same metropolitan jurisdiction) is envisaged.

\[ T_i = \theta t (B^* - B_i)P_i \]

where
\( T_i \) = equalization transfer to metropolitan local council \( i \);
\( t \) = average rate (cents per rand) across the metropolitan jurisdiction;
\( B^* \) = per capita rates base across the metropolitan jurisdiction;
\( B_i \) = per capita rates base in metropolitan local council \( i \);
\( \theta \) = degree of equalization with \( 0 \leq \theta \leq 1 \); and
\( P_i \) = population of metropolitan local council \( i \).
(3) Municipal institution (I) transfers: The objective of this transfer is to fund a minimum level of resources to provide and maintain basic facilities for the operation of local government (such as community centers and an office for elected officials). It will flow only to those municipalities currently lacking the administrative capacity to raise their own revenue and/or lacking the basic infrastructure needed to function as municipalities. This will be measured in terms of the difference between a threshold level necessary to support democratic local government and rates/general service income of the municipality. Population size will determine the size of the I transfer. The rationale for using normative rates income is to avoid perverse incentives for some municipalities to make no effort in collecting rates if actual rates income were used.

\[
I_i = \max \{0, I_n - R_i\}
\]

where

\[
I_i = \text{institutional transfer to municipality } i;
\]

\[
R_i = \text{normative rates income of municipality } i, \text{ given by the formula; and}
\]

\[
R_i = 0.05(y_i - 180) P_i,
\]

where

\[
y_i \text{ is the per capita income and } P_i \text{ is the population in municipality } i;
\]

and

\[
n = 0 \text{ if } P_i < 2000
\]

\[
n = 1 \text{ if } 2000 \leq P_i < 20,000
\]

\[
n = 2 \text{ if } 20,000 \leq P_i < 100,000
\]

\[
n = 3 \text{ if } P_i \geq 100,000;
\]

and

\[
I_0 = 0
\]

\[
I_1 = R \ 400,000
\]

\[
I_2 = R \ 800,000
\]

\[
I_3 = R1,600,000
\]

(4) Spillover matching (M) transfers: The objective of these transfers is to assist municipalities in providing essential infrastructure for services that create positive economic spillovers for residents of other municipalities.
The DOF has proposed complex reforms in this area. It regards the establishment and turnover taxes (which yield RSC levies) as inefficient forms of tax and advocates their replacement by some other form of tax that would raise the same quantum of revenue. This tax would accrue centrally and be passed back to municipalities as an M transfer without any net claim on existing central government resources. In the short term, since it is more feasible for the RSC levy system to remain intact, it would be ascribed as an M transfer, with measures taken to ensure that these funds are redirected to capital projects. I deal with this issue in Section 5.5 and in Chapter 7.

5.4.2 Conditional capital transfers

In the past few years, capital transfers have flowed from the national government to provincial governments, the size being determined by means of a formula, and then to municipalities on an application basis. A municipality that is interested in applying for capital funding for a project must submit a business plan to the province. Each year, the total amount requested by municipalities for capital grants exceeds the available funding. Each province determines which projects are funded based on a number of criteria, developed by the Department of Constitutional Development (DCD), including:

1. local need and demand;
2. priority with respect to provincial and national development strategies;
3. cost effectiveness of the proposed project;
4. service charge payment performance;
5. affordability of service levels;
6. capacity to manage the project; and
There has been considerable work done during the past year or so to consolidate this funding under the umbrella of the Consolidated Municipal Infrastructure Program (CMIP).

The primary goal of the CMIP is the provision of basic municipal services for all citizens within 10 years. A system of intergovernmental transfers that provides funds for meeting the capital costs of infrastructure for basic services has been designed by the DCD. The total amount of capital transfers under the CMIP was R540 million in the 1996/97 fiscal year and R1.8 billion in 1997/98. The DCD currently allocates these funds to the provinces according to a formula that equally weights (1) population; and (2) number of households below the poverty line.

Under the previous system, funds were allocated to the RDP and then to municipalities directly or through the provinces from line departments. Under the current system, a Municipal Infrastructure Fund (MIF) has been established for bulk and connector infrastructure to consolidate all capital grants into a single funding channel. Presently, although provinces have a role in the allocation of funds, transfers are conditional, based on standardized criteria (mentioned above). The MIF provides funds for three types of infrastructure, namely: (1) new and upgraded infrastructure (70% of funding); (2) rehabilitation (20%); and (3) special cases (10%). The funds are formula-funded to each province, which then disburses the funds to municipalities on a project basis, based on business plans produced by the latter. Projects are selected and prioritized according to the seven nationally defined criteria listed above. Provinces can

(7) financial sustainability.
give final project approval for all projects that comply with national criteria, other than special cases (which require national approval).

Municipalities may use the funds as equity to raise money from the DBSA or the private sector. However, no municipality is obliged to raise its own money as matching funds. The project must be financially sustainable, i.e., municipalities must be able to sustain the operating and maintenance costs. The capital cost for the basic level of service provision has been estimated at R3000 per eligible household.

5.5 EVALUATION OF THEORETICAL FRAMEWORK FOR CURRENT SYSTEM

How does the current system of intergovernmental transfers to local government in South Africa relate to the theoretical rationale described in Section 5.2? Does it meet the principles that the national government claims as objectives and are these supported by local finance norms of equity and efficiency? I first evaluate the unconditional (equitable-share) transfers and then examine the conditional capital transfers.

5.5.1 Unconditional (Equitable-Share) Transfers

On the whole, the four-component equitable share transfer program designed by the DOF has its share of problems. It purports to use four central objectives as a basis for restructuring the system of central-local transfers: (1) equity; (2) efficiency; (3) facilitating democracy; and (4) spillover effects. These are supposedly respectively translated into the four components: the S, T, I, and M transfers.

Although the above-mentioned objectives are not the usual rationales for designing a system of intergovernmental transfers, they are nonetheless important in
South Africa and must be evaluated accordingly. The S grant, in theory, does fulfill an equity objective (defined as ensuring that poor residents in all local government jurisdictions receive access to basic municipal services) by providing municipalities with an operating cost subsidy for basic services for poor residents. However, in practice, it appears to be biased towards urban areas through the choice of $\alpha$ (the budget adjustment parameter) at 0.6 in urban areas and 0.1 in rural areas in the first years of operation (and increased by 0.1 per year in urban areas and 0.15 in rural areas until it reaches 1). This is despite the fact that the relative need (in terms of existing service levels) is higher in rural than in urban areas (MIIF, 1996). This is a result of a political decision in South Africa and needs to be re-examined in terms of its negative impact on rural areas. The national government’s rationale for the initial low $\alpha$ in rural areas is that it reflects current administrative capacity constraints and is not permanent because $\alpha$ will increase over time in rural areas as capacity is built. However, as it stands, this argument does not have merit because, although the transfer is calculated for the rural municipalities, the money actually flows to the DC who is responsible for administering the rural LCs within its jurisdiction. I elaborate on this issue in Sections 5.6 and 6.2 below.

One of the most commonly stated rationales for the use of transfers, and of particular relevance to South Africa, is the need to reduce interjurisdictional fiscal disparities (Bahl and Linn, 1992; Bird, 1993; Shah, 1994a). Fiscal equalization, as a concept, attempts to solve the fiscal disparities among jurisdictions. The $T$ transfer is seen as an equalization transfer. However, equalization is envisaged only within
metropolitan areas and does not cover all municipalities in the country. This again reflects a strong urban bias in the transfer program.

As regards what it is that has to be equalized, policy makers have two views. The first group states that the capacities of municipalities to finance comparable levels of service provision across jurisdictions have to be similar. This group (Boadway and Flatters, 1983; Auld and Eden, 1984) would focus on the revenue-raising capacity of the jurisdictions and then seek to equalize these based on some notion of the national average or other norm. This appears to be the approach used by the DOF with the T transfer, except that the equalization is done within metropolitan areas and the revenue-raising capacity of metropolitan local councils is sought to be equalized based on the average revenue-raising capacity within the metropolitan area.

A second group (Courchene and Copplestone, 1980; McMillan, 1991; Shah, 1994a) states that both revenue-raising capacity and expenditure needs should guide the distribution of grants. The emphasis of this combined approach to equalization is on both service provision and financial capacity and calls for the national government to provide transfers to jurisdictions with relatively low fiscal capacity and/or relatively high fiscal needs. This features partly in the S grant and partly in the I grant.

If fiscal equalization were done solely on the basis of revenue-raising capacity in South Africa, it might result in some municipalities getting less than they need in terms of providing services to their constituents. If we consider a large rural municipality like East London TRC, for example, it has a larger revenue-raising capacity than a smaller municipality like Gatvana/Willowvale TRC. Thus, according to the revenue-raising
approach to fiscal equalization, East London would receive a lower grant than Gatyana/Willowwale. However, East London has a higher fiscal need (as measured by the cost of providing basic services to poor households), and this needs to be taken into account in the allocation of grants. Thus, the fiscal equalization objective of the T transfer can be met by combining the S and I transfers -- an alternative that I present in the next chapter.

The municipal institution (I) transfer, that is targeted mainly at rural areas, aims at providing jurisdictions with funds for a minimum level of resources to provide and maintain facilities for the operation of local government. Although this may not seem a bad idea on the face of it, rural local government as presently organized would be far better off with money going directly to district councils, because they currently are largely responsible for administering and managing rural local councils. Providing money to create new offices for each and every rural local council (which number in the 100s) will just create more bureaucracy instead of facilitating democracy. I arrived at this conclusion as a result of opinions voiced by district council officials, elected rural councilors (who sit on the district council board), and provincial and national government officials concerned with local government during my interviews with them.

The spillover matching (M) transfer is intended to support those municipalities who create positive economic spillovers for residents of other municipalities in the course of providing services. Although this is the intention, the M transfer, as presently conceived, does not fulfill this efficiency objective at all. The DOF basically wishes to reform the RSC levies by centralizing them and using them to fund capital projects. As
mentioned in Chapter 4, the RSC levies are already being used by MCs and DCs to fund capital projects within their jurisdictions. Thus, in essence, they are being put to the same use that is conceived for them by the DOF. The only difference is that the DOF wishes to centralize them. The RSC levies are by no means spillover transfers -- they are actual revenues raised by MCs and DCs. The usual way to deal with spillovers in terms of transfers is to provide conditional matching grants to the jurisdictions undertaking spillover-prone activities. In addition, the Department of Finance has not devised any mechanism by which it intends to redistribute the RSC levies once they are centralized.

It states that M transfers should be given to MCs and DCs to establish a core staff capability at the metropolitan and district level and to finance capital projects proportionally to their use by the poor from whom cost recovery is inappropriate -- these are the municipalities that are capable of undertaking spillover projects that no individual municipality has the incentive to undertake (a fallacious assumption). However, as envisaged by the DOF, M transfers are part of the equitable share of nationally collected revenues and cannot be given conditionally. This is a contradiction because spillover grants cannot be unconditional. Thus, the efficiency objective of correcting for inefficiencies from spillovers cannot be met through the equitable-share transfers in South Africa because of the national government’s interpretation of the Constitution that these transfers must be unconditional.

In addition to the above-mentioned problems with the M transfers conceived by the DOF, another issue is that matching transfers are used not only to account for spillover effects but can also be used to stimulate tax efforts by municipalities. I deal
with this issue in Chapter 6, when I discuss incorporating measures of tax effort into the grant formula as part of a long-term reform strategy.

In actual fact, the DOF has developed the distribution of the equitable share of R2.8 billion only in terms of the S and I transfers (R1.01 billion) and a set of discretionary transfers -- for R293 towns and a local government transition fund for emergency use (R1.79 billion, that will be phased out over the next 6 years). A political decision was taken in 1998 not to implement the equalization (T) and spillover matching (M) transfers in the foreseeable future (Department of Finance, 1998).

5.5.2 Conditional Capital Transfers

Presently, the conditional allocations for capital expenditures are made to provinces (to be redistributed to municipalities) on the basis of population and poverty. There are several reasons why this is not ideal.

In the first instance, a purely poverty-based formula (which is meant to measure expenditure need) is inappropriate for determining grants for capital expenditure. A more appropriate mechanism for allocating funds for capital expenditures is one that takes into account the expenditure need in terms of infrastructure for the provision of services instead of simply the poverty level in the jurisdiction. I elaborate upon this issue in the next section when recommending an alternative model.

In the second place, the province is not the right governmental level to which funds for local government should be targeted; these should go directly to local government. Currently, provinces assess applications from municipalities on the basis of the following nationally determined criteria: local need and demand; priority with respect
to provincial and national development strategies; cost effectiveness of the proposed
project; efficiency and speed of implementation; service charge payment performance;
affordability of service levels; capacity to manage the project; and financial
sustainability. In addition to constitutional and legal provisions (discussed later) that
mandate that grants to local government go directly to it, there is an efficiency argument
for allocating them to local government. Several authors (e.g., Rondinelli, 1990;
Wolman, 1990; Dillinger, 1994) argue that local officials are likely to be more
knowledgeable about the needs of their areas than higher-level government officials and
that the quality of the information about local conditions becomes increasingly distorted
as it moves from field officers to the central administration. Interviews with both local
and provincial government officials in South Africa corroborate this argument in the
context of the allocation of intergovernmental transfers. They indicate that, in general,
the specific allocation of funds can be done more efficiently at the MC or DC level where
the detailed needs and constraints of local communities can be evaluated more accurately
than at the provincial or national level. Provinces, being further removed from the
communities within each municipality, are not highly conscious of or responsive to
community preferences, problems, and priorities. Each of the nine provinces has a
Ministry for Local Government, located in its capital, from which it administers all the
municipalities within its area of jurisdiction. Additional costs must be incurred to obtain
and administer the information necessary for detailed allocations under these
circumstances. In contrast, each of the 48 MCs and DCs has a better knowledge of local
conditions within its jurisdiction to be able to judge local priorities with a justifiable
degree of confidence. Local government officials in the primary municipalities have also indicated that they have a better working relationship with the MC or DC than the province.

It might be argued that distributing the funds directly to local government focuses on the micro-efficiency of better local projects in a particular jurisdiction and that distribution to the provinces might be preferable because it could result both in the choice of projects with the highest overall returns province-wide as well as intra-provincial redistribution. Although this may sound logical on the face of it, there are two reasons why this argument does not have merit in the particular case of South Africa. First, I have argued for the funds to go to the MC or DC, as opposed to the primary-tier municipality. This would result in the choice of projects with the highest returns at the sub-province level. Second, I recommend in the next chapter that the fiscal capacity of the MCs and DCs should be taken into account in allocating the funds and this takes care of the issue of intra-provincial distribution. Within a province, an MC or a DC with a greater fiscal capacity will get a smaller share of the funds to be then redistributed to the primary-tier municipalities within its jurisdiction.

Support for this approach of allocating funds directly to local government is to be found in the current constitutional and legal provisions. The Constitution establishes three “spheres” of government, namely national, provincial, and local, each of which is entitled to its own “equitable share of revenue collected at the national level” and each of which is entitled to a reasonable level of independence. Furthermore, in terms of section 226 (3), revenue allocated to local government through a province is a direct charge against
the province’s revenue fund. Therefore, even if municipal allocations were to be channeled through a province, this would have to be done as conditional grants (from the province’s perspective) and the provincial treasuries would be no more than conduits.

One might ask, if the above is true, why not distribute the funds directly to the primary-tier municipality? With regard to single-tier urban municipalities, in addition to the earlier argument that distribution to the secondary-tier municipality would result in the choice of projects with the highest sub-province-wide returns, the lack of sufficient data at this level of disaggregation currently calls for their distribution at the secondary level. In the two-tier jurisdictions, there are also very good reasons for choosing the MC or DC over the primary municipality. With regard to rural areas, the rural municipalities have no administrative capacity, and the DCs provide services to them on an agency basis. In the metropolitan areas, there are strong arguments for MCs to be responsible for overall planning in the area. I elaborate on this in the next chapter.

In addition, Schedule 2 of the Local Government Transition Act, 1993, Second Amendment Act 1996, assigns redistributive powers to MCs to receive, allocate, and distribute transfers in accordance with an objective formula. Although the DCs are not rural carbon copies of MCs, they could be assigned similar functions.

As always in economics, trade-offs are involved. The first is that using aggregated data from the primary-tier jurisdictions could conceal the intra-regional disparities that may exist. Second, it is also recognized that the distribution of transfers by the MCs and DCs to municipalities in their regions needs to be closely monitored on the basis of the criteria established in section 214 (2) (a)-(j) of the Constitution. The national government
must establish guidelines and a monitoring mechanism. Nevertheless, as mentioned before, the secondary tier of local government is much closer to its constituency than the province and is in a better position to know its needs and to distribute funds. This attribute also implies a greater level of accountability to the electorate than at the provincial level. Furthermore, the Councils of the secondary-tier bodies are made up of representatives from the entire jurisdiction, who therefore are able to voice their opinions on priorities and relative allocations, based on the criteria accompanying the transfers.

An important role for the provinces could be to assist the national government in monitoring the distribution of funds by MCs and DCs. I discuss these issues further in Chapter 7.

5.6 EMPIRICAL EVALUATION OF EQUITABLE-SHARE ALLOCATIONS FOR 1998/99

The financial year 1998/99 marked the beginning of the implementation of the current system of unconditional intergovernmental transfers for operating expenditure -- the equitable share -- to local government. As mentioned earlier, the system consists of two grants, the Basic Services Transfer (S grant) and the Institutions Transfer (I grant) -- the T and M grants will not be implemented. In addition, the allocations do not reflect allocations to R293 towns -- the national government has paid this amount directly to the provinces and will continue to do so until all R293 staff and functions have been transferred from provinces to the respective municipalities.

To avoid serious fiscal disruption that would have been caused by the abrupt reduction of transfers to certain municipalities that were receiving large transfers under
the old system, every municipality was guaranteed an allocation equal to 70% of the average intergovernmental grant received in the previous two financial years (referred to as the “guaranteed amount”). Thus, in 1998/99, the historical allocations to municipalities are being phased out and the new system of $S$ and $I$ grants is being phased in. When the new system is fully phased in, the distribution of the equitable share of national revenue to local government is intended to be much more equitable than the prior distribution of intergovernmental grants.

Table 5.2 shows the equitable-share allocations by province. As expected, the actual total allocation exceeds the formula-generated $S+I$ total allocation (by 68%). Because Gauteng, KwaZulu Natal, and the Western Cape received relatively large grants under the old system, their total allocations in 1998/99 remain substantially larger than their calculated $S$ and $I$ grant. Given that both Gauteng and the Western Cape are relatively wealthy (in terms of average annual household income), the Western Cape receives an allocation that is larger than its population share, while Gauteng’s allocation share is much smaller than its share of national population. This is obviously a result of the phasing-out of the historical allocations (according to the formula-generated $S+I$ allocation, Gauteng should have received 9.4% of the total allocation, and the Western Cape only 8.6%). In future years, the distribution of grants among provinces and to municipalities is intended to be more closely aligned to the actual formula-generated amounts as the historical allocations get phased out.
<table>
<thead>
<tr>
<th>Province</th>
<th>Formula-Based S+1 Allocation (Rand)</th>
<th>Actual Total Allocation (Rand)</th>
<th>Actual Per Capita Allocation (Rand)</th>
<th>Formula-Based S+1 Allocation (Percent)</th>
<th>Actual Total Allocation (Percent)</th>
<th>Population</th>
<th>Population (Percent)</th>
<th>Rural Population</th>
<th>Rural Population (Percent)</th>
<th>Average Annual Household Income (Rand)</th>
<th>Poor</th>
<th>Poor (Percent)</th>
<th>Poverty Rate (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Cape</td>
<td>158,769,976</td>
<td>220,130,707</td>
<td>38</td>
<td>26</td>
<td>22</td>
<td>5,778,970</td>
<td>16</td>
<td>3,903,358</td>
<td>63</td>
<td>26,125</td>
<td>3,115,861</td>
<td>26</td>
<td>54</td>
</tr>
<tr>
<td>Free State</td>
<td>56,209,693</td>
<td>81,804,154</td>
<td>35</td>
<td>9</td>
<td>8</td>
<td>2,313,663</td>
<td>7</td>
<td>801,362</td>
<td>34</td>
<td>47,199</td>
<td>780,314</td>
<td>7</td>
<td>34</td>
</tr>
<tr>
<td>Gauteng</td>
<td>56,564,457</td>
<td>112,388,725</td>
<td>15</td>
<td>9</td>
<td>11</td>
<td>7,638,261</td>
<td>21</td>
<td>273,620</td>
<td>4</td>
<td>91,568</td>
<td>560,531</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>KwaZulu Natal</td>
<td>80,593,244</td>
<td>192,143,057</td>
<td>32</td>
<td>13</td>
<td>19</td>
<td>6,007,249</td>
<td>17</td>
<td>4,480,288</td>
<td>55</td>
<td>42,268</td>
<td>2,919,854</td>
<td>25</td>
<td>49</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>42,644,328</td>
<td>64,847,306</td>
<td>32</td>
<td>7</td>
<td>6</td>
<td>2,044,222</td>
<td>6</td>
<td>1,055,123</td>
<td>38</td>
<td>44,493</td>
<td>644,486</td>
<td>5</td>
<td>32</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>36,991,916</td>
<td>39,839,776</td>
<td>50</td>
<td>6</td>
<td>4</td>
<td>794,966</td>
<td>2</td>
<td>224,851</td>
<td>28</td>
<td>40,377</td>
<td>210,873</td>
<td>2</td>
<td>27</td>
</tr>
<tr>
<td>Northern Province</td>
<td>75,285,923</td>
<td>93,570,678</td>
<td>25</td>
<td>12</td>
<td>9</td>
<td>3,775,308</td>
<td>11</td>
<td>3,370,143</td>
<td>76</td>
<td>23,096</td>
<td>2,208,867</td>
<td>19</td>
<td>39</td>
</tr>
<tr>
<td>Northwest</td>
<td>47,724,380</td>
<td>67,271,763</td>
<td>24</td>
<td>8</td>
<td>7</td>
<td>2,800,112</td>
<td>8</td>
<td>1,736,415</td>
<td>54</td>
<td>32,996</td>
<td>1,034,214</td>
<td>9</td>
<td>37</td>
</tr>
<tr>
<td>Western Cape</td>
<td>51,844,820</td>
<td>139,953,854</td>
<td>32</td>
<td>9</td>
<td>14</td>
<td>4,388,311</td>
<td>12</td>
<td>442,238</td>
<td>10</td>
<td>49,978</td>
<td>384,486</td>
<td>3</td>
<td>9</td>
</tr>
<tr>
<td>Total</td>
<td>606,628,737</td>
<td>1,011,950,000</td>
<td>28</td>
<td>100</td>
<td>100</td>
<td>35,541,062</td>
<td>100</td>
<td>16,287,398</td>
<td>40</td>
<td>39,813</td>
<td>11,859,485</td>
<td>100</td>
<td>34</td>
</tr>
</tbody>
</table>

Source: Adapted from equitable-share allocation data provided by the Department of Constitutional Development.
Table 5.3 shows the number of municipalities receiving S+I allocations versus the 70% guaranteed allocation. Overall, 68% of the municipalities received the S+I grant and 32% received the guaranteed 70% allocation, and 57% of metropolitan municipalities, 97% of rural municipalities, and 51% of urban municipalities received the S+I allocation. This reflects a slower move towards the formula-generated allocations in metropolitan and urban areas.

**TABLE 5.3: PERCENTAGE OF MUNICIPALITIES BY TYPE OF MUNICIPALITY AND AMOUNT RECEIVED: 1998-99 (excluding R293 Towns)**

<table>
<thead>
<tr>
<th>Spatial Level</th>
<th>Guaranteed Amount (Percent)</th>
<th>S+I (Percent)</th>
<th>Total (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metro</td>
<td>43</td>
<td>57</td>
<td>100</td>
</tr>
<tr>
<td>Rural</td>
<td>3</td>
<td>97</td>
<td>100</td>
</tr>
<tr>
<td>Urban</td>
<td>49</td>
<td>51</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>32</td>
<td>68</td>
<td>100</td>
</tr>
</tbody>
</table>

**Source:** Adapted from equitable-share allocation data provided by the Department of Constitutional Development.

**TABLE 5.4: PERCENTAGE OF MUNICIPALITIES BY TYPE OF MUNICIPALITY AND AMOUNT RECEIVED: 1998-99 (excluding R293 Towns)**

<table>
<thead>
<tr>
<th>Spatial Level</th>
<th>Less than '97-'98 (Percent)</th>
<th>More than '97-'98 (Percent)</th>
<th>Total (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metro</td>
<td>43</td>
<td>57</td>
<td>100</td>
</tr>
<tr>
<td>Rural</td>
<td>5</td>
<td>95</td>
<td>100</td>
</tr>
<tr>
<td>Urban</td>
<td>42</td>
<td>58</td>
<td>100</td>
</tr>
<tr>
<td>Total</td>
<td>29</td>
<td>71</td>
<td>100</td>
</tr>
</tbody>
</table>

**Source:** Adapted from equitable-share allocation data provided by the Department of Constitutional Development.

Table 5.4 shows that 71% of the municipalities received more than they did in 1997/98, and that 57% of metropolitan municipalities, 95% of rural municipalities, and
58% of urban municipalities received more than they did in 1997/98. This reflects a strong move away from historically inequitable allocations for rural areas.

As shown in Table 5.5, per capita allocations were R23.36, R19.43 and R46.70 for metropolitan, rural, and urban municipalities, respectively. Thus, in the first year of implementation of the new system, per capita grants are higher in urban areas than in rural areas. This occurs primarily because: (1) urban municipalities tend to get historical allocations whereas rural municipalities tend to get the S+I allocation; and (2) the S grants are phased in much more slowly in rural areas than in urban areas (0.1 as opposed to 0.6).

**TABLE 5.5: EQUITABLE-SHARE ALLOCATIONS BY TYPE OF MUNICIPALITY: 1998-99**
(excluding R293 Towns)
(in Rand)

<table>
<thead>
<tr>
<th>Spatial Level</th>
<th>S Grant Per Capita</th>
<th>I Grant Per Capita</th>
<th>S+I Grant Per Capita</th>
<th>Allocation Per Capita</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metro</td>
<td>7.54</td>
<td>0.00</td>
<td>7.54</td>
<td>23.36</td>
</tr>
<tr>
<td>Rural</td>
<td>10.64</td>
<td>7.00</td>
<td>17.64</td>
<td>19.43</td>
</tr>
<tr>
<td>Urban</td>
<td>17.90</td>
<td>5.79</td>
<td>23.70</td>
<td>46.70</td>
</tr>
</tbody>
</table>

**Source:** Adapted from equitable-share allocation data provided by the Department of Constitutional Development.

The S grant was designed to help municipalities supply basic municipal services to poor people. Table 5.6 shows the S grant per capita and poverty rates for metropolitan, rural, and urban areas. Even though the poverty rate is much higher in rural than in urban areas (and relative need as well, as we have already seen), the latter receive a higher S grant per capita. This is easily explained as follows: the S grant per capita is equal to \( \alpha \cdot L \cdot \text{Poverty rate} \). Since \( \alpha \) is higher for urban areas (0.6) than for rural areas (0.1) in the
first year of implementation of the new system, urban areas have a higher S grant per capita. S grants per capita will converge over time in urban and rural areas as \( \alpha \) converges to 1.

**TABLE 5.6: EQUITABLE-SHARE ALLOCATIONS BY TYPE OF MUNICIPALITY: 1998-99**

*(excluding R293 Towns)*

(in Rand)

<table>
<thead>
<tr>
<th>Spatial Level</th>
<th>S Grant Per Capita</th>
<th>Poverty Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metro</td>
<td>R 7.54</td>
<td>7%</td>
</tr>
<tr>
<td>Rural</td>
<td>R10.64</td>
<td>58%</td>
</tr>
<tr>
<td>Urban</td>
<td>R17.90</td>
<td>16%</td>
</tr>
</tbody>
</table>

*Source:* Adapted from equitable-share allocation data provided by the Department of Constitutional Development.

However, we saw from Table 5.4 that almost every rural municipality received a larger grant than it did under the old system. This implies that as historical allocations continue to be phased out (and S grants phased in), rural municipalities will become more and more favored in the actual pattern of distribution. Thus, it is important to look at changes in grant allocations over time, because they tell a very different story than a snapshot of the distribution of per capita grants taken in the first year of a new grant program.

As seen in Table 5.7, the mean S grant per capita first increases as average per capita income increases up to R720 and then decreases. This is to be expected, since the goal of the S grant is to subsidize basic services for the poor. However, the mean actual allocations per capita exhibit a fluctuating pattern and are much higher for higher average per capita incomes. This is due to the policy decision to provide a guaranteed amount to every municipality, which results in a larger percentage of urban municipalities receiving
their historical allocations. Although almost all rural municipalities are receiving a larger allocation than they did in the past (which, in any case, was an inequitable allocation), the full impact of the S grant will only be felt in later years due to the fact that the allocations are being phased in differently in urban and rural areas.

**TABLE 5.7: MEAN ALLOCATIONS BY AVERAGE PER CAPITA INCOME: 1998-99**
(excluding R293 Towns)
(in Rand)

<table>
<thead>
<tr>
<th>Income Level</th>
<th>S Grant Per Capita</th>
<th>Per Capita Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than R181</td>
<td>15.23</td>
<td>57.33</td>
</tr>
<tr>
<td>R181-R360</td>
<td>16.74</td>
<td>48.78</td>
</tr>
<tr>
<td>R361-R540</td>
<td>19.01</td>
<td>65.83</td>
</tr>
<tr>
<td>R541-R720</td>
<td>23.96</td>
<td>78.08</td>
</tr>
<tr>
<td>R721-R900</td>
<td>22.64</td>
<td>106.01</td>
</tr>
<tr>
<td>R901-R1,260</td>
<td>17.15</td>
<td>100.65</td>
</tr>
<tr>
<td>R1,261-R2,000</td>
<td>11.58</td>
<td>101.06</td>
</tr>
<tr>
<td>R2,001 and more</td>
<td>9.61</td>
<td>88.03</td>
</tr>
</tbody>
</table>

**Source:** Adapted from equitable-share allocation data provided by the Department of Constitutional Development.

**TABLE 5.8: I GRANT PER CAPITA BY POPULATION SIZE: 1998-99**
(excluding R293 Towns)
(in Rand)

<table>
<thead>
<tr>
<th>Income Level</th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 1,000</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>1,000-1,999</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>2,000-4,999</td>
<td>93.62</td>
<td>34.14</td>
<td>19.53</td>
<td>184.07</td>
</tr>
<tr>
<td>5,000-7,499</td>
<td>39.03</td>
<td>18.75</td>
<td>0.00</td>
<td>130.87</td>
</tr>
<tr>
<td>7,500-9,999</td>
<td>20.46</td>
<td>15.08</td>
<td>0.00</td>
<td>63.26</td>
</tr>
<tr>
<td>10,000-14,999</td>
<td>12.14</td>
<td>12.87</td>
<td>0.00</td>
<td>42.18</td>
</tr>
<tr>
<td>15,000-24,999</td>
<td>9.09</td>
<td>12.04</td>
<td>0.00</td>
<td>45.76</td>
</tr>
<tr>
<td>25,000-49,999</td>
<td>8.08</td>
<td>8.95</td>
<td>0.00</td>
<td>30.84</td>
</tr>
<tr>
<td>50,000-99,999</td>
<td>5.20</td>
<td>5.54</td>
<td>0.00</td>
<td>19.40</td>
</tr>
<tr>
<td>100,000-499,999</td>
<td>5.01</td>
<td>5.67</td>
<td>0.00</td>
<td>17.17</td>
</tr>
<tr>
<td>500,000 and more</td>
<td>0.16</td>
<td>0.44</td>
<td>0.00</td>
<td>1.40</td>
</tr>
</tbody>
</table>

**Source:** Adapted from equitable-share allocation data provided by the Department of Constitutional Development.
The I grant is designed to provide support in the first few years to individual municipalities that are unable to raise enough revenue to facilitate democratic governance. The population size and normative income per capita in the municipality determine its size. Table 5.8 shows that, as expected, the I grant per capita decreases as population increases. There are, however, certain unintended consequences arising from the way the I grant is designed, which I analyze in the next chapter.

Table 5.9 shows that there is extremely high variation among municipalities across all types of per capita grants (S, I, S+I, and total allocation). Total allocations per capita range from R1.24 to R2,388.63 with a mean allocation of R83.53. The wide range clearly reflects the pattern of historical allocations. As shown by the minimum and maximum figures for the S+I grants per capita (R0.97 and R208.92), one can conclude that once the new system is fully phased in, there will be significantly less variation in the size of per capita grants than there is now.

**TABLE 5.9: EQUITABLE-SHARE ALLOCATIONS: 1998-99**
**DESCRIPTIVE STATISTICS**
(excluding R293 Towns)
(in Rand)

<table>
<thead>
<tr>
<th>Grant Type</th>
<th>Mean</th>
<th>Standard Deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>S Grant Per Capita</td>
<td>18.47</td>
<td>12.03</td>
<td>0.97</td>
<td>85.62</td>
</tr>
<tr>
<td>I Grant Per Capita</td>
<td>29.47</td>
<td>40.34</td>
<td>0.00</td>
<td>184.07</td>
</tr>
<tr>
<td>S+I Grant Per Capita</td>
<td>47.94</td>
<td>43.35</td>
<td>0.97</td>
<td>208.92</td>
</tr>
<tr>
<td>Allocation Per Capita</td>
<td>83.53</td>
<td>164.33</td>
<td>1.24</td>
<td>2,388.63</td>
</tr>
</tbody>
</table>

**Source:** Adapted from equitable-share allocation data provided by the Department of Constitutional Development.
In conclusion, an evaluation of the new system of intergovernmental transfers for 1998/99 reveals that, on the whole, the S and I formula-generated grants do fulfill the intended equity goals of reaching the poor and supporting municipalities with less revenue-raising ability. The goal of efficiency -- which is achieved through conditional matching transfers -- cannot be met through the equitable-share transfers because of the legal interpretation of the Constitution that these transfers must be unconditional. I discuss the possibility of building such efficiency measures into the capital transfer system in the next chapter.

Further, with regard to the S and I formula-generated grants, the use of $\alpha$ as a budget-adjustment parameter, which differs for rural and urban areas, biases the system against rural areas. In the next chapter, I make recommendations for dealing with this problem. Conceptually, the formula could be improved upon in terms of combining the S and I grants so that the S grant takes into account a municipality’s tax capacity. In addition, there are certain unintended consequences in terms of the design of the I grant on the basis of population tiers but these can be dealt with by revising the I grant formula to eliminate the tiers. I analyze both these issues in the next chapter.
6.1 INTRODUCTION

The theoretical and empirical evaluation, in the previous chapter, of the current system of intergovernmental transfers has revealed several problems with both the unconditional equitable-share (operating) and conditional capital allocations. In this chapter, I present an alternative model of transfers to local government, taking these problems into account and keeping in mind the need to encourage local government to become more self-financing in its effort to provide basic services. I first elaborate on some of the major issues with regard to the equitable-share formula, using the principles discussed in Chapter 5, and I propose an alternative model for it. I then undertake an empirical evaluation of my proposed model, first comparing it to the existing model and then to the actual allocations. Finally, I propose a redesign of the capital-transfer system.

6.2 AN ALTERNATIVE MODEL OF OPERATING TRANSFERS TO LOCAL GOVERNMENT IN SOUTH AFRICA

As a result of the evaluation of the equitable-share allocations to local government, I identify the following three main issues that the national government needs to solve:

(1) Bias against rural areas through use of $\alpha$ as a budget-adjustment parameter;

(2) Failure of the $S$ grant to take into account the fiscal capacity of municipalities; and
(3) Unintended consequences of the I grant in terms of its design on the basis of population tiers.

I discuss each of these, in turn, as well as its implications for proposing an alternative to the existing model of operating transfers.

6.2.1 Bias Against Rural Areas

As mentioned in the previous chapter, the budget parameter, \( \alpha \), is higher for urban than for rural areas (0.6 for the former, and 0.1 for the latter). This biases against rural areas, despite the fact that their relative needs are higher. The justification provided by the Department of Finance is that rural areas are not sufficiently capacitated to absorb a huge increase in intergovernmental transfers. However, in practice, although these transfers are calculated for each individual rural municipality, they actually flow to the relevant DC who performs their service-delivery functions on an agency basis. Thus, if \( \alpha \) is to be used as a budget-adjustment parameter, it should be the same for rural and urban areas to avoid this bias. This proposal fits in with my recommendation for reforming the structure of rural local government in Section 2.5.1. In the short to medium term, the DCs, who are sufficiently capacitated, should continue to serve the rural LCs within their jurisdiction and the national government must focus on building capacity in the latter (an issue I address in Section 7.4). In the longer term, once their capacity is built, the rural LCs should be combined with each other into larger fiscally and administratively viable structures. The question is whether or not to use \( \alpha \) at all as a budget-adjustment parameter. I deal with this issue in Section 6.2.2 below.
6.2.2 Failure of the S Grant to Account for the Tax Capacity of Municipalities

As mentioned in Chapter 5, one of the most commonly stated rationales for the use of transfers is the need to reduce interjurisdictional fiscal disparities, and this is done through fiscal equalization, which encompasses both expenditure need and tax capacity. In terms of the formula, the first aspect is dealt with in the allocation for operating expenditure (the S grant) but not for capital expenditure. The latter aspect deals with the revenue-raising capacity of the jurisdictions under consideration and uses measures such as personal income, property taxes, and other standard municipal taxes, and is accounted for in the I grant.

Of critical importance is that the tax-capacity measure (even if it is a proxy measure) has to be part of the operating transfer formula. A core principle in any system of intergovernmental fiscal relations is developing incentives for all governments to maximize the use of their own resources. The corollary to this is that governments should not be “subsidized” in such a manner that their tax effort (the ratio of actual tax collections to the tax base) is less than their tax capacity (the ability of the municipality to raise revenues from its own sources). If the tax-capacity component of the formula was not to be implemented, then the latter condition could prevail (i.e., municipalities might not have the incentive to raise their own revenue and rely on grants instead), which would be ineffective, unfair, and unconstitutional. Because the tax-capacity component measures potential revenue-raising capacity and not actual revenues, in principle, it does not create disincentives for fiscal effort (Bird, 1993).
As presently designed, the S and I grants are calculated separately. In fact, the I grant is calculated first, and the S grant is then calculated as a residual (a policy decision taken by the national government). Thus, the S grant does not take into account the tax capacity of municipalities. The I grant is only meant to be given for a limited period to municipalities, and once it is phased out, the S grant, as presently calculated, will not take the tax capacity of the municipality into account. The existing model would thus be improved if the S and I grants were combined into a single formula so that they are determined together and take account of tax capacity. In fact, it would be better for the I grant to be revised to exclude the tax-capacity component, which will be a separate component in the model.

With reference to the S grant, what is measured is the relative cost to a municipality of providing a minimum level of service to that target population needing financial assistance due to poverty. What the tax-capacity component, Ri, in the I grant does is to measure the relative ability of the municipality to “subsidize” its own “poor.” If the “wealth profile” of the municipality is of such a nature that relative wealth fully compensates for the relative need, then it will receive no I grant. In other words, if the aggregate wealth is equal to or more than the aggregate need of the jurisdiction, then that jurisdiction is considered able to provide for its own needs. This is true for the secondary-tier MCs and DCs and for many of the primary-tier urban municipalities. Clearly, as the profile’s balance changes to reflect a relatively poorer jurisdiction, then the I grant becomes positive. This is the case for the rural municipalities and some of the smaller urban municipalities.
The tax-capacity component is constructed in such a manner that it would not result in a negative amount large enough for the municipality to forfeit its own revenues in contravention of section 227(2) of the Constitution. Thus, as presently constructed, $I_i \geq 0$. If we combine the S and I grants into a single formula, as I suggest above, this constraint will change to $S_i + I_i - R_i \geq 0$.

Another important issue to consider when combining the S and I grants is the use of $\alpha$ as a budget-adjustment parameter. Given a population of 11.9 million people under poverty in 1998 and an annual cost of R230 per person of providing basic services, the S grant (i.e., the total operating cost of providing basic services to them) comes to R2,727 million. Due to budget constraints, this has been scaled down by the use of $\alpha$. If we combine the S and I grants into a single formula to take account of tax capacity, we would need to apply a single budgetary adjustment parameter, which I call $\beta$, to the entire formula.

Thus, my proposed model will look as follows:

$$ES_i = \beta (S_i + I_i - R_i);$$

where

- $ES_i =$ Equitable-Share Transfer for municipality $i$
- $S_i =$ Basic service transfer for municipality $i$
- $I_i =$ Institutional Transfer for municipality $i$
- $R_i =$ Tax Capacity Equalization Component for municipality $i$; and
- $\beta =$ Budget-Adjustment Parameter, where $0 \leq \beta \leq 1$

---

9 Section 227(2) of the Constitution states that: “Additional revenue raised by provinces or municipalities may not be deducted from their share of revenue raised nationally, or from other allocations made to them out of national government revenue. Equally, there is no obligation on the national government to compensate provinces or municipalities that do not raise revenue commensurate with their fiscal capacity and tax base.”

10 The Department of Finance (1998) used a monthly expenditure of R86 per household per month (using data from the DBSA’s (1995) Financial Modelling of Municipal Services in Twenty Towns) to arrive at an annual expenditure of R230 per person (assuming a household size of 4.5 persons).
Further,

\[ S_i = L H_i \]
where
\[ L = \text{annual cost of providing basic services per person; and} \]
\[ H_i = \text{population living in households with incomes less than R800 per month} \]

\[ I_i = I^* P_i^\gamma \]
where
\[ I^* = \text{per capita I grant policy parameter;} \]
\[ P_i = \text{population in municipality } i; \text{ and} \]
\[ \gamma = \text{scale parameter, where } 0 \leq \gamma \leq 1. \]

\[ R_i = \max \{0, 0.05^* \{y_i - 180\}^*P_i\} \]
where
\[ y_i = \text{average monthly income per capita in municipality } i; \text{ and} \]
\[ P_i = \text{population in municipality } i. \]

I have already discussed the rationale for the combined formula, the alternative formulation of the S grant (with no \( \alpha \) and, instead, a budget-adjustment parameter, \( \beta \), for the combined formula), and the inclusion of the tax-capacity component, \( R_i \). I now elaborate on the unintended consequences of the I grant designed by the national government in order to present the rationale for my above-stated proposed formula, viz. \( I_i = I^* P_i^\gamma \)

### 6.2.3 Unintended Consequences of the I Grant

As seen in the previous chapter, the I grant aims at enabling those jurisdictions that lack the basic administrative capacity to raise their own revenue and/or the basic infrastructure to function as municipalities. It funds a minimum level of resources to provide and maintain basic facilities (e.g., community centers and offices for elected officials) for the operation of local government.
As currently designed, eligibility for an I grant is restricted to municipalities with populations over 2,000. The rationale provided by the national government is that very small jurisdictions are too small to provide efficient public services and should either be consolidated with other jurisdictions or else services should be directly provided to their residents by the district council in whose geographical jurisdiction they fall. If we look at the equitable-share allocation data, we see that, of the 112 municipalities with populations less than 2,000, the majority (77%) are urban municipalities with fully functioning government offices. The remaining 33% rural municipalities are all administered by the district council under their jurisdiction. If the national government wishes to continue this policy of not funding very small municipalities, it must do something about consolidating these jurisdictions from a fiscal and administrative point of view, or else the small urban municipalities will be biased against under this scenario.

Larger municipalities whose residents have an average monthly per capita income of R180 or less (a policy parameter established by the national government as a threshold poverty level) will receive a fixed minimum grant of R400,000, R800,000 or R1,600,000 depending on within which of three population tiers -- 2,000 to 20,000; 20,000 to 100,000; or over 100,000 -- they fall. Municipalities that are able to raise their own revenue (i.e., those with per capita monthly incomes greater than R180) will receive an I grant that is equal to the difference between the fixed minimum grant and the normative rates income (an amount that the national government believes each municipality should be capable of raising from local sources).
Because the minimum grant within each population tier is fixed and the normative rates income for each municipality is proportional to its population, the I grant will decline as population increases. So, for example, for municipalities within the same population tier, a municipality with a population of 6,000 will receive a smaller I grant than a municipality with the same average income but a population of only 3,000.

Table 6.1, which lists pairs of municipalities with similar incomes but different populations, clearly illustrates this point. The first two pairs are in the first population tier, the third in the second tier, and the fourth in the third tier. Both the total and the per capita I grant are larger for the smaller municipality and vice versa. It is reasonable to expect economies of scale in the provision of the basic institutions of local government (i.e., the per capita costs of building the basic infrastructure as well as running the institutions for democratic government will decline as the size of the municipality increases) and that the total costs will increase less than proportionately with population. However, the total costs would still be higher for larger jurisdictions so that, even though the per capita I grant should be smaller for larger jurisdictions, the total I grant should first rise to a certain population threshold and then decline (since some larger municipalities may already have institutional capacity and require less financial assistance for institution-building). Table 6.1 clearly indicates that this is not the case. For example, both Aggeneys TRC and Diamantstreek TRC in the Northern Cape do not have any municipal offices (the grant allocation is paid directly to the Namaqualand District Council that administers them). Yet, Diamanstreek TRC, with a population over three times that of Aggeneys TRC, is allocated a much lower total I grant. Table 6.1 also
TABLE 6.1
1998-99 I Grant Allocations for Pairs of Municipalities with Similar Incomes and Different Populations

<table>
<thead>
<tr>
<th>Municipality</th>
<th>Type</th>
<th>Population</th>
<th>Mean Income per capita per month (Rand)</th>
<th>Existing Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>I Grant I Grant</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(Rand) per Capita</td>
</tr>
<tr>
<td>Eastern Cape Province:</td>
<td></td>
<td></td>
<td></td>
<td>(Rand) (Rand)</td>
</tr>
<tr>
<td>Alexandria TLC</td>
<td>Urban</td>
<td>5,432</td>
<td>624</td>
<td>279,362</td>
</tr>
<tr>
<td>Boesmansriviermond TLC</td>
<td>Urban</td>
<td>4,405</td>
<td>624</td>
<td>302,170</td>
</tr>
<tr>
<td>Northern Cape Province:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aggeneys TRC</td>
<td>Rural</td>
<td>2,911</td>
<td>473</td>
<td>357,362</td>
</tr>
<tr>
<td>Diamantstreek TRC</td>
<td>Rural</td>
<td>7,250</td>
<td>473</td>
<td>293,808</td>
</tr>
<tr>
<td>Free State Province:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Greater Fisksburg TLC</td>
<td>Urban</td>
<td>22,761</td>
<td>544</td>
<td>385,706</td>
</tr>
<tr>
<td>Sandrivier TRC</td>
<td>Rural</td>
<td>33,388</td>
<td>543</td>
<td>194,408</td>
</tr>
<tr>
<td>Mpumalanga Province:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nkomazi-East TRC</td>
<td>Rural</td>
<td>111,097</td>
<td>288</td>
<td>1,000,326</td>
</tr>
<tr>
<td>Nkomazi-West TRC</td>
<td>Rural</td>
<td>151,088</td>
<td>288</td>
<td>784,465</td>
</tr>
</tbody>
</table>

Source: Adapted from equitable-share data provided by the Department of Constitutional Development.
shows that municipalities in the third population tier with low average monthly per capita incomes (typically poor large rural municipalities) get very low I grants per capita.

Another problem that arises as a result of the population tiers is that, although the I grant declines as population grows within a tier, the grant increases as one moves from one population tier to another. For example, Piketberg TRC, with a population of 19,336, gets no I grant; however, Kokstad TLC, in the next population tier but with a similar income, gets an I grant of R287,960. This implies that although some municipalities at the top of a population tier receive no I grant, those with similar incomes at the bottom of the next tier receive fairly large grants.

Reschovsky and Vaz (1999) have proposed an alternative for changing the I grant allocation formula to solve the issues raised above. I have modified this formula to account for the fact that the S and I grants will now be calculated together. Consequently, the tax-capacity component, $R_i$, of the original I grant becomes an independent component in my revised model and does not feature as part of the revised I grant. This alternative I grant formula satisfies the following criteria:

1. Municipalities with populations under 2,000 are ineligible for the I grant;
2. For municipalities of the same size, smaller I grant allocations are made to municipalities with higher average monthly per capita incomes; and
3. For municipalities with the same per capita income, smaller per capita I grant allocations but larger total I grant allocations (upto a certain population threshold) are made to larger municipalities.
6.2.3.1 Alternative Formula for I Grant Allocations

This is a fairly straightforward formula that is similar to the existing formula, the main differences being that the population tiers are eliminated and the tax-capacity component is taken out (since it will be an independent component of the proposed model). As mentioned earlier, very small municipalities are too small to provide efficient public services and should be consolidated from a fiscal and administrative perspective. Thus, eligibility for the grant is still restricted to municipalities with at least 2,000 residents.

The formula is constructed so that, for any given income level, total I grant allocations increase in size as population rises up to a certain population threshold and decline thereafter. Per capita I grants will decline as population rises.

\[
I_i = I^* P_i^\gamma
\]

where

- \( I_i \) = I grant allocation to municipality \( i \);
- \( I^* \) = per capita I grant policy parameter;
- \( \gamma \) = scale parameter, where \( 0 \leq \gamma \leq 1 \);
- \( R_i = 0.05 \times (y_i - 180) \times P_i \);
- \( y_i \) = average monthly income per capita in municipality \( i \); and
- \( P_i \) = population in municipality \( i \).

If we rewrite this formula in per capita terms, we can analyze its effects.

\[
\frac{I_i}{P_i} = I^* y_i^{\gamma - 1}
\]

For any given income level, a rise in population leads to a reduction in the I grant per capita. For a given population level, a rise in per capita income will lead to a reduction in the I grant per capita.
I set the values of the policy parameters, $I^*$ and $\gamma$, so that the formula would allocate approximately the same total value of $I$ grants as was distributed in 1998/99.

With $I^*$ set at R1,580 and $\gamma$ at 0.515, the total $I$ grant allocations amount to R191,996,015 -- R44,912 greater than the actual 1998/99 allocations of R191,951,103.

From Table 6.2, we see that, for any given income level, the per capita allocation decreases as population increases, but the total allocation increases with population. The exception is Diamantstreek, which has a higher population than Aggeneys but receives a lower total grant. This is because the model is constructed in such a way that, for a given income level, the total allocation increases up to a certain population threshold and then declines (to account for the fact that larger jurisdictions may already have established institutions and may, thus, need less financial assistance for institution-building).

My alternative formula solves the problem -- created by population tiers -- of a municipality at the top of a tier receiving no allocation, while a municipality at the bottom of the next tier receives a large allocation. For example, Piketberg TRC (with a population of 19,336) receives an $I$ grant of R255,266 and Kokstad TLC (with a population of 20,068) receives an $I$ grant of R260,200. The model accounts for the fact that total $I$ grant allocations should increase up to a point as population increases. In addition, very large rural municipalities with low per capita incomes (such as Nkomazi-East and Nkomazi-West) receive very large allocations (while recognizing the economies of scale inherent, thus giving larger municipalities smaller per capita allocations).
TABLE 6.2
1998-99 Revised I Grant Allocations for Pairs of Municipalities with Similar Incomes and Different Populations

<table>
<thead>
<tr>
<th>Municipality</th>
<th>Population</th>
<th>Mean Income per capita per month (Rand)</th>
<th>Proposed Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>I Grant (Rand)</td>
</tr>
<tr>
<td>Eastern Cape Province:</td>
<td></td>
<td></td>
<td>I Grant per Capita (Rand)</td>
</tr>
<tr>
<td>Alexandria TLC</td>
<td>5,432</td>
<td>624</td>
<td>132,711</td>
</tr>
<tr>
<td>Boesmansriviermond TLC</td>
<td>4,405</td>
<td>624</td>
<td>119,129</td>
</tr>
<tr>
<td>Northern Cape Province:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Aggeneys TRC</td>
<td>2,911</td>
<td>473</td>
<td>96,235</td>
</tr>
<tr>
<td>Diamantstreek TRC</td>
<td>7,250</td>
<td>473</td>
<td>153,994</td>
</tr>
<tr>
<td>Free State Province:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Greater Fisksburg TLC</td>
<td>22,761</td>
<td>544</td>
<td>277,640</td>
</tr>
<tr>
<td>Sandrivier TRC</td>
<td>33,388</td>
<td>543</td>
<td>338,229</td>
</tr>
<tr>
<td>Mpumalanga Province:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nkomazi-East TRC</td>
<td>111,097</td>
<td>288</td>
<td>628,352</td>
</tr>
<tr>
<td>Nkomazi-West TRC</td>
<td>151,088</td>
<td>288</td>
<td>736,201</td>
</tr>
</tbody>
</table>

Source: Adapted from equitable-share data provided by the Department of Constitutional Development.
6.3 EMPIRICAL EVALUATION OF THE PROPOSED MODEL FOR OPERATING TRANSFERS

My proposed model needs to be empirically evaluated to see how it fares relative to both the existing model and the actual total allocations (the higher of the "guaranteed" amount or the formula-generated allocation) for 1998/99. For this purpose, I have done the following:

(1) First, I calculated each of the components -- $S_i$, $I_i$, and $R_i$ -- for each municipality without the budget-adjustment parameter, $\beta$.

(2) Then, I scaled the total allocation for each municipality by $\beta$ (calculated as 0.4) so that the total formula-generated allocation for the country is the same as that calculated by the existing model (R606,628,737). This enables me to compare formula-generated amounts for both models (Existing S+I Allocations and Proposed S+I-R Allocations in Table 6.1).

(3) Finally, I compared this budget-adjusted allocation for each municipality to the guaranteed amount, and I chose the higher as the actual new allocation according to my model. This allows me to compare actual total allocations for both models (R1,011,950,000 for the existing model and R1,061,111,288 for the proposed model -- Actual Total Allocations and Proposed Total Allocations in Table 6.3).

Table 6.3 shows the equitable-share allocations (both existing and proposed) by province. The proposed S+I-R allocations are much more strongly correlated with percent rural, percent poor, and poverty rate (correlation coefficients of 0.83, 0.99, and 0.88, respectively) than the existing S+I allocations (corresponding figures are 0.51, 0.82, and 0.57, respectively). This implies that the proposed formula-based allocations do a
### TABLE 6.3: EQUITABLE-SHARE ALLOCATIONS BY PROVINCE: 1998-99
(excluding R293 Towns)

<table>
<thead>
<tr>
<th>Province</th>
<th>Existing Formula-Based S+I Allocation (Rand)</th>
<th>Proposed Formula-Based S+I-R Allocation (Rand)</th>
<th>Actual Total Allocation (Rand)</th>
<th>Proposed Total Allocation (Rand)</th>
<th>Poor (Percent)</th>
<th>Average Annual Household Income (Rand)</th>
<th>Poverty Rate (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Cape</td>
<td>158,769,976</td>
<td>177,716,420</td>
<td>220,130,707</td>
<td>265,057,954</td>
<td>68,873</td>
<td>26,125</td>
<td>54</td>
</tr>
<tr>
<td>Free State</td>
<td>56,209,693</td>
<td>37,386,767</td>
<td>81,804,154</td>
<td>91,526,228</td>
<td>34,199</td>
<td>47,199</td>
<td>34</td>
</tr>
<tr>
<td>Gauteng</td>
<td>56,564,457</td>
<td>0</td>
<td>112,388,725</td>
<td>97,532,888</td>
<td>7,149</td>
<td>47,199</td>
<td>7</td>
</tr>
<tr>
<td>KwaZulu Natal</td>
<td>80,593,244</td>
<td>163,084,721</td>
<td>223,143,037</td>
<td>258,476,669</td>
<td>17,554</td>
<td>42,268</td>
<td>25</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>42,644,328</td>
<td>31,242,182</td>
<td>64,847,306</td>
<td>69,283,232</td>
<td>38,4495</td>
<td>5,32</td>
<td></td>
</tr>
<tr>
<td>Northern Cape</td>
<td>36,991,916</td>
<td>9,350,168</td>
<td>39,839,776</td>
<td>20,808,285</td>
<td>40,377</td>
<td>40,377</td>
<td>27</td>
</tr>
<tr>
<td>Northern Province</td>
<td>75,285,923</td>
<td>130,180,605</td>
<td>150,466,528</td>
<td>135,799,106</td>
<td>19,596</td>
<td>23,096</td>
<td>59</td>
</tr>
<tr>
<td>Western Cape</td>
<td>51,844,820</td>
<td>4,829,306</td>
<td>54,674,126</td>
<td>41,458,366</td>
<td>39,813</td>
<td>39,813</td>
<td>34</td>
</tr>
<tr>
<td>Total</td>
<td>606,628,737</td>
<td>606,628,736</td>
<td>1,213,255,473</td>
<td>1,061,111,289</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

Source: Adapted from equitable-share allocation data provided by the Department of Constitutional Development.
much better job of fulfilling the objective of helping municipalities meet the operating costs of basic services to the poor (who are mainly located in the rural areas in South Africa). This is corroborated by the data in Table 6.4, which shows that the rural areas, which have higher poverty rates than the urban and metropolitan areas, receive a higher S grant per capita. This has been achieved in the proposed formula by getting rid of $\alpha$ -- the budget-adjustment parameter that differs for rural and urban areas. Instead, I use an adjustment parameter, $\beta$, to scale all the components, viz., $S$, $I$, and $R$, of the formula in order to meet the existing budget constraint.

Table 6.3 also demonstrates the impact of including the tax-capacity component, $R$, as a separate component in the proposed formula, as opposed to it being included as part of the $I$ grant, and calculated separately from the $S$ grant, in the existing formula. The proposed formula-based allocations have a much stronger negative correlation (-0.60) with average annual household income (used as a proxy for tax capacity) than the existing formula-based allocations (-0.32). We see that the wealthiest provinces -- Gauteng and the Western Cape -- receive the smallest allocations (0% and 1%, respectively) and the poorest provinces -- the Northern Province and the Eastern Cape receive among the highest allocations (21% and 29%, respectively).

I have already demonstrated the merits of the proposed $I$ grant reformulation in Section 6.2.3 -- (1) getting rid of the population tiers to solve the problem of municipalities at the top of a tier receiving no allocation, while municipalities with the same per capita income at the top of the next tier receive a large allocation; (2) for municipalities of the same size, making smaller $I$ grant allocations to municipalities with
**TABLE 6.4: EQUITABLE-SHARE ALLOCATIONS BY TYPE OF MUNICIPALITY: 1998-99**
(excluding R293 Towns)
(in Rand)

<table>
<thead>
<tr>
<th>Spatial Level</th>
<th>Existing S Grant Per Capita</th>
<th>Proposed S Grant Per Capita</th>
<th>Poverty Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metro</td>
<td>R 7.54</td>
<td>R 2.81</td>
<td>7%</td>
</tr>
<tr>
<td>Rural</td>
<td>R 10.64</td>
<td>R 23.49</td>
<td>58%</td>
</tr>
<tr>
<td>Urban</td>
<td>R 17.90</td>
<td>R 6.59</td>
<td>16%</td>
</tr>
</tbody>
</table>

**Source:** Adapted from equitable-share allocation data provided by the Department of Constitutional Development.
higher per capita incomes; and (3) for municipalities with the same per capita income, making smaller per capita I grant allocations to larger municipalities.

The model I proposed above, however, generated allocations that are politically unacceptable in South Africa. For instance, Gauteng receives none of the equitable-share allocation, the Western Cape receives only 1%, and the Northern Cape only 2%. Nationwide, 13% of the municipalities receive no allocation. As we have seen in the last chapter, the national government has guaranteed every municipality at least 70% of its historical allocation to avoid sudden interruptions in service delivery that might result from a sudden cut in intergovernmental transfers to it. I have, therefore, adjusted the proposed formula-based allocations to reflect this decision (the proposed total allocation column in Table 6.3). In the next chapter, I discuss a suitable method for phasing out the historical allocations.

We see that the adjusted total allocations are much more responsive than the actual total allocations to the objective of subsidizing the operating costs of basic services to the poor. They have a stronger positive correlation with percent rural (0.59), percent poor (0.96), and poverty rate (0.67) than the actual total allocations (where the corresponding figures are 0.22, 0.76, and 0.30, respectively). Their stronger negative correlation (-0.29) with average annual household income than the actual allocations (-0.09) implies that tax capacity is more strongly considered in their calculation. At the same time, the adjusted total allocations give both Gauteng and the Western Cape an acceptable level of transfers (9% and 4%, respectively), even though they are lower than the actual total allocations (11% and 14%, respectively).
In conclusion, an evaluation of the proposed system of intergovernmental operating transfers after adjustment reveals that, on the whole, it does a much better job of fulfilling the intended goals of reaching the poor and supporting municipalities with less revenue-raising capacity. Over time, as the historical transfers are phased out, the proposed adjusted system is designed to result in a much more equitable pattern of allocations to municipalities than was originally in place. I now turn to some short-term issues for implementing the proposed system of transfers.

6.4 SHORT-TERM IMPLEMENTATION ISSUES

What are the main issues with regard to the implementation of the system of intergovernmental transfers? First, what is the strategy for dealing with the phasing out of the historical transfers? Second, what is the best method of integrating updated data into the formula?

6.4.1 The Phasing Out of Historical Allocations

In order to avoid potentially serious disruptions in municipal-service delivery arising from moving to the new system of allocating operating intergovernmental transfers, the DCD and DOF decided to phase out historical allocations rather than giving municipalities the calculated amounts from the formula from 1998/99 onwards. Thus, for the 1998/99 fiscal year, every municipality received at least 70% of the average intergovernmental transfer received in the previous two financial years or the calculated S+I grant (whichever was higher). There are two issues involved in phasing out the historical allocations: (1) the choice of base year; and (2) the method to be used.
(1) Choice of Base Year

In calculating the 1998/99 equitable-share allocations, the DCD had to choose a base year for determining the historical allocations. The natural choice would have been the actual allocations received by municipalities in 1997/98. However, this was not done for two reasons. First, a study of intergovernmental transfers for fiscal years 1996/97 and 1997/98, undertaken by Price Waterhouse on the DCD’s behalf, revealed that there were huge disparities in allocations to individual municipalities for the two years. Certain municipalities received much higher allocations in 1996/97 than in 1997/98 and vice versa. Second, reliable information for actual allocations for the 1997/98 financial year was difficult to obtain -- only budgeted information was available and there was considerable variance in the information received from provinces and municipalities.

Consequently, on June 25, 1998, the Director-General of the DOF approved the method of averaging intergovernmental transfers for the 1996/97 and 1997/98 fiscal years to determine base amounts. DCD used the average of actual reconciled figures for 1996/97 and provincial budgeted figures for 1997/98.

Currently, actual 1997/98 transfer data are available and these indicate that there are large differences between the budgeted and actual numbers for several municipalities. The simplest solution to correct for these data mistakes and thus protect municipalities from potentially severe fiscal problems as a result of miscalculated transfers would be to use the higher of the base used in calculation of the 1998/99 allocations or a revised base that is the average of the actual 1996/97 and 1997/98 allocations to municipalities.
(2) The Method for Phasing Out the Historical Allocations

The decision to use 70% of the historical allocations as the minimum guaranteed amount to municipalities in 1998/99 was taken by the DCD and DOF to comply with budgetary constraints. A decision needs to be made as to how to continue to phase out the historical allocations over the next six years (the national government made a political decision in 1998 to phase out the allocations over a period of seven years, of which one has already passed).

There are several ways in which historical allocations can be phased out and the actual method chosen will be a political decision. However, it is reasonable to consider the following criteria in developing a phase-out plan: (1) it should be easy to explain, both to municipal officials and the general public; (2) it should not create undue hardship on any municipality; and (3) to the extent possible, reductions in the guaranteed historical allocations should be spread evenly over the phase-out period (Reschovsky and Vaz, 1999).

In keeping with the above-mentioned criteria, two possible options come to mind. The first is a straight linear phase-out according to which the current guarantee is eliminated over the next six years using equal percentage point reductions of 11.667 (70% divided by six) per year. The second method is a geometric phase-out that uses equal percentage declines (70% of the previous year’s guarantee) in the guaranteed historical allocation. Table 6.5 below shows the two options.
TABLE 6.5: ALTERNATIVE METHODS FOR PHASING OUT HISTORICAL ALLOCATIONS

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Linear Method</th>
<th>Geometric Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998/99</td>
<td>70.00%</td>
<td>70.00%</td>
</tr>
<tr>
<td>1999/00</td>
<td>58.33%</td>
<td>49.00%</td>
</tr>
<tr>
<td>2000/01</td>
<td>46.67%</td>
<td>34.30%</td>
</tr>
<tr>
<td>2002/03</td>
<td>35.00%</td>
<td>24.01%</td>
</tr>
<tr>
<td>2003/04</td>
<td>23.33%</td>
<td>16.81%</td>
</tr>
<tr>
<td>2004/05</td>
<td>11.67%</td>
<td>11.77%</td>
</tr>
<tr>
<td>2005/06</td>
<td>0.00%</td>
<td>8.24%</td>
</tr>
</tbody>
</table>

Source: Reschovsky and Vaz (1999)

Method 1 results in equal percentage point reductions in guaranteed allocations over the next six years, while Method 2 results in larger percentage point reductions in the early years and smaller ones in the later years. The actual choice between the two plans is ultimately a political decision that will be based on budgetary constraints and the impact each will have on allocations to urban versus rural municipalities. As observed in Chapter 4, 43% of metropolitan municipalities, 49% of urban municipalities and 3% of rural municipalities received the guaranteed historical allocations. National priorities will determine whether or not the guaranteed amounts will be reduced more quickly (Method 2) or slowly (Method 1) for urban and metropolitan municipalities.

6.4.2 Integrating Updated Data into the Formula

In order to operationalize the equitable-share formula, the DCD required information on the population of the municipality, the mean income, and the number of people in poverty. Because detailed 1996 Census data were not available at the time, the modelers used preliminary population estimates (available at the provincial level) and voter registration rolls to estimate the population in each municipality. Mean income figures were obtained from the Bureau of Market Research Report 226 listing the
distribution of personal disposable income by magisterial district for the year 1994. The number of poor was calculated by making certain assumptions about the distribution of income within each municipality.

By the time the 1999/00 allocations need to be calculated, detailed 1996 Census data should be available and can be used. A further question that arises is whether or not to adjust the population and income data to reflect changes that have occurred between 1996 and the present. Over time, there are spatial variations in the growth of income and population, e.g., urban population grows faster than rural population. Because the South African national census is undertaken once every five years, a complete updating of the data used to calculate equitable-share allocations can only take place at five year intervals. This could possibly lead to large changes in the pattern of aid distribution at the time of updating. One possible solution is to update income and population data annually by using estimates of annual changes (Reschovsky, 1999).

Reschovsky (1999) highlights another important issue with regard to updating. Price increases over time affect variables, such as the cut-off income level below which people are considered to be poor and the nominal cost of providing basic municipal services -- both of which are components of the equitable-share formula. The national government should take this into consideration when calculating the aid allocations every year. There should also be consistency in the treatment of these variables across various national department funding programs.
6.5 AN ALTERNATIVE MODEL OF CAPITAL TRANSFERS TO LOCAL GOVERNMENT IN SOUTH AFRICA

The capital grant is seen as a conditional grant from the national government to the local government. This amount would be calculated as part of the national government’s equitable share of nationally collected revenue, so that the condition that these funds must be used for solving infrastructure backlogs can be set. In line with national government policy objectives of developing local government infrastructure to ensure that all South Africans have access to basic services, the national government will be able to apply such grants to cover these capital expenditure requirements. The Constitution requires that the actual disbursement of these grants must be based on equity.

In the interim, I have adopted a very crude measure of “access to basic services backlogs” to formulate the capital expenditure component of the formula. Mainly because of the inadequacy of other data, the measure focuses on the provision of two basic services -- water and sanitation.\(^{11}\) Weights are attached to the two services to derive a composite index of backlog/need. The choice of weights is a political decision in terms of national priorities regarding the relative importance of these two services.

The allocation for capital expenditure, \(G_i\), to a municipality is calculated on the basis of the cost to provide infrastructure to the qualifying population (i.e., the number of individuals or households below a defined poverty line)\(^{12}\) that do not have access to basic services.

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\(^{11}\) Although two services are used to “slice the cake” and are regarded as sensible proxies for a package of basic services, other services, such as solid-waste removal, roads and stormwater drainage, and electricity, are also important. They have been excluded at this time due to lack of data.

\(^{12}\) The poverty line is defined in terms of relative poverty, i.e., the poorest 40% of households (ranked by adult equivalence) in the country. This definition is taken from an October 1995 RDP report.
services. This is weighted by a combined index “I” in order to determine the allocation to each MC, DC, or primary-tier urban municipality. The real cost of providing basic infrastructure services needs to be spread out over a period of time, say 10 years, because it would be impossible to provide the total amount in one year.

The same rationale for adjusting the operating transfer to account for tax capacity (discussed in Section 6.2.2) applies to the capital transfer. Thus, once $G_i$ has been calculated, it will be adjusted by the amount of the tax-capacity equalization component, $T_i$. Again, in keeping with Section 227 (2) of the Constitution, $G_i - T_i \geq 0$.

Tax capacity at the MC and DC level ($X^i$) could be reflected in a representative tax system through a combined index which takes account of personal income, property taxes and RSC levies (and possibly other tax/revenue sources as data systems develop). The tax capacity for each component will be calculated by applying a normative national average tax rate to each tax base to give the per capita yield for each tax. These will be converted into per capita tax-capacity figures and then aggregated to get each MC or DC’s actual tax capacity, $X^i$. The national average tax capacity, $X^*$, will then be calculated from the aggregates.

The allocation of grants for capital expenditure, $C_i$, to MC or DC $i$ is as follows:

<table>
<thead>
<tr>
<th>$C_i = G_i - T_i$;</th>
</tr>
</thead>
<tbody>
<tr>
<td>where:</td>
</tr>
<tr>
<td>$C_i = $ Conditional Capital Transfer;</td>
</tr>
<tr>
<td>$G_i = $ Capital Grant before adjustment for equalization; and</td>
</tr>
<tr>
<td>$T_i = $ Tax Capacity Equalization Component for MC or DC $i$;</td>
</tr>
</tbody>
</table>
Further,

\[ G_i = \{1 - \frac{1}{I_i} \sum (1 - I_i)\} \times 1/n(x*H_{qi}); \]
where:
\[ I_i = \text{combined index for MC or DC}_i; \]
\[ x = \text{real average cost per household of providing infrastructure for basic services}; \]
\[ H_{qi} = \text{qualifying number of households in MC or DC}_i; \] and
\[ n = \text{number of years (phasing)}. \]

\[ T_i = (X_i' - X^*) P_i \]
where:
\[ X^* = \text{the norm/national average tax capacity per capita}; \]
\[ X_i' = \text{the actual tax capacity per capita of MC or DC}_i; \] and
\[ P_i = \text{the population of MC or DC}_i. \]

The composite index “I” will be constructed following the methodology used by Gill and Hall (1996) in the construction of their Development Indicators Monitoring System (DIMS) index. Observations for each variable will be scaled from 0 (the worst-off) to 1 (the best-off). For example, if the percentage of the population without access to the minimum level of water ranges between 20% and 60%, a place with 20% of the people having no access to water would have an index score of 0, while a place with 40% of the people having no access to water would receive an index score of 0.5. The composite index will then be calculated on the basis of a linear scale transformation of the average of the index scores for all variables. It will range in value from 0 (greatest need) to 1 (least need).

The composite index can be separated as follows:

- Level: MC, DC, or primary-tier urban municipality
- Values: Absolute (based on absolute numbers of housing units in need) Relative (based on relative proportion of housing units in need)
• Categories: Water
  Sanitation

• Indicators: Water: (number of housing units without access to on-site water)
  Sanitation: (number of housing units without access to adequate sanitation)

The definition of basic services and values can be developed in greater detail as more adequate data become available so that comprehensive indices can be constructed.

The real average cost per household of providing basic infrastructure services, “x”, will be calculated on the basis of how much it would cost to install bulk and connector infrastructure for basic services in the different jurisdictions under consideration. At present, the only information available is from the EMIP, which uses the Combined Services Model from the DBSA to calculate infrastructure costs for urban and rural areas.

Once each MC and DC has received its capital allocation, it will be responsible for redistributing the funds to municipalities within its boundaries or for metro-/district-wide capital expenditure purposes. The distribution procedure followed would be application-driven, with individual municipalities submitting applications for projects. Stringent criteria need to be applied to ensure that the MCs and DCs distribute the funds equitably and efficiently. The national government has already defined certain criteria for evaluating applications, including local need, cost effectiveness, affordability, managerial capacity, and financial sustainability (discussed in Section 5.4.2), and appropriate weights need to be attached to these criteria. An effective monitoring system also needs to be put in place, in the interests of efficiency, to ensure that conditional
funding is appropriately applied by the spending agencies. I discuss these issues in
greater detail in the next chapter.

There are several problems with regard to implementing the formula proposed
above. First, there are severe problems with the existing data on basic services needed to
compile the composite index. The figures available from the 1995 October Household
Survey are regarded, even by the CSS themselves, as being of too poor a quality to use at
a disaggregated level. Due to errors with regard to the sampling frame, these data are not
reliable at the magisterial district level. At best, they could be used at the MC or DC
level. Aggregation to any lower level (such as primary-tier municipality) would increase
the margin of error considerably. Thus, until more reliable data are available, the
allocations to the primary-tier urban municipalities should be made through the DCs. At
the time of writing, I was unable to obtain disaggregated data at the MC or DC level from
the CSS -- they only had provincial data. Due to time constraints arising from other
priorities, they were unwilling to disaggregate the data.

With regard to services cost data, the capital costs of providing basic
infrastructure differ markedly for urban and for rural areas and even among different
urban areas or rural areas, themselves. More detailed studies need to be done on this to
arrive at more accurate estimates that take these differentials into account and reflect the
true cost of service needs in these areas.

In terms of the tax-capacity component, at present, there are severe data
restrictions with regard to both personal income and property taxes. While data for
personal income are available at the national level, it is extremely difficult currently to
disaggregate them to the MC or DC level. With regard to property valuations, the data are both dated and incomplete in their geographical coverage and property valuation methods are not uniform across jurisdictions. If no national norms are imposed for property taxation, it would be impossible for this source to be used as a tax-capacity measure, on its own or in combination with other sources. Thus, in the short run, it may be possible to use only the RSC levies to estimate the tax base for each MC and DC.

For these reasons, I was unable to run the necessary simulations to demonstrate the advantages of my proposed model over the existing one for capital transfers and its practicality in terms of political implications. The national government needs to acquire these data and run simulations on the proposed model to see whether or not it fits with my theory of improving the allocations in terms of equity and efficiency.

6.6 LONG-TERM REFORM ISSUES

Over time, the national government of South Africa wishes to see a reduced reliance by municipal government on transfers from the higher levels of government. In order to do so, it must consider the redesign of both the operating and capital transfer systems so that they create incentives for municipalities to develop their own revenue sources more fully. In this regard, I discuss incorporating measures of tax effort into the intergovernmental grant formula. I also discuss the option of grant-loan linkages as a mechanism for encouraging municipalities with greater borrowing capacity to borrow for infrastructure investment in order to free up resources for less creditworthy municipalities.
6.6.1 Incorporating Measures of Tax Effort

Bahl and Linn (1992) indicate that, although theory does not provide a perfectly clear answer, it does suggest two possible ways to design grant programs to stimulate tax efforts by municipalities so as to foster accountability and encourage efficiency. They are: (1) the tax effort can be built directly into the allocation formula; or (2) a grant can be allocated to reimburse costs partially.

(1) Building the Tax Effort Directly Into the Formula: According to this approach, municipalities willing to tax themselves more heavily will be rewarded by receiving a larger share of the divisible grant pool. The reasoning behind this is that an increase in taxes will be rewarded by an even greater increase in expenditure benefits, so that there would be less resistance to the higher tax by citizens. This is a necessary, but not sufficient, condition for stimulating tax effort. It depends on the income and price elasticities of demand for local public goods, the weight attached to the tax-effort variable in the formula, and the degree of competition among municipalities for a larger share of grants. In addition, such a component might offset the effects of a fiscal-capacity measure that is included to compensate for differential tax bases across municipalities. In addition, this method is not widely used due to the conceptual and empirical problems associated with measuring tax effort. The common measure of tax effort is the ratio of taxes to personal income, and few countries, including South Africa, have adequate measures of the latter at the local level. I recommend that the national government undertake in-depth case studies of some of the few countries where this method is used,
such as India and Nigeria, and consider all these issues carefully before it decides to include such a component into the formula.

(2) **Grants to Reimburse Some Costs:** According to this method, the national government can subsidize less than 100 percent of costs, and it requires a match from the recipient municipality. Whether or not this stimulates tax effort depends on the percentage of reimbursement (which lowers the tax price of the service in question), on the income and price elasticities of demand for the service (which determines how the municipality will expand provision of the service as a result of the lower tax price); and on the fungibility of local expenditures (i.e., whether a dollar of matching funds is taken from a nonaided service). Another issue that arises is that such a grant may be counterproductive to the goal of regional equity -- most of the recipients might end up being wealthy municipalities who are most likely to be able to match the grant. This is certainly the case in South Africa, given the different fiscal capacities of municipalities (wealthy urban municipalities would be biased towards and poorer rural municipalities would be biased against and might offset any fiscal capacity measure incorporated into the formula). I recommend that the national government should undertake in-depth case studies of a few countries, such as Korea, Pakistan, and Zambia, and weigh the merits and demerits of applying such a method to the South African grant system.

**6.6.2 Developing Grant-Loan Linkages**

A second long-term issue with regard to intergovernmental transfers relates to grant-loan linkages. Bahl and Smoke (1998) point out that municipalities may have no incentive to borrow for infrastructure investment if the national government continues to
provide grants for funding capital projects. If the South African capital-transfer system can be redesigned such that municipalities with greater borrowing capacity are pushed to rely more heavily on loans and/or municipal bonds, this would release limited resources for less creditworthy municipalities. Such a reform initiative should go hand-in-hand with the reform of municipal borrowing discussed in Chapter 4.

Smoke (1999b) argues that the reform of grant and loan mechanisms should be implicitly linked in order to improve the overall effectiveness of the infrastructure finance system. A grant-loan linkage that assumes that revenue-generating infrastructure should be financed by loans at an interest rate that reflect the cost of capital would encourage more careful use of resources. If loan repayments impose an unacceptable burden to project beneficiaries, they could be supplemented by grants to cover part or all of initial financing. There would be clear rules to measure affordability, and a grant would be approved only if operating expenses are within an acceptable range and tariff collection efficiency is in line with specific standards. Although the latter condition implies that some municipalities are not subsidized unless they meet minimum performance standards, even if they should be on affordability grounds, this can be dealt with by providing appropriate technical assistance to them. Both efficiency and equity objectives will be served in the process.

Smoke (1999b) further points out that, although there are clear justifications for establishing grant-loan linkages in developing countries, implementation is complicated. The following major issues need to be considered in designing such linkages:
(1) A clear understanding of the tariff structure for the services for which the grant-loan linkage is to be applied;

(2) Measurement of the system cost effectiveness for the services;

(3) Documentation of demand (willingness-to-pay);

(4) Clear rules for defining affordability; and

(5) Determination of the subsidization method.

After the basic rules of the game are established, the national government will still have to consider the following issues: (1) the consolidation of competing national and provincial government sources of capital for the service; (2) the determination of the source and volume of grant and loan funds; and (3) the creation of a mechanism for allocating grants disbursed under this system. (Smoke, 1999b)

I recommend that the South African government should consider the idea of grant-loan linkages as a longer-term reform measure. Until a proper legal and regulatory framework for municipal borrowing is set in place and an enabling environment is created for municipalities to borrow on the capital market, it will be difficult to implement a system of grant-loan linkages.

6.7 CONCLUSION

Intergovernmental transfers play an important role in all countries in order to balance the mismatch between revenues and expenditures. Thus, the proper design of an intergovernmental transfer system is crucial for enabling municipalities to perform their service delivery functions. My analysis of the current system of intergovernmental
operating transfers to local government in South Africa reveals that it is biased against rural areas, fails to take the fiscal capacity of municipalities into account, and has unintended consequences with regard to the institutional component, I. In evaluating the capital transfer system, I show that it is based solely on poverty, which is an inadequate measure of expenditure need. Consequently, I have recommended an alternative model of operating and capital transfers that solves these problems. I have also explored long-term reform issues with regard to creating incentives for municipalities to develop their own revenue sources more fully. In this regard, the South African government needs to examine the options of incorporating measures of tax effort into the intergovernmental grant formula and developing grant-loan linkages to encourage municipalities with greater borrowing capacity to borrow for infrastructure investment.
CHAPTER 7
TOWARDS AN IMPLEMENTATION STRATEGY FOR DECENTRALIZATION IN SOUTH AFRICA

7.1 INTRODUCTION

Much of the decentralization literature (reviewed in Chapter 1) emphasizes the "assignment problem" viz., the allocation of expenditure and tax functions to various levels of government, and the design of intergovernmental transfers. Most decentralization analysts focus separately on these system-design components of decentralization without discussing the linkages among them. My study shows the importance of viewing all components of system design as an integrated piece, using South Africa as a case study. Specifically, it examines the linkages among the structure of local government, its expenditure responsibilities, its revenue sources, and the system of intergovernmental transfers that is needed as the government phases in local-revenue enhancement.

The local government system in apartheid South Africa was fragmented along racial lines (consisting of White Local Authorities (WLAs), Black Local Authorities (BLAs), and Indian and Colored Management Committees) and characterized by inequitable provision of services. The current system has redrawn municipal boundaries, creating new municipalities, some of which are amalgamations of the former WLAs and the former BLAs or Indian and Colored Management Committees. A two-tier system of local government exists in both rural and urban areas while a single-tier system prevails in some urban areas.
The fiscal situation inherited by the newly amalgamated municipalities remains unstable. On the one hand, they face huge backlogs in infrastructure and service delivery; on the other, their tax bases have failed to increase proportionately with the size of their geographical areas. In addition, although the Constitution confers the same powers and functions on all municipalities, most rural and some urban municipalities have little or no fiscal and administrative capacity. Thus, a need arises for a holistic reform of the local government system -- its structure; expenditure responsibilities; and revenue sources, including intergovernmental transfers -- in South Africa.

My study employs fiscal-federalism, economic-efficiency, and equity principles to propose the reform of the above components. This chapter first summarizes my key findings and then examines the implementation process -- which has received very little attention in the literature -- to recommend how these reforms can be implemented under the existing institutional, administrative, legal, and political conditions in the country. In essence, it outlines an implementation strategy for South Africa that draws on earlier findings; examines the constraints in terms of institutional arrangements, local capacity, and the legal framework; suggests ways to overcome them; and, accordingly, prioritizes reforms. The chapter concludes with guidelines for other developing countries that are either embarking on or continuing a process of decentralization.

7.2 SUMMARY OF KEY FINDINGS

The traditional model of fiscal federalism has limited relevance for developing countries and should be interpreted in light of the particular political, economic, legal,
and institutional factors prevalent in a particular country. This study considers these
issues, using the theoretical principles of efficiency and equity as an evaluative basis, to
design appropriate measures for restructuring intergovernmental fiscal relations in South
Africa. It examines what the decentralized system would look like in a normatively
“correct” sense and the extent to which this normative model can be applied in South
Africa. It identifies concerns with the different system-design components and considers
the linkages among them in order to recommend a decentralization-reform agenda. The
following summary of key findings sets the stage for outlining an implementation
strategy for my suggested reforms.

7.2.1 Reforming the Structure of Local Government

South Africa is undergoing a significant shift from a high degree of centralization
towards decentralization in order to comply with Constitutionally-mandated dictates for
reforming intergovernmental relations. This move has resulted in a major change in local
government, which was formerly under the control of the provincial government.

The Constitution has created local government as an autonomous sphere with its
own powers and responsibilities. In order to redress the backlogs in infrastructure and
service provision that resulted from apartheid, the Constitution aims, above all, for
equity. This appears in the mandate that grants local government an equitable share of
nationally raised resources to enable it to provide basic services and discharge its duties.
A second Constitutional provision (guaranteed under the Bill of Rights) entitles the
citizens of South Africa to access to basic services.
These two Constitutional stipulations, however, pose a potential contradiction because the national government has interpreted the equitable share as an unconditional transfer to local government. Thus, no guarantee exists that local government will use its share specifically for the provision of basic services. One problem the national government confronts, therefore, is how to resolve these and other potentially conflicting interpretations of the Constitution.

The White Paper on Local Government (1998) provides the basis for current policy reform. It calls into question the present two-tier structure of metropolitan local government and suggests a mega-city concept as a possible option in order that economies of scale can be reaped in the provision of certain basic services. My analysis of the advantages and disadvantages of the mega-city option concludes that the government should maintain the two-tier system in metropolitan areas because the metropolitan councils (MCs) achieve economies of scale through their responsibility for the bulk provision of basic services. A mega-city might undermine local accountability because the electorate is further away and might adversely affect redistribution because it may concentrate its resources on the city instead of the fringe areas (as is the case with Durban).

The widest variations in municipal fiscal and administrative capacity occur at the primary-tier level. Therefore, the national government should pay careful attention to their role. In particular, although retaining these municipalities as political units may be wise, a different distribution of service and revenue-generating responsibilities could be more efficient than their current equal treatment.
Instead of treating all municipalities as similar entities, the national government would need to differentiate among them based on their capacities. Combining the weaker primary-tier municipalities (all rural and some urban) either with existing municipalities or with each other would be more likely than present arrangements to achieve more efficient service provision and administration. Such an approach would aim at building capacity gradually in the deficient municipalities before transferring more responsibility onto them.

7.2.2 Reform of Expenditure Requirements and Existing Revenue Sources

The “assignment problem” traditionally uses the criteria of equity and efficiency to suggest broad principles for allocating expenditure and tax functions (and other revenue sources, including intergovernmental transfers) to various governmental levels. In assigning expenditure responsibility to local government, South Africa follows the allocative-efficiency tenet of decentralizing to the lowest geographic level possible, except when there are economies of scale, economies of scope, or interjurisdictional externalities. As noted above, the differential fiscal and administrative capacities of municipalities should further qualify this tenet -- primary-tier municipalities require different powers and responsibilities based on their differential capacities.

The two goals of efficiency and equity necessitate national standards for the provision of basic services, a key expenditure responsibility of local government. The absence of a national standard might trigger interjurisdictional competition among municipalities, resulting in lower levels of service and forcing a “race to the bottom.” A national standard would, however, ensure a minimum level of service beyond which local
jurisdictions could provide more, if they wished. This could possibly stimulate some mobility and improve efficiency because people's preferences are being better catered to in a Tiebout world.\textsuperscript{13}

In conjunction with a fiscal equalization grant, a national standard would improve equity because jurisdictions would be forced to provide a minimum acceptable level of service. Fiscal equalization on its own is a necessary, but not sufficient, condition for assuring that services are actually delivered and are of admissible quality nationally.

Various government policy documents (the RDP, White and Green Papers, and MIIF) prescribe general guidelines for national standards for water, sanitation, roads, and electricity. The national government should go a step further and legislate clear standards for the reasons discussed above. Its Consolidated Municipal Infrastructure Programme (CMIP) provides municipalities with conditional non-matching block grants for infrastructure to enable them to meet minimum standards for basic services. At the same time, however, municipalities can barely afford the costs of providing a basic level of service under the CMIP. This situation raises the problem of “unfunded” mandates -- the national government requires certain minimum standards but does not provide adequate transfers to municipalities to meet them.

Similarly, the infrastructure capital costs for even a basic level of service in rural areas exceed those in urban areas (due to factors such as distance from source of supply,

\textsuperscript{13} In the Tiebout model, mobile households “vote with their feet”, choosing to reside in a jurisdiction that offers the fiscal package best suited to their tastes. By using taxes that effectively communicate to households the cost of consuming different levels of local public goods, jurisdictions effect an efficient pattern of consumption of these goods.
density of settlement, and economies of scale). Yet, the national government provides equal amounts of funding to eligible rural and urban municipalities under the CMIP.

This discussion leads directly to revenue responsibilities in terms of what revenues local government can raise by itself to finance its expenditure responsibility and what it needs from other sources, including intergovernmental transfers and borrowing. Like many other developing countries, South Africa faces several constraints in local resource mobilization, particularly in rural areas. It differs, however, in the municipal authority through the Constitution to raise fairly stable sources of revenue, such as property taxes and user charges. This authority indicates that implementing decentralization reform efforts is likely to be easier because local government possesses an enabling legal framework for levying certain profitable sources of revenue.

In this regard, South Africa basically follows the fiscal-federalism principles of efficiency and equity in assigning revenue responsibility to local government. The Constitution, however, emphasizes equity in order to rectify the injustices in basic service provision resulting from apartheid. The two main equity issues concerning local revenue sources pertain to: (1) the role of local government in intrajurisdictional redistribution; and (2) interjurisdictional (rural and urban) equity.

**Intrajurisdictional Redistribution:** The debate on intrajurisdictional redistribution in South Africa centers round the RSC levy -- the national government wants either to abolish this tax or usurp it to prevent inequity and inefficiency. Both the payroll and the

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14 These revenue sources have long been the responsibility of local government in South Africa. They are now enshrined in the Constitution and extended to new municipalities that have been created as institutional reform proceeds.
turnover components of the levy are inefficient because the former raises the relative costs of labor and the latter raises prices due to its cascading nature.

Additionally, the interpersonal equity effects of the two components are unclear. Although the payroll tax could be considered progressive because it falls primarily on formal sector employees (who are relatively well-off within the South African national income distribution), it is only proportional within the target group because it is a flat-rate tax in South Africa. Regressivity is a concern with the turnover tax because it is likely to be passed on in the form of higher prices, and consumption taxes tend to fall more heavily on low-income people.

The national government needs to remember, however, that the RSC levy is a major source of revenue and a major redistributional tool at the MC and DC level. The levy’s intrajurisdictional redistributive effects arise from the fact that the former well-off white and poorer black or Colored or Indian areas have been amalgamated, and it falls primarily on the well-off areas because it is levied on formal sector employment.

The national government should, therefore, weigh the RSC levy’s potential interpersonal regressive effects against its intrajurisdictional redistributive effects. Ultimately, however, one would have to know if the resources raised are being spent on the poor areas -- an issue that has yet to be investigated empirically in South Africa -- in order to understand the overall impact.

**Interjurisdictional Equity:** The main issue pertains to the current differential treatment of rural and urban municipalities with regard to the property tax -- only the latter levy this tax in South Africa. The introduction of a land tax in rural areas would improve equity
between rural and urban areas. For example, urban commercial properties must pay property taxes; there is, thus, no reason (other than political) why rural commercial farms should not be subject to them. Further, a rural land tax would provide much-needed additional revenue in rural areas.

The national government would, however, need to structure this tax very carefully to avoid potential interpersonal regressive effects. These effects might occur if rural properties are assessed and taxed on a different basis than urban properties or are charged different rates even if taxed alike. In the short run, this differential is borne by property owners. Thus, if rural land is owned by wealthy city dwellers, the lower rural rates may have a regressive impact. In the long run, the differentiation may be passed on to consumers or to labor in the form of higher prices or lower wages. Since consumers of rural goods are likely to reside mainly in urban areas and goods produced in urban areas are consumed in rural areas, the incidence may again be regressive.

The tradeoffs, therefore, are between interpersonal inequity and interjurisdictional redistribution. In addition, this tax's politically contentious nature would necessitate a careful handling of the situation; its introduction (if so decided) would need to be timed properly, given the upcoming local government elections in 2000.

7.2.3 Reform of Intergovernmental Transfers

In the short term, local revenues are insufficient to meet South Africa’s basic service needs. This problem stems partly from inadequate fiscal capacity and partly from poor administrative capacity of municipalities (mainly rural). South African
municipalities, therefore, need a well-designed system of intergovernmental transfers to close the fiscal gap between revenues and expenditures in the short term.

Only an ad-hoc system of transfers to local government existed under apartheid, resulting in inequitable allocations, with the former white municipalities receiving the largest share. The current formula-based system aims to correct for these injustices but has its share of problems. The conditional capital transfers are poverty-based and do not consider the fiscal capacities and expenditure needs of municipalities.

The two components of the “equitable-share” i.e., unconditional operating transfers -- the municipal basic service (S) transfer and the municipal institution (I) transfer -- also have several problems. First, the S grant (whose objective is to ensure that poor residents in all municipalities receive access to basic services) is biased against rural areas, despite the fact that their relative needs are higher than urban areas.

Second, the I grant (which aims to fund a minimum level of resources needed for the operation of local government) has unintended consequences arising from its design based on population tiers. Municipalities with an average monthly per capita income of R180 or less (used as a proxy for fiscal capacity) receive a fixed I grant, the amount being dependent on within which of three population tiers they fall. The rest receive an I grant that is equal to the difference between the fixed minimum grant and the “normative rates” income (an amount that the national government believes each municipality should be capable of raising from local sources). The I grant declines as population increases because the minimum grant within each population tier is fixed and the normative rates income for each municipality is proportional to its population.
The problem with this pattern is that although the total costs of providing the basic institutions of local government would reasonably increase proportionately less than population due to economies of scale, they will still be higher for larger populations. Thus, contrary to the current allocations, the total I grant per municipality should first rise to a certain population threshold and then decline (since some larger municipalities may already have institutional capacity and need less assistance). Another problem with the population tiers is that although some municipalities at the top of a tier receive no I grant, those with similar incomes at the bottom of the next tier receive fairly large grants.

Third, the S and I grants are calculated separately; the I grant is calculated first and the S grant is calculated as a residual. Because the I grant (which includes the proxy fiscal capacity measure) is only meant to be given for a limited period to municipalities, the equitable-share transfers will take municipal fiscal capacity into account only in the short run.

Given these problems, the national government should redesign the existing system of capital and operating transfers to local government to take into account both municipal fiscal capacity and expenditure needs. The need to reduce interjurisdictional fiscal disparities is one of the most commonly stated rationales for the use of transfers. This concept of fiscal equalization, primarily justified on equity grounds, is particularly relevant for South Africa because of its apartheid legacy, which has resulted in huge inequities in the service needs of municipalities and in their capacities to finance comparable levels of service provision.
An intergovernmental transfer system needs to consider the allocative-efficiency effects pertaining to: (1) local government accountability to the national government; (2) local preferences in making local decisions; (3) local tax effort i.e., local government mobilization of resources; and (4) local government borrowing to promote efficiency in the capital market.

(1) **Local Government Accountability**: By imposing conditions on a grant, the national government can induce local government to be accountable to it and ensure that the money is spent on meeting national priorities. This accountability serves to encourage efficient operation by local government. The South African national government has interpreted the operating transfers to be unconditional; this treatment constrains it to using the capital-transfer system to hold local government accountable to it.

Although the conditional nature of the capital transfers ensures that the funds are spent on the national government’s priorities, it would not compromise the objective of local autonomy. This occurs because the conditions relate to meeting the national objective of minimum standards of service and access to basic service as opposed to mandating specifically how the money is to be spent.

(2) **Local Autonomy**: A cornerstone of the fiscal-federalism model to foster allocative efficiency is local autonomy and choice in the provision of public goods. Presently, in South Africa, the equitable-share transfers go directly to local government, which decides how to spend the money. The national government, however, allocates capital transfers to the provinces, which redistribute them to the primary-tier municipalities.
In addition to constitutional and legal provisions that mandate that grants go
directly to local government, the national government should allocate the capital transfers
to the secondary tier of local government in the interest of efficiency. The MCs and DCs
are in a better position than the provinces to evaluate the detailed basic-service needs and
constraints of local communities. This direct distributive mechanism also implies a
greater level of accountability to the electorate than at the provincial level.

**3) Tax Effort:** The national government can design the grant system to stimulate local
government to find ways to increase tax effort. Although theory does not provide a clear
answer, it suggests that this can be done by incorporating measures of tax effort into the
allocation formula, either directly or in the form of matching grants. The direct method is
not widely used due to the conceptual and empirical problems associated with measuring
tax effort. The efficiency gains from the matching method have to be weighed against
the disadvantage of it being counterproductive to the goal of regional equity (most of the
recipients might end up being wealthy municipalities who can most likely match the
grant). South Africa faces the problems -- lack of data at the local level and differential
fiscal capacities of municipalities -- associated with both methods.

**4) Grant-Loan Linkages:** The national government could develop a system of grant-
loan linkages in order to improve the overall effectiveness of infrastructure financing. A
grant-loan linkage would encourage efficient resource use under the assumption that
revenue-generating infrastructure should be financed by loans at an interest rate that
reflects the cost of capital. By encouraging municipalities with greater borrowing
capacity to rely more heavily on loans and/or municipal bonds, the national government
would be able to free up limited resources for less creditworthy municipalities (assuming that an appropriate institutional environment for such activities would develop). It could consider redesigning the capital-transfer system to include such a system of grant-loan linkages.

7.3 ELEMENTS OF AN IMPLEMENTATION STRATEGY

The preceding section reviewed the major issues concerning the design of fiscal decentralization in South Africa. I now turn to the often-neglected implementation strategy. Litvack, Ahmad, and Bird (1998) point out that, although analysts have paid some attention to institutional issues in recent years, they have focussed on the design of economic policies, with little regard for how they may be implemented in very different institutional settings. Bahl and Smoke (1998) voice the concern that the design of decentralization reform programs typically suffers due to inadequate attention paid to their implementation strategy.

Attending to these concerns, I outline a strategy for implementing my recommended decentralization reforms. I first examine the political, institutional, legal, and capacity constraints that South Africa faces; then suggest ways to overcome them; and, correspondingly, prioritize reforms.

7.3.1 Key Constraints With Regard to Implementation

South Africa faces four key constraints in implementing its decentralization reform: (1) the transitional nature of the structure of local government; (2) lack of coordination among actors involved in the process; (3) lack of capacity at the local level;
and (4) lack of a legal framework and enforcement authority. I next discuss the challenges with regard to each of these constraints and make recommendations for meeting them. (See Table 7.1 for summary of constraints, challenges, and recommendations.)

7.3.1.1 Transitional Nature of Local Government Structure

All local government structures are considered transitional until the new elections in the year 2000. As noted earlier, the Constitution provides the major impetus for the restructuring of local government. The Local Government Transition Act (1993) furnishes the legislative framework for interim measures for this restructuring through two phases -- pre-interim and interim -- that have already been completed.

The post-interim (and final) phase -- not covered by the LGTA -- deals with system redesign and implementation issues. This phase poses a major political challenge for policy-makers attempting to revise arrangements that have been approved in the earlier two phases. They have two choices: (1) accept the interim arrangements in the LGTA and leave the structure undisturbed; or (2) work around the interim arrangements through ingenious policies that will gain political acceptance.

Given the problems with the existing arrangements -- the lack of fiscal and administrative capacity in newly created municipalities and the unstable fiscal situation in municipalities that are amalgamations of formerly racially segregated units -- the first option is untenable. The White Paper on Local Government (1998) equips policy-makers with a starting-point for the second alternative. It acknowledges the above-mentioned problems and calls for the reform of the current local government structure. In order to
### TABLE 7.1

**TOWARDS AN IMPLEMENTATION STRATEGY: CONSTRAINTS, CHALLENGES, AND RECOMMENDATIONS**

<table>
<thead>
<tr>
<th>CONSTRAINTS</th>
<th>CHALLENGES</th>
<th>RECOMMENDATIONS</th>
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<tbody>
<tr>
<td>Political:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transitional nature of local government structure</td>
<td>Revise interim arrangements through policies that will gain political acceptance</td>
<td>Use White Paper on Local Government as a starting-point for policy reform. Achieve consensus among spheres of government</td>
</tr>
<tr>
<td>Institutional:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lack of coordination of actors involved in decentralization</td>
<td>Reduce interministerial and intergovernmental competition</td>
<td>Form decentralization task team to ensure coordination between spheres of government. Coordinate donor efforts through a central agency. Involve local government professional associations</td>
</tr>
<tr>
<td>Capacity:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Poor administration</td>
<td>Train local personnel who have limited education or background in fiscal issues</td>
<td>Identify municipalities most in need and target training and technical assistance programs to them. Furnish suitable incentives, such as bonuses, to those responsible for managing the system</td>
</tr>
<tr>
<td>Inadequate leadership and insufficient civic involvement</td>
<td>Encourage better revenue collection</td>
<td>Foster community involvement to improve local accountability</td>
</tr>
<tr>
<td>Legal:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Lack of legal framework and enforcement authority</td>
<td>Produce clear legal and regulatory framework</td>
<td>Develop a framework of principles for user charges, for municipal service partnerships, for monitoring the financial position of municipalities, and setting rules for intervention</td>
</tr>
<tr>
<td>Assign legal enforcement authority for revenue sources</td>
<td>Empower municipalities with legal enforcement authority to apply credit-control measures</td>
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**Source:** The author
gain political acceptance for this reform, it is crucial that the national, provincial, and local government agencies involved in the decentralization process achieve consensus. This leads directly to the institutional constraint described next.

7.3.1.2 Lack of Coordination of Actors Involved in the Decentralization Process

A related constraint pertains to the uncoordinated institutional arrangements among the different stakeholders in the decentralization process. The implementation strategy for this decentralization involves all governmental sectors -- national, provincial, and local. In addition, it includes donor organizations, such as the U.S. Agency for International Development (USAID), Gesellscaft fur Technische Zusammenarbeit (GTZ), and the World Bank, that provide technical assistance; and civic associations, such as Congress of South African Trade Unions (COSATU), National Economic Development and Labor Council (NEDLAC), and South Africa National Civics Organization (SANCO), that monitor government policy and performance. Coordination among these various actors would facilitate a smoother path for decentralization efforts.

Smoke and Lewis (1996) highlight three key challenges that Indonesia faced in its decentralization efforts: (1) reducing interministerial competition; (2) resolving competing donor interests; and (3) assuaging central mistrust of local governments. Although the origins of Indonesia’s decentralization reform efforts at the time of their writing differ from those in South Africa, the former being primarily donor driven and the latter largely internally driven to redress the apartheid legacy, strong parallels exist in the main challenges facing them. I will, thus, use these to discuss the institutional challenges in South Africa, because, with some modification, they all apply very well to this case.
(1) Reducing Interministerial and Intergovernmental Competition

Historically, several national and provincial ministries have been involved with local government in South Africa. The various sectoral ministries, such as the Department of Water Affairs and Forestry (DWAF), Department of Land Affairs (DLA), and Department of Housing (DOH), were primarily engaged in providing services to the municipalities. In each province, the Ministry of Housing and Local Government (MHLG) was mainly concerned with coordinating the efforts of the various national sectoral ministries and determining the allocation of intergovernmental transfers to municipalities. The Department of Finance (DOF) was primarily involved with monitoring municipal budgets and determining transfers to the provinces for redistribution to municipalities. The Ministry of Constitutional Development and Provincial Affairs (DCD) had (and still has) the mandate of ensuring coordination among the various ministries.

These relationships have become blurred now that the Constitution considers municipalities an autonomous sphere of government and no longer a creature of provincial government, and there is no clear understanding of what this implies. For example, the various provincial MHLGs are unsure how to relate to the primary municipalities who now possess well-defined revenue-raising powers and no longer depend on the provincial government for revenue.

In fact, the national government now distributes the intergovernmental operating transfers directly to the municipalities. However, it still channels the capital transfers through the provincial MHLGs. Although the MHLGs could still play an important role
in coordinating the sectoral ministries at the provincial level, they face increasing resistance from municipalities to be accountable to them.

The DOF, in turn, has new fiscal-decentralization priorities: rationalizing the system of intergovernmental transfers, trying to get municipalities to be less reliant on transfers through developing a framework for municipal borrowing, and strengthening local revenue sources. At the same time, the DCD is responsible for implementing the intergovernmental transfer system and is also trying to strengthen local revenue sources. The various sectoral ministries, such as the DWAF and the DLA, seem to view decentralization as nothing more than deconcentration, i.e., strengthening the power and capacity of their field offices, while limiting the role of municipalities (mainly rural to whom they provide services on an agency basis) to that of project partner.

The DCD plays a role in coordinating these various competing interests by chairing task teams involved in national programs aimed at strengthening local government. These include the Municipal Infrastructure Task Team (composed of various sectoral ministries responsible for the provision of bulk and connector infrastructure services to municipalities) and the Municipal Service Partnership (MSP) Task Team (composed of representatives from the various sectoral ministries, the DOF, DCD, organized local government, and organized labor). The DCD should do the same for the various other reform initiatives concerning local government structure, revenue sources, intergovernmental transfers, and capacity building.

In this regard, the national government could establish a decentralization task team (similar in composition to the MSP Task Team but with a broader agenda) first to chart a broad decentralization strategy (that I recommended in Chapter 4) and then to deal
with each of the reform initiatives. The Office of Policy Co-ordination and Advisory Services (OPCAS), located within the Office of the President, could chair such a team. This recently established office has the mandate of promoting the alignment of key government policies, programs, and institutions of delivery.

Some researchers (Cohen and Peterson, 1995; Rondinelli, 1990) question the effectiveness of such task teams. They argue that such efforts have usually been based in a ministry that is considered a rival by other ministries whose cooperation is needed for success.

My recommendation for such a team in South Africa has a couple of features that distinguish it from these other efforts and contribute to its possible effectiveness. First, the other government ministries view the OPCAS as an impartial ministry. Second, because the members of the task team include representatives from organized labor, the government ministries are more likely to take a position based on greater consensus among them during deliberations. I have observed this at several meetings of the MSP Task Team between June 1998 and January 1999.

One must remember that reaching such a consensus is not an easy matter. The different ministries have had a long history of rivalry in terms of pursuing their own agendas and they will take time to begin coordinating their efforts.

(2) Resolving Competing and Contradictory Donor Interests

Although the South African decentralization initiative is not donor driven, donors play a large role in providing technical assistance to the various ministries. USAID, the World Bank, GTZ, and other international agencies all currently participate in one or other of the decentralization reforms.
In South Africa, particular donors have established client relationships with the DOF or DCD or the various sectoral ministries to provide technical assistance on intergovernmental transfers, MSPs, municipal debt, capacity building, and so on. These relationships can reinforce tendencies for these ministries to specialize and compete with one another. For example, two separate teams working on intergovernmental transfers -- one funded by the United Kingdom government and the other funded by the World Bank -- visited the Financial and Fiscal Commission (where I was working) in 1997. The former team was based at the DCD and the latter at the DOF. Each was unaware of the other’s existence until we brought it to their attention.

In addition, contradictory interests within different divisions of a particular donor agency create similar problems. For example, between November 1998 and January 1999, there were two USAID-funded teams: one working with the DOF on municipal borrowing, and the other with the DCD on intergovernmental grants. These teams did not interact with each other. If they had, they might have been able to share their ideas and make some recommendations on cross-cutting issues, such as grant-loan linkages.

In both cases of competing and contradictory donor interests, various “missions,” working on related reform initiatives, visit the country at the same time and do not even know of the other’s existence, let alone liaise with one another. Under these conditions, implementation of integrated decentralized planning becomes very difficult to accomplish.

It would make more sense if some central agency, like the OPCAS, coordinated donor assistance so that interrelated donor projects can have a more effective impact. As is the case with coordination of ministries, donor coordination is not easy. The OPCAS
could facilitate this by creating a forum or developing a series of seminars where the
donors could meet with the different agencies involved in the decentralization reform to
provide information on current and proposed projects. These interactions would serve to
acquaint the different agencies with the various technical assistance efforts and could
help create an environment for sharing ideas and working together on interrelated
projects.

(3) Assuaging Central Mistrust of Local Government

My conversations with both national and local government officials indicated that
the various national government ministries -- especially the DOF, DWAF, and DLA --
are very wary of the level of responsibility that municipalities can handle. Some of this
mistrust results from the fact that the municipalities have historically been under the
direct control of provincial government (which has always been tightly controlled by the
national government), and some of this derives from the need to maintain central control
in the interest of overall macroeconomic stability.

The Institute of Municipal Finance Officers (IMFO) is a national professional
organization, open to all town treasurers who have an expertise in local government
finance, representing the interests of local government. It is responsible for policy
formulation and implementation on matters of local government finance. IMFO has
representation on different task teams, such as the Municipal Borrowing Task Team and
the Municipal Systems Bill Task Team. In addition, it is responsible for implementing
Project Viability -- an ongoing project to monitor municipal budgets. Through these
channels, IMFO can provide information to the national and provincial governments on
the existence and capabilities of fiscally and administratively responsible municipalities.
The South African Local Government Association (SALGA) was created to fulfill the Constitutional mandate of having representatives on the National Council of Provinces (NCOP).\(^{15}\) It consists of nine provincial associations, each of which has senior Councilors who represent the municipalities within each province. SALGA does not have any voting powers in the NCOP. It does have representation on the various interministerial task teams.

Tension, however, exists between SALGA and the various national ministries with regard to national versus local priorities. It is possible that allowing SALGA to participate more actively than before in decisions around decentralization reform initiatives could help to alleviate this tension (this tactic could, however, work in the opposite direction).

The DCD and the OPCAS could play a role in fostering more interaction between the ministries and SALGA so that the former can become better informed of local government’s position on various matters. Like IMFO, SALGA could also participate in collecting and providing information to the national and provincial governments on the ability of municipalities to handle increased responsibility.

7.3.1.3 Lack of Capacity at the Local Level

The White Paper on Local Government (1998) stresses the need for training and capacity building as an essential part of the strategy for municipal transformation (pp. 96 and 131). Most of the decentralization analysts who talk about capacity building at the local level (Cochrane, 1983; Rondinelli and Nellis, 1986; Smoke and Olowu, 1992; Dillinger, 1994; Smoke, 1994; Fiszbein, Campbell, et. al., 1995; Tendler, 1996) focus on

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\(^{15}\) NCOP is part of Parliament. By participating in the national legislative process, it ensures that provincial interests are taken into account.
capacity issues pertaining to: (1) poor administration; and/or (2) inadequate leadership and insufficient civic involvement. I analyze the major challenges pertaining to each of these constraints and recommend how South Africa could develop a comprehensive strategy for developing local government capacity -- a top priority.

(1) Poor Administration: The major challenges are: (1) training local personnel and developing their experience in technical and managerial skills; (2) encouraging better revenue collection; and (3) assigning legal enforcement authority for revenue sources. These factors manifest themselves in poor financial management (ability to construct proper and realistic budgets and financial statements); poor credit control (ability to render monthly accounts to all consumers, keep proper records of outstanding debtors); inability to apply proper credit control measures (such as cutting off electricity or water); and inability to provide basic services effectively.

Project Viability has done a fairly good job of identifying municipalities with financial-management and credit-control problems, and targeting training and technical assistance programs to them. In addition, the national government should place more emphasis on performance incentives (e.g., bonuses to those responsible for managing the system to encourage better revenue collection), support for improved service delivery (e.g., by providing training and technical assistance for project-proposal and investment-plan preparation), and legal enforcement authority for non-payment of taxes or user charges.

The national government should also develop suitable guidelines for monitoring and oversight of the fiscal activities of local government in order to foster accountability and encourage efficiency. In this regard, one must remember that a balance needs to be
struck between fiscal autonomy of local government and monitoring by higher levels of government to ensure macroeconomic stability and local efficiency.

(2) Inadequate Leadership and Insufficient Civic Involvement: Fostering widespread community involvement represents a major challenge for increasing the demand for local capacity development, and increasing capacity itself. This would enhance local accountability and encourage responsible leadership. In Italy, good regional governments were found where civic society was most developed, leading to the notion that a robust civic society is a prerequisite to good government (Putnam, 1993). In Brazil, improvements in local government were attributable less to decentralization than to a three-way dynamic between local government, civic society, and a very active central government (Tendler, 1996). In Colombia, widespread community participation (voicing demands, making choices, being involved in projects) increased the range of possibilities open to municipalities and provided the basis to sustain local government capacity over time (Fiszbein, Campbell, et al., 1995). These findings suggest that civic involvement can encourage local accountability and provide an additional basis for sustainable development of local capacity.

The South African government appears to recognize this need for civic involvement: “Without the capacity to strategize, integrate, and interface with non-municipal groups and interests, innovative new approaches to the traditional functions exercised by local government administrations are unlikely to be sustainable.” (DCD, 1998, p. 102). Accordingly, municipalities could develop (1) mechanisms to ensure more regular consultations with constituents (to identify service needs and priorities as well as community resources that can be channeled for development needs); and (2) stronger
channels for monitoring the satisfaction of users of local services (by capacitating frontline workers who interact with communities on a daily basis so that they can correctly assess, communicate, and respond to service needs).

It is clear that implementation issues with regard to capacity building are highly interdependent and should be considered as an integrated package in order to achieve significant results. Facilitating civic involvement, for example, will not by itself make municipalities more responsive to service-delivery needs if they do not have sufficient revenue or managerial capacity to provide basic services. Too often, national government policy or donor assistance concentrates on one specific aspect of reform, neglecting how it fits in with other aspects.

The South African government should, therefore, adopt a comprehensive strategy that considers all the above aspects of capacity building, and phase it in over time. It could start by identifying which of these aspects need to be developed in the different municipalities. It could do so by broadening the scope of Project Viability, which currently only concentrates on the financial condition of municipalities. It could also utilize local government associations, such as IMFO and SALGA, for this purpose. Some municipalities, for example the MLCs and certain urban LCs, have fairly well-developed managerial capacity but may need assistance with civic participation. Others, such as the rural LCs, are lacking in all these aspects, and reforms could be phased in over a reasonable time frame, beginning with the simpler and less bureaucratically contentious ones.
7.3.1.4 Lack of Legal Framework and Enforcement Authority

Although South Africa possesses an enabling environment for municipal authority to raise revenue through the Constitution, it lacks a proper legal framework for specific revenue sources. For example, the functioning of municipalities crucially depends on the issue of tariff structuring for user charges -- a local revenue source most directly tied to expenditure requirements. The national government should, thus, develop a framework of principles, which would serve as a guide for all municipalities, to determine tariffs for basic services.

The “culture of non-payment” for municipal services (used as a political tool in the townships during apartheid) contributes to poor collection in some municipalities. The national government’s Masakhane campaign -- an attempt to educate the citizens to pay for services -- has met with limited success. It should give more thought to empowering municipalities with the required legal enforcement authority to apply credit-control measures, such as cutting off electricity or water supply.

The Constitution also provides the national and provincial governments with legislative and executive authority to regulate the performance of municipalities. Project Viability enables the identification of municipalities in financial trouble. The national government should, however, go a step further and provide a clear enabling legal framework for intervention by provincial and, if necessary, national government.

One must acknowledge that the national government has made a concerted effort to develop an enabling legal environment for certain aspects of the decentralization process. It has solicited donor assistance for developing a legal and regulatory framework for property tax reform, for municipal borrowing, and for municipal service
partnerships. In this regard, I reiterate the need for a central agency to coordinate the donor assistance in all these endeavors in order to increase the chances for their success.

I also stress the need for caution -- it is not unusual for well-meaning policymakers to push for laws and constitutional interpretations so that the policies they recommend can be implemented quickly. Herein lies a danger in that these hasty decisions can actually complicate the implementation process -- a case in point is the contradiction raised by the national government’s interpretation of the equitable-share transfers as unconditional.

7.3.2 Prioritization of Reforms

In the previous section, I have discussed the various implementation constraints that South Africa faces and suggested ways to overcome them. I now take these into account to recommend an implementation strategy that prioritizes reforms.

Bahl and Smoke (1998) draw on their experience to warn that local revenue reforms that are not conceived as part of a larger fiscal system are unsustainable. In addition, many well-researched and normatively desirable reforms are never implemented because they do not garner sufficient political support from the concerned stakeholders and too much is done too quickly.

South Africa should be particularly mindful of these issues in the wake of a strong political motivation by the government to decentralize and produce visible results. The process of restructuring of intergovernmental fiscal relations -- mandated by the Constitution and aided by policy documents, such as the White Paper on Local Government -- should be carefully thought through and prioritized in order to maximize
its chances for adoptability and sustainability. (See Table 7.2 for summary of steps in a strategy for implementation).

The first priority is to achieve some sort of consensus on a broad decentralization agenda, given the various tensions, described in Section 7.3 above, among the different stakeholders (the DOF, DCD, national sectoral departments, provincial ministries, NGOs, municipalities, donors, and organized labor) involved in local government in South Africa. I have recommended above that this could be initiated through the creation of a decentralization task team, coordinated by the OPCAS.

Once again, I reiterate that this consensus-building is not an easy task. The difficulties relate to the fact that each of the different actors has a different goal and is focused on a different part of the picture with regard to decentralization issues. Once the task team reaches some sort of broad consensus, it can pay attention to specific policy reforms that should be designed in a manner that ensures broad acceptance and provides a strategy for implementation.

In Chapter 2, I emphasized the fact that the structure of local government is inextricably linked to its service responsibilities as well as its fiscal and financial powers. Any reform strategy should, therefore, consider the reform of the existing structure in conjunction with the reform of service responsibilities and revenue sources. Although all municipalities are conferred the same powers by the South African Constitution, they have very different fiscal and administrative capacities in reality. Thus, when implementing a reform strategy, the national government should take these differences into account.


<table>
<thead>
<tr>
<th>STEP</th>
<th>ACTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Achieve consensus on broad decentralization agenda</td>
<td>Form decentralization task team, coordinated by OPCAS</td>
</tr>
<tr>
<td>Prioritize reforms based on agreed criteria</td>
<td>Decentralization task team decides on criteria and prioritizes reforms in the context of agreed-upon decentralization agenda</td>
</tr>
<tr>
<td>Phase in reforms gradually so as not to overwhelm local government capacity</td>
<td>Utilize local professional organizations, like IMFO and SALGA to identify municipalities with specific constraints and target specific training and technical assistance programs to them</td>
</tr>
<tr>
<td></td>
<td>Coordinate donor assistance through OPCAS</td>
</tr>
<tr>
<td>Develop system for evaluating local capacity and performance</td>
<td>FFC develops evaluation system</td>
</tr>
<tr>
<td></td>
<td>National and provincial governments conduct actual evaluation</td>
</tr>
<tr>
<td>Develop incentive structures for municipalities to comply with informational requirements</td>
<td>DCD could make timely submission of quarterly reports and statements a condition for future receipt of CMIP allocations</td>
</tr>
<tr>
<td>Foster accountability through civic participation</td>
<td>Involve constituents in determining service needs and priorities</td>
</tr>
<tr>
<td></td>
<td>Explore options with regard to use of community resources as a viable option for municipal service partnerships</td>
</tr>
<tr>
<td></td>
<td>Develop channels for monitoring satisfaction of users of local public services</td>
</tr>
</tbody>
</table>

**Source:** Based on Smoke (1999a).
For example, when dealing with the reform of the property tax, the national government should recognize that, even though the general problem is one of broadening the base, the specific problem in some municipalities is the inability to render bills or to enforce collection. Thus, the focus should be different for different municipalities -- for some, it should be updating valuations whereas for others, it should be building local technical capacity. As mentioned earlier, the national government could solicit the help of IMFO and SALGA to identify the different types of problems faced by the various municipalities and, accordingly, apply differential technical assistance strategies to them.

The national government needs to recognize that strengthening local government capacity is a top priority in South Africa. If municipalities are unable to perform the essential administrative functions in terms of financial management (preparing budgets and financial statements) and credit control (rendering and collecting bills), they will not be very successful in implementing any of the local revenue mobilization reforms.

I have stressed the importance of linking local revenue reform to local expenditure requirements. We have seen in Chapter 4 that local revenues cannot meet South Africa’s basic service needs in the short run. The national government should, thus, conduct detailed studies on the cost of basic service provision in both rural and urban areas so that it can accurately determine the shortfall between revenues and expenditures. These need not preclude immediate reforms of crucial local taxes; rather, they should go hand-in-hand.

As discussed in Chapter 5, the shortfall can be met by reducing expenditure, mobilizing local revenues, or making intergovernmental transfers. Given that the national
government has prioritized meeting the backlogs in service provision caused by apartheid, a reduction in expenditure is not feasible. Local revenue mobilization is part of a broader reform strategy that will take time to operationalize. Intergovernmental transfers will, thus, continue to play a crucial role in closing the fiscal gap in the short term.

The national government should prioritize local revenue reforms in terms of importance of the revenue source, political acceptability, and ease of implementation to ensure their chances of success. Thus, it should begin with the more essential, less contentious, and simpler reforms in the short term and phase in the less important, more disputatious, and complex reforms in the longer term. The decentralization task team is the best forum to decide on this prioritization, based on the overall agenda it adopts and the above-mentioned criteria (and any others that the team agrees are important for South Africa). Based on my analysis of the South African situation, I next suggest some recommendations for prioritizing reforms.

Because the national government (mainly DCD) and municipalities feel that property-tax reform is a priority, and given that it is the major source of municipal revenue, I recommend that its reform be a first priority. Because the RSC levy is another major source of municipal revenue and the national government is considering its abolition, I recommend its study as the second priority. The levy’s elimination is politically contentious because it is currently a major redistributional tool at the local level.
The reform of user charges -- the other major revenue source -- is also important both because it is directly tied to expenditure requirements and because it would reduce the dependence on intergovernmental transfers. As with the RSC levy, this issue is politically charged with regard to cross-subsidization of consumers by business and of poor consumers by wealthy ones. Thus, user-charge reform should be the third priority for the national government in terms of developing a framework of principles to determine tariffs for basic services.

The first step regarding these revenue reforms is developing a proper legal framework for each of these revenue sources. The South African government has made some progress in this direction -- it has drafted a property rates bill and is in the process of drafting a framework for tariffs. Once these have been formalized, municipalities will have an enabling legal environment to implement the proposed reforms. This, of course, is contingent on their being sufficiently capacitated meanwhile through targeted training and technical assistance programs.

Both the property tax and RSC levy revenue sources are closely connected to the reform of the intergovernmental transfer system. As part of a broader long-term strategy to get local government to become more self-reliant and exploit existing and potential revenue sources more fully, the national government should properly redesign and implement the present transfer system. If the national government legislates a nationally uniform property tax base, it would be able to determine municipal fiscal capacity and use it in the calculation of capital transfers. If it administers the RSC levy in the interests of interjurisdictional redistribution or replaces it with an alternative revenue source, it
would need to incorporate this option in the transfer system. Given that the RSC levy will remain intact in the short run, a longer-term reform option is a study of comparable sources of revenue, such as an equal yield share of value-added tax revenues, to replace it.

Another issue that the national government should study over the long run is municipal borrowing. Due to investor lack of confidence in the creditworthiness of most municipalities and lack of local technical capacity, it is an unviable option in the short run and has a lower priority on the reform agenda in terms of developing a proper regulatory framework. The national government could pursue a related longer-term strategy for grant-loan linkages in terms of redesigning the capital-transfer system to push municipalities with greater borrowing capacity to rely more heavily on loans and/or municipal bonds.

Although, as discussed earlier, both these issues are important from an efficiency perspective, the national government has decided to prioritize the equity objective of meeting the backlogs in infrastructure and service provision. It should, therefore, focus on this equity issue first and phase in efficiency objectives gradually. However, with regard to both municipal borrowing and grant-loan linkages, the national government should prioritize local technical capacity building. This would enable municipalities to develop proper budgeting and sound financial-management procedures so that they can establish creditworthiness.

In order to ensure their success and sustainability, care should be taken to phase in all these reforms gradually so that they do not threaten the power base of the national and
provincial governments in the course of increasing local autonomy. Another important factor governing sustainability is the linkage among the different reforms. For example, in improving the property tax system, the national government could assist municipalities with holding town meetings and informational campaigns to make it clear to constituents what they are paying for and get their support for the reform. It could directly link these efforts to the Masakhane campaign -- a national program aimed at ending the rent and service charges boycott carried over from apartheid days. The national government could also use the intergovernmental transfer system to develop incentives to get municipalities to mobilize more revenue than before from the property tax. In the process, it could focus on strengthening administrative capacity in those municipalities that are unable to perform the essential financial-management and credit-control functions. Thus, the national government could effectively link property-tax reform to governance reform, the reform of the intergovernmental transfer system, and capacity building.

The reforms should also be introduced in such a way that they do not overwhelm local government capacity. For example, the redesign of the capital transfer system to incorporate grant-loan linkages for financing infrastructure investment could focus in the short term on the creditworthy municipalities and build capacity in the weaker municipalities to encourage better fiscal discipline. This strategy would help the latter to establish creditworthiness so that they can then move towards credit financing in the medium to long term.

The national government should, thus, consider developing a system for evaluating local capacity and performance in order to target municipalities with weaker
fiscal and administrative capacity and poorer performance with a higher level of technical assistance (Smoke, 1999a). Shah (1997) argues that such a system is vital for oversight by higher levels of government and fosters local accountability. The Financial and Fiscal Commission (FFC) -- an independent statutory body charged by the Constitution with making recommendations on intergovernmental fiscal relations -- could develop such an evaluation system in South Africa. The national government would need to conduct the actual evaluation with the help of the provincial governments because they have the Constitutional mandate of monitoring and oversight of local government.

Some researchers (Litvack, Ahmad, and Bird, 1998; Shah, 1997) note that a proper incentive structure needs to be in place to encourage municipalities to comply with the information demands needed by higher levels of government for monitoring their performance. For example, the DCD could make the timely submission of monthly and quarterly reports on municipal spending of CMIP allocations a condition for future receipt of such capital transfers. As Smoke (1999a, p. 31) aptly puts is: “Decentralization reforms would be expected to work best if they are phased in with incentives, such that it is clear to local units what they have to accomplish before they will be assigned additional responsibility or resources.”

A final element in the strategy for implementation is to foster local accountability through civic participation (Smoke, 1999a). South African municipalities could involve constituents in order to determine service needs and priorities. They could also investigate the possibility of using community resources in providing these services. The national government is pushing an agenda of municipal service partnerships (MSPs) to
induce municipalities to seek other forms of support if they cannot provide particular services themselves. The focus of these MSPs is on involving the private sector in large-scale water-supply projects. Municipalities could consider other arrangements, such as partnerships with community-based organizations, for the provision of services such as refuse removal. They could also be responsive to the service needs of citizens by developing channels for monitoring the satisfaction of their use of local public services.

7.4 CONCLUSION

What lessons does my case study suggest for other developing countries that are either beginning or continuing a process of decentralization? On the one hand, South Africa presents a unique case in that its apartheid legacy makes its equity concerns a particularly striking and pressing issue. On the other hand, it faces constraints similar to other developing countries with regard to local resource mobilization, local capacity, and institutional and legal issues. Thus, a few broad lessons apply.

Holistic Approach to Decentralization Reform: My in-depth case study of South Africa demonstrates that it is important to look at the linkages among the different components of system design -- the structure of local government, its expenditure responsibilities, its revenue sources, and the system of intergovernmental transfers. The fiscal and financial powers of local government are inextricably connected to its structure as well as to its expenditure responsibilities.
Thus, in working on decentralization reform, countries should not treat these in isolation of one another. Rather, the “appropriate model” should be the one that is optimal from the structural, functional, and fiscal points of view.

**Significance of Context:** Furthermore, it is important to understand the impetus for decentralization even before examining the interrelationships among the various system-design components. In South Africa, this was motivated by strong political considerations. Thus, in countries where political concerns dominate economic concerns, it is important first to determine the level at which decentralized units are politically feasible in terms of their ability to represent the voice of the citizens.

It is then crucial to determine the level at which decentralized units can effectively serve their constituents. In this regard, the fiscal and administrative capacities of these units have to be taken into account. As in South Africa, there may need to be a level of political decentralization different from that of fiscal decentralization. The fiscal-federalism tenet of decentralizing to the lowest geographic level possible in assigning expenditure responsibility needs to be revisited and qualified by the differential fiscal and administrative capacities of municipalities.

**Public Finance Considerations:** The preceding discussion leads directly to the ability of municipalities to raise their own resources to meet their constituents’ expenditure needs. South Africa is no different from many other developing countries with regard to local resource mobilization constraints.

At the same time, the national government has exploited certain sources of revenue, such as the RSC levy, which could have interpersonal regressive effects. This is
because it is an important revenue source and a major intrajurisdictional redistributional tool.

The lesson to be learned is that, despite conventional public-finance wisdom about the regressive effect of certain taxes, practical and political considerations may dictate that they need to stay in place until they can be replaced by an alternative source of income.

Another lesson is that one needs to distinguish between interjurisdictional redistribution (which is regarded primarily as a national function) and intrajurisdictional redistribution. This distinction is particularly important in South Africa. Its apartheid legacy, which created huge disparities in wealth and in service provision across and within jurisdictions, calls for the MCs and DCs to play a redistributive role.

Thus, the particular circumstances of a country might necessitate a role for local government in intrajurisdictional redistribution to the extent feasible. In this regard, each country needs to weigh the tradeoffs between interpersonal inequity and intrajurisdictional redistribution. The debate on extending the property tax to rural areas in South Africa also provides a valuable lesson in terms of the tradeoffs between potential interpersonal inequity and interjurisdictional redistribution.

**Intergovernmental Transfers:** The discussion on intergovernmental transfers in South Africa also provides valuable lessons for policy-makers undertaking reform efforts. First, even though it has some flaws, the equitable-share formula has begun reversing the process of ad-hoc and inequitable allocations to municipalities. For political reasons and
because of the paucity of data for measuring fiscal capacity and expenditure need, the national government has begun with a relatively simple formula.

Many developing countries face these political and data constraints. Policy-makers should, therefore, start with simple formulae that are easily understood by politicians and move gradually towards including more elements that will improve the formula and make it more equitable and efficient. They could incorporate elements like grant-loan linkages after developing a proper legal and regulatory framework for municipal borrowing and establishing an enabling environment for municipalities to be able to borrow on the capital market. In many developing countries, the capital market is not sufficiently developed for municipalities either to issue bonds or to borrow from private financial institutions.

Second, in order to gain political acceptance and to mitigate against negative consequences for service delivery by suddenly reducing transfers to some municipalities, the South African government has made a decision to phase out the historically inequitable allocations slowly. Thus, if developing countries find that their existing transfer system is ad-hoc and inequitable, they should phase out historical allocations over time rather than radically change the system quickly.

This approach would avoid sudden interruptions in service delivery at the local level and sudden shocks to the system. This issue of phasing in reforms slowly is also a crucial element in an implementation strategy.

**Implementation**: In the previous section, I indicated that South Africa needs to pay careful attention to its implementation strategy for decentralization reforms in order to
increase their chances of success and sustainability. It should develop such a strategy in light of key constraints, such as the transitional nature of local government structure, lack of coordination of actors involved in the decentralization process, lack of local capacity, and lack of a legal framework and enforcement authority. In this regard, I outline a set of steps with specific actions to be taken (Table 7.2).

Thus, developing countries should first achieve consensus on a broad decentralization agenda. Second, they should prioritize reforms, based on agreed criteria. Third, they should phase in these reforms gradually so as to gain political acceptance and not overwhelm local government capacity. Fourth, they should develop a system for evaluating local government capacity and performance to identify the neediest municipalities and target training and technical assistance to them. Last, but not least, they should foster accountability by developing incentive structures for municipalities to comply with informational requirements and by encouraging civic participation.

Although the recommended actions are specific to the particular institutional, political, legal, and administrative context in South Africa, these steps are generalizable to other developing countries, who will need to develop their own action plan, based on their particular constraints.
APPENDIX 1

The Assignment Problem Defined

The assignment problem deals with the question of allocation of expenditure and tax functions to various levels of government (Shah, 1994). With regard to the former, the basic principles enunciated in the fiscal federalism literature for delineating expenditure responsibilities among member units in a federation (also applicable to unitary forms of government) relate to:

(1) Efficient provision of public services: Public services are provided most efficiently "by the jurisdiction having control over the minimum geographic area that would internalize benefits and costs of such provision" (Oates, 1972, p. 55). A decentralized system would ideally ensure a level and combination of public services consistent with voters' preferences, while providing incentives for the efficient provision of such services. In certain situations, however, as in the case of spatial externalities (when benefits and costs of public services spill over to nonresidents) or economies of scale (where cost-effective provision of certain services requires areas larger than a local jurisdiction) or administrative and compliance costs (where centralized administration may reduce such costs associated with financing certain public services), some degree of central control or compensatory grants may be warranted.

(2) Fiscal efficiency: If decision-making is decentralized, it results in differential net fiscal benefits (NFBs - imputed benefits from public services minus tax burden) being realized by citizens depending on the fiscal capacities of their place of residence (richer jurisdictions could provide a higher level of service at lower tax rates). Such differential
NFBs might encourage people to move to a resource-rich area, even though proper economic opportunities may not be available, resulting in an inefficient resource allocation. It is argued that central government should play a role in correcting such fiscal inefficiencies (Boadway and Shah, 1993; Boadway, Roberts, and Shah, 1994).

(3) Regional (horizontal) equity: Citizens with identical private incomes will be treated differently across different jurisdictions due to the fact that their after-tax income inclusive of NFB would differ according to their place of residence. It is argued that central government should play a role in dealing with these fiscal inequities (Buchanan, 1950).

(4) Provision of quasi-private goods: Public provision of such services as health, education and social insurance (which are essentially private goods by virtue of their technologies) is justified on grounds of equity. While central government's involvement is justified in order to ensure horizontal equity and minimum standards of service in all jurisdictions, such services would be better provided by subnational governments since benefits accrue mainly to residents of separate jurisdictions.
APPENDIX 2

Schedule 4

Functional Areas of Concurrent National and Provincial Legislative Competence

Part A

Administration of indigenous forests
Agriculture
Airports other than international and national airports
Animal control and diseases
Casinos, racing, gambling and wagering, excluding lotteries and sports pools
Consumer protection
Cultural matters
Disaster management
Education at all levels, excluding tertiary education
Environment
Health services
Housing
Indigenous law and customary law subject to Chapter 12 of the Constitution
Industrial promotion
Language policy and the regulation of official languages to the extent that the provisions of section 6 of the Constitution expressly confer upon the provincial legislature legislative competence
Media services directly controlled or provided by the provincial government, subject to section 192
Nature conservation, excluding national parks, national botanical gardens and marine resources

Police to the extent that the provisions of Chapter 11 of the Constitution confer upon the provincial legislature legislative competence
Pollution control
Population development
Property transfer fees
Provincial public enterprises in respect of the functional areas in this Schedule and Schedule 5
Public transport
Public works only in respect of the needs of provincial government departments in the discharge of their responsibilities to administer functions specifically assigned to them in terms of the Constitution or any other law
Schedule 4 - Functional Areas of Concurrent National and Provincial Legislative Competence

Regional planning and development
Road traffic regulation
Soil conservation
Tourism
Trade
Traditional leadership subject to Chapter 12 of the Constitution
Urban and rural development
Vehicle licensing
Welfare services

Part B
The following local government matters to the extent set out in section 155(6)(a) and (7):

Air pollution
Building regulations
Child care facilities
Electricity and gas reticulation
Firefighting services
Local tourism
Municipal airports
Municipal planning
Municipal health services
Municipal public transport
Municipal public works only in respect of the needs of municipalities in the discharge of their responsibilities to administer functions specifically assigned to them under this Constitution or any other law
Pontoon, ferries, jetties, piers and harbours excluding the regulation of international and national shipping and matters related thereto
Stormwater management systems in built-up areas
Trading regulations
Water and sanitation services limited to potable water supply systems and domestic waste-water and sewage disposal systems
Schedule 5

Functional Areas of Exclusive Provincial Legislative Competence

Part A
- Abattoirs
- Ambulance services
- Archives other than national archives
- Libraries other than national libraries
- Liquor licences
- Museums other than national museums
- Provincial planning
- Provincial cultural matters
- Provincial recreation and amenities
- Provincial sport
- Provincial roads and traffic
- Veterinary services excluding regulation of the profession

Part B
The following local government matters to the extent set out for provinces in section 155(6)(a) and (7):
- Beaches and amusement facilities
- Billboards and the display of advertisements in public places
- Cemeteries, funeral parlours and crematoria
- Cleansing
- Control of public nuisances
- Control of undertakings that sell liquor to the public
- Facilities for the accommodation, care and burial of animals
- Fencing and fences
- Licensing of dogs
- Licensing and control of undertakings that sell food to the public
- Local amenities
- Local sport facilities
- Markets
- Municipal abattoirs
- Municipal parks and recreation
- Municipal roads
- Noise pollution
- Pounds
Public places
Refuse removal, refuse dumps and solid waste disposal
Street trading
Street lighting
Traffic and parking
APPENDIX 3

Table 2. Conceptual basis of expenditure assignment

<table>
<thead>
<tr>
<th>Expenditure category</th>
<th>Responsibility</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Policy standards, and oversight</td>
<td>Prevention</td>
</tr>
<tr>
<td>Defense</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Foreign affairs</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>International trade</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Monetary policy, currency, banking</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Interstate commerce</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Transfer payments to persons</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Subsidies to business and industry</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Immigration</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Unemployment insurance</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Airports and railways</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Fiscal policy, regulation</td>
<td>F.S.L</td>
<td>F.S.L</td>
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<tr>
<td>Natural resources</td>
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<td>F.S.L</td>
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<tr>
<td>Environment</td>
<td>F.S.L</td>
<td>S.L</td>
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<tr>
<td>Industry and agriculture</td>
<td>F.S.L</td>
<td>S.L</td>
</tr>
<tr>
<td>Education</td>
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<td>S.L</td>
</tr>
<tr>
<td>Health</td>
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<td>S.L</td>
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<tr>
<td>Social welfare</td>
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<td>S.L</td>
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<tr>
<td>Police</td>
<td>S.L</td>
<td>S.L</td>
</tr>
<tr>
<td>Water, sewerage, refuse, fire protection</td>
<td>F.S.L</td>
<td>F.S.L</td>
</tr>
<tr>
<td>Parks and recreation</td>
<td>F.S.L</td>
<td>F.S.L</td>
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<tr>
<td>Highways, interprovincial</td>
<td>F</td>
<td>S.L</td>
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<tr>
<td>Provincial</td>
<td>S</td>
<td>S.L</td>
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<tr>
<td>Intraregional</td>
<td>S</td>
<td>S.L</td>
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<tr>
<td>Local</td>
<td>L</td>
<td>L</td>
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<tr>
<td>Sponsoring power</td>
<td>F.S</td>
<td>F.S</td>
</tr>
</tbody>
</table>

Note: F is federal responsibility, S is state or provincial responsibility, and L is local responsibility.

APPENDIX 4

The Combined Services Model (CSM), developed by the Palmer Development Group for the Development Bank of Southern Africa, is a predictive model of the expenditures and cash flows associated with the provision of six basic municipal services (water, sanitation, electricity, roads, stormwater drainage, and refuse removal) for residential consumers. It illustrates the basic tradeoffs between service levels, household bills, and subsidies. It is designed to assess the financial viability to municipalities of alternative residential infrastructure investment programs.

The model calculates the capital and operating costs associated with the investment program. Calculations are done on an Excel spreadsheet. The model consists of three sections:

(1) An interactive section in which essential information is entered and an investment program is designed. The user then sets annual increases in average household bills to meet specified targets on the operating account.

(2) The user enters as much information as possible to replace default values that are used in the absence of local information. This will affect the outputs in section 1, and it is likely that fine-tuning of decisions taken there will be necessary.

(3) Outputs are presented in greater detail.

In the first section, the user designs an investment program that caters for new consumer (household) formation and eliminates backlogs in service provision. The model then calculates the total capital expenditure requirements of the program. The
user then enters essential municipal income and expenditure information and the model calculates total recurrent expenditure.

In Section 2, users can enter area-specific information in place of the default values. Such information includes demographic and economic projections, capital account information (such as the composition of packages of services, the capital costs for internal services and bulk and connector infrastructure of the package components), current account information (such as marginal operating costs of the new services provided, base year residential operating costs by level of service), and constraints on the feasibility of the program (such as maximum monthly household payments by income category).

The output information includes numbers of service packages provided per year by level of service, annual capital-expenditure requirements, annual income and expenditure, annual operating-expenditure requirements, and summary sheets showing capital and operating-account information respectively.
## APPENDIX 5

### Table 6. Conceptual basis of tax assignment

<table>
<thead>
<tr>
<th>Type of tax</th>
<th>Determination of base</th>
<th>Collection and administration</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customs</td>
<td>F</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Corporation income</td>
<td>F</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Resource taxes</td>
<td>F</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Resource rent (property income tax)</td>
<td></td>
<td>S.L</td>
<td>S.L</td>
</tr>
<tr>
<td>Revenues, fees, charges, severance taxes</td>
<td></td>
<td>S.L</td>
<td>S.L</td>
</tr>
<tr>
<td>Production output, and property taxes</td>
<td></td>
<td>S.L</td>
<td>S.L</td>
</tr>
<tr>
<td>Conservation charges</td>
<td>F</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Personal income</td>
<td>F</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Wealth taxes on capital, wealth transfer, transfers, and benefits</td>
<td>S.L</td>
<td>S.L</td>
<td>S.L</td>
</tr>
<tr>
<td>Property</td>
<td>F</td>
<td>F</td>
<td>F</td>
</tr>
<tr>
<td>Multiple sales taxes (value-added tax [VAT])</td>
<td>F</td>
<td>F</td>
<td>F</td>
</tr>
</tbody>
</table>

### Single-stage sales taxes

- **Option A**
  - Higher compliance costs
  - Harmonized, lower compliance cost

- **Option B**
  - To combat global/regional pollution
  - Tolls on federal/provincial/local roads

### Consumption taxes

- **Federal**
  - Tolls on federal/provincial/local roads
- **State**
  - To correct local congestion

### Sales taxes

- **State**
  - State responsibility
  - State/property tax
  - Property-based taxes
  - Complete immovable factor: benefit tax
  - Complete immovable factor: benefit tax
- **Local**
  - Complete immovable factor: benefit tax
  - Cost recovery
- **Property**
  - Payment for services
  - Payment for services received

### Source:
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