South Africa
Local Government Financial Reform Project

Final Synthesis Report

10 September 2001

Furthering Local Government Fiscal Reform in South Africa: Issues, Choices and Challenges

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SA LOCAL GOVERNMENT FINANCIAL REFORM PROJECT:
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FURTHERING LOCAL GOVERNMENT FISCAL REFORM IN SOUTH AFRICA: ISSUES, CHOICES AND CHALLENGES

10 September 2001

1 INTRODUCTION

This report is the final output of the Local Government Financial Reform Project, which has provided inputs defined by a detailed Scope of Work (SOW) to the Department of Provincial and Local Government (DPLG) since January 2000. First, we analyzed expenditure needs and revenue capacity of a sample of Category B and C municipalities (non-metropolitan/Category A). Based on this work, we developed a preliminary framework for considering the division of responsibilities and revenues between the B and C municipalities (Task 4). Second, we identified options for reforming the Regional Services Council (RSC) Levy, currently an important revenue source for Category A and C municipalities (Task 3). Third, we helped DPLG improve the local government equitable share (intergovernmental transfer) formula, better understand the vertical and horizontal dimensions of the equitable share, and consider options for further developing transfers as the intergovernmental fiscal system matures (Task 2). Fourth, we helped DPLG take initial steps towards developing a comprehensive municipal database (Task 1). Finally, we drafted a framework paper on intergovernmental fiscal reform and provided advice to DPLG (on request) regarding various current policy issues.

The Project SOW provided in Annex 1 contains details on the project tasks. Separate detailed reports listed in Annex 2 were prepared on each task. Rather than simply summarize the details from the individual reports on our specific project tasks, this synthesis report places the project findings in the broader context of intergovernmental fiscal reform.

The project team would like to express our sincere appreciation for support and/or comments on the final report and other project outputs to DPLG, National Treasury, the Financial and Fiscal Commission (FFC), the Project Reference Group, the South African Revenue Service (SARS), the Auditor General's Office, the Municipal Demarcation Board, the South Africa Local Government Association (SALGA), and the participants at the various workshops held to gather feedback on draft reports. We are also grateful to USAID for their support and to the municipalities who generously cooperated with our work. The opinions expressed here are those of the authors and should not be attributed to any other party or agency.

2 BACKGROUND

Even prior to the election of Nelson Mandela as president in 1994 and the subsequent dismantling of apartheid, the Republic of South Africa had begun to restructure its public sector. This restructuring has intensified in recent years, with a focus on creating a more decentralized and democratic system of government. In undertaking reform, the country faces the special challenge of redressing enormous disparities—both political and economic—among jurisdictions that had long been subject to strict racial segregation and very different types and levels of public services and revenues.

The South African Constitution assigns functions to three spheres of government—national, provincial and local (municipal). This report focuses on municipalities and the important role that national and provincial levels play in municipal reform. Municipal service assignments by the Constitution include water, sanitation, roads, storm water drainage, and electricity. A few functions are assigned through legislation. Municipalities are also granted revenue sources by the Constitution, including property rates and surcharges on service fees, and they have the right to borrow, except to finance recurrent deficits. Other sources not prohibited by the Constitution may be allowed by national legislation. In addition, the Constitution entitles municipalities to an "equitable share" of national revenues and allows them to receive additional conditional or unconditional grants from the national or provincial governments.

The Constitution gives higher levels of government considerable oversight and control powers over sub-national governments. Assignment of some powers and revenues to municipalities is at the discretion of the center and, to an extent, the provinces. The center develops national objectives and guidelines and ensures adequate coordination among all levels. The center also designs and administers intergovernmental transfers. Finally, national and provincial levels monitor municipal affairs—and can intervene as necessary—to ensure that basic standards of good governance, service provision, and financial discipline are being met. The DPLG is the major central institution involved in local government reform, supervision, and assistance, but other key agencies, such as the National Treasury and various sectoral departments, also play important roles.

Since the adoption of the Constitution, several related laws have been passed or are under development. The Local Government Municipal Structures Act consolidated a complex system of urban and rural transitional governments into three municipal categories. Metropolitan councils (Category A) cover large urban areas. Local councils (Category B) cover non-metropolitan localities, which vary in size and degree of urbanization. District councils (Category C) geographically encompass several B councils, provide services to areas not served by A or B councils, and coordinate integrated development planning for the entire district. The districts also provide services on behalf of weak Bs situated within their jurisdiction. Municipalities were reorganized and consolidated in the year 2000 by an independent board set up under the Municipal Demarcation Act.

DPLG designed the Municipal Systems Act to regulate internal municipal arrangements, focusing on support of economic development and establishment of participatory mechanisms. In addition, it mandates reforms in human resource management and service delivery arrangements. DPLG is also working on a new Property Rating Bill that intends to expand and improve municipal property rates. The National Treasury has moved forward the Municipal Financial Management Bill, which includes provisions about municipal financial management systems, municipal debt, and monitoring municipal fiscal condition. Based on their successful experiences with the provinces, National Treasury has taken important concrete steps to improve the budgeting and financial management system and capabilities of municipalities.

The next section outlines critical framework issues and choices that need to be considered in advancing fiscal decentralization, particularly with respect to B and C municipalities. Sections 3-5 respectively deal with municipal service assignment, own-source revenue generation, and intergovernmental transfers. The last section summarizes key project findings and policy recommendations and considers implementation challenges. Throughout the report, we highlight what the project has learned and what remains to be done.

3 CRITICAL CHOICES AND SUPPORT MECHANISMS

In moving forward with developing an intergovernmental fiscal system, a number of key interrelated choices must be made about the structure and objectives of the local government system. At the same time, certain mechanisms are required to support the reform process.

3.1 Basic Decisions about System Structure

The most basic choice concerns *municipal functions*. The Constitution and various laws outline basic responsibilities of municipalities, but considerable elaboration is needed, particularly to accommodate the post-Demarcation transition. The functions of Category A municipalities are relatively clear, although decisions remain about desired levels and appropriate costs of basic services. Moreover, the situation will change as new policies, such as the regionalization of electricity distribution and the devolution of health, are implemented. Functional assignment is far less clear for Category B and C municipalities, which have widely divergent needs and capacities. A Municipal Structures Act amendment in late 2000 assigned responsibility for certain key (non-A) municipal services to the Cs, but it is widely recognized that some flexibility in assignment is needed to reflect the current realities of the South African system. The service assignment question is the focus of Section 3 and the Task 4 Summary Report, which analyzes and consolidates findings from multiple Task 4 reports.

The second important choice is how to raise *local sources of revenue* in a way that helps to match the benefits and costs of municipal services. Municipalities, as noted above, have access to a variety of local revenue sources. Category A and B municipalities use property rates, while category A and C municipalities have the Regional Services Council (RSC) levy, a combination payroll and turnover tax. All municipalities can charge for services, and many use certain charges like a tax. Several proposals have been set forth to reform existing municipal revenues, including changes to tax bases and administration. Depending on decisions regarding service assignments and implementation strategies, proposed reforms could also include sharing property rates with Category Cs and/or RSC levy revenues with Category Bs, so that the revenue bases of municipalities reflect the functions they are expected to undertake. Given considerable service demands on municipalities, adoption of selected new revenue sources, such as motor vehicle taxes, might also be considered. Finally, National Treasury is also placing considerable emphasis on increasing the capital market access of municipalities, at least fiscally stronger ones, so that they can play a greater role in financing their infrastructure investment needs. Options and issues regarding selected municipal own-source revenues are considered in Section 4 and the Task 3 Report.

The third important choice is how to design a transparent and stable *intergovernmental transfer system* that provides an appropriate mix between transfers and local revenues while meeting other key national objectives. As in most countries, municipal service costs in South Africa often exceed revenue capacity. The vertical fiscal gap has not been fully documented, but preliminary evidence is discussed below. To the extent a gap exists, a decision must be made about how to close it—by reducing service expectations, raising more local revenues, or increasing transfers. As noted above, the Constitution entitles local government to an "equitable share" of national revenues, and it also allows for the use of other transfers. The current equitable share formula is based on the recurrent financing of selected basic services for poor residents of A and B municipalities. Although it has served a useful purpose, the formula must evolve as the municipal fiscal system matures and there is greater clarity and development of expenditure and revenue assignments and capacities. National Treasury is also making great efforts to consolidate a complex and fragmented set of conditional capital transfers under a consistently structured system that creates proper incentives for good municipal fiscal behavior. Options and issues regarding intergovernmental transfers are considered in Section 5 and the Task 2 Report.

It is important to emphasize that these basic decisions about the intergovernmental fiscal system are interrelated, as reflected throughout the report. Service assignments should be based on municipal needs and capacities, and revenue assignments should be consistent with expenditure responsibilities. Intergovernmental transfers should help to overcome the typical gap between municipal expenditure requirements and fiscal capacities, as well as meet other national objectives. At the same time, key elements of both the expenditure and revenue systems need to work in harmony. For example, recurrent expenditures should be based on the operating requirements of existing infrastructure facilities, and intergovernmental transfers should not undermine incentives for municipalities to raise local revenues or to tap capital markets for investment resources if they are able to do so.

3.2 Critical Choices that Reflect System Objectives

Embedded in these decisions about expenditure and revenue assignments/levels and the structure of intergovernmental transfers are a number of critical choices related to broader system objectives. Throughout the report, we consider the implications of alternative policy options for these choices.

First, there is the question of the *desired degree of asymmetry* in treatment of municipalities. In a world where municipalities had similar needs and capacities, uniform fiscal treatment would be appropriate. In South Africa, however, there are many differences among municipalities in terms of settlement patterns, service needs, revenue access, and capacities to perform effectively. Less dense rural jurisdictions, for example, have very different needs than more urbanized areas. Equally important, some legally empowered Cs have weak capacity, while some legally subsidiary Bs have long been providing services independently of the Cs. Service delivery also has various dimensions, such as the distinction between capital investment and service operation, which can in some cases be managed effectively by different levels or types of local government if well coordinated. In addition, it is possible to separate service responsibility and service provision, where the latter may be done on behalf of municipalities by private agents or by community groups at the settlement level. Finally, it is critical to distinguish between desired service responsibilities and what is currently possible given capacity constraints. The rules and guidelines for service delivery arrangements, which are considered in Section 3, should take this substantial local government diversity, the multi-dimensionality of service delivery, and the gap between the desired system and present realities into consideration.

Second, there is the issue of the *extent and form of local autonomy*, which defines how genuinely decentralized the system is. This is a complex matter in South Africa, where the Constitution mandates universal provision of basic services and gives municipalities access to revenues, but it also requires the national government to share an untied portion of its resources with local government. In an ideal decentralized world where municipalities were capable and accountable to their constituents, there should be a high degree of autonomy in

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both local expenditure and revenue decisions, as there already is in Category A and some Category B municipalities in South Africa. Autonomous municipalities that fail to perform should be subject to the discipline of elections. Strong autonomy advocates might suggest that substantial universal autonomy could be granted now in South Africa if a transparent vertical revenue sharing arrangement was established and a hard budget constraint imposed on municipalities. Alternatively, a case can be made that in the present South Africa, where many municipalities are just learning how to deliver services effectively and to function in a democratic environment, weaker municipalities should meet certain standards before higher levels of local autonomy are allowed.

Third, there is the issue of the *desired degree and form of redistribution*, including the central and local policy measures for achieving it. The decision, for example, that certain basic services should be provided at a minimum level throughout South Africa means that poorer municipalities require assistance to fund these mandates. To some extent, redistribution can be funded locally, such that a portion of property rates collected from wealthier areas in any municipality can be used to finance basic services in poorer neighborhoods. There are, however, constraints on this approach. From a national perspective, wealthier municipalities will be more able to effect intra-jurisdictional redistribution than their less-well-off counterparts. From a local perspective, ratepayers in wealthier areas of a particular municipality will not have an unlimited political tolerance for subsidizing services in the former townships and rural areas. The way the national government structures municipal revenue sources and the intergovernmental transfer system will have substantial implications for the degree of redistribution that occurs and mechanisms through which it is realized.

3.3 Support Mechanisms for Designing and Implementing Fiscal Decentralization

In order to make these critical decisions about fiscal decentralization and to implement supporting policies, a number of structures and mechanisms must be in place. First, it is essential to develop an adequate *municipal information system*. Better information is needed about expenditure levels and needs, revenue levels and capacities, and fiscal performance. Understanding these matters better would allow the design of appropriately asymmetric treatment of municipalities in assigning responsibilities, measuring fiscal capacity, and targeting intergovernmental transfers and capacity building. A good information system would also give the national government and citizens a mechanism for continuously monitoring local government performance. Initial efforts to develop such a system in South Africa are covered in the Task 1 Report.

Second, the government needs *appropriate administrative and managerial structures and procedures* for effective local fiscal and governance management, some of which are broadly defined in the Municipal Structures Act and the Municipal Financial Management Bill. Both the DPLG and the National Treasury have made great progress in developing municipal structures and procedures, but there is still more work to be done.

Third, effective *capacity building mechanisms* are required, as many municipalities may be initially unable to undertake functions they are responsible for. In fact, the local government system is continuously evolving, as recognized in various capacity-building efforts undertaken to date. The national government, however, needs a more developed capacity building system with incentives for good municipal behavior to support the maturation of the system. In addition, national agencies themselves require capacity building in policy analysis and the skills needed to monitor and support municipalities as per regulatory requirements. Options for how to meet capacity building needs, including possible development of a municipal training institution, need to be explored.

Finally, mechanisms for *integrating and coordinating fiscal decentralization* are needed. As emphasized above, there are key linkages among major components of the intergovernmental fiscal system, responsibility for which is spread across a number of national agencies, including National Treasury, the DPLG, and various sectoral departments. In some cases, there are problematic divisions of responsibility within the same department. Given the great interdependencies among the components of municipal finance, coordinated action is critical.

The need for these various support mechanisms and suggestions for how to further develop them are discussed as appropriate throughout the report. The critical issue of capacity building, which provides one type of mechanism for implementing fiscal decentralization reform components in an integrated way, is discussed along with broader implementation issues in Section 6.

Having laid out key choices and mechanisms involved in intergovernmental fiscal reform, we now turn to what the project has learned about municipal functions assignment, municipal revenue enhancement, and further development intergovernmental transfers.

4 ASSIGNMENT OF POWERS AND FUNCTIONS

Among the key choices to be made as the government attempts to craft a system of effective local government, none is more critical than assigning municipal powers and functions. Without a well-defined set of responsibilities (particularly between B and C municipalities) and assignment of appropriate revenues to meet them, certain functions may be duplicated in some areas, whereas services may not be provided in others.

This section presents a basic framework for considering the assignment of municipal powers and functions. This is followed by a brief summary of the key empirical results from our project work that is relevant for evaluating how to deal with the assignment process. The section closes with a discussion of a number of alternative approaches to developing assignment arrangements. A fuller discussion of these issues is contained in the Task 4 Summary Report.

4.1 Framework for Analyzing Functional Assignments

Any policy decision is intended to meet certain objectives. Unfortunately, assigning powers and functions is complicated because a long list of objectives can be considered desirable, but some of them may lead to different conclusions regarding assignment decisions. Thus, the government must explicitly or implicitly prioritize its objectives.

Before considering possible objectives, two points should be noted. The first is that policy setting can take a short- or long-term perspective. A long-term perspective considers what the local government system should look like when it has matured, whereas a short-term perspective is concerned with what is feasible today. The advantage of the shorter-term view is that it focuses pragmatically on how to get the system working now, but a key disadvantage is that changing rules for assigning powers and functions at a later time can be difficult since some municipalities and political groups will lose power. Using a long-term perspective may reduce later political disputes, but a system based on prerequisites of a mature system is unlikely to succeed in the short run. A compromise is to define a system that initially focuses on realizing short-term achievements but is structured in a way that will allow it to "grow" into a mature system, a point to which we return later.

The second point is that finance should follow function, i.e., revenues assigned to a municipality should be consistent with its functional responsibilities, a basic principle of intergovernmental finance. Beginning with revenue assignment creates the risk of some municipalities having spending responsibilities that exceed availability of revenues whereas others may have excess revenue potential that can lead to wasteful spending.

A set of municipal functional assignment objectives was issued prior to the 2000 Amendment of the Municipal Structures Act by DPLG in its July 2000 Policy Framework for the Adjustment of Division of Functions and Powers between District and Local Municipalities. This contained the following objectives and principles:

- Equitable, efficient, affordable, economical and sustainable access to basic municipal services by all consumers;
- The placement of responsibility of providing municipal services as close as possible to the communities the services are meant to serve;
- Minimizing costs of services to consumers or customers;
- Achieving economies of scale in the delivery of services;
- Minimizing inter-jurisdictional spillovers;
- Benefiting the greatest number of residents;
- Causing the least disruptive effect on the current delivery of services;
- Promoting a safe and healthy environment;
- Promoting efficient, effective and accountable public administration;
- Promoting co-operative government; and
- Addressing the historical inequities in society.

These objectives are individually desirable, but they focus heavily on expenditure concerns. We would add the objective that local revenue powers should be assigned so as to link as closely as possible the revenue burden with the benefits of services financed from local taxes. The rationale for this objective is closely linked to the underlying argument for fiscal decentralization—those who bear the burden of locally mobilized revenues have a strong incentive to hold decision-makers responsible for ensuring that the revenues are well spent on locally demanded services.

The above list clearly contains redundancies, but more important, it presents difficult conflicts, such that any assignment of powers and functions will necessarily be able to achieve only some of the desired objectives. For example, keeping government as close as possible to communities suggests smaller (more numerous) jurisdictions, whereas achieving economies of scale and minimizing inter-jurisdictional spillovers suggest larger jurisdictions. Minimizing the disruptive effect on service delivery is likely to imply that jurisdictions currently supplying certain services should continue to do so.

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One particularly important objective of functional assignment is the need to take into account historical inequities, but this creates conflicts with other stated objectives. Redressing inequities implies a need for redistributive cross subsidies from those who historically benefited from government policies to the historically deprived. This is consistent with ability-to-pay equity, but it conflicts with the principle that payments should be in line with benefits received. It may also be non-sustainable if potential payers resist compliance because substantial portions of their local tax payments are benefiting others. Finally, for local revenues not directly tied to services, i.e., local taxes, the policy will tend to favor larger and more heterogeneous rather than smaller and more homogeneous jurisdictions, which puts municipalities at a greater distance from their constituents.

Given such tradeoffs, the government will ultimately need to decide which of its objectives are more or less critical. In our analysis, we attempt to make explicit the various objectives that are likely to be attained or ignored under a particular set of assignments. An alternative value set will likely lead to other recommendations.

4.2 Recent Fiscal Status of Municipalities and Future Needs

Since municipalities are currently in place, the decision regarding assignment of powers and functions should recognize their recent fiscal status. Furthermore, it is helpful to know the types of service challenges that will have to be dealt with if municipalities are to meet their Constitutional mandates. This subsection very briefly reviews highlights of the empirical work carried out in conjunction with this project in order to shed light on the task of assigning powers and functions.

Data gathered from a small national sample of former Transitional Local Councils (TLCs) and Transitional Rural Councils (TRCs) illustrate major differences in the fiscal activities of these two types of transitional governments.

- Approximately 70 percent of total TLC revenues in 1998-99 were derived from tariffs for electricity, water, sanitation, and refuse collection services. On a per capita basis these revenue sources amounted to approximately R1,200 per TLC resident.

- Property rates contributed another 12 percent or so of total recurrent revenues of the TLCs. Thus, the TLCs raised a substantial portion of their revenues from own sources and were not heavily dependent on intergovernmental transfers.

- Nearly all TRC revenues, on the other hand, were derived from transfers and, unlike the TLCs, few of their expenditures were for basic services.

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

Districts are also mobilizing local resources, primarily from the RSC levy. Other district revenues are derived primarily from intergovernmental transfers.

- Approximately 40 percent of total district revenues (including agency revenues) in 1998-99 were raised from the RSC levy. For districts outside the metros, RSC levy revenues averaged approximately R50 per person, but per capita district revenues ranged from about R5 to nearly R160.

- Nearly one-half of total district revenues in 1998-99 were allocated to grants for capital expenditures.

The project also undertook a three-district case study to determine how, prior to the creation of newly demarcated municipalities, powers and functions were divided between districts and former TLCs and TRCs. Although small, the sample was sufficiently large to indicate that current arrangements were far from uniform. Some districts restricted their efforts primarily to allocating capital investment funds to local municipalities, while others were actively engaged in the provision of some recurrent services. The assignment task must recognize this diversity that is already in place.

Another integral part of the project was a simulation of expenditure needs for the next ten years in three districts and ten new B municipalities based on simple assumptions regarding population growth, household basic service costs, and service levels. A comparison of the present system with how it might evolve in the future provides an important input into determining an appropriate division of responsibilities. This comparison also allows analysis of the relationship between local expenditure needs and revenue capacity, which suggests how intergovernmental transfer mechanisms will have to respond to newly created municipalities.

- A comparison of current tariff and property rate revenues with simulated operating expenditure needs in the first year of the projections for 10 new B municipalities revealed revenue shortfalls as low as 10–12 percent of revenues for more urbanized B municipalities. (One of the ten sampled B municipalities could meet projected operating expenditure needs with current tariff and property rate revenues.)

- Rural-based B municipalities, however, would need to nearly triple current revenues to meet the projected recurrent spending shortfalls. This is not surprising given the present urban bias of the local revenue structure.

The simulation analysis further suggests that, if basic potable water, sanitation, electricity, road, and solid waste services are to be provided to all residents over the next ten years, significant increases in both recurrent and capital expenditures will be necessary. In addition to tariffs, rates imposed on property that is currently not a part of the tax base will help to meet those needs. Reliance on tariffs, however, may be at least partially limited by the new free basic services policy and poverty, and it is unlikely that rates will be a significant revenue source in the near term since developing property taxes is costly and time-consuming. Limited empirical analysis of current property rates in urban areas, however, suggests that it is possible to attain an effective property tax rate (collections relative to market value of land and improvements) of at least one percent. Jurisdictions with a lower rate were practicing poor administration, such as undervaluing property and undercollecting property levies.

The final analytical effort with direct implications on the assignment of revenue powers and expenditure functions focused exclusively on the capital spending needs projected from a district services simulation model. Even though our project had no mandate to focus on infrastructure finance, any realistic assignment process cannot ignore this key fiscal matter. Our simulations suggest that, given the current structure of the RSC levy, the tax could raise only 8 to 16 percent of projected capital costs required to meet five-year capital infrastructure investment targets. Again the government is faced with an important but critical choice – introduce new, more revenue-productive local tax instruments, enhance the flow of capital transfers to municipalities, or lower expectations concerning how soon basic services will be available to all South Africans.

4.3 Analysis of Alternative Assignments of Powers and Functions

The empirical findings of the project and the functional assignment objectives considered above allow us to evaluate several different alternatives regarding assignment of powers and functions to the B and C municipalities. The empirical results document that municipalities are highly diverse with respect to their economic and population bases, fiscal, managerial and technical capacities, and current service delivery performance. This suggests that, at least in the short to intermediate run, service responsibilities should be assigned asymmetrically, although it would be desirable to have default positions with exceptions made on a case-by-case basis. Fortunately, the Constitution (Section 155 (3) (c)) allows asymmetric treatment, but it does not provide clear guidance on the basis for imposing it.

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

- A service need not be provided by the legal "service authority." Authority means "the power of a municipality to regulate provision of a municipal service by a service provider." The provider may be any "person or institution or any combination."

- Various suppliers, including the public agency that is the authority, other public agencies, and private or non-governmental organizations, can be service providers, but each alternative arrangement will involve transaction costs.

- At least some public services and authority over them can be divided into their constituent parts. For example, some production processes consist of both bulk and reticulation activities that are separable, but this can be difficult and may involve nontrivial transaction costs.

- The B municipalities can be objectively categorized according to settlement pattern and economic base. We distinguish among three different types in our analysis—B1, containing a small city or large town as the economic core; B2, containing one or more small towns; B3, primarily rural or with scattered settlements.

- The menu of potential own-source revenues is limited to the existing set, namely the RSC levy, property rates (with a new statutory basis), and user charges.

- The RSC levy can, in spite of the original legislation, be used for both capital and recurrent spending within a district, which reflects current practice.

Our analysis considered four different arrangements for dividing powers and functions among the B and C municipalities. Briefly they include:

1. All powers and functions other than planning and capital infrastructure investments granted to the B municipalities, with the planning and investment function along with RSC levy revenue powers reserved for the districts.

2. B municipalities with large towns constituting their population/economic base having powers, functions and revenue bases comparable to the metros (Category A), with districts (Category C) retaining all service authority over all other B municipalities.

3. Districts retain all service authority and all local revenue powers while arranging with B municipalities to be local service providers on a case-by-case basis.

4. Asymmetric treatment of both municipalities and services, with the authority for some services assigned exclusively to the district, others assigned to a combination of the district and more "urban-like" municipalities, and service provision arrangements determined on a case-by-case basis. Districts would retain RSC levies.

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

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

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

The fourth option, unlike alternative 2, does not alter the current definition of B and C municipalities. It does, however, segment B municipalities into three mutually exclusive groups—B1, B2, and B3 municipalities (where the B1 are most highly urbanized and B3 are basically rural in nature)—to allow more fine-tuned assignment of individual service responsibilities. The Task 4 Summary Report considers each service separately and provides a detailed rationale for the service responsibilities summarized in Table 1. As shown there, the district would be the service authority for planning and would retain authority over local health services (to maximize coordination with the Health Ministry). For all other services there would be an asymmetric division of functions between the B1 (B municipalities with a large town or small city base) and the B2 and B3 municipalities. The district can, however, on a case-by-case basis according to a set of guidelines, negotiate with individual B2 and B3 jurisdictions to allow them to act as service providers. In particular, at least some B2s would likely be able to assume functional responsibilities similar to those assigned to the B1s.

Table 1:
Asymmetric Assignments by Service and Type of Municipality

	Type of Municipality			
Revenue Powers	C	B1	B2	B3
Tariffs		X	F	F
Property rates		X	F	F
RSC levy	X			
Equitable share grant	X*	X		
Capital grants	X**			
Expenditure Responsibilities				
Potable water	A*	A	P	P
Sewage	A*	A	P	P
Bulk electricity	A*	A		
Local health services	A	P		
Solid waste disposal	A*	A	P	P
Rural roads	A*	A	P	P
Fire fighting & emergency	A*	A	P	P
Planning	A			

X: Current revenue source
X*: Recipient of equitable shares grant allocated to the B2 and B3 municipalities
X**: Primary recipient of capital grants allocated across B municipalities
F: Revenue source that is likely to be available, but only in the future
A: Service authority
A*: Service authority in B2 and B3 municipalities
P: Service provider

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

What are the potential disadvantages of this approach? It makes assumptions that, if false, could frustrate implementation. For example, it assumes that all districts can take primary responsibility for many local services, which may not be true where districts' main recent function has been to allocate grants to the B municipalities. It also assumes that agreements between service authorities (districts) and service providers (B2 or B3 municipalities) involve minimal transaction costs, which is unlikely.

The revenue aspects of this alternative may also be problematic, particularly in the short run. Until property rates are implemented in previously untaxed areas, the more rural Bs will be strapped for revenues. Their only own-source alternative is service tariffs, but these can only be collected if service delivery facilities exist. Even where they exist, poverty and the emerging policy on free basic services may limit collection levels. If services are being delivered and tariffs do not cover recurrent costs, the equitable share can be designed to help, and some portion of the district RSC levy could be used if necessary. If B2 and B3 municipalities do not deliver services, their equitable share allocations will have to be channeled to the overlying C municipality (not unlike the equitable share to former TRCs). This arrangement could leave many B2 and B3 municipalities with no recurrent revenues to support even basic overhead expenditures. As this is likely to be politically unacceptable, rules will be needed to divide the equitable share grant between the district and B municipalities. It should also be noted that the use of a portion of the RSC levy to support recurrent spending would mean that less would be available to invest in new capital facilities throughout the district. Finally, as the RSC levy is the only local revenue source available to the C municipalities, increased administrative responsibilities at the district level will also have to be financed from this source unless additional grants are created.

Clearly, none of the four alternatives considered here is “optimal” in terms of being capable of achieving the full set of objectives desired by the government. We therefore repeat that hard choices need to be made, particularly concerning the relative priority of the various objectives that could be sought from assignment of powers and functions. At the same time, the fourth option may be the most reasonable next step given the current heterogeneity in B municipalities and the possible political infeasibility of further redefining basic local government roles in the near term. The fourth option pragmatically recognizes the current lack of capacity in many B municipalities. At the same time, it permits those Bs that are currently providing services to continue to do so (and to expand those services into their less urbanized hinterlands) with less disruption than the other alternatives.

This option, however, should be seen as an interim approach. A two-tier local system with asymmetric assignment of functions may be reasonable now; but transition must be considered if the eventual objective is to develop a more mature system similar the to ones embodied in alternatives 1 and 2. Assigning property rates to the B municipalities will enhance their fiscal independence, and capacity-building efforts can improve their administrative and technical skills over time, although it is possible that some weaker Bs might not be good candidates for capacity building in the foreseeable future. As capacities do develop, functions assigned to districts under Alternative 4 could be transferred to previously dependent B municipalities. Because districts may resist losing power, clear rules and incentives will have to be established to induce them to give up responsibilities and to redirect equitable share grants to B municipalities that demonstrate adequate capacity. In this view of the world, there is not a single, once-and-for-all assignment of municipal powers and functions, but there must be a relatively clear vision of where the system should be heading. The initial system would evolve over time, and revenue assignments and the structure of the equitable share transfer would develop with it.

5 MUNICIPAL REVENUES

Having discussed broader issues related to municipal powers and functions, we turn to more detail on revenue reforms. Three choices raised in the overview section are particularly important here—the degree of municipal autonomy in choosing tax rates and bases; the correct balance between local revenues and intergovernmental transfers; and the degree of asymmetry acceptable in assigning revenue-raising powers. Decisions on these policy choices are crucial, because they affect both the degree to which elected local councils are accountable to their constituents (for financial prudence and service levels/quality) and the degree of equalization present in the fiscal system.

This section begins by outlining principles for evaluating local revenue options and considering how well the present South Africa system meets them. We then consider possible reforms regarding a number of key existing or potential sources of municipal revenue. We focus on the RSC levy, the only tax specifically covered by the project. More detail on options for RSC levy reform is provided in the Task 3 Report.

5.1 Framework for Evaluating Revenue Options

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

A second guideline for choosing local taxes is that revenue base growth should match the growth of local service provision costs and help to reduce service level deficiencies. This will be difficult to accomplish in South Africa. The size of the revenue pool for equitable shares and conditional grants is determined by Parliament in an ad hoc way. This makes the long-run elasticity of transfers uncertain and suggests a need to develop an elastic local revenue base. Even if this can be realized, there will be great interjurisdictional differences in revenue base growth, especially between urban and rural municipalities. There is, however, some buoyancy in the revenue bases presently assigned to municipalities. The RSC levy and the property tax growth rates have been comparable to that of national taxes in recent years, and there is some evidence that the same is true of the electricity-trading surplus. However, reforms in all three of these local government revenue sources are presently under consideration, with uncertain implications for the overall elasticity of the local government revenue base.

Third, local government revenue choices should be made with full recognition of the great variation among municipalities in the ability to assess and collect local taxes. For many municipalities in South Africa, effective administration of modern income, consumption and property taxes is beyond reach. The staff skills and practical experience required for assessing and collecting these taxes are simply not in place. A number of the currently proposed reforms for property rates and the RSC levy will not take account of such differences in administrative and tax capacity, and some propose a uniform financing system for all municipalities. If uniformity is chosen, there is an urgent need to upgrade municipal administrative infrastructure, especially in rural jurisdictions.

Fourth, local government revenue sources should be structured so as to minimize disincentives to revenue mobilization. Moreover, municipalities should have the ability to increase revenues, if they choose, by increasing the tax rate. In this respect, grant formulae based on objective measures of need, matching grants, and grants that require minimum tax effort are good practice. Deficit (bailout) grants, grant formulae based on actual expenditures, and the absence of local taxing powers are less desirable practice in that they may not encourage increased tax effort by municipalities. The present system of local government finance in South Africa gets a mixed review on revenue incentives. On the one hand, the equitable share grant is based on objective measures of need and is distributed in a transparent way, and municipalities may adjust property tax rates and user charge levels without seeking central approval. On the other hand, bailout-like grants have been used by the national government, raising the moral hazard issue. Moreover, local governments are not allowed to raise the RSC levy rate, and legislation under consideration may circumscribe their discretion over the property tax rate.

The final guideline is that municipalities should not be given authority to levy taxes whose burden can be shifted significantly to residents of other jurisdictions. If the burden can be exported, then the taxing jurisdiction may overspend because its voters do not bear the full cost of local services. Payroll and property taxes, as well as user charges generally pass this test—those who bear their burden (workers, renters, and property owners) are generally local residents and service beneficiaries. Turnover taxes, income taxes on businesses, and income taxes on non-labor personal income do not pass this test. For example, consumers who live in other jurisdictions may ultimately pay gross business sales taxes because they are reflected in higher consumer prices. In South Africa, the biggest problem in this respect is the turnover tax component of the RSC levy. In the Task 3 Report, Category A municipalities (metros) are estimated to receive 58 percent of revenue from the turnover tax component of the RSC levy, but metro residents bear only 48 percent of the burden. Through tax shifting, residents of rural and smaller urban areas are financing part of the services provided in large metros.

5.2 Individual Sources of Municipal Revenue

5.2.1 The RSC Levy

The RSC levy is a revenue-productive tax that finances a significant share of the services provided by metro and district councils. It is levied at a flat rate on the gross sales and payrolls of businesses, with the turnover tax component accounting for about two-thirds of revenue. The base is set by the central government, and rates have been frozen by the central government since 1996.

Legal strictures have so flawed the assessment and collection of the RSC levy that it is doubtful that it actually taxes either gross sales or payrolls. It operates more like a donation by businesses to municipalities, which may neither issue an assessment nor examine the books of a company thought to be under-reporting liability. They may not penalize an outright delinquent, nor may they examine accounts of non-payers. Businesses simply declare and pay what they consider to be acceptable.

The six metros now account for about 55 percent of all collections. For smaller urban districts and rural districts, the RSC levy is not as revenue productive, but it is usually the dominant source, often accounting for as much as 90 percent of revenue. As only metros and districts have access to the RSC levy, changes in expenditure assignment between districts and B municipalities may necessitate a change in RSC levy revenue assignment, as discussed earlier.

The RSC levy in its present form fails most of the maxims for a "good tax." The pyramiding that characterizes the turnover tax component distorts final market prices and favors vertically integrated firms, while the payroll tax component offers a disincentive to employment in a labor-surplus economy. Neither the payroll nor the turnover component reaches the informal sector very well, indicating another source of horizontal inequity. On a more positive note, the cost of the administrative apparatus required to collect the present RSC is a modest two percent of revenues received. If those taxes that are legally due but not paid are included, however, collection costs are quite large.

The RSC levy accentuates the significant disparities in fiscal capacity across districts. Per capita collections range from over 1000 rand to less than 10 rand. On average, a 10 percent higher level of per capita gross product is associated with an 8.9 percent higher level of per capita collections. An equalizing grant will have to compensate for the counter-equalizing influence of the RSC distribution. This is yet another reason why the government needs to evaluate and reform the local revenue system in its entirety.

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

There are many reasonable options for RSC levy reform that meet one or more important goals. The right choice depends on what goals the government most wants to achieve, how it chooses to define municipal powers and functions, and what other sources of revenue are made available to municipalities. A particular issue is the level of government commitment to fiscal decentralization, i.e., to make municipalities more accountable by giving them independent taxing powers and imposing a hard budget constraint on them.

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

A second viable reform option, also a decentralization strategy, is a combination payroll tax and grant. The payroll tax would be levied by urban municipalities and would operate as described above. The grant would fund rural municipalities, and could be distributed like the present equitable shares grant. The cost to the central government would be relatively small. Under this asymmetric scheme, "rural" municipalities might at least initially include some weak Bs as well as the Cs. These weaker B municipalities could graduate from the grant to the tax when they meet clearly articulated conditions, such that grants would eventually go primarily to districts to fund services that could not be provided by the Bs. Under such an approach, the revenues raised locally will shift from districts to urban municipalities, assuming some similar shift in expenditure responsibility. This type of reform would clearly not be consistent with the assignment of more expenditure responsibility to the districts. Exactly what would happen to the equitable share under this approach would depend on the assignment of functions and the ability of the B municipalities to finance local services from the own-source revenues allowed to them.

If the government is less interested in emphasizing fiscal decentralization, then it could introduce a grant program to fully replace the RSC levy. This grant could be funded from a 1 percent add-on to the VAT rate (raising the overall rate to 15 percent), and could be revenue neutral. It could be distributed among municipalities on a derivation basis, but this would be counter-equalizing and would raise the issue of how to decide which district is entitled to what amount of VAT collections. This approach to revenue sharing would significantly advantage the metros and the urban districts. Alternatively, the grant pool could be distributed on an equalizing formula basis, in which case there would be an issue about how to close the revenue gap that would then face the urban municipalities. Either way, local councils would have no say in tax base or tax rate decisions.

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

5.2.2 Property Rates

By international standards, South Africa is a heavy user of the property tax. Moreover, municipalities in South Africa are given free reign in choosing the tax rate and the tax base. At present, some local councils tax improved value, some tax site value, and some levy a differential rate on land and improvements. The property tax is a revenue source available to the A and B municipalities but not the district councils.

Clearly, property rates should be a major source of local government revenue in South Africa. This tax passes the tests for a good local revenue source, though it does impose some significant administrative challenges. The major questions for the government to answer about this tax are how much of the local government-financing burden it should carry, and how adequate revenue growth can be assured.

Property rates will almost certainly be reformed. A bill under consideration by Parliament is now in its 11th draft, and the general outline of the new system is coming into focus. Two particularly important issues have yet to be resolved. The first is the degree of discretion municipalities will be given in choosing the tax base and rate. The second is whether municipalities will be allowed to tax property of other governments and give tax exemptions.

The latest draft of the bill suggests that the national government will exert more control over property rates in the future. The tax base might be mandated as uniform, i.e., a requirement that all municipalities tax the improved value of property. Another central restriction might be to cap the rate that can be levied. Reassessment may be mandated by national law and monitored, and there may be some prescriptions about the taxation of government property. While there are good arguments for some of these restrictions, they would limit the degree of local autonomy in taxing decisions.

5.2.3 A Tax on Utility Consumption

At present, many of the larger local authorities are heavily dependent on surpluses earned from the sale of electricity. Discussions now underway are likely to result in the removal of electricity as a local function, and as a result, the loss the present form of this source of local government revenue. The national government has indicated its intention to replace the lost revenue. Regardless of the outcome of current discussions about restructuring, careful thought must be given to the options for doing so.

One option is to enact a tax on electricity (and possibly water) consumption according to usage. There is much to say in favor of this option. It would give municipalities access to a large and growing tax base. It is equitable in the sense that consumers pay according to the benefits of services received. Such a tax would be easy to administer and have low compliance costs, requiring little or no additional record keeping. The proposed excise tax would also be relatively robust with respect to the changing governance structure of the utilities. The results of deliberations of the electrical industry as regards ring-fencing, ownership, appropriation of surpluses, or market territories would have little impact on the base of the proposed tax.

There are also drawbacks to this proposal. It can be argued that user charges on utilities impose a heavier burden (relative to income) on low-income versus high-income families. The result may be resistance to timely and full payment, although low-income people could be exempted or favorably treated. Estimates in the Task 3 report indicate that the ad valorem tax rate necessary to replace the trading surplus is between 5 and 10 percent. As in the case of all locally imposed taxes, revenues would accrue heavily to the higher income and more developed municipalities, highlighting the importance of including the revenues in any measure of municipal fiscal capacity. Finally, there is the issue of the correspondence between expenditure assignment and revenue assignment, i.e., which types of municipalities would be given authority to levy this excise tax?

5.2.4 Motor Vehicle Taxes

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

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

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

The national government may elect to adopt some or all of these revenue reforms. Whatever it decides, it must consider local sources not just individually, but as a group and in relation to expenditure needs, intergovernmental transfers, and borrowing capacity. In doing this, there are tradeoffs highlighted throughout the discussion that must be taken into account. Finally, there is a need to think about how to make the transition from the present system to a reformed one, a point to which we return.

6 INTERGOVERNMENTAL TRANSFERS

Having reviewed options for local own-source revenue generation, we now turn to the intergovernmental transfer system. As discussed above, the Constitution and subsequent legislation have given municipalities full or partial responsibility for the provision of a substantial number of services, some of which are considered basic rights. Municipal revenues allowed by the Constitution and legislation are expected to play an important role in the financing these services, but the Constitution recognizes that local revenues are unlikely to be sufficient to meet municipal expenditure needs. The Constitution thus specifies that local government is entitled to an equitable share of nationally raised revenue, which current legislation assigns to Category A and B municipalities.

In this section we first lay out a simple framework for thinking about the local government equitable share. We then take a brief look at the present system, analyzing its effects, strengths, and weaknesses. Finally, we consider how to improve the equitable share and how to approach the challenge of developing it for the longer term as the local government system matures. Local government will reach full maturity only after all municipalities have succeeded in providing all their residents with basic municipal services and have implemented a full set of local revenue instruments. Full details on our analysis of the equitable share are provided in the Task 2 Report.

6.1 Framework for Analyzing the Equitable Share

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

The Constitution points toward a system of unconditional local government transfers. The size of each municipality's allocation could be set equal to the minimum amount of money needed to perform functions assigned to it and provide basic services minus the amount of money it could be expected to raise from all major local sources at a minimum revenue effort. With the implementation of such a system, the equitable share would play a crucial role in guaranteeing that all South African municipalities would have sufficient resources available to them to meet their basic responsibilities without having to place extraordinary fiscal burdens on their residents.

To operationalize a system of transfers that can achieve this goal, it is necessary to have an objective and measurable indicator of the fiscal condition of each municipality. This indicator needs to measure both the costs of providing basic services and municipal ability (or inability) to finance them from local revenue sources. For this purpose, we propose the calculation of need-capacity (or fiscal) gaps, where the gap for each municipality is defined as the difference between its expenditure needs and its revenue-raising capacity. Expenditure needs are defined as the minimum funding necessary for a municipality to provide basic services and other assigned functions, and revenue capacity is a measure of the amount of revenue a municipality can raise from local sources by applying a uniform set of tax and tariff rates.

As we explain in detail in the Task 2 Report, the critical requirement for the definition of each municipality's expenditure need or revenue-raising capacity is that it should reflect only factors outside municipal control. Thus, for example, the calculation of a municipality's expenditure need should be based on an objective measure of the costs of providing a set of basic services determined by national norms and standards rather than current municipal expenditure levels. Likewise, a municipality's revenue capacity should provide an objective measure of its tax base, and not reflect its own decisions about tariff levels and rates.

By summing up the need-capacity gaps of all municipalities, it is possible to determine the extent to which aggregate municipal expenditure needs exceed the aggregate municipal revenue-raising ability. The resulting aggregate gap provides a measure of the fiscal imbalance that exists in the financing of local government. Helping to eliminate any existing fiscal imbalance should be an important goal of the local government equitable share, although the fiscal gap quantified through this analysis cannot be seen as an absolute local government claim on the national budget in a resource-scarce environment. The size of the aggregate fiscal gap is in fact determined through the process of setting national norms and standards. Conversely, defining a vertical share for local government has implications for the norms and standards municipalities can be expected to achieve. If the current revenue system cannot meet local expenditure needs, expenditure requirements can be reduced, existing local taxes can be increased or new ones introduced, or transfers can be increased.

6.2 The Current Local Government Equitable Share

Starting in the 1998/99 financial year, the equitable share to local government has been allocated using two formulas, the S grant and the I grant. The purpose of the S grant is to finance recurrent costs of basic municipal services to poor households, while the I grant is designed to finance the basic institutions of democratic governance in small, poor municipalities. In order to safeguard municipalities from large year-to-year drops in their equitable share allocations, each of them is guaranteed the larger of the sum of their formula-generated S and I grants or 70 percent of their equitable share allocation in the previous year. This system has provided a way to gradually phase-out the old system of intergovernmental grants developed under apartheid. By the 2003/04 financial year, the phase out of the old system will essentially be complete. In that year, over 92 percent of the equitable share allocation will be distributed through the S grant formula.

Although both formulas have undergone a number of modifications since 1998/99, the local government equitable share system for the 2001/02 to 2003/04 MTEF period is very similar to the original formulation. Our analysis of the distribution of the 2001/02 per capita S and I grant allocations indicates that both formulas favor smaller and poorer municipalities. Given that local government in South Africa has been in transition, and given the limited availability of appropriate data, the current formulation of the S and I grants has served South Africa quite well. As the focus of Task 2 has been on the long-run future of the local government equitable share, however, it is important that we ask whether the current S and I grant formulas can continue to satisfy the goals of the intergovernmental grant system in the future. We conclude that the system will need to change as local government matures.

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

We have argued that a central role of the equitable share in a mature system of local government is to ensure that municipalities have sufficient revenues to provide their residents with basic services. Designing an intergovernmental transfer system that meets this goal requires a distribution of grants that is proportional to the fiscal condition of municipalities as measured by their need-capacity gaps. We demonstrate in the Task 2 Report that the number of poor households—the basis for the allocation of the S grant—is not an appropriate indicator of these fiscal gaps. The current S grant formula provides a weak measure of expenditure needs and takes no direct account of the revenue-raising capacity of municipalities.

6.3 Looking Forward

The development of the equitable share transfer as the intergovernmental fiscal system matures requires a more sophisticated understanding of the need-capacity gap. The data required to measure need-capacity gaps for all municipalities do not yet exist. However, based on data from several case studies undertaken as part of our project, we were able to estimate expenditure needs, revenue-raising capacity, and hence, fiscal gaps, for 10 Category B municipalities situated in KwaZulu Natal, Eastern Cape, and Mpumalanga.

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

The next step in calculating expenditure needs is to determine costs of basic municipal services. These costs are not actual spending, but a measure of the minimum amount of money needed to provide the service. This amount depends on the technology available to provide the service and the environment in which the service is to be delivered. Thus, costs will be affected by the level of service to be provided—the costs of operating and maintaining a simple waterborne sewage system will be higher than the costs of a pit latrine. In addition, the topology of the land and the density of the settlement patterns can have large impacts on the costs of delivering any given service to a household.

Based on population projections by settlement type, e.g., farmland, villages, urban, data on costs, and assumptions about government norms for basic services, we estimated expenditure needs in our 10 sample municipalities for the year 2009. Our results indicate that expenditure

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needs per household vary substantially across municipalities. Per household expenditure needs in the sample range from R1,913 to R2,790 under moderate cost assumptions and from R2,776 to R4,420 under high cost assumptions. (All figures in this section are expressed in 1999 rands). In general, we found expenditure needs to be highest in large urban municipalities and lowest in rural areas.

In projecting the revenue capacity of the 10 municipalities for 2009, we made two sets of assumptions, one pessimistic, the other optimistic. Not surprisingly, there is a wide range in capacity per household, ranging from R685 to R4,475 under pessimistic assumptions, and from R1,236 to R5,5159 under optimistic assumptions. Revenue capacity, like expenditure needs, was generally highest in large urban areas and lowest in rural areas.

Our estimates of expenditure needs are based on two alternative sets of assumptions about costs, and we used two alternative estimates of revenue-raising capacity. Thus, we generated four different sets of estimates of the fiscal gaps in our 10 case study municipalities. Under the most optimistic, and probably most unlikely, of the four estimates, positive fiscal gaps would exist in four of the ten municipalities. These include three rural and one small urban municipality, with the largest gap per household being R667. Under the most pessimistic case, fiscal gaps existed in all but one of the 10 municipalities, with the largest gaps, exceeding R2,000 per household, existing in rural areas. Large fiscal gaps are, however, not an exclusively rural phenomena. Gaps over R1,500 per household were also found in two urban municipalities. It is also interesting to note that under the pessimistic case, the current year S grant allocations per household in nine of the 10 municipalities are substantially smaller than our projected fiscal gaps.

On the basis of calculations made for these 10 Category B municipalities, we can conclude that, unless our most optimistic scenario is realized, many municipalities will face substantial fiscal gaps in the future. The methodology we used in calculating expenditure needs and revenue-raising capacity allows us to predict that many other municipalities throughout the country with characteristics similar to our sample municipalities are also likely to face large fiscal gaps. However, the absence of data for Category A municipalities and the non-random nature of our sample prevent us from making a quantitative estimate of the national aggregate fiscal gap at the present time.

Despite the fact that we have found large fiscal gaps in some communities and evidence that the existing system of S grants does a poor job in filling those gaps, we recommend that over the next three years (the current MTEF period), the equitable share formulas remain basically unchanged. Municipalities are in a period of flux as they attempt to adjust to their newly demarcated boundaries. Having a stable and predictable revenue source over this difficult period will facilitate the adaptation process.

In the longer run, the current equitable share system based on the S and I grant formulas could be transformed to a system based on a formula that accounts for the expenditure needs and revenue-raising capacities of municipalities. The development of such a formula will take time and needs to be done with care. It should be based on the principle that the mechanism for allocating equitable share transfers to municipalities needs to reflect as closely as possible on-going changes in municipal expenditure needs and revenue-raising capacities.

In order to design and implement a formula, the government will need to make a number of policy decisions, including the exact definition of "basic" services to be included in the calculation of expenditure needs and the level of fiscal effort to be required of local residents and businesses. On the basis of these decisions, a fiscal gap for each municipality could be calculated. Although equitable share transfers would be allocated in proportion to the size of each municipality's gap, the government must also decide whether all municipalities, or only those in the weakest fiscal condition, would be entitled to equitable share grants.

Currently, many South Africans, particularly rural residents, receive few if any municipal services. The fact that a number of municipalities provide little in the way of municipal services implies that at present the expenditure needs of these municipalities are quite low. Over time, as capital infrastructure and capacity are built to support service delivery, the expenditure needs of these municipalities will grow. Steps could be taken now to begin measuring the costs of providing various level of public service in different settlement areas. This information could be used in the measurement of expenditure needs.

Substantial capital investments will be required before all South Africans can be guaranteed access to basic municipal services. Recurrent costs associated with basic service provision will only occur after the necessary investments occur. For this reason, among others, the system of national grants for infrastructure investment must be explicitly coordinated with the allocation of the local government equitable share. This is a complicated issue, but without coordination, equitable share allocations are likely to be highly inefficient. Under some circumstances, transfers would go to municipalities that have no capacity for delivering basic services, thus wasting resources. In other jurisdictions, equitable share allocations may be inadequate to allow for the operation and maintenance of existing infrastructure facilities.

On the revenue side, the economic base of many municipalities is quite weak. Even under a quite optimistic set of assumptions, the inference we draw from our sample is that rural municipalities, and some small urban municipalities, will as late as 2009 have limited capacity to generate revenues. This could, of course, change depending on the choices made about municipal revenue reforms, as discussed in the previous section. A measure of each municipality's revenue-raising capacity should be included in an equitable share allocation formula. In developing a new equitable share formula to replace the existing S grant, however, it is important to simultaneously add elements that account for the expenditure needs and the revenue-raising capacity of municipalities.

In the long run, fiscal gap of municipalities must be filled by providing equitable share grants, reducing expenditure needs, or raising revenue-raising capacity. Failure to do so will result in an inability of municipalities to fulfil their obligation to provide their residents with basic municipal services. We have emphasized a number of times in this report the important role of ensuring the mobilization of an adequate level of local own-source revenues in a decentralized system. We should, however, also recognize that relying too heavily on local revenues relative to transfers could force residents and businesses in some municipalities to bear onerous tax and tariff burdens.

7 CONCLUSIONS, RECOMMENDATIONS, AND THOUGHTS ON IMPLEMENTATION

As noted in the introduction to this report and highlighted throughout it, fiscal decentralization and municipal fiscal reform are complex and challenging undertakings. We have tried to outline a number of paths and options the South Africa government may wish to consider as it proceeds with the reform process. In this concluding section, we summarize key issues and express our opinions on a number of them. Although our analysis has probably raised as many questions as it has answered, our recommendations can serve as a guide for thinking about pending policy decisions and the need for further applied research.

7.1 Returning to the Basic Choices

Positions must be taken in broad terms on some of the basic decentralization choices considered throughout this report. To what extent is asymmetry in the treatment of municipalities acceptable? How much autonomy should municipalities have in making local expenditure and revenue decisions? How much redistribution is appropriate and how can it best be funded and managed?

From our perspective, asymmetric treatment of municipalities is necessary in South Africa. Variations in local government needs and capacities are too great, both across and within municipal categories, to justify uniformity. Some B and C municipalities are weak, while others are relatively capable. Asymmetry, however, must be defined on the basis of transparent standards to minimize unfair treatment and uncertainty, and it need not forever trap municipalities into a particular set of powers and functions. In fact, as suggested throughout the report, municipalities could "graduate" to a different status according to concretely defined rules. We recommended, for example, that weak B municipalities meeting certain well-defined conditions could be given additional responsibilities over time. Similarly, we suggested the possibility of an asymmetric approach to reforming the RSC levy that allows qualified councils to move from a grant intended for weaker municipalities to the regular RSC levy used by stronger municipalities.

With respect to autonomy, we recommend the maximum degree feasible because local autonomy is required for the benefits of decentralization to be realized. We do, however, have two caveats to this suggestion. First, some objective guidelines on service levels and revenue instruments are appropriate to ensure that key national goals are met and to prevent extreme variations in local fiscal policies that may have effects beyond individual municipal borders. Second, consistent with the above discussion on asymmetric treatment, we generally support the idea that weaker municipalities should to some degree "earn" autonomy by meeting basic capacity and/or performance standards. Significant autonomy given to weak and unaccountable municipalities is a recipe for poor performance.

As noted several times throughout this report, redistribution to redress historical inequities is a fundamental precept of decentralization in South Africa. We fully endorse this policy, and we believe that municipalities are often in a good position to target and manage activities that support local redistribution. At the same time, we caution that the funding of redistribution is primarily a responsibility of national government. Only the center can reduce disparities among municipalities, and redistribution within jurisdictions is limited by individual fiscal capacities. The creation of larger, presumably more fiscally viable municipalities under demarcation should improve intra-jurisdictional redistribution capacity, but there will certainly be limits to the willingness of wealthy taxpayers to bear higher local tax burdens designed to finance services for the less well off. In addition, municipalities in South Africa are expected to provide many types of services that can be priced. Pressuring them to use general-purpose taxes for local redistribution is likely to undermine the efficiency of their user charge mechanisms. The best way to deal with the redistribution issue, as emphasized in the previous section, is to properly measure expenditure needs and fiscal capacities, and then to use intergovernmental transfers to achieve the desired degree of redistribution.

7.2 Implications for Intergovernmental Fiscal System Design

What are the general implications of our positions on these core choices for the design of the intergovernmental fiscal system in South Africa? With respect to assignment of powers and functions, we would argue for an approach that embodies a number of principles. First, as already highlighted a number of times, differential treatment of municipalities can be clearly justified, and it should take into account the status quo. It makes no sense to give responsibilities to municipalities that cannot adequately manage them or to take responsibilities away from municipalities that are effectively providing them. Second, divisions in service responsibility can and should be fine-tuned where this would be productive and feasible—service authorities versus service providers, investment versus operation, separating components of service delivery (e.g., bulk supply vs. distribution), etc. Different public and private actors can be given responsibility for different functions as appropriate. Our illustrative recommendations in section 3 indicate some ways to think about differentiating service assignments by service type, service components, and overall responsibility versus delivery activities. Third, within the constraints of capacity, services should be assigned to the jurisdiction that is closest to voters unless there are economies of scale or spillovers. For this reason, we are concerned about the recent broad assignment of key expenditure functions to the Category C municipalities. Certain functions may legitimately be considered in the domain of Category C municipalities, and it makes sense for them to coordinate district-wide infrastructure planning and investment. To empower them with primary responsibility for all or most local service delivery, however, does not support decentralization, and it is not pragmatic or efficient in an environment where some Bs have been providing services effectively and some Cs have little capacity.

On the local own-source revenue side, there is obviously a need to ensure that municipalities expected to provide services are given some independent resources to do so. Urban municipalities—whether large or small—will generally need a broader range of revenue instruments than rural municipalities. This does not mean that rural municipalities do not need dedicated resources, but they are always likely to be more dependent on transfers. At least in the short run and possibly for longer, some sharing of revenues intended for one type of municipality with another type may be in order on a guideline-defined, case-by-case basis. If, for example, Category C municipalities need to provide for some functions on behalf of weak Category B municipalities under their jurisdiction, they might be entitled to some of the equitable share allocated to the Bs they are serving. Similarly, in cases where Category B municipalities are providing services that are the formal responsibility of their associated C, some portion of the RSC levy revenues accruing to the C could be shared with them. The details of such arrangements, however, cannot be worked out until further decisions are made on the desired longer-term structure of municipal expenditure and revenue assignments and a strategy for implementing them over time.

In terms of specific local revenue sources, political realities may require that the RSC levy be left alone in the near term. In the medium term, as the intergovernmental system evolves, it might be replaced with an asymmetric model that combines a payroll tax and grant as discussed in Section 4. Stronger, more urbanized municipalities would levy the payroll tax, while the formula-distributed grant would fund weaker, particularly rural municipalities. Under this asymmetric scheme, weaker municipalities would be able to graduate from grant to tax when they meet certain conditions. This type of scenario, which should be seen only as one illustration of how to proceed with reform, is consistent with our beliefs that well-functioning municipalities should have their own independent sources of revenue and that they should be treated differentially when appropriate.

Proposed property rates reforms are already in an advanced stage of discussion, and we strongly support the strengthening of this important tax for the Bs. Although property rates were not part of our project work, we do have some concerns about making it unduly standardized. We would consequently recommend minimizing the number of restrictions on local autonomy in tax administration included in the legislation under development, especially with respect to setting rates.

Perhaps the most pressing local revenue issue is how to ensure the replacement of resources the municipalities will lose from electricity sales surpluses when this service is reorganized. We cautiously recommend a tax on electricity usage, a source with a large, buoyant base that directly relates benefits to payments. Challenges in structuring such a tax include potential regressivity, the high rates that may be needed to replace trading surpluses, and the likely bias towards developed municipalities. Nevertheless, this source merits further investigation, a task the National Treasury is already moving on.

Finally, we endorse exploration of municipal motor-vehicle revenues, which have potentially great yield, equity, and efficiency benefits, and are also relatively easy to administer. As with the electricity consumption tax, there are potential concerns, including their suitability for local (as compared to provincial and national) use and the possibility of political sensitivity. The potential benefits, however, combined with significant and growing municipal revenue needs, recommend this base for further consideration.

Moving on to intergovernmental transfers, the equitable share has, given data constraints and the shifting context of the local government system, done a reasonable job of meeting certain goals to date. In the future, however, the formula needs to develop concurrently with the intergovernmental fiscal system and the availability of better information. We recognize that there is some concern at the national government level about using a cost-based approach for the analysis of the equitable share due to the potentially major implications for the national budget and possible misinterpretation or misuse of information by the public. While we understand and are sympathetic to these concerns, our preliminary research suggests the likelihood of a common and significant gap between municipal expenditure needs and fiscal capacity. Only if the relationship between needs and capacity is identified can the government develop an equitable share program consistent with Constitutional mandates.

Documenting individual and aggregate municipal fiscal gaps does not, however, mean that these figures can or should become an exclusive basis for national budget allocations to the equitable share pool or for individual municipal allocations. As emphasized throughout this report, there are multiple ways to close the fiscal gap, including increasing local revenues, increasing the equitable share, and decreasing service levels. The government may decide to use one or all of these instruments. Any combination is potentially appropriate and viable if fair processes and objective rules are used, but action to correct problems cannot be taken unless the situation is better understood. Once the government decides how to proceed, however, we believe that the pool of resources devoted to the local government equitable share should be defined in a transparent way that ensures an adequate degree of buoyancy.

We also want to emphasize the importance of giving more attention to capital grants. This was not explicitly part of our project scope of work, but the validity of many of our recommendations is contingent on the appropriate reform of the infrastructure development system, including capital grants. We recognize that important steps have already been taken in developing mechanisms to support municipal infrastructure investment. First, National Treasury has developed a borrowing local government framework that should support the ability of creditworthy municipalities to secure loans in the future. Second, DPLG has been implementing a variety of efforts to support municipal infrastructure planning and development. Third, National Treasury is beginning to consolidate a complex and fragmented set of conditional transfers, some of which currently complicate the financing of infrastructure by municipalities.

All of these are steps in the right direction, but they will not immediately help all municipalities, many of which have few reliable resources and inadequate capacity to develop infrastructure. The equitable share formula is based on recurrent costs of providing services to poor households, whether or not the infrastructure (or capacity) to provide those services exists. The lack of infrastructure also deprives municipalities of the opportunity to deliver revenue-generating services, which could be significant in some cases. Thus, equitable share allocations designed to help finance basic service delivery end up being used for basic administrative expenses that the municipality has no other way to support. This represents a kind of low-level equilibrium from which there is probably no escape without concerted and well-coordinated national government efforts to develop infrastructure and related local government capacity and revenue sources. Some elements of the national government might prefer do this by strengthening districts rather than Category B municipalities. As we have noted several times, however, we believe that a district-centered approach would undermine the development of a local government system that would be genuinely responsive to citizens and likely to generate the expected benefits of decentralization.

7.3 Strategically Approaching Transition

The above discussion of intergovernmental fiscal system design takes us back full circle to the assignment of powers and functions. As we have emphasized repeatedly, finance should follow function to the extent possible. We have indicated an array of policy options and made some recommendations throughout this report on how South Africa might proceed with various aspects of intergovernmental fiscal reform. Until some basic decisions are taken on unresolved aspects of municipal functions, it will be difficult to consider in an adequately informed way many decisions that need to be made on other aspects of the fiscal system. Without some basic rules on expenditure assignment, even if incrementally defined in a longer-term implementation framework, it is not possible to fully design a desirable revenue structure with proper fiscal correspondence. If revenue reforms are adopted independently and too hastily, they may have to be changed later as expenditure assignment changes, perhaps at great political expense.

As suggested above, however, neither expenditure assignments nor other aspects of municipal finance get settled overnight. Transition strategy is a critical element of planning the implementation of fiscal decentralization. There are questions regarding exactly what reforms to make, when to initiate them, and how many to undertake at one time. In fact, much has happened recently and much more is on the table, including boundary changes, new structures and procedures, free basic services, property rates and RSC levy reforms, electricity restructuring, etc. This raises concerns about how much "policy shock" municipalities can absorb at one time, how quickly they can climb the learning curve, and what the nation can afford. Ongoing and potential reforms often mandate completely new systems and procedures. Demanding too much at once, especially if uncoordinated and unsupported by adequate capacity building, may prevent municipalities from adopting reforms successfully, damaging economic development and social well being.

In order to minimize these transition problems, the total reform program needs to be sequenced in a well-planned way over a period of years. There are two aspects to such an approach. The first aspect is the asymmetric treatment recommended above, such that municipalities with varying capacities might start at different points in the reform process. The weakest municipalities would be given minimal responsibilities and revenues, but targeted for technical assistance. As they meet certain requirements, they could be rewarded with additional responsibilities and resources. The most capable municipalities could be more or less left alone to do their jobs, as some are now, although they would not be exempt from certain types of national guidelines and monitoring. Obviously, the details of such an approach—how various interrelated components of intergovernmental fiscal reform would be phased in with appropriate incentives for good municipal performance, as well as how this relates to existing efforts—need to be more fully examined and defined. One key consideration is that the transition process needs to be structured in as simple and transparent a way as possible, or there could be so much diversity and uncertainty introduced into the system that the potential benefits of asymmetric, gradual reform could be undermined.

The second aspect of transition relates to even the most capable municipalities. They may not need heavy supervision and capacity building as reforms proceed, but they cannot be expected to manage the administrative and political demands, for example, of simultaneously implementing new accounting codes, meeting new cost standards, adopting property rates and RSC levy reforms, etc. Thus, decisions must be made about the relative importance of these policies, so that realistic reform programs can be devised.

Throughout the report, we have suggested the need for more information to inform many of the outstanding decisions on fiscal decentralization. The municipal database piloted by this project (see the Task 1 Report) and efforts by National Treasury to develop better municipal budget systems are important steps in this regard, but there is also a need for further applied research, as indicated in various parts of this report. In order to develop more comprehensive recommendations on the assignment of municipal powers and functions, additional fieldwork beyond the small sample we investigated is needed. Similarly, it is important to better understand the magnitude of the vertical fiscal gap, both for individual municipalities and in the aggregate. This requires further exploration of municipal expenditure needs and revenue capacities. In addition, work will be needed to examine in more detail the possible impact of various options for reforming existing local taxes, adopting new municipal revenue sources, and evolving the intergovernmental transfer system, both the equitable share and capital grants. In many cases, the methodologies we have developed for this project can serve as a solid basis for the additional work required.

Finally, it would be very useful to take more careful stock of the numerous government-wide efforts in fiscal and general decentralization and to make a more concerted effort to consolidate and coordinate them. For example, capacity building has been identified as critical in many areas as well as a key mechanism for use in strategically developing the intergovernmental fiscal system if an asymmetric approach to reform is taken. There are, however, already many types of capacity building programs and plans to develop new programs—at DPLG, National Treasury, and some of the sectoral ministries. Are they working effectively? Are they complementary or redundant? Are any potentially in conflict with each other? Are the different types of capacity building being coordinated to maximize their impact? Only when these questions are better understood can the government devise an effective strategy for comprehensively developing municipal capacity in a way that supports the attainment of the potential benefits of fiscal decentralization.

ANNEX 1
PROJECT SCOPE OF WORK

LOCAL GOVERNMENT FINANCIAL REFORM:
TOWARDS A SUSTAINABLE SYSTEM OF LOCAL GOVERNMENT

I. PURPOSE

The purpose of this SOW is to provide the technical specifications for a USAID-funded contractor to assist the South African government in policy analysis on local government revenue, expenditure and related topics. The results from this project will inform the South African government on how to proceed with policy reforms aimed at strengthening local government's ability to afford key functions and responsibilities as outlined in the Constitution and national legislation.

II. BACKGROUND

In recent years the Department of Constitutional Development (DCD), together with the Department of Finance (DOF), has undertaken major policy research initiatives, which have laid the foundation to shape debate around local government finance policy reforms. With the process of institutionally restructuring the system of local government nearing completion, there is a need for complementary research and policy development on required financial reforms. This focus is required to strengthen all categories of municipalities into sustainable entities, as envisaged in the White Paper on Local Government, published in March 1998. Furthermore, such research is imperative as local government boundaries and structures are finalized, through on-going mandates from the Demarcation Act and the Structures Act. There is a need to ensure that functions and finances are properly assigned, and that municipalities can deliver a package of basic services financed by the sources of revenue available to them.

This Scope of work is divided into four major tasks that are mutually supportive, and noted as follows: (1) creation of a fiscal information database for local government, (2) research on local government's equitable share of nationally raised revenue, (3) research on financing district councils, and (4) research on the division of fiscal powers and functions between categories of municipalities. The results and key findings will be documented in a policy study to include a series of recommendations for policy-makers on the vision for key aspects of an optimal system of local government finance. The research must therefore give consideration to how the various fiscal reforms fit together and how they relate to expenditure needs. The research program outlined below must be interpreted in the context of the broader decentralization and local government reform agenda in South Africa.

Given the interdependence of various taxes, and their wider impact on the fiscal health of South Africa's three spheres of government, proposed reforms should be conducted under close analytical scrutiny. Attempts to better co-ordinate reforms are critical to ensuring a workable fiscal system with mutually supportive components. This research is to build on previous work by DCD and DOF on specific revenue issues, including property tax reform, exploration into the use of a land tax, national guidelines for local government tariffs and credit control, and formulation of an indigents policy.

III. PROJECT SUMMARY

DCD in South Africa, with funding from USAID/South Africa, is seeking technical services to assist DCD in the development of an optimal local government revenue system. The appointed contractor will assist DCD to first produce a fiscal information database, and second, utilise the data from the database, plus data from additional sources, to produce a policy study which will result in three working papers in the following areas: division of fiscal powers and functions between categories of municipalities, local government's equitable share of nationally raised revenue—including a computer modelling program that can reasonably forecast multiple scenarios for revenue distribution, and financing district councils. It is anticipated that this report will be utilized by the South African government as a key input into the development of legislation required to define an optimal system of local government finance. Estimated to span 14 months, the activity will be overseen by a steering committee consisting of DCD, DOF, the Financial & Fiscal Commission (FFC), the South African Local Government Association (SALGA), and the Coordination and Implementation Unit (CIU) at the President's Office. DCD anticipates that this project will require a team of international and local municipal finance experts. DCD forecasts that the following positions are required: a part-time international project manager to oversee and guide a team of policy analysts and researchers; a part-time advisory team of analysts with international and South African members to interpret data, analyze corresponding policy implications, and draft policy reports and recommended actions; and a full-time international research manager in-country to oversee data collection and assist in the day-to-day management of the project. Offerors shall propose alternative implementation teams/structures for consideration to carry out the work as described below.

The objectives of this project on local government fiscal reform are:

- To develop a clearer understanding of the status and impact of key sources of local government revenue on the overall fiscal system
- To develop concrete policy proposals for local government's sources of revenue, ensuring that these reforms are harmonized and mutually supportive
- To link the revenue system more fully to the expenditure requirements of municipalities
- To ensure a proper assignment of functions and finances between the different categories of municipalities as established by the Municipal Structures Act, and place these functions and finances in relation to provincial and national responsibilities
- To determine a more objective way of determining local government's share of revenue raised at the national level

IV. PROJECT TASKS

Task 1: Fiscal Information Database

The analysis to be carried out by the contractor depends on work with accurate, detailed, and comprehensive data on local governments' expenditures and income. Consequently, the first task of this study requires the creation of a local government fiscal information database. This task will require serious planning at the outset of the project on the part of the entire team and all stakeholders, and will span approximately three months to facilitate the data collection and its organization. Work on the various research topics in this study cannot commence until the database is functional.

Final accounts of local government are not available by one source in a comparable and accurate format; a special survey will be required. DCD wants to create the database with the intent of remedying the current lack of reliable and comprehensive data on local governments' finances, and to facilitate the creation of a much-needed database of information. The database will be maintained by DCD after the life of this project, and contribute to future studies in this critical research area. Consequently, the well-planned design of the database is of key importance.

Given that no one source has the required information for local government, the contractor will need to commission a special survey of government departments (including DOF and FFC) and key municipalities. Collection of this data through a representative sample that is accurate and detailed is critical for later analysis in other tasks noted in this scope of work. The final deliverable of this task is a database that will be a key element informing policy recommendations.

A range of government departments will have to be surveyed to gather comparable data for all large local authorities, and a sample of the smaller local authorities will have to be commissioned. The contractor will work with DCD at the outset of the project to determine potential case studies and receive direction on potential sources of information. Potential sources of information include: DCD, DOF[1], SALGA (national and provincial offices), SARS, Auditor General, FFC, Stats SA, the Reserve Bank, the Department for Water Affairs and Forestry (DWAF), the Development Bank of Southern Africa (DBSA), the Council of South African Banks, the Katz Commission, and private credit rating firms. In addition to coordinating data collection on the local sphere of government, the contractor shall have access to secondary information on provincial and national revenue sources and expenditures to facilitate the equitable share analysis in task two, should this be required by the steering committee.

The database shall be presented in a uniform format, contain all essential information for monitoring and evaluating fiscal performance, be timely, contain actual financial outcomes, and be user friendly. The sample shall adequately cover different provinces, municipalities of different sizes and economic bases, and take into account the re-demarcation of certain boundaries, particularly of the district councils. The sample selected should be done in consultation DCD, DOF, FFC, SALGA, and provincial governments, as it is critical that all stakeholders believe in the data and the manner in which it is collected/collated.

In co-ordination with DOF, the contractor may solicit input from a recently appointed and USAID/South Africa funded international Municipal Finance Advisor at DOF as needed given that the two scopes of work intersect in several cases.

Offerors may propose an initial list of data that should be collected. Offerors shall also comment on the potential organization of the information so that it can be easily accessed, used, and extrapolated for future analyses beyond the life of this project. Furthermore, offerors shall identify potential sources of information for this task.

This task should be completed by March 31, 2000.

[1]Review work from DOF at their website: www.finance.gov.za

Task 2: Local Government's Equitable Share

There is a need to move towards a more objective way of determining the local government's equitable share of nationally raised revenue, as provided in the Constitution. The objective is to develop a more transparent framework to develop a more rational method for deciding on the local government's allocation.

The contractor will present a working paper on policy recommendations about the equitable share to assist competing stakeholders with the task of evaluating the equitable share as it is reflected in policy to date. The following sections describe topics to be addressed in the working paper:

1. Defining the Equitable Share

The exercise must begin by reaching agreement with the principal stakeholders (including DCD, DOF, SALGA, the CIU in the President's Office, and the FFC) about what is an "equitable" share. The Constitution mandates an equitable share, but does not give much detail or guidance on how to determine this amount. The first order of business for this exercise is to review the constitutional and statutory underpinnings, and get some consensus on an operational definition.

The analysis should begin with the expenditure assignment question, and should end with the alternative methods for determining the equitable allocation of revenue raised nationally for the local sphere of government. This exercise will draw heavily on the results of Task 1.

The analysis must recognize that a completely objective system cannot be developed. Sectors are in competition for scare resources, and there is not likely to be much agreement over whether the share is "equitable". The goal of the study will be to develop recommendations to the steering committee on an objective framework around which advocates can debate and negotiate in a more transparent manner. Politics, policy choices and priorities of government will be part of the determination of the local government's share. What this study can do, however, is create an objective framework within which this debate can take place.

2. Description and Understanding of the Present System: The Problem

The present system must be described in detail, and the results of this system presented. What has been the local share in the years since the adoption of the new Constitution, and how was this share determined? What do the various actors have to say about the "equitable" features of this allocation? From this analysis, a "problem statement" has to be developed. The working paper shall begin by attempting to lay out the problems that it is trying to resolve.

3. Policy Analysis

The primary output of this exercise will be a policy analytic model that will allow a transparent analysis of the determinants of the "equitable share". The model will not likely give a point estimate of local government's "share" that will be adopted directly into law. Rather it will give a starting point around which the discussions of local government's equitable share can be determined. DCD requires a computer modelling system that can reflect various revenue source scenarios for local government and clearly present hypothetical outcomes for each potential scenario. This model is a key milestone for evaluating project progress as its ability to reflect these competing scenarios will inform the debate around the equitable share between competing stakeholders. The model shall possess the following characteristics.

First, it will link several considerations together to determine the equitable vertical share. These policy-related characteristics include:

- **Expenditure assignment**. The model should be based on the legal assignment of expenditures to local government, and should rely on the baseline data discussed in Task 1.

- **Budget priorities**. The model should be flexible enough to allow the government to simulate the implications of alternative spending priorities, for the allocation of revenue to local government. For example, should the government decide to emphasize education, or rural roads with increased spending, the implications this holds for local government should be an output of the model. One does not expect exact estimates to the rand, but this framework should give a basis for approximating the equitable share that is consistent with government policy.

- **Overall budget constraints**. The model should be capable of producing estimates of the equitable share that is consistent with an overall budget constraint of the country. This means that it must be a model that operates within the context of the other two spheres of government.

Second, the model must address the role of locally raised revenues in determining the equitable share. It is not yet clear whether enhanced local revenue effort will lead to a reward in terms of an increased share, or whether local government will be required to raise a certain amount of revenue as a condition of receiving a particular share. Nor is it clear on how much more revenue-raising capacity will be given to local government. Either way, the policy analysis model should be able to factor the local revenue component into the equitable share model to reflect various scenarios.

Third, the model should be detailed enough to produce the necessary simulations, but not so detailed as to cause the model designers and users to get so bogged down in the detail as to miss the main purpose of the model.

Finally, the model should be simple enough to be understood and used by the players in the policy debate. This means that is should be well documented, user friendly, and that its development should involve the potential end users.

4. Local Revenue Mobilization

Several questions below illustrate the main issues to be explored in this part of the task:

- Should the equitable share depend on the level of revenue mobilization by local government?

- Should the system include an incentive for revenue mobilization, and if so, what type of incentive? This section of the exercise should include a complete inventory of existing incentives, and at least a commentary on their effectiveness, if any.

- The exercise should produce a method for measuring fiscal capacity and tax effort in the local sphere. The exercise should address the question of how much of local budgets should be or can be financed from local sources.

The results from this research should highlight recommendations regarding alternatives for local revenue generation.

Task 2 is to be completed by September 15, 2000.

Task 3: Financing District Councils: RSC Levies

The most important source of revenue for District Councils (Category C municipality) is the Regional Services Council (RSC) Levy. DCD needs to determine if the RSC levy should be reformed and/or if it should be replaced with another source of local revenue. Furthermore, the financial impact of any proposed alternatives to the levy would have to be documented.

District financing warrants increased attention in light of newly assigned importance of these councils, especially insofar as rural development is concerned. DCD needs to know how the central government can assure that district councils carry out the functions as assigned in the Municipal Structures Act, particularly that revenue sources are adequate.

There are other research initiatives in the area of RSC levies that will help inform the work of the contractor. These include recent projects by the World Bank in South Africa and work to be undertaken by the USAID funded international Municipal Finance Specialist for DOF. The contractor shall consider and draw upon work to be undertaken by these other studies when completing this task.

Four key issues impact on the conduct of this study:

First, the RSC levy has become an important source of revenue for District Councils in South Africa. The extent to which the present form of the levy is currently being exploited, the potential for increasing revenue yields through various types of reforms, and the potential yields of possible substitute sources of revenue all need to be considered in the research program.

The second important issue regarding the levy is that the potential effects of its two components, a payroll tax and a turnover tax, are somewhat controversial. Empirical investigation is required to look at these components' impact on the cost of labor, cascading effects through the tax system, administrative costs, and equity effects (including examination of potentially regressive nature of these components).

A third set of issues regarding the levy concern whether it can be considered a genuine "local" tax in its present form and whether its status in this regard should change. Generally speaking, the tax as currently structured is more like a grant than a local tax. The extent and nature of variations in the levy across municipalities must be better understood (rate variations, different collection/enforcement records, etc.), and the potential implications of giving local government greater autonomy in the administration of the levy more fully documented.

A fourth set of issues relates to the way the levy affects the attainment of broader government policy objectives regarding macroeconomic balance, economic growth, decentralization, redistribution, the redressing of past imbalances in the provision of basic services, etc. If greater local autonomy in the administration of the tax could lead to higher and possibly geographically differentiated rates, greater overall tax burdens, and various types of efficiency effects, the potential national impact should explored. Even if it is conceived as a local tax, its differential yield across councils should be taken into consideration when defining redistributional components of the grant system.

To address the above issues, the research should be divided into the following sections:

1. Structure of the Current Major Revenue Source

This section will document use of the levy, covering all District Councils to the extent possible. The following questions should be included in the analysis.

- What are the tax rates charged on each the two components of the levy?

- Are there are major differences across District Councils in terms of the relative size of the payroll and turnover components of the levy? If so, are these differences related to any apparent characteristics of the local government or its economic base?

- Are the levy proceeds used as a general revenue source or earmarked for particular purposes? How do District Councils justify the way they allocate their revenues? Are there major differences across jurisdictions?

2. Administrative Capacity of the District Councils

This section will assess District Councils' administration of their revenue sources. A sample of councils will be selected for detailed analysis:

- How are tax bases and taxpayers identified? Who does the identification? How and with what frequency are the rolls of the levy payers updated?

- How are those liable for the levy assessed (both officially and unofficially)? Who does this assessment? Is there any assessment appeals process?

- What types of records are kept on levy payers and assessments? Who keeps these records? How are they used? How often are they updated?

- How are the various revenue sources collected? Who does the collection? How often are collections undertaken? Are there enforcement (official or unofficial) procedures for unpaid levies? Who applies them? In what way and how frequently are they used?

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- What are the administrative costs of revenue collection? Do they differ significantly across local governments? Why?

- What are the technical and logistical problems with existing procedures and their application for each area of administration? What are the effects of these problems? What types of actions could improve the situation?

Special attention should be paid to anecdotal reports on misuse of powers in cases where contractors have been used to collect the levy. The performance and viability of alternative approaches to the levy administration should be highlighted in the field research. In addition, computerization of any aspects of administration should be evaluated with respect to its suitability and the degree to which local staff have acquired the necessary skills.

3. Levy Use Relative to Potential

This section will assess the current use of the levy relative to its potential yield, using a sample of district councils as the basis for analysis.

- To what extent are liable levy payers fully identified? Which are the key reasons for poor identification?

- How do the District Councils with good identification manage to bring most payers into the tax net?

- To what extent are the assessed levies actually collected? What are the reasons for any under-collection? Which factors play the most important role in councils where there is successful collection?

To consider possible solutions to the problems identified, the report will note whether these problems are systematic and widespread versus random and sporadic. The contractor shall evaluate whether the operating procedures of the successful councils are replicable and under what circumstances.

4. The Economic Effects of the Levy

There are a number of potential economic effects of the levy that require further exploration. The key questions include:

- Do the two different components respond differently to changes in the state of the economy, population growth, etc.? Are there are clearly identifiable differences in buoyancy across local governments? If so, is it possible to identify the main factors that cause these differences?

- How substantial is the effect of the payroll tax component of the levy on the cost of labor? Is the effect significant enough to adversely affect international competitiveness?

- What are the likely interjurisdictional effects of the levy? Which places have the highest rates and revenue yields, and why? Are differences in rates significant enough to influence business location? Are any of the potential economic effects more pronounced in some provinces and/or municipalities than in others? If so, why?

5. Options for Expanding or Changing the Current Revenue Sources

This section turns to a realistic evaluation of the potential for increasing collections from the current levy. One possibility would be to expand the current levy (by increasing the allowable rates) or to alter the structure or administration of the levy (e.g., by shifting towards greater reliance on one or the other component taxes or by giving local governments more autonomy over the tax). Some of the key issues to be explored in determining the effects of such reforms include:

- What would be the effect on District Council budgets (in the aggregate and individually) of fully collecting the allowable levy? How would this affect the distribution of the levy across councils?

- What types of changes could be made in the design and administration of the levy to allow the goal of full collection to be realized? What impact would it have on the various efficiency and equity effects discussed above?

- To what extent would raising the currently low rates of the levy affect the answers to any of the questions considered above regarding the equity and efficiency effects of the payroll or the turnover taxes?

- What would be the effects of changing the balance between the payroll and turnover components of the levy (including administrative costs, tax incidence, and efficiency issues)?

- What could be the local and national impacts if local governments were given more discretion over the levy rates?

- If there were larger discrepancies in the rates on levies across jurisdictions due to increased local autonomy, would any serious efficiency effects be likely? Could the marginal tax burden be high enough to induce businesses to move?

6. Options for Financing District Councils

This section shall evaluate in a detailed manner the costs and benefits of the policy options described in this analysis. The options to be compared include:

1. Maintain the present system of District Council Financing;

2. Maintain the present system but shift collection responsibilities to the SARS;

3. Maintain the present system, but empower District Councils with more control over assessment, collection, etc.;

4. Convert the existing tax to an equal percentage yield of VAT and/or income tax; and

5. Allow local governments to piggyback on the existing VAT and/or income tax.

This section of the research will focus on the following questions:

- How would adoption of each of the proposed alternative options affect the stability and buoyancy of the yield?

- Do the efficiency and equity effects, including interjurisdictional patterns, laid out in section 4 above worsen or improve under each of the alternative options? If so, how and why?

- How does each of the alternative options affect administrative costs? Who would benefit from any savings? Who would bear the burden of any increases?

- What impact does each of the alternative options have on incentives for local revenue mobilization?

7. Special Considerations

A number of special considerations need to be taken into account. They include:

- In light of emerging recommendations from the Demarcation Board on proposed metro councils, the impact of these rulings needs to be documented in detail. For example, it is questioned if in the creation of new metro councils (thereby incorporating some areas that may have been district councils), if some type of compensation scheme or offsetting equalizing grant for the "losing" district councils would have to be developed.

- If collection responsibilities are given to the South African Revenue Service (SARS), a number of questions need to be considered.
  (a) What is the probability of a problem with the "flypaper effect," that the levy collections would stay where they are collected—at the central government level?
  (b) Is SARS willing and able to perform this function on behalf of District Councils? What are the cost/benefit implications of such an arrangement?
  (c) Would SARS have to be given an incentive in the form of a percentage of the yield as an incentive to collect the levy responsibly?
  (d) Would adding the turnover and payroll taxes to the current revenue system add undesirable complications and new administrative costs?

- Should the levy be earmarked for some particular purpose(s), or should it be used as a general-purpose source of revenue? What are the specific benefits of earmarking? Are there any efficiency implications of earmarking or any practical considerations related to the reduced flexibility in local government budgeting?

8. Recommendations

Based on a thorough review of all of the components of this program, the final step will be to make concrete recommendations on financing District Councils.

The recommendations should include detail information on and justification of:

- The form(s) the current major source of revenue or its replacement should take;
- Which level of government and which actors have responsibility for each aspect of tax design and administration;
- Which Category of municipalities will have access to the levy or its replacement source of revenue (including comment on impending demarcation effect);
- If the levy ends up substantially under local control, the types and degree of control the central government will retain over the component taxes;
- How central agencies (if a central transfer option is selected such as VAT) will allocate resources derived from the substitute revenue source to local governments;
- Details on any constitutional, legislative or policy changes required to support the recommended option;
- Details on any recommended conditions or special considerations, such as restrictions on the use of levy proceeds or the proceeds of its replacement, etc.
- Details on plans for implementing recommended reforms and which agencies are responsible for each aspect of the implementation plan.

The final report would recommend an appropriate source(s) of revenue to fund District Councils.

Task 4: Division of Fiscal Powers and Functions Between Categories of Municipalities

Utilizing the database from task one, the contractor will recommend key aspects of an optimal division of fiscal powers between municipalities that have executive and legislative authority over the same jurisdiction. Section 155 (1) of the Constitution defines the different categories of municipalities that may be established in the country, which broadly speaking are: category A (metro), category B (local municipality), and category C (district council).

While the Municipal Structures Act[2] defines the division of functions between category B and C municipalities, in terms of section 229 (3) of the Constitution, national legislation must be passed to determine an appropriate division of fiscal powers between category B and category C municipalities. The contractor's recommendation on the division of revenue raising powers referred to B municipalities must take into account the following.

1. Revenue adequacy – the need to ensure that each municipality has a sufficient revenue base (tax base, local tax sources, etc.) to perform functions assigned to it.

2. Funds should follow functions - the revenue instruments (central and local) assigned to each category should be commensurate with the functions. The Constitution

[2]To review legislation please refer to the DCD web page at www.local.gov.za.

clearly states that the functions of each municipality should be taken into account when deciding on revenue raising powers.

3. Principles of taxation, such as neutrality, should inform the division - the assignment of taxing powers to each category should have limited unintended influence on private economic decisions. There should therefore be an effort to limit distortionary effects that might alter decisions about where to locate the factors of production.

4. In addition to sorting out the policy side of the assignment question, there is also a need to focus on the administrative aspects. The ability of the different categories of municipalities to administer the various sources of revenue has to be addressed.

5. Finally, the effectiveness and efficiency of raising taxes, levies and duties must be examined.

In dealing with the assignment of functions and finances to the different levels of municipalities, the underlying concern should be on the efficient, equitable delivery, and financing of local services. The reality is that municipalities are not equal in population size, urban/rural nature, and economic base. Analysis in this project needs to take this diversity into account.

Although the assignment of revenue raising powers between the B and C categories will have to be resolved at a political level, this research will produce recommendations to inform the decision making process.

The contractor will present the analysis and recommendations through a working paper. The following sections highlight issues that should be addressed in the working paper for this task:

1. The Legal Assignment of Expenditures /Functions

The first task is a thorough review of the legal assignment of expenditures by function to the local sphere of government. This review will identify any confusion in the assigned responsibility, and clear up ambiguities. Local government services are unlikely to be efficiently provided unless the lines of responsibility and accountability are clearly established. The result of this work will be a detailed listing of expenditure assignment, and then a critique of this pattern against the international practice to determine if there are any significant "mis-assignments".

2. The Actual Assignment of Expenditure/Functions

A major component of this exercise will be to determine the actual assignment of expenditures (by function) for the local sphere of government, comparing the actual practice versus legal assignment. Issues to address include how much is local government spending, for what functions, and what share of this is financed from local resources. This is a crucial and essential part of the exercise, and one that impacts on the other tasks in this Scope of Work (and is one that draws heavily on work to be completed under task one).

- It is important that this expenditure breakdown not be too detailed. It should work with the main headings and subheadings of expenditure, so as not to get the basic question lost in detail. The basic question is "how much is spent by the local sphere of government, for each major function of government, and by each category of municipality."

- This research will also need to identify what percent of these expenditures are financed from the different sources of local revenue, and what percent comes from transfers.

- The analysis shall highlight any discrepancies between what is actually practiced with what the law stipulates about expenditure assignment.

- For each expenditure function analyzed, the issue of mandates and unfunded mandates should be examined. DCD needs to know the extent to which the budget is circumscribed by central government requirements, and the cost of these requirements. The exercise should produce a full inventory of mandated expenditures, with a detailed description of each.

3. The Current Assignment of Fiscal Powers

This section will document some of the initial basic data on the present assignment of fiscal powers. This will entail a detailed analysis of the overall existing revenue structure of local government, the potential revenue from the different sources, how this is assigned between the various levels and what should be the desired balance between the revenue sources. Information on the size, structure, diversity, revenue capacity and trends at the local level would be critical to addressing the following questions:

- What are the various sources of revenue for local government and how are these interrelated? What is the most important source of revenue for the different categories of municipalities?

- How do local governments use the different sources of revenue? Are they used as general-purpose revenues or are they earmarked for particular purposes?

- Are local own-source revenues adequate to meet local needs?

- What is the potential revenue stream of the different sources if fully exploited? In other words, to what degree are these sources of revenue not being collected?

- How are the sources of revenue assigned between the different municipal levels? Are they structured in the best possible way to avoid undesirable efficiency effects and to promote desirable equity effects?

- Do tax capacities vary significantly across municipalities? If so, are these differences related to any major characteristic of the local tax base, or are they an indicator of differences in administrative capacities?

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4. Options for Reform

Some of the key areas to be explored in determining the appropriate assignment of fiscal powers between Category B and Category C municipalities include:

- What are the implications of the Structures Act on the assignment of functions and revenues between Category B and C municipalities? What should be done to align functions with resources?

- How will future municipal demarcation affect these target areas?[3] How will the boundary changes affect the current revenue base of municipalities? What form of compensation should be given to those municipalities that stand to "lose" a portion of their revenue base?

- What revenues should be assigned to the different categories of municipalities?

- What sort of fiscal changes would be required in the design and administration of the different revenue sources? Discuss the implications of proposed changes from this project on other revenue sources.

- What are implications of the re-assignment of fiscal powers on the budgets of the different categories of municipalities? How would this affect the distribution of the different sources of revenue across councils? Computer modeling should demonstrate effects of various scenarios.

- How might these changes affect the preferred allocations of intergovernmental transfers (equitable share)?

- What options exist for revenue sharing? Which revenue sources should be shared between Category B and Category C municipalities?

- What would be the administrative implications of revenue sharing? Which category would be the collecting agency? Or should another level of government be responsible for collecting the shared revenue on behalf of local government? Which is the most appropriate agency to do the collection?

- What revenue sharing formula should be used? Should the formula be legislated?

The findings as submitted in the working paper will serve as the basis for drafting legislation on the assignment of fiscal powers among Category B and Category C municipalities. Task 4 should be completed by February 2001.

V. DELIVERABLES

There are a total of five deliverables for this SOW. The first four deliverables are all working papers, and the subject of each is dictated by the four topics outlined in the SOW (fiscal information database, local government's equitable share, financing district councils, and

[3] The Demarcation Board's regularly released reports can be viewed at www.demarcation.org.za

division of fiscal powers and functions between categories of municipalities). However, the first working paper—on the fiscal information database—must be accompanied by a functional database that can be easily used in analysis for the other deliverables. Furthermore, the second deliverable (a working paper on the equitable share) must be accompanied by a computer modelling system that forecasts various revenue scenarios for local government. The fifth and final deliverable is a final report, which incorporates the four working papers into a larger, more comprehensive local government revenue policy document. The main audience for the final deliverable will be policymakers at the national and provincial level, local governments, and SALGA.

As noted previously in the SOW, working papers and ultimately the final report will broadly follow the issues outlined above. However, the contractor will meet with DCD at the outset of the project to review each task's contents. Draft copies of all working papers are required so DCD and the steering committee can progressively monitor project progress.

Copies of all reports (15 for DCD and 5 for USAID), shall be submitted for all draft working papers, revisions of working papers, final working papers, and the final report.

While there will be periodic meetings between DCD and the contractor that will be arranged at DCD offices, organization of seven one-day meetings will be the responsibility of the in-country research manager. Six will be contractor/steering committee meetings (approximately 25 people in attendance), and the other will be a preliminary workshop with a wider audience (approximately 60 people in attendance).

All deliverables, related data, and research briefs will become property of DCD, and the contractor shall note this in subsequent use of these materials.

VI. ACTIVITY IMPLEMENTATION

A. Oversight

The project will be overseen by a steering committee with membership from at a minimum, DCD, DOF, FFC, the Coordination and Implementation Unit (CIU) at the President's Office, and SALGA. The lead consultant and key members of the team will meet periodically with the steering committee, and will hold regular report-back sessions based on interim reports.

B. Expertise Required

To successfully carry out the specific tasks and submit the deliverables, it is anticipated that experts proposed will be both highly respected academics and practitioners in the field of local government tax reform, public finance, and intergovernmental fiscal relations and will have detailed knowledge of and in depth, high level experience working on such reform efforts in the developing and/or transitional countries in Asia, Latin America, and/or the New Independent States and also have additional experience in Africa.

Offerors shall propose a team of local and international experts to effectively complete the task. Offerors shall also comment on the organization of their team, including detailing responsibilities of each team member. A suggested team is detailed below. Offerors may propose their own team composition to be consistent with their technical approach.

Project Manager. A suggested team leader/project manager would be a senior public finance consultant to direct and coordinate the entire project. Desired qualifications would include a strong knowledge of public finance and intergovernmental fiscal relations, and knowledge of the South African context.

Advisory Team. It is suggested that a team of up to three senior policy analysts assist in project implementation and undertake substantial parts of the research. This team would analyze data, describe implications of data analysis for policy development, and make initial recommendations in the form of working papers. A mix of international and South African analysts could be utilised to complete the task. Initial work could require intensive in-country visits, however once data sets and interviews are complete, work can take place at a location to be determined by the Offeror as long as deadlines are met.

Research Manager. It is recommended that an international research manager be assigned in South Africa for the duration of the project. The research manager would assist the Chief Directorate, Local Government Finance in the day-to-day management of the project.

Offerors who include a research manager should indicate if the individual will be able to complete the gathering of all data and its analysis, or if sub-contracting for research assistance is required.

VII. PERIOD OF PERFORMANCE

The project is estimated to span 14 months, from January 2000 to March 2001.[4] Initial efforts should focus on data gathering/organization of the fiscal information database and should take approximately three months. Task 1 should be completed by March 31, 2000. Work on the other tasks can go forward simultaneously. However, it is estimated that Task 2 will be completed by September 15, 2000 and that Tasks 3 and 4 will be completed by February 2001.

VIII. SELECTION PROCESS & PROPOSAL FORMAT

Offerors have been selected from contractors who hold Sustainable Urban Management (SUM) Indefinite Quantity Contracts. Offerors should provide the following information:

- Contractor bio-data forms and abridged CV for candidates for each of the offeror's project team positions. Three references, a concise writing sample and details regarding the each candidate's availability should also be provided

- A 5-10 page narrative on the Offeror's the technical approach for the completion of the Tasks. Detailed information should be included regarding teams structures; initial types of data (including sources) to be collected for task one and potential organization of the information; and identify areas of data collection and/or other related areas that require sub-contracting.

[4] All work shall end by February 2001, but the delivery order end date will be July 2001.

- A detailed implementation plan identifying outputs and their due dates, and how the proposed team will work both in-country and from the home office to meet noted deadlines.

The information requested shall be submitted by fax at 27 12 328 3718 or by email attachment (Microsoft Word format or text document) to jkryschtal@usaid.gov no later than 5:00 PM (South Africa time) on November 12, 1999. Interviews with DCD's Chief Director for Local Government Finance may be scheduled in December in Washington, DC with certain candidates. The Offerors will be responsible for the costs associated with their proposed candidates' participation in the interview process. It is anticipated that a final decision will be made on/about December 20, 1999.

IX. SELECTION PROCEDURE

The selection factors will focus on the qualifications of personnel, their availability and the Offeror's technical approach and implementation plan. Cost factors will be considered when determining the best value for the US Government.

ANNEX 2
LIST OF PROJECT OUTPUTS

Futhering Local Government Fiscal Reform in South Africa: Issues, Choices and Challenges (Final Synthesis Report)

Local Government Fiscal Information Database (Task 1)

The Role of the Equitable Share in the Financing of Local Government (Task 2)

The Regional Services Council Levy: Evaluation and Reform Options (Task 3)

Assignment of Local Government Powers and Functions (Task 4)

Palmer Development Group Reports (Task 4)

Revenue Expenditure Assignment—Overview Report

Evaluation of Alternative Arrangements of Powers and Functions—Report on Financial Arrangements for Each Municipal Services Sector

Evaluation of Alternative Arrangements of Powers and Functions—Eastern Cape Case Study – DC12

Evaluation of Alternative Arrangements of Powers and Functions—Kwa-Zulu/Natal Case Study – DC22

Evaluation of Alternative Arrangements of Powers and Functions—Mpumalamga Case

Study--DC32

Evaluation of Alternative Arrangements of Powers and Functions—User Charges for Trading Services

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

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