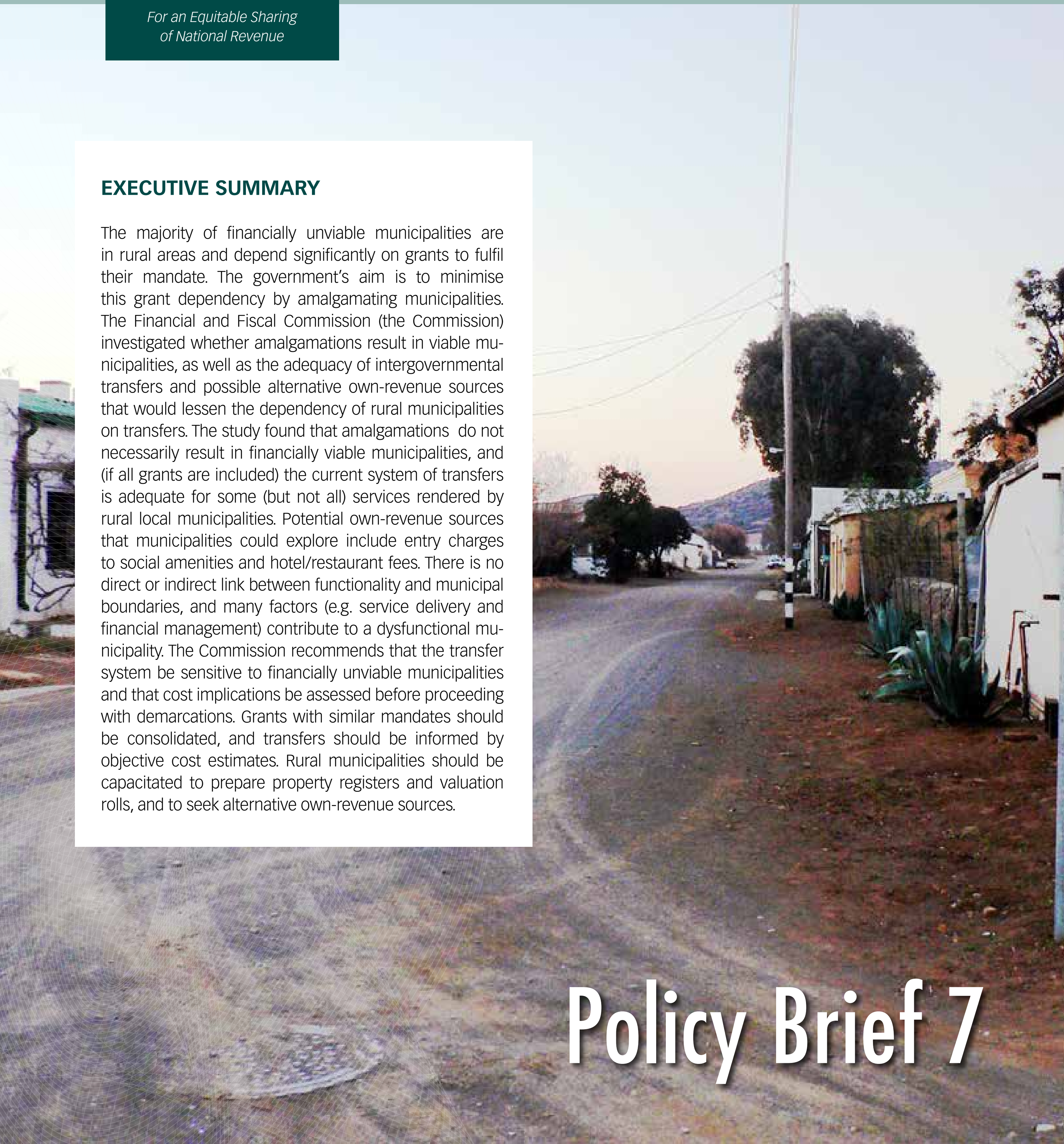
FINANCIAL AND FISCAL COMMISSION

For an Equitable Sharing of National Revenue

Who Finances Rural Local Municipalities?



EXECUTIVE SUMMARY

The majority of financially unviable municipalities are in rural areas and depend significantly on grants to fulfil their mandate. The government's aim is to minimise this grant dependency by amalgamating municipalities. The Financial and Fiscal Commission (the Commission) investigated whether amalgamations result in viable municipalities, as well as the adequacy of intergovernmental transfers and possible alternative own-revenue sources that would lessen the dependency of rural municipalities on transfers. The study found that amalgamations do not necessarily result in financially viable municipalities, and (if all grants are included) the current system of transfers is adequate for some (but not all) services rendered by rural local municipalities. Potential own-revenue sources that municipalities could explore include entry charges to social amenities and hotel/restaurant fees. There is no direct or indirect link between functionality and municipal boundaries, and many factors (e.g. service delivery and financial management) contribute to a dysfunctional municipality. The Commission recommends that the transfer system be sensitive to financially unviable municipalities and that cost implications be assessed before proceeding with demarcations. Grants with similar mandates should be consolidated, and transfers should be informed by objective cost estimates. Rural municipalities should be capacitated to prepare property registers and valuation rolls, and to seek alternative own-revenue sources.

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BACKGROUND

Local government is facing a myriad of problems that include poor economic growth, and high levels of unemployment and poverty. According to the Department of Cooperative Governance and Traditional Affairs (COGTA), a third of municipalities are dysfunctional and unviable, a third are at risk, while the remaining third are functional and viable. The majority of unviable municipalities are in rural areas and depend significantly on grants to fulfil their mandate. The government's aim is to minimise this dependency, as shown by the recent proposal by COGTA to amalgamate many municipalities in order to make them self-reliant.

The issue is whether the current funding model, which seeks to eliminate grant dependency and make municipalities financially viable, is appropriate for rural municipalities, considering their weak and fragile revenue bases. If the current financing model is not appropriate, then many rural municipalities will have to rely permanently on transfers because of low own revenues. Given the low own revenues, the related issue is whether intergovernmental transfers to rural municipalities are adequate and, if not, what are possible alternative own-revenue sources for rural municipalities that would lessen the dependency on transfers.

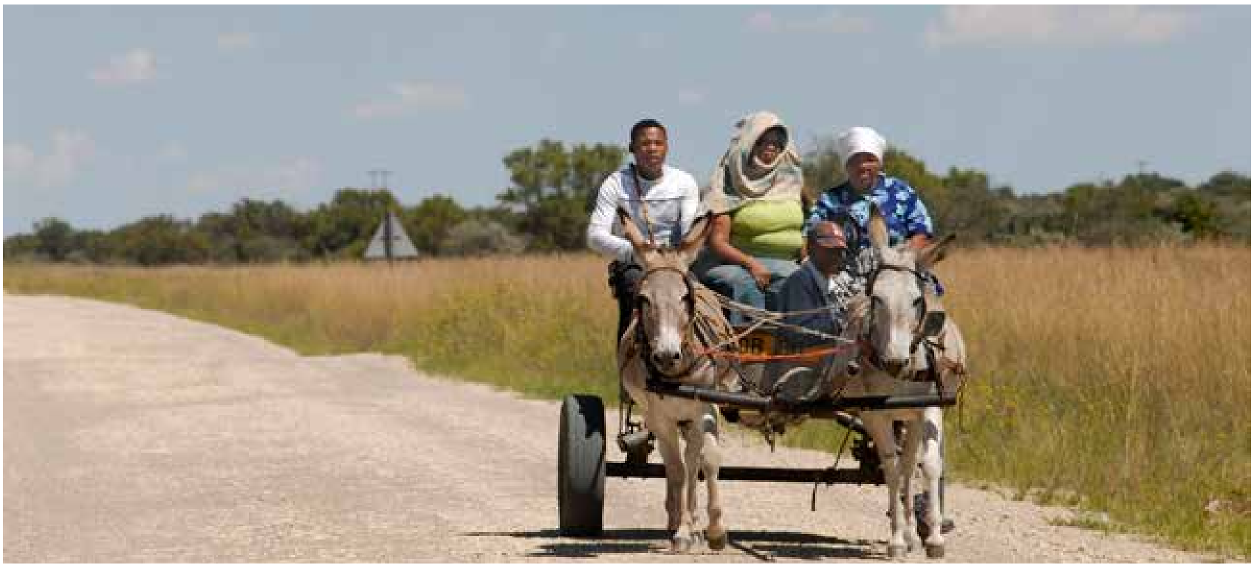
RESEARCH FINDINGS

Most of the recently amalgamated municipalities have low property rates and weak revenue-raising capacities. In other words, the amalgamations will not necessarily result in financially viable municipalities. Many rural municipalities will continue to be transfer-dependent, as their revenue bases are weak, and so the funding model of rural local municipalities should not ignore the fact that transfers will remain the mainstay of rural local government.

The research found that the current system of transfers adequately compensates rural local municipalities for their lack of own revenues in some (but not all) services. Therefore, transfers should be reviewed on a regular basis to avoid a situation where some services are over-compensated while others are not. In addition, viewing a grant in isolation may give the impression that a service is underfunded and yet when all grants are included, the service may be fully funded.

Where transfers are inadequate, rural municipalities could explore several potential revenue sources. Although property taxes are generally considered to be a reliable source for local governments, this is not the case for rural municipalities because of inadequate property tax administration and the lack of understanding of the role of traditional leaders in the rating of communal land and property on this land. Additional revenue sources include charging for entry to social amenities (e.g. parks, community halls) and levying fees on hotels and restaurants in areas with a vibrant tourism industry.

The study noted that elevating functionality to a demarcation criteria is problematic, as there is no direct or indirect link between functionality and municipal boundaries. Furthermore, the primary mandate of the Municipal Demarcation Board (MDB) is to demarcate municipal boundaries, delimit wards and carry out municipal capacity assess-



ments. Correcting for dysfunctionality in municipalities is clearly not part of the MDB mandate, but that of national and provincial governments, which have a range of monitoring, support, regulatory and intervening powers at their disposal. In any case, a municipality is dysfunctional because of many factors, such as service delivery, financial management and political stability, which are outside the control of the MDB and do not have a direct bearing on boundary changes.

CONCLUSION

As government seeks to make rural municipalities self-sufficient and less dependent on transfers, amalgamating municipalities will not necessarily make them self-reliant. Rural municipalities have weak revenue bases, and so the funding model cannot ignore the fact that transfers will remain the mainstay of rural local government. The Constitution acknowledges that some municipalities are transfer-dependent. Findings also suggest that transfers adequately compensate some (but not all) municipalities for lack of own revenues. In cases where transfers are inadequate, municipalities should seek alternative "non-traditional" revenue sources.

To enable rural municipalities to fulfil their constitutional mandate and ensure overall rural development, the following policy options should be considered:

- With assistance from the national and provincial Departments of Cooperative Governance and Traditional Affairs, rural municipalities should ensure that property registers and valuation-rolls in rural areas are in place and updated, and rural municipalities should be adequately capacitated to collect and administer property taxes.
- The National Treasury and Department of Cooperative Governance should note that some municipalities will never be self-funding. Therefore, demarcation processes must go beyond financial viability, to consider the equally important issues of democratic representation and community participation. The financial viability of municipalities can be improved by developing and increasing tax bases through economic development rather than amalgamations.
- The Department of Cooperative Governance should amend the Municipal Demarcation Act to ensure that the full financial impact of demarcations on a new municipality is assessed before any amalgamations are done. Dysfunctionality should be corrected through relevant legislative, policy and capacity-building measures rather than through amalgamations. The success (or not) and costs of mergers should be monitored.
- National Treasury should continue to consolidate grants (as previously recommended by the Commission) because reviewing grants in isolation gives the impression that some services are underfunded, whereas services may be fully or overfunded when the grants are viewed holistically.
- National Treasury should ensure that objectively derived cost estimates inform the local government equitable share and conditional grants, as without this the viability of rural municipalities will always be under threat.

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