
Financing Local Governments in South Africa

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ABSTRACT

The intergovernmental fiscal architecture for local governments in South Africa is a product of the negotiations in the late 1990ties to end apartheid, a thorough consideration at the time of what funding system for local government would serve a democratic South Africa the best, and the many developments that the system has undergone since its inception around the turn of the century. The architecture reflects South Africa's integrated system of multilevel government. The national government has a virtual monopoly on all taxes, and provinces almost rely almost entirely on transfers. Municipalities fund their budgets with own revenue, complemented by an equitable share of national revenue and conditional grants. This contribution sets out the considerations that influenced the system of financing local government, designed to usher in democracy at local level. It then examines the framework for own revenue generation by municipalities as well as the system for determining intergovernmental transfers. It considers practical challenges with the implementation of this framework, the extent to which the assumptions that underpin the architecture are still valid, and the system's capacity to respond to changing circumstances.

Keywords: South Africa; local fiscal autonomy; intergovernmental relations; local taxation; equitable share; division of revenue; intergovernmental transfers; conditional grants.

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1. INTRODUCTION

South Africa’s 1996 Constitution establishes a multilevel state with nine provinces and 257 municipalities. The multilevel government system was one of the outcomes of the negotiations that led to the dismantling of the apartheid system, and the introduction of democracy. It establishes a quasi-federal structure with provinces that have their own democratically elected leadership and constitutionally protected powers, but that operate within a highly integrated multilevel government and financial arrangement. The Constitution guarantees that local governments are led by democratically elected councils. They have constitutionally protected powers, and enjoy considerable fiscal autonomy.

This contribution focuses on how these local governments are funded. It briefly examines the history of local government, and discusses the rationale for the key choices that were made to structure a funding framework for municipalities in the post-apartheid era. It then sets out the own revenue sources of municipalities as well as the system of intergovernmental grants. Throughout the discussion, it will present observations about the challenges and opportunities in implementing the system.

2. LOCAL GOVERNMENT’S EXPENDITURE ASSIGNMENT

The nine provinces and 257 municipalities together are responsible for 52.9 % of total government expenditure, with municipalities responsible for 21 % of that share, and provinces 31.8 %. This is comparable to the situation in Spain where subnational governments are responsible for 47.3 % of government expenditure, with state and local governments spending 35.2 % and 12.2 % respectively (OECD/UCLG, 2022).

The 257 municipalities comprise eight single-tiered metropolitan municipalities and 44 district municipalities. Within those (two-tiered) district municipalities, there are 205 local municipalities. Expenditure assignments set out in the Constitution is largely symmetric: all nine provinces have the same constitutional powers. In principle, so do all local governments. Municipalities are responsible for the delivery of basic services to end-users, such as water, sanitation, refuse removal, and electricity. They perform infrastructure functions such as town planning, building regulations, and storm-

water drainage, and are also responsible for environmental health services and municipal public transport. Furthermore, they perform community services such as street lighting, cleansing, and firefighting¹. National and provincial governments may regulate these local government matters but only with minimum standards². Metropolitan municipalities perform all of the above functions. However, for district and local municipalities, a division of powers applies within each district, which distributes local government powers between the district municipality and the local municipalities within it.

3. OVERVIEW OF INTERGOVERNMENTAL FISCAL RELATIONS

The above expenditure assignment is complemented with the assignment of own revenue powers and intergovernmental transfers. The national government has a virtual monopoly over taxation. It collects almost all major taxes. Provinces have no constitutionally guaranteed taxing powers. They are almost entirely reliant on intergovernmental transfers with 96.6 % of provincial revenue coming from the national government³.

Local governments are expected to raise significant own revenue to fund at least a part of their expenditure. They are constitutionally empowered to levy property rates and charge fees for services⁴. On aggregate, municipalities are 75 % self-funded. Vertical and horizontal imbalances in local government are addressed with intergovernmental transfers, determined annually in an Act of Parliament. Local governments receive an unconditional grant, called the 'equitable share', and conditional grants. Furthermore, the allocation of responsibilities and resources to local government is complemented by a comprehensive system of financial and performance monitoring and supervision of municipalities by provinces and national government. Before unpacking this system in more detail, a brief overview of its rationale will follow.

3.1. The rationale for South Africa's system of financing local governments

The framework for the financing of local governments is informed by the history of local government under apartheid, and the choices that were made during the transition to democracy⁵. Under apartheid, local government was undemocratic, fragmented, subservient and racist. In line with the apartheid logic, there were separate local authorities for each racial category. While white voters could elect their councillors to lead white local authorities, the local government structures for black, Indian and coloured communities were led by stooges, appointed by the apartheid government. Local authorities

¹ See section 156(1)(a), read with Schedules 4B and 5B of the Constitution.

² Sections 155(6) and 155(7) of the Constitution.

³ Division of Revenue Bill B4-2-24, Annexure W1, p. 70.

⁴ Section 229(1)(a) Constitution.

⁵ For an overview of the history of local government, see STEYTLER and DE VISSER, 2023, Chapter 1.

were subject to intrusive national and provincial oversight, and the local government system was designed to implement the apartheid policy to segregate racial categories, and exploit the black majority. One of the most pernicious aspects of the apartheid local government system was its exploitative financing system. White local authorities governed distinctly demarcated wealthy areas with a buoyant tax base: they had the authority to tax properties and charge fees for services such as water, sanitation, electricity, refuse removal. As a result, they were able to deliver municipal services to their white residents that were more than adequate. In contrast, economic activity in the demarcated black, coloured and Indian areas was severely restricted, and their residents overwhelmingly poor. Their local authorities were thus starved of revenue, and dependent on meagre and unpredictable funding from the national government. Aside from being undemocratic and illegitimate, they were thus set up to fail in providing even the most basic level of services to guarantee the dignity of their residents. The integration of these racially separated local governments, in addition to their democratisation, was thus an imperative during the transition to democracy. This was aptly captured by the slogan 'one municipality, one tax base' (STEYTLER and DE VISSER, 2023: 1-11). Integrating the fragmented local authorities was necessary to enable integrated planning and redistribution within local governments. This was implemented with the result that the number of local authorities was drastically reduced from more than 1000 before 1994 to 284 in 2000 (and later reduced further to 257).

A further consideration was the need to protect local government autonomy by guaranteeing its authority to raise revenue. The authority to making spending decisions on a local government function, and the responsibility to raise revenue for it, should ideally be located in the same level of government. This would promote local accountability and enable local governments to deal with the necessary trade-offs, instead of creating local governments that would be dependent on senior governments for funding their expenditure (DEPARTMENT OF CONSTITUTIONAL DEVELOPMENT, 1998 G 2.1). At the same time, it was also determined that certain taxes would be best administered nationally, particularly the taxation of mobile tax bases such as personal and corporate income tax, and value-added tax.

There was also a realisation that, despite the prospect of integrated local authorities, national government was going to be better placed to ensure redistribution from wealthy regions to poorer regions. Not every local government was going to be able to extract the same level of resources from its residents. While the new, democratic and integrated local governments were going to play a role in redistributing resources from wealthy to poorer areas, they were obviously going to be limited to their own jurisdictions. In addition, the incoming national government, led by the African National Congress (ANC), was not convinced that every democratically elected local government was going to share its commitment to racial equality and redistribution. Consequently, it was decided that the national government needed to collect the majority of revenue, and take responsibility for distributing it across the provinces and local governments (VAN RYNEVELD, 1990).

Another consideration was that affording local governments fiscal autonomy (i.e. powers to levy taxes, borrow and determine spending priorities) would need to be balanced with the need to protect South Africa's fragile macro-economic stability, economic unity, and the health of the local, regional and national economy. For example, if local governments were to be permitted to raise taxes and fees excessively, it would drive up inflation, and disrupt macro-economic stability. Furthermore, economic unity and the free flow of goods and services would be jeopardised if local governments would use their taxing authority to erect barriers to the movement of goods and services, or if they would compete with one another for the lowest tax rate, resulting in a 'race to the bottom'. Finally, the unwieldy use of local taxes and fees could increase the cost of local goods and services and put a drag on the (local) economy. This prompted the drafters of the Constitution to reserve a strong regulatory role for the national government over municipal revenue and expenditure. Local government's constitutionally guaranteed revenue raising powers were thus limited to property rates and services fees, and national government was going to determine a national framework for these. Also, any further revenue raising powers would need to be based on legislation⁶.

In conceptualising a future democratic local government system, it became clear that local government was going to have more responsibilities than it would be able generate own revenue for. To fill this gap, intergovernmental transfers were going to be necessary. The determination of the size and purpose of these grants was going to be a critically important exercise performed by the national government. Particularly given South Africa's tumultuous past, it was going to be important that this power was not going to be neglected, or abused for nefarious political ends. Allocations had to be determined objectively, transparently, and based on reliable data. Furthermore, intergovernmental funding was going to have to at least address the need for (re)distribution (DEPARTMENT OF CONSTITUTIONAL DEVELOPMENT, 1998, G 2.2.3). Finally, the concerns of the recipients of the grants, i.e. the local governments, needed to be included in the dialogue towards the determination of these grants (DEPARTMENT OF CONSTITUTIONAL DEVELOPMENT, 1998, G 2.2.5). Trust in the process of determining intergovernmental transfers was essential, given the history of using financial and fiscal arrangements to exploit the black majority, as well as the still precarious nature of the new multilevel government constellation.

What follows is a brief outline of the most important features of the system that was designed, together with observations on its implementation to date.

3.2. Own revenue

The essential features of South Africa's intergovernmental fiscal system for (provincial and) local government are set out in Chapter 13 of the Constitution. In essence, the

⁶ Section 229(1)(b) and (2) of the Constitution.

system is based on municipalities collecting their own revenue, complemented by inter-governmental transfers to correct fiscal imbalances. The integrated or centralised nature of South Africa's multilevel government system comes through in the second feature, namely that there is an elaborate system of supervision, i.e. regulation and monitoring of financial performance.

3.2.1. *Property rates and service charges*

Section 229(1)(a) of the Constitution provides that municipalities may impose property taxes and charge fees for the services they provide. This broadly aligns with their constitutional powers which revolve around the built environment and the delivery of services to households. Several municipal functions entail the delivery of services to end-users who pay for those services, and where, in principle, cost recovery is thus possible. For example, municipalities may charge end-users for the provision of electricity, water, sanitation, and refuse removal. The municipal authority to determine, collect and retain property rates, and to charge fees for services is constitutionally guaranteed: in principle there is no empowering legislation needed. However, section 229(2) of the Constitution makes it clear that the national government regulates how municipalities may exercise these powers.

Property rates are levied in terms of a framework set out in the Local Government: Municipal Property Rates Act 6 of 2004 (MPRDA)⁷. The MPRDA grants local governments considerable discretion to value and rate immovable property. Local governments may determine property categories, attach rates to those categories, and determine annual rates increases. The MPRDA also sets limits. It instructs municipalities to adopt property rates policies in which they set out their policy approach, justify ratios (see below), rebates and exemptions (DE VISSER, 2013). A set of principles apply to these policies, which must then be passed as by-laws, to give them external effect. As part of the preparation of the annual budget, the municipality determines a rate on property. Other limits in the MPRDA to the municipal authority to set property rates include:

- principles for determining property values;
- caps on annual increases;
- mandatory property categories;
- maximum ratios for certain categories (e.g. agricultural property may not be rated beyond a certain ratio relative to residential property); and
- mandatory exclusions (mining rights, churches, sea shore, nature reserves etc.).

The Local Government: Municipal Systems Act 32 of 2000 regulates how municipalities must charge for services. Similar to the MPRDA, it instructs municipalities to adopt policies and by-laws, subjects to a set of principles. These include principles such as:

⁷ For an overview of the legal framework for municipal property rates, see STEYTLER and DE VISSER, 2023, Ch 13.

- users should pay for services consumed generally in proportion to their actual consumption;
- equitable treatment of consumers and access for the poor to basic services;
- tariffs must relate to the actual cost of delivering the service;
- using tariffs to recover cost and generate a surplus; and
- using tariff policy to promote local economic development⁸.

The Local Government: Municipal Fiscal Powers and Functions Act 12 of 2007 provides for a procedure for municipalities to apply for further taxing powers. In practice, the National Treasury has been parsimonious in granting municipalities taxation powers beyond those that are constitutionally guaranteed. Some change is in the offing once a new chapter on development charges (bulk infrastructure levies attached as conditions to land use management approvals) is put into operation⁹.

The extent to which municipalities raise own revenue varies greatly from one municipality to the next. The National Treasury remarks that it «varies dramatically, with poor rural municipalities receiving most of their revenue from transfers, while urban municipalities raise the majority of their own revenues»¹⁰. There are a number of reasons for this. First, the revenue assignment is determined by the division of powers between district and local municipalities. Generally speaking, it is metropolitan and local municipalities (not district municipalities) that levy taxes on property. Furthermore, while all metropolitan and most local municipalities perform the ‘trading services’ mentioned above, few district municipalities do. As a result, district municipalities raise very little own revenue and are largely dependent on national grants. Second, even if the tax assignment is there across the board for metropolitan and local municipalities, both the revenue base and tax effort vary substantially between them, resulting in wide variation. In reviewing the first twenty years of local government, a Presidency report remarked that «[t]he average collection rate of the ... metropolitan municipalities was 97 percent, while for the rest of the municipalities it ranged from an average of between 50 percent and 75 percent» (PRESIDENCY, 2015, 36).

In practice, many municipalities struggle to collect debt owed to them. In March 2023, the National Treasury reported that, at 31 December 2022, municipal consumer debts amounted to a staggering R305.8 billion / US 16.6 Billion (compared to R261.5 billion / US 14.22 Billion reported in the second quarter of the previous year). The largest component of this debt (71.1 %) relates to households. The outstanding debt includes an amount of R256.7 billion / US 14 Billion, which is debt older than 90 days (historic debt that has accumulated over an extended period), interest on arrears and other recoveries which may not be realistically collectable by municipalities (NATIONAL

⁸ For an overview of the legal framework for municipal service charges, see STEYTLER and DE VISSER, 2023, Ch 9.

⁹ Division of Revenue Bill B4-2-24, Annexure W1, p. 123. For a discussion of the legal framework for development charges, see CHONCO, 2020.

¹⁰ Division of Revenue Bill B4-2-24, Annexure W1, p. 92.

TREASURY, 2023). The reasons for this dire situation are manifold: municipal debt recovery is impacted by the sluggish economy, widespread unemployment, but also by the lack of fiscal effort (poor billing and collection practices and governance problems) on the part of municipalities.

3.2.2. *Borrowing*

Section 230A of the Constitution sets out a basic framework municipal borrowing. Municipalities are generally only permitted to borrow for capital expenditure. Borrowing for current expenditure is only allowed if the loan is repaid within the same financial year. The Local Government: Municipal Finance Management Act 56 of 2003 provides for a borrowing framework that makes municipal borrowing subject to strict requirements¹¹. Metropolitan and local municipalities have potential to borrow because they can offer a revenue stream (property rates, service fees) as security for debt. Some cities have issued bonds to finance capital expenditure. In practice, borrowing is mostly done by metropolitan and the largest local municipalities. For example, over the financial year 2016-2017, South Africa's eight metropolitan municipalities contributed almost two-thirds to municipal debt, followed by local municipalities at 32 % (or R72,8 billion) (STATISTICS SOUTH AFRICA, 2018).

3.3. Intergovernmental transfers

When comparing the constitutional responsibilities of municipalities with their own revenue, it becomes clear that there are vertical and horizontal fiscal imbalances. These fiscal imbalances are addressed through intergovernmental transfers. National government allocates intergovernmental funding to local government (provincial governments rarely make transfers to municipalities, because they themselves are almost entirely reliant on national transfers). The national government generally pursues three objectives with intergovernmental transfers to local government, namely to:

1. address fiscal imbalances;
2. ensure fair distribution of resources across the country; and
3. pursue national policy priorities.

The Constitution makes it clear that intergovernmental transfers complement a municipality's own revenue. A municipality will not be compensated with intergovernmental funding for a lack of fiscal effort. Similarly, own revenue will not be deducted from intergovernmental funding¹². Intergovernmental transfers are decided annually in

¹¹ For an overview of the legal framework for municipal service charges, see STEYTLER and DE VISSER, 2023, Ch 12.

¹² Section 227(2) Constitution.

the Division of Revenue Act (DORA) which is passed as part of the national government's annual budget.

3.3.1. Vertical division of nationally generated revenue

DORA sets out the vertical division of nationally generated revenue, i.e. it determines how all nationally generated revenue is split between national, provincial and local government. Before allocations to provincial and local government are determined, the national government takes the 'top slice' out of the National Revenue Fund. The 'top slice' comprises predetermined allocations, such as the costs of servicing national debt, contingency reserves, salaries of Member of Parliament and the judiciary and a few other costs.

For the 2024-2017 medium term, and after top slicing, 42.2 % was allocated to provinces, and 9.8 % was allocated to local government¹³. Over the years, the general trend in the vertical division of revenue is that national government retains approximately 50 % of national revenue, provinces just over 40 % and local government close to 10 % (NATIONAL TREASURY, 2023, 7).

The division, and the roughly 10 % share it produces for local government, is contested. Municipalities argue that their 10 % share is insufficient, given the functions they perform. It is then argued that it does not represent the full funding base for local government, given that municipalities also raise their own funding (LEDGER and RAMPEDI, 2021, 14). However, this may be based on assumptions that were valid when the system was designed in the latter part of the 1990ties, but that have been overtaken by a new reality. One of the main points of contestation is the assumption, underlying this funding model that municipalities purchase (cheap) electricity from ESKOM, the national electricity parastatal, and generate significant surpluses from the reticulation to end-users (LEDGER and RAMPEDI, 2020, 12). Indeed, in 1998, when the model was designed, South Africa had one of the cheapest electricity prices globally and a reliable supply, albeit to a much smaller number of people connected to the grid compared to twenty-five years later. However, since then, ESKOM bulk tariffs have increased substantially, supply has become notoriously unreliable, and businesses and more affluent consumers gradually defect from the electricity grid to alternative energy sources. This has significantly eroded the surpluses that municipalities generate with electricity sales (AJAM, 2021)¹⁴. This is just one of the many points of contestation in the debate about the vertical division of revenue.

3.3.2. Horizontal division of nationally generated revenue

Returning to the DORA, after setting out the vertical division it sets out the horizontal division: how much of the provincial share, will each of the nine provinces re-

¹³ Division of Revenue Bill B4-2-24, Annexure W1, p. 63.

¹⁴ Division of Revenue Bill B4-2-24, Annexure W1, p. 122.

ceive, and how much of the local government share will each municipality receive? DORA contains determinations of the vertical and horizontal division of revenue for the upcoming three financial years. This is in line with the national government's Medium-Term Expenditure Framework, which is its three-year policy framework and budget. For year one, DORA contains a definite allocation. For years two and three, it contains estimates which are adjusted in the following years. The estimates are usually close to accurate. This enables municipalities to plan their expenditure over at least a three-year period, as they are reasonably sure as to how much intergovernmental funding they will receive. Aside from determining how national revenue is shared across the three spheres of government, DORA contains a set of rules on how intergovernmental grants are going to be distributed and managed.

Intergovernmental funding for local government comes in the form of two types of grants. The first is an unconditional grant, called the 'equitable share'¹⁵. The Constitution provides that the equitable share is to «enable [a municipalities] to provide basic services and perform the functions allocated to it», but it is transferred without conditions. It is paid out of the local government share of national revenue, and the municipality is free to determine, in its budget, how to spend it. A failure to spend the equitable share at the end of the financial year, does not result in a duty to pay the funds back to the national government. Conditional grants, however, come with strings attached: they are earmarked for certain purposes, and are subject to conditions and monitoring.

Both the process of arriving at the vertical and horizontal division, as well as the division itself, are guided by the Constitution and legislation. First, section 214 of the Constitution contains substantive principles for vertical and horizontal revenue sharing. They concern issues such as the national interest, the need to service national debt, the need to ensure that provinces and municipalities can deliver basic services, economic disparities, fiscal capacity and efficiency, stability and predictability etc. Second, the Intergovernmental Fiscal Relations Act 97 of 1997 determines a process of intergovernmental consultation on the Division of Revenue Bill, which is followed annually. This process revolves around (1) independent expert input and (2) intergovernmental consultation in the run up to the tabling of the Division of Revenue Bill in Parliament.

3.3.3. The process towards the Division of Revenue Act

The process towards the annual DORA starts at least ten months before the beginning of the financial year with a report by the Finance and Fiscal Commission (FFC). The FFC is a national, independent, constitutionally recognised, body, tasked with advising governments in all the three spheres, on intergovernmental fiscal relations. It comprises nine members, appointed by the President. The Minister of Finance nominates members to the FFC with the involvement of the Premiers and organised local

¹⁵ Section 227 of the Constitution.

government¹⁶. In the abovementioned report, the FFC makes recommendations on (1) the vertical division of revenue and on (2) the allocations to (provinces and) municipalities. The National Treasury then prepares the Division of Revenue Bill. The National Treasury must respond to the recommendations by the FFC, and usually does that in the Explanatory Memorandum to the Division of Revenue Bill. The National Treasury consults with provinces in the Budget Council, and with provinces and local government in the Budget Forum¹⁷. The Budget Council is an intergovernmental forum that brings together the national Minister of Finance and his or her nine provincial counterparts. The FFC may also attend. The Budget Forum brings together the same representatives as the Budget Council, but adds a representative of organised local government. These two forums are platforms for information sharing, negotiation, and consultation surrounding intergovernmental fiscal transfers. The process is designed to include (provincial and) local government input into the process of designing the intergovernmental fiscal system. It is not without its challenges, however. It has been argued that the expert views of the FFC have little impact on what the National Treasury proposes (DE VISSER and AYELE, 2014). It has also been argued that, before the intergovernmental negotiations start, the die is cast in that the National Treasury has already effectively decided the vertical division (WEHNER, 2003: 7). Finally, it has been argued that the design of the process is flawed in that the entire local government sphere is represented with one representative, and that metropolitan municipalities for example, should have their own voice in the Budget Forum.

4. THE EQUITABLE SHARE

As indicated earlier, every municipality is entitled, in terms of the Constitution, to an equitable share of nationally raised revenue. The main objective of the equitable share for municipalities is to enable municipalities to deliver basic services. It is determined according to a formula, which relies on demographic and other data to calculate each municipality's share (National Treasury, 2016, p. 33). The formula has three parts, made up of five components:

$$\begin{aligned} & \text{Basic Services (BS) + Community Service (CS) + Institutional Funding (I)} \\ & \times \text{Revenue Adjustment (RA) +/- Correction and Stabilization (C)} \end{aligned}$$

The first part of the formula is constituted by the BS component, which funds the delivery of free basic services (water, electricity, sanitation, refuse removal and municipal health services) to poor households (NATIONAL TREASURY, 2016: 33). The 'free basic services' policy is a national policy that entails that a basic level of municipal services is provided to all households across the country (DEPARTMENT OF COOPERATIVE GOVERNANCE AND TRADITIONAL AFFAIRS, 2015). The National Treasury pursues this

¹⁶ See sections 220–222 of the Constitution and Finance and Fiscal Commission Act 99 of 1997.

¹⁷ See Part 3 of the Intergovernmental Relations Framework Act 97 of 1997.

objective by identifying poor households and allocating subsidies to the municipalities where they live. It estimates the number of poor households that reside in each municipality, using census and household survey data, collected by Statistics South Africa (StatsSA). The poverty threshold, used by the National Treasury is two old age state pensions per month which, in 2023 terms, is equivalent to approximately R 4200 (USD 233) per month (NATIONAL TREASURY, 2022: 37). If the combined monthly income of a household is less than two old age state pensions, the National Treasury includes a subsidy for that household in the equitable share for the municipality in which that household is located. This component of the equitable share is by far the largest of the three. In the 2023/2024 financial year, it represented 82.5 % of the total equitable share allocation.

The second part of the equitable share formula is there to ensure that municipalities, particularly poor ones, have the required administrative and governance capacity and are in a position to perform key municipal functions. It is constituted by three parts. The I component provides a subsidy to cover basic administrative costs. The formula takes the number of council seats as a proxy for the amount of support a municipality needs, and attaches a subsidy to each council seat in addition to a base allocation for each municipality. The CS component funds services that benefit communities rather than households (and for which a municipality thus cannot charge a fee). This involves functions such as environmental health, fire-fighting, roads, cemeteries, planning, stormwater management, street lighting and parks. The formula uses the number of households in a municipality and the services that a municipality provides. The RA adjusts for revenue capacity so that municipalities least able to raise their own revenue, benefit the most (NATIONAL TREASURY, 2016: 33). This aspect of the formula looks at the total income of individuals and households, property values, the number of households on traditional land (that may thus not yield property taxes), the unemployment rate in the municipality, and the percentage of the households that are poor.

The last part, the C component, ensures that changes in allocations to each municipality are evened out over time (NATIONAL TREASURY, 2016: 33). The C component ensures that municipalities are always guaranteed to receive at least 90 % of what is included in year two of three-year period covered in the DORA¹⁸.

The National Treasury publishes the details of the calculation of the equitable share for each municipality¹⁹. This is a remarkable display of transparency, and is uncommon on the African continent. It enables each municipality to verify the exact origins of the unconditional grant.

¹⁸ Division of Revenue Bill B4-2-24, Annexure W1, p. 101.

¹⁹ See http://mfma.treasury.gov.za/Media_Releases/LGESDiscussions/Pages/default.aspx (accessed 22 April 2024).

5. CONTESTATION SURROUNDING THE EQUITABLE SHARE

The above summary makes it clear that the majority of the funding, transferred to local government in the equitable share is aimed at supporting municipalities to provide free basic services. There are three main areas of contestation in the implementation of the free basic services component of the equitable share.

First, the grant is transferred without conditions, so it is up to municipalities to channel the funds to poor households in the form of free basic services. As indicated earlier, municipalities determine their own tariff and debt collection policies. These policies normally provide for a procedure for households to register with the municipality to receive basic services for free. Usually, residents must apply to be placed on a municipal indigent register, and must regularly renew their indigent status to remain eligible. The eligibility criteria often include means testing, which is administratively complex, controversial, and brings unintended consequences, such as stigmatisation. The criteria also differ from one municipality to the next. In general, municipal indigent policies are implemented through dense and inaccessible bureaucracies, aimed at reducing the number as much as possible. The reality is that, while the National Treasury calculates the number of poor households, using census and survey data, the implementation of municipal indigent policies by municipalities produces a vastly reduced number. As a result, less than a quarter of the equitable share funding makes its way to poor households. This brings two critical issues to the fore. On the one hand, a very substantial amount of national funding for poverty alleviation misses its target, despite being carefully calculated and targeted (LEDGER, 2021). The National Treasury's response, somewhat tersely, is that «[i]f municipalities choose to provide fewer households with free basic services than they are funded for through the local government equitable share, then their budget documentation should clearly set out why they have made this choice and how they have consulted with their community during the budget process»²⁰. On the other hand, it also points to underlying problems in the funding framework for local government, and the fact that «unemployment and poverty have a direct impact on municipal revenues, particularly in times of economic hardship, as households struggle to pay municipal accounts» (DEPARTMENT OF COOPERATIVE GOVERNANCE AND TRADITIONAL AFFAIRS, 2016: 107). In the Integrated Urban Development Framework (IUDF), government's policy on cities, it admits in carefully chosen language that «[t]hese effects are mitigated *somewhat* by national transfers to support the provision of free basic services for poor households» (DEPARTMENT OF COOPERATIVE GOVERNANCE AND TRADITIONAL AFFAIRS, 2016, 107 *emph. added*).

Second, the National Treasury's calculation of the number of poor households that attract subsidy for the municipality is based on the last available Census data, namely from 2011. The results of the 2022 Census were not yet available at the time of writing.

²⁰ Division of Revenue Bill B4-2-24, Annexure W1, p. 96.

The total number of households in each municipality is adjusted every year to account for growth. Therefore, while the number of households subsidised in a municipality increases annually in line with estimated household growth, the percentage of households subsidised in that municipality for free basic services through the formula has remained constant for over a decade. Municipalities have challenged this method for being out of touch with the reality of ever-changing settlement and migration patterns. The National Treasury admits that it is imperfect and, with the introduction of the 2023 Division of Revenue Bill, it promised to consider implementing a more refined model with the assistance of Statistics South Africa²¹.

The third challenge in relation to the equitable share formula is the difficulty of estimating the costs of providing basic municipal services such as electricity, water, sanitation and refuse removal. The formula currently uses standardised costing norms, but municipalities have argued that the costs of providing basic services vary significantly from one municipality to the next, and even from one area to the next. The remoteness of the community that must be serviced, the topography of the area where infrastructure must be installed and maintained, as well as settlement densities are but some examples of factors that greatly influence the municipality's costs in providing services. This is why the National Treasury is undertaking to assess the feasibility of introducing a cost differential model for the basic services component of the equitable share²².

6. CONDITIONAL GRANTS

There are four broad categories of conditional grants to municipalities:

1. Supplementary grants (comprising 13 % of the total volume of conditional grants) - these are general grants that supplement programmes partly funded by municipalities.
2. Specific purpose grants (72 %) - these assist with funding infrastructure and capacity building.
3. Indirect grants (14 %) - these address capacity and institutional issues and are generally used to fund operational spending.
4. Disaster response grants (1 %) - these enable the swift transfer of funds to assist with disasters or housing emergencies.

It is clear that the majority of funding, transferred through conditional grants, is used to fund capital expenditure. Even though municipalities are expected to raise funds in their own revenue streams for capital expenditure, most municipalities are unable to raise sufficient own revenue to fund capital expenditure. Often, municipalities must apply for conditional grants. Importantly, the conditional grants are paid from the na-

²¹ Division of Revenue Bill B4-2-24, Annexure W1, p. 97.

²² Division of Revenue Bill B4-2-24, Annexure W1, p. 121.

tional government's share of nationally generated revenue. They are accompanied by grant frameworks that determine issues such as the purposes for which the grant may be used and reporting requirements. These grants frameworks are included in DORA, thus contributing to the transparency of conditional grant funding. Conditional grants are included in the budgets of national line departments who transfer the funds and monitor the implementation. A failure to spend the grant generally results in a duty to pay it back to the national government.

From the point of view of local government, the proliferation of conditional grants has been a problem. For example, the 2024 DORA included more than 20 conditional grants, administered by seven different line departments²³. It is not uncommon that, to realise one specific infrastructure project, a municipality utilises conditional grants from multiple line departments in addition to its own revenue. The municipality's planning, budgeting and reporting with respect to this one infrastructure project must then be conducted in terms of multiple frameworks, each with their own priorities, objectives, and reporting cycles, in addition to its own. This is why the IUDF highlights «problems in the design and administration of grant programmes, including unclear and overlapping objectives, competing expenditure priorities, funding gaps and a lack of longer-term predictability and stability in funding flows» (DEPARTMENT OF COOPERATIVE GOVERNANCE AND TRADITIONAL AFFAIRS, 2016, 107). Municipal underspending on conditional grants is a significant problem and, while the reason often lies in poor planning and governance on the part of municipalities, the duplication and fragmentation also plays a role²⁴. This is one of the reasons why government is signalling a review of the framework for conditional grants²⁵.

7. CONCLUSIONS

The intergovernmental fiscal architecture for local government is a product of the negotiations to end apartheid, a thorough consideration at the time of what funding system would serve a democratic South Africa the best, and the many developments that the system has undergone since its inception around the turn of the century. It reflects the integrated system of multilevel government that characterises South Africa.

The national government has a virtual monopoly on all taxation, but responsibilities are spread across three spheres of government. This then necessitates an intricate system of intergovernmental fiscal transfers, which largely follows the division of responsibilities. The system for deciding on intergovernmental fiscal transfers is predictable, formula-based and backed by independently sourced data. Its rigorous transparency, insistence on intergovernmental consultation and objectivity are a model for countries the world

²³ See Schedules 4 to 7 of the Division of Revenue Bill B4-2024.

²⁴ Division of Revenue Bill B4-2-24, Annexure W1, p. 117.

²⁵ Division of Revenue Bill B4-2-24, Annexure W1, p. 117.

over. While by no means perfect, it has served South Africa well and has withstood political changes. For example, when the ANC lost its hitherto outright political control over a number of metropolitan municipalities, including the powerhouses of Johannesburg, Tshwane and Ekurhuleni, there were never any real fears that the national government would 'punish' these cities by leveraging its control over the national government's intergovernmental fiscal instruments. By then, the objectivity, intergovernmental consultation, and reliance on independent data of the intergovernmental fiscal architecture had settled in firmly, and the political change was absorbed into it.

The functional and revenue assignment is complemented by a system of vigorous monitoring of legal compliance, financial performance and service delivery performance. Like any intergovernmental fiscal system, it is not without its challenges, and under continuous review. The ability, but also the effort, on the part of local governments to raise own revenue is one of the most pressing issues. In a country with gaping inequality and staggering unemployment, collecting property taxes and payment for services is an arduous task for municipalities. As one of the most 'visible' of taxes, municipal taxes and fees often face resistance, as is the case in South Africa. This is compounded by the widespread service delivery and governance failures in municipalities. In 2021, the Minister of Finance reported that 163 municipalities were considered to be in financial distress, 40 were in a financial and service delivery crisis, and 102 had adopted unfunded budgets, i.e. budgets based on unrealistic revenue and expenditure estimates (NATIONAL TREASURY, 2022). There are no easy solutions to these problems, and there is certainly no silver bullet available in the intergovernmental fiscal system. Municipalities will have to improve their revenue effort, assisted by provinces and by a national government that is willing to consider new, alternative revenue sources for local government. They also have to prioritise spending on service delivery infrastructure and the maintenance of that infrastructure, as well as increase their capacity to spend the available infrastructure funding. The national government must resist the temptation to micro-manage municipalities with a dense web of conditional grants. Lastly, a continuous refinement of the equitable share formula is called for, in order to ensure it increases its precision in reaching the municipalities and communities that need it the most. The design of South Africa's fiscal architecture, with its emphasis on objectivity, reliance on independent data and intergovernmental consultation, ought to be eminently capable to produce those refinements and make an essential contribution to improve local government's ability to deliver on the promises of the Constitution.

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