

LOCAL Government Finance

A COMPARATIVE STUDY

DIRK BRAND



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Local Government Finance – A Comparative Study

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Foreword

Throughout the world societal and governance problems are manifest and increasing as poverty and inequality are evident and increasingly prevalent internationally, nationally, regionally and locally. South Africa is no exception to this rule and possibly reflects many of the global issues and challenges. The global configuration is evident in the genetic make-up of the South African national, regional and local governance, and the societal and governance structures and functions of the South African governance institutions.

Expeditious and timeous academic, political and professional attention to local government finance in South Africa is therefore necessary, as insight into the South African situation may provide benefits to global and local action learning.

This focus is long overdue. The last visible and prominent governmental focus on local government finance in South Africa happened in the context of the Browne Commission and the Croeser Working Group, which respectively delivered their reports related to public and local governance finance in 1980 and 1982 – more than 30 years ago. It has to be acknowledged that local government finance has received ongoing attention from the current government departments and the Financial and Fiscal Commission. But given the nature and scope of changes in the South African society and governance since 1980, and especially since 1990, as well as subsequent changes after the democratisation in 1994 and the 1996 Constitution, it is clear that urgent attention to local government finances is needed.

The Stellenbosch Good Governance Forum (SGGF), situated within the Stellenbosch School of Public Leadership (SPL) of Stellenbosch University, has identified a particular need for a research and academic focus on local government finance within the broader contexts of public governance and finance. This initiative is linked to the Municipal Minimum Competencies Programme of the SPL whose focus is on building financial competencies for local government in South Africa. The SPL also offers an ongoing research programme focusing on public finance and is linked to the system of intergovernmental relations and innovation in public finance. This research and teaching is applied to an action learning and research context within central, provincial and local government institutions. The aim is to enhance governance and financial innovation within the context of the emerging SGGF.

The nature and scope of challenges in South Africa, according to the National Development Plan in South Africa, are:

- 1 The unemployment challenge: too few South Africans are employed;
- 2 The education challenge: the quality of school education for most black pupils is substandard;
- 3 The infrastructural challenge: poorly located and inadequate infrastructure limits social inclusion and fast economic growth;
- 4 The marginalised poor challenge: spatial challenges continue to marginalise the poor;
- 5 The sustainability challenge: South Africa's growth path is resource-intensive and hence unsustainable;
- 6 The health challenge: the ailing public health system confronts a massive disease burden;
- 7 The public service capacity challenge: uneven public service delivery;
- 8 The corruption challenge: corruption undermines state legitimacy and service delivery; and
- 9 The divided society challenge: South Africa remains a divided society.

A research and academic focus on public finance and local government finance is not only called for, but also extremely important and urgent when considering evidence that, since 2007, service delivery protests in South Africa has shown an increase of more than 100% each year. The growth rate increased with more than 200% from 2011 to 2012. This alarming trend continued in the years subsequent to 2012, with a reported amount of 14 740 service delivery protests in 2014, of which 12 451 were peaceful and 2 289 turned violent.

The South African and global societies and societal institutions are under tremendous pressure. Innovative approaches to all governance systems will have to be found, which will require rigorous and committed research and knowledge based on ideas and evidence, rather than on ideology and emotion.

The work of Dr Dirk Brand on local governance finance represents a major step in the conceptual and comparative quest for improved governance and governance finance. It represents the conception of innovative ideas, improved performance and an aspiration to make the world a better place. The author should be commended for his exemplary effort to add to the knowledge-base and inspire action in this regard.

Erwin Schwella (PhD)

Professor of Public Leadership

Stellenbosch University

February 2016

CHAPTER 1

Introduction

1. Introduction
 - 1.1 South African context
 - 1.2 International context
2. Research questions and aim of study
3. Methodology
4. Overview of publication

1. Introduction

1.1 South African context

In a multi-sphere system of government, such as the constitutional system in South Africa which is characterised by cooperative government, effective financial intergovernmental relations are essential for the effective functioning of the whole constitutional system. Financial constitutional law *inter alia* includes the actual allocation of functions and financial resources to the three spheres of government, equalisation measures, policy issues relating to financial intergovernmental relations, as well as governance issues.

After two decades of constitutional democracy in South Africa, various aspects of the financial intergovernmental relations system are in the spotlight. Annual reports from the Auditor-General, regular newspaper reports and political debates in different legislatures confirm the bad state of affairs in many municipalities, various provinces and national government departments. It is in local government in particular that the consequences of a range of problems relating to the finances of municipalities are often quite visible since it translates into bad or no service delivery. This publication is thus focused on the local government finance model, but reference will also be made to the rest of the system of financial intergovernmental relations where relevant.

The motivation for focusing on this specific aspect of local governance, namely local financial governance, can be summarised as follows:

- The financial viability and sustainability of most municipalities in South Africa are under pressure;
- Insufficient or simply poor financial management contributes to this situation, but the finances of municipalities seem to be insufficient to support all the functions of municipalities in a sustainable manner;
- The increasing role of metropolitan government, as a distinct form of local government with substantial financial needs, should be properly acknowledged;
- The mismatch between the functions and funding of district municipalities and the lack of own funding require a rethink of the role of district municipalities;
- There is a need to focus on the outcomes of public spending and the strengthening of accountability; and
- The increasing dependence of municipalities on the equitable share allocation prevents municipalities from strengthening their own income, i.e. local sources of income.

The first question in this research study, which provides an important part of the context in which this study was done, is: What is the current state of the local government finance model in South Africa?

The notion of cooperative government implies that there are various centres of political authority or decision-making in the country that must cooperate with one another. The constitutional power and functions are divided between the three spheres of government, and all three spheres are obliged to adhere to the principles of cooperative government and intergovernmental relations according to Chapter 3 of the Constitution, which *inter alia* include that they must “provide effective, transparent, accountable and coherent government for the Republic as a whole” (sec. 41).

The financial constitution provides the basic framework for local government finances in South Africa and it is complemented by a series of further legislation such as the Municipal Finance Management Act (MFMA), 56 of 2003. The constitutional and legal framework constitutes the basic architecture of the local government finance model. In assessing the current state of affairs, the ability of local government to meet the legal requirements and constitutional goals is in the spotlight. Issues such as the following are part of this initial assessment: quality of local financial governance (including management and administrative capacity), revenue of municipalities, and effective management of expenditure of municipalities.

Public opinion and service delivery protests give some indication of the state of affairs in local government, but for the purposes of this study the official assessments (annual audits of municipalities) by the Auditor-General, reports by the Financial and Fiscal Commission and the recent Back to Basics report by the Department of Cooperative Governance and Traditional Affairs provide an appropriate and valuable basis for providing an overview of the current state of affairs.

The Back to Basics report draws a very bleak picture of the state of local government in South Africa.

The Financial and Fiscal Commission (FFC) has thoroughly researched and reported on the financial intergovernmental relations in South Africa since 1995 (e.g. its annual submission on the division of revenue). In the FFC's Annual Submission for 2015/16 it expressed concern about some issues that impact negatively on the financial position of local government. One of the key factors that contribute to the financial viability of municipalities is the demarcation thereof. The FFC stated in this regard:

"Municipal demarcations should ideally result in financially sustainable municipalities, but many municipalities lack a sound revenue base to sustain their activities" (FFC, May 2014:136).

International developments often have an impact on the economy and society in South Africa (see 1.2 for further discussion on the international context). The international financial and economic crisis that started in 2008 is one such an issue which caused an economic slowdown in South Africa (FFC, May 2014). The initial period of negative economic growth was reversed since 2010 with slow economic recovery and lower economic growth rates than what is needed in South Africa. This also had an impact on local government where the demand for more services and support to the poor increased. The financial position of many municipalities was thus negatively affected.

The standard of the local government sphere's public financial management is still far from the standard envisaged in the Constitution and expected by citizens. From the Consolidated general report on the audit outcomes of local government, MFMA 2012-13, by the Auditor-General, it is evident that there is much room for improvement when it comes to compliance with legislation, quality of financial statements and effective financial management in most municipalities. There are various contributing factors that lead to such a situation in a municipality, which in turn has an effect on service delivery to the community. The seriousness of the situation in local government is

emphasised in the Back to Basics report by the Department of Cooperative Governance and Traditional Affairs which states that only one third of the 278 municipalities is reasonably functional, with only 7% performing well (Department of Cooperative Governance and Traditional Affairs, 2014). The report highlights some of the key contributing factors:

“Institutional incapacity and widespread poverty have undermined the sustainability of the local government project, leading in some instances to a catastrophic breakdown in services. The viability of certain municipalities is a key concern. The low rate of collection of revenue continues to undermine the ability of municipalities to deliver services to communities. Our municipalities also need to be driven by appropriately skilled personnel and their correct placement.”
(Department of Cooperative Governance and Traditional Affairs, 2014:4)

In discussing the many governance challenges, including those in local government, the building of a capable state, as envisaged in the National Development Plan Vision 2030, is crucial for effectively dealing with these challenges (Schwella, 2015).

All local communities in South Africa are characterised by high levels of poverty, although the scope thereof differs from one area to another. It is estimated that 45% of the population is poor, with 20% living in extreme poverty (Khumalo & Ncube, 2015). These high poverty rates are contributing to the dire financial situation in many municipalities. Many municipalities, especially the rural ones, are reliant on grants for their capital expenditure as part of the equitable share allocation (National Treasury, 2014). On average municipalities rely on their own resources to fund 75% of their functional responsibilities, including their capital expenditure, but the dependence on transfer funding in some rural areas is up to 80% of a municipality’s budget (Khumalo & Ncube, 2015). This is part of the asymmetric reality of financial capacity across the spectrum of municipalities within the current system of local government.

The basic premise of the constitutional scheme is that the three spheres of government each have a specific constitutional mandate to perform the functions allocated to them. They are interrelated, interdependent and distinct spheres of government functioning within a system of a cooperative government (Constitution, 1996:s.40). The uneven division of funds between the three spheres of government resulted in a vertical fiscal gap which has to be bridged by some form of financial equalisation in order to enable the provinces and municipalities to perform their constitutionally allocated functions (Constitution, 1996:s.227; Brand, 2006). The financial equalisation mechanism, stipulated in the Constitution, is an equitable division of nationally collected revenue between the three spheres of government (Constitution, 1996:s.214). The equitable share allocation

to local government is an important source of revenue for municipalities and thus an important part of the architecture of the local government finance model.

In reviewing the current funding model for local government, it is therefore necessary to also discuss the financial intergovernmental relations system and the state of local government. The review of the local government finance model is furthermore motivated by international developments regarding decentralisation and local financial governance reform. While the South African context is obviously important, it is also evident that the international context within which South Africa functions is relevant to a publication such as this. The interaction between South Africa and many of its trading partners, international cooperation at national and regional level and the role of international institutions such as the World Bank in financial governance all contribute to the overall context in which a discussion on local financial governance reform should take place.

1.2 International context

South Africa's focus on local government is not unique. The decentralisation of government functions is an important issue in many countries and different types of constitutional systems. Financial decentralisation is very topical and also a complex and multi-faceted issue. The basic motivation for decentralisation is that local government is the closest form of government to the citizens and should thus be in a better position to effectively deal with the needs of citizens within their respective communities (United Cities and Local Governments (UCLG), 2011) compared to a national government.

Globalisation is defined by Held and McGrew (2004) as follows:

Globalisation can be conceived as a process (or set of processes) which embodies a transformation in the spatial organisation of social relations and transactions, expressed in transcontinental or interregional flows and networks of activity, interaction and power.

These authors further described the characteristics of globalisation in the following way: "First, it involves a stretching of social, political and economic activities across frontiers, regions and continents. Second, it is marked by the intensification, or the growing magnitude, of interconnectedness and flows of, for example trade, investment, finance, migration and culture. Third, it can be linked to a speeding up of global interactions and processes, as the development of world-wide systems of transport and communication increases the velocity of the diffusion of ideas, goods, information, capital and people. And, fourth, the growing extensity, intensity and velocity of global interactions can be associated with their deepening impact such that the effects of distant events can

be highly significant elsewhere and specific local developments can come to have considerable global consequences. In this way the boundaries between domestic matters and global affairs become increasingly fluid. Globalisation, in short, can be thought of as the widening, intensifying, speeding up, and growing impact of world-wide interconnectedness.”

Globalisation has a significant impact on both developed and developing countries, although the effect varies between states. Shah (2008) argues that the positive impact of globalisation on poverty alleviation, combined with the information revolution, act as catalysts for reshaping government functions both within countries as well as in an international context. These factors also have an impact on how local government functions: they lead to the strengthening of local government institutions as well as greater citizen empowerment in many countries, and thus the creation of new opportunities for co-production of public services. This specific trend is often referred to as localisation and contributes to improving social and economic conditions in local communities.

Globalisation also has a significant impact on the tax regimes of countries. The growing mobility of people, information and capital often has a limiting effect on countries’ potential to collect personal income and corporate tax, thus reducing the resources available to fund public services (Shah, 2008). This means that countries must rethink their internal tax arrangements and funding allocations to different levels or spheres of government.

Various global issues create both individual and collective challenges for countries. Climate change, the international financial and economic crisis in 2008 and later, pandemics such as Ebola and HIV/Aids and pressure on food security are some of the major global challenges that warrant the attention of individual countries and international organisations. These issues also impact on the way government is structured and functioning in individual countries, thus they influence the potential role of local governments. Responses to international crises often include local solutions, for example local measures to limit the spread of Ebola in West Africa were part of the international response to the crisis.

One of the effects of the international financial and economic crisis is low economic growth and increased unemployment in many countries, e.g. in Spain and Portugal. It also had a negative effect on the financial situation in many local governments, since it is not feasible to impose higher rates of local taxes or any additional taxes in such an economic climate. Many municipalities thus found themselves in a difficult situation: they could not easily raise local taxes without harming the local community, but if they

wanted to stimulate economic growth, they had to provide tax incentives which would reduce their tax income, thus limiting the service delivery ability of those municipalities (Chamber of Local Authorities, 2014). The financial crisis in many national governments in the European Union also put pressure on the transfer of funds to local governments in those countries.

There is a growing international trend towards urbanisation. This means that the number of inhabitants in cities and towns are growing and that these cities and towns must adjust accordingly. Currently, most of the people in the world live in urban areas and this figure is growing. It is expected that most of the urban growth will be in Africa and Asia (UCLG, 2011). Together with all the pressure urbanisation puts on infrastructure and service delivery in local communities, there is often the additional pressure that poverty is increased in urban areas, which requires even more attention to the financial situation of local governments. Growing urbanisation has such an important impact on local government finance that it justifies specific attention in this publication.

According to a recent study by the UCLG (2011) on decentralisation, the growth in metropolitan areas in particular requires innovative governance solutions and appropriate fiscal architecture. Infrastructure development – whether it is for the provision of basic services such as water, electricity and waste removal or the building of roads, schools, hospitals and the creation of Wi-Fi connectivity – requires significant funding. The growth in urbanisation intensifies a growing backlog in the provision and maintenance of infrastructure in local communities. This provides further motivation for focusing on decentralisation (including financial decentralisation) and developing innovative solutions for local communities. This is, however, a global issue and not only a South African one. The international economic crisis in 2008 had a negative impact on the ability of many local authorities to take care of infrastructure development, simply because less funding was available to do so (Chamber of Local Authorities, 2014).

Despite all these negative impacts of the global financial and economic crisis on local government in many countries, many positive developments were initiated in Europe since 2008. In a study by the Chamber of Local and Regional Authorities in Europe in 2014 it was reported that in Poland the reduction in national grants to local government led to the strengthening of the local tax revenue. In Macedonia the financial capacity of municipalities was strengthened in order to grow the local sources of revenue (Chamber of Local Authorities, 2014).

The global economic crisis has shown clearly how interlinked the international community became. The impact of the crisis in one country might also impact various other countries to varying degrees. It is therefore appropriate to consider international

developments and challenges in recent years, as well as what new solutions were developed for, among other things, local financial governance. Reform initiatives in various countries to attend to these and other challenges and re-shape the financial architecture of local government could have an impact on the South African situation.

2. Research questions and aim of study

The aim of this study is to find new solutions for the problems relating to the current finance model facing local government in South Africa, but which also affects provinces and, to a lesser extent, national government. The FFC, in its report on sustainable local government, referred to the municipal service delivery challenges, inadequate funding of municipalities, administrative incapacity and weak accountability systems as some of the key factors that motivate a review of the local government's current finance model (FFC, 2013). These issues are strong indicators of a need for local financial governance reform. Many international factors motivating reform are also relevant to South Africa, such as technological progress, "demographic change, spatial mobility and widening interregional disparities" (Blöchliger & Vammalle, 2012:12).

This publication includes a comparative analysis of and reflection on various current international developments. Its aim is to draw lessons from other multi-level systems of government and to find innovative approaches to some of the financing needs of local government. It is not a complete comparative study, but rather one that uses some international comparisons as well as international examples of successful innovative initiatives in local financial governance. In examining the situation in South African municipalities, it is necessary to include a comparative analysis of their financial performance as well in order to explore some of the practical solutions to improve their situation. There are economic disparities among the nine provinces in South Africa, as well as among all the municipalities in the country, which also impact on the financial situation in individual municipalities. The research questions, although focused on the future development of the financial governance system in South Africa, also have an international angle which could make it relevant to other multi-level systems of government.

It is therefore important to first get an understanding of the current state of local government finance in South Africa. This is provided in the first part of this introductory chapter.

Some of the critical questions that provide direction to this publication are:

- 1 What is the current state of the local government finance model in South Africa?
- 2 How could the local government finance model in SA be improved to be more sustainable and equitable?
- 3 What lessons could be learned from other multi-level systems of government that could be utilised in the SA context?
- 4 How should local government finances and functions be allocated to strengthen sustainability in a modern, multi-level system of government?

3. Methodology

The research is qualitative and mostly based on a literature study of relevant conceptual and comparative academic, policy and professional literature. Most of the research has been done by way of a desktop study that focuses on the most recent literature, including a focus on relevant legal reform of local government finances in a selection of countries.

A specific case study of the German local government finance model, with specific reference to Bavaria, includes a discussion of the applicable legal framework. A series of interviews with a range of people (practitioners and academics) in local and regional government in Bavaria, Germany, contributed to the understanding of the structure and functioning of the system. These interviews were semi-structured to allow for more interactive discussions about current challenges and reform initiatives and suggestions. The interviewees were practitioners at regional government level as well as people from different types of local government.

4. Overview of publication

This chapter provides the introduction to the study and sets the scene for the rest of the discussions in this publication. It provides perspectives on the South African as well as international context in which local government is functioning, and gives an overview of the current state of the local government finance model in South Africa. A short description of the research methodology is included. The rest of the chapter provides an overview of the entire publication.

Chapter 2 focuses on a conceptual framework for local financial governance. This chapter deals with key principles and concepts relevant for good local governance in a multi-level system of government. Reference is made to international developments in this regard, and a discussion on concepts and principles in South Africa, which underpin

the current local government finance model, is also included. In the shaping of a system of local financial governance it is important to have a clear understanding of the relevant concepts and principles that have an impact on such a system.

This research study uses a comparative analysis, as well as international examples of successful initiatives in local financial governance, to draw lessons from international developments that could be relevant for South Africa. Chapter 3 therefore provides a comparative overview of the finance models of local government in a selection of countries with different types of constitutional systems. It is a focused comparison that describes and discusses specific elements of the local government finance model in the specific countries. The selection of case studies includes one African country, one in Asia and three in Europe. This comparison will focus primarily on revenue sources for local government and reference will also be made to recent reforms in this regard.

In Chapter 4 an in-depth description of the current situation of the local government finance in Germany is provided. Germany, one of the five country cases in Chapter 3, had a significant influence on shaping the current constitutional order in South Africa, despite differences between the two countries. Financial equalisation in Germany is a very important source of revenue for the *Länder* as well as for the local governments, but a detailed discussion of the system of financial equalisation justifies a publication on its own. Therefore, reference will be made to the *Länder* financial equalisation only as far as it is relevant. The local government financial equalisation will be presented in more detail. This presentation will also include a discussion of the division of functions between the regional and local levels of government in Bavaria, Germany. A discussion of recent reform initiatives in Germany will also be included in this chapter.

Metropolitan governments around the globe are growing rapidly and in many countries it requires special attention that recognises its unique position and challenges within the field of local government. Urbanisation and the concomitant need to maintain and upgrade infrastructure to support growing populations in urban areas is an important issue of particular relevance to metropolitan local government. The funding of these infrastructure needs requires special attention. Chapter 5 deals with recent international trends, challenges and opportunities in metropolitan government which could be relevant to South Africa. This chapter focuses on urbanisation and the impact thereof on local government, with specific reference to one type of local government, namely metropolitan government. Although this emphasis on metropolitan government and urbanisation could be distinguished from the approach in most of the other chapters, the impact of growing urbanisation worldwide (including in South Africa) on local governance in general and local financial governance in particular is significant enough

to justify a separate chapter. It therefore contributes to the overall exploration of the local government finance model in this publication with a view to design appropriate reform proposals.

In Chapter 6 the focus falls on cost-effective and efficient local governance. An overview of the main determinants for effective, efficient and economic municipalities, including the use of a variety of financial sources available to local government, is provided. This is followed by an analysis, based on a series of financial ratios, of the financial performance of five municipalities in South Africa. It is important to understand the application of these ratios since it has an impact on the ability of municipalities to borrow money and on the quality of its service delivery. In the last part of this chapter, a discussion on the determination of the cost of service delivery is provided. The chapter concludes with recommendations for improving the situation in individual municipalities and a discussion on more general reform opportunities.

In the knowledge era of the 21st century, it is important to consider innovative approaches to public funding in order to deal more effectively with the challenges that government faces. This is of particular importance in areas such as renewable energy and new infrastructure developments in local communities. A growing demand for improved maintenance of infrastructure and development of new infrastructure requires significant additional funding. The current funding model for local government does not respond adequately to this demand. It is therefore important for local government in South Africa to embrace innovation and explore innovative approaches to funding, in addition to ensuring the effective and efficient use of existing funding. Chapter 7 provides an overview of relevant international examples, in addition to the international case studies in Chapters 3 and 4, of innovation in local government funding.

In a review of the local government finance model it is inevitable that there will also be a discussion on the division of functions between the levels or spheres of government and how this division is linked to the allocation of financial resources. A review of the current funding sources for local government is also provided in Chapter 8. South Africa has an integrated system of financial governance and any reform initiatives that focus on local government finance thus also have to take into account what impact these initiatives will have on the rest of the system of financial intergovernmental relations. Chapter 8 draws on the discussions in previous chapters to create a new or updated framework of division of functions and corresponding funding arrangements between provinces and local government in South Africa. It also includes relevant recommendations for local financial governance reform in order to strengthen good public governance in South Africa.

CHAPTER 2

Conceptual Framework for Local Financial Governance

1. Introduction
2. Concepts and principles
3. Structure of local financial governance
4. Conclusion

1. Introduction

The development of theoretical models of public finance in multi-level systems of government has a strong link to Musgrave's (1959) seminal work on public finance in the middle of the 20th century. A discussion on a conceptual framework for local financial governance in the 21st century would not be complete without looking at the historical development of the theory on public finance in multi-level systems of government.

Musgrave initially designed an economic model for an imaginary unitary state with three branches, namely the allocation, distribution and stabilisation branches. The allocation branch was responsible for developing the applicable revenue and expenditure policies and deciding how resources should be allocated. The distribution branch was responsible for making adjustments in the distribution of income and wealth, while the stabilisation branch had to ensure that economic stability occurred throughout the state. It is evident that these branches in this simplistic system were interdependent. Constitutional systems have since evolved to include a variety of multi-level or multi-sphere systems of government, inherently more complex than the original model of Musgrave. The later work of Musgrave, and also Oates, applied the initial economic theory to a multi-level system of government where decisions are taken at all levels of government (Musgrave, 1986; Oates, 1993; Brand, 2006).

In terms of this economic model for multi-level systems of government, services are provided at all levels, such as on a national level (e.g. defence) or regional or local level

(e.g. education or street lighting). It follows that the funding for services provided nationally should be provided by national taxes, while services provided at regional or local levels differ between jurisdictions and can thus ideally have differentiating taxes levied by each respective jurisdiction. Inter-jurisdictional transfers will also play a role to ensure a more equitable distribution of financial resources. Musgrave (1959:181) described it as follows:

“The heart of fiscal federalism thus lies in the proposition that the policies of the Allocation Branch should be permitted to differ between states, depending on the preferences of their citizens. The objectives of the Distribution and Stabilisation Branches, however, require primary responsibility at central level.”

In terms of this approach, macroeconomic stability and policies aimed at the redistribution of wealth are functions that should be exercised by a national government. In order to properly accommodate a variety of consumer preferences, needs and circumstances in the different sub-national jurisdictions, regional and local government (within a multi-level system of government) should be responsible for functions that respond to different consumer preferences (the Allocation Branch in Musgrave’s model).

The basic economic theory, applied to multi-level systems of government, has to be updated in the 21st century in view of many national and international developments in the constitutional, economic and social landscape. An important development in this context is the dramatic changes in the economic environment of the world during the past decades. International trade relations, the development of free trade agreements and supra-national institutions, as well as the huge impact of information and communication technology, are some of the key characteristics of the world economy.

Although economic theory plays a significant role in the design of financial governance models, including local financial governance, there are a host of other factors that also influence the design and functioning of financial governance models. Domestic factors (such as political realities, constitutional development and socio-economic conditions) play a role, in particular in local financial governance, while international developments (such as globalisation) also need to be considered in a discussion about local financial governance reform.

Globalisation and the information revolution play a significant role in the functioning of systems of government and could also have an impact on the design thereof. One of the implications of globalisation is that a producer of a service or product in one location such as a small village in India can sell that service or product anywhere in the world. A more traditional policy approach would be to focus on the development of the local market and to create welfare within the local economy, while globalisation created

a much larger international market for that local producer. Domestic policies should therefore take cognisance of the impact of globalisation. The rapid rate of technological innovations and the development of the information society are additional contributing factors to this continuously changing environment.

Supra-national relations and entities such as the European Union have an impact on the jurisdiction and functioning of national governments (i.e. the member states of the EU) and also on regional and local government. One of the implications of the continuous development of the EU is that policies and rules are no longer the sole domain of national governments, but mostly handled by Brussels. In the EU there are many examples of regional governments that formed international partnerships on common issues (e.g. regions along the Danube, or the Alpine regions) and they can access specific EU funding for projects within those areas. Cities are becoming important international role players, not only in cases such as the Olympic Games where they act as institutional partners for the International Olympic Committee, but in general economic activities such as tourism, trade and international conferences where there is a lot of competition between cities all around the globe. In Africa there are various regional cooperation initiatives with supra-national status such as the Southern African Development Community (www.sadc.int), COMESA (Common Market for Eastern and Southern Africa) (www.comesa.int) and the Economic Community of West African States (www.ecowas.int). These developments have an impact on issues such as the relations among the respective member states, the intra-regional trade and tax arrangements for citizens of member states.

In the past 50 years many developments in the international domain had an impact, and continue to make an impact, on the original theoretical model of public finance in multi-level systems of government. Some of these developments relate to structures and processes of a supra-national character, while the impact of others is even more widespread, for example climate change and global warming. In a study on local government finance reform it is important to start with the basics and reflect on the key concepts and principles that form the basis of the finance model. Various questions could therefore be asked about the foundations underpinning this model and amendments needed to respond to the challenges of the 21st century, such as: How do these developments affect the economic model of modern multi-level systems of government? What are the key principles and concepts that influence the design and functioning of multi-level systems of government, and more specifically, local government? These issues will be discussed in this chapter with a view to contribute to the development of an appropriate framework for local financial governance in a modern, multi-sphere system of government such as that of South Africa.

2. Concepts and principles

In a constitutional democracy, the governance framework created by the constitution of a country is fundamental to the organisation and funding of local government in that country. In some countries, for example South Africa, local government is regarded as a separate sphere of government which has a specific constitutional mandate, while in some other countries, for example in Canada, local government is a creature of provincial statute (Kincaid & Tarr, 2005). According to the European Charter of Local Self-Government (1985), the powers and responsibilities of local authorities shall be prescribed in a constitution or by statute (Art.4). In South Africa the basic provisions for local government (as one of the three spheres of government) are provided in the Constitution, 1996, and complemented by a range of laws that deal with the establishment, functioning and financing of local government. The constitutional and legal framework assigns the powers and functions to local authorities in a country and provides the applicable funding arrangements (UCLG, 2010).

Some of the underlying principles applicable to local government are sometimes included in a constitution, for example accountability, transparency and openness. In South Africa the Constitution includes, as part of its founding values in section 1, that South Africa has a multi-party system of democratic government which must ensure accountability, responsiveness and openness. Important principles underlying the financial arrangements in the Constitution are contained in section 215, which provides a constitutional basis for budgets and budgetary processes in all three spheres of government, namely that it must promote transparency, accountability and effective financial management. One of the Constitutional Principles that determined the design of the Constitution stipulated that there must be a separation of powers between the legislative, executive and judicial pillars of government to ensure accountability, transparency and openness (Constitution, 1993:CP VI, Schedule 4). It is thus evident that these principles are fundamental characteristics of the current multi-sphere system of government in South Africa, which includes local government.

The fact that these principles define the character of the constitutional order implies that it also have an impact on the detail of the system of government, such as public finance and financial intergovernmental relations. When designing the local government finance model, there should therefore be a proper consideration of these principles to ensure that the design includes appropriate normative criteria.

Accountability in public governance means that responsibility is accepted for a policy, action, decision and performance. This applies to officials as well as political representatives. Accountability can be rule-driven or value-driven. If accountability is rule-driven, the focus is on compliance with the applicable legislative framework,

e.g. compliance with a requirement that a minister must annually report to Parliament about his or her portfolio and how the applicable budget was spent. This aspect of accountability is important to ensure adherence to the rule of law and to strengthen a well-functioning system of government. Accountability also has a value base, namely that a person feels responsible for effective and efficient exercise of his or her duties as a public official, and acts accordingly. This includes an element of responsiveness, namely that officials should be responsive to the needs of society. The focus thus shifts from compliance to the measurement of performance. Both of these aspects of accountability are important in strengthening good governance.

In the local government sphere, accountability is an essential feature of a well-functioning municipality. A municipal council, as well as the management of a municipality, are accountable to the members of the local community. They must report regularly to the community about the activities of the council and how the budget of the municipality is spent (MFMA, 2003: sec.62, 121). The municipal manager is the accounting officer of a municipality (MFMA, 2003: sec.60) and is accountable to the mayor and the municipal council. Political accountability of the municipal council is to the local community. The citizens of a local community have a direct interest in the activities of the municipal council who are their elected representatives, and can therefore hold the council accountable to the community. Political accountability is ultimately measured by regular democratic elections (United Cities, 2010).

Any local government finance model should have accountability as one of its key characteristics. Accountability enhances sound financial management and is an important element of good governance. Whatever the sources of funding of a municipality are, the elected representatives, together with the accounting officer, are responsible for the efficient use of the funds and must thus account for the use of funds. This accountability would usually include proper financial statements, which must be audited, and annual reports on the performance of a municipality, which could be provided to citizens as well as the relevant provincial government which must monitor local government within that province.

Transparency and openness are also key elements of good governance. Transparency requires simplicity, clarity and understandability of government and “a free flow of information concerning the affairs of the state” (The President of the RSA v M&G Media (2010) ZASCA 177 (14 December 2010) par. 1). The way in which government works must be presented to people in a simple and understandable way. Transparency and openness also implies that the administration must be made accessible to the public. Modern information and communication technology that provides the tools for e-government and m-government (use of mobile phone technology in providing

government services) are important developments that can strengthen the accessibility of information and transparency. An open flow of information about the activities of government supports accountability, since it provides citizens with information to hold government accountable.

In the context of a local government finance model, transparency is a key characteristic, in particular in relation to sound financial management. The finance model should not be structured in such a complex way that it limits transparency and the accessibility of information about the finances of a municipality. Although the design of an appropriate local government finance model should take this into account, it is even more important that a municipal council should ensure that transparency is given effect to in its implementation of the finance model (Constitution, 1996: sec.215). The MFMA places an obligation on an accounting officer of a municipality to publish specific information on the website of a municipality in order to inform the public (MFMA, 2003: sec.74), which is one way of enhancing transparency. This information includes the annual budget, annual report, service delivery agreements and budget related policies. These statutory requirements could be treated in a formalistic way to ensure compliance, but should in fact receive more attention so that clear, understandable information about the finances and activities of a municipality is provided to everyone. Such an approach will enhance transparency.

“The level at which decisions can be taken most effectively in respect of the quality and rendering of services, shall be the level responsible and accountable for the quality and the rendering of the services, and such level shall accordingly be empowered by the Constitution to do so.” [CP XXI.1]

Subsidiarity is an important guiding principle in multi-level systems of government. Although it is not specifically attached to finances, it is nevertheless relevant to the current discussion since it has an influence on the allocation of functions to different levels of government. This principle has its origin in the early Roman Catholic Church where it was used to limit the sovereign power of the state. In the 17th century subsidiarity became relevant to multi-level systems of government when Johannes Althusius described the way in which functions should be allocated to different levels of government (Würtenberger, 1994).

Subsidiarity in the context of finance means that decisions should be taken at the lowest possible level of government, and thus as close as possible to the citizens (Brand, 2006). Shah argued that subsidiarity should also apply to the allocation of taxing and spending authority to different levels of government (Shah, 2006). Subsidiarity plays an important role in the European Union and was included in the Maastricht Treaty on the European Union, 1992.

In South Africa subsidiarity is not named in the Constitution, but it was included in the Constitutional Principles (Constitution, 1993: CP XXI.1 of Schedule 4) and is given effect to in the way functions are allocated to provinces and municipalities (Brand, 2006).

In accordance with the economic theory in decentralised systems of government, developed by Musgrave, public goods provided by the local level of government should essentially be paid for by the people that benefit from them, namely the local citizens (Musgrave, 2000; Brand, 2006). This implies that local sources of revenue should be the primary funding source of local government functions. Shah (1994) argued that the assignment of tax sources in a multi-level system of government should be based on two considerations, namely efficiency in tax administration and fiscal need. In terms of fiscal need, the revenue sources should be allocated as close as possible to the revenue needs or expenditure responsibilities. Efficiency in tax administration means that a tax should be assigned to the level of government where it can be administered the most effectively.

This approach within the field of economic theory is in line with the principle of *commensurability* found in Europe. The European Charter of Local Self-Government, 1985, stipulates that local government should have adequate financial resources linked to their responsibilities or functions.

“Article 9 paragraph 1: Local authorities shall be entitled, within national economic policy, to adequate financial resources of their own, of which they may dispose freely within the framework of their powers.”

Paragraph 2: “Local authorities' financial resources shall be commensurate with the responsibilities provided for by the constitution and the law.”

The commensurability principle means that there should be a balance between the total revenue of local authorities and their mandatory functions in terms of the applicable constitutional and legal framework. The United Cities and Local Governments also emphasised this approach in their 2010 research report: local government should have access to sufficient financial sources to fund their expenditure responsibilities (United Cities, 2010). They should also have a reasonable degree of expenditure autonomy, in other words the authority to decide how they will prioritise their spending. Own sources of revenue for local authorities include local taxes, user charges and fees such as licence fees paid by consumers of services provided by the local government concerned. This is not a rigid definition of own sources, but rather the approach followed by the Chamber of Local Authorities in Europe. In many European states (for example in Germany) the definition of own sources of local revenue also includes the local government share of a national tax. The scope of own sources of revenue for local authorities is directly linked

to their freedom to decide on the spending of the income. It creates a link between the cost and benefits of the delivery of local services (United Cities, 2010).

In South Africa the Constitution stipulates that local government and provinces should receive an equitable share of nationally raised revenue to enable it to provide basic services and perform their constitutionally and legally mandated functions (Constitution, 1996: s.227). This provision does not say anything about own sources of local revenue, but rather looks at the division of national revenue between the three spheres of government and links it to the performance of functions.

In applying the commensurability principle, it is important to have a clear understanding of the scope of functions to be exercised by local government. The local community must know which services are to be provided by the local authority, and likewise, the local authority must have clarity about the scope of their functional responsibility. This would be necessary to determine the funding sources and link it to the expenditure responsibilities. Shah's (1994) consideration of efficient tax administration and fiscal needs is a useful approach and would, for example, mean that property tax is an appropriate local source of revenue, since it can be administered more effectively at local level.

In the initial design of the local government fiscal framework in 1998, the following principles were used:

- | |
|---|
| <ul style="list-style-type: none"> a Revenue adequacy and certainty; b Sustainability; c Effective and efficient resource use; d Accountability, transparency and good governance; e Equity and redistribution; f Development and investment; and g Macroeconomic management. (FFC, 2013:13) |
|---|

The following objectives were also used in the design of the current system:

- | |
|---|
| <ul style="list-style-type: none"> a Equity; b Efficiency; c Ensuring a basic level of administrative capacity in the most resource-poor municipalities; d Predictability; and e Incentives for proper financial management at the local level. (FFC, 2013:13) |
|---|

Economic theory, political realities and specific constitutional objectives all contributed to the adoption of the above local government fiscal framework.

3. Structure of local financial governance

The basic economic theory, related to public finance, has developed substantially since the initial framework for a very simple structure of government was described by Musgrave. In his later work and in the work of economists such as Oates (1993; 1994) and Shah (1994; 2006) which relates to more complex systems of government, some important characteristics of a finance model can be identified. Today multi-level systems of government in many different jurisdictions have to take into account the fast changing environment in which they function and the impact of various socio-economic factors on them. This has a significant influence on the design of a finance model in a multi-level system of government, and thus also on the design of an appropriate local government finances model. Flowing from the discussion above, it is argued that the following basic features should be included in the design, created in a specific constitutional and legal framework:

- Accountability and transparency;
- Principle of subsidiarity, in particular relating to the allocation of expenditure responsibilities;
- Principle of commensurability, which is a way of linking the expenditure responsibilities to the allocation of funding sources; and
- Autonomy – in a multi-level system of government there cannot be absolute autonomy for local government, but from an economic perspective, it is important to create a reasonable amount of fiscal autonomy to allow decision-making on local taxes and local spending priorities.

Local government, irrespective of the jurisdiction within which it functions, is primarily mandated to provide a range of basic services to local communities. The scope of these services varies between different countries and sometimes includes functions which are either performed by provinces in some other countries or fall within the field of concurrent functions. It is important that local government functions are clearly defined, in particular if the other levels or spheres of government also play a role in the performance of specific functions. In the process of allocation of functions to local government, economic considerations (such as economies of scale, consumer needs and preferences and possible cost benefit spill over effects) must also be taken into consideration (Shah, 2006). The role of local government often also includes provision of infrastructure (such as local roads, water distribution and sewerage systems) as part of their functional jurisdiction. In accordance with the principle of commensurability, adequate sources should be allocated to local government to fund their infrastructure needs. In practice, however, dedicated funding for infrastructure maintenance and development is often obtained through special transfers from the national government. The role of public-

private partnerships in infrastructure development in local communities creates new financing options and will be discussed later in this publication.

Local government needs adequate funding from its own sources, other sources such as grants, financial equalisation mechanisms and borrowing to fund its functions. Once the range of local government functions or expenditure responsibilities is confirmed in a constitution or in legislation or both, the funding sources need to be determined. The following guidelines can be used to allocate various taxes to different levels of government.

Progressive taxes, which have redistributive objectives such as personal income tax, corporate income tax and value-added tax, should be allocated to the national government (Brand, 2006; Shah, 1994). This is in line with economic theory. Taxes on immobile tax bases (such as land or fixed property) should be decentralised and allocated to local or provincial government or both (Oates, 1994; Shah, 1994). Benefit taxes and user charges, for example on water or electricity use, can be levied at any level of government responsible for the provision of such services. It is an application of the benefit pricing approach used by Musgrave, which simply means that the users of services directly pay the producer of those services (Brand, 2006). In terms of Shah's (1994) approach to use only two criteria for tax allocation, namely efficiency in tax administration and fiscal need, the following allocation of the major tax types could be made in a multi-level system of government:

Income tax	National government (the revenue could also be shared between levels of government, but with the tax administration still at the national level)
Corporate tax	National government
Customs duty	National government
Value-added tax	National government (to ensure a uniform application throughout the country)
Motor vehicle tax/licence	Provincial government
Business tax (registration)	Provincial government
Inheritance tax, capital tax	National government
Property tax	Local government
User charges	All levels of government

Based on this traditional approach to tax allocation in multi-level systems of government, the tax sources for local government would consist of property taxes and user charges. This is, however, not the complete list of financial resources of local government. Transfers through financial equalisation mechanisms and borrowing are additional sources of revenue for local government.

Provincial and local government in multi-level systems of government are often made responsible for a whole range of expenditures, but are not given sufficient taxing authority to fund those functions. The major taxing authority then lies with the national government, which is also the case in South Africa. This situation is referred to as a vertical fiscal gap and financial equalisation mechanisms are required to bridge that gap in order to provide adequate funding to provincial and local governments (Brand, 2006). In South Africa this mechanism is regulated by the Constitution and referred to as the equitable share allocation. Section 214 of the Constitution determines that all nationally collected revenue must be shared equitably among the three spheres of government. This annual division of revenue plays a significant role in the whole financial intergovernmental relations system, and specifically also in local government. In some of the local municipalities in South Africa there are many poor citizens who don't pay any municipal taxes, therefore local government equitable share plays a disproportionately important role in funding the activities of these municipalities. In other multi-level systems of government different financial equalisation mechanisms are used.

The current finance model for local government in many multi-level systems of government, including that of South Africa, does not fully address the current needs of society and should be reformed. The development of a reform policy is therefore the prime focus of this study.

Shah (2006) argues that service delivery and accountability at local government level is under pressure in many of the current multi-level systems of government, in addition to any other problems that are country-specific. This is also the case in South Africa (see discussion in Chapter 1). In view of these problems and needs in many multi-level systems of government, some measure of local financial governance reform is needed, the extent of which will differ from one country to another. In creating a new governance model, the following characteristics are important:

- Subsidiarity;
- Accountability;
- Commensurability or connectivity;
- Responsiveness – governments must respond more effectively to the needs of citizens, and in this process utilise the input and expertise of citizens; and
- Responsible governance – this implies that government should act responsibly in utilising its financial resources, limiting risks and working more cost-effectively.

This new framework for governance, focused on enhanced performance, is termed citizen-centric governance (Shah, 2006). Such a governance framework is aimed at putting the needs of the citizens or consumers first, and includes involving citizens in

the defining of needs and priorities for service delivery and improving accountability to citizens. A new local government finance model should include these characteristics in order to determine the appropriate combination of own taxes, shared taxes, financial equalisation transfers, new sources of funding and borrowing. This will be discussed in more detail in Chapter 7 (innovation in funding) and in Chapter 8 (reform proposals).

4. Conclusion

Globalisation, the fast changing environment of information and communication technology, growing urbanisation and domestic factors such as corruption, poverty and unemployment, to name but a few, all have a significant impact on financial governance and local government. A new approach is needed to respond to all these challenges in order to design and implement an appropriate financial governance model. Economic theory, as it developed over the past few decades, provides important guidelines on designing a new finance model. Practical realities within a country, such as high levels of unemployment, socio-economic needs, existing constitutional and other legal provisions and appropriate financial administrative capacity at all levels of government, are additional factors to take into account.

It is evident from the discussion in this chapter that a new governance framework in multi-level systems of government is necessary in order to properly respond to the changing environment in which a government functions. Such a governance framework should focus on citizens and effective performance and include the principles of accountability, responsiveness, responsible government, subsidiarity and commensurability. It will also have an important influence on the design of a local government finance model. The South African Constitution already provides a good basis to work from since it includes most of these principles. In a system characterised by supremacy of the Constitution, and the rule of law reforming the current local government finance model, a principled approach, anchored in the Constitution, is required. In the further development of the model for local financial governance, proper consideration should be given to how these principles are accommodated and how they translate into practice.

Good governance is based on many of these principles. It is not a theoretical exercise but a practical way of doing things which is in the best interest of all spheres of government. The new approach to local government finance, referred to above, is focused on performance and impact of service delivery, which is in line with the principles of good governance. A new local government finance model, based on the principles discussed here, will therefore promote good governance and make a significant contribution to improving the lives of citizens in each local community.

CHAPTER 3

A Comparative Overview of Five Countries

1. Introduction
2. Tax competence
3. Effect of intergovernmental transfers on total local government finances
4. Public governance challenges and reform opportunities
5. Comparison
6. Conclusion

1. Introduction

When considering an improved design of the local government finance model in South Africa, it is crucial to conduct a comparative analysis of a selection of countries in different parts of the world. Although one could compare a variety of aspects relating to a local government finance model, it is submitted that the scope of tax autonomy or tax competence, as well as the impact of intergovernmental transfers to local government, are the most important and thus the most relevant issues to include in this comparison. The focus of this chapter is thus primarily on the revenue of local government and not on its expenditure responsibilities. Reference will also be made to other aspects of the specific finance model, where necessary. The method used is that of a focused comparison on specific elements of the local government finance model in the five country cases, with a view to explore the similarities and differences among them and to create possible guidelines for reform of local financial governance.

In this chapter, a comparison will be made between five countries from three different continents, namely Kenya, India, Germany, Belgium and the Netherlands. Although it is a diverse group of countries, there is some justification for the individual case selection. It is argued that one of the cases should be an African country, in particular one where decentralisation is important. Kenya has been selected as an African country where recent constitutional reforms, including the creation of counties as a second level of

government, took place and where decentralisation and devolution of powers receive much attention. India has a multi-level system of government and is part of the BRICS group to which South Africa also belongs. Decentralisation and the strengthening of local government is a topical issue in India. Germany, Belgium and the Netherlands have established multi-level systems of government, but each has unique characteristics. All three countries are member states of the European Union and important trading partners of South Africa. Although local government is important in all these countries, the respective constitutional arrangements are different in each of them, providing interesting as well as significantly relevant comparative material. The multi-level nature of the system of government is also different in each of the selected countries. In some of these countries there have been recent financial reforms in local government or suggestions for reform have been made, which is useful to consider in view of the need for reform in South Africa.

Kenya, which has a strong central government, has recently gone through a process of decentralisation, with the creation of 47 counties throughout the country (Constitution of Kenya, 2010: sec.176; Kenya County Government Act, 2012). Provision has been made for special governance arrangements for cities and urban areas which currently fall under the counties, and this is still a work in progress. Prior to the constitutional reform that culminated in the adoption of the current Constitution of Kenya, there were eight provinces and 175 local authorities comprising local and county councils. This has been changed in 2010 to the current two-tier system, which focuses on devolution of powers to the newly created counties and is based on three core values, namely the separation of powers and recognition of democratic principles, reliable sources of revenue and governance autonomy to strengthen effective service delivery (Kanyinga, 2014).

Legislation has been passed by the Kenyan Parliament to give effect to the constitutional provisions regarding the establishment and functioning of the 47 county governments, but the process of effective devolution has not yet been finalised. The previous local authorities were taken over by the central government in 2010, and are now part of the process of devolution of functions to the counties. A difference in viewpoints on the devolution of powers to the counties has so far delayed a speedy implementation of the applicable constitutional and legal provisions. In the 2015 Budget Speech, the Kenyan Minister of Finance, Mr Henry K. Rotich, confirmed that the decentralisation of service delivery and resources is important for improved service delivery and economic development in pursuing the country's Vision 2030 strategic plan (Rotich, 2015). He committed additional funds to the counties to strengthen the county governments.

India, the world's largest constitutional democracy, with a population of 1.2 billion (www.worldbank.org/en/country/india) and surface area of 3.2 million km²

(<http://data.un.org/CountryProfile.aspx?crName=India>), is composed of a three-level system of government that includes the Union (national government), 28 states (regions) and seven centrally administered territories, and a variety of local government institutions at the third level of government (Rao, 2007; Constitution of India, 1949). States have both exclusive powers and functions (e.g. police and public health), and concurrent powers and functions shared with the central government, who also has authority over a list of exclusive powers (e.g. defence and foreign relations) (Constitution of India, 1949: sec. 246, Seventh Schedule). A state may also determine the legislative powers and functions of local government in that state (Constitution of India, 1949: sec.243W).

Local authorities were constitutionally accommodated for the first time through amendments to the Constitution in 1992, which included a list of local government functions (Constitution of India, 1949: Twelfth Schedule). The diversity of local government structures includes thousands of small villages and more than 3000 large urban areas. Rural local authorities consist of districts, blocks and villages, and urban local government includes municipal corporations in large cities and municipalities and area committees in smaller cities and towns. Although India adopted a centralised federal system and functioned accordingly since 1950, there has been a new interest in decentralisation during the past few decades due to various economic and political factors. The constitutional recognition of local government was a key development in this regard. Rao (2007) argued that market-based economic reforms and the development of a more open economic environment have led to more fiscal decentralisation. The process of decentralisation has followed an asymmetric pattern in the sense that the fiscal powers assigned to local authorities are not directly linked to the functional authority of the local government structures in a particular state, and the situation also differs between states (Sahasranaman, 2009).

Germany has an integrated federal system of government which includes the federal government (*Bund*), 16 *Länder* (regions) and a variety of local government structures which fall under the *Länder* (Basic Law, 1949). The reunification of Germany in 1990 ensured that the same governmental structures which existed until then in the western part of Germany (Federal Republic of Germany) would also be implemented in the eastern part or the former German Democratic Republic (Laufer & Münch, 1997). Provision for this was made in the Basic Law for concurrent legislative responsibility (Art. 72, 74, 74a), while the federal level also has a list of exclusive legislative functions (Basic Law, 1949: Art. 73). The *Länder* has the responsibility to execute federal legislation (Art. 83). There were initially also framework legislative provisions which meant that the Federal Parliament can adopt a framework law on one of the listed issues and the

regional parliaments can add to this in accordance with their respective circumstances and needs. This provision was, however, abolished in 2006. Local government is recognised in Art. 28 of the Basic Law and is constitutionally entitled to manage all the local affairs of the respective local community within the applicable legal framework. Local government is not defined as a separate third sphere of government, but functions under the supervision of the *Länder* governments, and obtains its powers and functions from *Länder* constitutions or legislation or both. Funding arrangements are partly dealt with in the Basic Law and partly in separate legislation. The integrated nature of the German federal system of government is quite visible in the area of public finance, including in the application of the complex financial equalisation mechanisms. An overarching characteristic of the German constitutional system is the principle of *Bundestreue* or federal loyalty, developed over many years by the German Constitutional Court (Brand, 2006). An in-depth discussion of the German system, with particular focus on local government in Bavaria, is provided in the next chapter.

The Kingdom of **Belgium** has a unique constitutional structure consisting of a national government, regions and communities at the second level of government, and local government consisting of ten provinces and more than 500 municipalities (Constitution of Belgium, 1831 (official English translation, 2007): sec. 162; Wayenberg & De Rynck, 2008). The second level of government consists of three regions, namely the Flemish, Walloon and Brussels Capital Region, and the three language based communities, namely the Flemish (Dutch-speaking), French and German communities. The communities have jurisdiction over person-oriented functions such as education and culture, while the regions have jurisdiction over geographically based functions such as agriculture, economic affairs, public works and local government. There is a constitutional basis for the functioning of local government which includes constitutionally guaranteed principles to strengthen local democracy, but legislation enacted by the regions give effect to the structure, powers and functions of local government and its administrative and political functioning (Constitution of Belgium, 1831: sec. 162–166; Wayenberg & De Rynck, 2008). Provision is also made for inter-municipal cooperation, which is regulated by the respective regions.

The administration of the various local authorities, as well as the regional supervision of local government in that region, is the responsibility of the three regions. There are currently 589 municipalities in Belgium and they are spread over the three regions as follows: 262 in Wallonia (including nine German-speaking municipalities), 19 in Brussels Capital Region and 308 in Flanders (Lauwerysen, 2012). If one compares the local governments of all three regions, a clear asymmetrical approach to the administrative arrangements applicable to local government is evident. There is in

general more interactive intergovernmental cooperation in the Flemish Region than in the other two regions (Wayenberg & De Rynck, 2008). There have been a few state reform processes in recent years that had an impact on the division of powers between the regions, communities and local government. The unique bipolar linguistic and cultural characteristics of Belgium continue to influence political and constitutional developments in the country.

Netherlands, a constitutional monarchy like Belgium, has three levels of government, namely the central government, 12 provinces and over 400 municipalities (Figuee, 2008; Constitution of the Netherlands, 2008). The King is the head of state and the prime minister heads the national government. National functions include defence, foreign affairs, education and economic policy. Decentralisation and cooperation are key features of this multi-level system of government. Effective governance requires cooperation between the three levels of government and work agreements are often concluded with provinces and municipalities in areas such as roads or housing.

A unique sub-national institution of government in the Netherlands is the collection of 23 water boards (*waterschappen*) that manages water affairs in the Netherlands (www.waterschappen.nl). Provincial councils, which are directly elected, govern the provinces and a commissioner appointed by the King heads a provincial council. Provincial functions include the execution of national policies within their specific area, regional economic development, regional planning and also responsibility for the financial supervision of municipalities and water boards (Figuee, 2008; www.rijksoverheid.nl/onderwerpen/provincies/taken-provincie). Municipalities, being the closest form of government to the citizens, carry the responsibility for various typical local functions such as fire-fighting, disaster management, public housing and town planning. There is a great deal of inter-municipal cooperation and also cooperation between municipalities and water boards on issues of mutual concern, and cooperation and active citizen involvement have contributed to the improvement of services provided by municipalities.

2. Tax competence of local government

The tax competence allocation of the various countries and their legal status differ. The authority to levy taxes is sometimes described in a constitution and sometimes in legislation, but it is often a combination of constitutional and ordinary legislative provisions that deal with the issue. South Africa is a good example of where the national sphere of government is given authority over the main tax sources by the Constitution, but the tax rates are determined by ordinary legislation.

Kenya

In Kenya the authority over the main tax sources, namely income tax, value-added tax, customs duty and excise tax, is given to the national government (Constitution of Kenya: sec. 209(1)). Counties may impose property rates, entertainment taxes and any other taxes allowed by an Act of Parliament (Constitution of Kenya: sec. 209(2)). Counties may also levy service or user charges. This specific constitutional tax arrangement must be read in conjunction with one of the principles of devolved government – that each county shall have reliable sources of revenue (Constitution of Kenya: sec. 175(b)) – and the following principles of public finance (included in sec. 201 of the Constitution):

- b the public finance system shall promote an equitable society, and in particular –
 - i the burden of taxation shall be shared fairly;
 - ii revenue raised nationally shall be shared equitably among national and county governments.

The original tax authority of counties is quite common to local government in many countries.

India

Property tax is currently the main source of revenue for local government throughout India. The property tax regime, however, is not the same everywhere since the basis for valuation, method and frequency of valuations differ between the states (Sahasranaman, 2009). The success of implementation of property taxes also differs between states and within states, and in many rural areas in particular it is often poorly administered. Local government has, in addition to property tax, jurisdiction to levy user charges on water supply (Rao, 2007).

There is a basic division of legislative jurisdiction over taxes between the national sphere of government and the states, with the bulk of the taxes falling in the national sphere, which also has residual power over taxation. Personal and corporate income taxes (except tax on agricultural income) are important national taxes, while value-added tax and state excise duties are the most significant state taxes. States may also levy tax on agricultural income. The national government may also levy excise duties, but only on production, while states may levy it on the sale of goods. This situation has been uncoordinated for a long time and is in need of change.

States don't receive enough funds from their assigned tax sources and the Constitution thus provides for the sharing of certain taxes between the national government and the states (Constitution of India: s.270; Rao, 2007). States may, in addition thereto, also receive grants from the national government.

Germany

In Germany the authority to levy taxes is regulated in the Basic Law. The *Bund* has exclusive legislative authority over customs duties and finance monopolies, while the other major taxes such as income tax and corporate tax require the consent of the *Länder* through their participation in the *Bundesrat* (Basic Law:Art. 105). The major taxes are shared or joint taxes in the sense that the federal government, the *Länder* and the local authorities are constitutionally guaranteed a share in the revenue of the shared taxes. The federal government and the *Länder* are entitled to an equal share of the proceeds from personal income tax and corporate tax (Basic Law:Art. 106(3); Brand, 2006). The Basic Law further determines that a share of the income tax must be allocated to the municipalities and paid to them by the individual *Länder* on the basis of income tax paid by their population (Basic Law:Art. 106(5)). The details of this local government share must be regulated in a federal law. Currently the allocation of the joint taxes is as follows:

Tax	Federation	Länder	Municipalities
Personal income tax	42.5%	42.5%	15%
Corporate tax	50%	50%	0%
Turnover tax	53.4%	44.6%	2%

Table 3.1 Division of tax income in Germany [Source: BMF: Auf den Punkt – Bund/Länder Finanzen, 2015]

The federal level has exclusive legislative authority over customs duties and fiscal monopolies and it shares concurrent legislative jurisdiction with the *Länder* over all the other taxes if the proceeds of such taxes accrues to the federal government fully or in part, or if specified conditions for concurrent legislation apply (Basic Law:Art. 105). In addition to this concurrent legislative power, the *Länder* have own legislative jurisdiction on a range of smaller taxes such as capital (wealth) tax, church tax, gambling enterprise tax and beer tax (Basic Law: Art. 106(2) read with Art. 140). This constitutional arrangement regarding taxing authority means that all the major taxes in the country – namely income tax, corporate tax, customs duties and turnover tax – are federal taxes.

The revenue from property tax, business tax and local excise taxes shall accrue to the municipalities in accordance with Art. 106 (6) of the Basic Law. In addition, municipalities may levy a range of local taxes and may decide on the respective tax rates for these taxes, which include dog tax, second home tax, entertainment tax and beverage tax (Bundesministerium der Finanzen (BMF): *Auf den Punkt*, 2015; BMF: *Steuereinnahmen der Gemeinden*, 2015; BMF: ABC of Taxes, 1997). The municipalities can also share in the tax receipts from the *Länder*, determined by the specific legislation in a *Land*.

Belgium

The financial constitution of Belgium outlines complex arrangements between the three levels of government, reflecting the complexity of the constitutional framework. The federal government has legislative jurisdiction over the major taxes. Regions and communities receive specific income tax allocations from the federation based on the Special Finance Act, 1988 (*Bijzondere Financieringswet*). Through the important sixth State Reform in 2014, the financial situation of regions and communities was strengthened. This was achieved by allowing the regions to levy unlimited surcharges on personal income tax. The Special Finance Act, 1988, initially gave this taxing power to the regions, but it was only used since 2003. This new fiscal power is referred to as the regional personal income tax (Goossens & Cannoot, 2014). The communities, however, do not have own tax authority and are dependent on grant funding. The sixth State Reform also created new funding mechanisms to allow for additional transfers to the regions to support them during difficult economic cycles.

The tax income of local government consists of a percentage surcharge on personal income tax (federal government) and property tax (regions) (in total about 80% of local tax revenue) and a variety of small local taxes, such as taxes on camping sites and public advertising. The municipalities may decide on the tax level, but the federal and regional governments are responsible for the administration of those taxes that fall within their jurisdiction. Municipalities may also levy user charges for various public services they provide, such as swimming pools and libraries. In the case of Brussels Region, the surcharge on property tax is the most important tax source of the municipalities – 55.2% of total tax revenue in 2013 (Dessoy *et al.*, 2013). Most of the local tax revenue of municipalities in the Brussels Region comes from tax on office space, which is to be expected in view of the fact that Brussels is not only the capital of Belgium, but also of the European Union. In Flanders the municipalities received about 45% of their total income in 2013 through the surcharge on personal income tax and the surcharge on property tax, while local taxes constitute only about 7% of their income (Dessoy *et al.*, 2013). In comparison, municipalities in Wallonia received about 38% through surcharges on personal income tax and on property tax and about 10.4% in local tax revenue.

Netherlands

Dutch municipalities do not have a strong own tax revenue and receive most of their funding through national government transfers. Municipalities may levy property tax and a few other smaller taxes, such as dog tax and tourist tax. Property tax is the most important local tax. Municipalities' own tax income accounted for about 15% of their revenue in 2011 (Allers, 2011). They are also allowed to levy user charges and administrative fees for specific services rendered to the public, for example for building

permits. The legislative basis for local government taxes is the Dutch Municipalities Act (*Gemeentewet*, 1992). A municipal council must decide, in accordance with this Act, what tax should be levied, the level of tax and how it will be collected, and this detail is then provided in a local regulation (Monsma, 2013; Raad voor de Financiële Verhoudingen, 2011). Taxes may also be levied by provinces and water boards and is regulated in the specific governing legislation, namely the Provinces Act and the Water Boards Act. The limited scope of local government taxes is clearly illustrated by the following statistics. In 2013 the total division of tax income in the Netherlands was (www.cbs.nl):

National taxes (<i>Rijksbelastingen</i>)	91%
Local taxes	6%
Water board and provincial taxes	3%

Local fiscal autonomy is limited in terms of the scope of local taxes and is regulated by national legislation.

3. Effect of intergovernmental transfers on total local government finances

Kenya

Counties are entitled to an equitable share of the national pool of revenue and may receive additional conditional and unconditional grants from the national government (Constitution of Kenya: sec. 202). The Constitution guarantees a minimum of 15% of the national revenue as an equitable share to the counties (sec. 203; Kanyinga, 2014). Counties have different socio-economic profiles and the potential to raise own revenue through property rates and user charges differ from one county to another. There is thus a need for mechanisms which can provide some form of financial equalisation between the counties in giving effect to the principles of public finance and the criteria to determine the equitable share, for example to ensure that county governments are enabled to perform the functions allocated to them. An Equalisation Fund was created by sec. 204 of the Constitution and receives one half percent of all nationally collected revenue every year. It may only be used to assist counties in need of funding of basic services such as water, roads, health facilities and electricity.

The equitable share allocation to the counties took place for the first time in the 2013/14 financial year and is an important step in the process of the implementation of the new Constitution adopted in 2010. It is part of the fiscal decentralisation process which should enable all counties to have adequate financial resources to deliver basic services

and other functions allocated to it. The actual equitable share allocation in 2013/14 was as follows:

Total funds available	Counties	National government
682 000 000 000 Kenyan shillings	190 000 000 000 Kshs	492 000 000 000 Kshs
100%	28%	72%

Table 3.2 Equitable share allocation in Kenya 2013/14 [Source: Commission on Revenue Allocation, Annual Report and Financial Statements: 2013-14]

Fourteen of the counties were identified as marginalised and thus in need of additional grants to fund basic services.

In urban counties, property tax is the main source of revenue since there are many properties on which a tax could be levied. In rural counties, however, rural land (mainly agricultural or communal land) is currently not taxed (Kirira, 2014). In these counties the equitable share is the primary source of revenue.

India

The expenditure responsibilities of the states in India require much more funding than what is provided through state taxes. While most of the tax revenue is levied and collected at the centre, there is a need for additional funding to the states. This creates a vertical fiscal gap which is funded by transfers and allocation of an increased share in national taxes to the states.

Two institutions, namely the Planning Commission and the Finance Commission, play an important role in the financial intergovernmental relations process. It is on their recommendation that the fiscal gap at state level is addressed through specific financial equalisation mechanisms. The Finance Commission must *inter alia* make recommendations on the sharing of national taxes among the national government and the states, as well as on the principles on which additional grants to the states should be based (Constitution of India: s.280; Rao, 2007). It must also make recommendations regarding specific measures to support the financial position of municipalities in individual states. The Planning Commission, which has been replaced recently by a newly established National Institution for Transforming India (NITI Aayog), supported development in states by providing grants and loans to them (<http://planningcommission.nic.in>).

Intergovernmental transfers to the states thus could have three different origins, namely:

- Statutory transfers on recommendation by the Finance Commission (in the form of a share of national tax revenue);

- Grants and loans (non-statutory transfers) by the Planning Commission (until 2015); and
- Ministerial transfers, i.e. transfers from various line function ministries.

The Thirteenth Finance Commission (2010-2015) recommended that the states should get 32% of national tax revenue and the current Fourteenth Finance Commission (2015-2020) has recommended that the states' share in national tax revenue should be increased to 42% (<http://finmin.nic.in/14fincomm/14fcengExpMemo.pdf>), which was accepted by the national government.

Transfers to local government can occur in different ways: states receive transfers (as recommended by the Finance Commission) to be paid to local government; the individual states provide grants to local government as recommended by their respective State Finance Commissions; direct transfers are made from national government to municipalities; and specific grants from national government are earmarked to be implemented in national schemes, which could be transferred directly to municipalities or via the states (Rao, 2007).

The Thirteenth Finance Commission recommended that 2.28% of the divisible pool of national revenue should be allocated to local government (<http://finmin.nic.in>). The financial position of the various local government entities varies greatly and a gap between their expenditure responsibilities and the available financial resources is often experienced. This means that the scope of financial equalisation also differs among the various local government structures.

The individual states, on recommendation of the State Finance Commissions, play an important role in strengthening the financial position of the various local government entities by transferring general and specific grants to them. Rural local authorities are more dependent on the intergovernmental transfers it receives than urban local authorities who can raise substantial income through property taxes. Fiscal decentralisation to the level of local government has not yet proven to be very useful to the local authorities and there is a need for improvement and some reform of the system (Rao, 2007).

Germany

The German financial intergovernmental relations system is characterised by a cooperative approach to realising the constitutional obligations of the federal level as well as the *Länder*, including the municipalities. This implies cooperation in utilising the available financial resources. Since there is a gap between the expenditure responsibilities of the *Länder* and their financial resources, and the federal government has more financial resources than what their expenditure responsibilities require, there

is a need for some form of financial equalisation. The financial equalisation of the *Länder* is a crucial part of the whole financial intergovernmental relations system and will be discussed in more detail in the next chapter, but it should be noted that the *Länder's* financial equalisation (*Länderfinanzausgleich*) aims to ensure equal living conditions throughout the country (Basic Law: Art. 106(3); Brand, 2006). In implementing the financial equalisation mechanism, it is important to consider the financial capacity of the municipalities in a *Land* (Basic Law: Art. 107).

In each region or *Land* an effort must be made to establish financial equalisation since the financial situation in the various municipalities differ and a gap exists between the financial resources allocated to local government and their functions or expenditure responsibilities (fiscal gap). Although the general concept and aim is the same in each of the *Länder*, each *Land's* application varies and each *Land* must adopt legislation to regulate the local government financial equalisation (*Kommunaler Finanzausgleich*) (www.haushaltssteuerung.de/lexikon-kommunaler-finanzausgleich-kfa.html). This legislation plays an important role in the financial position of municipalities.

An example of how local government finance is structured and functions within a *Land* is the case of Bavaria, only referred to here, but discussed in more detail in Chapter 4. In Bavaria local government financial equalisation is regulated by a special financial equalisation law (*Finanzausgleichgesetz* (FAG)), based on Art.107 (7), read with Art.28 of the Basic Law (right of municipalities to manage their own affairs). The scope and detail of local government financial equalisation is determined by the specific *Land* government and forms part of its overall financial planning. The proceeds of a range of taxes form the basis of the local government financial equalisation funds. Local government consists of municipalities (*Gemeinden*), which include cities, district local authorities (*Landkreise*) and counties (*Bezirke*). The aim of the local government financial equalisation is firstly to enable all local authorities to perform the functions they are responsible for, and secondly, to give effect to the constitutional goal of ensuring a reasonable equalisation of living standards throughout the country (*Bayerische Finanzministerium*, 2012). The whole system of financial intergovernmental relations is strongly anchored in the Basic Law and it is quite evident in the way financial equalisation is dealt with at all levels of government.

In addition to the constitutionally assigned tax income local municipalities receive, they also participate in the financial equalisation process. In 2010 about 70% of all transfers to local municipalities came from the local government financial equalisation process (*Bayerische Finanzministerium*, 2012). Since 2004 the connectivity principle has been applied in Bavaria in support of the financial equalisation process. This means that funds should follow function. If either the federal or Land government assigns a

specific function to a municipality, they must ensure that sufficient funds are transferred to the municipality. The *Landkreise* and *Bezirke* don't have any own tax sources and are dependent on transfers through the local government financial equalisation system (Bayerische Finanzministerium, 2012).

Local municipalities will receive additional funding from the federal government in the current five-year financial planning cycle starting in 2015. These additional grants are for specific functions or to achieve specific goals, for example euro 5 billion will be transferred to local municipalities to promote investment and strengthen their capacity to get more local investment and economic growth.

Belgium

Fiscal federalism in Belgium is dominated by grants and there is not much tax decentralisation, in contrast to the decentralisation of many functions to the regions and communities. The three regions each deal with the transfer of funds to local government in their own specific way, but each region has a municipal fund that must financially support the municipalities in that region. This municipal fund (*Gemeentefonds*) is an important source of revenue for the municipalities and is administered by the regional government. Flanders, which has the strongest economy of the three regions, creatively uses its fund to assist municipalities that provide services for a wider area than their geographical jurisdiction. There is also a special cities-fund in support of local development priorities in cities (Wayenberg & De Rynck, 2008). In addition, the municipalities in all three regions receive specific allocations or grants to fund regional government programs which they must implement in the local communities, for example on sport, education or culture (Dessoy *et al.*, 2013).

In the Brussels Region, the municipalities receive a substantial part of their revenue through transfers (mostly unconditional and unspecified) from the Region (36% of total revenue in 2013) (Dessoy *et al.*, 2013). Regional fund transfers also play an important role in the funding of municipalities in Flanders and the Walloon Region.

It is evident that the regional governments have a close constitutional relationship with the municipalities within their jurisdiction. This is in particular demonstrated in the financial intergovernmental relations between these two levels of government.

Netherlands

Part of the functional responsibility of the Dutch municipalities is to execute national policies in specific functional areas such as social services, primary education and urban regeneration. The national government provides substantial funding to the

municipalities by way of unconditional or general grants (*Gemeentefonds*), as well as earmarked funds that could only be utilised for the specific goal indicated by the national government. General grants on average form about 33% of municipal revenue, while the specific grants amounts to an average of about 27% of municipal revenue (Figuee, 2008). The general grants are determined by considering a number of criteria, such as the size of the population in a municipal area, and is aimed at providing some form of financial equalisation so that all municipalities are in a position to deliver an equal level of service at a comparable cost level. Local government funding makes out one of the largest budget items in the national budget and is even more significant in the budget of each of the municipalities. The general grant transfers to municipalities are linked to the economic situation in the country – if the national government has more money available, the general grant normally increases and vice versa (Raad voor de Financiële Verhoudingen, 2011).

Specific grants to municipalities are used (if it is considered to be an appropriate way of funding specific decentralised activities) and the municipalities must report to the national government about the spending of such grants (Raad voor de Financiële Verhoudingen, 2011).

Municipalities in the Netherlands have a long tradition of inter-municipal cooperation and there are currently hundreds of agreements between municipalities specifying cooperation on specific local issues such as waste management and public health (Figuee, 2008). Municipalities also often cooperate with water boards on water related issues. Local government cooperation implies joint funding of activities and sometimes also the levying of joint local taxes.

4. Public governance challenges and reform opportunities

Financial intergovernmental relations in multi-level systems of government are never static. The constitutional developments in a country, politics, domestic economic situation and international economic developments are some of the factors that impact on the way in which financial intergovernmental relations develop. Globalisation and the information technology revolution are key international developments that have a significant impact on public as well as financial governance in developed and developing countries. These issues should be taken into consideration in the evolutionary development of financial governance and reform of local government finances. Poor economic conditions, limited administrative capacity and political instability are some of the key domestic public governance challenges that impact on financial governance.

The multi-level systems of governance of the five countries in this brief overview – one from Africa, one from Asia (and member of BRICS) and three from the European Union – are diverse. These countries have different constitutional arrangements and different economic profiles. The local public governance challenges they individually face are also varied, but they all have some form of local government that provides a range of services to the public in the local communities. In all these cases it is evident that the development of local financial governance is a journey developed over a period of time. Reform of local government finances is mostly linked to constitutional development or constitutional reform processes.

Kenya's recent constitutional reform process, which led to the adoption of the new Constitution in 2010, is still fairly new and has not been completely finalised. The Kenya County Governments Act, 2012, that provides the legal framework for the decentralisation of functions to the newly established counties (including local communities) is an important milestone in the constitutional development of Kenya. Despite recent developments, such as the establishment of the Council of County Governors as an important intergovernmental relations mechanism, the constitutional development is still a work in progress. Some of the challenges currently experienced relate to different views on centralisation and decentralisation and how these issues should play out in practice (Kanyinga, 2014; Roschmann, Wendoh & Ogolla, 2012). The strengthening of democratic accountability at both levels of government is an important aim of the constitutional development process. The financial intergovernmental relations system is very new and still developing. The newly established Equalisation Fund has been operational for one financial year during which the counties could receive their equitable share from the national pool of revenue. It requires time to fully implement these reform initiatives and much still needs to be done to strengthen local financial governance.

The 1992 constitutional recognition of local government was an important milestone in India's constitutional development. The various finance commissions, in particular the Thirteenth and Fourteenth Finance Commission, played an important role in the further development of fiscal federalism in India. More reform is needed, both institutionally and also in terms of financial arrangements. The decentralisation and the strengthening of the financial position of the states are continuing. Property tax is the most important tax source of local government, but it is not being implemented consistently throughout the country. States and the local authorities within each state should cooperate to improve the system. If municipalities can ensure a regular valuation of properties and build a good database of all the municipal properties it would greatly improve their revenue from property tax (Sahasranaman, 2009). Rao (2007) argued that many initiatives to empower local authorities in the past have failed and that new local

government reform should make provision for effective community participation and the reform of local government taxes.

An important institutional reform initiative was taken recently when the Indian Government replaced the Planning Commission with the NITI Aayog. This entity must strengthen cooperative government in India by improving the interaction and coordination between all three levels of government, even including villages at the local government level (Government of India: Press release, 2015). There is still a need for reform of financial transfers between states and local government and it is envisaged that this new institution would need to cooperate with the Finance Commission and the respective State Finance Commissions to provide a coherent approach to the various issues relating to financial reform.

The three European countries in this study do not only have to deal with internal issues relating to public governance and reform, but also have to consider developments in the European Union. The Chamber of Local Authorities in Europe has recently made recommendations to all its members about strengthening local financial governance, which they based on an expert study that showed that “many local authorities are facing increasing difficulties to cover their mandatory tasks and functions and few have the power to raise their own revenues, through charges and local taxes, or to determine their expenditure priorities” (Chamber of Local Authorities, 2014). The other EU institutions, such as the Committee of the Regions and European Commission, also have an impact on public governance in the member states. In addition, the member states within the Euro zone also have to comply with the rules within the Stability and Growth Pact that underpin the functioning of the Euro zone.

In Belgium, state reform initiatives are often linked to elections and are thus influenced by the political realities. The sixth State Reform in 2013 was linked to the negotiations to form a government after the previous election and also had an influence on the federal elections in 2014. An important element of that reform process was the strengthening of the financial position of the regions by increasing their tax authority and creating additional funding mechanisms to support them in difficult economic times. Brussels Region has also received additional grants from the federal government to help it to recover from consecutive budget deficits. Jennes (2014) argued that the increased use of grants by the regions, communities and local government has contributed to higher cost of government and a weakening of the overall budget. Future reform initiatives should thus consider increasing sub-national tax autonomy rather than providing more grant funding.

In the Netherlands there is a huge variety of specific grants provided to municipalities by the national government. It is argued that there should be a consolidation of most of these grants to simplify the system (Allers, 2011). This would save administrative costs and give municipalities more freedom to decide on their spending priorities. It would, however, not necessarily limit the national government in giving direction or setting goals for local government spending. The relative autonomy of municipalities is still subject to the legal and policy framework of the national government.

The German financial constitution has been shaped over the years by both legislative reform and decisions by the *Bundesverfassungsgericht* (Constitutional Court). The financial equalisation system remains a focus point and there were various attempts to simplify the legislation in order to make it more comprehensible and to improve transparency and accountability. The current legal framework has been in existence since 2001 when a new financial equalisation law (*Finanzausgleichgesetz*) and a standards law (*Maßstäbengesetz*) were adopted by the Federal Parliament, following a decision by the *Bundesverfassungsgericht* (Brand, 2006). It will be utilised until 2019 and it is expected that new calls for the simplification of the financial equalisation legislation will be made before a new law will be adopted. Proposals for the reform of the financial equalisation system from 2019 onwards have been made, but so far no agreement could be reached between the *Länder* and the *Bund*. Financial reform in the area of local government is dealt with by the federal government as well as by the individual *Länder*. In Bavaria, for example, the current local government financial equalisation law has been in operation since 2012.

5. Comparison

In the previous sections of this chapter, specific elements of the local government finance model of each of the five countries were discussed individually. In this section a comparative summary is provided and reflections made on issues that could be relevant to the proposed reform agenda in South Africa.

	Kenya	India	Germany	Belgium	Netherlands
National government level	Income tax, VAT, customs duty, excise tax	Personal income tax and corporate tax (except on agricultural income)	All major taxes (joint taxes require consent from Bundesrat)	All major taxes	All major taxes
Regional government level	Property tax, entertainment tax, user charges (counties)	VAT, state excise duties, agricultural income tax, property tax (base)	Church tax, local excise tax Joint taxes through participation in Bundesrat	Surcharge on personal income tax Property tax	Limited authority of provinces and water boards
Local government level	None	Property tax (rate)	Property tax (rate), business tax (rate)	Surcharge on personal income tax, surcharge on property tax, small local taxes	Property tax, small local taxes such as dog tax

Table 3.3 Division of tax legislative competences (Note: in Kenya the counties currently include the local authorities)

Transfers, whether in the form of conditional or unconditional grants or part of an equitable share allocation, play an important role in both Kenya and India. Different legal arrangements and thus different payment mechanisms are used. In Kenya there is a constitutionally provided equitable division of national revenue between the national government and the counties, which currently include the local authorities. In India special institutions, such as the Finance Commission and the new National Commission for Transforming India, play a key role in the allocation of national funds to states and local authorities. In Germany financial equalisation is determined by the German Basic Law and further regulated by federal legislation as well as *Länder* legislation (local government financial equalisation) and it is an important part of the whole financial governance in the country. Federal grants, as well as grants from the regions to the local authorities, play a significant role in public finance in Belgium. There is no special institution that has the responsibility for deciding on the intergovernmental transfers. As municipalities in the Netherlands are responsible for the implementation of various national programs, direct conditional and unconditional grants play an important role in Dutch local government funding. A peculiarity of the Dutch situation is that bilateral cooperation between municipalities *inter se* and between municipalities and water boards is quite common and joint financing of programs is then an appropriate funding solution for them.

	Kenya	India	Germany	Belgium	Netherlands
National government level	Revenue from national taxes	Revenue from national taxes	Revenue from joint taxes: Income tax Corporate tax Sales tax Capital gains tax Exclusive national taxes	Revenue from national (federal) government taxes	Revenue from national taxes
Regional government level	Share in national revenue, with 15% guaranteed equitable share Revenue from county taxes	Revenue from state (regional) taxes	Revenue from joint taxes: Income tax Corporate tax Sales tax Capital gains tax Exclusive <i>Land</i> taxes	Transfers from federal government, Revenue from a surcharge on income tax	National government transfers Limited own revenue (provinces and water boards)
Local government level		Property tax	Revenue from joint taxes: Income tax Sales tax Capital gains tax Property tax Business tax	Transfers, Revenue from local taxes	National government transfers Revenue from property tax and other local taxes

Table 3.4 Division of tax revenue

Intergovernmental transfers, irrespective of the legal basis or type of transfer, are used in all five country cases. It is evident that local government receives transfer funding for various reasons, such as to bridge a vertical fiscal gap, to fund national functions or to provide some form of financial equalisation. The relative importance of transfer funding to local government differs from one country to another. It is further evident that the reform of local financial governance is a topical issue in all these cases, although the scope and nature of reform is different in every country.

6. Conclusion

In the discussion of the five selected countries in this chapter it is evident that financial intergovernmental relations in general and local financial governance in particular are never static.

The ever-changing global and domestic political and economic landscape affects governance in general and financial governance in particular in a country. The extent of development of the local financial governance in the five case studies varies, but in all five, tax reform issues, the use of grants and financial equalisation mechanisms, are continuously debated. In assessing local financial governance it is important to have a clear understanding of the scope of own and shared taxes and mechanisms for the implementation of financial equalisation.

Various international studies in recent years have emphasised the importance of the reform of financial intergovernmental relations in multi-level systems of government to strengthen efficiency of sub-national government, e.g. the 2014 *Report on Adequate Financial Resources for Local Authorities* from the Chamber of Local Authorities (Congress of Local and Regional Authorities) and a study by the OECD titled *Reforming Fiscal Federalism and Local Government – beyond the zero-sum game* (Blöchliger & Vanmalle, 2012). International developments, such as globalisation and the information technology revolution, have a significant impact on governance issues, including local financial governance, and support the necessity of regular reform in a country such as South Africa. The OECD study describes the motivation for financial reform aptly:

“Sub-central entities are integrated into interregional and international trade and vulnerable to globalization pressures, requiring changes to sub-central taxation, more productive public spending and better intergovernmental transfer systems. Responsibilities across government levels are often opaque, raising demands for a more efficient division of tasks between government levels.”

(Blöchliger & Vanmalle, 2012:12)

Shah (2006) argues that the reform of local financial governance should focus on performance or outputs and outcomes, and that there should be a greater emphasis on responsive and accountable local government. This approach is in line with citizen-centred governance and will go a long way in improving the financial sustainability and the standard of local governance. Any reform initiatives in South Africa could benefit from a serious consideration of this new citizen-centred governance approach advocated by Shah and discussed in more detail in Chapter 8.

CHAPTER 4

Germany – A Case Study

1. Introduction
2. Division of functions
3. Financial constitution
4. Local government in Bavaria
5. Local government finance in Bavaria
6. Conclusion

1. Introduction

In this chapter a more detailed discussion on Germany is provided in view of its historic links to South Africa, and in particular in view of the influence of Germany on the development of constitutional democracy in South Africa. Since the focus of this study is on local government finance, it is important to first provide an overview of the German constitutional system and to include the position of local government. The second part of this chapter focuses on the financial situation of local government in one of the *Länder*, namely Bavaria, as an example of how the system is structured and functioning, since a discussion of local government in each of the sixteen *Länder* would not be feasible. Bavaria was selected in view of the fact that it has a very efficient system of local government in general and local financial governance in particular.

Germany has a long constitutional history, but the current constitutional system is grounded in the Basic Law of the Federal Republic of Germany, which was adopted by the Parliamentary Council on 8 May 1949 and promulgated on 23 May 1949; a culmination of negotiations between the Western Allied Forces and the minister-presidents of the Western Zones. The adoption of the German Basic Law signified the start of a divided constitutional path for Germany after World War II. Under the Soviet occupation forces, the Eastern Zones (including East Berlin) went a separate way and established the German Democratic Republic (*Deutsche Demokratische Republik (DDR)*) (Laufer & Münch, 1997; Funk, 2010).

It was only after four decades of separation that the democratic revolution of 1989 led to the process of the reunification of Germany. The Unification Treaty, which was eventually signed on 31 August 1990, stipulated that all the constitutional issues had to be attended to in order to effect the unification. On 3 October 1990 the Federal Republic of Germany was newly constituted when the old DDR ceased to exist and was united with the rest of Germany (Brand, 2006; Funk, 2010). This multi-level system of government consists of a federal level (*Bund*), 16 *Länder* and local government.

Today the multi-level system of government in Germany is characterised by:

- Protection of the constitutional order, including the existence of the 16 *Länder*, each with its own elected legislature and government;
- The establishment of the *Bundesrat*, the second chamber of the Federal Parliament and representative of the *Länder* governments (executive) in the Federal Parliament;
- Protection of the democratic and social federal state (German Basic Law: Art. 20);
- The *Rechtsstaat* (rule of law);
- An independent judiciary, including a constitutional court (*Bundesverfassungsgericht*); and
- Fundamental rights protected in the German Basic Law.

An important feature of the German constitutional system is the principle of *Bundestreue* or federal comity, not found in the German Basic Law, but developed by the German Constitutional Court over many years (De Villiers, 1995; Laufer & Münch, 1997; Brand, 2006). *Bundestreue* means loyalty of the constituent units to the federal state and it compels both the *Bund* and the *Länder* to federal-friendly conduct. It plays a significant role in the functioning of the German constitutional system, including the financial intergovernmental relations.

During the negotiations preceding the drafting of the German Basic Law in 1949, the three most contentious issues were:

- The composition and jurisdiction of the second chamber of the German Parliament;
- The division of financial legislative and administrative competences between the federal level and the *Länder*; and
- The division of the tax income between the federal level and the *Länder*.

A choice was made in favour of the *Bundesrat*, consisting of representatives of the *Länder* governments, as a second legislative chamber. This gave the *Länder* a significant voice in the national legislative arena. The *Bundesrat* has a suspensive veto over ordinary legislation and a full veto over constitutional matters and matters affecting the *Länder*

(German Basic Law: Art. 50–51, 76–78, Brand, 2006). The *Länder* are responsible for the administration of most of the federal legislation (German Basic Law: Art.83).

In terms of a compromise reached during the constitutional negotiations, the financial administration would be shared between the federal government and the *Länder* governments, and the legislative jurisdiction over taxes would be divided between these two levels of government. The *Bund* received the authority to legislate on the major taxes (such as personal income tax and corporate tax), while the *Länder*, through their participation in the *Bundesrat*, also received a say in this legislative process. Since most of the financial resources were allocated to the *Bund* and the *Länder* was made responsible for most of the administration, a fiscal gap was created. Provision therefore had to be made for a process of financial equalisation.

The German constitutional system is based on four fundamental principles contained in the German Basic Law, namely: the principles of a democratic and social federal state based on a *Rechtsstaat*, and the principle of subsidiarity contained in Article 23 of the German Basic Law. This subsidiarity provision is used in context of the relationship between Germany and the European Union. The subsidiarity principle is, however, applicable to the functioning of the whole system (Art 30), since it means that functions should be performed at the lowest level where it can be done effectively, and that a higher level of government should only take responsibility for a specific function if it cannot be effectively performed at a lower level. Article 20 (1) of the German Basic Law stipulates that “the Federal Republic of Germany shall be a democratic and social federal state”. The principle of the *Rechtsstaat*, contained in Article 20 (3) of the German Basic Law, is also one of the fundamental principles of the constitutional system and establishes the supremacy of the constitution. The *Rechtsstaat* further includes the following elements:

- The recognition of the separation of powers into the legislative, executive and judicial branches of government;
- The recognition and protection of human rights listed in the German Basic Law; and
- Confirmation of the role of the *Bundesverfassungsgericht* (Constitutional Court) as guardian of the constitutional order and final arbiter in constitutional disputes (Brand, 2006).

The inclusion of the social state principle in the German Basic Law reflects on the character of the German constitutional system and alludes to a caring state in which human dignity and the general welfare of the people of the country is a high priority. It obliges the executive and legislative branches of government to promote the welfare of the people. This principle is of particular relevance in the context of the financial constitution.

2. Division of functions

The discussions and fierce debates in 1948 and early 1949, which preceded the adoption of the German Basic Law as a constitution for the western part of Germany, provided an important historical context for the constitutional arrangements that are still in operation today. Since re-unification in 1990 this constitution also includes the eastern part of Germany. Some of the key issues under discussion that influenced the shaping of the German Basic Law were:

- The development of a modern economy;
- Strengthening the financial autonomy of the *Länder*; and
- The promotion of a welfare state based on the goal of uniformity of living standards throughout the country.

The structural organisation of the country, and the division of functions between the federal level, the *Länder* and the local authorities, is based on the federal state principle in Article 20 of the German Basic Law, and guaranteed in terms of Article 79 (3). Article 28, often referred to as the homogeneity clause, stipulates that the constitutional order in each of the *Länder* and the municipalities must conform to the principles of the democratic and social state governed by the rule of law. It also gives the municipalities the right to self-administration (*Kommunaler Selbstverwaltung*), which means that each municipality has a constitutional mandate to manage the affairs of the particular local community within the limits of the law, and it also includes the responsibility for financial matters. This is a very important constitutional provision that governs the way in which municipalities function and is also a very important constitutional building block.

The German constitutional system can be described as an integrated federal system, as opposed to a competitive federal system such as that of the United States of America. The principle of *Bundestreue* or federal loyalty is at the heart of the German constitutional system and provides the guiding light for the functioning of the constitutional system, giving it its integrated or cooperative character. Leonardy (1997) described it aptly as a principle that sets a standard of political behaviour.

The division of functions and revenue sources between the federal level (*Bund*) and the *Länder* is characterised by the following key elements:

- The legislative authority lies primarily with the Federal Parliament (Article 70–75), while the *Länder* administer most of the legislation (Article 83–90).
- Legislative authority includes exclusive federal legislative authority (Article 73), concurrent legislative powers (Articles 74 and 74a) and areas of federal framework legislation (Article 75). The federal legislative authority for framework legislation was, however, abolished in 2006. Article 72 (1) determines that the *Länder* may

legislate to the extent that the *Bund* has not done so. The *Länder*, in fact, have the residual legislative powers (Article 30). The Federal Parliament has nevertheless over the years played a substantial role in the legislative process and passed most of the legislation in the country.

- The legislative power for the most important taxes in the country is allocated to the *Bund*, but the *Bundesrat* gives the *Länder* an important voice in this legislative process since it must consent to any federal legislation on taxes that impact the *Länder* and the municipalities (Article 105; Leonardy, 1994).
- The financial administration of all the tax revenues is divided between the *Bund* and the *Länder* (Article 108).
- Specific vertical and horizontal financial equalisation mechanisms are provided by the German Basic Law (Article 106, 106a and 107; Häde, 1996).

The *Bundesrat*, as second chamber in the Federal Parliament, plays an important role in the national legislative process, thus giving the *Länder* a strong national platform. It has a significant influence on the adoption of federal legislation administered by the *Länder*, as well as on the funding arrangements related to such legislation (Leonardy, 1997), and is the most important legislative intergovernmental relations-forum in Germany.

Federal and *Länder* ministers of specific portfolios (for example transport or finance) meet regularly to discuss issues of mutual concern. These *Ministerkonferenzen* (ministers' conferences) are important executive intergovernmental forums, thus strengthening the notion of cooperative federalism.

3. Financial constitution

In any multi-level system of government, the constitutional arrangements dealing with the division of functions and funding resources form a key component within that constitutional system. Such provisions would be the basis of the financial constitution of that country. Financial constitutional law is a concept with a multi-disciplinary focus and it *inter alia* includes the following aspects:

- Economic and fiscal considerations;
- Specific constitutional provisions dealing with the division of functions and funding sources between the different levels of government;
- Financial and fiscal legislation that give effect to the relevant constitutional provisions; and
- The justiciability of legal provisions dealing with the division of funds between the levels of government and financial intergovernmental relations (Brand, 2008).

The financial constitution (*Finanzverfassung*) is an important part of the German constitutional system and is anchored in the German Basic Law. It consists of the constitutional provisions dealing with the division of functions between the *Bund* and the *Länder*, the allocation of legislative authority for taxes and financial administration, and the allocation of revenue sources to the *Bund* and the *Länder* respectively (Von Münch, 1993).

An important general principle in the German constitutional system is that each level of government should have reasonable financial autonomy, which implies that the expenditure responsibilities of each level should be in accordance with the allocation of obligations, unless the German Basic Law provides otherwise (Article 104a (1)). Both the *Bund* and the *Länder* are thus responsible for funding the functions allocated to them. Funds should thus follow functions, a principle also referred to as the connectivity principle (*Konnexitätsprinzip*). It reflects the general approach and not an absolute rule, with exceptions where, for example, specific federal programs require the *Bund* to provide financial assistance to the *Länder*. In the case of joint responsibilities between the *Bund* and the *Länder*, the German Basic Law provides for specific funding arrangements shared between the two levels of government (Article 91a).

The German Basic Law stipulates the division of legislative authority on taxes in the following way:

<i>Bund</i> (federal level)	Customs duties and fiscal monopolies (Art. 105 (1)) [exclusive legislative power]	All other taxes if the Bund is entitled to the whole or part of the proceeds, or if conditions for federal legislation apply (Art. 105(2)) [concurrent legislative power] All taxes from which the revenue accrues wholly or partly to the <i>Länder</i> or municipalities (Art. 105(3)) [requires the consent of the <i>Bundesrat</i>]
<i>Länder</i>	Local excise taxes in so far as they are not identical to federally imposed taxes (Art. 105 (2a)); Church tax (Art. 140) [exclusive legislative power]	
<i>Gemeinden</i> (local government)	Determining the tax rates on local taxes (property and business taxes) (Art. 106 (5))	

Table 4.1 Division of legislative authority on taxes (according to the German Basic Law)

The *Länder* have limited exclusive legislative competence over taxes, but they have a significant say (through the *Bundesrat*) in legislating various federal taxes, the most important taxes in the country. The *Länder* also have a constitutional guarantee of part of the revenue from joint taxes, which strengthens their relative fiscal autonomy (Brand, 2006).

The division of revenue from the different taxes is regulated separately in Article 106 of the German Basic Law, which stipulates that the *Bund* has the exclusive right to the revenue of some taxes (such as customs duties); the revenue of the joint taxes is shared between the *Bund* and the *Länder*; and the *Länder* have the exclusive right to the proceeds of some taxes (such as inheritance tax, beer tax and tax on gambling establishments). Provision is also made for revenue sharing of some of the major taxes (the joint taxes) between all three levels of government (Käsbohrer *et al.*, 2014). These joint taxes are personal income tax, corporate tax, sales tax and capital gains tax.

Tax	<i>Bund</i> (federal level)	<i>Länder</i>	<i>Gemeinden</i> (local government)
Personal income tax	42.5%	42.5%	15%
Corporate tax	50%	50%	0%
Sales tax (turnover tax)	51.4%	46.6%	2%
Capital gains tax	44%	44%	12%

Table 4.2 Division of tax revenue between the three levels of government

The *Bund* and the *Länder* share equally in the revenue from personal income tax and corporate tax and the local government is also entitled to a share of personal income tax, but the details must be provided by a federal law (German Basic Law: Art. 106 (3), (4), (5); Waldhoff, 2007). The rationale for the local government share is that the local communities should get a percentage of the income tax paid by their population. The economic wellbeing of a local community thus has an impact on the revenue from joint taxes that accrue to that community. The actual allocation of the revenue from income tax to municipalities is primarily linked to the locally produced revenue, but a formula or key (*Schlüssel*) is also applied that includes a maximum taxable income amount per municipality per year. This allows for some form of financial equalisation, in the sense that municipalities with a poor income tax situation can receive more revenue and those with a better income tax situation can receive less revenue (*Gemeindereformgesetz*, Art. 1, 2 and 3; Käsbohrer *et al.*, 2014). The *Länder* receive their own plus their local government share of income tax revenue and each *Land* is then responsible for transferring the local government share to each individual municipality.

The division of revenue from sales tax must be done in accordance with Article 106 (3) of the German Basic Law by way of a federal law that requires the consent of the

Bundesrat. There are two specific constitutional requirements with which such a law must comply, namely:

- The Federation and the *Länder* have an equal claim to funds from current revenue to finance their necessary expenditure; and
- Such an allocation of revenue must be aimed at establishing a fair balance and ensuring equal living conditions throughout Germany (Article 106 (3); Brand, 2006, Käsbohrer *et al.*, 2014).

The provisions in Article 106 (3) of the German Basic Law provide the basis of the financial equalisation system in Germany and contain the important goal of ensuring 'equal living conditions' throughout the country. This goal is based on the social state principle, one of the cornerstones of the constitutional system, and implies that a continuous effort will be made to provide the same standard of public services at a comparable cost level in the whole country. A further determinant is found in Article 83 of the Basic Law, which stipulates that the *Länder* must implement federal legislation in their own right. All the *Länder*, including the local authorities in each *Land*, must be in a financial position to give effect to these constitutional requirements.

The vertical division of revenue between the *Federation* and the *Länder*, in accordance with Article 106 (3), read with Article 107, is the first part of the financial equalisation system (*vertikaler Finanzausgleich*). The horizontal division among the sixteen *Länder* is the most important part of the financial equalisation process (*horizontaler Finanzausgleich*) (Brand, 2006, Waldhoff, 2007). It is in this stage of the process in particular that economic and financial inequalities between the *Länder* are placed in the spotlight. In the initial assessment, which forms part of the financial equalisation process, the financial needs of municipalities are included in the financial needs of the respective *Länder*. The financially weaker *Länder* receive substantial financial support from the financially stronger *Länder* through the financial equalisation process. Based on the principle of federal solidarity, the *Länder* are all obliged to support each other, as confirmed by the German Constitutional Court in a judgement in 1952 (*BverfGE* 1, 117 – judgement delivered on 20 February 1952). Provision is also made for additional federal allocations to the *Länder* after the vertical and horizontal equalisation processes have taken place.

The financial equalisation legislation flowing from these constitutional provisions provides complex processes and formulae to give effect to the equalisation aim, namely to "ensure a reasonable equalisation of the financial disparity of the *Länder*, due account being taken of the financial capacity and requirements of the municipalities (association of municipalities)" (Article 107(2) of the German Basic Law). It is only a "reasonable equalisation" that should be achieved and not an absolute equalisation, which would be unconstitutional. A reasonable equalisation has the effect of reducing the financial

inequality between the *Länder*, but in such a way that another constitutional aim of recognising the relative financial autonomy of the *Länder* is maintained. The Financial Equalisation Act (*Finanzausgleichgesetz*), 1993, governed the process of financial equalisation, until a decision of the German Constitutional Court in 1999 determined that the Act was unconstitutional and that new legislation had to be passed by the Federal Parliament (*BverfGE* 101, 158; Brand, 2006). The current legislative framework consists of a Standards Act, 2001 (*Maßstäbengesetz*) and a Financial Equalisation Act (*Finanzausgleichgesetz*), 2001. The current Financial Equalisation Act, 2001, follows a similar pattern to previous legislation, but it also includes provision for incentives to the *Länder* to increase their tax revenue, and the provision of a long-term financial equalisation plan, which is of great assistance in the financial planning of all levels of government. The current financial equalisation plan is valid for 2005–2019.

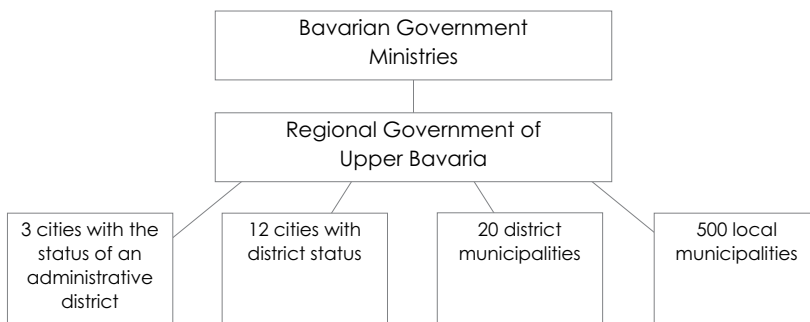
The implementation of the financial equalisation processes remains a topical issue. Economically stronger *Länder* often complain that their financial equalisation contributions are more than what is required of them and that some of the recipient *Länder* don't do enough to improve their financial situation. On the other hand, some *Länder* argue that their relative poor financial situation cannot be solved by them alone and that they need substantial equalisation payments. The international financial crisis of 2008, and subsequent increased debt in many countries, also had an impact on Germany, and thus also on the financial needs of the *Länder* and the local authorities. The Advisory Council (*Wissenschaftlicher Beirat*) of the Federal Ministry of Finance, an independent institution that advises the Ministry, has recently published a few proposals for reform of the financial equalisation arrangements in order to simplify the processes, reflect on changing circumstances and provide a fairer financial equalisation process (*Bundesfinanzministerium, Reform des Bundesstaatlichen Finanzausgleichs – Gutachten des Wissenschaftlichen Beirats beim Bundesministerium der Finanzen* 1/2015, 2015).

During September 2015 the German Federal Government and the Minister-Presidents of the 16 *Länder* engaged in important discussions on a new model of financial intergovernmental relations for Germany, as the current financial equalisation legislation will only be valid until 2019. In the Coalition Agreement of 2013 between the CDU (Christian Democratic Union)/CSU (Christian Social Union) and the SPD (Social Democratic Party) it was stipulated that during the term of the current German Government reform of the *Bund-Länder* financial relations will be discussed. The recent high-level discussions did not, however, produce any results. According to Renzsch (2015) a combination of political and factual considerations influenced the discussions and effectively prevented any progress. New proposals for reform and new high-level discussions are therefore needed long before 1 January 2019 – the date on which any changes to the current legal arrangements will have to be put in place.

4. Local government in Bavaria

In Bavaria, one of the sixteen German *Länder*, there are seven decentralised administrative structures of the Bavarian Government, called administrative regions (*Regierungsbezirke*). These seven regions are Upper Bavaria, Lower Bavaria, Upper Franconia, Middle Franconia, Lower Franconia, Upper Palatinate and Schwaben.

These executive authorities fulfil an important role as intermediary administrations between the Bavarian Government ministries in München and the local authorities. The seven regional administrations, for example the regional government of Upper Bavaria (Oberbayern) in München (www.regierung.oberbayern.bayern.de/englisch) and the regional government of Schwaben in Augsburg (www.regierung.schwaben.bayern.de), bring the Bavarian Government closer to local communities, bundle and coordinate the work of various ministries and monitor and supervise the multitude of local authorities within the respective regions. The decentralised public administration is based in the Bavarian Constitution, 1946 (amended version dated 15 December 1998) (Article 9), and regulated in further legislation.



Flow diagram 4.1: Organisation of government in Upper Bavaria.

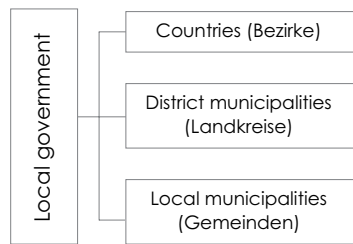
The monitoring role of the regional governments includes their approval of the annual budgets of the local government. In practice it also implies good intergovernmental relations in support of local financial governance.

Rural development is very important in Bavaria, and although local rural authorities have a key role to play in this regard, it is the Bavarian Government who ensures that rural development initiatives are implemented throughout Bavaria and that the seven regional administrations fulfil a crucial role in implementing the specific policies and programmes. Substantial funding of rural development is channelled via the regional administrations. Many small communities in Bavaria have local businesses with an international footprint and it is thus important to ensure that all the infrastructure in the rural areas are well maintained and upgraded to support local economic development.

An important current focus in the Bavarian rural development policy is the upgrading of the information technology infrastructure, including the provision of broadband and Wi-Fi access.

Local government in Bavaria is structured and functions within this context of decentralised administration. It furthermore gives effect to the subsidiarity principle in the German constitutional law, namely that functions should be administered at the lowest possible level. The right to self-administration (*Kommunaler Selbstverwaltung*) of local government is stipulated and guaranteed in Article 28 (2) of the German Basic Law, which provides the constitutional basis for local government.

In each of the sixteen *Länder* (regions) in Germany, local government is organised by the respective *Länder*, and the structure of local government, size and number of municipalities can thus differ from one *Land* to another. In Bavaria local government is organised in terms of the Bavarian Constitution and specific local government legislation (*Gemeindeordnung*, *Landkreisordnung* and *Bezirksordnung*) and has a three-tier structure.



Flow diagram 4.2: The structure of local government in Bavaria

There are more than 2000 local municipalities (*Gemeinden*) in Bavaria, which includes very small ones with a few hundred inhabitants and large cities. There are 71 district municipalities (*Landkreise*) and seven counties (*Bezirke*), which cover the same geographical area as the seven regional administrations of the Bavarian Government. The very small municipalities legally have the same functions as the larger municipalities, but cannot afford a complete administration. To overcome this administrative problem, provision is made for the cooperation between local municipalities. It is possible to have agreements among the very small municipalities for specific administrative purposes (*Zweckverbände*). An example of such an arrangement is found in Welden, a local municipality near Augsburg, where, in addition to the local municipality of Welden, there is also an administrative community of Welden (*Verwaltungsgemeinschaft*), which includes a few very small municipalities. It was created by law in 1971 and organised by the Bavarian Ministry of the Interior. This administrative community of Welden has delegated powers only and acts on behalf of the partner municipalities.

The **local municipalities** are most citizens' first contact with government and fulfil an important role in the development and functioning of local communities. The local municipalities are the primary local government institutions, responsible for a whole range of functions in accordance with Article 83 of the Bavarian Constitution, for example local streets, distribution of water, gas and electricity in the community, local planning, fire-fighting services, the building of primary and middle schools, and public swimming pools (Büchner, 2014). Local municipalities are governed by a mayor and a local council (*Gemeinderat*). The members of the local council and the mayor are directly elected by the voters for a period of six years (*Gemeindeordnung*, Büchner, 2014).

The **district municipalities**, similar to the local municipalities, are local democratic institutions for the citizens in each district, dealing with functions that span over more than one local community. They also have another role, namely that of lowest administrative office of the Bavarian Government. This dual function finds expression in the position of the chief executive officer (*Landrat*) of the district municipality, a person who is directly elected by the voters in that district for a period of six years. It is therefore a political office in Bavaria, but in some of the other *Länder* it is a purely administrative office. The chief executive officer also chairs the district council (*Kreistag*), whose members are elected by the voters in the district for a period of six years. The dual nature of the position of *Landrat* creates a very important link between the local community and the Bavarian Government. An important objective of this office is to give effect to the common goal of both local communities and the state to improve the general welfare of the citizens. Some of the functions of the district municipalities are the building and maintenance of district roads, district hospitals, gymnasiums (high schools), vocational schools, and the provision of social support services (Büchner, 2014). Since 2015, district municipalities' responsibility to house and support refugees, for which they receive additional funding from the federal government, has become increasingly important.

The **counties** form the third level of local government, an arrangement unique to Bavaria, and each county covers the geographical space of a group of district municipalities. The seven counties have original functions in terms of the Bavarian Constitution and the specific local government legislation (*Bezirksordnung*) which must span the jurisdiction of various districts. Although the counties have a limited range of functions, the subject matter is important to local communities. The most important functions are social services and cultural affairs. The responsibility for social services includes the maintenance of regional and specialised medical facilities, old age homes and care centres. The increasing numbers of refugees in Germany require support at local government level and the counties are only responsible for the disabled people

among the refugees. Cultural responsibilities include support for museums, traditional music and dance associations in the area of the county. Each county has an elected council and the president of the county council is an honorary position. The head of the county administration is a director, who is normally an experienced official appointed by the county council.

In Bavaria and in the rest of Germany, the representative organisations for local government play, in addition to the primary local government institutions, an important role in local government affairs.

Various representative organisations for the different types of local authorities, namely the *Bayerische Gemeindetag* (Bavarian Local Municipality Organisation), *Bayerische Städtetag* (Bavarian Cities Organisation), *Bayerische Landkreistag* (Bavarian District Council Organisation) and the *Bayerische Bezirkstag* (Bavarian County Council Organisation) have existed for many years. These representative local government organisations are recognised in terms of the Bavarian Constitution and must be heard in the affairs of local government. The functions of the *Gemeindetag* are to:

- Represent the interest of local communities;
- Provide information to members; and
- Provide legal advice to members – this is free, covered by the membership fees and provided to local municipalities, since many of them don't have sufficient or any legal support staff within the administration.

The cities are mostly better staffed than many of the smaller local municipalities and have in-house legal support. In the *Städtetag* the legal advice function is thus used much less than in the *Gemeindetag*.

The importance of local cooperation was confirmed in 2012 by the Bavarian Government in a policy document titled *Interkommunale Zusammenarbeit – Ein Erfolgsmodell mit Zukunftsperspektive* in which cooperation between different local authorities is promoted in order to be more competitive, cost-effective and technologically advanced. Such cooperation strengthens the ability of individual municipalities to serve their communities by creating more synergy in local governance matters.

5. Local government finance in Bavaria

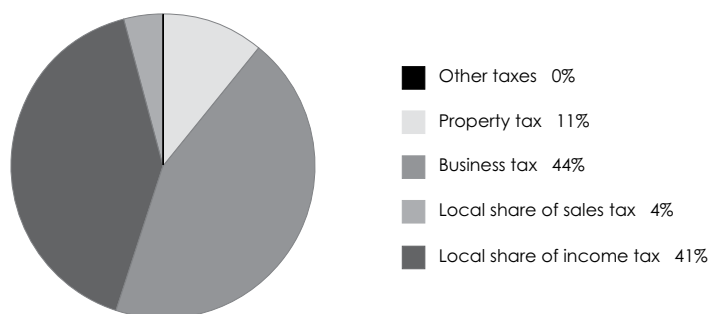
The right to local self-administration includes the responsibility for financial matters and implies that there should be appropriate financial resources for local government from which it should fund its functions (German Basic Law:Art. 28 (3); Büchner,

2014). In terms of the financial constitution in Germany, local government finances are structured as follows:

- 1 **Taxes**
 - Property tax
 - Business tax
 - Income tax (15% share)
 - Sales tax (2.2% share)
 - Capital gains tax (12% share)
 - Local taxes such as dog tax or second home tax (not in Bavaria)
- 2 **User charges** for services provided to the local communities, for example water and waste removal services
- 3 **Fees** for public facilities or services such as development fees
- 4 **Other revenue** such as credit finance or revenue from local public entities

Local government shares in the joint taxes (income tax, sales tax and capital gains tax) together with the federation and the *Länder* (German Basic Law: Art. 106 (3) and (5)). Own local taxes are property tax (agricultural and urban property tax), business tax and other smaller local taxes (German Basic Law: Art. 106(6)). The local municipalities have the above tax sources, but the district municipalities and counties don't have an own tax base.

Tax revenue in Bavarian local municipalities – 2014



Graph 4.1 [Source: Bayerische Staatsministerium der Finanzen, 2015]

The district municipalities receive a district levy (*Kreisumlage*), primarily based on the tax capacity of the local municipalities, from the local municipalities in that district. The motivation for this revenue allocation is the district municipalities' performance of functions beyond the borders of individual local municipalities, for the benefit of the whole district. Counties receive a county levy (*Bezirksumlage*), primarily based

on the tax capacity of the local municipalities, and paid by the districts and the cities without districts within that county (Büchner, 2014; Bayerische Staatsministerium der Finanzen, 2012). Specific formulae are used to determine the district levy and county levy respectively. The primary sources of tax revenue are in most cases not sufficient to fund all the local government functions. District municipalities and counties in particular experience such a funding gap. Specific financial equalisation arrangements are thus required to bridge this funding gap. Local government financial equalisation (*der Kommunalen Finanzausgleich*) is a very important part of local government finance and is based on the German Basic Law and specific financial equalisation legislation, namely the Bavarian *Finanzausgleichsgesetz*. Two important goals underpin the local government financial equalisation mechanisms, namely:

- The funding allocations must enable municipalities to fund their original and delegated functions appropriately; and
- It must contribute to the promotion of equal living standards in all areas of Germany (Bayerische Staatsministerium der Finanzen, 2012).

It is the responsibility of each of the sixteen *Länder* to implement the financial equalisation legislation in respect of local government within their respective jurisdictions. In Bavaria the local government financial equalisation is traditionally reasonably well funded and thus contributes to a solid financial basis for the Bavarian municipalities (Büchner, 2014).

The local government financial equalisation process is a complex process comprising a series of steps regulated by the *Gesetz über den Finanzausgleich zwischen Staat, Gemeinden und Gemeindeverbänden* (Local Government Financial Equalisation Act, 2013). The local government financial equalisation process in Bavaria includes the allocation of different tax revenue sources according to specific formulae and stipulated percentages, as well as specific allocations from the Bavarian Government budget to the three levels of local government. Local government in Bavaria share in three pools of tax revenue, namely:

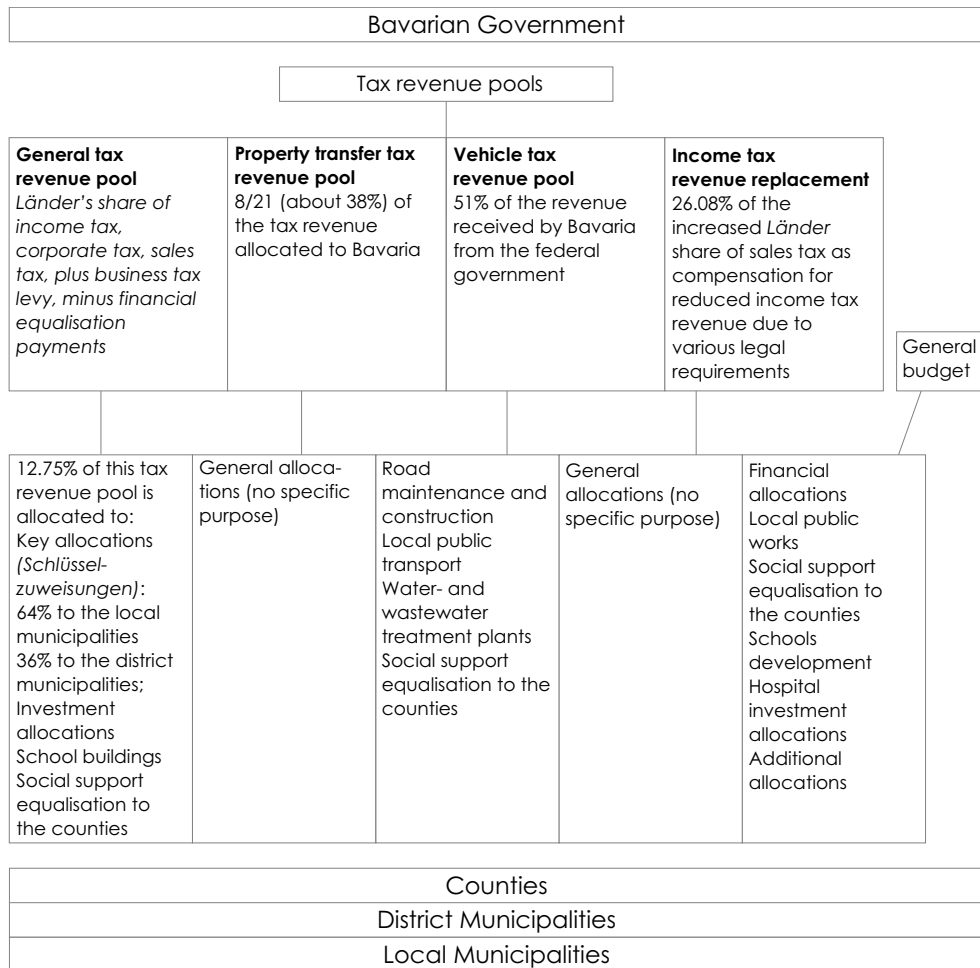
- General tax revenue (*allgemeinen Steuerverbund*)
- Vehicle tax revenue (*Kraftfahrzeug Steuerverbund*)
- Property transfer tax revenue (*Grunderwerbsteuerverbund*)

The most important part of the allocations to local government is the so-called key allocations (*Schlüsselzuweisungen*), which are paid to the municipalities in quarterly instalments. In determining the specific key allocations, formulae are used to provide additional revenue to poorer municipalities (municipalities that have a lower than a fictitious average financial position) to ensure “a reasonable equalisation” of the financial inequality between the various local authorities.

The local and district municipalities have to perform a range of functions delegated to them by the Bavarian Government in addition to their own original functions, and to compensate them, specific annual financial allocations are made directly from the Bavarian Government budget to the local and district municipalities respectively. All municipalities must receive adequate funding to fulfil their constitutional and legal mandates. Specific allocations for local public works, for example schools, sports fields or children's day care centres, are made to support infrastructure development and maintenance in all local communities and to ensure equivalent infrastructure in all communities in Bavaria. Legal guidelines for the development and maintenance of school buildings are provided by the Bavarian Government.

The details of the local financial equalisation process can differ between the sixteen *Länder*, and various other Länder use only the general tax revenue pool for the local government financial equalisation. The local government financial equalisation process implies financial support for poorer or economically weaker municipalities. Specific stabilisation programmes were implemented since 2012 for those local municipalities that experienced long-term financial hardship. These measures are temporary in nature and are aimed at helping local municipalities to help themselves (Bayerische Staatsministerium der Finanzen, 2012).

The financial equalisation process is described in more detail below:



Local government financial equalisation is an essential part of the financial intergovernmental relations in Bavaria and many of the poorer or economically struggling local municipalities will not be able to function effectively without it. The total amount of financial equalisation allocations, which includes specific financial aid from the Federal Government in Bavaria in 2015, is euro 8 289.7 million, of which euro 3 916.8 million comes from the general tax revenue pool and is used for the key allocations (Bayerische Staatsministerium der Finanzen, 2014). Through the local financial equalisation the financial position of the three levels of local government in Bavaria is strengthened. Included in the regulatory framework is the provision for levies to the district municipalities and the counties to enable them to perform their functions, and provision for the funding of specific investment initiatives in local government.

6. Conclusion

The German constitutional system, which has developed over a long period of time, is well anchored in the German Basic Law of 1949. The financial constitution is a crucial part of the current constitutional system, and it provides the legal framework for the financial intergovernmental relations in the country. It follows a principled approach by *inter alia* stipulating that each level of government should have adequate funding to finance their respective expenditure responsibilities (German Basic Law: Art.104a). This is referred to as the connectivity principle and is in line with economic theory on public finance in multi-level systems of government. There is thus a constitutional determination that expenditure responsibilities and the funding thereof are shared between the three levels of government. As far as local government is concerned, there is an additional element underpinning the local government finances, namely the constitutional stipulation of local self-administration, which includes the notion of adequate funding for local administrative functions.

Economic disparities between *Länder* as well as economic disparities between different municipalities are common in Germany, and are indeed common in many multi-level or federal systems of government. This implies that some form of financial equalisation is necessary to bridge the fiscal gap and to give effect to the constitutional requirement that all levels of government should be adequately funded. The financial equalisation system, which has its foundation in Articles 106 and 107 of the German Basic Law, is a complex system that has been contested in the German Constitutional Court on more than one occasion, and at present the reform of the system is once again being debated. Nevertheless, the main goal of the financial equalisation process – to provide a reasonable equalisation of the financial disparity of the *Länder* (including the municipalities) and ensure equal living conditions throughout the country – has constitutional status and therefore binds all levels of government and all political parties to give effect to this goal. It gives direction to the financial equalisation process between the *Länder* as well as to the local government financial equalisation process, and it gives expression to the social state principle in the German Basic Law, thus confirming the constitutional status of the financial equalisation goal. This is a very important characteristic of the German model. The goal of equality of living conditions throughout the country is in line with the constitutional framework that requires the *Länder* to administer federal legislation and implies that federal legislation must be uniformly implemented in all the *Länder*. Optimal arrangements must therefore be made for the provision of adequate funding for the *Länder* and the municipalities to give effect to their respective constitutional obligations. Disputes about the process and application of the financial equalisation in the past were not about the existence of this goal, but rather about the details of the process and how the legislation must give effect to it.

Thanks to the highly developed and strong economy of Bavaria it is in a financially fortunate position, which means higher revenue from its share in the joint taxes. The municipalities in Bavaria can therefore also share in a larger slice of the cake through the local financial equalisation process. The international economic crisis which started in 2008 also had a negative impact on many parts of Germany, including on the local government in Bavaria. Various local municipalities, in particular in rural areas near the northern and eastern borders of the region, are struggling to keep their finances afloat. These municipalities cannot survive without the local financial equalisation allocations they receive from the Bavarian Government. Local financial equalisation in Bavaria is efficient and is a good example of the effective translation of the constitutional aim of financial equalisation.

Municipalities should, however, not only depend on benefits from the financial equalisation process without contributing in one way or another to improve their financial situation. In fact, local self-administration implies some degree of own initiative to optimise the local finances. There are various ways in which local municipalities in Bavaria can improve their financial situation, for example by improving their expenditure management. Some municipal public entities or municipalities providing water and waste water services are suffering financial loss, while they should ensure a balanced budget. They could make more use of all the available funding mechanisms not fully utilised by municipalities.

Local financial governance in Germany, in particular in Bavaria, is characterised by a stable well-functioning system, despite the debates about the way in which financial equalisation takes place. Such discussions and contestations are normal in multi-level systems of government and help to refine and improve the system and to reflect on changing circumstances which have an impact on the system.

CHAPTER 5

The Future Development of Financial Governance in Metropolitan Areas

1. Introduction
2. Urbanisation globally
3. Major cities – local or regional government?
4. International profile of cities
5. Smart cities
6. Financial needs of and opportunities for metropolitan government

1. Introduction

Cities have been in existence for centuries and are found all around the globe. The character of local government in cities and the role cities, as a type of local authority, play varies from one country to another and depends on the specific constitutional arrangements in that country. Urbanisation is a growing phenomenon throughout the world that impacts on the functioning of local government, which implies that cities and metropolitan governance justify specific attention in a study on local government finance. Rapid urbanisation means that local authorities must provide services to a continuously growing number of people. Simultaneously, the available infrastructure cannot keep up with the increased demand. Infrastructure must therefore be upgraded and expanded and provision of the services a municipality is responsible for must be increased to serve the growing community. This, in turn, impacts on the expenditure (both capital and current) responsibilities, as well as the income of a municipality. An increase in the number of citizens does not necessarily mean an increase in taxes or financial allocations from the national government to municipalities. If there is, however, a growing need for more expenditure in a city without a concomitant increase in funding, a fiscal gap is

created or widened, placing pressure on the ability of a city to deal with urbanisation in an effective way.

Although basic elements of local government finance, such as the principles listed in Chapter 2, and the establishment of an own tax base apply to both rural local authorities as well as metropolitan local authorities, the needs of these two types of local authorities differ. Infrastructure needs, such as the development of metropolitan transport systems and large waste management facilities, require specific capital intensive solutions that are not needed in small rural municipalities. It is also evident that metropolitan municipalities can often make better use of external funding such as loans and municipal bonds and can utilise the financial markets to help fund urban development.

The number and size of local authorities in developed and developing countries are varied and there is no specific universal model applicable to all countries. The specific constitutional and legal framework for local government plays an important role in this respect, in addition to geographical and other factors. The rapid growth in the number and size of cities is markedly visible in China and India – two of the most populous countries in the world.

Globally the tempo and scale of urbanisation require innovative solutions for managing the growth of cities and responding to the emerging financial needs.

This chapter focuses on recent worldwide trends in urbanisation and the impact thereof on local governance. The specific financial needs and opportunities for metropolitan government as a distinct type of local government will also be explored. Questions to be considered are: Should there be an asymmetric approach to the allocation of financial resources to local government in order to acknowledge the specific needs of metropolitan government? What innovative funding solutions have already been tested internationally and could be considered in South Africa?

2. Urbanisation in the 21st century

Migration to cities all around the world creates larger local government jurisdictions and larger economic areas. In 2012 it was determined that more than 500 metropolitan areas, each with more than one million inhabitants, existed (Andersson, 2014).

The rapid urbanisation in China in the last four decades saw more than 500 million people migrating to cities. Many new modern cities have to be developed and massive increases in local government services have to be provided to all (Anonymous, 2014).

The ongoing growth of cities often results in an economic link to areas surrounding the core city, thus metropolitan areas are created. Sometimes the growth of neighbouring cities can create an economic corridor which attracts more investment and also provides a significant contribution to the national gross domestic product of a country, e.g. the Pretoria-Midrand-Johannesburg area in South Africa and the Bonn-Cologne-Düsseldorf area in Germany.

Urbanisation has also led to the formation of megacities in a few countries on different continents, for example Beijing in China, Cairo in Egypt, Tokyo in Japan and Sao Paulo in Brazil, to name but a few.

Currently more than half of the world's population live in urban areas and it is estimated that by 2030 the percentage will have increased to more than 60%. In 2014 cities produced more than 80% of the global gross domestic product (GDP) and were responsible for about 70% of global energy consumption (The Global Commission on Climate and Economy, 2014). The tempo and extent of urbanisation raises many questions about sustainability, quality of life, effective governance and environmental issues such as climate change and energy consumption. This warrants global attention, with the United Nations being one of the international institutions that dedicates time and resources to help find solutions to these questions. The improvement of cities, the quality of life in urban areas and the promotion of sustainable urban development were the key focus areas of the World Cities Day of the United Nations in 2015 (<http://unhabitat.org/wcd>).

Urbanisation creates both positive and negative consequences requiring focused attention from decision-makers in order to deal with the diverse issues of governance, economic development, social development and sustainability. On the one hand it creates a useful laboratory in which new governance mechanisms to strengthen democracy and the rule of law, initiatives to promote sustainability and effective methods to manage energy, water and waste in large urban areas are developed (Luther, 2014). On the other hand, the tempo and extent of urbanisation in many places produce informal settlements and places great pressure on the existing infrastructure and provision of services to inhabitants. Funding arrangements and administrative capacity are often insufficient to deal with all these challenges.

An example of the challenges faced by megacities is the case of Jakarta, capital of Indonesia. Jakarta has 13 million inhabitants, but when surrounding areas are included, the population is about 23 million, which makes it the largest metropolitan area in south-east Asia (Luther, 2014). Transport (12 million registered cars in 2012) and the lack of sufficient transport infrastructure is a big problem that has a negative effect on the economy. The city experiences serious environmental problems that impacts negatively

on the quality of life of citizens. Some of these problems relate to over-population, poor quality of drinking water, insufficient waste management infrastructure and flooding problems. All these problems put pressure on the financial resources available to the city. Jakarta is constitutionally stipulated as a province under the leadership of a governor, but it is divided into five separate cities that each has a mayor. There is thus a two-level governance structure which has to deal with all these complex governance challenges. Dealing with financial governance issues is not only a local and provincial government issue, but would also require the active involvement of the national government of Indonesia.

Cities are economic hubs and play an important role in international trade and investment. Some of the effects of the international economic crisis in 2008 were lower economic growth and increased unemployment in various EU member states, including in many cities. In the European Union the needs of local government, in particular of cities, are attended to in various ways and in different institutions at supra-national level. About 70% of the EU population live in urban areas. Cities, being centres of economic activity, are one of the focus areas for stimulating economic recovery. In accordance with the EU Cohesion Policy, economic growth and job creation are important aspects of recovery from the economic crisis and will strengthen the territorial cohesion within the EU (Committee of the Regions, 2013).

Issues such as infrastructure development, including improving broadband technology and dealing with pollution and traffic problems, are some of the key issues to be dealt with by cities. The continued impact of the migration of refugees from North Africa and the Middle East to Europe became a critical issue during the first few months of 2015. Although it is primarily cities in the southern EU member states such as Italy and France who feel the brunt of this migration first, it is a concern for the whole EU. Germany is the EU Member State that receives most of the refugees and German cities and towns had to find ways of accommodating all the refugees. Apart from the important humanitarian aspects which member states and some aid organisations attend to, this migration also put additional pressure on resources and the services to be provided in various local communities. Cities and other local authorities must therefore make financial provision to provide social support and other services to these migrants. National and EU funding also contribute to assist cities in dealing with this issue.

In the World Economic Forum's (WEF) Global Risk Report 2015, urbanisation is viewed in a positive light, but with the important qualification that the governance of cities will determine the ability to deal with major global risks such as pandemics, climate change, infrastructure development, cyber threats and civil unrest in local societies (WEF, 2015).

Many of the top risks listed in this report have an effect on cities and must be dealt with by city governments as well as provincial and national governments.

Some of the global risks relevant to cities are: large-scale involuntary migration, food crises, failure of urban planning, water crises, high unemployment rates and a failure to adapt to climate change. These are global risks that warrant international attention, but within a country these risks should be mitigated by all levels of government. It relates to effective governance, as indicated by the WEF report, and will consequently also have a financial impact since governments will have to take these risks into account when determining their budget.

3. Major cities – local or regional government?

Cities are important contributors to the gross domestic product of a country and can also play an important political role, e.g. Brussels in Belgium, London in the United Kingdom or Shanghai in China, to name just a few. It is thus relevant at this point to enquire about the constitutional or legal status of major cities. Can they still be regarded as local authorities, are they treated as regional governments, or is there perhaps a combined model that applies in particular cases? Inquiring about the constitutional or legal status of major cities is not merely an effort to gain an understanding of where they fit in with the overall constitutional scheme, but the answer will also have an effect on their particular funding arrangements.

The constitutional position and governance structures for metropolitan areas differ from country to country and depend on the specific constitutional arrangements that are in place. In South Africa the Constitution provides for three categories of municipalities, namely:

- Metropolitan municipalities;
- Local municipalities; and
- District municipalities.
- (Constitution: s.155; Municipal Structures Act: s.1)

Metropolitan municipalities are defined in section 2 of the Municipal Structures Act, 1998, to have the following characteristics:

- | | |
|-----|---|
| a | A conurbation featuring – |
| i | Areas of high population density; |
| ii | An intense movement of people, goods, and services; |
| iii | Extensive development; and |
| iv | Multiple business districts and industrial areas. |

- b A centre of economic activity with a complex and diverse economy;
- c A single area for which integrated development planning is desirable; and
- d Having strong interdependent social and economic linkages between its constituent units.

The major cities in South Africa could thus qualify to have metropolitan local government status, but the national minister responsible for local government must declare an area to be a metropolitan area. Each province must establish the different municipalities in that province.

Municipalities may establish different governance structures in accordance with the Municipal Structures Act, 1998, which includes the possibility of an executive mayor and mayoral committee as the political executive of a municipality.

Gauteng, the most urbanised of South Africa's nine provinces, has three metropolitan municipalities, namely Johannesburg, Tshwane (Pretoria) and Ekurhuleni (www.localgovernment.co.za).

The population (2014) of Gauteng is 12.2 million and the population of these three metropolitan municipalities contributes to the bulk of the numbers – Johannesburg has 4.4 million people, Tshwane 2.9 million people and Ekurhuleni 3.1 million people. The Gauteng province can be described as one large city state and is also the main economic engine of South Africa.

In Germany the capital city Berlin, as well as the cities of Hamburg and Bremen, are regarded as *Länder* and not as local authorities (Basic Law, 1949; Laufer & Münch, 1997). They are also referred to as city states. Due to historical developments, their constitutional status is regarded as regional and not local, as confirmed in the Basic Law.

During the first few years after World War II, the Allied Forces that occupied Germany established transitional governmental structures and made use of the historical developments in the areas under their jurisdiction to define the new *Länder*. The final confirmation of the constitutional establishment of the *Länder* in the Western occupied zones took place when the Basic Law was adopted in 1949. West Berlin was regarded as one of the *Länder* in the new Federal Republic of Germany, while East Berlin (who fell under occupation of the Soviet forces) formed part of the German Democratic Republic (Laufer & Münch, 1997; Brand, 2006). It was only in 1990, with the unification of Germany, that Berlin was also unified as one city state. These three *Länder* each have an elected legislature (parliament) with an executive (called the senate) and a mayor heading the executive. In view of their status as regional governments (*Länder*), these three city states are also represented by their respective executives in the *Bundesrat*, the

second chamber of the German Federal Parliament. The constitutional status of Berlin, Bremen and Hamburg as *Länder*, together with that of the rest of the sixteen *Länder*, is protected (Basic Law:Art.20, 79(3)).

Brussels, the capital of Belgium, can also be described as a city state and is one of the three regions in Belgium, the other two being Flanders and Wallonia (Constitution of Belgium, Art.3). Brussels Capital Region, the only bilingual (French and Dutch) region of Belgium, includes 19 local authorities called communes (*gemeenten*), one of which is the City of Brussels. Brussels has about 1.2 million inhabitants compared to the total population of about 11.1 million in Belgium (Brussels Instituut voor Statistiek en Analyse, 2014).

The region of Brussels has an elected Parliament of 89 members who elects the members of the Government of the Brussels Capital Region. The functional responsibilities of the Brussels Capital Region are similar to that of the other two regions and include urban development, environmental affairs, economic development and transport. The 19 communes each have an elected council which elects an executive from the members of the council. The mayor, who must also be a councillor, is appointed by the Government of the Brussels Capital Region (<http://be.brussels/>). The communes are responsible for various typical local government functions such as public parks, communal facilities (such as crèches), and local roads. The communal governments are accountable to the Brussels Capital Region which monitors the local authorities within its jurisdiction. Brussels thus have two levels of government, namely the regional government (Brussels Capital Region) and local government, in the form of 19 communes. Brussels also has another identity of capital of the European Union. It therefore hosts the European Parliament, European Commission, Committee of the Regions and various other institutions and offices related to the European Union. It is the only city in the world in which four levels of government are present, namely local, regional, national and supra-national.

Since 2013, Nairobi, the capital of Kenya, is now also one of the 47 county governments subsequent to the adoption of the current Constitution of Kenya 2010 and the establishment of counties as a second tier of government (Constitution of Kenya, 2010: sec. 174-176; County Governments Act, 2012). Nairobi City County covers a much larger area than the previous local government structure of the city of Nairobi prior to 2010 and has a whole range of functions which includes agriculture, trade, health services and water services. Nairobi, with its 3.5 million people, is divided into sub-counties and wards to ensure effective service delivery in all areas of the county (www.nairobi.go.ke). These are administrative sub-divisions of the county government, headed by a governor, and do not form a separate level of government.

From this brief overview of some of the major cities in the countries included in this comparative study it is evident that the constitutional and legal arrangements cover a diverse spectrum that includes county government (Nairobi; Kenya), regional government (Berlin, Hamburg and Bremen; Germany), metropolitan local government (Tshwane, Johannesburg and Ekurhuleni; South Africa) and a combined model of regional and local government (Brussels; Belgium).

The historical development and particular constitutional developmental history had a significant impact on how the various local and regional government structures have been established. There is thus not a specific model which suggests that a metropolitan area must have either regional or local government status. Jurisdictional or functional fragmentation, or amalgamation, often determines the way in which government is structured in metropolitan areas (UCLG, 2011). The establishment of a metropolitan government as a type of local government is a specific option available in South Africa.

4. International profile of cities

Through the ages cities with ports have always played an important role in international trade and were therefore also important economic centres in their respective local economies. This is still true today, but the international profile of cities has grown to be that of multi-faceted international actors. Globalisation has diminished the dominant role that national governments played in international relations for the last hundred years, since there are many new actors actively involved in the international arena. International relations are not the exclusive domain of nation-states any more, but regional governments, and also cities, play an increasingly important role in international relations.

Various large cities or local metropolitan governments around the world have active international relations activities, both bilateral and multilateral. An example of one such a multilateral grouping is the Great Wine Capitals of the World, of which cities and the wine regions around them are members, including Cape Town and the Cape Winelands, Bordeaux city and region, and San Francisco and the Napa Valley. Although wine production is the common characteristic among the members of this network, this multilateral initiative also focuses on tourism (www.greatwinecapitals.com).

The international economic role of cities has expanded over many years to include other economic activities in addition to trade. Cities compete internationally in a variety of areas, for example for the opportunity to host events in sport, tourism and international conferences. As an example, the two biggest international sporting events are both huge economic enterprises, namely the Olympic Games organised by the International

Olympic Committee, and the FIFA Soccer World Cup. Cities and the countries in which they are located spend enormous amounts of money to compete in a bidding process to host these major sporting events. The international sporting organisations place significant demands on a host city or host country, which includes substantial spending of tax payers' money on building new infrastructure and upgrading existing infrastructure. There is thus an economic injection in the years prior to hosting such an event. There is much debate about the economic benefits of hosting the Olympic Games, FIFA Soccer World Cup, Rugby World Cup or other major international sporting events. General improvement in transport and other infrastructure for example in München, Germany, with the development of its underground train system prior to the 1972 Olympic Games, and the modernised airports and roads in South Africa prior to the 2010 FIFA Soccer World Cup, are often quoted as indicators of economic benefits to the respective host cities. There are, however, also potentially negative impacts such as new stadiums specifically built for the soccer games in South Africa or Brazil in 2014, which are hardly used afterwards. In an article in the New York Times, the economist Philip Porter argues that the public support and positive image created by hosting such an event is perhaps more significant than any possible economic benefits (Appelbaum, 2014). Nevertheless, any host city of a major international sporting event must invest in building or upgrading infrastructure and promoting itself as a tourist and business destination, all of which have an impact on the budget and long-term financial planning of such a city.

Cities compete to host major international conferences and there is significant investment from both public and private funds to develop international conference and exhibition facilities. A detailed study about the economic impact of conferences, meetings and exhibitions in the United Kingdom showed that the attendees at conferences in the country in 2011 spent about £40 billion and that the conference industry contributed 2.9% to the GDP in the UK in that year (Li, 2013). The Cape Town International Convention Centre (CTICC), the leading conference destination in Africa, contributed R3.1 billion to the national GDP in 2014, of which a significant proportion is being spent in the Western Cape, while a total of R25 billion was added to the country's economy over the past ten years (CTICC Annual Report, 2014). The international conference and exhibition industry is thus an important contributor to the economic profile and growth of many cities and their surrounding regions.

The rapid pace of urbanisation around the globe requires a review of urban development planning, local governance and funding models in order to deal with the effects of growing urban populations. Climate change and the dire need for a reduction in greenhouse gasses are additional issues that place further demands on cities today. Cities, as economic

engines that make significant contributions to the domestic economy of a country, requires sufficient and appropriate infrastructure, which includes modern integrated urban transport systems, broadband and Wi-Fi internet access for everyone, more efficient energy use and increased use of renewable energy sources. These infrastructure demands place significant pressure on the budgets and long-term financial planning of cities. In India alone it is estimated that an investment of \$827 billion over the next 20 years is required for urban infrastructure such as roads and transport systems (Global Commission on Climate and Economy, 2014).

The economic and governance profile of cities will have to change to deal with these challenges effectively. In its 2014 report, the Global Commission on Climate and Economy argued that cities should adopt a strategy for sustainability consisting of three key elements, namely:

- Compact urban growth, which implies managed urban expansion, higher density and sufficient public green spaces. This should be complemented by a low-carbon economy, which includes energy efficiency in homes, offices and industries.
- Connected infrastructure, which means appropriate investment in innovative infrastructure and technology such as modern, rapid bus transport systems, electric vehicles, bicycle lanes and bike sharing schemes and broadband and Wi-Fi connectivity.
- Coordinated governance, which suggests effective and accountable institutions at different levels of government and good cooperation with the private sector and civil society, particularly in the areas of urban planning, land use and integrated transport (Global Commission on Climate and Economy, 2014).

The importance of integrated modern transport systems and land use planning to strengthen economic competitiveness and sustainability in cities of both developed and developing economies was confirmed in a World Bank study that compared a number of case studies in the world (Suzuki, Cervero & Iuchi, 2013).

5. Smart cities

In the knowledge economy of the 21st century, the rapid developments in the field of information and communications technology change the living and working environment of people significantly. It also changed the way in which government functions and deliver services. E-government, in various stages of development, has become the norm. The development of smart phones, and the accompanying technological developments to enhance the use of these smart phones as highly sophisticated hand-held computers, now also creates so-called m-government or mobile government.

The computer technology company IBM has developed the concept of smarter cities, a concept that promotes the innovative use of technology in finding solutions to some of the problems local authorities face, and also to focus on the involvement of citizens in contributing to finding solutions and using technology to improve the delivery of public services (www.ibm.com/smarterplanet/us/en/smarter_cities/overview).

Smart cities embrace digital technology to find new ways to govern and provide public services. This initiative has stimulated a huge variety of citizen-driven ideas to improve governance.

The number of apps for mobile phones increases daily and it is also in the field of local governance that mobile phone apps have made its mark. A South African example of one such initiative relates to the monitoring of water services, namely WaterWatchers (a water management app used in South Africa) that enables consumers to easily monitor the water supply system and report water leaks, burst water pipes and problems with the water supply infrastructure (IBM, 2013). Managing transport in innovative ways is an important part of the development of a smart city and can have a significant economic and environmental impact. Stockholm in Sweden has developed a system to improve their traffic management. The Stockholm Congestion Charging System has reduced peak hour traffic congestion and CO₂ emissions significantly, while increasing the number of passengers using public transport (IBM, 2009). It is also in the field of energy that technology can assist to improve energy efficiency and cost-effective management of energy distribution to local consumers. Smart grid technology can help cities and consumers to improve energy efficiency and reduce energy cost. Smart grids enable the improved monitoring of the flow of electricity and assist consumers in effectively managing their energy consumption.

The digital revolution includes the production, safe storage and useful analysis of vast amounts of data, and it also includes the convergence of different technologies. Government at all levels has an important role to play in using the opportunities provided by the digital revolution to transform the way it governs, interact with citizens and support the knowledge economy that will contribute to improving the quality of life of citizens. A new way of doing things is required: instead of the historic approach where the government designs and delivers services more or less without significant involvement of citizens, the involvement of citizens is central to strengthening good governance.

The economist Anwar Shah argues that in the knowledge economy, citizen-centric governance is necessary for the prosperity and competitiveness of countries, not only to embrace modern technology, but also to establish citizens as the principals of

government services (Shah, 2014). Citizens or consumers are increasingly demanding to help shape the services they receive from government, and the availability of new information and communication technology plays an enabling role to create a platform for innovation (Fleming *et al.* 2015). The co-design and co-delivery of services can enhance the legitimacy of government and improve the effectiveness of the services it has to deliver.

The concept of smart cities is clearly not a new buzz word, but rather a new paradigm within which local government should function. It embraces modern technology, while putting the citizens at the centre of its business approach. One of the prerequisites for smart cities is the development of appropriate technological infrastructure, which means investment by local government (and usually also other levels of government) and the private sector.

6. Financial needs of and opportunities for metropolitan government

A combination of factors such as climate change, the need for a reduction in CO₂ emissions, increased urbanisation and its concomitant infrastructure needs, requires local government in metropolitan areas to review their long-term financial needs in a way that properly reflects these and other factors. Changing the economic profile of cities to that of a low-carbon economy requires the appropriate policy and legal framework and also significant investment in infrastructure.

The different structural arrangements for metropolitan governance all around the world have an impact on how these governments deal with issues such as financial planning and investment in infrastructure. According to the Second Global Report on Decentralisation and Local Democracy there are three different approaches, namely:

- Jurisdictional fragmentation: In this model there is a dual level of local government: one central local authority and many smaller local authorities co-exist in a metropolitan area.
- Functional fragmentation: A local public entity or a special district government is responsible for one or more local government functions, while the rest of the local government functions are delivered by the various local municipalities. The water boards (*Waterschappen*) in the Netherlands are examples of such local public entities.
- Metropolitan government: A single local government for the whole of a metropolitan area takes responsibility for the delivery of all the local government functions and raising of revenue in that area. There are permutations of this

model, which includes local municipalities and which thus create jurisdictional or functional division. Some of the potential benefits of a metropolitan government are that the services are well coordinated, there is a high capacity for revenue and transport infrastructure and services are effectively integrated (UCLG, 2011).

There is a fourth possible governance arrangement in metropolitan areas, namely cooperation agreements between the local municipalities in a metropolitan area, for example to share service delivery costs (Andersson, 2014).

General funding arrangements for local government cover a wide spectrum of possibilities (see discussion in Chapters 2 and 3) and would normally include some form of local tax such as property tax. General or specific grants and financial equalisation transfers are additional sources of revenue that enable local government to perform their functions. In the case of metropolitan governments, the additional financial needs highlighted above suggest a funding approach which differ from that of local municipalities. The various funding opportunities can be categorised as follows: tax arrangements, service delivery agencies, major infrastructure investments and special funds.

i. Tax arrangements

Property tax is the most popular and appropriate form of local tax and the decentralisation of taxes on immobile tax bases (such as property tax) from central to provincial or local government is in line with economic theory (see discussion in Chapter 2; Oates, 1994; Brand, 2006). Metropolitan areas can thus also benefit from property taxes as its most important local tax. It is important that the administration of property tax, including the regular review of the valuations and property data base, is improved to increase its efficiency.

Tax sharing, utilising the same tax base for different levels of government, is an option for metropolitan areas. It could be done either by stipulating a percentage of the tax revenue, which could have a local residential link, for each participating level of government, or allowing local government to add a levy or surcharge on an existing national tax base (Brand, 2006). This is utilised for example in Japan and Germany where a sharing of tax bases occur. In Japan the Tokyo Metropolitan Government and the local municipalities in Tokyo share the same tax base (UCLG, 2011). In Germany local government is entitled to a percentage share of personal income tax and sales tax (see discussion in Chapter 4). The possibility of adding a surcharge on an existing national tax base is used in some countries like Belgium (see discussion in Chapter 3).

ii. Service delivery agencies

Economies of scale can be achieved if some local government services are provided on a metropolitan basis rather than by individual local authorities. It could be done directly by a metropolitan government, or special service delivery agencies could be mandated to perform such a function on behalf of the metropolitan government. An example of this is a local public entity that provides the service platform for an integrated public transport system for the whole metropolitan area in München, Germany. The Münchner Verkehr- und Tarifverbund (MVV), a local public entity, is responsible for all the public transport services, which include bus, tram, underground rail and surface rail services (www.mvv-muenchen.de).

iii. Special funds

Some countries provide special local government funding for infrastructure development, which is then transferred to municipalities in the form of grants, for example the municipal infrastructure grant in South Africa (annual Division of Revenue Act; Farvacque-Vitkovic & Kopanyi, 2014). The establishment of an infrastructure development bank is another way of providing special funding for the development of new infrastructure, for example the China Development Bank, the state infrastructure banks in the United States of America and the various structural and investment funds in the European Union (Committee of the Regions, 2013; ec.europa.eu/contracts_grants/funds_en.htm).

iv. Major infrastructure investments

Modern cities require large investments in the establishment and maintenance of infrastructure for many of the reasons related to the role of urbanisation already discussed. Climate change and rapid urbanisation require the development of a low-carbon economy and efficient connectivity in metropolitan areas. Dedicated public and private funding must be utilised to fund such infrastructure developments, since the normal funding arrangements will not be sufficient (Global Commission on the Economy and Climate, 2014). Investment in renewable energy and energy efficiency is an important characteristic of a low-carbon economy. Since most of the global energy consumption and greenhouse gas emissions take place in cities, significant investment in cities around the world needs to take place. The United Nations Environment Programme (UNEP) has launched a new initiative, called the District Energy in Cities Initiative, to stimulate more investment in renewable energy, energy efficiency and the green economy. Integrating land use and transport needs (transit-oriented development) in a growing urban environment is essential for sustainable cities (Suzuki, Cervero & Iuchi, 2013). This requires dedicated infrastructure funding, in particular for the development of an

integrated metropolitan transport system and the creation of economic hubs around transit areas, which in turn would attract private investment, thus contributing to economic growth.

7. Conclusion

In the fast changing world of the 21st century, of which a technology driven knowledge economy is a key feature, globalisation and localisation or decentralisation are forces that have an impact on the respective roles of the different levels or spheres of government in a country. Local governments, in particular in cities, have developed international profiles through globalisation and their active involvement in the field of international relations. The reality of high levels of urbanisation in the world means more cities, larger metropolitan areas and more economic centres, which all impact on the environment. Local government thus functions within a much more complex environment than it did a few decades ago. Although municipalities in rural areas also have an important role to play, it is government in metropolitan areas in particular, irrespective of how it is structured, that is in the spotlight.

Against this background it is evident that government in metropolitan areas will have to give careful consideration of their current situation in order to adopt appropriate strategies that will enable them to be competitive and sustainable cities. In some cases it might require legislative changes at higher levels of government and in local regulations, for example to promote energy efficiency. The description provided by the Global Commission on Climate and the Economy gives useful guidance to metropolitan governments for their future development, namely that sustainable cities should be compact, connected and have coordinated governance.

It is further concluded that, in order for cities and metropolitan governments to deal with urbanisation effectively and adopt this sustainability approach, significant infrastructure investment in fields such as energy, transport, information technology and water is needed over many years. The normal budget of metropolitan areas would in most cases not be able to deal with these demands effectively. Special funding arrangements that include other levels or spheres of government as well as the private sector are required to support this growth in metropolitan areas. This also applies to South Africa, where finding innovative solutions for the funding needs of metropolitan areas must be part of a total financial reform package. Existing funding opportunities and innovation in local government finance will be discussed in Chapter 7.

CHAPTER 6

Efficiency and Effectiveness in Local Financial Governance

Deon van der Westhuizen

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2. Sustainability
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1. Introduction

The public sector finances its activities through tax collection and distribution, but changing economic climates around the world emphasised the need to be self-sufficient. Sustainable local government is built on the principles of liquidity, solvency, excellent credit ratings and the ability to raise finance for both capital and operational expenditure. Finance is backed by solid credit ratings of both national and local government, and as in private sector, financiers like to back a good jockey, i.e. a municipal management team that can deliver operationally by optimising their income and spending their cash economically, efficiently and effectively.

There are 278 local authorities in South Africa, of which roughly 40% are totally illiquid, with low debt collection ratios, and very slow creditor payment periods. Add to that a

precarious cash position and a high number of protests against poor service delivery, and the issue of sustainability becomes ten times more critical.

Funding of municipalities relies on three streams, namely:

- 1 Equitable share and government grants (Constitution: sec. 214);
- 2 Own revenue (Constitution: sec. 229); and
- 3 Lending (Constitution: sec. 230A).

National government would like municipalities to be self-sufficient, which is achieved by enhancing own revenue and gaining access to capital markets directly. At the same time, accountability for operational performance should be shouldered by municipal management for the following three reasons:

- a Limitation of implicit or contingent liabilities: It is important to protect central government from ultimately inheriting the debts of local government. When local governments borrow (internationally) through central government, the debts of these bodies easily become the implicit or contingent liabilities of central government. It also ensures that municipalities have strong incentives to improve their own management and creditworthiness, knowing that it is unlikely that central support will be forthcoming to compensate for local mismanagement or policy errors.
- b Systemic discipline: International experience suggests that the indirect borrowing route can result in situations where credit allocation decisions become increasingly less commercial. Under such conditions, capital does not necessarily flow to the most productive uses, but to those players who are politically the most astute. In other words, the efficiency and accountability outcomes mentioned above become diluted. Incentives for inefficient and wasteful decision-making can replace those that encourage the productive use of capital and tight financial management.
- c Expanding investment resources: Local government borrowing via central government can result in the “squeezing out” of private capital from the municipal sector, thereby narrowing the aggregate resources available for investment. Moreover, central control of borrowing can also create incentives for local governments to elude these restrictions through innovative off-budget schemes. Centralised borrowing, therefore, does not necessarily increase the ability of central government to control the liabilities of local government, but it may simultaneously diminish the overall financial resource base available for investment in worthy projects.

Unfortunately the number of municipalities that can access these sources is reducing by the day. A dedicated turnaround strategy is needed, but before such a strategy can

take shape, one needs to understand the drivers for successful local government. These drivers are built around several financial and management ratios, and once these ratios are analysed and interpreted, a roadmap to recovery start to develop. This chapter will develop a possible roadmap by analysing five local municipalities in different provinces in South Africa: three successful ones, and two struggling ones.

2. Sustainability

In terms of the layout of this chapter, the research focuses on the following sequential logic:

- **Competent financial management:** Effective financial management leads to a strong set of unqualified financial statements, with effective working capital management, reasonable debt collection and creditor payment periods. Revenue and expenditure budgets are normally realistic, and capital expansion programs are well designed and affordable. Supply chain contracts are within the ambit of the supply chain management regulations and policy, and unauthorised, irregular, fruitless and wasteful expenditure are significantly lower.
- **Audit opinion:** Municipalities with effective financial management processes normally receive an unqualified audit opinion from the external auditors. Unfortunately qualified audit opinions and disclaimers are frequently part of the annual report of many municipalities in South Africa.
- **Unit cost calculations:** It is unfortunately true that without effective revenue and specifically expenditure management, it is also not possible to effectively cost the delivery of services. As with any business entity, if the cost is not known, the consequences are normally two-fold, namely the service charge (what the municipality charge the consumer) is frequently wrong, and secondly, costs are not recovered (mostly) because of an under-estimation of different cost elements. In the financial analysis it is clear that struggling municipalities often have a significant number of vacant posts and spend the bare minimum on repairs and maintenance. In the absence of expenditure management and accurate calculation of service charges, significant under-recovery is inevitable.
- **Credit rating:** The first two elements often feed into the credit rating of a municipality, although it is not the only criteria for a good credit rating. The credit rating for most municipalities was downgraded over the past three years.
- **Effective revenue collection:** Municipalities deliver several services at a cost to the consumer. These services are invoiced, but often not collected. Some analysis will illustrate that ineffective collection processes severely affect operational effectiveness.
- **Growing own revenue sources:** In addition to service charges, municipalities also tax properties on its valuation value. Municipalities would however, need to find

additional sources of revenue, and some of these initiatives will follow the route of public-private partnerships.

- Access to funding: The above elements are all intricate to the availability of funding sources, and effective municipalities have endless sources of financing, whereas struggling municipalities can only rely on the equitable share allocation and government grants, and an ever dwindling source of own revenue.
- Effective service delivery: Once the above elements fail, the impact on service delivery is immediate.

3. Economic, effective and efficient use of resources

One of the cornerstones of successful, continued service delivery is systemic discipline. It is a very broad subject in itself, but one element of such discipline is the optimisation of the resources that are currently available to municipal managers. Optimisation and sustainability are frequently linked to effective and efficient working capital management, which in turn hedges on the three value for money pillars, namely economy, efficiency and effectiveness.

Working capital management involves the effective management of cash resources, timely collection of revenue for services delivered and regular payment of suppliers and short-term commitments. It also entails optimising return on cash surpluses by reinvesting such surpluses at more attractive interest rates, and reducing the cost of short-term financing (interest paid on loans and overdrafts).

Poor working capital management often leads to weak liquidity, which in turn affects credit ratings negatively, and impacts on potential capital development programs. Poor credit ratings also severely affect the ability of municipalities to secure loans for future capital expansions.

The definitions of these principles are generically as follows:

- Economy – minimising the cost of resources, which includes management of costs, quantities, quality and timeframes (doing things at a low price);
- Efficiency – minimising the cost of resources and maximising the output derived from utilising these resources (doing things the right way); and
- Effectiveness – the extent to which objectives are met (doing the right things).

Value for money is about providing services that are of the right quantity, quality, level and cost and reflect the needs and priority of customers, taxpayers and the wider community.

Municipalities should thus endeavour to ensure that, by means of financial management, good procurement practices, business planning and periodic reviews of services, they are able to provide services that are good value for money. It will eventually be reflected in the unit cost of service delivery, a principle that is very important in this chapter.

4. Financial needs of municipalities

Municipal investment needs arise from spending pressures associated with growth in the economy, the replacement of assets and combating poverty. Municipalities are key role players in creating favourable conditions for economic development. The performance of the South African economy during the four years between 2006 and 2010 was fuelled by unprecedented growth in construction, financial services, transport and communication and wholesale and retail trade. The FIFA Soccer World Cup 2010 also contributed significantly. However, in the past four years the trend reversed and economic activity slowed, and financial woes increased exponentially. Municipalities therefore need to focus on three distinct responsibilities:

a. Capital infrastructure

The management and maintenance of existing infrastructure is lagging behind and could become a binding constraint to future local economic development. Municipalities need to put operational processes in place to avoid system failures such as power failures, water leakages, and damaged road surfaces. Renewed focus on infrastructure development, management and maintenance will improve the reliability of municipal service delivery and enhance the potential for sustained local and national economic growth. Municipalities have budgeted to spend R62.5 billion (www.gov.za/treasury-municipal-finance) on capital expenditure, which includes maintenance of existing infrastructure in 2015/16 (prior year: R56.7bn).

b. Cost of backlog

According to the financial analysts of News 24 (www.fin24.com), the total cost of eradicating backlogs in access to basic services is estimated to be around R68 billion. Municipalities will have to focus on eradicating backlogs in water and sanitation, electricity and waste management in established communities and simultaneously develop low income areas as a major priority. This needs to be a central component of a municipality's overall financing strategy. It is widely recognised that municipalities differ in terms of their fiscal capacity and that some municipalities will remain dependent on fiscal transfers over the medium to long term. This is because of the low revenue base, demographic structure and the generally low level of economic activity in some areas.

The latter group needs appropriate capacity building initiatives to help them achieve financial sustainability.

c. Financing strategy

It is crucial for municipalities to develop a financing strategy that optimises the leveraging of grant funding, own and external sources of finance and off and on-balance sheet funding. Approximately 80% of the country's GDP is generated in 27 of the country's largest cities (this includes the six metros and the 21 secondary cities). However, capital investment as a percentage of GDP by these municipalities remains low, at around 0.8%. Municipalities' debt as a percentage of revenue is also low, at approximately 1%. Taking the current credit rating of municipalities into account, there is scope to borrow a further R30 billion over the next three years to boost municipal infrastructure investment. The additional funds could be raised through long-term municipal bonds and bank loans and would allow creditworthy municipalities to address backlogs and invest in bulk projects needed for service delivery.

5. Financial instruments

There are two distinct levels to the question of debt-issuance powers: whether or not any governmental entity (national or provincial government) beyond the municipality should have any overriding authority (through approval or review procedures) over municipalities' power to issue or incur debt; and who, within the municipality, should be empowered to issue debt, and how. Section 46 (2) of the Municipal Finance Management Act, 56 of 2003, specifies that long-term borrowing should be authorised by the municipal council without any requirement for national or provincial approval. Section 48 states that borrowings can be secured by a lien, pledge, mortgage or ceding of assets as collateral, or ceding any category of revenue which is raised locally, as municipal debt is not underwritten by the central fiscus. Ensuring that borrowing decisions are local decisions will strengthen local accountability. Against this background, various key factors to be considered by a municipality when it wants to incur debt are discussed below.

a. Investors

Financing institutions and investors aided by credit rating agencies and the new accounting rules are much better placed and have much stronger incentives than any organ of government to assess whether a municipality is capable of borrowing. In order to maximise public accountability and sound fiscal management, local authorities should only issue long-term debt once a written debt policy and a capital improvement

strategy (which may form part of its Integrated Development Plan) are in place. The debt policy would indicate the overall limits and general direction to executive officials in the planning and issuance of debt, and should be approved by council. Similarly, an investment plan should broadly prioritise a municipality's capital needs over the medium to long term.

b. Security against loans

The question of what type of debt, or debt instrument, those municipalities may issue (and any regulation thereof) is best approached by examining the kinds of security that may be given by municipal borrowers. Until recently, most South African municipalities acquired unsecured loans, and most financing institutions have accepted whatever remedies they have in law. Increasingly, however, and following trends elsewhere in the world with established municipal debt markets, the financing institutions and investors are exploring ways of enhancing their security. Pledges of particular physical assets, of receivables, and of particular revenue streams have all been used in South Africa.

The contracting parties should be allowed broad leeway to craft security provisions that meet their needs. In addition to the conventional "full faith and credit" (general obligation) provisions, this should include special security arrangements including the pledging of assets, local tax and tariff revenue streams, intergovernmental grants or transfers, and tax and tariff level covenants. Certain limits should, however, apply. Specifically, municipalities should not be permitted to pledge assets deemed essential to the maintenance of public health and safety, nor should they be allowed to pledge revenue streams to the extent that this may compromise their ability to deliver certain essential services, which will need to be defined in law.

The ceding of revenues (Section 48 (2) of the MFMA) should emphasise the necessity to distinguish between the rules that apply to old general debt and those that apply to new debt issues. Suppliers with general obligation claims against municipalities may see the value of their collateral diminished by the issuance of instruments which "ring fence" certain revenues as security for the new debt issued.

c. Sources of financing

Municipalities can access many sources of financing in South Africa (www.treasury.gov), which are outlined below.

i. *The equitable share allocation and additional government grants*

Local government is entitled to an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it in terms of section 214 and 227 of the Constitution. The size of local government's equitable share

is determined by the national budget process. Local government's share then has to be divided horizontally among the country's 278 municipalities. This is done by a formula that uses objective data so that the split cannot be arbitrarily manipulated to benefit an individual municipality.

This approach has various strengths, as highlighted in the Local Government Equitable Share Formula Review, published in May 2012:

- Funding follows the formally assigned functions;
- Equal treatment of similar municipalities;
- Formula based, therefore cannot be manipulated;
- Provides a high level of stability and predictability (three-year indicative allocations with 100% guarantee for year one and 90% for year two); and
- Includes basic services provided.

However, the same review highlighted significant weaknesses:

- Current local government equitable share (LGES) formula does not capture service delivery progress between censuses;
- Strongly population biased;
- Not very transparent and difficult to understand the allocation mechanism;
- No proper costing of basic services;
- Lack of differentiation in costing; and
- Functional structure is ineffective and the majority of the value of allocations is determined through the adjustment factor.

National government is running increasingly short of their budget, and we are already operating on both a budget and trade deficit. The currency has deteriorated significantly, the GDP slowed to an annualised rate of 1.3% in the first quarter of 2015 (www.southafrica.info), international investment is not materialising, and many of the public utility entities are running short of cash (Eskom, SAA, SA Post Office). Personal taxes have been raised in 2015/16.

National government is simply no longer in a position to bail out struggling municipalities, and any reliance on government grants might be a big issue in the future.

These weaknesses should be addressed. The Minister of Finance has repeatedly stated that effective municipalities will be rewarded, and that budget will be reallocated if municipalities are ineffective. This chapter will focus on some of the weaknesses listed above, and mainly on the elements of:

- No costing of basic services; and
- Lack of differentiation in costing.

ii. *Own revenue*

Current revenues are income derived, mainly from rates and service charges. Surpluses generated from these sources can be used to finance assets. However, increasing property rates and service charges may not be the only or most appropriate answer to finance infrastructure. This is because it would place an immediate burden on current residents who may not be there to enjoy the benefits of the completed infrastructure in the future (www.statssa.gov.za).

South Africa has experienced unprecedented growth in residential and non-residential property developments over recent years. As the trend in property development is expected to continue in the future, albeit at a pace related to the prevailing economic conditions, municipalities will have to form strong partnerships with developers. These partnerships could unlock potential revenue sources through development charges. Development charges are an off-balance sheet source of finance for capital projects as they relate to residential and non-residential developments of land and buildings.

A typical agreement between property owners or developers and a municipality allows the municipality to recoup some of the cost of infrastructure development from the individual property owners who will benefit directly from the infrastructure. Municipalities will need to become more proactive partners in property developments in their areas. The benefit of this source of finance is that development charges are equitable in the sense that the infrastructure costs are not covered by a general increase in local taxes, but are recovered from residents who will benefit directly from the developments.

iii. *Public-private partnerships*

Public-private partnerships (PPPs) are important service delivery mechanisms that facilitate rapid infrastructure development. There are different types of PPPs that involve models for risk sharing between the municipality and its partners. In many cases the private party is in a better position to raise money via debt and equity to finance the project. Municipalities can take advantage of private sector expertise and experience in the construction of the infrastructure. Furthermore, the development of PPPs for economically justifiable projects eases the pressure on the municipality's budget and allows for better allocation of funds towards addressing the social needs of the community (www.statssa.gov.za).

PPPs are a good way to generate more revenues from municipalities' existing assets. The Johannesburg Water Management contract, established in 2001 (www.worldbank.org), turned around the operational and financial performance of the utility. Revenue

increased by 46% in four years and power and chemical consumption decreased by 9 and 57% respectively (www.treasury.gov).

iv. Development Bank loans

The Development Bank of Southern Africa (DBSA) is the largest public lender to municipalities, with a 46% share of total municipal debt in June 2007. In June 2014 the total value of loans to municipalities amounted to R10bn, although now only comprising 19% of total long-term loans (www.st.atssa.gov.za/quarterly-report-June-2014).

Although DBSA is lending to all municipalities, its bias in favour of the metros might be justified by the fact that the bank is fulfilling its mandate to fund social projects and projects that contribute to the broader transformation agenda. However, this bias is seen as potentially limiting for metros entering the bond market, as annuity loans are considered to be cheaper, when taking into account the initial fixed costs of bonds. The DBSA therefore needs to provide more assistance to municipalities that are not creditworthy so that they can become viable for funding by commercial banks. Such interventions would ensure that the DBSA crowds in private sector finance in the local government environment (www.treasury.gov).

v. Infrastructure finance corporation

Infrastructure Finance Corporation Limited, trading as INCA, was established in 1996 as a response to the South African government's call for increased private sector involvement in infrastructure funding (www.inca.co.za). INCA is a significant private lender and played a pivotal role to support the country's stalled municipal bond market by issuing bonds to raise funds. It acts as a bond bank that issues debt in the financial markets against its portfolio of municipal loans and also buys outstanding debt, thus providing liquidity in the municipal bond market. INCA accounted for R3.6 billion or 23% of municipalities' outstanding long-term loans as at 30 June 2007. Loans are not extended to municipalities that cannot demonstrate adequate financial management capacity. INCA has in recent years adopted a policy of managing down their portfolio, resulting in decreased assets and advances, and total advances were R607m for the 2015 financial year (interim financial report 2015).

vi. Commercial Bank loans

Local government legislation is designed to regulate, reform and stabilise municipal finances in a macroeconomic environment that is enabling private investment. Despite this, municipalities have not yet used the opportunity to borrow more creatively from capital markets, thereby expanding the potential financing instruments and sources of financing for major programmes. In June 2014 banks lent R17.5bn to municipalities,

which comprises 32% of total long-term debt compared to 27.6% over the four years up to the end of 2006/07 (www.statssa.gov.za).

Effective leveraging of private finance, through the optimal use of borrowing and PPPs, supports economic growth through ensuring the timely provision of infrastructure. It also releases municipal resources for poverty alleviation as well as encouraging improved governance practices by municipalities.

Over the years, municipalities have preferred long-term loans over bonds. This is partly because loans are less complicated to administer and only a few municipalities can absorb the high initial transaction costs associated with bond issues. Municipalities also may not have the technical capacity to issue bonds.

In 2014, long-term loans amounted to approximately 76% of total local government debt. Long-term loans may be offered at floating rates to the benefit of a municipality when its financial position improves and interest rates drop. The municipality will benefit from refinancing its debt, resulting in borrowing costs being lower than at the time when the loan was concluded. Despite the benefits of floating rates, their disadvantage is that the debt service costs can go up unexpectedly and the municipality's revenues may not increase in line with the interest costs. Floating rates are largely in favour of the lender and the cost of financing debt at fixed rates is predictable. The disadvantage of financing infrastructure with long-term loans is that banks may not be able to match the tenure of loans with the lifespan of some of the assets that the municipality wants to build. Some municipal assets (such as bridges) have very long life-spans.

South African banks usually price loans using an amortising profile, where monthly repayments incorporate capital and interest until the redemption of the loan. The bulk of initial repayments will consist mostly of interest and the capital (principal) will be evenly spread over the tenure of the loan. Amortised loans result in a higher cost of borrowing compared to a bond issue. This is because the interest is based on what the bank's risk perception of the municipality is rather than the perception of a multitude of lenders in a functioning market.

Banks and other financial institutions play an important intermediary role of linking the supply of capital to demand. They provide both short and long-term debt to municipalities and accounted for R17 billion of outstanding long-term loans in June 2014. Their approach to the long-term municipal borrowing market is that they would normally require municipalities to securitise their assets before they can lend to them (www.treasury.gov). Securitisation is the process where a municipality moves some of its assets to a low risk vehicle (normally called a special purpose vehicle). With securitisation, a pre-defined set of assets cannot be seized by a third party when a municipality becomes

bankrupt; the financial institution's risk exposure is thus lessened. This is then reflected in the pricing of the loan. Pension and insurance funds are very inactive in the market, only accounting for R28 million (0.2%) as at 30 June 2014 (www.statssa.gov.za). It appears that these players have withdrawn from the market and that the outstanding debt may be debt that was issued in the past and has not been redeemed. The lack of suitable municipal debt finance products, such as bonds with longer repayment cycles, could be an explanation for the low involvement in the market.

vii. Short-term loans

Short-term debt is permitted in terms of section 45 of the Municipal Finance Management Act, 2003 (MFMA). The Act makes provision for short-term debt to be incurred for bridging finance (for operational purposes only) and to be redeemed within the current financial year in which the debt was incurred. The risk of allowing short-term debt to accumulate is that the cost of servicing the debt can quickly become unaffordable. This may result in the need to finance old debt with new loans.

Overdrafts are the largest contributor to short-term debt instruments, and they have shown a significant decline, from R2.2 billion to R1 billion between 2003/04 and 2007/08. In 2014 the exposure to short-term loans increased to R1.8bn and the total value of overdrafts granted to municipalities was also R1.6bn. Short-term debt accounted for 7% of total municipal debt in the second quarter of 2014 (www.statssa.gov.za/publications).

viii. Municipal bonds

Municipal bonds are debt obligations, issued by government entities to members of the public who can use the debt to generate income and meet capital expenditure. The issuer of the bond guarantees to pay interest (coupons) at set periods and to repay the principal debt on a specified date. The interest paid on the bond is tax deductible. Issuing bonds is standard practice for cities in the developed world.

The total value of municipal bonds in June 2014 amounted to R11bn, of which R4.5bn was held by private companies and the balance by public financial corporations (www.statssa.gov.za).

Municipal bonds are an ideal instrument for financing large capital projects. They address the shortcomings of loans as the period of tenure of bonds can go up to more than 30 years and the issuer (municipality) is able to negotiate the interest rate payments and the repayment period to meet its own and investors' needs. With bonds there is a diverse pool of investors involved, whereas only two parties are involved in bank loans. As bond issues involve underwriters, credit rating agencies, trustees and the general public, they create an obligation for greater accountability and transparency on the part

of the municipality. All stakeholders and investors demand up to date knowledge of the financial affairs of the municipality and the issuer is required by the debt disclosure regulations of the MFMA to obtain an annually renewable credit rating. The regulations are aimed at improving transparency to protect investors.

Investors, for example, will know the extent to which changes in local taxes and service charges will affect the servicing of the bond repayments. For a successful bond issue, a municipality must have a good revenue collection and revenue growth rate, as this serves as an indicator of the ability of a municipality to meet its bond repayment obligation. The City of Johannesburg, Ethekweni Municipality, and the City of Cape Town are the only municipalities to have recently issued bonds. The benefit of issuing municipal bonds is that they are priced against government bonds, which are a true reflection of the pricing in the market. This can potentially reduce the cost of borrowing for a well-run municipality.

Johannesburg uses most of the funds raised by the bond issues to finance its capital expenditure backlog. The city's capital expenditure backlog is estimated at R8 billion. Johannesburg has, since 2004, successfully launched multiple municipal bonds. The city took advantage of its improved credit rating to issue two bonds, totalling R2bn, to recapitalise its debts and finance capital expenditure (see also discussion in Chapter 7).

All these loans, apart from government grants, are interest bearing, and the cost of loans is determined by many factors, including:

- Credit rating;
- Liquidity ratios;
- Current exposure to debt;
- Audit opinion on the financial statements; and
- The quality of management and their control processes.

6. Municipalities selected for the research

It is necessary to test the statements made above, and to compare operationally effective institutions with poorly managed institutions. The results of such comparisons should then be used to make deductions about the road forward and some of the suggestions contained in this publication. Several criteria for evaluation were selected, and for the following reasons:

- **Audit opinion:** It provides a clear picture of the effectiveness of financial management, the adequacy and design of financial controls, and compliance with legislative requirements relating to financial expenditure.

- Credit rating: It provides an independent perception about effective financial management, but also about the ability to repay commitments in both the short and long term.
- Current loans and the cost thereof: Access to financing indicates that the market perceives such a municipality to be able to repay loans and honour commitments. The cost of loans reflects on the credit risk that lenders attach to the particular municipalities.
- Unauthorised, irregular, fruitless and wasteful expenditure: The size thereof reflects directly on the ability of management to operate the municipality within the constraints of the laws and regulations.
- Liquidity ratio: Indicates the ability to repay short-term commitments.
- Debt collection ratio: Indicates the ability to both invoice and collect money for services delivered.
- Creditor's payment ratio: Indicates the ability of the municipality to procure goods or services from suppliers, and to pay them on time. Slow ratios have a significant impact on the local economy, which then flows through to future debt collection processes.
- Reliance on government grants: Indicates the ability of a municipality to rely on own funding for operational effectiveness.
- Staff cost ratio: Low staff cost ratios are normally a consequence of poor liquidity, and when cash resources dwindle, vacant posts are not being filled. Service delivery hinges on available staff to perform their responsibilities.
- The rate of repairs and maintenance: A low repairs and maintenance rate is normally a consequence of poor liquidity, and when cash resources dwindle, repairs and maintenance are neglected. This in turn leads to ageing infrastructure, and an exponential increase in the capital needed for future replacement of the infrastructure.

The following municipalities were selected for the study:

- Swartland Municipality (Western Cape);
- Mossel Bay Municipality (Western Cape);
- George Municipality (Western Cape);
- Lukhanji Municipality (Eastern Cape); and
- Matlosana Municipality (Northwest Province).

7. Audit opinions, credit ratings and cost of financing

A variety of audit opinions were included to illustrate that unqualified audit opinions form the basis of trust between borrowers and lenders. However, audit opinions include four basic types of assessment, namely:

- Unqualified: No material misstatements, errors or omissions in the financial statements;
- Qualified: A small number of critical (material) misstatements, errors or omissions in the financial statements;
- Adverse: A significant number of material misstatements, errors or omissions in the financial statements; and
- Disclaimer: No opinion at all.

The last three categories of audit opinions would normally raise concern with lenders.

The respective audit opinions of the selected municipalities are as follows:

Municipality	Current year	Prior year
Swartland	Unqualified – no significant findings	Unqualified – no significant findings
Mossel Bay (three consecutive years of clean audits)	Unqualified – no significant findings	Unqualified – no significant findings
George	Unqualified – no significant findings	Unqualified – no significant findings
Lukhanji	Disclaimer – 163 critical findings listed by the Auditor-General	Disclaimer – 165 critical findings listed by the Auditor-General
Matlosana	Qualified with 53 critical findings listed by the Auditor-General	Disclaimer

Table 6.1 Audit opinions [Source: Annual financial statements]

Audit opinions generically form a strong basis for the rest of the analysis, as disclaimers often indicate a lack of processes and controls, insufficient management of documents and the audit trails, and often reflect on significant amounts of unauthorised, irregular and fruitless and wasteful expenditure.

It was also noted that the findings relate to poor systemic discipline, with policies not being in place, disregard of financial controls in general and a lack of audit evidence being the root cause for disclaimers and qualified audit opinions.

a. Credit rating

It is accepted worldwide that a country's credit rating influences:

- Its ability to borrow;
- The interest rate that lenders charge on international loans;
- Repayment terms;
- The perception of investors; and
- The relative risk attached to any financing transactions.

It is also fairly common practice that the credit rating of a country as a whole influences the credit rating assigned to institutions within that country. South Africa has a credit rating that is at the lower end of investment grade, and a further lowering of that rating will move the country into non-investment grade categories. November 2015 saw credit rating agencies revisiting the national credit rating, and the new rating will dramatically affect future loan repayments. Should the rating depreciate further, increased interest rates will be inevitable, and therefore repayments will increase without bringing further value to the already struggling economy. In addition, it will also affect local governments, as their own credit ratings will be subjected to the national rating.

Credit ratings are a series of sophisticated calculations based on many economic and political variables, and it is not the purpose of this study to reinvent the wheel. However, understanding the critical ratios of a municipality, and the interpretation thereof, will assist greatly in determining whether a municipality can operate effectively with little reliance on national government intervention or bailout.

Leveraging municipal revenue with private sector capital carries risks. Large infrastructure projects tend to take several years to complete. The cost of material, labour and other overheads tend to escalate during the construction phase of the asset.

An example of this is the cost of building and rehabilitating stadiums for the 2010 FIFA Soccer World Cup, where medium-term allocations had to be brought forward to cover unexpected cost escalations. A recessionary cycle can result in a downward revision of municipal allocations over the medium term. A recession will result in interest rate fluctuations. The cost of financing infrastructure through debt can increase substantially if interest rates increase, which in turn may lead to defaults.

Options available to mitigate risks and provide comfort to investors include credit enhancements and improved credit ratings. Credit enhancements are programmes that are designed to reduce risk exposure of both the investor and the municipality. Municipalities would be required to apply credit enhancement procedures when applying for debt in order to reduce the risk the potential lender may be exposed to. Credit

enhancement is a process of reducing risk by providing collateral, insurance or other agreements to assure the potential lender that it will be compensated if the municipality defaults on its loan. Credit enhancement may be in the form of partial guarantees, where the guarantor covers a portion of the debt service costs, or comprehensive guarantees, which involve guaranteeing the debt entirely, irrespective of the cause of default.

b. Individual credit rating

As an indicator of risk, a credit rating is essential for municipalities' access to capital markets. A good rating reduces the cost of financing, while a bad rating will result in a premium being demanded to offset the increased risk. Another benefit of a credit rating is that it increases the marketability of the borrower and its debt instruments. It opens up more financing options and enhances the municipality's ability to choose the most efficient and cost-effective source of finance.

A credit rating of A3 falls in the investment grade category, indicating a strong ability to repay loans in the short and medium term. Below the credit ratings status of each municipality is noted:

Municipality	Current year	Prior year
Swartland	A3	A3
Mossel Bay	No rating	No rating
George	Withdrawn by Moody's in 2013.	
Lukhanji	No rating	No rating
Matlosana	Withdrawn by Moody's in 2013.	

Table 6.2 Credit ratings [Source: Moody's]

A rating methodology will look at the economic base of a municipality. The economic base will ultimately generate resources to pay the debt, which include the strength and diversity of its large taxpayers, unemployment rates and debt burden ratios per capita, as it demonstrates the ability of its residents to absorb the debt, among other things.

c. Loans and cost of loans

As municipalities need to fund their capital expansion programs through access to an array of lending options, they firstly need to qualify for such loans and then face the exposure to the interest rate risk that will be attached to such lending. Interest rates reflect the underlying risk, and can consume a significant percentage of the revenue collected by a municipality.

Interest rate risk can be measured in many ways, and often involves both rates and differences in the maturity of lending transactions. Another useful tool is to use the weighted average cost of capital (WACC) of each municipality. Each municipality has a combination of loans from different lenders, and all these loans will have different interest costs. By weighting the loans according to relative size of the lending book, and applying the weight to the interest cost, one can then calculate the average cost of lending.

Effective municipalities will have a very low WACC, and assuming that struggling municipalities can actually access lending, the opposite will be true for them. Access to financing is the only way to secure an increasing trend of income and sustainable service delivery. Many municipalities could fairly easily access financing up to 2010, but as their operational effectiveness dwindled, it became more difficult to access loans. Credit rating is also reflected in the cost of loans.

The current exposure to loans and the cost thereof for the selected municipalities are as follows:

Municipality	Current year	Prior year	Comment
Swartland	R137m at a spread of 7.9% to 11.6% interest	R141m at a spread of 7.9% to 11.6% interest	Strong set of financial ratios – weighted average cost of financing (WACC) below 11%
Mossel Bay	R22m at a cost of 8.275%		Strong set of financial ratios – weighted average cost of financing (WACC) below 8.5%
George	R409m at a spread of 6.75% to 12.665%	R450m	
Lukhanji	Less than R1m, with no new loans in the current year	R3.2m	Interest rate not available in the financial statements
Matlosana	R111m from the Development Bank at a spread of 9% to 15.6% interest	R127m	Highest cost of financing with a WACC of R12.15%, however the last loans had rates closer to 15%

Table 6.3 Weighted cost of financing [Source: Notes to the Annual financial statements]

Both Lukhanji and Matlosana did not acquire new loans, and will fail to do so with their current financial management weaknesses. Mossel Bay normally finances their capital development through the capital replacement reserve, and only engaged in one long-term loan over the past five years.

d. Unauthorised, irregular, fruitless and wasteful expenditure

Municipalities are subjected to various laws and regulations, enforcing the effective management of taxpayers' money. One critical indicator of such financial discipline is reflected in the size of the three elements below, which also influences the audit opinion of each municipality:

Municipality	Unauthorised	Fruitless	Irregular	Total
Swartland	R23m	0	0	R23m
Mossel Bay	0	0	0	R0
George	R18m	Insignificant	Insignificant	R18m
Lukhanji	R3m	R1m	R1m	R5m
Matlosana	R655m	R18m	R201m	R874m

Table 6.4 Irregular expenditure [Source: Annual financial statements]

Lukhanji: The amounts above only reflect the current year's increases in the three categories of expenditure. Should one analyse the closing balance of these expenses, the total amounts to R110m. However, the improvement in the current year is commendable.

Matlosana: The amounts above only reflect the current year's increases in the three categories of expenditure. Should one analyse the closing balance of these expenses, the total amounts to R3.3bn. Non-compliance with supply chain management controls is one of the root causes of the significant amount of irregular expenditure. Some investigations have been outstanding since 2010.

8. Financial analysis and comparison

A comparison of the different municipalities is useful for determining the systemic differences. The critical ratios that will be used include the following:

- Liquidity ratios (current ratio and the cash to creditors ratio);
- Debt collection ratio;
- Creditor payment ratio;
- Debt-to-equity ratios;
- Staff cost ratio;
- Reliance on government grants; and
- Repairs and maintenance ratio.

a. Liquidity ratio

The liquidity ratios include a class of financial metrics used to determine an institution's ability to pay off its short-term debt obligations. It compares current assets to current liabilities. The higher the ratio, the greater the margin of safety is that the institution possesses to cover short-term debts. In local government a ratio of 3:1 is regarded as prudent, as a big portion of current assets are made up of outstanding debt. Any financial institution will analyse this ratio first to assess whether a municipality can repay its debt.

When analysing the five selected municipalities, the current ratios differ significantly. It should be said that many factors can influence this ratio, and a mere impairment of debt will result in a weaker current ratio. Many municipalities are adjusting debt impairment to enhance the debt recovery ratio, but which has the opposite effect on the liquidity ratio.

It appears that the first four municipalities can easily repay their short-term liabilities, but Matlosana is under severe cash flow pressure. They only have 42 cents for every R1.00 owed to creditors.

Municipality	Current year	Prior year	Comments
Swartland	3.84 times	4.07 times	Excellent current ratio, indicating a strong ability to meet short-term commitments
Mossel Bay	2.5 times	2.3 times	Excellent current ratio, indicating a strong ability to meet short-term commitments
George	2.34 times	2.32 times	Strong current ratio, indicating a strong ability to meet short-term commitments
Lukhanji	2.6 times	3.4 times	Excellent current ratio, indicating a strong ability to meet short-term commitments
Matlosana	0.42 times	0.52 times	Critical position with debtors and cash totalling R134m compared to short-term liabilities of R369m

Table 6.5 Current ratios [Source: Annual financial statements]

The above position is further highlighted when one compares the cash to short-term debt cover.

Municipality	Current year	Prior year
Swartland	4.05 times	4.67 times
Mossel Bay	2.7 times	2.6 times
George	3.3 times	2.6 times
Lukhanji	2.1 times	4.6 times
Matlosana	0.08 times	0.11 times

Table 6.6 Cash to short-term debt cover ratios

b. Debt collection ratio

This ratio calculates how long it will take to collect debt for services rendered to the community. The ratio is often manipulated by writing off old debt, which reduces the value of debt on the balance sheet, and thus reduces the number of days in the calculation.

The calculation for the five municipalities was as follows:

Municipality	Current year	Prior year
Swartland	64 days	58 days
Mossel Bay	46 days	52 days
George	86 days	80 days
Lukhanji	74 days	41 days
Matlosana	39 days with debt impairment of R1.5bn	47 days with debt impairment of R1.2bn

Table 6.7 Debt collection ratio [Source: Annual financial statements]

For both Swartland and Lukhanji, an increase in the number of days it takes to collect their debt is evident. Although it is a reflection of current economic times, the Lukhanji increase might also reflect huge debt impairment in the previous year. Matlosana has the best results, but it was severely influenced when R1.5bn bad debts were written off in the current year (prior year: R1.2bn). Experience indicated that municipalities with a strong credit control policy and an effective debt collection process can maintain a 60 day collection period without tampering with the impairment of debt.

In Mossel Bay the 2013/2014 revenue collection rate amounted to 97.5 %, compared to 97.3% in 2012/2013. It once again exceeded the target of 95% and the benchmark of 80% for financial sustainability for South African municipalities. It provides proof of a good payment record of Mossel Bay ratepayers and service users as well as proof of the municipality's excellent and diligent revenue management system.

On the financial performance side, the Mossel Bay Municipality has managed to increase revenue from R680.9 million to R830.2 million. If the actuarial gains of employee benefits and the change in accounting treatment regarding traffic fines are left out of the calculations, then the revenue has increased by 2.09% to R746.6 million, despite the bad economic situation.

c. Creditor payment ratio

The creditor payment ratio indicates how long it takes for a municipality to pay the outstanding suppliers. Best practice hovers around 60 days if cash management and debt collection practices are effective.

The calculation for the five municipalities was as follows:

Municipality	Current year	Prior year
Swartland	62 days	54 days
Mossel Bay	30 days	29 days
George	53 days	50 days
Lukhanji	70 days	49 days
Matlosana	189 days	171 days

Table 6.8 Creditor payment period [Source: Annual financial statements]

In the above analysis it can be seen that the municipalities with the best debt management practices are all paying their suppliers within the 60 day mark. For many years Lukhanji managed to pay their suppliers sooner than that. The reality in Matlosana, however, is that the debt impairment merely manipulated their debt collection days, and that they are not able to pay their creditors. Suppliers are now waiting for almost half a year before they are paid for service delivery.

d. Debt-to-equity ratio

The calculation for the five municipalities was as follows:

Municipality	Current year	Prior year
Swartland	7.9 percent	7.6 percent
Mossel Bay	1.1 percent	1.44 percent
George	16.4 percent	20 percent
Lukhanji	0.11 percent	0.4 percent
Matlosana	2 percent	2.11 percent

Table 6.9 Debt-to-equity [Source: Annual financial statements]

The debt-to-equity ratio has little value, as equity in a municipal environment is based on the net asset value (total assets minus total liabilities). Even so, it allows for one useful deduction, i.e. it determines whether a municipality can access outside funding, or whether lenders are willing to make capital funding available to municipalities.

Mossel Bay has operated without long-term financing for a very long time, and always chose to finance capital development through grants and operational income (surplus income collected from residents during the year). Even in the analysis, above the exposure to loans is very low, but in this case it is by choice. Many financial analysts would question the low exposure, as using operational surpluses place a burden on residents in the current economic climate. It normally results in expensive service delivery and sometimes a negative effect on the local economic development domain. Lukhanji and Matlosana, however, cannot access loans, mainly because their liquidity ratios reflect the ineffectiveness of the working capital management. They struggle to find funding for capital projects, and lenders are unwilling to grant them loans. Service delivery is impacted severely. George Municipality, on the other hand, over-borrowed for many years and is currently in the process of repaying the debt. It is placing a huge burden on their cash flow as R51m of their operational income is used to repay interest on these loans.

e. Reliance on government grants

A strong reliance on government grants, in the context of a national government with a budget deficit, increasing interest rates and weakening exchange rates, will severely affect sustainability in the near future. The calculation for the five municipalities was as follows:

Municipality	Current year	Prior year
Swartland	33 percent	21 percent
Mossel Bay	17.2 percent	17.8 percent
George	70.8 percent	20 percent
Lukhanji	48 percent	51 percent
Matlosana	45 percent	59.4 percent

Table 6.10 Reliance on government grants [Source: Annual financial statements]

Normally financial analysts will use a different ratio, i.e. calculating grants as a percentage of total revenue, and sometimes differentiating between capital and operational grants. The ratio above calculated total grants as a percentage of own revenue (property rates and service charges), instead of total revenue. It shows, on a debatable scale, the ability of a municipality to be sustainable. The higher percentages indicate the need for

government contributions, while lower percentages indicate effective debt collection and cash management processes. Similar analysis for other municipalities indicates the same trend – if the liquidity ratios are under pressure, the reliance on government grants increase. As national government is struggling to create economic growth, municipalities with a strong reliance on government grants will find it increasingly difficult to operate.

f. Staff cost ratio

National Treasury targets staff cost as a percentage of total expenditure around 30%. In reality, with the unbundling of assets and the revaluation of assets in line with GRAP (Generally Recognised Accounting Practice) 17, total expenditure is often overstated by the increase in depreciation, and impairment of debtors and assets. Thus many municipalities would rather target 26%. There is a strong case to be made for the improvement of the ratio by comparing staff cost to revenue collected. This would result in employing people based on the effectiveness of revenue collection processes. The second ratio was not explored at this point in time.

Both Swartland and Mossel Bay often win awards for service delivery and clean towns, and one of the underlying reasons must be the staff complement (fewer vacant positions) and the productivity of staff members. George Municipality has struggled for the past few years with over-borrowing and interest repayments, and their low percentages might be a reflection of those pressures. Lukhanji and Matlosana on the other hand, are simply not filling vacant posts. If the costs of vacant posts were calculated, it would increase the struggling municipalities' liquidity problems, as they would simply not be able to fund the cost of employing additional staff members.

The calculation for the five municipalities was as follows:

Municipality	Current year	Prior year
Swartland	28.5 percent	30 percent
Mossel Bay	30.3 percent	30.6 percent
George	24.6 percent	26.9 percent
Lukhanji	25 percent	22 percent
Matlosana	21.4 percent	22.9 percent

Table 6.11 Employee cost ratio [Source: Annual financial statements]

g. Repairs and maintenance ratio

Many analysts would argue that a minimum of 8% of the book value of property, plant and equipment should be spent on keeping assets in a working condition. It is also an

undisputed fact that in times of poor liquidity, the upkeep of capital assets is often the first operational expenditure to be cut.

The calculation for the five municipalities was as follows:

Municipality	Current year	Prior year
Swartland	3.56 percent	3.9 percent
Mossel Bay	5.4 percent	5.96 percent
George	5.1 percent	6.2 percent
Lukhanji	2.1 percent	2.9 percent
Matlosana	2.0 percent	2.19 percent

Table 6.12 Repairs and maintenance [Source: Annual financial statements]

Swartland has had surprisingly low expenditures over the past two years, but extensive repairs and maintenance were conducted in the preceding years. Most worrying, however, is the low maintenance cost incurred by Matlosana and Lukhanji. On average, a ratio of 2% indicates emergency expenditure only, which means that almost no preventative maintenance is done.

9. High-level dashboard

It might be useful to summarise the ratios in a dashboard where one can use traditional risk assessment colours to plot the relative risk of each municipality. Light grey indicates relative low risk, medium grey indicates a strong warning signal, and dark grey illustrates the possibility of failure to deliver services and/or pay suppliers and staff. The quick view of each municipality is as follows:

	Swartland	Mossel Bay	George	Lukhanji	Matlosana
Credit rating					
Audit opinion					
Current ratio					
Debt collection ratio					
Creditors payment ratio					
Reliance on grants					
Employee cost ratio					
Repairs and maintenance					
Unauthorised, irregular, etc.					

Table 6.13 Comparative Dashboard

a. Swartland

- Strong liquidity with effective debt collection processes resulting in reliable payment of supplier accounts.
- Easy access to external funding, with a high percentage of filled staff positions and an adequate repairs and maintenance program.
- Self sustainable with low reliance on government grants.

b. Mossel Bay

- Strong liquidity with effective debt collection processes resulting in reliable payment of supplier accounts.
- Limited access to external funding (mostly by choice), with a high percentage of filled staff positions and an adequate repairs and maintenance program.
- Self sustainable with low reliance on government grants.

c. George

- Strong liquidity with effective debt collection processes resulting in reliable payment of supplier accounts.
- Easy access to external funding, but unfortunately over-borrowed in the past and is paying the price with significant repayments of capital and interest on loans with a high percentage of filled staff positions and an adequate repairs and maintenance program.
- Self sustainable with low reliance on government grants.

d. Lukhanji

- Strong liquidity, but increasingly struggling with debt collection processes, resulting in systematic slowing in the payment of supplier accounts.
- Limited access to external funding, with a high percentage of vacant staff positions.
- The repairs and maintenance program indicates a comprehensive preventative maintenance program, but it is financed through the government grant programs.

e. Matlosana

- Poor liquidity with ineffective debt collection processes resulting in delayed payment of supplier accounts.
- Limited access to external funding, with a high percentage of vacant staff positions and a limited repairs and maintenance program.

10. Cost of service delivery

Information in the public domain does not allow for accurate unit cost calculations, as the reliability and integrity of financial information of the struggling municipalities is questionable. The denominator of unit cost calculations that can be verified is the population size. Although there are far better denominators, inconsistent information in the annual reports of municipalities do not allow for useful analysis.

The following table indicates various income and expenditure trends based on the population size:

	Lukhanji	Matlosana	George	Mossel Bay	Swartland
Population size	190 723	398 676	193 672	89 430	113 762
Total income per person	R 2 986	R 5 426	R 6 521	R 7 735	R 4 209
Total expenditure per person	R 2 454	R 4 725	R 5 190	R 7 505	R 3 615
Property rates per person	R 389	R 477	R 814	R 942	R 620
Service charges per person	R 1 295	R 2 480	R 3 312	R 5 425	R 2 206
Employee cost per person	R 729	R 1 143	R 1 610	R 2 251	R 1 131

Table 6.14 Cost comparisons [Source: www.localgovernment.co.za]

According to the above information, municipalities with a large number of vacant posts have the lowest unit costs and underspend on repairs and maintenance. One exception to this rule seems to be Swartland, as their cost structure is comparable with that of the struggling municipalities. Swartland is located in the West Coast region of the Western Cape, where economic activity is slower than in the rest of the country, and salaries might also be the smallest.

Mossel Bay and George boasts significantly higher cost per resident, which clearly reflect in the service delivery to residents. Both towns have received awards for excellent service delivery.

With regards to income, a similar pattern develops where municipalities with a good service delivery record also end up charging residents for that specific service. As better managed municipalities normally have better debt collection processes, it means better collection rates and more available cash, with Swartland being the exception once again. This municipality charges lower rates and service charges, but their efficient spending and cash flow management assists greatly in balancing the books annually. However, it is noted that repairs and maintenance expenditure in Swartland started to decline over the past five years, and management has also alluded to this in the annual report.

11. Conclusion

Local government will have to deal with a variety of issues that influence the financial position of municipalities before financial sustainability is attained. External economic and other factors, combined with poor performance, insufficient management capacity and low skills levels (which all are common in many South African municipalities) make it extremely difficult to create sustainable municipalities. The focus in this chapter was primarily on a range of internal factors relating to costing, cost of finance, credit ratings and the quality of financial management – the combined effect of which is significant in determining the financial profile and sustainability of municipalities.

Emphasis was also placed on the three value-for-money-pillars, namely economy, efficiency and effectiveness. It is evident that a municipality must therefore give focused attention to and manage both the income and the expenditure of its budget, while taking these three pillars and the list of internal factors mentioned above into account. The dire need to maintain existing physical infrastructure and develop new infrastructure (such as local roads, water and electricity distribution, and Wi-Fi and broadband infrastructure) place additional pressure on municipalities. In order to become sustainable, dedicated attention and innovative financing options to effectively deal with all the infrastructure needs are necessary.

A comparative analysis was done between five municipalities in different provinces and with different financial profiles in order to test the statements in the earlier part of this chapter. This analysis emphasised the importance of good financial management, which includes a focus on proper costing of services, cost of finance and the effective utilisation of a variety of sources of revenue to strengthen the financial sustainability of a municipality. The analysis also helped to define a set of specific practical recommendations (as set out below) which municipalities could use to improve their financial profile, financial management and effective, economic and efficient delivery of services to the community.

12. Recommendations

The financial analysis indicates a trend that clearly differentiates between the results of effective versus ineffective financial management. To this effect, several recommendations can be made:

a. Systemic discipline

- i Financial departments within municipalities should be capacitated with skilled staff, and vacant positions should be filled to ensure a proper segregation of duties, a reduction in irregular expenditure and improvement of the audit opinions and the risk and control mechanisms.
- ii Ineffective municipalities should be placed under a management contract, administered by the effective municipalities. Effective financial management is built around solid policy development, effective enforcement of those policies and administrative adherence to these policies by staff, management and councillors. Placing management teams under the direct guidance of more experienced and effective management will lead to administrative improvements. Budgets and the spending thereof should also be subjected to supervision before payments are released. It will reduce inefficiencies and irregular expenditure.
- iii Liquidity is the cornerstone of sustainability, and to this effect the credit control policy, the indigent policy and the debt collection processes should be revisited. Effective debt collection processes are only possible when credit control mechanisms are implemented with a dedicated effort to collect money for service delivery. Matlosana is surrounded by mines and Klerksdorp boasts a huge industrial area. The low collection rates and the debt impairment are inexplicable and the result of poor debt collection processes.

b. Economic and efficient use of resources

- i The ratios mentioned in this chapter should be used in the performance agreements of Municipal Managers and Chief Financial Officers; a dashboard should be developed and information systems should monitor and report on weaknesses on a monthly basis.
- ii The cost of consultants can be heavily reduced if the “father-son principle” can be applied. The father in the scenario would be successful municipalities that meet a predetermined set of criteria. The son would be the municipality that fails all the criteria. Effective municipalities have developed all policies and processes that could be rolled out to

- supported municipalities.
- iii Capital grants should be authorised by more effective “father” municipalities. Capital expenditure must be optimised for maximum output and service delivery improvements, and overpayments on these projects can no longer be accommodated.
- ix A dedicated system of standard costing should be developed and implemented in all municipalities and should involve the calculation of what products and services are supposed to cost. These costs should then be used to calculate budgets and acceptable prices for future contracts. Actual costs should be measured against these standard prices.
- x Municipalities should urgently reassess the interest rates that they pay on loans, and actively try to lower them. Providing collateral against loans will reduce the risk to the lender, and also reduce the cost of lending.

c. Improving overall effectiveness

- i Separate audit committees should be replaced by a single Audit Committee that can oversee both partner municipalities and can be used to monitor progress and to report back to National Treasury. As municipalities improve their processes, budget and decision-making, they can once again take responsibility for their own management. The Audit Committee can also report annually on the progress made, specifically reflecting on the effectiveness of financial controls.
- ii A structured payment plan for all outstanding creditors should be developed. The local economy relies on government paying suppliers within the 30 days specified by law. Eskom, and specifically many Black Economic Empowered companies, are struggling to honour their own commitments to staff and suppliers. No performance bonuses should be paid until all suppliers have been paid in full.
- iii The root causes for the high monetary value of the impairment of debtors should urgently be investigated. Prepaid services should replace invoice systems as a matter of urgency, for both water and electricity usage. Daily patrols of areas known for power theft and the disabling of illegal lines are needed.
- iv A long-term plan should be developed that targets the working capital management and the improvement of credit ratings. Access to capital markets is the only way to improve infrastructure and enhance effective service delivery.

CHAPTER 7

Innovation in Financing of Local Government

1. Introduction
2. Revenue innovation
3. Expenditure innovation
4. Service delivery innovation
 - 4.1 General innovation initiatives
 - 4.2 Innovation in funding and provision of energy
 - 4.3 Innovative funding options for infrastructure development
5. Conclusion

1. Introduction

Governments in developed as well as developing countries face a great variety of challenges which relates to environmental, economic, political and social issues. In the globalised world of the 21st century, the context within which government functions changes faster than the pace at which the bureaucracy can adapt policies and legislation to deal with these changes effectively. Modern governance problems require innovative solutions. Local government, being the closest institution of government to the citizens, must continue to be the traditional provider of a range of basic services in most countries in the world, while at the same time adapting to this fast changing environment.

Sustainability is much more than a popular buzz word – it includes a diverse range of issues and could be defined as follows:

“... a requirement of our generation to manage the resource base such that the average quality of life that we ensure ourselves can potentially be shared by all future generations.” (Asheim, 1994:4)

In the context of local government, sustainability implies that municipalities should not only be responsive to the current needs of its inhabitants, but should also have future directed policies in place that could contribute to a sustainable local government. The

multitude of factors local government has to consider include issues such as urbanisation, climate change, the digital revolution and the need to promote good governance. It is evident that proper funding arrangements, which include a combination of own sources of revenue, intergovernmental transfers and borrowed funding, must be in place to ensure that local government can perform its constitutional mandate. The combined effect of major global issues, such as rapid urbanisation and climate change, require specific funding arrangements since these issues cannot effectively be dealt with within the ordinary scope of a municipal budget (see discussion in Chapter 5). Innovation in local government finance is thus necessary to provide appropriate financial solutions in response to these issues and thus contribute to sustainable local government.

This chapter focuses on innovation in local government finance and is aimed at strengthening local financial governance. Different factors contribute to ensure well-functioning municipalities that serve their respective communities well and are effective and efficient institutions of government. The discussion in this chapter focuses on some of the important financial factors, more specifically on innovative concepts and practices, which could contribute to the strengthening of local financial governance. Various innovation initiatives are examined and proposals for improving the situation in individual municipalities are provided.

Objects of local government

- 1 The objects of local government are:
 - a To provide democratic and accountable government for local communities;
 - b To ensure the provision of services to communities in a sustainable manner;
 - c To promote social and economic development;
 - d To promote a safe and healthy environment; and
 - e To encourage the involvement of communities and community organisations in the matters of local government.
- 2 A municipality must strive, within its financial and administrative capacity, to achieve the objectives set out in subsection 1.

Innovation in local government finance can be categorised in various ways. A practical approach is followed in this chapter, namely to consider revenue innovation, expenditure innovation, and service delivery innovation related to service delivery structures and service delivery processes in a municipality. The discussion includes references to relevant international examples of innovation initiatives from which lessons could be learned. In view of the importance of energy and the provision and maintenance of appropriate infrastructure in local communities, a specific focus will be placed on these issues in the discussion of innovation in local government finance. Although the recommendations at the end of this chapter are primarily aimed at contributing to local government finance

reform in South Africa, many of the discussions and recommendations have a more general application which could be useful in other jurisdictions as well.

In a constitutional democracy under the rule of law, such as in South Africa, the point of departure for a discussion about new options for local government finance is the Constitution. The financial constitution, in particular, is the basic legal framework within which such a discussion fits.

Budgets in all three spheres of government must promote transparency, accountability and effective financial management of the economy, debt and the public sector (Constitution: sec. 215(1)). It is further stipulated that budgets must clearly indicate the estimated revenue and expenditure, any intended borrowing and the way in which anticipated deficit would be financed. These requirements are in line with generally accepted accounting and financial management practice, and are dealt with in more detail in the Municipal Finance Management Act, 56 of 2003. This Act *inter alia* also provides for the establishment of municipal public entities and the use of public-private partnerships, which are specific vehicles to be considered for the provision of some public services (for example water or public transport) and the development of major infrastructure. The objectives of local government (in section 152 of the Constitution) provide direction to municipalities, but also allows for governance innovation. Section 153 of the Constitution places an obligation on local government to structure and manage its administrative, budgeting and planning processes to: give priority to the basic needs of the community; promote the social and economic development of the community; and participate in national and provincial development programmes (De Vos, 2014). While priority must be given to the basic needs of society, the policy framework of a municipality should also properly reflect the social and economic development needs, the environment and the intended methods for ensuring sustainability. There is sufficient scope in this constitutional framework for the development of a wide range of policy options by local government and for exploring innovative funding opportunities, but specific legislation (depending on the nature of the funding initiative) will have to be taken into account. New circumstances and international developments might, in particular cases, also require the amendment of existing legislation or the development of new legislation, for example for the establishment of a modern metropolitan transport system that has a low-carbon energy-efficient footprint.

Innovation in the financing of local government is not a simple once-off exercise in which the revenue of municipalities is increased. It is rather a journey that starts with the appropriate policy and legal framework that allows and stimulates innovation in service delivery and innovation in funding. It is a complex exercise that requires visionary leadership and good financial management capacity in municipalities, but it is not the

sole responsibility of local government. The other spheres of government, financial institutions, the private sector and local communities all have a role to play. Citizen-centric governance provides a good basis for public involvement and innovation.

Improving the state of local government finance in South Africa includes a review of both income and expenditure possibilities. It is evident from regular reports by the Auditor-General that huge amounts of money are not properly accounted for or badly managed in local government (Auditor-General, 2014). This means that there should be a significant improvement in the expenditure management, including the proper utilisation of capital budgets, by municipalities. This chapter will explore innovation in local government funding, as well as innovation in expenditure management and service delivery.

2. Revenue innovation

A detailed discussion about various reform proposals, including revenue innovation, is provided in Chapter 8. The discussion in this chapter focuses on tax sharing as a specific form of innovation in general local government revenue, although reference will also be made to innovative funding ideas as part of the discussion on service delivery innovation.

In various countries, in particular those with multi-level systems of government, it is common to find some form of tax sharing between different levels of government. In some Scandinavian and Central European countries, a flat rate surcharge on personal income tax is used as a source of local tax revenue (UCLG, 2010). In some of the case studies included in this publication the direct sharing of specific taxes form part of the specific tax regime.

In Belgium one of the sources of local tax revenue is a surcharge local government could levy on personal income tax, which is a national tax. The regions may also levy a surcharge on personal income tax (Dessoy *et al.*, 2013). In Germany, local government is guaranteed a share of some of the major national taxes. The German Basic Law stipulates that local government should get a percentage of the revenue from personal income tax, sales tax and capital gains tax (Basic Law, Art. 106(5), (6)). The actual percentages applicable to local government, which must be determined by further legislation, currently are:

- Personal income tax 15%
- Sales tax 2%
- Capital gains tax 12% (see discussion in Chapter 4; Waldhoff, 2007)

Local government is thus guaranteed a specific percentage of the revenue from these national taxes, which strengthens the financial position of municipalities and their relative financial autonomy. In Bavaria, as part of the local government financial equalisation process, provision is also made for a division of general tax revenue whereby the local municipalities (*Gemeinden*) receive 64% and the district municipalities (*Landkreise*) 36%. If district municipalities are retained as a type of municipality in South Africa, this model of tax sharing could perhaps provide a source of revenue to the district municipalities.

In Japan, the prefectures and the local municipalities each get a share of an inhabitant or resident tax, which is a form of personal income tax. The tax rate allocation is currently 4% of taxable income to prefectures and 6% to the local authorities (Kawakita, 2015). Japanese citizens also pay personal income tax to the Japanese national government.

Canada uses a form of tax sharing where a number of local municipalities in the same urban area in Montreal share the revenue from property tax (Tomalty, 2007). They agree on a specific base line or average tax level, and all the tax revenue above that base line is pooled into a communal revenue fund which is used as a form of financial equalisation payments to the local municipalities that have no or low tax base growth. The revenue is then used for infrastructure development. The Municipal Property Rates Act, 6 of 2004, makes provision for individual local or metropolitan municipalities to levy a rate on property located within its jurisdiction (sec. 2). If the example of Montreal would be considered in South Africa, it would require an amendment to this Act or at least an intergovernmental agreement between groups of local municipalities within one district. This is an initiative that will have to be explored within a specific district to ascertain whether it will be financially beneficial to the participating local municipalities.

In South Africa there is no provision for direct tax sharing between the three spheres of government, but the Constitution allows provinces to levy a flat rate surcharge on any national tax, levy or duty, (with the exclusion of corporate tax, value-added tax, property tax and customs duty) (Constitution, sec. 228(1)). This provincial tax-raising power is regulated by the Provincial Tax Regulation Process Act, 53 of 2001, but it has not been used so far. If such a provincial surcharge is introduced on personal income tax, it would create a form of tax sharing between the national government and one or more provinces. There is no similar provision for a municipality to levy a surcharge on a national tax (e.g. personal income tax) to create a further tax sharing opportunity. National legislation may, however, authorise municipalities to impose other taxes, levies and duties appropriate to local government, excluding personal income tax, value-added tax, customs duty and general sales tax (Constitution: sec. 229(1)).

Tax sharing, with the purpose of increasing the own sources of tax revenue in local government, is one possibility of strengthening local fiscal autonomy. It is in line with economic theory which suggests that revenue sources in multi-level systems of government should be allocated as close as possible to the expenditure responsibilities (Shah, 1994; see discussion in Chapter 2). In South Africa the introduction of tax sharing to benefit local government will possibly have to include some constitutional amendments.

3. Expenditure innovation

Cost-effective delivery of services makes an important contribution to good local financial governance. Citizens or consumers of public services demand value for money; therefore municipalities must ensure the delivery of services in the most cost-effective way. Efficiency and effectiveness are important principles on which good local financial governance is based. This implies doing the right things (effectiveness) and doing things in the right way (efficiency). Innovation in expenditure management can make a useful contribution to ensure efficient and effective delivery of services. Proper costing of services is an important part of good financial management, but the unfortunate reality is that the cost of services is not done properly in all municipalities. Basic information about the inhabitants or consumers in each municipality must be maintained and updated regularly. A municipality must know to whom and where it must deliver specific services and this requires a good database of consumer information. Utilising new appropriate computer software to maintain such a consumer database, including the extraction and analysis of relevant data, is a form of expenditure innovation that can enhance service delivery.

It is further important to know what the cost drivers in each municipality are and how to manage it properly. This *inter alia* implies shifting costs from the 'unavoidable costs' to the 'avoidable costs' category where it can be managed more effectively. More sophisticated costing systems and analysis are important management tools to improve good financial governance. Filling of vacant posts, in particular in critical technical and management positions, can also enhance a municipality's ability to deliver services at a more effective and efficient level, and underpins effective expenditure management. If there are vacancies in critical posts such as that of chief financial officer or head of civil engineering services, the municipal administration cannot function optimally and hence service delivery will suffer.

Reducing individual costs means reducing expenditure and thus more funds will be available for service delivery. Reduced expenditure could also lead to the lowering of

tariffs, which will increase the available income of consumers and could be used to pay debts or increase consumer spending; thus contributing to the economy.

Giving proper attention to the costing of services will provide a basis for working smarter and thus more economically with the available resources. It also implies an element of responsible government, namely that officials and elected representatives must act in a responsible way and limit risk in managing the municipality. Costing of services can differ from one municipal area to another, which means that there is no standard cost for individual services that applies throughout the country. It is therefore important that each municipality ensures proper costing of services to contribute to good expenditure management, which must be part of the annual financial planning and budgeting process (see discussion about costing of services in Chapter 6).

In addition to ensuring cost-effective service delivery, a municipality should have effective debt collection in place as part of the effective management of cash resources. Effective debt collection is necessary to improve a municipality's cash flow as well as its liquidity ratios, which in turn contributes to strengthening the credit profile of a municipality. A good credit profile is important when obtaining external funding such as bank loans.

Expenditure innovation does not function in isolation, but relates to service delivery innovation and is thus discussed further in the next section.

4. Service delivery innovation

4.1 General innovation initiatives

Municipalities have a constitutional and legal mandate to deliver a range of services to their respective communities. Although the scope of authority differs from one country to another, delivery of local services is the core function of local government. Continuous improvement of service delivery can validly be expected by the users of such services and it is therefore in the interest of a municipality to do so. A specific form of innovation, which is available to all municipalities, is to increase the menu of service options and thus creating more purchasers of services. This implies that a service can be provided at different levels to fit the needs and economic profile of consumers. For example, if 10 000 consumers pay R50 a month for a service, compared to receiving it for free, they can get a better quality service and the municipality has an additional revenue of R500 000 per month which could be used to improve infrastructure and the quality of services. Such an approach creates additional jobs and thus contributes to economic growth.

The citizen-centred approach to the future development of local government, articulated by Anwar Shah and others, provides an important directive to municipalities to be competitive in the knowledge economy of the 21st century (Shah, 2014). Such an approach creates more scope for initiatives from citizens that can enhance service delivery by municipalities. In this context two concepts which could benefit local government are co-production of public services and crowdsourcing.

Co-production is a form of innovation in public service delivery which makes use of the input of the public sector, consumers and citizens in the design and delivery of public services (Bovaird, 2007). Pestoff (2014) argues that co-production should be widely defined to include co-design, co-delivery and co-management of public services and that the experience and knowledge of the service user is placed at the centre of service delivery. This is in line with the views of Shah (2006) that local government should be citizen-centred, thus harnessing the local expertise, getting more public participation and strengthening accountability to the community. Co-production of public services is not limited to specific economic classes in society, but is rather determined by the willingness of both the public and private sectors to embrace the concept and explore ways of improving service delivery through co-creation in some form. Co-production can be utilised in different functional areas of government, for example in health, education or community safety. Examples of co-production in practice are private pharmacies that cooperate with the Western Cape Government to provide certain medical services to public sector patients, neighbourhood watches, community police forums who cooperate with the South African Police Service to promote a safe environment and the Partners for Possibility program in schools which uses business leaders to partner with school principals to improve the delivery of education in schools (<http://pfp4sa.org>). It is worthwhile exploring the use of co-production in aspects of urbanisation, for example urban planning and housing development, which requires radical new approaches to deal with the dire need of housing in the country. Modern information technology could be used creatively to enhance the potential of co-production of public services.

Crowdsourcing is a modern business term created in 2005, although crowdsourcing was already used in the 19th century, for example by the developers of the Oxford English Dictionary when they invited the public to submit entries of English words and they subsequently received more than 6 million submissions (Winchester, 1999). In the world of social media and modern information technology, crowdsourcing is an accepted term which refers to an open call to an undefined network or group of people to voluntarily provide input or expertise in solving a problem or developing a knowledge product to mutual benefit. It is mostly an online activity utilising smartphones, social media platforms or other web-based mechanisms. Crowdsourcing has also been used in the

field of public governance, for example in Finland where it was used in public policy making and developing traffic legislation (perhaps a form of co-designing of policies).

Aitamurto and Landemore (2015) used the Finnish experiment to design a framework within which crowdsourcing can work in designing public policies. They listed five principles, namely inclusiveness, accountability, transparency, modularity and synthesis, with the first three being the most crucial principles that also strengthen constitutional democracy. This is a relatively new approach, but one that could be put to good use in the local government environment, in particular when there is a need for policy or legislative reform. An activity related to crowdsourcing is crowdfunding, which is quite popular in the field of developing new information technology products. It is about collecting small contributions from a wide range of people to fund a new initiative, and thus spreading the risk. Instead of one funding institution taking the risk of funding a specific project, crowdfunding makes use of a large number of contributors to provide the project funding. Although crowdfunding is often associated with funding new business ventures where there is a substantial risk involved, the concept could be explored within the ambit of local government finance, in particular where new projects are considered.

4.2 Innovation in funding and provision of energy

Energy is a necessity in the human environment and a natural resource that must be managed properly to ensure sustainability. It is for these reasons that a focus on energy as a key service delivery area is included here. The negative effects of climate change and increased greenhouse gas emissions over many years have necessitated a move towards the use of more renewable energy and the promotion of energy efficiency in communities all over the world. In a study about financing infrastructure to strengthen a low-carbon economy in the European Union, it was argued that investment in new low-carbon technology and infrastructure is necessary to combat the negative effects of climate change, to strengthen European energy security and to achieve the greenhouse gas emissions targets, which are all important contributors to a sustainable environment (Holmes *et al.*, 2012). The increased implementation of energy efficiency measures and the use of more renewable energy sources in cities are the most important contributions to mitigating global warming, according to the United Nations Environment Programme (UNEP, 2015). Local government will therefore have to adopt specific policies and regulations where needed to provide the appropriate policy and legal framework for the transformation to an energy-efficient low-carbon economy. Policy and legislative changes at provincial and national government will most probably also be necessary to facilitate this. The State of Energy in South African Cities Report 2015 states that cities should adopt strategies for sustainability that include three key elements, namely energy efficiency, transport efficiency and renewable energy (Sustainable Energy Africa, 2015).

UNEP, together with other international partners, have developed the concept of district energy in cities to assist local government all over the world to unlock the potential of renewable energy and energy efficiency. They conducted a comparative study on 45 cities in the world and published their report, which includes guidelines for local government on the utilisation of the concept of district energy (UNEP, 2015). Modern district energy systems provide a combination of heating and cooling systems (depending on the geographical location), decentralised power generation, thermal storage and heat pumps. According to this study, such district energy systems provide a low-carbon, affordable and climate resilient solution to local government. It is a cost-effective way of reducing the dependence on fossil fuel energy sources and also promotes the green economy. Various business models and technological solutions were utilised in the 45 cities covered in this report. Local government can play different roles when utilising the district energy concept, namely that of facilitator, planner, regulator, producer and consumer, and a municipality has to consider all these roles when developing its energy strategy.

The UNEP report provides various financing possibilities to local government to assist in adopting and implementing a district energy plan. The range of options available to a municipality would depend on the regulatory framework within which it functions. Some of these funding options are:

- Issuing of long-term revenue bonds to fund projects, for example in St. Paul (USA) and Toronto (Canada);
- Specific grant funding, which would come from the national government or international funding institutions, for example Port Louis (Mauritius) who obtained a \$1m grant from the African Development Bank for feasibility studies of a district cooling project;
- Long-term national or international loans, for example the use of EU Structural Funds in local areas in EU member states to improve their energy situation;
- Revolving funds which provide subsidies, grants or low-cost financing for strategic developments to the benefit of the community, for example the Climate and Energy Fund of Oslo (Norway) which was initially funded by a surcharge on electricity and is now funded by the interest generated by this fund;
- Using local government assets such as land and buildings as part of a district energy plan, for example in Seoul (Korea) where city property was used as part of the development of fuel cell power plants; and
- A public-private partnership, for example Sonderberg (Sweden) that, as a joint initiative between the local government, various public and private sector partners and the local community, adopted Project Zero in 2007 to change to a green energy municipality (UNEP, 2015).

Early in 2015 the Department of Energy and the DBSA established the Green Fund to provide financial and technical support to initiatives that contribute to strengthening a low-carbon energy-efficient economy (www.sagreenfund.org.za). It is open to private as well as public sector applicants, and municipalities would be one of the key institutions to utilise this funding opportunity. Funding could be in the form of grants, loans or equity. The Green Fund created three categories or funding windows, namely for Green Cities and Towns, Low-Carbon Economy, and Environmental and Natural Resource Management, which covers a wide range of potential projects.

The region of Upper Austria was the first region in Europe to develop an innovative program for financing energy infrastructure and energy efficiency, called energy contracting. This was started in 2007 and involved the Upper Austria Government and more than 200 municipalities and private companies. The Upper Austrian regional energy agency, the Oberösterreich Energiesparverband, plays a leading role in this initiative and provides advice, technical support and subsidies to recipient institutions to implement this program (Oberösterreich Energiesparverband, 2007). Energy Contracting is available to municipalities or other public entities as well as private enterprises. It involves drafting a contract between a specialist energy company (the contractor) and a municipality or enterprise (recipient institution) in which details regarding the planning, installation and financing of a specific energy investment project at the recipient institution are specified. The contractor manages the whole project and guarantees that specific energy saving targets will be met during the agreed period (normally between five and fifteen years). The refinancing of the project is based on reaching the guaranteed energy savings or sale of energy target (Oberösterreich Energiesparverband, 2007). The benefits to the municipality are:

- It does not have to invest in new equipment;
- It does not have to carry the risk of such a project;
- Modernising public buildings to be more energy-efficient;
- The contractor provides expertise and the latest energy management technology; and
- The minimum energy savings are guaranteed and the cost and results are fixed and specified in the contract.

The contractor is ensured of a long-term contract with a stable client and can stay up to date with the latest technological developments since it impacts such an energy contract. Examples of successful energy contracting projects are:

- The replacement of old street lighting with modern LED lights in the Ternberg Municipality. The capital investment was euro 165 000 and the contract term is 10 years (2013–2023). The electricity saving is 69 700 kWh p.a. and euro 10 400 p.a.

- The renovation of improved insulation of the Upper Austria Red Cross building in Wels. The capital investment is euro 520 000 and the contract period is 15 years (2014–2029). Through improved insulation and general renovation of the building, energy savings of 214 500 kWh p.a. and euro 14 700 p.a. (Oberösterreich Energiesparverband, 2007) could be achieved.

Improving the energy landscape in a municipality is an area that by its nature requires the involvement of other spheres of government and also the private sector and local communities. Investing in and improving energy efficiency within a local community can largely be done by a municipality itself, but the participation of the local community will also play an important role. In the area of renewable energy cooperation between the different spheres of government, independent private power producers and funding institutions are required to ensure successful implementation of renewable energy projects. Some other options to be explored by municipalities in South Africa, to be more active role players in the field of renewable energy, are:

- Promoting small-scale embedded power production within the municipal area, e.g. covering a roof of a shopping mall, wine cellar (Villiera Wine Estate, Stellenbosch) or office building (Black River Office Park, Cape Town) with solar panels that produce more than what is needed by the owners, and the surplus energy is supplied to the grid; and
- Obtaining a license as independent power producer to generate renewable energy which could be supplied to the consumers in the municipal area.

4.3 Innovative funding options for infrastructure development

The combined effect of increased urbanisation and the digital revolution requires a dedicated effort by local government, specifically in cities, to adopt appropriate infrastructure development plans and to consider a variety of financing options for funding the maintenance of existing infrastructure and the development of new infrastructure. There is a huge infrastructure backlog in most African countries which would require massive funding beyond the scope of ordinary government budgets. The European Centre for Development Policy Management (ECDPM), which focuses on development partnerships between the EU and the Global South (in particular Africa), estimated in 2013 that, in addition to the public and private sectors' current expenditure on the development of infrastructure, Africa needs about \$31 billion p.a. (Pearson, 2013). Infrastructure investment requires public funding, via the normal budgets, and cooperation with the private sector in terms of funding and expertise that could be used in the co-creation, co-delivery and co-management of infrastructure projects.

The development of infrastructure in a municipality requires a long-term strategy and long-term financial plan. South African municipalities are required to include detailed information on planned capital expenditure in their budgets. In terms of the multi-year budgeting provisions, capital expenditure can be provided for three years, but in the case of longer term capital needs, further requirements must be met before it can be approved by a municipal council (MFMA, sec. 17(2), 19, 33, 46). It is thus possible, within the current regulatory framework, to plan for long-term infrastructure projects in a municipality. The vast infrastructure needs, however, prohibits a business-as-usual approach in many municipalities. Therefore, the normal municipal budgets will have to be supplemented by innovative plans and funding options.

Historically, municipalities have not been able to spend infrastructure budgets effectively. Performance has been characterized by delays, poor planning, lack of project management capacity and poor oversight on the part of provincial and national government. If planned investment is to foster stronger economic growth, these challenges will need to be overcome (FFC, 2014).

A review of infrastructure grants in South Africa confirmed that the upkeep of infrastructure in most municipalities in the country is severely backlogged (National Treasury, 2014). The report stressed the importance of investing in urban infrastructure that can contribute to economic growth and ensure the long-term financial viability of a municipality. It also recommended that an integrated approach to urban development and transport infrastructure, which must be supported by a redesigned grant structure, should be followed. In its 2014 Submission on the Fiscal Framework and Revenue Proposals, the FFC argued for a renewed focus on infrastructure development to support economic growth. They furthermore emphasised that municipalities should not only invest in new infrastructure, but should also make adequate provision for the maintenance of existing infrastructure. The DBSA, one of the key funding institutions for infrastructure development, has created a specific program for accelerated infrastructure development, which includes technical support and a variety of funding options such as loans, co-funding and equity investment (www.dbsa.org). New legislation was passed in Parliament in 2014 to *inter alia* give effect to the national infrastructure plan aimed at creating more synergistic infrastructure development that will support economic growth (National Infrastructure Act, 2014). It is too early to evaluate the effect of this legislation on local government, but municipalities will have to ensure that they benefit from the implementation of the Act, which *inter alia* implies that, in order to incorporate new

infrastructure development, they need to update their integrated development plans in accordance with the national infrastructure plan.

In a study on innovative funding options for infrastructure in Canada, Tomalty (2007) argued that a combination of innovative funding options, as well as innovative policy decisions, are required to contribute to smart growth in urban areas. The study indicated that infrastructure funding, and the use of specific infrastructure and land use planning, should be coordinated to strengthen efficiency and smart growth. Some of the funding options already utilised by local government in Canada are:

- Development cost charges imposed by municipalities to cover the infrastructure cost for new residential or commercial developments, e.g. in Vancouver and Ottawa. This could be applied throughout a municipal area or be focused in specific parts of a municipality.
- Tax increment financing, a financing mechanism based on the increase in property tax revenue (tax increment). The capital investment in infrastructure in a particular area will cause an increase in property values, which in turn gives rise to an increase in revenue from property tax. The municipality can use the increase in tax revenue to repay the loans used to fund the infrastructure investment. This has been used in Calgary, Alberta, for example.

Many countries in Europe have recognised the need to invest in low-carbon infrastructure, an approach also actively promoted by the European Union. Various EU funds have been established to provide infrastructure funding in member states, for example the European Regional Development Fund (ec.europa.eu/regional_policy/en/funding/erdf). The European Investment Bank (EIB) also plays an important role as funding institution to support infrastructure projects. It launched a Project Bond Initiative in 2012 which provides loans or other credit facilities to major infrastructure projects which in turn could attract further private sector investment in such projects (EIB, 2012). The importance of good connectivity to support the free movement of people and goods within the EU was reconfirmed by the decision of the European Commission to establish a new dedicated transport infrastructure fund, namely the Connecting Europe Facility. The EU has committed a record euro 13.1 billion investment for 276 transport projects under this initiative, which will also leverage further public and private sector co-funding (ec.europa.eu/transport/themes/infrastructure/news/2015-06-29-cef_en.htm). The EU funding for individual projects, e.g. the Brenner Base Tunnel, is made in the form of grants which could constitute between 20% and 85% of the funding of a project. In view of the huge demand for infrastructure investment in the EU member states and the pressure on the available public funding, innovative

funding options combining public and private sector funds are promoted. Public sector finance instruments could be utilised to leverage private investment, for example by institutional investors such as pension funds or private equity funds (Christopherson *et al.*, 2014). These special funding initiatives to support member states in developing new infrastructure will make a significant contribution to job creation, economic growth and sustainability.

The issuing of general municipal bonds is a well-known practice in many countries and is also used in South Africa, but in 2014 the City of Johannesburg became innovative by issuing green bonds. This first 'Green Bond' of R1.46 billion, issued by way of an auction, was over-subscribed, which is a positive sign that investors are keen to invest in green infrastructure. The funds received from this bond will be utilised specifically for green initiatives such as a biogas-to-energy initiative and a solar water heater project in Johannesburg (City of Johannesburg Press Release, 2014). This is one particular form of debt finance that could be used by a municipality. The credit rating of a municipality has a significant impact on its ability to obtain debt finance, for example by way of municipal bonds or loans from a commercial bank (see discussion in Chapter 6). The credit rating of municipalities is influenced by factors such as the standard of their financial management and general governance, which must therefore be addressed to ensure good credit ratings.

PPP's, a specific form of cooperation between public and private sector institutions, are often used in large infrastructure projects, for example in the development of a rapid rail system, broadband and Wi-Fi infrastructure, or new health care facilities. PPP's can have different configurations, but it creates the opportunity for more private funding and technical expertise in specific projects, while transferring some of the risk to the private partner. The MFMA makes provision for PPP's (MFMA: sec. 120; Municipal Public-Private Partnership Regulations, 2005) and the National Treasury has a special unit that supports the development of PPP's in South Africa (www.ppp.gov.za). The use of PPP's for longer term projects in particular is not optimally used by local government and could be utilised more in many municipalities in South Africa.

Local government should utilise different sources of funding for infrastructure development, not as alternatives, but rather in a complementary way in order to achieve optimal utilisation of the available funding and to improve the creation of infrastructure in local communities.

5. Conclusion

The globalised world of the 21st century is characterised *inter alia* by interconnectedness, a knowledge economy and increased pressure to deal more effectively with major environmental questions such as climate change. Globalisation and decentralisation, complementary forces in this fast changing environment, impact on all levels of governance, but in particular on local government. In addition, the increasing urbanisation experienced around the world means that local governments, in particular in urban areas, have to review their governance structures and processes as well as their financial arrangements. The financial needs, specifically the capital needs, have increased significantly in urban communities and require a new approach to the funding of local government.

In reviewing local government finance in South Africa, it is important to consider both revenue and expenditure in order to obtain a complete picture of the financial situation. In this chapter the focus was on innovation in revenue, expenditure and delivery of services, including innovation in the local communities' funding of specific capital needs relating to energy, infrastructure and sustainability. The chapter started with a discussion of tax sharing as a possible revenue innovation which is thus a specific option for the reform of the revenue sources of local government. The topic of revenue reform will be elaborated on in the next chapter.

Expenditure innovation includes utilising ideas and processes that can strengthen effectiveness and efficiency, and this includes proper costing of services. The importance of cost-effective delivery of services, including cost-effective management of current expenditure, as well as the long-term capital expenditure was emphasised. As far as the funding for long-term capital needs is concerned, for example the construction of roads, metropolitan transport systems, renewable energy plants or broadband technology, the review looked at a combination of specific capital needs and innovative funding solutions as part of innovation in service delivery. Various international examples of innovation in local government finance exist and can be explored for use in the South African context.

Internationally, the increased use of renewable energy is important in limiting carbon emissions and strengthening sustainability in a global context. In South Africa it is even more important to invest in renewable energy in view of the fact that the traditional coal-based power supply is insufficient for the growing needs of the country. As far as local government is concerned, it means that municipalities will have to invest in low-carbon energy-efficient strategies and infrastructure and even consider providing some of the renewable energy themselves. This requires innovative funding solutions,

which was discussed in this chapter. The maintenance and upgrading of infrastructure in all municipalities require sufficient funding and it is also evident that the existing ordinary funding sources are not sufficient to deal effectively with the needs of local communities. Municipalities should embrace innovative funding opportunities which could lead to the strengthening of local financial governance.

In conclusion, the process of local financial governance reform entails a comprehensive consideration of both revenue and expenditure. The reform process should furthermore include a range of innovative funding options for long-term capital needs in municipalities, which could contribute to improved service delivery.

CHAPTER 8

Local Financial Governance Reform in South Africa

1. Introduction
2. Financial reform – a principled approach
3. Re-shaping the functional division and institutional landscape
4. Revenue reform possibilities
5. Conclusion
6. Recommendations

1. Introduction

Financial constitutional law, a distinct part of constitutional law, has a multi-disciplinary character since it includes references to economic theory and public governance in addition to the constitutional law provisions. In a multi-level system of government, the legal arrangements governing financial intergovernmental relations are often quite complex and have to deal with diverse interests and needs of all levels of government. The basic constitutional division of functions and financial sources (including taxes, financial equalisation and other funding sources) between the levels or spheres of government forms the basis of the system, but it must be complemented by further legislation (e.g. on financial equalisation) to complete the legal framework. In addition, intergovernmental relations structures and mechanisms, such as the Budget Council in South Africa or finance ministers' conferences in other countries such as Germany, are important elements that contribute to the effective functioning of a multi-level system of governance. The system of financial intergovernmental relations in South Africa functions within this financial constitutional legal framework. Local government financial reform will thus have to take place within this framework.

The knowledge era of the 21st century is characterised by globalisation and the digital revolution. The world is simply much more connected in many ways compared to the situation two decades ago when major political changes took place in Europe, with

the fall of the Berlin Wall in 1989 and the advent of democracy a few years later in South Africa. Held and McGrew (1999) aptly referred to it as “the growing impact of worldwide interconnectedness”. An event in Cape Town is news all over the world within moments. These realities of living in a global community, where information and communication technologies are key drivers, have an impact on the governance (which includes financial governance) of a country. The forces of globalisation and localisation have a profound effect on communities worldwide and this development also indicates changing roles of national governments, other levels of government and non-governmental actors in an interconnected world (Shah, 2008). Globalisation causes a decline in the power of national governments in favour of local or regional governments and international institutions (such as the World Trade Organisation or the European Commission and European Parliament). Governance in this interconnected world is complex and indicates a need for a re-evaluation of the respective roles of different levels of government in a multi-level system of government.

The changing governance paradigm is described by Shah (2008:86) as follows:

“This shift implies that the world is gradually moving from a centralized structure to a globalized and localized (glocalized) one. In such a world, the role of the central government would change from that of a managerial authority to a leadership role in a multicentered government environment. The culture of governance is also slowly changing from a bureaucratic to a participatory mode of operation, from a command-and-control model to one of accountability for results, from being internally dependent to being competitive and innovative, from being closed and slow to being open and quick, and from being intolerant of risk to allowing freedom to fail or succeed.”

In the recent World Bank studies and other literature referred to in this study, it is evident that there is an increase in decentralisation or localisation in many countries in the world, a trend which is strengthened by globalisation and the information revolution (Farvacque-Vitkovic & Kopanyi, 2014; Shah, 2006; Blöchliger & Vamalle, 2012). The new approach to developing sustainable local government structures is citizen-centred local government in which the citizens are the principals, accountability is strengthened and innovation in service delivery contributes to better performance.

It is not only the world that has changed a lot during the past two decades; South Africa has also experienced many changes and currently faces a series of challenges within the public governance field which require urgent attention. The area of local government, in particular local financial governance, is of great concern and many municipalities experience a serious governance crisis, which relates both to their funding model as well as to their administrative and management capacity and performance. At the same time, other factors such as increased urbanisation and climate change, which are both

international realities and not limited to South Africa, further impact on the way in which government is structured and is enabled to respond to these factors effectively. A review of the current system of local government finance is therefore justified.

The National Development Plan Vision 2030 (NDP) also gives some direction to the need for improved public governance; also at local government level. The diverse range of challenges faced by South Africa in its endeavour to eliminate poverty and reduce inequality by 2030 (and the complexity thereof) is evident in the NDP. The key priorities to achieve the goals of the NDP (2012) are described as follows:

“While the achievement of the objectives of the National Development Plan requires progress on a broad front, three priorities stand out:

- Raising employment through faster economic growth,
- Improving the quality of education, skills development and innovation, and
- Building the capability of the state to play a developmental, transformative role”

(National Planning Commission, 2012)

Many of the challenges faced by local government relate to the capacity and capability of the institutions of government, and a process of local government financial reform must therefore also attend to it.

Local financial management is currently in the spotlight in view of the bad financial situation in most of the municipalities in South Africa. In the Consolidated general report on the audit outcomes of local government, MFMA 2012-13, by the Auditor-General, the poor state of local government finances was highlighted again. The report indicated that there is reason to be concerned and that municipalities must improve their legal compliance, quality of financial statements and general financial management. In addition, the FFC also expressed its concern about the financial viability of many municipalities (FFC, 2014). A national government study on the performance of municipalities in 2014 concluded that only one third of the 278 municipalities in the country are properly functioning on the level required by the Constitution. This situation of poor performance led to the introduction of a new program (Back to Basics) to strengthen institutional capacity and enhance service delivery in all the under-performing municipalities in the country (COGTA, 2014). The approach of this program is in line with what is so aptly argued by Shah, namely that local government should be citizen-centred.

“Put people and their concerns first and ensure constant contact with communities through effective public participation platforms. This is the essence of our ‘back to basics’ approach.” (COGTA, 2014:6)

In the comparative analysis of the five case studies in Chapter 3, it was pointed out that financial intergovernmental relations in multi-level systems of government are never static, but always in some form of continuous evolution. This means that elements of the system, or sometimes the whole system, have to be reviewed from time to time in view of a changing world within which these systems function. Local government finance is a specific part of the system and thus also subject to review. The extent to which development has taken place in the local financial governance of the five countries included in this study, differ. Belgium, despite the fact that it has a well-established system, for example experienced important reforms in 2013, while in India there is a growing need for some reform that could benefit local government.

Within the context described above, local financial governance reform is a natural process that should be taken seriously in multi-level systems of government, including in that of South Africa. The impact of the global context, combined with the domestic realities, imply a complex situation for which there are no quick fixes or simplistic answers. According to Schwella (2015), the complexity challenge impacting on South African governance suggests that joint and coordinated action is necessary to find workable solutions for complex public governance problems, for example in local financial governance. A comprehensive structured reform process is required in order to effect the necessary changes needed to improve local financial governance. In the rest of this chapter the various components of such a comprehensive reform process will be described in some detail.

2. Financial reform – a principled approach

Any financial reform process in South Africa must be anchored within the constitutional framework, based on the supremacy of the Constitution and the rule of law. The Constitution already contains some principles applicable to local government finance and the broader system of financial intergovernmental relations. Accountability and transparency are two key principles contained in the Constitution which generally apply to governance, but also specifically to financial governance (Constitution, 1996: sec. 1, 215 (1)). These are, however, not the only principles on which a model for local financial governance, and thus also the financial reform process, must be based.

In line with economic theory applicable to multi-level systems of government, the following principles are important foundational elements for modern local financial governance (see the discussion in Chapter 2):

- Accountability and transparency;
- Principle of subsidiarity, in particular relating to the allocation of expenditure responsibilities;

- Principle of commensurability, which is a way of linking the expenditure responsibilities with the allocation of funding sources; and
- Autonomy – in a multi-level system of government there cannot be absolute autonomy for local government, but from an economic perspective it is important to create a reasonable amount of fiscal autonomy to decide on local taxes and local spending priorities (see discussion in Chapter 2; Shah, 2006).

In its quite comprehensive review of the local government fiscal framework, the FFC listed the following principles for local government finance:

- a Revenue adequacy and certainty,
- b Sustainability,
- c Effective and efficient resource use,
- d Accountability, transparency and good governance,
- e Equity and redistribution,
- f Development and investment, and
- g Macroeconomic management. (FFC, 2013:13)

These principles, as well as the following objectives, were used in the design of the current system:

- a Equity,
- b Efficiency,
- c Ensuring a basic level of administrative capacity in the most resource-poor municipalities,
- d Predictability, and
- e Incentives for proper financial management at the local level. (FFC, 2013:13)

In its recommendations, the FFC did not depart from the principled approach outlined above, but it looked at the practical application of the principles and objectives and how these could be improved. An important recommendation made by the FFC, is that the review of the local government fiscal framework requires a whole government approach; the appropriate way to deal with local government financial reform in a multi-level system of government. Some aspects of the FFC's recommendations warrant further attention here.

An Intergovernmental Financial Relations System should promote equity, democracy, fiscal accountability and economic efficiency through its process of expenditure and revenue assignment to sub-national governments. [FFC, 2013]

Referring to the principle of differentiation, the FFC argued that the substantial differences in economic, social and demographic circumstances, as well as differences in administrative and management capacities across the spectrum of local government, warrant a differentiation in funding and functioning of local government (FFC, 2013). It is important to pursue such an asymmetric approach and to also take into account the actual performance of individual municipalities and the combined economic potential of metropolitan areas and their neighbouring local municipalities. These factors will impact the funding structure, as well as the functional alignment and the support mechanisms that could be provided to municipalities to enable them to perform their functions effectively and efficiently.

The FFC recommended the improved use of own revenue sources, in particular in urban areas. This includes the development of innovative funding methods, such as smart metering for electricity and water and the devolution of taxing powers to metropolitan municipalities. It is evident from the discussion in Chapter 7 that municipalities, in particular the metropolitan municipalities, should be more innovative in finding new or improved ways of funding their activities and capital projects. Local government tax space, however, should also be reviewed to strengthen the financial position of metropolitan areas considering their important economic contribution. Such an approach is in line with the commensurability principle which aims to create a better balance between local financial resources and funding responsibilities (see discussion in Chapter 2).

The citizen-centred approach to local governance in general, including the local financial governance referred to in Chapter 2, create a new improved governance framework that describes how government is involving citizens in defining needs and priorities, deciding on services, sharing information and giving effect to accountability to citizens. In a World Bank research study, Shah and Ivanyna (2010:4) defined governance as “an exercise of authority and control to preserve and protect public interest and enhance the quality of life enjoyed by citizens.” Inherent in this definition is the focus on citizens, how they are involved in government decision-making and what impact government policies have on the lives of citizens. Such a citizen-centred approach, which is strengthening good governance, should therefore be part of the local financial governance reform in South Africa.

Principles such as these listed above are not only important foundational elements of modern local financial governance; they also need to be given effect to in practice and in all facets of the financial governance model. This means that the principles apply to the design as well as the implementation of the model. Section 215 of the Constitution refers to budgets and budgetary processes that must promote accountability and transparency.

Procurement systems for contracting goods and services must, in accordance with section 217(1) of the Constitution, be fair, equitable, transparent, competitive and cost-effective. These are important provisions which must be consistently applied by all spheres of government. However, the principled approach described here suggests a more comprehensive application of the principles, with a view to improve local financial governance and have a positive effect on the lives of citizens in each local community.

It is concluded that the following core set of principles discussed here should apply to the local financial governance model:

- Accountability;
- Transparency;
- Subsidiarity;
- Commensurability;
- Autonomy; and
- Citizen-centred governance.

The application of these principles would *inter alia* in practice include the following matters:

- Ensuring that the accountability and transparency provisions in the MFMA (2003) and other relevant legislation are effective and implemented consistently. This also implies that all elected structures of government, including all the municipal councils, must adhere to it as a matter of high priority. Regular financial and performance reporting by municipal councils is one of the key practical implications (Brand, 2015).
- A pragmatic approach to the division of functions should apply the subsidiarity principle to ensure that functional responsibilities should be appropriately allocated and funded accordingly. Such an approach should also include the principle of differentiation, proposed by the FFC, in order to provide a better structured local government landscape.
- Commensurability and autonomy should be viewed in a complementary way, namely that the relative autonomy of municipalities should be strengthened, but in such a way that there is a closer link between their funding resources and their expenditure responsibilities. This implies a review of the tax regime, with the purpose of improving the tax space for cities, while maintaining an overall balanced and equitable tax system.
- The citizen-centred approach originates with a change in governance thinking, which implies that local government (but also the other two spheres of government) should give citizens a central position in the design and delivery of services. It implies greater involvement in issues such as long-term planning, urban design, service delivery improvement plans and co-production of public services.

3. Reshaping the functional division and institutional landscape

A review of local financial governance should, in addition to a focus on the revenue of municipalities, include the investigation of the division of functions among the different spheres of government and among municipalities. It is therefore in principle a constitutional issue, which could be classified as part of the financial constitution, as discussed earlier in this publication.

Constitutional reform initiatives are often complex and are influenced by political and economic considerations prevalent at the time. The reunification process of Germany in 1990 needed some degree of constitutional reform to properly accommodate the new *Länder*; therefore a constitutional reform commission was established in 1991. They were tasked with reviewing a variety of constitutional issues, of which the financial intergovernmental relations between the *Bund* and the *Länder* (which included the financial equalisation system) was of prime importance. Competing interests and needs have to be balanced somehow in the endeavour to find workable solutions for the future. This is a complex exercise, as is evident in the continuing debates on giving effect to the constitutional goal of ensuring equal living conditions throughout the country (Funk, 2010). It is now accepted that it means living conditions of equal quality and that it cannot mean uniformity, thus accommodating the differences among the various local communities and among the *Länder*.

The last constitutional reform process in Belgium, namely the sixth State Reform in 2013, included financial reform initiatives from which the regions benefitted. The difficult and long period of political negotiations which preceded the establishment of a new Belgian government contributed to the complex nature of this reform process (see discussion in Chapter 3). Financial issues are very often at the centre of constitutional reform processes, as illustrated by these two examples. In this research study the complex context, both locally as well as globally, within which the reform of local financial governance has to be considered, was discussed in detail. In this section, various reform elements are discussed in an attempt to provide a comprehensive proposal that is not unnecessarily complex.

In reviewing the functional division between provincial and local government and between municipalities at a horizontal level, the constitutional framework is the point of departure (see De Vos, 2014 for a discussion about the constitutional division of functions between the three spheres of government). The principle of differentiation, suggested by the FFC, is relevant when consideration is given to an appropriate division of functions between municipalities *inter se*. Legitimate questions about the financial viability and relevance of district municipalities have been raised. This should, however,

be considered in a slightly broader context, namely that of rural development. District municipalities have a rural character, and together with the local municipalities in rural areas, have some responsibility to promote economic development in those rural areas (Constitution, 1996: sec. 152; Malherbe & Brand, 2001). The reality is, however, that rural development is not given effect to by district municipalities. A major concern influencing the future of district municipalities is that they don't have an own source of revenue, unless they provide some bulk services for which they can collect user charges (FFC, 2014). The functional responsibility for rural development, however, falls within the concurrent functional areas of national and provincial legislative competence (Constitution, 1996: Schedule 4A). Except for Gauteng, which is largely urbanised, all the other provinces have significant rural areas. Rural development is thus, arguably, a key functional area which provinces should attend to. In view of the overarching principles of cooperative government (Constitution, 1996: Chapter 3), a great deal of cooperation, in particular between provinces and local government, is required to effectively deal with rural development.

Although agriculture is a key economic component in rural areas, rural development is a much broader concept that includes economic and social development. The arguments in support of energy efficiency and renewable energy, discussed in Chapter 7, are also relevant to rural municipalities. More efficient and cost-effective energy provision in rural areas would be a key component of the economic development of those areas. Rural development should be viewed as a comprehensive governance issue that includes all functional areas of provincial government, as well as the monitoring and support of local government in the province.

Provinces have, in various functional areas, already decentralised offices, for example the district offices for education. An extension of the decentralisation model, which aims to include other services in a coordinated fashion, could be viewed as part of an evolutionary development to bring services closer to communities. In order to effectively deal with rural development and provincial services in rural areas, it is proposed that provinces should consider adopting a rural development strategy that includes a restructured provincial administration, based on the decentralisation of services. An international example of such a model is the decentralisation of the Bavarian Government services into seven regional administrations (see the discussion in Chapter 4). Provinces should have the flexibility, as they currently have with their own administrations, to firstly decide if this approach will be of benefit to them; and secondly, to design a model that will suit the needs and circumstances of the particular province. Gauteng, for example, has different needs than the Northern Cape due to the vastly different economic, geographic

and demographic profiles. An asymmetric application of the decentralisation model is therefore proposed.

Provinces can decide how they want to organise their respective administrations within the framework of the Public Service Act, 1994 (Premier of the Province of the Western Cape v President of the RSA, 1999 4 BCLR 382 (CC); Brand, 2015). The Premier of a province may, in terms of section 3 A of the Act, make determinations regarding the allocation of functions to any department or government component in the province. No legislative or constitutional amendments are thus required prior to the inclusion of a regional office of a provincial administration.

In terms of this decentralisation model, it is proposed that a province creates decentralised administrative units that include all the provincial functions, as well as a specific focus on rural development within the provincial administration. The geographical division into decentralised administrative units could be based on the current geographical areas of district municipalities. A careful and thorough review of the position of district municipalities should be made and could possibly result in one of two outcomes, namely: a restructuring of the division of functions between local and district municipalities (supported by a dedicated revenue source to fund the district functions); or the abolition of district municipalities and the re-assignment of their functions to local municipalities, with the option that provinces (through the newly created regional administrations) could perform some of the functions on behalf of the local municipalities in that region. Such an arrangement, combined with a specific provincial focus on rural development, could have a significant positive impact on the overall economic and social development of rural areas and thus also on the quality of life of citizens in those areas. This is in line with the citizen-centred approach to local government outlined above. Some legislative reform is necessary to effect this proposal. The Municipal Structures Act, 1998, which provides for the establishment of district municipalities and the allocation of functions to different municipalities, would, for example, have to be amended.

Many rural municipalities in South Africa are barely functional due to administrative incapacity and a weak financial situation (COGTA, 2014). Low or no economic growth, combined with high levels of unemployment, contribute to this dire financial situation. A concerted effort is thus needed to create more economic growth in rural areas, which in turn could increase the own revenue of rural municipalities. This inclusive decentralisation proposal could be a catalyst for positive change in rural areas. Capable administrations are a further important building block in this initiative. An improved administrative support system should include some form of shared services, or agency agreements, through which urban or large municipalities could provide skilled, cost-

effective administrative services to smaller rural municipalities. Such an arrangement should be part of the institutional reform initiative.

There is an old saying in public finance that funds follow function, and in terms of such an approach, there is a close link between the expenditure responsibilities and the financial resources to fund these functions (Farvacque-Vitkovic & Kopanyi, 2014). If, however, the delineation of functional responsibilities between spheres of government is not sufficiently clear, it might result in inadequate funding of the respective governments. In addition, if local government receives additional administrative responsibilities through national legislation, but not specific funding to pay for it, municipalities will not be able to properly fulfil that specific legislative function. It is therefore crucial that the delineation of functional areas, in particular the division of functions between local and district municipalities, and between provinces and local government, is optimised. There are some areas of dispute or uncertainty which could result in specific functions either not taken care of or not administered properly. Libraries and museums are two functional areas in which provinces and municipalities have a stake, but municipal libraries and museums are not well funded and administered, because the Constitution has allocated the functional responsibility for all museums (accept national museums) and all libraries (accept national libraries) to provinces (Constitution, 1996: Schedule 5). There is clearly a role for both local and provincial government in both these functional areas. Since it is in the interest of municipalities to maintain and fund local libraries and museums, the equitable share allocation should take this into account. Local libraries and museums should, however, function within an overall provincial legislative framework on libraries and museums respectively.

Effective management of water is in everybody's interest and the three spheres of government enforce various regulations regarding water. National government is responsible for all water affairs; accept "water and sanitation services limited to potable water supply systems and domestic wastewater and sewerage disposal systems" and "storm water management systems in built-up areas", where local government has the primary administrative responsibility (Constitution, 1996: Schedule 4). Provinces have a more indirect role to play regarding water, since pollution control and environment are concurrent functions of provincial and national government, in addition to any specific responsibilities assigned to provinces in terms of national legislation. If one therefore considers water management in a holistic way, good intergovernmental cooperation is required to ensure the protection of a scarce natural resource to the benefit of everyone. This could be done in different ways, but includes specific intergovernmental mechanisms and protocols that will promote effective water management, which in turn will require appropriate funding to the respective institutions of government. These are

only some of the existing functional arrangements that should be reviewed, to ensure appropriate improvements and funding.

Another element of the institutional reform proposal is to improve the monitoring and support function of provinces with respect to local government by including the specific administrative components responsible for those functions in the new regional administration centres. Provinces are responsible for supporting and strengthening the capacity of municipalities and must ensure the effective functioning of local government within that province (Constitution, 1996: sec. 154(1) and 155(6)). In the capital cities in each province these functions could be effectively dealt with by the head office of the provincial department of local government. In the rural areas a decentralised unit, which can have more regular interaction with municipalities in that region, has the potential to provide a more cost-effective support and monitoring function to the municipalities. This should in turn contribute to better functioning municipalities and improved service delivery.

4. Revenue reform possibilities

4.1 Current situation

Local government revenue in South Africa consists of three main sources of revenue, as stipulated in the Constitution, namely:

- Own revenue, which consists of property rates (own taxes), user fees, charges and surcharges on fees (section 229);
- Local government equitable share (LGES) (section 214 (1)(a), 227(1)) and additional allocations (section 214 (1)(c)); and
- Borrowing or external funding (section 230A).

The primary own local tax is property rates which municipalities levy in terms of the Municipal Property Rates Act, 6 of 2004. Municipalities may impose different rates on different categories of property. The Municipal Fiscal Powers and Functions Act, 6 of 2007, regulates the levying of municipal taxes and surcharges other than property rates, which allows municipalities to introduce additional sources of own revenue.

The current revenue profile of municipalities varies significantly and many municipalities, including the metropolitan councils, have on average about 75% own revenue in their budgets. The situation in many other mainly rural municipalities is just the opposite, with a heavy reliance on the equitable share and other grants, which in some cases make up 80% of a municipality's budget (Khumalo & Ncube, 2015). The variation of the

contribution of property rates and service charges to the total revenue of the different types of municipalities is demonstrated in the table below.

Type of municipality	Property rates	Service charges
Metro	18%	48%
Secondary cities	14%	46%
Larger towns	19%	42%
Smaller towns	11%	37%
Rural municipalities	6%	11%

Table 8.1 Contribution of property rates and service charges to municipal revenue
[Source: Khumalo & Ncube, 2015]

The poor economic situation and high levels of unemployment in many rural areas are some of the factors contributing to this situation, with many municipalities having limited own financial resources, and thus not able to perform their constitutional obligations. They thus rely on significant national funding in the form of the equitable share allocation and additional grants.

In the comparative analysis in Chapter 3, it is evident that in all of these case studies the property tax in local communities contributes to a small percentage of their revenue. In Kenya and India tax sharing is of greater importance to local government compared to local property tax. India has the additional problem that the property tax system is not evenly developed in all areas in the country. In Belgium the local authorities collect most of their revenue through a surcharge on personal income tax. In the Netherlands the municipalities rely mainly on national transfers to fund them, while property tax contributes on average to less than 10% of their revenue. In Germany property tax on average currently contributes to about 11% of local government revenue, but local business tax (about 44%) is a much more important source of own revenue (see discussion in Chapter 4). However, in all the case studies it is clear that some form of financial equalisation is necessary in order to ensure that municipalities are in a financially sound position to fulfil their respective constitutional mandates.

In South Africa the local government equitable share allocation in terms of section 214 (1)(a) of the Constitution is based on a formula revised and updated in 2013 and which is still in use. The formula is aimed at enabling all municipalities to provide a set of basic services to poor households, as well as supporting poor municipalities to perform core municipal functions and funding essential administrative and governance functions.

Municipalities are allowed to borrow funds for capital expenditure and for bridging current expenditure within a financial year (Constitution, 1996: sec.230 A). This

Local Government Equitable Share is based on the following formula:

$$LGES = BS + (I+CS) \times RA \pm C$$

LGES = local government equitable share

BS = basic services component

I = institutional component

CS = community services component

RA = revenue adjustment factor

C = correction and stabilisation factor

[Source: National Treasury, 2013]

borrowing power is further regulated by the MFMA, which stipulated strict procedures to be followed by municipal councils when incurring short or long-term debt. Municipalities make use of a variety of external funding instruments, ranging from bank overdrafts to long-term loans with commercial banks and the Development Bank of Southern Africa, and capital market bonds (see discussions in Chapters 6 and 7). International credit rating agencies such as Standard & Poor's and Moody's analyse the ability of institutions (or even countries) to pay back its debt. Various factors can play a role in this rating process, for example the quality of management or government, political stability or the economic situation. The credit rating has an impact on the interest rate applied to

government debt. In terms of the local government it is of particular importance to the metropolitan councils. It is thus in the interest of a municipality to ensure stability and good financial governance in order to improve its credit rating.

Metropolitan municipalities also share in the general fuel levy, a national levy. This is provided for annually in the national budget (National Treasury, 2015).

This revenue model for local government, which functions within a comprehensive local governance system, must enable all municipalities to perform their constitutional mandate, or as the FFC stated in its report on Sustaining Local Government Finances: "The objective of the framework is to ensure that the revenue available to municipalities is adequate to cover the expenditure that is reasonable to achieve a level of service delivery that is acceptable for the functions for which they are responsible" (FFC, 2013:13). The practical reality is, as was pointed out earlier in this chapter, that most municipalities in South Africa don't measure up to the standard so aptly described by the FFC. The current system of local financial governance, including the revenue component, is under severe pressure. When taking into account the fast changing environment within which local government is functioning, it is clear that this system should be renewed in order to improve the overall local financial governance.

4.2 Future possibilities

Financial equalisation mechanisms in multi-level systems of government play an important role to bridge any fiscal gaps in the system and also to assist financially weaker provinces or municipalities. Although it is a constitutionally based instrument dealing with specific financial intergovernmental issues, policy considerations and decisions are also of importance. This means that politicians, practitioners and the various government institutions will have different views on the implementation of the financial equalisation mechanisms. This is the case in other multi-level systems of government, such as Belgium and Germany, and South Africa is no exception. Section 214 of the Constitution provides the basis for the financial equalisation or, as it is referred to in that section, the equitable division of nationally raised revenue. There are different ways of giving effect to this provision in the endeavour to create an equitable division of revenue, and the specific selected mechanism could also change over time. This financial equalisation process should be reviewed regularly to ensure that it meets the constitutional requirements and responds to changes in the environment in which the system of financial intergovernmental relations functions. The FFC, as an independent institution created by Chapter 9 of the Constitution, plays a crucial role in ensuring that the financial equalisation mechanism is correctly applied and updated from time to time.

The local government equitable share was renewed after it was thoroughly reviewed in 2013 (National Treasury, 2013). This new formula is designed to accommodate updated information on the cost of services, which is necessary to ensure that the formula provides a realistic view of the cost of basic services. Part of the FFC's mandate is to advise the Minister of Finance on the local government equitable share before the annual division of revenue process. An issue that warrants further attention is the differentiation between urban and rural municipalities. The revenue adjustment factor in the current formula attempts to accommodate the differences in tax capacity between municipalities, but it remains to be seen if the new formula adequately deals with the different situations in rural and urban communities.

The local government taxing power is regulated by section 229 of the Constitution and the levying of rates on property is the primary contributor to local tax. Property rates remain the biggest source of own revenue for local government, despite the low percentage revenue raised in many rural areas. It is, however, a revenue source that is not optimally utilised by all municipalities, but which is relatively inexpensive to manage. Effective and efficient administration is a key component of good governance

in each municipality. The following practical steps could improve the property rating system and thus the revenue it produces in each municipality:

- Ensure that all properties in the municipal area are valued;
- The correct zoning must be used when property valuations are done;
- Changes to the zoning of a property must be brought to the attention of the valuer, since it could influence the basis of valuation and thus the rate;
- A good data base of municipal consumers must be maintained to ensure that changes in addresses of rate payers are monitored and updated;
- Ensure that counter checking is done against other services used;
- Ensure that the valuation role is correctly advertised;
- Ensure that the rates policy and the by-law are regularly updated; and
- Ensure that the proposed rates are correctly advertised and that the prescribed public participation processes are followed correctly (Zybrands, 2014).

A number of sub-national tax options were discussed in the comparative analysis in Chapter 3, as well as in the revenue innovation section in Chapter 7. In some countries a form of tax sharing or a surcharge on a national tax base (such as income tax) are important sources of tax revenue that can strengthen the own tax revenue of provinces or regions. In Germany the Länder are guaranteed a fixed percentage of the revenue of the joint taxes, which is comprised of personal income tax, corporate tax, capital gains tax and sales tax (see discussion in Chapter 4). In Belgium the regions have the right to levy a surcharge on personal income tax, called the regional personal income tax, and thus sharing the same tax base as the Belgian government (see discussion in Chapter 3). Tax sharing could be an effective way of creating more revenue-raising options for provinces or regions and also strengthen their financial autonomy.

The FFC recommended that more revenue-raising responsibilities should be decentralised to provinces (FFC, 2015). The Constitution created some taxing power for provinces which must be regulated by national legislation. In terms of section 228 (1) provinces may impose taxes, levies or duties other than income tax, value-added tax, general sales tax, tax on property or customs duties. They may also impose flat rate surcharges on any tax, levy or duty, other than corporate income tax, value-added tax, rates on property or customs duty. The Provincial Tax Regulation Process Act, 53 of 2001, strictly regulates this taxing power and makes it very difficult for a province to introduce any form of tax. The possibility of a flat rate surcharge on personal income tax as a provincial tax should nevertheless be considered, but it should ideally be explored within a broader review of the current personal income tax, in particular regarding setting tax rates, in order to maintain tax stability and prevent any material and unreasonable prejudice to the national mobility of goods, services, or labour, national economic policies and economic

activities across provincial boundaries (Constitution, 1996: sec. 228(2)). If a flat rate surcharge on personal income tax is introduced as a provincial tax, the existing income tax rates will have to be reduced to maintain a balanced approach to personal taxes. Such an initiative will be a form of tax sharing (based on personal income tax) between the national and provincial governments and is a cost-effective way of creating a provincial tax which will strengthen the financial position of provinces, and which could make an important contribution to a rural development strategy, as suggested in this chapter.

Tax sharing that involves local government is another option used in some countries, for example in India, Belgium and Germany (see discussions in Chapter 3 and 7). Unlike provinces, local government does not have legal scope to impose a surcharge on personal income tax. A municipality may only impose a surcharge on user fees for services provided by or on behalf of the municipality (Constitution, 1996: sec. 229(1)), and this power is used effectively in many municipalities. National legislation may, however, authorise a municipality to levy other taxes, levies or duties appropriate to local government, excluding income tax, value-added tax, general sales tax or customs duty (Constitution, 1996: sec. 229(2)). Business tax is the most important local tax used in Germany and is based on the profit of business enterprises (Käsbohrer, 2014). The focus is generally on all profit making enterprises, but agriculture, forestry and individual professions are some of the exclusions (*Gewerbesteuer-gesetz*, 2015). Metropolitan municipalities should be allowed to levy a flat rate business tax, based on profit on all businesses located within their respective municipal areas, but small businesses should be exempted since they are important economic vehicles. Rural municipalities are specifically excluded for a similar reason, namely that a special effort must be made to strengthen rural development and that additional taxes on local businesses in those areas would be counter-productive. These tax proposals only focus on the current needs of local government, but tax reform requires a broader study that *inter alia* reviews the impact of all the different tax types on the economy and society. The Davis Tax Committee, appointed in 2013, is currently busy with a comprehensive review process to “assess our tax policy framework and its role in supporting the objectives of inclusive growth, employment, development and fiscal sustainability” (www.taxcom.org.za).

Metropolitan municipalities currently receive a share of the general fuel levy from the National Treasury. Rural municipalities are in need of more own tax revenue, but they lack sufficient own tax capacity. Using the general fuel levy as a source of tax revenue is an option that could benefit rural municipalities and thus strengthen their ‘own revenue’. It could be seen as part of their discretionary revenue, or it could be made conditional and linked to the upgrade and maintenance of road infrastructure in those municipal areas in view of the serious backlog in many municipalities. Sharing the general fuel levy with

rural municipalities is a cost-effective way of tax sharing since it would not require any new tax collection administration to be established and managed, while providing a new source of tax revenue to rural municipalities. An alternative to these tax options would be to give local government a fixed percentage of the revenue from VAT which would then be treated as 'own' or discretionary income of municipalities. It is a cost-effective way of taxation and would strengthen local fiscal autonomy.

These tax proposals should be considered as part of a total package of revenue reform proposals as discussed in this chapter. The introduction of new taxes is not something that any government should treat lightly and the potential economic impact thereof, both positive and negative, should be considered prior to implementation. The above proposals are, however, made with due regard to the limited legislative scope of provincial and local taxes and are a cost-effective way of introducing new tax revenue for provinces and municipalities.

The future reform of local government revenue will not be complete without the inclusion of innovative funding options (including the more productive and effective use of borrowed capital) in the delivery of services, specifically in the provision of energy and the development and maintenance of infrastructure. Various options for the funding of infrastructure maintenance and development, as well as the importance of improving the credit ratings of individual municipalities, were discussed in detail in Chapters 6 and 7. To summarise it can be said that funding for capital projects in municipalities is currently mostly done by way of national government grants and to some extent by long-term borrowing. In view of the huge infrastructure backlogs, increased urbanisation and insufficient funding supporting all municipalities with their respective capital programs, innovative funding mechanisms, as suggested in Chapter 7, as well as the funding options discussed in Chapter 6, should be developed and used where feasible. It is further evident that municipalities must also improve their credit ratings to enable them to acquire more external funding and to get access to lower cost funding (see discussion in Chapter 6).

Municipalities should develop their own individual combination of funding sources and review them regularly in accordance with the MFMA to maximise the best funding opportunities.

5. Conclusion

Globalisation, growing urbanisation and decentralisation all greatly influence governance institutions, mechanisms and, in particular, financial arrangements, in many countries in the world. It is evident from the comparative analysis in this publication that a review of local government finance in multi-level systems of government is necessary and, in fact, part of the evolutionary development of financial governance in such governmental systems. These systems are never static, but should be responsive to changing needs in society and changing local and international circumstances.

The current system of local government finance in South Africa has been in operation since 1998, but the global and domestic environment has changed dramatically during this period, providing justification for a review of the current system. In its review of the local government fiscal framework, the FFC stated that a restructuring of the fiscal framework should allow for differentiation between urban and rural municipalities in view of their different economic, demographic and social profiles (FFC, 2013). An asymmetric approach that properly reflects the financial impact of the specific issues relating to growing urbanisation in metropolitan areas, and the need to assist rural local municipalities to be sustainable, is necessary. Cities have the ability to raise more own revenue compared to small local municipalities where the economic potential is low. The funding arrangements should thus reflect this asymmetric situation.

In answer to the research questions posed in Chapter 1, this study provides a response to amending the financial architecture in the country to be more sustainable and equitable. In reaching the conclusions and formulating the recommendations, reference is made, where applicable, to useful international examples that could be utilised in South Africa.

Reform initiatives could be organisational, institutional or fiscal in nature and this research study considered all of these facets. Individual municipalities should be continuously focused on building appropriate functional and management capacity and the Back to Basics program of the Department of Cooperative Governance and Traditional Leaders is an initiative to give effect hereto. Strengthening administrative and management capacity also means filling vacancies in critical posts and appointing appropriately skilled staff. Organisational reform will have a cost implication too, namely that municipalities will have to do more with less. This means that more cost-effective delivery of services is required, which will in turn create opportunities for enhancing support to the poor (Farvacque-Vitkovic & Kopanyi, 2014). Proper costing of services and obtaining and managing reliable consumer data are essential elements in strengthening the cost effectivity of municipalities. Improving collection of own

revenue and credit ratings, and strengthening financial management, will go a long way to ensure good financial governance in a municipality.

Institutional reform is about finding the most appropriate institutional arrangements, within the sphere of local government, to meet the challenges of the 21st century. This could also have an effect on the division of functions between provinces and municipalities. A focused review of specific functional and funding responsibilities, as discussed above, should be done with a view to develop a clearer delineation of responsibilities. In other functional areas, such as water services, improved intergovernmental mechanisms are necessary to create a coherent and coordinated provision of services.

Institutional reform, with geographical and functional demarcation at its core, must contribute to the shaping of financially viable municipalities. The role of district municipalities must be reconsidered. Two alternatives – to scrap district municipalities or redefine its role, functions and finances – were proposed in this chapter, which both have financial implications. An additional institutional reform proposal is the decentralisation of provincial administrations to give specific attention to rural development and the support and monitoring of local municipalities in rural areas.

Fiscal reform is not necessarily about new or higher taxes, but it should rather focus on a reshaping and improving of the current taxes. It is in the interest of municipalities that they maximise their fiscal capacity, which implies that they should regularly update their property data base, review their tax rates and improve the collection of local revenue. One area of potential fiscal reform is the position of district municipalities. In addition, it is evident that some amendments to the current tax regime should also be considered as part of a larger scope of fiscal reform.

The reform of local government finances is an important part of the decentralisation of government, which contributes to building sustainable and stable local authorities that could enhance economic and social development and good public governance.

6. Recommendations

This research study has highlighted the complexity of local financial governance reform, whether it is in India, Germany or South Africa, or other multi-level systems of government. Some of the lessons learned in the comparative analysis of international case studies in this research publication could be applied to South Africa in one way or another.

Various reform possibilities have been discussed in this chapter and the recommendations listed here make use of some of those international experiences. South Africa is faced

with a complex set of challenges which can not easily be resolved. Changing the financial architecture requires a review of the foundations, the respective elements of the system and the way in which the system is functioning. It is therefore proposed that a comprehensive reform initiative encompassing a package of reform measures, which includes organisational, institutional and fiscal reform, should be adopted. The following recommendations, discussed in this publication, are made with the hope that it could be utilised to radically improve local financial governance and be of benefit to all communities in South Africa. The various recommendations are:

- i Adopt a principled approach to local financial governance reform by ensuring that the new or updated finance model is based on the principles listed in this chapter;
- ii Change the governance paradigm to a citizen-centred approach to the delivery of services;
- iii Ensure economic, effective and efficient use of resources in each municipality;
- iv Improve financial and credit ratios in each municipality to strengthen financial management and enhance the ability to obtain credit funding;
- v Improve costing and thus the cost-effective delivery of services;
- vi Invest in renewable energy, energy efficiency and a low-carbon economy, *inter alia* by improving cooperation with the private sector;
- vii Explore innovative financing options for infrastructure projects and energy initiatives, for example energy contracting, public-private partnerships, development charges and dedicated long-term bonds;
- viii Introduce tax sharing, which should include the creation of a provincial income tax surcharge, the sharing of the general fuel levy with rural local municipalities, and the introduction of a business tax in metropolitan and other major urban areas;
- ix Optimise the use of property tax in each municipality, including the efficient collection of debt;
- x Create the possibility of the decentralisation of provincial administrations, with the aim being the provision of focused attention to rural development and the support of local municipalities;
- xi Review the role of district municipalities by either abolishing it or redefining its functions and funding sources; and
- xii Ensure a regular review of the equitable share formula as an important financial equalisation mechanism that must enable provinces and municipalities to perform their respective constitutional mandates.

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