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An Assessment of Local Government Revenues during Limited Economic Growth and a Constrained National Fiscus

POLICY BRIEF

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ABOUT THIS BRIEF

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Introduction

Fiscal decentralisation in South Africa manifests with the assignment of public expenditure responsibilities across its three-sphere system of government. These public services are constitutionally assigned either exclusively to each sphere or such mandates are shared across spheres. This division of powers and functions sees key social services, such as education and health care, being shared by national and provincial government, while the delivery of basic services falls within the jurisdiction of local government. As such, the country's 257 municipalities are responsible for potable water provision, sanitation services, refuse removal and electricity reticulation as well as other range of other general local services. While the constitutional assignment of these functions ensures that the institutional integrity, as politically elected governments, of provinces and municipalities is augmented, public service delivery is also intended to occur within a spirit of cooperative governance across these three spheres.

Like any system of decentralisation, the delivery of services by sub-national governments occurs through their expenditures. Local government incurs a cost in the delivery of basic services, as well as other local services, such as storm water systems, streetlights, environmental health and local roads. In order to fund these expenditures, the constitution also assigns own-revenue collection powers to municipalities to support their expenditure responsibilities. The two major tax instruments that are assigned to municipalities are taxes on properties (also called property rates) and tariffs charged for services rendered. The local government fiscal framework was designed on the assumption that – in aggregate – 90% of local government's operating expenditure requirements would be funded by this own revenue. Municipalities in South Africa are also permitted to finance their expenditures via credit markets and other borrowing instruments. However, municipal borrowing is restricted mainly to capital expenditures i.e. investments in fixed assets, as opposed to funding operating expenditures, i.e., the recurring costs related to service delivery.

From a theoretical perspective, the nature of a system of fiscal decentralisation can inherently create fiscal gaps i.e. when expenditure mandates exceed revenue assignment. Such fiscal gaps can be "vertical" i.e. across spheres or "horizontal" i.e. across sub-national governments within a specific sphere. Vertical fiscal gaps can arise when expenditure mandates are relatively more decentralised, in other words, more evenly shared across spheres, while revenue powers are more centralised i.e. one sphere has relatively more taxation powers than the others. This is a feature of the South African fiscal decentralised system, where major taxation powers, such as income tax, corporate tax and value added taxes (VAT), are assigned to national government, while the revenue powers assigned to provincial and local government have relatively lower revenue potentials. This results in the bulk of tax revenues accruing to national government, but a significant level of expenditures occurring at sub-national levels.

While it is argued that local government in South Africa does have a reasonable degree of revenue powers, increasing household poverty, and the above-inflation increase in the municipal charges for water and electricity (driven in turn by increases from bulk service providers such as Eskom) means that many municipalities are struggling to reach the 90% of operating expenditure target funded by own revenue. As such, a key remedy to vertical and horizontal fiscal gaps are intergovernmental fiscal transfers. In situations where relatively more revenues accrue to a national government, grants to sub-national governments can play a role in supporting their expenditure responsibilities and minimising vertical and horizontal fiscal gaps.

South Africa implements a comprehensive system of intergovernmental transfers known as the division of revenue (DOR) process. As per this process, each spheres is constitutionally entitled to a share of nationally raised revenues from taxes and revenue instruments at the national level. This is commonly referred to as the equitable share. The equitable share supports service delivery and the developmental needs at sub-national levels. In supporting service delivery at the local government level, the local government equitable share (LES) also minimises the vertical fiscal gap that may exist in local government but also horizontal fiscal gaps that may exist across different municipalities. Certain municipalities with jurisdictions in more economically favourable areas are likely to generate relatively more revenues from their revenue instruments compared to other municipalities. However, the expenditure needs of the latter municipalities, particularly for social expenditures, are unlikely to be substantially less. As such, the LES and other grants plays a key role in supporting local government, as a sphere of government, and also individual municipalities in ensuring sufficient revenues to undertake their service deliver responsibilities.

Problem Statement

The narrative thus far outlined South Africa's system of fiscal decentralisation, the devolution of expenditure powers across the spheres of government and the assignment of revenue instruments, supported by intergovernmental fiscal transfers, to support these expenditures. However, the discussion on fiscal gaps has alluded to the possibility that revenue instruments and their revenue potential, both in general and at the local government level, can be impacted by fundamental economic and social factors. In other words, depending on the nature of the tax or revenue instrument, revenue potential largely depends on the ability of local taxpayers and consumers of local government services to pay. This ability to pay is largely dependent on the socio-economic status of the households and businesses in municipalities, as municipalities with relatively more employed and affluent households and further characterised by more business activity are likely to see a higher demand for local services and a greater ability to pay for such services. Therefore, the economic environment of a locality, but also of region and country at large, becomes a key determinant of the revenue potential of local (and general) revenue and taxation instruments.

Long-term economic growth and short-term macroeconomic stability are key economic goals of most, if not all, governments. While such goals intend to protect the citizens of a country from economic hardships and improve their quality of life, unsatisfactory levels of economic growth and severe downturns in economics activity, can have severely compromise a government's ability to provide public services. This is primary due to lower levels of economic activity having a negative impact on tax revenues. Higher levels of unemployment and lower business activity that characterises economic downturns or lower levels of economic growth results in less taxes being paid for income or corporate taxes, respectively. Higher levels of poverty mean lower demand for goods and services and thus lower revenues collected from VAT. Not only does lower taxes compromise public services, but dire economic circumstances also result in an increase in the demand for social goods, thus increasing the need for government services.

In circumstances of lower than usual economic growth or severe, but temporary, recessions, national government can debt finance expenditures for government services. Not only can this assist to maintain or even extend the levels of services provided, but it can also boost the overall economy. However, where does a situation of a depressed economy leave sub-national government, in this case local government? During these circumstances, local government also has key public services to provide to citizens. Indeed, the demand for such services is likely to increase, as citizens feel the brunt of depressed economic activity. However, like national government, local government taxation and revenue instruments are also likely to be negatively impacted by the state of the overall economy. Potentially falling revenues compromises the ability of municipalities to meet their expenditure obligations and, structurally, can increase the vertical and horizontal fiscal gaps likely inherent in the local government fiscal system. With that said, is the local tax base and are local taxes and revenue instruments equally susceptible to the negative impacts of national recessions? Are local tax revenues relatively more buoyant at times of economic downturns?

Unlike national government, local government cannot (by theoretical and legal design) debt finance expenditures or any deficit that may occur between their expenditure responsibilities and revenues. The implication is that a depressed economy may have a disproportionate impact on the fiscal sustainability of local government, because it does not have access to a toolkit of fiscal instruments to bridge expenditure deficits. Given the central role of local municipalities in providing basic services to households and small businesses, the developmental implications may be severe. If a municipality's only source of revenue is own revenue from property rates and service charges, and economic depression results in fewer customers being able to pay, there is a real risk of a municipal 'death spiral: decreasing own revenue pushes the municipality to increase service charges to fund expenditure. Increased service charges mean fewer people can afford to pay, and revenue declines further.

In theory, intergovernmental fiscal transfers can support local government expenditures at times when local revenues are also constrained. However, and depending on the system of grant design, the quantum of grants accruing to local government is at the overall behest of the national government, and there is no guarantee that any national response will be sufficient. Certainly, in South Africa, the DOR process, as state in the Constitution, explicitly states that the "national interest", "national debt" and "national obligations" needs to be considered in the DOR amongst the spheres of government. At times of economic downturns, national government priorities change and this can potentially compromise the usual distribution and role of intergovernmental fiscal transfers.

Therefore, what is the status of local government revenues and operating circumstances during periods of depressed economic growth or large economic downturns? Do national government and policy makers explicitly determine the impact of depressed economic activity and economic downturns on the vertical and horizontal fiscal gaps? Does the national government protect local government revenues via grants and the overall DOR process through increased national borrowing and can local government grants be used to achieve social and economic goals of the national government during depressed economic activity?

Purpose of this Policy Brief

This policy brief undertakes an analysis of municipal revenues over a 12-year period, covering two major recessions (2008 global financial crisis and the COVID-19 pandemic), its aftermath and a period of constrained economic growth in the country. This period was large recessions, followed by small periods of economic recovery and a general struggle for the economy to reach sustained and acceptable levels of economic growth. The policy brief provides simple trends in key municipal revenue instruments over this period to ascertain potential impacts of depressed economic activity on municipal revenue collection.

Furthermore, the policy brief explores whether there is a systematic change in the nature of intergovernmental fiscal transfers to local government during recessions and/or depressed economic growth. In addition to the constitutional and economic role grants play in South Africa's intergovernmental fiscal system, it is worth assessing whether expansionary fiscal policy, be it via increased social services or capital expenditures, is implemented via increases in local government grants. Also, one needs to ascertain whether the national government and the intergovernmental transfers system assessed and intended to remedy the potential negative impacts of lower levels of economic activity on local government finances. During the period of analysis, the South African government initiated a period of fiscal consolidation, attempting to reel in expenditures towards paying off public debt and consolidating the debt to GDP ratio. This followed a period of expansionary fiscal policy following the 2008 global financial crisis and subsequent recession in 2009. It is important to find out whether this change in fiscal position and priorities of the national government impacted on the nature of the distribution of grants to local government.

It is important to emphasise that the analysis in this policy brief is descriptive and makes observations based on trends and descriptive analysis. This policy brief does not intend to make a formal pronouncement on these issues. The policy brief's primary aim is to promote a narrative on the topic at hand and hopefully encourage further research and interrogation, with more robust data and statistical techniques. By design, this policy brief also implicitly raises the concerns with municipal reporting on key financial data and the maintenance of long-term financial data for trend analysis. There is a sole focus on the revenue side and, thus, no analysis is undertaken on likely pressures placed on municipal expenditures during recessions.

Important Notes on the Data Used in the Policy Brief

The primary source for municipal financial data was the Schedule C information submitted by all municipalities to the National Treasury, which is subsequently collated and made available on the National Treasury website. As per the reporting requirements for the current financial year, municipalities are required to report on the “audited” figures for the previous financial years. However, while these figures are termed as “audited”, the analysis found several extreme examples of reporting inconsistencies, under reporting, clear mistakes in numbers and significant missing data. While some of the missing data for the “audited” numbers were “corrected” with unaudited reported data from the Section 71 reports, there still remained large gaps in the data collected. This is a serious indictment on municipalities and their solemnity in reporting on financial matters. Observations were removed when clearly incorrect or unverifiable data heavily skewed the analysis. Furthermore, number of missing municipalities from the dataset i.e. municipalities that did report and potentially under reported numbers made overall financial analysis difficult. In other words, assessing aggregate variables, such as total municipal revenues, became incomparable over time if data was missing for some years and not others. As a result, all municipal financial data is presented and analysed per municipality, in an attempt to account for the potentially missing municipalities.

The National Treasury should be commended for making the municipal financial data available annually per municipality[1] and further designed an interactive platform for users to access, analyse and download such data[2]. However, of concern and a possible indication of a lack of attention to long-term trend analysis in local government finance, is that the data is not verified or corrected in instances clear mistakes or underreporting. Indeed, if a municipality did not report for a given year, this data will remain missing indefinitely or at least on the platforms mentioned above. This does constrain the ease to which long-term analysis can be done for municipal finances.

Consumer price index (CPI) data for the conversion of nominal values to real values was sourced from Quantec via their EasyData platform. This was available quarterly and was aligned to the municipal financial year i.e. July to June of the subsequent year. This ensured that nominal municipal financial data was deflated based on the pricing pressures of a municipal financial year and not a calendar year. For consolidated values, the CPI for all areas was used as a deflator, while CPI for urban areas was used for financial data for the metropolitan municipalities and secondary cities and the CPI for non-urban areas was used for other non-city municipalities. The CPI used had a base month of December 2021.

1 Available at: http://mfma.treasury.gov.za/Media_Releases/s71/Pages/default.aspx

2 Available at: https://lg.treasury.gov.za/ibi_apps/

An Assessment of Aggregate Municipal Revenues

This first part of the analysis assesses the trends of total municipal operating and capital revenues per municipality from the 2009/10 to the 2021/22 municipal financial years. The real growth in the economy over the period is also presented, using gross domestic product (GDP) [3]. Figure 1 shows the trends in the nominal operating revenues collected and the sources of capital revenue assigned for capital expenditure per municipality respectively. Municipal operating revenues presented here includes revenues from property rates, service charges, a range of local licenses and fees and intergovernmental fiscal transfers intended to support municipal operations. In terms of the latter, revenues from the LES would constitute the largest share of intergovernmental transfers for municipal operating revenues. Finances assigned for capital expenditures, termed as capital revenues, usually includes intergovernmental fiscal transfers to support local infrastructure (capital grants), municipal borrowing and municipal "own" contributions from their operating budget.

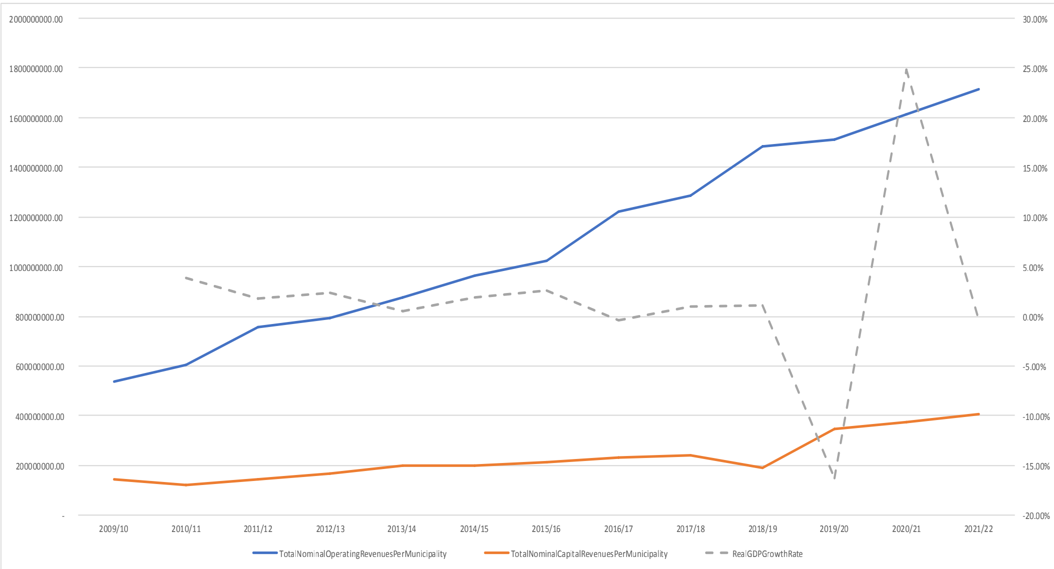

Figure 1: Nominal Operating Revenues and Capital Finance per Municipality and Real the Economic Growth Rate

Source: National Treasury Section 71 Reports and South African Reserve Bank

Figure 1 shows a largely expected upward trend in the operating revenues collected per municipality. Even during a downward trend in economic growth, operating revenues continued to rise on aggregate, in nominal terms. The analysis confirms that there was no significant negative nominal impact on total operating revenues per municipality. With capital revenues per municipality, which is substantially lower than operating revenues, there appears to be less of an obvious upward nominal trend when compared to nominal operating revenues per municipality. Indeed, From the 2013/14 financial year to the 2016/17 financial year, there appears to be a flattening of capital revenue per municipality and further corresponding with a downward trend in the economy. The more apparent changes in the capital revenue per a municipality from 2018/19 onwards is likely

3 Quarterly GDP data was aligned to municipal financial years to offer a better perspective of the actual state of the economy during a full municipal financial year of revenue collection. The GDP data was also deflated using CPI for a municipal financial year. The GDP data was sourced from the South African Reserve Bank at https://www.resbank.co.za/en/home/what-we-do/statistics/releases/economic-and-financial-data-for-south-africa

due to issues around data accuracy and potential under or over reporting[4].

Given the trends in nominal revenues, Figure 2 looks at the real growth in both operating and capital revenues per municipality and compares this to the growth rate of the economy and the growth in real revenues collected by national government.

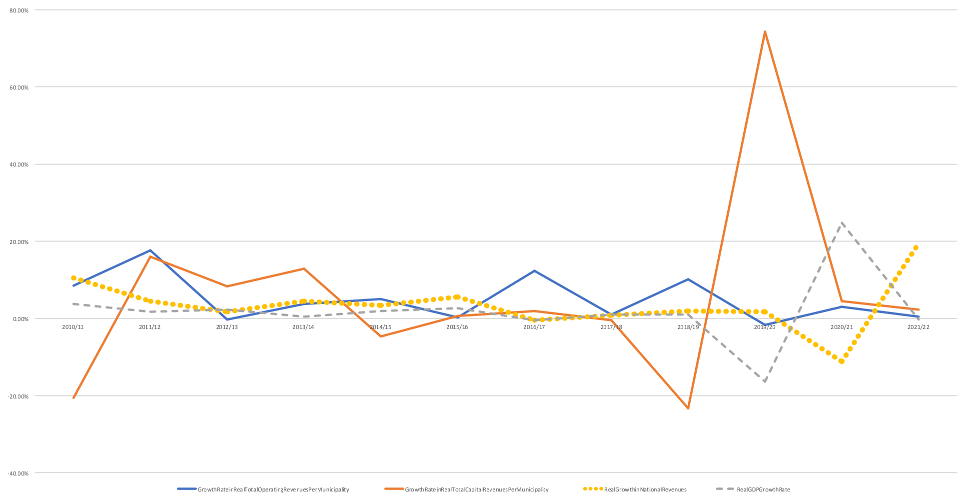

Figure 2: Growth in Real Operating and Capital Finance per Municipality, National Revenues Collected and Economic Growth

Source: National Treasury Section 71 Reports, National Budget Review and South African Reserve Bank (NB: National revenues are presented in national fiscal years)

Figure 2 seems to show an inverse correlation between the real growth rate of GDP and both that of national revenues and municipal operating revenues. In other words, revenues collected for both these sources increase when economic growth is on a decline and vice verse. This can suggest a lag in terms of the impact of changing economic circumstances and the impact on revenues. In other words, an economic downturn in one year tends to impact on revenues in the subsequent year. However, this assertion, based solely on the trends in Figure 2, is more likely applicable to municipal operating revenues as opposed to national revenues, as the latter's collection remains aligned to the national fiscal year and was not adjusted to the municipal fiscal year. Taking this into account, one would assume a more immediate adjustment of national revenues collected with economic downturns, given the nature of the tax bases for national taxes.

The real growth rates of both GDP and national tax revenues seem to be closer in value, while deviations in the real growth of municipal operating expenditures are quite stark. This can suggest that municipal operating revenues are more sensitive to changes in the economy, as opposed to national revenues. The potentially higher sensitivity of municipal operating revenues is quite surprising, as one would assume that local tax bases are relatively more diverse, with some being more susceptible to macroeconomic downturns than others. However, this could suggest that individuals under economic pressures are likely to adjust their demand downwards for municipal services or are unable to pay for such services, which will have an impact on operating revenues. Given the nature of municipal services i.e. key basic services that most households require to

4 The data collected for the 2018/19 and the 2019/20 financial years from the Schedule C reporting framework showed various inconsistent trends for most financial line items. This has led to the conclusion of likely incorrect reporting from municipalities during these periods. Ideally, one would have liked to verify the data with actual municipal annual financial reports, but the nature of this brief did not allow for detailed data verification.

meet their basic needs, it is likely that the falling revenues from the delivery of these services will manifest in non-payment for services used.

The extreme decline in real economic growth in 2019/20 and subsequent increase the following year was the economy's adjustment in the face of the COVID-19 pandemic and subsequent national lock down. The COVID-19 pandemic, as expected, had a huge impact on the national economy. However, from Figure 2, the impact of the pandemic and lockdown did not have as massive impact on municipal operating revenues collected, especially when compared to national revenues. There was a subsequent decline in real operating revenue collections in 2019/20, but not as stark as the impact on national revenues. This finding is contrary to the argument made in the previous paragraph that suggested that changes in macroeconomic activity tended to see large deviations in the real increase in municipal operating revenues. These two observations, analysed simultaneously, can suggest that municipal operating revenue collected are more resilient in extreme shifts of economic activities, such as recessions.

There does not seem to be an obvious trend in the real growth rate of total municipal capital financing per municipality and real economic growth. However, before analysing the trends in capital revenues, it is important to emphasise that capital finances are not "collected" directly from local taxpayers but are rather institutional decisions taken by the municipality on the nature and amount of funding allocated for capital spending in a given year. It is also determined by the amount of conditional grants a municipality receives from national government to support infrastructure for a given year. The key "municipal" sources for capital spending are municipal borrowing and "own revenue contributions". The latter are surplus funds generated on the operating budget, usually from profits in trading services but also determined via the municipal revenue fund. Therefore, municipal capital revenues could be determined by several factors, including the capital plans a municipality may have for the year and the availability of funds via own surpluses or intergovernmental fiscal transfers. In terms of the former, a greater demand for new infrastructure or a need to refurbish existing infrastructure can increase the capital budget. On the other hand, economic downturns and pressures on the operating revenues can also result in lower amounts of funding being allocated towards capital revenues.

With that said, there was a relatively large growth in real capital financing per municipality between 2011/12 and 2013/14, which does not seem to be correlated with the real growth in the economy or the real growth in the operating revenues per municipality. This can suggest that the increase in the capital spend could have been driven by conditional grants, as declining revenues on the operating budget compromises surpluses and the ability to borrow to fund capital expenditures. There is a decline in the real growth of capital finances per municipality from 2013/14 onwards, including a negative real growth in 2014/15. This could be due to a combination of lower infrastructure grants accruing to municipalities, due possibly to national government moving towards fiscal consolidation, and a lack of surpluses on the operating budget. The trends from 2018/19 onwards suggest issues with the data as opposed to extreme declines and increases in real capital revenues. This trend was presented here for illustrative purposes to highlight to the reader potential issues with the data, as reported by municipalities. However, future analysis will remove such trends under this qualification to ensure that the analysis remains meaningful.

This analysis suggests that municipal operating revenues are impacted by downwards trends in the economy, with a potential lag. It is now important to identify the key source of this influence i.e. if it is all or a few sources of operating revenues.

An Assessment of Operating Revenues

This section disaggregates municipal operating revenues by assessing the trends in the two main operating revenue instruments assigned to municipalities, namely, property rates revenues and revenues from service charges.[5]

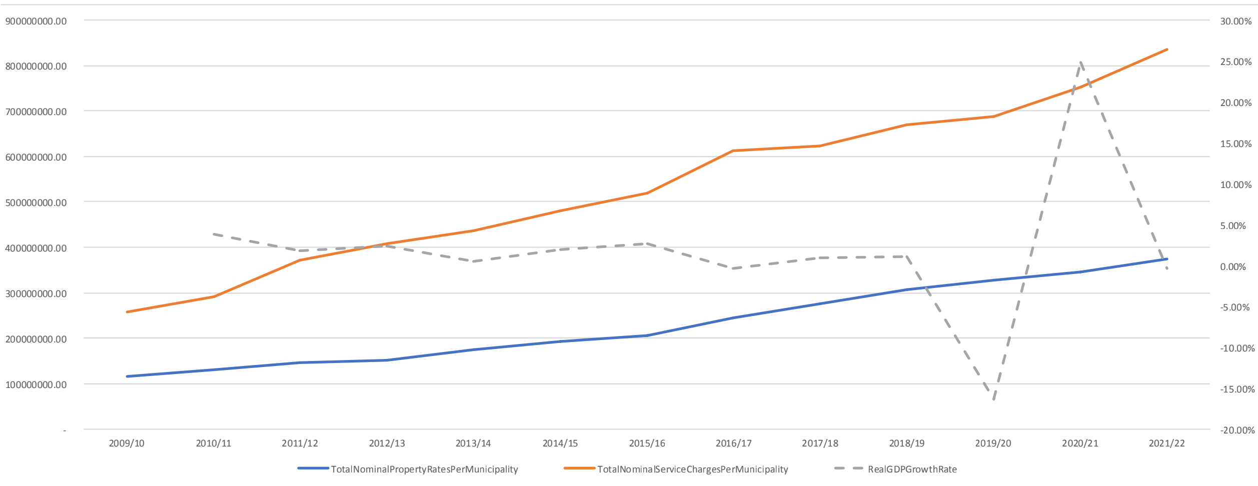

Figure 3: Nominal Property Rates and Service Charges Collected per Municipality and Real the Economic Growth Rate

Source: National Treasury Section 71 Reports and South African Reserve Bank

Note: Only municipalities that collect property rates were considered in the per municipal calculation

Given the trend in overall operating revenues collected per municipality in Figure 1, one would also expect a similar trend for nominal property rates and service charges revenues collected over the same period. Figure 3 shows a general upward trend with both revenue sources, with certain periods of sharp increases and decreases. There does appear to be some deviations in revenues collected from both sources with changes in the overall economy, but such deviations are better assessed in Figure 4, which shows the real growth rate in property rates and services charges collected per municipality. It is important to accentuate that municipal revenue collections are impacted by various factors, including municipal ability to accurately bill and collect revenues. Such factors can change over a period of time. Therefore, while the analysis shows overall trends of revenue collected with economic activity, this is not a controlled correlation.

5 It is important to clarify here that the Constitution assigns the ability for municipalities to apply surcharges on the tariffs charged to consumers for municipal services rendered. This, theoretically, would constitutes a significant tax power assigned to local government, while the crux of the revenue from the tariff itself should be aimed towards cost recovery in delivering the service. However, most, if not all, municipalities in the country do not explicitly apply or state a surcharge amount on municipal bills, but rather generate surplus revenues through profits generated directly via the tariff. This is not the ideal application of surcharges and the provisions of the Municipal Fiscal Powers and Functions Act (MFPFA) aims to remedy this behaviour.

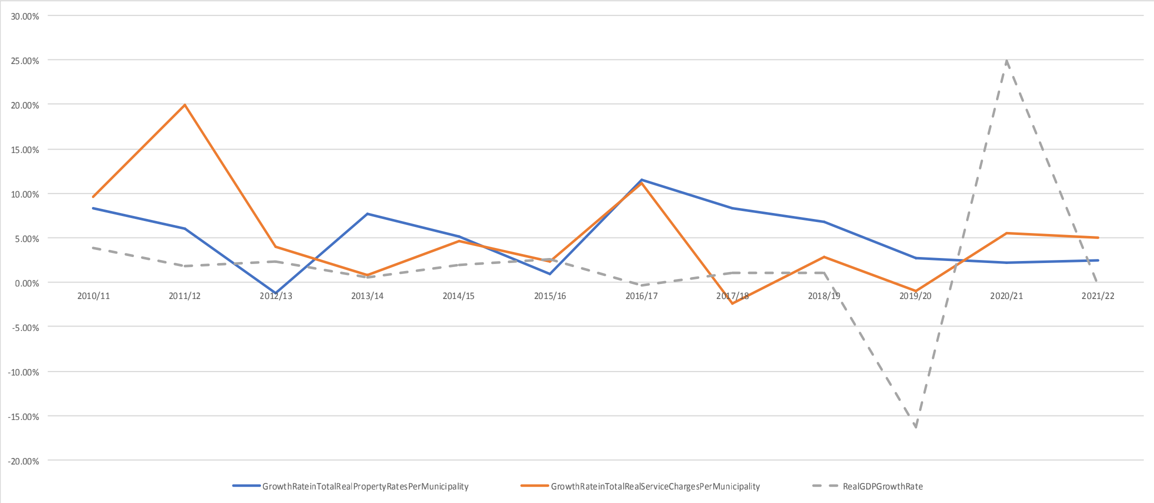

Figure 4: Growth in Real Property Rates and Service Charges Collected per Municipality and Economic Growth

Source: National Treasury Section 71 Reports and South African Reserve Bank

Note: Only municipalities that collect property rates were considered in the per municipal calculation

Figure 4 shows some rather erratic movements in the real growth of property rates and service charges revenue collections across the period. The trends suggest that service charges are relatively more sensitive to economic downturns, as opposed to property rates. This is likely due to the respective bases of these revenue sources. Property rates is considered a wealth tax, thus suggesting that the crux of the revenues is collected from middle to higher income households. On the other hand, basic services are used across the income spectrum. Therefore, lower income households that are more susceptible to economic downturns would likely be unable to pay for municipal services, but were either not contributing at all to property rates revenues or, at best, very little. Middle income households would be better placed to adjust consumption levels of municipal services, thus potentially paying less for services, but would likely continue to pay property rates.

Following the 2009/10 downturn in the economy, there was a gradual declining trend in the real growth of property rates revenues collected per municipality. This can suggest the gradual filtering of the impacts of the economic recession in society and local economies. Prior to the COVID-19 pandemic, both revenue sources showed relatively positive real growth over the period, even though real growth in the national economy was relatively modest. It is important to note that revenues from service charges are also impacted by the cost of delivering these services. Higher tariffs can impact on the ability of households and businesses to pay for such services. The increasing cost of electricity over this period could have also impacted on revenue collections from service charges.

A notable observation is the relative resilience of property rates revenues during the COVID-19 pandemic and subsequent economic decline. It is likely that this revenue source played a key role in protecting municipal finances during this time. Further work to investigate this trend would be required and whether property rates revenues are indeed resilient during extreme economic swings. With that said, property rates are considered a wealth tax. As such, one would expect relative buoyancy during economic downturns, as the crux of the tax base should be able better placed to adjust during tough economic times. There households are also likely to have more savings to maintain their expenditures and taxation obligations during economic downturns.

An Assessment of the Sources of Capital Financing

The sources of capital funds are essentially how municipal capital expenditures are financed. This is usually done through own municipal contributions, borrowing and infrastructure grants. Funding for capital expenditures is complex, as it is largely driven by the need for infrastructure and infrastructure plans of a municipality. For example, before entering the credit market, a municipality needs to ensure a proper repayment plan for such debt and whether the municipality can recoup the cost of borrowing from the potential investment. Own revenue contributions to capital financing depend on the health of the operating account and whether sufficient surpluses are generated from trading services. Notwithstanding these complexities and institutional decisions regarding a municipal capital outlay, periods of constrained revenues would likely see less own revenues being allocated to capital outlays, while the risk of borrowing also increases during times of financial stress. This analysis assesses own revenue contributions and borrowing patterns over the period of analysis.

Figure 5 shows the nominal own revenue and borrowing contributions per municipality towards its capital outlays, compared to the real economic growth rate over the period. One can clearly see a rather stagnant trend in the own revenue and borrowing contributions towards capital outlays over the period. Comparing this trend with the analysis in Figure 2 and Figure 3, one can conclude that the increases in capital outlays in the early period of analysis (2009/10 – 2012/13), are largely driven by increased intergovernmental transfers for capital expenditures. As mentioned previously, the trends in capital financing from 2018 onwards, particularly for own contributions, depicted unrealistic trends and are likely due to incorrect reporting over the period. Therefore, these years will not be analysed.

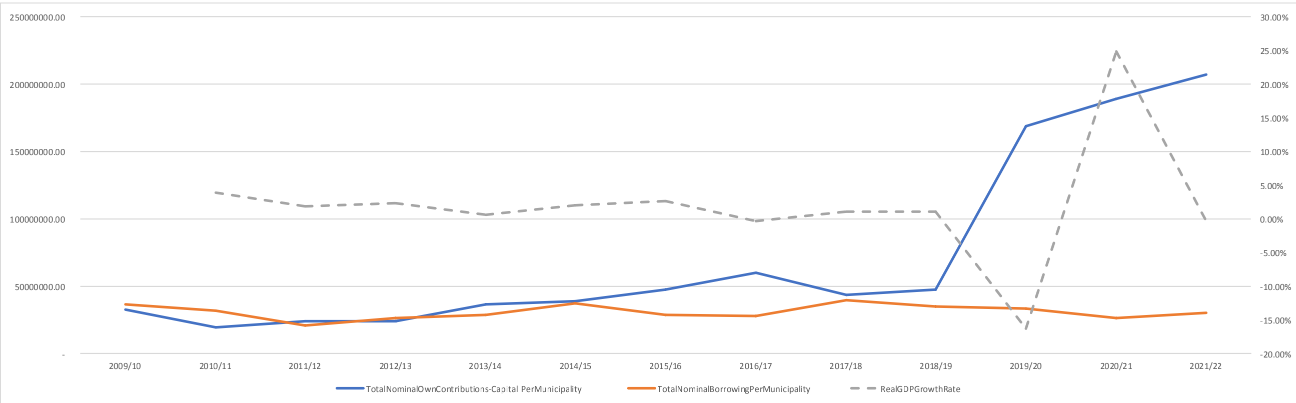

Figure 5: Nominal Own Contributions and Borrowing for Capital Expenditures per Municipality and Real the Economic Growth Rate

Source: National Treasury Section 71 Reports and South African Reserve Bank

Note: Data for periods after 2018/19 are likely inaccurate due to poor reporting

Figure 6 shows the growth in real own revenue and borrowing contributions to capital outlays. The trends here are rather erratic and it is difficult to determine whether such trends are due to poor reporting on the part of municipalities or actually poor planning and implementation of their capital budgets. One needs to undertake further analysis in this regard.

Figure 6: Growth in Real Own Contributions and Borrowing for Capital Expenditures per Municipality and Economic Growth

Source: National Treasury Section 71 Reports and South African Reserve Bank

Note: 2019/20 intentionally omitted

An Assessment of Intergovernmental Fiscal Transfers[6]

This part of the analysis shows the trends in intergovernmental fiscal transfers for operating and capital expenditures made to local government during the period of analysis. This part of the analysis is important, particularly from the perspective of how the fiscal position of the national government, in a unitary state, can have a potential impact on the policy and financing decisions with regards to the funding and role of local government during a recession or generally depressed economic activity. As alluded to in the introduction, the fiscal stance of the national government over most of this period was one of consolidation to rein in debt levels that were incurred during the expansionary fiscal policy adopted after the 2008 Global Financial Crisis[7]. The austerity measures and reprioritisation of expenditures that can characterise fiscal consolidation can have an impact on the quantum of grants allocated to local governments. Fiscal consolidation can lead to lower growth in intergovernmental transfers, which can have an impact on municipal finances. While the discussions above did suggest a level of resilience of local revenue sources in economic downturns and times of lower then usual economic growth, the analysis also showed that municipal own revenue contributions and borrowings towards capital expenditures can could become erratic.

Furthermore, during periods of expansionary fiscal policy, as was the initial case following the Global Financial Crisis, it is interesting to ascertain local government's role in such national macroeconomic policy. National government can finance their expenditures through debt. As a result, national revenues can be used to protect municipal finances during periods of economic slowdowns by increasing support to municipalities via an increase in grants, particularly grants that

6 It is important to point out that the data on "transfers recognised – operating" and "transfers recognised – capital" were sourced from the Schedule C reporting format, as reported by municipalities as "audited" figures. The data was not taken directly from the grant allocation schedules in the Division of Revenue Bill. The primary reason for this approach is due to municipalities not necessarily spending their initial allocations, so actual grant spending, as reported by municipalities, illustrates both national decisions towards grant allocations during a tight fiscal framework and municipal abilities to spend grants. However, this approach assumes the correct reporting by municipalities, which is likely not the case.

7 It is acknowledged that this is just one interpretation of the fiscal policy events over the period.

fund municipal operations, such as the LES. Expansionary fiscal policy can also be implemented through the spending of local government, either through an increase in expenditure on social and basic services and/or an increase in municipal capital expenditures to potentially stimulate the economy during depressed economic activity. This could be done by the national government via the intergovernmental transfer framework.

South Africa's intergovernmental transfer framework consists of a combination of unconditional and conditional grants, with the latter having relatively more stringent terms and conditions for it's spending. Both unconditional and conditional grants can be for either operating or capital expenditures, but grants for capital expenditures are usually conditional. The largest unconditional grant for operating expenditure is the LES, but there are also conditional grants that are used for operations, such as the municipal finance management grant. An important point worth accentuating at this point is the nature of conditional grants. There is a general misconception that conditional grants, particularly for infrastructure, are an entitlement to municipalities or forms part of local government's share of the fiscus. Conditional grants from national government to local government forms part of the national equitable share. In other words, these allocations would technically constitute national government expenditure for national priorities, but spent on behalf of national government by local government. This is an important distinction, especially in the context of this policy brief, as conditional grants to local government with constitute national expenditures and thus a potential instrument for its fiscal policy initiatives.

Figure 7 shows the trends in operating and capital grants per municipality in nominal terms, compared to the real growth rate in the national economy. The trend in the grant allocations suggests periods of nominal increases and decreases in both operating and capital grants. Operating grants tends to be higher in absolute terms and seems to have exhibited greater growth over the period. A detailed assessment of the real growth in both operating and capital grants per municipality is shown in Figure 8.

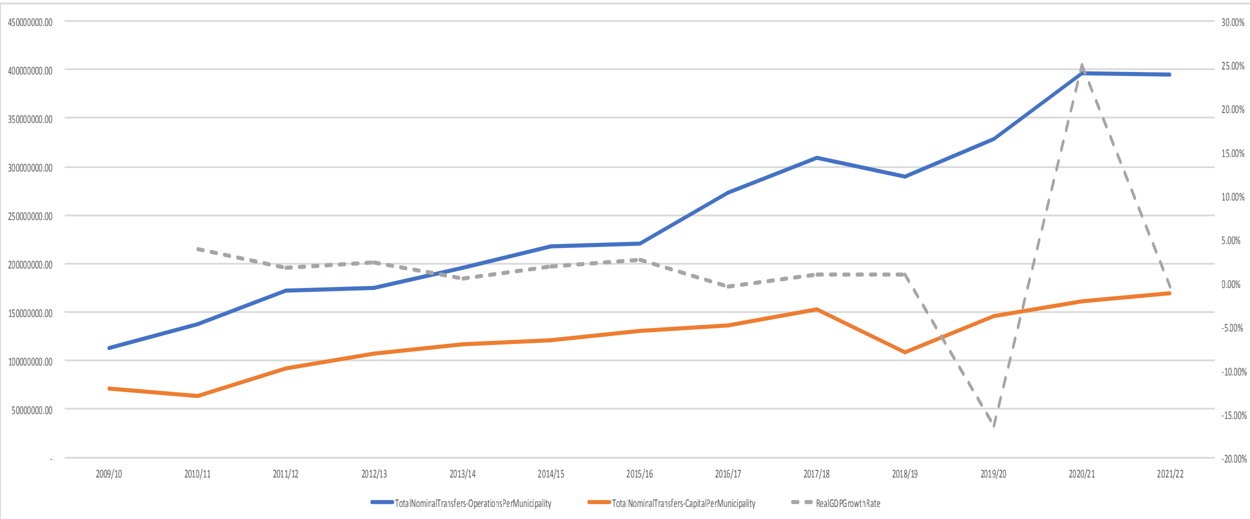

Figure 7: Nominal Operating and Capital Grants per Municipality and Real the Economic Growth Rate

Source: National Treasury Section 71 Reports and South African Reserve Bank

Figure 8 shows the growth in real operating and capital grants per municipality, compared to the growth in real national government expenditures and real economic growth. The inclusion of the growth in real national expenditures attempts to show the state of fiscal policy over the period i.e. points of expenditure expansion and contraction. It can also show whether the consequent changes in national expenditures impacted on the growth in real grant allocations to local government.

The trends in Figure 8 confirm the erratic real growth of both operating and capital grants over the period, as suggested in Figure 7. In the early years of the period under analysis, when the countercyclical stance of the national government resulted in relatively greater real growth in national expenditures (around 4% in real terms), there were relatively high real increases in both operating and capital grants being allocated to and spent by local government. This does suggest that the fiscal stance at the time with relatively higher real growth in national expenditure did filter through to local government as well, through greater need for municipal service delivery related expenditures and capital investments.

However, real growth in grants to municipalities declined considerably from 2013, when the fiscal consolidation efforts were introduced. This is also shown with lower real growth in the national expenditures as well. There was negative real growth in operating grants allocated to local government in 2012/13 and 2015/16 and negative real growth in capital grants in 2014/15 and 2016/17. These trends does suggest that local government also felt the brunt of the national fiscal consolidation efforts in the form of declining real values of grants being allocated. Indeed, if one has to compare the analysis in Figure 8 with that of Figure 2, Figure 4 and Figure 6, one can argue that the declines in real operating and capital revenues per municipality over the period was largely due to real declines in transfers to municipalities.

The analysis above brings into question the role of local government during times of changes in fiscal strategies. Further analysis is required to compare the growth of allocations to local government and allocations to other expenditure items to ascertain whether it was a relatively uniform decrease in expenditures or whether some sectors bore the greater brunt of budget cuts. With that said, local government is notorious for poor expenditure and revenue outcome, driven by significant capacity constraints across several municipalities. This could be a factor in the reprioritisation of nationally raised revenues to sectors of potentially greater efficiencies and impacts, as opposed to sectors that are constrained.

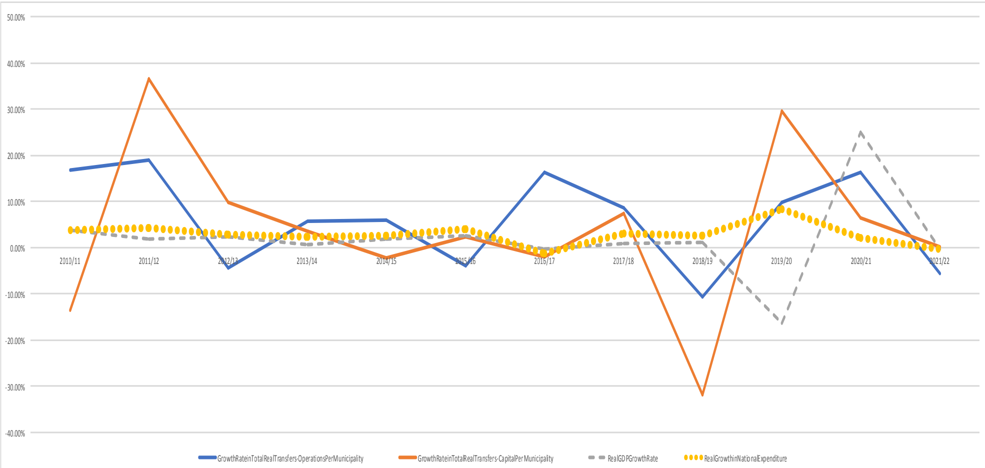

Figure 8: Growth in Real Operating and Capital Grants per Municipality, National Expenditures and Economic Growth

Source: National Treasury Section 71 Reports, National Budget Reviews and South African Reserve Bank

Note: National expenditures are presented in national financial years

Asymmetric Impacts Across Regions

One of the key aspects of assessing the impacts of the macro economy, fiscal policy and economic downturns on local government is an anecdotal notion that such impacts are likely felt different across municipalities. Municipalities operate in very different local contexts, ranging from urban metropolitan areas, characterised by dense settlements and a diversified local economy, to rural municipalities that are sparsely populated with limited economic activity dominated by fewer activities. As a result, the expenditure responsibilities and revenue potentials differ greatly across the municipal spectrum. This structural configuration across local government is also the source of horizontal fiscal gaps due to the varying revenue potential across different municipalities. The LES, by its design, attempts to account for the varying revenue potential across different municipalities towards its attempt to limit horizontal fiscal gaps in local government.

Notwithstanding the myriad of analytical issues associated with a heterogeneous local government sphere, for the purposes of this policy brief, it is important to assess whether downturns or upswings in the general economy is felt asymmetrical across the different regions and types of municipalities. Figure 9 shows the growth in real gross value added (GVA) in metropolitan, non-metropolitan areas and in the country as a whole over the period of analysis. One can see that the real growth in GVA for both the metro and non-metro areas tends to follow that of the national GVA growth rate. However, this visual correlation is more pronounced between real GVA growth in the metropolitan areas and the national economy. From 2011 to 2012, there was a downturn in the economy; however, this downturn was felt relatively greater in the non-metro (semi-urban and rural) areas. In this year, there was a zero real growth in the economy, while the overall economy and the economies of metropolitan areas saw a positive, albeit small, real growth. Even with the economic upturn in the subsequent year, the non-urban areas still experienced lower real growth rates than the metro areas and the national economy. While the trends in the metropolitan economies greater mirror that of the national economy, the same cannot be said about the non-metro economy. Given this relationship, it appears that metropolitan areas tend to bear the greater brunt large economic downturns, as depicted in 2020 with the COVID-19 pandemic.

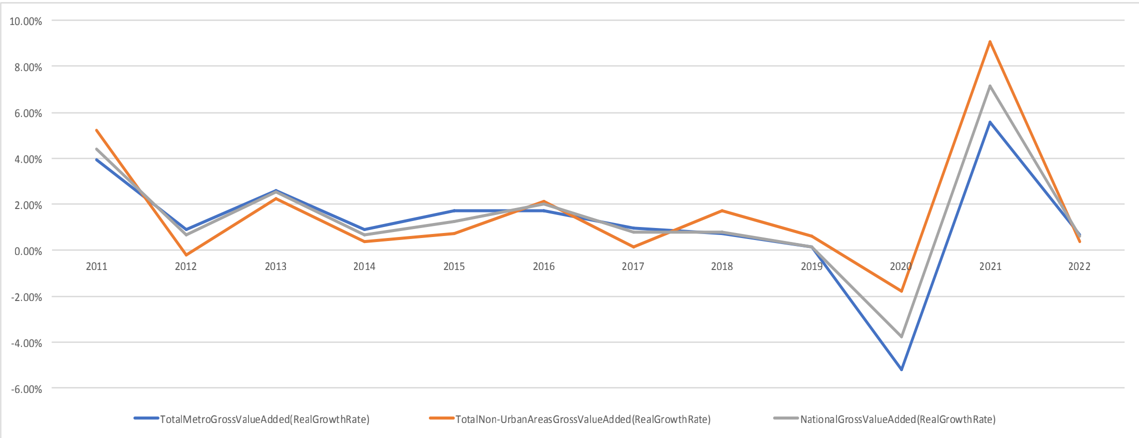

Figure 9: Growth in Real Gross Value Added in Metropolitan and Non-Metropolitan Areas

Source: Quantec

NB: Data in calendar years

Note: Data aligned to 2016 municipal demarcations across the period

Figure 10 shows the growth in the number of people considered poor in metropolitan and non-metropolitan areas, as measured by Statistic South Africa's upper bound poverty line, over the period of analysis. Over the period, there has been a consistent increase in the number of people living in poverty across the country, with the metropolitan areas exhibited the highest increases. While Figure 9 suggests that metropolitan areas tend to grow faster than non-metropolitan areas, Figure 10 shows a greater growth in poverty levels in the former areas. This could be driven by greater migration of less affluent individuals from non-metropolitan areas to metros seeking employment at times of dire economic circumstances.

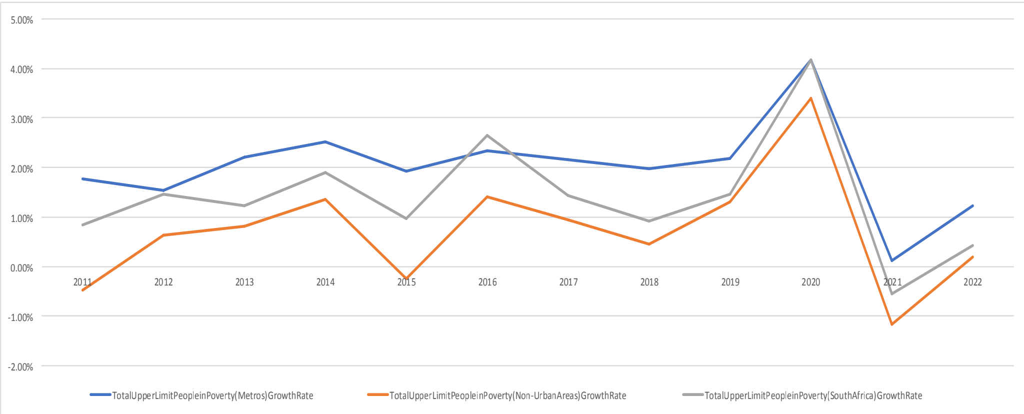

Figure 10: Growth in Number of Individuals in Poverty (Upper Bound Poverty Line) in Metropolitan and Non-Metropolitan Areas

Source: Quantec

NB: Data in calendar years; Note: Data aligned to 2016 municipal demarcations across the period

The analysis in Figure 9 and Figure 10 confirms a complex relationship between the general economy and the social, demographic and economic dynamics at the local government sphere. Changes in general economic conditions are felt differently across the country, thus having a profound impact on the municipalities operating in these different contexts. Some municipalities may see an increase in their fiscal gaps during an economic downturn while others may not. It is very difficult for a fiscal framework to be sensitive to such dynamics, but it is important that such impacts are researched and analysed. Other factors like the increase in poverty and migration further exacerbates these complexities. As the local government system matures, it is important for these factors to make their way into the determination of the local government fiscal framework.

Conclusions

This policy brief assessed the trends in local government revenues during depressed economic activity, a national fiscal policy stance of fiscal consolidation and two major recessions that characterised the period from the 2009/10 to the 2021/22. The intent was to start a dialogue on the impact of general macroeconomic circumstances on local government finances and whether the local government fiscal framework was sensitive to such dynamics. There is a general lack of attention given to local government at times of economic downturns, lower than expected economic growth and a constrained national fiscus and how these factors can impact municipalities. This policy brief presented simple trend analysis to look at the behaviour of key municipal revenue sources over the period. While acknowledging the simplicity of trend and descriptive analysis in making profound ascertains, the analysis can suggest the following:

i. Local revenue sources, in the form of property rates and services charges, are likely impacted by economic downturns and generally depressed economic activities
ii. Such revenue sources tend to depict a certain level of resilience to such downturns i.e. while revenues do fall; it is not as profound, particularly in extreme economic downturns.
iii. Municipal capital financing over the period was erratic, suggesting that general financing pressures compromises capital outlays in local government.
iv. Allocations to local government were definitely impacted by the fiscal consolidation stance of the national government with low levels of real growth in transfers over the period.
v. It is unclear whether the state of local government finances and the role of grants in the local government fiscal framework are considered when national government makes pronouncements on fiscal policy.
vi. The analysis suggested that the impact of changes in the economy is felt different across different municipalities, depending in their local contexts. Further disaggregated analysis is required to see how the revenues of different types of municipalities perform over periods of constrained or declining economic growth.

The policy brief makes the following suggestions:

i. The analysis of vertical and horizontal fiscal gaps is a complex exercise and fiscal frameworks that intend to minimise such gaps needs to be aware of the potential impacts of short-term economic downturns on municipal expenditure and revenues.
ii. National government needs to have a strategy for local government when determining its fiscal policy stance. This includes instances of expansionary fiscal policy or fiscal consolidation.
iii. It is clear that greater research is required to ascertain the impacts of a constrained national fiscus, recessions and constrained macroeconomic growth on local government. More robust statistical analysis and further data collation and verification will assist in this regard.
iv. National Treasury needs to ensure that accurate and verified municipal data is available over substantial financial years to assist in trend or time series analysis. Simply posting data, as reported by municipalities, can hinder accurate analysis over cetain periods. Efforts should be made to address missing data, even after the reporting period has ended, to ensure credibility of the data and assist in long term analysis.

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