

FIRST DRAFT

Institutional and Fiscal Challenges in responding to urbanisation in South Africa Contribution to the Integrated Urban Development Framework

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1. Introduction

Urbanisation poses complex institutional and fiscal challenges for urban areas across South Africa.

The dynamics of urbanisation will have widely varying impacts in different parts of the country, as some areas experience rapid population and economic growth, others stagnation or decline. Still others may face population growth without economic growth, or forms of growth that do not produce employment opportunities. Moreover, these trends are unlikely to be linear, predictable or determine the destiny of an area.

The response to complex demographic and economic trends presents a challenge for the management of urbanisation. Growth projections cannot be translated simply into requirements for infrastructure investment as they must take account of availability and condition of existing infrastructure assets at a local level. The amount of surplus bulk infrastructure capacity that is available, the age and condition of assets, the nature of projected service demand, and the resources available to finance investments must all be factored into a response to economic and demographic changes. Bad choices can leave expensive infrastructure under- or over-utilised and municipalities with an unsustainable fiscal burden. Good choices can unlock a virtuous cycle of growth.

The sustainable management of urbanisation is inseparable from the need to strengthen the institutional and fiscal capacity of municipalities. Urbanisation cannot be managed simply through centralised programmes of investment in urban infrastructure. A greater degree of “policy agility” is required to respond to changing conditions and demands – often moving in different directions or at different speeds in even adjacent local areas. Local governments must play a central role in managing public sector responses to urbanisation in South Africa. In order for them to effectively assume this role their accountability for the management and financing of investment in the urban built environment, in particular, needs to be significantly strengthened. Current institutional arrangements are distorting this accountability, and supporting the perpetuation of inefficient, inequitable and unsustainable growth patterns that lie at the heart of the “spatial paradox” confronting South African cities.

This paper has been prepared as a contribution to the preparation of an Integrated Urban Development Framework (IUDF) for South Africa. It focusses on the institutional and fiscal challenges associated with urbanisation in South Africa. The primary contributions of this report are to provide a conceptual framework for understanding dysfunctions in the current institutional framework for urban management, and to recommend specific policy options to address them. The paper does draw largely on existing analysis and data sources, alongside limited supplementary research that was commissioned to better understand the nature of the fiscal challenges facing South African cities.

¹ With the assistance of Nick Graham and Roland Hunter. All conclusions are my own.

2. Public policy and urban development dynamics²

A range of public policy affects urban areas and shapes the de factor policy response to urbanisation. Economic policy positions, such as the New Growth Path and the Industrial Policy Action Plan impact on the location, investment and timing decisions of people and firms. Micro-economic policies, such as administered prices or local content requirements for public procurement, impact on input costs for firms, labour markets and cost-pressures on households. Social policy instruments, such as social safety nets, education and health policies, and policies on housing finance and household savings, all impact on urban management. Finally, more traditional urban management policies affect land availability and use, public infrastructure availability, housing markets and urban transport systems. Coordinating this array of public policy instruments to produce positive urban development outcomes has been a central concern of the system of intergovernmental relations in South Africa for some time. Notwithstanding this complexity, there are two important areas of policy consensus:

Firstly, public institutions³ for urban management “matter” – they are important for the effective management of urbanisation. This has been recognised since 1994, albeit not always coherently, in the significant efforts to strengthen local-level governance through the fundamental overhaul of municipal boundaries, structures, systems and financial arrangements. It is reflected in the ongoing efforts to assign core functions in the management of the urban built environment to municipalities, including the management of spatial planning and land use, human settlements and infrastructure services, and public transport. The basis for these reforms has been the perceived greater responsiveness of local government to variations in local needs and demands, including their greater agility in responding to changing local circumstances. Municipalities have been assigned - although incompletely – a significant set of policy levers to respond to urbanisation. These include powers in land use management, responsibilities in local infrastructure service provision, expanding responsibilities in housing and public transport services, and a range of local revenue sources to finance these activities.

Secondly, public policy has tended to reinforce rather than alter the current inefficient, exclusionary and unsustainable patterns, dynamics and logics of urban growth. The underlying “logic” of public policy is based on a bi-furcation between “economic” and “subsidised” models of urban development, both of which have promoted powerful “centripetal” incentives for segregated, lower density, spatially peripheral development.

In the “economic” model, today’s infrastructure investment programmes are financed through the proceeds of future urban growth. This relies on consumers (households and firms) paying for infrastructure and services they receive. Municipalities bring forward (“time-shift”) the availability of resources they need to build infrastructure through using infrastructure financing instruments, such as long-term borrowings (repaid through annual operating surpluses) and upfront infrastructure development charges (that transfer financing costs to property owners). The model promotes the physical growth of urban areas in order to expand the number of new users participating in infrastructure networks, and thus lowering average unit costs. The primary criticisms of this model are that it provides a windfall benefit to new users who do not pay the full, long run marginal cost of their participation, and de-emphasizes the renewal of existing infrastructure assets.

²The dynamics of growth, stagnation and decline are well articulated in other papers in this series, and not repeated here. The broad diversity of urbanisation contexts make generalisations on challenges and policy responses problematic. Yet a degree of aggregation is possible at a systemic level.

³Defined as the set of rules, procedures, organisations, relationships and incentives that shape the way policy responses will be framed and acted upon. This includes all spheres of government, the private sector and households, and is not limited to formal organisations or stated policy intentions.

The economic model assumes that all new users are able to afford these costs, which is clearly not the case in South African cities⁴. Post-1994, the financial model was supplemented by a “subsidised” model of urban development, through the introduction of a series of national transfers to poor households (housing subsidies) and municipalities (infrastructure and operating grants) with the objective of addressing “backlogs” in access to housing and basic services. The focus on rapidly access to housing and services tended to emphasize low unit costs, which generally translated into the large-scale development of peripheral agricultural land within the same spatial logic of apartheid. This social package did little to create a sustainable basis for urban growth, as without economic opportunities poor households required ongoing operating subsidies to sustain their access to services. Moreover, the responsibility for financing eventual infrastructure renewal was left undefined.

3. The fiscal implications of urban growth

3.1 Trends in municipal finance

The financial strength of the major urban municipalities has improved since 2008, though significant challenges remain. Monitoring conducted by the National Treasury shows a significant decrease in operating deficits (amounting to a surplus of R2.3 billion in metropolitan municipalities), an increase in cash held, an increase in cash coverage from 1.8 to 2.5 months, the stabilisation of revenue collection rates (average 92.5 per cent), and a decrease in employee remuneration costs.

The primary underlying reason for the overall improvement in city financial strength appears to be the increased margins and cash flows that city governments have managed to obtain from their electricity distribution services. However, city governments face medium and long term fiscal constraints and risks in relation to operating efficiency, affordability of taxes and tariffs and fiscal challenges associated with the energy transition.

Real city government expenditures have grown at a compounding annual rate of 6.8% in real terms, reaching almost R145 billion in 2012. The nine largest municipal governments in South Africa spent a total of R934 billion rand over the eight financial years to June 2012. The growth in expenditures has outstripped economic and household population growth, with grew by around 16% and 4% respectively, between 2009 and 2012.

Table 1: Aggregate City Expenditure By Category (R billions)

	2005	2006	2007	2008	2009	2010	2011	2012
Remuneration	23.0	23.2	25.1	25.1	27.5	31.1	32.1	34.6
Bulk purchases	20.3	20.3	21.2	20.6	24.4	29.4	34.4	40.8
Other expenditure	35.4	36.7	37.1	40.5	44.6	49.6	48.5	49.8
Capital expenditure	12.2	13.9	16.0	23.4	29.4	26.5	18.1	19.3
TOTAL 9 CITIES	90.9	94.1	99.4	109.5	125.9	136.5	133.0	144.5

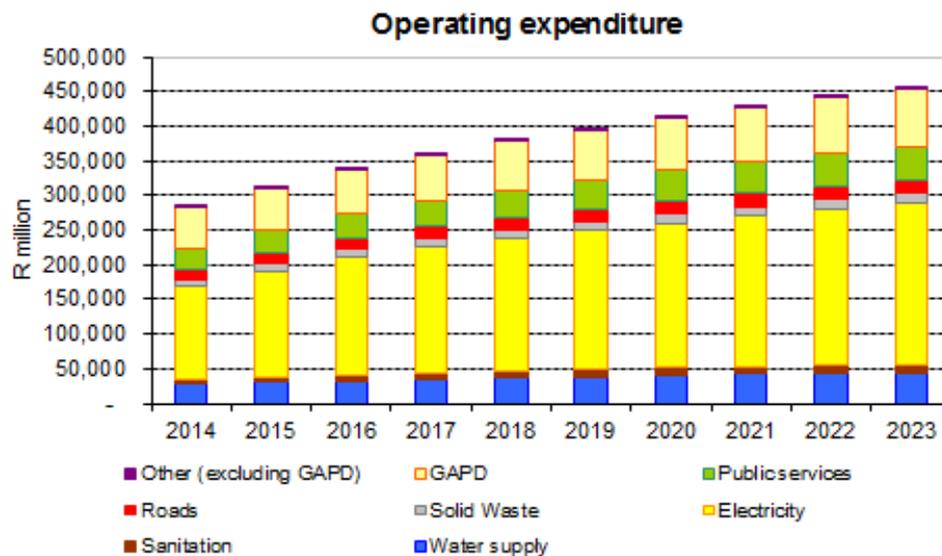
The fundamental drivers of city spending increases, especially since 2008, have been:

- a) *Bulk purchases:* Since 2008 aggregate city spending on bulk purchases has grown at a 21% compounding annual rate. In real terms, aggregate spending on bulk purchases rose slowly from

⁴Under apartheid, this problem was addressed through “influx control” (limiting the number of new, poor users), racially skewed resource distribution and, at the margin, through localised cross-subsidies in the form of Regional Services Council levies (a dual tax on business payroll and turnover). The constraints of localised redistribution effectively limited the scale of resources available to provide subsidised infrastructure.

2005 - 2008, probably reflecting the much more slowly increasing consumption as a result of demographic and economic growth. It then increased dramatically, to R223 billion in 2009 and to R40.8 billion in 2012. This trend is projected to continue, with projections over the next 10 years demonstrating the growing significance of electricity bulk purchase cost in particular; and

Figure 1: Project operating expenditures for metropolitan municipalities



b) *Employee-related costs*: Extraordinary real increases in bulk service charges masked the real increases in expenditure on employees, which were only slightly less dramatic. In 2012 the nine city governments spent a total of R34.6 billion on employee costs (81% more than in 2005 and 48% more than 2008). Aggregate real city spending on employee costs has been increasing at over 10% per year since 2008. The salary bill has been rising on almost all indicators (nominal, as a percentage of GDP and billings, and per resident and employee). It is important to note that it does not generally arise from increasing staff numbers.

Table 2: Indicators of employee-related spending (2011)

City	Pop (m)	Employees	Employees per 1,000 people	Pop. per employee	Nominal spending (R m)	per km ² (R m)	per 1,000 people (R m)	per employee (R)
Johannesburg	4 434 827	24 254	5.5	183	6 907	4.2	1.6	284 795
Cape Town	3 740 026	21 199	5.7	176	6 616	2.7	1.8	312 104
eThekweni	3 442 361	18 581	5.4	185	5 265	2.3	1.5	283 352
Tshwane	2 921 488	13 729	4.7	213	4 534	2.4	1.6	330 222
Ekurhuleni	3 178 471	17 934	5.6	177	4 815	2.2	1.5	268 467
NMBMM	1 152 115	6 561	5.7	176	2 064	1.1	1.8	314 654
Buffalo City	755 201	4 588	6.1	165	908	0.4	1.2	197 844
Mangaung	747 431	3 633	4.9	206	812	0.1	1.1	223 590
Msunduzi	618 536	2 855	4.6	217	701	1.1	1.1	245 443

The revenues required to support this rapidly rising real spending have come primarily from increasing charges for electricity (and more recently other services) and increasing property taxes, rather than rising *operating grants*. Aggregate city government revenues from all sources, which totalled R838 billion for the eight years, rose by an average of 7.3% per year since 2005, and the rate

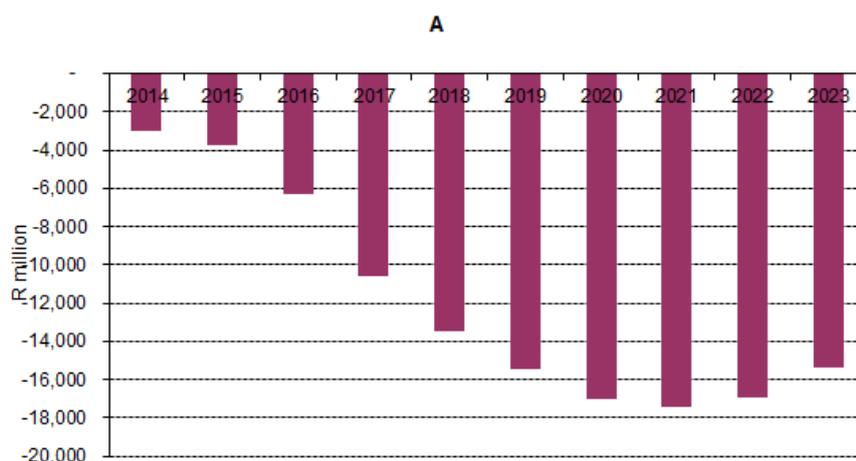
of increase is accelerating even faster than expenditure. Electricity revenues constituted only 35% of city operating revenues in 2008; but by 2012 fully 47% of city operating revenues were being derived from electricity sales, and corresponding ratios apply to cash flows⁵.

Table 3: Real growth rates and 2012 totals of aggregate 9-city spending and revenue

	Ave annual growth rate (%) since 2005	Ave annual growth rate (%) since 2008	Ave annual growth rate (%) since 2011	Aggregate for 2012 (R b)	Eight year totals (2005 to 2012) (R b)
Aggregate city spending	6.8%	7.2%	8.7%	144.5	933.7
Aggregate city revenues	7.3%	9.5%	12.9%	137.8	838.1

Projections over the next decade suggest that revenue growth may not be able to keep pace with cost increases over time, leading to a net operating shortfall of R12 billion per annum by 2020. This result is strongly influenced by the negative trend in the operating position of metropolitan municipalities in particular, as shown below, given that the total operating budget of these eight municipalities is 41% larger than all other municipalities combined. This result is, in turn, strongly influenced by the bulk cost of electricity and the ability of municipalities to pass these costs onto consumers.

Figure 2: Net operating account position for metropolitan municipalities



Moreover, the increase in tariff revenues has outstripped growth in average household incomes, which grew by only around 15% in total between 2009 and 2012. While nominal increases have been largest for wealthier households receiving larger service packages⁶, they have had a larger proportional impact on poor households. Poorer households in formal housing, which in 2009 were spending 10% to 14% of their household income on their municipal account, are now spending between 11% and 19%, for the same package of services. Higher income households which in 2009

⁵ City governments may have attempted to exercise restraint when increasing city electricity tariffs, as they are constrained by policy, politics and the affordability constraints facing their residents and businesses, but nevertheless Eskom's price increases have inevitably been passed onto electricity consumers. Even a declining percentage margin on a rapidly rising cost price can generate cash flows which rise in absolute terms.

⁶Households in Tshwane using 500 kwh of electricity and 25kl of water per month, and responsible for property taxes on a property of R250,000, are paying 28% more in 2012 than in 2009. Households in Johannesburg using 800 kwh of electricity and 30 kl of water per month, and responsible for rates on a property valued at R500,000 are paying 35% more. Households in Ekurhuleni paying rates on a R1 million property and using 1500 kwh of electricity and 40kl of water are paying 51% more in 2012 than in 2009.

were spending 6% - 7% of household incomes on municipal services, are now spending 8% - 9%, also for the same service package.

The sustainability of these trends in operating revenue is thus uncertain, and has broader implications for municipal finance:

a) The declining affordability of services may threaten payment levels. In the long run a city government which charges beyond what its residents and businesses can afford to pay will need to fundamental review its service delivery models and performance. Gross debtor's days⁷ (expressed in number of days' worth of billed revenue) may provide an early indication in this respect. These indicators represent revenues which should have accrued but did not (i.e. revenue effectiveness). Long overdue cash owed to the city government limits financial capacity and performance and therefore service delivery. Aggregate gross debtors was over R50 billion in 2012, over half the aggregate billed revenues for the year. Gross city debtors generally do not decline, only become less significant if consumption and sales continue to grow. Much of the improving trend seen in recent years can be ascribed more to rising total billing than to payments of arrears due or to write-offs. Can we always grow ourselves out of this problem of gross debtor's days? This growth cannot be sustainable if affordability is threatened.

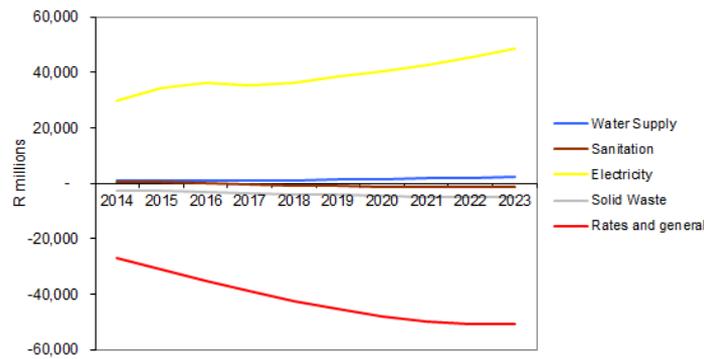
Table 4: Aggregate City Debtors

	2005	2006	2007	2008	2009	2010	2011	2012
Total cities gross debtors (R bn)	36.4	37.0	35.8	35.0	36.1	42.0	48.1	50.5
Total cities billed revenue (R bn)	59.2	59.0	60.8	60.8	64.0	76.8	86.3	96.0
Total cities net debtors (R bn)	13.2	13.0	13.1	14.0	14.5	15.4	17.8	19.9
Gross debtors days	225	229	215	210	206	199	203	192
Net debtors days	82	80	79	84	82	73	75	76

b) The energy transition will require municipalities to rebalance their own revenue sources. With electricity prices reaching all-time highs, the elasticity effects on demand will start to affect municipal revenues, as consumers will cut demand in response to price, or will increasingly default on payment. The ability of municipalities to rely on cross-subsidisation from electricity to other services is therefore at risk. A relative decline in service consumption will require municipalities to compensate through increases in other revenues, particularly property taxes. The figure below demonstrates the projected over and under-recover of various sources of revenue relative to associated costs, and thus the extent to which electricity surpluses have subsidised non-electricity service expenditures.

⁷ Chief Finance Officers like to focus on net debtors days (an indicator of financial discipline in terms of which most city governments can in recent years be classified as 'strengthening' or 'stable and disciplined')

Figure 3: Project annual operating surplus/shortfall per service – all municipalities



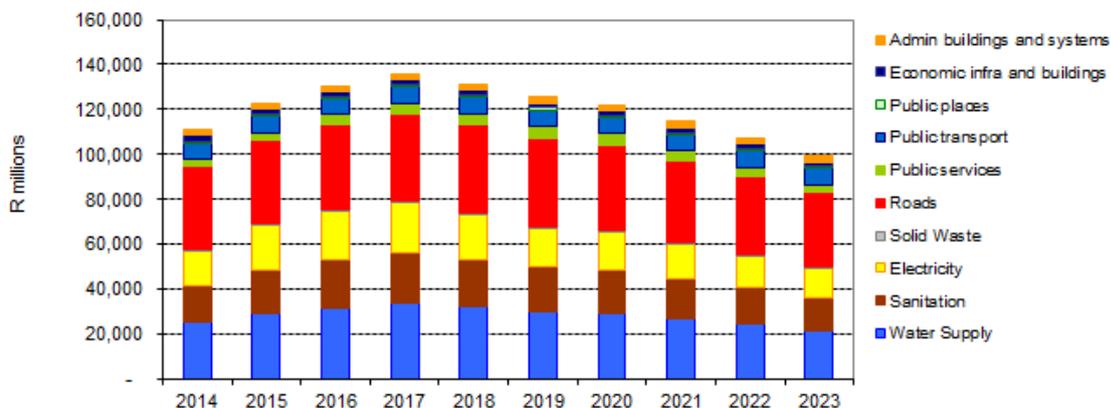
c) **Limited operating surpluses will restrict the scope for the expansion of municipal infrastructure.** Operating surpluses and cash balances are higher in 2012 than in 2009, but this has largely been due to the margins made on electricity. Growth trends in employee costs and bulk service charges are already reaching their limits in increasingly unaffordable service charges.

3.2 Municipal investment requirements

The nine city governments spent R117 billion on capital programmes, of which 60% was on infrastructure. In 2012 aggregate capital spending was about R19 billion, slightly higher than in 2011 but only three-quarters of the average during 2008–2010. Capital investment programmes undertaken in the run up to the 2010 World Cup were thus a secondary (and since exhausted) driver of city spending growth over the period. Grants funded about 46% of capital spending over this period, while only 16% of capital finance came from net borrowing. City governments are reducing their aggregate exposure to long-term debt, which peaked in 2011.

Capital expenditures of approximately R120 billion per year are required in all municipalities in order to reach service delivery targets, to cater for demographic and economic growth and to refurbish existing infrastructure assets. Projections show that this increases to almost R140 billion at the peak of service delivery, but reduces over time as targets are met.

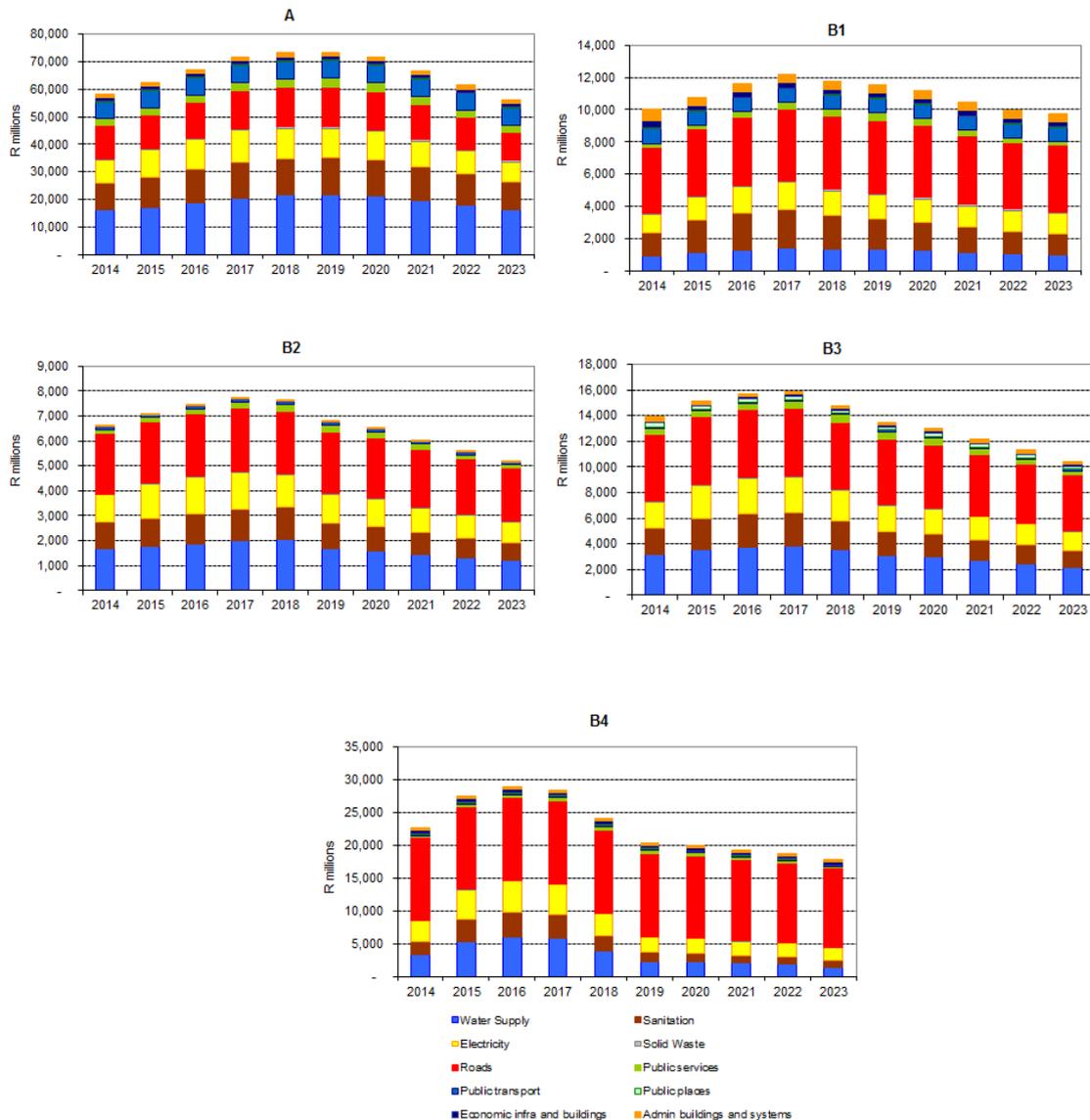
Figure 4: Total municipal capital expenditure (excluding land and top structure for housing)



Much of the capital required is for roads and water services infrastructure, but this varies between municipal categories (Figure 2). Metro municipalities have a fairly balanced investment profile between the services, with a greater obligation for public transport and other public infrastructure.

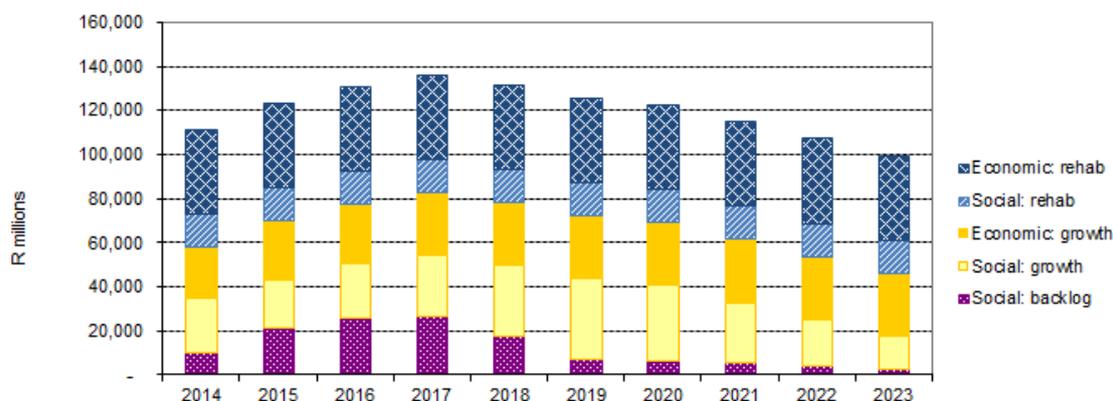
It is notable that these projections do not include the financial implications of the imminent devolution of the housing and public transport functions, and only accounts for what metros currently spend on this function. In contrast, municipalities in secondary cities (B1 municipalities) have a greater roads investment burden and a lesser water supply requirement, but still a substantial public transport obligation. Small and medium sized towns (B3 and B2 municipalities) are similar and show an equal weighting of roads and water services requirements, but for rural municipalities (B4s) the capital priority is clearly roads provision.

Figure 5: Capital expenditure requirement by service and municipal category



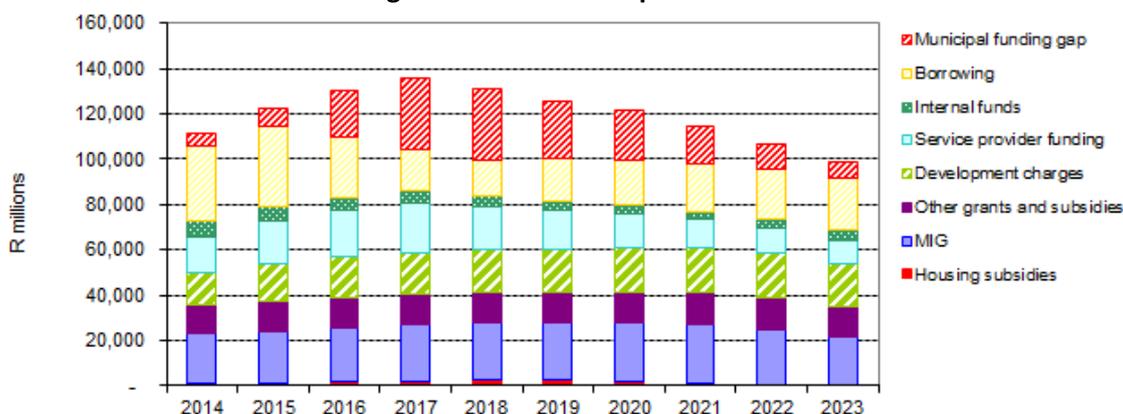
Importantly, it is estimated that only 10% of this investment is required to address historical backlogs in access to services, while 45% is required each for growth and rehabilitation of assets respectively. Some evidence suggests that social backlogs are a political priority, as is economic growth. The two areas that are apparently under-funded are social growth and rehabilitation. The implication of not spending on social (low income residential) growth is that informal settlements will persist, and even grow over time, thereby replacing the social backlog. The implication of under-spending of rehabilitation of capital on rehabilitation is aging infrastructure that provides a poorer level of service and requires higher levels of maintenance expenditure. Numerous sources cite this as a growing problem in South Africa (Boshoff, 2009; NPC, 2011; DBSA, 2012; SAICE, 2011)

Figure 6: Capital expenditure requirement by type



There is a chronic shortage of capital finance available to fund municipal infrastructure. It is estimated that a total theoretical shortfall in funding for local infrastructure (the difference between required investments and likely available resources) of R178 billion exists over a 10-year period. The real capital funding gap is far greater because municipal borrowing is constrained and developer charges are not recovered. Of the R59.5 billion to be funded directly by the municipalities themselves (excluding grants and service provider funding), only R37.2 billion has been budgeted for in the 2013/14 financial year, representing a real financing gap of R22.5% or 38%.

Figure 7: Sources of capital finance



The capital finance gap is largest for metros, but represents the greatest proportion of the capital requirement for Small Town (B3) municipalities (18%), as shown in Table . It is interesting to note that the capital funding gap to serve B4 municipalities is only 3%, largely because of the funding provided to district water services authorities and to Eskom serving these municipalities.

Table 5: Capital financing gap by municipal category

Municipal category	Total capital funding gap after 10 years (R billion)	Average gap as % of total capital required
A (Metros)	R 104,84	12%
B1 (Secondary Cities)	R 19,24	12%
B2 (Large Towns)	R 12,73	13%
B3 (Small towns)	R 35,15	18%
B4 (Rural)	R 6,43	3%

Some scope does exist for municipalities to expand their own financing of capital expenditures through improved operating performance. Options here include improvements expenditure efficiencies, billing completeness & accuracy, collections efficiency and debtor's management. Similarly, scope for the expansion of national grants to municipalities appears to be limited at present. However, these measures are unlikely to fully close the gap between required investments and available revenues.

Ultimately, bridging the capital finance gap will require accelerated urban economic growth. The relationship between economic growth, municipal revenues and public infrastructure investment is currently weak. Municipalities at present have only weak incentives to support accelerated growth initiatives as they receive only partial revenue returns.

4. Accountability for the built environment outcomes

The above discussion reveals something of a paradox: why has the strengthening of local government led to current sub-optimal outcomes? Empirically, significant progress has been made in expanding access to housing and basic services. Municipalities, particularly in metropolitan areas, have become a stable financial and service delivery platform, particularly when considered in relation to recent turbulence internationally (for example, in China, the USA) and – in some cases – their provincial counterparts. But this has not resulted in the development of more inclusive, sustainable or productive urban areas in South Africa. Developmental outcomes have been disappointing as there has been no correlation between the existence of urban institutions and effective management of urbanisation. Institutional variables are producing outcomes that are contrary to policy intentions.

The key institutional variable is the current failure of public policy to clearly assign accountabilities for the management of the urban built environment. Accountability typically refers to the obligation of an individual or organization to account for its activities, accept responsibility for them, and to disclose the results in a transparent manner. In the domain of public service delivery, and drawing from principal-agent theory, there are five key dimensions to accountability that need to be aligned: (i) *Delegation*, or the formal assignment of a function and the establishment of associated policies and standards; (ii) *Financing*, or the provision of access to sufficient resources to perform a delegation; (iii) *Performance* of a delegated responsibility, through planning, asset creation, operations, monitoring and reporting activities; (iv) *Oversight*, or the monitoring of the performance of a function by the delegating agency; and (v) *Enforcement*, particularly in the case a failure to perform a delegated function in accordance with prescribed policy and standards.

Weaknesses in any aspect of accountability can cause failure, and all dimensions must be present for accountability to work. Firstly, one cannot strengthen enforcement – holding an agent responsible for outputs and outcomes – in isolation. If an agent does not receive clear delegation or adequate financing then increasing enforceability is unfair and ineffective. Second, simply caring about an outcome controlled by another does not create a relationship of accountability.

Accountability for the urban built environment outcomes is central in terms of a policy response to urbanisation. The urban built environment spans three core areas of public responsibility, namely: (i) spatial planning and land use management; (ii) the management of human settlements, including the provision of land, access to housing and basic urban services; and (iii) the provision of urban public transport services. The accountability framework discussed above provides a lens through which we can evaluate the effectiveness of current public policy in achieving desired built environment outcomes. Within this accountability framework, it is evident that severe problems exist in the current policy framework for urban management in South Africa.

Firstly, the system of delegations of built environment functions are incomplete. Ongoing uncertainties exist across the intergovernmental system as to who should make urban policy decisions, and be held accountable for urban development outcomes. This is despite the formation of single tier metropolitan authorities with widely drawn boundaries, in 2000, and more recent legislation to devolve to municipalities the responsibilities for spatial planning and land use management, human settlements and urban public transport (as codified in the Spatial Planning and Land Use Management Act (SPLUMA), the National Housing Act (NHA), and the National Land Transportation Act (NLTA)). This focus on broad “functional assignments”⁸ has, to date, not yet provided a sufficiently coherent or detailed set of delegations within each functional area, clarified the residual role of other spheres of government, and / or has faced extensive delays in actual implementation. The NLTA, for example, provides very little guidance on how municipalities should finance public transport functions, and no implementation timetable has been developed. Housing accreditation in terms of the NHA has been subject to lengthy delays. Little attention has yet been paid to resolving overlapping powers and functions in the authorisation of land use development. The ongoing uncertainties about the nature and timetable of functional assignments obscure which sphere of government can be held accountable for their performance.

Secondly, financial constraints limit the ability of municipalities to perform their responsibilities effectively. Municipalities are experiencing a chronic shortage of capital finance for investment in municipal infrastructure. It is estimated that municipalities should, in total, invest approximately R120 billion per year over the next ten years in order to meet demand for infrastructure services. Of this amount, comparatively little is required to address current shortfalls in access to services (10%), with the bulk of resources required to support future demand (45%) and renew current assets (45%). Even after assuming that municipalities are able to expand their own sources of capital finance (through additional borrowings and revenues from development charges⁹), a financing gap of between 22% and 38% remains. Importantly, this does not account for the (still uncoded) financial implications of the devolution of housing and public transport functions to municipalities.

Pressures on operating budgets are a key driver of this shortfall, as discussed above, and have limited the operating surpluses that are essential to financing infrastructure investment (through direct contributions or leveraging). Despite a recent improvement, projections indicate that trading service expenditures will outstrip user charge revenues by 2020, largely due to the effect of demand elasticity. The erosion of trading surpluses, which have historically financed infrastructure investment, will compel local tax increases to avoid compounding investment shortfalls.

Importantly, no modelling has yet been done on the implicit costs associated with the devolution of housing and transport functions. These may significant add to the fiscal pressure on metropolitan municipalities in particular. The existing subsidy systems in both sectors are arguably both insufficient relative to demand, which has resulted in rationing of investment and declining service standards, and likely to generate significant longer term fiscal liabilities if devolved in their current form (i.e. project linked housing subsidies promoting peripheral development, and weak efficiency incentives for public transport operators)

⁸ Policy has been largely on the based on public finance criteria that underlie the prescriptions of the Constitution. These criteria enable trade-offs between: (i) the extent to which economies of scale and scope exist in the performance of a functions or group of functions; (ii) the significance of any externalities associated with a function, particularly negative externalities; (iii) the importance ascribed to concerns over equity in access to a service; and (iv) the importance of accommodating heterogeneity in demand for a service, particularly between areas.

⁹ There are severe constraints to the significant expansion of both of these sources of finance. Additional borrowing requires sufficient revenues for repayment, while regulatory uncertainties currently dampen municipal confidence in expanded revenues from development charges.

Capital financing constraints are already evident in the high level of reliance on national grants for infrastructure investment, which now finance about half of metropolitan capital expenditures and far more outside of the large cities. Although there is little empirical evidence of grant displacing own revenue effort, most grant programmes by design promote redistributive (“social package”) spending rather than directly supporting economic growth, and do not react rapidly to changing demographic trends.

Thirdly, municipal performance of built environment functions is variable. Municipal responses to urban growth pressures have been constrained by three major (and often related) internal factors, namely: (i) *Limited forward planning capacity* that has resulted in municipalities being largely reactive to urban development pressures. Specific weaknesses include limited demand forecasting capabilities and inadequate development and management of investment portfolios; (ii) *Persistent weaknesses in Infrastructure Delivery Management*, as evidenced in variable spending performance, that arises from poor project design, weak supply chain management systems (particularly in relation to specification, procurement and contract management) and inadequate integrity controls (whether real or perceived) to prevent resource misuse and promote value-for-money. These factors typically delay project implementation and drive cost over-runs and generate social and economic costs for residents and businesses; and (iii) *Gaps in operational management practice*, particularly related to inefficiencies in revenue and expenditure management, inadequate attention to asset management (repairs, scheduled maintenance, refurbishment and replacement of assets).

There are many underlying drivers of these problems, which can be summarised as:

- a) *Weak, unclear or volatile interfaces between political and administrative leadership* in municipalities that is reflected in high levels of instability and factionalism. Levels of frustration and suspicion are high on all sides, with allegation of political interference from officials and administrative intransigence from politicians.
- b) *Barriers to innovation*, including a risk averse “compliance culture” that has developed partially as a response to perceived regulatory overload, and a “standardised” regulatory system that does not adequately differentiate treatment of high and low performing municipalities
- c) *A lack of appropriate skills* for municipal service delivery, particularly in technical functions associated with engineering and financial management. This is evidenced in the high turnover rates in senior management, critical vacancy levels in key technical positions and long lead times for replacement of key personnel. Municipalities are no longer a desired employment opportunity for skilled personnel.

Fourth, systems of oversight of municipal performance are fragmented and weak. Extensive reporting requirements are placed on municipalities and generate large data flows to national government. The fragmentation of reporting systems across multiple, parallel programmes results in extensive duplication of effort. These weaknesses in the design of the reporting system are compounded by inappropriate skills and orientation of national officials operating these systems. Most monitoring agencies lack adequate analytical capacity to generate real insight into actual performance or emerging risks facing either individual municipalities or the sphere as a whole.

Moreover, this information seldom assists local-level oversight through enabling communities to hold their own municipalities to account. The effect has been for national monitoring systems to replace rather than assist community oversight. Community (citizen) engagement policy and strategy has typically been limited to participatory decision-making activities (particularly through ward committees), with only limited emphasis on or experimentation with complementary instruments such as community oversight of service delivery performance (using instruments such as scorecards or social audits, for example), citizen empowerment (such as enforceable service charters or experimentation with demand-side subsidies), or community co-production of services (such as small scale contracting for local services).

Finally, systems of enforcement are weak. Performance failures seldom have practical consequences for municipalities. This is partially – and legitimately - due to problems in attributing a failure solely to the actions of a municipality, including weak delegations and inadequate financing. However, enforcement actions are also hamstrung by the absence of effective oversight that could provide early warning of municipal under-performance. The fairly well-developed legal framework for formal intergovernmental interventions at municipal level has seldom resulted in sustainable solutions to performance failures, with actual crises more often being resolved through an implicit series of political and financial arrangements that, by their nature, leave considerable room for negotiation and perceptions of partiality in application.

5. Strengthening the accountability value chain

A systematic approach required to strengthen accountability, alongside strengthening municipal capacity. In this context, national and provincial programmes to strengthen municipal capacity are often too limited and fragmented to address the root causes of poor municipal performance. They tend to focus on one limited (often technical) issue outside of the institutional environment, systems and incentives that have produced it. It is important to note that enhanced delegations and financing will not automatically result in improved service delivery outcomes at municipal level.

First, municipalities need the appropriate **functional authority** to respond to the demands of urbanisation. The scope of the powers and functions assigned to local government must be sufficient to enable them to respond coherently and effectively to the particular challenges they face. Effective systems of **intergovernmental coordination** are required to ensure that the social and economic returns on all public sector investments are maximised. Poorly coordinated spending across spheres of government (and their associated entities) reduces the overall impact of public investment through (i) missing opportunities for leverage; and (ii) transferring long term operating liabilities to municipalities (moral hazard).

Secondly, **municipalities require the capabilities to perform their assigned functions effectively.** While appropriate management systems and skills are important inputs to this capability, they are not the sole predictor of positive outcomes. Importantly, municipalities need to face the appropriate incentives to continually improve their performance. The functional authority and discretion provided to municipalities must be counter-balanced by **effective, performance-focussed forms of oversight and strengthened, direct forms of accountability to the local population.** The role of citizens in decision-making, oversight and even the production of local services needs to be strengthened in order to drive improvements in the performance of elected local governments.

Thirdly, **the resources available to municipalities must be commensurate with their responsibilities,** without undermining incentives for intergovernmental coordination or local accountability. The long term predictability in the resource envelope is as important as the size of resources available – and must give a reasonable degree of funding certainty into the future to enable effective planning and asset management. For growing jurisdictions in particular, responsible borrowing is an essential element of a sustainable framework for financing infrastructure investments at the scale required.

There are five key recommendations that arise from this analysis:

Firstly, the system of delegations for built environment functions need to be detailed.

Considerable progress has already been made in clarifying intended functional assignments, but this has yet to be translated into practice. This requires intervention at policy, regulatory and procedural levels. At the policy level, consideration is required as to whether the functional reassignments will address the developmental challenges of urbanisation, or simply shift the authority for addressing

them. Uncertainty exists in each built environment function in this respect. The empowerment of municipalities with respect to spatial planning and land use management functions needs to be accompanied by a substantive shift in the objectives of and manner in which these functions are performed – from a control oriented framework to one that facilitates rapid development, particularly to support poor households. Similarly, simply shifting responsibilities for the delivery of project-linked public housing will not address the growing financial, economic and spatial problems with this delivery model. At the regulatory level, detailed delegations need to clarify performance targets, financial arrangements and the norms and standards associated with delegated functions in order to provide a benchmark against which performance can be assessed and accountability exercised. At a procedural level, a time-bound, coherent programme for functional transfers is required to clarify the objectives, form and sequencing of assignments in each sector, and specifically to reduce uncertainty currently associated with these processes.

Secondly, the fiscal framework for financing urban infrastructure investment requires detailed investigation and development. Specific opportunities exist to support innovation in capital financing instruments that interface with land and housing markets, such as the use of tax increment financing (TIFs) or to expand the use of Development Charges by municipalities to finance bulk and connector infrastructure required to support property development¹⁰. Scope exists to expand the operating surpluses generated by municipalities, as a precursor to additional borrowing for infrastructure investment. However, these measures alone are likely to be insufficient. Firstly, municipalities face the risks of a difficult energy transition alongside un-costed liabilities associated housing and public transport devolutions. These risks require careful management to avoid undercutting operational performance improvements by municipalities. Secondly, even with these gains investment levels are likely to remain sub-optimal, with the effect of slowing growth through delays in the provision of infrastructure and services. In this context, consideration needs to be given to the introduction of additional revenue sources for municipalities, specifically to finance infrastructure associated with economic growth, with due care not to displace efforts to improve operational performance by municipalities.

Thirdly, municipal performance improvements are essential to enable municipalities to effectively facilitate accelerated and more inclusive economic growth. Improved operating efficiencies and revenue productivity are essential to expanding resources available for infrastructure investment. But resource availability itself will not facilitate growth. Considerable further effort is required to improve capital programme planning and management by municipalities, including investment project identification, selection, design, execution and monitoring. Barriers to performance improvements, from systems weaknesses to regulatory obstacles need to be clearly identified and addressed. Moreover, variations in the needs of municipalities need to be accounted for in the design of any support. A comprehensive, differentiated framework for capacity support to municipalities is required to overcome the inefficiencies associated with the currently fragmented approach by national government.

Fourth, national monitoring of municipal performance requires streamlining and smartening. Consensus exists that current monitoring is fragmented, incomplete and ineffective in providing adequate oversight of municipal performance, despite the extensive data sets that are already available. Efforts to reform the approach to monitoring require clear leadership to minimise transaction costs for municipalities (as data providers) and communities (as data users). National monitoring systems should complement system oversight of municipal performance, particularly through prioritising the provision of accurate, timely and useful information to communities.

¹⁰ Both TIFs and Development Charges are already available as sources of capital finance for municipalities, though require both regulatory clarifications and support for innovation.

Finally, measures are required to strengthen the enforcement of delegations within the accountability framework. Improved data analysis capabilities are required in the public sector to provide an early warning system for municipal performance failures. A more clearly sequenced system of sanctions and rewards is required to provide incentives for ongoing performance improvements by municipalities, rather than a reactive response to municipal crises. Fiscal incentives, for example, can provide a useful intermediate instrument to incentivise municipal performance. This can be complemented by regulatory flexibility that can be offered to better performing municipalities to enable them to innovate in response to their service delivery challenges. Positive inducements need to be complemented by a stronger, less-partial regime for intervention in order to eliminate incentives for sustained under-performance by some municipalities that discredits the local government system as a whole.

6. Conclusion

South African municipalities face significant pressures arising from urbanisation. While important progress has been made in expanding access to basic services, this has not yet translated in the levels of economic growth required to finance the required responses to urban growth. Overcoming this paradox requires careful attention from policymakers. This paper has suggested that institutional issues, particularly in the form of a fragmented, incomplete accountability framework, lie at the heart of this paradox.

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