WPS4042

MOBILIZING URBAN INFRASTRUCTURE FINANCE WITHIN A RESPONSIBLE FISCAL FRAMEWORK

SOUTH AFRICAN CASE

Philip van Ryneveld[1]

World Bank Policy Research Working Paper 4042, November 2006

[1] former Chief Financial Officer, Capetown

1. Introduction

South Africa held its first democratic elections in 1994, marking the end of three and a half centuries of racially-based minority rule. The elections took place in accordance with an interim Constitution negotiated between the former *apartheid* regime, various movements and political parties unbanned in 1990[2]. The elected representatives formed the new parliament and functioned as a Constituent Assembly for the first two years, and in 1996, passed a new Constitution based on a set of pre-agreed constitutional principles.

The *apartheid* system entailed a systematic channeling of opportunity and resources towards the white minority and away from the majority black population. A key mechanism for achieving this was through the creation of sub-national territories and segregated residential areas for the different racial groups.

The mobilization of urban infrastructure finance over the recent past thus took place against a backdrop of very substantial constitutional and administrative changes that affected the running of sub-national governments in particular. Also at issue was the need to address severe services backlogs amongst the majority urban black population.

While many difficulties remain, South Africa has made significant progress over the last decade in addressing urban service backlogs in poor areas. At the same time, it has greatly improved the macro-economic fundamentals.

There are three levels – or 'spheres'-- of government in South Africa and most urban infrastructure is the responsibility of local governments. The process of constitutional change has enabled considerable attention to be directed towards the creation of a sound, overall framework of decentralization and to addressing infrastructure needs via the establishment of autonomous, financially stable local governments.

While the overall system has not yet been properly bedded down, the important elements are in place. Despite the fact that national government guarantees for local government debt are illegal, there is fairly significant lending by private financial institutions to metropolitan municipal governments in particular. In 2004, the City of Johannesburg successfully floated a general obligation municipal bond unsecured by any revenue intercept or national government guarantee.

This paper will attempt to sketch some of the main characteristics of the current approach to mobilizing urban infrastructure finance. It will place emphasis on describing the overall framework, since this, rather than the description of a specific city is likely to be of more interest.

South Africa is a middle-income country with a 2004 GDP of approximately R1,350 billion[3]. It has a population of 43 million, which, while being relatively small, is highly diverse.

2. Key relevant developments and achievements since 1994

2.1. <u>Achievements in the provision of urban services</u>

Much of the emphasis since 1994 has been on the extension of services to poor areas. This has been relatively successful.

---

[2] Of which the African National Congress (ANC) was by far the largest

[3] Approximately US$230 billion at the exchange rate of 1 US$=R5. 87 (which existed at the time)

Between 1996 and 2001, access to clean water was provided to approximately 9 million people increasing coverage from 60 per cent to 85 per cent of all households. In the same period, electricity provision increased from 50 per cent to 70 per cent. Between 1994 and 2003, 1.6 million houses were built for low-income families through a state subsidy scheme[4]. (GCIS 2003)

A composite index relating to the provision of housing, water and sanitation, electricity and telephones has increased from 0.46 to 0.60 between 1995 and 2002 (full provision to all would be indicated by a score of 1.00). (GCIS 2003)

Independent surveys[5] from 2003 indicated that public approval rates with regard to basic services stood at 75 per cent and housing at 64 per cent (up from 30 per cent in 1996). Between 1994 and 2002, housing as a key concern dropped from 46 per cent to 22 per cent.

Government spending has been substantially redistributive since 1994.

Of the total population of 43 million, the number of welfare grant recipients has increased from 2.6 million in 1994 to 6.8 million in 2003. The poorest quintile now receives two-thirds of its income from grants. A 2000 Gini coefficient of 0.59, when transfers to poor households are not taken into account, is transformed to 0.35 after these transfers. In 2003, independent surveys showed approval on welfare grants stood at 78 per cent. (GCIS 2003)

2.2. Demographic and economic changes

These improvements have taken place against a background of significant economic and demographic changes. Key trends have included significant urbanization, with the metropolitan areas and key cities expanding by between 21 per cent and 40 per cent between 1991 and 2001. There has been a large increase in the number of households accompanied by a decrease of average household size from 4.5 to 3.8 between 1996 and 2001. (Patel 2004)

Currently, 40 per cent of the urban population are regarded as 'poor' ; 54 per cent of the unemployed are located in urban areas; of them 38 per cent live in the 9 largest cities and more than 25 per cent live in informal settlements. (Patel 2004)

The change in the employment profile is of great significance. The net number of people in employment rose from 9.6 million to 11.2 million between 1995 and 2002. However, there was an even larger increase in the number of unemployed, from 1.9 million to 4.3 million during the same period. The increase in employment can be attributed to people from rural areas seeking work, especially women, entering the labor market. (GCIS 2003)

2.3. Macro-economic environment

Over the last decade the macro-economic environment has improved significantly.

Economic growth has been steady, albeit unspectacular, improving from negative per capita real growth in the decade prior to 1994, to an average of 3 per cent, equivalent to just over 1 per cent positive per capita growth since then. The country is currently experiencing the longest period of

---

[4] 49 per cent of recipients were women.

[5] These figures are drawn from surveys by IDASA (Institute for Democracy in South Africa) quoted in GCIS (2003)

uninterrupted growth since the 1960's and the rate appears to be set to move beyond 4 per cent on a sustained basis.

In 1993/94 financial year, the year immediately prior to the first democratic elections, the fiscal deficit of general government stood at 9.5 per cent of GDP. By 2002/2003, this had been reduced to 1 per cent, rising to 2.8 per cent in 2003/04.

Taxes of all spheres of government combined have been held at about 26 per cent of GDP for a few years.

Inflation has been reduced from approximately 15 per cent in 1994. For the last 18 months, it has remained within its targeted band of between 3 per cent and 6 per cent, and this is expected to continue for the foreseeable future.

3. Political background to the decentralization framework

3.1. The emphasis on local government

During the apartheid period, there was considerable dissatisfaction with the very poor urban services in black areas in contrast to high service levels in white areas. Much of the opposition to apartheid in the 1980's was rooted in protests linked to the appalling local services.

The banning of the main opposition movement, the African National Congress, meant that political activity in the late apartheid period was based, to a significant degree, on a coalition of local organizations called the United Democratic Front (UDF). The UDF addressed mainly local issues but also co-operated around a national agenda for fundamental democratic change. One of the key slogans of the time was 'One city – One tax base,' essentially a call to unite cities across racial lines, and amalgamate the separate, racially based municipalities while enabling local redistribution of resources.

With the unbanning of the ANC, many activists from these organizations became ANC office bearers and were closely involved in constitutional negotiations, taking a strong focus on local government into these negotiations.

3.2. The motivation for provincial government

Significant interest groups, largely on the side of the old apartheid regime, supported the creation of strong provincial governments. A number of political entities with regional ethnic power bases saw provinces as a means to control political power in their own territories, or at least to weaken national government, which they were unlikely to control.

Thus, while the creation of local governments had strong support from elements within the majority ANC, the creation of provinces was regarded by many as a compromise, which threatened to promote ethnic division. Attempts to increase the provinces' powers to tax were resisted on the grounds that key resources needed to be raised and distributed nationally to facilitate redistribution.

3.3. The resultant framework

Nine provinces and 284 municipalities were created under the new dispensation. The latter were created in a two-stage process, which initially entailed the formation of approximately 850 municipalities, subsequently reduced by means of a demarcation process.

The call for 'One city - One tax base' resulted in widely-drawn local boundaries. There was a strong emphasis on having bodies that could govern urban functional areas in an integrated manner. In the metropolitan areas, a two-tier metropolitan government system was initially created. However, this proved complex and was replaced in the final process of local re-demarcation in late 2000 with single tier metropolitan governments fully incorporating each of the major metropolitan areas.

Drawing from the assignment of responsibilities to regional governments during the apartheid period, the new provinces were given responsibility 'concurrently' with national government for primary and secondary education, and health. Over 80 per cent of their budgets are allocated to these services. They were also given responsibility for the distribution of welfare grants; however, this is in the process of being shifted to a single national welfare agency.

Local governments were given traditional municipal service responsibilities, including water, sanitation, electricity, refuse removal and a range of community services. This last category includes sports facilities, traffic, emergency services and the like.

The Constitution has two lists of functions set out in Schedule 4 and Schedule 5. Each schedule is divided into Part A and Part B. Schedule 4 contains functions for which national and provincial governments have concurrent legislative responsibility, while Schedule 5 contains functions for which provincial governments have exclusive legislative responsibility. But local governments have 'executive responsibility…and the right to administer' all functions listed in Part B of each of these schedules. Moreover, national and provincial governments 'must assign to a municipality, by agreement and subject to any conditions' matters listed in Part A of each of these schedules 'which necessarily relates to local governments, if a) that matter would most effectively be administered locally; and b) the municipality has the capacity to administer it.' (Section 156 of the Constitution of the Republic of South Africa)

Thus there is a constitutional commitment to the concept of 'subsidiarity' in respect of the functions listed in the two schedules. This is discussed further in section 7.

4. The inter-governmental fiscal structure

4.1. The distribution of revenue raising powers

Most power to raise revenue lies with the national government. However, municipalities have significant tax powers, including property taxes and a local business tax based on a combination of a small levy on turnover and total employee remuneration by firm. An investigation is currently underway regarding a possible reform of this second general source of local tax revenue[6].

User charges play a very important role in financing local government.

[6] The author of this paper is involved in this research, together with Professor Richard Bird.

Table 1 shows a breakdown of the main tax sources between different spheres of government. To demonstrate their significance, and for comparative purposes user charges levied by municipal government are also shown at the bottom of the Table

Table 1

Proportion of revenues raised by each key tax source for all spheres of government 2003/04 (revised estimate)		
Tax type	*Amount (R million)*	*Proportion of total tax revenues*
Total taxes raised nationally by national and local government	**317,992**	**100**
Net taxes raised by national government	**294,593**	**92.6**
Personal Income Tax	98,200	30.9
Corporate Income Tax	72,250	22.7
VAT	81,000	25.5
Excise duties	12,715	4.0
Fuel levies	16,350	5.1
Customs	8,800	2.8
Other	15,000	4.7
(less SA Customs Union payments)	(9,722)	-3.1
Taxes raised by provincial government	**3,531**	1.1
Taxes raised by local government	**19,868**	6.3
Property rates	14,343	4.5
RSC/JSB levies	5,525	1.7
User charges and other non-tax own recurrent revenue raised by local government	***45,300***	***14.3***

Source: South Africa (2004a)

4.2. <u>Fiscal transfers</u>

Such an approach to the allocation of tax sources results in significant vertical fiscal imbalances at the provincial level, which in turn lead to the need for a major grant or transfer system. Table 2 shows the flows of revenue between the different spheres.

It also shows that local governments do receive fiscal transfers from national government. However, they collect a substantial proportion of their own revenue and also borrow to finance part of their capital spending. The six metropolitan municipalities are largely self-financing. They receive just 3 per cent to 6.7 per cent of their budgets in grants. On the other hand, smaller and rural municipalities with weaker tax bases are much more dependent upon transfers; they receive up to 87.3 per cent of their resources from transfers.

Table 2

Own revenue versus grant revenue for the three different spheres of government 2003/04 (R billions)					
Sphere	Own revenue generated	Borrowing	Transfers from national government	All budgeted spending	Actual expenditure excl interest payments
National	300.3	27.1	-173.9	157.8	110.5
Provincial	6.6	0	161.5	168.1	170.8
Local	64.8	2.4	12.4	86.0	79.9
Total	371.70	29.5	0	411.9	361.2

Source: South Africa (2004a)

According to the Constitution, each local government and each province is 'entitled to an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it'. The Constitution specifies broadly what needs to be taken into account in determining the transfers. A permanent, independent Financial and Fiscal Commission, created in accordance with the Constitution, gives advice on all aspects of inter-governmental fiscal relations. The division of revenue has been surprisingly uncontentious since 1994.

The objective has been to ensure that transfers are formula-driven, based on objective criteria, well publicized, and determined well in advance. All transfers from national government have to be legislated. Thus, each year a Division of Revenue Act is passed along with the national budget. This Act explains the basis for the transfers, and sets out grants to each province and municipality for the coming three financial years. The outer years can be adjusted in subsequent budgets, but such adjustments are minimal.

4.3. Grants to local government

Transfers to local governments are divided into 'equitable share' (unconditional) and conditional grants, the latter include grants for capital purposes. Grants to local governments have been increasing significantly in real terms in recent years as indicated in Table 3.

Table 3

Conditional and unconditional transfers from national to local government (R millions)					
Year	2000/01	2001/02	2002/03	2003/04	2004/05
Equitable share and related	3,201	3,876	4,887	7,352	8,536
Conditional	2,336	2,642	3,820	5,038	5,709
Total	5,536	6,517	8,706	12,390	14,245

Source: South Africa (2004a)

These grants are essentially aimed at eliminating infrastructure backlogs in poor residential areas and financing the operating costs of the provision of basic services to poor households.

In 2003/04 R4, 137 million of the conditional grants provided were used to address infrastructure backlogs. This excludes transfers provided for low-income housing. R901 million was provided conditionally for capacity building.

In metropolitan municipalities in particular, as well as in the richer non-metropolitan cities, there is, in addition, considerable cross-subsidization of poor households out of locally generated revenue.

5. The overall framework and philosophy for the financing of urban infrastructure

5.1. Subsidization through grants, rather than cheap loans

The broad goal in financing municipal infrastructure, both urban and rural, has been to create autonomous, financially stable, self-financing municipalities able to borrow from the private financial sector on a sound basis.

A parastatal development bank, the Development Bank of Southern Africa has lent to municipalities alongside the private sector. However, the emphasis has been on subsidization via the grant system and not through the provision of cheap loans.

As indicated, there are formula-based, unconditional recurrent grants provided to assist in financing the operating costs of service provision to poor households. At the same time, significant resources are being provided in capital grants to help overcome infrastructure backlogs.

It is envisaged that poorer municipalities will remain largely dependent upon grants, while metropolitan and other wealthier municipalities will be largely self-financing for both operating and capital expenditure.

5.2. Building the conditions for financing infrastructure through borrowing

5.2.1.1. Avoiding national government guarantees

If municipalities are to be able to borrow from the private financial sector at reasonable rates, lenders need to be assured of being repaid. This can be achieved either by the national government guaranteeing repayment of loans, or by ensuring that the finances of local governments are sufficiently rigorous that such guarantees are not required.

The South African approach has been to avoid guarantees. Strong antagonism to that arises from the experience of the late apartheid period. The system created 'independent homelands' – territories in which black South Africans were intended to exercise their political rights, leaving whites in control of the core of the country. These homelands were, in effect, able to borrow with repayment implicitly or explicitly guaranteed by the main South African government. This was a major contributor to the very high fiscal deficits inherited in 1994.

Section 218 of the Constitution thus states that:

Government Guarantees

(1) The national government, a provincial government or a municipality may guarantee a loan only if the guarantee complies with any conditions set out in national legislation.

(2) National legislation referred to in sub-section (1) may be enacted only after any recommendations of the Financial and Fiscal Commission have been considered.

(3) Each year, every government must publish a report on the guarantees it has granted.

In essence, legislation now prevents national government from guaranteeing repayment of municipal loans.

5.2.1.2. Ensuring sound municipal financial management

Sound municipal financial management is dependent upon an overall sound local government framework.

The framework for municipal government has been built over the last decade through a number of processes. The Constitution had underpinned the framework. Flowing from this has been

- legislation on Municipal Structures, which establishes different types of municipal government
- a demarcation process in terms of a new Demarcation Act
- Municipal Systems legislation outlining the functioning of municipal systems
- new legislation on Municipal Property Rates (i.e. property tax)
- redesign of the grants systems
- significant capacity building initiatives
- modernization and standardization of municipal accounting
- a recently passed Municipal Finance Management Act

Work on building the system continues in a number of areas, including on the design of a second general source of tax revenue for local government.

5.2.1.3. Municipal Finance Management Act

The Municipal Finance Management Act is important recent legislation aimed at fostering sound municipal financial management.

The Act places great emphasis on clarifying accountability, and ensuring transparent processes so that key fiscal decisions have to be made public. The respective roles and responsibilities of mayors and municipal managers are clearly set out. Processes are stipulated for the drawing up of the budget, financial reporting, sound procurement practices, remuneration and performance contracts, the creation and governance of 'municipal entities'[7] and definitions of and sanctions for 'Financial Misconduct'. A significant section of the Act deals with borrowing, which inter *alia*,

[7] 'Municipal entities' are independent bodies created by municipalities, such as utilities

states that municipalities may not borrow to finance operating expenditure other than for bridging purposes during the course of a fiscal year.[8]

A detailed chapter entitled 'Resolution of Financial Problems' sets out processes for identifying financial problems and regulating intervention by provincial and national governments in the event of 'financial emergencies'. The Act also provides for the creation of a Municipal Financial Recovery Service within the National Treasury. The purpose is to specify processes for liquidating and distributing assets of municipalities not required for the provision of basic services in cases of bankruptcy.

5.3. The New Municipal Infrastructure Grant

Over a three year period beginning in 2003 the various conditional grants provided for financing the elimination of backlogs in capital infrastructure at local level are being consolidated into a single Municipal Infrastructure Grant (MIG).

This is intended to make the system simpler and more direct, while also putting in place a stricter approach to ensuring financial sustainability. Municipalities are given more flexibility in deciding how to allocate the capital resources because the MIG will not fund projects; instead, it is designed to support the capital budgets of municipalities.

On the other hand, municipalities are now required to report to the national government on their whole capital budget, showing how the operations and maintenance of newly provided infrastructure will be funded.

While the different national government departments will monitor different aspects, a single reporting process now replaces the plethora of different reporting processes under the previous approach.

Based on their capacity, the MIG categorizes municipalities into three groups. The 50 or so high capacity municipalities are those able to produce sufficiently rigorous medium-term capital and operating budgets. They receive the MIG grants directly into their budgets, while others receive the funds less directly and are provided with capacity building support.

The MIG is intended to place a greater emphasis on the achievement of outputs as opposed to inputs. It is focused on achieving a number of output conditions including the achievement of service coverage targets, employment creation, and the linkage of integrated development plans to budgets.

Over the next three years most of the grants will be directed at addressing backlogs in water and sanitation, with significant amounts also intended for roads.

6. Borrowing patterns

6.1. Borrowing by metropolitan and other municipal governments

Table 4. shows the total external borrowings by metropolitan governments as at March 2004.

[8] There are provisions whereby lenders that knowingly lend to finance operating expenditure do not need to be repaid.

Table 4
Municipal governments borrowing

Name of Municipality	Total external borrowings (R millions)
Cape Town	2 653.3
Johannesburg	3 842.8
Tshwane (Pretoria)	1 539.9
eThekwini (Durban)	3 085.4
Ekurhuleni (East Rand)	1 068.4
Nelson Mandela (Port Elizabeth)	296.9
TOTAL	12 486.7

Source: South Africa (2004b)
Note: These figures exclude the recent bond issues by Johannesburg totaling R2 billion.

The key lenders have been the Development Bank of Southern Africa with loans totaling to a little over R5 billion, and a private sector lender, the Infrastructure Finance Corporation (INCA), with loans of just under R3 billion. Other private banks account for most of the remaining amounts.

Loans to metropolitan governments represent approximately two-thirds of all loans to municipalities by the DBSA, and just under three quarters of loans by INCA.

6.2. The role of borrowing in the financing of the capital budgets of metropolitan councils

Tables 5 & 6 show the revenue sources of the Cape Town metropolitan municipality together with the funding sources for the capital budget and the funding sources of Johannesburg.

Municipalities in South Africa are in the process of introducing more modern and nationally standardized accrual accounting systems[9]. The Cape Town figures are presented in terms of the new definitions.

Municipalities are required to establish an External Financing Fund. This fund borrows from lenders such as DBSA, INCA and the private banks and lends to the various departments of the municipality.

The Capital Grants include housing grants, which are received via the province and implemented by the municipality.

[9] Accrual accounting has been used by municipalities in South Africa for more than two decades; however, new national standards are now being introduced bringing the system as close as is feasible to current internationally recognized GAAP. Part of the motivation for this change has been to the desire to improve transparency for prospective private sector lenders. However, there are many other advantages.

6.2.1.1. Cape Town

Table 5
Cape Town Metropolitan Municipality

2004/05 Budgeted Income (R millions) (US$1:R5.70)	
Property taxes	2,299.0
Business levies	850.2
User charges	4,376.0
Grants and Subsidies (including Capital Grants)	1,193.5
Other external income (incl. rent, fines, asset sales etc)	820.4
Internal income (including bulk charges, internal transfers etc)	1,786.4
TOTAL	11,325.5

2004/05 Budgeted Capital Sources (R millions)	
Capital Grants and Subsidies	630.6
Asset Financing Fund	258.3
External Financing Fund (i.e. borrowing)	685.0
Revenue	11.7
TOTAL	1,586.6

Source: City of Cape Town budget

Cape Town will need to borrow in the near future, and is considering, as are a number of other municipalities, the possibility of floating municipal bonds.

Cape Town, like most South African municipalities, is currently emerging from two hugely complex rounds of boundary changes and other institutional reforms. More than 30 municipalities in the metropolitan area, which existed in 1994, were first re-organized into a two-tier system with a metropolitan level and six sub-structures. In line with new legislation, this was replaced from early 2001 with a single metropolitan council. It is understood that the new amalgamated council is about to receive an unqualified audit from the Auditor-General for the 2003/04 financial year, the first after many years of restructuring. This is likely to be followed by the city seeking an independent credit rating, and depending on the outcome of this, the city may decide to go the bond route.

6.2.1.2. Johannesburg

Table 6. shows the relative importance of the different sources of funding in Johannesburg's capital budget.

Table 6

Share of various sources of capital financing for City of Johannesburg	
Loan funding	60%
Developers contributions	7%
Provincial housing grants	25%
National Infrastructure grants	8%

Source: Hunter (2004)

As indicated above, in 2004 Johannesburg successfully floated 2 bonds of R1 billion each. In the late 1990's, Johannesburg experienced serious financial problems. Much of this was related to the institutional changes and complexity of the two-tier system, which was initially introduced. Indeed, the Johannesburg experience was probably the crucial factor in the country deciding to create single-tier metropolitan governments from 2000.

The successful floating of the bonds was significant in that it not only confirmed Johannesburg's recovery, but also served to demonstrate the scope for municipalities to raise finance in this way.

The first bond was a 6-year unenhanced bond and carried a spread of 230 basis points over the rate for the equivalent national bond. The second is a 12-year bond and is enhanced by a 40 per cent guarantee by the IFC and INCA. It carried a spread of 164 basis points. Both bonds were over subscribed.

6.3. The scope for further bond issues

South Africa has a relatively sophisticated financial sector, including an active bond market.

There are R527.6 billion of outstanding bonds listed and traded on the Bond Exchange of South Africa (BESA).

Table 7
Breakdown of issues

Type of institution	Share of total bonds issued by value
Central government	73.5%
Corporates	15.1%
Parastatals/utilities	7.5%
Water Authorities	3.5%
Local authorities	0.4%

Source: Hunter (2004)

A municipal bond market did exist during the *apartheid* period but this was in the context of prescribed asset requirements, whereby insurance companies and other major investors were required to hold a proportion of their assets in instruments such as municipal and other government bonds.

The new municipal bond market is emerging in the context of no prescribed asset requirements, no national guarantees, and no tax benefits for municipal bonds. Indications are that it could become a very important source of future financing for local governments.

7. Further re-alignment of functions related to urban infrastructure provision

It was noted in Section 3, above, that provincial governments are responsible for functions such as primary and secondary education and health, while municipalities are responsible for services related to the provision of urban infrastructure.

This is somewhat of a simplification because important urban infrastructure remains currently a responsibility of national and provincial governments. In particular, as in many countries, national and provincial highways joining key national and provincial centers often constitute, in effect, a very significant part of intra-urban infrastructure. Furthermore, there are commuter rail systems in most of the major cities, which currently fall under Transnet, the national transport parastatal, which is in turn answerable to national government rather than to municipal governments.

Similarly, provinces continue to play a key role in the social housing sector, including making decisions on the distribution of social housing grants originating from the centre.

During the *apartheid* period, when municipalities were geographically and racially fragmented, each serving only a portion of an urban area, it was necessary for higher tiers of government to play a significant role in the provision and management of city wide urban infrastructure. Now that municipalities have been created incorporating the whole of urban areas, including metropolitan areas (in the form of single-tier metropolitan councils), the conditions have been created whereby there is scope for greater devolution.

Some of the constitutional provisions relating to the distribution of functions between different spheres of government have been noted in section 3. Currently, a debate is emerging as to how these provisions should be implemented in practical terms.

One possibility would be to regard provincial government as the key locus of responsibility for functions related to investment in people. This would include the functions where provincial governments are already dominant, including health and education. Conversely, local governments would be acknowledged as the key locus of responsibility for functions related to the built environment. Again, this is where, for historic reasons, municipal governments tend to be dominant. National and provincial governments would always need to exercise some control over and responsibility for intra-city national and provincial highways; however, this could be done within a framework that gave greater powers to city governments.

Making municipal governments, especially metropolitan and larger urban governments responsible for these functions would make it possible for local governments to manage all issues related to urban form and urban space. In this way linked functions can be dealt with by the same institutional entity and externalities more easily internalized.

One of the advantages of this approach is that it is broadly consistent with the current approach to financing of the two different spheres of government, whereby larger urban municipalities are financed primarily by local taxes and fees for services, whereas provinces are financed primarily by grants. Costs related to investment in people tend to be driven by population numbers, especially the size of the poor population. This places a limit on the extent to which provinces can be funded by provincial taxes since there will tend to be a mismatch between revenue and expenditure needs. While this could be managed with equalization grants, the inequalities at a provincial level are very substantial, making this somewhat problematic.

On the other hand, the intensity and costs of services and infrastructure related to servicing the built environment tend to be driven by levels of economic activity. This makes it possible to finance these types of functions by means of locally raised revenues in a manner which does not result in such severe fiscal imbalance. The feasibility of increasing local responsibility in the areas of housing and transport, in particular, would depend to a significant degree on how the second general source of local tax revenue and grant flows are reformed.

8. Concluding Remarks

8.1. Summary

Over the last decade South Africa has succeeded in addressing significant urban services backlogs, while achieving macro-economic balance from an initially precarious position.

This has been done through local borrowing and a combination of grants from national government to municipalities, particularly for provision of services to poor municipalities and neighborhoods.

Following Constitutional provisions, the legislative framework excludes national guarantees of repayment of municipal borrowing. Policy makers and administrators have thus sought to create the conditions for borrowing within this context, to hasten the emergence of sound municipal finances, while promoting autonomous local governments.

Indeed, given the relative ease with which national government can currently raise revenue for infrastructure purposes, it could be argued that the system of local borrowing is more important as a means to ensure local fiscal rigor than as a means to raise capital. It offers one of the few instances where local leadership is required to demonstrate to private lenders well-argued strategies and implementation plans well beyond forthcoming elections.

8.2. Key risks

While there are grounds for optimism, a number of risks remain, which need to be managed.

First, the institutional changes that have been required of municipalities over the last decade have been hugely onerous. While many municipalities are finally bedding down the new systems and achieving a measure of administrative stability, a large number of municipalities have not yet been sufficiently successful. There is a danger that the carefully crafted processes set in legislation to deal with default and other problems will be overwhelmed by a large number of failures, albeit amongst the smaller municipalities.

Second, until now the system has functioned reasonably successfully under relatively stable conditions and moderate economic growth. It may well be that the system is sufficiently stable to deal with much faster growth, or recession. However, this is as yet unproven.

Third, South Africa needs to pay far more attention to the provision of mass urban transit systems. As indicated, how it is to be financed within the inter-governmental system has not yet been clarified. A failure to address this issue effectively is likely to lead to huge long-term urban inefficiencies.

Fourth, there is a danger that insufficient attention is being paid to the maintenance of existing infrastructure.

Fifth, national government is currently reviewing the second general source of tax revenue to municipalities with a view to reforming it. If this is not well handled (both effectively and efficiently) the system could be significantly undermined.

Sixth, there are processes underway to create independent electricity distributors. The major cities have all had large electricity distribution entities for many decades. While it is hoped that the restructuring can be undertaken in such a way so as not to undermine municipalities, significant risks remain.

Seventh, the Constitution provides scope for increasing provincial autonomy. While municipal spending represents only about 6.5 per cent of GDP, provincial spending currently represents a further 12.5 per cent of GDP. As of now, provinces do not borrow. Were they to do so, the task of ensuring that the financing of infrastructure occurs within a responsible fiscal framework may become more onerous and the risks greater. This needs to be carefully managed, drawing upon the lessons learned at local level.

Finally, while it may take years to build trust in the rules of the game, a poor or populist response by national government to a major sub-national fiscal crisis has the potential to rapidly undermine this trust, despite carefully crafted legislation and other institutional arrangements. A system of the kind that South Africa is trying to establish needs to be constantly guarded and nurtured.

REFERENCES

GCIS (Government Communication and Information System): Towards a 10 year review: Synthesis report on implementation of government programs, discussion document published on behalf of the Presidency, October 2003, Pretoria: GCIS

Hunter, Roland (Chief Finance Officer, City of Johannesburg): City of Johannesburg Municipal Bond Issue presentation to IADF conference, [t] October 2004.

Patel, Yusuf (Executive Manager: Development Planning, Department of Provincial and Local Government): 'New Urban Realities; Overview of Urban Challenges Facing South Africa' presentation at the World Urban Forum (WUF) 2004, Barcelona

South Africa, Budget Review National Treasury, 2004 a, Republic of South Africa

South Africa, Trends in Inter-governmental Finances: 2000/01-2006/07 National Treasury, 2004 b, Republic of South Africa

ACRONYMS

ANC	African National Congress
BESA	Bond Exchange of South Africa
DBSA	Development Bank of Southern Africa
GCIS	Government Communication and Information System
INCA	Infrastructure Finance Corporation
MIG	Municipal Infrastructure Grant
UDF	United Democratic Front