FINANCIAL AND FISCAL COMMISSION

For an Equitable Sharing *of National Revenue*

POLICY BRIEF 7

THE ROLE OF TARGETED INTERGOVERNMENTAL TRANSFERS IN URBAN POVERTY REDUCTION

EXECUTIVE SUMMARY

In recent years recognition of cities as engines of economic growth, and their potential role in reducing poverty, inequality and unemployment, has generated a renewed focus on designing and implementing policy to overcome the constraints on maximising the potential of urban economies. In this regard, the Financial and Fiscal Commission carried out research to provide empirical evidence on how the structure of economic activity (the location of industries and employment) affects the economic performance of South Africa's urban municipalities, including the metropolitan areas and secondary cities which are touted as 'engines of growth'.

The research found that greater industrial diversity has a positive impact on growth in urban municipal per capita income. The study also found that municipalities with increased human capital, in the form of residents with certificates and graduate degrees, experience higher levels of growth in per capita income. The Commission recommends that, as part of the initiatives aimed at enhancing the local economic performance of city regions, government establish an economic diversification fund to broaden and deepen spatial transformation and economic growth by diversifying the economic activities within their jurisdictions.

BACKGROUND

In the post-1994 dispensation, South Africa's cities and urban centres are areas characterised by the concentration of economic activities. The local economies of South Africa's major metropolitan and secondary cities have consistently served as engines of growth and outperformed those of the country's rural areas and towns. In the post-1994 era urban economies have grown nearly twice as fast as the rest of the country and created twice as many new jobs. Despite this a number of challenges remain in exploiting the full economic potential of South Africa's urban areas. First, urban areas retain high levels of unemployment and income inequality. Second, the focus during the first decade of South Africa's democratic transition, on addressing macroeconomic challenges and establishing sustainable institutional and governance frameworks, meant that little attention was devoted to leveraging the economic potential of cities to address issues of economic growth, inequality and unemployment.

In recent years, the recognition of cities as engines of economic growth and their potential role in reducing poverty, inequality and unemployment has generated a renewed focus on designing and implementing policies aimed at overcoming constraints to maximizing the potential of urban economies.

In 2012, National Treasury initiated the Cities Support Programme (CSP) to address spatial inequalities and development challenges at the city level. In collaboration with key government departments, the programme aims to harness human, financial and institutional capacity and to improve planning, implementation and innovation. This is to ensure that cities are more inclusive, liveable and productive as well as being environmentally, financially and economically efficient, while being resilient to change.

Similarly, through the seventh iteration of the Industrial Policy Action Plan (IPAP 2015/16 – 17/18), government seeks to maximise the opportunities provided by the linkages and multipliers that exist between key economic sectors (such as mining and manufacturing) to extract full value from South Africa's enormous resource endowment, and ramp up export competitiveness. Included in these objectives is the stated aim of promoting increased diversity within South Africa's industrial sector, and for this diversity to enhance employment opportunities in an environment of rapid urbanisation.

Events such as the global recession of 2008, and the subsequent loss of markets and employers in the vulnerable sectors of mining and manufacturing, are a reminder of the need for proposed interventions to be sensitive to how geographical matters and the structure of economic activities within urban areas can influence regional economic growth and development and how unpredictable economic events, such as business cycles and exogenous shocks in export markets, can cause a major shift in the fortunes of local industries.

In this regard a key challenge facing policy makers in South Africa's urban areas is how to generate and allocate resources towards financing not only their service delivery mandate, but also stimulating local economic growth and employment. Therefore, the Commission examined the nature of the dynamic interactions between economic activities across major urban centres and outlying areas and the extent to which the diversity, or concentration of industrial activity, enhances the economic performance of urban municipalities.

RESEARCH FINDINGS

Using two measures – real per capita gross value added (GVA) and real per capita gross domestic product (GDP) – the study examined the link between industrial diversity and the economic performance of urban municipalities. Based on the Herfindahl index of industrial diversity, the empirical analysis found that increased concentration or specialisation of economic activities in a municipality, lowers growth in real per capita GVA by 0.04% (or alternatively a 1% decrease in the Herfindahl index raises growth in real per capita GVA by 0.04%). Similarly, using an alternative measure of diversity – the Shannon index – the study's findings indicated a positive relationship between diversification and economic performance, as a 1% increase in the Shannon index (i.e. greater diversification) results in 0.004% increase in real per capita GVA.

The study also evaluated the impact of other variables known to affect the economic performance of municipalities. The results indicate that municipalities with increased human capital, in the form of residents with certificates and tertiary degrees, will experience higher levels of growth in per capita income. The context of municipal size also matters for economic performance, as increased population density has a positive and statistically significant impact on growth in real GVA per capita. Finally, increased dependency, measured by the share of youth and elderly in the population, has a positive effect on the growth in municipal per capita income. This particular finding is in line with previous Commission analysis, which has shown that South Africa's implementation of a comprehensive social welfare system, to assist indigent children and elderly persons, has positive impacts on levels of poverty and inequality.

CONCLUSION

The main results emerging from the analysis can be summarised as follows:

1. Industrial diversification matters for economic performance based on regional output (GVA). On the other hand, greater specialisation can raise growth in average disposable incomes.
2. Existence of social support programmes benefiting the youth and the elderly helps ensure that urban municipalities with higher dependent populations do not experience slower growth in incomes.
3. Human capital accumulation matters for urban economic performance. In the case of growth in per capita value added output, urban municipalities with an increased share of their population with post-matric education are likely to experience growth in value added per municipal resident. At the same time increased human capital in the form of residents with bachelor's degrees positively impacts growth in average municipal incomes. Across different measures of municipal economic performance, growth in the share of the population with matric had a negative effect on the economic performance of municipalities.
4. Municipal type/status matters for economic performance as, relative to secondary cities, a municipality's status as a metropolitan area has a positive and statistically significant effect on growth in municipal value added per resident.

Government is increasingly aware that accelerated urbanisation could help drive rapid economic growth and reduce the burdens of poverty and inequality. Thus there is an important need, taking into account current economic dynamics, to appropriately reshape IGFR instruments to support one of the stated goals of the National Development Plan – creating cities that are economically inclusive, resilient and sustainable.

In this regard the Commission recommends that through National Treasury, government establish an economic diversification fund as part of its objective of supporting cities to promote spatial transformation and economic growth. This fund can either be ring-fenced within existing grants linked to the growth and spatial transformation of cities (such as the Integrated Cities Development Grant), or specified as a minimum spending requirement, to ensure that recipient municipalities spend allocated funds towards programmes that broaden and deepen spatial transformation and economic growth, through the diversification of economic activities within their jurisdictions.

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