FINANCIAL AND FISCAL COMMISSION

Funding of Municipal Capital Expenditure: Who Pays?

FINANCIAL AND FISCAL COMMISSION 7/2014 POLICY BRIEF

EXECUTIVE SUMMARY

Municipal capital investments (capex) in infrastructure stimulate the local economy and enable the roll-out of services to poor communities. However, in 2011, the Financial and Fiscal Commission (the Commission) found that infrastructure grants allocated to local government were not enough to cover expenditure needs, as other municipal revenue sources were limited.[1] In a consequent study, the Commission looked at the factors that affect municipal own-revenue contributions to capex. Municipal capex is increasingly funded by intergovernmental transfers. Factors affecting municipal own capital funds include declining economic activity (which means that municipalities receive less income in the form of local taxes) and the income levels of communities within the municipalities. The other factor is the ability of municipalities to manage their internal financial affairs, as reflected in whether they receive an unqualified audit or not. The research found that, surprisingly, local demand for infrastructure does not affect a municipality's decision to contribute own revenue to capital expenditure. The situation of limited funds is made worse by the persistent under-spending of municipal budgets. The Commission recommends improving the monitoring and evaluation of municipal capital planning and investment spending, finding alternative and innovative methods to fund infrastructure, and developing a new infrastructure funding model for poorly resourced (rural) municipalities.

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[1] Financial and Fiscal Commission. 2012. Sustaining Local Government Finances. Midrand: FFC.

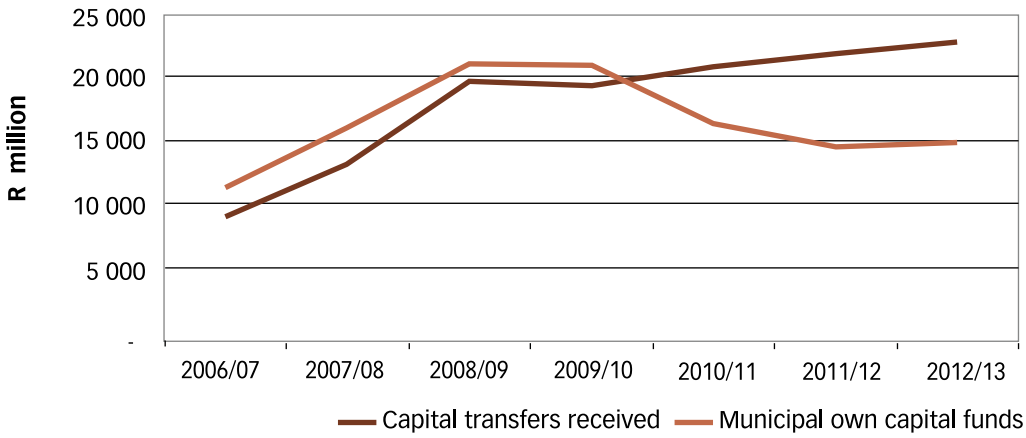
BACKGROUND

Municipal capital investments play a key role in stimulating the local economy and enabling the roll-out of services to poor communities. Thus a lack of municipal investment in new and existing infrastructure can hamper economic growth and compromise longer-term economic development. Municipalities fund their capital expenditures through a combination of own revenues, market credit and intergovernmental transfers (predominantly conditional grants). Since the 2008 global financial crisis, these revenue sources have come under increasing pressure, which could affect the delivery of crucial local infrastructure. In 2011 a review of the local government fiscal framework by the Financial and Fiscal Commission (the Commission) found that infrastructure grants allocated to local government are insufficient to cover capital expenditure needs, given the current constraints on other municipal capital sources. Building on this initial work, the Commission looked at the factors that affect own-revenue contributions and how much revenue is required to meet local infrastructure needs.[2]

FINDINGS

As Figure 1 shows, municipal capital expenditure (capex) is increasingly funded by intergovernmental transfers rather than by municipal own revenues. To fund the demand for local infrastructure and to eradicate service backlogs, municipalities depend more and more on intergovernmental grants and on other entities, such as Eskom and water boards.

Figure 1: Capex funded through capital transfers and own-revenue (2006/07–2012/13)



Source: Local Government Budget and Expenditure Review (National Treasury, 2011)

The analysis found that the factors affecting own-revenue contributions to capital expenditure are local economic circumstances (including income levels of communities in the municipality) and municipal internal planning ability. Declining economic activity (reflected in rising unemployment rates) means that municipalities receive less own income through local taxes and service charges, while rural and smaller municipalities (where abject poverty is rampant) are less able to use own revenues for capital expenditures than municipalities that contain wealthier communities. Therefore, the own-revenue capacity in rural and smaller municipalities is very limited, whereas metropolitan and other urban municipalities have relatively greater potential to increase own revenues (including through borrowing).

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[2] See Chapter 7: Improving the financing of municipal capital investments. In FFC (Financial and Fiscal Commission). 2013. Submission for the Division of Revenue 2015/16. Midrand: FFC.

The other factor identified was the ability of municipalities to manage their internal financial affairs, based on whether the municipality received an unqualified audit opinion. Such municipalities are able to prepare budgets, determine the local demand for infrastructure, better calculate the capital costs associated with refurbishments and possibly design better tariffs to fund these capital needs. Interestingly, the analysis found that a growth in bulk purchases does not have an impact on own-revenue contributions towards capital expenditure, suggesting that the increased demand for services and higher utility prices have not yet resulted in lower operating surpluses and consequent capital funding pressures.

The results suggest that local demand for infrastructure does not affect a municipality's decision to contribute own funds for capital expenditures. This finding is interesting and concerning, as a growing economy and households with no access to services are likely to demand greater support from state infrastructure investments.

Although municipal revenue sources for capital expenditure may be under pressure, the persistent under-spending of municipal capital budgets also has a major impact on infrastructure investment. Spending by metropolitan municipalities (metros) may have improved, but the under-spending of municipal capital budgets is pandemic in South African local government (see Table 1). Nevertheless, the under-spending of municipal capital budgets is an additional – but separate – dimension and should not be considered when assessing the funding needs required for municipal expenditures.

Table 1: Under-spending on capital budgets by municipal type (2003–2010)

Location	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Metropolitan Municipalities	31.1%	11.5%	1. 29.2%	2. 14.9%	3. 3.1%	4. -10.5%	5. 3.2%
Secondary Cities	30.0%	21.8%	33.9%	34.6%	30.7%	27.9%	29.4%
Larger Towns	51.4%	45.3%	21.2%	30.7%	27.7%	34.3%	36.0%
Smaller Towns	43.0%	27.2%	43.9%	35.3%	40.9%	33.6%	30.1%
Rural Municipalities	47.4%	36.9%	51.4%	48.9%	24.1%	32.8%	33.5%
Districts (not water service providers)	36.3%	-4.4%	57.0%	75.8%	41.3%	56.9%	-24.0%
Districts (water providers)	64.3	49%	33.5%	31.8%	52.7%	44.9%	40.3%
Total	**38.0%**	**21.6%**	**33.4%**	**27.3**	**21.3%**	**13.0%**	**18.1%**

Note: Positive number denotes under-expenditure while negative number denotes over-expenditure

Source: FFC own calculations – Actual capital expenditures a percentage of the original capital budget

The research estimated that, in order to meet local demand for infrastructure, local government would need to double their own-revenue contributions to capital expenditure. However, given the current economic climate, the space for increased own-revenue contribution appears to be limited.

CONCLUSION

Municipal capital expenditure is important for economic and social development. Such expenditure is funded through a combination of own revenues, market credit and intergovernmental transfers. Intergovernmental transfers are growing, while municipal own revenues are declining as a proportion of total capital funding. A municipality's ability to contribute own revenues depends on local economic activity, the income level within its jurisdiction and its ability to manage its internal financial affairs. Municipalities depend on intergovernmental grants to fund the demand for local infrastructure and on other entities (such as Eskom) to eradicate service backlogs. Under-spending of municipal capital budgets also affects infrastructure investment but should not be considered when assessing municipal infrastructure funding needs. Therefore, the Commission recommends that:

- National and provincial treasuries improve the monitoring and evaluation of municipal capital planning and investment spending.
- Municipalities use alternative and innovative methods to fund and deliver infrastructure, if capacity to plan and spend remains a concern.
- Government explores a new funding and infrastructure delivery model for poorly resourced rural municipalities.

POLICY BRIEF

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