Research and Recommendations Programme (RRP)

Financial and Functional Viability, and Sustainability of Municipalities – Beyond the Demarcation Instrument

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ABSTRACT
In 2015 the Minister of Cooperative Governance and Traditional Affairs (CoGTA) proposed amalgamations of municipalities in order to deal with challenges of financially unviable and dysfunctional municipalities. According to CoGTA, a third of municipalities are dysfunctional, while another third were at risk of being dysfunctional, and the remaining third were functional. This proposal was a major departure from the existing approach to local government demarcations because, for the first time, municipal financial viability and functionality was placed at the core of boundary changes. In other words, demarcation was to be used as an instrument for creating more financially viable and functional municipalities. The CoGTA proposal raised many policy issues and questions which need to be interrogated. This paper addresses the following questions: Is there a common understanding or definition of a viable/dysfunctional municipality? Whatever the definition, will the proposed mergers create financially viable municipalities? Is viability a requirement for demarcations and can it be elevated to dominate other factors? Can re-demarcating boundaries eliminate dysfunctionality, and should dysfunctionality be a factor when determining demarcations? After interrogating all the above questions, this paper notes that the concept of financial viability is often confused with economic viability and financial sustainability, and is even seen as synonymous with self-reliance or self-sufficiency. This lack of a common understanding means that it is risky to use financial viability as a criteria as it would be interpreted in various ways. Empirical evidence shows that many of the municipalities proposed for merger have limited economic activity and tax bases and thus will not be financially viable - as “zero plus zero plus zero cannot equal three”. The link between functionality and boundary changes is difficult to see. Functionality should not be a criteria for boundary changes, as the Municipal Demarcation Act does not recognise functionality as a criteria for demarcations. In addition empirical evidence indicates that dysfunctionality cannot be corrected by demarcating municipal spaces as dysfunctionality of a municipality can be traced back to other factors that have nothing to do with municipal boundaries. This paper also notes that arguing for amalgamation based on financial viability and functionality reasons should be weighed against other constitutional objectives of municipalities. In conclusion, the paper makes recommendations for the relevant Government departments and MDB on the treatment of “financially viability” and “functionality” in the demarcation process.
1. **Introduction**

Many municipalities in South Africa have not been able to fulfil their constitutional mandate. The Department Cooperative Governance and Traditional Affairs (CoGTA) has estimated that a third of South African municipalities are financially non-viable (whatever the definition) and non-functional. To correct for dysfunctionality and financial viability, in 2015, the Minister of CoGTA proposed the redrawing of some municipal boundaries. For the first time in the history of South Africa, this proposal was motivated by the desire to make municipalities functional and financially viable.

The CoGTA proposal raised a number of questions, including:

- Is there a common understanding of what constitutes a viable/dysfunctional municipality?
- Whatever the definition, will the proposed mergers create financially viable municipalities?
- Is viability a requirement for demarcations and can it be elevated to dominate other factors?
- Can re-demarcating boundaries eliminate dysfunctionality, and should dysfunctionality be a factor when determining demarcations.

**Methodology**

This paper is based on the following four related research areas of the Financial and Fiscal Commission (FFC):

- *Previous FFC work on the impact of the Tshwane merger.* In 2013 FFC was requested by the City of Tshwane to evaluate the impact of the merger between Tshwane Municipality and Metsweding District municipality, and the two municipalities under its jurisdiction (Kungwini and Nokeng tsa Taemane). This merger had come into effect in May 2011. This work culminated in a report entitled “Financial and Fiscal Commission Submission on the City of Tshwane and Metsweding District Municipality Merger” and is available on the FFC website.

- *FFC work on the Financial and Fiscal Implications of Mergers.* This work was part of the 2015/16 Annual Submission to the Division of Revenue. This work examined
the financial and fiscal implications of demarcations in a number of municipalities, (both rural and urban, large and small) between 2000 and 2013.

- **Colloquium:** On the 29 May 2015 FFC hosted a colloquium on “Municipal Viability.” The colloquium was held on the heels of a request by the Minister of Cooperative Governance and Traditional Affairs (CoGTA) to MDB for a further reduction in the number of municipalities. This request was for a review of the status of 73 “financially unviable and dysfunctional municipalities”. The main colloquium question was: Can the demarcation instrument make municipalities financial viable and also correct for municipal dysfunctionality?

- **FFC work on 2016 Mergers:** In 2015 undertook a study which sought to provide answers to some of the questions raised at the colloquium looked at the likely effects of the 2016 demarcations. The 2016 demarcations were done in the context of the Department of Cooperative Governance and Traditional Affairs (CoGTA) proposal to make financially non-viable and dysfunctional municipalities self-reliant and functional through the demarcation instrument. This work of the Commission asked the question: Is amalgamation the answer financially non-viable and dysfunctional rural municipalities? This study used the recent wave of demarcations to evaluate this question. The results of this study are found in the 2017/18 FFC Annual Submission for the Division of Revenue.

2. Background

2.1. Demarcations in a Historical Context

Amalgamation in the local government sphere is not a new phenomenon. For much of the period between 1948 and 1994, South Africa’s experimentation with decentralization focused on demarcating jurisdictions and organizing governance on the basis of race, rather than on the basis of functional linkages or similar criteria (van Ryneveld, 1996). Within the racially driven decentralized governance system existed a structure similar to that of local governments and consisting of two main categories – white local authorities (WLAs) and black local authorities (BLAs).

WLAs represented the earliest example of fiscal decentralization in South Africa. Established in the early 1900s, they covered most of the country’s urban areas, and were primarily responsible for providing services to urban white, coloured and Indian citizens resident in
areas outside of the homelands. Access to relatively wealthy sections of society meant that WLAs enjoyed a high degree of fiscal autonomy. In fact the notion of viable municipality comes from the era of WLAs. WLAs were “viable” in the sense that they were self-sufficient. They had all the tax bases (property taxes and fees) and thus relied entirely on own revenues while they served a small section of the population. Today it is difficult to subscribe to the same notion of viability as many post 1994 municipalities do not have all the revenue bases, rely significantly on transfers and serve bigger segments of the population. In other words, post 1994 municipalities have a fundamentally different mandate and they cover entire populations, and rural areas as well.

The apartheid government’s restrictions on economic development in black areas coupled with a hugely disproportionate allocation of socio economic infrastructure and a lack of access to property, quality education and formal employment amongst blacks impaired the capacity of BLAs to develop productive tax bases. As a result, BLAs generated very little own revenue, operated inefficient fiscal systems, and lacked capacity to provide necessary socio-economic services.

A major prerequisite for the 1995 elections was the need to amalgamate inherited apartheid-era local government structures. The demarcations that occurred in the 1990s had one underpinning motive, which can be traced back to the 1998 White Paper for local government. The mergers were meant to de-racialize municipalities that had always been segregated along apartheid spatial lines and to an extent redistribute resources from affluent municipalities to poor municipalities. A good example of a redistributive demarcation process was that of Cape Town in 1996 where the main rationale for amalgamation was to redistribute from rich municipalities to poor municipalities. The amalgamation of the previously black and white local authorities however created problems such as collapsing infrastructure (e.g. water and sewerage systems) because of the increasing number of people that now had to be serviced. There were also associated challenges such as financial stress in the context of increasing salaries, limited experience and lack of capacity that became prevalent after the amalgamations.

In 2002, financial viability became a demarcation issue following the Presidential Coordinating Council (PPC) passing a number of resolutions on local government and among them the building of financially viable municipalities. So issues of financial viability are not
new. The question then is why after 15 years of democratic local governments this issue has still not been resolved? In 2015 the Minister of CoGTA proposed more boundary changes that would see more municipalities becoming even larger. The 2015 boundary redeterminations has resulted in a reduction of local government structures by 21 municipalities: from 278 to 257.

2.2. Demarcations in a global context

As South Africa’s municipal space is downsizing from 278 to 257 municipalities, it is pertinent to draw comparisons with other countries. First and foremost, international literature is clear that there is no standard size of a municipality, whether it be by geographical space, population size, or political representation. Figure 1 and Table 1 compare South Africa’s local government space with that of other countries, in terms of the three main characteristics. In all three aspects South Africa seems to be on the extreme end of the spectrum. Although South Africa is downsizing, Figure 1 shows that it has one of the lowest number of municipalities and one of the highest in terms of average population size per municipality. This has some far reaching implications on political representation and accountability. Political representatives may be far removed from the electorate, which can potentially compromise democratic and governance accountability. Citizen participation is weaker when local government structure are large, while access to authority through public hearings, meetings, elections or direct contact is difficult. Table 1 also suggests the same, as the country has one of the highest numbers of citizens per councillor.
Figure 1: Number of Municipalities and Average Municipal Population Sizes


Table 1: Number of Citizens per councillor

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of councillors</th>
<th>Number of citizens per councillor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Republic of Ireland (2014)</td>
<td>949</td>
<td>4861</td>
</tr>
<tr>
<td>New Zealand (2000)</td>
<td>1892</td>
<td>2039</td>
</tr>
<tr>
<td>Philippines (2000)</td>
<td>2102</td>
<td>37075</td>
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<tr>
<td>Malaysia (2000)</td>
<td>2921</td>
<td>7654</td>
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<tr>
<td>Nepal (2000)</td>
<td>3344</td>
<td>7099</td>
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<tr>
<td>Australia (2000)</td>
<td>6637</td>
<td>2886</td>
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<tr>
<td>South Africa (2011)</td>
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<td>Canada (2014)</td>
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<td>Japan (2000)</td>
<td>62452</td>
<td>2031</td>
</tr>
<tr>
<td>China (2000)</td>
<td>653244</td>
<td>1933</td>
</tr>
</tbody>
</table>

3. Financial Viability: The Concept

As has been noted above, the proposal for amalgamating municipalities in 2016 was partly underpinned by a desire to make municipalities financial viable. The question is: is there a common understanding of the concept of financial viability? If the concept is elevated to a criterion/factor for demarcation, then it is important that stakeholders have a common understanding of its meaning. If there is no common understanding among stakeholders, the implementation, monitoring and evaluation of the merger project becomes difficult as the yardsticks for assessing the outcomes will vary as the definitions. According to National Treasury, financial viability refers to the sustainability of the municipal budget, and whether the municipality is able to sustainably meet its expenditure commitments from its own revenues and transfers. The key to this definition is that a municipality should be able to fulfil its mandate from available resources in a sustained manner. The Local Government Fiscal Framework, defines financial viability as the state of balancing revenue sources and expenditure responsibilities and if these two aspects balance then the municipality is financially viable. The NT definition allows for this dependency, i.e. some municipalities will be financially viable even if they are totally transfer dependent. The Constitution of the country provides for this dependency and in particular the fact that there should be an equitable sharing of revenues among the three spheres of government.

In contrast, the CoGTA definition equates financial viability with self-sufficiency/self-reliance. In other words, a municipality that is not self-sufficient/self-reliant or dependent on grants is considered financially non-viable. According to this definition, dependency should be eliminated. Following this line of reasoning, it means all District Municipalities are financially non-viable as they as they have few own revenue sources and instead, rely heavily on transfers. The main point is that financial viability should not be equated to self-sustainability or lack of dependence. The Division of Revenue is intended to make it possible for municipalities in all parts of the country to be financially sustainable. In terms of the composition of the fiscal framework, the funding of municipalities is structured such that approximately 25% of it comes from transfers. The transfers are intended to fund poor households’ services. The remainder of the revenues i.e. 75% of the local government fiscal framework, come from own revenue sources such as rates and charges. Thus dependency on its own should not be a problem but should be considered part of the design of the local government system.
This brief analysis of the concept of financial viability makes it clear that there is no common understanding of what constitutes financially viable municipalities. If there is no common understanding of the concept, then it should not dominate other factors in the demarcation process. Secondly, this brief analysis of the concept suggests that dependency on transfers by some municipalities cannot be eliminated, as some municipalities lack a sound revenue base and therefore will always be transfer dependent. In fact the Division of Revenue allows for this fact. Instead municipalities that are transfer dependent should be allowed to exist as they serve other purposes, e.g. political representativity or coordination, as is the case with district municipalities.

3.1. Is financial viability a factor or a criteria?

“Financial viability” (i.e. self-sufficiency) is neither a constitutional objective nor a demarcation objective. In fact, financial viability is just one of many factors that the MDB has to consider when determining boundaries. Section 24 of the Municipal Demarcation Act states that the MDB must take into account the following factors when demarcating municipalities:

- The interdependence of people.
- The need for cohesive, integrated and unfragmented areas.
- The financial viability and administrative capacity of the municipality to perform municipal functions effectively and efficiently.
- The need to share and redistribute financial and administrative resources.
- Existing boundaries.
- Existing and expected land use, social, economic and transport planning.
- The need for coordinated municipal, provincial and national programmes and services;
- Topographical, environmental and physical characteristics of the area.
- The administrative consequences of its boundary determination on municipal creditworthiness.
- The need to rationalise the total number of municipalities within different categories to achieve the objectives of effective and sustainable service delivery, financial viability and macro-economic stability.
The CoGTA proposal elevated financial viability to a demarcation criterion. This cannot be done without reviewing the MDB Act. It should also be noted that even if the Act is reviewed and financial viability made a criterion, (whatever its definition), a municipality becomes financially non-viable because of many factors, in addition to boundary changes. Following the COGTA definition of financial viability (i.e. self-sufficiency), a municipality maybe financially nonviable because of both internal (poor management, poor investment decisions, governance) and external factors (poor revenue base, unemployment and poverty within its borders, political and governance issues). So, in a nutshell, elevating financial viability will require, besides reviewing the MDB Act, coming up with a common understanding of what constitutes this concept.

3.2. Impact of Amalgamations on the Financial Viability of Municipalities: Lessons from other countries

The impact of municipal boundary changes on the financial viability of municipalities is deeply contested. The assertion that in principle it is possible to identify an optimal size for a municipality is inconclusive in theoretical and empirical terms (See Boyne 1998; Oakerson 1999; Bish 2000; Dollery, Kortt and Grant 2012). At a theoretical level, one strand of literature argues that the consolidation of municipalities improves the effectiveness and efficiency with which local government deliver services, or simply "bigger is better" or "bigger is cheaper" (Slack and Bird 2013). The gist of the argument advanced by advocates of municipal amalgamation is that bigger is better which then results in subsequent assumptions that bigger is cheaper which supposedly means that bigger translates to improved services, bigger is more efficient, and more recently bigger is more financially viable. Large municipalities are able to reap economies of scale and scope in service provision as well as savings in administrative overheads (e.g. duplications are eliminated and number of politicians and bureaucrats may be reduced), thus resulting in lower per unit costs as the amount of service delivered increases. The extension of this argument is that larger municipalities will result in cost savings, enhance productivity, improve the quantity, quality and mix of local services, boost administrative and technical capacity and strategic management, facilitate more effective lobbying with higher tiers of government, and increased financial sustainability (Dollery and Robotti 2008). Amalgamated municipalities are technical and financially able to provide an array of services than smaller fragmented
municipalities (Dollery et al 2007; Slack and Bird 2013). Municipal amalgamation eliminates some duplication, for instance, the number of politicians and bureaucrats could be reduced.

On the other hand, another group of studies argue that small and many municipalities are more efficient, more responsive to the changes in community needs, and accountability channels are clear cut (Faguet 2004, 2011). In addition, smaller municipalities stimulate competition, which is sometimes an incentive to be efficient. Furthermore, taxes to residents as well as municipal debt tend to increase substantially with amalgamation, and there are buried costs which may not be apparent when planning for amalgamation (Slack and Bird, 2013). Slack and Bird (2013) argue that the amalgamation of municipalities with different service levels and wage scales could translate into increased expenditures. Moreover, according to these authors, salaries and benefits tend to equalise up to the level of the former municipality with the highest expenditures. This upward harmonisation of wages and salaries may actually outweigh any cost savings.

As with the theoretical arguments, empirical literature on the impact of amalgamation on financial viability is also inconclusive (see Lago-Penas and Martinez-Vazquez 2013). Whereas the majority of empirical work has concentrated on American municipalities (Faulk and Hicks 2011), various studies have examined municipalities in Australia, Canada, Japan and Western Europe. For example, after reviewing research in the UK and USA on economies of scale, Byrnes and Dollery concluded that only 8% of the studies found evidence of economies of scale, 24% found evidence of diseconomies of scale, 29% found evidence of a U shaped cost curves and 39% found no evidence of economies of scale. Found (2012) found no evidence of economies of scale post 2005-2008 boundary changes in Canada. In Australia, for instance, many municipal amalgamations or consolidations were endorsed based on the prevalent assumption that larger municipalities would exhibit greater economic efficiencies. However, Byrnes and Dollery (2002) reviewed the literature to determine if an empirical basis existed for this view. Their conclusion was, there is lack of rigorous evidence of significant economies of scale in municipal service provision which casts considerable doubt on using this premise as the basis for amalgamations. In the USA, Boyne (1992) found evidence that consolidation is associated with higher spending while in Canada, Kushner and Siegel (2005) found that amalgamations of local governments improved efficiency in some municipalities while inefficiencies increased after some amalgamations.

3.3.1. Past Mergers

During the past two decades, successive demarcation processes have seen the numbers, sizes and types of municipalities change. With each demarcation cycle, concerns have been raised regarding the impact of demarcations on municipal finances. The Tshwane Municipality merger was a case in point. In 2013 at the request of Tshwane municipality, and on its own volition, the Financial and Fiscal Commission (Annual Submission for the 2015/16 Division of Revenue) undertook an assessment of the impact of boundary changes on municipal fiscal performance. In addition to Tshwane, the Commission looked at case studies of other previous mergers. The Commission concluded that demarcation processes are costly, affect the financial sustainability of affected municipalities, and that the process can be disruptive and distracting from the core business of a municipality. The Commission noted that in the short-run demarcations affected the viability of affected municipalities. The Commission identified a number of cost drivers, including; the integration and consolidation of programmes, upgrading of data services; rationalisation of services, fees and tax rates, payroll systems, voters roll and administrative policies; change management costs; harmonisation of systems, harmonisation of asset registers, human resources policies, wages, salaries and allowances; and costs associated with coordination, communication, retraining and retooling of workers.

The Commission recommended that before the actual decision to change boundaries is pronounced, the financial and fiscal implications of boundary changes should be established and such information made publicly available. In other words, at the point of making the decision to make boundary changes, the MDB should provide information on the financial and fiscal implications of the possible demarcation. The Commission further recommended that a transitional demarcation grant is awarded to the amalgamated municipality to facilitate the restructuring process and to minimise the effect of demarcation on municipal budgets.

In 2014 Government took heed of the Commission’s recommendations and introduced a transitional grant to support municipalities undergoing major boundary changes.
3.3.2. Future Mergers

As has been above, after the 2016 local government elections, South Africa’s municipal space will be downsizing from 278 to 257 municipalities. In 2015 the Department of Cooperative Governance and Traditional Affair (CoGTA) had proposed to MDB mergers of a number of municipalities in the hope that such mergers will result in a crop of self-reliant and self-sufficient municipalities (i.e. municipalities with minimum dependency on central government transfers). The COGTA proposal envisaged municipalities that have a sound fiscal base to support their constitutional mandates. Is that possible? Can the demarcation instrument result in financial viable municipalities? This section looks at this question. The analysis in this section is based on historical and current performance information of those municipalities due for merger in 2016.

As fiscal capacity is key to their viability/self-sufficiency or self-reliance of a municipality, this section evaluates the fiscal capacities of all municipalities due to be demarcated in 2016 using a number of indicators. As other studies (Bandyopadhyay 2013; City of Fort Lauderdale Fiscal Capacity Study 2013; Yesim et al 2007) all measures of fiscal capacity were indexed to the South African average, i.e the average figure for South Africa was equated to 100 and this was used as a base in which individual municipality indicators were compared to. The reader should note that these indicators are not measures of fiscal health of a municipality, but simple a relative gauge of whether a particular municipality can sustain its assigned mandates using its own resources without intervention from national and provincial governments. It should be noted also that the South African average is not necessarily the optimum, but in the absence of norms or standards, it gives an indication of where an average local government is operating in South Africa. The reader is also reminded that these measures evaluate a municipality’s fiscal capacities relative to the national average, not their absolute fiscal capacities. The selected measures are described in the following paragraphs.

(i) **Dependency on transfers**

According to the government proposal, a financial viable municipality is one that is self-reliant or self-sufficient. Self-sufficient municipalities do not need to be dependent on transfers for their basic needs, but are capable of delivering a range of services on their own. To ascertain whether a municipalities can sustain their mandates without significant assistance from national and provincial governments, a simple dependency ratio (transfers/Operating Revenues) suffices. In this case we use the ratio of Local Government Equitable share to total municipal revenues and the ratio of total capital transfer funding to
total capital funding. The dependency ratios used vary widely, ranging from metros that derive only less than 10% of their revenues from transfers to the other extreme, i.e. district municipalities that rely on transfers to the tune of almost 90% of their total revenues. Figure 2 shows that the majority of B3, and virtually all B4s are depended on transfers for more than 20% of their revenues. The majority of rural municipalities (B4s) rely for more than 50% of their operational expenses on the LES transfers. It is unlikely that such municipalities will be self-reliant, but in all likelihood, they will always be dependent on transfers. Turning to the municipalities due for demarcation (Figure 2), a majority of them depend for more than 50% of their operational revenues on the LGES. Figure 3 on the dependency on transfers for capital funding paints the same picture as the LGES. Most rural municipalities rely on transfers for their capital expenses. In a nutshell, what Figures 2 and 3 show is that rural municipalities and those due for demarcation will never sustain their activities without transfers. Thus amalgamations will never make them self-reliant, considering their limited revenue base and high levels of dependency.

**Figure 2: LGES as a percentage of Operating Revenue**

Source: Authors’ Calculations

**Figure 3: Total Transfer Capital Funding as a percentage of Total Capital Funding**
(ii) \textit{Per capita GVA Index}

As has been noted above this indicator measures the value of goods and services produced by a municipality over a given period. A higher per capita GVA value signifies a larger revenue base and greater ability to pay taxes. All municipalities due for demarcation were compared to the average for all municipalities. Figure 5 summarises the results of the GVA per Capita Index. It is quite clear from Figure 5 that the majority of municipalities due for demarcation in 2016 are below the South African average. Figure 5 suggests that over 80\% of the municipalities due for demarcation have a weak potential revenue base. There are amalgamations consisting of municipalities with GVA per capita indices below average: e.g. Camdeboo, Baviaans and Ikwezi; Hlabisa and The Big 5 False Bay; and Blouberg and Aganang. This observation suggests that amalgamating some of the municipalities would not necessarily result in the newly amalgamated municipalities having a better revenue base.

Figure 4: GVA Index

Source: Authors’ Calculations

(iii) \textit{Per capita income}

Per capita income is another well-known indicator of fiscal capacity (Tannernwald 1999; Bandyopadhyay 2013; Yasmin et al 2007). As is the per capita GVA measure, the per capita income measure captures the wealth or income potential of a municipality. It captures a
community’s ability to meet its financial needs. Figure 6 summarises the distribution of municipalities to be demarcated in 2016 with regard to the per capita index. Figure 6 shows that around 70% of the affected municipalities fall below the South African average, a further indication that, other things held constant, the communities of such municipalities (e.g. the Hlabisa and Big 5 False Bay amalgamation) would be hard pressed to meet their financial needs from own means.

Figure 5: Per Capita Income Index

(iv) Employment

A municipality’s revenue base depends also on the employed population within its jurisdiction. When a significant proportion of a municipality’s population is employed, the likelihood of it generating a steady stream of revenues is high. Conversely, when the unemployment rate is high, the tax base is constrained. Figure 7 below shows that almost half of the municipalities due for amalgamation in 2016 have below average unemployment rates; an indication that a significant proportion of local governments due for amalgamation have a weak revenue base. Clusters with above average unemployment rates include Camdeboo, Bavaians and Ikwezi; Inkwanca, Tsolwana and Lukhanji; and Ventersdorp and Tlokwe.

Figure 6: Unemployment Index
Poverty is another variable that explains a municipality’s fiscal capacity. High levels of poverty imply a weak revenue capacity. Poverty levels for all municipalities due for demarcation were compared with the average poverty level for all South African municipalities which assumed a value of one. The results are shown in Figure 8. Figure 8 indicates that over 60% of municipalities fall below the average poverty level for all South African municipalities. This suggests that for many municipalities (e.g. Hlabisa and The Big 5 False Bay), the mergers will not improve their poverty levels, or their revenue base.

Figure 7: Poverty Index

Source: Authors’ Calculations
To sum up, the above analysis on financial viability suggests that a significant number of municipalities due for amalgamations in 2016 have weak revenue raising capacities. This suggests that amalgamations will not make many municipalities viable or self-sufficient or self-reliant. With weak revenue bases, most of the municipalities will continue to depend on transfers. In a nutshell the results indicate that merging poor municipalities will not necessarily result in a “viable” municipality, as figuratively speaking “zero plus zero plus zero does not make it three”. In other words, amalgamating two or more poor municipalities will not result in a self-reliant municipality.

The huge costs associated with boundary changes demand a relook at the frequency of demarcations. Very frequent demarcations can be disruptive and counterproductive to many policies and initiatives to improve the wellbeing of municipalities. It is critical that boundary changes are scheduled less frequently. It is also important that they are allowed to take root first and also subject to proper evaluation before the process is repeated. In addition the MDB must be given sufficient time to engage more rigorously with any proposals and to consult comprehensively and extensively, carry out proper investigations, including financial modelling and viability studies of proposed mergers.

4. Dysfunctionality

4.1. Can amalgamations correct for municipal dysfunctionality?

The functionality of a municipality is, among other factors, a function of many factors, within and outside a municipality’s control. Using four factors: (i) institutional management, (ii) financial management, (iii) governance and (iv) service delivery; we assessed the functionality of municipalities due for amalgamation (Figure 10). Most municipalities- 80% are at risk of being dysfunctional and 6% are dysfunctional. Amalgamating municipalities that are at risk of being dysfunctional may actual worsen the problem.

Figure 11 also shows another interesting amalgamation - that of a functional metro (Mangaung) and a dysfunctional rural area (Naledi LM). Financial viability/self-reliance may be achieved by this merger, but governance and democratic issues may be compromised, i.e., two important elements of municipal viability. Political representation for marginalised communities in Naledi LM may virtually fade and rural governance of these communities will in many ways become less functional as an urban core governs and administers rural
areas. Naledi LM could not achieve financial viability, but it could serve a critical constitutional and democratic role.

Figure 8: Municipal Functionality

Source: Authors’ Calculations

Having noted that many municipalities due for demarcation are not functioning well, we ask the question: Is the demarcation the right instrument for dealing with dysfunctional municipalities and can it be a criteria for demarcating municipalities. The answer points to the contrary. The linkage between functionality and boundary changes is unclear, as a municipality can be dysfunctional because of various reasons that cannot be solved by changing boundaries. Dysfunctionality may be “imported”, i.e. when outside factors (political, financial etc.) affect the municipality. Dysfunctionality can also be because of managerial lapses, bad choices or instability at senior levels. The factors that can cause a municipality to be dysfunctionality are many and have no direct bearing on boundary changes, nor can they be influenced by boundary changes. CoGTA’s five “functionality” criteria (community satisfaction, institutional management, financial management, service delivery, governance and political stability) cover issues that are not directly relevant to boundaries, with many relating to broader performance and compliance issues. Functionality
involves a range of factors such as service delivery, institutional management, financial management, community satisfaction, governance or political stability. For example, using demarcation to correct for financial mismanagement is akin to providing a patient a wrong pill, which may do more harm than good, whilst corrective action (e.g. de-amalgamations) may be too expensive and impractical to implement. The MDB mandate includes, inter alia, demarcating municipal boundaries, ward delimitations, and conducting Municipal Capacity Assessments, and not correcting for dysfunctionality in municipalities, as the national and provincial executives have a wide array of regulatory, monitoring, support and intervention powers to deal with these issues. Correcting for dysfunctionality in municipalities is not part of the MDB mandate, but that of national and provincial executives which have a range of monitoring, support, regulatory and intervention powers at their disposal to deal with issues of functionality. As there are no apparent connections between municipal boundaries and municipal functionality, elevating the issue of functionality to a demarcation criteria may simply raise expectations about the demarcation instrument that will never be fulfilled by that tool. Problems of dysfunctionality are often temporary which cannot be solved by a long term drastic measure such as the demarcation instrument. The emphasis on functionality “ignores the long-term horizon” – functionality problems ebb and flow and are often temporary; altering boundaries is too drastic a measure and not the best way to solve temporary problems. Functionality cannot therefore be a criterion for demarcation as it is totally transient.

5. Conclusions and Recommendations
Government seeks to make rural municipalities self-sufficient and less dependent on transfers. In 2015 the government proposed to use demarcations to achieve financial viability or self-sufficiency among rural municipalities, and also improve their functionality. The question tackled in this paper was whether this model that seeks to make rural municipalities self-sufficient is appropriate. The study was based on case studies of rural municipalities due for demarcation in 2016. The foregoing analysis suggests that amalgamations will not necessarily result in financial viable municipalities, but in many cases the situation of demarcated municipalities will worsen. The dependency ratio of many demarcated rural municipalities is too high to be reversed by amalgamations. In fact the results indicate that many rural municipalities will continue to be transfer dependent as their revenues bases are fragile and weak. Transfers will remain the main stay of rural local government. It is also
important to note that the constitution is sensitive to transfer dependent municipalities and the transfer system has to cater for this. In other words, the constitution sets no financial viability requirement for all municipalities, but makes provision for some to be transfer dependent. Some municipalities should exist to serve other equally important roles such as ensuring that communities are politically and democratically represented.

On functionality, the study noted elevating this to a demarcation criteria is problematic as there is no direct nor indirect link with municipal boundaries. Municipalities can be dysfunctional for a variety of reasons that have no relationship with boundary demarcation. Amalgamations are a long term measure that cannot correct for short term operational problems associated with municipal dysfunctionality.

The foregoing analysis has demonstrated that many rural municipalities will continue to be transfer dependent. The analysis also suggests that demarcations are a weak instrument for pursuing financial viability of rural municipalities and a wrong one for improving the functionality of municipalities. The foregoing analysis lends itself to the following recommendations:

- The MDB should not make “financial viability”, the core criteria of demarcation given the absence of a shared definition or common understanding of this concept. The MDB should consider financial viability as one of the 12 factors when making boundary changes.

- The MDB needs to consider conducting proper investigations and studies on the viability of demarcated municipalities before making its final decisions on demarcations. The financial and fiscal implications of boundary re-determinations should be prioritised and established before any demarcation decision is pronounced.

- The National Treasury and the Department of Cooperative Governance and Traditional Affairs should:
  - Note that by their nature some municipalities will never be able to be self-funding and as such demarcation processes must go beyond financial viability but also consider as equally important issues of democratic representation and community participation. The transfer system should be allowed to fund
political and democratic representation, and community participation in municipalities considered “financial unviable”.

- Seek to achieve “financial viability” in municipalities by increasing or developing tax bases through economic development rather than amalgamating municipalities.

- The Department of Cooperative governance should:
  - Amend the Demarcation Act to ensure that the full financial impact of demarcations on a new municipality are assessed before any amalgamations are done.
  - Seek to correct for dysfunctionality through legislative, policy and capacity building measures than through amalgamations. The MDB mandate does not include correcting functionality challenges among municipalities as government has an array of measures at its disposal for addressing the issue of functionality. In addition, functionality should not be elevated to a demarcation criteria as it has no direct nor indirect link with boundary changes. Municipalities owe their functionality to a number of factors.
  - Evaluate whether mergers have been successful, and what the actual cost of mergers were.
  - Review the frequency of demarcation with a view to allowing the process to take root first and be subjected to rigorous evaluations before it is repeated. In addition the MDB must be given sufficient time to engage seriously with any proposals and to consult extensively, carry out proper investigations, including financial modelling and viability studies of proposed mergers.

6. References


