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Overview of the Local Government Revenue System

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INTRODUCTION

The most interesting feature of the local government revenue system in South Africa is the degree to which the larger councils have been given revenue-raising powers. As a result, there is in place a foundation on which to develop a much more efficient intergovernmental fiscal system than is typical in lower-income countries.

There are two categories of current (operating) revenue for local governments in South Africa: (1) 'own revenue', which includes taxes and user charges; and (2) transfers from the other spheres of government, which include both an 'equitable share of revenue collected nationally' and categorical grants. There are four potential sources of capital revenue: (1) 'own-source revenue', which includes both local taxes and the Regional Service Council (RSC) levies collected by metropolitan and district municipalities;[1] (2) earmarked grants from higher spheres of government; (3) borrowing; and (4) private-sector equity in infrastructure provided by municipalities. The composition of local government revenues was described in Chapter 1 (Table 1.2) on page 9.

On average, in 2000–2001, metropolitan (category A) municipalities generated 97 percent of revenue from their own sources. Own-source revenue also constituted about 92 percent of the income of the 20 largest local (category B) municipalities (those with budgets larger than R300 million). The remaining category B municipalities raised 65 percent of revenue themselves. The major source of category C (district) municipality revenue is the RSC levy, accounting for about 40 percent of 2000–2001 income. While the above figures are aggregates and hide the great variations across municipalities, they do describe a system with a remarkable degree of reliance on own-source revenues.[2]

At the macro-level, total local government revenues are equivalent to about 5 percent of GDP, with property taxes representing 21 percent of that total. Local governments account for around 20 percent of all government revenue collected nationally, provincially, and locally. This share is modest in international terms, but is high for Africa.

There has been a continuing discussion in South Africa about the need to reform the structure of local government revenues. Some would move the system more in the direction of less local autonomy and more central government control, while others would add to the list of own-source revenues that are already in place. The right choice, we argue, depends on the goals that the government most wants to achieve.

We begin this chapter with a review of the principles or 'norms' by which one might evaluate a local government revenue source, and then review how the major components of present system in South Africa measure up to these criteria. Our key question is whether and how the South African local government revenue structure is flawed. We then turn to a consideration of two major local government revenue sources that the South African government may wish to develop: a tax on utility sales and motor vehicle taxes. More detailed analysis of two key revenue sources currently in use, the property tax and the Regional Service Council levy, is provided in Chapters 4 and 5.

NORMS FOR A GOOD LOCAL TAX

There is no shortage of discussion in South Africa about how local revenues should be changed (Bell and Bowman, 2002; Solomon, 1997; Vaz, 1999; Solomon, 2000; and Bahl and Solomon, 2001). But how does one choose from among the options, and is reform of the present system needed? To begin to answer such questions, one might call on some normative principles that describe a 'good' local government tax.[3]

The amount of revenue generated by the tax should be *adequate* to cover budgetary needs. There should be a balance between budgetary needs based on expenditure assignment, the cost of producing local public services, and the combined amount of local taxes, charges, and intergovernmental transfers. The revenue adequacy norm is more easily stated as a principle than it is implemented as a practice. In theory, the central government might provide intergovernmental transfers to cover the difference between some 'minimum' acceptable level of local services and a normatively defined level of revenues raised from own-sources, an approach considered in detail in Chapter 6. In addition to raising funds from own-sources to satisfy any required tax effort mandates, the municipalities could tax their bases to 'top up' expenditures above minimum levels. The amount of local revenue raised depends on the demand by voters for local public services.

In practice, central grants are more often determined by affordability than by any calculation of minimum service levels. The principle of revenue adequacy, then, means that local governments should have access to a tax base that is broad enough to generate significant revenues at a reasonably low statutory rate. Bahl and Linn (1992, Chapter 5) argue that urban local governments require the property tax and at least one other broad-based local tax to support 'adequate' levels of local public services.

A second principle is that revenues from a local tax should be *elastic*, automatically growing in proportion to the growth in expenditure needs. If revenues grow more slowly than expenditure needs and the difference is not made up by a growth in intergovernmental transfers, local governments will always have to return to voters, or to the central government, to ask for discretionary increases. Alternatively, they would look for 'gimmicks' to cover their shortfalls. Fiscal gimmicks (extra-budgetary revenues, nuisance licenses or taxes, short-term borrowing to cover current expenditures, etc.) are almost always harmful to the economy and do not encourage fiscal discipline.

What is the 'right' income elasticity for the local government tax system?[4] One answer is that it should be exactly equal to the income elasticity of local public expenditures that are not financed by intergovernmental transfers. If this elasticity turns out to be greater than 1.0, then the effective rate of local government taxes automatically will rise over time. If a revenue-income elasticity greater than unity is required, the implication is that local governments will need access to buoyant tax bases, such as income or consumption.

Taxes should be *equitable*. But equity is not an easy concept to define, and is seen differently by different people. To design a fair tax system, one must first be clear about the definition of fairness. Most analysts talk about two concepts of equity (or fairness) in taxation: vertical equity and horizontal equity. Vertical equity is concerned with whether local taxes treat individuals at different income levels according to the standards of fairness that are acceptable to the country.

For example, is the overall national system of taxation meant to be proportional or progressive, and should the local taxation component contribute to that equity goal? Or, alternatively, should local government taxes be viewed as a quasi-user charge, i.e., as a payment for using local government services? In this case, the standard of fairness has to do with whether the local population 'gets what it paid for'.

Horizontal equity is a different notion of fairness. Here the concern is with whether equally situated individuals and enterprises are treated the same by the tax system. The difficult task here is to define what constitutes 'an equally situated' individual or enterprise. The principle, however, is clear. Subsets of individuals or enterprises should not be singled out by the local tax system for discriminatory (or preferential) treatment, unless there is a clear rationale. Most tax regimes in developing countries are not horizontally equitable, primarily for two reasons: the administration of the tax system is not able to reach all sectors of the economy to the same extent, and preferential treatment is commonly given to certain taxpayers. Local government tax administration systems tend to be weak and they rarely capture the 'hard to tax' in their base. The informal sector of the economy and the self-employed often escape income and payroll taxes, and the consumption of services is often missed by the sales tax. On top of this, governments also provide a number of exemptions and preferential rates for purposes of economic development or in the name of improving vertical equity. Because of administrative shortcomings, and perhaps for other reasons, it is not realistic to expect that a local government will have a tax that is horizontally equitable. A more realistic goal is probably to minimize the distortions created by the local tax structure and administration.

There should be a *correspondence* between those who bear the burden of the tax and those who enjoy the benefits of the expenditures financed by the tax. If the burden of a local government tax is exported to residents of other jurisdictions, the taxing jurisdiction will have an incentive to overspend because its population does not pay the full price of the services they consume. While the exporting of local tax burdens is a dream come true for locally elected politicians, it is not good for the country. In addition to harming fiscal discipline by local governments, it may result in a situation where residents of small towns end up paying for some of the services consumed in larger cities.

Local taxes should be structured to give the local government some degree of *fiscal autonomy*. In a decentralized system, local voters hold elected officials accountable for the quantity and quality of services provided. For this to happen, some minimal conditions must be met. The local government must have some control over tax rates, the tax must be large enough to be seen by the local population as a significant burden, and it should be visible enough for voters to recognize it as a levy placed on them by their elected local government. The overriding concern is that the local government must have the power to set the effective tax rate.

A good local tax will be *administratively feasible*. It should be simple enough to be understood by voters, and administrative costs should be reasonable. Local governments and the central government should resist the temptation to pursue multiple objectives with local taxes. These multiple objectives often complicate the tax administration, and may remove efficient collection and assessment from the reach of the local tax administration. The tracking of targeted deductions and exemptions are difficult administrative tasks for local governments, as are monitoring compliance with complicated rate structures. Broad-based local taxes with flat rates ought to be the goal.

Local government taxes should be *neutral* with respect to market decisions. That is, taxes should not cause businesses to change their mix of inputs, their employment levels, etc. In fact, however, violations of neutrality are common in local tax systems. Turnover taxes contain a 'tax on tax' element and therefore lead to higher market prices. Payroll taxes bias the choice between capital and labor in favor of the former. Deductibility of property taxes from the business income tax liability lowers the tax rate on businesses to below the rate levied on individuals. In the real world, there are no completely neutral taxes, but it is good practice to stay away from taxes that are known to significantly distort economic decisions.

Finally, local government taxes must be *politically acceptable*. No one likes taxes, but some taxes are less objectionable to voters than are others. One rule of thumb is that less visible taxes tend to be more acceptable, i.e., people like the illusion of not knowing how much tax they are actually paying. Taxes collected directly from businesses are examples of this. Taxes paid in small amounts (sales taxes) seem preferable to those paid in large annual or semi-annual installments (property tax), perhaps because the taxpayer is less aware of the total amount of tax paid. Such an approach, however, may undermine the revenue-expenditure linkage that is considered to be a principal benefit of fiscal decentralization. There is also a 'certainty' element to political acceptability, i.e., taxpayers like to understand the taxes they must pay.

One can see from this list that no tax can satisfy all of these maxims. Taxes that are politically acceptable may not offer the transparency necessary for a good local tax system, and those that provide ample local autonomy may lead to preferential treatments and horizontal inequities. The payroll, consumption, and property value tax bases may be quite buoyant, but they pose significant administrative challenges. So, constructing the local tax system is a matter of deciding on which objectives to emphasize, and this usually comes from national government policy about decentralization. We now turn to an evaluation of the overall South African system against these norms.

EVALUATING THE LOCAL REVENUE SYSTEM IN SOUTH AFRICA

As noted in previous chapters, the major sources of revenue for South African local governments are utility/user charges, property rates, and the Regional Service Council (RSC) levy. Each of these is briefly considered below in terms of the criteria outlined above.

Utility/User Charges

Most analysts argue that user charges should play a prominent role in local government finance. In principle, user charges, if properly structured, can score high on a number of the criteria outlined above. They can recover the cost of service provision, and can promote efficiency in the consumption of the service. They can be transparent, i.e., the users understand the price they are paying for the service. However, user charges do pose some problems for local government fiscal planners. One concern is that such charges can impose a heavy burden on lower-income service users, though adjustments can be made to offset such effects. Charges set at a level to recover full cost can be politically unpopular, especially in the case of essential services, and increases in the level of charges can face significant resistance.

User charges for 'trading services' – electricity, water, sanitation, and solid waste collection – are a major source of revenue in certain urban jurisdictions in South Africa.[5] Local governments also charge for other services, such as transport, clinics, recreation, etc., but these rarely generate much revenue.

Electricity is a particularly important revenue-generating service for South African municipalities. Of the 843 local governments in existence before the recent demarcation, 400 were licensed electricity providers. They bought bulk energy from the national grid, which is supplied and operated by a parastatal company, Eskom. The municipality provides the local distribution network and collects user charges. Of the authorities that do not distribute electricity to their residents, most are direct customers of Eskom. The remainder are clients of neighboring larger authorities.

Around a quarter of the electricity-distributing authorities have raised significant revenues from the surpluses earned from their sales. Gross utility receipts constitute more than a third of total local government receipts nationally, which is more than the share of the property tax. A significant portion of these electricity-undertaking revenues is used to cover the cost of providing the service, including the cost of the bulk energy from the national grid. Even so, for some authorities, a substantial surplus is left for general local government purposes. Almost the same number, however, lose money on their electricity and water undertakings, implying a subsidy from other tax payers to electricity users. About 50 percent of authorities hover around the break-even mark, with their utilities making no significant contribution to general-purpose revenue.

Although it can be revenue productive for many municipalities, there are a few problems with using utility surpluses to finance local services. First, the tax component of utility charges is 'hidden', therefore the true level of local government taxation is not transparent. It is difficult for voters to hold local officials accountable for expenditure of locally raised taxes when the amount of tax paid is not known. Another problem is that some sales of electricity are made to non-residents, hence the implicit tax is exported. Finally, the consumer price of electricity is overstated by the amount of the implicit tax, with attendant efficiency effects.

There are proposals to regionalize or privatize some services that currently generate surpluses used to fund general expenses. In particular, an upcoming regionalization of the electricity sector will take away from local governments one of their most productive sources of revenue. Not only will this deprive them of the net revenue available for spending for general purposes, but it also reduces the cash flows of many authorities to such a degree that debt ratings could be affected.

For many, their ability to piggyback such functions as credit control and general infrastructure projects on the back of electricity and water projects will be eliminated. While the restructuring threatens to remove the implicit tax from many user charges, it leaves behind a range of costs. Many local governments therefore see the expected reforms as a serious threat to their overall financial viability. Existing 'hidden taxes' in the form of surplus user charge revenues may be inefficient, but they can generate significant revenues and provide a shelter for a range of on-going costs. Their replacement is imperative, and it will require a careful analysis of alternative revenue enhancement measures.

Property Rates

The property tax is an important source of local revenue in South Africa, and accounts for about one-fifth of local government revenues (see Table 1.2). Compared to low-income countries around the world, South Africa makes heavy use of the property tax (Bahl, 2002). Arguably the best feature of the property tax is its significant local autonomy. South African local governments may (within limits) choose the tax rate and even the tax base, and may grant exemptions. Bell (2002, pp. 64–65) reports from a sample survey of South African local governments that one-third use site value ratings, 27 percent use total property value, and 40 percent tax land and improvements at a differential rate. Relatively few developing economies allow their local governments so much autonomy in forming property tax policy.

The property tax also fares reasonably well on equity grounds. The burden of that portion of the tax that is levied on land is likely borne by the owners of land. To the extent landowners belong to the higher income class, there is a progressive element to the property tax. The burden of that portion of the tax that is levied on structures may fall on renters and consumers in general. This will lead to an overall distribution of property tax burdens that is probably no worse than proportional. It is possible also that assessment practices can impact the vertical equity of the property tax. Recent survey work in South Africa suggests some assessment regressivity in larger cities, (Bell and Bowman, 2002).

On the negative side, the property tax is not neutral with respect to business decisions, is politically unpopular, fails the administrative ease test, and does not easily produce a buoyant revenue flow. On grounds of neutrality, the property tax gets a mixed review. A site value tax, as is practiced in about one-third of local jurisdictions in South Africa, has a neutral effect on real estate development. A capital value tax on land and improvements does discourage property investment at the margin, but the magnitude of the displacement is uncertain.

The property tax is politically controversial in all countries, and South Africa is no exception. There are many reasons for this. Probably the most important issues in this regard are that voters are subjected to an assessment procedure that they do not understand, they are taxed on accrued rather than realized income, and they are presented a property tax bill that makes their tax liability 'visible'. Compare this with the VAT for example, where the tax is collected at the time of transaction, and in small amounts. The average taxpayer probably has no idea of how much VAT he/she pays in a year. Transparency may be good for letting voters know the implications of spending and taxing choices, but in the case of the property tax, transparency serves as a lightning rod for voter resistance to taxation.

Although property tax revenues should grow with economic development and land values, politically sensitive rate increases and/or revaluations (also administratively burdensome) are necessary to realize growth potential. In many cases, these discretionary changes are introduced slowly, or only partially, or are never introduced at all.

The biggest problem with the property tax is that it cannot be properly administered at a low cost. In most countries, it is poorly administered in order to keep the collection cost in some balance with the amount of revenue collected. The administration of the property tax requires several steps: identification of taxpayers, assessment, record-keeping, collection, and audit/appeals. These are major tasks that are beyond the financial and technical capability of many local governments.

In summary, one could say that the property tax is the most 'locally controlled' tax in the system, generates significant revenue, and probably does no harm to the overall progressivity of the South African tax system. Its major failings are the high costs of good administration, the arbitrariness that sometimes results from poor administration, and the difficulty in making revenue growth from the property tax keep up with growth in the economy. The important point here is that a badly administered property tax leads to a failure of the tax to 'do its job' in the revenue system. Poor assessment leads to an unfairness because some taxpayers are more under-assessed than others, poor identification of property leaves some potential taxpayers off the roll, poor collection and enforcement procedures encourage non-compliance, and inadequate valuation staff and voter resistance combine to keep the tax rolls well out of date and to slow revenue growth. We hasten to point out that there is much variation in the efficiency of the practice of property taxation in South Africa. Even so, to say that most of the problems with the property tax in South Africa can be traced back to its poor administration would not be an overstatement.

Many of these issues are being dealt with in current legislative processes. A new Property Rates Bill currently under debate will assist uniform administration by reducing some of the local choices of base and exemptions, stipulate a nationally uniform mechanism of assessment, implement a monitoring process to ensure assessment quality, and introduce new relief mechanisms.[6] The treatment of newly taxed land, particularly in traditional areas, has been particularly controversial, because of the tight link between traditional political structures and traditional forms of property rights in land. The introduction of property taxes places these areas under pressure to convert land to conventional title. This is seen as a threat to the power base of traditional leaders, and is resisted as such. These and other advantages and disadvantages of the property tax and proposed reforms are considered in some depth in Chapter 4.

Regional Service Council (RSC) Levy

The RSC levy is a tax paid to metropolitan (category A) and district (category C) municipalities by businesses on their gross receipts and their payrolls. It has good revenue adequacy and elasticity, especially the turnover tax component. For all local governments in South Africa, it accounts for less than 10 percent of revenues (see Table 1.2). But for some district municipalities it is essentially the only own source revenue, as documented in Chapter 2. The main virtue of the RSC levy is its ability to generate significant revenue.

The RSC levy might be viewed less favorably in terms of other principles outlined above. There is not a good correspondence between where tax burdens are borne and where expenditure benefits are realized. The burden of the turnover tax on firms that sell in national markets is exported by the 'home-office' jurisdiction to residents in jurisdictions where the consumption takes place. This is the case to the extent that firms that sell nationally pay their full tax liability to the jurisdiction where their headquarters are located. The evidence suggests that most companies do not allocate their turnover tax liability among their individual sites. The payroll tax is somewhat easier. It is borne where taxpayers work, but it also fails the exporting test if there is significant cross-jurisdiction commuting to work.

The RSC levy does not support the goal of local autonomy. The tax rate and base are set centrally with little or no local government control. In some ways, it functions more as an intergovernmental transfer than as a local tax. The greatest failing of the RSC levy is in its administration. At present, local governments can do little more than ask businesses to make payment. They have, in practice, no legal authority to assess the tax or to properly enforce it. Even if local governments did possess the necessary legal authority to assess and collect the tax, it would be a problematic levy. Proper administration of this tax would be very complex, particularly for the turnover tax component. Administration would be easier for the payroll tax (if collected from withholdings). But potentially costly audit would be required for both components, and much of the tax base would be beyond the reach of the local governments.

In terms of vertical equity, the turnover tax component is likely to be regressive because it is passed forward to consumers. The payroll tax fares better because it falls primarily on those working in the formal sector of the economy. However, many of the self-employed in the formal sector are likely to be higher income and are probably out of the reach of the tax administration.

The RSC levy fails to meet norms of horizontal equity. There is an arbitrariness to the assessment and collection of RSC levy revenues. This uneven administration leads to discriminatory practices, where firm A might pay according to its full liability, but firm B might pay only a fraction of its liability. Efficiency distortions are also a concern, and a shortcoming of the RSC levy. The payroll tax discriminates against labor and at the margin discourages employment. The turnover tax is imposed at each stage of production, distribution and consumption, leading to higher prices and favoring vertically integrated firms. The extent to which these non-neutralities are damaging to the economy depends on the level of the effective rates of tax. At present, the effective rates are quite low.

In summary, the RSC levy has strong revenue benefits and seems to be politically acceptable, at least for now. The major question is whether these benefits and the low rate of taxation outweigh the considerable negative aspects of the tax. We consider the RSC levy in detail in Chapter 5.

OTHER LOCAL GOVERNMENT REVENUE OPTIONS

South African municipalities have more productive sources of revenue than local governments in many other countries. Still, expenditure needs are great, and there is reason to consider introducing additional taxes and charges. Moreover, there is substantial discussion about changing the local property tax and RSC levy in ways that would significantly dampen local government revenue-raising potential. In this section, we consider two possible additional local sources of revenue, an excise tax on utility sales and motor vehicle taxes. Each is briefly evaluated against the criteria outlined above.

Utility Excise Tax

As noted above, surplus revenues from utility charges, particularly electricity, have been very important for many local governments in South Africa. Two major reform processes are now under way which will affect this situation.[7] First, local governments have been re-demarcated, consolidating neighboring authorities into single jurisdictions. This has reduced the number of authorities from 843 to 284. In this process, utility operations have been merged, possibly resulting in a reduction of the number of loss-makers. Second, a proposal to restructure the entire electricity distribution industry has been accepted and is soon to be implemented. Distribution will be carried out by six Regional Electricity Distributors (REDs) which will take over the existing operations from local governments. In many cases the local authorities will continue to provide the service, but they will do so on behalf of the RED. The REDs have an effective monopoly in their area of jurisdiction and will set tariffs. The details of the regionalization process are not as yet determined, but it seems that authorities that are currently providing electricity will become shareholders in the RED, and will be paid 'dividends' according to their investment in local electricity infrastructure. Current revenue lost may be replaced by a local utility levy of between 8 percent and 16 percent. All new municipalities will be entitled to levy at the rate they determine within the regulated range. The result of this will be a net gain by municipalities that were making no money from electricity, and a distortion of the final electricity price away from the economically efficient marginal cost.

As noted above, many local governments remain concerned about this reform process because of their reliance on the very large cash flows associated with utility user charges to finance their operating capital needs, and because of the historical administrative association of the electricity credit control mechanisms with the much more difficult property tax collection processes. The councils interrupt electricity supply of residents who are in arrears with property taxes or other local charges in order to encourage payment. This powerful mechanism will be lost as a result of the restructuring, likely resulting in increases in the default rate. In view of the recent history of 'boycott' or tax revolt in South Africa, this is seen as very problematic.

In recognition of the inevitability of this restructuring provision, it would be prudent for local governments to divorce their revenue stream from the operation of utilities. An excise tax on the sale of utilities a more secure, less easily challenged source of revenue than the utility surpluses that many municipalities currently receive. Empowering municipalities to levy a tax on the sale of utility services sold in their regions would provide a suitable replacement for the loss of revenue that will result from the restructuring of the electricity sector.

The principal base of the new excise tax would be the sale of electricity. It is therefore a base of considerable size, and could yield significant revenue. Moreover, the shift to an *ad valorem* tax would give local governments a buoyant revenue flow that would grow with consumption and with the cost of service provision. This tax could be structured to provide fiscal discretion to the local governments. Local governments could set a schedule of rates at the level dictated by their own requirements and policies, and they could be empowered to offer rebates or incentives.

The utility excise tax would have other advantages over the present system. The surplus currently earned on utilities is an implicit tax, paid by all consumers in the service area. The excise tax that could replace it would be an explicit, visible charge. It could in principle be applicable to all utilities regardless of whether surpluses or profits are earned on them and regardless of which authority or service provider delivers them. Water supply could be a substantial part of the tax base in many areas, despite the fact that most water suppliers operate at a loss.

The proposed excise tax could reduce the degree of tax exporting compared with the present system. The implicit tax is paid by all consumers in the service area, regardless of whether they are residents of the taxing jurisdiction. This leads to a tax flow from one jurisdiction to another, with no commensurate benefit received by non-residents. This system resulted directly from the historical demarcation of jurisdictions on a racial basis by the apartheid government. By collecting electricity payments over a wide area, and spending the surpluses in the white municipal areas, some apartheid cities enriched themselves at the expense of their neighbors. An electricity excise tax would eliminate this spillover effect and will ensure that the revenue accrues to the body intended to be financed by it. The excise tax would be paid to the local authority with jurisdiction in the area, whether they are the service providers or not.

An excise tax on utilities meets the test of being easy to administer and having low compliance costs. Since the tax base is the utility bill, little or no additional record-keeping is required and no separate assessment is necessary. The tax could be paid as part of the utility bill, thereby minimizing enforcement and collection costs.

An important advantage of the excise tax over the implicit tax is that fiscal concerns become independent of restructuring issues. At present it is difficult to separate these issues. The on-going reform deliberations of the electrical industry as regards ring-fencing, cost allocation, ownership, appropriation of surpluses, or redefinition of market territories profoundly affect revenue arrangements under the present tax regime. This characteristic alone commends the excise tax option. All spheres of government in South Africa are engaged in the restructuring of every enterprise in which government is involved. Electricity in particular is not likely to see stability in industrial structure for some years to come, and the water utility is also likely to be relatively unsettled. A tax on electricity sales effectively insulates this fiscal component from the restructuring.

The excise tax is not without flaws as a local revenue source. Critics will argue that it is, in effect, a regressive tax. The consumption expenditures on essential services likely constitute a larger share of the income of poor families than of higher income families. And because the tax is transparent and falls on virtually all households, it likely will be politically unpopular. Significant grass-roots resistance might be expected, and the temptation to provide relief to low-income households would be strong.

The adoption of an excise tax on utilities would bring some changes in the access to revenues. In the case of the metropolitan governments, where the target surpluses are being earned, the switch to an excise tax would result in revenue decline because of the loss of non-residents who are presently contributing to the tax base. The loss of this source of revenue to the urban portion of the region could be compensated by a reduction of their responsibility for regional functions. In return, the district municipalities could be given access to the excise tax, i.e., to a tax on consumption by their residents. This would be a significant revenue enhancement.

The implementation of an electricity excise probably would not face legal hurdles. The Constitution allows for an excise tax at the local level, and the Local Government Municipal Systems Act (2000) specifically allows for a surcharge on utility tariffs.

Motor Vehicle Taxes

Motor vehicle licenses are currently a provincial government revenue source in South Africa. Passenger vehicle licenses are in the range of R100 per annum. Municipalities do not have access to motor vehicle taxes at present, though there has been discussion of this possibility (Permanent Finance Liaison Committee, 1996; Ministry For Provincial Affairs and Constitutional Development, 1997). There is ample justification for allowing local governments access to this tax base, and there are numerous options for taxing motor vehicle ownership and use. Certainly, local governments could share in annual license fees, or the right to levy the license could be transferred from the province to the local governments. Other options that might be considered include: restricted licenses for entry into congested areas, such as central business districts or office parks, parking fees, taxes on off-street parking, a motor vehicle fuel tax, and tolls.[8]

Motor vehicle taxes match up very well with nearly all of the maxims for good local tax. They can be quite revenue-productive and revenue-buoyant. The motor vehicle base is growing rapidly. It increased from 81 cars per 1,000 population in 1970 to 160 per 1,000 in 1997. Thus, the revenue potential is good, particularly in urban areas. Road use imposes several costs on the community that are not directly borne by the user. These include traffic congestion and air pollution. Motor vehicle taxes might capture some of these costs, or at the margin, might reduce congestion and pollution.

Vehicle users contribute to the deterioration of roads, and should therefore directly contribute to road maintenance costs. This part of the tax could be viewed as a kind of user charge, and in fact is used in many countries. In the United States, for example, motor fuel taxes are earmarked for state government highway expenditures. When road user charges are levied, however, there must be a correspondence between the assignment of expenditures for highway maintenance and the assignment of taxing power. In the case of South Africa, this would imply a division of revenues between the local and provincial governments.

Motor vehicle taxes would seem to satisfy equity norms. One would expect that motor vehicle owners are relatively higher income; hence a regressive distribution of burdens is not likely. That part of the tax on diesel fuel, however, could be more regressive in its impact. Or motor vehicle taxes can be thought of more as user charges, in which case there is a rough correspondence between benefits received and payments made. Some motor vehicle taxes also pass the test of administrative ease. Licenses must be paid for at registration and license plates provide a good check on compliance. Motor fuel taxes, congestion licenses, and parking taxes can be more difficult. Finally, there is no constitutional impediment to allocating motor vehicle revenue sources to local governments.

There are also potential disadvantages to motor vehicle taxation by local governments in South Africa. Some are general shortcomings and some are specific to particular sources. A major escalation of license fees would be required to raise significant revenues for local governments. An 80 percent across-the-board increase in existing fees would be required to raise one billion rand per annum. For example, this would increase the private vehicle license from R95 to R171. This could raise significant political opposition.

The most revenue productive motor vehicle taxes for urban local bodies are the motor fuel tax and the license fee. Designing a workable local government motor fuel tax, however, would be a challenge. First, the national government may not want to give up its claim on this revenue base. Second, there are problems of collection. If the tax can be collected at the pump or from distributors, a local tax could work. If collection is required from producers, then it is a more difficult matter. Finally, there is the problem of 'fuel carrying', the possibility that consumers would drive to the next, lowest taxing jurisdiction to buy their gas. Many would argue that if the motor fuel tax is to be decentralized, the provincial government is the more suitable recipient because it covers a wider geographic area.

SUMMARY

The South African system of local government revenues is relatively strong by developing country standards. Local governments in South Africa currently pass one of the acid tests of devolution: they do have access to some significant tax bases that are productive, and the urban councils do finance a significant share of their budgets from own sources. By contrast, the smaller, more rural councils lack resources and are much more dependent on intergovernmental transfers.

When matched up against the norms for a 'good local tax system', the South African structure has both strength and weakness. Since both revenue structure and expenditure assignment are now under review in South Africa, it is important to recognize the strengths to be preserved and the problems to be addressed.

The overall revenue adequacy of the system is not so easily assessed. There is never 'enough' revenue to satisfy all expenditure needs. Provincial and local governments together account for about one-half of all government expenditures in South Africa, a share that is more than twice the international average.[9] Local governments are the smaller partner in this expenditure, accounting for only one-third of the provincial and local total.

The share of national revenue that accrues to local governments, the local government's vertical share, is the smallest of the three spheres of government in South Africa. Moreover, we can report that the share of local government spending in national government spending has not grown in recent years. The local government share was 3.2 percent in 1995–1996, but only 2.8 percent in 1999–2000. It is projected to rise back to 3.3 percent in 2003–2004 (National Treasury, 2001).

There are reasons to argue that the expenditure needs of local governments are significant and that there is a deficit, i.e., the vertical share is too low, as discussed in Chapter 6. Certainly a backlog of unmet demand for basic services built up during the apartheid era, particularly in the former black townships and the rural areas. Partly due to the heavy demands of serving the former black townships, there has been fiscal stress even in the cities. Johannesburg was recently taken to the brink of loan default and bankruptcy. But, there is also general and significant unmet demand for services provided by the national government. Ultimately, the decision about the 'right' vertical share will be more subjective than based on hard numbers, and will be determined by the role local governments are expected to play in the fiscal system. It is clear, however, that finding the proper shares of national, provincial, and local governments is a priority agenda for the government.

As important as the vertical share is the buoyancy of the local revenue system.[10] Data are not available to make an estimate of the built-in or automatic income elasticity of the system. We can examine the buoyancy in terms of the features of each revenue instrument. The property tax in some jurisdictions has been plagued by the chronic lag in revaluation and by a lack of consistent administration; hence its base in some local jurisdictions has not grown in step with increases in property values. Property taxes in Cape Town, for example, are still based on 1979 valuations (van Ryneveld and Parker, 2002). Recent surveys of all South African local governments suggest that there is great variation in the age of valuation rolls (Kapp Associates, 1998; de Lange, 1998; Bahl, 2002). Absent revaluation, the revenue increases have come primarily because of the addition of new properties to the roll and rate increases. As a result, there has been some buoyancy to the South African property tax. Revenues as a percent of GDP fell from 1.66 percent in the 1970s to 1.41 percent in the 1980s, but rose to 1.87 percent in the 1990s (Bahl, 2002). The other major local government tax, the RSC levy, has shown a buoyant growth despite some severe limitations in terms of local powers to assess and collect the tax, as discussed in Chapter 5. Solomon (1998) reports that total local government tax revenue declined as a percent of GDP from 1.5 percent in 1994–1996 to 1.3 percent in 1997–1998, and was estimated to be 1.2 percent in 2000–2001.

We might conclude that the local governments have managed a revenue growth that is greater than what one would have expected, given the basic structure of their tax system. Maintaining and improving the buoyancy of the local government would seem a priority objective for local government fiscal reform.

With respect to efficiency issues and local autonomy, the South African system has some attractive features. The property tax is a local tax in the traditional sense. The local government sets the tax rate, and even the tax base is chosen by the local government, although proposed reforms will limit this discretion in the future. The local council may decide on exemption and incentive policies for economic development purposes and for general relief. Local governments can and do set user charge levels without significant restriction from the national government. In theory, the RSC levy empowers local governments to set the rates, but the rates have been frozen by the center since 1996. Borrowing powers of local governments are limited by a national government regulatory framework. Since 1997, borrowing from the private sector has not increased, while borrowing from public sector institutions has grown significantly (National Treasury 2001, pp. 189–190). All in all, local governments do have a significant degree of fiscal autonomy. If decentralization is an important part of the agenda of the South African government, the new reforms should protect this feature of the local revenue system to the extent possible.

Economic efficiency is also well served by a local tax system that does not distort choices of producers and consumers. In fact, no tax system is free of such distortions, and the question is whether the local tax rates are high enough to cause significant displacements. The RSC levy on turnover and payroll creates an unwanted distortion (see Chapter 5), but the tax rates are quite low. The property tax is levied on structures in some localities and only on sites in others. The former, which is the likely base under proposed reforms (see Chapter 4), discourages property investment, whereas the latter is neutral.

South Africa's tax system does not always conform to the notion of 'benefit-burden correspondence'. That is, the burden of the tax should be borne by those who benefit from its expenditure. The RSC levy on turnover is paid at the headquarters location rather than where the sales take place, hence some degree of tax exporting takes place. In addition, the inclusion of an implicit tax in utility charges imposes a tax on non-resident users of the utility service. This non-correspondence gives local governments an incentive to overspend because they are able to export part of their tax burden to non-residents.

The equity or fairness of the local government tax system is reasonably good. The property tax is probably roughly proportional in its distribution of burdens. The RSC levy is likely to be mildly regressive (the turnover tax constitutes about two-thirds of revenue) and the tax component of the electricity utility charge is probably regressive. Since local government taxes constitute less than 10 percent of total government taxes, the impact on the overall distribution of tax burdens is probably not very great.

As in most countries, South Africa's local tax system faces most of its problems in the area of administration. The property tax is plagued by insufficiently frequent revaluations that are at best of patchy quality. Valuation rolls are commonly three or four years old, resulting in a lag in revenue growth and chronic vertical and horizontal inequities in tax liabilities among properties. The administration of the RSC levy is particularly poor, to a point where the levies may best be described as a tax on honesty. Both the assessment and collection systems are badly in need of reform.

User charges, particularly for utilities, are in significantly better shape in terms of administration and revenue generation. This revenue source is, however, under threat. The proposed restructuring of the electricity sector into five Regional Electricity Distributors (REDs) has significant revenue implications for those local governments that currently include an implicit tax in their utility billings. Proposals now under consideration would de-link the local government revenue system from the structure of the electricity sector through the imposition of a municipal excise tax.

There are several options open to reform the local government revenue structure in South Africa. The administration if not the structure of the RSC levy must be modified in order to modernize this tax and make it better conform to notions of a good tax. The government is considering a variety of measures aimed at restructuring the property tax, many of which have positive characteristics despite the likelihood of some limitation on local autonomy. Two new proposed taxes might be given more consideration. The proposed excise tax on electric utility consumption has much to recommend it, as do local government levies on motor vehicles.

To sum up, there are many areas in which the present local government revenue system performs adequately, but there is also substantial room for improvement. Consideration of possible new sources of local government revenue also should be on the agenda. The government is presently considering reform proposals for all the major components of the local government revenue system. These reforms and restructurings are likely to continue for several years. It is important that decisions about reforms to existing sources and the adoption of new ones should be based on decisions made about the assignment of powers and functions, and about the government's goals for fiscal decentralization. The next two chapters turn to a more detailed analysis of the property tax and the RSC levy.

NOTES

1. The formal designation of the RSC levy as a source of revenue for capital financing is much more a statement of intention than reality. The RSC levy is better viewed as a source of general revenue that may or may not contribute to the financing of capital projects. This is also the position of the Financial and Fiscal Commission (2001a).
2. National Treasury (2001).
3. See for example, Bahl and Linn (1992); McLure (1998); and Bahl (2000) for a more detailed treatment of these criteria.
4. The revenue-income elasticity is the percent increase in revenue that is automatically generated by a one percent increase in income.
5. User charges in South Africa are discussed in Department of Constitutional Development (1997b); Eberhard (1995); Financial and Fiscal Commission (2001b); and National Treasury (2001).
6. At the time of this writing, a new property tax bill was approved by Cabinet and submitted to Parliament for consideration. This bill is discussed in detail in Chapter 4.
7. The proposed reforms and their potential impact on local governments are discussed in Financial and Fiscal Commission (2001b); National Treasury (2001); and Elexpert (2002).
8. The practice in some other countries is described in Bahl and Linn (1992), Chapter 7. For a discussion of the merits of a fuel levy for municipal governments in South Africa, see Naude (1998).
9. See Chapter 1 for a discussion of this measure of fiscal decentralization in South Africa.
10. Buoyancy is the increase in revenues associated with an increase in income, irrespective of whether the revenue increase is automatic or due to discretionary actions.

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