MEDIUM TERM BUDGET POLICY STATEMENT 97 - INTERGOVERNMENTAL FINANCIAL RELATIONS

Constitutional context

Background

There are three spheres of government: national, provincial and local. Each has responsibility for its own financial management and expenditure planning. Respect for this principle is the foundation of the budget process.

Equitable shares

The Constitution provides that each sphere of government is entitled to an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it. The equitable division of revenue takes into account the functions assigned to each sphere under the Constitution and the capacity of each government to pay for these functions through own receipts and revenues.

The equitable share is an unconditional allocation to the national government, to each of the nine provinces and to local government. Provincial and local governments, being distinct spheres of government, are fully responsible for these funds and are directly accountable for how they are spent. Government policies influence provincial and local government spending indirectly, through cooperative agreements and framework legislation setting norms and standards.

Other allocations

In addition to their equitable share, provinces and local governments may also receive other allocations from the national share to which the national government may attach conditions.

Financial and Fiscal Commission

In reaching agreement on the equitable division of revenue and on other allocations to provincial and local governments, the Government has benefited from the advice of the Financial and Fiscal Commission (FFC). The Commission’s proposals have been taken as point of departure in the deliberations of the Budget Council, comprising the Minister of Finance and Members of Executive Councils responsible for provincial finance. In brief, the recommendations of the FFC for the division of revenue between the national government and provinces were aimed at achieving:

- effective and efficient resource allocations;
- fiscal equity in the provision of services and the raising of provincial taxes; and
- development of fiscally sound and democratically responsive provincial governments.

In respect of local government, the aim of the equitable share is to provide a fair and transparent subsidy to municipalities to support the provision of basic services to low-income communities.

Division of Revenue Bill

After consultation with provincial governments and organised local government, proposals for the equitable division of revenue will be presented to Parliament. On Budget Day, the Minister of Finance will table a Division of Revenue Bill along with the national budget. The Division of Revenue Bill will specify:

- the equitable share for each of the three spheres of government as well as for each of the nine provinces; and
- all other conditional and unconditional grants from the national share.

This will give effect to the constitutional requirement that an Act of Parliament provide for intergovernmental financial arrangements, and that it take into account the needs and interests of the national government, the need to ensure that the provinces and municipalities are able to provide basic services and perform the functions allocated to them, and other relevant considerations.

Resources available

Economic projections

The resources available to be shared by the national, provincial, and local spheres of government over the coming three financial years are estimated on the basis of projections of the economy's performance over the medium term. These projections are set out in Chapters Three and Four of this Statement.

The Constitution requires that all revenue raised nationally be divided equitably between the three spheres of government. In addition to collecting revenue, government currently borrows to meet its expenditure requirements. Debt service and repayment obligations arise from this borrowing. It is the balance of national revenue plus borrowing, less debt obligations, that represents the total pool of resources available for sharing.

The Constitution provides for national legislation to govern the power of provinces and local government to borrow. Subject to national oversight, loans may be raised for capital expenditure and to bridge temporary current revenue shortfalls.

Own revenues

Provincial and local government own-revenues are not included in the calculation of equitable shares. The Constitution places limitations on the power of provincial and local government to raise revenue, and indicates that any additional revenues raised by a province or municipality cannot be deducted from its equitable share.

The vertical division

Definition

The *vertical division* is the allocation of the total available resources - after provision for debt service costs - between the three spheres of government.

Table 5.1: The vertical division

R million	1997/98	1998/99	1999/00	2000/01
National share	66 140	70 720	74 800	82 010
National share % of total	45,7%	45,8%	45,0%	44,9%
Local government equitable share	1 120	1 210	2 360	2 620
Local government share % of total	0,8%	0,8%	1,4%	1,4%
Provincial equitable share	77 410	82 480	88 970	98 070
Provincial share % of total	53,5%	53,4%	53,6%	53,7%

Note: The tables in this chapter do not reflect allocation of the policy reserve. The national share includes amounts that will be transferred to provincial and local governments through conditional and unconditional grants.

Projected shares

The projected division of revenue for the 1998/99-2000/01 period is set out in table 5.1. This division maintains a broadly stable share for each sphere, apart from identified function shifts. The preliminary division of revenue excludes the amounts set aside as policy and contingency reserves, discussed in Chapter 4.

The national government share is about 46 per cent, 53 per cent is allocated to provinces and about 1 per cent goes to local government. The national government share includes various amounts that will be transferred to provinces and local government through conditional grants. The local and provincial equitable shares must be viewed in the context of these additional transfers.

The projected increase in the local government share between 1998/99 and 1999/00 is a consequence of the envisaged Transfer of Staff to Municipalities Bill (discussed further below).

Improvements in remuneration

Improvements in conditions of service can either be transferred to provinces as a conditional grant from the national government share, or they can be met directly by the provinces from the provincial equitable share. In either case, the equitable share would be adjusted to reflect the assignment of responsibility for the costs of improvements. The table above shows funds for improvements in conditions of service as part of the provincial equitable share. The provincial budget allocations will exclude provision for improvement if this function is kept on the national budget.

Priorities

The division of funds between the spheres must reflect the nation's policy priorities. If the share of expenditure going to social services is to be increased, this will take effect through increases in the equitable share of provinces, or additional grants to provinces from the national share. If the criminal justice system is to be strengthened, this would require an increase in the national share.

Government's allocation of the policy reserve could alter both equitable shares and the proportion of the national share taken up by grants to provinces and local government. Such changes will be reflected in the allocations published in the 1998 Budget.

Horizontal division – equity between provinces

Definition

An explicit revenue sharing formula is used to divide the provincial equitable share between the nine provinces – this is called the *horizontal division*. It directs funds to provinces based on their demographic and economic profiles, as these provide an indication of the demand for basic services within the provinces.

Formula elements

The formula is comprised of the following six components:

- an education share, based on the average of the size of the school-age population and number of learners actually enrolled;
- a health share, based on the proportion of the population without private health insurance and weighted in favour of women, children, and the elderly;

- a social security component, based on the estimated numbers of people entitled to social security grants;
- a basic share, based on total population, with an additional 50 per cent weight in favour of rural communities;
- an economic output share, based on the estimated distribution of gross geographic product (GGP); and
- an institutional component, equally divided among the provinces.

Components of the equitable division

Table 5.2 sets out the contributions of the components of the formula to each province's equitable share of revenue.

The elements of the equitable division formula are not indicative budgets. The education, health or social security shares are not conditionally allocated to these functions. Provinces budget for these functions within their overall resource constraints, informed by their own processes of prioritising spending within the context of national policies.

Demographic data

The revenue sharing formula relies on provincial population estimates for the education, health and social security components and the basic share. At this stage, the preliminary results of the 1996 census are used, including estimates of the age distribution by province prepared by the Department of Finance in consultation with the Central Statistical Service.

Table 5.2: Components of the equitable shares formula

	Education	Health	Social security	Basic share	Economic output	Institutional	Weighted average
Weight	*39,0%*	*18,0%*	*16,0%*	*15,0%*	*8,0%*	*4,0%*	*100,0%*
Western Cape	8,5%	10,2%	9,1%	9,3%	14,1%	11,1%	9,6%
Eastern Cape	18,5%	17,3%	18,8%	16,6%	7,6%	11,1%	16,9%
Northern Cape	1,8%	2,0%	1,9%	1,8%	2,1%	11,1%	2,3%
KwaZulu-Natal	21,3%	21,1%	21,0%	21,2%	14,9%	11,1%	20,3%
Free State	6,3%	6,7%	6,6%	6,1%	6,2%	11,1%	6,6%
North West	8,0%	8,3%	8,8%	8,7%	5,6%	11,1%	8,2%
Gauteng	13,8%	15,6%	13,3%	15,8%	37,7%	11,1%	16,2%
Mpumalanga	7,5%	7,0%	7,2%	7,5%	8,1%	11,1%	7,6%
Northern Province	14,3%	11,8%	13,3%	12,8%	3,7%	11,1%	12,5%
Total		**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**

The full census results will become available during 1998. They will be used in the revenue sharing formula for next year’s budget process and may affect the last two years of the MTEF allocations. Once firm evidence of inter-provincial migration trends becomes available, it will also be possible to adjust provincial allocations for variations in population growth.

Tax shares

The economic output component of the formula directs a proportion of nationally collected revenue back to the provinces where the revenues are generated. This serves as a proxy for the provincial own-revenue that would be raised were provinces to raise additional taxes themselves. The possible future role of provincial tax powers is currently under review by the Commission of Inquiry into the South African Tax Structure.

This component acknowledges the link between investment and infrastructure needs and related economic services, and the level of economic output in a province.

Institutional component

The institutional component, which is divided equally among the provinces, provides for the cost of maintaining public administration, building essential capacity, and participating in intergovernmental forums. These costs, unlike those associated with basic services, are not directly related to a province’s demographic profile but represent fixed costs that are borne equally by all the provinces.

Phasing

The revenue sharing formula yields a distribution across the provinces that differs somewhat from the current distribution of funds. Government has agreed that the new shares will be phased in over five years – that is, by 2002/03.

Redistribution

By relying on provinces’ demographic and economic profiles, the revenue sharing formula represents a sharp break from historical funding patterns. The result is a significant redistribution of resources to reflect an equitable provision for services provided by provinces, taking into account demographic trends.

The 1996 census results suggest that the distribution of people between provinces is shifting in favour of the Western Cape and Gauteng. Elderly people, women and children are still disproportionately resident in provinces with large rural populations, such as the Eastern Cape, the Northern Province and KwaZulu-Natal. These are factors that impact directly on the provincial revenue shares.

Table 5.3: Impact of equitable shares formula

	1997/98 Equitable shares	2002/03 Target shares	Percent change
Western Cape	10,0%	9,6%	-3,8%
Eastern Cape	17,9%	16,9%	-5,7%
Northern Cape	2,6%	2,3%	-11,8%
KwaZulu-Natal	19,2%	20,3%	5,9%
Free State	6,9%	6,6%	-4,9%
North West	8,9%	8,2%	-7,3%
Gauteng	14,6%	16,2%	10,4%
Mpumalanga	6,3%	7,6%	20,0%
Northern Province	13,7%	12,5%	-8,9%
Total	100,0%	100,0%	

* Formula to be phased-in over five years. The "equitable shares" exclude other unconditional and conditional grants to the provinces from the national share.

Table 5.3 illustrates the impact on provincial equitable allocations of the revenue sharing formula. Shifts between provinces reflect:

- the poverty-related weighting of the rural population in the social security and basic components of the formula;
- the bias in favour of the school-going population and education enrolment in the education component;
- the bias in favour of people without private medical insurance in the health component;
- the weighting in favour of women, children and the elderly in the health and social welfare shares; and
- the increased share of the total population accounted for by Gauteng and the Western Cape in the preliminary 1996 census results.

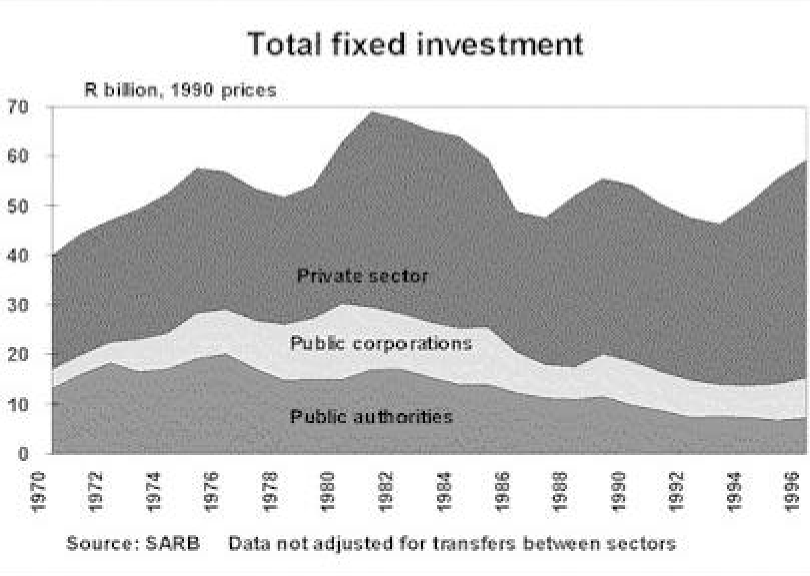

Figure 5.1: Equitable shares distribution

Per capita equitable shares

Figure 5.1 above illustrates the equitable allocations *per person* (using current population estimates) in 1997/98 and 2002/03 that are implied by the agreed revenue sharing formula, expressed as percentages above or below the national average. It should be noted that these shares exclude any conditional grants to provinces from the national share.

Conditional grants

The Constitution provides for transfers to provinces or local government out of the national equitable share of revenue. These grants can be assigned for particular purposes or be subject to specific conditions. Drawing on both the recommendations of the FFC and the work of MTEF sectoral teams, Government proposes the introduction of several conditional grants in 1998/99 as part of the overall share of resources to be available to provinces.

Health services

Past inequities have resulted in a geographically distorted health care system. Delivery of tertiary health care and medical training functions are concentrated in four provinces. These services are not restricted to the residents of those provinces and whilst there is a health component in the revenue sharing formula, it does not adjust for cross-boundary flows. Recognising the importance of central referral hospitals and medical training facilities as national resources, it has been agreed that conditional grants should provide for these services.

Components

The conditional health grant has three components:

- medical research and training – to compensate provinces for the additional costs associated with training health professionals;
- central hospital services – to contribute to the costs of providing tertiary level care and other referral services across provincial boundaries; and
- redistribution of tertiary services – to facilitate a redistribution of tertiary services to under-provided provinces.

It is envisaged that the total allocation for tertiary services should over time be more equitably distributed between provinces. This would enable the conditional grant to be reduced, with the funds returned to the equitable share for provinces and distributed according to the health component of the formula. The balance of the conditional grant for tertiary services would then focus on medical training and specialised services of national interest.

Primary School Nutrition Programme

The Primary School Nutrition Programme is a Presidential Lead Project that was originally funded through an RDP allocation. Provinces received a total of R496 million for this programme in the current financial year, and it is envisaged that this should continue to be funded through conditional allocations to provinces from the national share of revenue. A consultant has been appointed to support the management of the programme, and these costs will also be met from the programme's allocation.

Other grants

Other conditional grant amounts in 1998/99 include provision for outstanding commitments on school classroom building projects and a KwaZulu-Natal peace initiative task team.

Government is considering the possibility of conditional grants to support targeted capital spending in the provinces, in particular to address health and education infrastructure needs. Government is also looking into a proposal for a matching grant mechanism between the national and provincial governments to fund Curriculum 2005.

Local government share

Kinds of transfers

Intergovernmental transfers to local authorities in 1997/98 will exceed R5,9 billion. They include operating subsidies, capital grants, payments for specific agency services and transfers implicit in municipal services provided by provincial departments.

Advised by the FFC, an "equitable share" for local government will be introduced in 1998/99. This equitable share, which will be phased in, will replace the current patchwork of operating subsidies to local authorities from other spheres of government and will meet the constitutional requirement that local government receive an equitable share of revenue raised nationally.

The local government equitable share will replace the existing grants for operating costs of local government. Capital transfers to local government, such as the Consolidated Municipal Infrastructure Programme and the rural water supply and sanitation programme, will continue to be financed from the national share.

Proposed new system

The Department of Finance has developed a transparent formula-driven approach to subsidising the operating costs of local government, aimed at providing support to the extension of basic services to low-income communities. The new system will be phased in over a five- to seven-year period by replacing existing allocations incrementally.

Transfer of municipal staff

The new approach will have a significant impact on provincial budgets. Several provinces are still meeting the costs of municipal staff in so-called R293 (former homeland) towns. Government expects that the Transfer of Staff to Municipalities Bill will be passed at the beginning of the 1998 Parliamentary session to facilitate the transfer of the affected staff to the relevant local authorities in the course of 1998.

Conditional grant for local government

Beginning in 1998/99, it is proposed that all explicit operating transfers except R293 and Department of Water Affairs funds should be allocated in terms of the new subsidy system. This will take account of both the new formula allocations and existing levels of grants. As a transitional measure in 1998/99, the R293 transfers will go to provinces as a conditional grant for funding the services they provide in R293 towns. The water services transfers would also be dealt with as conditional grants.

With effect from 1999/00, all operating transfers will be allocated in line with the phase-in programme. By this time, provinces will have had sufficient time to carry out the transfer of R293 staff to the relevant local authorities. It is envisaged that operating subsidies for water services should also be phased in as part of the equitable share by the end of 1999/00.

Further consultation

Details of the division of the local government equitable share between municipalities are currently being finalised by the Department of Finance, in consultation with the South African Local Government Association and provincial governments. The proposal will be made public early next year.

Evolution of intergovernmental financial relations

Further refinement

Arrangements for the sharing of revenue between the national, provincial and local sphere of government will evolve further in future years. Whilst addressing some outstanding concerns, this year's approach has also raised further issues that need to be addressed. This year's formula will serve as the starting point for calculating the horizontal division in subsequent years, but it is likely that adjustments will also be made to the framework.

The present approach has drawn strongly on the reports of the Financial and Fiscal Commission dealing with both the provincial division and the financing of local government. Comments of the FFC on this year's approach to provincial revenue sharing have contributed to the refinement of the model and new population data have been introduced. The FFC will make recommendations in 1998 to be taken into account in preparing the framework for the 1999 Budget.

Foundation for future financial relations

Overall, a better understanding of actual expenditures is important for informing decisions about the vertical division. In addition, incorporating final census figures, other new data and elements of demographic change will be necessary. Government recognises, however, that stability in the overall intergovernmental financial framework is a pre-condition for sound financial planning and responsible government. The approach outlined here serves to establish a firm foundation for future intergovernmental financial relations.