6

Division of Revenue

South Africa's intergovernmental system has been developed and consolidated over the past five years. This is reflected most clearly in the turnaround of the financial position of the provinces.

The 2001 MTEF will see dramatic increases in the share of nationally-raised revenues allocated to local government. This reflects the growing importance of the local sphere of government in the delivery of services, especially to the poor.

Although national government's share of revenues will grow initially, by the end of the MTEF the proportion of revenue allocated to the provinces will have recovered.

Introduction

Stabilising provincial budgets

As the 2000 provincial budgets show, provinces have stabilised their finances, are succeeding in paying off their debts and redirecting spending to key priority areas. This lays the foundation for increased infrastructure spending and implementation of the institutional reforms necessary to improve service delivery.

Municipal restructuring

The rationalisation of 843 municipalities into 284 new municipalities is also expected to lead to greater stability in municipal finances in the longer term, as less viable local authorities are phased out. Major municipalities such as Johannesburg, Durban, Cape Town and Port Elizabeth show improvements as they restructure their fiscal and institutional priorities. Large non-metropolitan municipalities, however, will face significant challenges in assuming service delivery responsibilities for the many poor households in adjoining rural areas.

Provincial and local government finances

The *Intergovernmental Fiscal Review 2000* analyses the fiscal performance of provincial and local government.

Turnaround in provincial finances…

After recording a deficit of R5,5 billion in 1997/98, provinces recorded surpluses of R0,5 billion in 1998/99 and R3 billion in 1999/00. These surpluses have been used to pay off debts accumulated in previous years when provincial budgets rose rapidly.

This turnaround in financial performance takes place despite strong cost pressures arising from the provision of social services, high personnel expenditure, and little real growth in provincial budgets.

…despite pressures of social services spending…

The social service sectors' share of the total provincial budget has increased from 81,8 per cent of total provincial expenditure in 1997/98 to 83,4 per cent of budgeted provincial expenditure in 2000/01. This is due mainly to increases in personnel expenditure following the 1996 salary agreement, and the increased take-up rate of social security grants.

… and high personnel costs

Personnel costs as a share of provincial expenditure rose from 54,7 per cent of total provincial expenditure in 1996/97 to 59 per cent in 1998/99 following the 1996 salary agreement. This is expected to decline over the MTEF.

Progress in large municipalities

An overall assessment of local government finances remains difficult, given the lack of uniformity in municipal budgets. However, available information confirms that performance is highly variable, and that some progress has been made, particularly by large and medium-sized urban municipalities, in restructuring fiscal positions to meet service delivery challenges.

Provincial and municipal fiscal powers

Building on these achievements, Government intends to extend the fiscal framework for provinces and municipalities.

National legislation has been prepared to facilitate the introduction of provincial tax proposals. This legislation will give effect to section 228 of the Constitution, and will allow provinces to impose selected taxes within a nationally determined framework. From 2002/03 provinces may also be permitted to borrow for capital expenditure.

New legislation governing financial management and the borrowing and tax powers of local government has also been published for comment, and is expected to be tabled in Parliament next year.

Rationalisation of the local government grant system

Reforms introduced in the national and provincial spheres will be extended to the local sphere. The local government grant system is to be rationalised and allocated on a three-year basis to promote better planning in both the municipal budgeting and financial planning processes.

While local government will continue to receive its share of nationally-raised revenue in the present manner, changes will be made to the manner in which conditional and other grants are allocated to the local sphere. These changes include:

- The distribution of grants between municipalities in an equitable manner, and through a transparent process
- Enhanced transparency, with grants reflected on municipal budgets
- The allocation of grants in a manner that encourages and enhances financial sustainability at municipal level
- Measures to ensure that allocations are not fragmented into a large number of small grants
- Measures to ensure that grant spending is well planned and outcome focused.

To this end, consideration will be given to the rationalisation of municipal infrastructure transfers, such as Consolidated Municipal Infrastructure Programme (CMIP), the Community Water Supply and Sanitation Programme (CWSS) and the Community-based Public Works Programme, into a single allocation. Such an allocation would be formula-driven.

The division of revenue between spheres

Role of provincial and local government

The provincial and local spheres are responsible for the delivery of many of the services and functions central to Government's overarching objectives of redistribution and poverty-alleviation.

Provinces are responsible for school education, primary and specialised health care, social security grants and welfare services. They also take responsibility for the delivery of services in the areas of agriculture, provincial roads and housing.

Municipalities are responsible for household infrastructure. This includes access roads and streets, street lights, refuse collection and the provision of basic services like water and electricity.

Vertical division of revenue

However, provinces and municipalities have limited capacity to generate their own funds. This requires that nationally raised revenue be divided equitably between the national, provincial and local spheres, in proportion to their fiscal capacity and functional competencies.

Determination of the division of revenue

The division of revenue between spheres is determined by Cabinet, and is informed by the recommendations of the Budget Council, the Budget Forum, the Ministers' Committee on the

Budget, the Financial and Fiscal Commission (FFC) and, for the first time this year, the recommendations of an inter-governmental Division of Revenue workshop.

The allocation of revenue between spheres reflects the following considerations:

- The increasing budgetary pressures arising from HIV/Aids and the Child Support Grant
- The priority of increasing infrastructure spending, in order to redress the backlogs in maintenance, rehabilitate and expand the infrastructure base and to stimulate economic growth
- The prioritisation of poverty-alleviation programmes, including social security grants, and the provision of free basic services to the poor
- The costs associated with establishing newly demarcated municipalities.

Revised provincial and municipal allocations

Additional allocations in Adjustment Budget

The Adjustments Budget in August allocated a further R1,8 billion to the provincial sphere, in addition to resources earmarked for flood-related spending.

The adjustments were made to take account of the higher than budgeted salary increases, to accommodate the high take-up rate of the Child Support Grant and to provide resources for flood reconstruction. The local government sphere also received R100 million to assist municipalities in meeting costs associated with the demarcation of new municipal boundaries.

The revised budget framework provides for an additional R7,8 billion and R13,2 billion for 2001/02 and 2002/03 above the baseline allocations.

Revised Budget Framework

Of these amounts, the provinces will receive R4,1 billion and R7,5 billion in the first two years of the MTEF. Local government will receive R469 million and R905 million respectively.

Table 6.1 illustrates the "vertical" division of these additional allocations between the three spheres of government.

Increasing local government share

Over the course of the MTEF period, the provincial share will remain stable at around 56,6 per cent of the allocated resources, while the local government share will rise from 2,0 per cent in 2000/01, to 2,5 per cent in 2003/04. The increase in the local government share reflects the inclusion of CMIP funds in the broader allocation to local government. In the past, CMIP funds were shown as part of the national allocation.

Funding arrangement for flood-related reconstruction

Over the next three years financing will be made available in four provinces to meet the costs of damage arising from the February floods. Current estimates set the cost of damage to public infrastructure at approximately R2 billion.

A total of R895 million has been allocated to provinces for 2000/01 for disaster relief and infrastructure reconstruction this year. This comprises an initial allocation of R300 million, which was made in June, and a further allocation of R595 million, as set out in the Adjustments Budget in October.

The initial allocation provided for emergency reconstruction, and assessments of both the extent of the flood damage, and the cost of effecting repairs and rehabilitating infrastructure. Provincial allocations of the funds are set out below.

The proposed 2001 budget framework makes provision for a further R1,2 billion for reconstruction and rehabilitation over the next three years.

2000/01 flood relief allocations by province

	R million
Eastern Cape	90
Free State	38
Gauteng	10
KwaZulu-Natal	142
Mpumalanga	241
Northern Cape	6
Northern Province	343

Real increases in provincial allocations

Overall, total provincial transfers increase at an average annual growth rate of 7,1 per cent over the MTEF. Local government transfers increase at an average annual growth rate of 15 per cent. This provides for real increases in provincial and local expenditure, accelerated service delivery and the budget pressures arising from HIV/Aids, the Child Support Grant and the costs associated with the demarcation of new municipalities.

Table 6.1 The vertical division

R million	2000/01 Revised	2001/02	2002/03	2003/04
		Medium term estimates		
National	76 071	84 974	90 490	95 887
Provincial allocation	108 406	116 048	124 674	133 022
Of which:				
Equitable share	*96 185*	*103 011*	*110 761*	*118 118*
Conditional grants	*12 221*	*13 036*	*13 913*	*14 904*
Local government allocation [1]	3 826	4 538	5 244	5 865
Total to be shared	188 304	205 559	220 409	234 774
Changes from baseline				
National allocation	1 415	3 224	4 778	–
Provincial allocation	2 373	4 138	7 514	–
Of which:				
Equitable share	*1 778*	*2 845*	*5 604*	–
Conditional grants	*595*	*1 293*	*1 910*	–
Local government allocation	100	469	905	–

[1] Excludes certain agency payments, grants-in-kind and other transfers to the local government sphere

Provincial share

Types of transfers to provinces

Transfers to the provincial sphere from national government take two forms: the equitable share and conditional grants. The equitable share allocation is used to fund the bulk of public services rendered by provinces. Conditional grants are used to support compliance with national norms and standards, to compensate provinces for providing services that may extend beyond provincial boundaries, and to ensure that national priorities are adequately provided for in sub-national budgets.

The provincial equitable shares

Table 6.2 sets out the provincial equitable shares for the MTEF period.

The equitable share is the largest of the provincial allocations. Over the course of the MTEF the equitable share allocation will rise rapidly from R96,2 billion in 2000/01 to R118,1 billion in 2003/04 – an average annual average growth rate of 7,1 per cent a year.

Table 6.2 Provincial equitable shares

R million	2000/01	2001/02	2002/03	2003/04
		Medium term estimates		
Eastern Cape	16,750	17,771	18,913	19,962
Free State	6,536	6,942	7,411	7,846
Gauteng	14,517	15,677	17,013	18,309
KwaZulu-Natal	19,241	20,807	22,578	24,292
Mpumalanga	6,539	7,128	7,793	8,447
Northern Cape	2,342	2,505	2,687	2,857
Northern Province	12,866	13,859	14,990	16,079
North West	8,158	8,666	9,241	9,771
Western Cape	9,235	9,656	10,137	10,549
Total	**96,185**	**103,011**	**110,761**	**118,118**

Horizontal division

Revenue allocated to the provincial sphere is divided "horizontally" between provinces in accordance with a formula, which is based on 1996 recommendations of the Financial and Fiscal Commission. This formula takes into account the demographic and economic profiles of the provinces.

Components of the formula

Although the formula has components for education, health and welfare, the share "allocations" are intended merely as broad indications of relative need. Provincial Executive Councils have discretion regarding the provincial allocations for each function.

The equitable share formula includes the following components:

- An education share (41 per cent) based on the size of the school-age population (ages 6-17) and the number of learners enrolled in public ordinary schools
- A health share (19 per cent) based on the proportion of the population without access to medical aid
- A social security component (17 per cent) based on the estimated number of people entitled to social security grants – the elderly, disabled and children – weighted using a poverty index derived from the 1995 Income and Expenditure Survey
- A basic share (7 per cent) derived from each province's share of the total population of the country
- A backlog component (3 per cent) based on the distribution of capital needs captured in the schools register of needs, the audit of hospital facilities and the share of the rural population
- An economic output component (8 per cent) based on the distribution of total remuneration in the country
- An institutional component (5 per cent) divided equally among the provinces.

Government Response to the FFC Proposals

In line with the Constitution and the Intergovernmental Fiscal Relations Act, the Financial and Fiscal Commission (FFC) makes recommendations to Parliament on the sharing of nationally-raised revenue between the three spheres of government. The FFC's *Recommendations 2001-2004 MTEF Cycle* were published in May 2000.

The report suggests a new approach to allocating funds to the provinces, which entails dispensing with the present formula, and estimating the actual cost of providing basic services in education, health and welfare. Cost estimates would reflect national norms and standards in each area. The "costed norms approach," deals only with education, health and welfare spending, and not with the costing of other provincial functions, nor with national and local government functions.

While welcoming the proposals, and encouraging the use of costed norms as an analytical tool to help analyse specific sectoral budgets, Government has decided not to adopt the costed norms approach for the following reasons:

- Changing the current formula (which was adopted with the support of the FFC) has the potential to destabilise provincial budgets if the formula results in significant changes to provincial allocations
- A bottom up iterative approach is not an appropriate way to determine budgetary priorities, which requires political judgement in making difficult trade-offs
- The application of the costed norms approach only to health, education and welfare would introduce a bias against other provincial functions, as well as against the local and national spheres
- The data required to estimate the cost of providing services are unavailable

Government will respond in greater detail to the FFC recommendations when it tables the annual Division of Revenue bill with the Budget in February 2001, as required by the Intergovernmental Fiscal Relations Act.

Phasing in of the equitable share formula

The 2001 Budget marks the third year of the phased approach to the application of the equitable share formula. The phased approach was developed as a response to differences between the data on which the formula was originally based, and the data contained in the subsequent Census of 1996. The view was taken that the alignment of shares with more accurate demographic data would be phased in over four years, in order to avoid disruptions in service delivery, especially in those provinces in which shares are to be revised downwards.

Conditional grants

Conditional grants are national government transfers to provinces for identified purposes.

Continuing refinement of the conditional grant system

This is the third year in which Government has used conditional grants. Adjustments have been made to improve the processes and systems used in the administration of these grants. Among these improvements are measures to enhance accountability and responsibility in monitoring and reporting on conditional grants, as set out in the Division of Revenue Act, 2000 and the Public Finance Management Act, 1999. Further streamlining of conditional grants is expected to follow the National Treasury's review of conditional grants.

Table 6.3 sets out the allocations of conditional grants over the MTEF period.

With the exception of grant funding for provincial infrastructure, the level of funding for programmes already funded through conditional grants will remain broadly stable.

Increase for provincial infrastructure

Grant financing for provincial infrastructure was introduced last year to supplement existing expenditure on infrastructure in the provinces. The baseline allocation for the grant was R300 million a year over the MTEF period. Mindful of the role of infrastructure in sustained economic growth and accelerated service delivery, Government will increase the grant allocation by a projected R500 million in 2001/02, R1,2 billion in 2002/03, and R2,3 billion in 2003/04.

Introduction of three new conditional grants

Three new grants will be introduced in the next year. These are the Pretoria Academic Hospital Grant, the Flood Disaster Reconstruction Grant, and the Early Childhood Development Grants.

The Pretoria Academic Hospital grant

The Pretoria Academic Hospital Grant will support the construction of a new hospital building.

The Flood Disaster Reconstruction grant

The Flood Disaster Reconstruction Grant provides financing for flood-related reconstruction. An amount of R1,2 billion, to be spent over three years, has been set aside in the MTEF for this purpose.

The Early Childhood Development grant

The Department of Education has identified early childhood development and pre-primary schooling as critical areas in its initiative to improve the level of educational achievement in South Africa.

The Department is therefore piloting a number of early childhood development projects which will be funded through conditional grants of R45 million in 2001/02, R85 million in 2002/03 and R120 million in 2003/04. This grant is not included in table 6.3 and will be funded from the national allocation.

Review of conditional grants underway

Most conditional grants – both in terms of number and share of total grants – have been made to the Department of Health. Apart from the integrated nutrition programme, all grants to the Department of Health are aimed at hospitals, and deal with spillover benefits and restructuring, in order to pave the way for a more equitable distribution of specialised services. The Department of Health is undertaking a major review of its grants, with the aim of speeding up its progress, and better aligning its policies with its budgetary processes. The results of this review will be incorporated into the 2002/03 MTEF.

Table 6.3 Conditional grants to provinces

R million	2000/01	2001/02	2002/03	2003/04
Health				
Central hospitals	3 112	3 273	3 417	3 580
Training and research	1 174	1 234	1 291	1 351
Redistribution of specialised services	176	182	189	198
Hospital rehabilitation	400	500	520	543
Nkosi Luthuli Academic Hospital	273	103		
Pretoria Academic		50	70	90
Integrated Nutrition Programme	582	582	582	582
Finance				
Supplementary grant	2 212	2 000	2 000	2 000
Provincial Infrastructure	300	800	1 550	2 314
Provincial Financial management	100	140	140	146
Flood Disaster Reconstruction	595	600	400	200
Education				
Financial management and Quality enhancement	202	213	224	234
Housing				
Housing fund	3 017	3 226	3 390	3 547
Capacity building	10	10	10	10
Human Settlement	20	100	104	109
Doornkop	3	–	–	–
Welfare and Population Development	–	–	–	–
Financial management	27	26	25	–
Child Support	17	–	–	–
Total	**12 221**	**13 036**	**13 913**	**14 904**

Local government share

Challenges of local government

Local government, like provinces, faces significant financial pressures.

Municipalities are expected to provide basic services to all residents, with the poorest receiving a minimum level free. Huge backlogs remain in the maintenance of household infrastructure, particularly in former townships. Despite this, capital expenditure has fallen since 1997/98, as a result of large deficits and liquidity problems in many municipalities.

In 1999/00, municipal budgets totalled R57,4 billion, with 81 per cent of resources directed toward operating budgets and the remainder used for capital projects.

The creation of the new (and larger) municipalities will result in significant transition costs, as various administrations are merged. Municipalities face both the challenge of containing personnel expenditure – which has risen rapidly to an average of

31 per cent in the last four years – and the pressure of equalising salaries across merged municipalities.

Allocations to local government

Additional allocations

Given the pressures facing local government, and subject to macroeconomic revenue estimates, extra allocations will be made over the course of the MTEF.

Table 6.4 shows the distribution of these additional allocations.

Table 6.4: Baseline Allocations from the National Sphere[1]

	2000/01	2001/02	2002/03	2003/04	2000/01	2001/02	2002/03
	Revised	Medium Term Estimates			Changes from 2000 Budget		
Equitable share	1 867	2 201	2 570	3 109	–	204	440
R293 personnel[2]	463	463	463	463	–	–	–
Subtotal: Equitable share & related	2 330	2 664	3 033	3 572	–	204	440
Restructuring	300	350	450	465	–	–	50
LG support	150	160	220	230	–	–	50
Subtotal: Restructuring	450	510	670	695	–	–	100
Transition	100	250	200	–	–	250	200
Financial management	50	60	120	125	–	–	50
SALGA Allocation	–	15	15	15	–	15	15
Land Development Objectives	13	45	47	49	–	–	–
Subtotal: Capacity & transition	163	370	382	190	–	265	265
CMIP[3]	883	994	1 159	1 407	–	–	100
Subtotal: Infrastructure	883	994	1 159	1 407	–	–	100
Local Government Allocation[4]	**3 826**	**4 538**	**5 245**	**5 863**	**–**	**469**	**905**

[1] Excludes agency payments, grants-in-kind, and other allocations, such as bus subsidies, CWSS and poverty relief allocations, that benefit the local government sphere.
[2] Excludes salary increases for R293 personnel
[3] Excludes other infrastructure transfers and assumes progress with rationalisation of infrastructure transfers.
[4] Figures not comparable with Budget Review 2000 due to revision of classifications, or with table 6.1 due to rounding errors

The national medium-term estimates initially provided for a total allocation to local government of R3,8 billion in 2000/01, rising to R4,5 billion in 2001/02. Table 6.5 shows increases beyond the current local government baseline of R469 million, R905 million and R1,3 billion. These allocations are in addition to the R100 million appropriated for local government in the 2000 adjustment budget.

Break-down of local government allocations

The total allocation to local government of R4,5 billion for 2001/02 is made up of the following components:

- The local government equitable share of R2,2 billion
- The "R293 personnel allocation" of R463 million
- The Local Government Support Grant of R160 million
- The Restructuring Grant of R350 million
- The Financial Management Grant of R60 million
- The Land Development Objectives Grant of R45 million
- The CMIP grant of R994 million
- An allocation to organised local government (SALGA) of R15 million.

Other grants-in-kind directed to the local sphere are not reflected in the local government allocation. These include

- The Community Water and Sanitation Operating Grant of R731 million
- The Community Water and Sanitation Capital Grant of R744 million
- The Community Based Public Works programme of R334 million.

Twin pressures of local government

The significant increases in allocations to the equitable share, and the introduction of a transition grant reflect the twin pressures facing local government: ensuring access to basic services for poor households, and local government restructuring.

Ensuring access to basic services

Government's commitment to a better life for all its citizens finds expression in ensuring that all households have access to at least a basic level of municipal services.

National government support of this objective is reflected in the allocation of the equitable share to local government. The equitable share is distributed to municipalities relative to the extent of poverty within their jurisdictions. The grant is targeted at households earning less than R800 per month, and aims to support the delivery of a basic package of services, including water, sanitation and municipal services – currently estimated at R86 per household per month.

Although the equitable share is an unconditional allocation, municipalities are urged to ensure that their budgets reflect this basic package of services. New budget formats and reporting requirements will ensure that municipalities report regularly on spending on poor households. National and provincial governments will monitor such spending.

Progressive expansion of the equitable share

Government remains committed to the progressive expansion of the equitable share mechanism. Further allocations to the equitable share will become possible once national department votes (such as existing allocations within the water services trading account) have been restructured.

Increasing allocations to conditional grant programmes will not undermine the relative importance of the equitable share mechanism within the intergovernmental fiscal system.

Support for transition

Demarcation, together with the evolving developmental role of local governments, requires an overhaul of the structures, systems, and financial resources available to municipalities.

The demarcation process will impose a number of significant short-term costs on municipalities. These include the costs of moving, integrating or aligning systems, and consolidating assets and liabilities. In some instances municipalities will have to meet the challenge of remaining financially viable and creditworthy in the short-term, while taking measures to improve their positions in the longer-term.

These measures should result in an expansion and enhancement of service delivery – particularly in areas of high poverty – and an improvement in the financial position of municipalities.

Conclusion

The provincial and local spheres of government are increasingly well positioned to face their considerable service delivery challenges. Significant additional allocations to each sphere reflect Government's commitment to address the challenges of redistribution and service delivery. The consolidation of grants and other reforms to the framework for intergovernmental transfers will further enhance the capacity of provincial and local government.