W1

Explanatory memorandum to the division of revenue

Background

Section 214(1) of the Constitution requires that every year a Division of Revenue Act determine the equitable division of nationally raised revenue between national government, the nine provinces and 257 municipalities (278 municipalities prior to the 2016 local government elections). The tabled allocations are published with the new municipal demarcations even though the elections will be held later in the year.

The division of revenue takes into account the powers and functions assigned to each sphere of government. The process fosters transparency and is at the heart of constitutional cooperative governance.

The Intergovernmental Fiscal Relations Act (1997) prescribes the process for determining the equitable sharing and allocation of nationally raised revenue. Sections 9 and 10(4) of the act set out the consultation process to be followed with the Financial and Fiscal Commission (FFC), including considering the commission's recommendations regarding the division of revenue.

This explanatory memorandum to the 2016 Division of Revenue Bill fulfils the requirement set out in section 10(5) of the Intergovernmental Fiscal Relations Act that the bill be accompanied by an explanation of how it takes account of the matters listed in sections 214(2)(a) to (j) of the Constitution, government's response to the FFC's recommendations, and any assumptions and formulas used in arriving at the respective divisions among provinces and municipalities. This explanatory memorandum has six sections:

- Part 1 lists the factors that inform the division of resources between national, provincial and local government.
- Part 2 describes the 2016 division of revenue.
- Part 3 sets out how the FFC's recommendations on the 2016 division of revenue have been taken into account.

- Part 4 explains the formula and criteria for the division of the provincial equitable share and conditional grants among provinces.
- Part 5 sets out the formula and criteria for the division of the local government equitable share and conditional grants among municipalities.
- Part 6 summarises issues that will form part of subsequent reviews of provincial and local government fiscal frameworks.

The Division of Revenue Bill and its underlying allocations are the result of extensive consultation between national, provincial and local government. The Budget Council deliberated on the matters discussed in this memorandum at several meetings during the year. The approach to local government allocations was discussed with organised local government at technical meetings with the South African Local Government Association (SALGA), culminating in meetings of the Budget Forum (the Budget Council and SALGA). An extended Cabinet meeting involving ministers, provincial premiers and the SALGA chairperson was held in October 2015. The division of revenue, and the government priorities that underpin it, was agreed for the next three years.

Part 1: Constitutional considerations

The annual Division of Revenue Act is enacted after factors in sections 214(2)(a) to (j) of the Constitution are taken into account. These include national interest, debt provision, the needs of national government, flexibility in responding to emergencies, resource allocation for basic services and developmental needs, the fiscal capacity and efficiency of provincial and local government, the reduction of economic disparities, and the promotion of stability and predictability. The constitutional principles taken into account in deciding on the division of revenue are briefly noted below.

National interest and the division of resources

The national interest is encapsulated by governance goals that benefit the nation as a whole. The National Development Plan, endorsed by Cabinet in November 2012, sets out a long-term vision for the country's development. This is complemented by the strategic integrated projects overseen by the Presidential Infrastructure Coordinating Council and the 14 priority outcomes adopted by Cabinet in 2014 for the 2014–2019 medium-term strategic framework. In the 2015 *Medium Term Budget Policy Statement*, the Minister of Finance outlined how the resources available to government over the 2016 medium-term expenditure framework (MTEF) would be allocated to help achieve these goals. Chapter 4 of the 2015 *Medium Term Budget Policy Statement* and Chapters 5 and 6 of the 2016 *Budget Review* discuss how funds have been allocated across government based on these priorities. The frameworks for each conditional grant allocated as part of the division of revenue also note how the grant is linked to the 14 priority outcomes.

Provision for debt costs

The resources shared between national, provincial and local government include proceeds from national government borrowing used to fund public spending. National government provides for the resulting debt costs to protect the country's integrity and credit reputation. A more detailed discussion can be found in Chapter 7 of the 2016 *Budget Review*.

National government's needs and interests

The Constitution assigns exclusive and concurrent powers and functions to each sphere of government. National government is exclusively responsible for functions that serve the national interest and are best centralised. National and provincial government have concurrent responsibility for a range of functions. Provincial and local government receive equitable shares and conditional grants to enable them to provide basic services and perform their functions. Functions may shift between spheres of government to better meet its needs. The division of revenue responds to this by modifying the funding arrangements.

Changes continue to be made to various national transfers to provincial and local government to improve their efficiency, effectiveness and alignment with national strategic objectives.

Provincial and local government basic services

Provinces and municipalities are assigned service delivery functions such as education, health, social development, housing, roads, provision of electricity and water, and municipal infrastructure. They have significant autonomy to allocate resources to meet basic needs and respond to provincial and local priorities, while giving effect to national objectives. The division of revenue provides equitable shares to provinces and local government, together with conditional grants for basic service delivery.

Strong growth in allocations to provincial and local government reflects government's emphasis on priority services such as health, education and basic services, as well as the rising costs of these services due to higher wages, and bulk electricity and water costs. Transfers to local government have grown significantly in recent years, providing municipalities with greater resources to deliver basic services. This is in addition to local government's substantial revenue-raising powers.

The 2016 division of revenue has prioritised the rollout of water and sanitation infrastructure. In addition, a grant to municipalities affected by the 2016 boundary changes will help minimise any negative effects that the transition may have on service delivery. The division of revenue also gives expression to the National Development Plan's prioritisation of early childhood development.

Fiscal capacity and efficiency

National government has primary revenue-raising powers. Provinces have limited revenue-raising capacity and the resources required to deliver provincial functions do not lend themselves to self-funding or cost recovery. Due to their limited revenue-raising potential and their responsibility to implement government priorities, provinces receive a larger share of nationally raised revenue than local government. Municipalities finance most of their expenditure through property rates, user charges and fees. However, compared to large urban and metropolitan municipalities, rural municipalities raise significantly less revenue.

Local government's share of nationally raised revenue has increased from 3 per cent in 2000/01 to 9.1 per cent over the 2016 MTEF period. A review of the local government equitable share was completed in 2012 and a new formula is being phased in from 2013/14 to 2017/18. The new formula incorporates a revenue adjustment factor that considers the fiscal capacity of the recipient municipality (full details of the formula are provided in part 5 of this annexure). The mechanisms for allocating funds to provinces and municipalities are continuously reviewed to improve their efficiency. A new approach to the funding of provincial infrastructure is being introduced to promote better planning and implementation, and to improve efficiency in the delivery of health and education infrastructure. To maximise the effect of allocations, many provincial and local government conditional grants use criteria that consider the recipient's efficient use of previous allocations.

Developmental needs

Developmental needs are accounted for at two levels. First, in the determination of the division of revenue, which explains the continued commitment to grow the provincial and local government shares of nationally raised revenue; and second, in the determination of the division within each sphere through the formulas used to divide national transfers among municipalities and provinces. Developmental needs are encapsulated in the equitable share formulas for provincial and local government and in specific conditional grants, such as the *municipal infrastructure grant*, which allocates funds according to the number of households in a municipality without access to basic services. Various infrastructure grants and growing capital budgets aim to boost the economic and social development of provinces and municipalities.

Economic disparities

The equitable share and infrastructure grant formulas are redistributive towards poorer provinces and municipalities. Through the division of revenue, government continues to invest in economic infrastructure (such as roads) and social infrastructure (such as schools, hospitals and clinics) to stimulate economic development, create jobs, and address economic and social disparities.

Obligations in terms of national legislation

The Constitution confers autonomy on provincial governments and municipalities to determine priorities and allocate budgets. National government is responsible for policy development, national mandates, setting national norms and standards for provincial and municipal functions, and monitoring implementation for concurrent functions. The 2016 MTEF and division of revenue provide additional funding for municipalities affected by significant boundary changes due to take effect after the 2016 local government elections. To support the newly amalgamated municipalities and ensure a smooth transition, the *municipal demarcation transition grant* was established in 2015/16 for a period of three years (to 2017/18). National government will also ensure that baseline reductions do not affect important obligations that are already funded through existing provincial and local government allocations.

Predictability and stability

Provincial and local government equitable share allocations are based on estimates of nationally raised revenue. If this revenue falls short of the estimates within a given year, the equitable shares of provinces and local government will not be adjusted downwards. Allocations are assured (voted, legislated and guaranteed) for the first year and are transferred according to a payment schedule. To contribute to longer-term predictability and stability, estimates for a further two years are published with the annual proposal for appropriations. Adjusted estimates as a result of changes to data underpinning the equitable share formulas and revisions to the formulas are phased in to ensure minimal disruption.

Flexibility in responding to emergencies

Government has a contingency reserve that provides a cushion for emergencies and unforeseeable events. In addition, two conditional grants for disasters allow for the swift allocation and transfer of funds to affected provinces and municipalities in the immediate aftermath of a declared disaster. Sections 16 and 25 of the Public Finance Management Act (1999) make specific provision for the allocation of funds to deal with emergency situations. Section 30(2) deals with adjustment allocations for unforeseeable and unavoidable expenditure. Section 29 of the Municipal Finance Management Act (2003) allows a municipal mayor to authorise unforeseeable and unavoidable expenditure in an emergency. Section 20(6) of the 2016 Division of Revenue Bill also allows conditional grant funds to be reprioritised to respond to a disaster.

Part 2: The 2016 division of revenue

Government’s central fiscal objective over the MTEF period is to stabilise the growth of debt as a share of GDP and strictly adhere to the planned expenditure ceiling (see Chapters 1, 3 and 5 of the *Budget Review*). The most important public spending programmes that help poor South Africans, contribute to growth and generate employment have been protected from major reductions. The 2016 division of revenue reprioritises existing funds to ensure these objectives are met despite the lower expenditure ceiling. Parts 4 and 5 of this annexure set out in more detail how the baseline reductions have been applied to provincial and local government transfers.

Excluding debt-service costs and the contingency reserve, allocated expenditure shared between the three spheres amounts to R1.165 trillion, R1.250 trillion and R1.347 trillion over each of the MTEF years. These allocations take into account government’s spending priorities, each sphere’s revenue-raising capacity and responsibilities, and input from various intergovernmental forums and the FFC. The provincial and local equitable share formulas are designed to ensure fair, stable and predictable revenue shares, and to address economic and fiscal disparities.

Government's policy priorities for the 2016 MTEF period

Following the reductions to the baseline, existing budgets need to be reprioritised to meet government's policy priorities outlined in the medium-term strategic framework. Priorities over the 2016 MTEF period that are funded through reprioritisations in the division of revenue include:

- Introducing appropriate incentives to upgrade and maintain provincial and municipal infrastructure.
- Extending HIV/AIDS intervention spending to include tuberculosis.
- Completing the eradication of bucket sanitation systems in formal residential areas.
- Extending access to early childhood development centres through a new grant.

The fiscal framework

Table W1.1 presents the medium-term macroeconomic forecasts for the 2016 Budget. It sets out the growth assumptions and fiscal policy targets on which the fiscal framework is based.

Table W1.1 Medium-term macroeconomic assumptions, 2015/16 – 2018/19

	2015/16		2016/17		2017/18		2018/19
R billion/percentage of GDP	**2015 Budget**	**2016 Budget**	**2015 Budget**	**2016 Budget**	**2015 Budget**	**2016 Budget**	**2016 Budget**
Gross domestic product	4 191.8	4 073.2	4 538.8	4 388.4	4 926.1	4 750.7	5 161.3
Real GDP growth	*2.0%*	*0.9%*	*2.6%*	*1.2%*	*2.9%*	*1.9%*	*2.5%*
GDP inflation	*5.9%*	*5.1%*	*5.5%*	*6.4%*	*5.4%*	*6.3%*	*6.0%*
National budget framework							
Revenue	**1 049.3**	**1 074.5**	**1 166.0**	**1 162.0**	**1 265.4**	**1 264.3**	**1 388.7**
Percentage of GDP	*25.0%*	*26.4%*	*25.7%*	*26.5%*	*25.7%*	*26.6%*	*26.9%*
Expenditure	**1 222.3**	**1 247.3**	**1 309.9**	**1 318.3**	**1 420.9**	**1 421.7**	**1 540.0**
Percentage of GDP	*29.2%*	*30.6%*	*28.9%*	*30.0%*	*28.8%*	*29.9%*	*29.8%*
Main budget balance[1]	**-173.1**	**-172.8**	**-144.0**	**-156.3**	**-155.5**	**-157.4**	**-151.3**
Percentage of GDP	*-4.1%*	*-4.2%*	*-3.2%*	*-3.6%*	*-3.2%*	*-3.3%*	*-2.9%*

1. A positive number reflects a surplus and a negative number a deficit
Source: National Treasury

Table W1.2 sets out the division of revenue for the 2016 MTEF period after accounting for new policy priorities. The division of revenue includes an amount of R17.8 billion provisionally allocated in 2018/19, which will only be assigned to specific programmes during the 2017 budget process, subject to the approval of spending proposals. Of this amount, R5.8 billion has indicatively been allocated to the provincial equitable share and R4.5 billion to local government conditional grants. These amounts are not discussed in the rest of this explanatory memorandum because they will only be allocated to specific grants and programmes during the 2017 budget process.

Table W1.2 Division of nationally raised revenue, 2012/13 – 2018/19

R million	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
		Outcome		Revised estimate		Medium-term estimates	
Division of available funds							
National departments	**420 246**	**453 406**	**490 039**	**546 788**	**559 849**	**594 090**	**637 755**
of which:							
Indirect transfers to provinces	*2 315*	*2 693*	*5 808*	*3 150*	*3 636*	*1 663*	*1 765*
Indirect transfers to local government	*5 050*	*5 945*	*8 895*	*10 525*	*7 773*	*7 401*	*7 679*
Provinces	**380 929**	**410 572**	**439 544**	**471 768**	**499 844**	**542 344**	**582 913**
Equitable share[1]	310 741	336 495	359 922	386 500	410 699	441 831	474 852
Conditional grants	70 188	74 077	79 623	85 268	89 146	100 513	108 061
Local government	**76 200**	**82 595**	**87 656**	**99 650**	**104 925**	**113 340**	**125 811**
Equitable share	37 139	38 964	41 592	50 507	52 569	57 012	61 732
Conditional grants[2]	30 021	34 018	35 874	38 485	41 132	44 543	51 611
General fuel levy sharing with metros	9 040	9 613	10 190	10 659	11 224	11 785	12 469
Non-interest allocations	**877 374**	**946 574**	**1 017 239**	**1 118 206**	**1 164 618**	**1 249 774**	**1 346 479**
Percentage increase	*7.9%*	*7.9%*	*7.5%*	*9.9%*	*4.2%*	*7.3%*	*7.7%*
Debt-service costs	88 121	101 185	114 798	129 111	147 720	161 927	178 556
Contingency reserves	–	–	–	–	6 000	10 000	15 000
Main budget expenditure	**965 496**	**1 047 759**	**1 132 037**	**1 247 317**	**1 318 338**	**1 421 701**	**1 540 035**
Percentage increase	*8.5%*	*8.5%*	*8.0%*	*10.2%*	*5.7%*	*7.8%*	*8.3%*
Percentage shares							
National departments	*47.9%*	*47.9%*	*48.2%*	*48.9%*	*48.1%*	*47.5%*	*47.4%*
Provinces	*43.4%*	*43.4%*	*43.2%*	*42.2%*	*42.9%*	*43.4%*	*43.3%*
Local government	*8.7%*	*8.7%*	*8.6%*	*8.9%*	*9.0%*	*9.1%*	*9.3%*

1. Includes unallocated amounts
2. Includes unallocated amounts
Source: National Treasury

Table W1.3 shows how changes to the baseline are spread across all spheres of government. The new focus areas and baseline reductions are accommodated by shifting savings towards priorities.

Table W1.3 Changes over baseline,[1] 2016/17 – 2017/18

R million	2016/17	2017/18
National departments	6 071	8 003
Provinces	3 585	15 962
Local government	989	3 323
Allocated expenditure	**10 645**	**27 287**

Source: National Treasury

Table W1.4 sets out schedule 1 of the Division of Revenue Bill, which reflects the legal division of revenue between national, provincial and local government. In this division, the national share includes all conditional grants to provinces and local government in line with section 214(1) of the Constitution, and the allocations for each sphere reflect equitable shares only.

Table W1.4 Schedule 1 of the Division of Revenue Bill, 2016/17 – 2018/19

R million	2016/17 Allocation	2017/18	2018/19
		Forward estimates	
National[1, 2]	855 071	922 857	1 003 451
Provincial[3]	410 699	441 831	474 852
Local	52 569	57 012	61 732
Total	**1 318 338**	**1 421 701**	**1 540 035**

1. National share includes conditional grants to provinces and local government, general fuel levy sharing with metropolitan municipalities, debt-service costs and the contingency reserve
2. Direct charges for the provincial equitable share are netted out
3. Provincial share includes an unallocated amount of R5.8 billion in 2018/19 that is not included in the forward estimates of provincial allocations in tables W1.6 and W1
Source: National Treasury

The 2016 *Budget Review* sets out in detail how constitutional issues and government's priorities are taken into account in the 2016 division of revenue. It describes economic and fiscal policy considerations, revenue issues, debt and financing considerations, and expenditure plans. Chapter 6 focuses on provincial and local government financing.

Part 3: Response to the FFC's recommendations

Section 9 of the Intergovernmental Fiscal Relations Act requires the FFC to make recommendations regarding:

a) "An equitable division of revenue raised nationally, among the national, provincial and local spheres of government;
b) the determination of each province's equitable share in the provincial share of that revenue; and
c) any other allocations to provinces, local government or municipalities from the national government's share of that revenue, and any conditions on which those allocations should be made."

The act requires that the FFC table these recommendations at least 10 months before the start of each financial year. The FFC tabled its *Submission for the Division of Revenue 2016/17* to Parliament in May 2015. These recommendations cover the following areas: macro-micro and fiscal aspects of public investment management; the proliferation of indirect grants, as well as design and accountability in public infrastructure management; and state capacity improvements through education and productivity interventions.

Section 214 of the Constitution requires that the FFC's recommendations be considered before tabling the division of revenue. Section 10 of the Intergovernmental Fiscal Relations Act requires that the Minister of Finance table a Division of Revenue Bill with the annual budget in the National Assembly. The bill must be accompanied by an explanatory memorandum setting out how government has taken into account the FFC's recommendations when determining the division of revenue. This part of the explanatory memorandum complies with this requirement.

The FFC's recommendations can be divided into three categories:

- Recommendations that apply directly to the division of revenue
- Recommendations that indirectly apply to issues related to the division of revenue
- Recommendations that do not relate to the division of revenue.

Government's responses to the first and second categories are provided below. The relevant national departments are considering the recommendations that do not relate to the division of revenue, and they will respond directly to the FFC.

Recommendations that apply directly and indirectly to the division of revenue

Chapter 1: Responding to South Africa's infrastructure challenges

Infrastructure-led growth that provides the conditions for the future prosperity of all South Africans

The FFC recommends that government "redesigns capital conditional grants by:

(a) Allowing for payment of infrastructure upstream costs of provinces and municipalities;
(b) Making capital grants pledgeable where a long-term capital strategy is in place; and
(c) Extending the existing incentive/support for long-term capital planning."

Government response

Government continuously evaluates conditional grants to both provincial and local government. Its responses to the three points raised are detailed below.

Several grants allow for upstream costs (for example, transport planning or project management capacity). However, government is cautious of diverting excessive funds away from capital investment, which is why the need for upstream costs is evaluated on a grant-by-grant and differentiated basis.

The Division of Revenue Act does allow for pledging of municipal grants when a long-term capital strategy is in place. However, because borrowing should largely fund infrastructure that contributes to future revenues, municipal own revenues should be used to borrow against more than grants.

Given that provinces invest in capital projects that serve as public goods, and they have limited revenue-raising potential, borrowing is not encouraged, but is approved under special circumstances.

Several provincial infrastructure grants (including grants for health, education and roads) are allocated based on the submission of plans two years in advance to encourage longer-term planning.

The built environment performance plans required by the *integrated city development grant* already incentivise cities to engage in long-term planning. The review of local government infrastructure grants will introduce a number of reforms to enhance longer-term planning. Government will work with the FFC to implement the proposed solutions.

Efficiency and alignment of infrastructure procurement and management

The FFC recommends that government "enhance efficiency by ensuring alignment between infrastructure procurement planning, contract awards and management and other elements of infrastructure management."

Government response

Government agrees that conditional grants can and should incentivise improved practices beyond the transfer of funds.

Each province has to develop an approved framework to implement the infrastructure delivery management system, and several provincial grants make funding provisions to capacitate infrastructure units.

In local government, an incentive grant to metropolitan municipalities encourages integration across infrastructure management. In addition, the review of local government infrastructure grants has introduced reforms to improve asset management practices under the municipal infrastructure grant.

But building capacity and improving infrastructure management practices takes time, and grants are just one way to achieve these goals. There are many other interventions that aim to strengthen institutions and enhance capacity across government, including the Office of the Chief Procurement Officer and the Municipal Infrastructure Support Agent.

Chapter 2: Economic growth effects of municipal capital spending

Improving economic growth effects of municipal capital expenditure

The FFC recommends that, "Grant allocations for infrastructure investment reflect the prioritisation (or weighting) of growth-enhancing infrastructure programmes, to enable municipalities to play their (envisaged critical) role in promoting economic development and growth."

Government response

Conditional grants are primarily allocated to subsidise capital costs on behalf of the poor, who cannot afford to pay rates and tariffs. Economic infrastructure should largely be funded from own revenues through the use of cost-reflective tariffs and debt-financing.

Government does acknowledge the substantial growth-enhancing effects of infrastructure investments and has emphasised the importance of economic growth in recent reforms to urban grants and the *municipal infrastructure grant*. Government is also working with municipalities to increase their ability to access long-term financing so they can increase their own funding of infrastructure investments.

Long-term sustainability of infrastructure for local economic growth

The FFC recommends that "Government establishes either an incentive grant or a reserve fund for asset management, to ensure the long-term sustainability of critical socioeconomic infrastructure and enhance local economic growth."

Government response

Government agrees that improved municipal asset management is necessary to continue the gains made in service delivery in recent years. The local government equitable share includes a 10 per cent maintenance allocation on behalf of indigent households, while all other consumers are expected to pay fully cost-reflective tariffs to cover the capital, operations, maintenance and depreciation costs of infrastructure. This means that additional maintenance funding would be double-funding. Government is therefore proposing to incentivise better prioritisation of existing maintenance funds.

Grants, however, are increasingly shifting towards investment in both new and existing infrastructure. A more appropriate mix of capital funding will help address the difficulties experienced in asset management and ensure the long-term sustainability of infrastructure.

Transitional capacity-building grant

The FFC recommends that government "establish a transitional capacity-building grant to fund technical assistance to enable municipalities to prepare and implement credible infrastructure asset management plans."

Government response

Government agrees that technical assistance is often required to develop these plans and while there are municipalities that may need this support, many have already developed appropriate asset management strategies and should not be disincentivised. The Municipal Infrastructure Support Agent, the Department of Cooperative Governance and the local government infrastructure grant review are developing changes to the 2016 municipal infrastructure grant framework that will promote better use of the technical assistance and project management funding available in the grant.

Assistance need not be financial. Government has many initiatives to improve municipal asset management practices. For example, the Municipal Infrastructure Support Agent not only assigns engineers to municipalities to improve these systems, but it has also developed a municipal infrastructure performance management information system, rolled out the infrastructure delivery management system and will introduce a municipal standard chart of accounts from 1 July 2017.

Chapter 3: A review of direct and indirect conditional grants – the case of selected conditional grants

Management of direct and indirect grants

The FFC recommends that, "National Treasury and line departments consider the use of indirect grants as a measure of last resort while continuing to build capacity in provinces and municipalities."

Government response

Government agrees that indirect grants are not always a sustainable or effective way of improving service delivery. They must be seen as a last resort and transitional in nature. In recent years, direct grant spending has proven to be higher than indirect grant spending in several cases, leading to a number of provincial and local government grants shifting from indirect to direct grants.

Criteria to guide scheduling of grants

The FFC recommends that, "Clear criteria that will guide scheduling of conditional grants should be developed and must take into account (a) the historical financial performance, (b) non-financial performance and (c) the time period before converting a direct grant to an indirect grant."

Government response

Government agrees that criteria to guide the appropriate scheduling of conditional grants would be a useful tool. Historical performance and non-financial data would be needed to determine scheduling, while a time period for the conversion of a grant from direct to indirect would ensure stability. Government supports a differentiated approach, which has led to increasing splits in grants and shifts between direct and indirect grants in recent years. In collaboration with the FFC, government aims to develop clear guidelines on the appropriate scheduling of grants from inception.

Chapter 4: Accountability in infrastructure delivery – the case of the local government sphere

Accountability in local government infrastructure delivery

The FFC recommends that, "National Treasury and the Department of Cooperative Governance develop an accountability framework for indirect infrastructure grants to identify accountability lines, accountability mechanisms, accountability enforcement mechanisms, and spell out the consequences for undermining the accountability arrangements."

Government response

Government welcomes this recommendation and is seeking to establish such a framework. Although clear guidance on budget preparation, allocation and evaluation for both direct and indirect grants exists, accountability lines are not as explicit for indirect grants as they are for direct grants. Ensuring that appropriate monitoring and evaluation systems and a legal framework to manage indirect grants are in place is a priority.

Chapter 5: Fiscal arrangements for financing early childhood development infrastructure

Capital subsidy for constructing and upgrading early childhood development facilities

The FFC recommends that, "Government provides a full or partial capital subsidy for constructing and/or upgrading community- and non-profit-organisation-based early childhood development facilities, through the municipal infrastructure grant. The funding will facilitate compliance with the required infrastructure norms and standards, ensure that capital expenditure for early childhood development is carried out through municipalities and minimise inequities in quality standards and service levels."

Government response

The research and recommendations on this vital, complex sector are well received. However, the absence of clarity around the functional arrangements and the law regarding spending on non-state assets limits government's options in providing an effective capital subsidy for early childhood development facilities.

Government has indicatively allocated funds from 2017/18 for a new provincial conditional grant to support improved early childhood development services, including improved infrastructure. Government also supports the potential use of the community services component of the municipal infrastructure grant to fund the provision of facilities for early childhood development. Further work is needed to guide municipalities on how best to invest in early childhood development facilities.

Chapter 6: Public-sector productivity – the case of secondary education

Improving public-sector productivity

The FFC recommends that, "The Division of Revenue Act implements the finalised framework on measuring productivity. This may require the implementing agent of a conditional grant to report on the attainment of both quantitative and qualitative indicators of an output, including productivity indicators that track improvements of the service over time."

Government response

Government agrees that improvements in productivity are necessary to deliver value for money and enhanced service delivery. Reporting requirements for conditional grants can be useful sources of information on productivity. Once a productivity framework, as proposed in another FFC recommendation, is finalised, government will review how it can best be applied to the Division of Revenue Act's clauses and grant frameworks.

Part 4: Provincial allocations

Sections 214 and 227 of the Constitution require that an equitable share of nationally raised revenue be allocated to provincial government to enable it to provide basic services and perform its allocated functions.

National transfers to provinces increase from R471.8 billion in 2015/16 to R499.8 billion in 2016/17. Over the MTEF period, provincial transfers will grow at an average annual rate of 6.9 per cent to R577.1 billion in 2018/19. Table W1.5 sets out the total transfers to provinces for 2016/17. A total of R410.7 billion is allocated to the provincial equitable share and R89.1 billion to conditional grants, which includes an unallocated R111.5 million for the *provincial disaster grant.*

Table W1.5 Total transfers to provinces, 2016/17

R million	Equitable share	Conditional grants	Total transfers
Eastern Cape	58 060	10 243	**68 304**
Free State	22 995	6 816	**29 811**
Gauteng	79 600	18 839	**98 439**
KwaZulu-Natal	87 898	17 489	**105 387**
Limpopo	48 709	7 120	**55 829**
Mpumalanga	33 450	6 987	**40 437**
Northern Cape	10 863	3 751	**14 614**
North West	28 062	7 041	**35 103**
Western Cape	41 062	10 749	**51 811**
Unallocated	-	112	**112**
Total	**410 699**	**89 146**	**499 844**

Source: National Treasury

Changes to provincial allocations

The baseline reductions discussed in Chapter 5 of the *Budget Review* were shared across the three spheres of government in proportion to the division of revenue. A weaker-than-expected economic and fiscal environment has meant that the budget needs to be reprioritised to fund new and changing government priorities. In 2016/17, provincial baselines are reduced by R3.6 billion compared to indicative figures published in the 2015 *Medium Term Budget Policy Statement*. To protect basic services funded by the provincial equitable share, such as health and education, only 40 per cent (R1.5 billion) of this reduction was taken from the equitable share, despite its accounting for more than 80 per cent of transfers to provinces. The remaining 60 per cent (R2.1 billion) of this reduction comes from provincial conditional grants. Several grants funding essential services, such as the *national school nutrition programme grant*, the *land care grant*, and the *provincial roads maintenance grant*, were not reduced. In spite of these reductions to the baseline, the provincial equitable share grows at an average annual rate of 6.7 per cent over the MTEF period, while conditional grant allocations grow by 8.2 per cent per year. Where possible, baseline reductions have been weighted towards grants that have a history of underspending or grants involving infrastructure implementation that can be deferred, or that is still only in feasibility phase. The amount reduced on each grant is detailed in Table W1.6.

During the 2015 budget process, funds and functions under the National Health Laboratory Service (NHLS) were shifted to the national Department of Health. The Budget Council agreed to the shift provided that an audit is conducted after the first year to ensure that the change is revenue-neutral for provinces. The audit has revealed that this shift has not affected provincial revenue.

In addition to these baseline reductions, there were also several other reprioritisations and technical changes to conditional grants during the budget process that will be implemented over the 2016 MTEF period. These are shown in Table W1.6.

Table W1.6 Net changes to baseline provincial allocations, 2016/17 – 2018/19

R million	2016/17	2017/18	2018/19	2016 MTEF
Provincial equitable share	**5 434**	**12 939**	**15 283**	**33 655**
Provincial equitable share	5 434	12 939	15 283	33 655
Direct transfers	**-1 849**	**3 023**	**4 917**	**6 091**
Comprehensive agricultural support programme	-60	-70	-80	-210
Community library services	-10	-12	-15	-37
Education infrastructure	-160	2 450	2 582	4 872
Comprehensive HIV, Aids and TB	-176	220	1 580	1 624
Health facility revitalisation	-200	-47	-118	-365
Human papillomavirus vaccine	–	–	200	200
National health insurance	10	-80	-85	-155
Human settlements development	-1 600	–	–	-1 600
Substance abuse treatment	38	57	71	166
Early childhood development	–	320	493	813
Mass participation and sport development	-5	-10	-12	-27
Provincial roads maintenance	65	-54	101	111
Public transport operations	250	250	200	700
Indirect transfers	**40**	**-2 304**	**-2 432**	**-4 696**
National health insurance indirect	40	316	340	696
School infrastructure	–	-2 620	-2 772	-5 392
Total changes to provincial allocations				
Changes to provincial equitable share	5 434	12 939	15 283	33 655
Changes to direct conditional grants	-1 849	3 023	4 917	6 091
Changes to indirect conditional grants	40	-2 304	-2 432	-4 696
Net change to provincial allocations	**3 626**	**13 658**	**17 767**	**35 051**

Source: National Treasury

During the MTEF period, two education grants will merge into one grant to improve performance. The *school infrastructure backlogs grant* is absorbed into the *education infrastructure grant* from 2017/18, but the *school infrastructure backlogs grant* remains unallocated in these two years to allow for a proper conclusion of backlog projects. These projects will be reviewed in 2016 to ensure that all Accelerated Schools Infrastructure Development Initiative backlog projects have been added to the merged grant. As a result, the full value of the *school infrastructure backlogs grant* (R2.6 billion in 2017/18 and R2.8 billion in 2018/19) is added to the *education infrastructure grant* in the outer years of the MTEF period. The coverage of the *comprehensive HIV and Aids grant*, one of the largest in the system, will be extended to include tuberculosis intervention. Although the grant's baseline is reduced by 1.1 per cent in 2016/17, this will not adversely affect service delivery. The grant does, however, benefit from an injection of R1.6 billion in 2018/19.

Over the 2016 MTEF period, the provincial equitable share increases by R33.7 billion. After accounting for additions and reductions, the net revisions to the provincial direct and indirect allocations amount to an addition of R3.6 billion in 2016/17 and R13.7 billion in 2017/18.

The provincial equitable share

The equitable share is the main source of revenue for meeting provincial expenditure responsibilities. To ensure that allocations are fair, the equitable share is allocated through a formula using objective data on the context and demand for services in each of the nine provinces.

This brings the equitable share allocations to R411 billion, R442 billion and R469 billion respectively for each year of the 2016 MTEF period. These revisions result in the provincial equitable share increasing by 14.3 per cent between 2015/16 and 2017/18, and growing at an average annual rate of 6.7 per cent over the MTEF period.

Allocations calculated outside the equitable share formula

The equitable share includes an amount of R2.3 billion in 2016/17 that was previously part of the *devolution of property rate funds grant*. This grant, which funded provinces' municipal charges on provincial properties that were previously administered by national government, has been transferred as part of the provincial equitable share since 2013/14. These funds will be fully phased-in during 2016/17 and will be allocated using the provincial equitable share formula.

Over the 2016 MTEF period, funds from the provincial equitable share will be used to extend the human papillomavirus component of the *national health insurance indirect grant* and ensure the programme continues.

The equitable share formula

The provincial equitable share formula is reviewed and updated with new data annually. For the 2016 MTEF, the formula has been updated with data from the 2015 mid-year population estimates published by Statistics South Africa; the Department of Basic Education's preliminary 2015 data on school enrolment; data from the 2014 General Household Survey for medical aid coverage; and data from the health sector and the Risk Equalisation Fund for the risk-adjusted capitation index. Because the formula is largely population-driven, the allocations capture shifts in population across provinces, which results in changes in the relative demand for public services across these areas. The effect of these updates on the provincial equitable share is phased in over three years (2016/17 to 2018/19).

Full impact of data updates on the provincial equitable share

Table W1.7 shows the full impact of the data updates on the provincial equitable share per province. It compares the target shares for the 2015 and 2016 MTEF periods. The details of how the data updates affect each component of the formula are described in detail in the subsections below.

Table W1.7 Full impact of data updates on the equitable share

	2015 MTEF weighted average	2016 MTEF weighted average	Difference
Eastern Cape	14.0%	14.0%	0.00%
Free State	5.6%	5.6%	-0.05%
Gauteng	19.5%	19.7%	0.14%
KwaZulu-Natal	21.3%	21.2%	-0.06%
Limpopo	11.8%	11.8%	0.00%
Mpumalanga	8.2%	8.2%	0.02%
Northern Cape	2.7%	2.6%	-0.00%
North West	6.9%	6.9%	-0.00%
Western Cape	10.1%	10.0%	-0.04%
Total	**100.0%**	**100.0%**	**0.00%**

Source: National Treasury

Phasing in the formula

Official data used annually to update the provincial equitable share formula invariably affects each provinces' share of available funds. However, it is important that provinces have some stability in their revenue stream to allow for sound planning. As such, calculated new shares, informed by most recent data, are phased in over the three-year MTEF period.

The equitable share formula data is updated every year and a new target share for each province is calculated, as shown in Table W1.8. The phase-in mechanism provides a smooth path to achieving these new weighted shares by the third year of the MTEF period. It takes the difference between the target weighted share for each province at the end of the MTEF period and the indicative allocation for 2016/17 that was published in the 2015 MTEF, and closes the gap between these shares by a third in each year of the 2016 MTEF period. As a result, one-third of the data updates are implemented in 2016/17, two-thirds in the indicative allocations for 2016/17, and the updates are fully implemented in the indicative allocations for 2018/19.

Table W1.8 Implementation of the equitable share weights, 2016/17 – 2018/19

Percentage	2016/17 Indicative weighted shares from 2015 MTEF	2016/17 2016 MTEF weighted shares 3-year phasing	2017/18	2018/19
Eastern Cape	14.1%	14.1%	14.1%	14.0%
Free State	5.6%	5.6%	5.6%	5.6%
Gauteng	19.4%	19.5%	19.6%	19.7%
KwaZulu-Natal	21.3%	21.3%	21.2%	21.2%
Limpopo	11.8%	11.8%	11.8%	11.8%
Mpumalanga	8.2%	8.2%	8.2%	8.2%
Northern Cape	2.7%	2.7%	2.7%	2.6%
North West	6.9%	6.9%	6.9%	6.9%
Western Cape	10.0%	10.0%	10.0%	10.0%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: National Treasury

Provision for cushioning the impact of 2011 Census data updates and baseline reductions

The provincial equitable share formula was updated with 2011 Census data in 2013/14. The incorporation of new Census data for the first time in a decade resulted in significant changes to certain components of the formula. To give provinces time to adjust to their new allocations, the Census updates were phased in over three years and R4.2 billion was added as a "top-up" for provinces with declining shares over the 2013 MTEF period. This cushioning, which was due to come to an end in 2015/16, was extended for an additional year to 2016/17.

The same provinces that required support for the Census reductions will experience the slowest growth in their allocations due to the baseline reductions. As a result, provinces agreed that R2.1 billion should be taken out of the equitable share as a whole (from all nine provinces) and allocated to the four affected provinces as cushioning for 2016/17. Table W1.9 shows how these funds are allocated to the Eastern Cape, the Free State, KwaZulu-Natal and Limpopo in 2016/17.

Table W1.9 Cushioning for 2011 Census impact on provinces with declining shares in the 2016 MTEF

	2016/17	2017/18	2018/19
R thousand	**Medium-term estimates**		
Eastern Cape	685 628	–	–
Free State	171 261	–	–
Gauteng	–	–	–
KwaZulu-Natal	773 075	–	–
Limpopo	487 036	–	–
Mpumalanga	–	–	–
Northern Cape	–	–	–
North West	–	–	–
Western Cape	–	–	–
Total	**2 117 000**	**–**	**–**

Source: National Treasury

Provincial equitable share allocations

The final equitable share allocations per province for the 2016 MTEF are detailed in Table W1.10. These allocations include the full impact of the data updates, phased in over three years, as well as the cushioning amounts for 2016/17 described above.

Table W1.10 Provincial equitable share, 2016/17 – 2018/19

R million	2016/17	2017/18	2018/19
Eastern Cape	58 060	61 969	65 845
Free State	22 995	24 591	26 135
Gauteng	79 600	86 412	92 200
KwaZulu-Natal	87 898	94 051	99 450
Limpopo	48 709	52 087	55 176
Mpumalanga	33 450	36 208	38 506
Northern Cape	10 863	11 733	12 422
North West	28 062	30 361	32 311
Western Cape	41 062	44 418	47 008
Total	**410 699**	**441 831**	**469 051**

Source: National Treasury

Summary of the formula's structure

The formula, shown in Table W1.11 below, consists of six components that capture the relative demand for services between provinces and take into account specific provincial circumstances. The formula's components are neither indicative budgets nor guidelines as to how much should be spent on functions in each province or by provinces collectively. Rather, the education and health components are weighted broadly in line with historical expenditure patterns to indicate relative need. Provincial executive councils have discretion regarding the determination of departmental allocations for each function, taking into account the priorities that underpin the division of revenue.

For the 2016 Budget, the formula components are set out as follows:

- An *education component* (48 per cent), based on the size of the school-age population (ages 5 to 17) and the number of learners (Grades R to 12) enrolled in public ordinary schools.
- A *health component* (27 per cent), based on each province's risk profile and health system case load.
- A *basic component* (16 per cent), derived from each province's share of the national population.
- An *institutional component* (5 per cent), divided equally between the provinces.
- A *poverty component* (3 per cent), based on income data. This component reinforces the redistributive bias of the formula.
- An *economic output component* (1 per cent), based on regional gross domestic product (GDP-R, measured by Statistics South Africa).

Table W1.11 Distributing the equitable shares by province, 2016 MTEF

	Education	Health	Basic share	Poverty	Economic activity	Institu-tional	Weighted average
	48.0%	**27%**	**16%**	**3%**	**1%**	**5%**	**100%**
Eastern Cape	15.1%	13.5%	12.6%	16.2%	7.7%	11.1%	14.0%
Free State	5.3%	5.3%	5.1%	5.3%	5.1%	11.1%	5.6%
Gauteng	17.8%	21.7%	24.0%	17.2%	33.8%	11.1%	19.7%
KwaZulu-Natal	22.4%	21.8%	19.9%	22.3%	16.0%	11.1%	21.2%
Limpopo	13.1%	10.3%	10.4%	13.6%	7.3%	11.1%	11.8%
Mpumalanga	8.5%	7.4%	7.8%	9.1%	7.6%	11.1%	8.2%
Northern Cape	2.3%	2.1%	2.2%	2.2%	2.0%	11.1%	2.6%
North West	6.5%	6.7%	6.7%	8.0%	6.8%	11.1%	6.9%
Western Cape	9.0%	11.1%	11.3%	6.1%	13.7%	11.1%	10.0%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: National Treasury

Education component (48 per cent)

The education component uses the school-age population (5 to 17 years), based on the 2011 Census, and enrolment data drawn from the Department of Basic Education's 2015 School Realities Survey. Each of these elements is assigned a weight of 50 per cent.

Table W1.12 shows the effect of updating the education component with new enrolment data on the education component share.

Table W1.12 Impact of changes in school enrolment on the education component share

	Age cohort 5 – 17	School enrolment		Changes in enrolment	Weighted average		Difference in weighted average
		2014	2015		2015 MTEF	2016 MTEF	
Eastern Cape	1 856 317	1 916 285	1 948 855	32 570	15.1%	15.1%	-0.00%
Free State	657 489	671 139	681 310	10 171	5.3%	5.3%	-0.00%
Gauteng	2 231 793	2 178 282	2 247 389	69 107	17.7%	17.8%	0.13%
KwaZulu-Natal	2 758 594	2 865 984	2 875 074	9 090	22.5%	22.4%	-0.16%
Limpopo	1 536 294	1 719 134	1 752 451	33 317	13.0%	13.1%	0.01%
Mpumalanga	1 053 846	1 055 243	1 077 372	22 129	8.5%	8.5%	0.02%
Northern Cape	288 839	287 904	289 233	1 329	2.3%	2.3%	-0.01%
North West	824 724	798 894	813 161	14 267	6.5%	6.5%	0.00%
Western Cape	1 174 625	1 074 161	1 094 752	20 591	9.0%	9.0%	0.01%
Total	**12 382 521**	**12 567 026**	**12 779 597**	**212 571**	**100.0%**	**100.0%**	**–**

Source: National Treasury

Health component (27 per cent)

The health component uses a risk-adjusted capitation index and output data from public hospitals to estimate each province's share of the health component. These methods work together to balance needs (risk-adjusted capitation) and demands (output component).

The health component is presented in three parts below. Table W1.13 shows the shares of the risk-adjusted component, which accounts for 75 per cent of the health component.

Table W1.13 Risk-adjusted sub-component shares

Thousand	Mid-year population estimates 2015	Insured population 2014	Risk-adjusted index	Weighted population	Risk-adjusted shares 2015	Risk-adjusted shares 2016	Change
Eastern Cape	6 916	10.5%	96.9%	5 993	13.4%	13.3%	-0.05%
Free State	2 818	17.9%	103.3%	2 388	5.4%	5.3%	-0.11%
Gauteng	13 200	28.2%	105.4%	9 994	21.9%	22.2%	0.34%
KwaZulu-Natal	10 919	12.9%	98.9%	9 410	20.8%	20.9%	0.07%
Limpopo	5 727	8.6%	91.6%	4 795	10.7%	10.7%	-0.01%
Mpumalanga	4 284	14.9%	95.7%	3 487	7.8%	7.7%	-0.01%
Northern Cape	1 186	19.8%	100.7%	957	2.1%	2.1%	-0.00%
North West	3 707	14.8%	102.2%	3 228	7.2%	7.2%	-0.03%
Western Cape	6 200	26.3%	104.0%	4 752	10.7%	10.6%	-0.18%
Total	**54 957**			**45 004**	**100.0%**	**100.0%**	**–**

Source: National Treasury

The risk-adjusted sub-component estimates a weighted population in each province using the risk-adjusted capitation index, which is calculated using data from the Council for Medical Schemes' Risk Equalisation Fund. The percentage of the population with medical aid insurance, based on the 2014 General Household Survey, is deducted from the 2015 mid-year population estimates to estimate the uninsured population per province. The risk-adjusted index, which is an index of each province's health risk profile, is applied to the uninsured population to estimate the weighted population. Each province's share of this weighted population is used to estimate their share of the risk-adjusted sub-component. Table W1.13 shows the change in this sub-component between 2015 and 2016.

The output sub-component is shown in Table W1.14 below.

Table W1.14 Output sub-component shares[1]

Thousand	Primary healthcare visits 2013/14	2014/15	Average	Share	Hospital workload patient-day equivalents 2013/14	2014/15	Average	Share
Eastern Cape	17 379	17 907	17 643	13.7%	4 572	4 637	4 605	14.2%
Free State	6 894	6 792	6 843	5.3%	1 750	1 706	1 728	5.3%
Gauteng	23 647	23 743	23 695	18.3%	6 722	6 701	6 711	20.7%
KwaZulu-Natal	31 885	31 233	31 559	24.4%	8 043	7 911	7 977	24.6%
Limpopo	14 256	14 343	14 300	11.1%	2 922	2 883	2 902	8.9%
Mpumalanga	9 144	9 483	9 313	7.2%	1 931	1 963	1 947	6.0%
Northern Cape	3 421	3 308	3 365	2.6%	526	595	561	1.7%
North West	8 047	8 364	8 206	6.4%	1 674	1 721	1 697	5.2%
Western Cape	14 308	14 257	14 282	11.1%	4 283	4 341	4 312	13.3%
Total	**128 981**	**129 430**	**129 206**	**100.0%**	**32 424**	**32 457**	**32 440**	**100.0%**

1. Some provincial numbers for patient-days and healthcare visits for 2013/14 have been restated, resulting in small variances from numbers published in 2015

Source: National Treasury

The output sub-component uses patient load data from the District Health Information Services. The average number of visits at primary healthcare clinics in 2013/14 and 2014/15 is calculated to estimate each province's share of this part of the output component, which makes up 5 per cent of the health component. For hospitals, each province's share of the total patient-day equivalents from public hospitals in 2013/14 and 2014/15 is used to estimate their share of this part of the output sub-component, making up 20 per cent of the health component. In total, the output component is 25 per cent of the health component.

Table W1.15 shows the updated health component shares for the 2016 MTEF period.

Table W1.15 Health component weighted shares

Weight	Risk-adjusted 75.0%	Primary healthcare 5.0%	Hospital component 20.0%	Weighted shares 2015	Weighted shares 2016	Change
Eastern Cape	13.3%	13.7%	14.2%	13.5%	13.5%	-0.02%
Free State	5.3%	5.3%	5.3%	5.4%	5.3%	-0.14%
Gauteng	22.2%	18.3%	20.7%	21.4%	21.7%	0.26%
Kw aZulu-Natal	20.9%	24.4%	24.6%	21.8%	21.8%	-0.03%
Limpopo	10.7%	11.1%	8.9%	10.4%	10.3%	-0.03%
Mpumalanga	7.7%	7.2%	6.0%	7.3%	7.4%	0.03%
Northern Cape	2.1%	2.6%	1.7%	2.1%	2.1%	0.02%
North West	7.2%	6.4%	5.2%	6.7%	6.7%	0.02%
Western Cape	10.6%	11.1%	13.3%	11.3%	11.1%	-0.12%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**–**

Source: National Treasury

Basic component (16 per cent)

The basic component is derived from the proportion of each province's share of the national population. This component constitutes 16 per cent of the total equitable share. For the 2016 MTEF, population data is drawn from the 2015 mid-year population estimates produced by Statistics South Africa. Table W1.16 shows the impact on the basic component's revised weighted shares.

Table W1.16 Impact of the changes in population on the basic component shares

Thousand	Mid-year population estimates 2014	Mid-year population estimates 2015	Population change	% population change	Basic component shares 2015 MTEF	Basic component shares 2016 MTEF	Change
Eastern Cape	6 787	6 916	129	1.9%	12.6%	12.6%	0.02%
Free State	2 787	2 818	31	1.1%	5.2%	5.1%	-0.03%
Gauteng	12 915	13 200	286	2.2%	23.9%	24.0%	0.10%
KwaZulu-Natal	10 694	10 919	225	2.1%	19.8%	19.9%	0.06%
Limpopo	5 631	5 727	96	1.7%	10.4%	10.4%	-0.01%
Mpumalanga	4 229	4 284	55	1.3%	7.8%	7.8%	-0.04%
Northern Cape	1 167	1 186	19	1.6%	2.2%	2.2%	-0.00%
North West	3 676	3 707	31	0.8%	6.8%	6.7%	-0.06%
Western Cape	6 116	6 200	84	1.4%	11.3%	11.3%	-0.04%
Total	**54 002**	**54 957**	**955**	**1.8%**	**100.0%**	**100.0%**	**–**

Source: National Treasury

Institutional component (5 per cent)

The institutional component recognises that some costs associated with running a provincial government and providing services are not directly related to the size of a province's population or the other factors included in other components. It is therefore distributed equally between provinces, constituting 5 per cent of the total equitable share, of which each province receives 11.1 per cent. This benefits provinces with smaller populations, especially the Northern Cape, the Free State and the North West, because the allocation per person for these provinces is much higher in this component.

Poverty component (3 per cent)

The poverty component introduces a redistributive element to the formula and is assigned a weight of 3 per cent. The poor population includes people who fall in the lowest 40 per cent of household incomes in the 2010/11 Income and Expenditure Survey. The estimated size of the poor population in each province is calculated by multiplying the proportion in that province that fall into the poorest 40 per cent of South

African households by the province's population figure from the 2015 mid-year population estimates. Table W1.17 shows the proportion of the poor in each province from the Income and Expenditure Survey, the 2015 mid-year population estimates and the weighted share of the poverty component per province.

Table W1.17 Comparison of current and new poverty component weighted shares

Thousand	Income and Expenditure Survey 2010/11	Current (2015 MTEF) Mid-year population estimates 2014	Current (2015 MTEF) Poor population	Current (2015 MTEF) Weighted shares	New (2016 MTEF) Mid-year population estimates 2015	New (2016 MTEF) Poor population	New (2016 MTEF) Weighted shares	Difference in weighted shares
Eastern Cape	52.0%	6 787	3 531	16.2%	6 916	3 599	16.2%	0.0%
Free State	41.4%	2 787	1 154	5.3%	2 818	1 167	5.3%	-0.0%
Gauteng	28.9%	12 915	3 728	17.1%	13 200	3 811	17.2%	0.1%
KwaZulu-Natal	45.3%	10 694	4 845	22.2%	10 919	4 947	22.3%	0.1%
Limpopo	52.9%	5 631	2 976	13.6%	5 727	3 027	13.6%	-0.0%
Mpumalanga	47.3%	4 229	1 998	9.2%	4 284	2 024	9.1%	-0.0%
Northern Cape	40.8%	1 167	476	2.2%	1 186	483	2.2%	-0.0%
North West	47.9%	3 676	1 761	8.1%	3 707	1 775	8.0%	-0.1%
Western Cape	21.9%	6 116	1 337	6.1%	6 200	1 356	6.1%	-0.0%
Total		**54 002**	**21 807**	**100%**	**54 957**	**22 189**	**100.0%**	**–**

Source: National Treasury

Economic activity component (1 per cent)

The economic activity component is a proxy for provincial tax capacity and expenditure assignments. Given that these assignments are a relatively small proportion of provincial budgets, the component is assigned a weight of 1 per cent. For the 2016 MTEF, 2014 GDP-R data is used. Table W1.18 shows the weighted shares of the economic activity component.

Table W1.18 Current and new economic activity component weighted shares

	Current (2015 MTEF) GDP-R, 2012 (R million)	Current (2015 MTEF) Weighted shares	New (2016 MTEF) GDP-R, 2013 (R million)	New (2016 MTEF) Weighted shares	Difference in weighted shares
Eastern Cape	234 536	7.5%	272 714	7.7%	0.24%
Free State	162 601	5.2%	179 776	5.1%	-0.09%
Gauteng	1 089 535	34.7%	1 194 144	33.8%	-0.92%
KwaZulu-Natal	496 431	15.8%	565 226	16.0%	0.18%
Limpopo	223 090	7.1%	256 896	7.3%	0.16%
Mpumalanga	222 149	7.1%	269 863	7.6%	0.56%
Northern Cape	70 203	2.2%	71 142	2.0%	-0.22%
North West	201 736	6.4%	239 020	6.8%	0.34%
Western Cape	438 700	14.0%	485 545	13.7%	-0.24%
Total	**3 138 981**	**100.0%**	**3 534 326**	**100.0%**	**–**

Source: National Treasury

Conditional grants to provinces

There are four types of provincial conditional grants:

- Schedule 4A sets out general grants that supplement various programmes partly funded by provinces.
- Schedule 5A grants fund specific responsibilities and programmes implemented by provinces.
- Schedule 6A grants provide in-kind allocations through which a national department implements projects in provinces.

- Schedule 7A grants provide for the swift allocation and transfer of funds to a province to help it deal with a disaster.

Changes to conditional grants

Despite the baseline reductions, overall growth in direct conditional transfers to provinces is strong, averaging 8.2 per cent over the MTEF period. Direct conditional grant baselines total R89.1 billion in 2016/17, R100.5 billion in 2017/18 and R108.1 billion in 2018/19. Indirect conditional grants amount to R3.6 billion, R1.7 billion and R1.8 billion respectively for each year of the same period.

Table W1.19 provides a summary of conditional grants by sector for the 2016 MTEF period. More detailed information, including the framework and allocation criteria for each grant, is provided in Annexure W2 of the 2016 Division of Revenue Bill. The frameworks provide the conditions for each grant, the outputs expected, the allocation criteria used for dividing each grant between provinces, and a summary of the grant's audited outcomes for 2014/15.

Table W1.19 Conditional grants to provinces, 2015/16 – 2018/19

R million	2015/16	2016/17	2017/18	2018/19	MTEF total
Agriculture, Forestry and Fisheries	**2 171**	**2 202**	**2 334**	**2 464**	**7 001**
Comprehensive agricultural support programme	1 640	1 642	1 739	1 834	5 214
Ilima/Letsema projects	467	491	522	552	1 566
Land care programme: poverty relief and infrastructure development	65	69	74	78	221
Arts and Culture	**1 274**	**1 357**	**1 441**	**1 522**	**4 320**
Community library services	1 274	1 357	1 441	1 522	4 320
Basic Education	**15 632**	**16 213**	**19 717**	**20 851**	**56 781**
Education infrastructure	9 354	9 614	12 780	13 512	35 906
HIV and Aids (life skills education)	209	231	245	260	736
Maths, science and technology	317	362	385	407	1 155
National school nutrition programme	5 685	6 006	6 306	6 672	18 984
Occupational-specific dispensation for education sector therapists	66	–	–	–	–
Cooperative Governance and Traditional Affairs	**103**	**112**	**123**	**131**	**366**
Provincial disaster	103	112	123	131	366
Health	**31 905**	**33 972**	**37 588**	**41 247**	**112 808**
Comprehensive HIV and Aids	13 671	15 291	17 660	20 032	52 983
Health facility revitalisation	5 417	5 273	5 770	6 036	17 079
Health professions training and development	2 375	2 477	2 632	2 784	7 893
Human papillomavirus vaccine	–	–	–	200	200
National tertiary services	10 381	10 847	11 526	12 195	34 568
National health insurance	61	85	–	–	85
Human Settlements	**18 303**	**18 284**	**21 060**	**22 282**	**61 626**
Human settlements development	18 303	18 284	21 060	22 282	61 626
Public Works	**552**	**762**	**809**	**856**	**2 427**
Expanded public works programme integrated grant for provinces	326	402	424	448	1 274
Social sector expanded public works programme incentive for provinces	226	360	386	408	1 153
Social Development	**48**	**86**	**377**	**564**	**1 026**
Substance abuse treatment	48	86	57	71	213
Early childhood development		–	320	493	813
Sport and Recreation South Africa	**533**	**556**	**586**	**618**	**1 760**
Mass participation and sport development	533	556	586	618	1 760
Transport	**14 747**	**15 603**	**16 477**	**17 526**	**49 605**
Provincial roads maintenance	9 807	10 203	10 754	11 536	32 492
Public transport operations	4 939	5 400	5 723	5 990	17 113
Total direct conditional allocations	**85 268**	**89 146**	**100 513**	**108 061**	**297 720**
Indirect transfers	**3 150**	**3 636**	**1 663**	**1 765**	**7 064**
Basic Education	**2 047**	**2 375**	**–**	**–**	**2 375**
School infrastructure backlogs	2 047	2 375	–	–	2 375
Health	**1 103**	**1 261**	**1 663**	**1 765**	**4 689**
National health insurance indirect	1 103	1 261	1 663	1 765	4 689

Source: National Treasury

Agriculture grants

The *comprehensive agricultural support programme* is a grant for newly established and emerging farmers, particularly subsistence, smallholder and previously disadvantaged farmers. The grant supports production of both livestock and crops. It also aims to expand farm infrastructure and provide support for dipping, fencing and rehabilitating viable irrigation schemes. The grant’s 2016/17 allocations include

R76.7 million to repair flood-damaged agricultural infrastructure. The baseline reduction in 2016/17 is R60 million. The grant is allocated R5.2 billion over the medium term.

The *land care programme grant: poverty relief and infrastructure development* aims to improve productivity and the sustainable use of natural resources. Provinces are also encouraged to use this grant to create jobs through the Expanded Public Works Programme. Over the medium term, R220.7 million is allocated to this grant.

The *Ilima/Letsema projects grant* aims to boost food production by helping previously disadvantaged farming communities. The Department of Agriculture, Forestry and Fisheries is still testing the new approach, following which it will subject the grant to the standard operating procedure for farmer support. The grant's baseline is protected, with a R491.4 million allocation for 2016/17. It is allocated R1.6 billion over the MTEF period.

Arts and culture grant

The *community library services grant*, administered by the Department of Arts and Culture, aims to help South Africans access knowledge and information to improve their socioeconomic situation. The grant is allocated to the relevant provincial department and administered by that department or through a service-level agreement with municipalities. In collaboration with provincial departments of basic education, the grant also funds libraries that serve both schools and the general public. Funds from this grant may also be used to shift the libraries function between provinces and municipalities. The baseline reduction on this grant in 2016/17 is R10 million. The grant is allocated R4.3 billion over the next three years.

Basic education grants

Provinces use the *education infrastructure grant* to construct, maintain and refurbish education infrastructure and schools. The baseline reduction on this grant in 2016/17 is R160 million. The reduction to the baseline over the MTEF amounts to R520 million. The grant totals R35.9 billion over the MTEF period, which includes a ring-fenced amount of R112.9 million in 2016/17 to repair school infrastructure damaged by natural disasters.

The *school infrastructure backlogs grant* is an indirect grant to provinces that was introduced in 2011 as a temporary, high-impact grant. The Department of Basic Education uses this grant to build and upgrade schools on behalf of provinces to address inappropriate structures and access to basic services. To address the grant's disappointing performance, it will be merged with the *education infrastructure grant* from 2017/18. However, the baseline allocation under this grant will remain unallocated in 2017/18 and 2018/19, subject to a review of pipeline projects in 2016. In 2016/17, the last year of its current form, the grant is allocated R2.4 billion. The baseline of the *education infrastructure grant* is R9.6 billion in 2016/17, R12.8 billion in 2017/18 and R13.5 billion in 2018/19. Over the MTEF period, R3.6 billion in 2017/18 and R3.8 billion in 2018/19 will remain unallocated.

Infrastructure grant reforms to improve planning were introduced in 2013 after a decade of provincial capacity building through the Infrastructure Delivery Improvement Programme. Under the requirements introduced in the 2013 Division of Revenue Act, provincial education departments had to go through a two-year planning process to be eligible to receive incentive allocations in 2016/17. The departments had to meet certain prerequisites in 2014/15 and have their infrastructure plans approved in 2015/16. The Department of Basic Education and the National Treasury assessed the provinces' infrastructure plans. A moderation process was undertaken between the national department, provincial treasuries and provincial departments of basic education to agree on the final scores. From 2015/16, provinces needed to obtain a minimum score of 60 per cent to qualify for the incentive. Table W1.20 shows the final score and incentive allocation for each province.

Table W1.20 Education infrastructure grant allocations

R thousand	Planning assessment results from 2015	2016/17 Basic component	2016/17 Incentive component	2016/17 Disaster recovery funds	Final allocation for 2016/17
Eastern Cape	62%	1 443 538	–	61 550	1 505 088
Free State	54%	695 122	–	–	695 122
Gauteng	64%	1 252 428	133 309	–	1 385 737
KwaZulu-Natal	64%	1 825 012	133 309	–	1 958 321
Limpopo	46%	830 532	–	–	830 532
Mpumalanga	27%	788 153	–	–	788 153
Northern Cape	69%	353 229	133 309	–	486 538
North West	60%	787 249	133 309	51 431	971 989
Western Cape	78%	858 903	133 309	–	992 212
Total		**8 834 165**	**666 546**	**112 981**	**9 613 692**

Source: National Treasury

The *national school nutrition programme grant* seeks to improve the nutrition of poor school children, enhance active learning capacity and increase school attendance. It provides a free daily meal to pupils in the poorest 60 per cent of schools (quintile 1 to 3). In a handful of provinces, the shift from provincial quintile classification to the national quintile system meant a number of schools that were previously benefiting from the programme could no longer benefit, although the need remained. This gap has now been rectified, without diluting the benefits of the programme. The grant is allocated R19 billion over the MTEF period. The baseline has not been reduced.

The *maths, science and technology grant*, a grant that resulted from the merging of the *Dinaledi schools grant* and the *technical secondary schools recapitalisation grant*, is providing targeted interventions to improve outcomes in maths and science learning, and grant administration has been streamlined. The baseline is maintained at R1.2 billion over the MTEF period.

The *HIV and Aids (life skills education) programme grant* provides for life skills training and sexuality and HIV/AIDS education in primary and secondary schools. It is fully integrated into the school system, with learner and teacher support materials provided for Grades 1 to 9. The grant's baseline is preserved and allocated R735.7 million over the MTEF period.

The *occupational-specific dispensation for education sector therapists grant* provided funds for provinces to implement the occupation-specific dispensation agreement for therapists, counsellors and psychologists in the education sector. The grant was allocated for two years (2014/15 and 2015/16) while back-pay was funded and new remuneration levels were normalised. The grant no longer exists.

Cooperative governance grant

The *provincial disaster grant* is administered by the National Disaster Management Centre in the Department of Cooperative Governance and is unallocated at the start of the financial year. The grant allows for an immediate (in-year) release of funds to be disbursed by the National Disaster Management Centre after a disaster is declared, without the need for the transfers to be gazetted first. The reconstruction of infrastructure damaged by disasters is funded separately through ring-fenced allocations in sector grants.

The grant has partly funded mitigation strategies to address the ongoing drought. Since the effects of the drought are likely to persist into 2016/17, the grant's baseline is preserved, with an allocation of R365.6 million over the MTEF period. To ensure that sufficient funds are available in the event of a disaster, section 26 of the 2016 Division of Revenue Bill allows for funds allocated to the *municipal disaster grant* to be transferred to provinces if funds in the *provincial disaster grant* have already been exhausted, and vice versa. The bill also allows for more than one transfer to be made to areas affected by disasters so that an initial payment for emergency aid can be made before a full assessment of damages and costs has been completed.

Health grants

The *national tertiary services grant* provides strategic funding to enable provinces to plan, modernise and transform tertiary hospital service delivery in line with national policy objectives. The grant operates in 33 hospitals across the nine provinces. The urban areas of Gauteng and the Western Cape receive the largest shares of the grant because they provide the largest proportion of high-level, sophisticated services for the benefit of the country's health sector. In light of previous baselines reductions, coupled with the pressures that tertiary services face, this grant's baseline is preserved over the 2016 MTEF period. The grant is allocated R35 billion over the medium term.

The *health facility revitalisation grant* funds the construction and maintenance of health infrastructure. It was created in 2013/14 through the merger of three previous grants. The grant funds a wide range of health infrastructure projects, including large projects to modernise hospital infrastructure and equipment, general maintenance and infrastructure projects at smaller hospitals, and the refurbishment and upgrading of nursing colleges and schools. This grant's baseline is reduced by R200 million in 2016/17, and R365 million over the 2016 MTEF period. A total of R17 million has been ring-fenced to repair clinics damaged by natural disasters.

Similar to the reforms to the *education infrastructure grant* discussed above, a two-year planning process is now required for provinces to access this grant. The national Department of Health and the National Treasury conducted an assessment of the provinces' infrastructure plans, followed by a moderation process between the national department, provincial treasuries and provincial departments of health to agree on the final scores. Provinces had to obtain a minimum score of 60 per cent to qualify for the incentive. Table W1.21 sets out the final score and the incentive allocation per province.

Table W1.21 Health facility revitalisation grant allocations

R thousand	Planning assessment results from 2015	2016/17 Basic component	2016/17 Incentive component	2016/17 Disaster recovery funds	Final allocation for 2016/17
Eastern Cape	64%	509 587	109 454	-	619 041
Free State	52%	474 692	-	-	474 692
Gauteng	63%	668 364	109 454	-	777 818
KwaZulu-Natal	67%	1 005 239	109 454	-	1 114 693
Limpopo	43%	379 089	-	-	379 089
Mpumalanga	31%	281 174	-	-	281 174
Northern Cape	61%	362 813	109 454	-	472 267
North West	56%	480 434	-	-	480 434
Western Cape	84%	564 018	109 454	-	673 472
Total		**4 725 412**	**547 268**	**–**	**5 272 680**

Source: National Treasury

The *health professions training and development grant* funds the training of health professionals, and the development and recruitment of medical specialists. It enables the shifting of teaching activities from central to regional and district hospitals. The grant's baseline is protected over the 2016 MTEF period. It is allocated R7.9 billion over the medium term.

The *comprehensive HIV, Aids and TB grant* supports HIV/AIDS prevention programmes and specific interventions, including voluntary counselling and testing, prevention of mother-to-child transmission, post-exposure prophylaxis, antiretroviral treatment and home-based care. Over the 2016 MTEF period, the scope of the grant will be extended to include tuberculosis (the grant was previously called the *comprehensive HIV and Aids grant).* In 2016/17, this grant is reduced by R176 million, partly due to effective programme delivery and fewer-than-budgeted patients added to the antiretroviral therapy treatment programme. However, to cater for the grant's extended scope and additional priorities, R1.6 billion is added in 2018/19.

The *national health insurance grant* funds the national health insurance pilots introduced in 2012/13, which aim to strengthen primary healthcare for the implementation of national health insurance. Ten districts were selected as pilot sites to test interventions that aim to strengthen health systems and improve performance. However, this grant has performed poorly, with little evidence of impact. As such, 2016/17 is the final year for this grant, after which a close-out report will review the reasons for its conclusion. In 2016/17, the baseline allocation for this grant is R85 million. However, the vision that underpinned this grant will continue through the the *national health insurance indirect grant*. This grant will use targeted programmes to prepare the health sector for the rollout of national health insurance.

The *national health insurance indirect grant*, introduced in 2013/14, is spent by the Department of Health on behalf of provinces. The grant has five components, which target national health insurance scheme pilot sites in preparation for the eventual rollout of national health insurance in the country. The components of the grant are: health facility revitalisation, health professionals contracting, human papillomavirus vaccine, ideal clinics, and information systems (this component will come into effect in 2017/18).

Under this grant, the health facility revitalisation component will be used to accelerate construction, maintenance, upgrades and rehabilitation for new and existing health infrastructure, while the health professionals contracting component will pilot the contracting of general practitioners from the private sector for national health insurance sites. It will also support hospitals to strengthen their patient information systems and develop and pilot alternative hospital reimbursement tools. The human papillomavirus vaccine component is allocated for three additional years, and will be used to support provincial health departments with the vaccine's rollout. In the last year of the 2016 MTEF period, this component will become a direct grant to provinces. The *national health insurance indirect grant* is allocated R4.7 billion over the MTEF period.

Human settlements grant

The *human settlements development grant* seeks to establish habitable, stable and sustainable human settlements in which all citizens have access to social and economic amenities. This grant is allocated using a formula with three components:

- The first component shares 70 per cent of the total allocation between provinces in proportion to their share of the total number of households living in inadequate housing. Data from the 2011 Census is used for the number of households in each province living in informal settlements, shacks in backyards and traditional dwellings. Not all traditional dwellings are inadequate, which is why information on the proportion of traditional dwellings per province with damaged roofs and walls from the 2010 General Household Survey is used to adjust these totals so that only traditional dwellings that provide inadequate shelter are counted in the formula.
- The second component determines 20 per cent of the total allocation based on the share of poor households in each province. The number of households with an income of less than R1 500 per month is used to determine 80 per cent of the component and the share of households with an income of between R1 500 and R3 500 per month is used to determine the remaining 20 per cent. Data used in this component comes from the 2011 Census.
- The third component, which determines 10 per cent of the total allocation, is shared in proportion to the number of people in each province, as measured in the 2011 Census.

In addition to the allocations determined through the formula, a total of R3.6 billion is ring-fenced over the 2016 MTEF period to upgrade human settlements in mining towns in six provinces. These allocations respond to areas with significant informal settlement challenges, with a high proportion of economic activity based on the natural resources sector. A total of R329.3 million is also ring-fenced over the medium term to repair infrastructure damaged by natural disasters.

The grant's baseline is reduced by R1.6 billion in 2016/17, but it is protected for the remainder of the MTEF period. The grant's allocation totals R61.6 billion over the medium term.

Public works grants

The *expanded public works programme integrated grant for provinces* incentivises provincial departments to use labour-intensive methods in infrastructure, environmental and other projects. Grant allocations are determined upfront based on the performance of provincial departments in meeting job targets in the preceding financial year. It is allocated R1.3 billion over the MTEF period.

The *social sector expanded public works programme incentive grant for provinces* rewards provinces for creating jobs in the preceding financial year in the areas of home-based care, early childhood development, adult literacy and numeracy, community safety and security, and sports programmes. The grant's allocation model incentivises provincial departments to participate in the Expanded Public Works Programme and measures the performance of each province relative to its peers, providing additional incentives to those that perform well. The grant is allocated R1.2 billion over the MTEF period.

Social development grant

The *substance abuse treatment grant* aims to build public substance abuse treatment facilities in the four provinces that do not already have such facilities: the Eastern Cape, the Free State, the Northern Cape and the North West. The grant, which is administered by the Department of Social Development, funds the construction of treatment centres. After 2016/17, however, it will no longer operate in its current form. For the remainder of the 2016 MTEF period, allocations to this grant will supplement the operationalisation of these treatment centres. The grant's baseline has not been reduced. It has been allocated R213.3 million over the MTEF period.

From 2017/18, the new *early childhood development grant* will be introduced to the provincial fiscal framework. The grant will play a part in government's prioritisation of early childhood development, as envisioned in the National Development Plan. Over the MTEF period, the grant baseline totals R812.9 million.

Sport and recreation South Africa grant

The *mass participation and sport development grant* aims to increase and sustain mass participation in sport and recreational activities in the provinces, with greater emphasis on provincial and district academies. The baseline reduction on this grant in 2016/17 is R10 million. It is allocated R1.8 billion over the MTEF period.

Transport grants

The *public transport operations grant* subsidises commuter bus services. It supports provinces to ensure that contractual obligations are met and services are efficiently provided. The public transport contracting and regulatory functions may be assigned to certain metropolitan municipalities during 2016/17. If this takes place, grant funds will be transferred directly to the assigned municipality. Given the pressures this sector faces, R700 million is added to the grant's baseline over the medium term. The grant is allocated R5.4 billion in 2016/17, R5.7 billion in 2017/18 and R6 billion in 2018/19.

The *provincial roads maintenance grant* consists of three components. The largest component enables provinces to expand their maintenance activities. The other components allow provinces to repair roads damaged by floods and rehabilitate roads that are heavily used in support of electricity production. Grant allocations are determined using a formula based on provincial road networks, road traffic and weather conditions. These factors reflect the different costs of maintaining road networks in each province. The grant requires provinces to follow best practices for planning and to use and regularly update roads asset management systems.

In preparation for the grant's performance-based allocation, the model's indicators – vehicle operating costs and remaining asset lifespan – have been finalised and the performance component will inform future grant allocations. An amount of R10 million has been reprioritised within this grant for 2016/17 to fund preparations for the incentive measure. The total allocation for the MTEF period is R32.5 billion, including a ring-fenced allocation of R298 million in 2016/17 for the repair of infrastructure damaged by floods.

Part 5: Local government fiscal framework and allocations

The local government fiscal framework responds to the constitutional assignment of powers and functions to this sphere of government. The framework – including all transfers and own revenues – is structured to support the achievement of the National Development Plan's goals.

The framework refers to all resources available to municipalities to meet their expenditure responsibilities. National transfers account for a relatively small proportion of the local government fiscal framework, with the majority of local government revenues being raised by municipalities themselves through their substantial revenue-raising powers, including property rates and service charges. However, the proportion of revenue from transfers and own revenues varies dramatically across municipalities, with poor rural municipalities receiving most of their revenue from transfers, while urban municipalities raise the majority of their own revenues. This differentiation in the way municipalities are funded will continue in the period ahead.

The 2016 division of revenue includes several important changes that will affect municipalities, including changes to accommodate the effect of a series of major boundary changes that will come into effect following the 2016 local government elections, and changes as a result of the review of local government infrastructure grants.

Boundary changes will see the total number of municipalities in the country reduced from 278 to 257. Allocations published in the 2016 Division of Revenue Bill are based on the new municipal boundaries because these new demarcations will be in effect for the majority of the 2016/17 municipal financial year. In addition, the infrastructure grant review will reduce the number of grants to municipalities, helping to decrease the burden of reporting on municipalities and make the grant system more efficient.

This section outlines the transfers made to local government and how these funds are distributed between municipalities. Funds raised by national government are transferred to municipalities through conditional and unconditional grants. National transfers to municipalities are published to enable them to plan fully for their 2016/17 budgets, and to promote better accountability and transparency by ensuring that all national allocations are included in municipal budgets.

Transfers to local government

Over the 2016 MTEF period, R339.6 billion will be transferred directly to local government and a further R22.9 billion has been allocated to indirect grants. Direct transfers to local government over the 2016 MTEF period account for 9.1 per cent of national government's non-interest expenditure. When indirect transfers are added to this, total spending on local government increases to 9.8 per cent of national non-interest expenditure.

Table W1.22 Transfers to local government, 2012/13 – 2018/19

R million	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
		Outcome		Revised estimate		Medium-term estimates	
Direct transfers	**76 200**	**82 595**	**87 656**	**99 650**	**104 925**	**113 340**	**121 311**
Equitable share and related	**37 139**	**38 964**	**41 592**	**50 507**	**52 569**	**57 012**	**61 732**
Equitable share formula[1]	32 747	34 268	36 512	45 351	47 141	51 313	55 710
RSC levy replacement	3 733	3 930	4 146	4 337	4 567	4 795	5 073
Support for councillor remuneration and ward committees	659	766	935	819	862	904	949
General fuel levy sharing with metros	**9 040**	**9 613**	**10 190**	**10 659**	**11 224**	**11 785**	**12 469**
Conditional grants	**30 021**	**34 018**	**35 874**	**38 485**	**41 132**	**44 543**	**47 111**
Infrastructure	28 485	32 412	34 167	36 842	39 120	42 568	45 087
Capacity building and other	1 536	1 606	1 707	1 643	2 013	1 975	2 024
Indirect transfers	**5 050**	**5 945**	**8 895**	**10 525**	**7 773**	**7 401**	**7 679**
Infrastructure	4 819	5 705	8 643	10 274	7 689	7 297	7 564
Capacity building and other	230	240	252	251	84	103	115
Total	**81 250**	**88 541**	**96 551**	**110 175**	**112 698**	**120 740**	**128 990**

1. Outcome and revised estimate figures for the equitable share reflect amounts transferred after funds have been withheld to offset underspending by municipalities on conditional grants. Roll-over funds are reflected in the year in which they were transferred

Source: National Treasury

Changes to local government allocations

Direct transfers to local government grow at an annual average rate of 6.8 per cent over the 2016 MTEF period. Transfers to local government tabled in the 2016 MTEF have been reduced to make funding available for other government priorities. As outlined in the 2015 *Medium Term Budget Policy Statement*, additions of R2 billion in 2017/18 and R4 billion in 2018/19 were proposed for the local government equitable share to compensate for the effect of the rising costs of bulk water and electricity. These additions are now being reduced to R1.5 billion in 2017/18 and R3 billion in 2018/19. The local government equitable share allocation will also be reduced by R300 million in 2016/17. Since the 2015 *Medium Term Budget Policy Statement*, the allocations for direct and indirect conditional grants have also been reduced by a further R4.9 billion over the MTEF period.

In order to support the continued delivery of basic services, some conditional grants have been reprioritised, while others have been realigned and merged. Grant administrators and municipalities should maximise efficient spending to minimise the effect of these reductions on service delivery. These changes are summarised in Table W1.23.

Table W1.23 Revisions to direct and indirect transfers to local government, 2016/17 – 2018/19

R million	2016/17	2017/18	2018/19	2016 MTEF Total revisions
Technical adjustments	**0**	**0**	**0**	**0**
Direct transfers	**3 116**	**3 397**	**3 685**	**10 198**
Municipal infrastructure grant	-14	-14	-15	-43
Urban settlements development	14	14	15	43
Water services infrastructure	2 965	3 900	4 139	11 004
Municipal water infrastructure	-1 186	-1 773	-1 876	-4 835
Rural household infrastructure	-113	-124	-131	-369
Water services operating subsidy	-466	-502	-532	-1 500
Regional bulk infrastructure	2 000	2 000	2 200	6 200
Municipal systems improvement	-84	-103	-115	-302
Indirect transfers	**-3 116**	**-3 397**	**-3 685**	**-10 198**
Regional bulk infrastructure	-2 000	-2 000	-2 200	-6 200
Water services infrastructure	312	587	608	1 507
Municipal water infrastructure	-1 512	-2 087	-2 208	-5 807
Municipal systems improvement	84	103	115	303
Additions to baselines	**752**	**1 562**	**3 000**	**5 314**
Direct transfers	**247**	**1 562**	**3 000**	**4 809**
Local government equitable share	–	1 500	3 000	4 500
Municipal demarcation transition	247	62	–	309
Indirect transfers	**505**	**–**	**–**	**505**
Regional bulk infrastructure	155	–	–	155
Bucket eradication programme	350	–	–	350
Reductions to baseline	**-2 524**	**-1 806**	**-1 952**	**-6 282**
Direct transfers	**-2 374**	**-1 636**	**-1 772**	**-5 782**
Local government equitable share	-300	–	–	-300
Municipal infrastructure grant	-620	-430	-480	-1 530
Municipal human settlements	-100	-115	-122	-337
Water services infrastructure	-120	-170	-180	-470
Urban settlements development	-250	-250	-350	-850
Integrated national electrification programme	-90	-110	-120	-320
Public transport network	-570	-250	-200	-1 020
Regional bulk infrastructure	-150	-135	-140	-425
Municipal systems improvement	-174	-176	-180	-530
Indirect transfers	**-150**	**-170**	**-180**	**-500**
Integrated national electrification programme	-150	-170	-180	-500
Total change to local government allocations				
Change to direct transfers	989	3 323	4 913	9 226
Change to indirect transfers	-2 761	-3 567	-3 865	-10 192
Net change to local government allocations	**-1 772**	**-244**	**1 048**	**-967**

Source: National Treasury

Technical adjustments in Table W1.23 reflect the merging of the previous *municipal water infrastructure grant*, the *water services operating subsidy grant* and the *rural household infrastructure grant* to create a new *water services infrastructure grant*. There is also a significant shift of resources in water infrastructure grants from indirect to direct grant allocations. Over the MTEF period, R4.3 billion is shifted from the *water services infrastructure grant*'s indirect component to its direct component, and R6.2 billion is shifted from the *regional bulk infrastructure grant*'s indirect component to its newly created direct component. This will enable the Department of Water and Sanitation to transfer funds to municipalities to build and refurbish their own infrastructure. The remaining allocation for the *municipal systems improvement grant* will become an indirect grant, which will enable the Department of Cooperative Governance to implement capacity-building initiatives in a targeted group of municipalities. There is also a small shift of funds from the *municipal infrastructure grant* to the *urban settlements development grant* to account for the absorption of Naledi Local Municipality (which receives the *municipal infrastructure grant*) into Mangaung Metropolitan Municipality (which receives the *urban settlements development grant*).

A total of R5.3 billion is added to local government allocations over the MTEF period. Of this, R4.5 billion is added to the local government equitable share to assist municipalities with the rising costs of providing free basic services to their residents. To support the implementation of the Municipal Demarcation Board's major boundary changes, the *municipal demarcation transition grant* will be increased by R247.4 million in 2016/17 and R61.9 million in 2017/18 to subsidise the additional institutional and administrative costs arising from municipal mergers. A total of R350 million is added to the *bucket eradication programme grant* in 2016/17 to complete the eradication of bucket sanitation systems in formal residential areas. The *urban settlements development grant*, the *human settlements development grant* and the *municipal infrastructure grant* will continue to fund the upgrade of sanitation in informal settlements through various projects focused on improving these areas. An amount of R155 million is also reprioritised into the *regional bulk infrastructure grant*.

Reductions to transfers total R6.2 billion over the MTEF period, including reductions of 3.1 per cent of the *municipal infrastructure grant*, 2.4 per cent of the *urban settlements development grant*, 5.2 per cent of the *public transport network grant*, 4.3 per cent of the direct *water services infrastructure grant*, 6.9 per cent of the direct *regional bulk infrastructure grant*, 4.9 per cent of the direct *integrated national electrification programme grant* and 4.2 per cent of the indirect *integrated national electrification programme grant*. There is also a reduction of R485 million over the MTEF period from the *municipal systems improvement grant* and R530 million from the *municipal human settlements capacity grant*. The remainder of the *municipal systems improvement grant* will become an indirect grant to support the objectives of the Back to Basics strategy, while the *municipal human settlements capacity grant* will be discontinued. In future, the *urban settlements development grant* will fund built environment capacity building.

After accounting for all reductions and additions, direct transfers to local government increase by R9.2 billion over the MTEF period. This is primarily due to the shifting of indirect transfers to direct transfers in the water sector and the additions to the local government equitable share over the MTEF period. Indirect transfers to local government (allocations spent by national departments on behalf of municipalities) decrease by R10.1 billion over the medium term. Total allocations to local government (including direct and indirect transfers) decrease by R1.8 billion in 2016/17 and R244 million in 2017/18, followed by an increase of R1 billion in 2018/19. Over the MTEF period, local government allocations decrease by R967 million. Despite these reductions, total allocations to local government still grow at an annual average rate of 6.7 per cent over the MTEF period.

Demarcation effects

The Municipal Demarcation Board has announced several major boundary changes that will come into effect on the date of the 2016 local government elections, reducing the total number of municipalities in the country from 278 to 257. This is the most wide-ranging re-demarcation since the current system of wall-to-wall municipalities was introduced in 2000. It will have significant implications on allocations to municipalities in the Division of Revenue Act.

All formula-based allocations, including for the local government equitable share and the *municipal infrastructure grant*, have been updated with data that reflects the new municipal boundaries. Grant administrators for all project-based grants have assessed the location and needs of re-demarcated municipalities and taken this into account in determining their allocations for the 2016 MTEF period, so that funds are allocated to municipalities where projects will be implemented. Support to re-demarcated municipalities is provided through the *municipal demarcation transition grant*.

The date of the 2016 local government elections has not yet been declared, which means that it is also not yet known when the new demarcations will come into effect. The re-demarcation could take place before or after the start of the 2016/17 municipal financial year, which begins on 1 July 2016.

Allocations published in the 2016 Division of Revenue Bill are based on the new municipal boundaries because these new demarcations will be in effect for the majority of the 2016/17 municipal financial year. In terms of the guidance provided in the Municipal Financial Management Act (2003) Circular 78, if the elections are held before 1 July 2016, municipalities will be expected to complete the remaining weeks of the financial year on their existing budget structures (and existing demarcations). The allocations published in the 2016 Division of Revenue Bill will then be transferred to the re-demarcated municipalities from 1 July 2016.

However, additional clauses have been added to section 36 of the 2016 Division of Revenue Bill to enable the National Treasury to gazette revised allocations if the elections take place after 1 July 2016. These revised allocations will allow funds to be transferred to the current 278 municipalities for the period between 1 July 2016 and the date of the elections (when the re-demarcated municipal boundaries will come into effect). The remaining allocations will be transferred to the re-demarcated municipalities after the elections.

The local government equitable share

In terms of section 227 of the Constitution, local government is entitled to an equitable share of nationally raised revenue to enable it to provide basic services and perform its allocated functions. The local government equitable share is an unconditional transfer that supplements the revenue that municipalities can raise themselves (including property rates and service charges). The equitable share provides funding for municipalities to deliver free basic services to poor households and subsidises the cost of administration and other core services for those municipalities that have the least potential to cover these costs from their own revenues.

Over the 2016 MTEF period, the local government equitable share, including the *RSC/JSB levies replacement grant* and *special support for councillor remuneration and ward committees,* amounts to R171.3 billion – R52.6 billion in 2016/17, R57 billion in 2017/18 and R61.7 billion in 2018/19.

To help compensate for the rising costs of free basic service provision in municipalities, amounts of R1.5 billion in 2017/18 and R3 billion in 2018/19 will be added to the local government equitable share. However, in 2016/17 the local government equitable share is reduced by R300 million due to the need to reprioritise funds to urgent government priorities while reducing the expenditure ceiling. This reduction amounts to only 0.6 per cent of the value of the local government equitable share in 2016/17.

Formula for allocating the local government equitable share

The share of national revenue allocated to local government through the equitable share is determined in the national budget process and endorsed by Cabinet (the vertical division). Local government's equitable share is divided among the country's 257 municipalities, using a formula (the horizontal division) to ensure objectivity.

A new formula for the local government equitable share was introduced in 2013/14, following a review of the previous formula by the National Treasury, the Department of Cooperative Governance and SALGA, in partnership with the FFC and Statistics South Africa. The new formula is based on data from the 2011 Census. Statistics South Africa has updated the data from the 2011 Census to align with the geography of the new municipal boundaries, which resulted in small changes to some allocations. The local government equitable share formula's principles and objectives were set out in detail in the Explanatory Memorandum to the 2013 Division of Revenue.

Structure of the local government equitable share formula

The formula uses demographic and other data to determine each municipality's share of the local government equitable share. It has three parts, made up of five components:

- The first part of the formula consists of the *basic services* component, which provides for the cost of free basic services for poor households.
- The second part enables municipalities with limited resources to afford basic administrative and governance capacity, and perform core municipal functions. It does this through three components:
  - The *institutional component* provides a subsidy for basic municipal administrative costs.
  - The *community services component* provides funds for other core municipal services not included under basic services.
  - The *revenue adjustment factor* ensures that funds from this part of the formula are only provided to municipalities with limited potential to raise their own revenue. Municipalities that are least able to fund these costs from their own revenues should receive the most funding.
- The third part of the formula provides predictability and stability through the *correction and stabilisation factor*, which ensures that all of the formula's guarantees can be met.

Each of these components is described in detail in the subsections that follow. The formula's structure is summarised in the box.

Structure of the local government equitable share formula

$$LGES = BS + (I + CS) \times RA \pm C$$

where

LGES is the local government equitable share
BS is the basic services component
I is the institutional component
CS is the community services component
RA is the revenue adjustment factor
C is the correction and stabilisation factor

The basic services component

This component helps municipalities provide free basic water, sanitation, electricity and refuse removal services to households that fall below an affordability threshold. Following municipal consultation, the formula's affordability measure (used to determine how many households need free basic services) is based on the level of two state old age pensions. When the 2011 Census was conducted, the state old age pension was worth R1 140 per month, which means that two old age pensions were worth R2 280 per month. A monthly household income of R2 300 per month (in 2011) has therefore been used to define the formula's affordability threshold. Statistics South Africa has calculated that 59 per cent of all households in South Africa fall below this income threshold. The threshold is not an official poverty line or a required level to be used by municipalities in their own indigence policies – if municipalities choose to provide fewer households with free basic services than they are funded for through the local government equitable share, then their budget documentation should clearly set out why they have made this choice and how they have consulted with their community during the budget process.

The number of households per municipality, and the number below the poverty threshold, is updated annually based on the growth experienced in the period between the 2001 and 2011 Censuses. Provincial growth rates are then rebalanced to match the average annual provincial growth reported between 2002 and 2014 in the annual General Household Survey. Statistics South Africa has advised the National Treasury that, in the absence of official municipal household estimates, this is a credible method of estimating the household numbers per municipality needed for the formula. Statistics South Africa is researching methods for producing municipal-level data estimates, which may be used to inform equitable share allocations in future.

The basic services component provides a subsidy of R334.97 per month in 2016/17 for the cost of providing basic services to each of these households. The subsidy includes funding for the provision of free basic water (six kilolitres per poor household per month), energy (50 kilowatt-hours per month) and sanitation and refuse (based on service levels defined by national policy). The monthly amount provided for each service is detailed in Table W1.24 and includes an allocation of 10 per cent for service maintenance costs.

Table W1.24 Amounts per basic service allocated through the local government equitable share

	Allocation per household below affordability threshold (R per month)			Total allocation per service (R million)
	Operations	Maintenance	Total	
Energy	63.87	7.10	70.97	7 830
Water	96.58	10.73	107.31	11 839
Sanitation	76.72	8.52	85.24	9 403
Refuse	64.30	7.15	71.45	7 882
Total basic services	**301.47**	**33.50**	**334.97**	**36 953**

Source: National Treasury

The formula uses the fairest estimates of the average costs of providing each service that could be derived from available information. More details of how the costs were estimated can be found in the discussion paper on the proposed structure of the new local government equitable share formula. The per household allocation for each of the basic services in Table W1.24 is updated annually based on the following:

- The electricity cost estimate is made up of bulk and other costs. Bulk costs are updated based on the multi-year price determination approved by the National Energy Regulator of South Africa (NERSA). The NERSA-approved bulk electricity tariff for the multi-year price determination period from 2014/15 to 2018/19 allows for increases of 8 per cent per year. If any variations to this increase are approved for 2016/17, funding will be considered during the adjustments budget process. Other electricity costs are updated based on the National Treasury's inflation projections in the 2015 *Medium Term Budget Policy Statement*.
- The water cost estimate is also made up of bulk and other costs. Bulk costs are updated based on the average increase in bulk tariffs charged by water boards (although not all municipalities purchase bulk water from water boards, their price increases serve as a proxy for the cost increases for all municipalities). The approved average tariff increase for bulk water from water boards in 2015/16 was 8.9 per cent. Other costs are updated based on the National Treasury's inflation projections in the 2015 *Medium Term Budget Policy Statement*.
- The costs for sanitation and refuse are updated based on the National Treasury's inflation projections in the 2015 *Medium Term Budget Policy Statement*.

The basic services component allocation to each municipality is calculated by multiplying the monthly subsidy per household by the updated number of households below the affordability threshold in each municipal area. In 2016/17, a total of 9.2 million households are funded through the basic services subsidy. The subsidy is allocated to 99.3 per cent of households below the affordability threshold of two old age pensions, instead of the 100 per cent funded in previous years. This change ensures that the effect of reductions to the equitable share in 2016/17 is spread across all components of the formula. Although the proportion of poor households funded has been reduced in 2016/17, the number of households provided with free basic services should not be affected because municipalities have not yet extended the provision of free basic services to reach all poor households.

The basic services component

BS = basic services subsidy x number of poor households

Funding for each basic service is allocated to the municipality (metro, district or local) that is authorised to provide that service. If another municipality provides a service on behalf of the authorised municipality, it must transfer funds to the provider in terms of section 29 of the Division of Revenue Act. The basic services component is worth R37 billion in 2016/17 and accounts for 78.4 per cent of the value of the local government equitable share.

The institutional component

To provide basic services to households, municipalities need to be able to run a basic administration. Most municipalities should be able to fund the majority of their administration costs with their own revenue. But, because poor households are not able to contribute in full, the equitable share includes an institutional support component to help meet some of these costs. To ensure that this component supports municipalities with limited revenue-raising abilities, a revenue adjustment factor is applied so that a larger proportion of the allocation is received by municipalities with less potential to raise their own revenue. The revenue adjustment factor is described in more detail later in this annexure.

This component consists of a base allocation of R5.9 million, which goes to every municipality, and an additional amount that is based on the number of council seats in each municipality. This reflects the relative size of a municipality’s administration and is not intended to fund the costs of councillors only (the number of seats recognised for the formula is determined by the Minister of Cooperative Governance and Traditional Affairs). The base component acknowledges that there are some fixed costs that all municipalities face.

The institutional component

*I = base allocation + [allocation per councillor * number of council seats]*

The institutional component accounts for 8.6 per cent of the equitable share formula and is worth R4.1 billion in 2016/17. This component is also complemented by special support for councillor remuneration in poor municipalities, which is not part of the equitable share formula (described in more detail later).

The community services component

This component funds services that benefit communities rather than individual households (which are provided for in the basic services component). It includes funding for municipal health services, fire services, municipal roads, cemeteries, planning, storm water management, street lighting and parks. To ensure this component assists municipalities with limited revenue-raising abilities, a revenue adjustment factor is applied so that these municipalities receive a larger proportion of the allocation.

The allocation for this component is split between district and local municipalities, because both provide community services. In 2016/17, the allocation to district and metropolitan municipalities for municipal health and related services is R8.28 per household per month. The component’s remaining funds are allocated to local and metropolitan municipalities based on the number of households in each municipality.

The community services component

CS = [municipal health and related services allocation x number of households] + [other services allocation x number of households]

The community services component accounts for 13 per cent of the equitable share formula and is worth R6.1 billion in 2016/17.

The revenue adjustment factor

The Constitution gives local government substantial revenue-raising powers (particularly through property rates and surcharges on services). Municipalities are expected to fund most of their own administrative costs and cross-subsidise some services for indigent residents. Given the varied levels of poverty across South Africa, the formula does not expect all municipalities to be able to generate similar amounts of own revenue. A revenue adjustment factor is applied to the institutional and community services components of the formula to ensure that these funds assist municipalities that are least likely to be able to fund these functions from their own revenues.

To account for the varying fiscal capacities of municipalities, this component is based on a per capita index using the following factors from the 2011 Census (all data has been updated to reflect new municipal boundaries):

- Total income of all individuals/households in a municipality (as a measure of economic activity and earning)
- Reported property values
- Number of households on traditional land
- Unemployment rate
- Proportion of poor households as a percentage of the total number of households in the municipality.

Based on this index, municipalities were ranked according to their per capita revenue-raising potential. The top 10 per cent of municipalities have a revenue adjustment factor of zero, which means that they do not receive an allocation from the institutional and community services components. The 25 per cent of municipalities with the lowest scores have a revenue adjustment factor of 100 per cent, which means that they receive their full allocation from the institutional and community services components. Municipalities between the bottom 25 per cent and top 10 per cent have a revenue adjustment factor applied on a sliding scale, so that those with higher per capita revenue-raising potential receive a lower revenue adjustment factor and those with less potential receive a larger revenue adjustment factor.

The revenue adjustment factor is not based on the actual revenues municipalities collect. This component therefore does not create any perverse incentive for municipalities to under-collect potential own revenues to receive a higher equitable share.

Because district municipalities do not collect own revenues from property rates, the revenue adjustment factor applied to these municipalities is based on the *RSC/JSB levies replacement grant* allocations. This grant replaces a source of own revenue previously collected by district municipalities and it is still treated as an own-revenue source in many respects. Similar to the revenue adjustment factor for local and metropolitan municipalities, the factor applied to district municipalities is based on their per capita *RSC/JSB levies replacement grant* allocations. District municipalities are given revenue adjustment factors on a sliding scale – those with a higher per capita *RSC/JSB levies replacement grant* allocation receive a lower revenue adjustment factor, while those with lower allocations receive a larger revenue adjustment factor.

Correction and stabilisation factor

Providing municipalities with predictable and stable equitable share allocations is one of the principles of the equitable share formula. Indicative allocations are published for the second and third years of the MTEF period to ensure predictability. To provide stability for municipal planning, while giving national government flexibility to account for overall budget constraints and amend the formula, municipalities are guaranteed to receive at least 90 per cent of the indicative allocation for the middle year of the MTEF period.

The changes to municipal boundaries result in some significant changes to municipal allocations in 2016/17. To cushion the impact of these changes, all municipalities will receive at least 95 per cent of the equitable share formula allocation indicatively allocated to them in 2016/17 in the 2015 Division of Revenue Act. For merged municipalities, this guarantee will be based on the sum of the equitable share allocations to the previously separate municipalities. In cases where a municipality has been split, the guarantee is applied to an area's share of the former municipality's equitable share, based on its portion of the population in the former municipality.

A new equitable share formula was introduced in 2013/14 using updated 2011 Census data. As a result, some municipalities will experience large changes in their equitable share allocations. To smooth the impact of these changes and give municipalities time to adjust (both for municipalities with increasing and decreasing allocations), the new allocations are being phased in over five years, from 2013/14 to 2017/18. For municipalities with smaller allocations under the new formula, the phase-in mechanism measures the difference between the municipality's old and new allocations and closes this gap by 20 per cent each year. This means that in the first year, a municipality only experienced a change equivalent to 20 per cent of the gap between their allocations under the old and new formulas; in the second year, it completed 40 per cent of the change; in the third year (2015/16), it completed 60 per cent; and in 2016/17 it will complete 80 per cent. In 2017/18, the allocation will be determined entirely through the new formula.

To provide for this phase-in approach, while staying within the limits of the equitable share, municipalities with larger allocations will also have their increases phased in over five years. The total top-up amount needed to fund the phasing in for municipalities with declining allocations is calculated and deducted from those that do not require a top-up in proportion to their "surplus". This means that municipalities with larger allocations will have some of those gains delayed over the phase-in period.

Ensuring the formula balances

The formula is structured so that all of the available funds are allocated. The basic services component is determined by the number of poor households per municipality and the estimated cost of free basic services, so it cannot be manipulated. This means that the balancing of the formula to the available resources must take place in the second part of the formula, which includes the institutional and community services components. The formula automatically determines the value of the allocation per council seat in the institutional component and the allocation per household for other services in the community services component to ensure that it balances. Increases in the cost of providing basic services can result in lower institutional and community services allocations. To ensure that the amounts allocated through the institutional and basic services components do not decline by more than 10 per cent, the proportion of households funded for free basic services has been reduced from 100 per cent of households below the affordability threshold (equivalent to two old age pensions) to 99.3 per cent in 2016/17.

Potential future refinements to the formula

Although the local government equitable share formula has been through extensive consultations and technical work, national government continues to work with stakeholders to improve the formula. Areas of work include:

- Developing differentiated cost variables to take account of the costs of services in various circumstances, including costs related to the size of the land area served and settlement types in municipalities. SALGA and the FFC have undertaken a research project that could provide the basis for calculating such variables in future.
- Refining the methodology used to update household growth estimates, taking account of updated data from Statistics South Africa, and possibly including the 2016 Community Survey.

Government is committed to considering all proposed refinements to the formula, but another full review is not envisaged until the current formula has been fully phased in and municipalities have had time to adjust to the new allocations.

Details of new allocations

In addition to the three-year formula allocations published in the Division of Revenue Bill, a copy of the formula, including the data used for each municipality and each component, is published online (http://mfma.treasury.gov.za/Media_Releases/LGESDiscussions/Pages/default.aspx).

Other unconditional allocations

RSC/JSB levies replacement grant

Before 2006, district municipalities raised levies on local businesses through an RSC or JSB levy. This source of revenue was replaced in 2006/07 with the *RSC/JSB levies replacement grant*, which was allocated to all district and metropolitan municipalities based on the amounts they had previously collected through the levies (the *RSC/JSB levies replacement grant* for metropolitan municipalities has since been replaced by the sharing of the general fuel levy). The grant's value increases every year. In 2016/17, the grant increases by 8.5 per cent a year for district municipalities authorised for water and sanitation and 2.8 per cent for unauthorised district municipalities. The different rates recognise the various service delivery responsibilities of these district municipalities.

Special support for councillor remuneration and ward committees

Councillors' salaries are subsidised in poor municipalities. The total value of the support provided in 2016/17 is R861.7 million, calculated separately to the local government equitable share and in addition to the funding for governance costs provided in the institutional component. The level of support for each municipality is allocated based on a system gazetted by the Minister of Cooperative Governance and Traditional Affairs, which classifies municipal councils into six grades based on their total income and population size. Special support is provided to the lowest three grades of municipal councils (the smallest and poorest municipalities).

A subsidy of 90 per cent of the gazetted maximum remuneration for a part-time councillor is provided for every councillor in grade 1 municipalities, 80 per cent for grade 2 municipalities and 70 per cent for grade 3 municipalities. In addition to this support for councillor remuneration, each local municipality in grades 1 to 3 receives an allocation to provide stipends of R500 per month to 10 members of each ward committee in their municipality. Each municipality's allocation for this special support is published in the Division of Revenue Bill appendices.

All data used in these calculations was updated to take account of new demarcations and councillor numbers. The new grades for municipalities affected by boundary re-determinations will only be confirmed once the new municipalities have been formally established. For 2016/17 allocations, it was assumed that the grade of a new municipality would be equal to the highest grade of the existing municipalities being merged to form the new municipality. Because grades are based on municipal income and population, merging municipalities can only increase the grade. The new municipality created in Limpopo, formed by merging part of Thulamela Local Municipality and part of Makhado Local Municipality, is assumed to be a grade 3 municipality based on its population size.

Conditional grants to local government

National government allocates funds to local government through a variety of conditional grants. These grants fall into two main groups: infrastructure and capacity building. The total value of conditional grants directly transferred to local government increases from R41.1 billion in 2016/17 to R44.5 billion in 2017/18 and R47.1 billion in 2018/19.

There are four types of local government conditional grants:

- Schedule 4B sets out general grants that supplement various programmes partly funded by municipalities.
- Schedule 5B grants fund specific responsibilities and programmes implemented by municipalities.
- Schedule 6B grants provide in-kind allocations through which a national department implements projects in municipalities.
- Schedule 7B grants provide for the swift allocation and transfer of funds to a municipality to help it deal with a disaster.

Local government infrastructure grant review

The National Treasury, in collaboration with the Department of Cooperative Governance, the Department of Planning, Monitoring and Evaluation, SALGA and the FFC, has reviewed the system of local government infrastructure grants. The process has involved wide consultation, including many engagements with municipalities and national officials responsible for managing grants. The review proposes several changes that will be implemented in the 2016 Budget. The structure of grants allocated to different types of municipalities will be changed to increase their differentiation and reduce grant proliferation; improve asset management over the lifespan of municipal infrastructure; and enhance national grant support and oversight.

Following the implementation of the initial changes emerging from the review in 2015/16, further reforms will be phased in over the 2016 MTEF period in the following areas:

Asset management

The grant review has proposed several changes to incentivise asset management practices that improve functionality and reliability over the full lifecycle of municipal infrastructure. This includes allowing grant funds to be used to refurbish infrastructure (in the past, the focus was largely on constructing new infrastructure) and establish asset maintenance plans. Over time, stronger conditions will be put in place to require municipalities to use these asset management systems to prioritise the maintenance and investment needed on their infrastructure.

The quality of rural roads continues to be a major obstacle to mobility in rural communities. Over several years, data has been collected on the extent and condition of roads using the *rural roads asset management systems grant*. This data can be used to guide municipalities on which roads to maintain and upgrade to achieve the best return for their investment. Unlike other basic municipal functions, there is no funding for road maintenance in the local government equitable share. As such, the grant review proposes that municipalities should be allowed to use funds from the *municipal infrastructure grant* to maintain and refurbish roads if they use data from their roads asset management systems to prioritise their investments.

Differentiation and grant proliferation

The review acknowledged that the infrastructure needs of cities and rural areas are very different, which is why the grant system for these areas must be structured differently. While metropolitan municipalities already receive specialist urban grants such as the *urban settlements development grant*, secondary cities largely receive the same grants and are subject to the same rules as rural municipalities. In 2016/17, new planning requirements will be introduced for secondary cities as the first step towards introducing differentiation in the grant system to better respond to urban development challenges. Cities that meet the criteria will be eligible for a separate grant in the outer years of the MTEF period. The consolidation of infrastructure grants for metropolitan municipalities is also intended to be phased in over the medium term and eventually extended to secondary cities.

Major investments in urban public transport continue to be made through the grant system. Following the merging of two public transport grants in the 2015 Budget, the grant review engaged in further analysis and consultation to continue the reform. The Department of Transport will introduce a new formula-based allocation methodology for the *public transport network grant* over the 2016 MTEF period. This should increase municipalities' certainty about the national funding they can expect when planning for their public transport networks, and encourage cities to plan and develop systems that they can afford to operate in the long term.

In rural areas, the multiple grants in the water and sanitation sector will be merged to form two grants, the *regional bulk infrastructure grant*, which funds large bulk projects, and the *water services infrastructure grant*, which funds the building and refurbishment of water and sanitation schemes in municipalities with weaker capacity.

Grant management

The review concluded that there is substantial scope to improve the outcomes of the infrastructure conditional grants by enhancing the oversight and support provided to municipalities by the sector departments transferring conditional grants. Departments have been asked to identify and prioritise the resources they allocate to manage grants in their departments. The Municipal Infrastructure Support Agent will also play a greater role in helping municipalities improve their delivery of infrastructure, including through new regional management support contracts, which will be piloted in 2016/17. The Department of Cooperative Governance will work to strengthen the municipalities and their project management units that are funded using the *municipal infrastructure grant*. Each municipality will have to submit a plan for how they plan to use their project management unit funds and demonstrate how this will lead to improved performance. Performance can then be monitored against these plans and municipalities held accountable for their implementation.

Municipalities have raised many complaints about the extensive reporting required of them, including through the grant system. The Cities Support Programme is leading a project to reduce overlaps and simplify reporting requirements that may feed into grant requirements in future. In 2016/17, the reporting burden should be reduced because several grants have been consolidated, thereby reducing the number of grants on which municipalities have to report.

Infrastructure conditional grants to local government

National transfers for infrastructure, including indirect or in-kind allocations to entities executing specific projects in municipalities, amount to R149.3 billion over the 2016 MTEF period.

Table W1.25 Infrastructure grants to local government, 2012/13 – 2018/19

R million	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
		Outcome		Revised estimate		Medium-term estimates	
Direct transfers	**28 485**	**32 412**	**34 167**	**36 842**	**39 120**	**42 568**	**45 087**
Municipal infrastructure	13 879	14 224	14 745	14 956	14 914	15 991	16 894
Water services infrastructure	562	1 129	1 051	2 255	2 845	3 730	3 959
Urban settlements development	7 392	9 077	10 285	10 554	10 839	11 472	12 052
Integrated national electrification programme	1 151	1 635	1 105	1 980	1 946	2 087	2 204
Public transport network	4 884	5 550	5 871	5 953	5 593	6 360	6 793
Neighbourhood development partnership	578	586	590	607	624	663	702
Integrated city development	–	40	255	251	267	292	309
Regional bulk infrastructure	–	–	–	–	1 850	1 865	2 060
Rural roads asset management systems	37	52	75	97	102	107	114
Municipal disaster recovery	–	118	190	189	140	–	–
Indirect transfers	**4 819**	**5 705**	**8 643**	**10 274**	**7 689**	**7 297**	**7 564**
Integrated national electrification programme	1 879	2 141	2 948	3 613	3 526	3 876	3 995
Neighbourhood development partnership	80	55	58	26	22	28	29
Regional bulk infrastructure	2 523	3 261	4 005	4 858	3 479	2 806	2 931
Water services infrastructure	337	247	732	802	312	587	608
Bucket eradication programme	–	–	899	975	350	–	–
Total	**33 305**	**38 117**	**42 810**	**47 116**	**46 809**	**49 865**	**52 651**

Source: National Treasury

Municipal infrastructure grant

The largest infrastructure transfer is made through the *municipal infrastructure grant*, which supports government's aim to expand service delivery and alleviate poverty. The grant funds the provision of infrastructure for basic services, roads and social infrastructure for poor households in all non-metropolitan municipalities. Although the grant's baseline is reduced by R620.2 million in 2016/17, R430 million in 2017/18 and R480 million in 2018/19, total allocations amount to R47.8 billion over the MTEF period.

The Department of Cooperative Governance, which administers the *municipal infrastructure grant*, conducted a policy review of the grant during 2014. This review collaborated with the review of local government infrastructure grants to make proposals on the grant's future direction. In the 2016 MTEF period, the Department of Cooperative Governance will strengthen the grant's coordination structures and ensure that all departments responsible for sectors funded through the grant participate actively in the review of project proposals. Sector departments need to ensure that they dedicate sufficient capacity to fulfil their grant management role. The conditions for the use of *municipal infrastructure grant* funds for project management units will be expanded to include providing support to all grant-funded infrastructure projects in the municipality and will be subject to a plan against which expenditure can be monitored. The provisions introduced in 2015/16 that allow funds to be used for road refurbishment if certain conditions are met will be strengthened, and linked to the use of road condition and usage data collected through the *rural roads asset management grant*. The condition introduced in the 2014 Budget that municipalities with households served by bucket systems must prioritise sanitation upgrades is retained.

The *municipal infrastructure grant* is allocated through a formula with a vertical and horizontal division. The vertical division allocates resources between sectors and the horizontal division takes account of poverty, backlogs and municipal powers and functions in allocating funds to municipalities. The five main components of the formula are described in the box below.

Municipal infrastructure grant = C + B + P + E + N

C	Constant to ensure increased minimum allocation for small municipalities (this allocation is made to all municipalities)
B	Basic residential infrastructure (proportional allocations for water supply and sanitation, roads and other services such as street lighting and solid waste removal)
P	Public municipal service infrastructure (ring-fenced for municipal sport infrastructure)
E	Allocation for social institutions and micro-enterprises infrastructure
N	Allocation to the 27 priority districts identified by government

For the 2016 MTEF, the *municipal infrastructure grant* allocation formula uses data from the 2011 Census (updated to reflect municipal boundary changes). Allocations for basic services sub-components are based on the proportion of the national backlog for that service in each municipality. Other components are based on the proportion of the country's poor households located in each municipality. Table W1.26 sets out the proportion of the grant accounted for by each component of the formula. The C-component provides a R5 million base to all municipalities receiving *municipal infrastructure grant* allocations.

Table W1.26 Municipal infrastructure grant allocations per sector

Municipal infrastructure grant (formula)	Component weights	Value of component 2016/17 (R millions)	Proportion of municipal infrastructure grant per sector
B-component	**75.0%**	**10 113**	**67.8%**
Water and sanitation	72.0%	7 281	48.8%
Roads	23.0%	2 326	15.6%
Other	5.0%	506	3.4%
P-component	**15.0%**	**2 023**	**13.6%**
Sports	33.3%	674	4.5%
E-component	**5.0%**	**674**	**4.5%**
N-component	**5.0%**	**674**	**4.5%**
Constant		**1 130**	**7.6%**
Ringfenced funding for sport infrastructure		**300**	**2.0%**
Total		**14 914**	**100.0%**

Source: National Treasury

A total of R300 million of *municipal infrastructure grant* funds is allocated outside of the grant formula and earmarked for specific sport infrastructure projects identified by Sport and Recreation South Africa. In addition, municipalities are required to spend a third of the P-component (equivalent to 4.5 per cent of the grant) on sport and recreation infrastructure identified in their own integrated development plans. Municipalities are also encouraged to increase their investment in other community infrastructure, including cemeteries, community centres, taxi ranks and marketplaces.

Urban settlements development grant

The *urban settlements development grant* is an integrated source of funding to provide infrastructure for municipal services and upgrade urban informal settlements in the eight metropolitan municipalities. The grant is allocated as a supplementary grant to cities (schedule 4 of the Division of Revenue Act), which means that municipalities are expected to use a combination of grant funds and their own revenue to develop urban infrastructure and integrated human settlements. Cities report their progress on these projects against the targets set in their service delivery and budget implementation plans.

The *municipal human settlements capacity grant* was introduced in 2014/15 to build capacity in anticipation of the devolution of the housing function to metropolitan municipalities, which has not taken place. As a result, the 2016 Budget is concluding this grant. Instead, up to three per cent of the *urban settlements development grant* may be used to fund municipal capacity in the built environment.

As part of the demarcation process, *municipal infrastructure grant* funds previously allocated to Naledi Municipality have been shifted to the *urban settlements development grant* allocation for Mangaung Metropolitan Municipality, because the two municipalities are merging. The grant is allocated a total of R34.4 billion over the 2016 MTEF period.

Integrated city development grant

The grant provides a financial incentive for metropolitan municipalities to focus their use of infrastructure investment and regulatory instruments to achieve more compact and efficient urban spaces. Cities are required to submit built environment performance plans for this grant, including a brief strategic overview of the city’s plans for the built environment, with a focus on the infrastructure grants that form part of the capital budget. The plan should show how the municipality will ensure alignment between its different grant-funded programmes and how it will address related policy and regulatory matters. All projects funded by sector-specific infrastructure grants, including the *urban settlements development grant*, the *public transport network grant*, the *neighbourhood development partnership grant* and the *integrated national electrification programme grant*, must form part of a metropolitan municipality’s built environment performance plan. The grant is allocated R868 million over the 2016 MTEF period.

Public transport network grant

The *public transport network grant*, administered by the Department of Transport, helps cities create or improve public transport systems in line with the National Land Transport Act (2009) and the Public Transport Strategy. This includes all integrated public transport network infrastructure, such as bus rapid transit systems, conventional bus services and upgrades for pedestrian and cycling infrastructure. It also subsidises the operation of these services.

A new formula-based allocation methodology will be phased in over the medium term. This formula aims to increase certainty about the extent of national funding that municipalities expect when planning their public transport networks, and encourage cities to shift towards more sustainable transport investments. Cities need to plan within a realistic envelope of support from national government, without additional subsidies. By 2017/18, strict eligibility conditions will be enforced, including requirements that cities demonstrate that their planned public transport systems will be financially sustainable. The formula is made up of three components, which account for the number of people in a city; the number of public transport users in a city (the weighting of train commuters is reduced as trains are subsidised separately through the Passenger Rail Authority of South Africa); and the size of a city’s economy.

Table W1.27 Formula for the public transport network grant

	Population component shares	Regional gross value added component shares	Public transport users component shares	Grant formula shares
Non-formula-based allocations account for 20% of the grant				
Formula-based allocations account for 80% of the grant				
Formula shares for each city:				
Buffalo City	3.3%	2.8%	3.0%	**3.0%**
Nelson Mandela Bay	5.0%	4.7%	3.5%	**4.4%**
Mangaung	3.3%	2.4%	3.1%	**2.9%**
Ekurhuleni	13.8%	9.5%	15.2%	**12.8%**
City of Johannesburg	19.3%	25.2%	20.3%	**21.6%**
Tshwane	12.7%	15.0%	13.9%	**13.9%**
eThekwini	15.0%	15.8%	17.6%	**16.1%**
Msunduzi	2.7%	1.5%	2.3%	**2.2%**
MP326	2.6%	1.9%	2.2%	**2.2%**
Polokwane	2.7%	1.5%	1.2%	**1.8%**
Rustenburg	2.4%	3.5%	2.2%	**2.7%**
George	0.8%	0.5%	0.2%	**0.5%**
Cape Town	16.3%	15.8%	15.2%	**15.8%**
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: National Treasury

The grant has separate operational and capital windows based on cities' implementation plans. The grant is allocated R18.7 billion over the 2016 MTEF period.

Neighbourhood development partnership grant

The *neighbourhood development partnership grant* supports cities in developing and implementing urban network plans. The aim is to create a platform for third-party public and private investment, which will improve the quality of life in township urban hubs. Projects in towns and rural areas are implemented in conjunction with the Department of Rural Development and Land Reform to support catalytic projects in these areas. The grant is allocated R2.1 billion over the MTEF period, which consists of R2 billion for the direct capital grant and R79.3 million for the indirect technical assistance grant.

Water services infrastructure grant

The Department of Water and Sanitation administers several grants, including the *regional bulk infrastructure grant*, the *municipal water infrastructure grant*, the *water services operating subsidy grant*, the *rural household infrastructure grant* and the *bucket eradication programme grant*. Following extensive consultation with the Department of Water and Sanitation in 2015 as part of the review of local government infrastructure grants, it was agreed that there is a need to rationalise overlapping grants, ensure greater alignment between water and sanitation projects, and strengthen the alignment between different projects in the sector.

The *water services infrastructure grant* has been created through the merger of the *municipal water infrastructure grant*, the *water services operating subsidy grant*, and the *rural household infrastructure grant*. This grant aims to accelerate the delivery of clean water and sanitation facilities to communities that do not have access to basic water services. The grant, administered by the Department of Water and Sanitation, provides funding for various projects, including the construction of new infrastructure and the refurbishment and extension of existing water schemes. It has both direct and indirect components. In areas where municipalities have the capacity to implement projects themselves, funds will be transferred through a direct grant. In other areas, the Department of Water and Sanitation will implement projects on behalf of municipalities through an indirect grant. As with other indirect grants, the national department is required to transfer skills to the municipalities benefiting from the indirect grant so that they will be able to implement projects themselves in future. Over the 2016 MTEF period, the total allocation for the direct portion of the grant is R10.5 billion and an additional R1.5 billion will be made available for the indirect component.

Regional bulk infrastructure grant

This grant supplements the financing of the social component of regional bulk water and sanitation infrastructure. It targets projects that cut across several municipalities or large bulk projects within one municipality. The grant funds the bulk infrastructure needed to provide reticulated water and sanitation services to individual households. It may also be used to appoint service providers to carry out feasibility studies, related planning or management studies for infrastructure projects. It has both direct and indirect components. In areas where municipalities have the capacity to implement projects themselves, funds will be transferred through a direct grant. In other areas, the Department of Water and Sanitation will implement projects on behalf of municipalities through an indirect grant. A parallel programme, funded by the Department of Water and Sanitation, also funds water boards for the construction of bulk infrastructure. Though not part of the division of revenue, these projects still form part of the Department of Water and Sanitation’s larger programme of subsidising the construction of regional bulk infrastructure for water and sanitation. The grant has a total allocation of R15 billion over the 2016 MTEF period, consisting of R5.8 billion and R9.2 billion for the direct and indirect components respectively.

Bucket eradication programme grant

The *bucket eradication programme grant* is an indirect grant to municipalities administered by the Department of Water and Sanitation. It funds the eradication of bucket sanitation systems in formal residential areas. This indirect grant was due to end in 2015/16, but it has been extended by one year to allow the grant to complete its eradication work (implementation was delayed in 2014/15 due to a sanitation function shift between departments). The *human settlement development grant*, *urban settlements development grant* and *municipal infrastructure grant* will prioritise the upgrade of sanitation in informal areas as part of their funding for informal settlement upgrades. The programme will be reviewed in 2016/17 to inform the close-out (or extension) of this grant. It is allocated R350 million in 2016/17.

Integrated national electrification programme grants

The national electrification programme has been instrumental in providing 85 per cent of all households with access to electricity, as reported in the 2011 Census. To sustain progress in connecting poor households to electricity, government will spend R17.6 billion on the programme over the next three years. Of this, municipalities are allocated R6.2 billion and Eskom is allocated R11.4 billion to spend on behalf of municipalities through an indirect grant.

Rural roads asset management systems grant

The Department of Transport administers the *rural roads asset management systems grant* to improve rural road infrastructure. The grant funds the collection of data on the condition and usage of rural roads in line with the Road Infrastructure Strategic Framework for South Africa. This data will guide investments to maintain and improve these roads. District municipalities collect this data on all the municipal roads in their area so that the spending of infrastructure funds (from the *municipal infrastructure grant* and elsewhere) can be properly planned to maximise impact. As data becomes available, incentives will be introduced to ensure that municipalities use this information to plan road maintenance appropriately. The *municipal infrastructure grant* stipulates that municipalities must use data from roads asset management systems to prioritise investment in roads projects.

The Department of Transport has committed to working with the *municipal infrastructure grant* administrators to ensure that municipal roads projects are chosen, prioritised and approved using roads asset management systems data wherever possible. The data already collected suggests that as much as

30 per cent of investment required is for maintenance. A total of R322.4 million is allocated to this grant over the 2016 MTEF period.

Municipal disaster recovery grant

This grant, administered by the National Disaster Management Centre in the Department of Cooperative Governance, is used to rehabilitate and reconstruct municipal infrastructure damaged by disasters. R140 million is allocated in 2016/17 to repair infrastructure damaged by natural disasters.

Capacity-building grants and other current transfers

Capacity-building grants help to develop municipalities' management, planning, technical, budgeting and financial management skills. Other current transfers include the *expanded public works programme integrated grant for municipalities*, which promotes increased labour intensity in municipalities, and the *municipal demarcation transition grant*, which assists municipalities with the additional costs associated with significant boundary changes. A total of R6.3 billion is allocated to capacity-building grants and other current transfers to local government over the 2016 MTEF period.

Table W1.28 Capacity building and other current grants to local government, 2012/13 – 2018/19

R million	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
		Outcome		Revised estimate		Medium-term estimates	
Direct transfers	**1 536**	**1 606**	**1 707**	**1 643**	**2 013**	**1 975**	**2 024**
Local government financial management	403	425	449	452	465	502	531
Municipal human settlements capacity	–	–	300	100	–	–	–
2013 African Cup of Nations host city operating	123	–	–	–	–	–	–
2014 African Nations Championship host city operating	–	120	–	–	–	–	–
Expanded public works programme	662	611	595	588	664	716	758
Infrastructure skills development	75	99	104	124	130	141	149
Energy efficiency and demand-side	200	181	137	178	186	203	215
Municipal demarcation transition	–	–	–	39	297	112	53
Municipal disaster	73	171	121	161	270	300	318
Indirect transfers	**230**	**240**	**252**	**251**	**84**	**103**	**115**
Municipal systems improvement	230	240	252	251	84	103	115
Total	**1 766**	**1 846**	**1 959**	**1 894**	**2 097**	**2 078**	**2 139**

Source: National Treasury

Municipal demarcation transition grant

The *municipal demarcation transition grant*, administered by the Department of Cooperative Governance, assists municipalities with additional costs that may arise during the transition to the new municipal boundaries. This grant was introduced in 2015/16 to subsidise the costs involved in implementing major boundary re-determinations announced by the Municipal Demarcation Board in 2013. A further 12 major boundary re-determinations were subsequently approved by the board in 2015. Each major re-demarcation is eligible for an allocation, and the grant has been expanded to include these new cases from 2016/17.

For municipal re-demarcations announced in 2013, some funds have already been transferred in 2015/16 to enable municipalities to do preparatory work ahead of the mergers. As a result, they will receive smaller allocations in the 2016 MTEF period. A total of R309.3 million has been added to the *municipal demarcation transition grant* in 2016/17 and 2017/18. In line with the FFC's recommendations, the grant will conclude at the end of 2017/18 because it is only intended to fund transitional costs and it will not form a permanent part of the intergovernmental transfer system.

Local government financial management grant

The *local government financial management grant*, managed by the National Treasury, funds the placement of financial management interns and the modernisation of financial management systems. This includes building in-house municipal capacity to implement multi-year budgeting, linking integrated development plans to budgets, and producing quality and timely in-year and annual reports. The grant supports municipalities in the implementation of the Municipal Finance Management Act and also provides funds for the implementation of the municipal standard chart of accounts. Total allocations amount to R1.5 billion over the 2016 MTEF period.

Infrastructure skills development grant

The *infrastructure skills development grant* develops capacity within municipalities by creating a sustainable pool of young professionals with technical skills related to municipal services, such as water, electricity and town planning. The grant places interns in municipalities, so they can complete the requirements of the relevant statutory council within their respective built environment fields. The interns can be hired by any municipality at the end of their internship. The grant is allocated R420.2 million over the 2016 MTEF period.

Municipal systems improvement grant

The *municipal systems improvement grant* will be implemented as an indirect grant in the 2016 MTEF period. It will fund a range of projects in municipalities in support of the Back to Basics strategy, including helping municipalities set up adequate records management systems, drawing up organograms for municipalities and reviewing their appropriateness relative to their assigned functions, and assisting municipalities with revenue collection plans. The indirect grant will be complemented by the Department of Cooperative Governance’s work to develop an integrated consumer database that municipalities can draw data from, as well as a performance management system to track municipal performance. Over the MTEF period, R302.7 million is allocated to this grant.

Expanded public works programme integrated grant for municipalities

This grant promotes the use of labour-intensive methods in delivering municipal infrastructure and services. It is allocated through a formula based on past performance, which creates an incentive for municipalities. The formula has an extra weighting to give bigger allocations to poor, rural municipalities. The grant is allocated R664 million in 2016/17, and R2.1 billion over the 2016 MTEF period.

The energy efficiency and demand-side management grant

The *energy efficiency and demand-side management grant* funds selected municipalities to implement energy-efficiency projects, with a focus on public lighting and energy-efficient municipal infrastructure. In the 2016 MTEF period, the Department of Energy will monitor and verify grant-funded projects to ensure greater consistency in the procurement of accredited verification services. The grant is allocated R603.9 million over the 2016 MTEF period.

Municipal disaster grant

The *municipal disaster grant* is administered by the National Disaster Management Centre in the Department of Cooperative Governance as an unallocated grant to local government. The centre is able to disburse disaster-response funds immediately, without the need for the transfers to be gazetted first. To ensure that sufficient funds are available in the event of disasters, section 21 of the Division of Revenue Bill allows for funds allocated to the *provincial disaster grant* to be transferred to municipalities if funds in the *municipal disaster grant* have already been exhausted, and vice versa. The bill also allows for more than one transfer to be made to areas affected by disasters, so that initial emergency aid can be provided before a full assessment of damages and costs is complete. Over the MTEF period, R887.9 million is available for disbursement through this grant. To ensure that sufficient funds will be available for disaster relief, section 20 of the Division of Revenue Bill has been revised to allow funds from other conditional grants to be reallocated to fund disaster relief, subject to the National Treasury's approval.

Part 6: Future work on provincial and municipal fiscal frameworks

The fiscal frameworks for provincial and local government encompass all their revenue sources and expenditure responsibilities. As underlying social and economic trends evolve and the assignment of intergovernmental functions change, so must the fiscal frameworks. The National Treasury, together with relevant stakeholders, conducts continuous reviews to ensure that provinces and municipalities have an appropriate balance of available revenues and expenditure responsibilities, while taking account of the resources available and the principles of predictability and stability. This part of the annexure describes the main areas of work to be undertaken during 2016/17 as part of the ongoing review and refinement of the intergovernmental fiscal framework. Provinces and municipalities will be consulted on all proposed changes to the fiscal frameworks.

Review of the provincial equitable share formula

The Constitution stipulates that provinces are entitled to a share of nationally raised revenue to deliver on their mandates. The current process of dividing up provincial funds uses a formula that considers the spread of the burden of service delivery across provinces. The provincial equitable share formula contains weighted elements that reflect government priorities and incorporates elements to redress inequality and poverty across provinces. Over time, the formula, like any budgetary allocation tool, may no longer mirror the realities provinces face. As such, there is a need for periodic review of the formula to assess its continued appropriateness and equity. In 2016, the National Treasury will start a detailed review of the equitable share formula. The Technical Committee on Finance and the Budget Council will be consulted as part of this work.

The role of provinces in promoting economic development

Provinces and municipalities play a crucial role in advancing the economic development of their respective precincts. Fully functional, well-equipped schools will produce a vibrant and employable workforce. Smarter health systems develop and maintain the health of the workforce. Provincial agriculture departments' support to farmers can stimulate rural development. The provision of provincial and municipal roads and public transport services ensures mobility for goods and workers, while basic municipal services such as water, electricity and refuse removal, as well as business licencing and environmental health functions, enable businesses to operate and grow. Well-managed procurement can maximise developmental impact without compromising efficiencies.

Government in all three spheres must work with businesses and other relevant stakeholders to provide an enabling environment for the faster and more inclusive economic growth called for in the National Development Plan. Since 2015, national and provincial treasuries have been working together through a task team of the Technical Committee on Finance to better define the role provinces should play in promoting economic development. This will enable provinces to maximise their impact on provincial economies in future.

National health insurance policy work

The National Health Insurance White Paper was released on 11 December 2015 for public comment. The Technical Committee on Finance will review the white paper, with a focus on the impact it will have on provinces. The aim is to assess the restructuring of the health system, particularly primary healthcare, necessary to ensure the success of national health insurance in South Africa.

Local government grants

The system of transfers to local government is continuously being reviewed and refined to improve the effectiveness and value for money achieved from the funds transferred to municipalities. The local government equitable share was reviewed in 2012 and local government infrastructure grants were reviewed between 2013 and 2015. In 2016, the National Treasury will lead the continued implementation of the previous reviews' recommendations, and make further improvements to the effectiveness of local government capacity-building allocations.

Reforms to infrastructure grants in the period ahead will focus on:

- Improving asset management incentives and enhancing the new provisions in infrastructure grants that allow funds to be spent on refurbishment.
- Strengthening grant management practices in national departments.
- Continuing to consolidate urban infrastructure grants.

Supporting cities to promote urban spatial transformation and economic growth

Cities, through delivery of infrastructure and services, play an important role in creating a conducive environment for inclusive growth, job creation and poverty eradication. To achieve this will require well-managed spatial transformation of cities. Government is exploring changes to the fiscal and regulatory structures for urban municipalities to ensure that they have sufficient and effective instruments to mobilise revenue for financing municipal strategic infrastructure capable of promoting growth.

Potential changes to the structure of the fiscal framework include:

- Consolidating urban grants and enhancing the use of performance incentives with transfers, such as with the *integrated cities development grant* (this work will form part of the review of local government infrastructure grants).
- Enabling greater flexibility in the use of grants to accelerate the implementation of catalytic investments.
- Enabling cities to leverage grant and own-revenue funds over a longer period for strategic projects.

These measures will be complemented by reviews of, and potential changes to, the regulatory structures for development charges, municipal borrowing and metropolitan municipalities' own-revenue powers.

Any potential changes to the fiscal and regulatory systems will also be accompanied by additional technical support to further strengthen the capacity of cities to take advantage of these changes. The Cities Support Programme is coordinating initiatives in this area. Cities are already receiving expanded project preparation support to help them build a pipeline of strategic investment projects that can attract private finance. In addition, the Development Bank of Southern Africa is increasing its assistance to give cities better access to funding for strategic projects by enhancing their appraisal and supervision arrangements or extending the average debt maturity.

Regulating development charges

Municipalities charge developers a once-off fee before approving land development applications. The National Treasury has consulted with stakeholders on the draft policy framework for municipal development charges. The draft policy will be published for public comment following Cabinet's approval. The Municipal Fiscal Powers and Functions Amendment Bill has been drafted to make provision for the regulation of development charges. Due to a new requirement to conduct a socio-impact analysis on new legislation or amendments to existing legislation, the amendment bill will be published at the beginning of 2016/17.

Reforming municipal borrowing

Long-term borrowing can be an effective way for municipalities to finance infrastructure development. However, responsible borrowing requires an appropriate institutional framework and financial controls. The Policy Framework for Municipal Borrowing and Financial Emergencies (1999) and the Municipal Finance Management Act set out a range of measures to facilitate responsible municipal borrowing. These measures deal with issues such as sovereign risk, credit enhancements, maturities, avoidance of direct government assistance, and liquidity through the development of secondary markets.

However, there are still some bottlenecks that impede municipalities' full participation in the debt market to mobilise resources for infrastructure development. In August 2015, the National Treasury and the Department of Cooperative Governance organised the Urban Investment Partnership Conference, which aimed to renew and strengthen collaboration between government and the private sector on urban investment needs and opportunities. A working group has since been established as a platform for regular engagements between metropolitan municipalities, commercial banks, institutional investors, the National Treasury, the Development Bank of Southern Africa, development finance institutions and SALGA. The platform aims to jointly develop practical solutions for funding infrastructure in metropolitan municipalities that will support inclusive growth.

The working group will focus on:

- Finding innovative infrastructure financing instruments and mechanisms
- Updating the municipal borrowing policy framework.

Reviewing own-revenue sources for metropolitan municipalities

The review of metropolitan municipalities' own-revenue sources, led by the National Treasury in collaboration with the Department of Cooperative Governance, SALGA, the FFC and metropolitan municipalities, is ongoing. The review's first phase was completed in October 2015. The final report on the socioeconomic profile of metropolitan municipalities can be accessed on the National Treasury's website (www.treasury.gov.za).

The second phase of the review has started, with a focus on assessing whether the own-revenue sources of metropolitan municipalities are adequate to meet their service delivery and development mandates. The review aims to understand the underlying challenges faced by cities, which will inform the appropriate support to improve municipal revenue and/or the necessity for an additional local tax instrument to complement property rates. The review's outcomes and recommendations will be presented to the Budget Forum in October 2016 for adoption and approval.