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EXPLANATORY MEMORANDUM ON THE DIVISION OF REVENUE

Background

Section 214 of the Constitution requires that an annual Act of Parliament determine the equitable division of nationally raised revenue between the three spheres, and the horizontal division among provinces. It also spells out criteria for determining the division of revenue and consultations necessary before enactment of the Division of Revenue Bill.

The Intergovernmental Fiscal Relations Act, 1997 (No 97 of 1997) gives effect to the Constitution by spelling out the consultation process for the Division of Revenue Bill. It also establishes the Budget Council and Budget Forum as consultative intergovernmental forums. Sections 9, 10(3) and (4) of the Act set out the consultation process, including consideration of Financial and Fiscal Commission's (FFC) recommendations. Section 10(5) of the Act requires an explanatory memorandum detailing how the Division of Revenue Bill takes account of each of the matters listed in Section 214(2)(a) to (j) of the Constitution; recommendations of the Financial and Fiscal Commission (FFC); and assumptions and formulae used to arrive at the respective shares contained in schedules 1 and 2 of the Bill.

This document is the explanatory memorandum tabled with the Budget as required by section 10(5) of the Intergovernmental Fiscal Relations Act. It has five parts:

- Part 1 sets out how the FFC's June 2001 recommendations have been taken into account.
- Part 2 outlines the fiscal framework that informs the division of revenue between the three spheres of government.
- Part 3 is a summary of how the Bill and the division of revenue take account of Section 214(2)(a) to (j) of the Constitution.
- Part 4 explains the underlying formula and criteria for the equitable division of the revenue among provinces and conditional grants between provinces.
- Part 5 sets out the formula and criteria for dividing the local government equitable share and conditional grants among municipalities.

This document must be read with the Division of Revenue Bill that also contains:

- Schedules 1-6
- Memorandum on the objects of the bill
- Appendices on provincial and local government conditional grants
- Schedule of local government grants as per municipality

This Bill, and attendant documentation, is available on the National Treasury website (www.treasury.gov.za) where the other background material such as the Intergovernmental Fiscal Review is also available.

The Division of Revenue Bill and its underlying allocations represent the culmination of extended in-depth consultation processes. The Budget Council, made up of the Minister of Finance and the nine MECs for Finance, deliberated on these issues at its annual Lekgotla on 6 and 7 July 2001 and at meetings on 14 August, 20 September, and 23 October 2001. Consultations over the local government share allocation involved a Ministerial Task Team appointed by Cabinet, a Joint MinMEC with Local Government held on 2 August 2001, and several technical meetings that included the South African Local Government Association (SALGA) and its provincial associations. All these consultations culminated in a meeting of the Budget Forum (Budget Council plus SALGA representatives and its provincial associations), on 21 September 2001. Representations by the FFC were also made at the meetings of the Budget Council and Budget Forum. The Ministers' Committee on the Budget, composed of national government Ministers, deliberated on the division of revenue before forwarding recommendations to Cabinet for consideration. An Extended Cabinet, involving both Cabinet Ministers and Premiers of provinces, was convened on 26 September 2001 to discuss budget priorities and the division of revenue.

A draft Division of Revenue Bill was gazetted on 6 December 2001 for public comment, and for comment by the FFC, provinces, and local government. The Bill has since been amended to take into account comments received, as well as to adjust for changes to the fiscal framework and new priorities.

Part 1: Response to the Financial and Fiscal Commission recommendations

Section 214 of the Constitution and Section 9 of the Intergovernmental Fiscal Relations Act, 1997 (No 97 of 1997) require the FFC to make recommendations on the equitable division of nationally raised revenue. Under the Act, the FFC submits its recommendations to the Minister of Finance, Parliament and provincial legislatures 10 months ahead of the financial year, or later as may be agreed between the Minister of Finance and the FFC. The FFC presented nine proposals relating to provinces and 13 proposals relating to local government in *Financial and Fiscal Commission Submission: Division of Revenue 2002-2003* (June 2001).

The nine provincial-related proposals are grouped in the following categories:

- Equitable share (four proposals)
- Provincial own revenue (three proposals)
- Contingency reserve
- Capital grants.

The 13 proposals related to local governments are grouped in the following categories:

- Equitable share (two proposals)
- Funding basic municipal services
- Municipal powers and functions (four proposals)
- Municipal health services provision (two proposals)
- Infrastructure funding (two proposals)
- Municipal borrowing (two proposals).

The June 2001 recommendations of the FFC reaffirm that it is a national responsibility to manage economic and fiscal affairs, to determine the tax bases, the level and cost of servicing the national debt, and the overall borrowing requirement. The FFC supports the approach of deducting debt servicing costs and a contingency reserve from total revenue collected before dividing it among the spheres. It also notes that "any changes to the existing equitable share formula should reflect current priorities as determined by a political process". Government supports the FFC proposals on the process for determining the division of revenue.

The FFC recommendations are also underpinned by the principle of allocating to each sphere sufficient resources to enable it progressively to provide “constitutionally-mandated obligations in general and provision of basic services in particular”. This takes account of the following:

- The institutional element for each sphere of government
- Other constitutional functions for which norms and standards should also be specified
- Obligations other than constitutional functions, that may be funded through conditional grants, own revenue and borrowing
- The need for infrastructure funding, which should vary according to policy priorities.

Government agrees with the FFC that provincial and local governments must prioritise their spending on constitutionally mandated obligations including the provision of basic services. There are, however, differences between government and the FFC on matters of approach. The FFC proposals pursue an approach which seeks to translate constitutional provisions on basic services into a “formula-based approach” for the division of revenue. Government’s view, based in part on the analysis presented in the Intergovernmental Fiscal Review, is that such an approach would be impracticable. The following are some of the reasons:

- Lack of concise definitions of constitutionally mandated basic services associated with each sphere
- Absence of objectively determined norms and standards for basic services and other constitutional functions
- Unavailability of data that would enable the complete adoption of such an approach.

Unless it can be demonstrated that current vertical and horizontal divisions of nationally raised revenue both are inequitable between and within the spheres, it would be difficult to justify substantial revisions to the structure of the provincial and local government equitable share formula. Significant changes to the structure of the formula should be weighed against the potential disruptions, instability and uncertainty to budgetary planning that would arise from sudden shifts in allocations. The process of regularly reviewing - and adapting - the formula should however be maintained.

FFC’s recommendations on Provincial finances

The four 2001 FFC recommendations on the equitable share allocation reflect an ongoing enquiry into the mechanisms for objectively and consultatively determining allocations to provinces. This approach builds on foundations laid in the 2000 recommendations. A brief summary of each proposal and Government’s response is outlined below.

FFC Equitable Share Proposals

The FFC makes four proposals related to the equitable share formula:

a. A review of the current FFC/Treasury equitable share formula should start by involving the relevant role players in a study to provide clear definitions of constitutionally mandated basic services and other constitutional obligations.

b. The division of total national revenue available for equitable share allocations (net of debt service obligations and provision for contingencies) should take account of:

    - Constitutionally mandated obligations in general and the provision of basic services in particular
    - The institutional element for each sphere of government
    - Other constitutional functions for which norms and standards should also be specified

- Obligations other than constitutional functions that may be funded through conditional grants, own revenue and borrowing
- The need for infrastructure funding, which should vary according to policy priorities.

c. The equitable division of nationally collected revenue must proceed from the principle that constitutionally mandated basic services and other constitutional obligations should be prioritised and progressively realised.

d. A review of the current equitable share formula should take account of new tax legislation for provinces and the proposed introduction of a capital grants scheme.

Government Response to FFC Equitable Share Proposals

Government concurs on the need to develop more precise information to determine the cost of constitutionally mandated basic services and obligations. Such information will improve budget decision-making and could be an important step toward activity-based costing. The collection of more decentralised or activity-based information is being prioritised, but will only be fully achieved in the medium-term, as new budget formats and other reforms are implemented.

Due to a lack of clear definitions of constitutionally-mandated services and in view of the lack of data to support a costed norms approach, Government has not implemented this set of recommendations.

Government will undertake a comprehensive and fundamental assessment of the equitable share formula once the 2001 Census results become available, reviewing its structure, components and data and exploring ways to make the formula more forward looking and policy-based for the 2005 MTEF. Government also agrees that the provincial equitable share allocation and formula may have to be reviewed once provinces take up specific taxation powers as their fiscal capacity may change. The assessment will involve the FFC.

FFC Provincial Own Revenue Proposals

The FFC reiterates three proposals made previously on provincial own revenues:

a. The most feasible sources of provincial own revenue are surcharges on personal income tax and fuel levies, in addition to gambling and betting taxes, which are already allocated to provinces.

b. Provinces should be allowed the flexibility to determine their own tax rates within the bands determined by the Minister of Finance.

c. However, for (a) and (b) above to be operational, given the current tax-to-GDP target adopted by government, tax room should be created in order to maintain the tax burden within nationally determined targets, to ensure consistency with national economic policy.

The FFC proposals relate to provincial own revenues, proposals for specific taxation authorities, provincial flexibility to determine their own tax rates, and creation of tax room within national targets. These proposals were previously tabled in 1996. National government responded by referred this matter to the Katz Commission in 1998, and thereafter approved a framework in November 1999 in line with the recommendations of the Budget Council. Subsequently, Parliament passed a Provincial Tax Regulation Process Act that takes effect on 20 February 2002.

Government Response to FFC Provincial Own Revenue Proposals

The FFC proposals on provincial own revenue are largely consistent with government’s approach. There are, however, slight differences. The Provincial Tax Regulation Process Act, for instance, envisages the identification of specific taxes and rates as an outcome of a technical and political consultative process. In contrast, the FFC has put forward a list of taxes that provinces should be allowed to impose.

One of the taxes proposed by the FFC is a surcharge on personal income tax, a tax option that Government, the South African Revenue Service and the Katz Commission concluded is not feasible in the current environment. A number of technical factors make a personal income tax surcharge undesirable. These include additional administrative burdens, which may not be cost-effective in terms of revenue yield, and exacerbation of inter-provincial inequalities.

National government, the Budget Council, and the Katz Commission concluded that a fuel levy surcharge would be less of an administrative burden and has more potential if concerns about potential impacts on the national economy, inflation, and equity can be resolved.

Given the approach of Government, it follows that the three FFC recommendations above will be considered in relation to specific taxation proposals made by provinces.

FFC Contingency Reserves Proposal

The FFC proposes a study to determine a set of objective criteria for the utilisation of the national contingency reserve. The FFC expresses concern that the use of contingency amounts ultimately affects amounts available for equitable share funding and that provinces need financial stability, predictability, and flexibility. Accordingly, it proposes criteria for the use of the contingency reserve.

Government Response to FFC contingency reserve proposal

The Public Finance Management Act (chapter 4) provides for provincial budgets to be adjusted to provide for "unforeseeable and unavoidable expenditure". However, section 6 of the Treasury Regulations issued in terms of the PFMA does not provide specific criteria to define "unforeseeable and unavoidable." Currently, contingency reserve amounts are reserved in the expenditure framework to meet such needs for all spheres and the amounts are approved in an adjustments budget.

Although the concerns raised by the FFC are important, the current process for allocating contingency reserve amounts involves substantial consultation. Government maintains an open consultative process for dividing contingency reserve amounts, taking into account unforeseeable and unavoidable spending commitments across spheres. National government is not convinced it is more efficient for every province to have its own contingency fund. It will nonetheless explore, with the FFC, opportunities to improve mechanisms for provincial contingencies. This will include the use of criteria for allocating unexpended contingency amounts. National Government will consult with the FFC and make appropriate recommendations to amend the PFMA and/or its regulations to ensure stability and predictability in the use of contingency reserves.

FFC Capital Grants Proposal

The FFC proposes a capital grants model to allocate capital grants. The model is developed for the education, health and social welfare sectors and can be used to calculate service- and province-specific capital needs, as well as the relative shares for each social sector in a province. The model could be extended to cover other functions.

The proposed model takes into account inherited capital backlogs, ongoing capital expenditure needs, and depreciation. It starts by determining the efficient and actual capital stocks to establish an initial transition path that indicates "ideal needs". Once ideal needs are calculated, the model would calculate an actual transition path based on actual grants received and actual capital expenditures.

Government Response to FFC Capital Grants Proposal

Government has moved in the direction proposed by FFC. The infrastructure conditional grant was introduced in 2000/01 to boost provincial infrastructure spending and address backlogs. The Budget Council endorsed the allocation of the infrastructure grant with a two-part formula based on each province's proportion of equitable share funding and on their proportion of the backlog component of the equitable share formula.

Health, education, roads and rural infrastructure needs are an important part of the equitable share formula's backlog component. Infrastructure needs are also addressed by conditional grants. Accordingly, the potential practical contributions of the proposed FFC capital grants model should be considered as part of a comprehensive assessment of the equitable share formula's structure and data and its relationship to infrastructure needs funded by conditional grants.

The FFC-proposed capital grant model presents some useful ways to analyse infrastructure needs, but government believes that, in its current form, it would not be practical for allocating infrastructure grants.

The FFC's recommendations on local government finances

The scope and detail of the FFC's recommendations on local government are substantive, timely and are largely supported by national government. The FFC provided two further submissions in July 2001 entitled *Division of municipal powers and functions between district and local municipalities* and *Remuneration of municipal councillors.*

National government will implement many of the FFC recommendations on local government. Other recommendations require further development to refine them into practical recommendations for the medium to long term. A number of outstanding policy issues, such as the division powers and functions between district and non-metropolitan local councils require resolution before these recommendations can be revisisted. The Department of Provincial and Local Government (DPLG) is leading a process to finalise these issues.

Summary of each proposal and Government's response

FFC Fiscal framework proposals

The FFC's suggested framework for the local government equitable share involves:

- Articulation of the constitutional requirements for the local government share
- Definition and identification of basic municipal services and other municipal functions
- Development of the principles that should underlie the funding of basic municipal services, other municipal functions and lifeline tariffs
- Investigation of the implications of these principles for the equitable share formula, financing of districts, funding infrastructure and local government borrowing.

Government Response to FFC Fiscal Framework Proposals

The significance attached to the equitable share mechanism within the local government fiscal framework is being implemented by Government. The FFC's recommendations regarding infrastructure funding for municipalities, local government borrowing and non-metropolitan powers and functions are also supported. The framework should be expanded to spell out the extent and type of local government tax and tariff authority, as well as the role and type of intergovernmental transfers.

National government does not accept the FFC's recommendation for a once-off conditional grant for debt restructuring and cash flow improvement. The moral hazard implicit in this approach has been extensively considered and rejected by government. There is no evidence that debt repayments are a more significant problem for municipalities than, for example, personnel costs.

FFC proposal for local government equitable share

The FFC recommends alterations to the equitable share formula in the long term to improve its accuracy in targeting municipalities with limited tax capacity. The FFC also recognises the difficulties in making rapid changes, and proposes a phased approach. In the medium term, it proposes that the local government formula consist of a fiscal capacity measure and an estimated cost of basic municipal services (net of cost-recovery) component. Currently, the basket of services for the equitable share includes water and sanitation, electricity and refuse removal.

Government Response to FFC equitable share proposals

National government agrees with the FFC that it is important to evaluate the current formula and that a fiscal capacity parameter is desirable. However, the recommendations do not consider sensitivities of the current formula to specific variables, and thus the likely real effect of proposed changes on the distribution of resources between municipalities. Given that some new municipalities are fragile and require time to consolidate, and that information is poor or not available, it is premature to make significant changes to the current formula.

The initial formula proposed by Government on the inception of the equitable share included a tax capacity component, for intra-metropolitan tax equalisation, that was not implemented. This was because the regional service levy income at the metro level reduced the need for spillover transfers. Since demarcation, it has become necessary to include this component, to replace the inadequate fiscal capacity measure in the **I** grant. However, the tax capacity component cannot be implemented as current data on property rates is not readily measurable because::

- Municipal records do not often provide details of the categories and values of properties, and
- There are varying definitions of property tax bases in different parts of the country.

The Property Rates Bill will introduce a more uniform system of assessment, but will probably only be enacted in mid-2002. Current data submitted to Government do not follow uniform reporting formats, and data generated through budget reforms are only available for a few pilot municipalities. Measures are being implemented to address this situation. The FFC is working on proposals for fiscal capacity measures, assessing the availability of data for each proposed measure and modelling the distribution effects of various options.

It is worth noting that currently the Institutional component (**I** grant) allocations are made on the basis of municipal population and revenue-raising capacity parameters. This parameter assumes that individuals will pay 7,5 per cent of their income towards property taxes once the poverty threshold of R250 per month (R1100 per month for households) is taken into account. The FFC did not raise the issue of the cost of governance in its initial recommendations. However, it addressed this in a subsequent submission entitled *Remuneration of municipal councillors.* National Government concurs that councillor remuneration should be paid from own budgets.

The basic services component (**S** grant) of the equitable share grant will include a weighting factor to the nodes from 2002/03. As the equitable share is an unconditional transfer, it is unclear what benefit would be derived from introducing further services into the formula. However, the principle that such funds be included within this transfer mechanism, as opposed to the development of a conditional grant, is supported.

FFC proposal on defining and costing basic services

The FFC proposals use a number of criteria to determine whether a service is "basic". These include the intergovernmental assignment of services in the Constitution, that a service must be a basic right and essential for life, part of development and a policy priority. The FFC also stresses the importance of local considerations and that some communities might not achieve service access in the short term.

Government Response to FFC proposal on costing basic service

The FFC presents a Constitutional and legal basis for basic municipal services, but this legal and constitutional premise does not resolve problems in defining such basic services. Government's current approach is to allow for local discretion within broad norms and standards. It must be noted that the fiscal burden to support local government is already substantial, and that a change requires careful consideration. National government recommends that the FFC re-examine the benefits of this approach.

The FFC continues to pursue a costed-norms approach to the vertical division for local government. Although Government has reservations with a costed-norms approach for reasons outlined in response to the 2000 FFC proposals on provincial allocations, it concurs that there is analytical value to more accurate information on the cost of municipal services.

FFC lifeline tariffs, subsidies and redistribution proposal

The FFC proposes that national government fund lifeline tariffs. The recommendation equates the concept of subsidisation of service delivery with the introduction of "lifeline tariffs".

Government Response to FFC lifeline tariffs proposal

Government recognises its responsibility for redistribution, and by implication support for the provision of free basic services. This support is provided for in the equitable share, to avoid moral hazard implicit in a specific conditional grant for this purpose.

However, service delivery subsidies do not necessarily involve cross-subsidies. To the extent this is what the FFC intends, it must consider efficiency implications and potential economic distortions. This framework needs more consideration than received to date.

FFC infrastructure and capacity proposal

The FFC supports the principle of a single, integrated conditional grant for capital outlay, and its distribution on a three-year basis. It notes the current fragmentation does not promote an integrated development approach. It also supports a coordinated framework for capacity building and welcomes introduction of the Municipal Systems Improvement Programme.

Government Response to infrastructure grant proposal

Government supports this proposal, and began implementing it in the 2000/01 financial year. Given that this approach is being phased in over a few years, government also supports the FFC's recommendation for better coordination between various national departments. Whilst broadly supporting the FFC's recommendations for an allocation formula and grant-matching, Government recommends further work before implementing these proposals, specifically on the relationship between the equitable share and consolidated infrastructure transfers.

FFC Regional Services Council (RSC) levies proposal

The FFC proposes that revenue obtained via RSC levies be retained in the local government system and that local tax discretion be expanded. The FFC also proposes removal of the current earmarking on the use of the RSC levy (specifically the infrastructure earmarking) and the introduction of an equalisation grant.

Government Response to FFC RSC levy proposal

Further work is required on municipal revenue instruments, both in the context of RSC levies and the broader local government restructuring. The division of fiscal powers, will in part, be informed by the finalisation of the powers and functions of the sphere and each category of municipality. Though the national government supports the relaxation of spending controls on revenue generated from RSC levies, this can only be implemented once municipal budgets are more transparent. Municipal budget reforms will require all expenditure to be properly classified to minimise the risk associated with the removal of restrictions. Both FFC proposals require more investigation and discussion within this context.

FFC recommendations on Municipal Borrowing

The FFC supports national government's intention to promote a local government borrowing market. It proposes a rules-based approach, and recommends regulating the extent to which a municipality may pledge its equitable share revenue to access debt.

Government Response to FFC municipal borrowing proposal

Government and the FFC strongly agree on the need and benefits of municipal borrowing. National government published a framework for municipal borrowing and financial emergencies in July 2000, titled *The Policy Framework for Municipal Borrowing and Financial Emergencies.* Government views the roles of fiscal transfers and municipal borrowing as complementary. Potentially creditworthy municipalities should reduce reliance on fiscal transfers to allow these funds to flow to non-creditworthy municipalities. This distinction is critical to understanding current government policy on municipal borrowing.

The FFC also contends that a rules-based approach to borrowing is appropriate for certain categories of local government. Undifferentiated normative limits relating debt or debt service to fixed percentages of a municipality's budget could encourage under-capacitated municipalities to over-borrow and restrict healthy municipalities from appropriate levels of borrowing. Rules-based limits may be appropriate for countries with under-developed financial sectors. However, it is not necessary where capital markets are well developed, as they are in South Africa. The objective is to ensure that capable municipalities use their full potential to free up national capital resources for poor and rural municipalities that cannot attract private sector finance. Restricting the use of the equitable share would also impede budgetary discretion.

National government accepts the FFC's caution against creating dependence on national intervention, and believes local governments should assume the greatest possible level of accountability for financial health. However, under some circumstances, mechanisms to deal with municipalities in financial emergencies are required. Existing constitutional provisions and their implementation have proved inadequate. Hence the approach proposed in the Municipal Finance Management Bill and proposed constitutional amendment.

FFC district health services funding proposal

The FFC proposes funding for municipal health services be included within the equitable share for local government in the long term. In the interim, it is proposed that funding for district health services be disaggregated to a district level to enable more equitable allocations within provinces.

Government Response to FFC District Health Proposals

The devolution of functions from national or provincial government to local government is complex, involving not just the shifting of funds (as funds follow function), but also shifting personnel, assets and liabilities. As noted in the *2001 Intergovernmental Fiscal Review*, the financial impact of shifting staff from provincial to local government can be extremely costly as the experience of shifting of R293 personnel from provinces to the local governments has shown.

A second issue relates to *sequencing* the devolution of provincial functions. This must be informed by a process that prioritises such shifts, to avoid swamping local government with additional functions. The *timing* for such function shifts must take into account the capacity of local governments to perform their current functions.

This function is currently with provinces and the provincial equitable share formula includes a significant health component. For this reason, the transfer of functions should be duly identified and earmarked in the Division of Revenue Act on the basis that “funds follow function”.

The pace and extent of such decentralisation has not been finalised, the definition of health service provision has not been clarified and the costs thereof have not been quantified. The FFC proposal that health services be excluded from the local government equitable share for the time being is supported.

Summary of discussion on FFC local government recommendations

The scope and detail of the FFC’s recommendations on local government are commended. There are a number of recommendations that national government is in agreement with and accepts. Others require further development to become implementable recommendations for the medium to long term. A number of outstanding policy issues, such as the division of non-metropolitan municipal powers and functions, require resolution before final recommendations can be made. The timing for implementing many of the reforms must take into account that the new municipalities will require time to integrate and stabilise their delivery capacity.

Part 2: Fiscal Framework for 2002 MTEF

Fiscal framework

Table E-1 presents medium-term macroeconomic forecasts for the 2002 Budget. It sets out the growth assumptions and fiscal projections on which the fiscal framework is based.

Table E1 Medium-term macroeconomic assumptions

	2001/02		2002/03		2003/04		2004/05
	2001 Budget	2002 Budget	2001 Budget	2002 Budget	2001 Budget	2002 Budget	2002 Budget
Gross domestic product (R billion)	987,2	990,0	1 069,3	1 082,8	1 154,9	1 178,9	1 277,5
Real GDP growth	*3,7%*	*1,9%*	*3,5%*	*2,7%*	*3,3%*	*3,3%*	*3,6%*
GDP inflation	*6,0%*	*6,6%*	*4,7%*	*6,5%*	*4,6%*	*5,4%*	*4,6%*
National Budget Framework							
Revenue (R billion)	233,4	248,4	252,9	265,2	273,1	288,7	313,2
Percentage of GDP	*23,6%*	*25,1%*	*23,6%*	*24,5%*	*23,6%*	*24,5%*	*24,5%*
Expenditure (R billion)	258,3	262,6	277,3	287,9	297,5	311,2	334,6
Percentage of GDP	*26,2%*	*26,5%*	*25,9%*	*26,6%*	*25,8%*	*26,4%*	*26,2%*
Budget deficit (R billion)	-24,8	-14,1	-24,5	-22,7	-24,4	-22,5	-21,4
Percentage of GDP	*-2,5%*	*-1,4%*	*-2,3%*	*-2,1%*	*-2,1%*	*-1,9%*	*-1,7%*

Before resources can be divided, provision is made for national commitments such as debt service costs and a contingency reserve. Debt servicing obligations of R47, 5 billion, R49, 8 billion and R52, 4 billion are projected for the three MTEF years, and the contingency reserve amounts to R3,3 billion, R5 billion and R9 billion.

As shown in table E-2, once commitments are deducted, the total to be shared between the spheres amounts to R237, 1 billion, R256, 4 billion and R273, 1 billion over the three MTEF years. This revenue pool is available for sharing between national, provincial and local spheres.

The division of resources between the three spheres is determined primarily by the initial baseline allocations in the 2001 Budget, which reflect current priorities, together with priorities identified for additional resources in the framework. Hence, changes are generally restricted to the margin.

Additional allocations are made available from revisions to the framework arising from economic growth, robust tax collection, higher inflation, drawing down the contingency reserve and savings on debt service costs. The new priorities and pressures identified over and above the current priorities reflect Government's commitment towards reducing poverty, inequality and vulnerability. These include:

- Increasing the take-up of the child support grant and the impact of HIV/Aids on social development programmes
- Increasing health spending to cope with cost pressures such as HIV/Aids and hire professional staff, especially in rural areas
- Poverty alleviation programmes, including social security and support for municipalities in providing free basic services to the poor
- Increasing spending to redress serious backlogs in maintenance, rehabilitation, and construction of public infrastructure and to stimulate investment and economic growth
- Restructuring the Unemployment Insurance Fund and the Post Office to ensure improved service quality and access
- Increasing budget resources for rural electrification, and
- Expanding early childhood development, improving access to education for children with special needs and strengthening mathematics and science education.

Table E2 Division of revenue between the spheres of government

R million	2001/02 Budget[1]	2001/02 Revised estimate	2002/03	2003/04	2004/05
			Medium-term estimates		
National allocation	84 286	87 317	96 106	103 307	109 911
Provincial allocation	117 387	121 206	132 420	142 844	152 363
Equitable share	*106 260*	*107 460*	*119 452*	*128 466*	*137 089*
Conditional grants	*11 127*	*13 745*	*12 967*	*14 378*	*15 274*
Local government allocation	6 506	6 552	8 580	10 235	10 854
Equitable share	*2 618*	*2 618*	*3 852*	*5 021*	*5 461*
Conditional grants	*3 888*	*3 934*	*4 728*	*5 213*	*5 393*
Allocated expenditure	**208 179**	**215 075**	**237 106**	**256 386**	**273 128**
Plus:					
Debt service costs	48 138	47 515	47 503	49 845	52 434
Contingency reserve	2 000	–	3 300	5 000	9 000
Total expenditure	**258 317**	**262 590**	**287 909**	**311 231**	**334 561**
Percentage of shared total					
National allocation	*40,5%*	*40,6%*	*40,5%*	*40,3%*	*40,2%*
Provincial allocation	*56,4%*	*56,4%*	*55,8%*	*55,7%*	*55,8%*
Local government allocation	*3,1%*	*3,0%*	*3,6%*	*4,0%*	*4,0%*

1 For comparative purposes, local government transfers have been shifted from provincial share to the local government share.

These priorities determine how the additional allocations are divided between the spheres. Funds flow towards the sphere responsible for the prioritised functions. The impact of these policy decisions on the division of revenue is reflected in table E-2.

The revised budget framework provides for additional spending of R13,4 billion in 2002/03 and R17,9 billion in 2003/04 compared with forward estimates for these years in the 2001 Budget.

The national share decreases marginally from 40,6 per cent in 2001/02 to 40,5 in 2002/03 and further declines to 40,2 per cent in 2004/05. The local government share is significantly above previous budgets, rising from 3,0 per cent in 2001/02 to 4,0 per cent in 2004/05. The provincial share also decreases somewhat, from 56,4 per cent in 2001/02 to 55,8 per cent in 2004/05.

Schedule 1 of the Bill is the *legal* division of revenue between the three spheres, and is based on fiscal framework table E-3. The table indicates how Schedule 1 allocations are reconciled with the total available expenditure.

The national allocation in Schedule 1 (for 2001/02) is the actual amount allocated to the national government for appropriation or as a direct charge (but excluding the provincial equitable share). The national Appropriation Bill, based on the national allocation, includes conditional grants for provincial and local spheres, and (the top-sliced) allocation for state debt costs, a direct charge on the National Revenue Fund. It also includes the contingency reserve.

The provincial and local government allocations in Schedule 1 reflect their equitable share allocations only, and therefore exclude all conditional grants and grants-in-kind.

Table E3 Schedule 1 of the Division of Revenue Bill and the Fiscal Framework

R million	2001/02 Budget	2001/02 Revised estimate	2002/03	2003/04	2004/05
			Medium-term estimates		
Total expenditure	**258,317**	**262,590**	**287,909**	**311,231**	**334,561**
Less:					
Debt service costs	48,138	47,515	47,503	49,845	52,434
Contingency reserve	2,000	–	3,300	5,000	9,000
Total allocated expenditure	**208,179**	**215,075**	**237,106**	**256,386**	**273,128**
of which:					
National share including statutory appropriations and reserve	**149,439**	**152,184**	**164,604**	**177,743**	**192,012**
Less:					
Debt service costs	48,138	47,515	47,503	49,845	52,434
Contingency reserve	2,000	–	3,300	5,000	9,000
National share	**99,301**	**104,669**	**113,802**	**122,898**	**130,578**
of which:					
Conditional grants	*15,015*	*17,351*	*17,695*	*19,592*	*20,667*
National share (Excluding conditional grants)	**84,286**	**87,317**	**96,106**	**103,307**	**109,911**
Provincial share	**117,387**	**121,206**	**132,420**	**142,844**	**152,363**
of which:					
Equitable share	*106,260*	*107,460*	*119,452*	*128,466*	*137,089*
Conditional grants	*11,127*	*13,745*	*12,967*	*14,378*	*15,274*
Local government share	**6,506**	**6,552**	**8,580**	**10,235**	**10,854**
of which:					
Equitable share	*2,618*	*2,618*	*3,852*	*5,021*	*5,461*
Conditional grants	*3,888*	*3,934*	*4,728*	*5,213*	*5,393*

Part 3: Taking Account of the 10 factors set out in the Constitution

Section 214 of the Constitution requires that the annual Division of Revenue Act only be enacted after account is taken of factors set out in sub-section 214(2) (a) to (j), of the Constitution. These include national interests, provisions for debt, needs of the national government and emergencies; the allocation of resources to provide basic services and meet developmental needs; fiscal capacity and efficiency of the provincial and local spheres; reduction of economic disparities; and promotion of stability and predictability.

This part of the annexure gives effect to section 10(5)(a) of the Intergovernmental Fiscal Relations Act. Taking the Constitutional factors into account is integral to processes that determine the division of revenue. Below is a summary of the constitutional principles that were taken into consideration in deciding on the division of revenue. Detailed explanations are further articulated in the Budget Review Documentation.

National interest and the division of resources

A stable macroeconomic environment, strong economic growth, reduced poverty, inequality and vulnerability, low unemployment, reduced crime and an efficient public service are addressed by programmes coordinated by national government.

Provision for debt costs

The resources shared among the three spheres of government include proceeds from national government borrowing. In recognition of Government's obligation to repay its borrowing and protect its capacity to borrow at low rates, debt service costs are met before resources are shared.

National needs and interests

The Constitution assigns exclusive and concurrent powers to each government sphere. The national government is responsible for functions that cross provincial boundaries, including protection services, economic services and foreign affairs.

Provincial and local basic services

Sub-national governments have significant autonomy to allocate resources to meet basic needs and respond to provincial and local priorities. The division of revenue provides equitable share increases to provinces and local government. This year's division of revenue takes explicit account of cost pressures relating to social security grants, increased health costs related to HIV/Aids, and the provision of free basic services in local government.

Fiscal capacity and efficiency

The Constitution assigns the primary government revenues to the national sphere. Local governments finance most of their expenditure with property rates, regional service turnover and payroll levies, user charges and fees. The provincial sphere, however, has minimal revenue-raising capacity. To compensate for this, nationally raised revenue is shared, with provinces receiving the larger share. All three spheres are strengthening their financial management capacity.

Developmental needs

Developmental needs are incorporated into the equitable share formulae for provincial and local government and in specific conditional grants.

Economic disparities

Because there are economic and demographic disparities between and within provinces, the equitable share formulae are redistributive towards poorer provinces and municipalities.

Obligations in terms of national legislation

While the Constitution confers autonomy on provincial governments to determine priorities and allocate budgets, national government retains responsibility for policy development, national mandates and monitoring implementation within concurrent functions.

Predictability and stability

Equitable share allocations are based on estimates of nationally raised revenues, with allocations protected and not adjusted downwards. Allocations are for three years (although votes are annual) and are transferred according to a payment schedule.

Need for flexibility in responding to emergencies

Government has flexibility to respond to emergencies through a contingency reserve that provides a cushion for "unforseeable and unavoidable" expenditure.

Part 4: Provincial Allocations

National transfers to provinces comprise more than 96 per cent of provincial revenues, of which 90 per cent is through the equitable share (see table E-4). The remaining 10 per cent flows as conditional grants. Provinces raise less than 4 per cent of their revenues from own sources.

Table E4 Total transfers to provinces, 2002/03

R million	Equitable share	Conditional grants	Total transfers
Eastern Cape	20 498	1 522	22 020
Free State	7 996	970	8 966
Gauteng	18 224	3 488	21 712
KwaZulu-Natal	24 343	2 134	26 477
Mpumalanga	8 428	694	9 122
Northern Cape	2 907	247	3 153
Northern Province	16 145	1 256	17 401
North West	9 993	688	10 680
Western Cape	10 919	1 970	12 889
Unallocated			
Total	**119 452**	**12 967**	**132 420**

Provincial equitable share

The Constitution entitles provinces to a share of nationally raised revenue. The provincial equitable share allocation funds the bulk of public services rendered by provinces. The equitable share amounts to R119,5 billion in 2002/03, R128,5 billion in 2003/04, and R137,1 billion in 2004/05. It is divided between provinces using the provincial equitable share formula.

Revisions to the formula

The structure of the equitable share formula has been retained for the 2002 Budget. The formula, however, was adjusted to reflect increased provincial spending on social security grants and updates for new data on school enrolment. The weighting of the social services components reflect expenditures on these services over a three year period. Expenditure data reported in the *Intergovernmental Fiscal Review 2001,* indicated that welfare as a share of provincial expenditure in 2001/02 rose to 19 per cent (and reaches a high of 25 per cent in Northern Cape). Based on this, the weight for the welfare component was increased one percentage point. A balancing reduction in the weight of the economic component is also effected. The formula has been updated for latest enrolment data in education, the average of the past three years (1998, 1999 and 2000).

The revised equitable share formula

The equitable share formula comprises seven components that attempt to capture the relative demand for services between provinces and to adjust for particular provincial circumstances. It considers, for example, infrastructure backlogs and poverty levels. Although the formula has components for education, health and welfare, the share "allocations" are intended merely as broad indications of relative need. Provincial Executive Committees have discretion regarding the provincial allocations for each function. The provincial equitable share formula (with latest updates) comprises the following components:

- An education share (41 per cent) based on the size of the school-age population (ages 6-17) and the average number of learners enrolled in ordinary public schools for the past three years
- A health share (19 per cent) based on the proportion of the population with and without access to medical aid
- A social security component (18 per cent) based on the estimated number of people entitled to social security grants – the elderly, disabled and children – weighted by using a poverty index derived from the Income and Expenditure Survey
- A basic share (7 per cent) derived from each province's share of the total population of the country
- A backlog component (3 per cent) based on the distribution of capital needs as captured in the schools register of needs, the audit of hospital facilities and the share of the rural population
- An economic output component (7 per cent) based on the distribution of total remuneration in the country, and
- An institutional component (5 per cent) divided equally among the provinces.

Table E-5 shows the current structure and distribution of shares by component, and the target shares to be reached by 2003/04. The elements of the formula are neither indicative budgets nor guidelines as to how much should be spent on those functions. Rather, the components are weighted broadly in line with expenditure patterns to provide an indication of relative need.

Table E5 Distributing the equitable share, percentages by province

	Education	Health	Social welfare	Basic share	Economic activity	Institu-tional	Backlog	Target shares
Weighting	*41,0*	*19,0*	*18,0*	*7,0*	*7,0*	*5,0*	*3,0*	*100,0*
Eastern Cape	18,4	17,0	19,6	15,5	6,5	11,1	20,6	17,0
Free State	6,3	6,5	7,1	6,5	5,3	11,1	5,7	6,6
Gauteng	12,6	14,7	13,9	18,1	41,6	11,1	5,1	15,4
KwaZulu-Natal	22,0	21,7	19,6	20,7	17,0	11,1	22,9	20,6
Mpumalanga	7,3	7,2	6,5	6,9	4,9	11,1	8,5	7,2
Northern Cape	1,9	2,0	2,2	2,1	1,7	11,1	1,3	2,4
Northern Province	15,4	13,3	13,7	12,1	3,0	11,1	22,9	13,6
North West	8,0	8,6	8,7	8,3	5,7	11,1	9,4	8,3
Western Cape	8,0	8,9	8,8	9,7	14,4	11,1	3,7	8,9
Total	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**

Education component

The education component targets primary and secondary schooling, which accounts for roughly 90 per cent of provincial education spending. Both the school-age population and enrolment numbers are used to reflect the demand for education services. The school-age cohort, ages 6-17, is double weighted, reflecting Government's desire to reduce out-of-age enrolment. The enrolment figures have been updated for the 2002 Budget, taking into account the average enrolment of the last three academic years (1998, 1999 and 2000) provided by the national Department of Education.

Table E6 Calculation of education component

Thousands	Enrolment	School-age (6–17)	Weighted share (%)
Weighting	*1*	*2*	
Eastern Cape	2 253	2 010	18,4
Free State	784	680	6,3
Gauteng	1 508	1 394	12,6
KwaZulu-Natal	2 749	2 377	22,0
Mpumalanga	922	789	7,3
Northern Cape	202	223	1,9
Northern Province	1 904	1 665	15,4
North West	934	896	8,0
Western Cape	928	895	8,0
Total	**12 184**	**10 930**	**100,0**

Health component

The health component addresses the need for provinces to deliver primary and secondary health care services. As all citizens are eligible for health services, the provincial shares of the total population form the basis for the health share. The formulation of the health component recognises that people without medical aid support are more likely to use public health facilities, and are therefore weighted four times higher than those with medical aid support. This assumes the uninsured account for 95 per cent of the usage of public health facilities. The proportions of the population with and without access to medical aid are taken from the 1995 October Household Survey and applied to the census figures.

Table E7 Calculation of health component

Thousands	With medical aid	Without medical aid	Weighted share (%)
Weighting	*1*	*4*	
Eastern Cape	510	5 793	17,0
Free State	467	2 166	6,5
Gauteng	2 958	4 390	14,7
KwaZulu-Natal	1 103	7 314	21,7
Mpumalanga	392	2 409	7,2
Northern Cape	175	665	2,0
Northern Province	376	4 554	13,3
North West	457	2 897	8,6
Western Cape	1 127	2 830	8,9
Total	**7 566**	**33 018**	**100,0**

Welfare component

The welfare component captures provinces' responsibility for social security grants. The constituent parts reflect the target populations of social security payments, weighted by the distribution of expenditure for each type of grant. For example, the bulk of social security payments are old-age pensions. Means testing of grants is reflected through an income adjustment based on the provincial share of the population in the lowest two quintiles of the income distribution. This information was drawn from the 1995 Income and Expenditure Survey, which has not been updated. Data from the Department of Welfare on actual expenditure by grant type indicate the current weightings are still appropriate. These weights do not make explicit provision for the child support grant, although the vertical division of revenue takes this into account. The adjustments to the welfare component weight, which is based on the latest actual expenditure inclusive of the child support grant partially compensates for this.

Table E8 Calculation of the welfare component

Percentage	Old age	Disability	Child care	All grants	Income adjustment	Weighted share
Weighting	*65,0*	*25,0*	*10,0*	*75,0*	*25,0*	*100,0*
Eastern Cape	19,1	15,5	17,4	18,0	24,3	19,6
Free State	6,2	6,5	5,7	6,2	9,6	7,1
Gauteng	15,7	18,1	14,3	16,2	7,2	13,9
KwaZulu-Natal	19,8	20,7	21,7	20,2	17,6	19,6
Mpumalanga	5,9	6,9	7,3	6,3	7,1	6,5
Northern Cape	2,1	2,1	2,0	2,1	2,6	2,2
Northern Province	13,0	12,1	14,8	13,0	15,8	13,7
North West	7,8	8,3	8,4	8,0	10,7	8,7
Western Cape	10,4	9,7	8,4	10,0	5,2	8,8
Total	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**

Economic activity component

The economic activity component is a proxy for provincial tax revenue, directing a proportion of nationally collected revenue back to its source. It also reflects costs associated with economic activity, such as maintenance of provincial roads. In 1999, the distribution of employee remuneration replaced provincial Gross Geographic Product (GGP) figures, since remuneration comprises roughly 60 per cent of provincial GGP and the GGP figures had not been updated since 1994. For 2001, Government decided not to adjust this component of the formula, pending publication of new GGP data.

Table E9 Economic activity shares

Percentage	Share of Remuneration
Eastern Cape	6,5
Free State	5,3
Gauteng	41,6
KwaZulu-Natal	17,0
Mpumalanga	4,9
Northern Cape	1,7
Northern Province	3,0
North West	5,7
Western Cape	14,4
Total	**100,0**

Basic component

In 1999, the basic component was split into a basic share distributed by population and a backlog component. The backlog component incorporates estimates of capital needs as drawn from the Schools Survey of Needs and the 1998 MTEF health sector report on hospital rehabilitation. The backlog component also incorporates a rural factor, in keeping with Government’s focus on rural development. As no new information is available regarding its sub-components, the backlog component remains unchanged.

Table E10 Calculation of backlog component

Percentage	Health	Education	Rural	Weighted share
Weighting	*18,0*	*40,0*	*42,0*	*100,0*
Eastern Cape	16,3	22,0	21,3	20,6
Free State	3,8	7,8	4,4	5,7
Gauteng	10,8	6,3	1,2	5,1
KwaZulu-Natal	16,0	23,5	25,5	22,9
Mpumalanga	9,2	7,5	9,1	8,5
Northern Cape	1,2	1,2	1,3	1,3
Northern Province	27,5	20,4	23,3	22,9
North West	9,1	7,5	11,6	9,4
Western Cape	6,1	3,9	2,3	3,7
Total	**100,0**	**100,0**	**100,0**	**100,0**

Institutional component

The institutional component recognises that some costs associated with running a government and providing services are not directly related to the size of a province's population. It is therefore evenly distributed between provinces, as was the case last year. It constitutes 5 per cent of the total equitable share, of which each province gets 11,1 per cent.

The phasing-in of the formula

The formula determines the equitable share for each province. In 1999/2000, two years after the formula was introduced, data for the 1996 Census was published. The data reflected demographic profiles different from the preliminary census results used in the formula. Given the need to ensure stability in provincial budgets, it was agreed that revisions to the formula should be phased in over five years, from 1999/2000 to 2003/04. The target date of 2003/04 has been retained, so that the formula is fully implemented at the start of the 2003 MTEF cycle. Table E-11 shows the phasing.

Table E11 Phasing in the equitable share

Percentage	1999/00 base	2000/01	2001/02	2002/03	2003/04 target
Phasing	*Year 1*	*Year 2*	*Year 3*	*Year 4*	*Year 5*
Eastern Cape	17,6	17,4	17,3	17,2	17,0
Free State	6,8	6,8	6,7	6,7	6,6
Gauteng	14,9	15,1	15,2	15,3	15,4
KwaZulu-Natal	19,8	20,0	20,2	20,4	20,6
Mpumalanga	6,7	6,8	6,9	7,1	7,2
Northern Cape	2,4	2,4	2,4	2,4	2,4
Northern Province	13,3	13,4	13,5	13,5	13,6
North West	8,6	8,5	8,4	8,4	8,3
Western Cape	9,8	9,6	9,4	9,1	8,9
Total	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**

Conditional grants to provinces

Schedules 3 and 4 of the Division of Revenue Bill list all conditional grants to provinces. Conditional grants are a small but significant portion of provincial revenue. These grants were introduced in 1998/99 to support national priorities, particularly in the social services sectors. In particular, conditional grants are used to:

- Provide for national priorities in the budgets of other spheres
- Promote national norms and standards
- Compensate provinces for cross-boundary flows and inter-provincial benefits
- Effect transition by supporting capacity-building and organisational reforms, and
- Address backlogs and regional disparities in social infrastructure.

Although the conditional grant system has improved, some problems remain. Previous *Intergovernmental Fiscal Reviews* highlighted such problems, including non-transfers and underspending, while annual Division of Revenue Acts introduced corrective measures. The 2002 Division of Revenue Bill completes further reforms through advanced planning, enhanced transparency and clarifying responsibilities of national departments and provincial officers.

Except for the housing subsidy and HIV/Aids grants, no significant changes are made to conditional grants allocations in the 2002 MTEF. However, changes are introduced in the policy framework underlying some of the grants, particularly in health and housing. Policy and equity considerations necessitated restructuring and rationalisation of health grants.

Provincial Conditional Grant Framework

The provincial framework for conditional grants addresses problems that emerged with grant implementation. The framework aims to:

- Limit the number of conditional grants to those terrains where the equitable share and norms and standards cannot fund specific programmes
- Eliminate small conditional grants as they impose disproportionate administrative burdens
- Provide tougher criteria for national departments' planning to introduce conditional grants, including more rigorous consultation with provinces
- Incorporate conditional grants into the normal budget preparation process
- Provide best practice in designing, planning and monitoring conditional grants, and
- Focus on outcomes rather than inputs when monitoring conditional grants.

The framework draws a distinction between equitable shares and conditional grants. It emphasises that equitable shares are transfers made to enable provinces to provide basic services and nationally agreed priorities, such as school education, health and social grants, and other constitutionally assigned functions. The development of norms and standards with quantifiable service delivery measures will enable national departments to monitor the extent to which sub-national budgets comply with national standards. Reforms in the intergovernmental system, financial management and budget process provide for better understanding of national priorities and pressures on sub-national budgets and allow for effective monitoring to ensure provinces prioritise nationally-agreed policies in their budgets.

The framework draws a distinction between two types of conditional grants: block grants and specific purpose grants. Block grants provide recurrent funding for assigned or specialised functions and have limited conditionalities. Block grants include specialised grants like the National Tertiary Services and Health Professional Training grants.

Special purpose grants have strong conditionalities, often to fund specific national priorities. These grants are used to influence the way services are delivered in the short to medium term, through conditions imposed by a national department, which can result in a sanction if conditions are not met. Examples include the provincial infrastructure, housing subsidy, education financial management and HIV/Aids grants.

Specific purpose grants are *an option of last resort*, considered only if a national department demonstrates the equitable share mechanism has failed to get provinces to budget for specific priorities.

Given the system of intergovernmental relations, a set of principles to guide the budget process across all three spheres of government has been developed. These principles not only promote transparency, but also ensure accountability, better auditing, better planning and implementation of conditional grants. The critical principles are that:

- All fund allocations must be part of one comprehensive budget process
- Departments make three-year allocations for all grants
- Each grant to be appropriated by the receiving beneficiary government
- There should be transparency of criteria for division of a grant between provinces
- Focus should be on performance monitoring and outputs, and
- Clear arrangements that ensure national departments fulfil their fiduciary responsibilities.

Allocations

Tables E-12 and E-13 provide summaries of conditional grants for 2002/03 and allocations by province. The largest conditional grants in the 2002 Budget are in the health sector (R6,4 billion), followed by the Department of Housing (R3,8 billion), and the National Treasury (R2 billion). Education and Welfare Departments administer small but important grants for the improvement of financial management in these sectors. Four provinces, Gauteng, KwaZulu-Natal, Western Cape and Free State, benefit most from tertiary services and training grants in health. Significantly, they provide specialised services to all citizens. Other health grants flow mainly to poorer provinces. Below is a summary of the conditional grants listed in Schedules 3 and 4 of the Bill.

Table E12 Conditional grants for 2002

R thousand	2001/02 Revised[1]	2002/03	2003/04	2004/05
		Medium-term estimates		
Agriculture	**28 376**	**24 000**	**38 000**	**–**
Land Care Projects	28 376	24 000	38 000	–
Health	**5 984 293**	**6 399 710**	**6 804 711**	**7 256 548**
National Tertiary Services	3 459 594	3 666 842	3 892 849	4 151 542
Health Professions Training and Development	1 234 090	1 279 248	1 299 475	1 393 366
Hospital Revitalisation	500 000	520 000	543 400	576 004
Nkosi Luthuli Academic Hospital	103 800	–	–	–
Pretoria Academic Hospital	50 000	70 000	90 000	–
HIV/AIDS	54 398	157 209	266 576	380 480
Integrated Nutrition Programme	582 411	582 411	582 411	617 356
Hospital Management Improvement	–	124 000	130 000	137 800
National Treasury	**3 947 877**	**1 950 000**	**2 514 000**	**2 852 840**
Supplementary Allocation	2 247 877	–	–	–
Provincial Infrastructure	800 000	1 550 000	2 314 000	2 852 840
Infrastructure Rehabilitation	600 000	400 000	200 000	–
Section 100(1)(a) Agreement	300 000	–	–	–
Education	**297 500**	**418 320**	**439 814**	**373 403**
Financial Management and Quality Enhancement	213 000	224 320	234 414	248 479
HIV/AIDS	63 500	142 000	117 400	124 924
Early Childhood Development	21 000	52 000	88 000	–
Housing	**3 325 958**	**3 843 674**	**4 246 898**	**4 461 972**
SA Housing Fund	3 225 958	3 739 674	4 137 898	4 346 432
Human Resettlement Development	100 000	104 000	109 000	115 540
Social Development	**2 024 073**	**57 300**	**64 235**	**68 185**
Financial Management and Social Security System	10 236	10 800	–	–
Social Security Backlog	2 000 000	–	–	–
HIV/AIDS	12 500	46 500	64 235	68 185
Woman Flagship	1 337	–	–	–
Provincial and Local Government	**261 414**	**274 478**	**270 747**	**261 192**
Local Government Support	160 000	170 000	160 000	143 800
Consolidated Municipal Infrastructure Programme	98 914	104 478	110 747	117 392
Disaster Relief	2 500	–	–	–
Total	**15 869 491**	**12 967 482**	**14 378 405**	**15 274 140**

1 The total includes the supplementary grants to the amount of R2,124 billion, which have been phased into the equitable share, with effect from the 2002/03 financial year.

Table E13 Conditional Grants to Provinces for 2002/03

R thousand	Agriculture	Health	Provincial and Local Government	Infrastructure	Housing	Education	Welfare	Total
Eastern Cape	6 000	436 883	58 466	356 107	581 485	77 390	5 897	1 522 228
Free State	1 400	456 963	35 059	151 913	290 597	26 354	7 710	969 996
Gauteng	–	2 418 044	28 744	157 084	824 940	51 453	8 036	3 488 301
KwaZulu-Natal	4 000	921 905	40 772	331 123	733 759	92 449	9 662	2 133 670
Mpumalanga	2 000	177 094	18 749	208 961	248 038	30 537	8 128	693 507
Northern Cape	1 300	84 458	18 059	52 997	78 309	7 948	3 804	246 875
Northern P.	5 000	301 354	26 001	460 519	392 767	65 676	4 269	1 255 586
North West	3 000	177 786	23 771	135 086	308 001	33 466	6 548	687 658
Western Cape	1 300	1 425 223	24 857	96 210	385 778	33 047	3 246	1 969 661
Total	**24 000**	**6 399 710**	**274 478**	**1 950 000**	**3 843 674**	**418 320**	**57 300**	**12 967 482**

Health grants

Health grants amount to about R6,4 billion in 2002/03, and increase to R7,3 billion by 2004/05. They constitute about 49,4 per cent of the total conditional grants to provinces. The health sector's new framework for tertiary services and training constitutes a major reconfiguration of the three tertiary services and training grants and will improve equity. The new framework provides for the rationalisation of the three grants into two: the National Tertiary Services grant (NTS grant) and a Health Professional Training and Development grant (HPTD grant).

The NTS grant amounts to R3,7 billion in 2002/03, increasing to R4,2 billion in 2004/05. The NTS grant will fund tertiary units in 27 hospitals compared to the current central hospitals grant to 10 central hospitals. This entails redistribution of funds from Western Cape and Gauteng, which are expected to fund any resulting shortfalls from their equitable share or own revenue. The shift between provinces will be phased in over five years. The basis for the grant allocations in the base year is the actual cost of selected tertiary services. Since the cost methodology underlying the new grant includes certain training costs, part of the previous Health Professionals Training and Research grant has been incorporated into the NTS Grant.

The HPTD grant consists of several components. The largest is distributed to provinces according to a formula based on the number of medical students. A new component, amounting to R227 million over five years, will be introduced in 2002/03. This will provide for a phased increase in the number of medical specialists and registrars in under-served provinces to address inter-provincial inequities. The aim is that 25 per cent of post-graduate training capacity should be developed in provinces that do not have such capacity. The allocation for the HPTD grant is R1,3 billion in 2002/03.

The allocation for the Hospital Reviltalisation grant is R520 million in 2002/03, increasing to R576 million in 2004/05. Gauteng will receive R70 million in 2002/03 and R90 million in 2003/04 as a contribution towards the costs of construction of the Pretoria Academic Hospital.

The Integrated Nutrition Programme (INP) is targeted at poor provinces with large populations of school children. Eastern Cape, Northern Province and KwaZulu-Natal receive about 63,5 per cent of the allocation. This grant increases to R617 million in 2004/05 after being kept constant at R582 million. The Department of Health is also finalising a review of this programme to inform any changes in its administration and funding level for the 2003 MTEF.

The Department of Health received R79 million in 2001/02, for financial management, as part of the supplementary grant to pilot hospital management reforms. With the phasing out of the supplementary grant, the financial management grant amounting to R124 million in 2002/03 has been transferred to the Department of Health. This grant, renamed the Hospital Management and Quality Improvement grant will facilitate financial, personnel, and procurement delegations, strengthen financial management capacity and support the implementation of range of hospital quality of care interventions specified in the national policy for quality of care.

Education grants

The Department of Education manages grants for financial management and school quality enhancement, early childhood, and HIV/Aids. The financial management and quality enhancement grant was introduced in 1999/00 and was to be phased out in 2002/03. But the Department of Education proposed the grant be retained to consolidate gains achieved over the last three years in improving education outcomes. The grant plays a pivotal role in the implementation of *Tirisano*. No changes are proposed to the baseline allocations.

The early childhood development grant was introduced in 2001/02, and is phased into the equitable share in 2003/04. The roll-out of the programme, to be phased in over 10 years, will mainly be funded from provincial equitable shares.

The national Department of Education manages two projects from the national special poverty relief fund. The projects are for school building (Thuba Makote project) and training and development of adult learners (Ikhewelo project). These are considered indirect transfers as their outputs will benefit provinces, even though the national department implements them. The Thuba Makote project is an initiative of the Department of Education to develop and pilot cost effective approaches to the design, construction and management of school facilities that can also serve as community development centres. The allocation for this project is R34 million in 2002/03, increasing to R64 million in 2003/04. The Ikhwelo project aims to provide access to literacy and skills development to adult learners. It develops trainers who will train adult learners in agricultural and SMME skills and literacy. The allocation for Ikhwelo increases from R25 million in 2001/02 to R50 million in 2003/04.

National Treasury grants

The major change in National Treasury conditional grants is phasing out the supplementary grant in the 2002 MTEF. This grant has been used to improve financial management and implement budget reforms. The major portion of this grant (R2 billion) is phased into the provincial equitable share. A portion, which was supporting health financial management in provinces, has been transferred to the Department of Health for hospital management reforms and renamed the Hospital Management and Quality Improvement grant.

The provincial infrastructure grant grows from R800 million in 2001/02 to R1,6 billion in 2002/03, R2,3 billion in 2003/04 and R2,9 billion in 2004/05. This brings total infrastructure funds available through this grant to R6,7 billion over this period. To deal with backlogs, the provincial division has been effected using a combination of the equitable share formula and backlog component. This enables government to direct funds towards provinces with large backlogs, without neglecting provinces that inherited higher levels of infrastructure. Provinces are expected to use these funds mainly for rehabilitation and construction of roads, schools, and health facilities and to address infrastructure for rural development. Provincial treasuries administer this grant, with allocations made to line departments. Provinces are also expected to oversee implementation of infrastructure plans and capital projects.

The flood disaster reconstruction grant is used to assist with reconstruction and rehabilitation of infrastructure damaged by floods in 1999/2000 in all the provinces. The 2002 Budget framework sets aside funds for flood reconstruction amounting to R400 million in 2002/03 and R200 million in 2003/04. This grant is phased into the infrastructure grant in the last year.

Housing grants

The Department of Housing administers two grants. The Housing Subsidy Fund provides subsidies for low-income housing. The Human Settlement Redevelopment grant funds urban pilot projects. The department has made a number of policy changes that affect the housing subsidy grant. These include a shift in funding to urban areas, recognising the magnitude of housing backlogs; a focus on improving the quality of housing units being delivered; an increase in the maximum housing subsidy level; and implementation of a medium density housing strategy.

To enable the department to implement the new policies whilst still reducing backlogs, the grant increases by R300 million, R579 million and R574 million above baseline over the next three years. This will raise real growth in housing expenditure about 5,6 per cent a year. The department increases the housing subsidy 6 per cent from R16 000 to R17 920, for inflation. The subsidies for medium density housing will be paid up to a maximum of R27 000. Families earning R3 500 or less will get maximum amount of the subsidy. Given that the total cost for accessing medium density housing is estimated at R54 850 per unit, households that take this option will have to acquire mortgage loans to top up the subsidy.

The Department of Housing reviewed the formula for allocating funds between provinces to align it with the new policy for prioritisation of urban and medium density housing. The key elements of the new formula and weights are:

- Housing need defined by number of homeless living in shacks and informal units (50 per cent)
- Households earning less than R3 500 (30 per cent)
- Population based on the 1996 Census (20 per cent).

To reduce the impact of the new formula on provinces receiving reduced allocations, for the first two years the new formula is only applied to additional allocations above the 2001 baseline. Full implementation of the formula in the allocations begins in 2004/05.

Provincial and Local Government Grants to Provinces

The Department of Provincial and Local Governments transfers two grants to provinces – local government support and consolidated municipal infrastructure programme grants – to assist municipalities. The Local Government Support Grant is part of capacity building grant aimed at supporting smaller municipalities. This grant is allocated to provinces for municipalities facing financial difficulties in the medium term, by supporting efforts to restructure the institutional and financial arrangements. This grant amounts to R474 million over the 2002 MTEF.

A portion of Consolidated Municipal Infrastructure Programme is allocated to provinces to provide technical and administrative support to enable municipalities to implement the infrastructure programme. Provinces are allocated R104 million in 2002/03, increasing to R117 million in 2004/05.

Social development grants

Most social development grants have been phased out. The Financial Management Grant will be phased out this year and R11 million is set aside for provinces in 2002/03. The HIV/Aids grant is most important, as it provides for community and home-based care.

HIV/Aids conditional grants

Government began implementing an integrated strategy for HIV/Aids through the social service departments (Education, Health and Social Development) in the 2000 Budget. The strategy focuses on care and support for children and youth infected and affected by HIV/Aids. Provinces were allocated R110 million in 2001/02, 31 per cent of which is allocated to health departments for HIV testing and counselling and for home-based care, while 58 per cent is allocated to education for implementation of lifeskills programmes in schools. Mindful of the need to step up HIV/Aids programmes, government is setting aside increased earmarked allocations of R346 million in 2002/03, R448 million in 2003/04 and R574 million in 2004/05.

The health share increases from R54 million in 2001/02 to R157 million in 2002/03. This will enable provinces to strengthen voluntary counselling and testing, provincial programme management, introduce step-down care option, and roll-out of the mother-to-child transmission prevention program.

The education sector is responsible for the roll-out of the lifeskills programme in schools, and the Department of Social Development is responsible for the development of home-based care. The HIV/Aids grant allocation to Education increases from R63,5 million in 2001/02 to R142 million in 2002/02, and Social Development share increases from R12,5 million to R46,5 million.

Part 5: Local government allocations

The Constitution vests significant revenue-raising capacity with the local sphere of government in relation to its functions. The bulk of current budgeted municipal revenue (92 per cent) is derived from their own taxes and user charges. Grants from national government, including the equitable share and conditional grants, account for the remaining 8 per cent of municipal revenue.

There is, however, significant variation between municipalities, with poorer municipalities relying on grants for up to 37 per cent of their income and more urban municipalities raising up to 98 per cent of income through local taxes and tariffs. Although this variation may be largely due to differences in fiscal capacity, it may also reflect weak fiscal effort (the failure to collect all revenue due) in some areas.

Local government enjoys the largest increases in allocations for the 2002/03 MTEF. This includes substantial increases to the equitable share and an increase in grants focussed on infrastructure. In total, national transfers to local government have increased from R6,5 billion in 2001/02 to R8,5 billion in 2002/03 and will again increase in 2003/04 to R10,2 billion, and R10,9 billion in 2004/05. This represents an average annual increase of 18,3 percent over the MTEF period. The 2004/05 allocation includes poverty relief programmes amounting to R562 million; these programmes are expected to be phased into the local government share, pending their review by Cabinet later this year.

Types of Transfers

Transfers to local governments from nationally raised revenue take three forms: the equitable share grant, conditional grants and grants-in-kind.

- Equitable share allocations are made to municipalities, without conditions attached. Allocations are made in terms of a policy framework described below.
- Conditional grants for infrastructure and capacity building are disbursed by various departments in pursuit of specific policy objectives and with conditions attached.
- Grants-in-kind are made when municipalities perform certain services on behalf of national or provincial government, or are subsidised by a national or provincial department that provides a service for which a municipality is responsible. An example of the former are certain health and emergency services; an example of the latter is the Water Services Operating Subsidy.

National government is refining the system of intergovernmental transfers to municipalities to improve efficiency, equity, transparency and predictability. This reform programme will:

- Simplify and rationalise national transfers to the local government sphere into three funding streams, namely the equitable share, infrastructure and capacity building grants respectively

- Introduce three-year allocations to individual municipalities for all national transfers, to stabilise municipal budget processes and allow them to develop more credible Integrated Development Plans.
- Require municipalities to show all national and provincial transfers on their budgets and report on outputs achieved by conditional grant programmes, and
- Reduce grants-in-kind (such as asset transfers) to municipalities to enhance the sustainability and accountability of capital programmes.

Table E14 below reflects national transfers to local government by major category.

Table E14: National transfers to local government

R million	2001/02	2002/03	2003/04	2004/05
Equitable share[1]	2,618	3,852	5,021	5,461
Transition grant	578	200	–	–
Water & sanitation operating	660	700	776	768
Subtotal equitable share & related	**3,856**	**4,752**	**5,798**	**6,229**
Consolidated Municipal Infrastructure Programme	927	1,655	2,096	2,374
Water Services Project	758	884	1,012	818
Community Based Public Works Programme[2]	349	260	260	290
Local Ecomomic Development Fund[2]	99	99	117	127
Sport & Recreation facilities[2]	36	84	123	137
National Electrification Programme	–	228	210	210
Urban Transport Fund	38	40	41	44
Integrated Sustainable Rural Development	33	32	–	–
Subtotal capital	**2,241**	**3,282**	**3,859**	**4,000**
Restructuring grant	350	300	315	343
Financial management grant	60	154	162	149
Disaster Relief	3	–	–	–
Municipal System Improvement	43	93	100	132
Subtotal capacity building & restructuring	**456**	**548**	**577**	**624**
Total transfers to local government[3]	**6,552**	**8,581**	**10,234**	**10,854**

1 R293 municipal portion (R358 m) incorporated into equitable share from 2001/02.

2 Poverty relief allocations in 2004/05 are subject to Cabinet review.

3 The administrative overheads of grants have been shifted to the national and/ or provincial share to more accurately reflect actual spending.

The equitable share for local government

Background

The equitable share for local government is an unconditional transfer, with the formula for division between municipalities based on the principles of equity and predictability. It was first introduced in the 1998/99 financial year and replaced previous intergovernmental grants transferred through provinces, and whose division between municipalities was *ad hoc* and differed between provinces.

The equitable share is projected to increase 27,6 per cent a year from the 2001/02 allocation of R2,6 billion to R5,5 billion in 2004/05. As the intergovernmental transfer system is being rationalised, its share as a proportion of national transfers to local government increases from 40 per cent in 2001/02 to 50,3 per cent in 2004/05. These increases are to support institutionbuilding in newly demarcated municipalities and to provide resources to implement commitments on the provision of free basic services.

Two recurrent grants are expected to be incorporated into the equitable share over the MTEF. These are the Water Services Operating Subsidy, and the Local Government Transition Grant. The R293 personnel grant was incorporated in 2000/01.

The Water Services Operating Subsidy, funded through augmentation of the Water Services Trading Account on the Department of Water Affairs and Forestry (DWAF) vote, funds the operation of retail water schemes owned and run by DWAF. These schemes are intended for transfer to municipalities, although a lack of cost recovery and the need for refurbishment of some schemes has resulted in limited progress to date.

DWAF is currently preparing for the transfer of these schemes to municipalities. Once funding has been incorporated, it will enhance the ability of municipalities to address the challenge of providing free basic services to poor households.

The Local Government Transition Grant, aimed at supporting municipalities through the transition process by partially assisting with once-off costs directly related to the amalgamation, is set to be phased into the equitable share in the 2003/04 fiscal year.

The R293 grant was incorporated into the equitable share in 2000/01 although it is not allocated by the same formula. This grant covers towns under the old homeland administrations, and involved the transfer of staff and assets from provinces to municipalities. In 2000/01, the R293 allocation for municipal functions (R447 million) was incorporated into the local government equitable share. Based on the number of people transferred to municipalities or retained by provinces, the local government equitable share increased R358 million while R105 million remained with provinces. For 2002/03 the local government share of the R293 grant has been increased by R23 million. This updates incomplete information provided in 2001/02 on the number of staff that had been transferred to municipalities in KwaZulu-Natal. Based on previous agreements with local governments, municipalities are guaranteed their current R293 grant allocations in full until 2003/04, whereafter this grant will be incorporated into the equitable share.

Equitable share formula

Excluding the small R293 component, the local government equitable share formula consists of two components (with an added element that will allow for the recognition of nodal areas):

- An institutional grant (**I** grant) to support administrative capacity in municipalities
- A basic services grant (**S** grant) firstly, to support the provision of basic services to low-income households; secondly, to provide fiscal resources weighted towards the nodal areas.

The I grant

The institutional grant to local authorities has the following features:

- It assumes there are economies of scale in overhead operating costs in relation to population, so that as population rises, the I grant per capita falls.
- It declines as the average income of the municipality increases, so that for a given population size, poor municipalities receive higher I grants.

The formula for calculating the **I** grant is:

$$\mathbf{I}_i = \mathbf{I}^{*}\mathbf{P}_i^{g} - 0.075(\mathbf{y}_i - 250)^{*}\mathbf{P}_i$$

- where $\mathbf{I}_i$ is the **I** grant allocation to municipality i (with no grant allocated in cases where the formula yields values less than zero);

- $\mathbf{I}^*$ a per capita **I** grant parameter that serves to determine the total amount of money allocated through the **I** grant;
- $\mathbf{P}_i$ is the population in municipality *i*;
- g is a scale parameter that could take any value between > 0 and = 1;
- $\mathbf{y}_i$ is average monthly income per capita in municipality *i.* For values of y_i below the stated monthly per capita expenditure floor, the term is set equal *t*o zero;
- **0.075(y – 250)P** represents normative rates income and assumes individuals will pay 7,5 percent of their income towards property taxes once the poverty threshold of R250 per month (equivalent to R1 100 per month for households) is taken into account. A normative rates approach was taken so municipalities could not manipulate the **I** grant by imposing low rates.

Given the establishment of new municipalities in December 2000, the **I** grant portion of the equitable share was increased initially by 30 per cent in the 2001/02 Adjustment Budget. In the 2002/03 budget, the increase is 42 per cent as measured against the main budget in 2001/02. The **I** grant of the formula will be re-evaluated in future years

The **I** grant formula was adjusted in 2001/02 through changing the poverty threshold from R800 to R1100 (see below). This resulted in a change in the **I** Grant formula from ***0.05(y - 180)P*** to ***0.075(y - 250)P.***

The **I** grant will, from 2002/03, also be extended to category C municipalities to assist with the cost of governance. The **I** grant is a contribution to the cost of governance in a municipality and not an earmarked allocation. Municipal councils have the discretion to budget more or less in this regard, in line with any national framework. It must be noted that relatively well-capacitated category A, B and C municipalities will not qualify for the **I** grant.

The **S** grant

The **S** grant is designed to meet operating costs of a municipality when providing basic services to low income households. For this reason, the formula requires an estimate of the number of people in households below the poverty level for each local authority.

The formula for the **S** grant is:

$$S = abLH_i \text{ where}$$

- a is a phase-in parameter between zero and one based on the municipality’s classification as metropolitan, urban, or rural.
- b is a budget-adjustment parameter, set to adjust the size of grants to the available budget.
- L is the annual per capita cost of providing basic services to households in poverty.
- H_I is number of households in poverty.

Alphas were introduced in acknowledgement of the differences in the financial and institutional capacities of rural and urban municipalities to utilise their equitable share allocations towards basic services. Different phasing-in parameters (alphas) were set which will increase annually until they reach 1. However, the alphas were not changed during the 1999/2000 financial year from the previous financial year (0.7 for metros/urban and 0.25 for rural) in order to increase stability during the transition to the new municipalities. From the 2001/02 financial year, the alphas are again to be increased as the municipal demarcations are now complete. The urban/metro alpha will reach 1 in the 2003/04 financial year whereas the rural alpha will be completely phased-in (reach 1) during the 2005/06 financial year, to take account of capacity to spend efficiently and effectively.

An indicative estimate of R86 per month is used to determine the *L* parameter, which estimates cost of a basic basket of municipal services.

There are two methods to determine H, the number of households in poverty: derived household income and imputed household expenditure. Up to the 2000/01 financial year, the derived household income, supplied by Statistics SA, was used to determine the number of poor households. In a study for Statistics SA in 2000, an alternative was developed to the derived household income method. This new method imputes an income to each household, using regression results of income on a range of variables from the 1995 Income and Expenditure Survey. The relevant variables in the 1996 Census are then used to predict income for each household.

It is widely agreed that data on household expenditure, particularly for households with limited economic resources, provide a better measure of total income (or, more generally, ability to pay) than data on income itself. By combining various data sources (Census 1996 and Income and Expenditure Survey results), Statistics SA found it possible to determine imputed household expenditures for individual municipalities. Because Statistics SA's tabulations of imputed expenditure provide the most accurate measure of poverty available, they were used from the 2001/02 equitable share allocation model for calculating both the **I** and **S** grants. The data is being kept constant until new census data become available.

The basic **S** Grant is aimed at a category B or C municipality with the responsibility and authority for the provision of basic services. In instances where authority is shared within a single jurisdiction, the S grant will be divided between authorities in an equitable manner. Where the division of responsibilities is currently known, this will be effected in the publication of allocations to municipalities. This process will be subject to the provisions of Division of Revenue Act, 2002.

The Minister for Provincial and Local Government will finalise the division of powers and functions between category B and C municipalities in 2002. Any shifts in the functions of municipalities will impact on the 2003/04 and 2004/05 allocations of the equitable share that are indicatively published in 2002/03.

Prioritising nodal municipalities

From the 2001/02 financial year, national government prioritised the funding of the rural development and urban renewal programmes. In 2002/03 a new element is introduced in the **S** grant to allow for the prioritisation of areas identified in the Integrated Sustainable Rural Development Programme and Urban Renewal Programme. Amounts of R200 million, R212 million and R225 million in 2002/03, 2003/04 and 2004/05 will be redirected towards the nodes, enhancing their capacity to fund the provision of basic services.

The additional equitable share allocation will be split between the existing 13 rural nodes and the 8 urban nodes as follows:

- Rural nodes receive 65 per cent (R130 million, R137,8 million and R146,2 million over MTEF period), and
- Urban nodes receive 35 per cent (R70 million, R74,2 million and R78,7 million over MTEF period).

The additional equitable share funds allocated to the rural nodes will be allocated as follows:

Table E15 Additional funds to rural nodes

Rural Nodes R Thousand	Code	Province	2002/03	2003/04	2004/05
Chris Hani/North East	DC13	EC	15 893	16 508	17 029
Ukwahlamba	DC14	EC	10 412	10 508	10 383
OR Tambo	DC15	EC	29 247	30 962	32 802
Alfred Nzo/E.G.Kei	DC44	EC	9 987	11 124	12 589
Thabo Mofutsanyane	DC19	FS	9 699	10 401	10 859
Ugu	DC21	KZN	8 634	8 552	8 202
Umzinyathi	DC24	KZN	1 489	1 478	1 423
Zululand	DC26	KZN	5 068	5 668	6 447
Umkhanyakude	DC27	KZN	7 223	8 017	9 033
Kalahari-Kgalagadi	CBDC1	NC	5 240	5 491	5 736
Sekhukhune	CBDC3	NP	17 678	19 225	21 113
Eastern Municipality	CBDC4	NP	7 876	8 212	8 871
Central Karoo (WC)	DC5	WC	1 555	1 653	1 762
Total			**130 000**	**137 800**	**146 250**

The additional equitable share funds allocated to the urban nodes will be allocated as follows:

Table E16 Additional funds to urban nodes

Urban Node	Municipality	Province	Nodal population	Municipal population	Node value	2002/03	2003/04 R thousand	2004/05
Mdantsane	Buffalo City	EC	250 000	781 213	0,9	13 008	14 012	15 297
Motherwell	Nelson Mandela	EC	320 000	1 113 261	1,0	12 726	13 391	14 070
Alexandra	Johannesburg	GP	350 000	2 925 488	1,2	11 556	12 151	12 723
Inanda	eThekwini	KZN	199 291	3 059 012	1,1	7 858	8 389	9 007
Kwamashu	eThekwini	KZN	142 000	3 059 012	1,2	6 108	6 521	7 001
Galeshewe	Kimberley	NC	120 000	216 905	1,4	5 278	5 553	5 821
Khayalitsha	Cape Town	WC	600 000	2 798 968	0,8	8 851	9 334	9 745
Mitchell’s Plain	Cape Town	WC	265 383	2 798 968	1,0	4 614	4 850	5 086
Total						**70 000**	**74 200**	**78 750**

Equitable share distribution

The equitable share allocation is generally distributed directly to Category A and B municipalities. The exceptions to this rule are:

- Category C municipalities that qualify for the I grant
- District management areas in which there is no Category B municipality and the Category C municipality carries out the relevant functions
- Category B municipalities that have limited treasury functions, in which case the relevant Category C municipalities can manage this allocation on their behalf.
- Category C municipalities which have the authority to provide basic services directly. The S grant component will continue to be calculated by formula for Category B municipalities, subject to the resolution of the powers and functions of Category B and C municipalities respectively. In instances where Category C municipalities provide basic services, the relevant portion of the allocation calculated for a Category B municipality is allocated to the Category C municipality. In some instances, it is not possible to divide the allocations with certainty. In these cases, and in accordance with the principles of cooperative governance set out in the

Constitution and the Division of Revenue Act, 2002, negotiations between municipalities and with the assistance of provincial governments, will be entered into in terms of a framework determined by the Minister for Provincial and Local Government. A failure to reach an acceptable resolution will result in a determination on the division of an allocation being made by national government.

Guaranteed amounts

To prevent serious disruptions in services of municipalities that face substantial declines in transfers as a result of the equitable share formula, municipalities are guaranteed to receive at least 70 percent of the allocation of the previous year. Municipalities received either the **I** plus **S** grant or the guaranteed amount, whichever is the greater. R293 grant allocations are additional to the guaranteed amount for 2001/02 to 2003/04. From 2004/05, the R293 grant allocations will be incorporated into the formula and the guarantee will only apply to these total formula allocations.

Conditional grants to local government

Schedule 5 of the Division of Revenue Bill presents the conditional grants to municipalities. Conditional grants are a small but significant portion of municipal revenue. In particular, conditional grants are used to:

- Incorporate national priorities in municipal budgets
- Promote national norms and standards
- Effect transition by supporting capacity-building and restructuring of municipalities, and
- Address backlogs and regional disparities in municipal infrastructure.

Allocations for conditional grants will rise over the medium term, reflecting the priority attached to the extension of municipal infrastructure. Significant changes are introduced in the policy framework underlying some grants, particularly in infrastructure and capacity building. Below is a summary of all the conditional grants listed in Schedule 5 and 6 of the Division of Revenue Bill 2002.

Capacity-building grants

Many municipalities lack financial management, planning and project management capacity. Several grants support municipal capacity-building.

The range of programmes administered by different national departments is fragmented and has not delivered substantial improvements in municipal capacity to date. Government intends to move toward one consolidated local government capacity-building programme, governed jointly by a multi-departmental team at the national level. A rationalised, coordinated approach toward municipal capacity-building will:

- Encourage national departments to be more transparent about their capacity-building programmes and provide measurable outputs in this regard
- Stabilise municipal budgets and build strong financial management practices upon which other reforms can be implemented and infrastructure and services expanded
- Foster linkages between integrated development planning, spatial planning, and the budget process, and
- Develop project management skills in municipalities.

The Municipal Systems Improvement Programme was created in the 2001 Budget to move towards consolidation of these capacity-building initiatives. In the 2002 Budget, funds are redirected from the Local Government Support Grant and the Restructuring Grant to the Municipal Systems Improvement Programme.

An interim framework for municipal capacity-building allocations will regulate procedures for aligning these allocations into a consolidated grant by 2005/06. The framework provides for multi-departmental teams in the national and provincial spheres to oversee and manage the capacity-building programme, initially prioritising financial management and reform, strategic management and service delivery skills.

Restructuring grants

Restructuring support to large and smaller municipalities is effected through the Restructuring Grant and Local Government Support Grant. The Restructuring Grant provides an opportunity for large municipalities to access funding to implement medium-term fiscal and institutional restructuring exercises, on the basis of their own restructuring plans. It is a demand-driven grant that encourages municipalities to become financially self-sustaining. The Local Government Support Grant is a provincial grant to assist smaller municipalities in financial crisis through management support and emergency funding. The grant is increasingly focused on assisting these municipalities to restructure their medium-term fiscal positions and thus avert future crises.

Both grant programmes are projected to decrease in the medium term, due to limited take-up of funding to date and the implementation of strategic capacity-building programmes.

Table E17 Capacity building and recurrent transfers

R millions	2001/02	2002/03	2003/04	2004/05
Restructuring grant	350	300	315	343
Financial management grant	60	154	162	149
Disaster Relief	3	–	–	–
Municipal System Improvement	43	93	100	132
Total capacity building & recurrent transfers	**456**	**548**	**577**	**624**

Capital transfers to local government

Studies of municipal infrastructure grant disbursements have identified the need to rationalise the number of grants and to improve mechanisms for disbursement. These proposals come in response to problems of inequity in grant distributions, as well as flaws in arrangements for financial accountability identified by National Treasury and the Auditor-General. Rationalising and decentralising disbursement arrangements will offer clear benefits for the sustainability of infrastructure investments, transparency of allocations, and accountability for outcomes.

The rationalisation of the capital transfers to municipalities through the incorporation of other capital grants into CMIP is expected to be complete by 2004/05. These grants include the Community Water Supply and Sanitation Programme, Community Based Public Works Programme, Urban Transport Fund and Local Economic Development Fund. A framework for the phased consolidation of these programmes will be published shortly and placed on the National Treasury's website. The framework will also address the roles and relationships between infrastructure grants, municipal own revenue (such as that derived from RSC levies) and municipal borrowing.

The Consolidated Municipal Infrastructure Programme (CMIP) has been transformed from a project-based to a formula-based mechanism in the 2001/02 financial year. This will serve as a framework for one capital infrastructure grant governed by an interdepartmental team.

Consolidation of transfers and greater transparency in the allocation process will allow challenges related to coordination between the infrastructure and housing programmes to be addressed.

Table E19 Capital transfers to local government

R millions	2001/02	2002/03	2003/04	2004/05
Consolidated Municipal Infrastructure Programme	927	1,655	2,096	2,374
Water Services Project	758	884	1,012	818
Community Based Public Works Programme[1]	349	257	254	290
Local Ecomomic Development Fund[1]	99	99	117	127
Sport & Recreation facilities[1]	36	84	123	137
National Electrification Programme	–	228	210	210
Urban Transport Fund	38	40	41	44
Integrated Sustainable Rural Development	33	32	–	–
Total capital	**2,241**	**3,279**	**3,853**	**4,000**

1 Allocations in 2004/05 are subject to review by Cabinet of all poerty relief programmes.

As CMIP is the most appropriate vehicle for a rationalised capital grant programme, CMIP funding is expected to increase to R2 374 million in 2004/05. This will enhance assistance to municipalities in extending basic infrastructure services. The scope of CMIP funding will be expanded to include the rehabilitation of existing infrastructure, as well as infrastructure extension. CMIP funding is already no longer restricted to bulk and connector infrastructure only, although it continues to support housing programmes.

Consultations over the implementation of the reforms to conditional grants are being concluded, and will be implemented in the 2002 Budget. These reforms include:

- Appropriate phasing of the consolidation of infrastructure grants into a single, large grant to begin in the 2003/04 financial year
- Development of a framework for coordination and consolidation of capacity building grants
- Incorporation of grants-in-kind, such as the Water Services Operating Subsidy, into the equitable share for local government.

The result of this process will be a simpler system of three or four large funding windows that respond directly to government's key policy objectives. Consolidation will improve coordination between objectives, provide an easier framework for administration and the measurement of performance, and ensure that distribution of grants among municipalities is transparent, predictable, policy-sensitive and fair.