7

Provincial and local government finance

The 2002 Budget reflects a strong shift of resources towards provincial and local government. Transfers to provinces grow by 7,9 per cent and local government transfers grow by 18,3 per cent a year over the MTEF, reinforcing programmes aimed at reducing poverty, inequality and vulnerability.

In the provincial sphere, high priority programmes include social security grants, early childhood development, and strengthening of the health sector with special emphasis on HIV/Aids-related programmes.

In the local government sphere, the shift in resources contributes to the provision of core basic services such as water, sanitation, electricity and waste management.

Provinces and municipalities will both continue to prioritise infrastructure development.

Introduction

Provinces and municipalities responsible for key pro-poor programmes

The bulk of Government's pro-poor programmes are the functional responsibility of provinces and local government. These include social and municipal services that have a direct impact on the quality of life of all South Africans, especially the poor. Provision of these services receives substantial financial support from the national budget.

This chapter lays out the division of revenue between the three spheres of government, highlighting changes to the 2002/03 and 2003/04 estimates published in the 2001 Budget. It covers revenue and expenditure trends in provincial and local government. It also identifies notable changes since the publication of the *2001 Medium Term Budget Policy Statement* and the draft 2002 Division of Revenue Bill.

Detailed trends on revenue, expenditure and service delivery will be discussed in the *2002 Intergovernmental Fiscal Review* to be published after the tabling of the national and provincial budgets.

2002 allocations informed by FFC recommendations, details of which are in Annexure E

As in previous years, the division of revenue among the three spheres and the allocations within each sphere were determined after consideration of the recommendations of the Financial and Fiscal Commission (FFC). Annexure E provides a detailed account of the fiscal framework for provincial and local government, including the formulae used to divide resources between provinces and among municipalities. It also sets out Government's response to the recommendations of the FFC on the division of revenue. The annexure contains information on conditional grants, and explains how the local government formulae redistribute funds towards poor municipalities, particularly those within nodal areas identified in the *Integrated Sustainable Rural Development Programme* and *Urban Renewal Programme.*

Policy framework

The financial reform focus shifts to local government

The 2002 MTEF reflects the continuing evolution of South Africa's intergovernmental fiscal system. The initial challenge was the implementation of three-year rolling budgets by the newly established provincial governments, followed by financial management reforms underpinned by the Public Finance Management Act. One of the main challenges over the current MTEF cycle is to institute similar reforms in the local government sphere.

The provincial borrowing framework as well as legislative and constitutional initiatives to support municipal borrowing will constitute major policy developments over the next three years. In the provincial sphere, the focus will be on enhancing capacity to spend on infrastructure, improving the quality of spending, implementation of additional taxation powers and exploration of opportunities for borrowing.

Electricity restructuring will affect municipalities

Restructuring of the electricity distribution industry will impact on the structure of local government finances. The aims of this reform include consolidation and greater administrative efficiency in the provision of electricity services, while expanding the service to unserved communities. Municipalities have a key role to play in ensuring that revenue is not compromised and appropriate management and service standards are maintained.

Extension of provincial taxation powers takes effect this year

Currently, provinces have limited fiscal capacity. The recently enacted Provincial Tax Regulation Process Act (No. 53 of 2001) provides for an expansion of provincial taxation powers. It defines procedures by which the power of provinces to impose taxes is regulated. Under these procedures, a province has control over both the initiation of a provincial tax proposal in accordance with section 228(1) of the Constitution and its ultimate enactment by Parliament and province's legislature.

The Act spells out the process by which a province wishing to impose a new tax must make a submission to the Minister of Finance and Budget Council. The submission will assist the National Treasury, Budget Council, FFC and other interested parties in reviewing each proposal. This includes considering whether a tax is consistent with national economic policy.

Investigation of the feasibility of provincial borrowing under way

After an extensive review of the current provincial borrowing framework by the Budget Council, a second consultative phase has been initiated to develop a borrowing framework that considers the full range of provincial capacities and borrowing options. This process should take about two years.

Opportunity to introduce budget and financial management reforms in the local sphere

In local government, successful completion of the re-demarcation process, which saw a reduction in the number of municipalities from 843 to 284, presents an opportunity for the introduction of budget and financial management reforms. Starting with the 2001 Budget, national Government published three-year allocations for local government to allow municipalities to begin preparing three-year rolling budgets. This will strengthen forward planning and enhance service delivery. However, challenges that still need to be addressed include:

- Improving the participation of local government in the budget process, through the Budget Forum
- Enacting of the Municipal Finance Management Bill
- Finalising the powers and functions of category B and C municipalities
- Moderating growth in personnel costs
- Enhancing municipal revenue raising powers
- Phasing-in three-year municipal budgets based on key programmes
- Ongoing reforms of the grant system.

Tax and legislative reform at local government sphere are aimed at supporting overall reform agenda

Following intensive consultation and drafting over the last two years, parliamentary hearings on the *Municipal Finance Management Bill* commenced in February 2002. The Bill takes local government reforms further, covering general budgeting processes and formats, the modernisation of financial management and the role and responsibilities of national government. Key clauses deal with accountability arrangements over municipal entities, governance, reporting and auditing, as well as sanctions applicable in cases of financial misconduct. It also enables borrowing by municipalities and provides mechanisms to deal with financial emergencies.

The Bill is expected to be enacted by June 2002 for phased implementation thereafter. Reforms in the design of current municipal taxes and borrowing legislation will enhance the ability of municipalities to raise more resources for spending on service delivery. These include pending legislation to reform property and other taxes and measures to clarify the obligations of lenders and borrowers. Such legislation should lead to the establishment of a municipal bond market in the long-term and, in the short-term, enable municipalities to secure project loans.

Three-year rolling budgets to be introduced at local government sphere

The municipal budgeting system is to be modernised. Testing in pilot municipalities will commence in 2002/03 and should allow for extension to all municipalities over the next three years. Reforms to financial reporting are also on track with the introduction of processes to identify, quantify and price municipal assets in line with standards set out in Generally Accepted Municipal Accounting Practices (GAMAP).

The Division of Revenue Bill will deepen reforms to grant system

The 2002 Division of Revenue Bill seeks to deepen reforms introduced in the previous Acts. The draft Bill, published in a gazette for public comment in December 2001, included a framework that set out objectives, conditions and the horizontal division of funds among provinces for each grant. Key provisions of the Division of Revenue Bill will be included in the revised Public Finance Management Act and the Municipal Financial Management Bill, ensuring better alignment in the management of intergovernmental transfers with the requirements of the present Division of Revenue Act. To facilitate better planning and implementation of grants, the Bill outlines transfers to provincial and local governments.

Transfers to municipalities to be simplified

The 2002 MTEF will also see a simplification of transfers to local government, increasing certainty and greater flexibility for municipalities. Infrastructure and capacity building grants will be consolidated into two separate funding streams.

Significant changes occur in the policy framework underlying some grants, particularly in health and housing. Further details are provided in annexure E and the appendix to the Division of Revenue Bill.

Division of revenue

The division of revenue between spheres is determined by an extended Cabinet meeting including provincial Premiers, and follows a consultative process involving the Budget Council and Budget Forum incorporating organised local government, the Ministers' Committee on the Budget and the constitutionally independent FFC. The intergovernmental Division of Revenue workshop contributes to the deliberation and recommendations on the final division of revenue considered by Cabinet.

Division of Revenue encapsulates policy priorities

Table 7.1 sets out the division of revenue between spheres, and the revisions to the forward estimates published in the 2001 Budget.

It reflects the following considerations:

- Accelerating service delivery and improving public service quality in line with Government's priority of reducing poverty, inequality and vulnerability.
- Helping provincial and local governments play a greater role in enhancing the outreach of social programmes, especially those targeting the poor and that enhance economic growth and job creation.
- Expanding early childhood development, improving access to education for children with special needs and strengthening mathematics and science education.
- Investing in construction, rehabilitation and maintenance of infrastructure, mainly in education, health and transport.
- Helping the social development sector manage the impact of HIV/Aids on home-based care and increased take-up of the child support grant.

- Bolstering the health sector to cope with the impact of HIV/Aids and to enable the recruitment of skilled health professionals, especially in rural areas.
- Assisting municipalities to provide basic services to the poor and to further expand municipal infrastructure.
- Targeting resources towards nodal areas identified in the Integrated Sustainable Rural Development and Urban Renewal Programmes.

Table 7.1 The division of revenue between the spheres of government

	2000/01	2001/02		2002/03	2003/04	2004/05
R million	**Outcome**	**Budget[1]**	**Revised**	**Medium-term estimates**		
National allocation	73 142	84 286	87 317	96 106	103 307	109 911
Provincial allocation	108 904	117 387	121 206	132 420	142 844	152 363
Equitable share	*98 398*	*106 260*	*107 460*	*119 452*	*128 466*	*137 089*
Conditional grants	*10 506*	*11 127*	*13 745*	*12 967*	*14 378*	*15 274*
Local government allocation	5 576	6 506	6 552	8 580	10 235	10 854
Equitable share	*2 315*	*2 618*	*2 618*	*3 852*	*5 021*	*5 461*
Conditional grants	*3 261*	*3 888*	*3 934*	*4 728*	*5 213*	*5 393*
Allocated expenditure[2]	**187 621**	**208 179**	**215 075**	**237 106**	**256 386**	**273 128**
Percentage shares						
National	*39,0%*	*40,5%*	*40,6%*	*40,5%*	*40,3%*	*40,2%*
Provinces	*58,0%*	*56,4%*	*56,4%*	*55,8%*	*55,7%*	*55,8%*
Local government	*3,0%*	*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.

2 Excludes the contingency reserve for the period 2002/03 to 2004/05, which remain unallocated at this stage.

Revised framework

Baseline allocations published in 2001 have been increased substantially

Revisions to 2001/02 expenditure were approved by Parliament in the *2001 Adjusted Estimates*, and provide for R4,8 billion additional expenditure. Of this, R2,9 billion was allocated to national departments, R1,5 billion to the provinces and R328 million to local government. In addition to these adjustments, an amount of R2 billion will be transferred to provinces to fund additional costs related to the payment of arrears in social security grants.

Government spending shows substantial real growth over the MTEF

The revised national budget framework provides for additional spending of R13,4 billion in 2002/03 and R17,9 billion in 2003/04, over the forward estimates published in the *2001 Budget Review.* Excluding debt service costs and provision for contingencies, allocations totalling R237,1 billion are provided for in 2002/03, rising to R273,1 billion in 2004/05.

National departments receive about 40 per cent of allocated expenditure, provinces 56 per cent and local government 4 per cent.

Provincial government finance

Transfers from national government dominate provincial government finances. Provincial own revenue accounts for about 3 per cent of total provincial revenue. Table 7.2 sets out the components of provincial revenue from 2001/02 to 2004/05.

Table 7.2 Provincial revenue

	2001/02		2002/03	2003/04	2004/05
	Budget	Revised	Medium-term estimates		
R million		estimate[1]			
Transfer from national	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*
Own revenue	3 957	4 313	4 103	4 448	4 806
Total	**121 344**	**125 519**	**136 523**	**147 293**	**157 169**
Percentage growth					
Transfers from national	–	–	*9,3%*	*7,9%*	*6,7%*
Equitable share	–	–	*11,2%*	*7,5%*	*6,7%*
Conditional grants	–	–	*-5,7%*	*10,9%*	*6,2%*
Own revenue	–	–	*-4,9%*	*8,4%*	*8,0%*
Total	**–**	**–**	***8,8%***	***7,9%***	***6,7%***

1 The total differs from the total revenue in table 7.7 due to an amount of R303 million transferred to provinces from extra budgetary institutions.

Transfers to the provincial sphere

Transfers to the provincial sphere take two forms: the equitable share, which accounts for 90 per cent of transfers to provinces, and conditional grants, which account for the remaining 10 per cent. Table 7.3 shows the total transfers to each province over the 2002 MTEF period.

Table 7.3 Total transfers to provinces

	2000/01	2001/02		2002/03	2003/04	2004/05
	Outcome	Budget	Revised	Medium-term estimates		
R million			estimate			
Eastern Cape	18 316	19 515	19 784	22 020	23 639	25 252
Free State	7 443	8 036	8 157	8 966	9 604	10 299
Gauteng	17 650	19 321	19 530	21 712	23 469	25 009
KwaZulu-Natal	21 724	23 292	23 585	26 477	28 873	30 819
Mpumalanga	7 314	7 903	8 312	9 122	9 973	10 637
Northern Cape	2 534	2 764	2 810	3 153	3 408	3 645
Northern Province	14 249	15 307	15 510	17 401	18 861	19 979
North West	8 865	9 471	9 602	10 680	11 484	12 339
Western Cape	11 144	11 778	11 915	12 889	13 534	14 384
Unallocated[1]	–	–	2 000	–	–	–
Total	**109 237**	**117 387**	**121 206**	**132 420**	**142 844**	**152 363**

1 Reflects funds earmarked for social security backlog which are unallocated at this stage.

National transfers to provinces grow by 7,9 per cent a year over the MTEF period

Provinces' share of nationally raised revenue rises from a revised level of R121,2 billion in 2001/02 to R132,4 billion in 2002/03 and grows at an annual average rate of 7,9 per cent to R152,4 billion in 2004/05.

Table 7.4 provides a breakdown of total transfers to provinces for 2002/03.

Table 7.4 Transfers to provinces 2002/03

R million	Equitable share	Conditional grants: Health	Finance	Housing	Other[1]	Total
Eastern Cape	20 498	437	356	581	148	22 020
Free State	7 996	457	152	291	71	8 966
Gauteng	18 224	2 418	157	825	88	21 712
KwaZulu-Natal	24 343	922	331	734	147	26 477
Mpumalanga	8 428	177	209	248	59	9 122
Northern Cape	2 907	84	53	78	31	3 153
Northern Province	16 145	301	461	393	101	17 401
North West	9 993	178	135	308	67	10 680
Western Cape	10 919	1 425	96	386	62	12 889
Total	**119 452**	**6 400**	**1 950**	**3 844**	**774**	**132 420**

1 Includes small grants mainly in education, provincial and local government and welfare.

The equitable share

Growth in transfers to provinces largely due to equitable share

The equitable share is the largest source of provincial revenue. Over the 2002 MTEF period, the equitable share allocation will rise from a revised R107,5 billion in 2001/02 to R119,5 billion in 2002/03 and grows at an annual average rate of 8,5 per cent. Table 7.5 below sets out the provincial equitable shares for the 2002 Budget. The shares are allocated on the basis of relative need with each province allocating its equitable share according to its own or agreed priorities.

Table 7.5 Provincial equitable shares

R million	2000/01 Outcome	2001/02 Budget	2001/02 Revised estimate	2002/03 Medium-term estimates	2003/04	2004/05
Eastern Cape	17 139	18 344	18 550	20 498	21 856	23 324
Free State	6 685	7 184	7 269	7 996	8 538	9 111
Gauteng	14 840	16 149	16 329	18 224	19 736	21 061
KwaZulu-Natal	19 693	21 468	21 708	24 343	26 416	28 190
Mpumalanga	6 692	7 352	7 435	8 428	9 221	9 840
Northern Cape	2 393	2 582	2 609	2 907	3 120	3 329
Northern Province	13 171	14 295	14 464	16 145	17 459	18 631
North West	8 344	8 936	9 038	9 993	10 666	11 382
Western Cape	9 441	9 948	10 056	10 919	11 453	12 221
Total	**98 398**	**106 260**	**107 460**	**119 452**	**128 466**	**137 089**

The equitable share is divided by an objective formula

The equitable share is allocated "horizontally" among the nine provinces according to the equitable share formula. Based on 1996 recommendations of the FFC, it recognises that provinces have different economic profiles, demographic variations and significant variations in socio-economic circumstances. The redistributive nature of the formula assists all provinces to provide basic levels of service for their citizens.

Current formula takes account of FFC recommendations

For the 2001 Budget, the FFC reviewed the provincial transfer system. It proposed an alternative approach to allocating funds, which would entail dispensing with the present formula in favour of a cost based distribution of funds. The 'costed norms approach' entails estimating the cost of basic services in education, health and welfare based on nationally determined norms and standards in each sector. The recommendations for the 2002 Budget reflect an ongoing enquiry into mechanisms for objectively determining provincial allocations.

The weight of the welfare component increases by 1 percentage point

After a thorough examination of the practicality of the alternative approach and its likely impact on the stability of the intergovernmental system, Government agreed that the structure of the equitable share formula should be retained for the 2002 Budget. The basis of this decision is set out in detail in Annexure E. The weights of the formula, however, have been adjusted to reflect spending on social services in provinces in recent years. Based on social service spending trends reported in the *2001 Intergovernmental Fiscal Review*, the weight for the welfare component is increased by one percentage point and the weight for the economic component decreased by one percentage point. In addition, Government agreed that the formula be updated to take account of education enrolment data for the 1998-2000 period.

The seven components of the equitable share formula

The equitable share formula comprises seven components, explained in detail in Annexure E. The components are summarised below, with the share of each given in brackets:

- An education share based on the average school-age population (ages 6–17) and the number of learners in schools (41 per cent).
- A health share based on the proportion of the population without access to medical aid funding (19 per cent).
- A social security component 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 *1995 Income and Expenditure Survey* (18 per cent).
- An economic output share based on the distribution of total remuneration in the country (7 per cent).
- A basic share derived from each province's share of the total population of the country (7 per cent).
- An institutional component divided equally among the provinces to contribute to the costs of running a provincial government that are not associated with the size of population (5 per cent).
- A backlog component based on the distribution of capital needs as captured in the schools register of needs, the audit of hospital facilities and share of the rural population (3 per cent).

Equitable share phased in over five years

The 2002 Budget marks the fourth year of the phased approach to the implementation of the equitable share formula. This approach was developed as a response to differences between the data on which the formula was originally based and the data contained in the subsequent census of 1996, and on the need to avoid disruption to provincial government finances while adjusting for the new data.

Conditional grants

Conditional grants fund national priorities

In addition to the equitable share, conditional grants remain an important part of the intergovernmental transfer system. They are used to:

- Provide for national priorities in provincial budgets
- Promote national norms and standards
- Compensate provinces for cross-boundary flows and specialised services that have cross-province externalities
- Effect transition by supporting capacity building and structural adjustment within recipient administrations.

Rationalisation of conditional grants continues

Conditional grants are overseen by national government and are earmarked for priority programmes. They are reflected in the 2002 Division of Revenue Bill, which spells out monitoring and reporting requirements. The 2002 Budget takes further steps in restructuring and rationalising conditional grants to improve administrative efficiency.

Treasury supplementary grant phased out with immediate effect

The supplementary grant, administered by the National Treasury over the past four years, is being phased out. In the 2001 Budget, a number of small grants were phased into the supplementary grant. With the exception of the health financial management grant, which is shifted to the Department of Health, the remaining grants have now been phased into the equitable share.

Secondly, significant changes are introduced in the policy frameworks underlying the health and housing grants. Certain policy and equity considerations have necessitated restructuring and rationalising health grants in the 2002 Budget.

The national Departments of Health and Housing administer the largest grants to provinces. Table 7.6 sets out conditional grants for the next three years.

Housing and HIV/Aids grants rise sharply over the MTEF

Except for the housing subsidy and HIV/Aids grants, no significant changes are made to the global allocations for conditional grants in the 2002 Budget. Housing grants increase by 10,3 per cent a year while grants to tackle HIV/Aids increase sevenfold over the period. Table 7.6 indicates that conditional grant funding decreases from a revised R13,7 billion in 2001/02 to about R13,0 billion in 2002/03. This is mainly due to a once-off payment of R2 billion in 2001/02 for social security backlogs. Excluding this once-off amount, conditional grants grow by 9,2 per cent a year to R15,3 billion in 2004/05.

Infrastructure grant grows in anticipation of improved institutional capacity

The provincial infrastructure grant, introduced in the 2000 Budget, was significantly increased in the 2001 Budget. The 2002 Budget maintains this trend, with further increases in the third year. As a result, provinces will receive R6,7 billion from this grant over the three-year period, an increase of about 44 per cent over the 2001 Budget. Roads, schools, health facilities and rural development projects will continue to receive priority for these funds.

Infrastructure spending in the current year has been slower than anticipated because provinces were not institutionally geared for planning and managing infrastructure programmes. A review of problems in infrastructure delivery has been initiated. This study will provide a diagnostic analysis of the current constraints and make recommendations on institutional reforms and capacity requirements to accelerate the pace of infrastructure delivery.

Early Childhood Development grant phases into the equitable share in 2004/05

The Early Childhood Development grant was introduced in the 2001 Budget to enable the national Department of Education to continue with pilot projects for early childhood and pre-primary schooling. As this programme - aimed at improving the long-term performance of learners - becomes a core function of provincial education departments, the grant is phased out and provinces are expected to budget for the programme from the equitable share.

Quality enhancement in education remains priority

In addition to the Early Childhood Development Grant, the Department of Education will provide R224 million in 2002/03, R234 million in 2003/04 and R248 million in 2004/05 to support quality enhancement and financial management in education. The distribution of the grant is redistributive, with more funds going to poorer provinces.

Health still manages biggest proportion of conditional grants

Health grants constitute over 49 per cent of total conditional grants to provinces. The two largest grants fund specialist tertiary services in central hospitals, research activities and health professional training. The health sector undertook a review of tertiary and training grants and proposed a major reconfiguration of the three tertiary services and training grants (central hospitals, redistribution of specialised health services and training and research grants) in the 2002 Budget.

Three health grants streamlined

The new framework for tertiary services and training grants will support a more equitable distribution of services over time. It provides for rationalisation of the three grants into two: a National Tertiary Service 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. It will fund tertiary units in 27 hospitals, whereas the current central hospitals grant only took into account service costs in ten hospitals. This will lead to a redistribution of funds from Western Cape and Gauteng to other provinces. This shift is phased in over five years.

Health Professional and Development grant aims to boost post-graduate training capacity

The HPTD grant consists of two components. The major portion is distributed to provinces based on the number of current medical students. It also provides for a phased increase in the number of medical specialists and registrars in under-served provinces. The aim is that 25 per cent of post-graduate training capacity be developed in provinces that presently do not have such capacity. The allocation for the HPTD grant is R1,3 billion in 2002/03 rising to R1,4 billion by 2004/05.

Table 7.6 Conditional grants to provinces

R million	2001/02 Revised[1]	2002/03	2003/04	2004/05
		Medium-term estimates		
Agriculture	**28**	**24**	**38**	**–**
Land Care Projects	28	24	38	–
Health	**5 984**	**6 400**	**6 805**	**7 257**
National Tertiary Services	3 460	3 667	3 893	4 152
Health Professions Training and Development	1 234	1 279	1 299	1 393
Hospital Revitalisation	500	520	543	576
Nkosi Luthuli Academic Hospital	104	–	–	–
Pretoria Academic Hospital	50	70	90	–
HIV/AIDS	54	157	267	380
Integrated Nutrition Programme	582	582	582	617
Hospital Management Improvement	–	124	130	138
National Treasury	**3 948**	**1 950**	**2 514**	**2 853**
Supplementary Allocation	2 248	–	–	–
Provincial Infrastructure	800	1 550	2 314	2 853
Infrastructure Rehabilitation	600	400	200	–
Section 100(1)(a) Agreement	300	–	–	–
Education	**298**	**418**	**440**	**373**
Financial Management and Quality Enhancement	213	224	234	248
HIV/AIDS	64	142	117	125
Early Childhood Development	21	52	88	–
Housing	**3 326**	**3 844**	**4 247**	**4 462**
SA Housing Fund	3 226	3 740	4 138	4 346
Human Resettlement Development	100	104	109	116
Social Development	**2 024**	**57**	**64**	**68**
Financial Management and Social Security System	10	11	–	–
Social Security Backlog	2 000	–	–	–
HIV/AIDS	13	47	64	68
Woman Flagship	1	–	–	–
Provincial and Local Government	**261**	**274**	**271**	**261**
Local Government Support	160	170	160	144
Consolidated Municipal Infrastructure Programme	99	104	111	117
Disaster Relief	3	–	–	–
Total	**15 869**	**12 967**	**14 378**	**15 274**

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.

HIV/Aids grants to be increased

The government aims to step up implementation of an enhanced strategy for prevention of HIV/Aids, focusing on care and support for children and youth affected by HIV/Aids. The allocation resides on the health vote and increases from R130 million in 2001/02 and to R574 million in 2004/05. These increases will strengthen home and community-based care, support voluntary counselling and testing and provide for the roll-out of the mother-to-child transmission prevention programme.

Amounts on the education and social development votes cater for lifeskills programmes and community support for people affected by HIV/Aids. The National Department of Health coordinates the programme.

Earmarked allocation to strengthen financial management in health

The hospital management improvement grant, moved from the National Treasury's supplementary grant, will aim to improve hospital management improvement and the quality of healthcare, initially in tertiary hospitals but gradually expanding to other hospitals. This grant receives R124 million in 2002/03 rising to R137,8 million in 2004/05.

Hospital revitalisation programme

The hospital revitalisation grant (formerly rehabilitation grant) receives R1,6 billion over the MTEF period. The grant will support a hospital modernisation and transformation programme to improve the quality of care in line with the national planning framework.

Housing grant increased to accommodate medium density housing and higher subsidies

The housing allocation increases by R300 million in 2002/03, R579 million in 2003/04 and R574 million in 2004/05 above forward estimates, with a total allocation of R12,6 billion over the three-year period. This will enable the Department of Housing to accelerate housing delivery in urban areas, focus on improving the quality of housing units through an increase in the subsidy level and implementing the medium density housing strategy.

Provinces receive grants to assist them in supporting local government

Two grants managed by the Department of Provincial and Local Government are transferred to provinces:

- The Local Government Support Grant (R474 million over the period) goes to provinces to provide assistance to municipalities facing financial difficulties by supporting their efforts to restructure institutional and financial arrangements.
- A portion of the Consolidated Municipal Infrastructure Programme (R333 million) goes to provinces to provide technical and administrative support to municipalities to implement the programme.

Provincial own revenue

Provincial own revenue makes up less than 3 per cent of total provincial revenue. The main sources of provincial own revenue are vehicle registration fees collected in terms of the Road Traffic Act (about 45 per cent), hospital fees (10 per cent) and gambling licenses (10 per cent).

Growth in provincial own revenue continues to be sluggish

Between 1998/99 and 2001/02, provincial own revenue grew at an annual average rate of 7,9 per cent, from R3,4 billion in 1998/99 to R4,3 billion in 2001/02. Provincial own revenue is projected to decrease by R200 million or 4,4 per cent from R4,5 billion in 2000/01 to a revised estimate of R4,3 billion in 2001/02. Own revenue is projected to decline by 4,9 per cent to R4,1 billion in 2002/03 but is set to rise to R4,8 billion in 2004/05, though still remaining slightly below 3 per cent of total provincial revenue over the next three years. This is partly due to substantial growth in national transfers to provinces.

Steps are taken to improve the efficacy of the tax system and optimise provincial own revenue collection. These include reviewing billing systems and introducing incentives for provincial departments.

Provincial budget estimates

Table 7.7 presents actual provincial revenue and expenditure for 1998/99 to 2000/01, a revised estimate for 2001/02, and projected estimates for 2002/03 to 2004/05.

Table 7.7 Consolidated provincial expenditure according to function[1]

R million	1998/99 Outcome	1999/00 Outcome	2000/01 Outcome	2001/02 Revised estimate	2002/03 Medium-term estimates	2003/04	2004/05
Education	38 723	39 828	43 255	47 243	50 778	54 654	57 541
Health	24 025	25 110	27 621	30 731	32 871	35 418	37 409
Welfare	18 441	19 373	20 929	23 843	30 265	31 621	34 274
Housing and Community Development	5 315	4 507	5 161	5 398	6 160	6 660	7 021
Other functions	10 772	11 250	13 560	15 183	17 822	18 936	20 586
Unallocated reserve	–	–	–	–	295	278	266
Total expenditure	**97 275**	**100 068**	**110 526**	**122 399**	**138 189**	**147 567**	**157 096**
Total revenue	**97 842**	**103 628**	**113 731**	**125 822**	**136 523**	**147 293**	**157 169**
Surplus/(deficit)	**566**	**3 559**	**3 206**	**3 423**	**-1 666**	**-274**	**73**
Economic classification							
Current expenditure	90 896	93 857	102 884	112 769	125 129	132 981	141 039
Of which remuneration	*57 339*	*59 461*	*63 912*	*67 818*	*72 838*	*77 768*	*82 190*
Capital expenditure (incl. Housing)	6 380	6 211	7 642	9 630	12 765	14 308	15 792
Percentage shares of total expenditure							
Social services	*83,5%*	*84,3%*	*83,1%*	*83,2%*	*82,4%*	*82,5%*	*82,3%*
Other functions(Incl. Housing)	*16,5%*	*15,7%*	*16,9%*	*16,8%*	*17,4%*	*17,3%*	*17,6%*
Contingency reserve					*0,2%*	*0,2%*	*0,2%*

1 Inherited debt, local government transfers and unallocated reserves have been deducted from total provincial spending.

Provincial expenditure continues to show strong recovery over the MTEF

Provincial expenditure on social services recovers strongly over the next three years, growing at 11,9 per cent in 2002/03 and by 8,3 per cent a year over the period. This is due to significant increases in the take-up of the child support grant, above inflation grant increases and provincial responses to the impact of HIV/Aids. Table 7.7 also shows that total provincial expenditure grows by 12,9 per cent from a revised R122,4 billion in 2001/02 to a projected R138,2 billion in 2002/03. This is attributable to the payment of social security backlogs and strong growth in capital expenditure.

Share of social services stable around 83 per cent of total expenditure

Social service spending constitutes the largest proportion of provincial budgets. The share of actual expenditure on social services rose from 83,5 per cent in 1998/99 to 84,3 per cent in 1999/00. Although social services expenditure still grows fast on a year-on-year basis, its share of total spending declines marginally to 82,3 per cent in 2004/05 and levels off at about 82 per cent over the MTEF. Capital expenditure rises while the growth rate of the wage bill of provincial governments slows down. These trends indicate that some of the measures initiated three years ago to contain wage bill growth and improve the quality of service delivery, are beginning to yield results.

Strong growth in capital expenditure

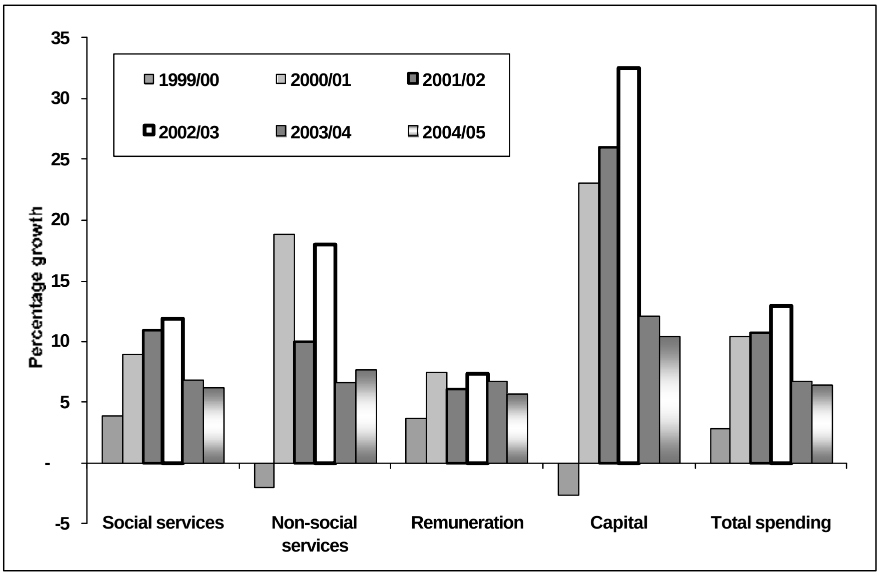
Capital expenditure grows by 17,9 per cent a year between 2001/02 and 2004/05, from R9,6 billion to R15,8 billion, reflecting the strong growth in infrastructure grants and a high priority attached to capital spending in provinces.

Slow pace of spending on capital projects reflects need to strengthen capacity

The long lead-time of infrastructure projects may result in underspending in 2001/02. In the 2001 Budget, provinces projected growth in capital expenditure of 21,5 per cent. However, latest projections indicate that actual expenditure on some projects may not take place by the end of the financial year. This underscores the need to improve capacity to manage and implement infrastructure projects.

Increases in social service spending up to 2000/01 were partially accommodated by a reduction in planned capital spending. However, trends in provincial budgets reflect a reversal of the downward trend in non-social services expenditure and an upward trend in infrastructure investment. The provincial infrastructure grant will help sustain this trend over the medium term. figure 7.1 illustrates these trends.

Figure 7.1:Growth in categories of spending



Provincial surplus expected in 2001/02

The R3,4 billion surplus that provinces are reflecting this year is mainly due to the transfer of R2 billion by national government late in 2001/02 for social security backlogs that will probably only be paid to beneficiaries in 2002/03. This implies that provinces are likely to run a combined surplus in 2001/02 followed by a deficit of about R1,6 billion in 2002/03.

Local government finance

Transformation continues

The largest increases in the 2002 Budget are in transfers to the local sphere, rising by 18,3 per cent a year from 2001/02 to 2004/05. These increases support the delivery of basic municipal services, infrastructure investment and reform of the local government system.

Local government transfers increase sharply by 18,3 per cent over the MTEF

Since 1994, local government has undergone a thorough transformation with the creation of 284 municipalities in December 2000 providing shape to a sphere of Government that is responsible for key services impacting on the lives of all South Africans. These municipal reforms support the drive to expand infrastructure and services to all and are complemented by initiatives to restructure sectors such as electricity, water, sanitation, and waste management.

Chapter 8 of the *2001 Intergovernmental Fiscal Review* discusses these policy challenges. It acknowledges that new municipalities face many pressures as they seek to meet the developmental goals set out in the Constitution without disrupting the financial sustainability.

Local government has to address development challenges and be fiscally sustainable

Transfers from national government constitute a small part of local government finances. The long-term viability of municipalities depends on improved revenue capacity and sound financial management. For this reason, initiatives by the National Treasury have focused on working with municipalities to improve multi-year budgeting and the reliability of information to increase accountability and transparency at a local level. The Municipal Finance Management Bill and the introduction of Generally Accepted Municipal Accounting Practices (GAMAP) will reinforce norms and standards in this regard.

Policy changes will also make municipalities more attractive to private lenders and investors by creating a more predictable and stable fiscal environment. Government will continue to rationalise the system of intergovernmental transfers to support municipal reform, alongside policy reforms and institutional support to bolster the fiscal base of municipalities.

As in previous years, the Minister of Finance has indicated guideline growth parameters for municipal budgets. Aimed at fiscal prudence and macroeconomic stability, this guideline is set at 6 per cent for 2002-03. Exemptions apply to funding received from national and provincial governments and suitably financed capital spending. Further deviations will be accommodated after considering issues of financial viability, revenue collection, sustainability of budget proposals and the availability of funding to support the extension of services to under-serviced areas.

Growth in municipal operational budgets capped at 6 per cent

The municipal fiscal framework

In aggregate, own revenue accounts for over 90 per cent of total local government income, though this varies considerably between municipalities. National government supports municipalities in delivering basic services to poor households through the equitable share

National transfers support basic service delivery to the poor allocated from nationally raised revenues. Transfers for infrastructure investment, capacity building and restructuring are also provided.

The 2002 Budget shifts resources towards local government

The 2002 Budget provides significant increases in the allocation to local government. Total allocations rise from R6,6 billion in 2001/02 to R8,6 billion in 2002/03, R10,2 billion in 2003/04, and R10,9 billion in 2004/05. These allocations are R1,6 billion and R2,4 billion higher in 2002/03 and 2003/04 respectively than the forward estimates published in the 2001 Budget and exclude amounts from provincial own revenue, some agency payments and some in-kind services provided by national departments. The administrative overheads or in-kind support associated with conditional grants have been shifted to the national and provincial shares to reflect actual transfers more accurately.

Additional allocations to local government also include equitable share allocations for district (category C) municipalities. The earlier exclusion of district municipalities was due to uncertainty with regard to the division of powers and functions between non-metropolitan (category B) and district municipalities. The 2002 Division of Revenue Bill takes account of the judgement passed by the KwaZulu-Natal Supreme Court in this regard.

The equitable share

The equitable share is an unconditional transfer to assist municipalities to deliver basic services such as water, sanitation, electricity and refuse removal to poor households. The equitable share formula, outlined in detail in annexure E, continues to facilitate a shift in resources towards poor municipalities.

Substantial increases to equitable share support free basic services

In light of Governments objective of providing a basic level of free municipal services to poor households, substantial increases are being provided over the three-year period. The equitable share rises from a revised R2,6 billion in 2001/02 to R3,9 billion in 2002/03, R5,0 billion in 2003/04 and to R5,5 billion in 2004/05. These increases take the local government share of nationally raised revenue up from 2,5 per cent in 1999/00 to 4,0 per cent by 2003/04 and will assist municipalities in expanding services to poor households.

In the main, the provision of free basic services is funded from within local budgets through reprioritisation towards basic service delivery and a degree of cross-subsidisation in the tariff structure for certain services. The main component of the local government equitable share formula targets poor municipalities with small revenue bases and limited potential to effect local cross-subsidisation.

Investigation of possible changes to equitable share formula under way

The equitable share formula is being reviewed to take account of revenue-raising capacity and data on the cost of providing services. Reforms to the formula in 2002/03 include:

- An increase in the allocation of the institutional grant component to assist fiscally weak and district municipalities
- Greater support for nodal areas prioritised for rural development and urban renewal
- Ongoing improvements in data to reflect new municipal boundaries

- Further absorption of the former R293 personnel grant.

More detail on changes to the formula is provided in Annexure E.

Table 7.8 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 Systems 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 Allocations in 2004/05 are subject to review by Cabinet of all poverty relief programmes.

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

Incorporating other grants into the equitable share

Local government grants are being consolidated to give recipient municipalities greater responsibility for the use of funds and to increase certainty and transparency in grant allocations. Changes to the grant structure include:

- The R293 personnel grant, originally aimed at municipalities that fell into former homeland areas, has now been incorporated into the equitable share.
- The Transition Grant, designed to assist municipalities in meeting the costs of amalgamation, will be phased into the equitable share in 2003/04.
- Consideration is being given to moving the Water Services Operating Subsidy into the equitable share. This allocation, made as an augmentation to the Water Services Trading Account on the vote of the Department of Water Affairs and Forestry, provides an untargeted subsidy to users of water schemes directly operated by that Department. Once these schemes are transferred to municipalities, it is envisaged that the funds will be incorporated in the local government equitable share.

Transfers for municipal infrastructure

Local government infrastructure development focuses on poor areas

The framework for planning and financing infrastructure investment requires municipalities to use their own revenue, grant funding and loans from the capital market. The primary objective of infrastructure grants is to expand delivery of basic infrastructure services to poor households.

Total budgetary allocations for local government infrastructure transfers (including electrification) are also set to rise significantly from R2,2 billion in 2001/02 to R3,3 billion in 2002/03, R3,9 billion in 2003/04, and to R4,0 billion in 2004/05. This represents an average annual increase of 21,3 per cent between 2001/02 and 2004/05.

Consolidation of municipal infrastructure funding explored

A single Municipal Infrastructure Grant replacing existing grants will be phased in over the next two years. Funds will be allocated to municipalities by formula on a three-year basis to improve the predictability and transparency of transfers. Municipalities with adequate capacity will be permitted greater discretion in the use of funds to enhance the sustainability of assets created. The new grant will support investment objectives identified in local integrated development plans. The formula for the grant, associated conditions and related issues will be addressed in a discussion document to be published this year.

Capacity Building Grants

Consolidation of grants to bring strategic focus

The development of a capacity building framework allows for further grant consolidation in the local sphere through the amalgamation of various recurrent grants into the Municipal Systems Improvement Grant. In 2002/03, funds are redirected from the Local Government Support Grant. As a result, this grant increases to R93 million in 2002/03, R100 million in 2003/04 and R132 million in 2004/05. Total allocations for capacity building and restructuring programmes amount to R548 million in 2002/03, R577 million in 2003/04 and R624 million in 2004/05. This represents an average annual increase of 4,7 per cent over the period.

International technical expertise to assist financial management reforms

The Financial Management Grant is projected to spend R154 million in 2002/03, R162 million in 2003/04 and R149 million in 2004/05 to assist municipalities to reform financial management and budgeting practices. Government aims to source international technical expertise to assist in implementing the reforms proposed in the Municipal Financial Management Bill in 30 pilot municipalities.

Support to larger municipalities

Large municipalities - with budgets of over R300 million – are eligible to apply for the Local Government Restructuring Grant for long-term institutional and budgetary restructuring. This support is aimed at enhancing the efficiency of service delivery and the growth potential of large urban economies partly through tapping private sector debt markets.

Support for smaller municipalities

The Local Government Support Grant flows through provinces to assist medium and small municipalities experiencing severe financial problems to restructure their financial positions and organisations over the medium term. The grant currently reflected on the provincial share, will be consolidated into the Municipal Systems Improvement Programme over the medium term.

Municipal own revenue

A number of measures are being introduced to enhance the revenue-raising powers of local government. These include legislative measures to improve property tax administration, clarify municipal tax powers, and reform Regional Services Council (RSC) levies. Improved billing systems and enhanced revenue collection mechanisms are key to sustaining service delivery at a local level.

Municipal borrowing

To increase the pace of infrastructure delivery, financially well-managed municipalities should be able to borrow, and to repay loans from existing revenue streams such as intergovernmental transfers, municipal taxes, or user tariffs.

Borrowing framework provides for oversight role

The White Paper on Local Government emphasised the importance of gearing in private investment and using capital markets. It also pointed out the need to define clearly the "rules governing intervention in the event municipalities experience financial difficulties." In 2000, Cabinet adopted a *Policy Framework for Municipal Borrowing and Financial Emergencies*. The Municipal Finance Management Bill includes such a framework.

Municipal budgets

Municipal budgets in transition

Municipal budgets and budgeting processes are in transition, requiring systems to be merged and priorities to be refocused. The Municipal Finance Management Bill proposes changes to budget processes, formats and reporting requirements. The aim is to create improved and more accountable local environments, with better services distributed across a wider spectrum of the population.

Table 7.9 sets out consolidated expenditure for municipalities for the years 1998/99, 1999/00, 2000/01 and budgets for 2001/02. Municipal budgets are tabled in July, hence it is difficult to present a forward looking analysis of municipal budgets. The 2001/02 budgets are the first since demarcation and therefore trend analysis is limited to high-level aggregate figures.

23 municipalities make up 80 per cent of local government budgets

The National Treasury received budget information from 244 of the 284 municipalities, comprising more than 95 per cent of the total value of municipal operating expenditure for the country. The six metropolitan areas - Johannesburg, Cape Town, eThekwini, Ekurhuleni, Tshwane and Nelson Mandela – account for over R41 billion or 64 per cent of municipal spending. The next 17 biggest cities, including provincial capitals, account for R10 billion or 15,6 per cent of total municipal budgets. This analysis highlights the significant concentration of economic activity in certain localities.

Although some smaller municipalities only report occasionally, they account for a very small percentage of total expenditure and thus do not impact significantly on the trends outlined below.

Table 7.9 Consolidated municipal expenditure budgets

R billion	98-99	99-00	% change	00-01	% change	01-02	% change	% of budget
Salaries	12,8	13,8	7,8%	15,9	15,2%	17,9	12,6%	34,0%
Bulk services	12,8	13,8	7,8%	14,9	8,0%	14,5	-2,7%	27,5%
Other	15,6	16,9	8,3%	17,3	2,4%	20,3	17,3%	38,5%
Operating budget	**41,1**	**44,4**	**8,0%**	**48,1**	**8,3%**	**52,7**	**9,6%**	
Capital budget	**13,7**	**13,7**	**0,0%**	**13,7**	**0,0%**	**11,7**	**-14,6%**	
Total	**54,8**	**58,1**	**6,0%**	**61,8**	**6,4%**	**64,4**	**4,2%**	

Structural changes make comparisons difficult

The bulk services component reflected above is the total amount budgeted for bulk purchases of electricity, water and sewerage treatment. In aggregate the slight decrease in bulk services expenditure can be attributed to some municipalities having corporatised or restructured this function. For example, the mining sector in the jurisdiction of the Rustenburg Municipality no longer purchases bulk electricity from the municipality, but directly from Eskom.

8,6 per cent growth in operating expenditure

Operating budgets grew by an annual average of 8,6 per cent a year between 1998/99 and 2001/02, with the fastest growth being salaries at 11,9 per cent and “other” at 9,3 per cent.

Substantial increases in the salary component from 31 per cent of total operating budget in 1998/99 to 34 per cent in 2001/02 squeezes out other spending and reduces the capacity for an extension of service delivery.

Audited figures for expenditure are seldom available on time and differ from the budgeted figures in table 7.9. The reason for the difference is that budgeted figures tend to over estimate revenue, and hence expenditure.

Operating expenditure outstrips capital spending

Municipalities budgeted approximately R64 billion in 2001/02, of which R11,7 billion was for planned capital investments. The R52,7 billion operating budget is to be covered by R27,7 billion (51 per cent) in user charges levied for the provision of electricity, water and sewerage. R11,5 billion or 21 per cent of revenue is raised from property rates and taxes and R3,9 billion recovered from Regional Services Council levies on businesses. The remaining R11,2 billion will come from other income sources, predominantly grants and subsidies, other user charges, tariffs and fines.

Projected operating revenues are set out in table 7.10

Table 7.10 Consolidated municipal operating income budgets

R billion	1998-99	1999-00	% change	2000-01	% change	2001-02	% change
Property tax	7,8	8,4	7,7%	10,1	20,2%	*11,5*	13,4%
Bulk services	19,7	23,1	17,3%	23,6	2,2%	*29,6*	25,5%
RSC levies	3,3	3,1	-6,1%	3,9	25,8%	*3,9*	-1,0%
Other	10,3	9,8	-4,9%	10,6	8,2%	*9,3*	-12,1%
Total	**41,1**	**44,4**	**8,0%**	**48,1**	**8,3%**	**54,3**	**12,8%**

Growth in income from property tax and service charges exceeds inflation

Property rates and taxes grew 13,8 per cent a year between 1998/99 and 2001/02; income from electricity, water and sewerage services by 12,3 per cent; and other income by 3 per cent. Included in the operating income of R54,2 billion is nearly R1 billion for financing capital expenditure from own revenue. The Regional Services Council levies comprise payroll and turnover taxes. Metropolitan municipalities raise two-thirds of all regional levies with the remainder collected by district municipalities.

Capital expenditure at a municipal level is financed through:

- Historical operating surpluses
- Own revenue generated during the year
- Loans
- Contributions from district municipalities
- Conditional grants and other transfers from National and Provincial Governments.

Conclusion

The intergovernmental system hinges on cooperative governance, is built on regular engagement between the spheres and allows for supporting, nurturing and developmental roles to come to the fore. The system is maturing and will develop further over time.

Improved policy coordination and budget reforms enhance accountability and service delivery

Policy-making and fiscal and financial management across all spheres have brought greater coherence in implementation and a foundation has been laid for improved coordination of programmes and accelerated service delivery. A range of public finance and budget reforms has strengthened the link between policy and budgets in the provincial sphere, and similar reforms are in progress in municipalities.

The system of intergovernmental transfers has been overhauled to support service delivery in the provincial and local spheres through increased predictability, transparency and coordination between Government departments.

Progress has been substantial in developing new approaches, budget formats and reporting requirements. However, linkages between multi-year planning and budgeting in the different spheres is in its infancy, revenue management and credit control are weak, and transition places many pressures on local governments. Transformation has unleashed many operational and budgetary pressures that will continue to test the capacity and sustainability of provinces and local governments for some time to come.

On the whole, while provinces enter a phase in which healthier fiscal positions underlie improved service delivery and infrastructure expenditure, local governments still face significant transition challenges.