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EXPLANATORY MEMORANDUM TO THE DIVISION OF REVENUE

Background

The allocation of resources to the three spheres of government is a critical step in the budget process, required before National Government, nine provinces and 284 municipalities can determine their own budgets. The process for making this decision is at the heart of co-operative governance as envisaged in the Constitution of South Africa.

It is a Constitutional requirement (Section 214(1)) that an annual Act of Parliament must determine the equitable division of nationally raised revenue between the national, provincial and local spheres, the equitable division among the nine provinces of the provincial allocation, and any other allocation from the national sphere to provincial and local governments. Section 214(2) details criteria to be taken into account in determining the division of revenue and indicates the consultation process necessary before enactment of the Division of Revenue Bill.

The *Intergovernmental Fiscal Relations Act* (Act 97 of 1997) gives effect to section 214 of the Constitution by establishing the forums and processes for consultation. It establishes the Budget Council and Budget Forum as consultative intergovernmental forums with provincial and local governments respectively. The Act outlines various consultation processes (sections 9, 10(3) and 10(4)) that should precede the tabling of the Division of Revenue Bill, including the consideration of recommendations of the Financial and Fiscal Commission (FFC).

Section 10(5) of the *Intergovernmental Fiscal Relations Act* requires that when the Division of Revenue Bill is introduced to Parliament, an explanatory memorandum should accompany it. It must explain how the Division of Revenue Bill takes into account the considerations listed in Section 214(2)(a) to (j) of the Constitution, government's response to the recommendations of the FFC (on the vertical division, equitable share and other allocations), and the assumptions and formulae used to effect divisions among provinces and municipalities.

This document is the explanatory memorandum to the 2003 Division of Revenue Bill. It expands on the Division of Revenue Bill and Budget as tabled on 26 February 2003.

It has five parts:

- Part 1 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 2 sets out how the FFC's recommendations on the 2003 Division of Revenue have been taken into account.
- Part 3 outlines the fiscal framework that informs the division of revenue between the three spheres of government.
- Part 4 expands on all provincial grants, providing an explanation of the formulae and criteria for the equitable division between provinces of the provincial equitable share and conditional grants.
- Part 5 expands on all local government grants, providing an explanation of the formulae and criteria for dividing the local government equitable share and conditional grants among municipalities.

The Division of Revenue Bill and its underlying allocations are the culmination of extended consultation processes. The Budget Council, made up of the Minister of Finance and the nine provincial Members of Executive Council (MECs) responsible for Finance, deliberated on the issues discussed in this memorandum at its annual Lekgotla on 22 to 24 August 2002 and at meetings of 3 and 10 October 2002. Consultations over the local government share allocation involved a Joint MinMEC with local government held on 12 August 2002, and several technical meetings that included the South African Local Government Association (SALGA) and provincial associations. All these consultations culminated in a meeting of the Budget Forum (Budget Council plus SALGA) on 3 October 2002. Representations by the FFC were made at these 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 Cabinet Ministers, Premiers of provinces and the chairperson of SALGA, was held on the 16 October 2002 and agreed on the final budget priorities and the division of revenue consistent with these priorities.

The 2003 Division of Revenue Bill sets out the division of revenue as agreed through the consultative processes explained above, while this memorandum elaborates on the policy priorities and legal and economic criteria which inform the division.

This memorandum does not discuss the utilisation of this revenue by provincial and local government. This information will only be available after they have tabled their budgets. The *2003 Intergovernmental Fiscal Review* (published in the first week of April), will examine budget trends in the 2003 provincial budgets, as well as the 2002 municipal budgets. It will also provide sectoral information for key concurrent functions like school education, health, social development, housing, roads, water and electricity.

The *2003 Intergovernmental Fiscal Review (IGFR)* is being printed earlier to assist Parliament and provincial legislatures to conduct more comprehensive budget hearings for key concurrent sectors. Apart from the many hard copies to be printed, the IGFR will be available on the National Treasury website www.treasury.gov.za. Other relevant documents to this memorandum, including the *Budget Review 2003* (particularly chapters 6 and 7), the 2003 Division of Revenue Bill and all its Schedules, allocations per province and per municipality for all grants, and the frameworks for all conditional grants, will also be available on the National Treasury website.

Part 1: Taking account of factors set out in the Constitution

Section 214 of the Constitution requires that the annual *Division of Revenue Act* be enacted only after account is taken of factors in sub-section 214(2) (a) to (j) of the Constitution. These include national interest, provision for debt, needs of 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.

Chapters 2 to 6 of the *2003 Budget Review* set out in detail the economic and fiscal policy considerations, revenue issues, debt and financing considerations and expenditure plans of government. Aspects of provincial and local government financing are discussed in chapter 7. The constitutional principles taken into account in deciding on the division of revenue are briefly noted below.

National interest and the division of resources

The national interest is encapsulated by those governance goals that benefit the nation as a whole. The policies and programmes that give effect to these goals include the development of a stable macroeconomic environment, strong economic growth, and an efficient public service. It also encompasses policy objectives such as reducing inequality, unemployment, crime, poverty and vulnerability, thus contributing to a better quality of life for all South Africans. Programmes directed towards these purposes cut across all spheres of Government and are largely coordinated by National Government.

Provision for debt costs

The resources shared among the three spheres of Government include proceeds from National Government borrowing used to fund spending by all spheres. National Government provides for the resulting debt costs as a first obligation, to protect the integrity and credit reputation of the country.

National Government needs and interests

The Constitution assigns exclusive and concurrent powers and functions to each sphere of government. National Government is exclusively responsible for functions that serve the national interest and are best centralised, like national defence, foreign affairs, the criminal justice system, home affairs, higher education, national tax collections and certain economic services. For the division of revenue, national government priorities were taken into account. These include crime prevention, improved court administration, security infrastructure and increased international commitments, particularly related to the New Partnership for Africa's Development (NEPAD) and the African Union (AU), land restitution and reform, higher education, promoting infrastructure investment and industrial development, and improved services to citizens.

Provincial and local government basic services

Provinces and municipalities are assigned key delivery functions such as school education, health, social development, housing, roads, provision of electricity, water and municipal infrastructure. They have significant autonomy to allocate resources to meet basic needs and respond to provincial and local priorities, whilst at the same time giving effect to nationally agreed priorities.

The division of revenue provides equitable shares to provinces and local government. This year's division of revenue takes explicit account of cost pressures relating to extending social security grants, increasing spending on professional personnel with scarce skills (for example doctors, pharmacist in health sector) and stepping up provision of critical inputs such as textbooks, stationery and medicines in education and health. Further, the division of revenue allows for the phased extension over the next three years of the child support grant to children up to their 14^{th} birthday. This is done through a conditional grant to provinces to fund expenditure relating to the extension of the Child Support Grant. The division of revenue also reinforces government's commitment to the expansion of free basic services at the municipal level. In this regard it introduces a further supplementary free basic services component in the local government equitable share allocation, for provision of free basic electricity and water to poor households.

Fiscal capacity and efficiency

The Constitution assigns the primary government revenue power to the national sphere. Despite the promulgation of the *Provincial Tax Regulation Process Act* (no 53 of 2001), provinces still have limited revenue raising capacity relative to the resources required to deliver provincial functions that do not lend themselves to self-funding or cost recovery. To compensate for this, provinces receive the largest share of nationally raised revenue. Local governments finance most of their expenditure through property rates, user charges and fees. It is recognised, however, that rural municipalities raise significantly less revenue than the urban metro municipalities.

Fiscal efficiency indicators are still being developed, as budget and expenditure classifications are standardised to allow for comparisons between various governments. The implementation of the *Public Finance Management Act* has improved the fiscal efficiency of provincial governments, and the pending promulgation of the Municipal Finance Management Bill is expected to do the same for municipalities over the next few years. Once more accurate data on these indicators become available it will be possible to take more explicit account of these in the determination of the division of revenue.

Developmental needs

Developmental needs are encapsulated in the equitable share formulae for provincial and local government and in specific conditional grants. In particular, the various infrastructure grants and growing capital budgets aim to boost the economic and social development of provinces and municipalities. Developmental needs are accounted for at two levels: firstly, in the determination of the division between the three spheres, which explains the strong growth in the provincial and local government shares of nationally raised revenue, and secondly, in the determination of the division within each sphere, through the formulae used for dividing the grants among municipalities and provinces.

Economic disparities

Both the equitable share and infrastructure grant formulae are redistributive towards poorer provinces and municipalities because of the economic and demographic disparities between and within provinces and municipalities. In particular, Government has increased allocations to invest in economic infrastructure like roads, and social infrastructure like schools, hospitals and clinics, in order to stimulate economic development and job creation. Further, the extension of the child support grant to children up to 14 years will greatly assist in alleviating poverty. The prioritisation of nodal areas in the allocation of local government grants seeks to address disparities among local authorities.

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 the monitoring of implementation for concurrent functions. New national mandates and priorities result in increased allocations to provincial and local government over the 2002 MTEF baseline allocations. In particular, the 2003 MTEF and division of revenue provides funding for statutory obligations relating to social security grants – both increases in grant values and the phased extension of the age limit for the child support grant to children until they turn fourteen.

Predictability and stability

Provincial equitable share allocations are based on estimates of nationally raised revenues. These allocations are protected. In the event that nationally raised revenue falls short of the estimates, the equitable share will not be adjusted downwards. Allocations are assured (voted, legislated and guaranteed) for the first year and are transferred according to a payment schedule. In order to contribute to longer term predictability and stability, forward estimates for a further two years are published alongside the annual proposal for appropriations. For the first time, the allocations per municipality are also published with the Division of Revenue Bill. The Bill also requires provincial governments to publish all their grants to local government per municipality. This will enable municipalities to incorporate all national and provincial grants in their budgets.

Need for flexibility in responding to emergencies

Government has flexibility to respond to emergencies through a contingency reserve that provides a cushion for "unforeseeable and unavoidable" expenditure. Sections 16 and 25 of the *Public Finance Management Act* make specific provision in relation to allocation of funds to deal with emergency situations while section 30(7) deals with adjustment allocations in respect of unforeseeable and unavoidable expenditure.

Part 2: Response to the Financial and Fiscal Commission recommendations

Section 214 of the Constitution and Section 9 of the *Intergovernmental Fiscal Relations Act* (Act 97 of 1997) require the Financial and Fiscal Commission (FFC) to make recommendations on the division of revenue. Under the Act, the FFC submits its recommendations to the Minister of Finance, Parliament and provincial legislatures ten months ahead of the financial year, or later as may be agreed between the Minister of Finance and the FFC.

The FFC tabled proposals for this year in Parliament on 30 April 2002 in *Financial and Fiscal Commission Submission: Division of Revenue 2003 – 2004*. The provincial proposals were presented to the Budget Council meeting of 17 May by the FFC, and discussed at the Budget Council meetings of the 19 July, 22-24 August and 3 October. The local government proposals were discussed at the joint Finance and Local Government MinMEC of 12 August 2002 and the Budget Forum of 3 October 2002. The extended Cabinet meeting of 16 October also considered national Government's response.

The FFC presented 12 proposals: four proposals on provincial government, five proposals on local government, and three proposals on crosscutting equitable share issues. Most of these do not have immediate implications for 2003 Budget, as they are either of a general nature or require more research or time to investigate or implement. Some of the proposals are summaries of, and work in progress arising from proposals made to Parliament during 2001/02.

The proposals can be divided into the following categories:

Provincial government proposals:

- Provincial Own Revenue Sources
- Provincial Tax Regulation Process Bill (2001)
- Early childhood development funding
- Implications of HIV/Aids for Health, Welfare and Education sectors
- Primary Health Care
- Framework for Comprehensive Social Security Reform

Local government proposals:

- Division of powers and functions between district and local municipalities (July 2001)
- Restructuring of the electricity distribution industry
- Municipal borrowing and municipal finance markets
- Municipal Finance Management Bill
- Remuneration of municipal councillors (July 2001)
- Measurement of Revenue Raising Capacity.

Cross-cutting proposals:

- Review of the Intergovernmental System
- Central Contingency Reserve
- Assessment of Disaster Management Funding.

Summary of each proposal and Government's response

Provincial government proposals

FFC proposals on Provincial Own Revenue Sources and the Provincial Tax Regulation Process Bill

The FFC makes two proposals on provincial own revenue. Firstly, it notes the relative decline in provincial own revenue has, to a certain extent, been the result of management and technical-capacity problems. It identifies some of the obstacles, and notes that the possibility of improvement exists, particularly if reforms already implemented in some provinces spread to others. The reforms include better data-management systems, financial management, regular review of fees, tariffs and fines, incentives and monitoring.

Secondly, in a 2001 submission, the FFC recommends that the provincial Tax Regulation Process Bill ought to have:

- Specified criteria against which the Minister of Finance would assess provincial tax proposals
- Clarified the implications and procedures relating to capacity limitations of the South African Revenue Service (SARS) in advance
- Allowed provinces maximum flexibility in determining tax rates within tax rate bands
- Included guidelines with regard to tax room and equalisation measures, where certain taxes have implications for the equitable share revenue pool
- Specified regulations for dispute resolution, especially where a province may fail to reach an agreement with SARS on certain tax proposals
- Included a clause for dealing with the impact on local government finances of a proposed provincial tax or surcharge.

National government's response to the FFC proposals on Provincial Own Revenue and the Provincial Tax Regulation Process Act

National Government notes the problems identified by the FFC on the collection of revenue by provinces. Many of these problems have been raised in the 2001 *Intergovernmental Fiscal Review* and Budget Council. A revenue task team was formed, and resulted in the implementation of some of the proposals made by the FFC. All provinces now regularly review their fees and tariffs. However, National Government recognises the need for more improvements, particularly in the area of motor license fees and road traffic enforcement. This includes the better use of Natis and its interface with the financial management system (BAS), and the need for proper contracts with municipalities registering motor vehicles and enforcing traffic laws. A revenue classification project has also been initiated to ensure that all revenue collected is properly classified, and reconciled, with the financial management system. A further area of improvement is in revenue projections for own revenue. Further improvements will be effected on an on-going basis, as provinces improve their monitoring and collecting capacity.

The second proposal of the FFC on the Provincial Tax Regulation Bill relates to a 2001 submission. The Bill was passed by Parliament in that year, and proclaimed into law on 10 December 2001. Before, and during, the hearings in Parliament to adopt the Bill, proposals by the

FFC were considered by National Government. Many of the recommendations were accepted, and implemented, including the proposals on the role of the Minister of Finance and SARS with regard to a provincial tax, and procedures for dealing with disputes.

Some of the recommendations could not be taken into account in the Act because it does not deal with specific provincial taxes, but with the *process* to approve tax proposals by provinces. These recommendations (for example to what extent a province has tax discretion to determine tax rates, the impact of a tax on local government) will be considered for specific provincial taxes, as and when they are proposed, and considered, by the Minister of Finance. Further, the comments of the FFC will also be taken into account when any specific tax proposal is considered.

The Act does not stipulate which taxes provinces can or cannot impose, as provisions on this matter are contained in the Constitution. In deciding on the feasibility of a tax, the Minister of Finance will examine the anticipated impact of a specific tax on government's macroeconomic policy objectives and the implementation mechanisms contained in the proposal. Decisions on the administrative feasibility, or otherwise, of a specific tax would also be informed by an assessment of the capacity of SARS. The assessment of the anticipated macroeconomic impact and appropriateness of implementation mechanisms can only be done once a proposal is made, and cannot be stipulated in advance. Similarly, the administrative feasibility (largely a matter between SARS and the province(s) concerned) can only be determined after a tax proposal is made.

FFC proposal on Early Childhood Development Funding

The FFC proposes that the current conditional grant funding arrangements for Early Childhood Development (ECD) continue until ECD can be fully incorporated into the provincial equitable share formula. The FFC will consider ECD funding issues in its review of the provincial equitable share formula.

National government's response to the FFC proposal on Early Childhood Development Funding

As indicted in the 2002 Budget, conditional grant funding for ECD will cease at the end of 2003/04, and the programme will become part of the equitable share to provinces. Government agrees that, in future, the equitable share formula should attempt to capture funding for ECD more explicitly. The increase in the baseline provincial equitable share of the forthcoming MTEF period takes account of the phased roll out of ECD.

FFC proposals on implications of HIV/Aids for Health, Welfare and Education Sectors

The FFC reiterates its previous recommendation that conditional grants remain the most appropriate mechanism for targeting spending on HIV/Aids. It proposes that the development of a suitable data and information base for long-term projections on HIV/Aids be prioritised.

National government's response to the FFC proposals on implications of HIV/Aids for Health, Welfare and Education Sectors

Whilst agreeing with the thrust of the proposal, including the impact on provincial health budgets and the problem of hidden costs. Government, however, is of the opinion that earmarked funding for HIV/Aids is only appropriate for limited aspects of HIV/Aids related spending, such as the prevention of mother to child transmission, Home based care and awareness programmes. Other aspects of HIV/Aids expenditure such as treatment of opportunistic infections, cost of hospitalisation, which are hard to isolate are better funded through the equitable share. The problem of poor information identified by the FFC makes the task of separating conditional grant funding from the equitable share an even harder task. While supporting the view that conditional grant funding for conditional grant-funded HIV/Aids programmes be increased, Government is also of the view that unconditional funding to provinces should be increased to reinforce relevant HIV/Aids programmes funded from own provincial revenue. National Government also agrees that a strong information base is necessary to design and implement more effective programmes to treat, and contain, HIV/Aids.

FFC proposals on Primary Health Care

On the primary health care package the FFC lists the following issues for investigation:

- the need for reliable data on spending for primary health care
- the role of the private sector and local government
- a thorough analysis of the implications of any decentralisation to local government
- the extent to which primary health care services correspond with constitutionally mandated basic health services.

National government's response to the FFC proposal on Primary Health Care

Since there are no specific proposals on primary health care, National Government notes the area for further work identified, which will be taken into account for further investigation and consultation with key stakeholders.

FFC proposals on the Framework for Comprehensive Social Security Reform

The FFC proposes that the following guidelines be used to assist interested stakeholders in reviewing the *Comprehensive Social Security Review Report* :

- principles and criteria that may be used
- background and contextual information requirements
- range of services that might be encompassed
- financial and administrative frameworks for implementation of social security policy.

For the interim the FFC reiterates its proposals that old age and veteran pensions be budgeted and administered by National Government. In the medium- to long-term, it believes that social security should be a national responsibility administered through the establishment of a national social security agency. Among other functions, the core business of the agency would be the payment of old age and child support grants.

National government's response to the FFC proposal on the Framework for Comprehensive Social Security Reform

Building on the *Comprehensive Social Security Review,* Cabinet has in principle approved the establishment of a public entity in the national sphere to administer and pay social grants. A Transition Committee under the leadership of the Department of Social Development is currently working to advise Cabinet further on the implications of such a step. Final approval of such an entity may entail the complete shift of responsibility for social grants to the national sphere.

In the interim, while institutional arrangements are being finalised, the bulk of social grants will continue to be funded through the provincial equitable shares for the 2003 Budget. The review of the equitable share formula next year will consider funding social grants separately, either as a conditional grant or transfer on the budget of the National Government, depending on the final decision on the role of the national public entity.

Government also recognises the significant pressure on provincial budgets due to the child support grant, and has therefore significantly increased the equitable share allocation to provinces over the MTEF. These increases also take into account the grant increases announced by the Minister of Finance in the Budget. Further, a new conditional grant, the child support extension grant, has been created to fund the extension of the child support grant from 2003/04 to children between the ages of seven and fourteen years. The funding for children less than seven years is included in the equitable share grant.

Local government proposals

Two of the FFC proposals deal with significant restructuring of local government. These relate to the division of functions between local and district municipalities (made in 2001, but to which National Government was not in a position to respond in time for the 2002/03 Budget) and the restructuring of the electrification industry (EDI). Both these reforms will have significant fiscal implications for the local sphere. However, work on revising the fiscal framework can only commence now that the division of functions of category B (local) and C (district) municipalities have been finalised. Much of this work will require additional information on municipal budgets and actual spending for key functions in electricity, water, sanitation and municipal health, as well as for all other local government functions. National Government is therefore not in a position to respond to any proposals on the fiscal framework.

Given the impending restructuring of the electrification industry, the finalisation of the reconfigurations of functions of category B and C municipalities, and the imminent publication of Census 2001 results, National Government is proposing a comprehensive review of the local government fiscal system. This would include a review assessing whether current revenue raising powers match the functions of various categories and types of municipalities, the tax-raising powers of local government and their assignment within the local sphere, the future of the RSC levies, the feasibility of implicit or explicit municipal levies on key municipal services like electricity and water, and the division of fiscal powers between category B and C municipalities. The review will also include the formulae for the equitable share, and conditional, grants. It is anticipated that this review will be completed in time for the 2004 Budget.

The National Treasury will consult key stakeholders for the review, including national departments (Departments of Provincial and Local Government, Mineral and Energy, Water Affairs and Forestry), SALGA and the FFC. The Budget Forum and Cabinet will consider the proposals for implementation in the 2004 Budget.

The response of National Government to the 2003/04 proposals of the FFC on local government is therefore an interim measure, taking account of urgent revisions on current grants. Some major proposals are also being implemented, including the creation of a consolidated municipal infrastructure grant (MIG). National Government is finalising the governance arrangements for the MIG grant, which is expected to take effect around October 2003.

FFC proposal on the Division of Municipal Powers and Functions

The FFC proposes that the following two principles inform the division of powers and functions between district and local municipalities:

- Existing local government policy should inform the division of powers and functions. Hence local municipalities should be responsible for the delivery of municipal services, and district municipalities should be responsible for district-wide and support functions.
- Issues of redistribution should not determine the division of powers and functions between local and district municipalities, given the primary role that National Government should play in funding redistribution.

The FFC further proposes that:

- District municipalities should be the service authorities for municipal health services, except where efficiency considerations dictate otherwise
- District municipalities play no role in the distribution of electricity
- Local municipalities should be the service authorities for water and sanitation services, and district municipalities should be responsible for sanitation promotion (as part of their municipal health function)
- Both district and local municipalities be empowered to operate municipal enterprises such as abattoirs and fresh produce markets. District municipalities should bear responsibility for regulating the public health aspect of these enterprises.

National government's response to the FFC proposal on the Division of Municipal Powers and Functions

Government agrees with the FFC that local municipalities should be responsible for the delivery of municipal services and that district municipalities should be responsible for district-wide functions. Government also agrees that redistribution issues should not be a factor in determining the division of functions between category B and C municipalities, as this is primarily the role of National Government when determining the grants framework for local government.

The proposals on the responsibilities for local municipalities for water, sanitation and electricity, and the proposal that districts should not play any role in electricity distribution, are supported by National Government. Government also supports the proposal that district municipalities be responsible for municipal health services, as these mainly comprise environmental health services and not primary health care (which is the responsibility of provincial governments).

The national executive (Cabinet) approved the division of the above four functions, after the Minister for Provincial and Local Government completed his consultations with provincial Local Government MECs and SALGA. As a result, the Minister gazetted the new division of the four "national" functions (electricity, water, sanitation, health) on 3 January 2003 Gazette number 24228. The gazetted functions differ from the general approach of the FFC, as provincial and local government comments have been taken into account. As a result, the functions that will be performed differ from region to region. An asymmetrical approach has been adopted for water and sanitation. Where there are marked district-wide service delivery backlogs and inequities, the approach is for the district to retain the service authority function. In these instances, local municipalities (category B) will be regarded as potential service providers only, and (where agreed with the district municipality) will receive funding to perform such function from the district municipality. The national Department of Provincial and Local Government (DPLG) is also holding workshops in all provinces to explain how the newly-gazetted division of functions are to be implemented.

The implications of Gazette 24228 require adjustments in 2003/04 in the equitable share allocations to category B and C municipalities to ensure appropriate alignment with the revised division of functions. The allocations in Schedule 4 of the Division of Revenue Bill have taken the new division of functions into account.

FFC proposal on Restructuring of the Electricity Distribution Industry (EDI)

The FFC makes detailed proposals on the restructuring of the electricity redistribution industry. Their proposals are mainly centred on funding proposals, efficiency gains and consolidated billing systems for municipalities.

The funding issues raised by the FFC include that:

- No stakeholder should experience deterioration in its circumstances owing to the restructuring process, unless this is an explicit policy decision
- Tariff support to low-income consumers be financed primarily by a national grant to Regional Electricity Distributors (REDs) for the provision of free electricity, and to a lesser extent by a consumer cross-subsidy
- Capital electrification for low-income consumers be financed by National Government, and provision for this should be made in the MTEF estimates
- The local government levy be made available to all municipalities:
  - Municipalities be allowed to set the levy up to a maximum level
  - The possibility of allowing a higher cap for distributing municipalities should be investigated, so as to take account of the net loss experienced by some municipalities.
  - The local government levy should not be phased out unless fiscal mechanisms are in place to fully compensate for the loss of revenue.
- The cap of R2,4 billion placed on local government revenue be re-examined, and given the increasing loss in receipts to local government implied by the restructuring process, consideration should be given to regular increases to the absolute cap on local government revenue.
- Consideration be given to introducing a "local government levy" for large customers imposed by National Government and disbursed through the local government equitable share.
- The restructuring process focuses on compensation to municipalities through the local government levy and not through dividend income.
- The REDs structure ensure that accountability for efficient service delivery is promoted in a simple and effective way.
- Municipalities be compensated for all losses related to the transfer of electricity distribution to REDs.
- The advantages and disadvantages of retaining consolidated billing systems with municipalities be carefully weighed, and measures should be implemented to retain the advantages.
- RED boundaries be co-terminus with municipal boundaries to ensure that residents of a given municipality do not fall within different REDs and hence under different tariff structures.
- Implementation of any proposal be carefully phased-in owing to the integral role played by electricity provision in the system of local government finance.

National government's response to the FFC proposal on the Restructuring of the Electricity Distribution Industry (EDI)

National Government agrees that restructuring of the electricity distribution industry and the creation of REDs will have a major impact on local government finances. Government has committed itself to more work in this area and put forward detailed proposals regarding both the funding requirements and financial impact of the restructuring. The financial and fiscal implications for each municipality will be considered. Government is therefore not in a position to comment in detail on the FFC proposals until negotiations between key stakeholders are completed, and more detailed proposals put forward. The allocations for the 2003 Budget do *not* take into account the impact on municipalities of electricity distribution restructuring.

Government supports a broad and comprehensive approach to the funding of the restructuring of electricity distribution industry. It agrees that municipalities need to be compensated for any significant loss in their revenue stream, and that this should be done in a fair and consistent manner.

National Government notes the proposal on an imposition of a local government levy, and believes that such new funding mechanisms need to be investigated further, including the impact of a levy on large industrial customers. These proposals will be considered as part of the comprehensive review of local government fiscal framework, and the impact of such local taxes on economic activity will be assessed.

Cross subsidies also need careful consideration, and should not be the automatic first choice for funding lifeline tariffs. The national grants system will be designed to subsidise poorer households in this respect. Any cross subsidies should not place an excessive burden on those paying for the cross subsidy, and should not vary significantly across the REDs.

National Government is also mindful that the advantages and disadvantages of retaining consolidated billing systems with municipalities should be carefully weighed, and measures should be implemented to retain current advantages. It agrees that a key operational issue is the impact on municipal billing of the restructuring of electricity. The Department of Minerals and Energy has agreed this should be looked at in greater depth. Government does not, however, want to impose a uniform solution on municipalities, and it believes that a range of options may be needed to ensure that each municipality can implement a solution that suits its needs.

Lastly, the FFC proposes that the implementation of any proposals should be sequenced owing to the integral role played by electricity provision in the system of local government finance and the somewhat precarious financial state and transitional nature of the local government sphere. Government agrees that the EDI restructuring process needs to be carried out in a careful and phased manner. The timetable for the EDI will ensure that the restructuring process does not cause any significant disruption to the finances or operations of municipalities.

In the interim for the 2003 Budget, National Government has allocated funds for a minimum level of electricity into the equitable share allocation to local government.

FFC proposals on Municipal Borrowing and Municipal Finance Markets

The FFC:

- Reiterates its proposal of last year that there be a combination of market discipline and the rules-based approach applied to the municipal borrowing market
- Is of the view that there be a differentiated approach to the borrowing market, with classes of municipalities being treated differently according to objective criteria
- Is of the view that those municipalities that are able, should continue to issue bonds and access other forms of loan finance
- Advises that municipalities that have no capacity to access debt should be assisted through deliberate policy measures to build their creditworthiness. This objective should be supported through the capital grants system and other appropriate forms of funding and capacity building.

National Government's response to the FFC proposal on Municipal Borrowing and Municipal Finance Markets

Government supports the FFC's proposals on municipal borrowing. Given that the municipal borrowing market is no longer as active as it was previously, a combination of market discipline and a rules-based approach is supported. This approach is appropriate as not all municipalities are able to borrow from the private sector presently and in the foreseeable future.

There are two potential issues of concern in relation to poor municipalities and borrowing.

Firstly, poor municipalities may not be able to access credit. National government's view is that, over time, all municipalities should be able to borrow for capital infrastructure delivery. Borrowing is not appropriate for municipalities that lack the management capacity to plan and borrow wisely, neither is it appropriate for municipalities that lack stable and adequate revenues with which to repay loans. In order to help these municipalities, Government has a two-fold strategy: (1) as more creditworthy municipalities increasingly draw capital from the private sector, national grant programmes can become more targeted at municipalities that are not able to attract private finance; and (2) as intergovernmental transfers are increasingly consolidated, and made predictable over time, these flows can be leveraged for borrowing.

Secondly, poor municipalities may take on more loans than they can really sustain. Government's preference has been to rely on the discipline of the market to avoid over-borrowing by under-capacitated municipalities. The removal of explicit and implicit government guarantees means that lenders making risky or irresponsible loans to municipalities will not be compensated by national or provincial governments. This is expected to act as a powerful deterrent to irresponsible lending practices. Rules limiting borrowing could also be formulated, and such options were considered in the development of government policy. One option would be a rule limiting debt service to some measure of potential revenue.

Government would welcome specific proposals from the FFC as to how municipalities should be differentiated in a way that does not distort incentives, and clarification of the FFC's view on what should be done to make credit available to non-creditworthy municipalities, without giving guarantees.

FFC proposal on the Municipal Finance Management Bill, 2001

The FFC proposes that the Bill should allow for classification of municipalities according to objective criteria, with different provisions and regulations applying to different categories of municipalities. It proposes clearer lines of accountability between national, provincial and local government, and the need for a careful balance between oversight and discretion, and inter sphere co-operation for the future. It also proposes that the Bill include procedures to be followed if municipalities default on their loans.

National Government's response to the FFC proposal on the Municipal Finance Management Bill, 2001

The proposals of the FFC have been considered by both National Government, and the Portfolio Committee on Finance during its hearings on the Bill in Parliament. Since the Bill has already been tabled, any final decision on any recommendation resides with Parliament rather than with national Government.

National Government agrees with the FFC comments and has inserted new provisions in the Bill dealing with the strengthening of intergovernmental relations and co-operative governance between the spheres. The complex nature of the intergovernmental relations system in South Africa is acknowledged by the addition of a new chapter, and the Bill further defines the role of treasuries and local government departments in the national and provincial spheres. The revised Bill caters more strongly for monitoring, supervision, support and intervention in the event of financial emergencies, including municipal defaults. The approach to municipal defaults has also required constitutional amendments to section 139 of the Constitution. The Minister of Finance and the Minister for Provincial and Local Government are also working closely on harmonisation of the Bill with the *Municipal Systems Act* and the *Municipal Structures Act*.

The Bill also offers a clear accountability regime and allows for phased implementation taking into account capacity differences within and between municipalities. New provisions dealing with capacity building by provincial and National Government have been added.

FFC proposal on the Remuneration of Municipal Councillors

The FFC proposes that:

- Resources for the remuneration of councillors be channeled through local government revenue which includes the municipality's own revenue as well as the existing Institutional (I) Grant of the local government equitable share
- The current Institutional Grant be reviewed in light of the most recent legislation and regulations concerning councillor remuneration

National government's response to the FFC proposal on the Remuneration of Municipal Councillors

This proposal is not new, and was addressed last year. National Government supports the recommendation that councillor remuneration be paid from own budgets, as is the case with provinces and National Government. National Government also supports the need for the institutional **I** grant to support the costs of governance generally. The current **I**-grant includes a population component, so that higher-populated municipalities become eligible for larger institutional support, as recommended by the FFC. Nevertheless, the **I**-grant also has a fiscal capacity measure, so that wealthier municipalities get less support than poorer ones. The allocation to the **I** grant has been revised upwards to take account of the most recent recommendations of the Goldstone Commission on the remuneration of political office-bearers.

FFC proposal on Measurement of Revenue Raising Capacity

Following its submission for 2002/03, the FFC has identified that it will conduct further research, in the coming year, on the following five methods for measuring the fiscal capacity for the local government equitable share formula:

- Revenue collected
- Per capita income
- Gross Geographic Product
- Total Taxable Resource
- Representative tax system

National government's response to FFC proposal on Measurement of Revenue Raising capacity

As noted in the response to last year's FFC proposals (tabled with the 2002 Division of Revenue Bill and published in the *2002 Budget Review*, Annexure E), National Government agrees with the FFC that it is desirable to include a fiscal capacity parameter in the local government equitable share formula. The response last year noted that the information required to do so is not available or reliable at this stage. The FFC suggestion on the five possible measures represents a step forward, and National Government welcomes the intention of the FFC to conduct further research with a view to identifying the most appropriate measure. Should it complete this research in time, it will be considered for the review of the local government equitable share formula. The desire to improve on the fiscal capacity measure is therefore supported, but cannot be taken into account for the 2003 Budget allocations to local government.

Cross-cutting proposals:

FFC proposal for the Review of the Intergovernmental Fiscal System

The FFC present the following recommendations when reviewing current intergovernmental fiscal mechanisms and processes:

- The possible incorporation of elements and parameters in the intergovernmental transfer formulae that will balance the need to provide Constitutionally mandated obligations with the considerations listed in Section 214(2)(a-j) of the Constitution
- The need for substantial improvement in data collection to enhance the development of intergovernmental fiscal mechanisms
- The development of specific intergovernmental fiscal capacity building programmes, both inside and outside of Government.

National government's response to the FFC proposal for the Review of the Intergovernmental Fiscal System

Government intends to undertake a comprehensive and fundamental review of the equitable share formula, and all other allocations for both provincial and local government once the results of Census 2001 become available. It is expected that the results of the review will be implemented in the 2004 Budget. This review and assessment will involve the FFC and give careful consideration to its proposals, as well as the impact of possible provincial and local government tax proposals. It will explore mechanisms that would make the formulae more forward looking and policy-based. Government also notes the need to emphasise improved data collection by relevant agencies, and has convened a number of forums with key sectors to standardise and prioritise basic information. Further, the publication of the Census 2001 results will provide valuable new information to inform the review of the grants system.

National Government has also initiated a 'Provincial Good Practice Programme' that focuses on improving the quality of strategic departmental plans that are linked to budgets, uniform formats for budgets and strategic plans for provincial departments in the same sector, the development of non-financial performance systems, in-year financial management and sector-specific annual reports.

FFC proposal on the Central Contingency Reserve

The FFC proposes that:

- A more defined legal basis be provided for the contingency reserve. This should ensure that the reserve is for emergency purposes
- The contingency reserve for a relevant budget year be allocated for two emergency purposes, namely macroeconomic stability and response to natural or human-made disasters
- The "new spending priorities" of the outer years of the MTEF be categorised separately as the "policy reserve"
- The Municipal Finance Management Bill include a provision that empowers municipalities to make appropriations to defray expenditure of an exceptional nature (similar to the provisions of Sections 16 and 25 of the PFMA)
- Provinces and municipalities should exercise their discretion in determining how to build flexibility into their budgets.

National government's response to the FFC proposal on the Central Contingency Reserve

Government is in agreement with the broad approach of the FFC, and believes that its current approach is in line with the recommendations of the FFC

In assessing the FFC's recommendations, it is important to note that the budget framework provides for a contingency reserve for each of the three MTEF years. It is important to differentiate between the coming budget year (in year) contingency reserve, and that for the two outer years.

The contingency reserve for the budget year allows for the possibility that funds might be required for unforeseeable and unavoidable expenditure. These appropriations cover disaster and emergency funding and are in terms of sections 16 and 25 of the PFMA. It is set aside in the national Appropriation Act, and then allocated to the three spheres (and their departments) through the mid-year adjustments process, where Parliament and provincial legislatures enact Adjustments Appropriation Acts. The contingency funds are therefore allocated through several legal processes, and no funds are spent outside such legal appropriations by National and provincial governments.

The contingency reserve for the two outer years includes both a policy reserve and an emergency reserve for unforeseeable and unavoidable expenditure. In the next Budget these funds are then divided between new spending priorities and in-year emergency reserve. These funds are therefore allocated legally in the Division of Revenue and Appropriation and Adjustments Acts in the next year. Government does not see merit in dividing the contingency reserve into two parts in advance, as there does not appear to be any objective basis for such a division. It is unclear how an *ex ante* division of the contingency could be reconciled with the annual revision of the framework to take account of changes in the macro-economic forecasts and other policy considerations.

Government does not share the FFC's view that the (in-year) contingency grant be confined to cover specific emergencies related to macroeconomic stability and natural or human-made disasters. Recent experience demonstrates that such a narrow approach would prevent Government in dealing with other valid pressures that may be unforeseeable and unavoidable but do not qualify as disasters. An example of this is the faster than anticipated take-up of social grants, which have tended to squeeze out other priorities in provincial budgets.

Government agrees that the adjustment process also be extended to the local sphere. This is covered in the coming Municipal Finance Management Bill, which makes provision for in year adjustment budgets (similar to sections 16 and 25 of the Public Finance Management Act).

Government also agrees, and respects, the right of municipalities and provinces to determine their own budgets, and believes that the current approach to intergovernmental budgeting allows them to exercise their discretion to determine how they can build flexibility in their budgets.

FFC proposal on Disaster Management Funding

The FFC proposes that:

- Central funding mechanisms for disaster management be introduced, so as to ensure budget frameworks and that the delivery of Constitutionally mandated basic services are not compromised
- Local municipalities be primarily responsible for the co-ordination and management of local disasters, unless they lack the necessary capacity
- Start-up costs for emergency preparedness for local government be funded from a national conditional grant targeted primarily at municipalities with limited capacity

- On-going institutional costs for emergency preparedness be incorporated into the equitable share
- Funding for prevention/mitigation projects be provided by National Government to provinces and municipalities on a matching-grant basis
- A portion of the contingency reserve be used to fund emergency response activities once provinces and municipalities have exceeded a specified financial threshold of disaster response expenditure
- National departments, provinces, and municipalities submit requests for reconstruction funding to National Government, a budget appropriations would be requested based upon the sum of the approved claims
- The three relief funds administered by the Department of Social Development be combined and administered centrally. Where budgeted funds are exceeded, the contingency reserve could be drawn upon.

National government's response to the FFC proposal on Disaster Management Funding

Major disasters and emergencies are, by their nature, unforeseeable and unavoidable, and hence cannot be budgeted for in advance. National Government accepts responsibility for emergencies and disasters that call for resources beyond the capacity of provinces or local authorities. This is one of the key reasons for the contingency reserve.

Government agrees that the three relief funds (Disaster Relief Fund, the Social Relief Fund and the State President's Fund) administered by the national Department of Social Development be combined and administered centrally. These funds also provide sources of funds available to assist relevant national departments, provinces and local governments in the event of a major disaster. Currently, these funds are administered by separate Boards and regulated by different legislation. The Department of Social Development has initiated a process to consolidate the various components of legislation and create a central Board to administer these funds centrally.

Infrastructure rehabilitation is funded through national grants. In-year, such grants are made through the Adjustments Budget and/or in terms of emergency funding in accordance with section 16 of the PFMA. Thereafter, they are funded through the normal budget process, through a conditional grant.

For minor disasters or emergencies, and where no national funds are deemed to be necessary, provincial and local government budgets have the discretion to fund such emergencies and disasters. The *Public Finance Management Act* and Municipal Finance Management Bill contain specific provisions to provide for appropriations to accommodate emergency-related spending at national, provincial and local levels.

Nothing in the current legal framework precludes a province or municipality from allocating funds to disaster related programmes (mitigation, relief, etc) to the extent that its resources allow. The current framework does not set predetermined ratios or proportions to be contributed by each sphere in the event of a disaster. There are both advantages and disadvantages with this approach. The advantage is that it leaves room for discretion among decision makers depending on circumstances. On the other hand, it creates uncertainty for the affected organ of state as to how much financial support it would receive from other sources.

Current funding arrangements for disasters and emergencies therefore take advantage of both centralised and decentralised mechanisms. National Government does not see the need for a separate conditional grant to enable municipalities and provinces to perform their emergency or disaster responsibilities. The current equitable share mechanism allows local governments to perform this function adequately for routine emergencies or disasters.

The FFC is invited to provide more specific information on any other problems that it believes should be resolved, including the advantages of alternative funding proposals over current arrangements.

Part 3: Fiscal Framework for 2003 MTEF

Fiscal framework

Table E-1 presents medium-term macroeconomic forecasts for the 2003 Budget. It sets out the growth assumptions and fiscal projections on which the fiscal framework is based.

Cabinet determines the division of revenue between spheres of Government using the previous year's baseline division as a point of departure and taking account of ongoing commitments, current and new policy priorities. For the 2003 Budget, the priorities are:

- Extending social assistance through enhanced income support to the poor, and improvements in the social grant payment system
- Improving the health capital infrastructure and increased spending on professional personnel with scarce skills, equipment and medicines
- Improving capacity to deal with the impact of HIV/Aids
- Enhanced spending on education programmes administered by provinces, specifically relating to the roll-out of the early childhood development programmes, supply of learner support material and reduction of classroom backlogs

Table E1 Medium-term macroeconomic assumptions

	2002/03		2003/04		2004/05		2005/06
	2002	2003	2002	2003	2002	2003	2003
R billion	Budget	Budget	Budget	Budget	Budget	Budget	Budget
Gross domestic product	1 082,8	1 120,1	1 178,9	1 234,6	1 277,5	1 344,3	1 466,6
Real GDP growth	*2,7%*	*3,2%*	*3,3%*	*3,4%*	*3,6%*	*3,8%*	*4,0%*
GDP inflation	*6,5%*	*7,7%*	*5,4%*	*6,6%*	*4,6%*	*4,9%*	*4,9%*
National Budget Framework							
Revenue	265,2	275,7	288,7	304,5	313,2	331,0	361,2
Percentage of GDP	*24,5%*	*24,6%*	*24,5%*	*24,7%*	*24,5%*	*24,6%*	*24,6%*
Expenditure	287,9	291,8	311,2	334,0	334,6	363,3	395,6
Percentage of GDP	*26,6%*	*26,1%*	*26,4%*	*27,1%*	*26,2%*	*27,0%*	*27,0%*
Budget deficit	-22,7	-16,1	-22,5	-29,5	-21,4	-32,4	-34,4
Percentage of GDP	*-2,1%*	*-1,4%*	*-1,9%*	*-2,4%*	*-1,7%*	*-2,4%*	*-2,3%*

- Enhancing investment in municipal household service infrastructure, including the prioritisation of basic services in support of the rural development and urban renewal strategies and labour-intensive job creation projects
- Accelerating the extension of free basic municipal services
- Accelerating the land reform and restitution programmes
- Improvements in the transport infrastructure at national, provincial and local level
- Higher education restructuring, including support for institutional mergers and investment in infrastructure
- Re-engineering services provided to citizens by the Department of Home Affairs
- Expanding capacity in the safety and security sector to prevent and combat crime, including a particular focus on the functioning of the court system
- A growing international role through increased regional representation and international commitments, in particular, support for the African Union and NEPAD.

The new priorities, and expansions of previous year's programmes, are accommodated through reprioritization and growth in the resource envelope. Growth in the resource envelope is due to robust tax collection, drawing down of the contingency reserve, unallocated infrastructure funds, and savings on debt service costs. In addition, higher inflation and revisions to the fiscal framework due to higher economic growth increases the amount of fiscal resources. Table E-2 reflects the additional resources available over last year's baseline allocations, totalling R25 billion in 2003/04 and R35 billion in 2004/05.

Table E2 Changes over baseline

	2003/04	2004/05	2005/06[1]
National	7 176	9 639	11 938
Provincial	16 150	23 105	30 085
Local	1 767	2 395	3 119
Allocated expenditure	**25 093**	**35 139**	**45 142**

1. The assumed baseline for 2005/06 is the 2004/05 baseline plus 6 per cent.

The additional funds are divided between the spheres depending on which sphere is responsible for the prioritised functions. The impact of the new policy priorities and additional funds on the total division of revenue is reflected in table E-3. The total division firstly makes provision for national commitments such as debt service costs as a direct charge on the National Revenue Fund, and the contingency reserve. Debt servicing obligations of R50,9 billion, R53,1 billion and R55,1 billion are projected for the three MTEF years, and the contingency reserve amounts to R3,0 billion, R4,0 billion and R8,0 billion. Once these commitments are taken into account, the revenue pool available for sharing between national, provincial and local spheres amounts to R279,9 billion, R306,2 billion and R332,5 billion over the three MTEF years.

Table E3 Division of revenue between spheres of government

	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
R million	Outcome	Outcome	Outcome	Revised	Medium-term estimates		
National departments[1]	66 385	73 178	87 709	98 853	108 983	117 549	126 323
Provinces	99 465	108 899	121 099	136 919	158 995	175 468	191 590
Equitable share	*89 094*	*98 398*	*107 460*	*123 457*	*142 386*	*155 313*	*167 556*
Conditional grants	*10 370*	*10 501*	*13 638*	*13 462*	*16 609*	*20 155*	*24 033*
Local government	4 610	5 536	6 516	8 801	12 001	13 249	14 624
Equitable share	*2 163*	*2 315*	*2 607*	*3 964*	*6 343*	*7 078*	*7 698*
Conditional grants	*2 447*	*3 221*	*3 909*	*4 837*	*5 658*	*6 171*	*6 926*
Non-interest allocations	**170 460**	**187 613**	**215 324**	**244 573**	**279 979**	**306 266**	**332 536**
Percentage increase	*7,4%*	*10,1%*	*14,8%*	*13,6%*	*14,5%*	*9,4%*	*8,6%*
State debt cost	44 290	46 321	47 581	47 250	50 986	53 079	55 070
Contingency reserve	–	–	–	–	3 000	4 000	8 000
Main budget expenditure	**214 750**	**233 934**	**262 905**	**291 823**	**333 965**	**363 345**	**395 606**
Percentage increase	*6,6%*	*8,9%*	*12,4%*	*11,0%*	*14,4%*	*8,8%*	*8,9%*
Percentage shares							
National departments	*38,9%*	*39,0%*	*40,7%*	*40,4%*	*38,9%*	*38,4%*	*38,0%*
Provinces	*58,4%*	*58,0%*	*56,2%*	*56,0%*	*56,8%*	*57,3%*	*57,6%*
Local government	*2,7%*	*3,0%*	*3,0%*	*3,6%*	*4,3%*	*4,3%*	*4,4%*

1. Includes a transfer of R855 million to the Umsobomvu Fund in 1999/00.

Both the shares for provincial and local government allocations increases significantly, with the provincial allocation increasing from 56,0 per cent to 57,6 per cent, and the local government allocation from 3,6 per cent in 2002/03 to 4,4 per cent in 2005/06. These increases are at the cost of National Government, whose share decreases from 40,5 per cent in 2002/03 to 38,0 per cent in 2005/06.

Table E-3 is the *actual* division of revenue between the three spheres of government, and Table E-4 is the Schedule 1 of the Division of Revenue Bill that reflects the *legal* division of revenue between the three spheres. In this legal division, the national share includes all conditional grants to the other two spheres, and the provincial and local government allocations reflect their equitable share only. This is because section 214 of the Constitution regards all conditional grants as additional funds allocated from the national equitable share.

Table E4 Schedule 1 of the Division of Revenue Bill

Sphere of government	Column A	Column B	
	2003/04	Medium term forward estimates	
R million	Allocation	2004/05	2005/06
National [1, 2]	185 236	200 954	220 352
Provincial	142 386	155 313	167 556
Local	6 343	7 078	7 698
Total	**333 965**	**363 345**	**395 606**

1. National share includes conditional grants to provinces and local spheres, debt service cost and the contingency reserve.

2. The direct charges for the provincial equitable share is netted out.

Nationally-raised revenue is distributed either through appropriation to main division of votes (programmes of national departments) or as a direct charges on the National Revenue Fund, in accordance with the Division of Revenue Bill and the Constitution.

Provincial equitable shares are direct charges on the National Revenue Fund and flow directly into Provincial Revenue Funds, where provincial legislatures appropriate the funds to main divisions of votes – in this instance, votes and programmes of provincial departments. Various local government allocations are appropriated on national votes, as the Constitution does not make them a direct charge on the National Revenue Fund. The local government equitable share is appropriated on the vote of the Department of Provincial and Local Government. The actual division of all grants (whether appropriated or a direct charge) between provinces or municipalities is in accordance with the Division of Revenue Bill and this memorandum.

Part 4: Provincial Allocations

National transfers to provinces for 2003/04, comprise more than 96 per cent of provincial revenues, with provinces raising less than 4 per cent of their revenues from own sources. Of the funds that are transferred, 90 per cent is through the equitable share and the remaining 10 per cent grants flows as conditional grants.

Table E5 Total transfers to provinces: 2002/03

R million	Equitable share	Conditional grants	Total transfers
Eastern Cape	24 228	2 219	26 447
Free State	9 463	1 247	10 709
Gauteng	21 876	3 919	25 794
KwaZulu-Natal	29 279	2 917	32 196
Limpopo	19 352	1 691	21 043
Mpumalanga	10 220	911	11 131
Northern Cape	3 455	386	3 841
North West	11 822	1 048	12 869
Western Cape	12 692	2 272	14 964
Total	**142 386**	**16 609**	**158 995**

Provincial equitable share

The Constitution entitles provinces to a share of nationally raised revenue. It is divided between provinces on the basis of the provincial equitable share formula. The provincial equitable share allocation funds the bulk of public services rendered by provinces. The equitable share amounts to R142,3 billion in 2003/04, R155,3 billion in 2004/05, and R167,5 billion in 2005/06. The structure of the equitable share formula has been retained for the 2003 Budget. Updates of data are effected on an annual basis, depending on availability of official data.

The equitable share formula

The equitable share formula comprises seven components or indices of the relative demand for services between provinces and taking into account 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 as broad indications of relative need and not earmarked allocations. Provincial Executive Committees have discretion regarding the provincial allocations for each function. The provincial equitable share formula comprises of 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
- 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 distribution of the rural population
- An economic output component (7 per cent) based on the distribution of total remuneration in the country
- An institutional component (5 per cent) divided equally among the provinces.

Table E-6 shows the current structure and distribution of shares by component. 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 for the purpose of allocating funds.

Table E6 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
Limpopo	15,4	13,3	13,7	12,1	3,0	11,1	22,9	13,6
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
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**

The phasing-in of the formula

In 1999, two years after the formula was introduced, data for the 1996 Census was published. 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 1999/00 to 2003/04. The target date of 2003/04 has been reached, and the formula is now fully implemented. Table E-7 shows the phasing. The 2001 Census are still to be published, so it has not been used in the current formula.

Table E7 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**

Education component

The education component targets primary and secondary schooling, which accounts for roughly 80 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. For 2003, Government has decided to retain the weightings in the 2002 Budget.

Table E8 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
Limpopo	1 904	1 665	15,4
Mpumalanga	922	789	7,3
Northern Cape	202	223	1,9
North West	934	896	8,0
Western Cape	928	895	8,0
Total	**12 184**	**10 930**	**100**

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 more than those with medical aid support. 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. Although there have been October Household Surveys in subsequent years, these do not improve the quality of this information and the 1995 data have been retained.

Table E9 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
Limpopo	376	4 554	13,3
Mpumalanga	392	2 409	7,2
Northern Cape	175	665	2,0
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 has two elements, the target population for the main social grants ("all grants" in Table E-10) and the population in the lowest two quintiles of the income distribution ("income adjustment"). The first element weights the target population groups (the elderly, disabled and children) according to historical distribution of expenditure on the different grants. The second element is based on results of the 1995 Income and Expenditure Survey (IES). The distribution of expenditure between grants has changed significantly since the introduction of the child support grant and updated information on this is readily available. However, it is also likely that income distribution has changed since 1995. Results of the 2000 Income and Expenditure

Survey have, however, only recently become available and need to be reviewed before the formula can be updated. Changes to the welfare component based on partial information would therefore not be appropriate. The welfare component is an index of the distribution of economic dependency and poverty levels between provinces and captures the responsibility of provinces to pay social grants. The weight of this component was increased to 18 per cent in 2002 from the initial 17 per cent to reflect the increasing relative expenditure on grants as a result of the child support grant. Increasing spending pressures as a result of the child support grant have also been accommodated in the vertical division of revenue, and the introduction of a new conditional grant for its extension to children up to the age of fourteen years.

Table E10 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
Limpopo	13,0	12,1	14,8	13,0	15,8	13,7
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
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 raised 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. The new GGP estimates published by StatsSA in November 2002 came out after Cabinet had decided on the formula for 2003, and will only be considered in next year’s budget.

Table E11 Economic activity shares

Percentage	Share of Remuneration
Eastern Cape	6,5
Free State	5,3
Gauteng	41,6
KwaZulu-Natal	17,0
Limpopo	3,0
Mpumalanga	4,9
Northern Cape	1,7
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. However, with the imminent phasing out of the provincial infrastructure grant, it is anticipated that this component will be reviewed.

Table E12 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
Limpopo	27,5	20,4	23,3	22,9
Mpumalanga	9,2	7,5	9,1	8,5
Northern Cape	1,2	1,2	1,3	1,3
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.

Conditional grants to provinces

Schedules 4 and 5 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 to provide for national priorities and compensate provinces for cross-boundary use of services, particularly in hospital services. The current conditional grant system has been shaped by reforms introduced through successive Division of Revenue Acts since 2000. These reforms have contributed to clarifying accountability between spheres. They have also helped sharpen description of policy objectives and grant outputs, thus resulting in improved use of grants in speeding delivery, and the strengthening of Parliamentary oversight.

Allocations

Table E-13 provides a summary of conditional grants by sector and province for 2003/04. Conditional grants to provinces amount to R16,6 billion in 2003/04, increasing to R24 billion in 2005/06, an average annual increase of 20,3 per cent from 2002/03. Seven departments administer grants, with the largest being in the health sector, totalling R7,4 billion, followed by housing, R4,4 billion, and the infrastructure grant, R2,5 billion. The most significant new conditional grant introduced is in Social Development, to fund the extension of the child support grant to children up to fourteen years. Education and Social Development departments also administer small but important grants for the improvement of financial management and the combating of HIV/Aids.

The major health grants were reconfigured in the 2002 Budget. Gauteng, and Western Cape continue to receive the largest share of health grants, as they receive most of the tertiary services and training grants in health (which make up more than 70 per cent of all health grants) since they provide most of the tertiary and specialised referral health services for the whole country. Apart from these health grants, and the housing subsidy grant, all other conditional grants favour poorer provinces.

Table E13 Conditional Grants to provinces for 2003/04

R thousand	Agriculture	Health	Provincial and Local Government	Infrastructure	Housing	Education	Social Develop-ment	Total
Eastern Cape	8 000	592 080	54 981	456 673	652 757	81 935	372 921	2 219 347
Free State	1 800	567 609	33 541	162 950	333 903	27 902	119 059	1 246 764
Gauteng	1 600	2 551 993	25 738	235 802	944 892	54 475	104 043	3 918 543
KwaZulu-Natal	6 500	1 127 856	46 754	500 302	822 390	97 877	315 324	2 917 003
Limpopo	8 000	371 682	25 590	540 632	437 160	69 534	238 468	1 691 066
Mpumalanga	3 500	242 765	18 231	216 066	282 408	32 330	115 832	911 132
Northern Cape	1 800	161 629	19 210	72 394	88 973	8 415	33 360	385 781
North West	5 000	249 671	22 681	204 479	355 974	35 431	174 621	1 047 857
Western Cape	1 800	1 548 592	24 021	145 190	436 782	34 989	80 289	2 271 663
Total	**38 000**	**7 413 877**	**270 747**	**2 534 488**	**4 355 239**	**442 888**	**1 553 917**	**16 609 156**

Table E-14 presents a summary of all the conditional grants listed in Schedules 4 and 5 of the Bill for the 2003 MTEF.

Health grants

Health grants amount to about R7,4 billion in 2003/04, and increase to R8,8 billion by 2005/06, reflecting an annual average increase of about 9 per cent. Health grants constitute about 44 per cent of total conditional grants to provinces. Following comprehensive research, the health sector reconfigured the three tertiary services and training grants and implemented a new framework for tertiary services and training in the 2002 Budget. The two grants are: the National Tertiary Services grant (NTS) and a Health Professions Training and Development grant (HPTD).

The NTS grant amounts to nearly R4 billion in 2003/04, increasing to R4,5 billion in 2005/06. The NTS grant targets 27 hospitals spread across the provinces. However, given the provisioning of tertiary services in the Western Cape and Gauteng for the benefit of the health sector countrywide, about 70 per cent of the grant still flows to these provinces. Further research to explore ways of improving inter-provincial distribution of medical specialists is under way. The outcome of the research will inform government's approach to funding tertiary services ahead of the 2004 Budget.

The HPTD grant increases from R1,3 billion in 2003/04 to R1,5 billion in the third year, and consists of several components. The largest portion is distributed to provinces according to a formula based on the number of current medical students. In the 2002 Budget, an additional component was introduced to provide for a phased increase in the number of medical specialists and registrars in under-served provinces to address inter-provincial inequities in post-graduate training capacity. This additional component amounts to R227 million over five years.

The Hospital Revitalisation grant funds a broader range of activities aimed at improving the quality of hospital infrastructure and quality of services, including upgrading and replacement of equipment. The allocation for the Hospital Revitalisation grant amounts to R717 million in 2003/04, an increase of about 11 per cent compared to 2002/03. The allocation grows to R1 billion in the last MTEF year. Over the next three years the grant will fund revitalisation of a further 18 hospitals, two in each province. The 2003 MTEF allocation for the revitalisation grant includes a new component aimed at improving systems for medical equipment and mechanisms for facilitating adoption of modern technology.

The Integrated Nutrition Programme (INP) is targeted at poor provinces with large populations of school children. The Eastern Cape, Limpopo and KwaZulu-Natal receive more than 60 per cent of the allocation. The 2003 MTEF provides for an average annual increase of 21 per cent for the Integration Nutrition Programme rising from R592 million in 2002/03 to R808 million in 2003/04, further increasing to R1 billion in 2005/06. This increase will provide for expansion of the programme to cover more school children, rising prices, and improved quality of feeding. The grant is at present administered by the Department of Health but will be moved to the Department of Education from 2004/05, as this programme is delivered through the schooling system.

The Hospital Management and Quality Improvement grant is allocated R133 million in 2003/04, increasing to R150 million in 2005/06. This grant facilitates financial, personnel, and procurement delegations and strengthens financial management capacity. It also supports the implementation of a range of hospital quality of care interventions specified in the national policy for quality of care and can be seen as complimentary to the aims of the hospital revitalisation programme.

The health sector share of the HIV/Aids grant increases from R210 million in 2002/03 to R334 million in 2003/04. The significant increase in the allocation of this grant to the health sector is to give effect to Cabinet decisions and to implement additional programme priorities - post exposure prophylaxis for victims of sexual abuse, rollout of mother-to-child transmission prevention and targeted interventions for commercial sex workers – whilst still maintaining other HIV/Aids prevention programmes.

Table E14 Conditional grants per sector

R thousand	2002/03	2003/04	2004/05	2005/06
Provincial and local government	**293 131**	**270 747**	**261 192**	**43 558**
Local Government Capacity Building Fund	241 244	232 339	220 459	–
Consolidated Municipal Infrastructure Programme	51 887	38 408	40 733	43 558
National Treasury	**1 950 000**	**2 534 488**	**2 876 362**	**3 055 773**
Provincial Infrastructure	1 550 000	2 334 488	2 876 362	3 055 773
Flood Rehabilitation	400 000	200 000	–	–
Education	**408 778**	**442 888**	**377 058**	**399 681**
Financial Management and Quality Enhancement	228 320	234 414	248 479	263 388
HIV/Aids	127 458	120 474	128 579	136 293
Early Childhood Development	53 000	88 000	–	–
Health Professions Training and Development	**6 820 945**	**7 413 877**	**8 192 855**	**8 803 986**
National Tertiary Services	3 727 077	3 994 774	4 273 005	4 529 386
Health Professions Training and Development	1 299 248	1 333 499	1 434 132	1 520 180
Hospital Revitalisation	649 000	717 628	911 856	1 027 427
Cholera Epidemic - KwaZulu-Natal	147 000	–	–	–
Pretoria Academic Hospital	70 000	92 356	–	–
HIV/Aids	210 209	333 556	481 612	535 108
Integrated Nutrition Programme	592 411	808 660	950 418	1 041 543
Hospital Management and Quality Improvement	126 000	133 404	141 832	150 342
Social development	**58 300**	**1 553 917**	**3 858 180**	**6 862 391**
HIV/Aids	47 500	65 917	70 180	74 391
Child Support Extension Grant	–	1 100 000	3 400 000	6 400 000
Food Relief	–	388 000	388 000	388 000
Financial Management	10 800			
Agriculture	**24 000**	**38 000**	**–**	**–**
Land Care and Special Food Security Projects	24 000	38 000	–	–
Housing	**3 906 674**	**4 355 239**	**4 589 137**	**4 867 876**
Housing Subsidy	3 800 674	4 246 239	4 473 597	4 745 404
Human Resettlement and Redevelopment	106 000	109 000	115 540	122 472
TOTAL	**13 461 828**	**16 609 156**	**20 154 784**	**24 033 265**

Education grants

The Department of Education manages grants for financial management and school quality enhancement, early childhood development and HIV/Aids. The financial management grant is in its fifth year, and it plays a pivotal role in the implementation of the strategic objectives of education transformation (*Tirisano* strategy). No changes are proposed to the baseline allocations of this grant.

The early childhood development grant was introduced in 2001. This grant is now in its last year and will be incorporated into the equitable share in 2004, with the allocation of R88 million. The roll out of the programme, to be phased in over 10 years, will mainly be funded from provincial equitable shares.

The education sector is also responsible for the roll out of to the HIV/Aids programme life skills in schools. This grant increases from R120 million in 2003 to R136 million in 2005.

National Treasury grants

The provincial infrastructure grant grows from R2,5 billion in 2003/04 to R3 billion in 2005/06. This brings the total infrastructure funds available through this grant to R8,2 billion over this period. In order to deal effectively 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 have 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 needs for rural development. Provincial treasuries administer this grant and make allocations are made to the line departments.

The flood disaster reconstruction grant is used to assist with the reconstruction and rehabilitation of infrastructure damaged by floods in 1999 in all the provinces. This grant phases out with the final allocation of R200 million in 2003.

Housing grants

The Department of Housing administers two grants. The Housing Subsidy Fund provides subsidies for low-income housing, and the Human Settlement Redevelopment grant funds urban pilot projects. The Housing Subsidy allocation increased significantly in the 2002 Budget in order to enable the department to improve the quality of houses and to take on new priorities, including the implementation of medium density housing. The 2003 budget makes an above baseline allocation of R373 million to allow for an inflation adjustment of subsidies. The housing subsidy grant increases from R4,2 billion in 2003/04 to R4,7 million in 2005/06.

In 2001, 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).

In order 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.

Department of Provincial and Local Government Grants to Provinces

The Department of Provincial and Local Governments transfers two grants to provinces – Local Government Capacity Building Fund and the Consolidated Municipal Infrastructure Programme grants – to enable provinces to assist municipalities. The Local Government Capacity Building Fund is allocated to support efforts to restructure institutional and financial arrangements and assist municipalities facing financial difficulties in the medium term. It amounts to R232 million and R220 million in 2003/04 and 2004/05. In the 2003 allocation, the component of CMIP that focused on capacity building, is consolidated into this grant. By 2004/05, this grant will be phased out and a consolidated Municipal System Improvement Grant capacity building grant (inclusive of all capacity building initiatives at local government) will be created and funds will be transferred directly to municipalities.

In addition to the CMIP component that focused on capacity building (now incorporated into the LGCBF), the CMIP funding to provinces contain a component that is focused on managerial, technical and administrative support to enable municipalities to implement the infrastructure programme. This component of the grant continues, and provinces are allocated R38 million in 2003/4, increasing to R44 million in 2005/06.

Social development grants

The Department of Social Development manages grants for Child Support Grant Extension, Food Security and the HIV/Aids Integrated Plan.

The Child Support Extension grant amounts to R1,1 billion in 2003 increasing to R3,4 billion in 2004 and R6,4 billion in 2005. The grant will fund the phased extension of the means-tested child support grant to children until they reach the age of 14 years. The phasing will start with 7 and 8 year old children in 2003/04, incorporate 9 and 10 year old children in 2004/05 and, in 2005/06 incorporate 11, 12 and 13 year old children. The allocations also make provision for reasonable administration and payment costs.

The aim of the Food Relief grant is to provide emergency food assistance to destitute individuals and households. This grant contributes towards mitigating the effect of higher food prices and provides a mechanism to rapidly respond to urgent needs of poor people, especially women and children in poor and rural communities where food deprivation is the greatest. The food relief grant amounts to R388 million a year.

The HIV/Aids Integrated Plan grant amounts to R66 million in 2003/04, increasing to R70 million in 2004/05 and R74 million in 2005/06. The main focus of this grant is to facilitate the implementation of an integrated HIV/Aids programme through home based and community based care.

The Financial Management Grant was phased out 2002/03.

Part 5: Local government allocations

Local government's share of nationally raised revenue increases significantly from 3,6 per cent in 2002/03 to 4,4 per cent in 2005/06. It grows from R8,8 billion in 2002/03 to R12,0 billion in 2003/04, an increase of R3,2 billion or 36,4 per cent. The allocation grows to R14,6 billion at the end of the MTEF in 2005/06.

The funds are distributed through three major funding sources, the equitable share, two conditional grants for municipal infrastructure and capacity building, and a number of grants-in-kind. National allocations are an important (and growing) source of revenue for municipalities, and are expected to comprise approximately 17 per cent[1] of all municipal revenue in the 2003 municipal budgets. For poorer municipalities the share is even higher, typically making up 60 per cent of their total revenue.

The 2003 Budget will build on previous budgets and continue to support the National Government's commitment to poverty relief and job creation. Additional resources will remain focused on the provision of free basic services, infrastructure provision and institution building.

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[1] The National Treasury estimates that the 284 municipalities will collect around R68 billion for their 2003 budgets. This estimate is lower than budgeted figures since municipalities do not collect all revenue budgeted, and also include borrowed funds.

Table E 16 National transfers to local government

R million	2002/03	2003/04	2004/05	2005/06
Equitable share	3 964	6 343	7 078	7 698
Transition grant	223	–	–	–
Water & sanitation operating	700	836	858	934
Subtotal equitable share & related	**4 887**	**7 180**	**7 936**	**8 633**
Consolidated Municipal Infrastructure Programme	1 671	2 246	2 724	3 016
Water Services Project	999	1 102	948	1 037
Community Based Public Works Programme	260	260	–	–
Local Ecomomic Development Fund	111	117	–	–
Sport & Recreation facilities	76	123	–	–
National Electrification Programme	228	240	245	258
Urban Transport Fund	40	9	–	–
Integrated Sustainable Rural Development	32	–	–	–
Municipal Infrastructure Grant	–	47	117	97
Unallocated[1]	–	–	555	588
Subtotal capital	**3 416**	**4 144**	**4 588**	**4 996**
Restructuring grant	250	315	343	363
Financial management grant	154	212	199	208
Municipal Systems Improvement	94	150	182	423
Subtotal capacity building & restructuring	**498**	**677**	**724**	**995**
Total transfers to local government	**8 801**	**12 001**	**13 249**	**14 624**

1. Poverty relief allocations in 2004/05 & 2005/06 are subject to a Cabinet review and therefore unallocated.

Table E-16 reflects all the national grants to local government.

This year, for the first time, all grants to municipalities are published per municipality as part of this Budget as annexures to this memorandum to facilitate credible budgeting at local government sphere. Previously, these allocations were only published about two months after the national Budget.

The allocations are also published for both the national and municipal financial year. The local government financial year commences three months later than the national and provincial financial year, on 1 July. The allocation in terms of the national financial year is the legal requirement and serves as the legal requirement for national and provincial transferring departments, and for audit purposes. The allocations in terms of the municipal financial year facilitates municipal budgeting as these allocation are required for municipal revenue budgets. Some conditional grants allocation could not be published for the municipal financial year – these will be provided to Parliament during the Portfolio Committee hearings on the Bill.

Municipalities take responsibility for the delivery of services to residents in their jurisdiction and this means that all grants provided to public entities, like Eskom and Water Boards, for the provision of municipal services will be done through the municipality. Service delivery agreements will have to be signed between the municipality and national public entities like Eskom and Water Boards. *The Municipal Systems Act* require that such providers be accredited as external mechanisms for the delivery of municipal services.

The equitable share for local government

Background

Section 227 of the Constitution requires that an equitable share of revenue raised nationally be allocated to local sphere of government to enable it to provide basic services and perform the functions allocated to it. The equitable share grant and formula were first introduced in 1998/99. It is an unconditional grant assisting municipalities in supplementing their revenue to deliver services to poor households.

The equitable share formula was developed at a time when there was little information on each municipality. Essential information on population and income demographics of every municipality, their fiscal capacity and efficiency, backlogs, budget and costing information was not available and the formula had to be designed around the limited information that was available at the time. The population, per capita expenditure, household size, urban/rural proportions, and the number of poor households in the municipality are the primary factors used in determining formulae-based allocations for individual municipalities.

Table E-14 shows that the equitable share is growing in importance and is projected to increase by R2,4 billion from the 2002/03 figure of R3,9 billion to R6,3 billion in 2003/04. This reflects government's commitment to the provision of basic municipal services to poor households. As the intergovernmental system is maturing, the equitable share grant increases in relation to other local government grants, from 45 per cent in 2002/03 to 53 per cent in 2003/04.

The equitable share grant has undergone a number of changes since its inception. These include the incorporation of R293 town subsidies, the re-alignment of allocations to the newly demarcated municipalities, and allocations to the district municipalities in the 2002/03 financial year. For 2003/04, a separate window for the funding of free basic services (electricity, water and sanitation) is created. This will enable municipalities to accelerate the provision of free basic services to poor communities.

A major change implemented for 2003/04 is the alignment of the equitable share allocation to the new division of functions between local (Category B) and district (Category C) municipalities. These divisions were gazetted by the Minister for Provincial and Local Government on 3 January 2003, and take effect from 1 July 2003 for the new municipal financial year. The Local Government Transition Grant is also discontinued as a separate grant and incorporated into the main equitable share formula.

The publication of the 2001 Census data during the course of 2003 will provide the opportunity to comprehensively review the local government equitable share formula. Given the impending restructuring of the electrification industry, the review will also assess whether current revenue raising powers match the functions of various categories and types of municipalities, the tax-raising powers of local government and their assignment within the local sphere, the future of the RSC levies, the feasibility of municipal levies on key municipal services like electricity and water, and the division of fiscal powers between category B and C municipalities. The review will also include the formula for the equitable share, and conditional grants, and include the phasing in of other grants – such as the water services operating subsidy – into the equitable share. It is anticipated that this review will be completed in time for the 2004 Budget.

The adjustments to the equitable share grant formula for the 2003 Budget is an interim measure to take account of urgent considerations. The following six budget windows are used in the allocation of the equitable share grant for the 2003/04 *national* financial year:

Element	**R million**
Equitable share allocation	6 343
(1) Less: R293 allocations	*381*
Amount available for distribution through the formula	5 962
(2) S-grant (including guarantees)	4 178
(3) I-grant	450
(4) Nodal allocation	212
(5) Free basic services (water, sanitation, refuse)	822
(6) Free basic electricity	300

Each of these windows are discussed below. Additional information on R293 allocations and the demographic information used in the equitable share is provided by StatSA and is included as annexures to the Division of Revenue Bill.

R293 allocation

This window is phased out in 2004/05. It originally had two components, one dealing with non-personnel and the other with personnel. The non-personnel component of the R293 allocation was phased-out and included into the local government equitable share for the 2000/01 financial year.

The equitable share allocations for the 2001/02 to 2003/04 financial years included funding for R293 staff transferred to municipalities. Municipalities were guaranteed to receive a R293 town allocation for staff (100 per cent as at transfer) over a three year period ending 30 June 2004. Thereafter the normal formula allocations will apply, and the guarantee mechanism (as discussed below) will also apply.

S-grant

The S-grant is the biggest component within the equitable share grant, and is designed to meet the operating costs of a municipality when providing a package of basic services to low income households. Poor households are classified as those spending less than R1 100 per month.

The formula for the S-grant is:

$$S = \alpha \beta L H_i$$

Where : α = a phase-in parameter with 0< a ≤ 1;

β = a budget-adjustment parameter, set to adjust the size of the grants to the available budget;

L = an estimate of the annual cost of providing basic public services; and

H_i = the number of poor households.

The following parameters will be used for the 2003 MTEF:

	Parameter	2003/04	2004/05	2005/06
α	Rural alpha	0.7	0.85	1
	Urban alpha	1	1	1
β	Budget adjustment parameter	1,3582		
L	Annual cost of basket of basic services	R1 032		

The alpha parameters were introduced in recognition of the differences in the financial and administrative capacities of rural and urban municipalities. The alpha values for urban and metropolitan municipalities will reach 1 in the 2003/04 financial year, whilst the alpha values for the rural municipalities will reach 1 in the 2005/06 financial year. This will take account of capacity to spend efficiently and effectively.

The threshold poverty level is set at R1 100 household expenditure per month. According to the 1996 Census, 3,2 million households are living in poverty.

In the 2003/04 financial year corrections have been made for the powers and functions carried out by different municipalities. The S-grant is divided between category B and C municipalities in line with functions performed. The overall S-grant is split up as follows: 23,3 per cent is for water supply, 41,9 per cent is for electricity supply, 11,6 per cent for sanitation services and 23,3 per cent for refuse removal.

I-grant

The purpose of the I-grant is to provide resources to municipalities to assist in institutional and governance requirements. The grant is designed to target municipalities with little capacity to fund their own administrative infrastructure. Currently the I-grant formula is applied to metropolitan, local and district municipalities. However, metropolitan municipalities have relatively high fiscal capacity and, do not qualify for the grant. Unlike last year, the grant allocations for district municipalities are determined by the same formula.

The first part of this formula captures how the administrative costs of a municipality increase with population size. It assumes that these costs increase more slowly than population does, i.e. a larger municipality has more costs, but not proportionately more than a smaller one. The second part of the formula is a correction for the inability of the municipality to fund its own administrative overheads. The formula for the I-grant is:

$$Ii = I_0 Pi^{\gamma} - 0.075\,(yi - 250\,)Pi$$

Where: I_0 = a per capita ***I***-grant parameter that serves to determine the total amount of money allocated through the I-grant;

Pi = is the population in the municipality i;

γ = a scale parameter that could take any value > 0 and ≤ 1; and

yi = is the average monthly per capita expenditure in municipality i. for values of yi below the stated monthly per capita floor of R250 , the term (yi - per capita floor) is set equal to zero.

The following values are allocated to the I-grant for Category A and B municipalities for the 2003 MTEF:

	Parameter	Value
I_0	per capita parameter for category B municipalities	R195 397
	per capita parameter for category C municipalities	R329 818
γ	Scale parameter	0.25
y_i	Average per monthly per capita expenditure threshold	250
	Population cut-off	5 000
	Per capita floor	R250

Nodal Allocations

The President announced 21 development nodes in his 2001 State of the Nation Address. Departments were subsequently requested to prioritise funding to these under-developed areas. In line with this objective, additional equitable share allocations are made available to these nodes for non-infrastructure developmental programmes, beginning in 2002/03. The funding of the nodes are linked to the life-span of projects. Similar to last year, 65 per cent of the nodal equitable share allocation will be allocated to the rural nodes and 35 per cent to the urban nodes.

Free Basic Services

This is a new supplementary component to accelerate the pace for the provision of free basic electricity/energy and free basic services (water, sanitation, refuse) to poor households. The division between municipalities has been determined by the S-grant formula and 1996 Census data on municipal infrastructure for water, sanitation, refuse and electricity infrastructure for poor households.

"Guaranteed" Amount

To create stability and prevent the disruption of services, municipalities are guaranteed 70 per cent of their previous year's allocation. However, given the new functions for the 2003/04 financial year for category B and C municipalities, the equitable share allocations have been adjusted to provide funds to the municipality legally entitled to perform that function.

The guarantee mechanism does not apply to that portion where a municipality no longer carries out a specific function.

Conditional grants to local government

Schedule 6 and 7 of the Division of Revenue Bill presents the conditional grants to municipalities. Conditional grants are a significant portion of national grants. In particular, conditional grants are used to:

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

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 6 and 7 of the Division of Revenue Bill, 2003.

Capacity-building and restructuring grants

Over the past years, national and provincial government have committed significant resources to assist in building capacity at the local level of government. The range of programmes administered by different national departments is fragmented and in the process has delayed or does not appear to have delivered substantial improvements in municipal capacity. Government is concerned that the lack of coordination among capacity-building initiatives reduces their impact in improving the capacity of municipalities. Government intends to create one consolidated local government capacity-building programme, overseen by a multi-departmental team.

The Department of Provincial and Local Government (DPLG) is spearheading the shift towards a comprehensive capacity-building strategy. An interim framework for municipal capacity building allocations regulates the alignment of 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 integrated development planning, strategic management and service delivery skills, and financial management and budget reforms. In line with this approach, the Local Government Capacity Building Grant, which is currently distributed via provinces to municipalities, will be incorporated into the Municipal Systems Improvement Grant and will be transferred directly to municipalities. The financial management grant under the National Treasury vote is committed to the international technical assistance programme. The demands of the coming *Municipal Finance Management Act* will require significant capacity building in municipalities. The National Treasury is working closely with DPLG to ensure co-ordination between the various capacity building programmes.

Capacity building and restructuring grants doubles from R498 million in the 2002/03 financial year to R995 million in the 2005/06 financial year. This translates to a nominal average annual increase of 26 per cent (19, 4 per cent in real terms) over the next three years. Capacity building grants to municipalities that flow through provinces will be incorporated into the municipal systems improvement grant in 2005/06. This translates to an additional R233 million to the local sphere and hence the sharp increase in the municipal systems improvement grant in 2005/06.

The bulk of capacity building grants are targeted at smaller and medium size municipalities whereas the restructuring grant is targeted at larger municipalities with budgets exceeding R300 million.

Capital transfers to local government

Infrastructure grants are a critical component of the national government's objective to expand the delivery of basic services to poor households and to alleviate poverty. They complement the equitable share allocations to give effect to government's commitment for delivery of free basic services.

A further objective of the infrastructure grants is to stimulate job creation, and ensure skills transfer and gainful employment creation over the medium term. An additional R1 billion over the next three years is allocated for the purpose of labour-based infrastructure investments. These funds will be distributed through the existing municipal infrastructure grants framework.

Infrastructure grants increase to R4,1 billion in 2003/04 from R3,4 billion in 2002/03. For the outer years, total infrastructure transfers rise to R4,6 billion and R4,9 billion. The largest rise is in the Consolidated Municipal Infrastructure Programme (CMIP) grant, which experience an average annual increase of 21,8 per cent between 2002/03 and 2005/06.

Of the total infrastructure transfers allocated in the period 2003/04, about 49 per cent goes to nodes identified as part of the Urban Renewal and the Integrated Sustainable Rural Development programmes. Metropolitan areas receive 16,3 per cent of the total, of which 84 per cent goes into urban development nodes. District municipalities and district management areas receive 67,8 per cent of which about 51 per cent are for rural development nodes.

National Government is in the process of finalising the rationalisation of the many infrastructure grants to municipalities, and create the new Municipal Infrastructure Grant (MIG). The MIG gives effect to earlier Cabinet and Budget Forum decisions and policy positions on the establishment of a single consolidated fund for municipal infrastructure provisioning. The MIG gives municipalities a central role in coordinating development activity within their jurisdictions and the delivery of municipal infrastructure. The conditionalities of the MIG is focused on achieving a number of output conditions, including the achievement of service coverage targets and employment creation and link directly with Municipal Integrated Development Plans (IDP). The IDPs will be the primary strategic management tools for determining the scope, scale and mix of local service delivery activities through assessing local needs and priorities. The role of National Government would be to support, monitor policy outcomes and regulate municipal infrastructure investments. Crucially the policy reform around infrastructure grants will bring the grant system in line with the general direction and path of the intergovernmental system, which is focused towards improving the capacity, efficiency, effectiveness, sustainability and accountability of the local sphere.

Implementation of the MIG is expected to commence in October this year, and to be fully in place by 2005/06. Phased in over a three-year period, the new MIG will be created through the merger of the Consolidated Municipal Infrastructure Programme, the Water Service Grant (managed by the Department of Water Affairs and Forestry), and the National Electrification Programme (managed by the Department of Minerals and Energy). Current electrification funding will be incorporated once the framework for restructuring of the electricity distribution industry has been finalised. Consideration will also be given to including the existing poverty-relief programmes like the Local Economic Development Fund, the Community Based Public Works Programme and the Building for Sports and Recreation in the consolidated grant. These programmes will be incorporated after National Government has reviewed the poverty-alleviation programmes.

The Division of Revenue Bill, attendant documentation (schedules indicating revenue division and grant frameworks), and background material such as the *Intergovernmental Fiscal Review* are available on the National Treasury website (www.treasury.gov.za).