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Explanatory memorandum to the Division of Revenue

Background

Section 214(1) of the Constitution of South Africa requires that every year a *Division of Revenue Act* determine the equitable division of nationally raised revenue between the three spheres of government. The Act should also explain the formulae for dividing the equitable shares among the 9 provinces and 284 municipalities.

The *Intergovernmental Fiscal Relations Act (No. 97 of 1997)* reinforces section 214 of the Constitution by promoting co-operative governance on fiscal, budgetary and financial matters and by prescribing the process for determining the equitable sharing and allocation of revenue raised nationally. It establishes the Budget Council and Budget Forum – the consultative intergovernmental forums for the budget and fiscal management process. Sections 9 and 10(4) of the Act set out the consultation process to be followed with the Financial and Fiscal Commission (FFC), including the process of considering recommendations made with regard to the equitable division of nationally raised revenue.

This explanatory memorandum to the 2005 Division of Revenue Bill fulfils the requirement set out in Section 10(5) of the *Intergovernmental Fiscal Relations Act* which requires the Division of Revenue Bill to be accompanied by an explanatory memorandum detailing how the Bill takes account of the matters listed in section 214(2) (a) to (j) of the Constitution, Government's response to the recommendations of the Financial and Fiscal Commission and any assumptions and formulae used in arriving at the respective divisions among provinces and municipalities.

The explanatory memorandum contains six 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 2004 division of revenue have been taken into account. Part 3 outlines the fiscal framework that informs the division of resources between the three spheres of government. Part 4 explains the new formula and criteria for the division of the provincial equitable share among provinces, and also for conditional grants to provinces. Part 5 sets out the new formula and criteria for the division of the local government equitable share and conditional grants between municipalities. Part 6 summarises issues that will form part of subsequent reviews of sub-national fiscal frameworks.

This explanatory memorandum must be read with the Division of Revenue Bill. The Division of Revenue Bill and its underlying allocations are the culmination of extensive consultation processes between the three spheres of government. The Budget Council deliberated on the matters discussed in this memorandum at its annual Lekgotla from 2 to 5 September 2004, and meetings of 8 June, 14 October and 6 December 2004 and 3 February 2005. The approach to local government allocations were discussed with organised local government at several technical meetings with the South African Local Government Association (SALGA), culminating in a meeting of the Budget Forum (Budget Council plus SALGA) on 14 October 2004. The Ministers' Committee on the Budget (which also consulted MECs for Finance on social sector budgets) forwarded its recommendations on the division of revenue to Cabinet for consideration. An Extended Cabinet meeting, involving Cabinet Ministers, Premiers of provinces and the chairperson of SALGA, was held on 20 October 2004 and agreed on the final budget priorities and the division of revenue over the next three years. Subsequent revisions to the provincial and local government framework after the Medium Term Budget Policy Statement tabled on 26 October 2004 have also been discussed in the Ministers' Committee on the Budget, Budget Council, SALGA and FFC, and approved by Cabinet.

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

This part shows how Government complies with section 214(2) of the Constitution, which requires that the annual *Division of Revenue Act* only be enacted after taking account of the factors in sub-section 214(2) (a) to (j) of the Constitution. Government's medium term strategic goals give effect to section 214(2) (a) to (j) of the Constitution and form the thrust of the 2005 MTEF which consolidates efforts targeted at strengthening investment and job creation, reducing poverty and supporting vulnerable groups, education and skills development, creating sustainable communities, and enhancing service delivery. Government's priorities centre on the following key focal points:

- Promoting economic growth through an increase in the rate of productive investment in the economy.
- Improving the quality of livelihoods for the marginalised by encouraging employment and enterprise development.
- Maintaining a social security net, while mobilising human resources and investing in community services.
- Improving the State's capacity by enhancing public administration and fighting crime.
- Promoting international and regional relations for growth and development.

The *2005 Budget Review* sets out in detail how the constitutional issues and Government's priorities are taken into account in the 2005 Division of Revenue. It focuses on the economic and fiscal policy considerations, revenue issues, debt and financing considerations and expenditure plans of Government, and aspects of provincial and local government financing, are discussed in chapters 6 and 7. Readers are thus advised to read this annexure with the *2005 Budget Review*. Below is a summary of the Constitutional principles that informed the division of revenue.

National interest and the division of resources

After 10 years of democracy during which Government has consistently and steadfastly pursued the objective of a stable macroeconomic environment, and reduction in income poverty, South Africa has begun to enjoy the fruits of this policy through higher growth, low and stable inflation and signs that the economy is beginning to experience the creation of jobs. Government remains committed to eradicating social exclusion, creating more employment opportunities, reducing crime, addressing HIV and Aids, developing an efficient public service and nation-building which are key contributors to a better life for all South Africans. Since programmes to meet these goals cut across all three spheres of government, and often across departments, they are most appropriately guided by policies set by national government. Broad-based programmes in the national interest introduced by Government include the prioritisation of the social sectors (education, health and social welfare), expansion of the social safety net, nutrition (including food security), housing, sustainable infrastructure development (at provincial and municipal level) and rural development. One of the key reforms introduced in the national interest includes a change in the way social grants are to be funded, by centralising its funding from the national equitable share.

Provision for debt costs

Government's debt management strategy over the past few years has contributed to the current strong macroeconomic environment. Government has succeeded in bringing down debt service costs, thus freeing up more funds for essential public expenditure, while contributing to capital market stability. Debt service costs as a percentage of GDP are set to continue to decline. Government will continue with its prudent debt management strategy over the medium term. Chapter 5 in the *2005 Budget Review* deals with financing the budget deficit and debt service costs.

In deciding the division of revenue between the three spheres of government provision is made for the proceeds of borrowing by national government. The bulk of that borrowing is in the form of savings of South African citizens and the remainder is in foreign savings. In recognition of Government's obligation to repay those citizens and to protect the capacity to borrow at the lowest rates, the costs of servicing debt are met before resources are shared. Most of this borrowing went into financing Government programmes across the three spheres of government. Chapters 3 and 5 discuss debt costs and their financing in more detail.

National government needs and interests

While taking into account the exclusive and concurrent functions assigned to provincial and local governments, the 2005 division of revenue provides for functions that transcend provincial and local boundaries and serve national interest. These include growing the economy, creating a stable macroeconomic environment, protecting its citizens, dealing with equity and fairness in society and at the same time addressing poverty and vulnerability. More directly, national government is strengthening foreign relations through, involvement in peacekeeping efforts in other parts of Africa and its representation in multilateral institutions such as the World Bank, International Monetary Fund, World Trade Organisation, SADC and the African Union, among others. Key priorities on the national budget are the strengthening of the integrated justice sector, infrastructure development and rehabilitation, employment creation and programmes aimed at alleviating poverty. The national sphere is also responsible for meeting the contractual and statutory commitments of the state and for providing transversal systems of governance, including tax administration and financial information systems. National government is responsible for policy development, regulation and monitoring of functions shared with provincial and local government.

Provincial and local government basic services

The division of revenue provides equitable share increases to provinces and local government to give effect to Government's commitment in progressively meeting basic needs. The formulae used to divide resources among the 9 provinces and among the 284 municipalities takes into account the powers and functions of these spheres. This year's division of revenue strengthens current pro-poor programmes and seeks to extend the outreach of basic services to the poor. The housing programme is allocated an additional R2 billion rand over the next three years reflecting Government's commitment to speed up housing delivery and at the same time develop sustainable communities. Government also recognises the need to invest in old townships and new housing estates aimed at creating integrated and dynamic urban livelihoods alongside the municipal infrastructure investment programme – focused on basic residential services infrastructure such as water, sanitation, roads and refuse removal. In this regard R3 billion is set aside for this community investment programme. To improve access to free basic services and deal with backlogs in basic municipal infrastructure, all funds for municipal infrastructure have been consolidated into the Municipal Infrastructure Grant (MIG). The MIG is further augmented by R1,2 billion to eradicate the bucket system and replace it with a proper waterborne sanitation system. Chapter 7 contains further details on national transfers to provinces and local government.

Fiscal capacity and efficiency

The Constitution assigns substantial revenue-raising powers to the national sphere. Despite the promulgation of the *Provincial Tax Regulation Process Act (No. 53 of 2001)*, no province has as yet introduced a new provincial tax. Consequently provinces still have limited revenue-raising capacity relative to the resources required to deliver provincial functions, which 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.

Developmental needs

Government's priorities and the division of revenue are aligned to the Millennium Development Goals which seek to, among other things, eradicate poverty, ensure a minimum level of schooling, reduce child mortality, combat HIV and Aids and other diseases, ensure environmental sustainability, and develop a global partnership for development. The extent of interventions needed in South Africa differs among provinces and among municipalities mainly due to the disproportionate development strategies of the apartheid era. Government's priorities over the years have sought to ensure that social and economic deficits inherited from apartheid are addressed. The 2005 Budget reinforces Government's commitment of addressing and achieving its developmental goals.

The equitable share formulae for provincial and local government and specific conditional grants are revised to deal with the disproportionate levels of development among provinces and among municipalities. Further, various infrastructure grants and growing capital budgets aim to boost economic and rural development of provinces and municipalities and at the same time address the social and economic infrastructure backlogs.

Economic disparities

Economic disparities exist between and within provinces and municipalities. The equitable share formulae are redistributive and recognise that provinces and municipalities have different demographic and economic profiles and markedly different levels of economic development. In particular, Government has increased allocations to invest in economic infrastructure like roads, and social infrastructure like schools, hospitals and clinics, in order to accelerate economic growth and job creation. Under the umbrella of programmes such as the Expanded Public Works, Government intends to spread opportunities for more South Africans to engage in income earning activities.

Obligations in terms of national legislation

While the Constitution confers significant autonomy on provincial governments to determine provincial priorities within a national policy framework and allocate provincial budgets, national government retains responsibility for policy development and for monitoring implementation within concurrent functions. Although the equitable share allocations and other transfers allow provinces and local government discretion, national policies create mandates, which define the broad framework within which provincial and municipal budgets are framed. Conditional grants also provide funding for national priorities that are implemented by provincial or local government. These include grants for housing and integrated nutrition.

The enactment of the National Health Act, Social Assistance Act and Social Security Agency Act impacts on future obligations of the provincial and local spheres of government. These sets of legislation are implemented on a phased basis in order to minimise their impact on the services delivered by provincial and local governments. For example, the primary health care function currently administered by district and local municipalities is shifting to the provincial sphere and will be phased in over the next few years. The social security grant function will be administered by national government through an agency and will, as an interim measure be funded through a conditional grant from 1 April 2005 to ensure its smooth transition to the national agency.

Predictability and stability

Government has resolved that the equitable shares for a given year will be based on estimates of nationally raised revenues, as announced in the Budget. Provincial and local government equitable share allocations are based on projections of revenue to be raised nationally. These allocations are protected. In the event that nationally raised revenue falls short of the estimates, the equitable share will not be adjusted downwards. All conditional grants to be allocated to provinces and local government are allocated on a three-year basis to enable the two spheres to undertake forward planning of programmes funded through these grants. The Bill also requires provincial governments to publish all their grants to local government per municipality. In addition, care is taken when the provincial and local government formulae are revised that their impact on the funding streams to these spheres are minimal.

Furthermore, the Division of Revenue Bill specifies that all allocations must be transferred according to a payment schedule. Thus, at the beginning of the financial year, provinces and local governments are assured of the resources they will receive and know the dates on which the allocations will be transferred. Any amendments to the payment schedule require a fair and transparent process. The Bill also enables provincial and local governments to account for all transfers from the national government. Greater certainty of revenues improves the quality of budget planning and expenditure projections in all spheres of government.

Need for flexibility in responding to emergencies

When Government introduced multi-year rolling budgets seven years ago, it also introduced the concept of a contingency reserve. Government has flexibility to respond to emergencies or other needs 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. The *Disaster Management Act* provides the legal framework for government to respond to emergencies. In addition to the prescripts of the PFMA and the MFMA, Government is developing a framework that would allow it to respond more speedily to disasters, where these may occur.

Part 2: Response to the Financial and Fiscal Commission recommendations

Section 214 of the Constitution and Section 9 of the *Intergovernmental Fiscal Relations Act* require the Financial and Fiscal Commission (FFC) to make recommendations on or soon after April every year on the division of revenue for the coming budget. In view of the April 2004 elections, the FFC complied with this obligation by tabling its submission entitled *"Submission for the Division of Revenue 2005/06-Proposals from the FFC Review of the Intergovernmental Fiscal relation System"* in Parliament in June 2004. Subsequently, the FFC also submitted two supplementary proposals at the end of January 2005. The first one suggests a possible approach on how to determine the amount of funds to be shifted from the provincial equitable share with the social security function. The second proposal is a further elaboration of the FFC's model for allocating capital grants to provinces.

The Constitution and section 10 of the *Intergovernmental Fiscal Relations Act* require national government to take account of the annual recommendations of the FFC when determining the division of revenue between the three spheres of government. This part of the explanatory memorandum sets out how the Government has taken into account the FFC's recommendations when determining the division of revenue for the 2005 MTEF.

The 2005 FFC proposals, although covering a broad range of issues, are divided into three main parts:

- Part 1 reviews the provincial equitable sharing system and covers the provincial equitable share formula, provincial own revenue and the use of conditional grants in the transfer system.
- Part 2 reviews the local government equitable sharing system and covers the different 'funding windows' of the local government equitable share formula, measurement of municipal revenue-raising capacity, explores any linkages between the local government equitable share and the infrastructure grant formulae, and pronounces on the ceding of the equitable share as security for municipal loans.
- Part 3 reviews the Intergovernmental Fiscal Relations system and covers poverty targeting, the budgeting systems supporting the IGFR system, and evaluates the key data sources needed to support the IGFR system.

While some of the proposals contained in the FFC's submission for the 2005 Budget are new, others represent reiteration, improvements and refinements of past proposals. Accordingly, some of Government's past responses are still relevant and where this is not the case explanation is given. For instance, the FFC calls for a review of the intergovernmental system and a change in the financing of social security grant. The two proposals were accepted last year, and as it will be evident in the later discussion, Government has also taken steps to address the two proposals.

A major part of the review of the intergovernmental system focused on the need to implement new formulae for both the provincial and local government equitable share grant. This has required careful examination and analysis of policy and implementation issues surrounding the shifting of social grant funding from the provincial equitable share to the national equitable share, and for the local government equitable share on the creation of Regional Electricity Distributors (REDs). Work on other aspects of the review is still under way and its recommendations will be considered for implementation in future budgets.

Significant progress has been made on the tax frameworks for provinces and local government. Despite the provincial taxation framework, no province has as yet formally submitted a proposal for any new provincial tax. With regard to municipalities, aspects of the new property rates system will be implemented over the 2005 MTEF.

With regard to borrowing, municipalities are now able to borrow more easily with the Local Government: *Municipal Finance Management Act (MFMA)*, which took effect from 1 July 2004. Coming regulations on municipal borrowing will give further effect to the local government borrowing framework.

In relation to provinces, Government is exploring how to give effect to provincial borrowing, beginning with loans from the Development Bank of South Africa. However, the biggest challenge facing both provinces and municipalities is that of modernising and improving capacity to spend on capital before considering borrowing, as spending capacity is still significantly lower than budgetary resources.

Part 2.1: Review of the Provincial Equitable Sharing System

FFC proposal on the weights assigned to the different components in the provincial equitable share formula

The FFC proposes that the weights assigned to the different components of the provincial equitable share formula need to be revised to take account of the changing priorities and changing composition of shares of social services in total provincial expenditure.

Government's response

Part of the divergence in the weights in the formula and shares of education, health and welfare in expenditure has been due to very rapid changes in the composition of provincial expenditure. This was largely influenced by two factors: a very sharp growth in social security expenditure and strong growth in expenditure on non-social services functions mainly attributed to substantial resources allocated towards infrastructure and other non-personnel inputs.

The weights in the new formula have been rescaled, to take into account the impact of the shifting of the payment of social security grants to national government on expenditure. The rescaled weights were then adjusted to be in line with the average share of education and health in total provincial expenditure over the last three years. The shares are based on provincial expenditure exclusive of conditional grants.

FFC proposal on the education component of the formula

The FFC proposes that 'the formula used to allocate the education component of the equitable share be revised to end the double weighting of school age children.' In this respect, the department of education should ensure that reliable school enrolment data is collected regularly.

Government's response

Government has taken this recommendation into account by proposing equal weights for the two elements - school age and enrolment - rather than a complete abolishment of the school age element. There are still good arguments for retaining the school age cohort in the education component. Firstly, unlike the enrolment data, the age cohort data are gathered independently of schools through censuses, and will therefore not have any systematic bias. They therefore attenuate the impact of any systematic inaccuracies that might exist in the enrolment data. Secondly, the measure reflects the approximate number of pupils who ought to be at school at any given time in a province.

Previously, the inclusion and double weighting of school age was a carefully considered decision, and took into account the objective of eliminating out-of-age enrolment, which reflects an inefficiency in the education system. Notwithstanding evidence of a drop in out-of-age enrolment, in view of the above considerations, Government has decided to retain this element in the formula, albeit with a reduced weight.

FFC proposal on the funding for Early Childhood Development (ECD)

The FFC proposes that, given that ECD is funded through the provincial equitable share, the education component should be augmented by at least the full amount of the current conditional grant.

Government's response

In relation to ECD the approach taken by Government is consistent with the FFC recommendation. The funds that previously flowed as a conditional grant are now part of the provincial equitable share. The adjusted weight for education has taken into account the share of education budget, including the full amount of the current ECD conditional grant. Further, the age cohort data in the formula includes the age group attending grade R.

FFC proposal on the health component of the formula

FFC proposes that 'in the case of health care services, the formula should be revised to take account of the gender and age profile of the population in order to reflect differential needs for health care services.' Furthermore, the national department of health should ensure that data on health care utilisation rates for different population groups is regularly collected.

Government's response

Government explored the possibility of using age and gender profiles, as well as taking into account health utilisation rates when the health component was reviewed. This would be a better approximation of relative demand for health care. However, the data required to make such a change in the formula are not readily available.

The proposed use of data on differential utilisation rates for different age groups and gender, while sensible, is not possible to implement immediately, as there are variations in the manner in which such data are collected across health institutions. Indeed, if such data were to be available and comparable, it would be worthwhile exploring more sophisticated measures of relative demand for health services. The FFC notes in its review of the health component that a survey would have to be undertaken *"to quantify the intensity of use of public health facilities…to design the variable and weighting system."*

A further constraint is that even if utilisation information were available per hospital and per clinic, cost centre information is generally not available per hospital or per clinic. This makes it impossible at this stage to "consider the possibility of economies of scale or unit cost differences among the provinces resulting from population density" in the fashion proposed by the FFC.

Government is in agreement with the FFC that steps need be taken to collect data on health utilisation rates for the different age and gender groups regularly. The health sector will need to put in place mechanisms for collecting such information, and ensuring that they are reliable and comparable. It will take several years before such information will be available.

FFC proposal on the welfare component of the formula

The FFC proposes that the welfare component (social security grants) should be removed from the formula and the function be converted into a conditional grant or any other appropriate funding mechanism while the issue of the National Social Security Agency is addressed. In addition the national Department of Social Development must ensure that adequate measures are in place to monitor the proper administration and payment of social security grants.

In its supplementary submission titled "*The financial and institutional implications of shifting the social security transfers and their administration to national government*" the FFC presents three options for dealing with the function shift. The first option is to shift an amount equal to the share of welfare in the equitable share formula, which is 18 per cent. The second option is to take an amount equal to 18 per cent plus 6,8 per cent. The last option is to separate social security expenditure from total provincial social development expenditure so that only the portion spent on social security is shifted from the provincial equitable share.

Government's response

In the main, the FFC proposal regarding social security is a reiteration of a previous recommendation, which Government is already implementing. In this regard, the South African Social Security Agency Act was enacted and amendments to the Social Assistance Act have been effected. The shifting of the financing and administration of social security grants impacts significantly on the current size and formula of the provincial equitable share. The provincial equitable share will be reduced while the national equitable share will be increased to fund social grants.

A key decision in this respect for the 2005 MTEF is the amount or percentage share of funds to be taken away from the provincial equitable share. After taking into account current trends in social security expenditure and based on projected demand for grants, taking account of future changes in grant values, the provincial equitable share has been reduced. At the same time, two conditional grants totalling R181 billion over the next three years, have been created. Overall the approach adopted by Government (and after consultations with the Budget Council and Extended Cabinet) takes account of both options 2 and 3 proposed by the FFC in its supplementary submission. The supplementary submission from FFC on social grants was submitted to Government after Government adopted its approach, and after their tabling on 26 October 2004 in the Medium-Term Budget Policy Statement.

The national Department of Social Development will administer social grants as two conditional grants to provinces until such time that the Agency is fully established and ready to take over the function. Like all conditional grant the funds will thus be appropriated on both the vote of the national Department of Social Development and provincial departments.

FFC proposal on the economic activity component of the formula

The FFC proposes that 'in the absence of significant own revenue from provinces, the economic activity component of the provincial equitable share formula should be defined to provide for the maintenance expenditure requirements of social and public infrastructure and should be redesigned accordingly'.

Government's response

Government accepts the need to support provinces in funding the maintenance of social and public expenditure, but believes that existing conditional grants like the provincial infrastructure conditional grant and hospital revitalisation grant are adequate, when taking account of capacity. Government believes that the review of provincial conditional grants must first be completed before a determination can be made on whether the provincial equitable share formula needs to be adjusted for maintenance of social infrastructure. A further point to note is since some provinces have relatively more backlogs than others, it may be more feasible at this stage to fund such backlogs through a conditional grant. Furthermore, Government supports the FFC proposal that provinces should be encouraged to raise more own revenue.

Arising from the review of the equitable share formula, Government proposes to retain the economic activity component with a weight or share of 1 per cent. This is because this component significantly reduces the redistributive thrust of the equitable share formula.

FFC proposal on equity and efficiency aspects of the formula

The FFC proposes that, to address certain equity and efficiency considerations, the 'provincial equitable share formula should be revised to account for relevant cost disabilities of provinces'.

Government's response

While conceptually appealing, this proposal would be hard to implement at this stage. Firstly, very few of the services that provinces are responsible for delivering lend themselves to succinctly defined standards at this stage to allow calculation of the cost differential of rendering the same standard of service across provinces. Secondly, the costs of providing certain public services are difficult to ascertain (given that provinces need to have better cost centre information) and determining them would require more information than is currently available. A further challenge would be to separate the component of the differential that is due to factors beyond each province's control from variations in efficiency levels. Lastly, it is unclear how one would control for the quality aspects of the inputs in determining the cost differentials. It would appear that this proposal has elements of a costed norms approach and some of the reasons why Government did not adopt the approach would hold against the "cost disabilities" argument.

The FFC proposal on the provincial infrastructure grant

The FFC proposes that Government should incorporate the backlogs component of the provincial equitable share formula into the basic component and a separate conditional grant should be set up for financing capital infrastructure. This should be allocated to provinces using the FFC's proposed provincial capital grants model.

The FFC further submitted a supplementary proposal in which it explains in more detail its proposed capital grant model.

Government's response

Firstly, as the revised provincial equitable share formula shows, Government accepts the proposal that the backlog component be removed from the equitable share formula. Secondly, the proposal of using a conditional grant to fund infrastructure is also accepted hence the continued retention of the infrastructure grant for provinces.

Nevertheless, a number of practical problems make it impossible to implement the FFC's capital grant proposal beyond the two aspects referred to above. Firstly, the model needs data that are not available, for example very little is known about the value and condition of Government's capital stock. Secondly, given the very dynamic nature of population migration patterns in South Africa, an appropriate infrastructure model would need to take this into account to prevent building infrastructure in areas that are losing people while not attending to pressure on infrastructure in areas where people are moving. This is the real dilemma that Government is facing to which there are no easy answers. Nevertheless, the National Spatial Development Perspective that has been adopted by Government will begin to provide an overarching framework to guide future infrastructure plans. Lastly, there are other developments that need to be explored further before changing the way provincial infrastructure development is financed, going forward. Chief among these are the possible introduction of new taxes and introduction of borrowing by provinces, and the exploration of alternative approaches to the financing of large-scale capital projects that have national economic effects.

The FFCs observations in the use of conditional grants in the transfer system

The FFC makes a number of conclusions on the conditional grant system. Firstly, that the mobilisation of resources within the conditional grant system may require a review of the policy on the shifting of funds from provinces that are not spending their conditional grants to provinces that are spending. Secondly, that there is a need for formal agreements between the national sphere and the recipient province in the conditional grant system. Thirdly, that there is a case for relaxing some of the stringent conditions for different conditional grants, especially those that seek to ensure adherence to norms and standards.

Government's response

Government agrees with the FFC on the need to review provincial conditional grants, and deal more systematically with how underspending on conditional grants can be taken into account when determining how to divide such grants between provinces. The dilemma facing Government is that in many instances it is poor provinces with relatively large backlogs in infrastructure that have poor capacity, and hence will be further discriminated against if spending capacity is taken into account. Notwithstanding this dilemma, for the first time, the Division of Revenue Bill proposes reallocation of conditional grant funds within the financial year precisely to deal with the problem of underspending.

Cabinet has also agreed that a review of all hospital grants be prioritised for the 2006 MTEF, and should be completed by the Department of Health and National Treasury by September 2005. This is an area that Government hopes the FFC will make further recommendations in its 2006 submission.

Part 2.2: Review of the Local Government Equitable Sharing System

FFC proposal on the use of funding windows in the local government equitable share formula

The FFC proposes that Government should avoid the use of funding windows in the equitable share formula. The following concerns are raised with respect to the use of funding windows in the equitable share:

a) There is no indication from Government that these windows are temporary.

b) There is no information on the basis for determining the global allocation to each funding window, or for that matter the S and I components.

c) There is duplication between the S component and the Free Basic Electricity and Free Basic Services windows.

Government's response

Government has previously indicated that the current equitable share formula for local government has shortcomings, and requires a fundamental review. However, replacing this formula has not been an easy task due to lack of data on each municipality. Government is in agreement with the FFC that the windows approach in the equitable share formula should be avoided where possible, hence the new formula abolishes the windows approach, replacing it with a component-based approach.

FFC proposal on the structure of the local government equitable share formula

The FFC reiterates it previous proposal that the long-term equitable share formula should be based upon the constitutional requirements, which suggests the following formula:

$$LES = S + B + I + T + m$$

Where:

LES = Local government equitable share allocation

S = Component to support the delivery of basic municipal services

B = Component to fulfil other constitutional and legislative requirements

I = Component to finance core administrative functions

T = Component for tax capacity equalisation

m = Spillover grant to provide finance for services with intermunicipal spillover effects

Government's response

Government is in agreement with the broad approach proposed by the FFC on the structure of a new formula. This is particularly important for the I and S components. Government has also taken a revenue-raising component into account in the new formula. However, Government does not believe that it is practical to consider a spillover grant and a component to fulfil other constitutional and legislative requirements.

FFC's proposal on assessment of municipal service cost

The FFC proposes that the assessment of municipal service costs should be informed by the following principle:

a) Residents in a given jurisdiction have the right to a basic level of service provision.

b) That there will be different types of service delivery within the basic level owing to the nature of the technology required.

Government's response

Government is in agreement with the FFC that residents have a right to basic level of service provision, and that municipalities need to be funded for this taking account of their fiscal capacity. However, this approach also has potential weaknesses, particularly where a municipality is unable to provide or fails to prioritise provision of basic services to all its residents. The fact that many municipalities have weak management and data systems makes the monitoring of services very difficult at this stage. Census information only allows a form of measurement once every five or ten years, rather than annually. Government is considering what forms of annual surveys may be undertaken to produce information on progressive improvements in service delivery per municipality.

The new formula also makes provision for municipalities that offer higher levels of service, for example, water-borne sanitation as opposed to more basic sanitation systems. However, this approach is in an early stage of development, with Government using indicative costs based on its own research. Government is mindful that the formula is not a costed norm for services, but an indicative guide for the budget of the municipality – this is even more relevant where a municipality has significant revenue raising capacity. More research will be necessary to further develop the approach of catering for different levels of service, but a basic form is adopted for the new formula.

FFC's proposal on the review of the local government equitable share formula

The FFC proposes that the following principles should inform the development of the methodology for assessing municipal service costs:

a) In developing a measure of expenditure needs, municipalities should not be able to influence the magnitude of their expenditure needs through fiscal decisions;

b) The methodology should not be too data intensive;

c) A strategy that combines statistical analysis of data with expert opinion provides a realistic approach for South Africa;

d) Calculations of the costs of providing basic services should be built up separately for each local government function; and

e) It is important that the grant formula should be as simple as possible.

Government's response

Government is in agreement with the FFC that the formula should be as simple as possible, and not too data intensive. Indeed, Government does not have much choice in this respect given data limitations. The new formula adheres to this approach.

Government also agrees that more information and data are required on each basic service, for purposes of research, modelling and analysis, rather than for allocations. In this respect, Government concurs with the FFC that a more accurate measure of expenditure needs of municipalities should be developed, but for the purpose of better modelling and analysis only. Lastly, Government is of the view that consideration should also be given to exploring alternative data sources in the absence of a Census. However, an approach should be developed similar to the one proposed by the FFC to ensure that credibility of data is not compromised.

Government also believes that the impact of the establishment of regional electricity distributors will have a significant impact on municipal finances. Government has adopted a set of working principles to guide such restructuring of electricity distribution (outlined in Part 6), and it is hoped that the FFC will make recommendations on the impact of this restructuring in its 2006 submission.

FFC proposal on a revenue-raising capacity measure

The FFC proposes that consideration should be given to applying a revenue raising-capacity measure to the local government equitable share formula as a whole, rather than only on the I-component.

Government's response

Government accepts the FFC proposal that a revenue-raising component should be applied to the whole formula rather than only the I-component. This is given effect in the new formula by removing it from the I grant, and incorporating a new component specifically for in the new formula.

FFC proposal on the disbursement of capacity-building funds

The FFC suggests that it is currently inappropriate to develop a formula for the disbursement of capacity-building funds directly to municipalities, as most capacity building initiatives are not supported by direct grants to municipalities. However, it is advisable to develop appropriate administrative or institutional instruments that ensure that capacity needs are identified and adequately targeted.

Government's response

Government agrees that building the capacity of municipalities is one of the biggest challenges it is facing. It is also aware that current capacity-building programmes are not as successful as they should be, irrespective of whether capacity-building grants are paid directly to a municipality or paid to a province. One of the key challenges facing such grants is to ensure that they build capacity in municipalities, and do not inadvertently build greater dependence on consultants. The funding mechanism is therefore not necessarily the critical factor as to the success or failure of such grants. Government has accepted that current funding levels of all capacity building grants is relatively high, and that capacity-building grants should be phased out over the medium-term and incorporated into the equitable share formula. For this reason, Government intends to review the performance of current grants, rather than developing an extensive formula for their disbursement. In the short-term, the allocation criteria for distributing capacity-building funds should be transparent and should be published with the Budget.

FFC proposal on the collection of municipal-level data

The FFC proposes that Government should ensure that the following municipal-level data is collected:

a) Regional levies: skills development levy data disaggregated to district municipal level (if the payroll is retained);

b) Property tax: municipal valuation roll data and specific rates data (that is, rates charged for each category of property); and

c) Electricity; consumption data (disaggregated into consumer categories)

Government's response

Government agrees that comprehensive information and data are required on each basic service and tax source for purposes of research, modelling and analysis. Government will explore how such a database can be established, and be accessible to key stakeholders. Such a system will target key revenue and expenditure information, which is crucial for policy-making purposes. Given that the RSC levy will be phased out, there is little point in collecting more information on these levies. Data on property taxes and municipal valuation will be highly welcome, but depend on the systems for recording in each municipality, and even if available, will not necessarily be comparable – in spite of these difficulties, Government agrees that it is necessary to collect such information.

FFC proposal on the subsidisation of tariff charges of low-income households

The FFC proposes that funds required to subsidise tariff charges of low-income households should be carefully assessed in order to ensure that poor residents in all jurisdictions have access to a minimum levels of basic service provision.

Government's response

While Government accepts the need for ensuring municipalities use their equitable share grants to provide subsidised services to low-income households, it is not constitutionally possible to do so by imposing conditions on the equitable share grant. The focus will rather be to ensure that all municipalities report against their budget on spending programmes to support poor households, and to put in place support systems to assist municipalities to better identify and target poor households, and to provide basic services to such households. Government will also consider issuing guidelines and norms and standards on how the equitable share should be utilised, to target poor households for the provision of basic services.

FFC proposal on linking the Municipal Infrastructure Grant and the equitable share formula

The FFC proposes that consideration should be given to linking the MIG and the equitable share formula. In doing so, the following should be taken into account:

a) The need to provide municipalities with appropriate incentives to extend municipal infrastructure;

b) The need to achieve equity in addressing the expenditure needs of local government;

c) The need to take account of the differing capacities of municipalities; and

d) The need to ensure that LES allocations keep pace with the installation of household infrastructure.

Government's response

The MIG and the current equitable share formula are already linked in various ways and the above issues have already been taken into account in the design of the grant. The objectives outlined by the FFC are general in nature, and already taken into account in the design of the MIG grant. Furthermore, the MIG formula has an M component to provide a negative or positive allocation related to the past performance for each municipality relative to grant conditions. This element will be introduced once the MIG programme has been given sufficient time to mature.

It should also be noted that at this stage the MIG has a projected lifespan of 10 years and, though subject to a review, will ultimately be incorporated into the equitable share formula.

FFC proposal on ceding of equitable share revenue

The FFC proposes that Government should consider two broad options with respect to the ceding of equitable share revenue as security to obtain loan finance:

a) The Municipal Finance Management Act could be amended to ensure safeguards proposed in section 48(3) and (4) apply also to ceding of equitable share revenue.

b) In light of the overall safeguard provided by the Constitution and national legislation, Government could issue guidelines to municipalities with respect to the ceding of equitable share revenue. This could propose safeguards and recommend that the pledging of equitable share revenue only occur when the loan is intended to finance infrastructure for basic service delivery.

Government's response

Government believes that it is too soon to consider amending the MFMA at this stage. While Government approves the need for a guide on borrowing for municipalities to ensure that they do not recklessly cede part of their equitable share, the FFC proposal does not take into account the comprehensive process requirements and consultations required before a municipality is allowed to cede its future equitable share grants. The proposal made by the FFC was also considered by Parliament during the process to approve the MFMA, but was not accepted by Parliament.

Part 2.3: Review of the Intergovernmental Fiscal Relations System

The FFC proposals on the data requirement for the Intergovernmental Relations System

The FFC proposals on the intergovernmental fiscal relations (IGR) system covers poverty targeting, the budgeting systems supporting the IGFR system, and evaluates the key data sources needed to support the IGFR system.

Government's response

Government notes the proposals on the Intergovernmental Fiscal System. The proposals on the intergovernmental system (Part 3 of the proposals) are a welcome contribution on the system of government in South Africa. It encourages broader discussion, by going beyond financial and fiscal matters, on how best to co-ordinate the policy-making, planning and budgeting processes between sectors and spheres of government.

The issue of performance accountability and co-ordination is a major priority for all governments in all spheres. These objectives are given effect in legislation like the *Public Finance Management Act (PFMA)*, the *Municipal Systems Act* and the *Municipal Finance Management Act (MFMA)*, which focus on outputs, outcomes and performance. Government has also taken a number of steps in this regard, such as designing performance measures and targets, and implementing performance agreements to improve the system of accountability. However, further steps need to be taken by departments that use management information and data to improve management systems needed for the collection of credible data that could be used to inform division of revenue decisions.

Part 3: Fiscal Framework for 2005 MTEF

Table E.1 Medium-term macroeconomic assumptions, 2004/05 – 2007/08

	2004/05		2005/06		2006/07		2007/08
R billion	2004 Budget	2005 Budget	2004 Budget	2005 Budget	2004 Budget	2005 Budget	2005 Budget
Gross domestic product	1 331.8	1 403.9	1 455.6	1 528.6	1 592.6	1 674.0	1 847.3
Real GDP growth	*3.3%*	*4.2%*	*3.6%*	*4.1%*	*4.0%*	*3.9%*	*4.4%*
GDP inflation	*5.4%*	*5.4%*	*5.5%*	*5.7%*	*5.2%*	*5.2%*	*5.3%*
National Budget Framework							
Revenue	327.0	338.0	360.3	369.9	394.0	405.4	444.6
Percentage of GDP	*24.6%*	*24.1%*	*24.7%*	*24.2%*	*24.7%*	*24.2%*	*24.1%*
Expenditure	368.9	370.1	404.7	417.8	439.1	456.4	494.9
Percentage of GDP	*27.7%*	*26.4%*	*27.8%*	*27.3%*	*27.6%*	*27.3%*	*26.8%*
Budget deficit	-41.9	-32.2	-44.4	-47.9	-45.1	-51.0	-50.3
Percentage of GDP	*-3.1%*	*-2.3%*	*-3.0%*	*-3.1%*	*-2.8%*	*-3.0%*	*-2.7%*

Fiscal framework

Table E1 presents medium-term macroeconomic forecasts for the 2005 Budget. It sets out the growth assumptions and fiscal policy targets on which the fiscal framework is based.

Table E2 sets out the impact of these policy decisions on the division of revenue. Before resources can be divided, provision is made for national commitments such as debt service costs and a contingency reserve. Debt service obligations of R53,1 billion, R56,6 billion and R59,4 billion are projected for the three MTEF years, and a contingency reserve amount of R2 billion, R4 billion and R8 billion is set aside. Once these allocations are deducted, the total to be shared between the three spheres amounts to R362,7 billion, R395,8 billion and R427,5 billion over the three MTEF years.

Table E.2 Division of revenue between spheres of government, 2001/02 – 2007/08

	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
R million		Outcome		Revised	Medium-term estimates		
National departments	87 705	99 091	108 459	121 101	136 262	146 800	157 817
Provinces	121 099	136 873	161 494	185 354	209 273	229 282	248 236
Equitable share	*81 670*	*93 827*	*110 004*	*122 426*	*134 706*	*146 757*	*157 678*
Conditional grants	*39 429*	*43 046*	*51 490*	*62 928*	*74 567*	*82 525*	*90 558*
Local government	6 520	8 759	12 396	14 757	17 159	19 708	21 461
Equitable share	*3 184*	*4 187*	*6 350*	*7 678*	*9 643*	*10 515*	*11 371*
Conditional grants	*3 336*	*4 572*	*6 045*	*7 080*	*7 516*	*9 193*	*10 090*
Non-interest allocations	**215 324**	**244 722**	**282 349**	**321 212**	**362 694**	**395 789**	**427 513**
Percentage increase	*14,8%*	*13,7%*	*15,4%*	*13,8%*	*12,9%*	*9,1%*	*8,0%*
State debt cost	47 581	46 808	46 313	48 901	53 125	56 603	59 381
Contingency reserve	–	–	–	–	2 000	4 000	8 000
Main budget expenditure	**262 904**	**291 530**	**328 662**	**370 113**	**417 819**	**456 392**	**494 894**
Percentage increase	*22,4%*	*10,9%*	*12,7%*	*12,6%*	*12,9%*	*9,2%*	*8,4%*
Percentage shares							
National departments	*40,7%*	*40,5%*	*38,4%*	*37,7%*	*37,6%*	*37,1%*	*36,9%*
Provinces	*56,2%*	*55,9%*	*57,2%*	*57,7%*	*57,7%*	*57,9%*	*58,1%*
Local government	*3,0%*	*3,6%*	*4,4%*	*4,6%*	*4,7%*	*5,0%*	*5,0%*

The revised fiscal framework aims at further strengthening social service delivery and is prepared within Government's medium term strategic goals which focus on key developmental goals with specific targets in key service delivery areas. The revisions to the fiscal framework put Government in a stronger position to:

- Step up spending on education, including making provision for pay progression for educators and investment in further education and training colleges, key curriculum support material and improved maintenance of infrastructure and other inputs needed to further strengthen the quality of school education especially in poor communities
- Raising spending on health, including improved remuneration of professional staff, and comprehensive HIV and Aids prevention and treatment programmes
- Extending social assistance through enhanced income support to the poor, including completion of the take up of 11, 12 and 13 year old children, protecting the real value of social security grants and improvements in the social grant payment system
- Supporting provincial economic development programmes with high potential for creating employment opportunities, such as the Expanded Public Works Programme and Comprehensive Agricultural Support Programme

- Increasing allocations for road infrastructure to improve national and provincial road networks in line with the National Roads Strategy
- Accelerating the rollout of free basic electricity, water, refuse removal and sanitation to poor households and investment in municipal infrastructure to create sustainable local communities
- Consolidating local government financial management and budget reforms as envisaged in the *Municipal Finance Management Act (No. 56 of 2003)*
- Stepping up resources for land restitution to complete this process
- Supporting the implementation of the new housing delivery strategy premised on the creation of sustainable human settlements
- Expanding capacity in the safety and security sector in support of the sector policing strategy and the establishment of a new Protection and Security Services Division
- Taking core administrative services to citizens, particularly in rural areas where access is limited
- Supporting South Africa's ongoing commitment to actively promote peace in Africa and support regional trade and development.

Government determines the division of revenue between national, provincial and local government spheres using the previous year's baseline division as a point of departure and taking account of ongoing commitments, current and new policy priorities, and the FFC recommendations. The new priorities, and expansions of previous year's programmes, are accommodated through reprioritisation and growth in the resource envelope.

Both the shares for provincial and local government allocations increase significantly, with the provincial share increasing from 57,5 per cent to 58,1 per cent, and the local government allocation from 4,6 per cent in 2004/05 to 5,0 per cent in 2007/08. The share of national government decreases from 37,9 per cent in 2004/05 to 36,9 per cent in 2007/08. Over half of the additional resources are allocated to provinces in recognition of the challenges they face in delivering social services, building and maintaining economic infrastructure, employment creation, promoting rural development and coping with HIV and Aids.

Table E3 reflects the additional resources available over last year's baseline allocations, totalling R16,0 billion in 2005/06, R22,8 billion in 2006/07 and R35,7 billion over the new baseline for 2007/08. The additional funds are divided between the spheres depending on which sphere is responsible for the prioritised functions and taking account of each sphere's revenue raising capacity.

Table E.3 Changes over baseline, 2005/06 – 2007/08

	2005/06	2006/07	2007/08[1]
National	5 287	8 111	12 282
Provincial	9 540	12 916	20 963
Local	1 200	1 650	2 500
Allocated expenditure	**16 027**	**22 677**	**35 745**

1. The assumed baseline for 2007/08 is the 2006/07 baseline plus 5 per cent.

Table E4 sets out Schedule 1 of the Division of Revenue Bill that reflects the legal division of revenue between the three spheres. In this division, the national share includes all conditional grants to the other two spheres in line with section 214(1) of the Constitution, and the provincial and local government allocations reflect their equitable shares only.

Table E.4 Schedule 1 of the Division of Revenue Bill, 2005/06 – 2007/08

Sphere of government R million	Column A Allocation 2005/06	Column B Medium-term forward estimates 2006/07	 2007/08
National [1, 2]	273 470	299 120	325 846
Provincial	134 706	146 757	157 678
Local	9 643	10 515	11 371
Total	**417 819**	**456 392**	**494 894**

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 are netted out.

Nationally raised revenue is distributed between spheres in accordance with the Division of Revenue Act and the Constitution. The national equitable share is divided between national departments through an Appropriation Act. 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 votes and their main divisions – 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 Act and this memorandum.

Part 4: Provincial Allocations

Sections 214 and 227 of the Constitution require that an equitable share of nationally raised revenue be allocated to the provincial sphere of government to enable it to provide basic services and perform the functions allocated to it. The size of the equitable share and conditional grant allocations to the provincial sphere of government takes account of the fiscal capacity, fiscal efficiency, developmental needs, extent of poverty and backlogs, to the extent that such information is available for all provinces.

Table E.5 Total transfers to provinces, 2005/06

R million	Equitable share	Conditional grants	Total transfers
Eastern Cape	22 202	13 086	35 288
Free State	8 660	5 491	14 152
Gauteng	20 810	11 235	32 045
KwaZulu-Natal	28 399	16 054	44 453
Limpopo	18 376	9 205	27 580
Mpumalanga	9 976	4 802	14 778
Northern Cape	3 124	1 899	5 023
North West	11 086	5 947	17 033
Western Cape	12 072	6 849	18 922
Total	**134 706**	**74 567**	**209 273**

National transfers to provinces for 2005/06 comprise more than 97 per cent of provincial revenues, with provinces raising less than 3 per cent of their revenues from own sources. The size of transfers also takes into account the basic services and functions allocated to provinces, including concurrent functions like the provision of school education, further education (but not higher education), tertiary and primary health care, social grants and welfare services, housing and exclusive functions like provincial roads. Some concurrent functions like housing (and now social grants and their administration) are funded through conditional grants from the national equitable share. National transfers in 2005 comprise of 64,4 per cent equitable share and 35,6 per cent conditional grants. Table E5 shows all transfers to provinces for 2005/06.

Changes to Provincial Fiscal Framework

A major change in the provincial fiscal framework for the 2005 MTEF is the shift of the social security grant function from the provincial to the national sphere of government which impacts directly on the composition of provincial allocations, and the size of the provincial equitable share relative to conditional grants. The social security grant function will be administered as a conditional grant from 1 April 2005.

Another change to the provincial fiscal framework relates to the delivery of primary health care by municipalities. Though provinces currently provide most primary health services, the Health Act (Act No. 61 of 2003) also shifts the basic primary health care currently provided by some municipalities, excluding environmental health, from municipalities to provincial governments from 2005. Annual expenditure by municipalities on this function is approximately R1 billion. Government has decided to adopt a phased approach in shifting this function. As a first step, provinces will in 2005/06 fund the components of primary health that are performed by non-metropolitan municipalities. During the transition, non-metropolitan municipalities will continue to render the function on behalf of provinces on an agency basis. Government adjusted the provincial budget framework upwards by R200 million in 2005/06, R300 million 2006/07 and R400 million in 2007/08 to augment funds in non-metropolitan municipalities budgets for this function.

With the impending accreditation of metropolitan municipalities to take more responsibility for housing planning and delivery, it is expected that most metropolitan and large urban municipalities will have received accreditation by the end of this financial year. Where this occurs, the housing grant will be allocated to municipalities via the province.

No changes on provincial taxes will take effect in 2005/06, as no province has as yet submitted to the Minister of Finance any formal application for a new provincial tax in accordance with the Provincial Tax Regulation Process Act (Act No. 53 of 2001). However, provinces are expected to apply for some new taxes to be approved during the course of the 2005 MTEF.

Although provinces have the power to borrow for capital, the Budget Council has in the past few years agreed not to exercise this power. However, going forward, the Budget Council is exploring whether provinces should not consider borrowing over the next few years, as they improve their capital planning and spending capacity. If provincial borrowing were to be re-introduced, it may take the form of project-linked borrowing through Development Bank of Southern Africa (DBSA) in the initial stages. Nevertheless, no borrowing is expected to take place in 2005/06.

Provincial equitable share

The provincial equitable share allocation is the main source of revenue for funding provincial expenditure on the bulk of public services. It is divided between provinces on the basis of the provincial equitable share formula. The provincial equitable share is R134,7 billion in 2005/06, R146,8 billion in 2006/07 and R157,7 billion in 2007/08.

The shifting of the social security grant function from the provincial to the national sphere of government results in the equitable share component of national transfers to provinces decreasing from 88,4 per cent in 2004/05 to 64,4 per cent in 2005/06, while the share of conditional grants increase from 12,6 per cent to 35,6 per cent. In deciding the portion of the equitable share to be shifted, Government sought to balance the full liability related to the function (the administration, grant beneficiary numbers and the grant values) with the need to leave sufficient resources in provinces to further augment funding for key provincial programmes and priorities. In this regard Government agreed to reduce the provincial equitable share by an amount that was less than what provinces had budgeted for social security grants in 2004/05.

The equitable share formula

The division of the equitable share allocation among provinces is done through an objective redistributive formula. The formula is reviewed and updated every year for new data, taking account the recommendations of the Financial and Fiscal Commission (FFC). For the 2005 MTEF, a broad-ranging review of the formula has been undertaken to deal with the shift of the funding of social security grants. The review covered the structure of the formula, weights of components and other economic development and poverty related policy considerations. It also took into account the change in the financing and administrative arrangements relating to the delivery of social security grants.

Table E.6 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	17,3	17,0	19,6	14,4	8,1	11,1	20,7	16,6
Free State	6,0	6,5	7,1	6,0	5,4	11,1	5,6	6,5
Gauteng	13,6	14,7	13,9	19,7	33,4	11,1	5,0	15,3
KwaZulu-Natal	22,8	21,7	19,6	21,0	16,5	11,1	23,0	20,9
Limpopo	15,0	13,3	13,7	11,8	6,6	11,1	22,9	13,7
Mpumalanga	7,6	7,2	6,5	7,0	6,9	11,1	8,5	7,4
Northern Cape	1,7	2,0	2,2	1,8	2,0	11,1	1,3	2,3
North West	7,8	8,6	8,7	8,2	6,7	11,1	9,5	8,3
Western Cape	8,2	8,9	8,8	10,1	14,2	11,1	3,6	9,0
Total	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**

Table E.6 shows the old formula, its structure, components, component weights and the target shares it generates. The formula has seven components of which the social services components (health, education and welfare) made up 78 per cent of the formula. Details relating to this formula are contained in *Annexure E* of the *2004 Budget Review*.

The new formula (Table E.7) consists of four main components and two smaller elements, which capture the relative demand for services between provinces and take into account particular provincial circumstances:

- An *education share (51 per cent)* based on the size of the school-age population (ages 5-17) and the average number of learners (Grade R to 12) enrolled in public ordinary schools for the past three years
- A *health share (26 per cent)* based on the proportion of the population with and without access to medical aid
- A *basic share (14 per cent)* derived from each province's share of the total population of the country
- An *institutional component (5 per cent)* divided equally between the provinces
- A *poverty component (3 per cent)* reinforcing the redistributive bias of the formula
- An *economic output component (1 per cent)* based on Gross Domestic Product by Region (GDP-R) data

Table E7 shows the new 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 education and health components are weighted broadly in line with expenditure patterns to provide an indication of relative need for the purpose of allocating funds. Provincial Executive Committees have discretion regarding the determination of departmental allocations for each function.

Table E.7 Distributing the equitable share, percentages by province

	Education	Health	Basic	Poverty	Economic activity	Institu-tional	Target shares
Weighting	*51,0*	*26,0*	*14,0*	*3,0*	*1,0*	*5,0*	*100,0*
Eastern Cape	17,4	15,1	14,2	20,7	8,1	11,1	16,0
Free State	5,8	6,0	6,0	7,1	5,5	11,1	6,2
Gauteng	13,9	17,9	20,0	11,3	33,0	11,1	15,7
KwaZulu-Natal	22,8	21,8	21,0	23,3	16,5	11,1	21,7
Limpopo	14,9	12,6	11,7	17,0	6,5	11,1	13,7
Mpumalanga	7,6	7,2	7,0	6,7	7,0	11,1	7,5
Northern Cape	1,7	1,8	1,8	2,0	2,4	11,1	2,2
North West	7,7	8,4	8,2	8,0	6,5	11,1	8,1
Western Cape	8,2	9,4	10,2	3,8	14,5	11,1	8,9
Total	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**	**100,0**

The phasing-in of the formula

The revised formula results in shifts in individual provincial equitable shares. To avoid disruptive adjustments in provincial allocations and to ensure stability in provincial budgets, Government agreed to phase in the impact of the new formula over the next three years, from 2005/06 to 2007/08. Table E8 shows the phasing.

Table E.8 Phasing in the equitable share, 2004/05 – 2007/08

Percentage	2004/05	2005/06	2006/07	2007/08
	Base shares	3-year phasing		
Phasing	*Year 1*	*Year 2*	*Year 3*	*Year 4*
Eastern Cape	16,7	16,5	16,3	16,0
Free State	6,5	6,4	6,3	6,2
Gauteng	15,3	15,5	15,6	15,7
KwaZulu-Natal	20,8	21,1	21,4	21,7
Limpopo	13,6	13,7	13,7	13,7
Mpumalanga	7,3	7,4	7,5	7,5
Northern Cape	2,4	2,3	2,3	2,2
North West	8,3	8,2	8,2	8,1
Western Cape	9,0	8,9	8,9	8,9
Total	**100,0**	**100,0**	**100,0**	**100,0**

Education component

The education component is weighted 51 per cent of the equitable share formula. Like in the previous formula, the weight is derived from average provincial spending on education in total provincial spending for the past three years excluding conditional grants.

The education component is intended to enable provinces to fund school education, which accounts for roughly 80 per cent of provincial education spending. For the 2005 MTEF, Government decided that the new formula should use the school-age population (5 to 17 years) and enrolment elements to reflect the relative demand for education with each element assigned a weight of 50 per cent.

Table E9 shows the weighted target shares for the 2005 MTEF after updating the education component for new data.

Table E.9 Calculation of education component

Thousands	2004/05 Weighted share (%)	2005 Medium-term estimates Enrolment	School-age (5-17)	Weighted target (%)
Weighting		*1*	*1*	
Eastern Cape	17,3	2 114	2 219	17,4
Free State	6,0	694	760	5,8
Gauteng	13,6	1 669	1 786	13,9
KwaZulu-Natal	22,8	2 750	2 946	22,8
Limpopo	15,0	1 812	1 915	14,9
Mpumalanga	7,6	918	969	7,6
Northern Cape	1,7	203	222	1,7
North West	7,8	892	1 021	7,7
Western Cape	8,2	957	1 095	8,2
Total	**100,0**	**12 009**	**12 933**	**100,0**

Health component

The health component is weighted 26 per cent of the equitable share formula. Its weight is derived from average provincial spending on health in total provincial spending for the past three years excluding conditional grants.

The health component (table E10) addresses the need for provinces to deliver health care. As all citizens are eligible for health services, the provincial shares of the total population form the basis for the health share. Within the health component, people without medical aid are assigned a weight four times the weight assigned to people with medical aid on the grounds that the former group is likely to use public health care more. The proportions of the population with and without medical aid are taken from the 2002 and 2003 General Household Surveys (GHS) and applied to average total population derived from the 2001 Census and the 2002 and 2003 GHS figures.

Table E.10 Calculation of health component

Thousands	With medical aid	Without medical aid	Weighted share (%)
Weighting	*1*	*4*	
Eastern Cape	607	23 603	15,1
Free State	405	9 187	6,0
Gauteng	2 281	26 448	17,9
KwaZulu-Natal	1 077	33 954	21,8
Limpopo	381	19 820	12,6
Mpumalanga	392	11 170	7,2
Northern Cape	133	2 693	1,8
North West	460	13 084	8,4
Western Cape	1 183	13 867	9,4
Total	**6 917**	**153 826**	**100,0**

It should be noted that the health component would be greatly enhanced if better data on utilisation rates by different population and gender groups were available at the level of hospitals and clinics. Given the difficulties of collecting such information, it will appears that it may take several years before such information is available in the level of detail required to implement more sophisticated proxies of demand for health care.

Poverty component

Arising from the review of the equitable share formula the welfare and backlog components were removed from the equitable share formula thus reducing the redistributive nature of the formula. A poverty component with a weight of 3 per cent is introduced in order to retain some degree redistribution within the formula. The poor population is defined as those people whose incomes fall in quintiles 1 and 2 based on the 2000 Income and Expenditure Survey. Each province's share is then expressed as the percentage of the "poor" population residing in that province, where the population figure is the average population from the census 2001 and the 2002 and 2003 General Household Surveys. Table E11 shows the new shares of the poverty component.

Table E.11 Calculation of poverty component

Thousands	IES Survey 2000 (Q1+Q2)	Basic component value	Poverty index[1]	Weighted share
Eastern Cape	56,4%	6 475	3 654	20,7%
Free State	45,7%	2 722	1 245	7,1%
Gauteng	21,9%	9 119	1 997	11,3%
KwaZulu-Natal	43,0%	9 574	4 113	23,3%
Limpopo	56,3%	5 334	3 003	17,0%
Mpumalanga	36,9%	3 184	1 174	6,7%
Northern Cape	44,0%	820	361	2,0%
North West	37,9%	3 730	1 415	8,0%
Western Cape	14,6%	4 631	674	3,8%
Total	**100,0%**	**45 589**	**17 635**	**100,0%**

Economic activity component

The economic activity component is a proxy for provincial tax capacity. Table E12 shows the new target shares for the economic activity component based on the 2001 GDP-R data.

Table E.12 Economic activity shares

Percentage	2004/05 GDP-R, 2001	2005 Medium-term estimates GDP-R, 2003
Eastern Cape	8,1	8,1
Free State	5,4	5,5
Gauteng	33,4	33,0
KwaZulu-Natal	16,5	16,5
Limpopo	6,6	6,5
Mpumalanga	6,9	7,0
Northern Cape	2,0	2,4
North West	6,7	6,5
Western Cape	14,2	14,5
Total	**100,0**	**100,0**

Arising from the review of the equitable share formula, the weight of this component is reduced to 1 per cent as this component reduces the redistributive thrust of the formula. Furthermore, now that the Provincial Tax Regulation Process Act (Act No. 53 of 2001) is in place and provinces (particularly those with relatively high economic activity) can impose new taxes in order to raise more revenues. This is consistent with the FFC proposal that provinces should be encouraged to raise more own revenue.

Basic component

The basic component is derived from each province's share of the total population of the country and is weighted 14 per cent. The average population of the 2001 Census and the 2002 and 2003 General Household Surveys determines this component. The inclusion of GHS population estimates ensures that population data used in the formula is not very outdated. Table E13 shows the new weighted target share.

Table E.13 Basic component shares

Thousands	Population: 2001 Census	General household survey July 2002	General household survey July 2003	Average[1]	Weighted share
Eastern Cape	6 437	6 483	6 505	6 475	14,2
Free State	2 707	2 719	2 741	2 722	6,0
Gauteng	8 837	9 077	9 442	9 119	20,0
KwaZulu-Natal	9 426	9 531	9 766	9 574	21,0
Limpopo	5 274	5 313	5 415	5 334	11,7
Mpumalanga	3 123	3 178	3 252	3 184	7,0
Northern Cape	823	819	818	820	1,8
North West	3 669	3 721	3 799	3 730	8,2
Western Cape	4 524	4 612	4 757	4 631	10,2
Total	**44 820**	**45 453**	**46 495**	**45 589**	**100,0**

1. Average of 2001 Census Population and Population of General Household Surveys of 2002 & 2003.

Institutional component

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

Conditional grants to provinces

Conditional grants were introduced in 1998 to provide for national priorities and compensate provinces for cross-boundary use of services, particularly for specialised or tertiary services provided by central or academic hospitals. 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 for conditional grant funds 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.

There are two types of provincial conditional grants, classified as Schedule 4 and 5 grants. Governance arrangements for the two types differs, as Schedule 4 grants are more general grants that supplement various programmes also funded by the province, like infrastructure and central hospitals. Transfer and spending accountability arrangements differ, as more than one national or provincial department may be responsible for different outputs expected from the grant, so accountability is broader and more comprehensive and related to entire programmes rather than specific projects. On the other hand, Schedule 5 grants are specific conditional grants, with specific responsibilities for both the transferring and receiving provincial accounting officers.

In this year's budget framework three new grants are introduced. The Social Assistance Transfers and the Social Assistance Administration which together add up to over R181,0 billion over the MTEF represent the most significant changes to conditional grants. The third new grant is the Further Education and Recapitalisation Grant to be administered by Education from 2006/07. Another change in the framework is the phasing out of the Local Government Capacity Building Fund and the Consolidated Municipal Infrastructure Programme (for capacity building) administered by the Department of Provincial and Local Government. These grants will now flow directly to municipalities. Table E14 provides a summary of conditional grants by sector and province for 2005/06.

Table E.14 Conditional grants to provinces, 2005/06

R million	Agriculture	Health	Land Affairs	Provincial Infrastructure Grant	Housing	Education	Social Development	Sport & Recreation SA	Total
Eastern Cape	56	848	–	675	581	218	10 705	3	**13 086**
Free State	23	759	–	221	408	62	4 015	3	**5 491**
Gauteng	8	2 547	8	370	1 345	102	6 852	3	**11 235**
KwaZulu-Natal	54	1 315	–	788	800	230	12 865	3	**16 054**
Limpopo	47	522	–	661	399	188	7 385	3	**9 205**
Mpumalanga	29	257	–	286	321	81	3 826	3	**4 802**
Northern Cape	15	249	–	181	80	27	1 345	3	**1 899**
North West	39	353	–	321	468	90	4 674	3	**5 947**
Western Cape	20	1 815	–	229	466	51	4 265	3	**6 849**
Total	**290**	**8 666**	**8**	**3 731**	**4 868**	**1 048**	**55 932**	**24**	**74 567**

More detailed information, including the framework and formula for each grant, is provided in Appendix E1 of the Division of Revenue Bill. The frameworks provide the conditions for each grant, the outputs expected, the allocation criteria used for the dividing the grant between provinces, the audit outcome in 2003/04 and any other material issues to be addressed. Table E15 presents a summary of all the conditional grants listed in Schedules 4 and 5 of the Bill for the 2005 MTEF. Conditional grants to provinces grow considerably from R62,9 billion in 2004/05 to R74,6 billion in 2005/06 mainly due to the two Social Development grants. Conditional grants to provinces increase to R90,6 billion by 2007/08.

Agriculture grants

The Department of Agriculture administers two programmes: the *Land Care Programme* and the *Comprehensive Agriculture Support Programme*.

The *Land Care Programme* is allocated R131 million over the next three years. The goal of the *Land Care Programme* is to promote sustainable use and management of natural resources by encouraging and empowering communities to take responsibility for the management of resources in order to support food security and job creation through increased productivity. Other objectives of this grant relate to taking care of resources such as water, soil, and veldt and land.

The second programme administered by the Department is the *Comprehensive Agriculture Support Programme (CASP)*, which is allocated R250 million, R300 million and R415 million over the MTEF years to promote and facilitate agricultural development to farmers benefiting from the land reform programme. The programme seeks to provide management, capacity building and business development support to emerging farmers. In addition, the programme aims to further expand farm infrastructure for dipping, fencing, and the rehabilitation of irrigation schemes.

Table E.15 Conditional grants to provinces, 2004/05 – 2007/08

R million	2004/05	2005/06	2006/07	2007/08
Agriculture	**344**	**290**	**345**	**462**
Comprehensive Agricultural Support Programme Grant	200	250	300	415
Land Care Programme Grant: Poverty Relief and Infrastructure Development	44	40	45	47
Agricultural Disaster Management Grant	100	–	–	–
Education	**991**	**1 048**	**1 743**	**1 805**
Further Education and Training College Sector Recapitalisation Grant	–	–	500	500
HIV and Aids (Life Skills Education) Grant	134	136	144	152
National School Nutrition Programme Grant	832	912	1 098	1 153
Early Childhood Development Grant	2	–	–	–
Financial Management and Quality Enhancement Grant	22	–	–	–
Health	**7 655**	**8 666**	**9 408**	**9 870**
Comprehensive HIV and Aids Grant	782	1 135	1 567	1 646
Health Professions Training and Development Grant	1 434	1 520	1 520	1 596
Hospital Management and Quality Improvement Grant	142	150	159	167
Hospital Revitalisation Grant	912	1 027	1 180	1 239
Integrated Nutrition Programme Grant	112	123	–	–
National Tertiary Services Grant	4 273	4 709	4 981	5 221
Housing	**4 589**	**4 868**	**5 660**	**6 918**
Integrated Housing and Human Settlement Development Grant	4 474	4 843	5 660	6 918
Human Settlement Grant and Redevelopment Grant	116	24	–	–
Land Affairs	**6**	**8**	**8**	**–**
Land Distribution: Alexandra Urban Renewal Project Grant	6	8	8	–
National Treasury	**3 348**	**3 731**	**4 118**	**5 324**
Provincial Infrastructure Grant	3 348	3 731	4 118	5 324
Provincial and Local Government	**220**	**–**	**–**	**–**
Local Government Capacity Building Fund Grant	220	–	–	–
Social Development	**45 766**	**55 932**	**61 205**	**66 139**
Integrated Social Development Services Grant	388	388	411	432
HIV and Aids (Community-Based Care) Grant	70	138	139	143
Social Assistance Administration Grant	–	3 382	3 584	3 734
Social Assistance Transfers Grant	45 308	52 023	57 070	61 830
Sport and Recreation South Africa	**9**	**24**	**39**	**41**
Mass Sport and Recreation Participation Programme Grant	9	24	39	41
Total	**62 928**	**74 567**	**82 525**	**90 558**

Education grants

The Department of Education administers three conditional grants: the *National School Nutrition Programme*, *Recapitalisation of FET Colleges*, and the *HIV and Aids (Life Skills Education) Grants*.

The *National School Nutrition Programme* seeks to improve nutrition of poor school children and to enhance active learning capacity and improve attendance in schools. The programme targets about 15 000 schools in poor communities at which about 5 million learners will be fed for approximately 156 school days. The programme is allocated R912 million in 2005/06, R1,1 billion in 2006/07 and R1,2 billion in 2007/08.

The *FET Recapitalisation Grant* is introduced in 2006/07 to fund the recapitalisation of further education and training institutions in order to equip them to provide more appropriate courses that facilitate the modernisation of skills critical to the needs of the economy. The recapitalisation targets the rehabilitation of infrastructure (modernisation of equipment and facilities), improved governance and administration, and greater curriculum flexibility. The grant is allocated R500 million in each of the outer years of the MTEF.

The national Department of Education also manages the *HIV and Aids (Life Skills) Programme Grant*, which provides care and support to children infected and affected by HIV and Aids. In addition, the grant is spent on provision of life skills training, sexuality and HIV and Aids education in primary and secondary schools. The *HIV and Aids Grant* is allocated R136 million in 2005/06, R144 million in 2006/07 and R152 million in 2007/08. The programme is now fully integrated into the schooling system with learner and teacher support material provided for grades 1 to 9 learners. Since the inception of the programme in 1999/00 provinces trained 12 989 learners as peer educators and 34 470 educators in life skills. In addition, over 300 district officials were trained as master trainers to train educators in life skills.

Health grants

The national Department of Health administers the most number of conditional grants, and second largest in size, with its 6 conditional grants that comprise 11,6 per cent of total conditional grants and 4,1 per cent of national transfers to provinces. Health grants are R8,7 billion in 2005/06, and are budgeted to increase to R9,9 billion by 2007/08.

Four of the grants are linked to tertiary and central hospital services and training. These are the *National Tertiary Services Grant*, the *Health Professions Training and Development Grant*, the *Hospital Revitalisation Grant*, the *Hospital Management and Quality Improvement Grant*. The other two grants are the *Comprehensive HIV and Aids Grant* and the *Integrated Nutrition Grant* that will be phased into the provincial equitable share from 1 April 2006. The *National Tertiary Services* and *Health Professions Training and Development Grant* are both Schedule 4 grants.

The *National Tertiary Services Grant* is allocated R4,7 billion in 2005/06, increasing to R5,2 billion in 2007/08 to fund national tertiary services delivered in 27 hospitals across the nine provinces and ensure the equitable access to basic tertiary services in the country. Given the specialised nature of tertiary and other hospital services, these services tend to be concentrated in larger cities such as Johannesburg, Pretoria, Cape Town, Durban and Bloemfontein. Consequently, Western Cape and Gauteng receive 63,6 per cent of the grant as they provide the largest proportion of these sophisticated services for the benefit of the health sector countrywide. However, the grant has declined in real terms for Gauteng and Western Cape, as national health policy has attempted to better redistribute such services to other provinces, and also due to the scaling down of the number of hospitals offering tertiary services in favour of lower levels of care to community and district hospitals. However, such restructuring requires a broad strategy to shift staff, resources, assets, and a realistic phasing-in period. Government is currently in the process of reviewing its long-term vision for such hospitals and for tertiary services, their distribution between provinces, the restructuring required to effect such transformation, and the link between financing of academic hospitals and university medical faculties. Such vision will be finalised through the Modernisation of Tertiary Services Project, which is examining a ten-year framework for future provision of highly specialised services. The review is still in progress, and will be concluded ahead of the finalisation of the 2006 Budget. In line with a Cabinet decision, the review will focus on all current hospital grants.

It also appears that the current four hospital grants may be not properly aligned to provincial hospital and training programmes and provincial budgets. There is also a lack of available information on the outputs achieved by the hospital grants. A review of these grants will seek to determine whether there might be a case for rationalising them.

The *Health Professions Training and Development Grant (HPTD)* compensates provinces for their role in supporting teaching and training of health science students. It enables the shifting of teaching activities from central to regional and district hospitals. It increases from R1,4 billion in 2004/05 to R1,5 billion in 2005/06 and to R1,6 billion in 2007/08. The largest portion is distributed to provinces according to a formula based on the number of current medical students. A further component (developmental component) provides for a phased increase in the number of medical specialists and registrars in historically under-served provinces to address inter-provincial inequities in post-graduate training capacity. The grant is kept constant in nominal terms pending completion of the review of this grant and its improved alignment with higher educational funding streams.

The *Hospital Revitalisation Grant* plays a key role in transforming and modernising infrastructure and equipment in hospitals. It funds the upgrading and replacement of hospital infrastructure and focuses primarily on projects in which an entire hospital is upgraded. The grant also includes a component aimed at improving systems for medical equipment. Since the start of the grant in 1999/00, 210 hospitals have been fully revamped. In 2002/03 the grant focused on large upgrading and replacement projects. The first 27 of these are under way of which 10 will be completed in 2005/06. The largest hospitals funded and completed through this grant is Inkosi Albert Luthuli Hospital (with 846 beds) in KwaZulu-Natal, Nelson Mandela Hospital (with 460 beds) in Eastern Cape and Pretoria Academic (with 777 beds) in Gauteng. The grant is allocated R3,4 billion to rehabilitate and upgrade 59 hospitals over the next three years.

The *Hospital Management and Quality Improvement Grant* is allocated R150 million in 2005/06, increasing to R167 million in 2007/08. This grant facilitates a range of management development initiatives, including personnel, and procurement delegations and financial management capacity. It also supports the implementation of a range of hospital quality of care interventions specified in the national policy and can be seen as complimentary to the aims of the hospital revitalisation programme.

The *Comprehensive HIV and Aids Grant* enables the health sector to develop a specific response to the HIV and Aids epidemic. The grant supports, in addition to maintaining other HIV and Aids prevention programmes, specific interventions, which include voluntary counselling and testing, prevention of mother to child transmission, post exposure prophylaxis and home based care. So far 650 sites provide comprehensive prevention of mother to child transmission interventions to more than 80 000 women. KwaZulu-Natal, Western Cape and Gauteng achieved full coverage in the implementation of post-exposure prophylaxis. By 2002/03 about 1 625 sites were providing voluntary counselling and testing for HIV and Aids. The grant is allocated R1,1 million in 2005/06 growing to R1,6 million in 2007/08 to, in addition to other HIV and Aids interventions, implement Government's Comprehensive HIV and Aids Treatment and Care plan.

The *Integrated Nutrition Programme (INP)* is being phased-out as most of this grant was transferred to the National School Nutrition Programme under the Department of Education from 1 April 2004. It currently is aimed at assisting malnourished pre-school children under the age of five through feeding schemes. The grant is allocated R123 million in 2005/06 and phased into the equitable share formula from 1 April 2006 with the programme continuing and funded directly by provinces.

Housing grants

Government approved a comprehensive housing strategy to speed up housing delivery and at the same time develop sustainable human settlements. To streamline the funding for housing development, the *Housing Subsidy Grant*, which provides subsidies for low-income housing, and the *Human Settlement Redevelopment Grant*, which funds projects that aim to address dysfunctionalities in human settlements, have been subsumed into a single grant (the *Integrated Housing and Human Settlements Grant*). The new grant takes effect from 1 April 2005. However, part of the *Human Settlement Grant* is retained for 2005/06 to fund outstanding commitments on some of the projects not finalised in 2004/05.

To implement the comprehensive housing strategy, R2 billion is added to the new *Integrated Housing and Human Settlement Grant* over the next three years. The *Integrated Housing and Human Settlement Grant* increases from R4,5 billion in 2004/05 to R6,9 billion in 2007/08. Part of the *Human Settlement Grant*, which is retained to fund outstanding commitments in 2005/06, is allocated R24 million.

A major change expected over the 2005 MTEF relates to the accreditation of municipalities in terms of the Housing Act (Act No. 107 of 1997 as amended). Municipalities, particularly the ones with sufficient capacity, will be encouraged to apply for accreditation.

Land Affairs grants

The *Land Redistribution: Alexandra Urban Renewal Project Grant* contributes towards the purchase of land for the relocation and settlement of Alexandra residents and other qualifying beneficiaries. The grant is allocated R8 million in 2005/06 and 2006/07 upon which it is phased out.

National Treasury grants

In line with Government's commitment to sustain social and economic infrastructure investment in provinces and at the same time stimulating rural and provincial economic development and addressing unemployment through an Expanded Public Works Programme, R1,0 billion is added to the *Provincial Infrastructure Grant* bringing its allocation over the next three years to R13,6 billion. The grant grows from R3,3 billion in 2004/05 to R3,7 billion in 2005/06 and is budgeted to grow to R5,3 billion by 2007/08. The growth in this grant 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 focusing on agriculture. Since this is a Schedule 4 grant, provincial treasuries administer the grant and allocations are made to the line departments. In order to deal effectively with backlogs, the provincial division has been effected using a combination of the equitable share formula, roads element, and backlog component.

Provincial and Local Government grants to provinces

The two grants administered by the Department of Provincial and Local Government and transferred to provinces – *Local Government Capacity Building Fund* and the *Municipal Infrastructure Grant* – to enable provinces to assist municipalities have been discontinued. These grants will now flow directly to municipalities. Provinces are expected to fund their own capacity-building programmes for municipalities from their own revenue.

Social development grants

The shift in funding of social grants from 1 April 2005 means that the Department of Social Development manages the largest share (75 per cent) of conditional grant allocations to provinces constituting 26,7 per cent of total national transfers to provinces. Total conditional grants administered by the Department of Social Development are R55,4 billion in 2005/06 growing to R65,6 billion by 2007/08. The Department will administer 4 grants from 1 April 2006, two of which are for social security transfers and their administration, and the other two are for integrated social development services and HIV and Aids (Community-Based Care).

The shift of funding social security transfers and their administration is a transitional measure until such time that the social security agency is fully established at a national and regional level. The social security grant function will be administered through two conditional grants: the *Social Assistance Transfer Payment Grant*, which will fund the actual transfers to beneficiaries, and the *Social Assistance Administration Grant*, which will fund the overall administration of the function.

The *Social Assistance Transfers Grant* is allocated R52,0 billion in 2005/06, R57,1 billion in 2006/07 and R61,8 billion in 2007/08 and will fund grant payments in terms of the Social Assistance Act (Act No. 13 of 2004). These allocations now incorporate the *Child Support Extension Grant* conditional grant that was funding the phased extension of the means-tested child support grant. The phasing started with 7 and 8 year old children in 2003/04, was extended to 9 and 10 year old children in 2004/05 and is expected to cover 11, 12 and 13 year-old children in 2005/06.

The *Social Assistance Administration Grant* is allocated R3,4 billion in 2005/06, R3,6 billion in 2006/07 and R3,7 billion in 2007/08. This grant will fund the overall administration of the function, which includes employees, cost of payment contractors and other administrative aspects that are involved in the processes of paying grants to beneficiaries. The administrative function will discharge its responsibilities such as the processing of grant applications.

The introduction of the two social grant programmes has necessitated revisions to the 2005 Division of Revenue Bill, to deal with the risk of moral hazard (where provinces spend national government funds), and ensure that national and provincial accounting officers and treasuries exercise their responsibilities in a way that reduces such risk.

The *Integrated Social Development Services Grant* (formerly called Emergency Food Relief Grant) has been reconfigured into a general-purpose grant (Schedule 4 grant) to enable provinces to support and provide appropriate social welfare services, development interventions, and immediate and appropriate short-term relief to vulnerable individuals and households who are not receiving any form of assistance in terms of the Social Assistance Act. Allocations for this grant are R388 million in 2005/06, R411 million in 2006/07 and R432 million in 2007/08.

The *HIV and Aids (Community-Based Care) Grant* amounts to R138 million in 2005/06 and increases to R143 million in 2007/08. The grant provides social welfare services to orphans and vulnerable children who are infected and affected by HIV and Aids, within family and community context, in partnership with non-profit organizations (NGOs, CBOs and other community organisations). It further seeks to develop and support institutional structures, professionals, community workers, and child and youth care workers through targeted training programmes in order to ensure effective support to people affected by HIV and Aids.

Sports and Recreation grants

The Department of Sport and Recreation has been allocated R24 million in 2005/06, R39 million in 2006/07 and R41 million in 2007/08 to promote mass participation within historically disadvantaged communities in a selected number of development sporting activities.

Part 5: Local government fiscal framework and allocations

The local government fiscal framework

During 2004, the local government fiscal framework was subjected to a two-part review. The first part focused on the local government equitable share formula, while the second part covered matters pertaining to local government taxes, among other things. Although the reform of the local government equitable share formula is now completed, further work on the local government fiscal framework will continue in a number of areas.

In exercising their revenue powers, it is important that municipalities do so in a manner that does not impact materially on national macroeconomic policy imperatives, such as inflation targeting. A local government taxation bill may need to be prepared by national government to deal with the future of the Regional Services Council (RSC) levy, and to regulate the exercise of all other taxation powers of municipalities.

An assessment of the impact of the new property rates legislation on public infrastructure and state-owned properties, particularly those offering local services like schools and clinics will be undertaken. The review will investigate the possibility of an intergovernmental agreement on low or no rates to be charged on such categories of infrastructure, including the possibility that the I component be reviewed in 2006 to compensate for public infrastructure and per local service.

National legislation in terms of sections 155 and 229 of the Constitution may regulate how fiscal powers and functions are to be divided or shared between B and C municipalities. At present, property taxes are allocated to category A and B municipalities on the basis that category B municipalities are responsible for functions such as water, sanitation, electricity, refuse removal. Due to an asymmetric division of powers and functions between category B and C municipalities, certain category C municipalities are assigned the water function by the Minister for Provincial and Local Government, even though it is category B municipalities that collect (and retain) property taxes. Similarly, although certain category C municipalities have no major functions to perform, they receive RSC levy income.

In preparation for the local government elections at the end of this year or early next year, the Demarcation Board is in the process of delimiting municipal wards and reviewing provincial boundaries to do away with cross-boundary municipalities. Changes may be required to the framework due to new demarcations and other changes for the newly-elected municipalities, including potential adjustments to the I component and other components of Equitable Share and MIG formula.

While the equitable share provides support for operational expenditure on providing basic services for poor households, MIG supports the rollout of infrastructure for poor households to have access to these basic services. Therefore as MIG reduces backlogs in infrastructure delivery, the equitable share needs to account for the fact that a greater percentage of the population is serviced. Reliable and regular data at a municipal level are difficult to obtain. Data used for determining the current equitable share and MIG allocations were obtained from the 2001 Census. The next census will only take place in 2011 and the Census Replacement Survey will only provide data up to district municipal level. As agreed to by the Budget Forum, an annual data survey will be put in place, possibly with the assistance of STATS SA, in an attempt to update the data used in the equitable share and MIG formulas on an annual basis.

The National Treasury has conducted a survey among all municipalities, and classified them into three categories of high, medium or low capacity municipalities as published in Gazette No. 26511. National government is increasingly dealing with municipalities depending on this classification to phase in sections of MFMA, as well as to phase in specific powers and functions, as well as whether grants like MIG are to be given directly to the municipality or not.

National transfers to local government

The local government share increases over the next three years by R5, 4 billion to R58,3 billion over the 2004 budget baseline of R54,9 billion. National allocations to local government (Table E16) grow from a revised allocation of R14, 8 billion in 2004/05 to R17, 2 billion in 2005/06, R19,7 billion in 2006/07 and R21,5 billion by the end of the MTEF in 2007/08.

Table E16 indicates that the share of nationally raised revenue for local government rises from 4,6 per cent in 2004/05 to 5,0 per cent in 2007/08. National allocations are an important source of revenue for municipalities, comprising around 14,7 per cent of total local government budgets of over R100 billion in 2004/05, varying between 3 to 6,7 per cent for metros, and as high as 87,3 per cent in some districts. Major sources of own revenue for municipalities include property taxes, regional service levies, user charges on electricity, water, refuse removal and other municipal services.

Table E.16 National transfers to local government, 2004/05 – 2007/08

R million	2004/05	2005/06	2006/07	2007/08
Equitable share and related	**8 626**	**10 578**	**11 505**	**12 411**
Equitable share	7 678	9 643	10 515	11 371
Water and sanitation operating	949	934	991	1 040
Infrastructure	**5 363**	**5 833**	**7 454**	**8 301**
Programme	–	–	–	–
Water Services Project	217	139	–	–
Community Based Public Works Programme	–	–	–	–
Local Economic Development Fund	–	–	–	–
Sport and Recreation Facilities	134	–	–	–
National Electrification Programme	251	258	–	–
Urban Transport Fund	–	–	–	–
Municipal Infrastructure Grant	4 481	5 436	7 454	8 301
Disaster relief	280	–	–	–
Current transfers	**768**	**749**	**749**	**749**
Restructuring grant	388	350	350	350
Financial management grant	198	199	199	199
Municipal Systems Improvement	182	200	200	200
Total	**14 757**	**17 159**	**19 708**	**21 461**

National transfers to local government are divided into three major categories, namely:

- the equitable share grant (together with the water operating grant);
- infrastructure conditional grants; and
- capacity-building and restructuring conditional grants.

The unconditional equitable share allocation is the largest and most significant national allocation, in accordance with section 214 of the Constitution, and grows in significance relative to all other grants, rising from 52 per cent in 2004/05 to 56,2 per cent in 2005/06. This amount rises to 61,7 per cent when the water operating grant is included in total national grants. The second largest allocation to local government is the *municipal infrastructure conditional grant (MIG)*, which is 32 per cent in 2005/06, and the third and smallest category of grants are the capacity and restructuring grants, whose share amounts to 4,4 per cent in 2005/06.

The biggest reform to the local government grants system in 2005/06 is the adoption of a new local government equitable share formula, which is phased in over the MTEF. By introducing a revenue raising component, the new formula addresses concern about the varying fiscal capacities of municipalities.

Government has also announced further supplementary allocations to be allocated between all three spheres of government, but from which many municipalities will benefit, including:

- R1,2 billion for sanitation to eradicate the bucket sanitation system, which is fully incorporated into the *Municipal Infrastructure Grant*;

- R3 billion for community infrastructure, which is not allocated, but a significant portion is expected to be allocated to municipalities through the MIG; and
- R3 billion for public transport infrastructure, which is not allocated, but a significant portion will be allocated to those municipalities, which have stadiums that will be used for the 2010 World Cup.

All grants to municipalities are published per municipality to enable municipalities to plan fully for their coming 2005/06 budgets, and to promote better accountability by ensuring that all national allocations are included in municipal budgets. The allocations are published for both the national and municipal financial years. The municipal 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 serves as the legal appropriation requirement for national and provincial transferring departments. The allocations in terms of the municipal financial year facilitate proper reconciliation for audit purposes.

These allocations include the sanitation allocation of R1,2 billion, but exclude the R3 billion for community infrastructure and R3 billion for public transport infrastructure to be allocated within six months for publication in a gazette.

The local government equitable share formula: Its evolution since 1998

Sections 214 and 227 of the Constitution require that an equitable share of nationally raised revenue be allocated to the local sphere of government to enable it to provide basic services and perform the functions allocated to it. The size of the equitable share allocation to the local sphere of government takes account of the fiscal capacity, fiscal efficiency, developmental needs, extent of poverty and backlogs in municipalities, to the extent that such information is available for all municipalities.

The equitable share grant is an unconditional grant assisting municipalities to supplement their revenue to deliver services to poor households. Table E16 shows that the equitable share increase by R3,7 billion from the 2004/05 allocation of R7,7 billion to R11,4 billion in 2007/08.

The equitable share grant and formula were first introduced in 1998/99. It has undergone a number of changes since its inception, to take account of costs of transformation, data updates and new priorities. These changes are listed below as follows:

- 2000/01 – incorporation of the former R293 town subsidies (excluding R293 personnel),
- 2001/02 – incorporation of the R293 personnel subsidies, adjustments to the method of measuring poverty, and increasing the poverty threshold from R800 to R1 100,
- 2002/03 – the re-alignment of functions to the newly demarcated municipalities, the funding of district municipalities and the introduction of a nodal component to support the operational costs,
- 2003/04 – the introduction of free basic services to support poor communities and the alignment of the equitable share to the division of powers and functions between local and districts,
- 2004/05 – update data from the 2001 census, and adjusting the guarantee mechanism to phase in the impact of the new census results, and
- 2005/06 – will see the introduction of the new formula, which is more redistributive with a revenue raising and development component.

In 2002 Government recognised the need to review the formula, given the major restructuring that the local government sphere has undergone since 1998, and announced a comprehensive review. This review has, however, taken much longer than initially expected largely because of difficulties in obtaining consistent data across all municipalities. Notwithstanding the challenges of data and the uncertainty on some of the broad policy issues that will impact on the local government framework such as the establishment of Regional Electricity Distributors and the Municipal Property Rates Act, a new formula is introduced in this Budget. The new formula will be phased in over the 2005 MTEF with full implementation in 2007/08.

Structure of previous local government equitable share formula

Grant = S + I + FBS + FBE + R293 + Nodal Allocation + Top up

where

S is the basic services component

I is the institutional support component

FBS** and **FBE are for free basic services and electricity

***R293, Nodal Allocations** are transitional or specific windows*

The previous formula is explained in detail in previous Budget documentation (refer to *Annexure E* of the *Budget Review 2004*), and is not dealt with here. A detailed explanation of the new formula follows below.

New equitable share formula

Guiding principles

The point of departure for the equitable share formula is the constitutional requirement that the local government equitable share must take into account, among other things:

- the ability of municipalities to provide basic services
- the fiscal capacity and efficiency of municipalities
- developmental and other needs of local government
- the desirability of stable and predictable revenue shares.

The guiding principles for the new formula remain the same as those for the previous formula, and include:

a) *Equity*: Intergovernmental transfers should promote the constitutional goal of ensuring that all South Africans have access to basic services.

b) *Efficiency*: The new transfer system should promote allocative efficiency by ensuring that interjurisdictional competition is an effective check on fiscal performance. This would imply a certain amount of fiscal equalisation, but such flows should not be of such a magnitude as to deter investment or cripple particular areas.

c) *Spillover effects*: The transfer system should find ways of ensuring that projects with strong spillover effects are appropriately funded.

d) *Facilitating democracy*: The transfer system should help build the capacity of local authorities as one of the cornerstones of a democratic society.

e) *Additional considerations*: Several additional principles were listed to enable the system to meet these objectives:

- Rationality – the system should be based on clearly articulated arguments about how the transfers would promote the goals of equity, economic growth and efficiency
- Unintended consequences should be limited. In particular perverse incentives should be avoided
- Predictability – the transfers should facilitate proper budgeting
- Accountability – since without accountability valuable national resources could be wasted
- Political acceptability and institutional capacity building – the transfer system should be seen to be as broadly based as possible and should facilitate the consolidation of South Africa's new democracy
- Simplicity and transparency – to keep the systems and mechanisms simple.

Using the above principles, and recommendations of the Financial and Fiscal Commission, the National Treasury, working closely with the Department of Provincial and Local Government, South African Local Government Association, Statistics South Africa and the FFC, developed the following formula for discussion at the Budget Forum of 14 October 2004, and thereafter for adoption by Cabinet on 20 October 2004 and 16 February 2005.

The structure of the new formula

The new formula for the local government equitable share grant consists of four main components, for basic services, development needs, institutional needs and fiscal capacity.

Structure of new local government equitable share formula

Grant = BS + D + I – R ± C

where

BS is the basic services component

D is the development component

I is the institutional support component

R is the Revenue Raising Capacity Correction and

C is a correction and stabilisation factor.

The Basic Services Component

Municipalities are expected to provide water, sanitation, electricity, refuse removal and other municipal services. The purpose of the basic services component is to enable municipalities to provide basic services and free basic services to poor households.

The previous formula supported basic services through several "windows" like the S grant, the FBS grant and the FBE grant resulting in some duplication in funding basic services. The new Basic Services component has the following characteristics:

- Supporting only poor households earning less than R800 per month;
- Distinguishing between poor households provided with services and those provided with lesser or no services; and

- Recognising water reticulation, sanitation, refuse removal and electricity reticulation as the core services.

> **The Basic Services Component**
>
> ***BS=[Water Subsidy 1*Poor with Water + Water Subsidy 2*Poor without Water] +***
>
> ***[Sanitation Subsidy 1*Poor with Sanitation + Sanitation Subsidy 2*Poor without Sanitation] +***
>
> ***[Refuse Subsidy 1*Poor with Refuse + Refuse Subsidy 2*Poor without Refuse] +***
>
> ***[Electricity Subsidy 1*Poor with Electricity + Electricity Subsidy 2*Poor without Electricity]***

For each of the subsidised services there are two levels of support: a full subsidy for those households that actually receive services from the municipality and a partial subsidy for unserviced households, currently set at a third of the cost of the subsidy to serviced households.

The Institutional Support Component

The *Institutional component* is also retained from the previous formula, as it is a standard component required for both the local government and provincial equitable share formulae. It is particularly important for poor municipalities, who often are unable to raise sufficient revenue to fund the basic costs of administration and governance. Such funding gaps make it impossible for poor municipalities to provide basic services to all their residents, businesses and other clients or customers.

The aim of this component is to supplement the funding of a municipality for administrative and governance costs, but not to fully fund the entire administration and governance cost of a municipality – this remains the primary responsibility of each municipality.

> **The Institutional Component**
>
> There are two elements to the institutional component: administrative capacity and local electoral accountability – the grant therefore is as follows:
>
> ***I = Base allocation + [Admin support * Population] + [Council support * Number of Seats]***
>
> *Where the values used in the formula are:*
>
> ***I = R350 000 + [R1*population] + [R36 000* councillors]***

The I grant in the previous formula assumed that there are strong economies of scale in the functioning of local government – that larger municipalities are able to operate more cheaply than smaller ones. The new formula maintains this assumption of decreasing average costs by incorporating a base allocation that goes to all municipalities regardless of size.

The “Base Allocation” is an amount that will go to every municipal structure (except for a district management area (DMA)). The higher this allocation is set at, the more the formula benefits smaller municipalities. The second term of this formula recognises that costs go up with population. The third term is a contribution to the cost of maintaining councillors for the legislative and oversight role. The number of “seats” that will be recognised for purposes of the formula is that determined by the Minister for Provincial and Local Government.

The I grant will be updated for the 2006 MTEF to take into account any changes that may occur when new councils take over after the local government elections to be held later this year or early next year.

The Development Component

This component seeks to give effect to the developmental objectives for local government, beyond those identified with basic municipal services, and as envisaged in terms of section 214 of the Constitution. It is also intended as a policy component for future policy as the development objective is better identified, particularly for previously deprived areas.

The previous formula gave effect to the development component through a window for nodal allocations. The FFC has questioned the appropriateness of allocating a portion of the equitable share to selected municipalities. The new formula provides for clearer and specified criteria for all municipalities.

This component will not take effect immediately, but has been included in the formula as a future variable. A series of consultations held with various stakeholders could not yield any agreement in the limited time available on the factors to be taken into account for the development component. Further research and consultations will take place during 2005, including a request to the FFC to recommend an approach to give effect to this component. In the meantime, for the 2005 MTEF, it was decided to set this component at zero.

The Revenue Raising Capacity Correction

The FFC has recommended the inclusion of a fiscal capacity or revenue raising capacity measure in the equitable share formula. Government accepted this recommendation, but the lack of data to measure fiscal capacity has made it difficult to implement this recommendation earlier. The fundamental problem is that at present there is no national property valuation roll that can be used to approximate revenue raising capacity consistently across the country. It would not be desirable or equitable to use actual revenues raised, since this would immediately create perverse incentives in the system. Furthermore some municipalities do not seem to make enough effort to raise revenues. The National Treasury has considered suitable ways of creating proxies that would deal with all of these problems. The basic approach is to use the relationship between demonstrated revenue raising capacity among municipalities that report information and objective municipal information from Statistics South Africa to proxy revenue raising capacity for all municipalities. The total revenue that should be available to a municipality then is converted to a "correction" by imposing a "tax" rate of 5 per cent. At this level, municipalities end up contributing around R1,2 billion in 2005/06 towards the cost of basic services and administrative infrastructure.

Stabilising Constraint

The local government equitable share has been characterised by many large-scale changes since its inception in 1998, including the addition of different windows. In an effort to ensure some stability in grant allocations, the previous formula provided a 70 per cent guarantee on previous year's allocation. With the publication of three-year budget allocations it is more sensible to apply the guarantee mechanism to the indicative outer-year baseline amounts rather than to current or past year allocations. In particular the aim should be to give municipalities what they were promised in the previous MTEF round of allocations, as far as this is possible.

An additional constraint is to ensure that allocations are not negative due to the revenue raising correction.

Other considerations in applying the formula

The formula as outlined above has to be modified somewhat in order to take account of some of the intricacies of the allocation process. In particular one needs to ensure that powers and functions are taken into account and that the overall budget balances.

a) Powers and Functions

The local government system has a number of asymmetries, not only between different categories of municipalities, but also between the same category of municipalities. Firstly, there is the broad division of the sphere into category A, B and C municipalities. Secondly, the division of powers and functions between category B and C municipalities differs, even between the different category B municipalities within the same category C district. For example, a category B municipality may or may not have the power or function for potable water, which may be with the category C municipality. However, the formula still provides an indicative amount for that category B municipality, as there may be another category B municipality within the same district that has the water function assigned to it. In order to deal with these differences the model has to ensure that the allocations made in terms of the "Basic Services" component have to go to the municipality that actually performs the function.

b) Balancing allocations

The "horizontal division" of allocations made between municipalities depends on the size of the overall allocation that is made to the local government sphere, normally determined through a separate consultative process to determine the equitable share of nationally raised for each of the three spheres of government (i.e. the "vertical division"). Since there is no guarantee that allocations made in terms of the vertical division add up precisely to the amount allocated to the local government equitable share, such allocations need to be adjusted to fit within the constraints outlined above.

Rescaling of the BS, D and I Components

The simplest way of making the system balance is to rescale the BS, D and I components to the available budget, hence the formula actually becomes:

Grant = Adjustment Factor*(BS + D + I) – R ± C

This adjustment factor is calculated so as to ensure that the system balances.

In order to deal with the constraints, municipalities are divided into two groups. Those municipalities that require a "top up" in order to meet the stabilising constraints and those that do not. The total size of the top up is calculated and this is deducted from those that do not require a top up in proportion to the "surplus".

In the previous formula this process is done in a more complicated way. The disadvantage of the previous formula is that the final allocations had to be calculated iteratively, making the model very complex (and hence difficult for many policy-makers and the public to comprehend).

Measurement Issues

In order to implement the revised formula, one has to be able to measure the variables quite accurately. The integrity of the data is as important as the set of equations in determining whether the allocations meet the constitutional requirement of equity. It should be noted that measurement is itself a dynamic issue – new data sets become available, while existing data series might be discontinued. This means that the allocation process is subject to regular changes and innovation.

a) Poverty

The baseline information for the measurement of poverty comes from Census 2001. A technical issue is whether to use the "income" or "imputed expenditure" method to estimate poverty at the municipal level. At present the "imputed expenditure" method does not allow for a cross-tabulation of poverty against servicing levels, so the "income" method is used for the formula, as it is matters whether the poor are actually receiving services or not.

b) Servicing levels

A key ingredient in the current formula is the subsidy received by poor households for various services delivered to them. Given that most municipalities are unable to provide cost information per service, alternative sources of information are required for key data on costing of services.

In the previous formula the amounts were based on a study that was conducted in the late 1990s by the Development Bank of Southern Africa (DBSA). The subsidy amounts are updated in the new formula, using a more recent study by the Department of Provincial and Local Government.

The new service costs are R130 per month for a serviced household and R45 per month for an unserviced household (refer to columns b and c of Table E17 below).

Table E.17 Service costs

Service costs per month	1998 Estimates	Serviced households	Unserviced households[1]
Electricity	36,0	40,0	15,0
Water	20,0	30,0	10,0
Refuse	20,0	30,0	10,0
Sanitation	10,0	30,0	10,0
Total	**86,0**	**130,0**	**45,0**

1. One third of serviced households (2004 DPLG study).

c) Revenue Raising Capacity

In order to introduce the revenue raising capacity measure one has to be able to approximate revenue capacity reasonably accurately. This has been the major impediment to introducing this component. Information on revenue collected (by source) is only available from each municipality, and even where a municipality is able to provide such information, it must be comparable between municipalities so as not to expose the formula to data manipulation. The lack of such information requires the use of alternative research. For the new formula an imputation process using municipal revenue data and census information was undertaken. This process has the advantage that:

- It leads to measures of revenue raising capacity that are highly correlated with actual revenues raised
- Municipalities cannot manipulate it in order to influence their equitable share allocations.

Phasing-in of the new formula

The new formula will be phased-in and fully introduced only in the 2007/08 financial year. The new formula is used to generate the allocations by municipality based on the new baseline allocations for 2005/06, 2006/07 and 2007/08 announced in the 2005 National Budget. The indicative allocations for 2005/06 and 2006/07, which were generated by the previous formula, are guaranteed.

The Water Service Operating Subsidy

This is a transitional operational grant closely related to the local government equitable share grant and in principle should be part of the equitable share grant. The grant is also an indirect grant, used to fund over 300 water schemes in municipalities through the Water Trading Account on the vote of the Department of Water Affairs and Forestry (DWAF). DWAF has administered a number of these schemes in poor areas prior to 1994. The operating grant amounts to R948 million in 2004/05, R934 million in 2005/06, R990 million in 2006/07 and R1 040 million in 2007/08 or a total of R2,9 billion over the MTEF.

DWAF is in the process of transferring schemes over the next three years, for which funding will be phased out from 2007/08. Like the process for the R293 staff, DWAF plans to conclude bilateral negotiations with municipalities by 31 March 2006. All funds on this programme will thereafter be transferred to municipalities directly as soon as such transfers occur. Direct grants to DWAF will be phased progressively downwards and those to municipalities upwards.

The transfer of water schemes involves the transfer of both assets and staff, and the resulting operating costs of salaries and free basic services. The 300 schemes employ 8 094 staff and affect 53 municipalities. So far 25 agreements had been signed, 495 staff transferred, 301 staff seconded and 84 schemes with a total asset value of approximately R1 billion. Over 40 per cent of the staff is to be transferred to municipalities in Limpopo. Estimated ‘once off’ personnel related costs over the three years amount to R393 million. Full costs for the operations of the schemes are being finalised. The medium-term plan is to transfer at least 4 000 staff in 2005/06 and the remainder of the staff in the 2006/07 and 2007/08 financial years.

All receiving municipalities will be required to conclude formal transfer agreements where the latest effective date of transfer is 31 March 2006. The operating and transfer subsidy will be treated as a grant-in-kind until the effective date of transfer, and thereafter progressively phased into the equitable share. The operating subsidy will cover staff related costs (HR component) and direct operating and maintenance costs (O component), whilst provision is also made for made the refurbishment of infrastructure. The allocation per municipality will be according to the operational budget for each scheme and the funding requirements identified and agreed in the transfer agreement. Clear performance targets will be set with the assistance of the Department of Provincial and Local Government and SALGA to complete the process.

Conditional grants to local government

Schedules 4, 6, 6A and 7 of the Division of Revenue Bill provides for the conditional grants to municipalities. Despite the growing importance of the unconditional equitable share grant, conditional grants are still a significant portion of national grants to local government. 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.

Total conditional grants, including the water operating subsidy, to municipalities increase from R7,1 billion in 2004/05, to R7,5 billion in 2005/06, R9,2 billion in 2006/07 and R10,1 billion in 2007/08. There are two categories of conditional grants, infrastructure and capacity-building/ restructuring grants. The most significant development for 2005/06 is the finalisation of the consolidation of the remaining infrastructure grants into the Municipal Infrastructure Grant. The capacity building and restructuring grants are capped at R749 million for the two outer years, and are being rationalised over the medium term. Below is a summary of all the conditional grants listed in Schedules 4, 6, 6A and 7 of the 2005 Division of Revenue Bill.

Infrastructure conditional grants to local government

The *Municipal Infrastructure Grant* is a critical instrument for achieving Government's objective of expanding the delivery of basic services to poor households and alleviating poverty. This grant is listed on Schedule 4 of the Division of Revenue Bill, as it supplements municipal allocations for infrastructure expenditure. For this reason, the role of national departments in relation to this grant is limited only to enforcing compliance with the minimal conditions set out in its framework and monitoring performance by receiving municipalities.

The *Municipal Infrastructure Grant* complements the equitable share allocations to give effect to Government's commitment towards access to basic services to all households, including the delivery of free basic services to poor households and other poverty alleviation objectives.

This grant is also aimed at stimulating local economic development and job creation over the medium term. Municipalities are therefore required to dedicate a portion of their capital budgets to labour-based infrastructure methods to meet the objectives of the Expanded Public Works Programme. The total allocation for infrastructure is R5,4 billion, R7,5 billion, R8,3 billion for each of the MTEF years.

The *Municipal Infrastructure Grant (MIG)* established in 2004 simplifies and rationalises policy and funding mechanisms for municipal infrastructure. The MIG merged the following grants in a phased manner over a three-year period ending by 2005/06:

- *Consolidated Municipal Infrastructure Programme*, in support of internal bulk, connector infrastructure and community facilities to poor households
- *Water Service Capital Fund*, in support of bulk, connector and internal infrastructure for water services at a basic level
- *Community Based Public Works Programme*, in support of the creation of community assets in rural, historically disadvantage communities
- *Local Economic Development Fund*, in support of planning, and implementation of job creation and poverty alleviation
- *Building for Sport and Recreation Programme*, in support of promoting sport and recreation facilities within disadvantage communities
- *Electrification* funding in support of addressing the electrification backlog of permanently occupied residential dwellings that are situated in historically under-supplied areas.

The MIG is geared to making the system of transfers to municipalities simpler, more certain, direct and reduces the number of steps in decision-making processes. Its conditions are more flexible, designed to support the capital budgets of municipalities, and to facilitate integrated development planning. The MIG does not fund specific projects, but is designed to complement the capital budgets of municipalities (similar to the provincial infrastructure grant).

The MIG gives municipalities a central role in coordinating development activity and the delivery of municipal infrastructure within their jurisdictions. It is focused on achieving a number of outputs, including the achievement of service coverage targets, employment creation and linking Integrated Development Plans (IDPs) and budgets. The role of national and provincial government is to support, and monitor policy outcomes of 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 on improving the capacity, efficiency, effectiveness, sustainability and accountability of the local government sphere, and making integrated development plans the primary mechanisms for intergovernmental coordination. Hence the MIG is re-classified as a Schedule 4 grant.

To ensure that commitments made by departments whose grants are subsumed in MIG before 30 September 2003 are honoured by municipalities, a specific condition is imposed. The remaining commitments by the Water Services Capital Grant and the Integrated National Electrification Programme run out by 2005/06, thereafter these programmes will be fully phased into the MIG.

The MIG policy also makes provision for various capacity levels of municipalities namely, high, medium and low capacity municipalities. As from the 2005/06 financial year, all high, medium and selected low capacity municipalities will receive allocations directly. The final allocations equal either the existing commitments for the municipality or the allocation as calculated by the MIG formula, whichever is higher. The high and medium capacity municipalities will be expected to produce medium term capital plans and budgets, reflecting all projects to be funded in each sector.

The low capacity municipalities, with the exception of a few selected municipalities will receive their grants, via the district municipality. Various levels of support are available to municipalities either by the national government, provincial government and Project Management Units to ensure that low capacity municipalities improve their capacity to the point where they can receive their grants directly.

The grant framework for the MIG reflects the output-based reporting as required in terms of the Division of Revenue Act. Municipalities will be required to report on spending on capital in accordance with the Municipal Finance Management Act through monthly reports, quarterly on performance and the annual reports, particularly for priority sectors like water and sanitation, refuse removal, roads and community facilities and on expanded public works.

MIG Formula

The 2005 MTEF introduces a ring-fenced amount for the eradication of the bucket sanitation system by 2010. The programme has been kick started with an additional allocation of R1,2 billion over the 2005 MTEF. For the 2005/06 financial year, R200 million is to be targeted to specific municipalities with a high prevalence of the bucket sanitation system that would be able to implement projects sooner. Although an upfront allocation is made for the 2006/07 and outer years, municipalities should prepare and submit plans to demonstrate their readiness in meeting this challenge over the medium term. These plans are to be submitted to the Department of Water Affairs and Forestry by no later than 1 October 2005.

There are five main components of the formula, after accounting for funds flowing to the Special Municipal Infrastructure Fund (SMIF) (R128 million of total funds in 2005/06) for innovation and region-wide programmes. The SMIF is a project-based allocation made by the Department of Provincial and Local Government to municipalities.

For the 2005/06 municipal financial year, R128 million is top-sliced from the MIG allocation and distributed on a project basis to municipalities through the SMIF. The balance of the MIG allocation is then applied through the formula to determine the allocation due to each municipality using the formula. Since no multi-year applications have been received, no allocation is set aside for the SMIF in 2006/07 and 2007/08. However, the DPLG will be allowed to commit up to R155 million in each of the outer years. These amounts will then to be top-sliced from the increase in the baseline for the MIG programme in the 2006 MTEF.

Depending on the level of existing commitments and the capacity of the municipality, a proportion will flow as MIG funds to the municipality as described above. The key condition over this initial period is the submission of three-year capital plans. The other applicable conditions and outputs are contained in the MIG framework as per the Division of Revenue Gazette.

$$MIG_{(F)} = B + P + E + N + M$$

B Basic residential infrastructure (new and rehabilitated)

Proportional allocations for water supply and sanitation, electricity, roads and 'other' (Street lighting and solid waste removal)

P Public municipal service infrastructure (new and rehabilitated)

E Allocation for social institutions and micro-enterprises infrastructure

N Allocation to all nodal municipalities

M Negative or positive allocation related to past performance of each municipality relative to grant conditions

Over the 2005 MTEF, R21,2 billion is available for the MIG Programme. The Electricity Programme (both municipal and Eskom programmes) is incorporated into the MIG in 2006/07. This requires a rescaling of the weights of the B component. The rescaling and weighted shares per sector are illustrated in Table E18.

Table E.18 Municipal Infrastructure Grant (MIG) allocations per sector, 2004/05 – 2007/08

	2004/05		2005/06	2006/07	2007/08
Weights	**Original weights**		**Adjusted weights**		
Municipal Infrastructure Grant (a)	**100,0%**				
Special Municipal Infrastructure Fund and Management (b)	4,0%				
Ring-fenced allocation: Eradication of Bucket Sanitation System (c)					
Municipal Infrastructure Grant (formula)	96,0%	*(a)-(b)*	*(a)-(b)-(c)*	*(a)-(b)-(c)*	*(a)-(b)-(c)*
***of which* Municipal Infrastructure Grant (formula)**					
B Component	**75,0%**	**75,0%**	**75,0%**	**75,0%**	**75,0%**
Water and sanitation	*72,0%*	*72,0%*	*72,0%*	*53,0%*	*53,0%*
Electricity	*0,0%*	*0,0%*	*0,0%*	*22,0%*	*22,0%*
Roads	*23,0%*	*23,0%*	*23,0%*	*20,0%*	*20,0%*
Other	*5,0%*	*5,0%*	*5,0%*	*5,0%*	*5,0%*
P Component	**15,0%**	**15,0%**	**15,0%**	**15,0%**	**15,0%**
E Component	**5,0%**	**5,0%**	**5,0%**	**5,0%**	**5,0%**
N Component	**5,0%**	**5,0%**	**5,0%**	**5,0%**	**5,0%**

Table E19 shows the respective components of the MIG allocation and how they are distributed by the formula. The formula allocations have been adjusted to provide funds to the municipality assigned the function to perform the particular service, in line with Government Gazette No. 24228 of 3 January 2003 issued by the Minister of Provincial and Local Government.

Table E.19 Municipal Infrastructure Grant (MIG) allocations per sector, 2004/05 – 2007/08

	2004/05		2005/06	2006/07	2007/08
R million	**Original weights**	**Adjusted weights**			
Municipal Infrastructure Grant (a)	**4 446**	**4 440**	**5 436**	**7 454**	**8 301**
Special Municipal Infrastructure Fund and Management (b)	178	33	129	–	–
Ring-fenced allocation: Eradication of Bucket Sanitation System (c)	–	–	200	400	600
Municipal Infrastructure Grant (formula)	4 268	4 407	5 107	7 054	7 701
of which **Municipal Infrastructure Grant (formula)**					
B Component	**3 201**	**3 305**	**3 830**	**5 291**	**5 776**
Water and sanitation	*2 305*	*2 380*	*2 758*	*2 804*	*3 061*
Electricity	–	–	–	*1 164*	*1 271*
Roads	*736*	*760*	*881*	*1 058*	*1 155*
Other	*160*	*165*	*192*	*265*	*289*
P Component	**640**	**661**	**766**	**1 058**	**1 155**
E Component	**213**	**220**	**255**	**353**	**385**
N Component	**213**	**220**	**255**	**353**	**385**

Capacity building and restructuring grants

The capacity building grants were set up to assist municipalities in building management, planning, technical, budgeting and financial management skills. There are two capacity building grants, the *Financial Management Grant* and the *Municipal Systems Improvement Programme*, and a *Restructuring Grant*. These grants total R749 million each for the 2005 MTEF. Government intends to phase these grants into the equitable share over the medium term.

During the past few years, national and provincial governments have committed significant resources to capacity building. The capacity building funds have been directed to a number of initiatives. The success of this programme will only be measurable during this MTEF period. Emphasis has shifted towards building in-house municipal capacity, supporting an internship programme to develop new skills in financial management, improve service delivery and value-for-money. The primary beneficiaries of these grants are municipalities.

The *Municipal Systems Improvement Grant (MSIG)* under the vote of the Provincial and Local Government Department assists municipalities to build through district and selected local municipal support and focuses on stabilising municipal and governance systems, planning and implementation management support centres (PIMS), reviewing IDP's and implementing the Municipal Systems Act. To date 47 PIMS centres have been established in all districts. Allocations over the 2005 MTEF amount to a further R600 million.

The *Financial Management Grant* under the National Treasury vote funds the modernisation of financial management, including building in-house municipal capacity to implement multi-year budgeting, link integrated development plans to budgets, produce quality and timely in-year and annual reports, and generally supports municipalities in the implementation of the Municipal Finance Management Act, Act 56 of 2003. A portion of the grant is used to leverage international technical assistance support. Currently over thirty advisors are working in selected municipalities supporting the implementation of the Act. Furthermore, to facilitate skills development in financial management, municipalities have utilised the grant to appoint over two hundred and fifty Interns, to qualify in terms of the newly registered Level 6 Financial Management Certification Qualification registered with SAQA. The programme funded budget training for over 600 municipal officials from high, medium and low capacity municipalities. Allocations over the 2005 MTEF amount to R596 million.

The *Restructuring Grant* under the National Treasury vote is a demand driven grant and is aimed at funding municipal restructuring initiatives of a financial, institutional and developmental nature that are locally designed and supported. Only large municipalities are eligible for this grant. Reviews of implementation plans have been undertaken during 2004 in the all the Metropolitan municipalities and some other large municipalities. Multi-year contracts will be concluded with several new municipalities, and future efforts will focus on assessing the successful implementation in terms of agreed milestones. The grant has been capped at R350 million from 2006 and will be reviewed thereafter.

Part 6: Future work on sub-national fiscal frameworks

Crosscutting issue: data

The review of the provincial and local government fiscal frameworks has highlighted major problems of unavailability of consistent and comparable data for a number of key variables that are important in informing policy, decision-making and resource allocation within each sphere. This problem hampers a number of possible improvements that could be effected to the resource allocation formulae for equitable shares and conditional grants. In some cases it implies that components of formulae use outdated information. This problem needs urgent attention. In this regard a number of initiatives are under way or are being considered. Firstly, departments are encouraged to establish and improve systems for maintaining administration records, for example health records on utilisation of health care services by different gender groups. Relevant national departments have a central role to play insofar as ensuring consistency in approaches to record keeping, measurement and comparability. A process for verifying and accrediting information has to be part of this process. Secondly, on the issue of capital and infrastructure, there is a clear need to put in place mechanisms for defining and measuring backlogs, taking account of the dynamic nature of population migration across provinces and between rural and urban areas. This is vitally important for both the provincial and municipal government infrastructure grants. Thirdly, major users of information have to liaise with StatsSA with the view of presenting their information needs and agreeing how such requirements could be met as well as the regularity with which certain information can be gathered.

Provincial fiscal framework issue for future budgets

In reviewing the provincial fiscal framework for the 2005 Budget the following issues have been identified as requiring further work:

- The first issue relates to the major hospital grants such as the National Tertiary Services Grant and the Health Professions and Training Grant, which will be reviewed ahead of the 2006 Budget. Among other things, the review will seek to determine whether the current trends in total allocations for these grants and their distribution among provinces are consistent with their original and future policy objectives.
- The second issue relates to borrowing and financing of major infrastructure projects. About six years ago, Budget Council agreed to a moratorium on provincial borrowing in part because provinces did not have adequate capacity to utilise available resources. With evidence of improvement in capacity, the policy position on borrowing is under review. It is anticipated that during the course of the current, provinces will be allowed to borrow for specific projects. In the initial stages such borrowing may be limited to the Development Bank of Southern Africa, which will also be expected to agree terms for providing technical support to provinces that borrow from it.

Local government fiscal framework issues for future budgets

The national framework for municipal taxation powers is determined by section 229 of the Constitution, which empowers municipalities to impose a property tax and surcharge on fees for municipal services, subject to national regulation. Other taxes, levies and duties appropriate to local government or to the category of local government may also be allocated in terms of national legislation. A review of the local government fiscal framework is currently being undertaken and is aligned to and complements the work on the reform of the local government equitable share formula discussed above.

Reform of regional services council (RSC) levies

The Regional Services Council (RSC) levies (referred to as Joint Services Board levies in the KwaZulu-Natal Province) consist of two components, a regional services levy and a regional establishment levy, calculated on payroll and turnover respectively. The RSC levy is allowed in terms of section 21 in Schedule 6 of the Constitution until the national legislation required for section 229(1)(b) is enacted. The RSC levy is an important source of revenue for metropolitan and district municipalities making up 9 per cent or R5,2 billion of total local government revenue in the 2003/04 municipal fiscal year.

The RSC levy has been criticised as an inefficient, inequitable and poorly administered tax instrument. A good local tax relates the tax burden to the ability to pay. Neither component of the RSC levy complies with this criterion. Though it is possible to improve the design of the RSC levy and to reform it, there is a strong case for it to be phased out completely. A menu of alternative sources of revenue such as new taxes, levies and surcharges and grants are being explored as replacements for revenue currently collected from RSC levies. It is the intention to table legislation to this effect before the end of the year.

Transitional mechanisms will be dealt with in the 2006 MTEF, as actual impact on funds will only take effect from 1 July 2006 for the 2006/07 municipal financial year. National government will request the FFC to provide a specific report on what tax it would recommend, as well as whether a transitional or new grant should fund category A or C municipalities. The FFC will be requested to make recommendations during their 2006 submission.

Restructuring of the electricity distribution industry (EDI) and the establishment of regional electricity distributors (REDs)

The coming EDI restructuring will have a significant impact on metro and large category B municipalities, as electricity comprises about 40 per cent of their revenue budget. It is estimated that municipalities will have to shift over R21 billion of their operating budgets to REDs as part of the restructuring effort, resulting in municipal operating budgets shrinking from R73 billion to R52 billion. The value of assets to be shifted is not yet known.

In order to minimise such fiscal risk, and to ensure that municipal finances are not adversely affected, the National Treasury has convened a process involving key stakeholders (SALGA, metro municipalities, dplg, DME, EDI Holdings, Eskom) to develop a set of guiding principles to assist EDI when establishing a RED. The following four principles are proposed for the establishment of REDs:

- Restructuring must be in accordance with the Constitution
- Financial state of municipalities currently performing the electricity function must not be adversely affected
- Aggregate personnel costs must not increase

- No additional funds or taxes to fund restructuring.

It is hoped that a preliminary report by the Task Team on the impact of REDs on the local government fiscal framework will be completed by 30 April 2005. National government will request the FFC to consider the impact of REDs on municipalities and to recommend by 31 August 2005 whether any other fiscal steps necessary to protect municipalities from negative fiscal impact.

Implementation of the Local Government: Municipal Property Rates Act

An assessment of the impact of the new property rates legislation on public infrastructure and state-owned properties, particularly those offering local services like schools and clinics will be undertaken. The review will investigate the possibility of an intergovernmental agreement on low or no rates to be charged on such categories of infrastructure, including the possibility that the I grant be reviewed in 2006 to compensate for public infrastructure and per local service.

National legislation in terms of sections 155 and 229 of the Constitution may regulate how fiscal powers and functions are to be divided or shared between B and C municipalities. At present, property taxes are allocated to category (A and B) municipalities on the basis that category B municipalities are responsible for functions such as water, sanitation, electricity, refuse removal. Due to an asymmetric division of powers and functions between category B and C municipalities, certain category C municipalities will be responsible for the water function but the category B municipalities will still have all the property tax. Similarly, although certain category C municipalities have no major functions to perform, they have access to RSC levies.

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