# E

# 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 Intergovernmental Fiscal Relations Act (1997) reinforces section 214 of the Constitution by promoting cooperative governance on fiscal, budgetary and financial matters and by prescribing the process for determining the equitable sharing and allocation of revenue raised nationally. 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 2006 Division of Revenue Bill fulfils the requirement set out in section 10(5) of the Intergovernmental Fiscal Relations Act that 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 five parts:

- Part 1 describes the division of resources between the three spheres of government
- Part 2 sets out how the FFC's recommendations on the 2006 division of revenue have been taken into account
- Part 3 explains the formula and criteria for the division of the provincial equitable share and for conditional grants to provinces.
- Part 4 sets out the formula and criteria for the division of the local government equitable share and conditional grants between municipalities.
- Part 5 summarises issues that will form part of subsequent reviews of provincial and local government fiscal frameworks.

This memorandum should 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 and Budget Forum deliberated on the matters discussed in this memorandum at meetings held on 18 July 2005 and 13 October 2005. The approach to local government allocations was 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 18 July 2005 and 13 October 2005. An extended Cabinet meeting, involving cabinet ministers, premiers of provinces and the chairperson of SALGA was held on 19 October 2005 and agreed on the final budget priorities and the division of revenue over the next three years.

## Part 1: The 2006 division of revenue

Taking into account government's spending priorities, the revenue-raising capacity and functional responsibilities of each sphere, inputs from various intergovernmental forums and the recommendations of the FFC, and excluding debt service costs, the total to be shared between the three spheres amounts to R362,7 billion, R395,8 billion and R427,5 billion over each of the MTEF years. The 2006 division of revenue seeks to strengthen the ability of provinces and municipalities to provide basic services and perform the functions allocated to them, and provide for their developmental and other needs. This year's division of revenue is framed in the backdrop of the accelerated and shared growth initiative. Further, the design of the equitable share formulae for both provincial and local governments are such that these spheres have desirable, stable and predictable revenue shares, and that economic and fiscal disparities that exist are addressed. Section 6 of the Division of Revenue Bill also ensures that the provincial and local governments are protected against any shocks should revenue shortfalls from nationally raised revenue arise.

### Government's policy priorities for the 2006 MTEF

Government seeks, through the annual Budget, to redress the legacy of historical injustice, provide for the progressive realisation of basic social rights, address economic disparities, and ensure that future generations will enjoy the fruits of broad-based development and robust economic growth. Government's priorities over the medium term centre on 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 promoting international and regional partnerships for growth and development. To achieve these objectives the following form the core areas that the 2006 Budget will be supporting:

- *Education and the labour market:* A core priority for the period ahead is to strengthen education and improve performance of the labour market. Investing in people and ensuring that skills development complements employment creation, are critical platforms on which to build future prosperity.
- *Targeted welfare services:* Alongside an expanded income security net, shared growth must also involve targeted welfare services and stronger partnerships with non-governmental welfare organisations. Addressing the impact of HIV and AIDS, care of child-headed households and appropriate management of children in conflict with the law are among the social service priorities for the 2006 Budget.
- *Improving the built environment:* Housing delivery needs to be accelerated, together with municipal capacity building and investment by both the public and the private sectors in improving the quality of life in poor neighbourhoods.
- *Investment in economic infrastructure:* Economic infrastructure for a more rapidly growing economy includes power generation capacity, rehabilitation and expansion of road and rail transport networks, improved water resource management and modernisation of communications.
- *Industrial development and employment creation:* Industrial development and employment creation will be boosted over the period ahead through several sectoral growth initiatives, improved spatial and intergovernmental planning and targeted research and technology investment. Small business development and more effective economic regulation are aimed in part at bridging the divide between the formal and informal sectors.

- *Support for the integrated justice system:* The challenge of reducing crime, improving the performance of courts and security services and improving safety on our roads remain key priorities for the years ahead.
- *Matters of national interest*: South Africa continues to extend and deepen its diplomatic presence on the African continent and participation in various international forums. Defence modernisation and military skills development are prioritised for the 2006 Budget in line with South Africa's current and potential involvement in international affairs.
- *Strengthening service delivery capacity:* Public administration reform is strongly focused on building local government capacity and improving training activities across the public service.

Table E.1 shows how the additional allocations are apportioned to the different priority areas across the three spheres of government.

**Table E.1 2006 Budget priorities – additional MTEF allocations, 2006/07 – 2008/09**

| R million | 2006/07 | 2007/08 | 2008/09 | Total |
|---|---|---|---|---|
| **Provincial equitable share**<br>*includes school education, health care, welfare services, provincial roads, agriculture and economic development* | 3 511 | 9 517 | 17 853 | **30 881** |
| **Education, health and welfare** | | | | |
| Higher education and recapitalisation of FET institutions | 350 | 750 | 1 300 | **2 400** |
| Revitalisation of hospitals and forensic pathology services | 340 | 554 | 657 | **1 551** |
| Social grants and SA Social Security Agency administration | 660 | 910 | 1 090 | **2 660** |
| **Housing and community development** | | | | |
| Housing grants | 800 | 1 200 | 1 500 | **3 500** |
| Municipal infrastructure, transport and water schemes | 1 180 | 1 470 | 3 100 | **5 750** |
| Community libraries, cultural institutions, sports promotion | 170 | 428 | 843 | **1 441** |
| Neighbourhood development partnerships | 50 | 950 | 1 500 | **2 500** |
| Soccer World Cup infrastructure | 400 | 1 000 | 1 600 | **3 000** |
| **Economic infrastructure investment** | | | | |
| National roads and rail rehabilitation | 600 | 1 100 | 1 800 | **3 500** |
| Gautrain rapid rail link | 3 241 | 2 151 | 1 736 | **7 128** |
| Industrial development zones and other infrastructure | 445 | 790 | 1 050 | **2 285** |
| **Industrial development, science & technology** | | | | |
| Research and Development | 285 | 430 | 640 | **1 355** |
| Pebble Bed Modular Reactor & NECSA | 650 | 120 | 110 | **880** |
| Tourism promotion | 20 | 60 | 100 | **180** |
| Regulatory capacity | 199 | 187 | 214 | **600** |
| **Justice and crime prevention** | | | | |
| Courts administration and capacity | 350 | 550 | 900 | **1 800** |
| SA Police Service infrastructure and personnel | 509 | 962 | 2 095 | **3 566** |
| **International relations and defence** | | | | |
| Military skills development | 100 | 200 | 300 | **600** |
| Defence modernisation, IT and infrastructure | 691 | 940 | 1 430 | **3 061** |
| Foreign Affairs capacity and African Renaissance Fund | 229 | 320 | 367 | **916** |
| **Public administration capacity** | | | | |
| Maintenance and investment in government accommodation | 988 | 1 095 | 1 198 | **3 281** |
| Municipal equitable share & Project consolidate | 563 | 730 | 967 | **2 260** |
| National Treasury - SARS & financial management systems | 420 | 680 | 840 | **1 940** |
| Statistics SA | 168 | 123 | 274 | **565** |
| Other adjustments | 1 389 | 1 789 | 3 073 | **6 251** |
| Less: Infrastructure announced in 2005 & savings | -2 922 | -3 669 | -5 102 | **-11 693** |
| **Total policy adjustments** | **15 386** | **25 337** | **41 435** | **82 158** |

## Fiscal framework

Table E.2 presents medium-term macroeconomic forecasts for the 2006 Budget. It sets out the growth assumptions and fiscal policy targets on which the fiscal framework is based.

**Table E.2 Medium-term macroeconomic assumptions, 2005/06 – 2008/09**

| | 2005/06 | | 2006/07 | | 2007/08 | | 2008/09 |
|---|---|---|---|---|---|---|---|
| R billion | 2005 Budget | 2006 Budget | 2005 Budget | 2006 Budget | 2005 Budget | 2006 Budget | 2006 Budget |
| Gross domestic product | 1 528,6 | 1 559,6 | 1 674,0 | 1 714,5 | 1 847,3 | 1 884,9 | 2 095,9 |
| *Real GDP growth* | *4,1%* | *4,9%* | *3,9%* | *4,8%* | *4,4%* | *4,7%* | *5,3%* |
| *GDP inflation* | *5,7%* | *4,6%* | *5,2%* | *5,4%* | *5,3%* | *5,7%* | *4,7%* |
| **National Budget Framework** | | | | | | | |
| Revenue | 369,9 | 411,1 | 405,4 | 446,4 | 444,6 | 492,0 | 547,1 |
| *Percentage of GDP* | *24,2%* | *26,4%* | *24,2%* | *26,0%* | *24,1%* | *26,1%* | *26,1%* |
| Expenditure | 417,8 | 419,0 | 456,4 | 472,7 | 494,9 | 519,2 | 571,3 |
| *Percentage of GDP* | *27,3%* | *26,9%* | *27,3%* | *27,6%* | *26,8%* | *27,5%* | *27,3%* |
| Budget deficit | -47,9 | -7,9 | -51,0 | -26,4 | -50,3 | -27,2 | -24,2 |
| *Percentage of GDP* | *-3,1%* | *-0,5%* | *-3,0%* | *-1,5%* | *-2,7%* | *-1,4%* | *-1,2%* |

Table E.3 sets out the impact of policy decisions on the division of revenue.

**Table E.3 Division of revenue between spheres of government, 2002/03 – 2008/09**

| | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 |
|---|---|---|---|---|---|---|---|
| R million | | Outcome | | Revised | | Medium-term estimates | |
| National departments | 129 297 | 148 142 | 168 018 | 196 429 | 214 964 | 233 996 | 254 495 |
| Provinces | 107 317 | 122 673 | 137 836 | 154 528 | 176 679 | 196 351 | 217 481 |
| *Equitable share* | *93 895* | *107 538* | *120 885* | *135 292* | *150 753* | *167 701* | *187 100* |
| *Conditional grants* | *13 422* | *15 135* | *16 951* | *19 237* | *25 926* | *28 649* | *30 382* |
| Local government | 8 102 | 11 581 | 13 837 | 16 859 | 26 532 | 30 503 | 35 575 |
| *Equitable share* | *4 187* | *6 350* | *7 678* | *9 643* | *18 058* | *20 076* | *22 775* |
| *Conditional grants* | *3 916* | *5 231* | *6 159* | *7 215* | *8 474* | *10 428* | *12 801* |
| **Non-interest allocations** | **244 717** | **282 396** | **319 690** | **367 816** | **418 176** | **460 850** | **507 552** |
| *Percentage increase* | *13,7%* | *15,4%* | *13,2%* | *15,1%* | *13,7%* | *10,2%* | *10,1%* |
| State debt cost | 46 808 | 46 313 | 48 851 | 51 160 | 52 049 | 53 324 | 55 716 |
| Contingency reserve | – | – | – | – | 2 500 | 5 000 | 8 000 |
| **Main budget expenditure** | **291 525** | **328 709** | **368 541** | **418 976** | **472 725** | **519 174** | **571 268** |
| *Percentage increase* | *10,9%* | *12,8%* | *12,1%* | *13,7%* | *12,8%* | *9,8%* | *10,0%* |
| Percentage shares | | | | | | | |
| *National departments* | *52,8%* | *52,5%* | *52,6%* | *53,4%* | *51,4%* | *50,8%* | *50,1%* |
| *Provinces* | *43,9%* | *43,4%* | *43,1%* | *42,0%* | *42,3%* | *42,6%* | *42,8%* |
| *Local government* | *3,3%* | *4,1%* | *4,3%* | *4,6%* | *6,3%* | *6,6%* | *7,0%* |

Table E.4 shows how additional resources are divided among the three spheres of government. The new priorities and additional allocations are accommodated through reprioritisation and growth in the resource envelope.

**Table E.4 Changes over baseline, 2006/07 – 2008/09**

| R million | 2006/07 | 2007/08 | 2008/09 |
|---|---|---|---|
| National departments | 6 303 | 9 436 | 14 742 |
| Provinces | 7 791 | 13 352 | 21 806 |
| Local government | 8 292 | 10 549 | 13 887 |
| **Allocated expenditure** | **22 386** | **33 337** | **50 435** |

Table E.5 sets out Schedule 1 of the Division of Revenue Bill, which 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.5 Schedule 1 of the Division of Revenue Bill, 2006/07 – 2008/09**

| | 2006/07 | 2007/08 | 2008/09 |
|---|---|---|---|
| | Column A | Column B | |
| R million | Allocation | Forward estimates | |
| National[1, 2] | 303 914 | 331 397 | 361 393 |
| Provincial | 150 753 | 167 701 | 187 100 |
| Local | 18 058 | 20 076 | 22 775 |
| **Total** | **472 725** | **519 174** | **571 268** |

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

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

The *2006 Budget Review* sets out in detail how the constitutional issues and government's priorities are taken into account in the 2006 division of revenue. It focuses on the economic and fiscal policy considerations, revenue issues, debt and financing considerations and expenditure plan of government. Aspects of national, provincial and local government financing are discussed in some detail in chapters 6 and 7. For this reason, this memorandum should be read with the *2006 Budget Review*.

## Part 2: Response to the recommendations of the Financial and Fiscal Commission

Section 214 of the Constitution and section 9 of the Intergovernmental Fiscal Relations Act require the FFC to make recommendations in April every year, or soon after, on the division of revenue for the coming budget. The FFC complied with this obligation by tabling its submission entitled *Annual Submission for the Division of Revenue 2006/07* in Parliament in April 2005. The FFC also submitted two supplementary proposals in December 2005. The first supplementary submission makes a recommendation on the development component of the local government equitable share formula. The second proposal deals with the financing of municipal health services.

This part of the explanatory memorandum complies with the Constitution and section 10 of the Intergovernmental Fiscal Relations Act by setting out how government has taken into account the FFC's recommendations when determining the division of revenue for the 2006 MTEF. The FFC proposals, although covering a broad range of issues, are divided into two main parts. The first part deals mainly with the division of revenue and focuses on the following areas:

- It reviews the conditional grant system as it pertains to the national tertiary services and the health professions training and development grants;
- It makes proposals on the financing of social welfare services now that the social security grant function has shifted to the national sphere.
- It analyses the framework on the assignment of powers and functions in the intergovernmental system and outlines a number of unresolved issues in this regard.
- It reviews the institutional and funding framework for housing.
- It outlines the current policy, legislative, and funding framework for transport provision.
- It makes proposals on the financing of municipal health services.

- It makes recommendations on the developmental component of the local government equitable share.

The second part is work in progress and deals with the FFC's work on learner support material, to which no response is provided at this stage.

### Review of health conditional grants

#### *FFC proposal on the national tertiary services grant*

In relation to the *national tertiary services grant* (NTSG) the FFC recommends that government continue using the conditional grant mechanism to finance tertiary services. Most tertiary services and other specialised health services are currently provided in some, but not all provinces, and spill-over effects in relation to tertiary and other highly specialised health services are likely to persist in the short to medium term. The FFC also recommends that government clarify why the NTSG is only meant to compensate provinces for cross-boundary flows/referrals relating to level 3 (tertiary) health care services and not level 2 (secondary) health care services. The FFC further recommends that government develop a national policy framework that clearly defines the required minimum level of service for all hospital services, distinguishing clearly between the requirements for secondary and tertiary health care services. The framework should also indicate expected service levels, human resource requirements, financial and capital resource requirements, and the funding mechanism for the provision of tertiary and secondary health care services.

#### *Government's response*

Government agrees that the conditional grant mechanism should be retained for national tertiary services, as these and other highly specialised services are disproportionately spread across the country, and spillovers persist. However, government is of the view that the grant be reformed to accommodate the modernisation of tertiary services (MTS) proposals. Ultimately certain basic tertiary services (e.g. basic ophthalmology), once well established in all provinces, should shift to the equitable share.

This grant is not extended to level 2 (secondary) health services as it targets highly specialised tertiary services that require national planning. Level 2 health services are considered to be a function that all provinces should provide. Further, the extent of spillover of level 2 services is not known as the data to capture this is inadequate.

The recommendation that a national policy framework be developed that clearly defines the required minimum level of service for all hospital services, distinguishing clearly between the requirements for secondary and tertiary healthcare services, is supported, albeit within a clearly defined range.

#### *FFC proposal on the health professions training and development grant*

The FFC recommends that the Health Professions Training and Development Grant (HTPDG) be kept as a conditional grant and that its framework be tightened to ensure that it is used only to fund accredited qualifications and training.

#### *Government's response*

Government agrees that the HTPDG should be retained as a conditional grant. Further, government recognises the need for the grant to be redesigned to improve its efficiency and to make sure that it is used only to fund accredited qualifications and training.

## The financing of social welfare services

### *FFC proposal on the financing of social welfare services through the provincial equitable share*

Anticipating the possible disjuncture between the national payment of social security grants and the provincial delivery of social welfare services, the FFC recommends that specific consideration be given to allocating funds to social welfare services in the provincial equitable share.

### *Government's response*

Government agrees that financing of social welfare services should be augmented through the provincial equitable share and has made substantial allocations for the function over the next three years.

### *FFC proposal on the setting of norms and standards for the delivery of a defined minimum basket of social welfare services by provinces*

The FFC recommends that government work faster to set the norms and standards for the delivery of a defined minimum basket of social welfare services by provinces. In particular, government should define the basket of social welfare services, and develop a rigorous, transparent and robust way of calculating the reasonable operating costs of efficient and effective social welfare services. To ensure uniformity and compliance, government should set norms and standards informed by national legislation and policies, country level priorities and norms, while local needs, goals and anticipated outcomes should be reflected at the provincial level.

### *Government's response*

Government supports the need to have a clearly defined basket of social welfare services, and norms and standards at which these should be delivered. Government is undertaking a study to clearly define this basket. This will apply especially to statutory services and will provide for provincial flexibility to deliver the services based on available resources, and in line with the provinces' circumstances, given that these services are often delivered by NGOs.

## Framework for the assignment of powers and functions in South Africa's intergovernmental system

### *FFC proposal on the framework on the assignment of powers and functions to local government*

The FFC recommends that the Department of Provincial and Local Government's framework on the assignment of powers and functions to local government and the instruments that give effect to the framework should be finalised as a matter of urgency.

In addition, an intergovernmental assignment framework that applies to all three spheres of government should be developed. This framework should seek to identify the location of powers and functions according to generally accepted intergovernmental fiscal principles as outlined in sections 41(1), 126, and 156 of the Constitution; ensure that agreement on funding arrangements is reached before a function is assigned; develop criteria for assessing whether a sphere of government has sufficient capacity to fulfil a function; and rationalise the institutional arrangements for assigning or delegating functions. In addition, monitoring capacity should be established in the national sphere of government to ensure that assignment and delegation processes are consistent with the intergovernmental framework for the assignment of functions.

The FFC further recommends that for any function that may be assigned or delegated, government should develop a clear definition of that function, and develop norms and standards for that function, to understand service level responsibilities and concomitant funding implications.

### *Government's response*

Government agrees that the framework on the assignment of powers and functions to local government and the instruments that give effect to it should be finalised as a matter of urgency. The current framework provides for the assignment of powers and functions to the local sphere only. Government supports the need to develop an intergovernmental assignment framework that applies to all three spheres. Such a framework should clearly define a function to be assigned, the roles and responsibilities of each party in such assignment and assess its concomitant funding implications. However, not every function lends itself to tightly defined norms and standards.

## Assessment of the institutional and funding framework for housing delivery

### *FFC proposals on housing delivery*

The FFC proposals on the institutional and funding framework for housing delivery discuss steps to speed up service delivery; accreditation of municipalities; management of rental schemes; and alignment of new housing subsidies, municipal infrastructure and the local government equitable share to ensure the sustained delivery of basic services.

The FFC proposes that government address housing delivery bottlenecks to reduce underspending in provinces. It further proposes that where municipalities have the capacity to become accredited to administer housing programmes, government should ensure that funds are available to administer the function; consider the funding implications of any policy changes; and funding gaps, particularly in municipalities with weak capacity.

Rental housing for low-income earners is becoming a permanent feature of the housing programme. In this regard, the FFC proposes that a sustainable financial framework for the demand for rental housing schemes be developed.

Lastly, the FFC proposes that consideration be given to link new housing subsidies with the municipal infrastructure grant (MIG) and the equitable share formula to ensure that municipalities can deliver basic services to poor households.

### *Government's response*

The speedy delivery of quality low-cost housing remains one of government's key developmental goals. Government fully supports the FFC's recommendation that all bottlenecks to reduce underspending in provinces be addressed. Government is providing technical assistance to provinces and municipalities to unblock stalled housing projects and fast-track emergency housing delivery. These interventions also aim to improve the built environment and to ensure sustainable human settlements. The accreditation of municipalities is one such intervention. Government agrees with the FFC that accreditation should be done in a manner that does not destabilise the financial viability of municipalities. The Housing Act (1997) stipulates how such accreditation should take place. However, given the process and requirements for accreditation, it is doubtful that municipalities with poor fiscal capacity would be considered for accreditation.

Government agrees that a sustainable financial framework for the ongoing demands for rental housing schemes should be developed. The new social housing policy provides this framework, while the 2006 Budget provides for the establishment of a social housing regulatory authority and social housing institutions to manage this portfolio.

Government supports the principle that increases in the housing conditional grant be matched by increases in the MIG and the local government equitable share. In the current budget, the housing conditional grant, MIG and the local government equitable share are growing on more or less the same trajectory. However, it should be noted that the local government equitable share supports municipalities, particularly the poorer ones, to deliver free basic services, and that municipalities should augment these from their own resources. The proposed alignment may prove very difficult given the lag that exists between when a subsidy is approved and when a house is completed. Secondly, MIG does not target new housing only – it also funds the development of municipal infrastructure in existing housing settlements. Thirdly, MIG and the local government equitable share are pro-poor, and linking them to new subsidies would introduce a regressive element, since poor municipalities (with a lesser demand for housing) would not be receiving the funds needed to roll-out free basic services. It is thus clear that the important equity and fiscal capacity considerations purported by the FFC will not be achieved through alignment.

## Transport funding issues

### *FFC proposal on transport funding issues*

The FFC recommends that criteria and processes for classifying all roads and assigning each class of roads to the respective sphere of government or category of local government be developed as a matter of urgency. Further, it proposes that the length and condition of all roads, and the estimated expenditure needed for rehabilitation and maintenance, be assessed; and that government should develop a coherent funding framework for roads. This framework should consider the role of the provincial equitable share and existing provincial funding and the MIG.

The FFC also propose that government:

- Consider the devolution of bus and taxi subsidies to municipalities where the capacity exists to manage these services.
- Implement mechanisms to improve the efficiency of intermodal transport planning.
- Address certain issues that need to be resolved for setting up transport authorities, including funding arrangements and how the authorities' governing bodies are constituted.

### *Government's response*

Government agrees that the process of reclassifying roads and their assignment to the various spheres of government should be completed, a condition analysis of the road network should be undertaken, and that a funding framework for roads should be developed. A technical roads coordinating body is currently working on this.

Government has always held the view that the bus and taxi subsidies should be devolved to municipalities, and the newly established transport authorities are expected to play a key role in this process.

Government supports the proposal that mechanisms be put in place to improve the efficiency of intermodal transport planning.

## Decentralisation of health care

### *FFC proposal on the decentralisation of health care*

The FFC recommends that environmental health care be added to the list of basic services under the local government equitable share formula, and that a detailed 'environmental health care package' be developed.

### *Government's response*

Government agrees that environmental health care services should be included in the package of basic services funded through the local government equitable share. The 2006 Budget provides for the phasing in of environmental health care services until the estimated costs of providing the service are matched. At the same time, the basic component of the local government equitable share formula is adjusted to include environmental health care services in metropolitan and district municipalities.

On the need to develop an environmental health care package, government is of the view that its elements are adequately listed in the National Health Act (2003).

## Development component of local government equitable share formula

### *FFC proposal on the development component of equitable share formula*

The FFC proposes that the development component not be incorporated in the local government equitable share formula as it will not result in an overall increase in the local government equitable share but will result in the realignment of the relative shares within the same envelope. The FFC is of the view that the developmental needs of local governments should be better accounted for by designing a formula that fully accounts for the full expenditure needs of local government. This will require:

- Recognition that for municipalities to fully engage in stimulating local economic development, they need not provide four basic services, but additional services covering a wide array of public services such as all-weather road, street lights, and environmental health care, public transport, housing, etc.
- Designing a process of "costing out" a full array of local services to ensure that the basic services and the development needs of municipalities are taken into account in the formula, and together account for the full expenditure needs of local government.

### *Government's response*

Government agrees that the development component should not be included in the formula, as its inclusion will not result in an overall increase in the local government equitable share and may create unintended distortions in municipal equitable shares. Government also notes the FFC comments that the development needs of local governments would be better accounted for by designing a formula that fully accounts for the full expenditure needs of local government. Government would welcome specific proposals from the FFC as to how this could be achieved.

# Part 3: 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 the provinces to provide basic services and perform the other functions allocated to them.

## Provincial equitable share

The provincial equitable share allocation is the main source of revenue for funding provincial expenditure. The provincial equitable share is R150,8 billion in 2006/07, R167,7 billion in 2007/08, and R187,1 billion in 2008/09. The division of the equitable share allocation among provinces is done through an objective redistributive formula.

**Table E.6 Total transfers to provinces, 2006/07**

| R million | Equitable share | Conditional grants | Total transfers |
|---|---|---|---|
| Eastern Cape | 24 643 | 2 810 | **27 453** |
| Free State | 9 595 | 1 687 | **11 282** |
| Gauteng | 23 362 | 8 744 | **32 106** |
| KwaZulu-Natal | 32 052 | 3 965 | **36 018** |
| Limpopo | 20 616 | 1 996 | **22 612** |
| Mpumalanga | 11 227 | 1 208 | **12 435** |
| Northern Cape | 3 452 | 916 | **4 367** |
| North West | 12 347 | 1 653 | **13 999** |
| Western Cape | 13 459 | 2 948 | **16 407** |
| **Total** | **150 753** | **25 926** | **176 679** |

### *The equitable share formula*

The equitable share formula is reviewed and updated every year for new data, taking account the recommendations of the FFC. For the 2006 Budget the formula was updated for data and the weights remained unchanged. The 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 national population
- 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 GDP by region (GDP-R) data.

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

| Percentage | Education | Health | Basic share | 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 | 15,3 | 14,4 | 21,0 | 8,1 | 11,1 | 16,1 |
| Free State | 5,8 | 6,1 | 6,1 | 7,1 | 5,5 | 11,1 | 6,2 |
| Gauteng | 13,8 | 17,7 | 19,8 | 11,2 | 33,0 | 11,1 | 15,6 |
| KwaZulu-Natal | 22,8 | 21,7 | 20,9 | 23,1 | 16,5 | 11,1 | 21,6 |
| Limpopo | 15,1 | 12,7 | 11,8 | 17,1 | 6,5 | 11,1 | 13,8 |
| Mpumalanga | 7,6 | 7,2 | 7,0 | 6,6 | 7,0 | 11,1 | 7,5 |
| Northern Cape | 1,7 | 1,8 | 1,8 | 2,1 | 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 | 9,2 | 10,1 | 3,8 | 14,5 | 11,1 | 8,8 |
| **Total** | **100,0** | **100,0** | **100,0** | **100,0** | **100,0** | **100,0** | **100,0** |

Table E.7 shows the structure and distribution of shares by component. The components 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 councils have discretion regarding the determination of departmental allocations for each function, taking into account the priorities that underpin the division of revenue.

### *The phasing-in of the formula*

The formula has been updated for the latest available data, which 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 2006/07 to 2008/09, as shown in Table E.8.

**Table E.8 Phasing in the equitable share, 2005/06 – 2008/09**

| Percentage | 2005/06<br>Base shares | 2006/07 | 2007/08<br>3-year phasing | 2008/09 |
|---|---|---|---|---|
| *Phasing* | *Year 1* | *Year 2* | *Year 3* | *Year 4* |
| Eastern Cape | 16,5 | 16,4 | 16,2 | 16,1 |
| Free State | 6,4 | 6,4 | 6,3 | 6,2 |
| Gauteng | 15,5 | 15,5 | 15,6 | 15,6 |
| KwaZulu-Natal | 21,1 | 21,2 | 21,4 | 21,6 |
| Limpopo | 13,7 | 13,7 | 13,7 | 13,8 |
| Mpumalanga | 7,4 | 7,4 | 7,5 | 7,5 |
| Northern Cape | 2,3 | 2,3 | 2,3 | 2,2 |
| North West | 8,2 | 8,2 | 8,1 | 8,1 |
| Western Cape | 8,9 | 8,9 | 8,9 | 8,8 |
| **Total** | **100,0** | **100,0** | **100,0** | **100,0** |

### *Education component*

The education component is assigned a weight of 51 per cent of the equitable share formula. This 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 E.9 shows the weighted target shares for the 2006 MTEF after updating the education component for new data.

**Table E.9 Calculation of education component**

| Thousands | 2005/06<br>Weighted share percentage | 2006 Medium-term estimates<br>Enrolment | School-age (5-17) | Weighted target share percentage |
|---|---|---|---|---|
| *Weighting* | | *1* | *1* | |
| Eastern Cape | 17,4 | 2 113 | 2 219 | 17,4 |
| Free State | 5,8 | 697 | 760 | 5,8 |
| Gauteng | 13,9 | 1 659 | 1 786 | 13,8 |
| KwaZulu-Natal | 22,8 | 2 744 | 2 946 | 22,8 |
| Limpopo | 14,9 | 1 850 | 1 915 | 15,1 |
| Mpumalanga | 7,6 | 921 | 969 | 7,6 |
| Northern Cape | 1,7 | 203 | 222 | 1,7 |
| North West | 7,7 | 897 | 1 021 | 7,7 |
| Western Cape | 8,2 | 960 | 1 095 | 8,2 |
| **Total** | **100,0** | **12 044** | **12 933** | **100,0** |

### *Health component*

The health component is assigned a weight of 26 per cent of the equitable share formula. This 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 E.10) 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 of those 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 percentage |
|---|---|---|---|
| *Weighting* | *1* | *4* | |
| Eastern Cape | 629 | 24 057 | 15,3 |
| Free State | 416 | 9 397 | 6,1 |
| Gauteng | 2 295 | 26 363 | 17,7 |
| KwaZulu-Natal | 1 040 | 34 079 | 21,7 |
| Limpopo | 373 | 20 116 | 12,7 |
| Mpumalanga | 391 | 11 187 | 7,2 |
| Northern Cape | 131 | 2 790 | 1,8 |
| North West | 455 | 13 167 | 8,4 |
| Western Cape | 1 181 | 13 770 | 9,2 |
| **Total** | **6 912** | **154 926** | **100,0** |

### *Poverty component*

A poverty component is assigned a weight of 3 per cent and provides some degree of redistribution within the formula. The poor population is defined as those 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 GHS. Table E.11 shows the new shares of the poverty component.

**Table E.11 Calculation of poverty component**

| Thousands | IES Survey 2000 (Q1+Q2) percentage | Basic component value | Poverty index[1] | Weighted share percentage |
|---|---|---|---|---|
| Eastern Cape | 56,4 | 6 614 | 3 732 | 21,0 |
| Free State | 45,7 | 2 778 | 1 270 | 7,1 |
| Gauteng | 21,9 | 9 051 | 1 982 | 11,2 |
| KwaZulu-Natal | 43,0 | 9 576 | 4 113 | 23,1 |
| Limpopo | 56,3 | 5 402 | 3 041 | 17,1 |
| Mpumalanga | 36,9 | 3 188 | 1 175 | 6,6 |
| Northern Cape | 44,0 | 839 | 369 | 2,1 |
| North West | 37,9 | 3 748 | 1 422 | 8,0 |
| Western Cape | 14,6 | 4 610 | 671 | 3,8 |
| **Total** | **100,0** | **45 807** | **17 635** | **100,0** |

*1. IES Survey 2000 (Q1% + Q2%) multiply by Basic Component value.*

### *Economic activity component*

The economic activity component is a proxy for provincial tax capacity and is assigned a weight of 1 per cent. Table E.12 shows the new target shares for the economic activity component based on the 2001 GDP-R data.

**Table E.12 Economic activity shares**

| Percentage | 2006 Medium-term estimates GDP-R, 2003 |
|---|---|
| Eastern Cape | 8.1 |
| Free State | 5.5 |
| Gauteng | 33.0 |
| KwaZulu-Natal | 16.5 |
| Limpopo | 6.5 |
| Mpumalanga | 7.0 |
| Northern Cape | 2.4 |
| North West | 6.5 |
| Western Cape | 14.5 |
| **Total** | **100.0** |

### *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.

### *Basic component*

The basic component is derived from each province's share of the total population of the country and is assigned a weight of 14 per cent. The average population of the 2001 Census and the 2002, 2003 and 2004 GHS determines this component. The inclusion of GHS population estimates ensures that population data used in the formula is not very outdated. Table E.13 shows the new weighted target share.

**Table E.13 Basic component shares**

| | Population 2001 | General household survey | | | Average[1] | Weighted share |
|---|---|---|---|---|---|---|
| Thousands | Census | July 2002 | July 2003 | July 2004 | | percentage |
| Eastern Cape | 6 437 | 6 483 | 6 505 | 7 030 | 6 614 | 14,4 |
| Free State | 2 707 | 2 719 | 2 741 | 2 947 | 2 778 | 6,1 |
| Gauteng | 8 837 | 9 077 | 9 443 | 8 848 | 9 051 | 19,8 |
| KwaZulu-Natal | 9 426 | 9 531 | 9 765 | 9 581 | 9 576 | 20,9 |
| Limpopo | 5 274 | 5 313 | 5 415 | 5 608 | 5 402 | 11,8 |
| Mpumalanga | 3 123 | 3 178 | 3 252 | 3 200 | 3 188 | 7,0 |
| Northern Cape | 823 | 819 | 818 | 897 | 839 | 1,8 |
| North West | 3 669 | 3 721 | 3 799 | 3 801 | 3 748 | 8,2 |
| Western Cape | 4 524 | 4 612 | 4 757 | 4 547 | 4 610 | 10,1 |
| **Total** | **44 820** | **45 453** | **46 495** | **46 459** | **45 807** | **100,0** |

*1. Average of 2001 Census Population and Population of General Household Surveys of 2002, 2003 and 2004.*

## Conditional grants to provinces

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, such as 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. Schedule 5 grants are specific conditional grants, with specific responsibilities for both the transferring and receiving provincial accounting officers.

### *Changes to conditional grant framework*

A major change in the provincial fiscal framework for the 2006 MTEF is the shift of the social security grant function from the provincial to the national sphere of government. The South African Social Security Agency (SASSA) is now in a position to fully administer the social assistance function. From 1 April 2006, social security assistance will no longer be administered as a conditional grant but will be funded from SASSA through the Department of Social Development.

To streamline the delivery of programmes, government agreed to further rationalise the conditional grant system:

- The programmes funded through the integrated social development and HIV and AIDS grants administered by the Department of Social Development, and the integrated nutrition grant administered by the Department of Health, are from 1 April 2006, funded through the provincial equitable share.
- The human settlement and redevelopment grant, administered by the Department of Housing, is phased into the integrated housing and human settlement development grant to enable government to deliver on its comprehensive housing strategy in a systematic way.
- The hospital management and quality improvement grant, which facilitates management development and financial management capacity, is phased into the hospital revitalisation grant.

Table E.14 provides a summary of conditional grants by sector and province for 2006/07.

**Table E.14 Conditional grants to provinces, 2006/07**

| R million | Agricul-ture[1] | Education | Health | Housing | National Treasury | Sport & Recreation SA | Transport | Total |
|---|---|---|---|---|---|---|---|---|
| Eastern Cape | 64 | 320 | 905 | 762 | 742 | 17 | – | **2 810** |
| Free State | 28 | 103 | 780 | 523 | 243 | 10 | – | **1 687** |
| Gauteng | 18 | 226 | 3 077 | 1 758 | 408 | 17 | 3 241 | **8 744** |
| KwaZulu-Natal | 62 | 362 | 1 601 | 1 048 | 870 | 21 | – | **3 965** |
| Limpopo | 58 | 267 | 406 | 521 | 729 | 15 | – | **1 996** |
| Mpumalanga | 32 | 127 | 300 | 421 | 317 | 10 | – | **1 208** |
| Northern Cape | 22 | 42 | 539 | 105 | 202 | 6 | – | **916** |
| North West | 45 | 135 | 495 | 613 | 354 | 11 | – | **1 653** |
| Western Cape | 24 | 130 | 1 930 | 599 | 253 | 12 | – | **2 948** |
| **Total** | **353** | **1 713** | **10 033** | **6 350** | **4 118** | **119** | **3 241** | **25 926** |

*1. Includes Land Affairs.*

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 dividing the grant between provinces, the audit outcome in 2004/05 and any other material issues to be addressed. Table E.15 presents a summary of all the conditional grants listed in Schedules 4 and 5 of the bill for the 2006 MTEF.

**Table E.15 Conditional grants to provinces, 2005/06 – 2008/09**

| R million | 2005/06 | 2006/07 | 2007/08 | 2008/09 |
|---|---|---|---|---|
| **Agriculture** | **410** | **345** | **462** | **484** |
| Agricultural disaster management grant | 120 | – | – | – |
| Comprehensive agricultural support programme grant | 250 | 300 | 415 | 435 |
| Land care programme grant: poverty relief and infrastructure development | 40 | 45 | 47 | 49 |
| **Education** | **1 248** | **1 713** | **1 900** | **2 195** |
| Further education and training college sector recapitalisation grant | – | 470 | 595 | 795 |
| HIV and AIDS (life skills education) grant | 136 | 144 | 152 | 162 |
| National school nutrition programme grant | 1 112 | 1 098 | 1 153 | 1 238 |
| **Health** | **8 907** | **10 033** | **10 721** | **11 343** |
| Comprehensive HIV and AIDS grant | 1 150 | 1 567 | 1 646 | 1 735 |
| Forensic pathology services grant | 271 | 525 | 551 | 467 |
| Health professions training and development grant | 1 520 | 1 520 | 1 596 | 1 676 |
| Hospital revitalisation grant | 1 256 | 1 440 | 1 707 | 1 983 |
| National tertiary services grant | 4 709 | 4 981 | 5 221 | 5 482 |
| **Housing** | **4 868** | **6 350** | **7 938** | **8 721** |
| Integrated housing and human settlement development grant | 4 868 | 6 350 | 7 938 | 8 721 |
| **Land Affairs** | **8** | **8** | **–** | **–** |
| Land distribution: Alexandra urban renewal project grant | 8 | 8 | – | – |
| **National Treasury** | **3 731** | **4 118** | **5 324** | **5 697** |
| Provincial infrastructure grant | 3 731 | 4 118 | 5 324 | 5 697 |
| **Provincial and Local Government** | **41** | **–** | **–** | **–** |
| Disaster relief grant | 41 | – | – | – |
| **Sport and Recreation South Africa** | **24** | **119** | **154** | **205** |
| Mass sport and recreation participation programme grant | 24 | 119 | 154 | 205 |
| **Transport** | **–** | **3 241** | **2 151** | **1 736** |
| Gautrain rapid rail link | – | 3 241 | 2 151 | 1 736 |
| **Total** | **19 237** | **25 926** | **28 649** | **30 382** |

### *Agriculture grants*

The *land care programme* is allocated R140 million over the next three years. This programme promotes sustainable use and management of natural resources by encouraging and empowering communities to take responsibility for the management of resources 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 land.

The *comprehensive agriculture support programme (CASP)* is allocated R300 million, R415 million and R435 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.

### 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 16 000 schools in poor communities at which about 5,5 million learners will be fed for approximately 156 school days. The programme is allocated R1,1 billion in 2006/07, R1,2 billion in 2007/08 and R1,2 billion in 2008/09.

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 R470 million in 2006/07, R595 million in 2007/08 and R795 million in 2008/09.

The *HIV and AIDS (life skills) programme grant* provides care and support to children infected and affected by HIV and AIDS. In addition, the grant is spent on the provision of life skills training, sexuality and HIV and AIDS education in primary and secondary schools. The grant is allocated R144 million in 2006/07, R152 million in 2007/08 and R162 million in 2008/09. The programme is now fully integrated into the school system, with learner and teacher support material provided for grades 1 to 9.

### Health grants

The national Department of Health administers the greatest number of conditional grants. The department also has responsibility for the largest grants, five of which comprise 38,7 per cent of total conditional grants and 5,7 per cent of national transfers to provinces. Health grants are R10 billion in 2006/07, R10,7 billion in 2007/08 and R11,3 billion in 2008/09.

The *national tertiary services grant (NTSG)* (schedule 4 grant*)* is allocated R4,9 billion in 2006/07, R5,2 billion in 2007/08 and R5,5 billion in 2008/09, to fund national tertiary services delivered in 27 hospitals across the nine provinces, and to ensure equitable access to a minimum level of tertiary health services. These services tend to be concentrated in larger cities such as Johannesburg, Pretoria, Cape Town, Durban and Bloemfontein. Consequently, the Western Cape and Gauteng receive 63,6 per cent of the grant as they provide the largest proportion of these high-level, sophisticated services for the benefit of the health sector countrywide. Government is reviewing its long-term vision for such hospitals and for tertiary services, their distribution between provinces, the restructuring required to effect transformation, and the link between financing of academic hospitals and university medical faculties. This vision will be finalised through the Modernisation of Tertiary Services Project, which is examining a 10-year framework for future provision of highly specialised services.

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 is allocated R1,5 billion in 2006/07, R1,6 billion in 2007/08 and R1,7 billion in 2008/09.

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. The *hospital management and quality improvement grant* which facilitates a range of management development initiatives, including personnel, and procurement delegations and financial management capacity, is phased into the Hospital Revitalisation Grant.

The *comprehensive HIV and AIDS grant* enables the health sector to develop a specific response to HIV and AIDS. The grant supports, in addition to HIV and AIDS prevention programmes, specific interventions that include voluntary counselling and testing, prevention of mother-to-child transmission, post-exposure prophylaxis and home-based care. The grant is allocated R1,6 billion in 2006/07, R1,6 billion in 2007/08 and R1,7 billion in 2008/09.

### *Housing grants*

Government approved a comprehensive housing strategy to speed up housing delivery and 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 dysfunctional human settlements, have been subsumed into the *integrated housing and human settlements grant*.

To implement the comprehensive housing strategy, R2 billion is added to the new *integrated housing and human settlement redevelopment grant* over the next three years. The is allocated R6,4 billion in 2006/07, R7,9 billion in 2007/08 and R8,7 billion in 2008/09.

A major change expected over the medium term relates to the accreditation of municipalities in terms of the Housing Act (1997). 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 to the purchase of land for the relocation and settlement of Alexandra residents and other qualifying beneficiaries. The grant is allocated R8 million in 2006/07, after which it is phased out.

### *National Treasury grants*

In line with government's commitment to sustain social and economic infrastructure investment in provinces, R1 billion is added to the *provincial infrastructure grant* bringing its allocation over the next three years to R15,1 billion. The grant is allocated R4,1 billion in 2006/07, R5,3 billion in 2007/08 and R5,7 billion in 2008/09. The growth in this grant enables government to direct funds to 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 line departments. To deal effectively with backlogs, the provincial division has been effected using a combination of the equitable share formula, a roads element and a backlog component.

### *Sports and Recreation grants*

The Department of Sport and Recreation is allocated R119 million in 2006/07, R154 million in 2007/08 and R205 million in 2008/09 to promote mass participation by historically disadvantaged communities in a selected number of development sporting activities.

### *Transport grant*

The Department of Transport is allocated R3,2 billion in 2006/07, R2,1 billion in 2007/08 and R1,7 billion in 2008/09 as national government's contribution to the construction phase of the Gautrain rapid rail project.

# Part 4: Local government fiscal framework and allocations

## The local government fiscal framework

In 2004, the local government fiscal framework was subjected to a two-part review. The first part was completed and saw the introduction of a new equitable share formula on 1 April 2005. The second part is still under way and covers matters pertaining to local government taxes, among other things. 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. Legislation will be prepared in 2006 to deal with the abolition of the RSC levies from 1 July 2006.

Further work will *inter alia* focus on an assessment of the impact and implementation of the new property rates legislation, the alignment between the functional and fiscal division of powers and functions between Category B (local) and Category C (district) municipalities, and other related matters that affect the local government fiscal framework, such as the restructuring of the electricity distribution industry.

In preparation for the local government elections in March this year, the Demarcation Board completed the delimiting of municipal wards, while cross-boundary municipalities have been eradicated. The local government equitable share formula and the MIG allocations have been updated to reflect changes in population, poverty and service delivery indicators arising from this.

## National transfers to local government

National allocations to local government (Table E.3) grow from a revised allocation of R16,9 billion in 2005/06 to R26,5 billion in 2006/07, R30,5 billion in 2007/08 and R35,6 billion by the end of the MTEF in 2008/09. Table E.3 indicates that the share of nationally raised revenue for local government rises from 4,6 per cent in 2005/06 to 7,0 per cent in 2008/09. The sharp rise is mainly due to the R7 billion, R8 billion and R9 billion added to compensate local government for RSC levies.

All grants to municipalities are published to enable them to plan fully for their coming 2006/07 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 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. From the 2006/07 financial year, the equitable share allocations for the national and municipal financial year are aligned and payments will be made in three tranches within the municipal financial year.

## The local government equitable share

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. Table E.16 shows that the equitable share increases by R9,6 billion from the 2005/06 to R22,8 billion in 2008/09.

**Table E.16 National transfers to local government, 2002/03 – 2008/09**

| | 2002/03 | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 |
|---|---|---|---|---|---|---|---|
| **R million** | | **Outcome** | | **Revised** | | **Medium-term estimates** | |
| **Direct transfers to local government** | | | | | | | |
| **Equitable share and related** | **4 230** | **6 623** | **7 811** | **9 808** | **18 558** | **20 626** | **23 375** |
| Equitable Share[1] | 4 187 | 6 350 | 7 678 | 9 643 | 18 058 | 20 076 | 22 775 |
| Water and Sanitation Operating | 43 | 273 | 133 | 165 | 500 | 550 | 600 |
| **Infrastructure** | **3 472** | **4 102** | **5 258** | **6 302** | **7 225** | **9 129** | **11 801** |
| Municipal Infrastructure Grant | 1 865 | 2 442 | 4 440 | 5 436 | 6 265 | 7 149 | 8 053 |
| Public Transport Infrastructure and Systems | – | – | – | 242 | 519 | 624 | 1 790 |
| Local Neighbourhood Development Partnership Grant | – | – | – | – | 50 | 950 | 1 500 |
| National Electrification Programme | 225 | 245 | 196 | 313 | 391 | 407 | 458 |
| Implementation of Water Services Projects | 999 | 1 022 | 208 | – | – | – | – |
| Disaster Relief | – | – | 280 | 311 | – | – | – |
| Poverty Relief Funds and other[2] | 383 | 393 | 134 | – | – | – | – |
| **Current transfers** | **400** | **856** | **768** | **749** | **749** | **749** | **400** |
| Restructuring Grant | 151 | 494 | 388 | 350 | 350 | 350 | – |
| Financial Management Grant | 155 | 211 | 198 | 199 | 199 | 199 | 200 |
| Municipal Systems Improvement Grant | 94 | 151 | 182 | 200 | 200 | 200 | 200 |
| **Sub total direct transfers[3]** | **8 102** | **11 581** | **13 837** | **16 859** | **26 532** | **30 503** | **35 575** |
| **Indirect transfers to local government** | | | | | | | |
| Water and Sanitation Operating | 656 | 817 | 819 | 904 | 491 | 490 | 531 |
| National Electrification Programme | 740 | 796 | 819 | 863 | 977 | 1 016 | 1 143 |
| **Sub total indirect transfers** | **1 396** | **1 613** | **1 638** | **1 767** | **1 468** | **1 506** | **1 673** |
| **Total** | **9 498** | **13 194** | **15 474** | **18 626** | **28 000** | **32 010** | **37 249** |

1. *Includes main local government equitable share, replacement of RSC levies and special support for councillor remuneration.*
2. *Includes phasing out of poverty relief grants and Urban Transport Fund.*
3. *Reflects local government's share of the division of revenue.*

### *Equitable share formula*

The structure and components of the formula are summarised in the text box below:

**Structure of the 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 basic services. The purpose of the basic services component is to enable municipalities to provide basic services and free basic services to poor households. For each of the subsidised basic 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 characteristics of the basic services component are:

- 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
- Recognising water reticulation, sanitation, refuse removal and electricity reticulation as the core services
- As from 1 April 2006, environmental health care services are included as a basic service. Since environmental health by its nature is delivered to all individuals in a municipality, this subcomponent is calculated on all households, not only the poor ones.

**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] +***

***[Environmental Healthcare Subsidy*Total number of households]***

### *The institutional support component*

The *institutional support component* is particularly important for poor municipalities, which 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, clients and businesses. The component supplements the funding of a municipality for administrative and governance costs, but does not 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 "base allocation" is an amount that will go to every municipal structure (except for a district management area). 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 determined by the Minister for Provincial and Local Government.

The I component for the 2006 MTEF takes into account all changes that may occur when new councils take over after the local government elections to be held later this year, e.g. the new number of council seats per municipality.

The local government budget framework makes provision for a revised remuneration framework for councillors. The elements of the revised remuneration framework include:

- Grading municipalities from 1 to 6 on new criteria – total population and total own revenue. The same criteria is also used to grade district municipalities.
- Classifying mayors and executive committee members as full-time in all grades of municipalities whilst all other councillors are regarded part-time. The current full-time status of speakers in grade 6 (metros) is maintained
- Benchmarking the upper salary limits of mayors against certain posts in the provincial legislature, and cascading the rest downwards, depending on the grading of the municipality.
- Special financial support to poorer municipalities – grades 1, 2 and 3

However, the formula has not been adjusted to incorporate the new remuneration framework. In the interim the additional funding will be distributed separately from the equitable share (but included in schedule 3 of the Division of Revenue Act) until the most appropriate mechanism is found.

### *The development component*

The development component was set at zero when the current formula was introduced on 1 April 2005 pending an investigation on how best to capture the factor in the formula.

### *The revenue-raising capacity correction*

This mechanism raises additional resources to fund the cost of basic services and administrative infrastructure. 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 (Stats SA) to proxy revenue-raising capacity for all municipalities. The revenue that should be available to a municipality then is converted to a “correction” by imposing a “tax” rate of 5 per cent. In the case of the RSC levy replacement grant the correction is based on the actual grant to each municipality.

### *Stabilising constraint*

With the publication of three-year budget allocations, a guarantee mechanism is applied to the indicative outer-year baseline amounts with the aim of ensuring that municipalities are given 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. The 2006 MTEF provides guarantees of 100 per cent and 90 per cent on the allocations for the respective outer years of the MTEF cycle.

One important point to note in this regard is that the allocations published for the 2006/07 financial year are still based largely on the 2004/05 model, since the allocations made by that model were guaranteed for the past two years. Similarly the indicative allocations published for 2007/08 are based on the new model.

### *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 within 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 – and this is also true between the different Category B municipalities within the same Category C district. 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.

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".

### *Measurement Issues*

The integrity of the data is as important as the set of equations in determining whether the allocations meet the constitutional requirement of equity. Measurement itself is a dynamic issue – new data sets become available, while existing data series might be discontinued. Thus, the allocation process is subject to regular changes and innovation. The allocations for the 2006 MTEF account for all the data changes caused by the elimination of cross-boundary municipalities.

#### a) Poverty

The baseline information for the measurement of poverty comes from Census 2001. The "income" method is used to estimate poverty at a municipal level as it allows for a cross-tabulation of poverty against servicing levels.

### b) Servicing levels

A key ingredient in the current formula is the subsidy received by poor households for various services delivered to them. The subsidy amounts have been updated in the current formula, using a more recent study by the Department of Provincial and Local Government. The service costs remain at R130 per month for a serviced household and R45 per month for an unserviced household (see Table E.17 below). In addition, all households receive approximately R12 a year towards the provision of environmental health care services.

**Table E.17 Service costs**

| Service costs per month<br>Rand | 1998<br>Estimates | Serviced<br>households | Unserviced<br>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

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; and municipalities cannot manipulate it in order to influence their equitable share allocations.

### *Phasing-in of the new formula*

The formula is being phased in and takes full effect in the 2007/08 financial year.

## The water service operating subsidy

This is a transitional operational grant closely related to the local government equitable share and, in principle, should be part of the equitable share grant. It is an indirect grant, used to fund 321 water schemes in municipalities through the water trading account on the vote of the Department of Water Affairs and Forestry. The department administered a number of these schemes in poor areas prior to 1994. The operating grant (direct and indirect) amounts to R934,4 million in 2005/06, R991 million in 2006/07, R1 040 million in 2007/08 and R1 131 million in 2008/09 or a total of R3,2 billion over the MTEF.

The department is in the process of transferring the schemes over the next three years, for which funding will be phased out from 2008/09. It plans to conclude bilateral negotiations with municipalities by 31 March 2006. All funds on this programme will subsequently be transferred directly to municipalities in terms of the provisions of the transfer agreements.

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 321 schemes employ 8 094 staff and supply water to 53 municipalities. So far 38 agreements have been signed, 659 staff transferred, 1 636 staff seconded and 169 schemes with a total asset value of approximately R3,4 billion. Over 40 per cent of the staff are 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 1 900 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 the transfer agreement is 31 March 2006. The operating and transfer subsidy will be treated as a grant-in-kind until the effective date of transfer. Thereafter, it will be treated as a conditional grant up to 2008/09 and subsequently phased into the equitable share. The operating subsidy will cover staff-related costs and direct operating and maintenance costs, while provision is also made for 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 provide for the conditional grants to municipalities. Despite the growing importance of the unconditional equitable share grant, conditional grants still form 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; and effect transition by supporting municipal capacity building and restructuring.

Total conditional grants to municipalities, including the water operating subsidy, increase from R7,0 billion in 2005/06 to R7,9 billion in 2006/07, R9,9 billion in 2007/08 and R12,2 billion in 2008/09. There are two categories of conditional grants – infrastructure and capacity-building/ restructuring grants. The most significant development for 2006/07 is the deferment of the Integrated Electricity Programme (INEP) into the MIG. Below is a summary of all the conditional grants listed in Schedules 4, 6 and 7 of the 2006 Division of Revenue Bill.

### *Infrastructure conditional grants to local government*

National transfers for infrastructure amount to R8,2 billion, R9,2 billion and R9,8 billion for each of the MTEF years. The municipal infrastructure, public transport infrastructure and national electrification programmes are the infrastructure transfers to local government.

#### *Municipal infrastructure grant*

The largest infrastructure transfers – R6,3 billion, R7,1 billion and R8,1 billion over the MTEF years – are through the MIG, which supports government's objective of expanding the delivery of basic services to poor households and alleviating poverty. The grant also seeks to stimulate local economic development and job creation over the medium term. Municipalities are required to dedicate a portion of their capital budgets to labour-based infrastructure methods to meet the objectives of the expanded public works programme. This grant is listed on Schedule 4 of the Division of Revenue Bill, as it supplements municipal allocations for infrastructure. For this reason, the role of national departments in relation to this grant is limited to enforcing compliance, with the conditions set out in its framework and monitoring performance by receiving municipalities. Its conditions are more flexible, designed to support the capital budgets of municipalities, and to facilitate integrated development planning.

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.

The MIG formula comprises of a vertical and horizontal division. The vertical division allocates resources to sectors or other priority areas; the horizontal division is determined based on a formula that takes account of poverty, backlogs, and municipal powers and functions. There are five main components of the formula, as demonstrated in the box below.

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

**B** Basic residential infrastructure (new and rehabilitation of existing ones)

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

**P** Public municipal service infrastructure (new and rehabilitation of existing ones)

**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 2006 MTEF, R21,5 billion is available for the MIG programme. The ring-fenced allocation for the eradication of bucket sanitation system is phased into the local government equitable share in 2007/08 as the programme will be completed by that time. The special infrastructure fund also winds up in 2007/08, which will release additional resources for the horizontal division of revenue. The 2006 MTEF provision also makes provision for bulk infrastructure. The incorporation of the electricity programme (which includes both municipal and Eskom programmes) into the MIG is, however, deferred until the completion of the restructuring of the electricity distribution industry. This requires a rescaling of the weights of the B component to its original split. The rescaling and weighted shares per sector are illustrated in Table E.18.

**Table E.18 Municipal infrastructure grant (MIG) allocations per sector, 2005/06 – 2008/09**

| | 2005/06 | 2006/07 | 2007/08 | 2008/09 |
|---|---|---|---|---|
| **Weights** | | | **Adjusted weights** | |
| **Municipal Infrastructure Grant (a)** | | | | |
| Special Municipal Infrastructure Fund and Management (b) | | | | |
| Ring-fenced allocation: Eradication of Bucket Sanitation System (c) | | | | |
| Bulk infrastructure (d) | | | | |
| Municipal Infrastructure Grant (formula) | *(a)-(b)* | *(a)-(b)-(c)-(d)* | *(a)-(b)-(c)-(d)* | *(a)-(b)-(c)-(d)* |
| *of which Municipal Infrastructure Grant (formula)* | | | | |
| **B Component** | **75,0%** | **75,0%** | **75,0%** | **75,0%** |
| Water and sanitation | 72,0% | 72,0% | 72,0% | 72,0% |
| Electricity | 0,0% | 0,0% | 0,0% | 0,0% |
| Roads | 23,0% | 23,0% | 23,0% | 23,0% |
| Other | 5,0% | 5,0% | 5,0% | 5,0% |
| **P Component** | **15,0%** | **15,0%** | **15,0%** | **15,0%** |
| **E Component** | **5,0%** | **5,0%** | **5,0%** | **5,0%** |
| **N Component** | **5,0%** | **5,0%** | **5,0%** | **5,0%** |

Table E.19 shows the respective amounts that flow through the vertical division of the MIG funds.

**Table E.19 Municipal infrastructure grant (MIG) allocations per sector, 2005/06 – 2008/09**

| Weights | | 2005/06 | 2006/07 | 2007/08 | 2008/09 |
|---|---|---|---|---|---|
| | | | Adjusted weights | | |
| **Municipal Infrastructure Grant (a)** | | **5 436** | **6 265** | **7 149** | **8 053** |
| Special Municipal Infrastructure Fund and Management (b) | | 129 | 72 | 38 | – |
| Ring-fenced allocation: Eradication of Bucket Sanitation System (c) | | 200 | 400 | 600 | – |
| Bulk infrastructure (d) | | | 28 | 30 | 50 |
| Municipal Infrastructure Grant (formula) | | 5 107 | 5 765 | 6 479 | 8 003 |
| *of which Municipal Infrastructure Grant (formula)* | | | | | |
| **B Component** | **75,0%** | **3 830** | **4 324** | **4 860** | **6 002** |
| Water and sanitation | 72,0% | 2 758 | 3 113 | 3 499 | 4 322 |
| Electricity | 0,0% | – | – | – | – |
| Roads | 23,0% | 881 | 995 | 1 118 | 1 381 |
| Other | 5,0% | 192 | 216 | 243 | 300 |
| **P Component** | **15,0%** | **766** | **865** | **972** | **1 200** |
| **E Component** | **5,0%** | **255** | **288** | **324** | **400** |
| **N Component** | **5,0%** | **255** | **288** | **324** | **400** |

### *The public transport infrastructure and systems grant*

This grant supports municipal transport infrastructure. It is allocated R519 million in 2006/07, R624 million in 2007/08 and R1,8 billion in 2008/09.

### *Capacity-building and restructuring grants*

The *neighbourhood development partnership grant (NDPG)* is introduced to provide municipalities with technical assistance to develop appropriate project proposals for property developments in townships and new residential neighbourhoods. The grant will be administered by the National Treasury and is allocated R50 million in 2006/07, R950 million in 2007/08 and R1,5 billion in 2008/09.

The *capacity-building grants* were set up to assist municipalities in building management, planning, technical, budgeting and financial management skills. These grants are capped at R749 million in 2006/07 and 2007/08, and reduced to R400 million in 2008/09, when the restructuring grant is phased into the equitable share.

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 (2003). Allocations over the 2006 MTEF amount to R598 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. The grant has been capped at R350 million per year and is phased into the local government equitable share in 2008/09.

The *municipal systems improvement grant (MSIG)* under the vote of the Department of Provincial and Local Government focuses on stabilising municipal and governance systems, planning and implementation management support centres, reviewing integrated development plans and implementing the Municipal Systems Act (2000). The grant is allocated R200 million a year over the next three years.

## Part 5: Future work on sub-national fiscal frameworks

### Cross-cutting issue: data

The review of the provincial and local government fiscal frameworks has highlighted major problems associated with a lack 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 classified by gender. Relevant national departments have a central role to play insofar as ensuring consistency in approaches to recordkeeping, 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 communicate with Stats SA with the view of presenting their information needs and agreeing how such requirements can 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 2006 Budget the following issues have been identified as requiring further work:

- The first issue relates to the major hospital grants, which will be reviewed ahead of the 2007 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 the implications of the newly demarcated provincial boundaries, which will take effect from 1 March 2006 or at the commencement of sections 2 to 4 of the Constitution Twelfth Amendment Act (2005). The implementation of the Cross-boundary Municipalities Laws Repeal and Related Matters Act (2005) necessitates arrangements concerning the financing of provinces. The implementation of the financial aspects of the changes is only taking place from 1 April 2006. All allocation formulas and provincial budgets will have to be realigned to the new provincial boundaries.

### 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 property taxes 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 under way 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 KwaZulu-Natal) were introduced in 1985 and 1990 respectively to fund the provision of basic services such as water, electricity, sewerage and bulk waste to under-serviced communities. Metropolitan (Category A) and district (Category C) municipalities have access to this source of revenue. RSC levies 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.

Recognising that the RSC levies performed poorly with regard to the generally accepted principles of sound taxation (e.g. equity, efficiency, certainty, simplicity, ease of administration), the Minister of Finance announced in the 2005 Budget that RSC levies would be phased out on 30 June 2006. However, for municipalities to meet their expenditure obligations, especially in terms of poverty alleviation and social and economic development, it is important to maintain existing levels of revenue. The 2005 *Medium Term Budget Policy Statement* indicated that national government would compensate municipalities for lost revenue within the national budget framework, and that options for alternative tax or revenue sharing arrangements were under consideration.

To ensure a smooth transition from the old to the new system, allocations in the short- to medium-term will be based on historical RSC levy income collected. Actual RSC levies collected as obtained from audited financial statements for the 2004/05 financial year were used (and where not available, unaudited ones were used) and converted to a base for the 2005/06 financial year using actual growth rates in RSC levies income for the last three years. Growth rates were adjusted to 5 per cent in instances where lower growth rates were realised. A correction was made to the base amounts of metropolitan municipalities to take account of the zero-rating of property tax that will be implemented from 1 July 2006. The base amount (2005/06) was then allocated in terms of available funding for the 2006 Budget (R7 billion in 2006/07, R8 billion in 2007/08 and R9 billion in 2008/09). Similar to RSC levies, the replacement grant should be prioritised towards basic services and infrastructure development in under-serviced communities.

Overarching legislation will be submitted to Parliament during the first quarter of 2006 to deal with the abolition of RSC levies.

Allocations for the 2006 Budget will be subject to any further reforms to replace RSC levies with alternative sources of revenue as discussed in the 2005 *Medium Term Budget Policy Statement*. A discussion document on *Options for the Replacement of RSC and JSB levies* has been released for comment by 31 March 2006 (obtainable at www.treasury.gov.za). The discussion document highlights the following options as possible replacement sources:

- ***VAT zero-rating*** of municipal property rates as from 1 July 2006 is estimated to result in just under a R1 billion benefit to Category A and B municipalities
- ***Tax sharing of an existing national tax instrument*** (such as general fuel levy)
- A ***surcharge on user charges for municipal services***, including a municipal electricity surcharge
- ***Grants*** could perform two functions, namely:
  - A guaranteed revenue source for municipalities or categories of municipalities and
  - A transitional funding mechanism to smooth any possible shocks from the abolition of RSC levies.
- A ***new own revenue source or sources for municipalities***, such as a local government business tax (possibly complemented with a business license fee for companies falling outside the local business tax system).

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

The restructuring of electricity distribution, if not correctly implemented, could have a significant negative impact on larger municipalities that distribute electricity. Alternative restructuring models were considered to limit the fiscal risk and exposure of these municipalities, including the revision of the six REDs boundaries.

In September 2005, Cabinet approved a plan to accelerate the implementation of REDs. In this regard, the six metro REDs need to be set up as soon as possible after the 2006 local government elections. Selected municipalities will be given the option to form part of the metro RED or the national RED. The remainder of the country will be covered under a national RED, or a limited number of REDs, incorporating Eskom distributional capacity.

The governance structure and financial framework will, however, be more complex for the national RED, and any other non-metro RED(s) subject to financial viability, given the large number of municipalities that may be involved. Further work is required to determine the optimal governance structure and fiscal arrangements of the national RED(s) to ensure that these municipalities are also able to play their service authority role in determining electricity priorities within their jurisdiction. The roll out of the national RED is targeted for 2007.

Legislation to regulate the restructuring of the electricity distribution industry (the Electricity Distribution Industry Restructuring Bill) to complement existing local government legislation and legislation to regulate the electricity reticulation function (the Electricity Reticulation Bill) is likely to be put into the parliamentary process during 2006.

### Implementation of the Local Government: Municipal Property Rates Act

Although the Municipal Property Rates Act took effect from 2 July 2005, the new property rating and valuation system will only take effect when a council has adopted its rates policy and has prepared the first valuation roll in terms of the act (municipalities are required to bring their valuation records up to date within four years of the effective date of the legislation). The act also requires that a rate levied on newly rateable property must be phased-in over a period of three financial years. It extends or increasingly extends property rates to public service infrastructure and state properties. Most metropolitan and larger urban municipalities are targeting 1 July 2007 as the earliest date for introducing new valuation rolls in terms of the act.

### Alignment between the functional and fiscal division of powers and functions between Category B (local) and Category C (district) municipalities

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 Category B and C municipalities. At present, property taxes are allocated to Category A and B municipalities. Property tax is allocated to Category B municipalities on the basis that they are responsible for functions such as water, sanitation, electricity and 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 may have access to RSC levies (or subsequent funding sources to replace RSC levies).

Joint work is currently being undertaken by National Treasury and the Department of Provincial and Local Government to improve the alignment between the functional and fiscal division of powers and functions between Category B and C municipalities.

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).