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) prescribes 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 2007 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 FFC, and any assumptions and formulae used in arriving at the respective divisions among provinces and municipalities. This 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 2007 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 deliberated on the matters discussed in this memorandum at its 23 to 25 August 2006 Lekgotla and at several other meetings held during the year. 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 5 October 2006. An extended Cabinet meeting, involving cabinet ministers, premiers of provinces and the chairperson of SALGA was held on 18 October 2006, and agreed on the final budget priorities and the division of revenue over the next three years.

Part 1: The 2007 division of revenue

The 2007 division of revenue seeks to strengthen the ability of provinces and municipalities to provide social and municipal basic services and perform the functions allocated to them, and provide for their developmental and other needs and is in line with section 214(2)(a to j) of the Constitution. Excluding debt service costs and the contingency reserve, the total to be shared between the three spheres amounts to R478 billion, R533,2 billion and R586,4 billion over each of the MTEF years. These allocations take into account government's spending priorities, the revenue-raising capacity and functional responsibilities of each sphere, and inputs from various intergovernmental forums and the recommendations of the FFC. 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 economic and fiscal disparities 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 2007 MTEF

The 2007 budget framework gives greater attention to economic growth and people-centred development through strategic economic investment, progressive realisation of basic social rights, and by improving public sector governance and service delivery. Improving the quality of public services has been a consistent theme of government's development and transformation agenda over the years. Following more than a decade of comprehensive transformation of policy and public service organisation, the pace of service delivery is gaining momentum. Access to services such as housing, electricity, water and sanitation, education and health, of which the largest beneficiaries are the poor, has improved considerably. While progress has been made, social and developmental challenges remain to be addressed. Investment in people needs to be accelerated, education, health and social development services improved, crime prevention strengthened, and, employment creation and community development efforts reinforced. Government's policy priorities and spending proposals are informed by these challenges. To achieve these objectives the following form the core areas that the 2007 Budget will be supporting and these are in line with section 214(2)(a to j) of the Constitution:

- *Accelerated infrastructure investment:* Economic infrastructure for a more rapidly growing economy includes power generation capacity, rehabilitation and expansion of road and rail transport networks, infrastructure for the 2010 FIFA World Cup, improved water resource management and modernisation of communications.
- *Skills development for economic growth:* Skills development is important in ensuring sustained economic growth and development. 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.
- *Sustainable livelihoods, urban development and planning:* Housing delivery and the rollout of basic services 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.
- *Industrial development, economic transformation and employment creation:* Industrial development and employment creation will be boosted over the period ahead through investment in economic infrastructure in targeted sectors 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.
- *Social security, targeted welfare services and health:* 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 were among the social service priorities for 2006 and are further consolidated in the 2007 Budget. Investments in health are targeted at improving the remuneration packages of certain categories of health professionals and providing for the further recruitment of health professionals.

- *Support for justice, crime prevention and policing:* The 2007 Budget reinforces attempts targeted at 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 2007 Budget in line with South Africa's current and potential involvement in international affairs.
- *Strengthening service delivery capacity:* Improving the quality of public service delivery in national, provincial and local government remains a central goal of public policy. Public administration reform is strongly focused on building local government capacity and improving training activities across the public service.
- *International relations, peace and security:* South Africa's international engagements are organised around the consolidation of the development agenda for Africa; cooperation between developing nations; improved global governance; and strengthening bilateral relations. South Africa has taken its place as non-permanent member of the United Nations Security Council for a two-year period.

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

Table E.1 2007 Budget priorities – additional MTEF allocations

R million	2007/08	2008/09	2009/10	Total
Provincial equitable share	3 570	6 374	14 652	**24 596**
includes school education, health care, welfare services, provincial infrastructure and economic development				
Education, health and welfare				
Higher education and FET bursaries,research on ICT, adult literacy planning and mass literacy campaign	342	727	1 162	**2 231**
Teacher and social worker bursaries	270	485	910	**1 665**
Hospitals and modernisation of tertiary services	300	700	1 030	**2 030**
Comprehensive HIV and AIDS plan	300	500	850	**1 650**
Housing and community development				
Housing grants	302	1 134	1 294	**2 730**
Municipal infrastructure, transport and water schemes	1 853	2 665	3 241	**7 759**
Municipal equitable share & Siyenza Manje	825	1 247	3 669	**5 741**
Cultural institutions and sports promotion	143	207	362	**712**
2010 FIFA World Cup stadiums and infrastructure	3 500	5 500	4 300	**13 300**
Economic infrastructure and investment				
National roads and rail rehabilitation	550	800	1 806	**3 156**
Communication networks	176	65	75	**316**
Provincial infrastructure	840	1 150	2 300	**4 290**
Industrial development zones and other infrastructure	377	37	10	**424**
Industrial development, science & technology				
Research and development	165	261	272	**698**
Sector support and economic empowerment	872	325	430	**1 627**
Regulatory capacity	15	18	10	**44**
Justice and crime prevention				
Reducing case backlogs and enhanced capacity	325	478	659	**1 461**
Policing equipment, facilities and personnel	358	661	1 332	**2 351**
Correctional facilities and security systems	953	966	1 011	**2 929**
International relations and defence				
Military skills development	50	100	300	**450**
Defence modernisation	300	1 000	2 250	**3 550**
Foreign Affairs capacity and African Renaissance Fund	158	166	372	**696**
Public administration capacity				
SARS core systems upgrade and customs scanners	274	423	620	**1 317**
Statistics SA	170	166	394	**730**
Other adjustments	844	51	2 201	**3 096**
Total policy adjustments	**17 833**	**26 206**	**45 510**	**89 550**

Fiscal framework

Table E.2 presents medium-term macroeconomic forecasts for the 2007 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, 2006/07 – 2009/10

	2006/07		2007/08		2008/09		2009/10
R billion	2006 Budget	2007 Budget	2006 Budget	2007 Budget	2006 Budget	2007 Budget	2007 Budget
Gross domestic product	1 674,0	1 755,3	1 884,9	1 938,9	2 095,9	2 141,7	2 379,3
Real GDP growth	*3,9%*	*4,9%*	*4,7%*	*4,8%*	*5,3%*	*5,2%*	*5,3%*
GDP inflation	*5,2%*	*4,7%*	*5,7%*	*4,9%*	*4,7%*	*5,0%*	*5,6%*
National Budget Framework							
Revenue	446,4	475,8	492,0	544,6	547,1	591,2	641,5
Percentage of GDP	*26,7%*	*27,1%*	*26,1%*	*28,1%*	*26,1%*	*27,6%*	*27,0%*
Expenditure	456,4	470,6	519,2	533,9	571,3	594,2	650,3
Percentage of GDP	*27,3%*	*26,8%*	*27,5%*	*27,5%*	*27,3%*	*27,7%*	*27,3%*
Budget deficit	-10,0	5,2	-27,2	10,7	-24,2	-3,0	-8,8
Percentage of GDP	*-0,6%*	*0,3%*	*-1,4%*	*0,6%*	*-1,2%*	*-0,1%*	*-0,4%*

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, 2003/04 – 2009/10

	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
R million		Outcome		Revised		Medium-term estimates	
National departments	148 201	168 046	195 384	213 470	240 881	262 092	286 333
Provinces	122 673	137 836	153 782	177 887	202 765	229 296	254 444
Equitable share	*107 538*	*120 885*	*135 292*	*150 753*	*171 271*	*193 474*	*215 784*
Conditional grants	*15 135*	*16 951*	*18 490*	*27 134*	*31 494*	*35 822*	*38 660*
Local government	11 521	13 808	16 682	27 079	34 311	41 843	45 608
Equitable share	*6 350*	*7 678*	*9 643*	*18 058*	*20 676*	*23 775*	*29 444*
Conditional grants	*5 171*	*6 131*	*7 038*	*9 021*	*13 636*	*18 069*	*16 164*
Non-interest allocations	**282 396**	**319 690**	**365 848**	**418 436**	**477 957**	**533 231**	**586 386**
Percentage increase	*15,4%*	*13,2%*	*14,4%*	*14,4%*	*14,2%*	*11,6%*	*10,0%*
State debt cost	46 313	48 851	50 912	52 178	52 916	52 967	50 915
Contingency reserve	–	–	–	–	3 000	8 000	13 000
Main budget expenditure	**328 709**	**368 541**	**416 760**	**470 614**	**533 873**	**594 198**	**650 301**
Percentage increase	*12,8%*	*12,1%*	*13,1%*	*12,9%*	*13,4%*	*11,3%*	*9,4%*
Percentage shares							
National departments	*52,5%*	*52,6%*	*53,4%*	*51,0%*	*50,4%*	*49,2%*	*48,8%*
Provinces	*43,4%*	*43,1%*	*42,0%*	*42,5%*	*42,4%*	*43,0%*	*43,4%*
Local government	*4,1%*	*4,3%*	*4,6%*	*6,5%*	*7,2%*	*7,8%*	*7,8%*

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, 2007/08 – 2009/10

R million	2007/08	2008/09	2009/10
National departments	7 294	8 418	16 546
Provinces	6 228	11 470	21 538
Local government	4 311	6 318	7 427
Allocated expenditure	**17 833**	**26 206**	**45 510**

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, 2007/08 – 2009/10

	2007/08	2008/09	2009/10
	Column A	Column B	
R million	Allocation	Forward estimates	
National[1, 2]	341 926	376 950	405 073
Provincial	171 271	193 474	215 784
Local	20 676	23 775	29 444
Total	**533 873**	**594 198**	**650 301**

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 2007 *Budget Review* sets out in detail how the constitutional issues and government's priorities are taken into account in the 2007 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 7 and 8. For this reason, this memorandum should be read with the 2007 *Budget Review*.

Part 2: Response to the recommendations of the FFC

Section 214 of the Constitution and Section 9 of the Intergovernmental Fiscal Relations Act (Act 97 of 1997) 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 *Submission for the Division of Revenue 2007/08* to Parliament in May 2006. The FFC also submitted a supplementary and detailed publication of research supporting this year's recommendations. In December 2006, the FFC made a supplementary submission entitled *Financial and Fiscal Commission Supplementary Submission for the Division of Revenue 2007/08 – the Fiscal Implications of the Re-demarcation of Provincial Boundaries,* which covers proposals on how to manage the impact of the re-demarcation on provincial and municipal finances in the year ahead.

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 2007 MTEF. The FFC proposals, although covering a broad range of issues, are divided into three main parts. The first part deals mainly with the review of conditional grants in the intergovernmental relations system; the second part reviews the equitable sharing of nationally raised revenue; the third part reviews the Western Cape fuel levy, assesses the proposals to replace RSC and JSB levies, comments on the development component of the local government equitable share formula, and looks at the impact of re-demarcation on provincial and municipal finances.

Review of the conditional grants in the intergovernmental fiscal relations system

General recommendations on conditional grants

FFC general proposals on conditional grants

The FFC reiterates its previous recommendations that conditional grants should be used solely to address problems of spill-over benefits and to deal with the funding of national priority programmes that still need to be institutionalised in provincial or municipal budgets. In the latter case, according to the commission, these conditional grants should be phased into the equitable share once the programmes are institutionalised by provinces and municipalities.

The commission reiterates that national government departments should clearly define norms and standards for delivery in areas of concurrent responsibility, and should monitor the performance of provinces to ensure that the minimum requirements for the use of conditional grants are met.

Government response

National government agrees with the commission on its general recommendations and many of the grants currently in the system meet these requirements. In cases where grants are introduced to cement national priorities in sub-national governments, these are phased out once the intended objective is achieved. The *Further Education and Training (FET) college recapitalisation*, *food relief* and *integrated social development grants* are examples of grants that are temporary and are phased or to be phased into the provincial equitable share.

Government agrees that norms and standards be in place for the delivery of services funded through conditional grants. In addition, for the 2007 Budget, clear measurable outputs and outcome indicators are included for each conditional grant in the frameworks. It is envisaged that these would improve monitoring and evaluation.

Specific recommendations on conditional grants to provinces

FFC proposal on the HIV and Aids grant

The FFC recommends that the *HIV and Aids grant* administered by the Department of Health remain a conditional grant to ensure that sufficient focus and resources continue to be channelled to dealing with the pandemic. This is in line with the commission's previous view that funding for all HIV and Aids programmes must be done through the conditional grant mechanism.

Government response

Government agrees that the *HIV and Aids grant* should continue as a conditional grant and not be phased into the equitable share at this stage. Government is of the view that if certain aspects of the programme are fully entrenched in provinces, consideration could be given to phase these into the equitable share. For example, the prevention of mother-to-child transmission programme is now widely rolled out and should form part of the normal responsibility of provincial health departments and could be phased into the equitable share. Government continues to prioritise programmes that aim to mitigate the impact of HIV and Aids on citizens. Further, in line with the FFC's recommendation, government will step up its HIV and Aids programme by R1,7 billion over the next three years. By 2009/10 spending on the *HIV and Aids grant* will be R2,7 billion per year.

FFC proposal on the hospital revitalisation grant

The FFC proposes that the *hospital revitalisation grant* be incorporated into the *provincial infrastructure grant* as there is a strong convergence of purpose between the two infrastructure conditional grants, and this may improve the efficacy of the *hospital revitalisation grant*. According to the commission, the stricter conditions attached to the *hospital revitalisation grant* are the main reason for poor spending and by merging it with the *provincial infrastructure grant*, which is a Schedule 4 grant with less stringent conditions, spending would be enhanced.

Government response

While the view that grant flows to provinces be streamlined has appeal, government is of the opinion that it may remain prudent to maintain separate funding streams for selected specific purpose grants in the immediate to medium term. However, taking into account the purpose and structure of the two grants, national government will examine the funding model for hospital construction in the period ahead.

FFC proposal on the land care and comprehensive agriculture support grants

The FFC recommends that the *land care* and the *comprehensive agricultural support programme (CASP)* grants be merged into a single Schedule 4 grant as their objectives overlap. The commission believes that the merger would reduce the administrative burden and improve the efficiency of spending on the grants.

Government response

Government does not support this recommendation as it is of the view that the two grants have different objectives. The *CASP* targets agricultural extension services to beneficiaries of the land reform programme, while the *land care* programme seeks to promote the sustainable use and management of natural resources.

FFC proposal on the national school nutrition grant

The FFC proposes that the conditions to the *national school nutrition grant* that relate to the development and approval of business plans must be refined to take into account the minimum time spent on the process of developing and approving plans, and the delays in the submission of plans and excessive non-compliance by provinces. Further, consideration should be given to relax the stringent conditions, especially for those grants that seek to ensure adherence to national norms and standards, which can allow for some level of decision space, innovation and creativity in spending.

Government response

A baseline study on the financing and administration of the national school nutrition programme is being finalised by the national Department of Education. The matters raised by the FFC are being considered as part of this study.

FFC proposal on the HIV and Aids life skills education programme grant

The FFC proposes that the grant should continue to be conditional with a clear focus on enrolment as opposed to the current allocation mechanism that uses the education component of the provincial equitable share formula.

Government response

Government is of the opinion that a long-term view needs to be adopted in deciding the allocation mechanism of this grant. HIV and Aids life skills education should become part of the education system over the medium term, with provincial education departments assuming full responsibility for this. In that case consideration would be given to phasing the grant into the provincial equitable share. Keeping the current allocation criteria would minimise distortions in provincial allocations when such phasing is considered.

Specific recommendations on conditional grants to local government

FFC proposal on the municipal infrastructure grant

The FFC recommends that the municipal infrastructure grant go beyond funding the B (Basic residential infrastructure), P (Public municipal service) and E (Social institutions and microenterprise) components in the formula. The formula should include operational and maintenance costs.

Government response

Government does not support this recommendation as it is incumbent upon each municipality to make provision for operations and maintenance in their budgets according to the provisions of section 17 (2) of the Municipal Finance Management Act (2003) (MFMA). Municipalities have a substantial revenue base and should fund the operation and maintenance of municipal infrastructure from their own resources. The current grant is a mechanism used to assist municipalities to roll out infrastructure to enable them to extend free basic services to qualifying households.

Review of health conditional grants

FFC proposal on the national tertiary service grant

With regard to the *national tertiary service grant* the FFC recommends that:

- An allocation framework based on approved policy norms and standards, underpinned by an explicit service plan, be introduced. This allocation framework should ensure that funds flow in accordance with the calculated full cost of norms and standards and per achievements of these.
- Norms and standards should be specified for functions such as casualty and outpatient services, theatres, beds by level of care and resource requirements – on the basis of health care per staff ratio and non-staff cost. According to the proposal these indicators can be reported by hospital and activity, and further used to incorporate planned upgrading or downgrading of any service in the area.
- Government develop a national service plan that includes level 1 services for hospitals as a matter of urgency.
- The Department of Health establish a chief directorate (or unit) dedicated to the provision of ongoing technical assistance to support the framework for administering the grant.
- The redistribution of services should be achieved through separate capital allocations, either conditional or appropriated at a provincial level.
- The grant should be retained as a conditional grant, given that the allocation criteria will be based on the set norms and standards and would also reduce the spill-over effects associated with downgrading of referral services by provincial services.

Government response

The existing methodology of the grant is based on actual service delivery trends and benchmark unit costs. Allocations on the grant have been reviewed twice based on updated performance data. Government agrees that the future approach to the grant should incorporate shifts towards a proposed future delivery dispensation for tertiary services. In this regard the Modernisation of Tertiary Services Report prepared by the national Department of Health provides a useful mechanism to do exactly this. This will require translation of the broader modernisation of tertiary services model into more detailed and specific strategic and implementation plans at both national and provincial levels to allow for the development of a financing framework. Government agrees that the recommendations of the tertiary services report need to be institutionalised; and norms, standards and resource requirements developed to inform a funding model linked to practical operational and strategic plans. In general, norms and standards for these tertiary services are strongly supported, provided they are developed within an affordability framework and adaptable to local conditions.

Government agrees that tertiary services be funded through a conditional grant and supports the idea that the allocation framework be based on agreed policy norms and standards underpinned by an explicit service plan. However, government is of the view that the development of norms and standards, a service delivery plan and allocation framework for tertiary services should be within an affordability framework and are adaptable to local conditions.

Generally, government agrees that national departments administering conditional grants must have the requisite capacity to administer such grants. Further, such capacity should be extended to the receiving department. Given the huge task of coordinating tertiary hospital services, a dedicated section that is adequately resourced would be useful. The Department of Health has a unit that administers this grant. The level at which this unit is established remains the discretion of the responsible accounting officer. Therefore, the national Department of Health will consider this recommendation within that context.

Redistribution of services needs to be achieved through changing both recurrent and capital allocations. At present the *hospital revitalisation grant* and the *provincial infrastructure grant* are important sources of capital financing and are separate funding streams outside the *national tertiary service grant*. Greater attention needs to be given to the capital implications of implementing the modernisation programme. This will require greater coordination of the *hospital revitalisation* and *national tertiary service grant grants*.

FFC proposal on the health professions training and development grant

With regard to the *health professions training and development grant* the FFC recommends that:

- The organisational structure of the national Department of Health should be adjusted to include a unit with sufficient technical capacity to coordinate and manage this grant, and that a standing committee comprising all role players in the teaching and training of health professionals be established for joint decision-making on policy targets, input requirements and the flow of funding.
- Measurable policy targets be set as gazetted minimum norms and standards for any sphere of government and/or institution receiving earmarked funding for training health professionals.
- The policy framework underpinning the training of health professionals should be determined nationally and the allocations flowing through the Department of Health should be made a conditional grant, while those flowing through the Department of Education should form an earmarked subsidy to tertiary education institutions.
- All institutions receiving funding from national government for the purpose of achieving legislated national norms and standards should be subjected to an annual external audit.
- The grant be converted to a specific purpose grant with the allocation by province based on target enrolment by the type of health professional and all institutions receiving funding from this grant should be subjected to an annual external audit.
- The allocations in respect of pathology students making use of the national laboratory service be incorporated into the *health professions training and development grant.*

Government response

Government agrees that the organisational structure of the national Department of Health should be adjusted to include a unit of sufficient technical capacity to administer the grant and to manage policy issues relating to health science education and its funding. The development, management and funding of quantitative training plans for each health profession, with joint agreement between the health and education sectors, is an extremely complex task and requires strong dedicated skills. Further, government agrees that a standing committee is required especially between the health and education sectors to coordinate the training of health professionals. This will be essential to provide stronger leadership and direction, as well as agreed quantitative plans for training health professionals.

Government agrees that measurable policy targets should be set for any sphere of government and/or institution receiving earmarked funding for the training of health professionals. The new framework should link funding to specific supply-side human resource planning and targets. The human resource planning and costing model developed by the FFC provides a useful tool for informing a future funding model. Government supports proposals that seek to link funding to an explicit process of quantitative planning for health human resources with clear production targets. However the gazetting of minimum norms and standards may not be the most appropriate way of doing this and the role for norms and standards in this area needs to be defined more clearly.

Government agrees that the policy framework underpinning the training of health professionals should be determined nationally and that part of the funding for training health professionals should be via the higher education funding stream and, to some extent, via the *health professions training and development grant* for the present. However, government would favourably consider a purchaser-provider split in which higher education institutions purchase clinical teaching services from the province. Government is of the view that such an arrangement may strengthen accountability, reporting, planning and performance.

While government supports the idea that this grant should be subjected to an external audit, such an audit would be difficult because it is not possible to split the costs associated with teaching within these institutions in a meaningful way. Government supports the reform of the grant and linking it to clear teaching output targets. Once this reform has been achieved, an audit against the agreed targets, norms and standards will become possible.

While government supports the argument put forward to make this grant a Schedule 5 grant, it is of the opinion that it would be difficult to effect such a conversion, because the large majority of costs incurred in training are incurred through shared resources, in which teaching and service are inextricably linked. For example, teaching of medical students is largely performed by medical specialists who perform service, and it is not possible to separate these costs in the financial accounting system in the kind of way that a Schedule 5 grant would require. Given that the grant is currently not a Schedule 5 grant, and that further work needs to be done on developing the policy and targets for the grant, the recommendation for annual audits needs to be considered in future.

FFC proposal on the national housing allocation formula

The FFC recommends that:

- The housing subsidy formula should, as much as possible, use variables that take account of provincial disabilities and peculiarities, as this will, to a large extent, eliminate bias. Factors like traditional housing, delivery capacity and development potential should be taken into account.
- The housing subsidy formula should recognise variation in regional cost, such as building and land cost difference between provinces.
- The delivery of housing should not result in communities being forced to live in areas where there is neither supporting infrastructure nor economic or livelihood potential. Funding for houses should also contribute to the attainment of sustainable rural development, and the formula should take into account rural housing needs when backlogs are calculated.
- Monitoring of compliance to minimum quality standards should be enhanced to ensure that rapid delivery of housing targets does not result in compromised or poor-quality housing that will result in additional costs in future, with negative implications for eradicating backlogs.

Government response

Housing statistics suggest that housing shortages are predominantly urban. In finalising its allocations, government continues to ensure that funds are channelled to areas where there is greater demand. This is done without any prejudice to provinces that are predominantly rural. This is evident in the sharp growth in allocations to these provinces.

Government does not support the recommendation that delivery capacity should be used as a criteria in the housing formula because it would have unintended consequences for equity.

Government does not support the recommendation that the housing formula should recognise variation in regional cost. It would be difficult to accurately determine such variation, given that there are variations between and within provinces, and the need to keep the formula simple. Government agrees that the housing programme should ensure sustainable communities with access to social and economic infrastructure that would contribute to improved livelihoods. In this regard, provincial governments are encouraged, through their integrated planning processes, to ensure that the entire necessary social and economic infrastructure is in place when large housing projects are completed. In the 2006 Budget, the *neighbourhood development partnership grant* was introduced to ensure that there is economic integration into low-income housing settlements.

Government agrees that compliance with minimum norms and standards should be enhanced to ensure quality delivery. In this regard, the National Home Builders Registration Council warranty scheme is extended to low-cost housing to protect beneficiaries from substandard construction. Further, government recognises that municipalities need to execute their inspectorate responsibilities in terms of housing in general, and low-cost housing in particular.

FFC proposal on incorporating social welfare into the provincial equitable share

The FFC recommends that:

- A social development component based on population, population in poverty and institutional capacity, should be incorporated into the provincial equitable share formula.
- The funding for social welfare services should take into account the need to maximise the spread of both welfare delivery institutions and human resources.

Government response

Government agrees that the equitable share formula should include a component that captures the demand for social welfare services. The equitable share formula is to be reviewed in the period ahead and the FFC's proposal will be considered as part of the review. The formula currently has a poverty component that is based on the proportion of the population deemed to be poor.

The review of provincial own-revenue trends

On provincial own revenue, the FFC does not make specific recommendations. It notes the progress with the implementation of the Provincial Tax Regulation Process Act in some provinces. The FFC further notes that its previous recommendations with respect to the structures and systems relating to the collection of provincial own revenues are being implemented.

The Western Cape fuel levy

The FFC includes as an annexure, recommendations regarding the Western Cape fuel levy. In approving the fuel levy, national government took into account all the proposals put forward by the commission. National government will be tabling enabling legislation for the introduction of the levy during 2007.

FFC recommendation on the basic services component of the local government equitable share formula

The FFC recommends that government revise the estimated cost of basic services (R130) per poor household per month as it is not sufficiently close to the true cost of providing basic services across a range of municipalities. The commission proposes that government consider raising the estimated cost to R175. This would help ensure that grant allocations are directed towards enhancing the ability of poor municipalities to carry out their constitutional mandate. Within a revenue-neutral scenario, this estimate allocates more basic services grants to Category A and B municipalities by only R22 million.

In the longer term, the efficiency of the local government equitable share formula in addressing its stated principles and objectives will be enhanced if a comprehensive review and assessment of the cost of providing basic services is urgently undertaken. An extensive exercise of this nature must take into account the crucial differences in the demographic composition, as well as the regional and geographical disparities, that affect the quality and quantity of service delivery.

Government response

Government acknowledges the need to review the costs of providing basic services for water, sanitation, electricity and refuse removal from time to time.

In deriving the equitable share of municipalities, the components are scaled upwards in order for the model to match the baseline amount of what becomes available to the local government sphere in the vertical split of nationally raised revenue, plus what is available through the revenue-raising capacity correction. Each year, since the inception of the new formula, this rescaling has had the result of increasing the subsidy for basic services, as the share of the local government sphere increases and as municipalities raise more of their own revenue. The result of this rescaling is such that the actual subsidy for basic services becomes much higher than the R130 per poor household per month.

Furthermore, the equitable share model makes provision for a full subsidy for basic services to households that have access to basic services, as well as a partial subsidy for those without access. Another characteristic of the model is that it recognises the powers and functions of municipalities and, where the local municipality does not have a specific power to perform a certain function, that part of its allocation is passed on to the district municipality performing the function. Therefore, it is not uncommon to find that a rural municipality has a relatively low number of households with access to a particular service and at the same time does not have the power to perform a certain function. Notwithstanding this, the allocation of the subsidy to the district municipality does not mean that the ultimate beneficiary, the poor household, is not reached.

A review of the local government fiscal framework is currently underway and includes a study on the cost of providing a basket of essential public services to the poor. It is important to note that although the outcome of this review could lead to the realignment of the level of support given to municipalities, it will remain a subsidy that is determined in the context of affordability and after making trade-offs with other national priorities in the normal budget process.

FFC proposal on the development component of the local government 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 only for basic services, but additional services covering a wide array of public services such as all-weather roads, street lights, 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 response

Government is exploring options to include the development component in the local government equitable share. The decision in this regard will be communicated with the tabling of the 2008 Budget. Government also notes the FFC's 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, bearing in mind that local government has substantial revenue-raising powers, and that some of the services are self-funding.

FFC proposal on the use of the grant as a replacement for the RSC levy

The FFC supports the proposal (as implemented in the 2006 Division of Revenue) to use a grant as a replacement of the RSC/JSB levy as a transitional measure to ensure that municipalities that were benefiting from the RSC/JSB levy are not prejudiced as a result of their abolishment.

The FFC proposes that any long-term replacement revenue instrument for RSC levies should take the following into account:

- Proposals should be viewed as part of the broader exercise of assigning revenue sources to local government. Hence the proposals to replace RSC/JSB levies should be understood in a broader context, where replacement options are not just limited to already constitutionally assigned revenue sources but are also opened up to other completely new sources.
- The objectives that the replacement is supposed to meet must be clearly defined.
- There is a need for wider discussion about the overall objectives of local government revenue and expenditure assignments and how these are expected to be aligned with the new proposals. Such an approach will ensure that the choice between decentralising and centralising revenue sources is an informed one, guided by the clear assignment of expenditure responsibility and the degree to which South Africa wishes to entrench the fiscal autonomy of sub-national governments. In effect, this means that the replacement of RSC/JSB levies should be viewed as an opportunity for aligning the local government fiscal framework with the assignment of powers and functions.

Government response

Government acknowledges that the most appropriate sources of revenue to replace RSC/JSB levies should be explored and not be limited to the already constitutionally assigned revenue sources. Replacement options, as listed in the discussion document, as well as any others identified through the consultation process, will be evaluated in terms of the intergovernmental fiscal and taxation framework as well as the fiscal framework for local government to ensure that any replacement option(s) have limited negative economic impact, provide adequate revenue at acceptable rates and are easy to administer. Although options that enhance local government fiscal autonomy are preferred, any replacement option will need to comply with the municipal fiscal powers and functions framework as prescribed in section 229 of the Constitution.

Government agrees that although the purpose of the RSC/JSB levies system, when introduced, was to address the infrastructure backlogs in the historically disadvantaged areas of the country, municipalities have increasingly used RSC levies for general operating expenditure. Any replacement option(s) will most probably be allocated to municipalities as a general revenue source – in other words, no predetermined conditions will be set.

Government agrees that the replacement of RSC/JSB levies provides an opportunity for improving the alignment between the services (functional) and fiscal division between municipalities. A review is underway to improve this alignment.

FFC proposal on the fiscal implications of the re-demarcation of provincial boundaries

The FFC supports the view that both the provincial and local government equitable share formulae should be updated to take into account changes, including the revised census data from Statistics South Africa (Stats SA), resulting from the re-demarcated boundaries for municipalities and provinces.

The FFC proposes that:

- Any additional costs faced by provinces and municipalities that cannot be met through the revised equitable share allocations be funded through a once-off allocation from national government. Such an allocation may be justified on the basis that in principle the formulae are designed so that funds follow need determined by the demographic composition in provinces and municipalities. However, currently the formulae do not fund the administrative costs associated with the prioritisation and the choice of norms and standards for the delivery of basic services.
- That any changes to the boundaries of provinces and municipalities be aligned with the financial year(s) system applicable for provincial and municipal authorities. This will allow for the required fiscal changes to be phased in and reduce the fiscal burden related to dealing with fiscal implications that might arise out of the re-determination of boundaries.

Government response

The provincial and local government equitable share formulae have been realigned to the revised boundaries. The revisions to the local government equitable share formula have been effected with the tabling of the 2006 Budget, while the changes to the provincial equitable shares are implemented in the 2007 Budget.

No additional allocations were made to the local government sphere to address any additional costs to municipalities that may have arisen through the demarcation. Government agreed that provinces prepare their 2007 budgets based on the realigned provincial equitable shares. The implementation of these budgets will be closely monitored to inform any adjustments that may be required. Early assessments of provincial budgets suggest that provinces have succeeded in realigning their budgets to the revised boundaries and any pressures that may arise may be minimal. Furthermore, provinces may be able to absorb any additional costs that arise through the demarcation.

Government agrees that any changes to the boundaries of provinces and municipalities must be aligned with the financial year system of provinces and municipalities.

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.

The 2007 Budget provides for total additional provincial spending of R6,2 billion in 2007/08 and R11,5 billion in 2008/09 over the forward estimates published in the 2006 *Budget Review*, and an increase of R21,5 billion to the newly created 2009/10 baseline allocation. The provincial equitable share baselines are revised upwards by R24,6 billion and conditional grants are increased by R14,6 billion over the next three years. National transfers to provinces increase from R177,9 billion in 2006/07 to R202,8 billion in 2007/08. Over the three-year period provincial transfers are projected to grow at an average annual rate of 12,7 per cent to R254,4 billion in 2009/10.

Provincial equitable share

The bulk of the provincial share of nationally raised revenue is allocated to provinces mainly through the equitable share grant. At 81,5 per cent of total provincial revenue and 84,5 per cent of national transfers, the equitable share constitutes the main source of revenue for meeting provincial expenditure responsibilities. The equitable share is budgeted to increase from R150,8 billion in 2006/07 to R171,3 billion in 2007/08, R193,5 billion in 2008/09 and R215,8 billion in 2009/10. The increase represents a real growth rate of 7,6 per cent per annum over the MTEF.

Table E.6 Total transfers to provinces, 2007/08

R million	Equitable share	Conditional grants	Total transfers
Eastern Cape	27 074	3 758	**30 832**
Free State	10 745	2 202	**12 947**
Gauteng	28 217	9 626	**37 843**
KwaZulu-Natal	37 067	5 024	**42 091**
Limpopo	22 340	2 504	**24 843**
Mpumalanga	14 140	1 684	**15 824**
Northern Cape	4 598	1 022	**5 619**
North West	11 973	2 001	**13 973**
Western Cape	15 118	3 673	**18 791**
Total	**171 271**	**31 494**	**202 765**

The equitable share formula

An objective redistributive formula is used to divide the equitable share among provinces. The formula is reviewed and updated with new data annually. For the 2007 MTEF, the formula is mainly affected by the re-benchmarking of the General Household Surveys (GHS), the re-demarcation of provincial boundaries to eradicate cross-boundary municipalities, and the use of latest available information.

The re-benchmarking of the General Household Surveys

Using mortality data from administration records of the Department of Home Affairs, and with the benefit of a more sophisticated demographic model, Stats SA adjusted population growth rates and absolute population figures for provinces in the 2004 mid-term population estimates. These were factored in the GHS for that year and subsequent periods. To ensure that population figures for the period prior to 2004 are consistent and comparable to those from 2004 onwards, they have had to be re-benchmarked. This ensures that the growth rates for the entire period bear relation to one another. Specifically, the population model was updated with the latest available mortality data. The benchmarks for all such previous surveys have been adjusted accordingly. This has resulted in revisions of population statistics of all provinces, which affects the equitable share formula and provincial equitable share allocations. These changes are captured in table E.7.

Table E.7 Comparing Census 1996, Census 2001 and Stats SA adjusted mid-year estimates

	Census results (October)			Stats SA midyear adjustments	
	1996	2001	Growth rate (% per year)	2001	Growth rate (% per year)
Eastern Cape	6 302 525	6 436 763	0,4%	6 929 869	1,9%
Free State	2 633 504	2 706 775	0,6%	2 893 541	1,9%
Gauteng	7 348 423	8 837 178	3,7%	8 254 103	2,3%
Kwazulu-Natal	8 417 021	9 426 017	2,3%	9 263 134	1,9%
Mpumalanga	2 800 711	3 122 990	2,2%	3 103 451	2,1%
Northern Cape	840 321	822 727	-0,4%	870 657	0,7%
Limpopo	4 929 368	5 273 642	1,4%	5 474 683	2,1%
North West	3 354 825	3 669 349	1,8%	3 686 162	1,9%
Western Cape	3 956 875	4 524 335	2,7%	4 207 044	1,2%
Total/Average	**40 583 573**	**44 819 776**	**2,0%**	**44 682 644**	**1,9%**

When the provincial equitable shares for the 2006 MTEF were finalised, the re-benchmarked 2002 and 2003 GHS population estimates were not available. The allocations were based on overstated and understated population figures for provinces. This had an impact on the 2007 equitable shares before the formula was updated for the revised provincial boundaries. The re-benchmarking affects the basic, health and poverty components of the formula, which in turn affect total provincial equitable shares. The three components combined account for 33 per cent of the total equitable share formula. When the revised population figures are included, the weighted equitable shares of provinces are revised as per table E.8.

Table E.8 Changes in weighted shares to provinces resulting from demarcation

	2007 MTEF weighted shares 3-year pahsing		
	2007/08	2008/09	2009/10
Eastern Cape	0,18%	0,27%	0,27%
Free State	0,07%	0,10%	0,10%
Gauteng	-0,21%	-0,31%	-0,31%
Kwazulu-Natal	-0,05%	-0,08%	-0,08%
Mpumalanga	0,08%	0,11%	0,11%
Northern Cape	-0,01%	-0,02%	-0,02%
Limpopo	0,02%	0,03%	0,03%
North West	0,00%	0,00%	0,00%
Western Cape	-0,08%	-0,12%	-0,12%

Table E.8 also shows that there will be an impact on the allocations of all provinces before taking account of changes that arise due to demarcation. For example, the Western Cape and the Free State, although not directly affected by the demarcation, will have their equitable shares adjusted.

The re-demarcation of provincial boundaries

From 1 March 2006, provincial boundaries were redrawn to eradicate cross-boundary municipalities. However, the impact of the new boundaries on provincial allocations and budgets was deferred to the 2007 Budget. Table E.9 shows the population shifts between provinces as a result of the revised provincial boundaries. The population of the Northern Cape increases by 21,9 per cent while there is a sharp decline in North West (15 per cent) and moderate declines in Limpopo (4,5 per cent) and Eastern Cape (2,8 per cent).

Table E.9 Population shifts due to demarcation

	2005 General household survey			Percentage change	Re-aligned	Current Shares	Difference
	Pre-demarcatio	Post demarcatio	Difference				
Eastern Cape	7 040	6 841	*-199*	-2.8%	14.6%	14.4%	0.1%
Free State	2 953	2 953	–	0.0%	6.3%	6.1%	0.2%
Gauteng	9 029	9 443	*414*	4.6%	20.1%	19.8%	0.4%
KwaZulu-Natal	9 655	9 854	*199*	2.1%	21.0%	20.9%	0.1%
Limpopo	5 636	5 380	*-256*	-4.5%	11.5%	11.8%	-0.3%
Mpumalanga	3 221	3 440	*219*	6.8%	7.3%	7.0%	0.4%
Northern Cape	903	1 101	*198*	21.9%	2.3%	1.8%	0.5%
North West	3 825	3 250	*-575*	-15.0%	6.9%	8.2%	-1.3%
Western Cape	4 652	4 652	–	0.0%	9.9%	10.1%	-0.1%
Total	**46 914**	**46 914**	**–**	**0.0%**	**100.0%**	**100.0%**	**0.0%**

The demarcation affects the education, health, basic, poverty and economic activity components, as the supporting data needs to be realigned to the new provincial boundaries. The updates to the different components are covered in the discussion under each of the components.

Policy change impact on the formula

To smooth the impact of new data updates to the provincial equitable share formula in previous years, government agreed to use moving averages. For the 2007 MTEF, government agreed that the use of moving averages in the formula be discontinued because it:

- Distorts the demographic shifts in provinces. The historical information tends to delay the shifts in allocations resulting from population shifts.
- Introduces a further lag in the formula as historic information forms a greater determinant in the formula. For example, the 2005 GHS will only account for 20 per cent of the output where its data is used, and the demographic shifts there are markedly different from the 2002 GHS.
- Proves difficult to rework historical information with the highest levels of confidence.

Summary of the structure of the formula

The formula (Table E.10) consists of six components which capture the relative demand for services between provinces and take into account specific provincial circumstances. 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. 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. For the 2007 Budget, the distribution of the weights by component remains unchanged as set out below:

- An *education share* (51 per cent) based on the size of the school-age population (ages 5-17) and the number of learners (Grade R to 12) enrolled in public ordinary schools
- 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.10 Distributing the equitable shares by province

	Education	Health	Basic share	Poverty	Economic activity	Institu-tional	Weighted average
	51%	**26%**	**14%**	**3%**	**1%**	**5%**	**100%**
Eastern Cape	16,9%	15,1%	14,5%	21,2%	8,1%	11,1%	15,8%
Free State	5,7%	6,3%	6,2%	7,4%	5,5%	11,1%	6,3%
Gauteng	14,8%	18,8%	20,1%	11,4%	33,3%	11,1%	16,5%
KwaZulu-Natal	22,9%	21,5%	20,9%	23,2%	16,7%	11,1%	21,6%
Limpopo	14,1%	12,1%	11,3%	16,5%	6,7%	11,1%	13,1%
Mpumalanga	8,6%	7,6%	7,4%	7,0%	6,8%	11,1%	8,2%
Northern Cape	2,2%	2,4%	2,3%	2,6%	2,2%	11,1%	2,7%
North West	6,5%	7,0%	7,1%	7,0%	6,3%	11,1%	7,0%
Western Cape	8,2%	9,2%	10,0%	3,8%	14,4%	11,1%	8,8%
Total	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**

The phasing-in of the formula

For the 2007 Budget, government agreed not to phase in the impact of the updates effected to the formula. This is mainly due to the fact that there is a structural shift in the expenditure of affected provinces that should be accompanied by the requisite revenue shifts. Table E.11 shows the revised weighted provincial equitable shares for the period 2006/07 to 2009/10.

Table E.11 Implementation of the equitable share weights, 2006/07 – 2009/10

	2006/07	2007/08	2008/09	2009/10
Percentage	**Base shares**		**3-year phasing**	
Phasing	*Year 1*	*Year 2*	*Year 3*	*Year 4*
Eastern Cape	16,4%	15,8%	15,8%	15,8%
Free State	6,4%	6,3%	6,3%	6,3%
Gauteng	15,5%	16,5%	16,5%	16,5%
KwaZulu-Natal	21,2%	21,6%	21,6%	21,6%
Limpopo	13,7%	13,1%	13,1%	13,1%
Mpumalanga	7,4%	8,2%	8,2%	8,2%
Northern Cape	2,3%	2,7%	2,7%	2,7%
North West	8,2%	7,0%	7,0%	7,0%
Western Cape	8,9%	8,8%	8,8%	8,8%
Total	**100,0%**	**100,0%**	**100,0%**	**100,0%**

Education component

The education component is intended to enable provinces to fund school education, which accounts for about 80 per cent of provincial education spending. The formula uses school-age population (5 to 17 years) based on Census 2001 and actual enrolment drawn from the 2006 Snap Survey to reflect the relative demand for education, with each element assigned a weight of 50 per cent. Table E.12 shows the impact of the revised provincial boundaries on the data sets that support the component.

Table E.12 Enrolment shifts and age-cohort shifts due to demarcation

	Enrolment			Age-cohort		
	Pre-demarcation	Post demarcation	Difference	Pre-demarcation	Post demarcation	Difference
Eastern Cape	2 165 994	2 101 768	-64 226	2 219 325	2 151 992	-67 333
Free State	686 346	686 346	–	760 488	760 486	-2
Gauteng	1 770 110	1 850 072	79 962	1 785 973	1 893 198	107 225
KwaZulu-Natal	2 709 408	2 773 634	64 226	2 945 916	3 013 243	67 327
Limpopo	1 931 207	1 763 081	-168 126	1 914 893	1 798 862	-116 031
Mpumalanga	944 108	1 102 637	158 529	969 153	1 074 972	105 819
Northern Cape	210 981	261 736	50 755	221 723	280 975	59 252
North West	905 256	784 136	-121 120	1 021 021	864 739	-156 282
Western Cape	978 826	978 826	–	1 094 573	1 094 565	-8
Total	**12 302 236**	**12 302 236**	**–**	**12 933 065**	**12 933 032**	**-33**

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. Table E.13 shows the weighted target shares for the 2007 MTEF after updating the education component for new and realigned data.

Table E.13 Comparison of new and old education component weighted shares

	Revised education component				New weighted average	Old weighted average	Difference in weighted shares
	2006 School enrolment	Age cohort 5 - 17	% share school enrolment	% share age cohort 5 - 17			
Eastern Cape	2 101 768	2 151 992	17.1%	16.6%	16.9%	17.4%	-0.5%
Free State	686 346	760 486	5.6%	5.9%	5.7%	5.8%	-0.1%
Gauteng	1 850 072	1 893 198	15.0%	14.6%	14.8%	13.8%	1.0%
KwaZulu-Natal	2 773 634	3 013 243	22.5%	23.3%	22.9%	22.8%	0.1%
Limpopo	1 763 081	1 798 862	14.3%	13.9%	14.1%	15.1%	-1.0%
Mpumalanga	1 102 637	1 074 972	9.0%	8.3%	8.6%	7.6%	1.1%
Northern Cape	261 736	280 975	2.1%	2.2%	2.2%	1.7%	0.5%
North West	784 136	864 739	6.4%	6.7%	6.5%	7.7%	-1.1%
Western Cape	978 826	1 094 565	8.0%	8.5%	8.2%	8.2%	0.0%
Total	**12 302 236**	**12 933 032**	**100.0%**	**100.0%**	**100.0%**	**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 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 that 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 2005 GHS. Table E.14 shows the impact of the revised weighted shares of the health component.

Table E.14 Comparison of new and old health component weighted shares

	Old			New			Difference
	Population with medical aid	Population without medical aid	Weighted shares	Population with medical aid	Population without medical aid	Weighted shares	
Eastern Cape	629	24 057	15,3%	684	24 628	15,1%	-0,2%
Free State	416	9 397	6,1%	410	10 172	6,3%	0,2%
Gauteng	2 295	26 363	17,7%	2 061	29 528	18,8%	1,1%
KwaZulu-Natal	1 040	34 079	21,7%	1 111	34 968	21,5%	-0,2%
Limpopo	373	20 116	12,7%	372	20 032	12,1%	-0,5%
Mpumalanga	391	11 187	7,2%	339	12 404	7,6%	0,4%
Northern Cape	131	2 790	1,8%	150	3 804	2,4%	0,5%
North West	455	13 167	8,4%	393	11 428	7,0%	-1,4%
Western Cape	1 181	13 770	9,2%	1 041	14 444	9,2%	0,0%
Total	**6 912**	**154 926**	**100,0%**	**6 561**	**161 408**	**100,0%**	–

Poverty component

The poverty component provides for redistribution within the formula and is assigned a weight of 3 per cent. The poor population is defined as income earners who fall in quintiles 1 and 2 based on the 2000 Income and Expenditure Survey (IES). Each province's share is then expressed as the percentage of the "poor" population residing in that province, where the population figure is drawn from the 2006 mid-year estimates. Stats SA indicated that it would be difficult to realign the 2000 IES to the new provincial boundaries given the methodology, sample size and reporting domain these samples. For the 2007 MTEF the component is partially realigned to the revised provincial boundaries with the 2006 mid-year population estimates. Table E.15 shows the impact of the revised weighted shares of the poverty component.

Table E.15 Comparison of new and old poverty component weighted shares

	Old				New				Differ-ence
	IES Survey 2000 (Q1+Q2)	Basic component value	Poverty index	Weighted shares	IES Survey 2000 (Q1+Q2)	Basic component value	Poverty index	Weighted shares	
Eastern Cape	56.4%	6 614	3 732	21.0%	56.4%	6 894	3 890	21.2%	0.2%
Free State	45.7%	2 778	1 270	7.1%	45.7%	2 959	1 353	7.4%	0.2%
Gauteng	21.9%	9 051	1 982	11.2%	21.9%	9 526	2 086	11.4%	0.2%
KwaZulu-Natal	43.0%	9 576	4 113	23.1%	43.0%	9 924	4 263	23.2%	0.1%
Limpopo	56.3%	5 402	3 041	17.1%	56.3%	5 365	3 021	16.5%	-0.7%
Mpumalanga	36.9%	3 188	1 175	6.6%	36.9%	3 508	1 293	7.0%	0.4%
Northern Cape	44.0%	839	369	2.1%	44.0%	1 095	481	2.6%	0.5%
North West	37.9%	3 748	1 422	8.0%	37.9%	3 374	1 280	7.0%	-1.0%
Western Cape	14.6%	4 610	671	3.8%	14.6%	4 746	691	3.8%	0.0%
Total		**45 807**	**17 777**	**100.0%**		**47 391**	**18 358**	**100.0%**	–

Economic activity component

The economic activity component is a proxy for provincial tax capacity and is assigned a weight of 1 per cent. For the 2007 MTEF, 2004 GDP-R data is used. The component is not aligned to the revised provincial boundaries as Stats SA indicated that it would be difficult to adjust GDP-R data with high levels of confidence. Table E.16 shows the impact of the revised weighted shares of the economic activity component.

Table E.16 Comparison of new and old economic activity component weighted shares

	Old		New		Difference
	GDP-R, 2003	Weighted shares	GDP-R, 2004	Weighted shares	
Eastern Cape	101 127	8,1%	112 908	8,1%	0,1%
Free State	69 094	5,5%	75 827	5,5%	-0,1%
Gauteng	413 554	33,0%	462 044	33,3%	0,3%
KwaZulu-Natal	206 766	16,5%	231 616	16,7%	0,2%
Limpopo	81 295	6,5%	93 188	6,7%	0,2%
Mpumalanga	87 461	7,0%	94 450	6,8%	-0,2%
Northern Cape	29 659	2,4%	30 087	2,2%	-0,2%
North West	81 442	6,5%	87 127	6,3%	-0,2%
Western Cape	181 069	14,5%	199 412	14,4%	-0,1%
Total	**1 251 468**	**100,0%**	**1 386 659**	**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. It constitutes 5 per cent of the total equitable share, of which each province receives 11,1 per cent.

Basic component

The basic component (Table E.17) is derived from each province's share of the total population of the country and is assigned a weight of 14 per cent. For the 2007 MTEF population data is drawn from the 2006 mid-year estimates. Table E.17 shows the impact of the revised weighted shares of the basic component.

Table E.17 Comparison of new and old basic component weighted shares

	Old		New		Difference
	Average	Weighted shares	2006 Mid-year	Weighted shares	
Eastern Cape	6 614	14,4%	6 894	14,5%	0,1%
Free State	2 778	6,1%	2 959	6,2%	0,2%
Gauteng	9 051	19,8%	9 526	20,1%	0,3%
KwaZulu-Natal	9 576	20,9%	9 924	20,9%	0,0%
Limpopo	5 402	11,8%	5 365	11,3%	-0,5%
Mpumalanga	3 188	7,0%	3 508	7,4%	0,4%
Northern Cape	839	1,8%	1 095	2,3%	0,5%
North West	3 748	8,2%	3 374	7,1%	-1,1%
Western Cape	4 610	10,1%	4 746	10,0%	-0,1%
Total	**45 807**	**100,0%**	**47 391**	**100,0%**	**–**

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 differ, as Schedule 4 grants are more general grants that supplement various programmes also funded by provinces, 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

Minor changes are effected to the provincial fiscal framework for the 2007 MTEF. The *national community library services grant* to be administered by the Department of Arts and Culture is introduced to step up and consolidate library services at provincial level. The *FET colleges recapitalisation grant* administered by the Department of Education is phased into the provincial equitable share from 1 April 2009, and the *Alexandra renewal programme* is phased out from 1 April 2007.

Table E.18 shows the proposed revisions to conditional grants. These revisions of R2,7 billion, R5,1 billion and R6,9 billion (R14,6 billion over the next three years) bring the conditional grant baselines to R31,5 billion in 2007/08, R35,8 billion in 2008/09 and R38,7 billion in 2009/10.

Table E.18 Revisions to conditional grant baseline allocations, 2007/08 – 2009/10

R million	2007/08	2008/09	2009/10	Total Revisions
Conditional grants				
Hospital revitalisation	*200*	*300*	*500*	*1 000*
Comprehensive HIV and Aids	*300*	*500*	*850*	*1 650*
National tertiary services grant	*100*	*400*	*530*	*1 030*
Intergrated housing and human settlements	*300*	*1 131*	*1 289*	*2 720*
Provincial infrastructure grant	*840*	*1 150*	*2 300*	*4 290*
Gautrain rapid rail link	*878*	*1 530*	*1 231*	*3 639*
Sports and recreation	*40*	*85*	*187*	*312*
Total change to baseline	**2 658**	**5 096**	**6 886**	**14 641**

Table E.19 provides a summary of conditional grants by sector and province for 2007/08. More detailed information, including the framework and formula for each grant, is provided in Appendix E1 of the 2007 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 2005/06 and any other material issues to be addressed. Table E.19 presents a summary of all the conditional grants listed in Schedules 4 and 5 of the bill for the 2007 MTEF.

Agriculture grants

The *comprehensive agriculture support programme* is allocated R1,3 billion over the next three 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.

The *land care programme* is allocated R147,1 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.

Education grants

The Department of Education administers the *national school nutrition programme, HIV and Aids (life skills) programme* and *FET recapitalisation grants,* which make up 6,1 per cent of total conditional grant spending.

The *national school nutrition programme* seeks to improve nutrition of poor school children, 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 per year. The programme is allocated R1,2 billion in 2007/08, R1,2 billion in 2008/09, and R1,3 billion in 2009/10. A baseline study on how the programme is to evolve over the medium to long term is under way.

The *HIV and Aids (life skills) programme grant* provides for life skills training, sexuality and HIV and Aids education in primary and secondary schools. The grant is allocated R157,7 million in 2007/08, R167,9 million in 2008/09, and R177,4 million in 2009/10. The programme is now fully integrated into the school system, with learner and teacher support material provided for grades 1 to 9.

The *FET recapitalisation grant* funds the recapitalisation of 50 FET colleges to improve their capacity in contributing to skills development and training. In addition to skills development, the grant also contributes to upgrading of physical infrastructure for the colleges and acquisition of equipment. The grant is allocated R595 million in 2007/08 and R795 million in 2008/09 and is phased into the equitable share by 2009/10.

Table E.19 Conditional grants to provinces, 2006/07 – 2009/10

R million	2006/07	2007/08	2008/09	2009/10
Agriculture	**401**	**462**	**484**	**530**
Agricultural disaster management grant	45	–	–	–
Comprehensive agricultural support programme grant	300	415	435	478
Land care programme grant: poverty relief and infrastructure development	56	47	49	51
Arts and Culture	**–**	**180**	**338**	**466**
Community library services grant	–	180	338	466
Education	**1 713**	**1 906**	**2 201**	**1 501**
Further education and training college sector recapitalisation grant	470	595	795	–
HIV and Aids (life skills education) grant	144	158	168	177
National school nutrition programme grant	1 098	1 153	1 238	1 324
Health	**10 207**	**11 321**	**12 543**	**13 726**
Comprehensive HIV and Aids grant	1 616	1 946	2 235	2 676
Forensic pathology services grant	562	551	467	422
Health professions training and development grant	1 520	1 596	1 676	1 760
Hospital revitalisation grant	1 527	1 907	2 283	2 582
National tertiary services grant	4 981	5 321	5 882	6 286
Housing	**6 404**	**8 238**	**9 853**	**11 531**
Integrated housing and human settlement development grant	6 404	8 238	9 853	11 531
Land Affairs	**8**	**–**	**–**	**–**
Land distribution: Alexandra urban renewal project grant	8	–	–	–
National Treasury	**4 983**	**6 164**	**6 847**	**7 997**
Infrastructure grant to provinces	4 983	6 164	6 847	7 997
Sport and Recreation South Africa	**119**	**194**	**290**	**402**
Mass sport and recreation participation programme grant	119	194	290	402
Trade and Industry	**58**	**–**	**–**	**–**
Industrial development zones grant	58	–	–	–
Transport	**3 241**	**3 029**	**3 266**	**2 507**
Gautrain rapid rail link grant	3 241	3 029	3 266	2 507
Total	**27 134**	**31 494**	**35 822**	**38 660**

Health grants

The health sector accounts for the bigger share (35,9 per cent) of the total provincial conditional grants. The sector accounts for at least five conditional grants with a total allocation of over R11 billion annually.

The *national tertiary services grant* aims to provide strategic funding to enable provinces to plan, modernise, and transform the tertiary hospital service delivery platform in line with national policy objectives. The grant operates in 27 hospitals across the nine provinces, concentrated in urban Gauteng and Western Cape. Consequently, the Western Cape and Gauteng receive 61,9 per cent in 2007/08 of the grant as they provide the largest proportion of these high-level, sophisticated services for the benefit of the health sector countrywide.

The baselines for the *national tertiary services grant* are revised upwards by R100 million in 2007/08, R400 million in 2008/09, and R530 million in 2009/10 to fund radiology and oncology equipment. The additional funds will strengthen cancer services and medical and radiology equipment. The grant grows to R5,3 billion in 2007/08, R5,9 billion in 2008/09 and R6,3 billion in 2009/10.

The *health professions training and development grant* funds the costs associated with the training of health professionals, development and recruitment of medical specialists. It enables the shifting of teaching activities from central to regional and district hospitals. It is allocated R1,6 billion in 2007/08, R1,7 billion in 2008/09 and R1,8 billion in 2009/10.

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 revised upwards by R300 million in 2007/08, R500 million in 2008/09 and R850 million in 2009/10 to extend coverage of the programme. The grant is allocated R1,9 billion, R2,2 billion and R2,7 billion over the MTEF ending 2009/10.

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, and supports management development initiatives, including personnel, procurement delegations and financial management capacity. The grant is allocated an additional R1 billion over the next three years. The additional allocations in the first two years will address tender shortfalls and faster-than-anticipated progress on the 26 hospitals currently on-site, whereas the additions in the outer year will allow additional hospitals to enter the programme. The grant grows to R1,9 billion in 2007/08, R2,3 billion in 2008/09 and R2,6 billion in 2009/10.

The transitional *forensic pathology services grant* assists with the transfer of medico-legal mortuaries from the South African Police Service to the health sector and to provide comprehensive forensic pathology services for the criminal justice system. The allocation rises to R551,4 million in 2007/08 before declining to R466,9 million in 2008/09 and R421,7 in 2009/10.

Housing grants

The *integrated housing and human settlement development grant* facilitates the establishment of habitable, stable and sustainable human settlements in which all citizens have access to selected social and economic amenities. The programme targets eradication or formalisation of informal settlements on a phased basis by 2014. The baselines for this grant are revised upwards by R300 million in 2007/08, R1,1 billion in 2008/09, and R1,3 billion in 2009/10. Taking into account these revisions, government plans to spend R29,6 billion over the medium term on low-cost housing. Spending on the *housing subsidy programme* is set to reach R11,5 billion by 2009/10.

National Treasury grants

The *provincial infrastructure grant* augments provincial funding to accelerate construction, maintenance and rehabilitation of new and existing infrastructure in education, roads, health and agriculture, and also contributes to rural development. The grant also focuses on the application of labour-intensive methods in delivery in order to maximise job creation and skill development.

In line with government's commitment to sustain social and economic infrastructure investment in provinces, R4,3 billion is added to the *provincial infrastructure grant,* bringing its allocation over the next three years to R21 billion. The bulk of the additional allocation will strengthen the expanded public works programme in roads, boosting employment and skills acquisition. The grant is allocated R6,2 billion in 2007/08, R6,8 billion in 2008/09 and R8,0 billion in 2009/10.

Arts and culture grants

Community library services are important for building well-informed communities as they give direct access to information and knowledge that contribute to education and self-empowerment. This new grant provides R984 million to transform urban and rural community library infrastructure facilities and services.

Sports and recreation grants

An additional allocation of R312 million to the mass sport and recreation participation programme is targeted at developing grassroots club structures to foster mass participation in sports and recreation, leaving a legacy beyond 2010. The grant is allocated R194 million in 2007/08, R290 million in 2008/09 and R402,3 million in 2009/10 to promote mass participation by historically disadvantaged communities in a selected number of development sporting activities.

Transport grant

The Department of Transport is allocated R3,0 billion in 2007/08, R3,3 billion in 2008/09 and R2,5 billion in 2009/10 as a contribution to the construction of the Gautrain Rapid Rail Link.

Part 4: Local government fiscal framework and allocations

Government continues to explore efficient options for financing local government. The ultimate goal is to ensure that each municipality has a sufficient resource base to execute its constitutional mandate. The local government equitable share was reviewed in 2004 with the revised formula fully implemented in 2007/08. Currently, the local government fiscal framework is reviewed to, among other things, ensure greater alignment between powers and functions, and resource generation and allocation. 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.

The current focus of the review is to assess 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.

All national transfers to municipalities are published to enable them to plan fully for their coming 2007/08 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.

National transfers to local government

National allocations to local government (Table E.3) grow from a revised allocation of R27,1 billion in 2006/07 to R34,3 billion in 2007/08, R41,8 billion in 2008/09 and R45,6 billion by 2009/10. Table E.3 indicates that the share of nationally raised revenue for local government rises from 6,5 per cent in 2006/07 to 7,7 per cent in 2009/10.

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.20 shows that the equitable share increases from R18,1 billion in 2006/07 to R20,7 billion in 2007/08 and is budgeted to grow to R29,4 billion in 2009/10.

Table E.20 National transfers to local government, 2003/04 – 2009/10

R million	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
		Outcome		Revised estimate		Medium-term estimates	
Direct transfers to local government							
Equitable share and related	**6 623**	**7 811**	**9 808**	**18 358**	**21 226**	**24 375**	**29 906**
Equitable share[1]	6 350	7 678	9 643	18 058	20 676	23 775	29 444
Water and sanitation operating	273	133	165	300	550	600	462
Infrastructure	**4 102**	**5 299**	**6 286**	**7 931**	**12 390**	**17 119**	**15 302**
Municipal infrastructure grant	2 442	4 481	5 436	6 756	7 549	8 053	9 130
Public transport infrastructure and systems	–	–	242	170	1 174	3 170	2 325
National electrification programme	245	196	297	355	468	596	897
Local neighbourhood development partnership grant	–	–	–	50	500	1 500	1 650
Implementation of water services projects	1 022	208	–	–	–	–	–
Disaster relief	–	280	311	–	–	–	–
2010 FIFA World Cup stadia development	–	–	–	600	2 700	3 800	1 300
Poverty relief funds and other[2]	393	134	–	–	–	–	–
Current transfers	**796**	**699**	**588**	**790**	**695**	**350**	**400**
Restructuring grant	494	388	255	445	350	–	–
Financial management grant	151	129	133	145	145	150	200
Municipal systems improvement grant	151	182	200	200	200	200	200
Sub total direct transfers[3]	**11 521**	**13 808**	**16 682**	**27 079**	**34 311**	**41 843**	**45 608**
Indirect transfers to local government							
Water and sanitation operating	817	819	904	440	490	531	393
Water services regional bulk infrastructure	–	–	–	–	300	450	650
Backlogs in the electrification of clinics and schools	–	–	–	–	45	90	150
Backlogs in water and sanitation at clinics and schools	–	–	–	–	105	210	350
National electrification	796	819	863	893	973	1 151	1 421
Financial management grant	60	69	66	53	53	50	–
Sub total indirect transfers	**1 673**	**1 707**	**1 833**	**1 387**	**1 967**	**2 481**	**2 964**
Total	**13 194**	**15 515**	**18 515**	**28 466**	**36 278**	**44 325**	**48 572**

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.
- Providing for environmental health care services to all households, not only 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 of Provincial and Local Government.

The development component

This component has been set at zero since the inception of the current formula and will remain inactive until a suitable factor can be found that adequately captures the developmental needs of local government.

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 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 2007 MTEF provides guarantees of 100 per cent and 90 per cent on the allocations for the first two years of the MTEF cycle, respectively.

Other considerations in applying the formula

The formula as outlined above has to be modified to account of intricacies in the allocation process. In particular, powers and functions must be taken into account, and the overall budget must balance.

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 revenue 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 amount 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.

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.21 below). In addition, all households receive approximately R12 a year towards the provision of environmental health care services.

Table E.21 Service costs

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

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

c) Revenue-raising capacity

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 was being phased in over the last two financial years and takes full effect in 2007/08.

The water service operating subsidy

The *water service operating subsidy* 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 318 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 R1,0 billion in 2007/08, R1,1 billion in 2008/09 and R855 million in 2009/10.

The department is in the process of finalising the transferring of the schemes. 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 318 schemes employ 7 482 staff and supply water to 54 municipalities. So far 43 agreements have been signed, and 1 841 staff have been transferred, along with 232 schemes with a total asset value of approximately R4,6 billion.

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

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 R9,0 billion in 2006/07 to R13,6 billion in 2007/08, R18,1 billion in 2008/09 and R16,2 billion in 2009/10.

Below is a summary of all the conditional grants to municipalities listed in Schedules 4, 6, 6A and 7 of the 2007 Division of Revenue Bill.

Infrastructure conditional grants to local government

National transfers for infrastructure amount to R12,7 billion, R17,3 billion and R15,1 billion for each of the 2007 MTEF years. The *municipal infrastructure, public transport infrastructure, national electrification programme, water services regional bulk infrastructure, water and sanitation to schools and clinics, electrification of schools and clinics* and *2010 FIFA World Cup stadiums development grants* are the infrastructure transfers to local government.

Additional to the existing transfers to local government for municipal infrastructure, public transport infrastructure and the national electrification programmes, new grants were introduced for water services regional bulk infrastructure, stadium development, water and sanitation services to schools and clinics and the electrification of schools and clinics.

Municipal infrastructure grant

The largest infrastructure transfers – R7,5 billion, R8,1 billion and R9,1 billion over the MTEF years – are through the *municipal infrastructure grant* (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 2007 MTEF, R24,7 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 2008/09 as the programme will be completed by that time. The 2007 MTEF 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.22.

Table E.22 Municipal infrastructure grant allocations per sector, 2006/07 – 2009/10

	2006/07	2007/08	2008/09	2009/10
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.23 shows the respective amounts that flow through the vertical division of the MIG funds.

Table E.23 Municipal infrastructure grant allocations per sector, 2006/07 – 2009/10

		2006/07	2007/08	2008/09	2009/10
Weights			**Adjusted weights**		
Municipal Infrastructure Grant (a)		**6 756**	**7 549**	**8 053**	**9 080**
Special Municipal Infrastructure Fund and Management (b)		72	38	–	–
Ring-fenced allocation: Eradication of Bucket Sanitation System (c)		400	1 000	–	–
Bulk infrastructure (d)		28	30	50	–
Municipal Infrastructure Grant (formula)		6 256	6 481	8 003	9 080
of which Municipal Infrastructure Grant (formula)					
B Component	**75,0%**	**4 692**	**4 861**	**6 002**	**6 810**
Water and sanitation	72,0%	3 378	3 500	4 322	4 903
Electricity	0,0%	–	–	–	–
Roads	23,0%	1 079	1 118	1 381	1 566
Other	5,0%	235	243	300	341
P Component	**15,0%**	**938**	**972**	**1 200**	**1 362**
E Component	**5,0%**	**313**	**324**	**400**	**454**
N Component	**5,0%**	**313**	**324**	**400**	**454**

The public transport infrastructure and systems grant

The *public transport infrastructure grant* is administered by the Department of Transport. The grant provides for planning, establishment, construction and improvement of new and existing public transport infrastructure and systems. It is allocated R1,2 billion in 2007/08, R3,2 billion in 2008/09 and R2,3 billion in 2009/10.

The neighbourhood development partnership grant

The *neighbourhood development partnership grant* provides 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 R500 million in 2007/08, R1,5 billion in 2008/09 and R1,7 billion in 2009/10.

The national electrification programme

In line with its objectives to eradicate the electricity backlogs, particularly to poor households, government plans to spend R6 billion over the next three years on its national electrification programme. Of this R2,2 billion will be spent by municipalities directly and R3,8 billion by Eskom on behalf of municipalities.

The water services regional bulk infrastructure grant

This grant supplements the financing of the social component of regional bulk water and sanitation infrastructure and is allocated R300 million in 2007/08, R450 million in 2008/09 and R650 billion in 2009/10.

The water services to schools and clinics grant

This grant has been created to eliminate the backlog in access to water and sanitation services at schools and clinics. An amount of R665 million is available over the MTEF cycle for ensuring access for all identified clinics and schools by 2008/09 and 2009/10 respectively.

The national electrification of schools and clinics grant

The grant provides funding to the amount of R285 million over the next three years for connecting 6 928 schools and 411 clinics with electricity by 2009/10.

The 2010 FIFA World Cup stadiums development grant

The purpose of the grant is to provide funding for the design and construction of new stadiums and the upgrading of existing ones in 2010 FIFA World Cup host cities. Funds of R2,7 billion in 2007/08, R3,8 billion in 2008/09 and R1,3 billion in 2009/10 are allocated for this grant.

Capacity-building grants

The *capacity-building grants* were set up to assist municipalities in building management, planning, technical, budgeting and financial management skills. These grants are R749 million 2007/08, and reduced to R400 million in 2008/09 and R400 million in 2009/10. The *restructuring grant* is phased into the equitable share in 2008/09.

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, linking integrated development plans to budgets, producing quality and timely in-year and annual reports, and generally supporting municipalities in the implementation of the MFMA. Allocations over the MTEF amount to R495,2 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 and is phased into the local government equitable share in 2008/09.

The *municipal systems improvement grant* 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

Refinement of the local government fiscal framework

Various reforms have been made to the local government fiscal system, such as the reforms to the local government equitable share and infrastructure grant formulas. Further refinements will be made to the local government fiscal framework to enhance the ability of municipalities to perform their developmental and service delivery responsibilities. Some of the key issues that will form part of the further reform and refinement of the local government fiscal framework are discussed in more detail below.

Interim and longer-term arrangements to replace funding from RSC/JSB 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 and accrued to metropolitan (Category A) and district (Category C) municipalities.

The Minister of Finance announced in the 2005 Budget speech the phasing out of RSC and JSB levies with effect from 1 July 2006. The Small Business Tax Amnesty and Amendment of Taxation Laws Act, 2006 revoked the power of district and metropolitan municipalities to impose RSC and JSB levies from 1 July 2006. Legislative provision is made for municipalities to continue to collect any RSC and JSB levies that became due on or before 30 June 2006 (for a stipulated period).

The importance of maintaining existing levels of revenue in order for municipalities to meet their expenditure obligations was however acknowledged in the 2005 *Medium Term Budget Policy Statement*. National government will compensate municipalities for lost revenue within the national budget framework, while exploring permanent replacement options. For the 2007 Budget, R26,0 billion (R8 billion in 2007/08, R9 billion in 2008/09 and R9 billion for 2009/10) has been made available as part of the local government share to replace RSC and JSB levies as an interim funding measure. Actual RSC levies collected as obtained from financial statements for the 2005/06 financial year were used to determine allocations for the 2007 Budget (allocations to metropolitan municipalities were adjusted to take into account the VAT zero-rating of property tax from 1 July 2006). Similar to RSC levies, the replacement grant should be prioritised towards basic services and infrastructure development in under-serviced communities.

Various medium- to long-term options to replace RSC and JSB levies were proposed in a discussion document that was received by the National Treasury. Replacement options, as listed in the discussion document, as well as any others identified through the consultation process, will be evaluated in terms of the intergovernmental fiscal and taxation framework as well as the fiscal framework for local government so as to ensure that any replacement option(s) have limited negative economic impact, provide adequate revenue at acceptable rates and are easy to administer. Although options that enhance local government fiscal autonomy are preferred, any replacement option will need to comply with the municipal fiscal powers and functions framework as prescribed in section 229 of the Constitution.

The intention is to announce long-term options to replace RSC and JSB levies as part of the 2008 (or possibly 2009) Budget.

Legislation dealing with the regulation of municipal fiscal powers and functions

Section 229(1)(a) of the Constitution empowers municipalities to impose municipal surcharges on fees for services provided by them or on their behalf. Municipalities may in terms of section 229(1)(b) also, if authorised by national legislation, impose other taxes, levies and duties ("taxes") appropriate to local government or to the category of local government into which that municipality falls, but excluding an income tax, a value-added tax, general sales tax and customs duties. Section 229(2) subjects these powers to regulation by national legislation and policy.

The draft Municipal Fiscal Powers and Functions Bill will be resubmitted to Cabinet for approval to publish for public comment. The draft bill will primarily deal with the following:

- Permanently abolishing RSC and JSB levies from 1 July 2006
- Prescribing the process for authorisation and regulation of a municipal tax
- Setting out norms and standards for municipal surcharges.

Restructuring of the water and electricity distribution industries

Reform of the water and electricity distribution industries has been driven by the need to address their fragmentation, which could have led to a number of problems – including the inability of small municipalities to achieve economies of scale, skills and specialisation.

The following key principles should underpin any sector restructuring process:

- Restructuring must be in accordance with the Constitution
- The financial state of municipalities now performing the function(s) must not be adversely affected
- Aggregate personnel costs must not increase in a way that undermines the objective of one public service
- No additional funds or taxes to fund restructuring (fiscus and/or local government) may be introduced without the approval of Cabinet.

The electricity distribution industry (EDI) restructuring process has commenced, while the restructuring of the water industry is still in the planning stages.

In October 2006, government agreed that six wall-to-wall regional electricity distributors (REDs) be established as public entities. Eskom will become a shareholder in the respective REDs for a transitional period and will reduce its shareholding over a period of time. Government is developing a road map to move into the new industry structure. EDI restructuring legislation will be introduced in 2007 as the legislative instrument for the formation of the REDs.

The Electricity Regulation Amendment Bill dealing with the regulation of the electricity reticulation function (municipal responsibility) will complement the planned legislation to deal with municipal fiscal powers and functions.

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 property rates to public service infrastructure and state properties. Only a limited number of municipalities have introduced new valuation rolls in terms of the act (most municipalities are targeting 1 July 2007 or 1 July 2008 as the earliest date for introducing new valuation rolls).

The first set of regulations in terms of the Municipal Property Rates Act focusing on administrative issues was gazetted for public comment in 2006. It is the intention to publish the second (final) set of regulations focusing on financial issues for public comments in 2007.

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 materials are available on the National Treasury website: www.treasury.gov.za.