W1

Website annexure to the 2015 Budget Review

Explanatory memorandum to the division of revenue

Background

Section 214(1) of the Constitution requires that every year a Division of Revenue Act determine the equitable division of nationally raised revenue between national government, the nine provinces and 278 municipalities. This process takes into account the powers and functions assigned to each sphere of government. The division of revenue process fosters transparency and is at the heart of constitutional cooperative governance.

The Intergovernmental Fiscal Relations Act (1997) prescribes the process for determining the equitable sharing and allocation of nationally raised revenue. Sections 9 and 10(4) of the act set out the consultation process to be followed with the Financial and Fiscal Commission (FFC), including considering recommendations made regarding the division of revenue.

This explanatory memorandum to the 2015 Division of Revenue Bill fulfils the requirement set out in section 10(5) of the Intergovernmental Fiscal Relations Act that the bill be accompanied by an explanatory memorandum detailing how it takes account of the matters listed in sections 214(2)(a) to (j) of the Constitution, government's response to the FFC's recommendations, and any assumptions and formulas used in arriving at the respective divisions among provinces and municipalities. This explanatory memorandum has six sections:

- Part 1 lists the factors that inform the division of resources between national, provincial and local government.
- Part 2 describes the 2015 division of revenue.
- Part 3 sets out how the FFC's recommendations on the 2015 division of revenue have been taken into account.
- Part 4 explains the formula and criteria for the division of the provincial equitable share and conditional grants among provinces.

- Part 5 sets out the formula and criteria for the division of the local government equitable share and conditional grants among municipalities.
- Part 6 summarises issues that will form part of subsequent reviews of provincial and local government fiscal frameworks.

The Division of Revenue Bill and its underlying allocations are the result of extensive consultation between national, provincial and local government. The Budget Council deliberated on the matters discussed in this memorandum at several meetings during the year. The approach to local government allocations was discussed with organised local government at technical meetings with the South African Local Government Association (SALGA), culminating in meetings of the Budget Forum (the Budget Council and SALGA). An extended Cabinet meeting involving ministers, provincial premiers and the SALGA chairperson was held in October 2014. The division of revenue, and the government priorities that underpin it, was agreed for the next three years.

Part 1: Constitutional considerations

Section 214 of the Constitution requires that the annual Division of Revenue Act be enacted after factors in sub-sections (2)(a) to (j) of the Constitution are taken into account. These include national interest, debt provision, the needs of national government, flexibility in responding to emergencies, resource allocation for basic services and developmental needs, the fiscal capacity and efficiency of provincial and local government, reduction of economic disparities, and promotion of stability and predictability. The constitutional principles taken into account in deciding on the division of revenue are briefly noted below.

National interest and the division of resources

The national interest is encapsulated by governance goals that benefit the nation as a whole. The National Development Plan, endorsed by Cabinet in November 2012, sets out a long-term vision for the country's development. This is complemented by the strategic integrated projects overseen by the Presidential Infrastructure Coordinating Council and the 14 priority outcomes adopted by Cabinet in 2014 for the 2014–2019 Medium Term Strategic Framework. In the 2014 *Medium Term Budget Policy Statement*, the Minister of Finance outlined how the resources available to government over the 2015 medium-term expenditure framework (MTEF) would be allocated to help achieve these goals. Chapter 4 of the 2014 *Medium Term Budget Policy Statement* and Chapters 5 and 6 of the 2015 *Budget Review* discuss how funds have been allocated across the three spheres of government based on these priorities. The frameworks for each conditional grant allocated as part of the division of revenue also note how the grant is linked to the 14 priority outcomes.

Provision for debt costs

The resources shared between national, provincial and local government include proceeds from national government borrowing used to fund public spending. National government provides for the resulting debt costs to protect the country's integrity and credit reputation. A more detailed discussion can be found in Chapter 7 of the 2015 *Budget Review*.

National government's needs and interests

The Constitution assigns exclusive and concurrent powers and functions to each sphere of government. National government is exclusively responsible for functions that serve the national interest and are best centralised. National and provincial government have concurrent responsibility for a range of functions. Provincial and local government receive equitable shares and conditional grants to enable them to provide basic services and perform their functions. Functions may shift between spheres of government to better meet government's needs. The division of revenue responds to this by modifying the funding arrangements. For example, in 2015/16 the port health and further education and training functions will shift from provincial to national government, so the funds for these functions will move from the provincial equitable share and conditional grants to the budgets of the national departments of Health and

Higher Education and Training. Changes continue to be made to various national transfers to provincial and local government to improve their efficiency, effectiveness and alignment with national strategic objectives.

Provincial and local government basic services

Provinces and municipalities are assigned service delivery functions such as education, health, social development, housing, roads, and provision of electricity, water and municipal infrastructure. They have significant autonomy to allocate resources to meet basic needs and respond to provincial and local priorities, while also giving effect to national objectives. The division of revenue provides equitable shares to provinces and local government, together with conditional grants for basic service delivery.

Baseline reductions to the provincial and local fiscal frameworks in this year's division of revenue have been structured to minimise the effect on basic service delivery. For example, the *comprehensive HIV and AIDS grant* to provinces and the local government equitable share have not been reduced. Transfers to local government have grown significantly in recent years, providing municipalities with greater resources to deliver basic services. This is in addition to local government's substantial own-revenue-raising powers.

The 2015 division of revenue has made additional resources available to accelerate the rollout of water and sanitation infrastructure, and a new grant to municipalities affected by the 2016 boundary changes will help minimise any negative effects that the transition may have on service delivery.

Fiscal capacity and efficiency

National government has primary revenue-raising powers. Provinces have limited revenue-raising capacity and the resources required to deliver provincial functions do not lend themselves to self-funding or cost recovery. Municipalities finance most of their expenditure through property rates, user charges and fees. However, rural municipalities raise significantly less revenue than larger urban and metropolitan municipalities. Due to their limited revenue-raising potential and their responsibility to implement government priorities, provinces receive a larger share of nationally raised revenue than local government.

Local government's share of revenue has increased from 3 per cent in 2000/01 to 9 per cent over the 2015 MTEF period. A review of the local government equitable share was completed in 2012 and a new formula is being phased in from 2013/14 to 2017/18. The new formula incorporates a revenue adjustment factor that considers the fiscal capacity of the recipient municipality (full details of the formula are provided in part 5 of this annexure). The mechanisms for allocating funds to provinces and municipalities are continuously reviewed to improve their efficiency. A new approach to the funding of provincial infrastructure is being implemented to promote better planning and implementation, and to improve efficiency in the delivery of health and education infrastructure. To maximise the effect of allocations, many provincial and local government conditional grants use criteria that consider the efficiency with which the recipient has used previous allocations.

Developmental needs

Developmental needs are accounted for at two levels. First, in the determination of the division of revenue, which explains the continued commitment to grow the provincial and local government shares of nationally raised revenue, and second, in the determination of the division within each sphere through the formulas used to divide national transfers among municipalities and provinces. Developmental needs are encapsulated in the equitable share formulas for provincial and local government and in specific conditional grants, such as the *municipal infrastructure grant*, which allocates funds according to the number of households in a municipality without access to basic services. Various infrastructure grants and growing capital budgets aim to boost the economic and social development of provinces and municipalities.

Economic disparities

The equitable share and infrastructure grant formulas are redistributive towards poorer provinces and municipalities. Through the division of revenue, government continues to invest in economic infrastructure (such as roads) and social infrastructure (such as schools, hospitals and clinics) to stimulate economic development, create jobs, and address economic and social disparities.

Obligations in terms of national legislation

The Constitution confers autonomy on provincial governments and municipalities to determine priorities and allocate budgets. National government is responsible for policy development, national mandates, setting national norms and standards for provincial and municipal functions, and monitoring implementation for concurrent functions. The 2015 MTEF and division of revenue provide additional funding for municipalities affected by significant boundary changes due to take effect after the 2016 local government elections. National government will also ensure that baseline reductions do not affect important obligations that are already funded through existing provincial and local government allocations.

Predictability and stability

Provincial and local government equitable share allocations are based on estimates of nationally raised revenue. If this revenue falls short of the estimates within a given year, the equitable shares of provinces and local government will not be adjusted downwards. Allocations are assured (voted, legislated and guaranteed) for the first year and are transferred according to a payment schedule. To contribute to longer-term predictability and stability, estimates for a further two years are published with the annual proposal for appropriations. Adjusted estimates as a result of changes to data underpinning the equitable share formulas and revisions to the formulas are phased in to ensure minimal disruption.

Flexibility in responding to emergencies

Government has a contingency reserve that provides a cushion for emergencies and unforeseeable events. In addition, two conditional grants for disasters allow for the swift allocation and transfer of funds to affected provinces and municipalities in the immediate aftermath of a declared disaster. Sections 16 and 25 of the Public Finance Management Act (1999) make specific provision for the allocation of funds to deal with emergency situations. Section 30(2) deals with adjustment allocations for unforeseeable and unavoidable expenditure. Section 29 of the Municipal Finance Management Act (2003) allows a municipal mayor to authorise unforeseeable and unavoidable expenditure in an emergency.

Part 2: The 2015 division of revenue

As announced in the 2014 *Medium Term Budget Policy Statement*, government has lowered its expenditure ceiling to reduce the budget deficit and stabilise public debt (see Chapters 1, 3 and 5 of the *Budget Review*). However, the most important public spending programmes that help poor South Africans, contribute to growth and generate employment have been protected from major reductions. The 2015 division of revenue reprioritises existing funds to ensure these objectives are met despite a lower expenditure ceiling. The lower spending ceiling has been applied proportionately across the three spheres of government. Parts 4 and 5 of this annexure set out in more detail how the baseline reductions have been effected on provincial and local government transfers.

Excluding debt-service costs and the contingency reserve, allocated expenditure shared between the three spheres amounts to R1.1 trillion, R1.2 trillion and R1.2 trillion over each of the MTEF years. These allocations take into account government's spending priorities, each sphere's revenue-raising capacity and responsibilities, and input from various intergovernmental forums and the FFC. The provincial and local equitable share formulas are designed to ensure fair, stable and predictable revenue shares, and to address economic and fiscal disparities.

Government's policy priorities for the 2015 MTEF period

Following the reductions to the baseline, existing budgets need to be reprioritised to meet government's policy priorities outlined in the Medium Term Strategic Framework. Priorities over the 2015 MTEF period that are funded through reprioritisations in the division of revenue include:

- The repair of provincial and municipal infrastructure damaged by disasters during 2013 and 2014
- The upgrade of the R573 Moloto Road by the South African National Roads Agency Limited
- The accelerated provision of bulk water and sanitation and the extension of basic infrastructure to areas without water supply
- A new grant to assist municipalities with the costs associated with major boundary changes.

Table W1.1 shows how major reprioritisations are distributed to priority areas across national, provincial and local government over the MTEF period.

Table W1.1 Top increases and major rescheduling, 2015/16 – 2017/18

R million	2015/16	2016/17	2017/18	Total
National departments				
Compensation of employees cost pressures	1 334	1 212	952	3 498
Water and Sanitation				
Water infrastructure grants: Shift from the water trading entity	700	700	1 000	2 400
Regional water programme: Housing development and social infrastructure	–	–	550	550
Rural Development and Land Reform				
Settlement of land restitution claims: Administration, research and payment of	461	489	163	1 113
Implementation of Spatial Planning Land Use Management Act, 2013	27	139	–	165
Establishment of the office of the valuer-general	33	35	76	144
National Treasury				
Military pensions and other benefits: Inclusion of non-statutory forces	266	271	273	810
South African Revenue Service: Adequacy of accumulated surplus	-464	-75	381	-158
Defence and Military Veterans				
Spares for military machinery and equipment, and acquisition of transport aircraft to transport troops and equipment to deployment area	84	262	457	803
Telecommunications and Postal Services				
Funding of pilot for SA Connect: Broadband policy	200	268	272	740
Transport				
South African National Roads Agency: Moloto Road upgrade	45	331	329	705
Repair to transport infrastructure damaged by disasters	163	215	270	648
Human Settlements				
Repair of housing infrastructure damaged by disasters	232	195	134	561
National Housing Finance Corporation: Affordable housing finance	100	100	100	300
Housing Development Agency: Project management and informal settlement upgrading support	72	57	100	229
Statistics SA				
Large sample community survey	89	381	39	509
Cooperative Governance and Traditional Affairs				
Repair to municipal infrastructure damaged by disasters	167	140	–	307
Municipal demarcation transition conditional allocation: Gauteng and KwaZulu-Natal	39	50	50	139
Justice and Constitutional Development				
Capacitation of courts in rural areas: Employment of 67 court administrators	74	79	83	236
Legal Aid South Africa: Employment of public defenders to complement the increase in magistrates' capacity to reduce case backlogs	39	42	45	127
Public Service and Administration				
Public Service Sector Education and Training Authority: Skills development project plans	68	72	75	215
Basic education				
National Education Collaboration Trust: Piloting of interventions to improve the	20	30	150	200
Trade and Industry				
Export Credit Insurance Corporation interest make-up scheme: Support to exporters to access new export markets and diversify South African exports	50	50	50	150
Small Business Development				
2014 national macro organisation of the state: Establishment of department, and interventions to assist small, medium and micro businesses and cooperatives	44	46	49	139
Home Affairs				
Implementation of new immigration regulations: Employment of 111 immigration inspectors	36	37	45	118
Mineral Resources				
Shale gas exploration: Consultations, advocacy and research	28	36	44	108
Police				
Transport equipment: Extending the replacement cycle of vehicles	–	-494	400	-94

Source: National Treasury

The fiscal framework

Table W1.2 presents the medium-term macroeconomic forecasts for the 2015 Budget. It sets out the growth assumptions and fiscal policy targets on which the fiscal framework is based.

Table W1.2 Medium-term macroeconomic assumptions, 2014/15 – 2017/18

	2014/15		2015/16		2016/17		2017/18
R billion/percentage of GDP	**2014 Budget**	**2015 Budget**	**2014 Budget**	**2015 Budget**	**2014 Budget**	**2015 Budget**	**2015 Budget**
Gross domestic product	3 789.6	3 879.9	4 150.5	4 191.8	4 552.9	4 538.8	4 926.1
Real GDP growth	*2.9%*	*1.4%*	*3.3%*	*2.0%*	*3.5%*	*2.6%*	*3.0%*
GDP inflation	*6.3%*	*6.0%*	*6.0%*	*5.9%*	*5.9%*	*5.5%*	*5.4%*
National budget framework							
Revenue	**962.8**	**954.3**	**1 058.1**	**1 049.3**	**1 172.6**	**1 166.0**	**1 265.4**
Percentage of GDP	*25.4%*	*24.6%*	*25.5%*	*25.0%*	*25.8%*	*25.7%*	*25.7%*
Expenditure	**1 142.6**	**1 135.1**	**1 232.6**	**1 222.3**	**1 323.6**	**1 309.9**	**1 420.9**
Percentage of GDP	*30.1%*	*29.3%*	*29.7%*	*29.2%*	*29.1%*	*28.9%*	*28.8%*
Main budget balance[1]	**-179.8**	**-180.9**	**-174.5**	**-173.1**	**-151.0**	**-144.0**	**-155.5**
Percentage of GDP	*-4.7%*	*-4.7%*	*-4.2%*	*-4.1%*	*-3.3%*	*-3.2%*	*-3.2%*

1. A positive number reflects a surplus and a negative number a deficit
Source: National Treasury

Table W1.3 sets out the division of revenue for the 2015 MTEF period after accounting for new policy priorities.

Table W1.3 Division of nationally raised revenue, 2011/12 – 2017/18

R million	**2011/12**	**2012/13 Outcome**	**2013/14**	**2014/15 Revised estimate**	**2015/16**	**2016/17 Medium-term estimates**	**2017/18**
Division of available funds							
National departments	**389 376**	**420 015**	**453 171**	**491 368**	**522 992**	**553 778**	**586 087**
of which:							
Indirect transfers to provinces	700	2 315	2 693	4 116	3 458	3 596	3 967
Indirect transfers to local government	2 660	4 548	5 523	8 536	10 395	10 634	10 916
Provinces	**355 824**	**380 929**	**410 572**	**439 661**	**468 159**	**496 259**	**526 382**
Equitable share	289 628	310 741	336 495	359 922	382 673	405 265	428 893
Conditional grants	66 197	70 188	74 077	79 739	85 485	90 994	97 490
Local government	**68 251**	**76 430**	**82 836**	**89 076**	**99 753**	**103 936**	**110 017**
Equitable share	33 173	37 139	38 964	43 290	50 208	52 869	55 512
Conditional grants	26 505	30 251	34 258	35 595	38 887	39 844	42 720
General fuel levy sharing with metropolitan municipalities	8 573	9 040	9 613	10 190	10 659	11 224	11 785
Non-interest allocations	**813 451**	**877 374**	**946 579**	**1 020 105**	**1 090 904**	**1 153 973**	**1 222 486**
Percentage increase	*10.0%*	*7.9%*	*7.9%*	*7.8%*	*6.9%*	*5.8%*	*5.9%*
Debt-service costs	76 460	88 121	101 185	115 016	126 440	140 971	153 376
Unallocated reserves	–	–	–	–	5 000	15 000	45 000
Main budget expenditure	**889 911**	**965 496**	**1 047 764**	**1 135 122**	**1 222 345**	**1 309 944**	**1 420 862**
Percentage increase	*10.4%*	*8.5%*	*8.5%*	*8.3%*	*7.7%*	*7.2%*	*8.5%*
Percentage shares							
National departments	*47.9%*	*47.9%*	*47.9%*	*48.2%*	*47.9%*	*48.0%*	*47.9%*
Provinces	*43.7%*	*43.4%*	*43.4%*	*43.1%*	*42.9%*	*43.0%*	*43.1%*
Local government	*8.4%*	*8.7%*	*8.8%*	*8.7%*	*9.1%*	*9.0%*	*9.0%*

Source: National Treasury

Table W1.4 shows how additional resources are divided. The new focus areas and additional allocations are accommodated by shifting savings towards priorities.

Table W1.4 Changes over baseline, 2015/16 – 2016/17

R thousand	2015/16	2016/17
National departments	-4 966	-5 224
Provinces	-3 779	-5 976
Local government	-294	-1 250
Allocated expenditure	**-9 039**	**-12 450**

Source: National Treasury

Table W1.5 sets out schedule 1 of the Division of Revenue Bill, which reflects the legal division of revenue between national, provincial and local government. In this division, the national share includes all conditional grants to provinces and local government in line with section 214(1) of the Constitution, and the allocations for each sphere reflect equitable shares only.

Table W1.5 Schedule 1 of the Division of Revenue Bill, 2015/16 – 2017/18

	2015/16	2016/17	2017/18
	Column A	Column B	
R million	Allocation	Forward estimates	
National[1, 2]	789 464	851 811	936 458
Provincial	382 673	405 265	428 893
Local	50 208	52 869	55 512
Total	**1 222 345**	**1 309 944**	**1 420 862**

1. National share includes conditional grants to provinces and local government, general fuel levy sharing with metropolitan municipalities, debt-service costs and the contingency reserve
2. Direct charges for the provincial equitable share are netted out
Source: National Treasury

The 2015 *Budget Review* sets out in detail how constitutional issues and government's priorities are taken into account in the 2015 division of revenue. It describes economic and fiscal policy considerations, revenue issues, debt and financing considerations, and expenditure plans. Chapter 6 focuses on provincial and local government financing.

Part 3: Response to the FFC's recommendations

Section 9 of the Intergovernmental Fiscal Relations Act requires the FFC to make recommendations regarding:

a) "An equitable division of revenue raised nationally, among the national, provincial and local spheres of government;
b) the determination of each province's equitable share in the provincial share of that revenue; and
c) any other allocations to provinces, local government or municipalities from the national government's share of that revenue, and any conditions on which those allocations should be made."

The act requires that the FFC table these recommendations at least 10 months before the start of each financial year. The FFC tabled its *Submission for the Division of Revenue 2015/16* to Parliament in May 2014. These recommendations are divided into 11 chapters, which cover four main areas: macroeconomic and fiscal frameworks for inclusive growth; improving investments in education and health; investment in infrastructure; and the implications of municipal demarcations.

Section 214 of the Constitution requires that the FFC's recommendations be considered before tabling the division of revenue. Section 10 of the Intergovernmental Fiscal Relations Act requires that the Minister of Finance table a Division of Revenue Bill with the annual budget in the National Assembly. The bill must be accompanied by an explanatory memorandum setting out how government has taken into account the FFC's recommendations when determining the division of revenue. This part of the explanatory memorandum complies with this requirement.

The FFC's recommendations can be divided into three categories:

- Recommendations that apply directly to the division of revenue
- Recommendations that indirectly apply to issues related to the division of revenue
- Recommendations that do not relate to the division of revenue.

Government responses to the first and second categories are provided below. The relevant national departments are considering the recommendations that do not relate to the division of revenue, and they will respond directly to the FFC.

Recommendations that apply directly and indirectly to the division of revenue

Chapter 2: Public debt challenges and the need for fiscal reforms

Use cost-cutting as an opportunity for reform

The FFC recommends that, "Government does not resort simply to cutting costs to reduce public debt. The need to restrain spending should be an opportunity to reform programmes and service delivery. Simple cost cutting may be effective in achieving deficit reduction targets but does not encourage longer-run fiscal stability or allow for reforms that will generate more value for money spent."

Government response

Government agrees with the recommendation. The National Treasury has undertaken a careful review of current expenditure trends to identify areas where spending on non-essential items can be reduced. Government's major programmes to reduce poverty and create jobs have been protected. This includes expenditure on social grants, public employment programmes and economic incentives. Major cuts have focused on non-essential goods and services, including catering, entertainment and travel budgets.

Avoid expenditure ceilings as a means of debt control

The FFC recommends that, "Government avoids across-the-board cuts or expenditure ceilings as a means of debt control. Such blunt tools treat valuable, efficiently run programmes and outdated, poorly managed programmes in the same way. Spending should be aligned with government priorities, to ensure adequate funding of high-priority initiatives and elimination or substantial reduction of lower-priority programmes."

Government response

The expenditure ceiling announced in the 2012 Budget is an important policy tool for ensuring that government closes its structural budget deficit over the medium term. Government agrees that maintaining this ceiling should not be done using across-the-board cuts. Government has carefully analysed current expenditure trends to ensure that spending in priority areas is maintained, including the large poverty-reduction and job-creation programmes. In national departmental budgets, major cuts have been limited to non-essential goods and services, and provinces and municipalities have been encouraged to follow the same approach in their budgets. In the event of a shortfall in revenue in 2015/16, further fiscal consolidation will focus on poorly managed programmes.

Chapter 4: Equitable resourcing of schools for better outcomes

Education infrastructure grants

The FFC recommends that, "The allocation framework for education infrastructure conditional grants sets out clear expenditure targets for quintile 1 to 3 schools and timelines for addressing priority infrastructure backlogs in each quintile. The *school infrastructure backlogs grant* must also make provision for the transitional asset handover process to school governing boards and provincial education departments on newly built schools. This would address alignment between funding for non-physical inputs and physical inputs, as well as curb the decay of newly constructed infrastructure."

Government response

The aim of the *school infrastructure backlogs grant* is to replace unsafe school structures with appropriately built ones. While government appreciates the FFC's research into the appropriate frameworks for such grants, a project list has already been established and projects are at various stages of implementation. As a result, it is not feasible to shift schools on this project list on the basis of the quintiles in which they fall without delaying the overall backlog reduction.

Government agrees on the importance of timelines for addressing infrastructure backlogs and ensuring that schools have access to water, sanitation and electricity, and are built with appropriate and safe materials. In 2013, government published minimum norms and standards for school infrastructure, and provinces have been given until 2016 for all schools to meet these standards.

Government's focus on replacing, upgrading or rehabilitating existing schools to meet safety or basic service standards, rather than building new schools, means the problem of poorly planned handovers is largely avoided. However, government does acknowledge the risk, which is why the provincial education department must be notified before a school is transferred onto its asset register. This ensures that there is a current budget (for employees, learner materials and maintenance) so that the school is functional before the start of the school year.

Chapter 5: Adequacy and efficiency in primary healthcare financing

Increase primary healthcare allocation levels in line with norms and standards

The FFC recommends that, "Provincial governments increase their allocation levels to primary healthcare funding, to be in line with the minimum norms and standards for the primary healthcare package set by the national Department of Health, in particular on clinic services such as integrated management of childhood illnesses, reproductive health and HIV/AIDS."

Further engagements with the FFC led to the clarification that this recommendation should be read as: "The provincial equitable share or health conditional grants may need to increase or be re-allocated to take account of provincial primary healthcare requirements set out by the national Department of Health. An absence of such increased funding or revising the allocation method of current funding may result in norms and standards, set by the national department, not being met adequately by the provincial departments with service delivery suffering as a result."

Government response

Government welcomes the suggestion that further work is needed to ensure primary healthcare funding is sufficient and equitably allocated. However, the norms and standards referenced in the study were published in 2000, so updated norms and standards are needed before increased funding or reallocation can be considered. Government has recently taken steps to improve the functioning of primary healthcare clinics through the ideal clinic initiative. The conditional health grants – together with departmental budgets – are being aligned with this initiative. A reengineering of primary healthcare is also envisaged as part of the national health insurance reforms, with emphasis shifting from a curative to a preventative approach. Government continues to commit funds in this regard. For example, indirect *national health grant* (national health insurance component) funds will be used to test contracting with health professionals in the 10 national health insurance pilot districts.

Chapter 6: Impact of fiscal expenditure on food security

Better enforcement of agricultural grant conditions

The FFC recommends that, "The Department of Agriculture, Forestry and Fisheries strengthens its ability to enforce the conditions in the grant framework to ensure better oversight of provinces, so that spending and performance of the agricultural conditional grants can be improved. The Commission suggests that norms and standards be developed to assess the performance of provinces and five-year evaluations of conditional grants be institutionalised."

Government response

Government agrees that norms and standards should be developed to assess provincial performance. Regarding the institutionalisation of the evaluation of agricultural conditional grants, government (via the Department of Planning, Monitoring and Evaluation) is reviewing the *comprehensive agricultural support programme grant*'s performance. The review report will be used as a basis to institutionalise evaluation processes.

Review agricultural grants

The FFC recommends that, "The terms of reference for the committee to review the agricultural conditional grants are finalised without unnecessary delays. The review should be comprehensive in scope and should include assessing the value chain of conditional grants and unlocking operational constraints, especially in relation to planning, procurement, comprehensive smallholder support, cash-flow and monitoring and evaluation. Stakeholders such as the Department of Rural Development and Land Reform should be invited to be part of the committee, and ways to streamline the funding overlap between the *Ilima/Letsema projects grant* and the recapitalisation and development programme should be examined."

Government response

Government agrees with the recommendation that this work is a priority and that overlaps between grants are to be avoided. The Department of Agriculture, Forestry and Fisheries, the National Treasury and the Department of Rural Development and Land Reform are discussing ways to streamline existing overlaps in provincial grants.

Chapter 8: Improving public transport for better mobility

Develop a transport subsidy framework

The FFC recommends that, "The Department of Transport (the custodian of national transport policy) formulates and implements a transport subsidy framework, which explicitly incorporates social welfare, service productivity and environmental management, which are the three aspects endorsed by national transport policy."

Further discussions with the FFC led to the clarification that this recommendation should be read as: "The development of a transport subsidy framework is crucial to effectively guiding the allocation of transport conditional grants. The FFC study found that the existing public transport grants perpetuate the fragmented transport planning processes and are not effective in achieving the goal of integrated public transport. Therefore the consolidation of transport funding, allocated via the Division of Revenue Act, is required and should be driven by a new transport subsidy framework."

Government response

Government agrees that a more integrated approach to funding public transport and a transport subsidy framework is required. It has begun taking steps in this regard – in the 2015 division of revenue, two of the municipal public transport grants have been consolidated into a single grant and the framework for this new *public transport network grant* includes a commitment for the national Department of Transport to develop a draft public transport subsidy framework. The City Support Programme in the National Treasury has undertaken to assist the Department of Transport in this regard.

Chapter 11: The impact of demarcations on municipal finances

Demarcation grant to affected municipalities

The FFC recommends that, "For every vertically decided demarcation process, government bears the transitional costs of the restructuring. A transitional demarcation grant should be awarded to the amalgamated municipality. This grant should be temporary and be awarded over at least three years (at least a year before, the year of and the year after demarcation takes place). The purpose of the grant will be to facilitate the restructuring process. This includes the following:

a. Planning and preparing an amalgamated municipality's delivery model, e.g. combining the delivery models of individual municipalities.
b. Rationalising and harmonising policy regimes, integrated development plans and bylaws of different municipalities.
c. Rationalising tariffs.
d. Rationalising employment policies and other human resources systems (grading of workers and job evaluation processes).
e. Rationalising and harmonising evaluation rolls and asset registers.
f. Building capacity to deal with change management.
g. Facilitating communication about the demarcation."

Government response

Government agrees that major boundary changes can be costly for affected municipalities. The Select Committee on Appropriations has also recommended in its report on the 2014 Division of Revenue Bill that funding be allocated to provide for these costs. As such, government is proposing a *municipal demarcation transition grant* for the demarcation changes that will come into effect after the 2016 local government elections. Rather than unconditionally funding every cost associated with changed demarcations, government proposes that the following principles should be applied:

a. Only major re-demarcations should be eligible for funding (for example, amalgamations).
b. Only administrative costs directly related to the change in demarcations can be funded (for example, upgrading service levels should not qualify).
c. A differentiated approach should be applied, so that municipalities with larger own-revenue capacity are expected to fund more of the re-demarcation costs themselves.
d. Benefits and efficiencies that can be gained as a result of the new demarcations should also be taken into account in determining allocations for support.
e. Funds should be allocated for a maximum of one year before the boundary change (for planning and preparation costs only) and for two years following the change.

Government has consulted relevant stakeholders and used research by the FFC and SALGA to assist in the costing of such a grant. Based on this research and the above principles, government has introduced a grant worth R139 million over the MTEF period, with R39 million transferred in 2015/16 to 21 municipalities for preparatory costs. In 2016/17 and 2017/18, R50 million per year will be transferred to the 10 new municipalities.

Part 4: Provincial allocations

Sections 214 and 227 of the Constitution require that an equitable share of nationally raised revenue be allocated to provincial government to enable it to provide basic services and perform its allocated functions.

National transfers to provinces increase from R439.7 billion in 2014/15 to R468.2 billion in 2015/16. Over the MTEF period, provincial transfers will grow at an average annual rate of 6.2 per cent to R526.4 billion in 2017/18. Table W1.6 sets out the total transfers to provinces for 2015/16. A total of R382.7 billion is allocated to the provincial equitable share and R85.5 billion to conditional grants, which includes an unallocated R100 million for the *provincial disaster grant*, but excludes indirect transfers of R3.5 billion.

Table W1.6 Total transfers to provinces, 2015/16

R million	Equitable share	Conditional grants	Total transfers
Eastern Cape	54 312	10 060	**64 372**
Free State	21 757	6 609	**28 367**
Gauteng	73 413	17 123	**90 537**
KwaZulu-Natal	82 254	16 881	**99 135**
Limpopo	45 377	6 742	**52 120**
Mpumalanga	31 030	6 851	**37 881**
Northern Cape	10 138	3 665	**13 803**
North West	26 151	6 942	**33 093**
Western Cape	38 242	10 507	**48 749**
Unallocated	–	103	**103**
Total	**382 673**	**85 485**	**468 159**

Source: National Treasury

Changes to provincial allocations

The baseline reductions discussed in Chapter 5 of the *Budget Review* were shared across the three spheres of government in proportion to the division of revenue. In 2015/16, provincial baselines are reduced by R4.4 billion compared to indicative figures published in the 2014 Budget. To protect basic services funded by the provincial equitable share, such as health and education, only 60 per cent (R2.6 billion) of this reduction was taken from the equitable share, despite its accounting for over 80 per cent of transfers to provinces. The remaining 40 per cent (R1.8 billion) of this reduction came from provincial conditional grants, although two grants that fund essential services (the *national school nutrition programme grant* and the *comprehensive HIV and Aids grant*) and two small grants (the *occupational-specific dispensation for education sector therapists* and the *substance abuse treatment grant*) were not reduced. The reduction that would have been made on these grants was offset by reprioritising funds from the indirect *school infrastructure backlogs grant* and the *national health grant*. As a result of these baseline reductions, the provincial equitable share baseline was reduced by 0.7 per cent and most conditional grants were reduced by 2.1 per cent in 2015/16. Many of the grants with reduced baselines have a history of underspending, so the impact on service delivery should be minimised if spending patterns improve. The amount reduced on each grant is detailed in Table W1.7.

Table W1.7 Baseline reductions to provincial allocations, as announced in the 2014 MTBPS

R million	2015/16	2016/17
Provincial equitable share	**-2 631**	**-3 960**
Direct conditional grants	**-1 496**	**-2 248**
Agriculture, Forestry and Fisheries	**-50**	**-74**
Comprehensive agricultural support programme	-37	-55
Ilima/Letsema projects	-11	-16
Land care programme: poverty relief and infrastructure development	-2	-2
Arts and Culture	**-30**	**-44**
Community library services	-30	-44
Basic Education	**-228**	**-339**
Education infrastructure	-214	-319
HIV and AIDS (life skills education)	-5	-8
Maths, science and technology	-8	-12
National school nutrition programme	–	–
Occupational-specific dispensation for education sector therapists	–	–
Cooperative Governance and Traditional Affairs	**-3**	**-4**
Provincial disaster	-3	-4
Health	**-417**	**-616**
Comprehensive HIV and AIDS	–	–
Health facility revitalisation	-123	-180
Health professions training and development	-54	-81
National tertiary services	-238	-353
National health insurance	-2	-2
Higher Education and Training	**–**	**–**
Further education and training colleges	–	–
Human Settlements	**-411**	**-641**
Human settlements development	-411	-641
Public Works	**-14**	**-25**
Expanded public works programme integrated grant for provinces	-6	-10
Social sector expanded public works programme incentive for provinces	-8	-15
Social Development	**–**	**–**
Substance abuse treatment	–	–
Sport and Recreation South Africa	**-13**	**-18**
Mass participation and sport development	-13	-18
Transport	**-332**	**-488**
Provincial roads maintenance	-219	-320
Public transport operations	-113	-168
Indirect transfers	**-257**	**-392**
Basic Education	**-121**	**-176**
School infrastructure backlogs	-121	-176
Health	**-137**	**-216**
National health	-137	-216
Total	**-4 385**	**-6 600**

Source: National Treasury

In addition to these baseline reductions, there were also several other reprioritisations and technical changes to conditional grants during the budget process that will be implemented over the 2015 MTEF period. These are shown in Table W1.8.

Table W1.8 Revisions to baseline provincial allocations, 2015/16 – 2017/18

R million	2015/16	2016/17	2017/18	2015 MTEF
Technical revisions	**-5 723**	**-6 044**	**-6 356**	**-18 123**
Provincial equitable share	**-2 663**	**-2 814**	**-2 957**	**-8 435**
Function shifts to the national Department of Higher Education	-2 215	-2 343	-2 460	-7 018
Function shift to the national Department of Health (Port Health Services)	-118	-127	-136	-380
Funding shift to the national Department of Health (National Health Laboratory Services)	-330	-345	-362	-1 037
Direct conditional grants	**-2 776**	**-3 149**	**-3 364**	**-9 289**
Education Infrastructure	262	55	–	317
Comprehensive HIV and AIDS (NHLS funding shift)	-220	-230	-241	-691
Further education and training colleges (function shift)	-2 819	-2 974	-3 123	-8 915
Indirect transfers	**-284**	**-80**	**-35**	**-399**
National health	-22	-25	-35	-82
Schools infrastructure backlog	-262	-55	–	-317
Additions to baseline	**334**	**410**	**404**	**1 148**
Direct transfers	**334**	**410**	**404**	**1 148**
Health facility revitalisation	10	–	–	10
Human settlements development	161	195	134	491
Provincial roads maintenance	163	215	270	648
Reductions to baseline	**-4 444**	**-6 500**	**-316**	**-11 259**
Provincial equitable share	**-2 631**	**-3 960**	**–**	**-6 591**
Impact of reductions to provincial equitable share baseline announced in 2014 MTBPS	-2 631	-3 960	–	-6 591
Direct transfers	**-1 744**	**-2 481**	**-241**	**-573**
Impact of reductions to conditional grant baseline announced in 2014 MTBPS (see detail in Table W1.7)	-1 496	-2 248	–	-3 744
Maths, science and technology	-5	-5	-6	-16
Provincial disaster grant	-99	-100	-100	-299
Human settlements development	-80	-80	-80	-240
Social sector expanded public works programme incentive grant for provinces	-19	–	–	-19
Provincial roads maintenance	-46	-49	-55	-149
Indirect transfers	**-69**	**-59**	**-75**	**-203**
Impact of reductions to conditional grant baseline announced in 2014 MTBPS (see detail in Table W1.7)	-257	-392	–	-650
National health	-65	-54	-71	-190
School infrastructure backlogs	-4	-4	-5	-13
Total changes to provincial allocations				
Changes to provincial equitable share	-5 294	-6 774	-2 957	-15 026
Changes to direct conditional grants	-4 186	-5 221	-3 200	-12 607
Changes to indirect conditional gramts	-353	-139	-110	-602
Net change to provincial allocations	**-9 833**	**-12 133**	**-6 268**	**-28 234**

Source: National Treasury

Two function shifts and a change to the National Health Laboratory Service (NHLS) funding arrangements will also be effected over the 2015 MTEF period. The further education and training colleges and adult basic education function is shifted from provinces to the national Department of Higher Education and Training. As a result, the full value of the *further education and training colleges grant* (R8.9 billion over the MTEF period) and R7 billion from the provincial equitable share are shifted to the national department's budget. The port health function is transferred from provinces to the national Department of Health, resulting in a total of R380.4 million shifting from the provincial equitable share to the national department's budget over the MTEF period. The FFC has assessed these function shifts and the accompanying changes to provincial transfers, and the Budget Council and sector MinMECs have given their approval.

The NHLS funding arrangements are being amended so that national functions for training and research are funded directly by the national Department of Health from 2015/16, and no longer paid for through fees charged to provinces for NHLS services. To ensure this change does not affect provincial budgets, the fees charged for NHLS services will be reduced to offset the funds taken out of the provincial equitable share and the *comprehensive HIV and Aids grant*. Over the 2015 MTEF period, the provincial equitable share will be reduced by R1 billion. The *comprehensive HIV and AIDS grant* will be reduced by R691.2 million. These funds will be allocated to the national department for the NHLS's national functions. The Budget Council has agreed to this arrangement and an audit will be conducted after the first year to ensure that the change is revenue-neutral for provinces.

After accounting for the reductions and function shifts, net revisions to the provincial direct and indirect allocations amount to a reduction of R10.1 billion in 2015/16 and R12.5 billion in 2016/17.

The provincial equitable share

The equitable share is the main source of revenue for meeting provincial expenditure responsibilities. To ensure that allocations are fair, the equitable share is allocated through a formula using objective data on the context and demand for services in each of the nine provinces. The revisions due to function shifts in health and higher education and the change in NHLS funding arrangements reduce the provincial equitable share by R5.3 billion in 2015/16, R6.8 billion in 2016/17 and R3 billion in 2017/18. This brings the equitable share allocations to R382.7 billion, R405.3 billion and R428.9 billion respectively for each year of the 2015 MTEF period. These revisions result in the provincial equitable share increasing by 6.3 per cent between 2014/15 and 2015/16, and growing at an average annual rate of 6 per cent over the MTEF period.

Allocations calculated outside the equitable share formula

The equitable share includes an amount of R2.3 billion in 2015/16 that was previously part of the *devolution of property rate funds grant*. This grant, which funded provinces to pay municipal charges on provincial properties that were previously administered by national government, has been transferred as part of the provincial equitable share since 2013/14. These funds are still allocated to provinces in the same proportions as the former grant, but from 2016/17 they will be allocated using the provincial equitable share formula.

Over the 2015 MTEF period, the amounts taken out of the provincial equitable share to implement the change in the NHLS's funding arrangements will be subtracted from each province's allocation in proportion to their share of the formula's health component.

The equitable share formula

The provincial equitable share formula is reviewed and updated with new data annually. For the 2015 MTEF, the formula has been updated with data from the 2014 mid-year population estimates published by Statistics South Africa; the 2014 preliminary data published by the Department of Basic Education on school enrolment; data from the 2013 General Household Survey for medical aid coverage; and data from the health sector and the Risk Equalisation Fund for the risk-adjusted capitation index. Because the formula is largely population-driven, the allocations capture shifts in population across provinces, which results in changes in the relative demand for public services across these areas. The effect of these updates on the provincial equitable share is phased in over three years (2015/16 to 2017/18).

Full impact of data updates on the provincial equitable share

Table W1.9 shows the full impact of the data updates on the provincial equitable share per province. It compares the target shares for the 2014 and 2015 MTEF periods. The details of how the data updates affect each component of the formula are described in detail in the subsections below.

Table W1.9 Full impact of data updates on the equitable share

	2014 MTEF weighted average	2015 MTEF weighted average	Difference
Eastern Cape	14.0%	14.0%	-0.01%
Free State	5.6%	5.6%	-0.00%
Gauteng	19.5%	19.5%	0.04%
KwaZulu-Natal	21.3%	21.3%	-0.06%
Limpopo	11.8%	11.8%	-0.04%
Mpumalanga	8.2%	8.2%	0.01%
Northern Cape	2.7%	2.7%	-0.00%
North West	6.9%	6.9%	0.00%
Western Cape	10.0%	10.1%	0.06%
Total	**100.0%**	**100.0%**	**–**

Source: National Treasury

Phasing in the formula

To mitigate the effect of annual data updates on provincial equitable shares, the new shares are phased in over the three-year MTEF period. An amended phase-in mechanism was introduced for the 2014 MTEF to ensure that the weighted share of the provincial equitable share allocated to each province over the medium term closely follows the indicative shares for each year published in the previous MTEF.

The equitable share formula data is updated every year and a new target share for each province is calculated, which is shown in Table W1.10. The phase-in mechanism provides a smooth path to achieving these weighted shares by the third year of the MTEF period. It takes the difference between the target weighted share for each province at the end of the MTEF period and the indicative allocation for 2015/16 that was published in the 2014 MTEF, and closes the gap between these shares by a third in each year of the 2015 MTEF period. As a result, one-third of the impact of the data updates is implemented in 2015/16, two-thirds in the indicative allocations for 2016/17, and the updates are fully implemented in the indicative allocations for 2017/18.

Table W1.10 Implementation of the equitable share weights, 2015/16 – 2017/18

Percentage	2015/16 Indicative weighted shares from 2014 MTEF	2015/16	2016/17	2017/18
		2015 MTEF weighted shares 3-year phasing		
Eastern Cape	14.2%	14.1%	14.1%	14.0%
Free State	5.7%	5.7%	5.6%	5.6%
Gauteng	19.3%	19.3%	19.4%	19.5%
KwaZulu-Natal	21.4%	21.4%	21.3%	21.3%
Limpopo	11.9%	11.8%	11.8%	11.8%
Mpumalanga	8.2%	8.2%	8.2%	8.2%
Northern Cape	2.7%	2.7%	2.7%	2.7%
North West	6.9%	6.9%	6.9%	6.9%
Western Cape	9.9%	10.0%	10.0%	10.1%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: National Treasury

Provision for cushioning the impact of 2011 Census data updates and baseline reductions

The provincial equitable share formula was updated with 2011 Census data in 2013/14. The incorporation of new Census data for the first time in a decade resulted in significant changes to certain components of the formula. To give provinces time to adjust to their new allocations, the Census updates were phased in over three years and R4.2 billion was added as a "top-up" for provinces with declining shares over the 2013 MTEF period. This cushioning was due to come to an end in 2015/16, but it has been extended for another year to reduce the impact of the baseline reductions discussed above. The same provinces that required support for the Census reductions will experience the slowest growth in their allocations due to the baseline reductions. To prevent this, provinces agreed that R2.1 billion should be taken out of the equitable share as a whole (from all nine provinces) and allocated as cushioning to the four affected provinces for another year (2016/17). Table W1.11 shows how these funds are allocated to the Eastern Cape, the Free State, KwaZulu-Natal and Limpopo in 2015/16 and 2016/17.

Further work will be undertaken during 2015 to examine the long-term implications of the current approach to updating and phasing in the data used in the equitable share formula for the financial sustainability of provinces. The Technical Committee on Finance and the Budget Council will be consulted as part of this work.

Table W1.11 Cushioning for 2011 Census impact on provinces with declining shares in the 2015 MTEF

	2015/16	2016/17	2017/18
R thousand	**Medium-term estimates**		
Eastern Cape	685 628	685 628	–
Free State	171 261	171 261	–
Gauteng	–	–	–
KwaZulu-Natal	773 075	773 075	–
Limpopo	487 036	487 036	–
Mpumalanga	–	–	–
Northern Cape	–	–	–
North West	–	–	–
Western Cape	–	–	–
Total	**2 117 000**	**2 117 000**	**–**

Source: National Treasury

Provincial equitable share allocations

The final equitable share allocations per province for the 2015 MTEF are detailed in Table W1.12. These allocations include the full impact of the data updates, phased in over three years, as well as the cushioning and amounts determined outside of the formula, as described above.

Table W1.12 Provincial equitable share, 2015/16 – 2017/18

R million	2015/16	2016/17	2017/18
Eastern Cape	54 312	57 368	60 069
Free State	21 757	22 775	23 979
Gauteng	73 413	78 237	83 602
KwaZulu-Natal	82 254	86 885	91 430
Limpopo	45 377	48 121	50 502
Mpumalanga	31 030	32 971	35 113
Northern Cape	10 138	10 730	11 397
North West	26 151	27 676	29 493
Western Cape	38 242	40 501	43 308
Total	**382 673**	**405 265**	**428 893**

Source: National Treasury

Summary of the formula's structure

The formula, shown in Table W1.13 below, consists of six components that capture the relative demand for services between provinces and take into account specific provincial circumstances. The formula's components are neither indicative budgets nor guidelines as to how much should be spent on functions in each province or by provinces collectively. Rather, the education and health components are weighted broadly in line with historical expenditure patterns to indicate 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 2015 Budget, the formula components are set out as follows:

- An *education component* (48 per cent), based on the size of the school-age population (ages 5 to 17) and the number of learners (Grades R to 12) enrolled in public ordinary schools.
- A *health component* (27 per cent), based on each province's risk profile and health system case load.
- A *basic component* (16 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), based on income data. This component reinforces the redistributive bias of the formula.
- An *economic output component* (1 per cent), based on regional gross domestic product (GDP-R, measured by Statistics South Africa).

Table W1.13 Distributing the equitable shares by province, 2015 MTEF

	Education	Health	Basic share	Poverty	Economic activity	Institu-tional	Weighted average
	48%	**27%**	**16%**	**3%**	**1%**	**5%**	**100%**
Eastern Cape	15.1%	13.5%	12.6%	16.2%	7.5%	11.1%	14.0%
Free State	5.3%	5.4%	5.2%	5.3%	5.2%	11.1%	5.6%
Gauteng	17.7%	21.4%	23.9%	17.1%	34.7%	11.1%	19.5%
KwaZulu-Natal	22.5%	21.8%	19.8%	22.2%	15.8%	11.1%	21.3%
Limpopo	13.0%	10.4%	10.4%	13.6%	7.1%	11.1%	11.8%
Mpumalanga	8.5%	7.3%	7.8%	9.2%	7.1%	11.1%	8.2%
Northern Cape	2.3%	2.1%	2.2%	2.2%	2.2%	11.1%	2.7%
North West	6.5%	6.7%	6.8%	8.1%	6.4%	11.1%	6.9%
Western Cape	9.0%	11.3%	11.3%	6.1%	14.0%	11.1%	10.1%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: National Treasury

Education component (48 per cent)

The education component uses the school-age population (5 to 17 years), based on the 2011 Census, and enrolment data drawn from the Department of Basic Education's 2014 School Realities Survey. Each of these elements is assigned a weight of 50 per cent.

Table W1.14 shows the effect of updating the education component with new enrolment data on the education component shares.

Table W1.14 Impact of changes in school enrolment on the education component share

	Age cohort 5 – 17	School enrolment		Changes in enrolment	Weighted average		Difference in weighted average
		2013	2014		2014 MTEF	2015 MTEF	
Eastern Cape	1 856 317	1 927 081	1 916 285	-10 796	15.2%	15.1%	-0.12%
Free State	657 489	663 312	671 139	7 827	5.3%	5.3%	0.01%
Gauteng	2 231 793	2 116 391	2 178 282	61 891	17.5%	17.7%	0.16%
KwaZulu-Natal	2 758 594	2 857 959	2 865 984	8 025	22.6%	22.5%	-0.08%
Limpopo	1 536 294	1 713 696	1 719 134	5 438	13.1%	13.0%	-0.04%
Mpumalanga	1 053 846	1 049 995	1 055 243	5 248	8.5%	8.5%	-0.02%
Northern Cape	288 839	281 500	287 904	6 404	2.3%	2.3%	0.01%
North West	824 724	787 470	798 894	11 424	6.5%	6.5%	0.02%
Western Cape	1 174 625	1 048 883	1 074 161	25 278	9.0%	9.0%	0.06%
Total	**12 382 521**	**12 446 287**	**12 567 026**	**120 739**	**100.0%**	**100.0%**	**–**

Source: National Treasury

Health component (27 per cent)

The health component uses a risk-adjusted capitation index and output data from public hospitals to estimate each province's share of the health component. These methods work together to balance needs (risk-adjusted capitation) and demands (output component).

The health component is presented in three parts below. Table W1.15 shows the shares of the risk-adjusted component, which accounts for 75 per cent of the health component.

Table W1.15 Risk-adjusted sub-component shares

	Mid-year population estimates	Insured population	Risk-adjusted index	Weighted population	Risk-adjusted shares		Change
Thousand	**2014**	**2013**			**2014**	**2015**	
Eastern Cape	6 787	10.5%	96.9%	5 883	13.1%	13.4%	0.22%
Free State	2 787	17.1%	103.3%	2 385	5.4%	5.4%	0.06%
Gauteng	12 915	29.3%	105.4%	9 626	21.9%	21.9%	-0.05%
KwaZulu-Natal	10 694	13.3%	98.9%	9 170	20.9%	20.8%	-0.03%
Limpopo	5 631	9.0%	91.6%	4 695	10.7%	10.7%	-0.04%
Mpumalanga	4 229	15.6%	95.7%	3 416	7.8%	7.8%	-0.01%
Northern Cape	1 167	20.2%	100.7%	937	2.2%	2.1%	-0.06%
North West	3 676	15.6%	102.2%	3 172	7.3%	7.2%	-0.06%
Western Cape	6 116	25.7%	104.0%	4 728	10.8%	10.7%	-0.03%
Total	**54 002**			**44 013**	**100.0%**	**100.0%**	**–**

Source: National Treasury

The risk-adjusted sub-component estimates a weighted population in each province using the risk-adjusted capitation index, which is calculated using data from the Council for Medical Schemes' Risk Equalisation Fund. The percentage of the population with medical aid insurance, based on the 2013 General Household Survey, is deducted from the 2014 mid-year population estimates to estimate the uninsured population per province. The risk-adjusted index, which is an index of each province's health risk profile, is applied to the uninsured population to estimate the weighted population. Each province's share of this weighted population is used to estimate their share of the risk-adjusted sub-component. Table W1.15 shows the change in this sub-component between 2014 and 2015.

The output sub-component is shown in Table W1.16 below.

Table W1.16 Output sub-component shares

	Primary healthcare visits				Hospital workload patient-day equivalents			
	2012/13	2013/14	Average	Share	2012/13	2013/14	Average	Share
Eastern Cape	17 725	17 379	17 552	13.6%	4 523	4 572	4 548	14.1%
Free State	7 488	6 894	7 191	5.6%	1 824	1 736	1 780	5.5%
Gauteng	23 084	23 647	23 366	18.1%	6 611	6 722	6 667	20.7%
KwaZulu-Natal	31 112	31 885	31 498	24.4%	8 112	7 995	8 054	25.0%
Limpopo	14 330	14 256	14 293	11.1%	2 898	2 922	2 910	9.0%
Mpumalanga	9 056	9 143	9 100	7.1%	1 819	1 931	1 875	5.8%
Northern Cape	3 413	3 398	3 406	2.6%	514	526	520	1.6%
North West	7 890	8 047	7 969	6.2%	1 578	1 674	1 626	5.0%
Western Cape	14 859	14 308	14 584	11.3%	4 196	4 283	4 240	13.2%
Total	**128 957**	**128 957**	**128 957**	**100.0%**	**32 075**	**32 363**	**32 219**	**100.0%**

Source: National Treasury

The output sub-component uses patient load data from the District Health Information Services. The average number of visits at primary healthcare clinics in 2012/13 and 2013/14 is calculated to estimate each province's share of this part of the output component, which makes up 5 per cent of the health component. For hospitals, each province's share of the total patient-day equivalents from public hospitals in 2012/13 and 2013/14 is used to estimate their share of this part of the output sub-component, making up 20 per cent of the health component. In total, the output component is 25 per cent of the health component.

Table W1.17 shows the updated health component shares for the 2015 MTEF period.

Table W1.17 Health component weighted shares

	Risk-adjusted	Primary healthcare	Hospital component	Weighted shares		Change
Weight	**75.0%**	**5.0%**	**20.0%**	**2014**	**2015**	
Eastern Cape	13.4%	13.6%	14.1%	13.4%	13.5%	0.12%
Free State	5.4%	5.6%	5.5%	5.4%	5.4%	0.01%
Gauteng	21.9%	18.1%	20.7%	21.5%	21.4%	-0.07%
KwaZulu-Natal	20.8%	24.4%	25.0%	22.0%	21.8%	-0.14%
Limpopo	10.7%	11.1%	9.0%	10.4%	10.4%	-0.07%
Mpumalanga	7.8%	7.1%	5.8%	7.3%	7.3%	0.03%
Northern Cape	2.1%	2.6%	1.6%	2.1%	2.1%	-0.01%
North West	7.2%	6.2%	5.0%	6.8%	6.7%	-0.03%
Western Cape	10.7%	11.3%	13.2%	11.1%	11.3%	0.15%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**–**

Source: National Treasury

Basic component (16 per cent)

The basic component is derived from the proportion of each province's share of the national population. This component constitutes 16 per cent of the total equitable share. For the 2015 MTEF, population data is drawn from the 2014 Mid-Year Population Estimates produced by Statistics South Africa. Table W1.18 shows the impact on the basic component's revised weighted shares.

Table W1.18 Impact of the changes in population on the basic component shares

	Mid-year population estimates 2013	Mid-year population estimates 2014	Population change	% population change	Basic component shares 2014 MTEF	2015 MTEF	Change
Eastern Cape	6 620 100	6 786 900	166 800	2.5%	12.5%	12.6%	0.07%
Free State	2 753 200	2 786 800	33 600	1.2%	5.2%	5.2%	-0.04%
Gauteng	12 728 400	12 914 800	186 400	1.5%	24.0%	23.9%	-0.11%
KwaZulu-Natal	10 456 900	10 694 400	237 500	2.3%	19.7%	19.8%	0.07%
Limpopo	5 518 000	5 630 500	112 500	2.0%	10.4%	10.4%	0.01%
Mpumalanga	4 128 000	4 229 300	101 300	2.5%	7.8%	7.8%	0.04%
Northern Cape	1 162 900	1 166 700	3 800	0.3%	2.2%	2.2%	-0.03%
North West	3 597 600	3 676 300	78 700	2.2%	6.8%	6.8%	0.02%
Western Cape	6 016 900	6 116 300	99 400	1.7%	11.4%	11.3%	-0.03%
Total	**52 982 000**	**54 002 000**	**1 020 000**	**1.9%**	**100.0%**	**100.0%**	**–**

Source: National Treasury

Institutional component (5 per cent)

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 or the other factors included in other components. It is therefore distributed equally between provinces, constituting 5 per cent of the total equitable share, of which each province receives 11.1 per cent. This component benefits provinces with smaller populations, especially the Northern Cape, the Free State and the North West, because the allocation per person for these provinces is much higher in this component.

Poverty component (3 per cent)

The poverty component introduces a redistributive element to the formula and is assigned a weight of 3 per cent. The poor population includes people who fall in the lowest 40 per cent of household incomes in the 2010/11 Income and Expenditure Survey. The estimated size of the poor population in each province is calculated by multiplying the proportion in that province that fall into the poorest 40 per cent of South African households by the province's population figure from the 2014 Mid-Year Population Estimates. Table W1.19 shows the proportion of the poor in each province from the Income and Expenditure Survey, the 2014 Mid-Year Population Estimates and the weighted share of the poverty component per province.

Table W1.19 Comparison of current and new poverty component weighted shares

Thousand	Income and Expenditure Survey 2010/11	Current (2014 MTEF) Mid-year population estimates 2013	Poor population	Weighted shares	New (2015 MTEF) Mid-year population estimates 2014	Poor population	Weighted shares	Difference in weighted shares
Eastern Cape	52.0%	6 620	3 445	16.1%	6 787	3 531	16.2%	0.08%
Free State	41.4%	2 753	1 140	5.3%	2 787	1 154	5.3%	-0.04%
Gauteng	28.9%	12 728	3 675	17.2%	12 915	3 728	17.1%	-0.09%
KwaZulu-Natal	45.3%	10 457	4 738	22.2%	10 694	4 845	22.2%	0.06%
Limpopo	52.9%	5 518	2 917	13.6%	5 631	2 976	13.6%	0.00%
Mpumalanga	47.3%	4 128	1 951	9.1%	4 229	1 998	9.2%	0.04%
Northern Cape	40.8%	1 163	474	2.2%	1 167	476	2.2%	-0.04%
North West	47.9%	3 598	1 723	8.1%	3 676	1 761	8.1%	0.01%
Western Cape	21.9%	6 017	1 316	6.2%	6 116	1 337	6.1%	-0.02%
Total		**52 982**	**21 377**	**100.0%**	**54 002**	**21 807**	**100.0%**	**–**

Source: National Treasury

Economic activity component (1 per cent)

The economic activity component is a proxy for provincial tax capacity and expenditure assignments. Given that these assignments are a relatively small proportion of provincial budgets, the component is assigned a weight of 1 per cent. For the 2015 MTEF, 2013 GDP-R data is used. Table W1.20 shows the weighted shares of the economic activity component.

Table W1.20 Current and new economic activity component weighted shares

	Current (2014 MTEF)		New (2015 MTEF)		Difference in weighted shares
	GDP-R, 2011 (R million)	Weighted shares	GDP-R, 2012 (R million)	Weighted shares	
Eastern Cape	219 170	7.5%	234 536	7.5%	-0.04%
Free State	153 284	5.3%	162 601	5.2%	-0.07%
Gauteng	1 005 795	34.5%	1 089 535	34.7%	0.24%
KwaZulu-Natal	458 841	15.7%	496 431	15.8%	0.09%
Limpopo	207 308	7.1%	223 090	7.1%	0.00%
Mpumalanga	205 600	7.0%	222 149	7.1%	0.03%
Northern Cape	65 259	2.2%	70 203	2.2%	-0.00%
North West	189 047	6.5%	201 736	6.4%	-0.05%
Western Cape	413 235	14.2%	438 700	14.0%	-0.19%
Total	**2 917 539**	**100.0%**	**3 138 981**	**100.0%**	**–**

Source: National Treasury

Conditional grants to provinces

There are four types of provincial conditional grants:

- Schedule 4A sets out general grants that supplement various programmes partly funded by provinces
- Schedule 5A grants fund specific responsibilities and programmes implemented by provinces
- Schedule 6A grants provide in-kind allocations through which a national department implements projects in provinces
- Schedule 7A grants provide for the swift allocation and transfer of funds to a province to help it deal with a disaster.

Changes to conditional grants

Despite the baseline reductions described in Table W1.7, overall growth in direct conditional transfers to provinces is buoyant, averaging 6.9 per cent over the MTEF period. Direct conditional grant baselines total R85.5 billion in 2015/16, R91 billion in 2016/17 and R97.5 billion in 2017/18. Indirect conditional grants amount to R3.5 billion, R3.6 billion and R4 billion respectively for each year of the same period.

Table W1.21 provides a summary of conditional grants by sector for the 2015 MTEF period. More detailed information, including the framework and allocation criteria for each grant, is provided in Annexure W2 of the 2015 Division of Revenue Bill. The frameworks provide the conditions for each grant, the outputs expected, the allocation criteria used for dividing each grant between provinces, and a summary of the grant’s audited outcomes for 2013/14.

Table W1.21 Conditional grants to provinces, 2014/15 – 2017/18

R million	2014/15	2015/16	2016/17	2017/18	MTEF total
Agriculture, Forestry and Fisheries	**2 389**	**2 188**	**2 262**	**2 404**	**6 855**
Comprehensive agricultural support programme	1 861	1 651	1 702	1 809	5 162
Ilima/Letsema projects	461	471	491	522	1 484
Land care programme: poverty relief and infrastructure development	68	66	69	74	209
Arts and Culture	**1 016**	**1 311**	**1 367**	**1 453**	**4 131**
Community library services	1 016	1 311	1 367	1 453	4 131
Basic Education	**13 532**	**15 856**	**16 373**	**17 267**	**49 497**
Education infrastructure	7 327	9 518	9 774	10 331	29 622
HIV and AIDS (life skills education)	212	221	231	245	697
Maths, science and technology	319	347	362	385	1 095
National school nutrition programme	5 462	5 704	6 006	6 306	18 016
Occupational-specific dispensation for education sector therapists	213	67	–	–	67
Cooperative Governance and Traditional Affairs	**197**	**103**	**112**	**123**	**338**
Provincial disaster	197	103	112	123	338
Health	**30 164**	**31 858**	**34 338**	**37 495**	**103 692**
Comprehensive HIV and AIDS	12 102	13 737	15 467	17 440	46 644
Health facility revitalisation	5 502	5 276	5 473	5 817	16 565
Health professions training and development	2 322	2 375	2 477	2 632	7 483
National tertiary services	10 168	10 398	10 847	11 526	32 771
National health insurance	70	72	75	80	228
Human Settlements	**17 084**	**18 203**	**19 884**	**21 060**	**59 147**
Human settlements development	17 084	18 203	19 884	21 060	59 147
Public Works	**607**	**591**	**762**	**809**	**2 162**
Expanded public works programme integrated grant for provinces	349	351	402	424	1 176
Social sector expanded public works programme incentive for provinces	258	241	360	386	986
Social Development	**29**	**48**	**48**	**–**	**95**
Substance abuse treatment	29	48	48	–	95
Sport and Recreation South Africa	**526**	**537**	**561**	**596**	**1 694**
Mass participation and sport development	526	537	561	596	1 694
Transport	**14 194**	**14 790**	**15 288**	**16 281**	**46 359**
Provincial roads maintenance	9 361	9 851	10 138	10 808	30 797
Public transport operations	4 833	4 939	5 150	5 473	15 563
Total direct conditional allocations	**79 739**	**85 485**	**90 994**	**97 490**	**273 970**
Indirect transfers	**4 116**	**3 458**	**3 596**	**3 967**	**11 021**
Basic Education	**2 541**	**2 047**	**2 375**	**2 620**	**7 042**
School infrastructure backlogs	2 541	2 047	2 375	2 620	7 042
Health	**1 575**	**1 411**	**1 221**	**1 347**	**3 979**
National health	1 575	1 411	1 221	1 347	3 979

Source: National Treasury

Agriculture grants

The *comprehensive agricultural support programme* aims to support newly established and emerging farmers, particularly subsistence, smallholder and previously disadvantaged farmers. Of the grant, 70 per cent is allocated to the production of livestock and crops. The grant also aims to expand farm infrastructure and provide support for dipping, fencing and rehabilitating viable irrigation schemes. Allocations over the MTEF period include R195.7 million for the repair of flood damage to agricultural infrastructure. The baseline reduction on this grant in 2015/16 is R37.1 million. The grant is allocated R5.2 billion over the medium term.

The *land care programme grant: poverty relief and infrastructure development* aims to improve productivity and the sustainable use of natural resources. Provinces are also encouraged to use this grant to create jobs through the Expanded Public Works Programme. The baseline reduction on this grant in 2015/16 is R1.8 million. Over the medium term, R209.2 million is allocated to this grant.

The *Ilima/Letsema projects grant* aims to boost food production by helping previously disadvantaged farming communities. After the Department of Agriculture, Forestry and Fisheries has tested the new approach, it will make this grant subject to the standard operating procedure for farmer support. The baseline reduction on this grant in 2015/16 is R11 million. It is allocated R1.5 billion over the MTEF period.

Arts and culture grant

The *community library services grant*, administered by the Department of Arts and Culture, aims to help South Africans access knowledge and information to improve their socioeconomic situation. The grant is allocated to the relevant provincial department and administered by that department or through a service-level agreement with municipalities. In collaboration with provincial departments of basic education, the grant also funds dual service point libraries that serve both schools and the general public. Funds from this grant may also be used to shift the libraries function between provinces and municipalities. The baseline reduction on this grant in 2015/16 is R29.5 million, but average annual growth over the MTEF period remains strong at 12.7 per cent. The grant is allocated R4.1 billion over the next three years.

Basic education grants

Provinces use the *education infrastructure grant* to construct, maintain and refurbish education infrastructure and schools. The baseline reduction on this grant in 2015/16 is R213.9 million. The grant totals R29.6 billion over the MTEF period, which includes a ring-fenced amount of R322.1 million over the three years to repair school infrastructure damaged by natural disasters.

Infrastructure grant reforms to improve planning were introduced in 2013 after a decade of provincial capacity building through the Infrastructure Delivery Improvement Programme. Under the requirements introduced in the 2013 Division of Revenue Bill, provincial education departments had to go through a two-year planning process to be eligible to receive incentive allocations in 2015/16. The departments had to meet certain prerequisites in 2013/14 and have their infrastructure plans approved in 2014/15. The national Department of Basic Education and the National Treasury assessed the provinces' infrastructure plans. A moderation process was undertaken between the national departments, provincial treasuries and provincial departments of basic education to agree on the final scores. Provinces needed to obtain a minimum score of 60 per cent to qualify for the incentive. Table W1.22 shows the final score and incentive allocation for each province.

Table W1.22 Education infrastructure grant allocations

R million	User Asset Management Plan assessment	2015/16			Final allocation for 2015/16
		Basic component	Incentive component	Disaster recovery funds	
Eastern Cape	71%	1560	94	50	1 704
Free State	42%	763	–	–	763
Gauteng	63%	852	84	–	936
KwaZulu-Natal	64%	1870	85	24	1 979
Limpopo	43%	736	–	69	805
Mpumalanga	48%	848	–	10	857
Northern Cape	66%	359	88	–	447
North West	69%	852	92	51	995
Western Cape	81%	920	108	5	1 032
Total		**8 758**	**550**	**209**	**9 518**

Source: National Treasury

The national Department of Basic Education is reviewing the *education infrastructure grant* formula for outer-year allocations, so changes should be expected in the indicative allocations published for 2016/17 and 2017/18. Allocations for the incentive component in the outer years are shown as unallocated.

The *national school nutrition programme grant* seeks to improve the nutrition of poor school children, enhance active learning capacity and increase school attendance. It provides a free daily meal to pupils in the poorest 60 per cent of schools (quintile 1 to 3). The grant's purpose has been expanded to include deworming of learners without incurring a change in its 2015 MTEF allocations. This expansion will be funded through the grant's nutrition and food production component. The grant is allocated R18 billion over the MTEF period. The baseline has not been reduced.

The *maths, science and technology grant* has been created by merging the *Dinaledi schools grant* with the *technical secondary schools recapitalisation grant*. By combining these similar and overlapping programmes, they can be better administered and expanded to reach more schools. The new grant's baseline is the sum of the baseline allocations for the two previous grants after 1 per cent has been removed to fund improved administration of the grant at national level. The baseline reduction on this grant in 2015/16 is R8.3 million. It is allocated R1.1 billion over the 2015 MTEF period.

The *HIV and Aids (life skills education) programme grant* provides for life skills training and sexuality and HIV/AIDS education in primary and secondary schools. It is fully integrated into the school system, with learner and teacher support materials provided for Grades 1 to 9. The baseline reduction on this grant in 2015/16 is R5.3 million. It is allocated R697.2 million over the MTEF period.

The *school infrastructure backlogs grant* is an indirect grant to provinces that was introduced in 2011 as a temporary, high-impact grant. The national Department of Basic Education uses this grant to build and upgrade schools on behalf of provinces to address inappropriate structures and access to basic services. Due to the grant's lack of spending, R297 million has been reprioritised over the MTEF period to offset the impact of the baseline reductions on the *occupational-specific dispensation for education sector therapists grant*, the *further education and training colleges grant* and the *national school nutrition programme grant*. The grant is allocated R7 billion over the next three years.

The *occupational-specific dispensation for education sector therapists grant* provides funds for provinces to implement the occupation-specific dispensation agreement for therapists, counsellors and psychologists in the education sector. The grant is allocated for two years (2014/15 and 2015/16) while back-pay is being funded and new remuneration levels are normalised. No baseline reduction has been effected on this grant. From 2016/17, the funds will be allocated as part of the provincial equitable share. The grant has been allocated R67 million for its last year in 2015/16.

Cooperative governance grant

The *provincial disaster grant* is administered by the National Disaster Management Centre in the Department of Cooperative Governance and is unallocated at the start of the financial year. The grant allows for an immediate (in-year) release of funds to be disbursed by the National Disaster Management Centre after a disaster is declared, without the need for the transfers to be gazetted first. The reconstruction of infrastructure damaged by disasters is funded separately through ring-fenced allocations in sector grants. Due to past underspending on this grant, R298.5 million has been reprioritised out of the grant over the 2015 MTEF period. To ensure that sufficient funds are available in the event of a disaster, section 26 of the 2015 Division of Revenue Bill allows for funds allocated to the *municipal disaster grant* to be transferred to provinces if funds in the *provincial disaster grant* have already been exhausted, and vice versa. The bill also allows for more than one transfer to be made to areas affected by disasters so that an initial payment for emergency aid can be made before a full assessment of damages and costs has been completed. The baseline reduction on this grant in 2015/16 is R2.6 million. Over the MTEF period, R338.2 million is available for disbursement through this grant.

Health grants

The *national tertiary services grant* provides strategic funding to enable provinces to plan, modernise and transform tertiary hospital service delivery in line with national policy objectives. The grant operates in 33 hospitals across the nine provinces. The urban areas of Gauteng and the Western Cape receive the largest shares of the grant because they provide the largest proportion of high-level, sophisticated services for the benefit of the country's health sector. The baseline reduction on this grant in 2015/16 is R237.9 million. The grant is allocated R32.8 billion over the MTEF period.

The *health facility revitalisation grant* funds the construction and maintenance of health infrastructure. It was created in 2013/14 through the merger of three previous grants. The grant funds a wide range of health infrastructure projects, including large projects to modernise hospital infrastructure and equipment, general maintenance and infrastructure projects at smaller hospitals, and the refurbishment and upgrading of nursing colleges and schools. The baseline reduction on this grant in 2015/16 is R122.8 million. The grant totals R16.6 billion over the MTEF period, which includes R17.8 million ring-fenced to repair clinics damaged by natural disasters.

Similar to the reforms to the *education infrastructure grant* discussed above, a two-year planning process is now required for provinces to access this grant. The national Department of Health and the National Treasury conducted an assessment of the provinces' infrastructure plans, followed by a moderation process between the national departments, provincial treasuries and provincial departments of health to agree on the final scores. Provinces had to obtain a minimum score of 60 per cent to qualify for the incentive. Table W1.23 sets out the final score and the incentive allocation per province.

Table W1.23 Health facility revitalisation grant allocations

R million	User Asset Management Plan assessment	2015/16			Final allocation for 2015/16
		Basic component	Incentive component	Disaster recovery funds	
Eastern Cape	71%	451	139	2	592
Free State	52%	565	–	–	565
Gauteng	59%	314	–	–	314
KwaZulu-Natal	66%	1 100	129	–	1 230
Limpopo	58%	187	–	7	194
Mpumalanga	57%	287	–	1	288
Northern Cape	70%	456	137	–	594
North West	61%	569	120	7	695
Western Cape	76%	655	149	–	804
Total		**4 585**	**674**	**17**	**5 276**

Source: National Treasury

The national Department of Health is reviewing the *health facility revitalisation grant* formula for outer-year allocations, so changes should be expected in the indicative allocations for 2016/17 and 2017/18. Allocations for the incentive component in the outer years are shown as unallocated.

The *health professions training and development grant* funds the training of health professionals, and the development and recruitment of medical specialists. It enables the shifting of teaching activities from central to regional and district hospitals. The baseline reduction on this grant in 2015/16 is R53.9 million. The grant is allocated R7.5 billion over the medium term.

The *comprehensive HIV and Aids grant* supports HIV/AIDS prevention programmes and specific interventions, including voluntary counselling and testing, prevention of mother-to-child transmission, post-exposure prophylaxis, antiretroviral treatment and home-based care. In addition to substantial increases to this grant and the provincial equitable share over previous MTEF periods, no baseline reduction has been effected on this grant and R1.2 billion is added in the baseline in 2017/18 to cover the increased antiretroviral treatment take-up rate. Because funds from this grant are used to pay for a significant number of tests conducted by the NHLS, R691.2 million has been taken out of this grant over the MTEF period as part of the change in funding arrangements for the NHLS described above. This brings the baseline to R46.6 billion over the MTEF period, with average annual growth of 12.3 per cent.

The *national health insurance grant* funds the national health insurance pilots introduced in 2012/13, which aim to strengthen primary healthcare for the implementation of national health insurance. Ten districts have been selected as pilot sites to test interventions that aim to strengthen health systems and improve performance. The baseline reduction on this grant in 2015/16 is R1.9 million. Over the 2015 MTEF period, the grant has been allocated R227.6 million. This grant is complemented by the national health insurance component within the *national health grant*.

The *national health grant* is an indirect grant introduced in 2013/14, which is spent by the Department of Health on behalf of provinces. The grant has three components, one to support infrastructure projects, a second to support the national health insurance scheme pilot sites, and a third to support the rollout of the human papillomavirus vaccine. The infrastructure component will be used to accelerate construction, maintenance, upgrades and rehabilitation for new and existing health infrastructure. The second component will be used to contract general practitioners from the private sector for national health insurance sites. It will also support 10 central hospitals to strengthen their patient information systems and develop and pilot alternative hospital reimbursement tools. Funds for exploring the use of diagnostic-related groups to structure health budgets has been shifted from the national health insurance component of the indirect *national health grant* to the Department of Health’s core budget. The human papillomavirus vaccine component is allocated for two years (2014/15 and 2015/16), and will be used to support provincial health departments with the rollout of the vaccine. Funds for the vaccine have been added to the provincial equitable share in 2016/17. A total of R352.7 million was reprioritised from this grant to offset the baseline reductions that would have been effected on the *comprehensive HIV and Aids grant*. The *national health grant* is allocated R4 billion over the MTEF period.

Human settlements grant

The *human settlements development grant* seeks to establish habitable, stable and sustainable human settlements in which all citizens have access to social and economic amenities. This grant is allocated using a formula with three components:

- The first component shares 70 per cent of the total allocation between provinces in proportion to their share of the total number of households living in inadequate housing. Data from the 2011 Census is used for the number of households in each province living in informal settlements, shacks in backyards and traditional dwellings. Not all traditional dwellings are inadequate, which is why information on the proportion of traditional dwellings per province with damaged roofs and walls from the 2010 General Household Survey is used to adjust these totals so that only traditional dwellings that provide inadequate shelter are counted in the formula.
- The second component determines 20 per cent of the total allocation based on the share of poor households in each province. The number of households with an income of less than R1 500 per month is used to determine 80 per cent of the component and the share of households with an income of between R1 500 and R3 500 per month is used to determine the remaining 20 per cent. Data used in this component comes from the 2011 Census.
- The third component, which determines 10 per cent of the total allocation, is shared in proportion to the number of people in each province, as measured in the 2011 Census.

In addition to the allocations determined through the formula, a total of R3.3 billion is ring-fenced over the 2015 MTEF period to upgrade human settlements in mining towns in six provinces. These allocations respond to areas with significant informal settlement challenges, with a high proportion of economic activity based on the natural resources sector. A total of R740.1 million is also ring-fenced over the MTEF period to repair infrastructure damaged by natural disasters.

The baseline reduction on this grant in 2015/16 is R411.4 million. A further R240 million over the 2015 MTEF period has been reprioritised from the grant to the Housing Development Agency, which is expanding its mandate to include some of the planning and project development work that was previously carried out by provinces. The grant's allocation totals R59.1 billion over the medium term.

Public works grants

The *expanded public works programme integrated grant for provinces* incentivises provincial departments to use labour-intensive methods in infrastructure, environmental and other projects. Grant allocations are determined upfront based on the performance of provincial departments in meeting job targets in the preceding financial year. The baseline reduction on this grant in 2015/16 is R5.96 million. It is allocated R1.2 billion over the MTEF period.

The *social sector expanded public works programme incentive grant for provinces* rewards provinces for creating jobs in the preceding financial year in the areas of home-based care, early childhood development, adult literacy and numeracy, community safety and security, and sports programmes. The grant's allocation model incentivises provincial departments to participate in the Expanded Public Works Programme and measures the performance of each province relative to its peers, providing additional incentives to those that perform well. The baseline reduction on this grant in 2015/16 is R8 million. The grant is allocated R985.8 million over the MTEF period.

Social development grant

The *substance abuse treatment grant* aims to build public substance abuse treatment facilities in the four provinces that do not already have such facilities: the Eastern Cape, the Free State, the Northern Cape and the North West. The grant is administered by the Department of Social Development and is expected to run for two more years before it is incorporated into the provincial equitable share in 2017/18. The grant has adopted the processes implemented for the *education infrastructure grant* and the *health facility revitalisation grant* to streamline the process of planning and building these facilities, although the allocation criteria for the grant remains unchanged. No baseline reduction has been effected on this grant. It has been allocated R95 million over the 2015 MTEF period.

Sport and recreation South Africa grant

The *mass participation and sport development grant* aims to increase and sustain mass participation in sport and recreational activities in the provinces, with greater emphasis on provincial and district academies. The baseline reduction on this grant in 2015/16 is R12.5 million. It is allocated R1.7 billion over the MTEF period.

Transport grants

The *public transport operations grant* subsidises commuter bus services. It supports provinces to ensure that contractual obligations are met and services are efficiently provided. The public transport contracting and regulatory functions may be assigned to certain metropolitan municipalities during 2015/16. If this takes place, funds for this grant will be transferred directly to the assigned municipality. The baseline reduction on this grant in 2015/16 amounted to R113.3 million. The grant is allocated R15.6 billion over the MTEF period.

The *provincial roads maintenance grant* consists of three components. The largest component enables provinces to expand their maintenance activities. The other components allow provinces to repair roads damaged by floods and rehabilitate roads that are heavily used in support of electricity production. Grant allocations are determined using a formula based on provincial road networks, road traffic and weather conditions. These factors reflect the different costs of maintaining road networks in each province. The grant requires provinces to follow best practices for planning and to use and regularly update road asset management systems.

In future the grant will be allocated based on performance. The model's indicators – vehicle operating costs and remaining asset lifespan – have been finalised and the performance component will inform future grant allocations. An amount of R149 million has been reprioritised out of this grant over the 2015 MTEF period in anticipation of the transfer of the R573 Moloto Road from provinces to SANRAL. The agency will perform urgent upgrades to improve the road's safety as part of its non-tolled network once the provincial governments in Gauteng, Mpumalanga and Limpopo formally transfer the road. The baseline reduction on this grant in 2015/16 is R219.1 million. The total allocation for the MTEF period is R30.8 billion, including ring-fenced allocations of R1 billion for the repair of infrastructure damaged by floods.

Part 5: Local government fiscal framework and allocations

The local government fiscal framework responds to the constitutional assignment of powers and functions to this sphere of government. The framework refers to all resources available to municipalities to meet their expenditure responsibilities. National transfers account for a relatively small proportion of the local government fiscal framework, with the majority of local government revenues being raised by municipalities themselves through their substantial revenue-raising powers, including property rates and service charges. However, the proportion of revenue from transfers and own revenues varies dramatically across municipalities, with poor rural municipalities receiving most of their revenue from transfers, while urban municipalities raise the majority of their own revenues. This differentiation in the way municipalities are funded will continue in the period ahead.

The 2015 MTEF does not significantly alter the structure of transfers to local government. Instead, it makes several small changes as part of the ongoing policy reforms and baseline reductions outlined in the 2014 *Medium Term Budget Policy Statement*. Despite the reductions, allocations to municipalities continue to grow in real terms, with significant growth in water and sanitation and electricity grants. This emphasis on basic services aligns with the back-to-basics approach to local government announced by the Minister of Cooperative Governance in 2014. The local government fiscal framework as a whole – including all transfers and own revenues – is structured to support the achievement of the National Development Plan's goals.

The first phase of the review of local government infrastructure grants is complete and its outcomes have begun to be implemented. The recommendation to rationalise grants, for example, has led to the consolidation of two public transport grants to cities. Elsewhere, the emphasis on enhanced life-cycle asset management is reflected in new conditions allowing certain grant funds to be used for refurbishment. Planned changes to individual conditional grants over the 2015 MTEF period are discussed in detail below and more extensive reforms will follow the second phase of the review.

This section outlines the transfers made to local government and how these funds are distributed between municipalities. Funds raised by national government are transferred to municipalities through conditional and unconditional grants. National transfers to municipalities are published to enable them to plan fully for their 2015/16 budgets, and to promote better accountability and transparency by ensuring that all national allocations are included in municipal budgets.

Transfers to local government

Over the 2015 MTEF period, R313.7 billion will be transferred directly to local government and a further R31.9 billion has been allocated to indirect grants. Direct transfers to local government in 2015/16 account for 9.1 per cent of national government's non-interest expenditure. When indirect transfers are added to this, total spending on local government increases to 10 per cent of national non-interest expenditure.

Table W1.24 Transfers to local government, 2011/12 – 2017/18

R million	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
		Outcome		Revised estimate	Medium-term estimates		
Direct transfers	**68 251**	**76 430**	**82 836**	**89 076**	**99 753**	**103 936**	**110 017**
Equitable share and related	**33 173**	**37 139**	**38 964**	**43 290**	**50 208**	**52 869**	**55 512**
Equitable share formula[1]	29 289	32 747	34 268	38 210	45 052	47 419	49 794
RSC levy replacement	3 544	3 733	3 930	4 146	4 337	4 567	4 795
Support for councillor remuneration and ward committees	340	659	766	935	819	883	923
General fuel levy sharing	**8 573**	**9 040**	**9 613**	**10 190**	**10 659**	**11 224**	**11 785**
Conditional grants	**26 505**	**30 251**	**34 258**	**35 595**	**38 887**	**39 844**	**42 720**
Infrastructure	24 643	27 923	31 991	33 345	36 440	37 254	39 911
Capacity building and other	1 862	2 329	2 267	2 250	2 447	2 590	2 809
Indirect transfers	**2 660**	**4 548**	**5 523**	**8 536**	**10 395**	**10 634**	**10 916**
Infrastructure	2 541	4 548	5 523	8 536	10 395	10 634	10 916
Capacity building and other	119	–	–	–	–	–	–
Total	**70 911**	**80 978**	**88 359**	**97 612**	**110 149**	**114 570**	**120 933**

1. Outcome figures for the equitable share reflect amounts transferred after funds have been withheld to offset underspending by municipalities on conditional grants

Source: National Treasury

Changes to local government allocations

Direct transfers to local government will grow at an annual average rate of 7.3 per cent over the 2015 MTEF period. As discussed in Chapter 5 of the *Budget Review*, a reduced expenditure ceiling is being applied proportionately across all three spheres of government. No reductions are made to the local government equitable share, which continues to experience substantial growth in real terms in 2015/16. This protects the main source of funding for free basic services in municipalities. All conditional grants have been reduced by between 0.9 per cent and 5.5 per cent of each grant's baseline allocation in 2015/16, with larger reductions on slow-spending grants and non-infrastructure grants. Grant administrators and municipalities should be able to absorb the impact of these reductions without having to reduce planned outputs. Achieving this will require greater efficiency in spending. Details of each conditional grant's reductions are provided in Table W1.25.

Table W1.25 Baseline reductions to local government allocations announced in the 2014 MTBPS

R million	2015/16	2016/17
	Medium-term estimates	
Infrastructure conditional grants	**-623**	**-1 000**
Municipal infrastructure	-142	-219
Municipal water infrastructure	-76	-116
Urban settlements development	-100	-156
Integrated national electrification programme	-76	-129
Public transport network	-188	-304
Neighbourhood development partnership	-22	-38
Integrated city development	-15	-26
Rural roads asset management systems	-1	-1
Rural households infrastructure	-3	-11
Capacity building and other conditional grants	**-297**	**-370**
Municipal systems improvement	-10	-16
Local government financial management	-17	-29
Municipal human settlements capacity	-200	-200
Water services operating subsidy	-17	-29
Expanded public works programme	-23	-42
Infrastructure skills development	-5	-8
Energy efficiency and demand-side management	-10	-18
Municipal disaster	-15	-26
Total reduction to baseline	**-921**	**-1 370**

Source: National Treasury

In addition to the baseline reductions discussed above, several other reprioritisations and changes to the structure of conditional grants were agreed to during the budget process. These are summarised in Table W1.26.

Table W1.26 Revisions to direct and indirect transfers to local government, 2015/16 – 2017/18

R million	2015/16	2016/17	2017/18	2015 MTEF Total revisions
Technical adjustments	**–**	**–**	**–**	**–**
Direct transfers	**529**	**30**	**22**	**581**
Municipal water infrastructure	500	–	–	500
Neighbourhood development partnership	29	30	22	81
Indirect transfers	**-529**	**-30**	**-22**	**-581**
Municipal water infrastructure	-500	–	–	-500
Neighbourhood development partnership	-29	-30	-22	-81
Additions to baselines	**906**	**890**	**1 050**	**2 846**
Direct transfers	**206**	**190**	**550**	**946**
Municipal demarcation transition	39	50	50	139
Municipal disaster recovery	167	140	–	307
Municipal water infrastructure	–	–	500	500
Indirect transfers	**700**	**700**	**500**	**1 900**
Regional bulk infrastructure	700	700	–	1 400
Municipal water infrastructure	–	–	500	500
Reductions to baseline	**-1 096**	**-1 569**	**-223**	**-2 887**
Direct transfers	**-1 029**	**-1 470**	**-100**	**-2 599**
Impact of reductions to baseline announced in 2014 MTBPS (see detail in Table W1.25)	**-921**	**-1 370**	**–**	**-2 291**
Municipal disaster	-100	-100	-100	-300
Expanded public works programme integrated grant for municipalities	-8	–	–	-8
Indirect transfers	**-67**	**-99**	**-123**	**-288**
Integrated national electrification programme	-67	-99	-123	-288
Total change to local government allocations				
Change to direct transfers	-294	-1 250	472	-1 072
Change to indirect transfers	104	571	355	1 031
Net change to local government allocations	**-190**	**-679**	**827**	**-41**

Source: National Treasury

An addition of R2.4 billion has been made to the *municipal water infrastructure grant* and the *regional bulk infrastructure grant* over the MTEF period to accelerate the provision of basic water supply to all households and improve the state of water services infrastructure nationwide. A new grant of R139 million will subsidise the additional institutional and administrative costs arising from municipal mergers due to come into effect at the time of the 2016 local government elections, as announced by the Municipal Demarcation Board.

Other changes to local government allocations are more technical and reflect the shift of funds between direct and indirect grants, and the impact of the national macro-organisation of the state that followed the 2014 national elections. For example, the sanitation function, including all sanitation-related grants, has shifted from the Department of Human Settlements to the Department of Water and Sanitation.

After accounting for all reductions and additions, direct transfers decrease by a net amount of R1.1 billion over the medium term when compared to the indicative baseline published in the 2014 Budget. Indirect transfers to local government (allocations spent by national departments on behalf of municipalities) increase by R1 billion over the MTEF period, bringing the net decrease in local government allocations to R41 million. Despite this small baseline reduction, total allocations to local government will experience above-inflation growth over the MTEF period, increasing by R12.5 billion in 2015/16 alone.

The local government equitable share

In terms of section 227 of the Constitution, local government is entitled to an equitable share of nationally raised revenue to enable it to provide basic services and perform its allocated functions. The local government equitable share is an unconditional transfer that supplements the revenue that municipalities can raise themselves (including property rates and service charges). The equitable share provides funding for municipalities to deliver free basic services to poor households and subsidises the cost of administration and other core services for those municipalities that have the least potential to cover these costs from their own revenues.

Over the 2015 MTEF period, the local government equitable share, including the *RSC/JSB levies replacement grant* and *special support for councillor remuneration and ward committees*, amounts to R158.6 billion – R50.2 billion in 2015/16, R52.9 billion in 2016/17, and R55.5 billion in 2017/18.

Formula for allocating the local government equitable share

The share of national revenue allocated to local government through the equitable share is determined in the national budget process and endorsed by Cabinet (the vertical division). Local government's equitable share is divided among the country's 278 municipalities using a formula (the horizontal division) to ensure objectivity.

A new formula for the local government equitable share was introduced in 2013/14, following a review of the previous formula by the National Treasury, the Department of Cooperative Governance and SALGA, in partnership with the FFC and Statistics South Africa. The new formula is based on data from the 2011 Census, which resulted in major changes to some allocations. As a result, new allocations are being phased in over a five-year period, ending in 2017/18. The local government equitable share formula's principles and objectives were set out in detail in the Explanatory Memorandum to the 2013 Division of Revenue.

Structure of the local government equitable share formula

The formula uses demographics and other data to determine each municipality's share of the local government equitable share. It has three parts, made up of five components:

- The first part of the formula consists of the *basic services* component, which provides for the cost of free basic services for poor households.
- The second part enables municipalities with limited resources to afford basic administrative and governance capacity, and perform core municipal functions. It does this through three components:
  - The *institutional component* provides a subsidy for basic municipal administrative costs.
  - The *community services component* provides funds for other core municipal services not included under basic services.
  - The *revenue adjustment factor* ensures that funds from this part of the formula are only provided to municipalities with limited potential to raise their own revenue. Municipalities that are least able to fund these costs from their own revenues should receive the most funding.
- The third part of the formula provides predictability and stability through the *correction and stabilisation factor*, which ensures that all of the formula's guarantees can be met.

Each of these components is described in detail in the subsections that follow. The formula's structure is summarised in the box.

Structure of the local government equitable share formula

$$LGES = BS + (I + CS) \times RA \pm C$$

where

LGES is the local government equitable share

BS is the basic services component

I is the institutional component

CS is the community services component

RA is the revenue adjustment factor

C is the correction and stabilisation factor

The basic services component

This component helps municipalities provide free basic water, sanitation, electricity and refuse removal services to households that fall below an affordability threshold. Following municipal consultation, the formula's affordability measure (used to determine how many households need free basic services) is based on the level of two state old age pensions. When the 2011 Census was conducted, the state old age pension was worth R1 140 per month, which means that two old age pensions were worth R2 280 per month. A monthly household income of R2 300 per month (in 2011) has therefore been used to define the formula's affordability threshold. Statistics South Africa has calculated that 59 per cent of all households in South Africa fall below this income threshold. The threshold is not an official poverty line or a required level to be used by municipalities in their own indigence policies – if municipalities choose to provide fewer households with free basic services than they are funded for through the local government equitable share, then their budget documentation should clearly set out why they have made this choice and how they have consulted with their community during the budget process.

The number of households per municipality, and the number below the poverty threshold, is updated annually based on the growth experienced in the period between the 2001 and 2011 Censuses. Provincial growth rates are then rebalanced to match the average annual provincial growth reported between 2002 and 2013 in the annual General Household Survey. Statistics South Africa has advised the National Treasury that, in the absence of official municipal household estimates, this is a credible method of estimating the household numbers per municipality needed for the formula. Statistics South Africa is researching methods for producing municipal-level data estimates, which may be used to inform equitable share allocations in future.

The basic services component provides a subsidy of R313.76 per month in 2015/16 for the cost of providing basic services to each of these households. The subsidy includes funding for the provision of free basic water (6 kilolitres per poor household per month), energy (50 kilowatt-hours per month) and sanitation and refuse (based on service levels defined by national policy). The monthly amount provided for each service is detailed in Table W1.27 and includes an allocation of 10 per cent for service maintenance costs.

Table W1.27 Amounts per basic service allocated through the local government equitable share

	Allocation per household below affordability threshold (Rands per month)			Total allocation per service (R millions)
	Operations	Maintenance	Total	
Energy	59.57	6.62	66.19	7 122
Water	89.77	9.97	99.75	10 732
Sanitation	72.37	8.04	80.41	8 651
Refuse	60.67	6.74	67.41	7 252
Total basic services	**282.38**	**31.38**	**313.76**	**33 757**

Source: National Treasury

The formula uses the fairest estimates of the average costs of providing each service that could be derived from available information. More details of how the costs were estimated can be found in the discussion paper on the proposed structure of the new local government equitable share formula (available at: http://mfma.treasury.gov.za/Media_Releases/LGESDiscussions/Pages/default.aspx).

The per household allocation for each of the basic services in Table W1.27 is updated annually based on the following:

- The electricity cost estimate is made up of bulk and other costs. Bulk costs are updated based on the multi-year price determination approved by the National Energy Regulator of South Africa (NERSA). In October 2014, NERSA granted Eskom a 12.69 per cent increase in electricity prices in 2015/16, which has been factored into the equitable share's cost estimate. Bulk electricity prices for 2016/17 and 2017/18 are based on NERSA's approved multi-year price determination increase of 8 per cent per year. If NERSA approves further increases, the revised amounts will be taken into account in future formula updates. Other electricity costs are updated based on the National Treasury's inflation projections in the 2014 *Medium Term Budget Policy Statement*.
- The water cost estimate is also made up of bulk and other costs. Bulk costs are updated based on the weighted average increase in bulk tariffs charged by water boards (although not all municipalities purchase bulk water from water boards, their price increases serve as a proxy for the cost increases for all municipalities). The approved weighted average tariff increase for bulk water from water boards in 2014/15 was 8.3 per cent. Other costs are updated based on the National Treasury's inflation projections in the 2014 *Medium Term Budget Policy Statement*.
- The costs for sanitation and refuse are updated based on the National Treasury's inflation projections in the 2014 *Medium Term Budget Policy Statement*.

The basic services component allocation to each municipality is calculated by multiplying the monthly subsidy per household by the updated number of households below the affordability threshold in each municipal area.

The basic services component

BS = basic services subsidy x number of poor households

Funding for each basic service is allocated to the municipality (metro, district or local) that is authorised to provide that service. If another municipality provides a service on behalf of the authorised municipality, it must transfer funds to the provider in terms of section 29 of the Division of Revenue Act. The basic services component is worth R33.8 billion in 2015/16 and accounts for 74.9 per cent of the value of the local government equitable share.

The institutional component

To provide basic services to households, municipalities need to be able to run a basic administration. Most municipalities should be able to fund the majority of their administration costs with their own revenue. But, because poor households are not able to contribute in full, the equitable share includes an institutional support component to help meet some of these costs. To ensure that this component supports municipalities with limited own-revenue-raising abilities, a revenue adjustment factor is applied so that a larger proportion of the allocation is received by municipalities with less potential to raise their own revenue. The revenue adjustment factor is described in more detail later in this annexure.

This component consists of a base allocation of R5.6 million, which goes to every municipality, and an additional amount that is based on the number of council seats in each municipality. This reflects the relative size of a municipality's administration and is not intended to fund the costs of councillors only (the number of seats recognised for the formula is determined by the Minister of Cooperative Governance and Traditional Affairs). The base component acknowledges that there are some fixed costs that all municipalities face.

The institutional component

*I = base allocation + [allocation per councillor * number of council seats]*

The institutional component accounts for 10 per cent of the equitable share formula and is worth R4.5 billion in 2015/16. This component is also complemented by special support for councillor remuneration in poor municipalities, which is not part of the equitable share formula (described in more detail later).

The community services component

This component funds services that benefit communities rather than individual households (which are provided for in the basic services component). It includes funding for municipal health services, fire services, municipal roads, cemeteries, planning, storm water management, street lighting and parks. To ensure this component assists municipalities with limited own-revenue-raising abilities, a revenue adjustment factor is applied so that these municipalities receive a larger proportion of the allocation.

The allocation for this component is split between district and local municipalities, because both provide community services. In 2015/16, the allocation to district and metropolitan municipalities for municipal health and related services is R7.81 per household per month. The component's remaining funds are allocated to local and metropolitan municipalities based on the number of households in each municipality.

The community services component

CS = [municipal health and related services allocation x number of households] + [other services allocation x number of households]

The community services component accounts for 15 per cent of the equitable share formula and is worth R6.8 billion in 2015/16.

The revenue adjustment factor

The Constitution gives local government substantial own-revenue-raising powers (particularly through property rates and surcharges on services). Municipalities are expected to fund most of their own administrative costs and cross-subsidise some services for indigent residents. Given the varied levels of poverty across South Africa, the formula does not expect all municipalities to be able to generate similar amounts of own revenue. A revenue adjustment factor is applied to the institutional and community services components of the formula to ensure that these funds assist municipalities that are least likely to be able to fund these functions from their own revenues.

To account for the varying fiscal capacities of municipalities, this component is based on a per capita index using the following factors from the 2011 Census:

- Total income of all individuals/households in a municipality (as a measure of economic activity and earning)
- Reported property values
- Number of households on traditional land
- Unemployment rate
- Proportion of poor households as a percentage of the total number of households in the municipality.

Based on this index, municipalities were ranked according to their per capita revenue-raising potential. The top 10 per cent of municipalities have a revenue adjustment factor of zero, which means that they do not receive an allocation from the institutional and community services components. The 25 per cent of municipalities with the lowest scores have a revenue adjustment factor of 100 per cent, which means that they receive their full allocation from the institutional and community services components. Municipalities between the bottom 25 per cent and top 10 per cent have a revenue adjustment factor applied on a sliding scale, so that those with higher per capita revenue-raising potential receive a lower revenue adjustment factor and those with less potential receive a larger revenue adjustment factor.

The revenue adjustment factor is not based on the actual revenues municipalities collect. This component therefore does not create any perverse incentive for municipalities to under-collect potential own revenues to receive a higher equitable share.

Because district municipalities do not collect own revenues from property rates, the revenue adjustment factor applied to these municipalities is based on the *RSC/JSB levies replacement grant* allocations. This grant replaces a source of own revenue previously collected by district municipalities and it is still treated as an own-revenue source in many respects. Similar to the revenue adjustment factor for local and metropolitan municipalities, the factor applied to district municipalities is based on their per capita *RSC/JSB levies replacement grant* allocations. District municipalities are given revenue adjustment factors on a sliding scale – those with a higher per capita *RSC/JSB levies replacement grant* allocation receive a lower revenue adjustment factor, while those with lower allocations receive a larger revenue adjustment factor.

Correction and stabilisation factor

Providing municipalities with predictable and stable equitable allocations is one of the principles of the equitable share formula. Indicative allocations are published for the second and third years of the MTEF period to ensure predictability. To provide stability for municipal planning, while giving national government flexibility to account for overall budget constraints and amend the formula, municipalities are guaranteed to receive at least 90 per cent of the indicative allocation for the middle year of the MTEF period.

A new equitable share formula was introduced in 2013/14 using updated 2011 Census data. As a result, some municipalities will experience large changes in their equitable share allocations. To smooth the impact of these changes and give municipalities time to adjust (both for municipalities with increasing and decreasing allocations), the new allocations are being phased in over five years, from 2013/14 to 2017/18. For municipalities with smaller allocations under the new formula, the phase-in mechanism measures the difference between the municipality’s old and new allocations and closes this gap by 20 per cent each year. This means that in the first year a municipality only experienced a change equivalent to 20 per cent of the gap between their allocations under the old and new formulas, in the second year they completed 40 per cent of the change, in the third year (2015/16) they will complete 60 per cent, in 2016/17 they will complete 80 per cent, and in 2017/18 – the final year of the 2015 MTEF period – their allocation will be determined entirely through the new formula.

To provide for this phase-in approach, while staying within the limits of the equitable share, municipalities with larger allocations will also have their increases phased in over five years. The total top-up amount needed to fund the phasing in for municipalities with declining allocations is calculated and deducted from those that do not require a top-up in proportion to their "surplus". This means that municipalities with larger allocations will have some of those gains delayed over the phase-in period.

Ensuring the formula balances

The formula is structured so that all of the available funds are allocated. The basic services component is determined by the number of poor households per municipality and the estimated cost of free basic services, so it cannot be manipulated. This means that the balancing of the formula to the available resources must take place in the second part of the formula, which includes the institutional and community services components. The formula automatically determines the value of the allocation per council seat in the institutional component and the allocation per household for other services in the community services component to ensure that it balances. Significant increases in the cost of basic service provision – due to escalating bulk electricity prices for example – is fully funded by the formula, but this will result in slower growth in the institutional and community services allocations.

Potential future refinements to the formula

Although the local government equitable share formula has been through extensive consultations and technical work, national government continues to work with stakeholders to improve the formula. Areas of work include:

- Exploring the introduction of factors to account for costs related to the size of the land area served and settlement types in municipalities.
- Developing differentiated costing variables to take account of the different costs of services in various circumstances. SALGA and the FFC have completed the first phase of a project that could provide the basis for calculating such variables in future. This work will continue in 2015/16.
- Exploring the creation of separate sub-components for fire services and municipal health services within the community services component. This would enhance transparency in allocations, although funds for the fire services function would need to be allocated to the municipality (district or local) authorised for this function within a specific area. The process can only be completed after the National Disaster Management Centre has completed its consideration of policy and legislative changes for fire services.

Government is committed to considering all proposed refinements to the formula, but another full review is not envisaged until the current formula has been fully phased in and municipalities have had time to adjust to the new allocations.

Details of new allocations

In addition to the three-year formula allocations published in the Division of Revenue Bill, a copy of the formula, including the data used for each municipality and each component, is published online (http://mfma.treasury.gov.za/Media_Releases/LGESDiscussions/Pages/default.aspx).

Other unconditional allocations

RSC/JSB levies replacement grant

Before 2006, district municipalities raised levies on local businesses through an RSC or JSB levy. This source of revenue was replaced in 2006/07 with the *RSC/JSB levies replacement grant,* which was allocated to all district and metropolitan municipalities based on the amounts they had previously collected through the levies (the *RSC/JSB levies replacement grant* for metropolitan municipalities has since been replaced by the sharing of the general fuel levy). The grant's value increases every year. In 2015/16, the grant increases by 7.4 per cent a year for district municipalities authorised for water and sanitation and 2.5 per cent for unauthorised district municipalities. The different rates recognise the various service delivery responsibilities of these district municipalities.

Special support for councillor remuneration and ward committees

Councillors' salaries are subsidised in poor municipalities. The total value of the support provided in 2015/16 is R818.9 million, calculated separately to the local government equitable share and in addition to the funding for governance costs provided in the institutional component. The level of support for each municipality is allocated based on a system gazetted by the Minister of Cooperative Governance and Traditional Affairs, which classifies municipal councils into six grades based on their total income and population size. Special support is provided to the lowest three grades of municipal councils (the smallest and poorest municipalities). During 2014, gradings for all municipalities were recalculated using data from the 2011 Census. The revised gradings, approved by Members of the Executive Council for Cooperative Governance and collated by the national Department of Cooperative Governance, have been used to update the allocations for the 2015 MTEF period. The use of 2011 Census data means that a number of municipalities increased their grading levels and are consequently no longer eligible to receive the special support for councillor remuneration. These funds have been returned to the local government equitable share formula to be allocated to all municipalities.

A subsidy of 90 per cent of the gazetted maximum remuneration for a part-time councillor is provided for every councillor in grade 1 municipalities, 80 per cent for grade 2 municipalities and 70 per cent for grade 3 municipalities. Because the new maximum limits for councillor remuneration had not been gazetted when the 2015/16 allocations were determined, the level of subsidies provided for that year are based on the 2014/15 maximums plus inflation. In addition to this support for councillor remuneration, each local municipality in grades 1 to 3 receives an allocation to provide stipends of R500 per month to 10 members of each ward committee in their municipality. Each municipality's allocation for this special support is published in the appendices to the Division of Revenue Bill.

Conditional grants to local government

National government allocates funds to local government through a variety of conditional grants. These grants fall into two main groups: infrastructure and capacity building. The total value of conditional grants directly transferred to local government increases from R38.9 billion in 2015/16 to R39.8 billion in 2016/17 and R42.7 billion in 2017/18.

Infrastructure conditional grants to local government

National transfers for infrastructure, including indirect or in-kind allocations to entities executing specific projects in municipalities, amount to R145.5 billion over the 2015 MTEF period.

Table W1.28 Infrastructure grants to local government, 2011/12 – 2017/18

R million	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
		Outcome		Revised estimate		Medium-term estimates	
Direct transfers	**24 643**	**27 923**	**31 991**	**33 345**	**36 440**	**37 254**	**39 911**
Municipal infrastructure	11 443	13 879	14 224	14 429	14 956	15 548	16 435
Municipal water infrastructure	–	–	602	536	1 804	1 186	1 773
Urban settlements development	6 267	7 392	9 077	10 285	10 554	11 076	11 708
Integrated national electrification programme	1 097	1 151	1 635	1 105	1 980	2 036	2 197
Public transport network	4 612	4 884	5 550	5 871	5 953	6 163	6 610
Neighbourhood development partnership	738	578	586	591	607	624	663
Integrated city development	–	–	40	255	251	267	292
Rural roads asset management systems	35	37	52	75	97	102	107
Rural households infrastructure	–	–	107	5	48	113	124
Municipal disaster recovery	450	–	118	194	189	140	–
Indirect transfers	**2 541**	**4 548**	**5 523**	**8 536**	**10 395**	**10 634**	**10 916**
Integrated national electrification programme	1 165	1 879	2 141	2 948	3 613	3 776	3 946
Neighbourhood development partnership	50	80	55	58	26	22	28
Regional bulk infrastructure	1 260	2 523	3 261	4 005	4 922	5 324	4 855
Municipal water infrastructure	–	–	–	559	792	1 512	2 087
Bucket eradication programme	–	–	–	899	975	–	–
Rural households infrastructure	65	65	65	66	67	–	–
Total	**27 184**	**32 471**	**37 514**	**41 881**	**46 835**	**47 888**	**50 826**

Source: National Treasury

Municipal infrastructure grant

The largest infrastructure transfer is made through the *municipal infrastructure grant*, which supports government's aim to expand service delivery and alleviate poverty. The grant funds the provision of infrastructure for basic services, roads and social infrastructure for poor households in all non-metropolitan municipalities. Although the grant's baseline reduction amounts to R142.3 million in 2015/16, total allocations still increase to R15 billion in the same year, R15.5 billion in 2016/17 and R16.4 billion in 2017/18.

The Department of Cooperative Governance, which administers the *municipal infrastructure grant*, conducted a policy review of the grant during 2014. This review collaborated with the review of local government infrastructure grants to make proposals on the grant's future direction. These changes will be introduced in the 2016 Budget, but the 2015 Budget already makes a significant change through a new condition that allows the grant to be used for refurbishment projects, subject to proof of the asset's proper maintenance. The grant framework also clarifies that funds can be used to upgrade informal settlements. The condition introduced in the 2014 Budget that municipalities with households served by bucket systems must prioritise sanitation upgrades is retained.

The *municipal infrastructure grant* is allocated through a formula with a vertical and horizontal division. The vertical division allocates resources between sectors and the horizontal division takes account of poverty, backlogs and municipal powers and functions in allocating funds to municipalities. The five main components of the formula are described in the box.

Municipal infrastructure grant = C + B + P + E + N

C	Constant to ensure increased minimum allocation for small municipalities (this allocation is made to all municipalities)
B	Basic residential infrastructure (proportional allocations for water supply and sanitation, roads and other services such as street lighting and solid waste removal)
P	Public municipal service infrastructure (ring-fenced for municipal sport infrastructure)
E	Allocation for social institutions and micro-enterprises infrastructure
N	Allocation to the 24 priority districts identified by government

For the 2015 MTEF, the *municipal infrastructure grant* allocation formula uses data from the 2011 Census. Allocations for basic services sub-components are based on the proportion of the national backlog for that service in each municipality. Other components are based on the proportion of the country's poor households located in each municipality. Table W1.29 sets out the proportion of the grant accounted for by each component of the formula. The C-component provides a R5 million base to all municipalities receiving *municipal infrastructure grant* allocations.

Table W1.29 Municipal infrastructure grant allocations per sector

Municipal infrastructure grant (formula)	Component weights	Proportion of municipal infrastructure grant per sector	Value of component 2015/16 (R millions)
B-component	**75.0%**		**10 291**
Water and sanitation	72.0%	54.0%	7 409
Roads	23.0%	17.3%	2 367
Other	5.0%	3.8%	515
P-component	**15.0%**		**2 058**
Sports	100.0%	15.0%	2 058
E-component	**5.0%**	**5.0%**	**686**
N-component	**5.0%**	**5.0%**	**686**
Constant			**1 235**
Total			**14 956**

Source: National Treasury

Since 2011/12, the P-component (15 per cent of the grant) has been ring-fenced for municipal sport and recreation infrastructure. This continues in the 2015 MTEF.

Urban settlements development grant

The *urban settlements development grant* is an integrated source of funding to provide infrastructure for municipal services and upgrade urban informal settlements in the eight metropolitan municipalities. The grant is allocated as a supplementary grant to cities (schedule 4 of the Division of Revenue Act), which means that municipalities are expected to use a combination of grant funds and their own revenue to develop urban infrastructure and integrated human settlements. Cities report their progress on these projects against the targets set in their service delivery and budget implementation plans. The grant's baseline is reduced by R100.4 million in 2015/16, and it is allocated a total of R33.3 billion over the 2015 MTEF period.

Metropolitan municipalities are still required to prioritise the eradication of bucket sanitation backlogs. In addition, new conditions in the framework require that at least 50 per cent of grant funds be used to upgrade informal settlements.

Integrated cities development grant

The grant provides a financial incentive for metropolitan municipalities to focus their use of infrastructure investment and regulatory instruments to achieve more compact and efficient urban spaces. Cities are required to submit built environment performance plans for this grant, including a brief strategic overview of the city's plans for the built environment, with a focus on the infrastructure grants that form part of the capital budget. The plan should show how the municipality will ensure alignment between its different grant-funded programmes and how it will address related policy and regulatory matters. All projects funded by sector-specific infrastructure grants, including the *urban settlements development grant,* the *public transport infrastructure grant*, the *neighbourhood development partnership grant* and the *integrated national electrification programme grant,* must form part of a metropolitan municipality's built environment performance plan. The grant's baseline reduction amounts to R14.7 million in 2015/16 and it is allocated R810.2 million over the 2015 MTEF period.

Neighbourhood development partnership grant

The *neighbourhood development partnership grant* supports cities in developing and implementing urban network plans. The aim is to create a platform for third-party public and private investment, which will improve the quality of life in township urban hubs. Projects in towns and rural areas are implemented in conjunction with the Department of Rural Development and Land Reform to support catalytic projects in these areas. The baseline reduction on this grant in 2015/16 is R22.1 million. The grant is allocated R2 billion over the MTEF period, which consists of R1.9 billion for the capital (direct) grant and R75.8 million for the technical assistance (indirect) grant.

Municipal water infrastructure grant

This grant was introduced in 2013/14 to accelerate the delivery of clean water to communities that do not have access to basic water services. The grant, administered by the Department of Water and Sanitation, provides funding for various projects, including the construction of new infrastructure and the refurbishment and extension of existing water schemes. It has both direct and indirect components. In areas where municipalities have the capacity to implement projects themselves, funds will be transferred through a direct grant. In other areas, the Department of Water and Sanitation will implement projects on behalf of municipalities through an indirect grant. As with other indirect grants, the national department is required to transfer skills to the municipalities benefiting from the indirect grant, so that they will be able to implement projects themselves in future. In 2015/16, R500 million is shifted from the indirect to the direct portion of the grant as municipal capacity to deliver improves. Following a reprioritisation within the department, an addition of R1 billion will be made available in 2017/18, which is split equally between the direct and indirect components.

The grant's baseline is reduced by R76.3 million in 2015/16. It has a total allocation of R9.2 billion over the 2015 MTEF period, consisting of R4.8 billion and R4.4 billion for the direct and indirect components respectively.

Following the outcomes of the first phase of the local government infrastructure grant review, the *municipal water infrastructure grant* is one of several water and sanitation grants that will be restructured over the 2015 MTEF period. This grant is expected to merge with other water and sanitation grants for a more consolidated water services funding package to municipalities. Further details will be announced in the 2015 *Medium Term Budget Policy Statement*.

Regional bulk infrastructure grant

This indirect grant supplements the financing of the social component of regional bulk water and sanitation infrastructure. It targets projects that cut across several municipalities or large bulk projects within one municipality. The grant funds the bulk infrastructure needed to provide reticulated water and sanitation services to individual households. It may also be used to appoint service providers to carry out feasibility studies, related planning or management studies for infrastructure projects. A parallel programme on the budget of the Department of Water and Sanitation also funds water boards for the construction of bulk infrastructure. Though not part of the division of revenue, these projects still form part of the Department of Water and Sanitation’s larger programme of subsidising the construction of regional bulk infrastructure for water and sanitation.

Following reprioritisation in the department, additions of R700 million in 2015/16 and a further R700 million in 2016/17 have been made to the grant, bringing its total value to R15.1 billion over the 2015 MTEF period.

Rural households infrastructure grant

The *rural households infrastructure grant* funds the provision of on-site solutions for sanitation services for rural households where piped infrastructure is not feasible. The grant is now managed by the Department of Water and Sanitation, as a result of the shift of the sanitation function from the Department of Human Settlements. The grant has both direct and indirect components. In areas where municipalities have the capacity to implement projects themselves, funds will be transferred through the direct grant. In other areas, the Department of Water and Sanitation will implement projects on behalf of municipalities through an indirect grant. The baseline reduction on this grant in 2015/16 amounts to R2.8 million. It is allocated R353.2 million over the 2015 MTEF period and will be subject to the aforementioned restructuring of water and sanitation grants.

Bucket eradication programme grant

The *bucket eradication programme grant* – previously the indirect *human settlements development grant* to provinces under the Department of Human Settlements – is an indirect grant to municipalities administered by the Department of Water and Sanitation. It retains the same purpose of eradicating bucket sanitation systems, but it is now better aligned with functional arrangements, given that sanitation is a municipal function. The bucket eradication programme was established in 2014 for a period of two years, which is why this grant has an allocation of R975.4 million for 2015/16 only. Several other grants also fund the upgrading of sanitation backlogs, including the *municipal infrastructure grant*, the *urban settlements development grant* and the *rural households infrastructure grant*.

Integrated national electrification programme

The national electrification programme has been instrumental in providing 85 per cent of all households with access to electricity, as reported in the 2011 Census. To sustain progress in connecting poor households to electricity, government will spend R17.5 billion over the next three years on the programme, representing average annual growth of 14.9 per cent over the MTEF period. Of this, municipalities are allocated R6.2 billion and Eskom is allocated R11.3 billion to spend on behalf of municipalities through an indirect grant. The baseline reduction on this grant in 2015/16 amounts to R75.7 million.

Public transport network grant

The *public transport network grant*, administered by the Department of Transport, helps cities create or improve public transport systems in line with the National Land Transport Act (2009) and the Public Transport Strategy. This includes all integrated public transport network infrastructure, such as bus rapid transit systems, conventional bus services and upgrades for pedestrian and cycling infrastructure. It also subsidises the operations of these services. The grant is allocated R18.7 billion over the 2015 MTEF period.

This grant has been created through the merger of two separate grants: the *public transport network operations grant* and the *public transport infrastructure grant*, for operational and infrastructure expenditure respectively. This consolidation is the first step towards changing the implicit incentives in the grant structure, so that cities are encouraged to plan for systems that will meet their public transport needs while still being financially sustainable over the long term. The grant will still have separate operational and capital windows but it will be easier to shift funds between these windows. As a result, cities will have to trade-off increased capital funding from the grant against the need to make greater contributions from their own funds to the operating costs of their networks. During 2015, the grant’s allocation method and rules will be further refined as part of the review of local government infrastructure grants.

Rural roads asset management systems grant

The *rural roads asset management systems grant* is administered by the Department of Transport to improve rural road infrastructure. The grant funds the collection of data on the condition and usage of rural roads in line with the Road Infrastructure Strategic Framework for South Africa. This data will guide investments to maintain and improve these roads. District municipalities collect this data on all the municipal roads in their area so that the spending of infrastructure funds (from the *municipal infrastructure grant* and elsewhere) can be properly planned to maximise impact. From 2015/16, the grant is allocated to all district municipalities. As data becomes available for use in planning road maintenance, incentives will be introduced to ensure that municipalities use it to plan maintenance appropriately. The baseline reduction on this grant in 2015/16 amounts to R0.9 million and it is allocated R305.7 million over the MTEF period.

Municipal disaster recovery grant

This grant, administered by the National Disaster Management Centre in the Department of Cooperative Governance, is used to rehabilitate and reconstruct municipal infrastructure damaged by disasters. Over the 2015 MTEF period, R328.9 million is made available to repair infrastructure damaged by natural disasters that took place in 2013 and 2014.

Capacity-building grants and other current transfers

Capacity-building grants help to develop municipalities' management, planning, technical, budgeting and financial management skills. Other current transfers include the *expanded public works programme integrated grant for municipalities*, which promotes increased labour intensity in municipalities, and the new *municipal demarcation transition grant*, which assists municipalities with the additional costs associated with significant boundary changes. A total of R7.8 billion is allocated to capacity-building grants and other current transfers to local government over the 2015 MTEF period.

Table W1.30 Capacity building and other current grants to local government, 2011/12 – 2017/18

R million	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18
		Outcome		Revised estimate		Medium-term estimates	
Direct transfers	**1 862**	**2 329**	**2 267**	**2 250**	**2 447**	**2 590**	**2 809**
Municipal systems improvement	220	230	240	252	251	259	279
Local government financial management	385	403	425	449	452	465	502
Municipal human settlements capacity	–	–	–	200	100	100	115
2013 African Cup of Nations host city operating	–	123	–	–	–	–	–
2014 African Nations Championship host city operating	–	–	120	–	–	–	–
Water services operating subsidy	542	562	421	450	453	466	502
Expanded public works programme integrated grant for municipalities	364	662	611	595	588	664	716
Infrastructure skills development	39	75	99	104	124	130	141
Energy efficiency and demand-side management	280	200	181	137	178	186	203
Municipal demarcation transition	–	–	–	–	39	50	50
Municipal disaster	32	73	171	64	261	270	300
Indirect transfers	**119**	**–**	**–**	**–**	**–**	**–**	**–**
Energy efficiency and demand-side management	119	–	–	–	–	–	–
Total	**1 981**	**2 329**	**2 267**	**2 250**	**2 447**	**2 590**	**2 809**

Source: National Treasury

Municipal human settlements capacity grant

This grant, administered by the Department of Human Settlements, funds capacity building for the development of human settlements in metropolitan municipalities. It was introduced in 2014/15 to fund capacity for the six metropolitan municipalities that were due to be assigned the housing function. The assignment process for this function has been held in abeyance, so the grant will now be extended to all eight metropolitan municipalities to build their capacity to deliver and subsidise the operational costs of administering human settlement programmes. Due to the changed focus of this grant, a larger baseline reduction has been effected on it than on other grants. In 2015/16, the baseline reduction on this grant is R200 million. The grant has allocations of R100 million in 2015/16, R100 million in 2016/17 and R115 million in 2017/18.

Municipal demarcation transition grant

The *municipal demarcation transition grant*, administered by the Department of Cooperative Governance, assists municipalities with additional costs that may arise during the transition to the new municipal boundaries due to come into effect after the 2016 local government elections. Only municipalities affected by type C boundary changes, involving amalgamations and category changes in terms of the Municipal Demarcation Board classifications, will receive allocations. The grant is therefore only allocated to the municipalities in KwaZulu-Natal and Gauteng that are affected by municipal mergers. This transitional grant has been introduced for a period of three years. It has been allocated R39 million in 2015/16, R50 million in 2016/17 and R50 million in 2017/18.

Local government financial management grant

The *local government financial management grant*, managed by the National Treasury, funds the placement of financial management interns and the modernisation of financial management systems. This includes building in-house municipal capacity to implement multi-year budgeting, linking integrated development plans to budgets, and producing quality and timely in-year and annual reports. The grant supports municipalities in the implementation of the Municipal Finance Management Act and also provides funds for the implementation of the municipal standard chart of accounts. The grant's baseline is reduced by R17.3 million in 2015/16. Total allocations amount to R1.4 billion over the 2015 MTEF period.

Infrastructure skills development grant

The *infrastructure skills development grant* develops capacity within municipalities by creating a sustainable pool of young professionals with technical skills related to municipal services, such as water, electricity and town planning. The grant places interns in municipalities, so they can complete the requirements of the relevant statutory council within their respective built environment fields. The interns can be hired by any municipality at the end of their internship. The grant's baseline reduction in 2015/16 amounts to R4.8 million and it is allocated R395.7 million over the 2015 MTEF period.

Municipal systems improvement grant

This grant helps municipalities perform their functions and stabilise institutional and governance systems, as required in the Municipal Systems Act (2000) and related legislation. The grant's baseline is reduced by R9.6 million in 2015/16. It is administered by the Department of Cooperative Governance and is allocated R788.9 million over the 2015 MTEF period.

Expanded public works programme integrated grant for municipalities

This grant promotes the use of labour-intensive methods in delivering municipal infrastructure and services. It is allocated through a formula based on past performance, which creates an incentive for municipalities. The formula has an extra weighting to give bigger allocations to poor, rural municipalities. R8.5 million in 2015/16 was reprioritised out of this grant during the 2015 budget process. The baseline reduction on this grant in 2015/16 amounts to R22.8 million and it is allocated R2 billion over the 2015 MTEF period.

The energy efficiency and demand-side management grant

The *energy efficiency and demand-side management grant* funds selected municipalities to implement energy-efficiency projects, with a focus on public lighting and energy-efficient municipal infrastructure. In the 2015 MTEF period, the Department of Energy will monitor and verify grant-funded projects to ensure greater consistency in the procurement of accredited verification services. The grant's baseline is reduced by R10.4 million in 2015/16 and it is allocated R566.8 million over the 2015 MTEF period.

The water services operating subsidy grant

The *water services operating subsidy grant* funds the refurbishment of water schemes previously owned and managed by the national Department of Water and Sanitation. The grant used to have an indirect component that funded the costs of staff transfers to municipalities, but this is no longer needed because no further staff transfers are anticipated. Staff remaining with the national department will be paid using the R142.6 million that has been allocated to the department's budget baseline.

The baseline reduction on the remaining direct portion of the grant is R17.3 million in 2015/16. It is allocated R1.4 billion over the 2015 MTEF period and will be subject to the aforementioned restructuring of water and sanitation grants.

Municipal disaster grant

The *municipal disaster grant* is administered by the National Disaster Management Centre in the Department of Cooperative Governance as an unallocated grant to local government. The centre is able to disburse disaster-response funds immediately – without the need for the transfers to be gazetted first. Due to past underspending on this grant, R300 million has been reprioritised out of the grant over the 2015 MTEF period. To ensure that sufficient funds are available in the event of disasters, section 26 of the Division of Revenue Bill allows for funds allocated to the *provincial disaster grant* to be transferred to municipalities if funds in the *municipal disaster grant* have already been exhausted, and vice versa. The bill also allows for more than one transfer to be made to areas affected by disasters, so that initial emergency aid can be provided before a full assessment of damages and costs is complete. The baseline reduction on this grant in 2015/16 amounts to R15.3 million. Over the MTEF period, R831.4 million is available for disbursement through this grant.

Part 6: Future work on provincial and municipal fiscal frameworks

The fiscal frameworks for provincial and local government encompass all their revenue sources and expenditure responsibilities. As underlying social and economic trends evolve and the assignment of intergovernmental functions change, so must the fiscal frameworks. The National Treasury, together with relevant stakeholders, conducts continuous reviews to ensure that provinces and municipalities have an appropriate balance of available revenues and expenditure responsibilities, while taking account of the resources available and the principles of predictability and stability. This part of the annexure describes the main areas of work to be undertaken during 2015/16 as part of the ongoing review and refinement of the intergovernmental fiscal framework. Provinces and municipalities will be consulted on all proposed changes to the fiscal frameworks.

The role of provinces and local government in promoting economic development

Provinces and municipalities play a crucial role in advancing the economic development of their respective precincts. Fully functional, well-equipped schools will produce a vibrant and employable workforce, which promotes higher employment. Smarter health systems develop and maintain the health of the workforce. Provincial agriculture departments' support to farmers can stimulate rural development. The provision of provincial and municipal roads and public transport services ensures mobility for goods and workers, while basic municipal services such as water, electricity and refuse removal, as well as business licencing and environmental health functions, enable businesses to operate and grow. Well-managed procurement can maximise developmental impact without compromising efficiencies.

Government in all three spheres must work with businesses and other relevant stakeholders to provide an enabling environment for the faster and more inclusive economic growth called for in the National Development Plan. From 2015, national and provincial treasuries will work together through a task team of the Technical Committee on Finance to better define the role provinces should play in promoting economic development. This will enable provinces to maximise their impact on provincial economies in future.

Local government infrastructure grants review

The local government infrastructure grant system is being reviewed to improve the efficiency and effectiveness of infrastructure grants to municipalities. The National Treasury is leading the review in collaboration with the Department of Cooperative Governance, the Department of Planning, Monitoring and Evaluation, the FFC and SALGA through a working group and a steering committee. The first phase of the review was completed in September 2014, when the Budget Forum endorsed a set of principles for the grant system and a broad outline of the reforms' direction. A working paper detailing the draft recommendations is available for comment on the National Treasury's Municipal Finance Management Act website (http://mfma.treasury.gov.za/Media_Releases/ReviewOfLGInfrastructureGrants/Pages/default_final.aspx).

The second phase of the review continues in 2015 to develop the draft recommendations for reform. Based on the Budget Forum's endorsement, the reforms will broadly focus on the following areas:

- Rationalising the number of grants that each municipality receives
- Greater differentiation in the types of grants and levels of oversight for different municipalities
- Life-cycle asset management to sustain the functionality of existing infrastructure
- Strengthening administrative oversight to avoid ad-hoc proliferation of grants
- Standardising reporting to increase accountability
- Improving performance monitoring and benchmarking.

Small changes to certain grants have already been implemented to align with the strategic direction of the reforms. Following further analysis and stakeholder engagement, the review's working group and steering committee will use the draft recommendations to develop final reforms that will be discussed at the Budget Forum. The outcomes will be announced in October 2015, at the time of the *Medium Term Budget Policy Statement*, to prepare municipalities and other role-players for a phased implementation of reforms over the 2016 MTEF period.

Municipal demarcations

As described in part 5 of this annexure, a new *municipal demarcation transition grant* was introduced in the 2015 MTEF. In 2015/16, allocations are divided equally across the municipalities affected by amalgamations and category changes to prepare for the demarcations. Funds remain unallocated in the outer years, but work will continue in 2015 to develop appropriate criteria for allocating funds in 2016/17 and 2017/18 to the new municipalities that will come into effect following the 2016 local government elections.

These new municipalities do not yet legally exist, so they do not have indicative allocations for 2016/17 and 2017/18 in the 2015 Division of Revenue Bill. The 2011 Census data will have to be recalculated for the new municipal areas to determine indicative allocations for large formula-driven allocations such as the local government equitable share and the *municipal infrastructure grant*. Statistics South Africa has already been asked to recalculate this data and the National Treasury will work with transferring officers to develop indicative allocations for the newly formed municipalities. These allocations will be published on the Municipal Finance Management Act website and shared with the relevant municipalities during 2015.

This will enable improved planning and budgeting before the demarcations come into effect, which will help ensure that service delivery is not adversely affected by grant allocation uncertainty.

As per its first circular of 2015, the Municipal Demarcation Board is considering the request of the Minister of Cooperative Governance and Traditional Affairs to re-determine the boundaries of a number of additional municipalities. Should further demarcations result from this process, the National Treasury will work with relevant stakeholders and consult the Budget Forum on how the local government fiscal framework should respond. Any changes will be implemented in the 2016 Budget.

Supporting cities to promote urban spatial transformation and economic growth

Cities, through delivery of infrastructure and services, play an important role in creating a conducive environment for inclusive growth, job creation and poverty eradication. To achieve this will require well-managed spatial transformation of cities. Government is exploring changes to the fiscal and regulatory structures for urban municipalities to ensure that they have sufficient and effective instruments to mobilise revenue for financing municipal strategic infrastructure capable of promoting growth.

Potential changes to the structure of the fiscal framework include:

- Consolidating urban grants and enhancing the use of performance incentives with transfers, such as with the *integrated cities development grant* (this work will form part of the review of local government infrastructure grants).
- Enabling greater flexibility in the use of grants to accelerate the implementation of catalytic investments.
- Enabling cities to leverage grant and own-revenue funds over a longer period for strategic projects.

These measures will be complemented by reviews of, and potential changes to, the regulatory structures for development charges, municipal borrowing and metropolitan municipalities' own-revenue powers.

Any potential changes to the fiscal and regulatory systems will also be accompanied by additional technical support to further strengthen the capacity of cities to take advantage of these changes. The Cities Support Programme is coordinating initiatives in this area. Cities are already receiving expanded project preparation support to help them build a pipeline of strategic investment projects that can attract private finance. In addition, the Development Bank of Southern Africa is increasing its assistance to give cities better access to funding for strategic projects by enhancing their appraisal and supervision arrangements or extending the average debt maturity.

Regulating development charges

A development charge is a once-off infrastructure access fee imposed on a land owner as a condition of approving a land development that will substantially increase the use of or need for municipal infrastructure engineering services. Development charges are based on the concept that urban growth and expanded land use creates the need for additional infrastructure services, therefore the developer should pay the incidence costs. This prevents the financial burden from being imposed on municipalities or existing communities through higher tariffs and rates.

In 2009, the National Treasury, in conjunction with metropolitan municipalities and other stakeholders, began to develop a national policy framework for municipal development charges. The National Treasury is amending the Municipal Fiscal Powers and Functions Act (2007) to incorporate the regulation of development charges. Consultations with relevant stakeholders on the draft policy framework for development charges will take place in 2015 and a draft bill will be published by mid-2015.

Reforming municipal borrowing

Long-term borrowing can be an effective way for municipalities to finance infrastructure development. However, responsible borrowing requires an appropriate institutional framework and financial controls. The Policy Framework for Municipal Borrowing and Financial Emergencies (1999) and the Municipal

Finance Management Act set a range of measures to facilitate responsible municipal borrowing. These measures deal with issues such as sovereign risk, credit enhancements, maturities, avoidance of direct government assistance, and liquidity through the development of secondary markets.

Despite these measures, there are still some bottlenecks that impede the full participation of municipalities in the debt market to mobilise resources for infrastructure development. In October 2014, the National Treasury started a two-year review of the system of municipal borrowing to expand its scope. During this period, it will analyse the existing policy and regulatory framework, strengthen partnerships with financial institutions, improve monitoring and evaluation, and design municipal capacity-building programmes and strategies for responsible municipal borrowing. To date, the National Treasury has conducted consultation sessions with private lenders, investors and credit rating agencies to better understand the existing challenges. In 2015/16, government will work with the Development Bank of Southern Africa to further expand the scope for private lending to municipalities, including measures to improve liquidity in the municipal bond market and extend bond maturities. These measures include:

- Municipal infrastructure bonds
- Municipal bond underwriting by the Development Bank of Southern Africa
- Innovations in project finance (such as tax increment financing and special district areas).

Reviewing own-revenue sources for metropolitan municipalities

Government is reviewing metropolitan municipalities' own-revenue sources to assess whether they are adequate to meet service delivery and development mandates. A task team consisting of the National Treasury, the Department of Cooperative Governance, SALGA, the FFC, and metropolitan municipalities was established in 2014. The review seeks to answer the following questions:

- Are metropolitan municipalities' budgets complying with the principle of matching revenue sources with corresponding expenditure categories?
- To what extent are metropolitan municipalities maximising the full scope of existing own-revenue sources?
- Are existing sources of revenue buoyant, adequate and sustainable for metropolitan municipalities to execute their present expenditure responsibilities, and are they sustainable in the medium to long term?
- What are the challenges that prevent metropolitan municipalities from optimising their use of existing revenue sources?
- Is the sharing of the general fuel levy an appropriate long-term revenue source? Metropolitan municipalities have raised concerns that the long-term effects of sharing a revenue source based on fuel consumption is contrary to their mandate of encouraging the use of public transport.

Based on the review's outcomes, recommendations will be made to Budget Forum in October 2015 for reforms to the local government fiscal framework that better allow metropolitan municipalities to meet their mandate. Parallel to this process, the National Treasury is developing a local government fiscal decentralisation framework that will outline the different types of own-revenue sources applicable to different types of South African municipalities. These sources will be considered in line with existing legislation.

Municipal Property Rates Amendment Act

The Municipal Property Rates Act (2004), which is administered by the Department of Cooperative Governance, regulates the power of municipalities to impose rates on properties. The act was amended through the Municipal Property Rates Amendment Act (2014), which will come into effect on 1 July 2015. The amendment act improves transparency in the categorisation of property and the determination of rates for each property category, which strengthens oversight. The amendments provide for the property rates liability to be phased out over a five-year period on the following properties: national, provincial and other public roads; water or sewer pipes; railway lines; runways or aprons at national or provincial airports; and breakwaters, sea walls, channels and basins. These exclusions are made because of the importance of these types of infrastructure in enabling economic growth and social change. The act also strengthens its regulatory, monitoring and reporting provisions, which in turn will improve its implementation and minimise legal ambiguities. The Department of Cooperative Governance will implement the regulatory framework that will give effect to the amendment act in due course.