W1

Website annexure to the 2018 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 257 municipalities. The division of revenue process takes into account the powers and functions assigned to each sphere of government, fosters transparency and is at the heart of constitutional cooperative governance.

The Intergovernmental Fiscal Relations Act (1997) prescribes the steps 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 2018 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 2018 division of revenue.
- Part 3 sets out how the FFC's recommendations on the 2018 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 2017. 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. The constitutional principles considered in the division of revenue are briefly noted below.

National interest and the division of resources

The national interest is captured in governance goals that benefit the nation as a whole. The National Development Plan 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 2017 *Medium Term Budget Policy Statement*, the Minister of Finance outlined how the resources available to government over the 2018 medium-term expenditure framework (MTEF) would be allocated to help achieve these goals. Cabinet's commitment to keeping South Africa's debt on a sustainable path is coupled with commitments to new national priorities that have emerged and must be accommodated in the budget. Chapter 4 of the 2017 *Medium Term Budget Policy Statement* and Chapters 5 and 6 of the 2018 *Budget Review* discuss how funds have been allocated across the three spheres of government based on these priorities. The framework for each conditional grant allocated as part of the division of revenue also notes 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 2018 *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 the country's needs, which is reflected in the division of revenue through modified funding arrangements. 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 responsible for providing education, health, social development, housing, roads, electricity and water, and municipal infrastructure services. They have the autonomy to allocate resources to meet basic needs and respond to provincial and local priorities, while 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.

Growth in allocations to provincial and local government have been safeguarded to reflect the priority placed on health, education and basic services, as well as the rising costs of these services as a result of higher wages, and bulk electricity and water costs. 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 2018 division of revenue prioritises the sustained delivery of free basic services in municipalities. New grants for emergency housing relief in both provinces and municipalities aim to improve government response times to disasters that are outside the purview of the National Disaster Management Centre.

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. 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. Municipalities finance most of their expenditure through property rates, user charges and fees. But their ability to raise revenue varies – rural municipalities raise significantly less revenue than large urban and metropolitan municipalities.

Local government's share of nationally raised revenue has increased from 3 per cent in 2000/01 to 9 per cent over the 2018 MTEF period. The local government equitable share 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. As such, government's approach to funding provincial infrastructure aims to promote better planning and implementation, and 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 recipient's efficiency in using allocations in the past.

Developmental needs

Developmental needs are accounted for at two levels. First, in the determination of the division of revenue, which continues to grow the provincial and local government shares of nationally raised revenue, and second, in the formulas used to divide national transfers among municipalities and provinces. Developmental needs are built into 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 gives provincial governments and municipalities the power to determine priorities and allocate budgets. National government is responsible for developing policy, fulfilling national mandates, setting national norms and standards for provincial and municipal functions, and monitoring the implementation of concurrent functions. It also ensures that baseline reductions do not affect important obligations that are already funded through existing provincial and local government allocations.

The 2018 MTEF, through the division of revenue, continues to fund the delivery of provincial, municipal and concurrent functions through a combination of conditional and unconditional grants.

Predictability and stability

Provincial and local government equitable share allocations are based on estimates of nationally raised revenue. If this revenue falls short of 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 themselves are phased in to ensure minimal disruption.

Flexibility in responding to emergencies

Government has a contingency reserve 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 2018 division of revenue

The central fiscal objectives over the MTEF period are to stabilise the growth of debt as a share of GDP and to strictly adhere to the planned expenditure ceiling (see Chapters 1, 3 and 5 of the 2018 *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 2018 division of revenue reprioritises existing funds to ensure these objectives are met despite a lower expenditure ceiling. Parts 4 and 5 of this annexure set out in more detail how the baseline reductions affect provincial and local government transfers.

Excluding debt-service costs and the contingency reserve, allocated expenditure shared across government amounts to R1.32 trillion, R1.43 trillion and R1.53 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 2018 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 2018 MTEF period that are funded through reprioritisations in the division of revenue include:

- Improving government's responsiveness to housing disasters through the introduction of emergency housing grants.
- Intensifying the role of home-based carers in improving national health through earmarked supplementary funds from the *comprehensive HIV, AIDS, TB and community outreach services grant*.
- Protecting the school nutrition initiative by ensuring that allocations continue to feed more children.
- Providing free basic services to poor households.
- Promoting access to social housing by boosting subsidies.

The fiscal framework

Table W1.1 presents the medium-term macroeconomic forecasts for the 2018 Budget. It sets out the growth assumptions and fiscal policy targets on which the fiscal framework is based.

Table W1.1 Medium-term macroeconomic assumptions

	2017/18		2018/19		2019/20		2020/21
R billion/percentage of GDP	**2017 Budget**	**2018 Budget**	**2017 Budget**	**2018 Budget**	**2017 Budget**	**2018 Budget**	**2018 Budget**
Gross domestic product	4 741.2	4 699.4	5 129.2	5 025.4	5 545.5	5 390.1	5 808.3
Real GDP growth	*1.3%*	*1.3%*	*2.1%*	*1.5%*	*2.3%*	*1.9%*	*2.1%*
GDP inflation	*6.1%*	*5.3%*	*6.0%*	*5.4%*	*5.7%*	*5.3%*	*5.5%*
National budget framework							
Revenue	**1 242.4**	**1 194.6**	**1 351.0**	**1 321.1**	**1 471.5**	**1 427.8**	**1 542.7**
Percentage of GDP	*26.2%*	*25.4%*	*26.3%*	*26.3%*	*26.5%*	*26.5%*	*26.6%*
Expenditure	**1 409.2**	**1 411.9**	**1 522.2**	**1 512.2**	**1 652.2**	**1 632.6**	**1 757.5**
Percentage of GDP	*29.7%*	*30.0%*	*29.7%*	*30.1%*	*29.8%*	*30.3%*	*30.3%*
Main budget balance[1]	**-166.8**	**-217.3**	**-171.2**	**-191.1**	**-180.7**	**-204.8**	**-214.8**
Percentage of GDP	*-3.5%*	*-4.6%*	*-3.3%*	*-3.8%*	*-3.3%*	*-3.8%*	*-3.7%*

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

Table W1.2 sets out the division of revenue for the 2018 MTEF period after accounting for new policy priorities.

Table W1.2 Division of nationally raised revenue

	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
		Outcome		Revised estimate	Medium-term estimates		
R million							
Division of available funds							
National departments	**489 987**	**546 065**	**555 738**	**599 886**	**628 621**	**685 927**	**736 551**
of which:							
Indirect transfers to provinces	5 413	3 458	3 636	3 813	3 776	4 366	4 744
Indirect transfers to local government	8 052	10 370	8 112	7 803	6 896	7 265	7 664
Provinces	**439 544**	**471 424**	**500 384**	**538 160**	**570 997**	**611 758**	**657 455**
Equitable share	359 922	386 500	410 699	441 331	470 287	505 020	542 447
Conditional grants	79 623	84 924	89 685	96 829	100 711	106 739	115 008
Local government	**87 570**	**98 338**	**102 867**	**110 728**	**118 458**	**126 914**	**137 462**
Equitable share	41 592	49 367	50 709	55 312	62 732	68 973	75 683
Conditional grants	35 788	38 313	40 934	43 631	43 258	44 773	47 752
General fuel levy sharing with metros	10 190	10 659	11 224	11 785	12 469	13 167	14 027
Provisional allocation not assigned to votes	–	–	–	–	6 000	2 308	2 125
Non-interest allocations	**1 017 102**	**1 115 827**	**1 158 989**	**1 248 774**	**1 324 076**	**1 426 907**	**1 533 593**
Percentage increase	*7.5%*	*9.7%*	*3.9%*	*7.7%*	*6.0%*	*7.8%*	*7.5%*
Debt-service costs	114 798	128 796	146 497	163 155	180 124	197 664	213 859
Contingency reserves	–	–	–	–	8 000	8 000	10 000
Main budget expenditure	**1 131 900**	**1 244 623**	**1 305 486**	**1 411 930**	**1 512 200**	**1 632 571**	**1 757 452**
Percentage increase	*8.0%*	*10.0%*	*4.9%*	*8.2%*	*7.1%*	*8.0%*	*7.6%*
Percentage shares							
National departments	*48.2%*	*48.9%*	*48.0%*	*48.0%*	*47.7%*	*48.1%*	*48.1%*
Provinces	*43.2%*	*42.2%*	*43.2%*	*43.1%*	*43.3%*	*42.9%*	*42.9%*
Local government	*8.6%*	*8.8%*	*8.9%*	*8.9%*	*9.0%*	*8.9%*	*9.0%*

Source: National Treasury

Table W1.3 shows how changes to the baseline are spread across government. The new focus areas and baseline reductions are accommodated by shifting savings towards priorities.

Table W1.3 Changes over baseline

R million	2018/19	2019/20
National departments	-2 827	4 327
Of which: Higher education	*12 355*	*25 050*
Provinces	-7 617	-9 237
Local government	-3 012	-5 363
Allocated expenditure	**-13 456**	**-10 273**

Source: National Treasury

Table W1.4 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 W1.4 Schedule 1 of the Division of Revenue Bill

R million	2018/19 Allocation	2019/20 Forward estimates	2020/21 Forward estimates
National[1]	979 182	1 058 578	1 139 322
Provincial	470 287	505 020	542 447
Local	62 732	68 973	75 683
Total	**1 512 200**	**1 632 571**	**1 757 452**

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

Source: National Treasury

The 2018 *Budget Review* sets out in detail how constitutional considerations and government's priorities are taken into account in the 2018 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 2018/19* to Parliament in May 2017. These recommendations focus on urban development issues, following the FFC's focus on rural development in 2017/18. The recommendations for 2018/19 cover the following areas: macroeconomic parameters underpinning urban development; city-level productivity, competitiveness and the well-being of residents; and local government issues, including urbanisation impacts and revenue diversification.

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's 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: Assessment of Integrated Urban Development Framework and Cities Support

Strengthening the Integrated Urban Development Framework and the Cities Support Programme

The FFC recommends that, "The Department of Cooperative Governance and Traditional Affairs and the National Treasury consolidate the urban development related grants (for example incorporate the *integrated city development grant* into the *urban settlements development grant*) so as to achieve the Integrated Urban Development Framework objectives and address urban development holistically."

Government response

Government recognises the need for the progressive consolidation of conditional grants to metropolitan municipalities. It remains committed to consolidating grants for urban municipalities as a long-term objective, while acknowledging that several sector-specific grants, such as the *public transport network grant*, will need to remain separate in the short term to fund specific programmes within cities.

Government will review spending on urban informal settlement upgrades, with a view to changing the grant system to enable increased investment in on-site upgrades. This may have implications for the structure of the grants mentioned in the FFC's recommendation, as the *urban settlements development grant* is the main source of grant funding for informal settlement upgrades in metros and the *integrated city development grant* is the main grant for improved governance and spatial transformation in metros. National departments, cities and the FFC will be invited to participate in the review.

A new *integrated urban development grant* will be introduced for non-metropolitan cities in 2019/20. While this grant will initially be funded by reprioritising amounts previously allocated to qualifying cities through the *municipal infrastructure grant*, it could include the consolidation of other grants in time.

Government has consistently emphasised the need to increase the proportion of own revenue in urban municipalities' capital budgets. Reforms to conditional grants, including the proposed consolidation of grants, must be structured to promote this objective, as it is the best way of increasing total capital investment in urban infrastructure.

The current structure of the *integrated city development grant* aims to incentivise municipalities to invest in a targeted and sequenced manner to achieve a more compact, inclusive, productive and sustainable urban environment. The incentive is based on the performance of the metropolitan municipality as a whole, including performance on all grants and own-revenue-funded projects. Steps to incorporate this grant into

another grant will need to be structured carefully to ensure that the incentive created for holistic planning and development across municipalities is not distorted.

Chapter 3: Cities Compaction – An Evaluation of Legislation and Policies

Achieving compact metropolitan cities

The FFC recommends that, "National Treasury introduces an incentive grant specifically targeted at city compaction, an urban form that has the potential to remedy apartheid geography and bring the masses closer to the opportunities of work and facilities. The spatial development grants currently accessed through the built environment performance plans treat compaction as only a small and negligible component of spatial transformation."

Government response

The National Treasury agrees that there is a need for incentives to encourage targeted densification that restructures South Africa's urban spaces. This has been identified as a key measure in the fiscal framework, and confirmed by the local government infrastructure grant review process. A small incentive grant has already been introduced in the form of the *integrated city development grant.*

Government has adopted an incremental approach to introducing performance incentives for two reasons. First, there is a need to ensure there are objective, measurable indicators of performance in place that are well understood by all eligible municipalities and consistent with global and national monitoring frameworks. To accomplish this, the National Treasury and the Department of Cooperative Governance have led the reform of outcome indicators and reporting for urban local governments – a process that is nearing completion. Second, there is a need to ensure that measures are taken to address countervailing incentives to spatial restructuring, which could mute the impact of the fiscal incentives. These could include changes to policies and regulations to ensure they do not create implicit incentives that encourage investments in low-density developments on the edges of cities.

Incentive effects are not drawn solely from the size of financing provided, but also from the extent to which they complement other initiatives in a coherent programme. The built environment performance plans provide each city with a mechanism to coordinate infrastructure investment funded through grants and own revenues that will lead to spatial transformation. Section 14(2) of the Division of Revenue Act requires that cities invest an increasing proportion of their grant allocations in the integration zones identified in their built environment performance plans. Several grants to metropolitan municipalities also have an explicit focus on spatial transformation and compact cities, including the *public transport network grant*, which promotes transit-oriented development along public transport corridors, and the *neighbourhood development partnership grant*, which funds the development of urban hubs in townships.

Chapter 4: Transport and Mobility Consolidating Programmes

Retaining locally earned fiscal revenue and ring-fencing local income sources for public transport

The FFC recommends that, "The Department of Transport should review the *public transport network grant* and investigate options to shift sources of funding towards retaining locally earned fiscal revenue and ring-fence the local income sources for public transport use. Examples include possible retention of a larger portion of the fuel levy generated in the municipality.

- "Develop case studies or support pilot projects in selected municipalities to develop key potential sources of funding including funding related to parking, developer charges and ring-fencing a portion of the fuel levy."

Government response

Government supports the increased use of municipal own revenues to fund public transport. Efficient and reliable public transport is vital to the long-term economic performance of cities. Progressively increasing the share of locally generated funds allocated to public transport is an investment in urban development.

The structure of the *public transport network grant* has been extensively reviewed and reformed through the local government infrastructure grant review, in which the FFC participates. This has led to the change from a project-based allocation methodology to one based on a formula, and the announcement that from 2019/20 an incentive component will be added to the grant. Both of these changes are intended to encourage cities to increase investment in public transport networks from their own revenues.

While cities and the Department of Transport can research potential municipal revenue sources that could support public transport, new municipal tax instruments can only be approved by the Minister of Finance in terms of the Municipal Fiscal Powers and Functions Act (2007). Cities should also be encouraged to maximise their use of existing own-revenue sources and prioritise more of these resources towards investment in public transport.

The National Treasury has already announced its intention to amend the Municipal Fiscal Powers and Functions Act to better regulate municipal development charges. The sharing of the general fuel levy with metropolitan municipalities was introduced in 2008/09 as a replacement for the RSC levies previously collected by municipalities. As such, it was allocated to metropolitan municipalities as an unconditional transfer and it would therefore be inappropriate for national government to retrospectively ring-fence it for a particular purpose.

Consolidation of public transport functions as defined in the National Land Transport Act

The FFC recommends that, "The Department of Transport should approve and pilot the consolidation of public transport functions as defined in the National Land Transport Act within a well-capacitated city, with supporting funding (in line with a previous Commission study). In this regard, the Department of Transport should:

- "Identify the most appropriate options for arrangements outside of large urban municipalities where financial resources and capacity to take on the integrated function are more limited; and
- "Identify the legal and institutional structures needed to properly integrate planning and management across modes (including rail) into the broader management of municipal transport networks, which are also adequately funded by a conditional grant."

Government response

Government acknowledges the need to consolidate the public transport functions as defined in the National Land Transport Act (2009). The Department of Transport is considering a pilot project in the uMhlathuze and/or Lephalale municipalities. However, this consolidation of functions could not be funded through the *public transport network grant* because it is for a specific purpose (integrated networks).

The National Land Transport Act provides that all municipalities establishing integrated public transport networks should create intermodal planning committees and land transport advisory boards solely for integrated planning and public transport management. Municipalities can use these existing institutions rather than prescribing new arrangements or structures.

Approaches to integrated public transport networks that support financial sustainability

The FFC recommends that, "The Department of Transport should support the development of approaches to integrated public transport networks that support financial sustainability. These approaches should focus on leveraging the strengths of existing services, promoting incremental improvement of public transport based on affordability and impact, recognising the significant role that new technologies will play in providing demand-responsive services, and considering alternative models of industry transformation.

This could take the form of piloting and sharing learning from revised approaches to integrated public transport networks in one or more urban municipalities and should be funded through the *integrated public transport network grant* or a similar funding instrument."

Government response

Government agrees with this recommendation. Municipalities are encouraged to implement integrated public transport networks that are appropriate for their environments. Innovations are encouraged, but they need to be costed and have a sound business case. The *public transport network grant* already funds several different types of quality bus services that require substantially less infrastructure than bus rapid transit systems (in George, Mangaung, Mbombela and Msunduzi, for example).

Several cities are exploring options to use existing minibus vehicles in their integrated public transport networks (these include Tshwane, Polokwane, Cape Town Phase 2, eThekwini, Ekurhuleni and Nelson Mandela Bay). The Public Transport Strategy and the framework for the *public transport network grant* allow for experimentation with the incremental integration of minibus-type services into public transport networks. The main reason there has not been more success in this area is not national policy or grant design but the lack of political will, technical capacity, as well as regulatory and enforcement capabilities and business development expertise at local level. However, cities are improving their capacity and it is likely that minibus taxis will become more integrated in future.

Chapter 5: Aligning Urban Housing Supply with Unhoused Urban Population

Alignment of infrastructure delivery plans to new human settlements development

The FFC recommends that, "Provincial departments of human settlements and other key departments including the provincial departments of basic education and transport should align their infrastructure delivery plans particularly for new human settlements development. This can be done by:

- "Establishing functional inter-sectoral coordination committees where relevant departments will meet to discuss new infrastructure development projects relating to habitable human settlement.
- "Ensuring that the portion of *education infrastructure grant* and funding from the provincial equitable share are aligned to the portion of the *human settlements development grant* for new housing developments."

Government response

Government recognises the importance of improving the coordination of infrastructure delivery. As a result, provincial treasuries have established infrastructure medium-term expenditure committee forums as part of their budget processes. These structures bring together national and provincial departments to facilitate inter-sectoral discussions on the planning and implementation of infrastructure projects. These new forums will need to be further developed and strengthened with support from the National Treasury and relevant national departments. Provinces need to ensure that their infrastructure investment plans are consistent with the spatial development plans set out in municipal integrated development plans.

Chapter 6: Implications of Urbanisation Induced Learner Mobility on Education Planning and Funding

Review of the provincial equitable share formula

The FFC recommends that, "The National Treasury should incorporate weighted learner socio-economic profiles into the education component of the provincial equitable share formula as an additional indicator of education needs."

Government response

The National Treasury is reviewing the provincial equitable share formula. This review is set to take place over a number of years and includes assessing the continued appropriateness of all aspects of the formula. The first phase of the review is to assess the data that informs all of the formula's current components. The Department of Basic Education has introduced an improved way of collecting learner enrolment numbers and this will be incorporated into the equitable share formula. Subsequent phases of the review will consider other factors such as the alignment of the formula to national sector policy, which may include an assessment of the impact of weighted learner socio-economic profiles, as recommended by the FFC.

Demographic patterns and forecasts in provincial education infrastructure planning

The FFC recommends that, "Both the National Treasury and Department of Basic Education must ensure that the framework for the *education infrastructure grant* incorporates the need for provincial infrastructure plans to take into account spatial demographic patterns and forecasts, particularly when decisions to build, expand or maintain schools are made."

Government response

Government agrees with this recommendation. Provincial departments of basic education are required to submit user asset management plans to the national Department of Basic Education that consider, among others, the need to provide school infrastructure in different parts of their province. These plans must comply with human settlements planning guidelines to ensure education facilities are accessible to new and existing communities. They must consider the geographic distribution of existing and new school infrastructure against the demographic distribution of beneficiaries (accounting for population dynamics and learner movements).

Chapter 7: Industrial Diversity and Economic Performance in Urban Municipalities

Improving industrial diversity and economic growth in urban municipalities

The FFC recommends that, "Through the National Treasury, government establishes an economic diversification plan as part of its objective to support cities in promoting spatial transformation and economic growth. This fund can either be ring-fenced within existing grants linked to growth and spatial transformation of cities (such as the *integrated cities development grant*), or specified as a minimum spending requirement to ensure that recipient municipalities spend allocated funds towards programmes that broaden and deepen spatial transformation and economic growth through diversification of economic activities within their jurisdictions."

Government response

Government acknowledges the importance of diversified local economies and the effect they can have on spatial development in cities. However, ring-fencing grant funding to cities is not the best way to achieve this.

Promoting economic diversification is an industrial policy issue and not a mandate of local government. The fundamental role of municipalities in local economic development is to provide efficient and effective basic infrastructure services and urban management regulation (including land-use planning and management systems) that support economic activities.

Chapter 8: The Effects of Municipal Spending on Urban Employment

Redesign of the expanded public works programme integrated grant for municipalities

The FFC recommends that, "The Departments of Public Works and Cooperative Governance and Traditional Affairs should carry out an assessment of the *expanded public works programme (EPWP)*

integrated grant for municipalities to ascertain how the grant can be redesigned to encourage more secondary cities and large towns to apply for a bigger portion of this grant."

Government response

The Department of Public Works is working with the South African Cities Network through a reference group, which discusses and monitors plans to expand the EPWP in cities. These reference group meetings are also a forum where best practices are shared so that cities learn from each other. The EPWP's implementation in secondary cities and large towns is also being encouraged through the provision of technical support from the national and provincial departments of public works.

The EPWP aims to create more jobs through the labour-intensive implementation of municipal functions. The *EPWP integrated grant for municipalities* is intended to act as a supplementary source of funding for labour-intensive projects. Cities should be creating jobs through all of their activities, not only those funded through this grant.

In 2017/18, cities and large towns accounted for 19 per cent of allocations through the *EPWP integrated grant for municipalities*, which is a significant portion of the grant. A Government Technical Advisory Centre review of the *EPWP integrated grant for municipalities* in 2016/17 confirmed that urban municipalities are able to access a large proportion of this grant. Accessing the grant depends on municipalities reporting their EPWP job creation. To get bigger allocations, secondary cities and large towns need to report better performance.

It should also be noted that any change to bias the allocation methodology in favour of cities would mean that less funding is available for rural municipalities. Because of the large unemployment burden in rural areas, government does not support this aspect of the recommendation.

Chapter 10: ICT and City Governance

Funding towards municipal standard chart of accounts compliance

The FFC recommends that, "The National Treasury should ensure that allocations for assisting municipalities with municipal standard chart of accounts implementation through the *financial management grant* be ring-fenced and deliberately biased towards lesser resourced urban municipalities who struggle under the financial burden of attaining compliance with the municipal standard chart of accounts financial reform."

Government response

Government acknowledges the financial challenges experienced by some municipalities in complying with the municipal standard chart of accounts regulations. The *financial management grant*, however, is relatively small, with municipalities allocated about R1.7 million each, on average. Allocations are biased towards municipalities with financial management challenges identified in the Financial Management Capability Maturity Model and/or disclaimer audit opinions. In addition to supporting the implementation of the municipal standard chart of accounts, the grant also supports a host of other financial reforms, including preparing funded budgets, improving asset management and ensuring audit outcomes are consistent with Outcome 9 (a responsive, accountable, effective and efficient developmental local government system). The amount spent on each activity must be specified and approved in the *financial management grant* support plan submitted by each municipality and approved by the National Treasury. As such, there is no need to ring-fence funds for a particular activity.

All municipalities and municipal entities should have complied with the regulations for implementation of the municipal standard chart of accounts by 1 July 2017. It is the responsibility of those municipalities that are not yet compliant with the regulations to ensure that they appropriately budget for its implementation using the revenue at their disposal (including own resources and transfers). Municipalities needing technical assistance to help with their budgeting can ask the relevant provincial treasury for support.

Chapter 11: Financing of Urban Municipalities and Own Revenue Diversification

Improving access to credit markets for large cities

The FFC recommends that, "The National Treasury improves access to credit markets for large cities by allowing them to use their infrastructure grant funding allocations to leverage private capital."

Government response

Government agrees that there is a need to improve municipal access to credit markets and has been emphasising this point in the *Budget Review* for several years. The National Treasury is updating the policy framework for municipal borrowing.

While municipalities will always borrow primarily against future revenue-generating assets, government acknowledges that infrastructure grants can provide additional certainty that enables improved access to borrowing. To facilitate this, the 2018 Division of Revenue Bill includes a redrafting of clause 8(4), which in previous years said a municipality needs the National Treasury's approval to borrow funds using future grant allocations as part (or all) of the future revenue against which they borrow. This limited the potential revenue considered when a municipality tried to borrow capital, unless they formally pledged funds. The changes to this section of the bill mean that the National Treasury will no longer approve the pledging of anticipated future grant funds. Instead, any borrowing against expected future grant transfers must be done in terms of the processes and criteria set out in the Municipal Finance Management Act, which requires public consultation, comments from the relevant treasury and approval by the municipal council. This provides greater flexibility for municipalities to account for anticipated future grant revenues as part of their borrowing frameworks (and for longer than the three-year MTEF period).

Improving the flow of public-private partnerships within municipalities

The FFC recommends that, "The Public Private Partnership Unit at the National Treasury improves the flow of public-private partnerships within municipalities by using the *financial management grant* to build capacity within large cities in specialised skills in public-private partnership development, procurement, negotiation and monitoring."

Government response

The Public Private Partnership Unit in the Government Technical Advisory Centre provides support and technical advice to municipalities, along with formal training courses on public-private partnerships for any municipality wishing to build the capacity of their officials. The Government Technical Advisory Centre also provides an extensive library of literature on public-private partnerships, including manuals, guidelines and case studies, all of which can be accessed at www.gtac.gov.za.

As discussed above, the *financial management grant* is a small grant that already has a large number of competing priorities to fund. Its allocations favour municipalities with substantial financial management capacity needs. This grant is therefore not an appropriate source of funding for establishing new units in cities that have substantial revenue sources of their own.

Land value capture fiscal instruments among large cities

The FFC recommends that, "The National Treasury creates awareness of land value capture fiscal instruments among large cities and extends the scope of the *financial management grant* to cater for capacity building in the design and implementation of land value capture mechanisms."

Government response

The National Treasury, through the Cities Support Programme, is already undertaking extensive activities to broaden municipal access to sources of capital finance, particularly in larger cities. This includes developing a specific toolkit on land-based financing instruments, holding a series of three technical workshops with metropolitan municipalities and providing specific technical assistance in pilot

municipalities. In addition, the National Treasury is reviewing the existing policy framework for municipal borrowing and providing technical support to cities to develop long-term financial strategies within their built environment performance plans. It has also announced its intention to table amendments to the Municipal Fiscal Powers and Functions Act during 2018 to better regulate development charges so that cities can make greater use of this revenue source.

The National Treasury does not support the recommendation that the purpose of the *financial management grant* be changed to fund specific capacity building for land-based financing instruments. As discussed above, it is a small grant with several competing priorities to fund. Its allocations are also biased in favour of assisting municipalities with substantial financial management capacity needs. Government believes that the use of land-value capture can be promoted through technical assistance (as is already being done), rather than funding capacity building through conditional grants.

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 R538.2 billion in 2017/18 to R571 billion in 2018/19. Over the MTEF period, provincial transfers will grow at an average annual rate of 6.9 per cent to R657.5 billion. Table W1.5 sets out the transfers to provinces for 2018/19; a total of R470.3 billion is allocated to the provincial equitable share and R100.7 billion to conditional grants, which includes an unallocated R123.6 million for the *provincial disaster relief grant.*

Table W1.5 Total transfers to provinces, 2018/19

R million	Equitable share	Conditional grants	Total transfers
Eastern Cape	65 500	11 263	**76 763**
Free State	26 178	7 561	**33 739**
Gauteng	93 384	21 511	**114 895**
KwaZulu-Natal	99 264	19 753	**119 017**
Limpopo	55 179	8 544	**63 723**
Mpumalanga	38 468	7 937	**46 404**
Northern Cape	12 475	4 387	**16 862**
North West	32 392	7 467	**39 859**
Western Cape	47 447	11 904	**59 351**
Unallocated	–	384	**384**
Total	**470 287**	**100 711**	**570 997**

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 line with their ability to adjust to the cuts and raise their own revenue. A weaker than expected economic and fiscal environment has meant that the budget had to be reprioritised to fund new and changing government priorities. In 2018/19, compared with the figures published in the 2017 *Medium Term Budget Policy Statement*, provincial baselines have been reduced by R5.2 billion. Of this, 27.7 per cent (R1.4 billion) was applied to the equitable share, despite it accounting for more than 80 per cent of transfers to provinces. This ensures that the basic services funded by the provincial equitable share, such as health and education, are protected. The remaining R3.7 billion of the reduction comes from provincial direct conditional grants. Notwithstanding the need for fiscal consolidation announced in the 2017 *Medium Term Budget Policy Statement*, the baselines for several grants funding essential services such as the *national school nutrition programme grant*, the *early childhood development grant* and the *comprehensive HIV, AIDS, TB and community outreach services grant* are preserved. The provincial

equitable share grows at an average annual rate of 7.1 per cent over the MTEF period, while conditional grant allocations grow by 5.9 per cent per year. As far as possible, the provincial share of the baseline reductions has been weighted towards conditional grants with a history of underspending or infrastructure grants that can absorb deferred implementation.

Two new grants are introduced into the provincial framework. The first is the *provincial emergency housing grant*, which should allow national government to respond to emergency housing situations quickly and flexibly. It has a total allocation of R831.8 million over the 2018 MTEF period. The second grant is the *title deeds restoration grant*, which aims to improve the property market by eradicating the long-standing backlog in title deeds registration associated with past beneficiaries of state-subsidised housing.

The *school infrastructure backlogs grant*, which was due to merge with the *education infrastructure grant* in 2017/18, was extended for an additional year and will continue over the 2018 MTEF period. Although progress under this grant has been sluggish, an assessment of its projects, both current and in the pipeline, revealed that merging the two grants will derail progress made to date. However, given its underperformance and the need for fiscal consolidation, the grant's baseline is reduced by R3.6 billion over the MTEF period.

Accounting for all additions, reprioritisations and fiscal consolidation efforts, the net revisions to the provincial direct conditional grants since the 2017 *Medium Term Budget Policy Statement* amount to a reduction of R3.7 billion in 2018/19, R4.8 billion in 2019/20 and R5.1 billion in 2020/21.

The provincial equitable share

The equitable share is the main source of revenue through which provinces are able to meet their expenditure responsibilities. To ensure that allocations are fair, the equitable share is allocated through a formula using objective data to reflect the demand for services across all nine provinces. For each year of the 2018 MTEF, the following amounts are allocated to the provincial equitable share respectively: R470.3 billion, R505 billion and R542.4 billion. These revisions result in the provincial equitable share increasing by 22.9 per cent (R101 billion) between 2017/18 and 2020/21.

The equitable share formula

Apart from the annual review and updates to the provincial equitable share formula to ensure that it is informed by the most recently available information, a detailed review usually takes place every four or five years. This ensures that it remains impartial, fair and responsive to the needs of the provinces. The most recent, and ongoing, review started at the end of 2016. As part of the review, all components of the formula will be assessed. This year is the first in which changes based on the review will be included in the equitable share formula.

The first phase of the review assessed the appropriateness of the datasets that inform the equitable share formula. The Department of Basic Education has improved the collection and tracking method it uses to monitor scholars making use of the public education system, moving from the Schools Reality Survey to a new tracking system for learners (Learner Unit Record Information Tracking System, or LURITS). As such, school enrolment numbers for the country will be taken from this new system to inform the education component of the equitable share formula. These changes will be phased in over the 2018 MTEF period. Further details of these changes are explained in the education component section below. Changes to any other component of the formula flowing from the review will be introduced in consultation with provincial treasuries and all other relevant stakeholders.

For the 2018 MTEF, the formula has been updated with data from the 2017 mid-year population estimates published by Statistics South Africa and the 2017 preliminary data published by the Department of Basic Education on school enrolment from the LURITS database. Data from the 2016 General Household Survey for medical aid coverage and data from the health sector and the Risk Equalisation Fund for the risk-adjusted capitation index have also been updated. Allocation changes tend to mirror shifts in population

across provinces, which result 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 (2018/19 to 2020/21).

Allocations calculated outside the equitable share formula

From 2018/19, all allocations provided to provinces as an equitable share but not allocated through the equitable share formula come to an end. The last allocation of this kind was in 2017/18, which amounted to R2 billion. This allocation previously funded adult basic education and training; a function that shifted from national to provincial government at the start of the 2015 MTEF period.

Full impact of data updates on the provincial equitable share

Table W1.6 shows the full impact of the data updates on the provincial equitable share per province. It compares the target shares for the 2017 and 2018 MTEF periods. The details of how the data updates affect each component of the formula are described in detail in the sub-sections below.

Table W1.6 Full impact of data updates on the equitable share

	2017 MTEF weighted average	2018 MTEF weighted average	Difference
Eastern Cape	14.0%	13.7%	-0.30%
Free State	5.6%	5.6%	-0.01%
Gauteng	19.8%	20.1%	0.31%
KwaZulu-Natal	21.1%	21.0%	-0.10%
Limpopo	11.7%	11.7%	-0.02%
Mpumalanga	8.1%	8.2%	0.07%
Northern Cape	2.7%	2.7%	0.00%
North West	6.9%	6.9%	0.00%
Western Cape	10.1%	10.1%	0.05%
Total	**100.0%**	**100.0%**	**0.00%**

Source: National Treasury

Phasing in the formula

Official data used annually to update the provincial equitable share formula invariably affects each province's share of the available funds. However, it is important that provinces have some stability in their revenue stream to allow for sound planning. As such, calculated new shares informed by recent data are phased in over the three-year MTEF period.

The equitable share formula data is updated every year and a new target share for each province is calculated, as shown in Table W1.7. The phase-in mechanism provides a smooth path to achieving these new 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 2018/19 published in the 2017 MTEF, and closes the gap between these shares by a third in each year of the 2018 MTEF period. As a result, one-third of the impact of the data updates is implemented in 2018/19, two-thirds in the indicative allocations for 2019/20, and the updates are fully implemented in the indicative allocations for 2020/21.

Table W1.7 Implementation of the equitable share weights

Percentage	2018/19 Indicative weighted shares from 2017 MTEF	2018/19	2019/20	2020/21
		2018 MTEF weighted shares 3-year phasing		
Eastern Cape	14.0%	13.9%	13.8%	13.7%
Free State	5.6%	5.6%	5.6%	5.6%
Gauteng	19.7%	19.9%	20.0%	20.1%
KwaZulu-Natal	21.2%	21.1%	21.1%	21.0%
Limpopo	11.7%	11.7%	11.7%	11.7%
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	10.1%	10.1%	10.1%	10.1%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**

Source: National Treasury

Provincial equitable share allocations

The final equitable share allocations per province for the 2018 MTEF are detailed in Table W1.8. These allocations include the full impact of the data updates, phased in over three years.

Table W1.8 Provincial equitable share

R million	2018/19	2019/20	2020/21
Eastern Cape	65 500	69 807	74 411
Free State	26 178	28 071	30 108
Gauteng	93 384	100 923	109 092
KwaZulu-Natal	99 264	106 364	113 998
Limpopo	55 179	59 188	63 503
Mpumalanga	38 468	41 395	44 555
Northern Cape	12 475	13 404	14 405
North West	32 392	34 789	37 372
Western Cape	47 447	51 080	55 003
Total	**470 287**	**505 020**	**542 447**

Source: National Treasury

Summary of the formula's structure

The formula, shown in Table W1.9, consists of six components that capture the relative demand for services across 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. Rather, the education and health components are weighted broadly in line with historical expenditure patterns to indicate relative need. Provincial executive councils determine the departmental allocations for each function, taking into account the priorities that underpin the division of revenue.

For the 2018 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 caseload.
- 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).

In 2017, Statistics South Africa fully applied its provincial demographic data. This means that the 2017 mid-year population estimates now fully reflect changes in provincial populations, leading to a substantive revision to the estimates. As such, all components that use the mid-year population estimates mirror this change in population numbers. To accommodate these substantial changes, the affected components will receive additional cushioning, over and above the usual three-year phasing-in of all data updates. This will provide stability in the provincial allocations and allow provinces to adjust to the changes. The mid-year population estimates affect the *health*, *basic* and *poverty* components of the provincial equitable share formula.

Table W1.9 Distributing the equitable shares by province, 2018 MTEF

	Education	Health	Basic share	Poverty	Economic activity	Institu-tional	Weighted average
	48.0%	**27.0%**	**16.0%**	**3.0%**	**1.0%**	**5.0%**	**100.0%**
Eastern Cape	14.9%	13.1%	12.1%	15.6%	7.8%	11.1%	13.7%
Free State	5.3%	5.2%	5.1%	5.2%	5.1%	11.1%	5.6%
Gauteng	18.1%	22.4%	24.7%	17.7%	34.1%	11.1%	20.1%
KwaZulu-Natal	22.3%	21.5%	19.7%	22.2%	16.0%	11.1%	21.0%
Limpopo	13.1%	10.2%	10.3%	13.5%	7.2%	11.1%	11.7%
Mpumalanga	8.4%	7.4%	7.8%	9.2%	7.5%	11.1%	8.2%
Northern Cape	2.3%	2.1%	2.1%	2.2%	2.1%	11.1%	2.7%
North West	6.5%	6.7%	6.8%	8.1%	6.5%	11.1%	6.9%
Western Cape	9.1%	11.4%	11.4%	6.2%	13.6%	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)

There is a change to this component of the formula. The methodology, and subsequently the dataset that informs the enrolment numbers, is changed from 2017 onwards. Previously, learner enrolment numbers were based on annual surveys of schools. To ensure the formula remains equitable and fair, and reflects the most recent and officially endorsed data, it will use figures from the Department of Basic Education's new data collection system, LURITS. The new system allows data to be verified and learners' progress to be tracked throughout their school careers. It also allows for duplicates and repetitions to be detected, improving the integrity of the numbers that are reported.

The changes will be phased in over three years to ensure provinces' allocations are stable and fair. The education component continues to have two sub-components, the school-age population (5 to 17 years), based on the 2011 Census, and enrolment data drawn from the Department of Basic Education's 2017 LURITS database. Each of these elements is assigned a weight of 50 per cent.

Table W1.10 shows the effect of updating the education component with new enrolment data on the education component shares.

Table W1.10 Impact of changes in school enrolment on the education component share

	Age cohort 5 – 17	School enrolment 2016	School enrolment 2017	Changes in enrolment	Weighted average 2017 MTEF	Weighted average 2018 MTEF	Difference in weighted average
Eastern Cape	1 856 317	1 957 187	1 902 213	-54 974	15.1%	14.9%	-0.21%
Free State	657 489	687 072	691 295	4 223	5.3%	5.3%	0.02%
Gauteng	2 231 793	2 310 810	2 342 025	31 215	18.0%	18.1%	0.13%
KwaZulu-Natal	2 758 594	2 873 339	2 868 598	-4 741	22.3%	22.3%	-0.01%
Limpopo	1 536 294	1 764 551	1 768 125	3 574	13.0%	13.1%	0.03%
Mpumalanga	1 053 846	1 072 151	1 080 084	7 933	8.4%	8.4%	0.03%
Northern Cape	288 839	291 650	291 760	110	2.3%	2.3%	0.00%
North West	824 724	828 674	827 628	-1 046	6.5%	6.5%	-0.00%
Western Cape	1 174 625	1 113 563	1 117 468	3 905	9.1%	9.1%	0.02%
Total	**12 382 521**	**12 898 997**	**12 889 196**	**-9 801**	**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 W1.11 shows the shares of the risk-adjusted component, which accounts for 75 per cent of the health component.

Table W1.11 Risk-adjusted sub-component shares

Thousand	Mid-year population estimates 2017 [1]	Insured population 2016	Risk-adjusted index	Weighted population	Risk-adjusted shares 2017	Risk-adjusted shares 2018	Change
Eastern Cape	6 780	9.6%	96.9%	5 936	13.2%	12.8%	-0.45%
Free State	2 864	16.7%	103.3%	2 463	5.4%	5.3%	-0.06%
Gauteng	13 888	27.6%	105.4%	10 600	22.3%	22.8%	0.53%
KwaZulu-Natal	11 077	11.9%	98.9%	9 652	20.9%	20.8%	-0.13%
Limpopo	5 791	9.0%	91.6%	4 829	10.5%	10.4%	-0.15%
Mpumalanga	4 386	14.3%	95.7%	3 597	7.6%	7.7%	0.16%
Northern Cape	1 203	15.4%	100.7%	1 024	2.1%	2.2%	0.06%
North West	3 823	15.4%	102.2%	3 307	7.1%	7.1%	-0.02%
Western Cape	6 402	24.7%	104.0%	5 015	10.8%	10.8%	0.05%
Total	**56 215**			**46 425**	**100.0%**	**100.0%**	**–**

1. 2017 mid-year population estimate is weighted 50-50 in 2016 and 2017 to cushion the large change between the two years

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 insurance, based on the 2016 General Household Survey, is deducted from the 2017 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.

The output sub-component is shown in Table W1.12 below.

Table W1.12 Output sub-component shares[1]

	Primary healthcare visits				Hospital workload patient-day equivalents			
Thousand	**2015/16**	**2016/17**	**Average**	**Share**	**2015/16**	**2016/17**	**Average**	**Share**
Eastern Cape	18 208	18 116	18 162	14.5%	5 717	5 531	5 624	14.1%
Free State	6 537	6 170	6 354	5.1%	2 022	1 925	1 973	4.9%
Gauteng	22 099	22 037	22 068	17.7%	8 523	8 931	8 727	21.9%
KwaZulu-Natal	30 872	29 211	30 041	24.0%	9 481	9 117	9 299	23.3%
Limpopo	14 357	15 269	14 813	11.9%	3 580	3 644	3 612	9.1%
Mpumalanga	9 309	9 449	9 379	7.5%	2 463	2 491	2 477	6.2%
Northern Cape	2 992	515	1 753	1.4%	755	761	758	1.9%
North West	8 185	8 010	8 097	6.5%	1 925	2 037	1 981	5.0%
Western Cape	14 151	14 413	14 282	11.4%	5 478	5 431	5 455	13.7%
Total	**126 709**	**123 190**	**124 950**	**100.0%**	**39 944**	**39 868**	**39 906**	**100.0%**

1. Some provincial numbers for patient-days and healthcare visits for 2015/16 have been restated, resulting in small variances from numbers published in 2017
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 2015/16 and 2016/17 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 2015/16 and 2016/17 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 W1.13 shows the updated health component shares for the 2018 MTEF period.

Table W1.13 Health component weighted shares

	Risk-adjusted	Primary healthcare	Hospital component	Weighted shares		Change
Weight	**75.0%**	**5.0%**	**20.0%**	**2017**	**2018**	
Eastern Cape	12.8%	14.5%	14.1%	13.5%	13.1%	-0.35%
Free State	5.3%	5.1%	4.9%	5.3%	5.2%	-0.08%
Gauteng	22.8%	17.7%	21.9%	21.8%	22.4%	0.53%
KwaZulu-Natal	20.8%	24.0%	23.3%	21.7%	21.5%	-0.26%
Limpopo	10.4%	11.9%	9.1%	10.3%	10.2%	-0.07%
Mpumalanga	7.7%	7.5%	6.2%	7.3%	7.4%	0.15%
Northern Cape	2.2%	1.4%	1.9%	2.1%	2.1%	0.01%
North West	7.1%	6.5%	5.0%	6.7%	6.7%	-0.01%
Western Cape	10.8%	11.4%	13.7%	11.3%	11.4%	0.08%
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 2018 MTEF, population data is drawn from the 2017 mid-year population estimates produced by Statistics South Africa. Table W1.14 shows how population changes have affected the basic component's revised weighted shares.

Table W1.14 Impact of the changes in population on the basic component shares

Thousand	Mid-year population estimates 2016	Mid-year population estimates 2017 [1]	Population change	% population change	Basic component shares 2017 MTEF	Basic component shares 2018 MTEF	Change
Eastern Cape	7 062	6 780	-282	-4.0%	12.6%	12.1%	-0.57%
Free State	2 862	2 864	3	0.1%	5.1%	5.1%	-0.02%
Gauteng	13 498	13 888	390	2.9%	24.1%	24.7%	0.56%
KwaZulu-Natal	11 080	11 077	-2	-0.0%	19.8%	19.7%	-0.11%
Limpopo	5 804	5 791	-13	-0.2%	10.4%	10.3%	-0.08%
Mpumalanga	4 328	4 386	58	1.3%	7.7%	7.8%	0.06%
Northern Cape	1 192	1 203	11	0.9%	2.1%	2.1%	0.01%
North West	3 791	3 823	33	0.9%	6.8%	6.8%	0.02%
Western Cape	6 293	6 402	109	1.7%	11.3%	11.4%	0.13%
Total	**55 909**	**56 215**	**307**		**100.0%**	**100.0%**	**–**

1. 2017 mid-year population estimate is weighted 50-50 in 2016 and 2017 to cushion the large change between the two years

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 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 of people in that province that fall into the poorest 40 per cent of South African households by the province's population figure from the 2017 mid-year population estimates. Table W1.15 shows the proportion of the poor in each province from the Income and Expenditure Survey, the 2017 mid-year population estimates and the weighted share of the poverty component per province.

Table W1.15 Comparison of current and new poverty component weighted shares

Thousand	Income and Expenditure Survey 2010/11	Current (2017 MTEF) Mid-year population estimates 2016	Current (2017 MTEF) Poor population	Current (2017 MTEF) Weighted shares	New (2018 MTEF) Mid-year population estimates 2017[1]	New (2018 MTEF) Poor population	New (2018 MTEF) Weighted shares	Difference in weighted shares
Eastern Cape	52.0%	7 062	3 674	16.3%	6 780	3 528	15.6%	-0.7%
Free State	41.4%	2 862	1 185	5.2%	2 864	1 186	5.2%	-0.0%
Gauteng	28.9%	13 498	3 897	17.3%	13 888	4 010	17.7%	0.5%
KwaZulu-Natal	45.3%	11 080	5 020	22.2%	11 077	5 019	22.2%	-0.0%
Limpopo	52.9%	5 804	3 068	13.6%	5 791	3 061	13.5%	-0.0%
Mpumalanga	47.3%	4 328	2 045	9.1%	4 386	2 073	9.2%	0.1%
Northern Cape	40.8%	1 192	486	2.2%	1 203	491	2.2%	0.0%
North West	47.9%	3 791	1 815	8.0%	3 823	1 831	8.1%	0.1%
Western Cape	21.9%	6 293	1 376	6.1%	6 402	1 400	6.2%	0.1%
Total		**55 909**	**22 566**	**100%**	**56 215**	**22 597**	**100.0%**	**–**

1. 2017 mid-year population estimate is weighted 50-50 in 2016 and 2017 to cushion the large change between the two years

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 2018 MTEF, 2016 GDP-R data is used. Table W1.16 shows the weighted shares of the economic activity component.

Table W1.16 Current and new economic activity component weighted shares

	Current (2017 MTEF) GDP-R, 2015 (R million)	Current (2017 MTEF) Weighted shares	New (2018 MTEF) GDP-R, 2016 (R million)	New (2018 MTEF) Weighted shares	Difference in weighted shares
Eastern Cape	290 581	7.6%	315 603	7.8%	0.17%
Free State	189 183	5.0%	205 350	5.1%	0.11%
Gauteng	1 309 552	34.3%	1 382 096	34.1%	-0.22%
KwaZulu-Natal	615 607	16.1%	649 124	16.0%	-0.12%
Limpopo	271 725	7.1%	289 940	7.2%	0.03%
Mpumalanga	286 295	7.5%	305 016	7.5%	0.02%
Northern Cape	80 149	2.1%	85 282	2.1%	0.00%
North West	249 724	6.5%	264 616	6.5%	-0.02%
Western Cape	519 790	13.6%	552 732	13.6%	0.02%
Total	**3 812 607**	**100.0%**	**4 049 760**	**100.0%**	**–**

Source: National Treasury

Conditional grants to provinces

There are four types of provincial conditional grants:

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

Changes to conditional grants

The overall growth in direct conditional transfers to provinces averages 5.9 per cent over the medium term. Direct conditional grant baselines total R100.7 billion in 2018/19, R106.7 billion in 2019/20 and R115 billion in 2020/21. Indirect conditional grants amount to R3.8 billion, R4.4 billion and R4.7 billion respectively for each year of the same period.

Table W1.17 provides a summary of conditional grants by sector for the 2018 MTEF period. More detailed information, including the framework and allocation criteria for each grant, is provided in the 2018 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 grants' audited outcomes for 2016/17.

Table W1.17 Conditional grants to provinces

R million	2017/18 Adjusted budget	2018/19	2019/20	2020/21	MTEF total
Agriculture, Forestry and Fisheries	**2 242**	**2 381**	**2 542**	**2 704**	**7 627**
Comprehensive agricultural support programme	1 646	1 751	1 876	2 002	5 629
Ilima/Letsema projects	522	552	583	615	1 751
Land care programme: poverty relief and infrastructure development	74	78	82	87	247
Arts and Culture	**1 420**	**1 424**	**1 501**	**1 584**	**4 509**
Community library services	1 420	1 424	1 501	1 584	4 509
Basic Education	**17 154**	**17 519**	**18 369**	**20 089**	**55 977**
Education infrastructure	10 046	9 918	10 314	11 467	31 699
HIV and Aids (life skills education)	245	243	257	271	771
Learners with profound intellectual disabilities	72	185	221	243	649
Maths, science and technology	365	370	391	413	1 175
National school nutrition programme	6 426	6 802	7 186	7 696	21 684
Cooperative Governance and Traditional Affairs	**123**	**124**	**131**	**138**	**393**
Provincial disaster relief	123	124	131	138	393
Health	**37 570**	**41 123**	**44 423**	**48 212**	**133 758**
Comprehensive HIV, AIDS, TB	17 578	19 922	22 039	24 438	66 399
Health facility revitalisation	5 684	5 816	6 047	6 380	18 242
Health professions training and development	2 632	2 784	2 940	3 102	8 827
Human papillomavirus vaccine	–	200	211	223	634
National tertiary services	11 676	12 401	13 186	14 069	39 655
Human Settlements	**19 969**	**18 945**	**19 657**	**20 975**	**59 577**
Human settlements development	19 969	18 167	18 833	20 102	57 101
Human settlements development: title deeds restoration	–	519	548	578	1 644
Human settlements development: provincial emergency housing	–	260	277	295	832
Public Works	**781**	**824**	**882**	**931**	**2 637**
Expanded public works programme integrated grant for provinces	396	416	452	476	1 344
Social sector expanded public works programme incentive for provinces	386	408	431	454	1 293
Social Development	**556**	**758**	**806**	**859**	**2 423**
Substance abuse treatment	57	71	75	79	225
Early childhood development	318	491	518	553	1 562
Social worker employment	182	197	213	227	636
Sport and Recreation South Africa	**586**	**587**	**620**	**654**	**1 861**
Mass participation and sport development	586	587	620	654	1 861
Transport	**16 477**	**17 026**	**17 807**	**18 862**	**53 696**
Provincial roads maintenance	10 754	11 036	11 482	12 113	34 630
Public transport operations	5 723	5 990	6 326	6 750	19 066
Total direct conditional allocations[1]	**96 879**	**100 711**	**106 739**	**115 008**	**322 458**
Indirect transfers	**3 813**	**3 776**	**4 366**	**4 744**	**12 886**
Basic Education	**2 180**	**1 472**	**1 327**	**969**	**3 768**
School infrastructure backlogs	2 180	1 472	1 327	969	3 768
Health	**1 633**	**2 304**	**3 039**	**3 775**	**9 118**
National health insurance indirect	1 633	2 304	3 039	3 775	9 118

1. Excludes provisional allocations
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. The commercialisation of black farmers with potential is central to transformation in the agriculture sector.
To this end, access to capital, a widely accepted barrier to the commercialisation of farmers, requires a co-funding financing model to identify and help potential commercial farmers, leveraging both public and private funds. A portion of the *comprehensive agricultural support programme* is reserved for this financing model. At present, just under R600 million is earmarked over the 2018 MTEF period to fund the sector's efforts to leverage capital for the commercialisation of black farmers.

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 EPWP. Over the medium term, R246.9 million is allocated to this grant.

The *Ilima/Letsema projects grant* aims to boost food production by helping previously disadvantaged farming communities. The grant's baseline is protected, with R552.4 million allocated for 2018/19, and a total of R1.8 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 information to improve their socio-economic 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 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 2018/19 is R74.9 million. The grant is allocated R4.5 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 indirect *school infrastructure backlogs grant* was introduced in 2011 as a temporary, high-impact grant for provinces. The national Department of Basic Education uses this grant to replace unsafe and inappropriate school structures and to provide water, sanitation and electricity on behalf of provinces. Although scheduled to end in 2017/18 by merging with the *education infrastructure grant*, the *school infrastructure backlogs grant* continues over the 2018 MTEF period to complete projects under way or in the pipeline. However, as part of fiscal consolidation efforts, the grant's baseline is reduced by R3.6 billion over the medium term. Moreover, as provinces work to consolidate schools, the need on the grant eases somewhat. It is allocated R3.8 billion over the MTEF period.

The *education infrastructure grant*'s baseline is reduced by R3.6 billion over the medium term and the total allocation for this period is R31.7 billion; R9.9 billion in 2018/19, R10.3 billion in 2019/20 and R11.5 billion in 2020/21.

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 Act, provincial education departments had to go through a two-year planning process to be eligible to receive incentive allocations from 2016/17 onwards. To receive the 2018/19 incentive, the departments had to meet certain prerequisites in 2016/17 and have their infrastructure plans approved in 2017/18. The national Department of Basic Education and the National Treasury assessed the provinces' infrastructure plans. The national departments, provincial treasuries and provincial departments of basic education undertook a moderation process to agree on the final scores. Provinces needed to obtain a minimum score of 60 per cent to qualify for the incentive. Table W1.18 shows the final score and incentive allocation for each province.

Table W1.18 Education infrastructure grant allocations

R thousand	Planning assessment results from 2017	2018/19			Final allocation for 2018/19
		Basic component	Incentive component	Disaster recovery funds	
Eastern Cape	78%	1 346 255	133 573	–	1 479 828
Free State	64%	621 764	133 573	–	755 337
Gauteng	75%	1 239 500	133 573	–	1 373 073
KwaZulu-Natal	80%	1 732 862	133 573	–	1 866 435
Limpopo	46%	1 011 680	–	–	1 011 680
Mpumalanga	61%	704 978	133 573	–	838 551
Northern Cape	79%	435 193	133 573	–	568 766
North West	60%	869 415	133 573	–	1 002 988
Western Cape	88%	887 503	133 573	–	1 021 076
Total		**8 849 150**	**1 068 584**	**–**	**9 917 734**

Source: National Treasury

The *national school nutrition programme grant* seeks to improve the nutrition of poor school children, enhance their capacity to learn and increase their attendance at school. The programme provides a free daily meal to learners in the poorest 60 per cent of schools (quintile 1 to 3). To provide meals to more children, while still providing quality food, growth in the grant's allocations over the MTEF period averages 6.2 per cent, with a total allocation of R21.7 billion.

The *maths, science and technology grant* resulted from the merging of the *Dinaledi schools grant* and the *technical secondary schools recapitalisation grant*. This grant, in its third year, appears to be gaining some traction, but is still underspending. As a result, R50.5 million is cut from the grant's baseline over the 2018 MTEF period, allowing these funds to be used in other priority areas. The grant's total allocation is R1.2 billion over the medium term.

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 grant's baseline is reduced by R51.9 million over the MTEF period, with allocations of R243.2 million in 2018/19, R257 million in 2019/20 and R270.6 million in 2020/21.

The *learners with profound intellectual disabilities grant*, which was introduced last year, aims to expand access to education for learners with profound intellectual disabilities. After starting with an allocation of R72 million in 2017/18, the grant expands its rollout in 2018/19 with an allocation of R185.5 million, R220.8 million in 2019/20 and R242.9 million in 2020/21.

Cooperative governance grant

The *provincial disaster relief grant* is administered by the National Disaster Management Centre in the Department of Cooperative Governance. It is unallocated at the start of the financial year. The grant allows the National Disaster Management Centre to immediately (in-year) release funds 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. Mitigation strategies against the ongoing drought have, in part, been funded by this grant.

To ensure that sufficient funds are available in the event of a disaster, section 26 of the 2018 Division of Revenue Bill allows for funds allocated to the *municipal disaster relief grant* to be transferred to provinces if funds in the *provincial disaster relief 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. Over the 2018 MTEF period, a total of R393 million has been allocated to the *provincial disaster relief 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. In light of previous baselines reductions, coupled with the pressures that tertiary services face, this grant's baseline is preserved over the 2018 MTEF period. The grant is allocated R39.7 billion over the medium term. The national Department of Health has committed to reviewing the allocation criteria under this grant in 2018 to ensure continued fairness in allocations to provinces.

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. This grant's baseline is reduced by R100 million in 2018/19 and by R411 million over the remainder of the 2018 MTEF period. In spite of the reduction, R18.2 billion is allocated to this grant over the medium term, with ring-fenced funds for disasters.

Similar to the reforms to the *education infrastructure grant* discussed previously, a two-year planning process is also 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. Funds for the incentive component in the outer years are shown as unallocated. Table W1.19 sets out the final score and the incentive allocation per province.

Table W1.19 Health facility revitalisation grant allocations

R thousand	Planning assessment results from 2017	2018/19			Final allocation for 2018/19
		Basic component	Incentive component	Disaster recovery funds	
Eastern Cape	73%	556 932	95 139	-	652 071
Free State	60%	481 223	95 139	-	576 362
Gauteng	65%	779 703	95 139	-	874 842
KwaZulu-Natal	69%	1 107 341	95 139	-	1 202 480
Limpopo	61%	441 759	95 139	-	536 898
Mpumalanga	56%	333 935	-	-	333 935
Northern Cape	53%	374 391	-	-	374 391
North West	61%	490 747	95 139	-	585 886
Western Cape	88%	583 690	95 139	-	678 829
Total		**5 149 721**	**665 973**	**–**	**5 815 694**

Source: National Treasury

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 for this grant is protected over the MTEF period, with an allocation of R8.8 billion over the medium term.

The *comprehensive HIV, AIDS, TB and community outreach services 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 the 2016 MTEF, the grant's scope was extended to include Tuberculosis. In the 2018 MTEF, a sub-component for community outreach services is introduced, so that funds used to support community health workers can be explicitly earmarked. This will help ensure that this cadre of workers is better integrated into national health services. Moreover, to make provision for the continued expansion of antiretroviral

treatment in response to the universal test-and-treat policy, R1 billion has been added to the grant in 2020/21. The grant's total baseline amounts to R66.4 billion over the medium term.

Last year it was announced that the national Department of Health would fund all preparatory work for universal health coverage under the *national health insurance indirect grant*. This grant previously had five targeted components, but this has been replaced by three components in the 2018 MTEF. The grant will still cover the preparatory work, but having three components rather than five will ensure a more integrated approach to national health insurance. The grant includes an existing component (health facilities revitalisation) and two new integrated components (personal services and non-personal services). Personal services will aim to test a priority set of health services and contracting modalities that would be best suited to South Africa's sector. Non-personal services will test, and scale up when ready, the technology platforms and information systems needed to ensure a successful transition to national health insurance.

In 2018/19, the human papillomavirus vaccine component of the *national health insurance indirect grant* will become a standalone direct grant to provinces (now called the *human papillomavirus vaccine grant*). Over the course of 2017, the national Department of Health worked to ensure that provincial departments were ready to take over the provision of this service and preserve the high coverage ratios that were achieved under this component.

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. Following the 2017 *Medium Term Budget Policy Statement*, this grant was identified for reprioritisation as part of government's fiscal consolidation efforts. A total of R7.2 billion is reprioritised from the grant's baseline, while R842 million is earmarked within the grant to improve social housing by boosting government's subsidy programme.

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 billion is ring-fenced over the 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.

Public works grants

The *EPWP 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 grant is allocated R1.3 billion over the MTEF period.

The *social sector EPWP 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 EPWP and measures the performance of each province relative to its peers, providing additional incentives to those that perform well. The grant is allocated R1.3 billion over the MTEF period.

Social development grants

The *substance abuse treatment grant* aims to build public substance abuse treatment facilities in the four provinces that did not already have such facilities: the Eastern Cape, the Free State, the Northern Cape and the North West. Previously, this grant was exclusively used to construct treatment centres. In 2018/19, it now supplements the operationalisation of the newly constructed centres. No baseline reduction has been effected on this grant. It has been allocated R224.5 million over the medium term.

The *early childhood development grant* is now in its second year. It plays a part in government's prioritisation of early childhood development, as envisioned in the National Development Plan. The grant has two distinct objectives: improve poor children's access to early childhood programmes and ensure that early childhood centres have adequate infrastructure. The grant baseline totals R1.6 billion over the MTEF period.

The *social worker employment grant*, also in its second year, was created to help reduce the backlog in the number of unemployed social worker graduates while the need for social work across the country continues to increase. The grant uses reprioritised funds that the Department of Social Development previously used to subsidise the education of social workers. A total of R636.3 million has been allocated to this grant over the medium term.

Sport and recreation 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 of this grant is reduced by R99 million, with an allocation of R1.9 billion over the MTEF period.

Transport grants

The *public transport operations grant* subsidises commuter bus services. It helps ensure that provinces meet their contractual obligations and provide services efficiently. The public transport contracting and regulatory functions may be assigned to certain metropolitan municipalities during 2018/19. If this takes place, funds for this grant will be transferred directly to the assigned municipality. Given the pressure this sector faces, the grant's baseline is protected, with allocations of R6 billion in 2018/19, R6.3 billion in 2019/20 and R6.7 billion in 2020/21.

The *provincial roads maintenance grant* has three components. The largest component enables provinces to expand their maintenance activities, while the other two 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.

The performance indicators for the incentive portion of the grant, based on traffic loads, safety engineering and visual condition indicators, came into effect in 2017/18. The total allocation for the MTEF period is R34.6 billion.

Part 5: Local government fiscal framework and allocations

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 2018/19 budgets, and to promote better accountability and transparency by ensuring that all national allocations are included in municipal budgets.

Over the 2018 MTEF period, R382.8 billion will be transferred directly to local government and a further R21.8 billion has been allocated to indirect grants. Direct transfers to local government over the medium term account for 9 per cent of national government's non-interest expenditure. When indirect transfers are added to this, total spending on local government increases to 9.5 per cent of national non-interest expenditure.

Table W1.20 Transfers to local government[1]

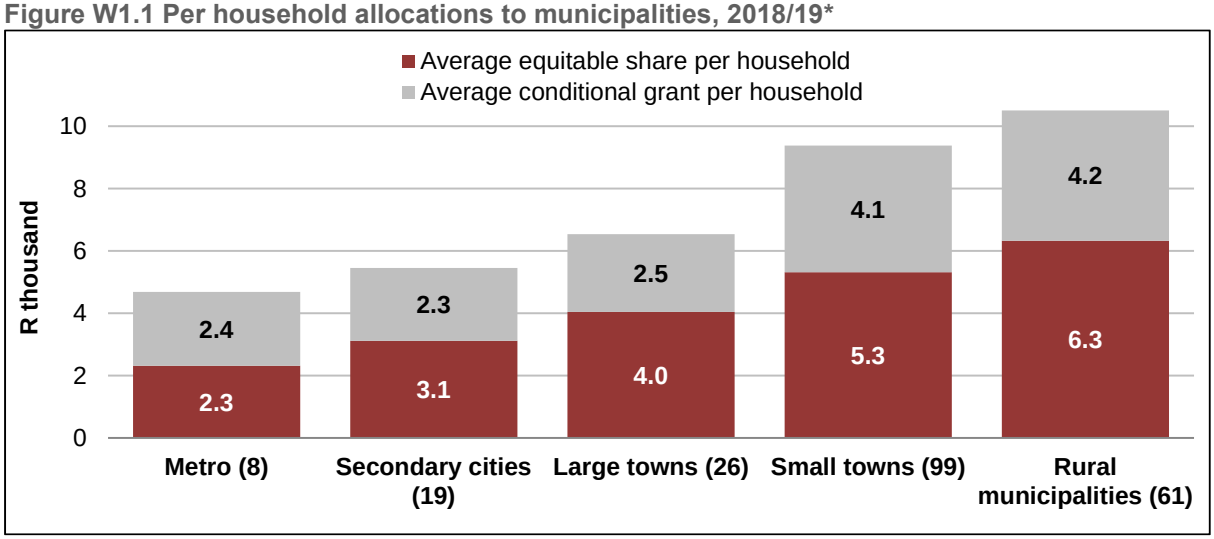
R million	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
		Outcome		Adjusted budget	Medium-term estimates		
Direct transfers	**87 570**	**98 338**	**102 867**	**112 578**	**118 458**	**126 914**	**137 462**
Equitable share and related[1]	**41 592**	**49 367**	**50 709**	**57 012**	**62 732**	**68 973**	**75 683**
Equitable share formula[2]	36 512	44 211	45 259	51 326	56 722	62 633	69 001
RSC levy replacement	4 146	4 337	4 567	4 795	5 073	5 357	5 652
Support for councillor remuneration and ward committees	935	819	883	891	937	983	1 030
General fuel levy sharing with metros	**10 190**	**10 659**	**11 224**	**11 785**	**12 469**	**13 167**	**14 027**
Conditional grants	**35 788**	**38 313**	**40 934**	**43 781**	**43 258**	**44 773**	**47 752**
Infrastructure	34 167	36 866	39 073	41 804	41 214	42 637	44 982
Capacity building and other	1 621	1 446	1 861	1 977	2 043	2 136	2 769
Indirect transfers	**8 052**	**10 370**	**8 112**	**7 803**	**6 896**	**7 265**	**7 664**
Infrastructure	7 800	10 119	8 093	7 699	6 780	7 143	7 536
Capacity building and other	252	251	19	103	115	122	128
Total	**95 622**	**108 708**	**110 979**	**120 381**	**125 354**	**134 178**	**145 126**

1. Excludes provisional allocations
2. Outcome figures for the equitable share reflect amounts transferred after funds have been withheld to offset underspending by municipalities on conditional grants. Roll-over funds are reflected in the year in which they were transferred
Source: National Treasury

The local government fiscal framework responds to the constitutional assignment of powers and functions to this sphere of government. The framework – including all transfers and own revenues – is structured to support the achievement of the National Development Plan's goals.

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. 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. As a result, transfers per household to the most rural municipalities are more than twice as large as those to metropolitan municipalities.

Figure W1.1 Per household allocations to municipalities, 2018/19*



**Reflects funds allocated through Division of Revenue Bill. Allocations to district municipalities are reassigned to local municipalities where possible.*

Source: National Treasury

Changes to local government allocations

Over the next three years there is strong growth in allocations to the local government equitable share, alongside a significant reduction in conditional grants. As a result, total direct allocations to local government grow at an annual average rate of 6.9 per cent over the MTEF period. The changes to each local government allocation are summarised in Table W1.21.

Table W1.21 Revisions to direct and indirect transfers to local government[1]

R million	2018/19	2019/20	2020/21	2018 MTEF Total revisions
Technical adjustments	**140**	**149**	**159**	**448**
Direct transfers	**140**	**149**	**159**	**448**
Municipal disaster recovery	21	-	-	**21**
Municial disaster relief	-21	-	-	**-21**
Municipal emergency housing	140	149	159	**448**
Additions to baselines	**–**	**1 500**	**2 413**	**3 913**
Direct transfers	**–**	**1 500**	**2 413**	**3 913**
Local government equitable share	–	1 500	1 899	3 399
Municipal restructuring	–	–	514	514
Reductions to baseline	**-3 852**	**-5 962**	**-6 290**	**-16 104**
Direct transfers	**-3 152**	**-5 212**	**-5 499**	**-13 863**
Municipal infrastructure	-1 500	-2 000	-2 110	-5 610
Water services infrastructure	-78	-88	-93	-259
Urban settlements development	-650	-750	-791	-2 191
Public transport network	-329	-848	-895	-2 072
Expanded public works programme integrated grant for municipalities	-36	-39	-41	-117
Integrated national electrification programme (municipal)	-300	-1 200	-1 266	-2 766
Neighbourhood development partnership	-100	-120	-127	-347
Integrated city development	-15	-16	-17	-49
Rural roads asset management systems	-6	-6	-6	-18
Regional bulk infrastructure	-103	-109	-115	-327
Local government financial management	-27	-28	-30	-85
Infrastructure skills development	-7	-8	-8	-23
Indirect transfers	**-700**	**-750**	**-791**	**-2 241**
Integrated national electrification programme	-700	-750	-791	-2 241
Total change to local government allocations				
Change to direct transfers	-3 012	-3 563	-2 927	-9 502
Change to indirect transfers	-700	-750	-791	-2 241
Net change to local government allocations	**-3 712**	**-4 313**	**-3 718**	**-11 743**

1. Excludes provisional allocations
Source: National Treasury

Just under R6 billion is added to the local government equitable share over the medium term. This will fully cover the increased municipal costs of providing free basic services to a growing number of households, and takes account of likely above-inflation increases in the costs of bulk water and electricity. It will also allow for faster increases in the allocations to poorer and rural municipalities through the redistributive components of the equitable share formula.

A new conditional grant will be introduced to help municipalities in financial crisis to implement reforms to turn themselves around. This grant receives an allocation of R514 million in 2020/21. It also has a provisional allocation of R300 million in 2019/20, but this is not reflected in Table W1.21 because provisional allocations are not yet confirmed. The allocation will be confirmed based on the quality of preparatory work for the grant completed in 2018. This new grant is discussed further in Part 6.

Since the 2017 *Medium Term Budget Policy Statement*, large reductions to major government spending programmes across all three spheres of government have been required, as discussed in Chapter 3, 5 and 6 of the *Budget Review*.

A total of R13.9 billion has been cut from direct local government conditional grant allocations for the MTEF period ahead since the 2017 *Medium Term Budget Policy Statement* was tabled. Indirect grants to local government have been reduced by an additional R2.2 billion.

Not all conditional grants were reduced, and not all grants were reduced by the same amount. Cuts were mostly made to infrastructure conditional grants, particularly the larger ones, as this was the most practical way of making the necessary reductions. The effect on each conditional grant is discussed in more detail in the sub-section below on conditional grants.

Technical adjustments include the shift of R448 million over the MTEF period from the provincial *human settlements development grant* to establish the new *municipal emergency housing grant*.

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 revenue raised through 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 2018 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 R207.4 billion – R62.7 billion in 2018/19, R69 billion in 2019/20 and R75.7 billion in 2020/21.

To help compensate for the rising costs of providing free basic services in municipalities, R1.5 billion will be added to the local government equitable share in 2019/20 and R2.6 billion will be added in 2020/21. This is in addition to previous increases of R3 billion for 2018/19 in the 2016 division of revenue and a further R1 billion in 2018/19 and R2.3 billion in 2019/20 added in the 2017 division of revenue.

Formula for allocating the local government equitable share

The portion 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 257 municipalities, using a formula (the horizontal division) to ensure objectivity.

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 current formula for the local government equitable share was introduced in 2013/14. The 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 demographic and other data to determine each municipality's portion 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 sub-sections that follow.

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. However, the proportion in each municipality varies widely. If this monthly household income is to be shown in 2017 terms, this is equivalent to about R3 350 per month. This 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. In 2018/19 the number of households used in the formula will be updated from the 2016 Community Survey. The three-year process of phasing in the impact of the 2016 Community Survey data began in 2017/18. In 2018/19, allocations are based on data from the 2016 Community Survey, but the impact of the changes resulting from this updated data are cushioned through a phase-in mechanism described below (under the correction and stabilisation component).

From 2019/20, the number of households per municipality used to calculate indicative allocations for the outer years of the MTEF is updated based on the growth experienced between the 2001 Census and the 2016 Community Survey. Provincial growth rates are then rebalanced to match the average annual provincial growth reported between 2002 and 2016 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 proportion of households below the affordability threshold in each municipality is still based on 2011 Census data. This is because the 2016 Community Survey did not publish data on household incomes.

Although the total number of households in each municipality is adjusted every year to account for growth, the share of those households that are subsidised for free basic services through the formula remains constant (but the number of households subsidised increases annually in line with estimated household growth). In 2018/19, a total of 9.8 million households are funded through the basic services subsidy.

The basic services component provides a subsidy of R383.12 per month in 2018/19 for the cost of providing basic services to each of these households. The subsidy includes funding for the provision of free basic water (six 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 W1.22 and includes an allocation of 10 per cent for service maintenance costs.

Table W1.22 Amounts per basic service allocated through the local government equitable share, 2018/19

	Allocation per household below affordability threshold (R per month)			Total allocation per service (R million)
	Operations	Maintenance	Total	
Energy	73.46	8.16	81.62	9 604
Water	112.90	12.54	125.45	14 761
Sanitation	86.19	9.58	95.77	11 269
Refuse	72.25	8.03	80.28	9 447
Total basic services	**344.81**	**38.31**	**383.12**	**45 081**

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 on the National Treasury website. The per-household allocation for each of the basic services in Table W1.22 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 bulk price determination approved by the National Energy Regulator of South Africa. As the bulk price increase for municipalities for 2018/19 will only be announced after the 2018 Budget is tabled, the 8 per cent annual increase approved for the previous multi-year price determination period has been used to calculate equitable share allocations. Other electricity costs are updated based on the National Treasury's inflation projections in the 2017 *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 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 average tariff increase for bulk water from water boards in 2017/18 was 8.8 per cent. Other costs are updated based on the National Treasury's inflation projections in the 2017 *Medium Term Budget Policy Statement*.
- The costs for sanitation and refuse removal are updated based on the National Treasury's inflation projections in the 2017 *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 R45 billion in 2018/19 and accounts for 79.5 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 revenue-raising abilities, a revenue adjustment factor is applied so that municipalities with less potential to raise their own revenue receive a larger proportion of the allocation. The revenue adjustment factor is described in more detail later in this annexure.

This component consists of a base allocation of R6.6 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 Minister of Cooperative Governance and Traditional Affairs determines the number of seats recognised for the formula). 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 8.2 per cent of the equitable share formula and is worth R4.7 billion in 2018/19. This component is also complemented by special support for councillor remuneration in poor municipalities, which is not part of the equitable share formula.

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 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, which both provide community services. In 2018/19, the allocation to district and metropolitan municipalities for municipal health and related services is R9.31 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 12.3 per cent of the equitable share formula and is worth R7 billion in 2018/19.

The revenue adjustment factor

The Constitution gives local government substantial 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 revenue.

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 have a larger revenue adjustment factor.

The revenue adjustment factor is not based on the actual revenues municipalities collect, which ensures that this component does not create a 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 have a higher revenue adjustment factor.

Correction and stabilisation factor

Providing municipalities with predictable and stable equitable share 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.

The changes resulting from updating the formula with 2016 Community Survey data are phased in through the correction and stabilisation factor over three years (2017/18 to 2019/20). The updated data results in some significant changes to municipal allocations because the number of households in some municipalities in the survey differs from the projected numbers used in the local government equitable share formula (based on 2011 Census numbers, updated annually using past growth rates). Although the projected number of households in the formula for the country as a whole differed from the 2016 Community Survey results by only about 1 000 households, or a difference of only 0.006 per cent, in

some individual municipalities the differences were as high as 24 per cent. In 44 per cent of municipalities, the difference between the formula's projections and the 2016 Community Survey results was less than 5 per cent, but to preserve the stability of allocations to those municipalities with larger differences it is necessary to phase in the updates over a three-year period.

In 2018/19, the phasing in of the 2016 Community Survey data is structured so that the municipality with the highest percentage decrease as a result of the update receives 90 per cent of its indicative allocation for 2018/19, as set out in the 2016 Division of Revenue Act. The rest of the municipalities receive allocations above their 90 per cent guaranteed amount that are proportional to the size of their total allocation, adjusted to account for the percentage increase or decrease resulting from the data updates. The same methodology was applied in 2017/18, but with the municipality with the highest percentage decrease receiving 95 per cent of its indicative allocation, giving them more cushioning in the first year. By 2019/20, municipalities will be receiving allocations as determined by the updated formula.

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 balancing 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. Increases in the cost of providing basic services can result in lower institutional and community services allocations.

Providing for bulk price increases in the outer years

As an additional safeguard in case of bulk costs for electricity or water that are higher than anticipated, or household growth, amounts of R500 million in 2019/20 and R1 billion in 2020/21 will remain unallocated. These funds were added to the local government equitable share through the budget process partly to offset Eskom's major requested increase in electricity bulk costs, which has not been approved to date. Setting these amounts aside as unallocated in the outer years of the 2018 MTEF period also prevents them from being allocated to municipalities through the community services and institutional components, only to have to reverse those increases in future if the funds have to be reprioritised into the basic services component.

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 use of differentiated cost variables to take account of the cost of services in various circumstances, including costs related to the size of the land area served and settlement types in municipalities. SALGA and the FFC have completed a research project that provides some estimates of these different cost factors and demonstrates how complex it would be to incorporate such details into the formula. SALGA has undertaken to propose how aspects of this study might be incorporated into the formula.
- Refining the methodology used to update household growth estimates, taking account of updated data from Statistics South Africa, and possibly using district-level data.
- Improving the responsiveness of the formula to the different functions assigned to district and local municipalities. This work depends on the availability of credible official records of the functions assigned to each sphere of government.

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 a Regional Services Council (RSC) or Joint Services Board (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 *RSC/JSB levies replacement grant*'s value increases every year.

In the 2017 Explanatory Memorandum to the Division of Revenue it was announced that adjustments would be made to the grant to redistribute funds to the 13 district municipalities with the smallest allocations from this grant. These adjustments are being implemented over a two-year period, from 2017/18 to 2018/19. To fund these increased allocations, the growth rates of the 10 district municipalities with the largest allocations were reduced so that they received two-thirds of their original growth rate in 2017/18 and they will receive one-third of their original growth rate in 2018/19. Provincial treasuries have been asked to engage with the district municipalities that receive increased allocations to ensure that they use these additional funds to improve services.

In the year following the completion of this adjustment (2019/20), the grant increases by 8.8 per cent a year for district municipalities authorised for water and sanitation and 2.9 per cent for unauthorised district municipalities. The different rates recognise the various service-delivery responsibilities of these district municipalities and the fact that the allocations to unauthorised municipalities have an average growth rate below inflation.

Special support for councillor remuneration and ward committees

Councillors' salaries are subsidised in poor municipalities. The total value of the support provided in 2018/19 is R937 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).

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. 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 Division of Revenue Bill appendices.

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 R43.3 billion in 2018/19 to R44.8 billion in 2019/20 and R47.8 billion in 2020/21.

There are four types of local government conditional grants:

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

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 R150.3 billion over the 2018 MTEF period.

Table W1.23 Infrastructure grants to local government[1]

R million	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
		Outcome		Adjusted budget	Medium-term estimates		
Direct transfers	**34 167**	**36 866**	**39 073**	**41 804**	**41 214**	**42 637**	**44 982**
Municipal infrastructure	14 745	14 956	14 914	15 891	15 288	15 734	16 599
Water services infrastructure	1 051	2 305	2 831	3 329	3 481	3 669	3 871
Urban settlements development	10 285	10 554	10 839	11 382	11 306	11 881	12 534
Integrated national electrification programme	1 105	1 980	1 946	2 087	1 904	2 128	2 245
Public transport network	5 871	5 953	5 593	6 160	6 254	6 114	6 450
Neighbourhood development partnership	590	584	592	663	602	621	655
Integrated city development	255	251	267	292	294	310	327
Regional bulk infrastructure	–	–	1 850	1 865	1 957	2 066	2 180
Rural roads asset management systems	75	97	102	107	108	114	120
Municipal disaster recovery	190	186	140	26	21	–	–
Indirect transfers	**7 800**	**10 119**	**8 093**	**7 699**	**6 780**	**7 143**	**7 536**
Integrated national electrification programme	2 948	3 613	3 526	3 846	3 262	3 432	3 621
Neighbourhood development partnership	30	13	15	28	29	31	33
Regional bulk infrastructure	4 005	4 858	3 422	2 974	2 881	3 037	3 204
Water services infrastructure	732	659	298	852	608	642	678
Bucket eradication programme	84	975	831	–	–	–	–
Total	**41 967**	**46 985**	**47 166**	**49 503**	**47 995**	**49 780**	**52 519**

1. Excludes provisional allocations
Source: National Treasury

Municipal infrastructure grant

The largest infrastructure transfer to municipalities 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 is reduced by R1.5 billion in 2018/19, R2 billion in 2019/20 and R2.1 billion in 2020/21, total allocations still amount to R47.6 billion over the 2018 MTEF period and grow at an average annual rate of 1.5 per cent. The impact of this reduction will be shared among municipalities in line with the *municipal infrastructure grant* formula. The formula's base component ensures that smaller municipalities will see a much smaller cut in percentage terms than large

municipalities – the municipality with the smallest grant allocations will receive a cut of about 2.5 per cent in 2018/19, while the largest reduction to a municipality will be 9.5 per cent.

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 below.

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 (including sport infrastructure)

E Allocation for social institutions and micro-enterprise infrastructure

N Allocation to the 27 priority districts identified by government

Allocations for the water and sanitation sub-components of the basic services component 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. The formula considers poor households without access to services that meet sector standards to be a backlog.

Data used in the municipal infrastructure grant formula

Component	Indicator used in the formula	Data used (all data is from the 2011 Census)
B	Number of water backlogs	Number of poor households[1] that do not have adequate access to water (adequate access defined as piped water either inside their dwelling, in the yard or within 200 meters of their dwelling)
	Number of sanitation backlogs	Number of poor households that do not have adequate access to sanitation (adequate access defined as having a flush toilet, chemical toilet, pit toilet with ventilation or ecological toilet)
	Number of roads backlogs	Number of poor households
	Number of other backlogs	Number of poor households that do not have access to refuse disposal at Reconstruction and Development Programme levels of service
P	Number of poor households	Number of poor households
E	Number of poor households	Number of poor households
N	Number of households in nodal areas	Allocated to the 27 priority districts identified by Cabinet as having large backlogs. Allocation is based on total households (not poor households)

1. Poor household defined as a monthly household income of less than R2 300 per month in 2011 Census data

Table W1.24 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 W1.24 Municipal infrastructure grant allocations per sector

Municipal infrastructure grant (formula)	Component weights	Value of component 2018/19 (R millions)	Proportion of municipal infrastructure grant per sector
B-component	**75.0%**	**10 413 368**	**68.1%**
Water and sanitation	54.0%	7 497 625	49.0%
Roads	17.3%	2 395 075	15.7%
Other	3.8%	520 668	3.4%
P-component	**15.0%**	**2 082 674**	**13.6%**
Sports	33.0%	687 282	4.5%
E-component	**5.0%**	**694 225**	**4.5%**
N-component	**5.0%**	**694 225**	**4.5%**
Constant	**5.0%**	**1 130 000**	**7.4%**
Ring-fenced funding for sport infrastructure		**273 195**	**1.8%**
Total		**15 287 685**	**100.0%**

Source: National Treasury

The *municipal infrastructure grant* includes an amount allocated outside of the grant formula and earmarked for specific sport infrastructure projects identified by Sport and Recreation South Africa. These earmarked funds amount to R273.2 million in 2018/19, R266.2 million in 2019/20 and R266.2 million in 2020/21. This allocation takes into account a reduction of R26.8 million in 2018/19, R33.8 million in 2019/20 and R33.8 million in 2020/21. In addition, municipalities are required to spend a third of the P-component (equivalent to 4.5 per cent of the grant) on sport and recreation infrastructure identified in their own integrated development plans. Municipalities are also encouraged to increase their investment in other community infrastructure, including cemeteries, community centres, taxi ranks and marketplaces.

The Department of Cooperative Governance, which administers the *municipal infrastructure grant*, continues to implement measures to strengthen the management and implementation of the grant in line with the ongoing review of local government infrastructure grants. In 2018/19, two local municipalities, Polokwane and uMhlathuze, will be used to pilot a new approach to funding infrastructure in intermediate cities in 2018/19. These cities face spatial and urban development challenges similar to metropolitan municipalities. The pilot project will shift the *municipal infrastructure grant* towards programmatic, rather than project-based, planning and reporting requirements. This will create greater flexibility in the use of grants to implement catalytic investments and leverage other sources of funding. From 2019/20, more cities will be able to apply to participate in this grant structure, and a new *integrated urban development grant* will be created through the reprioritisation of funds from the *municipal infrastructure grant.* Further details of plans for this grant are discussed in Part 6.

Urban settlements development grant

The *urban settlements development grant* is an integrated source of funding for infrastructure for municipal services and upgrades to urban informal settlements in the eight metropolitan municipalities. It is allocated as a supplementary grant to cities (schedule 4, part B 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. This grant helps cities provide services to the large number of urban households living in informal settlements. At least 50 per cent of the grant must be used to fund the upgrading of informal settlements. Government will review the performance of urban informal settlement upgrading programmes during 2018 and propose changes to grants where necessary to improve performance. Up to 3 per cent of the *urban settlements development grant* may be used to fund municipal capacity in the built environment in line with the capacity-building guideline to be published by the Department of Human Settlements.

Reporting on urban infrastructure grants, including the *urban settlements development grant*, will be simplified in 2018/19, helping to reduce the reporting burden on cities. This is the result of a process led by the National Treasury to rationalise and streamline built environment reporting for the eight metropolitan municipalities. The National Treasury has also created a set of indicators to enable government to monitor progress on the integrated and functional outcomes. These reforms will progressively be extended to non-metropolitan municipalities over the medium term.

Although the grant's baseline is reduced by R650 million in 2018/19, R750 million in 2019/20 and R791 million in 2020/21, total allocations still amount to R35.7 billion over the MTEF period and grow at an average annual rate of 3.3 per cent. The impact of this reduction will be shared proportionately across the eight metropolitan municipalities.

Integrated city 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. The grant's incentive allocations were previously based on performance measures of good governance and administration. However, an additional indicator based on an assessment of a city's built environment performance plan was introduced in 2017/18. Cities are required to adopt performance plans that provide a strategic overview of their plans for the built environment, and how their infrastructure investments will transform spatial development patterns over time. Including a peer-reviewed assessment score in the allocation criteria for this grant provides a tangible reward for cities that improve the quality of their plans. This is in line with the reforms emerging from the ongoing review of local government infrastructure grants, which calls for increased use of incentives in urban grants and the use of grants to support urban spatial transformation.

Although the grant's baseline is reduced by R15 million in 2018/19, R16 million in 2019/20 and R17 million in 2020/21, total allocations still amount to R931 million over the 2018 MTEF period and grow at an average annual rate of 4 per cent. Because this grant allocates formula-determined incentives, the reduction will mean that the incentives available for each qualifying city will be slightly smaller.

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 pedestrian and cycling infrastructure. The grant also subsidises the operation of these services.

A formula-based grant allocation has been implemented since 2016/17. This increases certainty about the extent of national funding that municipalities can expect when planning their public transport networks, and encourages cities to shift towards more sustainable public transport investments.

Previously, a formula was used to determine 80 per cent of the grant allocations and the remaining 20 per cent provided for discretionary allocations. In practice these discretionary allocations were mostly used to top-up amounts for smaller cities. From 2018/19, the formula includes more stable and predictable allocations for smaller cities. A new base component will account for 20 per cent of total allocations, divided equally among all participating cities, to ensure that smaller cities in particular have a significant base allocation to run their transport system regardless of their size. The bulk of the formula (75 per cent) will be allocated based on three demand-driven factors, which account for the number of people in a city, the number of public transport users in a city (the weighting of train commuters is reduced as trains are subsidised separately through the Passenger Rail Authority of South Africa) and the size of a city's economy. The remaining 5 per cent is earmarked for a performance incentive, which will take effect in 2019/20 when an approach to measuring performance has been finalised. In the meantime, the Department of Transport allocates this 5 per cent as a discretionary amount.

Strict eligibility conditions are also being introduced, including requirements that cities demonstrate that their planned public transport systems will be financially sustainable. Several cities have already revised their planned public transport networks as a result of these new planning requirements, and further improvements are expected.

Table W1.25 Formula for the public transport network grant

	Base 20%	Demand-driven factors 75%			Subtotal: base and demand driven factors	Perfomance 5%	100%
	Equally shared	Population component shares	Regional gross value added component shares	Public transport users component shares		Discretionary/incentive R 000	Grant allocations R 000
Buffalo City	7.7%	3.3%	2.8%	3.1%	**3.8%**	-152 256	**95 165**
Cape Town	7.7%	16.3%	15.8%	13.9%	**13.0%**	242 296	**1 045 522**
City of Johannesburg	7.7%	19.3%	25.2%	20.5%	**17.8%**	–	**1 112 936**
City of Tshwane	7.7%	12.7%	15.0%	14.0%	**12.0%**	62 900	**808 194**
Ekurhuleni	7.7%	13.8%	9.5%	14.9%	**11.1%**	–	**694 640**
eThekwini	7.7%	15.0%	15.8%	18.0%	**13.7%**	25 443	**883 887**
George	7.7%	0.8%	0.5%	0.2%	**1.9%**	49 813	**167 674**
Mangaung	7.7%	3.3%	2.4%	3.2%	**3.8%**	–	**234 831**
Mbombela	7.7%	2.6%	1.9%	2.4%	**3.3%**	–	**203 454**
Msunduzi	7.7%	2.7%	1.5%	2.4%	**3.2%**	–	**199 104**
Nelson Mandela Bay	7.7%	5.0%	4.7%	3.6%	**4.9%**	–	**304 942**
Polokwane	7.7%	2.7%	1.5%	1.3%	**2.9%**	22 717	**205 107**
Rustenburg	7.7%	2.4%	3.5%	2.3%	**3.6%**	78 221	**298 212**
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**95.0%**	**329 134**	**6 253 669**

Source: National Treasury

The grant is allocated R18.8 billion over the medium term. Its baseline has been reduced by R329 million in 2018/19, R848 million in 2019/20 and R895 million in 2020/21. These reductions will be implemented proportionately across all 13 participating cities. The smaller reductions in the first year of the MTEF period allow time for the national Department of Transport and the National Treasury to assess the plans and performance of each city and to determine whether all cities should continue implementing their planned systems. If some cities have plans that do not fully meet the criteria of the grant (including for sustainable public transport systems), their future allocations will be reviewed. This process may result in some funds being released that could lessen the effect of the budget reductions on other participating cities in 2019/20 and 2020/21.

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. Although the grant's baseline is reduced by R100 million in 2018/19, R120 million in 2019/20 and R127 million in 2020/21, total allocations still amount to R2 billion over the 2018 MTEF period, made up of R1.9 billion for the direct capital component and R93 million for the indirect technical assistance component. Grant reductions will mean that the implementation of some planned projects will be delayed.

Water services infrastructure grant

This grant, administered by the Department of Water and Sanitation, aims to accelerate the delivery of clean water and sanitation facilities to communities that do not have access to basic water services. It 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 are transferred through a direct grant. In other areas, the Department of Water and Sanitation implements projects on behalf of municipalities through an indirect grant. In 2018/19, the total indirect portion (R608 million) of this grant will be allocated to projects under the bucket eradication programme. The programme funds the eradication of bucket sanitation systems in formal residential areas. By the end of 2018/19, the Department of Water and Sanitation expects to have eradicated all bucket sanitation systems that were in existence in 2014.

The direct component of this grant is reduced by R78 million in 2018/19, R88 million in 2019/20 and R93 million in 2020/21, meaning that the implementation of some projects will be delayed. However, total allocations for the direct component still amount to R11 billion over the medium term and grow at an average annual rate of 5.2 per cent. Reductions to this grant will not impact water augmentation projects in drought-affected municipalities. Over the MTEF period, the total allocation for the indirect portion of the grant is R1.9 billion. This portion has not been reduced.

Regional bulk infrastructure grant

This 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. It has both direct and indirect components. In areas where municipalities have the capacity to implement projects themselves, funds are transferred through a direct grant. In other areas, the Department of Water and Sanitation implements projects on behalf of municipalities through an indirect grant. A parallel programme, funded by 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.

In 2018/19, R440 million of the indirect portion of the grant will be ring-fenced for the bulk infrastructure needed for the completion of the bucket eradication programme.

The direct component is reduced by R103 million in 2018/19, R109 million in 2019/20 and R115 million in 2020/21. As a result, the implementation of some projects will be delayed. Reductions to this grant will not impact water augmentation projects in drought-affected municipalities. The grant has a total allocation of R15.3 billion over the medium term, consisting of R6.2 billion and R9.1 billion for the direct and indirect components respectively.

Integrated national electrification programme grants

The aim of this grant is to provide capital subsidies to municipalities to electrify poor households and fund bulk infrastructure to ensure the constant supply of electricity. Allocations are based on the backlog of un-electrified households and administered by the Department of Energy. The grant only funds bulk infrastructure that serves poor households. The national electrification programme has helped provide 91 per cent of all poor households with access to electricity, as reported in the 2016 Community Survey (up from the 85 per cent reported in the 2011 Census). To sustain this progress, government will spend R16.6 billion on the programme over the next three years. Of this, municipalities are allocated R6.3 billion and Eskom is allocated R10.3 billion to spend on behalf of municipalities through an indirect grant.

The *integrated national electrification programme (Eskom) grant* allocation is reduced by R700 million in 2018/19, R750 million in 2019/20 and R791 million in 2020/21. In addition, the *integrated national electrification programme (municipal) grant* is reduced by R300 million in 2018/19, R1.2 billion in 2019/20 and R1.3 billion in 2020/21, growing at an average annual rate of 2.5 per cent. The large reductions to this grant in the outer two years reflect reversed additions made to the grant in the previous

MTEF period. These grants are not determined using formulas, so the distribution of reductions is based on which individual projects can be scaled back or delayed.

Rural roads asset management systems grant

The Department of Transport administers the *rural roads asset management systems grant* 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 information guides investments to maintain and improve these roads. District municipalities collect data on all the municipal roads in their area, ensuring that infrastructure spending (from the *municipal infrastructure grant* and elsewhere) can be properly planned to maximise impact. As data becomes available, incentives will be introduced to ensure that municipalities use this information to plan road maintenance appropriately. The *municipal infrastructure grant* stipulates that municipalities must use data from roads asset management systems to prioritise investment in roads projects.

The Department of Transport will work with the *municipal infrastructure grant* administrators to ensure that municipal roads projects are chosen, prioritised and approved using roads asset management systems data wherever possible. The grant's baseline is reduced by R6 million for each year over the medium term and the grant is allocated a total of R341.9 million over the MTEF period.

Municipal disaster recovery grant

After the initial response to a disaster has been addressed, including through funding from the *municipal disaster relief grant* discussed below, the repair of damaged municipal infrastructure is funded through the *municipal disaster recovery grant*. In 2018/19, this grant is allocated R21 million for the repair of municipal infrastructure in Merafong Local Municipality that has been damaged or made unsafe by sinkholes. There are no allocations for this grant in the outer years of the MTEF period. However, if further disasters occur that require recovery projects to be funded through this grant, additional allocations may be made to it in future.

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 *EPWP integrated grant for municipalities*, which promotes increased labour intensity in municipalities, and the *municipal disaster relief grant*. A total of R6.9 billion is allocated to capacity-building grants and other current transfers to local government over the medium term.

Table W1.26 Capacity-building and other current grants to local government[1]

R million	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
		Outcome		Adjusted budget	Medium-term estimates		
Direct transfers	**1 621**	**1 446**	**1 861**	**1 977**	**2 043**	**2 136**	**2 769**
Local government financial management	449	452	465	502	505	533	562
Municipal human settlements capacity	300	100	–	–	–	–	–
Expanded public works programme integrated grant for municipalities	595	588	664	691	693	742	783
Infrastructure skills development	104	124	130	141	141	149	158
Energy efficiency and demand-side	137	178	186	203	215	227	240
Municipal demarcation transition	–	4	297	140	–	–	–
Municipal restructuring grant	–	–	–	–	–	–	514
Municipal emergency housing grant	–	–	–	–	140	149	159
Municipal disaster relief	36	–	118	300	349	335	354
Indirect transfers	**252**	**251**	**19**	**103**	**115**	**122**	**128**
Municipal systems improvement	252	251	19	103	115	122	128
Total	**1 873**	**1 698**	**1 880**	**2 081**	**2 158**	**2 257**	**2 898**

1. Excludes provisional allocations
Source: National Treasury

Local government financial management grant

The *local government financial management grant*, managed by the National Treasury, funds the placement of financial management interns in municipalities 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 provides funds for the implementation of the municipal standard chart of accounts.

The *local government financial management grant* baseline is reduced by R26.6 million in 2018/19, R28 million in 2019/20 and R30 million in 2020/21. Total allocations amount to R1.6 billion over the MTEF period and grow at an average annual rate of 3.8 per cent.

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 is reduced by R7.4 million in 2018/19, R7.9 million in 2019/20 and R8 million in 2020/21. Total allocations amount to R449 million over the medium term and grow at an average annual rate of 6 per cent.

Municipal systems improvement grant

The *municipal systems improvement grant* funds a range of projects in municipalities in support of the Back to Basics strategy, including helping municipalities set up adequate record management systems, drawing up organograms for municipalities and reviewing their appropriateness relative to their assigned functions, and assisting municipalities with revenue collection plans. From 2018/19, the grant also supports intermediate cities to implement the Integrated Urban Development Framework and assists with the completion of transitional work in municipalities affected by major boundary changes in 2016. The

Department of Cooperative Governance implements the indirect grant. This grant has not been reduced, with allocations of R115 million in 2018/19, R122 million in 2019/20 and R128 million in 2020/21.

EPWP 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 to create more jobs. Based on a review of the allocation methodology, from 2018/19 the categories for labour-intensity have been increased from three to seven to incentivise more municipalities using labour-intensive methods. The formula is weighted to give larger allocations to poor, rural municipalities. The grant's baseline is reduced by R36.5 million in 2018/19, R39 million in 2019/20 and R41 million in 2020/21. The impact of these reductions will be spread across municipalities in line with the grant's formula. The grant is allocated R2.2 billion over the MTEF period.

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 2018 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 is allocated R681.6 million over the medium term.

Municipal disaster relief grant

The *municipal disaster relief 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. The grant supplements the resources local government would have already exhausted in responding to disasters. To ensure that sufficient funds are available in the event of disasters, section 21 of the Division of Revenue Bill allows for funds allocated to the *provincial disaster relief grant* to be transferred to municipalities if funds in the municipal 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 conducted. Over the MTEF period, R1 billion is available for disbursement through this grant. To ensure that sufficient funds are available for disaster relief, clause 20(6) of the Division of Revenue Bill allows funds from other conditional grants to be reallocated for this purpose, subject to the National Treasury's approval.

Municipal emergency housing grant

A new *municipal emergency housing grant*, to be administered by the Department of Human Settlements, is introduced in 2018/19. These funds will enable the department to rapidly respond to emergencies by providing temporary housing in line with the Emergency Housing Programme. However, the grant is limited to funding emergency housing following the immediate aftermath of a disaster, and not the other emergency situations listed in the Emergency Housing Programme.

As emergency housing was previously meant to have been budgeted for in the business plans for the *human settlements development grant*, the funding for the *municipal emergency housing grant* will be reprioritised out of that grant. The new grant is allocated R140 million in 2018/19, R149 million in 2019/20 and R159 million in 2020/21.

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 2018/19 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.

Review of the provincial equitable share formula

The Constitution stipulates that provinces are entitled to a share of nationally raised revenue to deliver on their mandates. Provincial funds are allocated using a formula that considers the spread of the burden of service delivery across provinces. The provincial equitable share formula contains weighted elements that reflect government priorities and incorporates elements to redress inequality and poverty across provinces. The periodic review of the formula to assess its continued appropriateness and equity continues in 2018. The Technical Committee on Finance and the Budget Council is consulted as part of this work.

Over the course of the year, work on the review of the equitable share will intensify. Now that the new data-collection methodology for education is part of the formula, the next step is to interrogate the component's policy alignment with government's education policy vision. Work on the disparity in costs in the delivery of services across the country will also continue, led by the FFC. All affected stakeholders will be invited to a colloquium to better understand these disparities. The National Treasury will work with the national Department of Health and Statistics South Africa to fully understand health information and the delivery of services in the health sector.

National health insurance policy work

Government is working to increase life expectancy for South Africans from 62.5 years in 2014 to at least 70 years by 2030 through interventions such as the continued expansion of antiretroviral therapy and the implementation of national health insurance. Following extensive public consultation, government adopted the National Health Insurance White Paper in June 2017. Since then, the national Department of Health and the National Treasury have been working on the draft National Health Insurance Bill, which, when promulgated, will provide the legal foundation for national coverage and establish the National Health Insurance Fund. Over the course of the year, the two departments will focus on how to pilot the provision and delivery of a prioritised set of health services. This will include developing and testing payment mechanisms that prescribe, for a specified set of primary health services, a predetermined minimum price for health service providers to serve a certain number of people each year. In addition, efforts will focus on scaling up work initiated by the Western Cape Department of Health to develop an information system that classifies hospital cases into categories of diagnosis, which will assist in monitoring costs.

The role of provinces 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 produce a vibrant and employable workforce. 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.

All three spheres of government must work with businesses and other relevant stakeholders to provide an enabling environment for faster and more inclusive economic growth. In 2018, further research into the role of special economic and industrial development zones will be conducted to understand their effect on development in provinces, and why their impact has stalled.

Improving intergovernmental coordination on infrastructure investment

Public infrastructure investments can play a major role in transforming South Africa's spatial development patterns. This requires a significant improvement in intergovernmental coordination in planning and budgeting for infrastructure. In particular, provinces need to ensure that their investments in schools, roads, health facilities and housing are made in locations that align with the spatial development plans of municipalities.

To facilitate improved planning alignment with municipalities, the guidelines for provincial infrastructure require that municipalities are consulted and agree on the location and bulk services requirements of all provincial infrastructure projects. Provincial treasuries are also to include municipalities in their infrastructure medium-term expenditure committee meetings when selecting projects to be included in the next budget. The National Treasury will continue to work with provincial treasuries throughout 2018 to improve infrastructure planning in provinces.

Local government transfers

The system of transfers to local government is continuously being reviewed and refined to improve spending efficiency and the impact achieved through these transfers. Over the period ahead, the National Treasury will continue to examine the funding of, and budgeting by, rural municipalities and how the transfers they rely on can be structured to improve their sustainability and performance. At the same time, urban municipalities will be encouraged to further increase their reliance on own-revenue sources to fund their budgets (including borrowing to fund infrastructure investments, especially in light of the reductions to transfers announced in the 2018 Budget).

As part of the ongoing review of local government infrastructure grants, the National Treasury, the Department of Cooperative Governance, SALGA and the FFC will work closely with the Department of Human Settlements to explore how informal settlement upgrades can be improved.

A new integrated urban development grant

The Department of Cooperative Governance is leading the design of a new *integrated urban development grant* for urban local municipalities. Initial proposals have been developed and consulted on with stakeholders. The new grant will be introduced in 2019/20. Eligible municipalities will be invited to apply for the grant during 2018. The application process is set out in clause 27(5) of the 2018 Division of Revenue Bill.

This new grant will extend some of the fiscal reforms already implemented in metropolitan municipalities to non-metropolitan cities. This aligns with the policy set out in the Integrated Urban Development Framework approved by Cabinet in April 2016. The framework calls for a radically different, more integrated, approach to managing urbanisation.

Principles for the new integrated urban development grant

- *Municipalities take the lead in dealing with the urban challenge.* Municipalities must have discretion to identify local priorities, with due consideration to provincial and national priorities, and allocate investment accordingly.
- *Municipal differences continue to be acknowledged.* Municipalities differ in terms of their context and the Integrated Urban Development Framework has been developed to respond to the needs of urban municipalities. Recognition and incentives must be provided to municipalities able to perform, and support provided to improve the performance of those who do not yet qualify for recognition.
- *Municipalities invest to unlock growth.* Research by the FFC found that capital spending by municipalities, particularly on core services such as water, sanitation and electricity, improves economic growth. This positive effect is enhanced if the resulting assets are well managed. As grants remain targeted at poor households, unlocking investment in economic infrastructure requires non-grant sources of finance.

- *Infrastructure investment is made with due consideration to spatial form.* Too often, infrastructure investment has entrenched undesirable apartheid spatial forms. To prevent this, plans for investment in new infrastructure should be aligned with well-planned spatial development frameworks.
- *Municipalities are held accountable for outcomes.* Municipalities will have discretion to make choices about the allocation of infrastructure investment. With this increased discretion comes strong accountability for what is achieved through that investment.
- *The assets financed through a grant are well managed.* Significant new infrastructure investments have been made over the past 20 years. However, in too many cases this infrastructure has not been well managed, with inadequate investments in renewal and maintenance.

Design of the new integrated urban development grant

There will be minimum conditions for accessing the grant. As previously discussed, the new grant will place more discretion in the hands of local municipalities. The minimum conditions for entry will ensure a degree of certainty that recipient municipalities have adequate oversight, their reporting can be trusted and they are able to manage their existing capital programmes. It is proposed that minimum conditions cover the following areas:

- Management stability
- Audit findings
- Unauthorised, irregular, fruitless and wasteful expenditure
- Capital expenditure
- Reporting in terms of the Municipal Finance Management Act.

To qualify, an eligible municipality will need to apply for the grant and demonstrate compliance with the prescribed minimum conditions. Approved municipalities will then receive support in developing a capital expenditure framework and associated three-year capital programme.

Not every urban, non-metropolitan municipality will qualify for the grant in 2018/19. Some municipalities may take time to meet the qualification criteria, while others may choose not to apply because they are comfortable with their existing grant structures.

The new grant will include a support programme to help urban municipalities comply with the minimum conditions of the grant and improve performance. This support programme will also be extended to urban municipalities not participating in the grant.

The *integrated urban development grant* will initially be funded through shifts of allocations from the *municipal infrastructure grant*. Over time, other grants may be consolidated into the new grant. Municipalities receiving the grant will therefore not receive significantly different infrastructure grant allocations. The main benefit of the grant is its revised structure and rules that enable more integrated development, not increased allocations.

The new *integrated urban development grant* is intended to ensure that municipalities give poor households sustainable access to the municipal infrastructure they need in spatially transformed cities.

Based on its review of local government infrastructure grants, government and its partners aim to consolidate such grants in the long term. This could be achieved by progressively combining most local government infrastructure grants into the *integrated urban development grant* for those municipalities that qualify. This will enable these cities to coordinate their priorities across infrastructure sectors and shift towards a more programmatic and outcome-driven process.

Under the *integrated urban development grant*, municipalities will no longer require approval for individual projects to be funded through the grant. Monitoring will be against a three-year capital programme that is aligned with a 10-year capital expenditure framework. The framework must in turn

show alignment with the municipality's spatial development framework. This will require a shift to a more programmatic monitoring system, rather than a project-based system.

The grant will have an incentive component, which will use performance indicators to reward good performance across the following three areas:

- The extent to which municipalities are making use of non-grant finance
- Sound asset management practices
- Spatial transformation.

The performance incentive will be funded through the reprioritisation of 1 per cent of the *municipal infrastructure grant*. In the outer years of the 2018 MTEF period, these funds are shown as unallocated in the municipal infrastructure grant.

A new municipal recovery grant

The 2017 *Medium Term Budget Policy Statement* announced a new funding mechanism to support recovery plans for municipalities that face a financial crisis, as provided for in section 139(5) of the Constitution. The National Treasury will consult with national departments, provinces and SALGA on the design of the grant and its coordination with other capacity-building programmes during 2018. The grant is intended to be a short-term intervention that will fund the turnaround of struggling municipalities. It will help identified municipalities that are in financial distress, but have demonstrated a commitment to implementing the necessary reforms. If needed, the intervention powers outlined in section 139 of the Constitution may also be used as part of the broader approach to turning around these municipalities.

The *financial recovery grant* will be made available within the parameters of the existing legal framework and will not provide bailouts to municipalities. It will fund the implementation of specific outputs in support of a financial recovery plan approved by a municipal council. The council must demonstrate political buy-in by adopting such a plan, and the municipality must also commit its own resources to implementing parts of the plan. Municipalities will be expected to demonstrate commitment to implementing the financial recovery plan by:

- Containing employee-related costs and other rapidly escalating categories of expenditure items
- Limiting non-priority spending
- Increasing revenue collection
- Adopting funded budgets that generate surpluses.

A provisional allocation of R300 million in 2019/20 has been set aside for this proposed grant. This allocation will be confirmed or cancelled as part of the 2019 Budget process, depending on progress made in planning for the grant (including the willingness of municipalities to implement the necessary reforms) and the availability of resources. The grant is allocated R514 million in 2020/21.

Reforms to local government own-revenue sources

Municipalities, especially cities and other large urban municipalities play a critical role in boosting economic growth and providing an enabling environment for job creation by providing well-maintained and functioning infrastructure services. However, these municipalities are finding it increasingly difficult to meet the demand for housing, urban services and infrastructure due to rapid urbanisation.

Given the extent of the infrastructure needs in these municipalities, the National Treasury is exploring how cities and large urban municipalities can use a broader package of infrastructure financing sources to meet their developmental mandate. These activities include, among others, the review of the municipal borrowing policy framework and setting rules for levying development charges.

Development charges

Despite their potential as an alternative option for financing infrastructure, municipalities have not fully used development charges due to uncertainty surrounding the regulatory frameworks. Development charges are once-off infrastructure access fees 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. They 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. To deal with the regulatory framework's challenges, the National Treasury is amending the Municipal Fiscal Powers and Functions Act to incorporate the regulation of development charges.

Municipal borrowing

Municipal borrowing policy has been in place since 1999. Over the years, the National Treasury has enhanced its capacity to monitor municipal borrowing trends, while creating an enabling environment and developing strategies that will help municipalities to attract creditors. However, there is scope for policy adjustments to support expanded municipal borrowing. The National Treasury is exploring ways to enable the extensive participation of financial institutions and the broad market in financing municipal infrastructure. Areas of possible reform include the roles of multilateral development banks and development finance institutions in urban infrastructure financing, pooled finance for local government, and project finance instruments. These reforms target creditworthy municipalities, because a key principle that underpins the municipal borrowing framework is that there will be no national government guarantees.

The National Treasury publishes a quarterly Municipal Borrowing Bulletin, which is available at www.mfma.treasury.gov.za