# Intergovernmental Fiscal Review

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**National Treasury**

**Republic of South Africa**

**October 2000**

ISBN: 0-621-30275-9

RP No: 170/2000

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# PREFACE

The *Intergovernmental Fiscal Review* analyses and reflects provincial and local government fiscal trends. This year's issue – the second – retains the analysis of provincial data and adds important perspectives on local government. This is in keeping with an undertaking made in last year's issue to include financial data from local government in future. While Local Government financial information remains incomplete, the last three chapters show that considerable progress has been made. The intention is to continue this process so that the next *Review* will be even more comprehensive in its coverage and more robust in its analysis.

The *Intergovernmental Fiscal Review* complements the 2000 *Budget Review*, which provides consolidated MTEF figures but not detailed provincial and local budgets. It provides provincial budget details, as well as a thorough analysis of selected municipal budgets.

Considering the pivotal roles of provincial and local government in the delivery of social and basic services, this information is important for understanding public service delivery. This *Review* should therefore assist all stakeholders in effectively and meaningfully participating in budget processes and debating budget options.

The publication reflects progress in budget reform in the provincial and local spheres. Provinces are now integrally part of the multi-year budget process, and the first steps are under way to ensure the same among local governments. There has also been a marked shift towards outputs and service delivery – a critical step in ensuring effective performance management and analysis of actual service delivery.

I want to thank the Budget Office in the National Treasury, and particularly the Chief Directorate: Intergovernmental Relations, for the extensive analysis that went into producing the publication. Chris Heymans and Joel Friedman deserve a special mention for seeing this publication through to completion. Janine Thorne provided meticulous editorial assistance. The *Review* has already – in only its second year – become a vital part of the package of reviews that helps South Africa to analyse and debate budget information on an informed basis and in a transparent manner.

**Maria Ramos**

**Director-General: National Treasury**

# ABBREVIATIONS

| | |
|---|---|
| CBPWP | Community-based Public Works Programme |
| CMIP | Consolidated Municipal Infrastructure Programme |
| CWSSP | Community Water Supply and Sanitation Programme |
| GAMAP | Generally accepted municipal accounting practice |
| GFS | Government Financial Statistics |
| HIV/Aids | Human immuno-deficiency virus/Acquired immuno-deficiency syndrome |
| IMF | International Monetary Fund |
| INCA | Infrastructure Finance Corporation |
| LED | Local Economic Development |
| MEC | Member of the provincial Executive Council |
| MinMEC | Meeting of Minister with the nine members of the provincial executive councils |
| MTEF | Medium-term Expenditure Framework |
| NaTIS | National Traffic Information System |
| NGO | Non-governmental Organisation |
| PFMA | Public Finance Management Act |
| RAMS | Representative Association of Medical Schemes |
| RTMC | Road Traffic Management Corporation |
| RDP | Reconstruction and Development Programme |
| RSC | Regional Services Council |
| SALGA | South African Local Government Association |
| SARB | South African Reserve Bank |
| SARS | South African Revenue Service |
| SDDS | Special Data Dissemination Standard |
| SNA | System of National Accounts |

# CONTENTS

# I. OVERVIEW

# Introduction

*Covers both provinces and local government*

This second *Intergovernmental Fiscal Review* takes the analysis of intergovernmental finances one step further from the previous year. Whereas the 1999 *Review* focused on provinces, this year's includes three chapters on local government. The result is a more elaborate – albeit not yet complete – reflection of intergovernmental fiscal trends and issues.

Data remain difficult to come by, particularly for local government. However, every *Review* helps to focus national departments and provincial and local governments on the information needed to ensure effective accounting and analysis. We foresee that the progress made this year will again be improved on in future.

Provincial and local governments' spending budgets are economically significant and exceed the spending of the national budget. Provincial budgets for 2000/01 are estimated at just under R110 billion, and local government budgets at R60 billion, as against the national budget (excluding transfers, grants-in-kind and debt servicing) of just over R70 billion.

The *Review* is based on the 2000 MTEF budgets of the national and provincial governments, as tabled in February 2000, and the 1999/00 local government budgets. It does not cover any additional allocations from the coming Adjustments Budget, nor is it updated for the revised allocations in the 2001 *Medium Term Budget Policy Statement* (to be tabled on 30 October 2000). The *Review* complements the 2000 *Budget Review* as it analyses provincial and local government budgets for the transfers tabled in the 2000 Budget.

This *Review* does not attempt to repeat all the data and analysis in the 1999 *Review*. Readers can refer to the 1999 *Review* for a more comprehensive picture of the provinces (e.g. demographics).

## Intergovernmental system

The Constitution creates three spheres of government with different revenue-raising capacities. These capacities are complemented by intergovernmental transfers to ensure that each sphere has sufficient funds to discharge its expenditure responsibilities.

### Equitable share

*Revenue sharing*

Sections 214 and 227 of the Constitution obligate the national government to share its revenue and provide an equitable share to provinces and municipalities to enable them to provide basic services and perform their functions.

The successful introduction of the formula-driven equitable share allocations in 1997 (provinces) and 1998 (local government) has created certainty in the budgetary process. It provides a systematic method for allocations within the framework of Cabinet's strategic priorities.

The allocation to provinces is significantly larger than that to local government, although the local government allocation is projected to grow over the Medium-term Expenditure Framework (MTEF) period. As explained below, the greater allocation to provinces is mainly due to their smaller fiscal capacity and their role in providing tax-funded public goods. Hence, the formula for equitable share allocations to provinces includes shares for education, health and social security. The shares are also derived from the relative population size of each province, backlogs, economic output and an institutional component covering the costs of running a provincial government. The allocation to local government, in turn, supports the provision of basic services to poor households, and its institutional component is related to the running of a municipality.

### Conditional grants

Provinces and municipalities also receive other grants from the national government's share of revenue, which may be conditional or unconditional. These include grants-in-kind and agency payments.

Conditional grants were introduced in 1998 to enable provinces and local governments to meet nationally determined priorities or to provide funds for services that spill over to other provinces.

*Initial problems*

The introduction of conditional grants has not been without problems. Chapters 3 and 7 examine conditional grants to the two spheres, explaining the various types of grants and assessing the reasons for the non-transfer and underspending of some grants.

Capital grants to municipalities are particularly problematic. Most national and provincial departments transferring grants to local government prefer to do so on a project basis, frequently because of poor capacity at the municipal level. This complicates the municipal budget process, frequently resulting in suboptimal outcomes.

This *Review* does not cover grants from provinces to local government. Such grants include agency payments for health (e.g. ambulance services or clinics).

*Reforms*

In considering the development of the intergovernmental system, envisaged reforms must be taken into account. In addition to the budgeting and financial reforms, current non-financial reforms are also significant. For example, the new demarcation of municipalities not only rationalises local government (as it reduces the current 843 municipalities to 284), but should also make municipalities more viable and better capacitated. Structural reforms of the division of fiscal powers between the district councils and primary local authorities will also significantly affect the budgets of those municipalities.

The budgeting and financial reforms should resolve many of the problems associated with conditional and capital grants. These reforms will facilitate better budget coordination between the three spheres and improve management, transparency and accountability.

*Principles*

The critical principles are:

- All conditional and unconditional grants are to be determined through a single resource allocation process – the annual MTEF budget process.
- Governments in all spheres must budget on a three-year basis. This implies that all transfers from national government (and, where appropriate, from a provincial government) must be on a three-year allocation basis, by province and municipality.
- To promote better planning, accountability and sustainability, each grant must be on the budget of the benefiting government.
- The criteria for dividing the grant by province or municipality must be transparent and based on generally recognised data sources.
- Any conditions, monitoring mechanisms, the dates of transfer of grants, etc. must be completed at least four months before the start of the financial year to promote better planning and certainty. This involves bringing conditional grants within the overall strategic planning and performance management framework of national departments.
- Each grant must specify the responsibilities for maintenance, ownership, accounting and auditing.

Many of these principles have informed the approach to conditional grants for the 2001 Budget and have, in effect, been legislated in the Division of Revenue Act, 2000.

## Functions of provincial and local spheres

*Commonalities and differences*

Although the chapters on the provinces and local governments do not follow identical patterns, there are several common points. These include intergovernmental transfers, expenditure and revenue analysis, reflections on service delivery trends, and budget reforms. However, the functions and powers of these spheres differ – local governments have access to own revenue and borrowing, neither of which is available to provinces.

*Constitutional responsibilities*

Schedules 4 and 5 of the Constitution set out the responsibilities of provinces and municipalities relative to those of national government. For provinces, these include the major social functions of school education, health and welfare. Key services in health comprise primary health care and regional, specialised and academic hospitals, while welfare includes social security grants and welfare services. Other services, such as the building and maintenance of provincial roads, are exclusive provincial responsibilities.

Basic municipal services include the provision of basic household infrastructure. Such services are municipal roads, pavements, street lighting, reticulation infrastructure for electricity, water and sanitation, parks, sports facilities, refuse removal and municipal health services (preventative health care, like child vaccination, and promotive health care).

Provinces therefore have a significantly larger role in providing tax-funded public goods, with local government only providing basic roads, street lighting and refuse removal in this respect. The provision of user-charge services, like electricity and water, make up almost two-thirds of the local budget.

While municipalities have significant tax and user-charge revenue (over 90 per cent in the aggregate), provinces raise only about 5 per cent of their total revenue. For this reason, provinces receive a significant equitable share allocation of R94 408 million in 2000/01, while the local sphere receives R1 867 million.

Given that there are only nine provinces as against the current 843 (transitional) municipalities, far more progress has been made on implementing significant reforms in the provincial sphere.

*Municipal reforms only starting*

Whereas provinces have already implemented significant reforms to their budgeting systems, the process of reform within municipalities is at an early stage. In both cases, however, the anticipated outcomes are more accessible budgetary information, improved planning and greater accountability. The process of reform remains incremental and the full benefits will only become obvious over time.

The *Review* explores major expenditure and revenue trends, grant flows and the reform and transformation processes in the provincial and local spheres. It starts with an overview of provincial trends, followed by three chapters on the provinces, dealing with expenditure, conditional grants and revenues. These are followed by an overview of local government, an analysis of municipal budgets, revenues and expenditure and, finally, a review of transfers to local government.

## Addressing poverty

*Poverty alleviation activities*

As a significant number of South Africans can be classified as poor, pro-poor programmes enjoy a high priority in government spending. While national government allocates specific poverty relief funds to national departments, its overall programme on poverty alleviation is far more comprehensive.

Most spending on the poor is through provincial and local governments, which are responsible for social services such as welfare, health and education, municipal services like housing and municipal infrastructure, and basic services such as water and electricity.

Given the complexities of the intergovernmental budgeting system, no comprehensive analysis has yet been done on the actual impact of government expenditure on the poor. Pro-poor expenditure constitutes a significant part of the various budgets, but these allocations should be interpreted with caution, as they do not represent actual expenditure. Furthermore, the information required for a comprehensive incidence study is as yet unavailable.

Government's poverty alleviation activities vary in scale. Some departments have reprioritised their entire budget to give substance to a poverty alleviation focus. For example, the provincial welfare departments spend most of their budget on social security grants to children and elderly or disabled people. This is the biggest poverty alleviation programme of Government, followed by the housing subsidy grants.

Many other programmes, like health and education, play a critical role in delivering basic services to poor communities. However, because they provide services to all communities (e.g. public schools), not all such expenditure is for the poor. Still, most departments have shifted expenditure towards poorer communities, by prioritising these communities and by addressing backlogs inherited from apartheid.

The national Treasury has conducted an incidence analysis of social service expenditure to estimate the proportion that reaches poor people (see *Budget Review* 2000, pp 145 & 146). The findings, with some qualifications, indicate that significant shifts in spending from rich to poor took place in education, health and welfare between 1993 and 1997.

*Conditional allocations*

Various departments also have specific pro-poor programmes or grants. These include the Department of Health's Integrated Nutrition Programme, which funds meals for poor children in primary schools. Another is the Department of Provincial and Local Government's Consolidated Municipal Infrastructure Programme (CMIP), which funds basic municipal infrastructure. Other specific grants that fund poverty reduction are the Poverty Relief, Infrastructure Investment and Job Summit allocations. They finance projects like the Working for Water Programme of the Department of Water Affairs and Forestry, and the Community-based Public Works Programme (CBPWP) of the Department of Public Works. Although these are grants to national departments, some of the funds are transferred to municipalities as conditional grants or grants-in-kind.

Other departments, while not delivering anti-poverty programmes, contribute to poverty alleviation by setting frameworks with an anti-poverty focus. For example, the Department of Transport is developing a rural transport strategy that will deal with the full range of rural transport needs, from non-motorised transport and footpaths to commuter transport and commercial farming requirements.

*Need for reliable data*

A reliable set of socio-economic data is an important element of an anti-poverty strategy. It is used for establishing the baseline from which the effectiveness of anti-poverty policies can be measured and for providing a means for targeting government expenditure.

Statistics South Africa has released a publication, *Measuring Poverty*, that examines four different methods for measuring and monitoring poverty. One method lends itself for use as an allocation mechanism for conditional grants or for dividing funds between the provinces and between the municipalities in a pro-poor manner. This method maps poverty using household monthly expenditure, obtained by integrating data from the 1995 October Household Survey, the 1995 Income and Expenditure Survey, and Census 1996.

Using the method, the results show that:

- Eastern Cape is the poorest province in terms of average monthly household expenditure, followed by Free State and Northern Province. The wealthiest is Gauteng, followed by Western Cape.
- The poorest district council is the Wild Coast, followed by the Kei District Council (both in Eastern Cape). The wealthiest are the four metropolitan councils in Gauteng (treated as one unit), followed by the Cape Metropolitan Council.
- The poorest magisterial district, according to this method, is Elliotdale followed by Willowvale, both in Eastern Cape, while the wealthiest is Pretoria, followed by Bellville in Western Cape.

Studies of this nature must be updated regularly to fine-tune targeting mechanisms and to enable Government to measure the impact of its budget on the poor.

## Key observations and trends

*Provincial and local sections*

Intergovernmental fiscal relations have developed significantly over the past five years. The 1999 *Intergovernmental Fiscal Review* captured the broad trends and development in provincial finances. This edition expands the horizon of financial reporting to include local government. Since the publication of the 1999 *Review*, the major features in provincial finances have been:

- Provincial finances have stabilised. After rising rapidly to R96,0 billion in 1997/98, provincial expenditure rose to R107,9 billion in 2000/01. This increase is flat in real terms, but is projected to grow over the MTEF.
- Financial management has improved. Provinces turned around a deficit of R5,5 billion in 1997/98 to a surplus of R549 million in 1998/99. This trend continues as provinces use the surplus to pay off debt.
- The social sector’s (health, education and welfare) share of the total provincial budget has stabilised at around 83,4 per cent in 2000/01. Health expenditure rose faster than that of any of the other social sectors between 1996/97 and 1999/00.
- Personnel as a share of provincial expenditure has stabilised after increasing rapidly following the 1996 salary agreement. It rose from 54,7 per cent of total spending in 1996/97 to 59 per cent in 1998/99.
- The share of personnel rose to a peak of 91,2 per cent of all education expenditure in 1998,99, and 62,3 per cent in health in 2000/01.
- After being under pressure between 1997/98 and 1999/00, capital expenditure is projected to increase over the next few years.

- Provincial revenue declined from R4 billion in 1996/97 to a projected R3,6 billion in 2000/01.
- Some initial problems have been experienced with conditional grants. These are reflected in non-transfers by national departments, and underspending by provinces where such transfers occurred.

The major features of the local government review are:

- Municipal budgets totalled R57,4 billion in 1999/00, with 81 per cent of resources directed toward the operating budget and the remainder used for capital projects.
- Municipalities have considerable own revenues, collecting over 90 per cent of their total budget.
- Expenditure on salaries, at 31 per cent, continues to take up the largest portion of municipal budgets.
- The expenditure of the ten largest municipalities amounts to R37 billion, or 65 per cent of total local government expenditure.
- Many smaller municipalities do not have significant fiscal capacity, and are in fiscal distress. The consolidation of such municipalities through the new demarcation, alongside related structural systems and financial reforms, is expected to resolve the problem of non-viable municipalities.
- Significant institutional and legal reforms are being implemented to improve financial management, accountability and efficiency.
- New policy, legislative and financial initiatives aim to develop a more predictable and stable environment that will enhance municipal creditworthiness and, hence, access to capital markets.

## Scope of the *Review*

The first four chapters of this *Review* (Section II) focus on provinces and the last three (Section III) on local government.

*Provincial government*

Section II, Chapter 1 reviews provincial budgets and actual revenue and expenditure for 1996/97 to 1998/99, estimated actual outcomes for 1999/00 and budgeted amounts for 2000/01 through 2002/03. There has been considerable stabilisation in provincial budgets since 1998/99, as well as progress in addressing the debts accumulated in 1996/97 and 1997/98. The spending reductions required to align revenue and expenditure must be seen in the context of significant expenditure increases in 1996/97 and the reprioritisation of provincial budgets to meet government policy objectives.

In Chapter 2, variations in expenditure between provinces are analysed. The chapter presents information on the target populations in the social services, highlights key policy developments and identifies spending pressures on provincial budgets over the next three years. It comprises four sections – education, health, welfare and the remaining services delivered by provinces. In line with the period covered in the new provincial budget presentations, the chapter examines provincial expenditures and budgets between 1998/99 and 2002/03, with particular emphasis on the current budget.

Focusing on conditional grants, Chapter 3 reviews how the system of grants evolved and analyses the grant system and its challenges. The chapter also looks at current efforts aimed at improving the conditional grant system.

Chapter 4 reviews policy and administrative issues affecting the collection of existing provincial revenues, and the proposed new policy framework to regulate provincial powers to impose new taxes.

*Local government*

In Section III, Chapter 5 provides an overview of local government issues, giving background details to inform this first attempt at describing intergovernmental finances relevant to the local sphere.

Chapter 6 reviews expenditure and revenue trends in the local sphere, drawing on selected case studies. In compiling this chapter, the authors became acutely aware of the weak records currently available. One of the primary objectives for next year's *Review* will be to improve the process and framework for information gathering.

Chapter 7 provides an overview of grants and transfers to local government, highlighting trends in equitable share allocations, infrastructure grants and transfers for capacity building. While interesting, the data here too lacked depth and will be a priority for the next *Review*.

## Conclusion

*Cooperative governance taking root*

On the whole, the *Review* reflects a systematically unfolding set of intergovernmental fiscal relations. The trends since 1994 show that provinces and local governments are gradually shaping their roles in the democratic South Africa. Many problems remain, but the culture of cooperative governance the Constitution aspires to is taking root.

# II. PROVINCES