# 5

# Intergovernmental transfers

## Introduction

The system of transfers to municipalities is intended to assist them in combating poverty and strengthening their own capacity to provide services. Municipal expenditures that directly support economic growth are intended to be largely self-funding through service charges and subsidised through local taxes, although a new generation of national transfers is beginning to support municipalities in this process. In addition, transfers support economic growth indirectly through releasing municipal resources for this purpose.

*The system of transfers is to assist municipalities in combating poverty and strengthening their capacity to provide services*

In general, transfer programmes play three roles:

- addressing the structural imbalance between revenues available to municipalities and the expenditure responsibilities assigned to them
- supporting national priorities as outlined through different sectoral policies, in particular those focused on providing universal and sustainable access to services
- establishing incentives for good governance and building local government capacity within a sound fiscal framework.

In practice, transfers from national and provincial government are made through a range of different mechanisms and instruments. The most basic distinction is between those that are directly transferred to municipalities as cash, either on a conditional or unconditional basis, those that are transferred indirectly in the form of assets or in instances where other spheres of government perform functions or services on behalf of a municipality and those transfers that are made as agency payments to reimburse municipalities for expenditures incurred on behalf of other spheres of government.

*There are different types of national and provincial transfers*

While some transfer programmes explicitly focus on strengthening municipal capacity and providing incentives for good governance, it is important that the overall system of transfers is designed to support these objectives. This will assist in the national and provincial spheres presenting a coherent stance to individual municipalities. For example, the overall system of transfers should not reduce the incentives for municipalities to remain accountable to their citizens or to abandon fiscal discipline. Individual programmes must therefore avoid undermining these incentives by imposing particularly stringent conditions that are focused on the needs of other spheres rather than local citizens, inadvertently encouraging inappropriate or unsustainable expenditures at the municipal level or rescuing municipalities from the consequences of poorly conceived expenditure commitments that they have made.

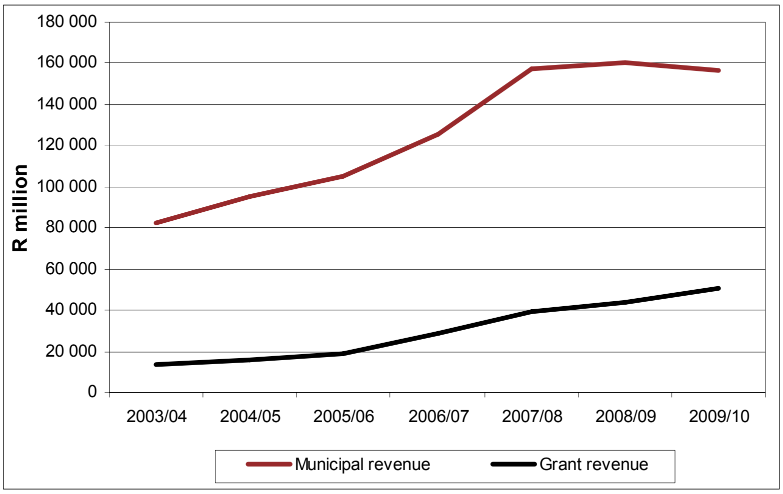
*The major transfer programmes contribute significantly to the fight against poverty*

National government transfers to local government have continued to grow strongly in real terms since 2003/04. This has led to a structural adjustment in the vertical division of resources between the spheres of government. These new resources and improvements to the mechanisms through which funds are transferred, have allowed the major transfer programmes to contribute significantly to the fight against poverty. Transfers are also increasingly effective in targeting priority geographical areas of poverty. A new generation of programmes is beginning to help municipalities meet the challenges of economic growth at the local level, through encouraging infrastructure investment.

*Municipal dependence on grants as a source of revenue has risen dramatically*

Yet the rapid growth in transfers and the reforms to transfer mechanisms have also exposed a new set of challenges. Municipal dependence on grants as a source of revenue has risen dramatically. Figure 5.1 shows this increase. The figure includes the metros, which contribute significantly to the municipal revenue trend and which are less dependent on grant income.

**Figure 5.1 Municipal revenue and grant revenue, 2003/04 – 2009/10**




*Source: National Treasury local government database*

Between 2003/04 and 2006/07, municipalities generated own revenue of R408.2 billion, of which metros generated 52 per cent and the 21 secondary cities 15 per cent. This means that the remaining 256 municipalities are largely dependent on national transfers, which were R76.3 billion for the same period. It must be noted that this amount is spread across all municipalities. Figure 5.1 also shows that municipal own revenue is expected to grow by a slow rate of 2.3 per cent, while grants to municipalities are expected to grow by 14.9 per cent over the medium-term in real terms.

*Metros generated more than 50 per cent of total own revenue between 2003/04 and 2006/07*

This reflects both the expansion of the expenditure responsibilities of municipalities as well as a decline in own revenue collection efforts. Co-ordination between transfer programmes with locally funded municipal expenditures remains problematic. Some conditional grants are allocated in a formulaic way, without taking into account the particular dynamics or requirements of an area. For example, experience with the special allocation for the eradication of the bucket sanitation system showed wide variations in the unit cost of toilet units due to varied geological conditions. Furthermore, the continuous introduction of indirect transfers that are managed at the national level for municipal functions undermines efforts to strengthen municipal capacity and the introduction of sustainable improvements to service delivery.

This chapter gives an overview of:

- the vertical division of revenue
- the horizontal division of revenue
- the division of revenue process
- grant performance.

## Vertical division of revenue

The Constitution guarantees the provincial and local government spheres an “equitable share of nationally-raised revenues”. This recognises that a fundamental imbalance exists between the expenditure functions assigned to them and the instruments they have available to generate their own revenues. The main purpose of the equitable share is to close this fiscal gap, as there are few additional revenue instruments that would be appropriate at the sub-national level.

Nationally raised revenues, less debt repayment liabilities, are divided between the three spheres of government based on their expenditure responsibilities and the other revenue sources available to them. Thus provincial governments, which have far fewer revenue sources than local governments, receive a commensurately larger portion of their resources from national transfers.

In practice, the vertical division of revenue is an outcome of government’s deliberations on policy and associated expenditure priorities. It reflects government’s balanced approach to meeting policy priorities over the medium-term, considering the responsibilities, expenditure pressures, capacity and performance of each sphere of government. Inevitably, this involves difficult trade-offs between functions and spheres of government over time.

*The vertical division of revenue has favoured national and provincial government as local government can draw on other sources*

The size and nominal value of increases in the vertical division of revenue have typically benefited national and provincial governments. This reflects their reliance on the vertical division of revenue to secure resources, whereas local government can draw on more sources of own revenue. In addition, it reflects the significant expenditure allocations and the priority attached to programmes such as safety and security, education, social development and health, in the national and provincial spheres.

However, the local government share has risen at the fastest rate, averaging 21.3 per cent annually since 1995/96, compared to the other spheres of government. This is well above the rate of increase in available national revenue, which averages 12.3 per cent over the same period. This means that local government is getting a rapidly rising proportion of nationally raised revenue, although it is starting from a low base. This realignment shows that the provision of basic services like water, sanitation and electricity is becoming more of a government priority.

Table 5.1 summarises these trends in the vertical division of revenue. The local government sphere received approximately R11.6 billion in 2003/04 and is projected to grow to R47.7 billion by 2009/10.

**Table 5.1 Vertical division of revenue, 2003/04 – 2009/10**

| | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
|---|---|---|---|---|---|---|---|
| **R million** | | **Outcome** | | **Estimate** | | **Medium-term estimates** | |
| National government | 148 142 | 167 289 | 194 723 | 212 629 | 246 937 | 273 929 | 302 672 |
| Provincial government | 122 673 | 138 511 | 154 368 | 178 871 | 205 224 | 238 076 | 268 158 |
| Local government[1] | 11 581 | 13 808 | 16 682 | 26 501 | 37 127 | 47 651 | 47 651 |
| **Total** | **282 396** | **319 608** | **365 773** | **418 001** | **489 288** | **559 656** | **618 481** |
| *Percentage share* | | | | | | | |
| National government | 52.5% | 52.3% | 53.2% | 50.9% | 50.5% | 48.9% | 48.9% |
| Provincial government | 43.4% | 43.3% | 42.2% | 42.8% | 41.9% | 42.5% | 43.4% |
| Local government | 4.1% | 4.3% | 4.6% | 6.3% | 7.6% | 8.5% | 7.7% |
| **Total** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** | **100.0%** |

*1. RSC levies abolished from 1 July 2006. Interim replacement grant included in Equitable share.*

*Source: National Treasury local government database*

The increases to the local government share result from growth in three programmes areas. First, the allocation to the local government equitable share grows due to the abolition of the Regional Services Council levies and the introduction of a temporary replacement grant and the special contribution towards the councillor remuneration grant. Second, the municipal infrastructure grant grows rapidly to support municipal expenditures on infrastructure. Finally, a new set of grants has been introduced to support the 2010 FIFA World Cup and encourage township development, as well as scale-up spending on regional bulk infrastructure.

*Provisional transfers are made at the discretion of provinces*

These figures exclude provincial transfers to local government. These transfers are made at the discretion of provinces and focus on supporting any additional provincial development priorities or making agency payments to local governments for services delivered on behalf of the province. (They exclude payments for services rendered to provinces by municipalities, such as service charges for water and sanitation services). Provincial transfers do not assist in addressing any structural imbalance between the revenues and expenditures of local government.

Table 5.2 highlights the generally poor quality of data on provincial transfers to local government. Some provinces are not consistently gazetting their municipal allocations and it is safe to assume that they transfer larger amounts than what they are publishing. Provincial transfers to municipalities have not been consistent, evident in the 11.3 per cent decline between 2003/04 and 2006/07 in real terms. The transferred amount decreased in 2004/05 and started to increase from 2005/06 onwards. This is a clear indication of uncertainty on the part of provinces in relation to their planning, which in turn makes it difficult for municipalities to plan for this funding.

**Table 5.2 Provincial transfers to local government, 2003/04 – 2009/10**

| | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 | % average annual | |
|---|---|---|---|---|---|---|---|---|---|
| | | Outcome | | Estimate | | Medium-term estimates | | 2003/04 – | 2006/07 – |
| R thousand | | | | | | | | 2006/07 | 2009/10 |
| **Provincial transfers** | | | | | | | | | |
| Eastern Cape | 410 140 | 401 377 | 512 188 | 498 517 | 365 444 | 639 532 | 531 002 | 1.2% | -2.9% |
| Free State | 316 820 | 183 290 | 99 175 | 80 616 | 42 137 | 210 043 | 162 025 | -39.9% | 20.0% |
| Gauteng | 697 758 | 597 171 | 496 324 | 427 533 | 451 780 | 506 476 | 534 077 | -19.4% | 2.4% |
| KwaZulu-Natal | 482 964 | 258 572 | 340 102 | 478 763 | 742 938 | 944 853 | 997 826 | -5.4% | 21.4% |
| Limpopo | 318 | 252 | 543 | 10 331 | 10 590 | 82 562 | 17 200 | 202.6% | 12.7% |
| Mpumalanga | 47 948 | 53 756 | 36 980 | 34 962 | 18 012 | 52 518 | 60 094 | -14.6% | 13.9% |
| Northern Cape | 204 044 | 164 087 | 148 198 | 119 392 | 96 253 | 116 728 | 122 683 | -20.7% | -4.1% |
| North West | 126 436 | 71 693 | 96 447 | 125 391 | 129 268 | 80 600 | 81 100 | -5.4% | -17.8% |
| Western Cape | 1 202 352 | 812 104 | 958 551 | 1 079 599 | 1 528 970 | 1 709 118 | 1 748 457 | -8.5% | 11.6% |
| **Total** | **3 488 780** | **2 542 302** | **2 688 508** | **2 855 104** | **3 385 392** | **4 342 430** | **4 254 464** | **-11.3%** | **8.6%** |
| **Per category** | | | | | | | | | |
| Category A | 1 235 941 | 1 018 719 | 1 126 754 | 1 143 453 | 1 481 637 | 2 270 002 | 2 159 970 | -7.6% | 17.5% |
| Category B | 641 045 | 746 718 | 825 434 | 814 582 | 798 599 | 1 037 324 | 831 707 | 2.7% | -4.3% |
| Category C | 1 611 794 | 776 865 | 736 320 | 897 069 | 1 105 156 | 1 035 104 | 1 262 787 | -22.0% | 6.5% |
| **Total** | **3 488 780** | **2 542 302** | **2 688 508** | **2 855 104** | **3 385 392** | **4 342 430** | **4 254 464** | **-11.3%** | **8.6%** |

*Source: National Treasury provincial database*

## Horizontal division of revenue

*The horizontal division of revenue gives concrete expression to government's policy priorities*

The vertical division of revenue determines only the quantum of nationally raised resources that are available to the local government sphere. These resources must be divided into transfer programmes and allocated between municipalities. Individual municipalities will thus experience higher or lower increases as a result of the mechanisms used to allocate funds between them. This process is known as the horizontal division of revenue. It gives expression to the policy priorities of government, as this is where specific instruments are introduced to pursue the objectives that underlie the outcomes of the vertical division of revenue. National Treasury continues to play an important role in reconciling the design and inter-relationships of individual transfer programmes with the overall fiscal stance of government towards the local sphere, as reflected in the vertical division of revenue. This oversight role is important for ensuring that municipalities are able to pursue national priorities, while remaining subject to mechanisms of local democratic accountability.

Table 5.3 summarises the allocation of national resources between specific transfer programmes between 2003/04 and 2009/10.

**Table 5.3 Transfers to local government, 2003/04 – 2009/10**

| R million | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
|---|---|---|---|---|---|---|---|
| | | Outcome | | Estimate | Medium-term estimates | | |
| **Equitable share and related** | **6 624** | **7 811** | **9 808** | **18 421** | **21 297** | **25 750** | **31 011** |
| Equitable share[1] | 6 350 | 7 678 | 9 643 | 18 058 | 20 676 | 24 889 | 30 156 |
| Water services operating subsidy grant | 273 | 133 | 165 | 363 | 622 | 861 | 855 |
| **Infrastructure: MIG** | **2 323** | **4 481** | **5 436** | **5 809** | **8 262** | **8 657** | **10 330** |
| Municipal infrastructure grant | 2 323 | 4 481 | 5 436 | 5 809 | 8 262 | 8 657 | 10 330 |
| **Other direct transfers** | **364** | **330** | **539** | **909** | **1 758** | **4 173** | **3 922** |
| Integrated national electrification programme (municipal) grant | 245 | 196 | 297 | 391 | 468 | 596 | 897 |
| Public transport infrastructure and systems grant | – | – | 242 | 518 | 1 174 | 3 170 | 2 325 |
| Neighbourhood development partnership grant | – | – | – | – | 116 | 407 | 700 |
| Building for sports and recreation programme grant | 119 | 134 | – | – | – | – | – |
| **2010 FIFA World Cup stadiums development grant** | **–** | **–** | **–** | **600** | **4 605** | **2 895** | **1 400** |
| **Infrastructure: Indirect transfers** | **2 727** | **2 126** | **1 939** | **1 333** | **2 576** | **2 293** | **2 741** |
| Water services operating subsidy grant | 817 | 819 | 626 | 440 | 497 | 269 | – |
| Community based public works programme grant | 12 | – | – | – | – | – | – |
| Implementation of water services projects (capital) | 1 102 | 208 | 139 | – | – | – | – |
| Disaster relief grant (DWAF) | – | – | – | – | 100 | – | – |
| Disaster funds (DPLG) | – | 280 | 311 | – | 492 | – | – |
| Integrated national electrification programme (Eskom) grant | 796 | 819 | 863 | 893 | 973 | 1 151 | 1 421 |
| Regional bulk infrastructure grant | – | – | – | – | 300 | 450 | 650 |
| Backlogs in water and sanitation at clinics and schools grant | – | – | – | – | 105 | 210 | 350 |
| Backlogs in the electrification of clinics and schools grant | – | – | – | – | 45 | 90 | 150 |
| Neighbourhood development partnership grant (technical assistance) | – | – | – | – | 64 | 123 | 170 |
| **Capacity building** | **998** | **768** | **655** | **664** | **929** | **430** | **500** |
| Municipal systems improvement programme grant | 150 | 182 | 200 | 200 | 200 | 200 | 200 |
| Local government restructuring grant | 539 | 388 | 256 | 265 | 530 | – | – |
| Local government financial management grant | 280 | 137 | 132 | 145 | 145 | 180 | 300 |
| Financial management (DBSA) grant | 29 | 61 | 66 | 53 | 53 | 50 | – |
| **Other recurrent transfers** | **–** | **–** | **–** | **–** | **–** | **–** | **488** |
| 2010 FIFA World Cup host city operating grant | – | – | – | – | – | – | 488 |
| **Total** | **12 672** | **15 186** | **17 838** | **26 827** | **37 669** | **40 025** | **46 470** |

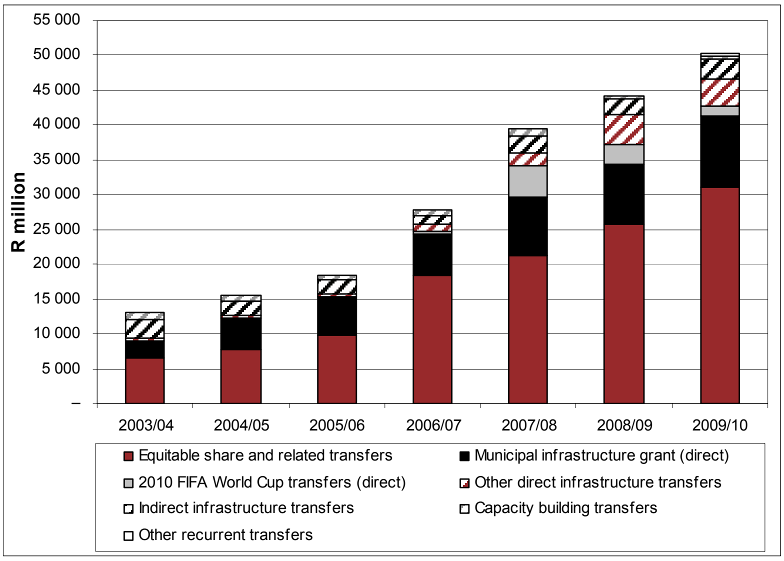
*1. RSC levies abolished from 1 July 2006. Interim replacement grant included in Equitable share.*

*Source: National Treasury local government database*

### Transfer instruments

The most basic distinction between types of transfers is between conditional and unconditional funding instruments. A conditional transfer is earmarked for specific types of expenditures by municipalities and must be spent in accordance with prescribed processes. An unconditional transfer has no such conditions attached, although it must be spent in accordance with existing standards and requirements for all public expenditure.

**Figure 5.2 Transfers by type, 2003/04 – 2009/10**




*Source: National Treasury local government database*

### *Unconditional transfers*

The only unconditional transfer in South Africa is the local government equitable share which is a constitutional entitlement. Municipalities are largely free to allocate the equitable share as they see fit after taking account of national priorities that underpin the vertical division of revenue. It was first introduced in 1998/99. The main purpose of this programme is to address the gap between the revenues and expenditures of municipalities. In the South African context, the main cause of this gap is high levels of poverty. The equitable share thus allocates resources between municipalities largely on the basis of the proportion of poor households in their jurisdiction. The formula does, however, have five variable components: basic services (BS); development (D), institutional (I); revenue-raising capacity (RRC); and correction and stabilisation (R) components. Further details on the formula can be found in National Treasury's annual Budget Review and the Division of Revenue Act.

*The local government equitable share is the only unconditional transfer in South Africa*

The equitable share is intended to fund a range of municipal activities, although national free service levels are the main purpose. Most importantly, government uses this mechanism to support municipalities in providing free basic services to poor households. Municipalities have discretion in designing the actual subsidy mechanism that channels these resources to intended beneficiaries, as

*Municipalities can exercise discretion in how to channel the equitable share to beneficiaries* there is no single subsidy mechanism that is appropriate across all services and municipalities in South Africa. The equitable share also supports the general expenditures of municipalities, including specific items such as councillor remuneration. Many smaller municipalities use their equitable share to pay basic operating expenditures such as salaries, due to their limited capacity to raise their own revenue.

Since 2006/07, part of the equitable share has been used to temporarily channel funding to replace revenues lost to municipalities as a result of the withdrawal of RSC levies on the payroll and turnover of businesses. This accounts for the large rise in the transfer in this year.

*The equitable share is the largest single transfer programme*

The equitable share is the largest single transfer programme, accounting for an average of 56.7 per cent of all transfers between 2003/04 and 2009/10. It has also experienced strong real growth of 31.4 per cent between 2003/04 and 2005/06. Real growth of 12.8 per cent is projected over the medium-term as government continues to prioritise universal access to basic municipal services.

The equitable share is generally classified together with the direct transfer component of the water service operating subsidy, managed by the Department of Water Affairs and Forestry. This grant funds the operating costs of water services schemes that have been transferred to municipalities. It is complemented by an indirect transfer, through an augmentation to the water services trading account on the Department of Water Affairs and Forestry's budget vote. This funds the costs of schemes that have not yet been transferred to municipalities. The direct transfer component of this programme is thus projected to rise over time, as more scheme transfers take place. Ultimately, these resources will be consolidated into the equitable share once the transfer of schemes has been accomplished. This programme makes up a small and declining proportion of total transfers to local government, although it has shown real growth as the costs of operating these water services schemes have increased.

### *Conditional transfers*

*Conditional transfers support municipal infrastructure investment and strengthen municipal capacity*

Conditional transfers make up the remainder of the resources transferred by national government to municipalities. These transfers are provided to support municipal infrastructure investment and to strengthen municipal capacity. In both cases, transfers are made directly, in the form of cash and indirectly, in the form of assets or support services provided to a municipality. The specific conditions and procedures associated with individual programmes are provided in annexures to the annual Division of Revenue Act.

Infrastructure transfers collectively make up an average of 40.2 per cent of all conditional transfers to municipalities between 2003/04 and 2009/10. Infrastructure transfers have also experienced strong real growth, averaging 17.8 per cent over the period. Government has a distinct policy preference for direct (cash) transfers. These make up an average of 81 per cent of all infrastructure transfers and are projected to constitute an ever larger share of infrastructure transfers over the period.

*The municipal infrastructure grant is the largest infrastructure transfer programme*

The largest infrastructure transfer programme is the municipal infrastructure grant (MIG), currently administered by the Department of Provincial and Local Government. It accounts for an average of 54.1 per cent of all infrastructure transfers between 2003/04 and 2009/10. The MIG has shown strong real growth over the period, averaging 6.4 per cent between 2004/05 and 2006/07. Real growth is projected to accelerate to an average of 21.4 per cent over the medium-term.

The MIG was introduced in 2004/05 through consolidating various sector infrastructure grants, each administered by different departments, into a single programme. This was intended to make the system of transfers to municipalities simpler, more certain and more supportive of municipal infrastructure priorities. The programme is designed to supplement the capital budgets of municipalities, with a focus on providing basic infrastructure services to the poor, while stimulating local economic development and job creation over the medium-term. Funding for electrification has not yet been incorporated into the MIG, due to uncertainties associated with the restructuring of the electricity distribution industry. MIG funds are distributed to all municipalities based on a formula that accounts for existing backlogs in service delivery as well as the functions assigned to individual municipalities. In some instances, portions of MIG allocations are earmarked for specific expenditures by municipalities, although on the whole they have the flexibility to determine their own expenditure priorities.

The remaining direct transfers account for an average of 24.8 per cent of all infrastructure transfers between 2003/04 and 2009/10. The significant growth in these transfers from 2007/08 is related to the development of stadiums and public transport systems in preparation for the 2010 FIFA World Cup. These expenditures benefit only the host cities and will peak at R6 billion, or 33.7 per cent of all infrastructure transfers in 2008/09. Other direct infrastructure transfers support electrification programmes of municipalities and township development initiatives through the recently introduced neighbourhood development partnership grant.

*Indirect infrastructure transfers focus mainly on electrification and water services*

Indirect infrastructure transfers make up an average of 24 per cent of infrastructure transfers between 2003/04 and 2009/10. This declines rapidly from 57.2 per cent of infrastructure transfers in 2003/04 to a projected 14.9 per cent in 2009/10. The declining trends of the indirect grants are because the implementation of the water services projects was phased out from 2004/05. The trend starts to rise again from 2007/08 due to the introduction of more indirect grants in the local government sphere. The major programmes here focus on electrification and water services. Electrification transfers are made to Eskom through the Department of Minerals and Energy, which accounts for an average of 71.6 per cent of electrification transfers over the period. However, Eskom's share of these transfers is declining, due to more rapid growth in direct transfers to municipalities. Additional transfers are also made to support electrification in clinics and schools. Indirect transfers for water services focus on the construction of regional bulk water assets by the

Department of Water Affairs and Forestry and water services in clinics and schools.

**The neighbourhood development partnership programme**

The neighbourhood development partnership grant (NDPG) and the Neighbourhood Development Programme (NDP) Unit were established by National Treasury in 2006. The NDPG is a new hybrid grant (combining technical assistance for project planning and a capital grant).

Its goals are to support "neighbourhood development projects that provide community infrastructure and create the platform for private sector development and that improve the quality of life of residents in targeted areas".

The NDP unit delivers on its mandate through supporting the creation of plans that mainstream future-oriented township development to support neighbourhood development. Capital injections for kick-starting township regeneration projects are also available for initiatives such as:

- the creation of a critical mass of commercial and community facilities (such as nodes and precincts) and/or
- the creation of internal and external linkages within townships and/or between townships and main economic centres and/or
- the provision of general environmental improvements in townships.

An example of the application of the NDPG is the Bridge City project, undertaken by the eThekwini metropolitan municipality. (Bridge City is a large scale project that aims to build a new mixed-use town centre within the Inanda-Ntuzuma-KwaMashu area in KwaZulu-Natal). Critical fast-tracked transportation linkages are enhancing the feasibility and attractiveness of the development. The NDPG's key role here is to address constraints to investments in the Inanda, KwaMashu and Ntuzuma townships by establishing certainty about infrastructure investments.

NDPG investment into the CBD of Khayelitsha, a township located 35km from the heart of Cape Town, will support its growth as a regional commercial centre, with anticipated outlays for the public environment, social infrastructure and urban management.

Capacity building transfers account for only an average of 2 per cent of all transfers to municipalities between 2003/04 and 2009/10. This share declines over the medium term due to the ending of some programmes and strong growth in other categories of transfers. These transfers support municipalities in introducing reforms to management practices associated with the Municipal Systems Act (2000) and the Municipal Finance Management Act (2003). The financial management grant (FMG) has replaced the restructuring grant as the largest single transfer to municipalities in this category. The restructuring grant supported large cities with the transition costs of adjusting their fiscal positions to better support growth and poverty alleviation and has been phased out.

*Municipalities receive different kinds of capacity building support*

Different kinds of capacity building support are also provided to municipalities, most often through direct hands on assistance (such as the deployment of technical advisors). The Siyenza Manje programme, managed by the DBSA, is one such example. The lack of standardised information on these indirect transfers prevents accurate analysis of their contribution to the overall system of transfers. This matter is being addressed by National Treasury, with the intention of introducing more rigorous monitoring and evaluation of expenditure and output performance of all capacity building programmes.

Furthermore, the municipalities are receiving transfers from provinces in the form of a direct transfer. This is mainly from programmes that are administered at the provincial level, but have local government related programmes. Programmes such as ambulance services and primary health clinics are administered at the local level, though they are partly funded by the provincial departments of health.

Municipalities are required to provide a service on behalf of the province for these programmes. Provinces should therefore provide municipalities with a clear indication of the exact amounts to be transferred to them during the course of the financial year. This will assist municipalities in planning.

### Issues in horizontal division of revenue for local government

There are four issues that emerge from this analysis of the horizontal division of revenue for local government:

- the consolidation of transfers into the equitable share and the MIG
- increasingly equitable distribution of grants between municipalities
- the increase in levels of grant dependence
- the prevalence of indirect transfers.

First, the consolidation of transfers into the equitable share and MIG is increasingly being counterposed by the expansion in the number of specific purpose conditional transfers. Consolidation was a strong feature in recent years as government sought to strengthen the accountability of municipalities for spending outcomes, give greater policy direction to transfers and improve co-ordination between spending programmes at the municipal level. Much of this was achieved through strengthening regulatory controls in the annual Division of Revenue Act.

Consolidation created scope for a step increase in the quantum of transfers to local government, as reflected in the structural shift in the vertical division of revenue. However, it brought with it two challenges.

*National departments are now engaging with municipalities on sectoral priorities to influence local decision-making processes*

On the one hand, national departments have found it considerably more challenging to engage with municipalities on their sectoral spending priorities. In the past, grants were earmarked for specific sectors and specific amounts allocated to municipalities, but with only limited information on their relative needs and priorities. Now national departments must engage with municipalities on sectoral priorities to influence local decision-making processes. This requires significantly more information and a different approach to co-ordination with municipalities.

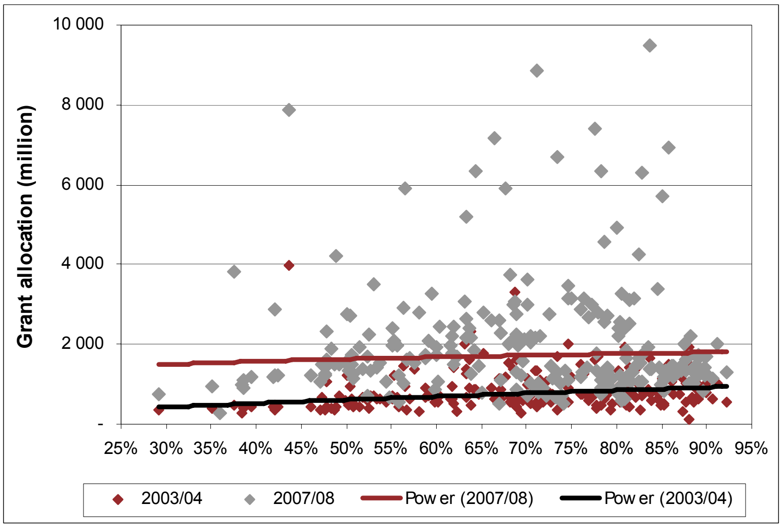
On the other hand, the consolidation was intended to improve co-ordination between remaining programmes, specifically between the equitable share and MIG and with the national housing subsidy transfers that are made to provinces. In the past, the plethora of grant programmes made co-ordination difficult. Yet while internal co-ordination within municipalities has improved, co-ordination between municipal infrastructure and housing programmes remains highly problematic and dysfunctional. (These problems are discussed in more detail in Chapter 10 on the built environment.)

*The consolidation exercise has created space for a new generation of transfer programmes to emerge*

Nonetheless, a positive result of the consolidation exercise has been the space that has been created for the emergence of a new generation of transfer programmes. These programmes have emerged to address newly identified gaps and opportunities in the transfer system, such as funding for the 2010 FIFA World Cup and the neighbourhood partnership development programme. These programmes have adopted innovative approaches in grant design that could be more widely adopted by other transfer programmes.

Second, the distribution of grants between municipalities has become increasingly equitable over time. This means that municipalities with larger proportions of poor people have received an increasingly larger allocation of available resources. As poverty in South Africa is increasingly located in large urban areas, these municipalities have benefited from this trend. However, the benefits to large urban municipalities have been reinforced by the introduction of additional transfers, such as the RSC levy replacement grant that is included within the equitable share and the 2010 FIFA World Cup transfers to host cities. This has tended to skew the distribution of transfers and reduce the overall equalisation effects in the system.

**Figure 5.3 Total grant allocations per household as a percentage of the population in poverty, 2003/04 and 2007/08**



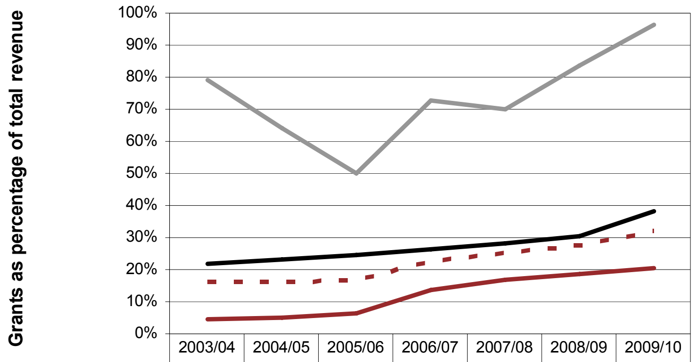

*Source: Stats SA and National Treasury database*

*The levels of municipalities' dependence on grants have increased for all categories*

Third, the significant real increase in transfers has resulted in an increase in levels of grant dependence across all categories of municipalities. Average levels of grant dependence are projected to rise to 31.9 per cent by 2009/10. Metros, in particular, have become increasingly dependent on grants as a result of the removal of RSC levies and funding for the 2010 FIFA World Cup. But district municipalities are mostly dependent on grants, given the absence of other revenue instruments at this level of local government.

Rising levels of grant dependence can become problematic if they are associated with a decline in revenue collection efforts by municipalities. An increase in municipal dependence on conditional grants can be problematic if this diffuses direct municipal accountability to citizens and replaces it with reporting to national government. This emphasises the importance of retaining the decentralised nature of funding instruments such as the MIG and preserving their importance in the system of transfers.

**Figure 5.4 Average levels of grant dependence by category of municipality, 2003/04 – 2009/10**




| | 2003/04 | 2004/05 | 2005/06 | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
|---|---|---|---|---|---|---|---|
| Category A (Metros) | 4.6% | 5.2% | 6.4% | 13.8% | 16.9% | 18.5% | 20.3% |
| Category B (Locals) | 22.0% | 23.3% | 24.3% | 26.5% | 28.2% | 30.4% | 38.1% |
| Category C (Districts) | 79.1% | 64.2% | 50.1% | 72.7% | 69.9% | 83.7% | 96.5% |
| Total | 16.1% | 15.7% | 16.4% | 22.5% | 25.0% | 27.3% | 31.9% |

*Source: National Treasury local government database*

Fourth, the ongoing prevalence of indirect transfers remains an ongoing challenge to the fiscal stance of national government in relation to the local sphere. The construction of infrastructure assets by national administering departments on behalf of municipalities can limit their commitment to associated maintenance and replacement responsibilities, even if these assets are formally included in municipal asset registers. If other spheres assume a direct responsibility for municipal operating expenditures this allows municipalities to expand expenditures elsewhere. This may ultimately create an unsustainable local fiscal position for that municipality. The provision of non-cash operating support to municipalities, such as the deployment of technical advisors, can limit municipal commitment to the outcomes of these advisory programmes unless these relationships are clearly contracted. Also, the limited information on resources spent per municipality, particularly when indirect transfers are not captured within the division of revenue process, limits the extent of oversight and performance evaluation of these programmes.

*The ongoing prevalence of indirect transfers remains an ongoing challenge to the fiscal stance of national government in relation to the local sphere*

## Division of revenue process and administration of grants

The horizontal division of revenue is mediated by a formal process to divide available revenues. This process has been developed and institutionalised over a number of years and continues to evolve as government seeks to ensure closer alignment between policy priorities and funding programmes and seeks mechanisms to improve value-for-money in spending outcomes.

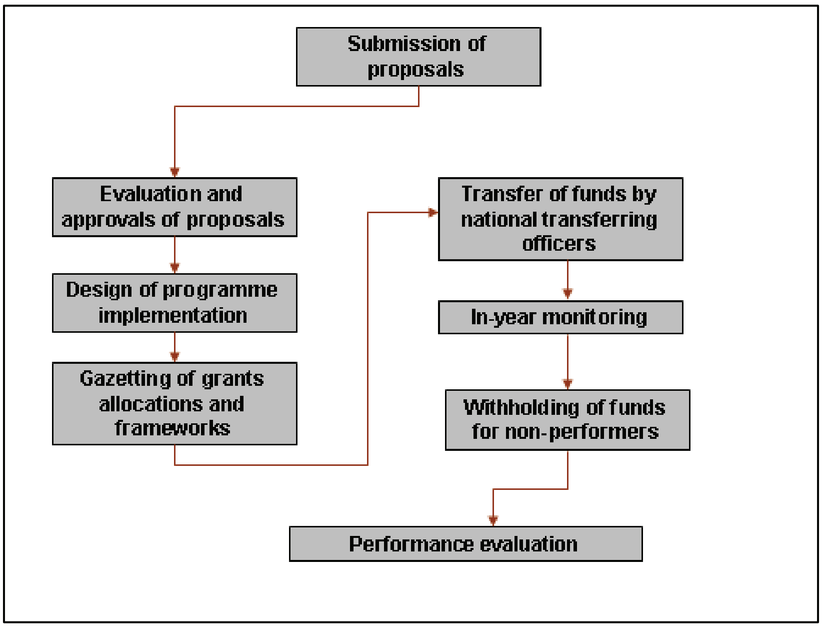
*The division of revenue process involves eight generic steps*

Following the determination of policy priorities and the vertical division of revenue, the horizontal division of revenue process involves eight generic steps.

***Step 1 – Submission of spending proposals:*** Following the determination of the vertical division of revenue, National Treasury engages sector departments on priority areas for additional funding to local government. Departments then submit proposals for new or expanded grant programmes as part of their individual budget proposals.

***Step 2 – Evaluation and approval of proposals:*** An evaluation committee comprising National Treasury, the transferring national officer and other sector departments evaluate new programme applications and in the case of large infrastructure projects, specific municipal project proposals. Emphasis is placed on ensuring a robust design to ensure overall readiness to transfer and spend grant resources. For a new grant programme to be included in the following year's budget, the project evaluation process must be concluded before the tabling of the annual Medium Term Budget Policy Statement (MTBPS).

**Figure 5.5 Main steps in budget process**




***Step 3 – Detailed design of programme implementation procedures:*** After the tabling of the MTBPS, three-year indicative allocations for each programme are issued to national departments through the standard budget allocation letters. Successful programmes must then begin detailed planning for programme implementation. The period between October and January before the beginning of each national financial year is used to engage all stakeholders to finalise the allocations and to determine the extent of readiness by the department and municipalities to implement the programme.

***Step 4 – Gazetting of programme framework and allocations to municipalities:*** The Division of Revenue Act (DoRA) requires transferring national departments to submit a payment schedule that outlines how they intend to transfer funds to different municipalities to National Treasury before the tabling of the April DoRA gazette. National transferring officers are required, in consultation with the municipalities, to determine a schedule on how and when they would like to receive the grant funding. The final payment schedule must be communicated to all municipalities before the first transfer is made. This assists municipalities in planning expenditures, tabling their budgets and is also used for their internal reporting purposes.

Infrastructure-related grants may, at this stage, require submission of projects plans by municipalities to the relevant national department. These projects should meet the requirements of the relevant grant programme.

***Step 5 – Transfer of funds:*** National Treasury periodically transfers funds to national departments in accordance with the agreed payment schedule. These funds are then transferred to municipalities, provided they have met the conditions of the relevant grant programme.

***Step 6 – In-year monitoring:*** The Act requires national departments to monitor grants that are transferred to municipalities. The Act requires the transferring national officer to report to National Treasury on a monthly basis on information on grant amounts transferred, actual expenditure and any material differences with regard to transfers that are not in line with the payment schedule. The payment schedule is used by National Treasury to monitor spending on grants and on service delivery by checking whether the amounts scheduled were indeed spent within that period. This monitoring process assists in averting problems with fiscal dumping by transferring national officers.

***Step 7 – Withholding of funds in cases of non-performance:*** In instances where municipalities are not adhering to the provision of the Act, or specific grant conditions, the Act allows for the allocation to be withheld, stopped or re-allocated to other municipalities:

- *Withholding transfers:* Funds may be withheld if municipalities show significant under-spending or in instances where the municipalities are in contravention of any provision of the Act. Withholding can be for a period of not more than 30 days, but if contravention of the Act persists, the transferring national officer can request National Treasury to withhold transfers for more than 30 days.
- *Stopping transfers:* If municipalities continue contravening the provisions of the Act, National Treasury may stop the transfer of the grant to municipalities at its discretion or at the request of the transferring national officer.
- *Re-allocation of transfers:* National Treasury may, when it stops the transfers to municipalities and after consultations with the transferring officer, determine that a portion or the entire transfer be re-allocated to one or more municipalities.

***Step 8 – Performance evaluation:*** The final stage in the process is to evaluate the performance of grant programmes, both to determine spending pressures facing local government that require redress in the budget for the following year and to identify steps to improve the design and operation of programmes. Evaluations of grant programmes are particularly important when they are wound up, as this provides insights into the design of new programmes.

### Concerns about the division of revenue process

*The design and procedures of individual grant programmes have improved*

The division of revenue process has evolved considerably since it was introduced. Its evolution has assisted in improving the design and procedures of individual grant programmes. Despite the progress that has been made, there are still a number of concerns about the current operation of grant programmes.

First, programme designs concentrate on specifying inputs to be made by municipalities, rather than establishing and monitoring desired outcomes. This selection of monitoring indicators tends to emphasise expenditure *per se* rather than the developmental outcomes expenditures are intended to achieve.

Second, national departments have not been effective in applying procedures for withholding, stopping or reallocating funds. (The most advanced programme in this respect is the MIG, which stopped allocations twice in both 2006/07 and 2007/08). This reflects weaknesses in the monitoring systems of departments and limited commitment to effective oversight of municipal performance. National Treasury intends to tighten its monitoring of grant programmes from 2008/09 in terms of applicable sections of the Division of Revenue Act.

Finally, to date there have been few rigorous evaluations of grant programmes. This shortcoming is now being addressed by government and will become an increasingly important component of the transfer system in future.

## Grant performance

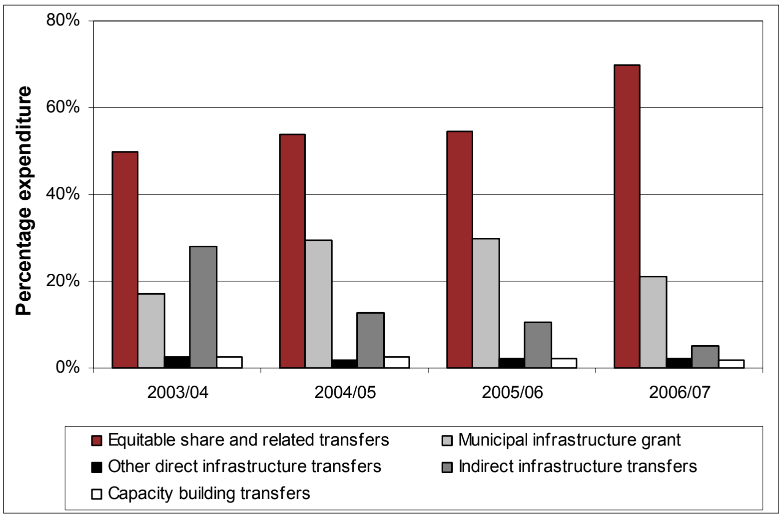
*Performance monitoring and evaluation are important tools in strengthening the outcome and impacts of individual programmes*

Grant programmes are intended to impact positively on the lives of citizens, particularly the poor. Merely allocating and transferring funds to municipalities does not guarantee these impacts. Municipalities must spend funds appropriately and in terms of individual programme objectives, while transferring national departments need to continually monitor and engage with municipalities to address emerging problems and seek new ways to improve programme performance. Performance monitoring and evaluation are important tools in strengthening the outcome and impacts of individual programmes through, for example, focusing on the value for money of outputs. Recent improvements in monitoring systems have begun to allow a tentative evaluation of the performance of grant programmes to be conducted for the first time.

Five key issues emerge in the discussion of a review of the performance of grant programmes:

First, levels of expenditure relative to allocations vary considerably between categories of programmes and individual programmes. Figure 5.6 demonstrates the excellent spending performance of the equitable share and MIG. This indicates the efficacy of formula based and outcomes focused programmes in ensuring funds are transferred to municipalities. In comparison, other direct infrastructure programmes reported far lower expenditure levels in 2003/04 (before the introduction of the MIG). Indirect infrastructure transfers report a very volatile expenditure pattern, with overspending of allocations by almost 40 per cent in 2003/04, but under-spending by 14 per cent the following year. This reflects poor planning by national spending agencies.

**Figure 5.6 Expenditure performance of selected grant programmes by category, 2003/04 – 2006/07**




*Source: National Treasury local government database*
*Note: Figure excludes 2010 FIFA World Cup programmes and the Neighbourhood development partnership grant*

Capacity building programmes report the lowest spending levels. Collectively, they spent only 38.7 per cent of their allocations in 2003/04, although this has now risen to almost 54.5 per cent for the capacity building category in 2006/07. The growth in spending levels counteracts arguments that spending is disrupted by weak municipal capacity and compliance. The worst performer in this category was the municipal systems improvement grant managed by the Department of Provincial and Local Government, one of government's flagship capacity building programmes that receives over R200 million per year. An average of 33.9 per cent of this allocation was spent between 2003/04 and 2006/07, though spending levels have risen from 6.5 per cent in 2003/04 to 58.1 per cent in 2006/07.

*Infrastructure programmes contribute to combating poverty through expanding access to basic services*

Second, infrastructure programmes have made a significant contribution to combating poverty through expanding access to basic services. Table 5.4 summarises progress made in servicing households through the MIG. As at March 2007, nearly 2.9 million households had been serviced through completed MIG projects since the inception of programme in April 2004. In addition, the MIG had funded the eradication of 121 228 bucket toilets by the end of 2006/07.

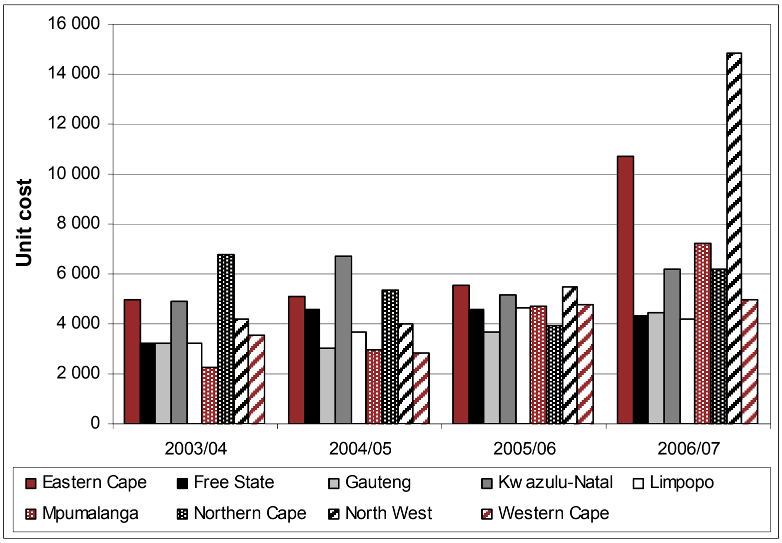
**Table 5.4 Impact on the Municipal Infrastructure Grant, 2006/07**

| MIG formula | 2006/07 Estimate |
|---|---|
| **Number of households serviced on MIG projects** | **Up to March 2007** |
| B-Component | 1 980 301 |
| P-Component | 874 652 |
| E-Component | 3 872 |
| **Total** | **2 858 825** |
| **Households serviced on Basic Infrastructure Projects** | **Up to March 2007** |
| Water | 610 293 |
| Sanitation | 324 071 |
| Roads | 520 119 |
| Stormwater | 89 411 |
| Street / Community Lighting | 204 147 |
| Solid Waste Removal | 232 260 |
| **Total** | **1 980 301** |

*Source: Department of Provincial and Local Government*

The integrated national electrification programme (INEP) is managed by the Department of Minerals and Energy and implemented by municipalities (as a direct transfer) and Eskom (as an indirect transfer). The intention of this programme is to achieve universal household access to basic electricity by 2014.

**Figure 5.7 Average cost of electrification per household by province, 2003/04 – 2006/07**




*Source: National Treasury local government database*

*The cost of electrification per household has risen considerably*

An average of almost 200 000 connections has been made every year over the last four years, predominantly in more rural provinces where the backlogs are greatest. The average cost of a single connection over the period has been R5 006, but this has begun to rise dramatically. In 2006/07, the average cost of connections was R7 014, due to both significant growth in the cost of materials and the costs associated with servicing outlying areas. As the connection costs of the decreasing number of connections completed has increased, the number of connections made has declined by an average of almost 19.6 per cent per year since 2003/04, despite a decrease in the total allocation for electrification by 2.6 per cent. A further factor influencing the rate of progress has been the unavailability of houses for electrification, due to delays in the implementation of housing projects and the inability to service informal settlements.

*MIG funded projects are specifically intended to be labour intensive*

Combating poverty involves more than providing basic infrastructure to poor households. Labour intensive construction methods can provide poor households with job opportunities, supporting livelihoods and reducing poverty. MIG funded projects are specifically intended to be labour intensive. Up to the end of March 2007, more than 28.3 million person-days' employment opportunities had been created through MIG projects. Women (including female youth and disabled persons) benefited from 38 per cent of the total employment opportunities, while the youth benefited from 40 per cent. The community at large has also benefited from the MIG programme because it uses local contractors and suppliers when implementing projects.

*2010 FIFA World Cup related programmes are intended to have direct and indirect effects on economic activity*

Third, there has been early progress in programmes supporting municipalities' economic development activities. These programmes are generally part of the new generation of transfers described earlier in this chapter. The 2010 FIFA World Cup related programmes for stadium development and public transport improvements are intended to have both direct effects on economic activity through the construction process and indirect effects through improving urban infrastructure to support local economic development. R8.4 billion has been allocated to host cities for stadium development.

**Table 5.5 2010 FIFA World Cup stadium development grant allocations, 2006/07 – 2009/10**

| | 2006/07 | 2007/08 | 2008/09 | 2009/10 |
|---|---|---|---|---|
| **R million** | **Estimate** | **Medium-term estimates** | | |
| City of Cape Town | 98 256 | 842 248 | 686 000 | 776 022 |
| City of Johannesburg | 101 476 | 1 079 265 | 634 000 | 60 770 |
| City of Tshwane | 4 000 | 52 778 | 46 000 | 1 166 |
| eThekwini | 108 977 | 811 871 | 690 000 | 299 432 |
| Mangaung | 4 000 | 110 213 | 117 800 | 3 563 |
| Mbombela | 88 052 | 469 916 | 255 500 | 96 208 |
| Nelson Mandela Bay | 110 087 | 552 896 | 296 000 | 51 135 |
| Polokwane | 81 152 | 613 599 | 91 000 | 110 527 |
| Rustenburg | 4 000 | 72 215 | 78 700 | 1 177 |
| **Total** | **195 239** | **1 238 710** | **465 700** | **162 839** |

*Source: Division of Revenue Act (2008)*

Stadium construction is advanced for most cities and it is expected that all cities will meet the completion target date. According to the project register, most cities are slightly behind schedule as a result of technical issues such as rain, late delivery of materials from suppliers and labour conflicts in Mbombela, City of Cape Town and eThekwini. But this is not expected to affect completion dates. Indeed, funding schedules have had to be accelerated in the case of seven fast moving projects, with R1.9 billion being brought forward from the 2008/09 allocation.

Related expenditure on the public transport infrastructure and systems grant (PTIS) is also accelerating, given its slow take-off in 2005/06, when the grant was established. Many cities are investigating the development of innovative mass transportation systems that promise to alter mobility patterns in South African cities over the long term. (These issues are addressed in Chapter 9 on roads and public transportation).

The grant was established in 2005/06 with an allocation of R241 million, which grew to R519 million in 2006/07. The grant is expected to grow by 56.7 per cent in real terms between 2006/07 and 2009/10.

Performance on the PTIS grant has not been satisfactory. The PTIS allocation process was done in such a way that the cities received the bulk of the allocation in the first year, when in reality, they needed 10 per cent in the first year, for the preliminary project stages. This therefore means that the 2005/06 allocation was largely unspent, as they still had to finalise the requisite environmental impact assessments, land acquisition and preliminary and detailed designs. A delay in the signing of the memorandum of understanding (MOU) between the national Department of Transport and municipalities has been the major cause for under expenditure by municipalities. Transfers are made only to municipalities that have signed the MOUs.

The proposed budget for the neighbourhood development partnership grant (NDPG) is some R10 billion over 10 years at current values (2007). To date, awards have been made for 72 projects, covering 46 municipalities in all 9 provinces. By the end of 2008, the targeted number of projects under management by the NDP Unit is 100.

*Spending on the neighbourhood development partnership grant is picking up*

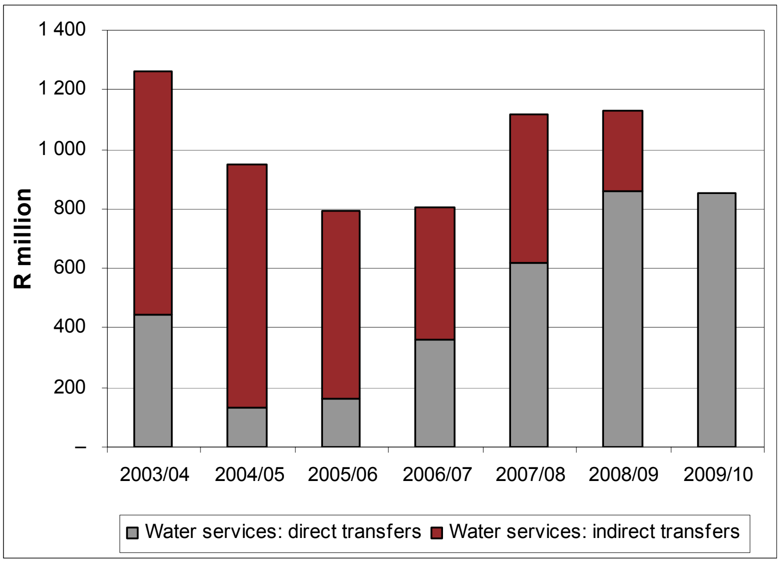
Funding agreements are being concluded with municipalities as the award status of projects is confirmed. While expenditure on the NDPG has been initially slow, this is now improving as the programme becomes established. A significant challenge is to shift the municipal mindset from coping with backlogs to long-term, area-based, economic development planning for townships. In addition, dealing with the demand for building the capacity for such strategic planning in municipalities is taking longer than envisaged. Nonetheless, over the past nine months there has been an increase in programme expenditure as municipalities start take-up of the available funding for technical assistance and capital investments. The estimated contribution of the NDPG to the costs of regeneration projects is currently 30 per cent of an anticipated R26.2 billion investment into townships across South Africa.

*The lowest levels of spending are on programmes for supporting municipal capacity development*

Fourth, there has been only limited progress in programmes supporting municipal capacity development. As already discussed, expenditure levels are the lowest in this category of programmes, while severe problems with municipal capacity persist. Assessing the efficacy of these programmes is made more difficult by the expansion of indirect transfers and incomplete information on progress towards identified outcomes. Weak co-ordination may be resulting in duplicated expenditures.

However, some programmes are demonstrating significant progress. The local government financial management grant (FMG), administered by National Treasury, aims to promote and support financial management reforms in building capacity in municipalities for the implementation of the MFMA (2003). Some reforms achieved by the FMG programme include support to municipalities for the MFMA reforms; all 283 municipalities are now participating and over 450 graduate finance interns have been appointed by municipalities using the FMG programme; and five advisors are currently placed in Eastern Cape, Free State, Limpopo, Mpumalanga and North West to assist in the implementation of the MFMA reforms.

**Figure 5.8 Direct and indirect transfers in the water services operating and transfer subsidy programme, 2003/04 – 2009/10**




*Source: National Treasury local government database*

*The remaining transition process involves the transfer of water services infrastructure from the Department of Water Affairs and Forestry to municipalities*

Fifth, a further aspect of enhancing municipal capacity is the completion of the process of restructuring local government. This has been a long and difficult process that has sought to align municipal assets, staff and finances with the constitutional assignment of functions. Past grant programmes, such as the R293 towns transition grant and the local government transition grant have already successfully run their course, with funds consolidated into the equitable share. The remaining transition process involves the transfer of water services infrastructure from the Department of Water Affairs and Forestry to municipalities. The water service operation subsidy and transfer grant was established in 2003 to support this process. It provides for the refurbishment, operation and maintenance of the department's water schemes prior to their transfer to municipalities and also for the costs of transferring assets and staff to municipalities. Funds are converted from an indirect transfer (through an augmentation to the water services trading account on the Department of Water Affairs and Forestry's budget vote) into a direct transfer to the relevant municipality once the transfer of assets and staff has been formalised through a transfer agreement. Figure 5.8 shows actual and projected progress with the conversion of funds from an indirect transfer to a direct transfer to municipalities.

## Conclusion

The system of national transfers to local government has adapted well to rapid real increases in resources being transferred from national government. This is largely due to the establishment of two flagship grant instruments, the equitable share and the MIG and the emergence of a new generation of grant programmes supporting economic development. Ongoing progress is evident in the contribution of these programmes to supporting the objectives of economic growth, combating poverty and strengthening municipal capacity.

However, a number of issues are beginning to emerge and will have to be addressed within the system of transfers over time.

First, co-ordination between programmes remains weak. The overall implication is that transfers are not yet reaching their potential in terms of comprehensively supporting economic growth and poverty alleviation. Delays in housing implementation which is not a municipal function, for example, can slow down the rate of infrastructure investment by municipalities. The proliferation of indirect infrastructure transfers further complicates co-ordination arrangements.

Second, transfers continue to weaken local democratic accountability. The growth in grant dependence and the prevalence of indirect transfers obscure the accountability of municipalities. The grant conditions often replace local oversight of municipal performance with complicated reporting requirements to national departments.

Third, weak programme design, implementation and evaluation procedures limit the impact of grants on the development outcomes sought by government. Smaller grant programmes, in particular, continue to underspend relative to their allocations and produce sub-standard information on their impacts. Few evaluations of programme performance are available to contribute to the ongoing refinement of the transfer system. Although a number of grant programmes have been phased out on completion of their design lives, this has not been accompanied by exit evaluations. Many others continue regardless of their performance.

Finally, programmes to strengthen the capacity of municipalities remain fragmented and are difficult to evaluate. This is a significant problem, given concerns over capacity constraints in municipalities.

The system of transfers to local government has evolved considerably since the advent of democracy in 1994. Significant restructuring of transfers has had significant positive impacts, but has also presented a range of second generation challenges. The emerging challenges identified in this chapter will continue to inform the ongoing evolution of the transfer system, as government seeks to assist municipalities in responding to the challenges of economic growth, poverty alleviation and local governance in accordance with national policy.