AN EXPLANATORY MEMORANDUM ON THE DIVISION OF REVENUE

INTRODUCTION

Requirements of the Constitution

Section 10(5) of the Intergovernmental Fiscal Relations Act, 1997 (Act No 97 of 1997) requires the Division of Revenue Bill to be accompanied by an explanatory memorandum detailing how the Bill takes account of the following:

- Each of the matters listed in section 214(2) (a) to (j) of the Constitution.
- Any recommendations of the Financial and Fiscal Commission.
- Any assumptions and formulae used in arriving at the respective shares contained in schedules 1 and 2 of the Bill.

Adjustments to 1998 projections

Although the Division of Revenue Bill deals only with the 1999/2000 financial year, as these are the amounts Parliament is being asked to vote, the division of revenue takes place in the context of the Medium Term Expenditure Framework. This memorandum, therefore, makes reference where appropriate to the MTEF and deviations from the medium-term projections contained in last year's budget.

Section One of this memorandum explains how the division of revenue complies with the requirements of the Constitution. Section Two discusses the recommendations of the Financial and Fiscal Commission and identifies reform initiatives undertaken. The remaining sections explain the assumptions and formulae on which the final division of revenue is based.

The formula for sharing revenue equitably amongst provinces has undergone some adjustments and has been updated to incorporate the detailed 1996 census results.

The Intergovernmental Fiscal Relations Act, 1997

The Intergovernmental Fiscal Relations Act, 1997 (Act No 97 of 1997) came into effect on 1 January 1998. The 1999 budget process is the first year in which the Act has been fully implemented.

The Act formalises a process for dealing with intergovernmental budget issues. It gives effect to section 214 of the Constitution by setting out the process for revenue sharing and to section 41 of the Constitution by promoting co-operative governance.

In terms of the Act, the Financial and Fiscal Commission makes recommendations on the division of revenues ten months before the start of the financial year. These are submitted to the Minister of Finance, Parliament and the nine provincial legislatures. The Minister then consults the provinces, local government and the FFC before taking any proposals to Cabinet. To facilitate such consultation, the Act establishes the Budget Council and the Budget Forum.

The final step in the process is that the Minister tables a Division of Revenue Bill at the time of the budget, setting out the final allocations to the three spheres and each of the provinces and any conditions that apply to these allocations. Neither the Constitution nor the Act requires that the division of the local government share between municipalities be detailed. The Bill must be accompanied by a memorandum explaining any assumptions and formulae used in determining the allocations and how those allocations comply with constitutional requirements and the recommendations of the FFC.

CONSTITUTIONAL REQUIREMENTS

National interest and the division of resources

Promoting Government's goals

Government seeks to foster a democratic society and to give effect to the rights laid out in Chapter Two of the Constitution. Government promotes this and other objectives through the appropriation of resources for the transformation of public services and society. Many of Government's goals must be pursued across all three spheres of government. These include reconstruction and development, poverty reduction, economic growth and job creation, stable and sustainable economic policies and gender and racial equity.

In order to deliver its promise of a better life for all, Government seeks to ensure that public funds are spent on the nation's priorities; that the maximum benefit is given to citizens from every rand spent by providing more services and delivering them more equitably; and that total expenditure is affordable and sustainable.

Protection of social services

The distribution of resources between the spheres of government in 1999/00 reflects Government's commitment to protecting the social services and basic service delivery by municipalities despite the slowdown in economic growth. Significant steps have already been taken to improve financial management at provincial and local level to ensure better value for money in the use of public funds. National government continues to support these initiatives through conditional grants, totalling R191 million for 1999/00 increasing to R433 million in 2001/02.

Intergovernmental institutions and the medium term expenditure framework have enhanced policy co-ordination and forged a stronger link between policies and budgets. For example, during 1998, the Budget Council met with MinMEC's for Health, Education and Welfare to discuss issues of particular concern to the social services.

Grants address national concerns

Some functions or resources are provided by sub-national governments but serve the national interest. There is also freedom of movement across provincial boundaries which means that citizens do not necessarily use services only in the province in which they live. National legislation may impose expenditure mandates on provinces and municipalities, or set norms and standards to ensure a basic level of services for all citizens. The Budget includes conditional grants to provinces and local government to support these national concerns and address the financial implications of national mandates and cross-border flows.

Provision for debt costs

The total resources shared between the three spheres of government include the proceeds of borrowing by national government. The bulk of that borrowing is the savings of South African citizens. In recognition of Government's obligation to repay those citizens and to protect the capacity borrow at the lowest possible rates, the costs of servicing debt are met before the remaining resources are shared.

Division of functions

National government needs and interests

The Constitution assigns exclusive and concurrent responsibilities to each sphere. The national government is responsible for those functions that transcend provincial boundaries including protection services (policing, defence, correctional services and justice), economic services (finance, trade and industry, labour) and foreign affairs. These responsibilities are financed from national government's equitable share of revenues. In addition the national government is responsible for policy co-ordination and establishing national norms and standards. These are met through conditional grants and agency payments to other spheres. There are also special projects to address national concerns, such as unemployment and poverty, which are initiated at the national level and funded through agency payments or conditional grants. Examples of these projects include Working for Water and the Primary School Nutrition Programme.

Provincial and local basic services

The division of revenue follows the principle that funds should follow functions and is informed by the responsibilities of each sphere, their capacity to generate revenue to meet those obligations and the work of intergovernmental forums.

Sub-national governments have a significant degree of autonomy in allocating resources to meet basic needs and respond to provincial and local priorities. The equitable shares reflect the relative priority of, and demand for, the services for which each sphere is responsible. Conditional grants and agency payments, such as the supplementary allocation to provinces and the municipal infrastructure investment programme for local governments, assist in providing a package of basic services to all households.

Fiscal capacity and efficiency

Fiscal capacity refers to the ability of each sphere to raise revenue to cover expenditures. The Constitution assigns the most important taxes, such as company tax, personal income tax and VAT, to the national sphere. The local government sphere is able to meet over ninety per cent of its expenditure commitments from own revenues. Provinces, on the other hand, are able to raise four per cent of their budgets from sources such as vehicle licences and fees. To compensate for these different fiscal capacities, the revenues collected nationally are shared between the three spheres, with provincial government receiving a larger share than local government.

Provincial taxation

The Commission of Inquiry into the Tax Structure of South Africa (Katz Commission), at the request of the Budget Council, examined the options and implications of extending provincial tax powers. In its Seventh Interim Report the Commission recommended that Government proceed with caution in this regard.

Output-based budgeting

Budget reforms and the medium term expenditure framework stress the importance of efficiency. The proposed shift towards outputs and outcomes will create greater incentives for the efficient delivery of services. In recognition of the importance of financial management and capacity building to increase efficiency, the 1999 Budget includes R191 million to fund special initiatives within the Departments of State Expenditure, Housing, Education and Welfare.

Developmental needs

Redistribution through the revenue sharing formula

Development needs are taken into account in both the equitable share formulae for provincial and local government and in specific conditional grants. For instance, the provincial formula distributes resources towards poorer provinces through the poverty adjustment in the welfare component and the additional weighting for people without medical aid in the health component. A backlog component has been introduced to reflect the need for basic infrastructure in rural areas and within the health and education sectors.

Conditional grants and agency payments include amounts for hospital rehabilitation and construction; to develop municipal infrastructure; to subsidise low-cost housing; and to support nutrition in primary schools.

Economic disparities

Economic disparities occur between and within provinces. The use of a formula to allocate resources between provinces, as opposed to provinces raising their own revenues, helps to address these disparities. The demographic nature of the formula and the weights attached to the independent variables capture the relative demand for services across provinces, redistributing funds and promoting equity. Components of the formula also recognise disparities in the distribution of income and infrastructure backlogs across provinces.

Conditional grants for redress

Provincial governments are responsible for allocating resources to promote equity and redress within provinces. Assistance is provided through the national budget by allocating funds for initiatives such as the municipal infrastructure programme; poverty reduction and job creation programmes.

Obligations in terms of national legislation

National government assists sub-national government in meeting obligations in terms of national legislation through funding and policy processes.

Meeting obligations and recognising autonomy

The equitable share allocations and other transfers are intended to allow provinces and local government to meet their obligations while recognising their autonomy to set their own priorities. Roles and responsibilities regarding concurrent competencies are being refined and adjusted as the intergovernmental system evolves, and are reflected in the division of resources between national and provincial government.

Individual components of the revenue sharing formula capture national obligations. For example, national legislation requires a poverty (or means) test for citizens to qualify for welfare grants. The welfare component targets the recipients of welfare grants and is poverty weighted.

As part of the MTEF process, review teams met to evaluate past expenditures and identify policy options for the social services, social justice, personnel issues and infrastructure spending. To further support obligations in terms of the social services, three joint technical committees have been established.

Predictability and stability

Payment schedules

Government has resolved that the equitable shares for a given year will be based on estimates of nationally collected revenues announced in the Budget. Allocations will not be adjusted if actual revenue collected is different from the targets set. Furthermore, the Division of Revenue Bill specifies that all allocations must be transferred in accordance with a payment schedule. Thus, provinces and local governments are assured of the resources they will receive, at the beginning of the financial year and know the dates on which the allocations will be transferred.

Medium term allocations

Stable and predictable revenue flows are essential for departments to undertake sound planning and to encourage better financial management. It is impossible to predict revenues with absolute certainty but the three-year projections provided as part of the MTEF give departments a baseline allocation against which to plan. Although the forward estimates are a statement of intention and are revised annually, changes must be justified in terms of a revised macroeconomic framework or specific policy changes. The reserve adds to the stability of resource flows by providing the flexibility to respond to new priorities or adverse circumstances without altering existing allocations.

Government is committed to shifting the current distribution of resources within spheres in order to promote equity. To maintain stability and predictability of resource flows during the transition, however, the equitable shares will be phased in over a five-year period.

Need for flexibility

Although stable and predictable allocations encourage fiscal discipline and improve planning and cash management, Government needs to be able to respond to changing circumstances and to accommodate shifts in priorities. As in past years this flexibility is provided by the contingency reserve. The size of the reserve increases in the outer years to reflect the increasing uncertainty over time and to recognise that policy choices made now incur future costs. Part of the contingency reserve will be allocated as part of the 2000/01 and 2001/02 budget processes.

FINANCIAL AND FISCAL COMMISSION RECOMMENDATIONS

1999 budget process

The Intergovernmental Fiscal Relations Act, 1997 requires the FFC to submit recommendations regarding the equitable division of nationally collected revenues. The recommendations must take into account all the allocations specified under section 214(1) of the Constitution and the requirements laid out in section 214(2). The FFC submitted these recommendations to the Minister of Finance in May 1998, in accordance with the Act.

Recommendations of the Commission

The intergovernmental financial system has evolved rapidly over the past four years, reflecting the new relations between the three spheres of government envisaged in the Constitution. During this time, provinces became responsible for setting their own budgets; multi-year budgeting and the Medium Term Expenditure Framework were introduced; the provincial revenue-sharing formula has been refined, reflecting the availability of new census data; intergovernmental institutions and forums have been established to facilitate co-operative governance; and there have been improvements in financial management. In the light of these developments, the FFC made three major recommendations for the 1999 Budget:

- In view of the negotiated and agreed system in place for the medium-term, substantial changes should be avoided in favour of a period of consolidation and refinement.
- Further research and consultation with stakeholders needs to take place to produce substantive recommendations for 2000/01.

Stakeholders should evaluate the system against agreed upon founding principles set out by the FFC in its *Framework Document for Intergovernmental Relations in South Africa*, June 1995. These principles, and initiatives to comply with them, are set out in table E.1.

The FFC submission highlighted two key respects in which its recommendations have been met in both principle and practice:

- The medium term expenditure framework addresses the need for long-term fiscal planning and a multi-year resource allocation process.
- Both the provincial and local government equitable shares are distributed by formulae based on prior recommendations of the FFC.

Table E.1 Principles of the intergovernmental financial system and corresponding reforms

Principle	Initiatives
Effective resource use	Budget reforms encourage efficiency by: creating stronger links between budgets and policy; devolving responsibility for setting budget priorities and making allocations to the level closest to service delivery; shifting the focus to outputs and outcomes.
Accountability and transparency	Publication of three-year estimates allows more debate on the trends in Government spending and makes it more difficult for allocations to be changed in-year.
	Conditional grants, such as the Finance supplementary allocation, have encouraged improved budgeting and financial management.
	The Treasury Control Bill, which is being finalised, introduces significantly more stringent accountability and reporting standards.
Nation building and fiscal autonomy	Intergovernmental institutions and processes have been introduced to encourage co-operative governance.
	Improved policy co-ordination ensures that a consistent level of basic services are available to all citizens. Conditional grants also support national goals.
	Provincial and local governments are able to allocate their budgets according to their specific priorities.
Certainty of revenue	Revenue can never be projected with certainty but the MTEF forward estimates provide a baseline for planning.
	The contingency reserve provides a cushion against economic and other uncertainties so that revenue allocations are more certain.
Equity	The formulae for distributing the provincial and local equitable shares have a strong equity bias, taking into account the different demographic and economic profiles.
	Conditional grants are used to address specific equity needs, such as access to specialised health care.
Development	Development needs are addressed indirectly through the provincial and local government revenue sharing formulae and directly through conditional grants.
Macroeconomic management	The MTEF process and institutions such as the Budget Council and Budget Forum ensure that macroeconomic issues are part of intergovernmental financial management.
	Significant steps have been taken to deal with shortcomings in provincial financial management, including interventions under section 100 of the Constitution and the application of the conditions for the Finance supplementary allocation.

Provincial tax surcharge

Government's approach continues to differ from that suggested by the FFC in respect of provincial taxing powers. Section 228(1)(b) of the Constitution provides for the imposition of flat-rate surcharges by provinces on national taxes, levies or duties except for corporate income tax, value-added tax, property rates or customs duties. The FFC has advocated a provincial surcharge on the personal income tax base.

Benefits of provincial taxes

The economic arguments for giving provinces taxing powers focus on the benefits of expanded fiscal autonomy, and its potential to foster responsible government and encourage more efficient use of resources. A stronger link between revenue generation and expenditure encourages greater accountability because a government must justify to its electorate both the amounts raised and uses of those funds. If a sphere of government is largely dependent on transfers from another sphere it is easier to claim that those transfers are insufficient to meet the demand for services. If provinces must raise their own revenue to cover expenditure and are held accountable for the outputs there is an incentive for more efficient delivery of services.

Katz Commission report

The Budget Council requested the Katz Commission to review the issue of provincial taxing powers.

The Commission noted that, in addition to the benefits of provincial taxation, a number of other considerations must be taken into account:

- Allowing each province to choose the applicable tax rate raises the possibility of tax competition between provinces, which can interfere with trade, investments or migration across provincial boundaries.
- Economic disparities between provinces could be reinforced by expanded revenue-raising powers. There is a trade-off for provinces between additional revenues raised through a surcharge and the loss of revenue from a smaller provincial equitable share. Given the redistributive nature of the formula, poorer provinces are likely to be disadvantaged.
- Tax revenues generated from a surcharge will remain a small proportion of total provincial budgets, particularly in poorer provinces, calling into question whether they would stimulate the desired improvements in accountability.
- Collecting provincial surcharges will pose administrative problems, at least in the foreseeable future. The South African Revenue Service indicated that it is not yet in a position to collect the surcharge on behalf of provinces because, amongst other things, insufficient information on the residence of taxpayers is available.
- Section 228(2) of the Constitution states that the exercising of provincial taxing powers may not prejudice national economic policies or economic activity across provincial borders.

Government's approach to provincial tax powers

Taking account of capacity issues and other considerations discussed above, Government remains cautious in its approach to extending provincial taxing powers. Provincial revenue issues are nevertheless a vital component of Government's ongoing assessment of the intergovernmental system. Specific research on provincial revenues is being undertaken at the request of the Budget Council. The research should highlight ways to improve the collection of current provincial own-revenue and inform the drafting of legislation required under section 228(2) to regulate provincial revenue sources.

In view of this, the revenue sharing formula retains a tax shares component that diverts a portion of the provincial equitable share according to the provincial tax base.

ECONOMIC ASSUMPTIONS

The growth and performance of the economy must be taken into account in determining the resources available for allocation. The economy has grown more slowly than projected at the time of the 1998 Budget, primarily because of the global economic crises. Slower growth and the changed outlook for the MTEF period are reflected in the revised medium term macroeconomic framework set out in table E.2.

Table E.2 Medium term macroeconomic assumptions

	1998/99		1999/00		2000/01		2001/02
	1998 Budget	1999 Budget	1998 Budget	1999 Budget	1998 Budget	1999 Budget	1999 Budget
Gross domestic product (R billion)	669,3	**654,0**	734,3	**708,4**	809,6	**766,9**	**828,7**
Real GDP growth	3,0%	**-0,1%**	4,0%	**1,8%**	5,0%	**3,2%**	**3,8%**
GDP inflation	6,0%	**7,6%**	5,5%	**6,4%**	5,0%	**4,9%**	**4,1%**
Revenue (R billion)	176,6	**180,0**	192,9	**191,7**	210,0	**207,4**	**222,3**
Per cent of GDP	26,4%	**27,5%**	26,3%	**27,1%**	25,9%	**27,0%**	**26,8%**
Expenditure (R billion)	200,3	**204,3**	215,2	**216,8**	234,5	**230,7**	**247,2**
Per cent of GDP	29,9%	**31,2%**	29,3%	**30,6%**	29.0%	**30,1%**	**29,8%**
Budget Deficit	23,7	**24,3**	22,3	**25,1**	24,5	**23,4**	**25,0**
Per cent of GDP	3,5%	**3,7%**	3,0%	**3,5%**	3,0%	**3,0%**	**3,0%**

VERTICAL DIVISION OF REVENUE

The Constitution requires that all revenue raised nationally be divided equitably between the three spheres of government taking into account their ability to generate revenue. In addition to collecting revenue from taxes, government borrows to meet its expenditure requirements.

Amounts set aside

The first stage in the division of revenue is to remove from the shared pool the costs of servicing debt and a reserve for contingencies. Interest payments already constitute the second largest expenditure item and higher interest rates translate into higher repayments. They are, however, contractual obligations that must be honoured. The contingency reserve plays an important role in absorbing the impact of unforeseen circumstances. In 1998/99, for instance, the contingency reserve was used to offset the higher-than-anticipated debt servicing costs.

Consistent with budget reform measures to increase transparency donor financed expenditure is reflected in the Budget. These amounts are committed to specific projects and are not available to be shared. The skills development levy grant scheme, to be introduced in 2000/01, will be dedicated to training as specified in the Skills Development Levy Bill.

Calculating the division of revenue between spheres of government

The shares allocated to each sphere are a political judgement made by Cabinet. A consultative process generates the information on which this judgement is made, taking into account the following factors:

- The expenditure responsibilities of each sphere, as determined by the Constitution
- The ability of each sphere to fund its responsibilities by raising revenues
- National priorities
- Recommendations and analysis of key sectors by MTEF review teams
- Analysis by each sphere of the implications of baseline allocations
- The delivery implications of alternative levels of funding and policy options

This information is reviewed and discussed at intergovernmental meetings – the Budget Council, Budget Forum and MinMECs – before a final proposal is presented to Cabinet and Parliament.

Funding priorities

The division of remaining resources between the three spheres of government is arguably the most important judgement made in the budget. It determines the broad allocation of nationally collected resources between the respective responsibilities of the three spheres of government. For example, national government allocates funds to its core responsibilities of protection services and economic services while provinces spend approximately eighty five percent of their budgets on primary and secondary education, health and welfare.

Division based on political judgement

Although analyses of the functions being performed by different spheres and the impact on service delivery of different funding levels must inform the vertical division, it fundamentally remains a political choice about the relative priorities of these functions. Table E.3 sets out the division of revenue between the three spheres for 1999/00, compared to that projected in last year's budget. It is the outcome of Government's valuation of various priorities, including:

- Giving priority to the social services.
- Strengthening justice and policing.
- Continuing to support basic service delivery by municipalities.

Table E.3 Division of Revenue

R million	1999/00		Medium term expenditure framework[2]		
	1998 Budget[1]	1999 Budget	1999/00	2000/01	2001/02
National equitable share Of which:	81 312	**80 833**	78 733	81 101	84 489
National departments	70 289	**69 073**	69 973	72 739	76 232
Conditional grants	7 723	**8 761**	8 761	8 361	8 257
Total improvements in conditions of service (ICS)	3 300	**3 000**			
Provincial equitable share	84 069	**84 202**	86 302	92 071	96 822
Local government equitable share	2 316	**1 673**	1 673	2 480	2 580
Total to be shared	**167 696**	**166 708**	**166 708**	**175 652**	**183 891**
Plus:					
Debt service costs	45 000	**48 222**	48 222	49 820	52 609
Contingency reserve	3 000	**1 100**	1 100	3 500	8 000
Skills development levy grant scheme	-	**-**	-	1 000	2 000
Donor-financed spending	-	**750**	750	750	750
Total expenditure	**215 696**	**216 780**	**216 780**	**230 722**	**247 250**
Addendum					
National departments, incl. national ICS	71 337	**69 973**			
Provincial share, incl. provincial ICS	86 320	**86 302**			
Per cent of shared total with ICS and conditional grants distributed					
National	42.5%	**42.0%**	42.0%	41.4%	41.5%
Provincial	56.1%	**56.6%**	56.6%	57.2%	57.1%
Local	1.4%	**1.4%**	1.4%	1.4%	1.4%

1. Baseline shares adjusted for comparability to reflect lower pension contributions and the carry-through costs of previous improvements in conditions of service(ICS).

2. The MTEF estimates include improvements in conditions of service in the respective national and provincial shares.

Revised projections

The revised macroeconomic framework meant that projections of the division of revenue between the three spheres of government are different to those contained in last year's budget, as reflected in table E.3 above. The amount to be shared between the spheres declined in 1999/00 to accommodate the unanticipated rise in the costs of servicing debt. The provincial share, including estimated improvements in conditions of service, was protected, demonstrating the priority given to the social services. The national department's share shows a decline from the 1998 Budget levels, but part of the reduction is caused by a re-classification of certain agency payments as conditional grants.

NATIONAL GOVERNMENT SHARE

Funding national departments

The national equitable share includes amounts for national departments as well as conditional grants and agency payments to other spheres. The expenditure responsibilities of national government are defined by the Constitution. Some functions, such as protection services, economic services and foreign affairs, are exclusively performed by national departments. Other functions, including education, health and welfare, are performed in conjunction with other spheres. All national government activities must be paid for from the national equitable share.

Conditional grants and agency payments to other spheres

Conditional grants and agency payments, which are presented in Schedule 3 of the Division of Revenue Bill, are made to:

- Enable national priorities to be provided for in the budgets of other spheres.
- Promote national norms and standards.
- Compensate provinces for cross-border flows and specialised services of nation-wide benefit such as the training of medical professionals.
- Recognise that other spheres implement some national government functions, such as the provision of housing.

Conditional grants were only introduced into intergovernmental financial relations in 1998/99. In most cases, the conditions were met and funds flowed as planned. There was some confusion on the part of some national and provincial departments in terms of their roles and responsibilities. These issues were addressed at intergovernmental forums, and steps are being undertaken to help to clarify the lines of accountability with regard to these grant funds.

Accountability for conditional grants

A conditional grant is voted in both the budgets of the national and provincial department. The national department is responsible for monitoring compliance with the conditions of the grant. The provincial department is accountable for the actual expenditure of the funds. The incentive, therefore, lies with the provincial department to meet the conditions of the grant as efficiently as possible. Specific conditional grants to provinces are discussed below.

In an agency payment, the national department retains the full accounting responsibility for the funds. The department in essence hires the provincial or local government to perform a function. The implementing agency at provincial or local level is entitled to charge the department an administration fee. Because the national department remains accountable for the expenditure of the funds, it tends to exercise far more control over the application of the funds than in a conditional grant. Agency payments are generally made on a reimbursable basis, while conditional grants are usually transferred in advance and based on an agreed-upon schedule.

Conditional grants to provinces

The national share includes R10,9 billion in conditional grants to provinces in 1999/00, as shown in table E.4 below.

Table E.4 Conditional grants to provinces for 1999/00

R million	ICS estimate	Finance	Health	Local Govern-ment	Other	Total
Eastern Cape	362	445	240	70	21	1 137
Free State	153	168	354	55	16	745
Gauteng	333	358	2 013	0	14	2 717
KwaZulu-Natal	407	509	916	144	25	2 001
Mpumalanga	133	171	60	30	8	402
Northern Cape	40	58	32	0	2	133
Northern Province	302	346	123	102	17	891
North West	168	211	60	62	56	556
Western Cape	203	234	1 260	0	9	1 706
Unallocated	0	0	312	180	80	572
Total	**2 100**	**2 500**	**5 371**	**643**	**248**	**10 861**

Improvements in conditions of service (ICS)

The provincial equitable shares include the carry-through costs of previous improvements in conditions of service but not those anticipated for 1999/00, as those still have to be negotiated in the Public Service Central Bargaining Chamber. The distribution of improvements shown above is an estimate based on the distribution of the public sector wage bill. The new improvements will be funded as a conditional grant for the last time in 1999/00. Funds to cover the cost of new improvements in conditions of service will be included in the equitable share amounts beginning in 2000/01. Accordingly, provincial MTEF budgets include estimates of improvements in conditions of service.

The supplementary allocation

The Department of Finance administers the supplementary allocation. It is intended to supplement provincial funding of social services and assist in improving financial management. The supplementary allocation, which is R2,5 billion in 1999/00, is divided between the provinces by formula.

Sub-components of the health conditional grant

There are several conditional grants for health services. Funds are provided to support research and the training of health professionals across all the provinces. Further support is provided to the four provinces (Gauteng, Western Cape, Free State and KwaZulu-Natal) that provide specialised health services through central hospitals. Separate amounts are provided to fund hospital rehabilitation and construction. There is also a grant for the Primary School Nutrition Programme, which is a Presidential lead project.

Provincial grants for R293 towns

Provinces continue to receive grants to assist in the transfer of functions and staff to local government and to ease the adjustment by municipalities to the formula distribution of the equitable share.

Other grants

Other grants include amounts to support capacity building and improvements in financial management in housing and welfare; systems development and support by the Department of State Expenditure; and training centres in two provinces.

PROVINCIAL GOVERNMENT SHARE

Equitable share

The assignment of revenue raising capabilities and expenditure responsibilities in the Constitution creates a fiscal imbalance: provinces account for some sixty per cent of non-interest expenditure and seventy per cent of public service employment yet are able to raise, on average, less than five per cent of their budgets. To remedy this, section 214(1) of the Constitution stipulates that nationally collected revenues must be distributed equitably between the three spheres of government; that the provincial share must be divided equitably between the nine provinces; and provides for other allocations to be made from the national share, with or without conditions. The total transfers to provinces for 1999/00 are shown in table E.5 below. The distribution of the equitable share between provinces is determined by a formula discussed below.

Table E.5 Total transfers to provinces for 1999/00

R million	Equitable share	Conditional grants[1]	Total
Eastern Cape	14 819	1 137	15 956
Free State	5 742	745	6 487
Gauteng	12 573	2 717	15 290
KwaZulu-Natal	16 707	2 001	18 707
Mpumalanga	5 646	402	6 048
Northern Cape	2 084	133	2 216
Northern Province	11 144	891	12 035
North West	7 213	556	7 770
Western Cape	8 274	1 706	9 980
Unallocated	0	572	572
Total	**84 202**	**10 861**	**95 062**

1. Including estimates of improvements in conditions of service.

Sharing of revenue between provinces

The provincial horizontal distribution allocates resources to provinces based on their demographic and economic profiles, as shown in table E.6. The formula has a strong redistributive effect while creating sufficient incentives for provinces to develop productive capacity and stimulate growth.

The elements of the formula are not indicative budgets or guidelines to provinces on how they should spend their allocations. The final allocations are discretionary but the components are broadly weighted in line with expenditure patterns. The 1999/00 budget is the third year of distributing the provincial equitable share by formula, though the formula has been revised.

Table E.6 Distributing the equitable share

Per cent	Education	Health	Social welfare	Basic share	Economic activity	Institu-tional	Backlogs	Target shares
Weighting	*40.0*	*18.0*	*17.0*	*9.0*	*8.0*	*5.0*	*3.0*	*100.0*
Eastern Cape	18.5	17.0	19.6	15.5	5.9	11.1	20.7	16.8
Free State	6.3	6.5	7.1	6.5	5.1	11.1	5.6	6.6
Gauteng	12.3	14.7	13.9	18.1	43.2	11.1	5.0	15.7
KwaZulu-Natal	22.1	21.7	19.6	20.7	18.9	11.1	23.0	20.7
Mpumalanga	7.3	7.2	6.5	6.9	4.7	11.1	8.5	7.1
Northern Cape	1.9	2.0	2.2	2.1	1.6	11.1	1.3	2.4
Northern Province	15.7	13.3	13.7	12.1	1.7	11.1	22.9	13.5
North West	8.0	8.6	8.7	8.3	5.1	11.1	9.5	8.2
Western Cape	7.9	8.9	8.8	9.7	13.7	11.1	3.6	8.9
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Changes to the formula

As noted by the FFC's *Framework Document for Intergovernmental Relations in South Africa*, adjustments to the formula are to be expected from two sources. Changes can occur in the underlying data or structural changes can be made to the formula to reflect improved information or changed circumstances. Adjustments made to the provincial formula for 1999/00 primarily reflect the incorporation of new data, particularly revised census data. Certain structural refinements were also made, in consultation with provinces, national departments and the FFC, to better reflect provincial needs. The specific changes are discussed in detail below, and summarised in table E.14.

Impact of the final 1996 census

The final census impacted on the allocations in the formula, given its sensitivity to demographic factors. The 1996 figures show a different population distribution than the preliminary estimates, which were used to calculate equitable share allocations in the 1998 Budget. Provinces such as the Northern Province and KwaZulu-Natal gained from the revised census data. The population data used in calculating the distribution of the equitable share for 1999/00 are summarised in table E.7 below.

Phasing in the target shares

The FFC has recommended that the equitable share formula be phased in to avoid dislocations in provinces where the target shares differ substantially from the current allocation of resources. Given the significant impact that the final census data had on the allocation of funds, the Budget Council agreed to retain a five-year phasing period. The starting point for the phasing in process is the final equitable share allocations in 1998/99. Actual expenditures were not incorporated into the base shares because a once-off base adjustment was made last year and improvements in budgeting and financial planning have reduced the gap between budgeted and actual expenditures. The phasing is on a straight-line basis with five equal moves towards the target share. For example the final allocation in 1999/00, before the pension adjustment, weighted a province's target share twenty percent and its base share eighty percent.

Table E.7 Population data

Thousands	Total	Rural	Children (0-6)	School age (6-17)	Elderly	Quintile 4 & 5[1]	No medical aid[2]
Eastern Cape	6 303	3 998	1 113	2 010	477	3 718	5 793
Free State	2 634	827	366	680	156	1 475	2 166
Gauteng	7 348	218	915	1 394	392	1 102	4 390
KwaZulu-Natal	8 417	4 789	1 384	2 377	496	2 693	7 314
Mpumalanga	2 801	1 706	466	789	147	1 092	2 409
Northern Cape	840	251	127	223	54	395	665
Northern Province	4 929	4 388	944	1 665	326	2 415	4 554
North West	3 355	2 183	536	896	196	1 644	2 897
Western Cape	3 957	441	539	895	259	791	2 830
Total	**40 584**	**18 802**	**6 390**	**10 930**	**2 502**	**15 327**	**33 018**

1. Based on the1995 Income and Expenditure Survey

2. Based on the 1995 October Household Survey

Table E.8 Phasing in the equitable shares formula[1]

Per cent	Base shares 1998/9	Current shares 1999/00	Target shares 2003/4
Eastern Cape	17.8	17.6	16.8
Free State	6.9	6.8	6.6
Gauteng	14.8	15.0	15.7
KwaZulu Natal	19.6	19.8	20.7
Mpumalanga	6.6	6.7	7.1
Northern Cape	2.5	2.5	2.4
Northern Province	13.2	13.3	13.5
North West	8.6	8.5	8.2
Western Cape	10.1	9.8	8.9
Total	**100.0**	**100.0**	**100.0**

1. Shares include improvements in conditions of service but exclude other conditional grants

Adjusting the weightings of components

The weightings given to each component have changed slightly from last year. The weightings attached to education and welfare have been increased to reflect actual expenditure trends, based on the findings of the MTEF review teams. The weighting of the institutional component increased by one percentage point.

The basic component in the previous formula has been split into a basic share and a backlog component. The combined weighting of these components has been reduced from fifteen per cent to twelve per cent to accommodate the increases in other components.

Calculating the education component

The education component targets primary and secondary schooling, which accounts for roughly ninety per cent of provincial education spending. Both the school-going age population and the numbers of pupils enrolled are relevant to funding needs, but each presents difficulties. The distribution of children of school-going age does not reflect repeater rates and the numbers of under or over age pupils in the system but using the number of pupils enrolled creates perverse incentives. Both need to be used in tandem to reflect the demand for education services. Last year a simple average of the two was used, to compensate provinces where learners do not match the age profile for historical reasons and to reflect the target population. The problem of over-enrolment has placed severe strain on education resources particularly in poorer provinces prompting education policies to reduce the number of over and under age learners. For example, from 1999/00 children should only start school in the year they turn seven. To reflect this, the education component double weights the school-age cohort.

Table E.9 Calculation of education component

Thousands	Enrolment	School-age (6-17)	Weighted share %
Weighting	*1*	*2*	
Eastern Cape	2 295	2 010	18.5
Free State	808	680	6.3
Gauteng	1 400	1 394	12.3
KwaZulu Natal	2 812	2 377	22.1
Mpumalanga	924	789	7.3
Northern Cape	202	223	1.9
Northern Province	2 043	1 665	15.7
North West	946	896	8.0
Western Cape	905	895	7.9
Total	**12 335**	**10 930**	**100.0**

Calculating the health shares

The health component addresses the need for provinces to deliver primary and secondary health services. All citizens are eligible for health services so the provincial shares of the total population are the basis for the health share. Within the target population, a distinction is made between those with access to medical insurance and those without. Contrary to last year, people with private medical insurance have not been removed from the base population, to reflect that they are eligible to use public health facilities should they choose to do so.

People without medical aid support are more likely to use public health facilities than the insured. Therefore, this component is calculated by weighting the population without medical aid four times higher than those with medical aid. This implies that the uninsured account for ninety-five per cent of public health facilities usage. The proportions of the population with and without access to medical aid are taken from the 1995 October Household Survey and have been applied to the census figures.

Table E.10 Calculation of health component

Thousands	With medical aid	Without medical aid	Weighted share %
Weighting	*1*	*4*	
Eastern Cape	510	5 793	17.0
Free State	467	2 166	6.5
Gauteng	2 958	4 390	14.7
KwaZulu Natal	1 103	7 314	21.7
Mpumalanga	392	2 409	7.2
Northern Cape	175	665	2.0
Northern Province	376	4 554	13.3
North West	457	2 897	8.6
Western Cape	1 127	2 830	8.9
Total	**7 566**	**33 018**	**100.0**

Calculating the welfare shares

The welfare component captures the responsibility of provinces to provide social security grants. The constituent parts reflect the target populations of social security payments weighted by the historical distribution of each type of grant. For example, the bulk of social security payments are old-age pensions. Thus the base population for the old age and childcare sub-components are those proportions of the population that are eligible for grants: males over age sixty-five, females over age sixty and children under six. The base population for the disability sub-component is the total population, based on the assumption that the distribution of the disabled population follows the distribution of total population. An income factor is incorporated to capture the impact of the means test for old age and child support grants. The income adjustment is the provincial share of the population that falls in the lowest two quintiles of the income distribution. The final welfare share is a combination of the income factor, weighted twenty-five per cent, and the weighted average of grant populations.

Table E.11 Calculation of the welfare component

Per cent	Old age	Disability	Child care	All grants	Income adjustment	Weighted share
Weighting	*65.0*	*25.0*	*10.0*	*75.0*	*25.0*	*100.0*
Eastern Cape	19.1	15.5	17.4	18.0	24.3	19.6
Free State	6.2	6.5	5.7	6.2	9.6	7.1
Gauteng	15.7	18.1	14.3	16.2	7.2	13.9
KwaZulu Natal	19.8	20.7	21.7	20.2	17.6	19.6
Mpumalanga	5.9	6.9	7.3	6.3	7.1	6.5
Northern Cape	2.1	2.1	2.0	2.1	2.6	2.2
Northern Province	13.0	12.1	14.8	13.0	15.8	13.7
North West	7.8	8.3	8.4	8.0	10.7	8.7
Western Cape	10.4	9.7	8.4	10.0	5.2	8.8
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Changes to the basic component

The basic share was previously weighted in favour of the rural population as a proxy for poverty in order to address developmental needs and backlogs. These concerns are now addressed in a separate backlog component that incorporates the rural weighting. The basic share is distributed by percentage share of the total population, as shown in table E.6.

Taking account of economic activity

The economic activity component acts as a proxy for provincial tax revenue by directing a proportion of nationally collected revenues back to source. It also reflects the costs associated with economic activity, such as maintenance of provincial roads. Gross geographic product (GGP) from 1994 was used last year to estimate the distribution of economic activity across the provinces. Because updated GGP figures are unavailable, they were replaced by the distribution of remuneration of employees. Remuneration data are the largest component of provincial GGP.

Table E.12 Distribution of remuneration

Per cent	Weighted share
Weighting	*100.0*
Eastern Cape	5.9
Free State	5.1
Gauteng	43.2
KwaZulu Natal	18.9
Mpumalanga	4.7
Northern Cape	1.6
Northern Province	1.7
North West	5.1
Western Cape	13.7
Total	**100.0**

Taking account of institutional costs

The institutional component recognises that there are costs associated with running government and providing services that are not directly related to the size of a province's population. For this reason, it is evenly distributed between provinces as shown in table E.6.

The weight attached to the institutional component is an attempt to take into account certain fixed costs that all provinces must incur, irrespective of their size or state of development. For example, the Northern Cape incurs higher costs per person because it has a smaller, highly dispersed population.

Introducing a backlog component

The backlog component was introduced to address criticisms that the formula failed to take account of the significant backlogs faced by some provinces. Its three sub-components recognise the need for capital spending on rural infrastructure and facilities in the health and education sectors. The health and education sub-components are weighted, as in the main formula, to reflect actual provincial spending on these functions. Provincial shares of the rural population make up the remaining forty-two percent of the weighted share. The health and education distributions are based on the distribution of capital needs identified in the audit of hospital facilities and schools register of needs respectively.

Table E.13 Calculation of backlog component

Per cent	Health	Education	Rural	Weighted share
Weighting	*18.0*	*40.0*	*42.0*	*100.0*
Eastern Cape	16.3	22.0	21.3	20.7
Free State	3.8	7.8	4.4	5.6
Gauteng	10.8	6.3	1.2	5.0
KwaZulu Natal	16.0	23.5	25.5	23.0
Mpumalanga	9.2	7.5	9.1	8.5
Northern Cape	1.2	1.2	1.3	1.3
Northern Province	27.5	20.4	23.3	22.9
North West	9.1	7.5	11.6	9.5
Western Cape	6.1	3.9	2.3	3.6
Total	**100.0**	**100.0**	**100.0**	**100.0**

Adjustments to the formula distribution

For 1999/00 two personnel related adjustments were made to the provincial equitable shares as calculated by the formula explained above. These adjustments are shown in table E.14. The equitable share calculated by the formula includes improvements in conditions of service. As mentioned elsewhere in this Annexure, new improvements will be allocated as a conditional grant once negotiations in the Public Service Central Bargaining Chamber are complete. The estimated distribution of improvements was, therefore, removed from the equitable share.

Lower pension contributions

The employers' contribution to the Government Employees Pension Fund was reduced from 17 per cent to 15 per cent, consistent with actuarial advice. Although this proposal was first included in the 1998 Budget, the savings of lower pension fund contributions were carried as an offset to total expenditure rather than allocated to provincial and national departments. The adjustment has now been distributed, which reflect lower expenditure commitments rather than a reduction in services.

Table E.14 Adjustments to the 1999/00 equitable share

R million	1998 Budget Estimate	Census/ phasing change	Formula changes	Other changes	1999 Budget Estimate	Pension adjust-ment	Remove ICS	Equitable share 1999/00
Eastern Cape	15 246	81	-37	2	15 292	-111	-362	14 819
Free State	5 931	-29	39	1	5 942	-47	-153	5 742
Gauteng	13 196	-245	87	-30	13 008	-102	-333	12 573
KwaZulu-Natal	17 175	54	7	3	17 238	-125	-407	16 707
Mpumalanga	5 936	-56	-61	1	5 820	-41	-133	5 646
Northern Cape	2 104	12	19	1	2 136	-12	-40	2 084
Northern Province	11 300	306	-70	1	11 538	-93	-302	11 144
North West	7 403	35	-7	1	7 433	-52	-168	7 213
Western Cape	8 672	-157	23	2	8 539	-62	-203	8 274
Total	**86 964**	**0**	**0**	**-19**	**86 946**	**-644**	**-2 100**	**84 202**

LOCAL GOVERNMENT SHARE

Equitable share

Local government responsibilities include the provision of municipal infrastructure and basic services such as electricity, water, sanitation and refuse removal. Overall, local government is largely self-funded through property taxes, regional levies and user charges so it receives the smallest equitable share. Different municipalities, however, have different tax bases and thus differing abilities to deliver services and raise revenues. The equitable share is intended to ensure that all municipalities are able to deliver a basic package of services to all households. It is based on an investigation by the Department of Finance into the historical flow of funds to local government and the recommendations of the Financial and Fiscal Commission. The respective reports, *The Introduction of an Equitable Share of Nationally Raised Revenue for Local Government, 1998* and *Local Government in a System of Intergovernmental Fiscal Relations in South Africa, 1997* have been published and are available on the respective web sites.

Funding for R293 towns

The 1999/00 equitable share for local government totals R1 673 million. In addition, there are conditional grants for local government totalling R643 million, largely to support provincial staff working in R293 towns. The combined total of the equitable share and conditional grants is R2 316 million, which is equal to the equitable share projected for local government in the 1998 Budget. Last year, it was assumed that R293 town personnel that were funded by the provinces would be transferred to municipalities. However, this transfer of staff has not yet been completed. The Budget Forum and Minister of Constitutional Development agreed that the original 1999/00 total for municipalities would be unchanged, but that funds would have to be allocated through both the equitable share and conditional grants in order to accommodate the transition in local government.

A review of R293 staff costs by the Departments of Finance and Constitutional Development, based on data provided by the provinces, indicated that only R463 million was needed to fund the approximately thirteen thousand provincial R293 staff in 1999/00. Another R40 million is provided to assist provinces with the transition of R293 staff to municipalities, and R120 million is available as general support to local government. In addition, R477 million that had originally been set aside for R293 towns was shifted into the local government equitable share. Consequently, the equitable share comprises an allocation of R447 million that will go directly to R293 towns to fund the provision of services and R1 226 million that will be distributed between other municipalities by formula.

The medium-term estimates in the budget reflect no conditional grants to local government beginning in 2000/01 and a commensurate increase in the local government equitable share. However, the Budget Forum has agreed that, as in 1999/00, continued use of conditional grants may be necessary to assist with the transition of R293 towns. It further agreed that a portion of the equitable share would be dedicated specifically for R293 towns for the next three years.

Local government formula

The formula to allocate the equitable share to non-R293 municipalities has two components:

- A municipal basic services transfer to enable all municipalities to deliver basic services to poor households, based on an average cost per person.
- A municipal institutions transfer to provide the minimum resources necessary to maintain basic facilities for the operation of local government.

Other allocations

In addition to the equitable share and conditional grants discussed above, local governments receive other allocations directly from national government and through provincial governments. These allocations total R1 965 million for 1999/00, including R696 million for the Consolidated Municipal Infrastructure Programme, R136 million for urban renewal projects and R429 million for water subsidies.