NATIONAL TREASURY
REPUBLIC OF SOUTH AFRICA

INTERGOVERNMENTAL FISCAL REVIEW PRESS RELEASE

Background

This is the second *Intergovernmental Fiscal Review* to be published. Given the institutional arrangements underpinning the intergovernmental system in South Africa, where social and basic service expenditure is on the budgets of provinces and municipalities, a thorough analysis and understanding of budgets of the provincial and local spheres is critical in assessing the overall service delivery of Government.

Provinces are responsible for the delivery of school education, health (basic and specialised) and welfare services, whilst municipalities are responsible for basic household services, streets and street lights, and the provision of services like electricity, water, sewerage and garbage collection. Provinces are more reliant on transfers from the national government, raising 4 per cent of their budgets. Local governments, on the other hand, have greater fiscal capacity, with more than two thirds of their budgets focus on services that raise revenue. As a sphere, local government raises over 90 per cent of its budget.

The *Review* complements the 2000 Budget Review, as it provides information on the transfers in this budget, by focusing on provincial and local government budgets . The *Review* does not cover any additional information after the February 2000 budgets, and does not include the additional allocations of R2.8 billion to provinces and local government in the 2000 Adjustments budget. Neither is it updated for the revised allocations for the forthcoming 2000 Medium Term Budget Policy Statement (MPBPS), which provides information on the 2001 MTEF.

Chapters 1 to 4 cover provincial finances, whilst Chapters 5 to 7 cover local government finances. Annexures C and D provide more detailed information on provincial and local government budgets.

Chapters 1, 2 and 6 are the most important chapters in terms of providing information on provincial and local government budgets.

TRENDS IN PROVINCIAL BUDGETS (CHAPTER 1)

The *1999 Review* showed how provinces turned around their finances. Provinces projected surpluses of R1,1 billion in 1998/99 and R187 million in 1999/00, following a spell of budget overruns of R2,9 billion and R5,5 billion in 1996/97 and 1997/98 respectively. This *Review* updates the data and revises the figures published in last year's review. The 1999/00 surplus has been revised downwards to R0,5 billion while the surplus for 1999/00 is revised upwards to R3 billion. This, and the fact that provinces are further budgeting for combined surpluses of R1,3 billion, R0,9 billion and R0,7 billion over the MTEF is evidence that provincial finances are on a sound footing.

The provincial surpluses are often misconstrued as unspent funds that could have been spent on the delivery of services. However, the surpluses were necessitated by the substantial deficits incurred by provinces during the period 1996-1998. The surpluses were used to repay those debts. The consolidated provincial MTEF budgets show some provinces still have outstanding debt from the previous years, and are budgeting for surpluses to further reduce and/or eliminate the debt.

The turnaround in provincial finances has laid a sound basis for the focus to shift towards micro-reforms to improve the quality of spending in provinces.

Trends in expenditure

Provincial expenditure grew by 3,8 per cent between 1996/97 and 1999/00 against an average inflation rate of 6,4 per cent. Provincial revenues kept pace with inflation, growing at an annual average rate of 6,4 per cent over the period 1996/97-1998/99.

There is, however, evidence of recovery in expenditure over the MTEF. Budgeted expenditure in 2000/01 is expected to be 7,7 per cent higher than preliminary actual expenditure in 1999/00, and is expected to grow at an annual average rate which is 1,1 percentage points higher than inflation over the MTEF, implying that there will be real growth in provincial expenditure over this period.

Other key trends to note include:

- Strong growth in personnel expenditure particularly between 1996/97 and 1997/98 squeezed out non-personnel expenditure, rising from 54,7% of total spending in 1998/99 to 59% in 1998/99. Provinces are making a concerted effort to contain current expenditure, in general, and personnel expenditure in particular (see Table1.6). They are beginning to redirect more resources towards non-personnel expenditure in social services, non-social services and infrastructure. Growth over the MTEF has been reduced to approximately 5,6% a year, stabilising its share around 57,8%.

- The social services sector share (education, health, welfare) at 83,4% in 2000/01 comprised of education at 40,2%, health at 24,3% and welfare at 18,9%. Mpumalanga and North West are significant outliers, spending just under 78% on the social sector.

- The social services sector grew by an average of 4,5% between 1996/97 and 1999/00, exceeding the 3,8% growth rate for total expenditure, increasing its share over this period from 81,7% to 83,2%. Budgeted expenditure for social services over the MTEF is projected to grow more slowly than other expenditure, at an annual average rate of 5,7% per annum.

- Capital spending grew by only 0,9 per cent between 1996/97 and 1999/00. With the stabilisation of provincial finances and recovery of provincial expenditure, there is evidence that provinces are prioritising infrastructure expenditure. Most of the growth in provincial spending is directed towards capital expenditure and expenditure on non-personnel expenditure. Provinces' capital budgets are projected to rise 18,8% in 2000/01 to just under R8 billion. This figure includes the housing allocation of just under R3 billion.

The success of provinces in achieving the goals they have set themselves and in ensuring that these are sustained over the long term depends on the extent to which they succeed in dealing with the following challenges:

- The choices they confront in relation to spending on urgent social services versus spending towards infrastructure in the context of limited resources;
- Coping with spending pressures relating to social services: rising demand for social security grants due to the fast rising child support grant and the impact of HIV/AIDS on health spending and welfare services; and
- Continued pressure from personnel spending.

LIST OF SELECTED TABLES IN CHAPTER ONE

Table1.1: Total provincial revenue and expenditure

The table is a summary of total provincial revenue by type (national transfers including conditional grants plus provincial own revenue) and expenditure by functions (education, health, welfare and other services). It also sets out combined provincial budget outcomes, surpluses and deficits. The figures contained in the table show that after experiencing budget overruns of R2,9 billion in 1996/97 and R5,5 billion in 1997/98 provinces turned around their finances and recorded a combined surplus of R0,5 billion in 1998/99, R3 billion in 1999/00, and are budgeting for a combined surplus of R1,2 billion in 2000/01. A similar trend continues over the MTEF.

Table 1.2 Provincial surpluses and reserves

Table 1.2 sets out budgeted surpluses and reserves for 2000/01 by province. The reserve amounts are funds that had not been appropriated to any department at the time of the tabling of the budgets.

Table 1.3 Adjusted provincial revenue and expenditure

This table provides a breakdown of the adjustments to provincial revenue and expenditure, notably the change in the treatment of housing funds, which were previously agency payment and budgeted for as conditional grant henceforth and the treatment of debts of the past.

Table 1.6 Adjusted expenditure by economic classification

The economic classification set out in Table 1.6 shows emerging trends in the composition of provincial expenditure:

- Current expenditure, the bulk of which is personnel expenditure, is budgeted to decline over the MTEF, from 93,3 per cent in 1999/00 to 91,8 per cent in 2002/03. In particular, the share of personnel in total provincial expenditure drops by about a percentage point from 58,7 per cent in 1999/00 to 57,8 per cent over this period; and

- Capital expenditure is budgeted to rise, from 6,7 per cent in 1999/00 to 7,3 percent in 2002/03.

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PROVINCIAL EXPENDITURE (CHAPTER 2)

Chapter 2 covers all aspects of provincial spending with a section dedicated to education, health, welfare, other non-social service expenditure and provincial infrastructure spending.

Each of these sections highlights the main developments in the sector from a policy perspective, key trends in spending across provinces, progress in improving service delivery and the main issues that will have to be faced over the MTEF period. As provinces spend more than half of the consolidated general government expenditure and are responsible for the delivery of key social services, information on policy developments and spending trends in these areas are critical to the deepening of democracy and accountability in South Africa. Chapter 2 also highlights the differences between provinces in terms of demographics, poverty levels and economic activity and how these impact on the delivery of services in provinces.

Provincial spending numbers have been adjusted to take into account the shift of housing allocations to provincial budgets as a conditional grant. Part of the provincial contingency reserves is to pay off debt while the remaining amounts are allocated to departments. Adjustments to numbers have been made for all years from 1996/97 to 2002/03 to allow for comparability across years.

Education

Education spending has grown in real terms since 1995/96 (except for 1999/00) and is projected to grow by 6,4 per cent over the MTEF period to 2002/03. Provincial education departments have been able to reduce personnel costs from 91 per cent of total expenditures in 1998/99 to 90 per cent in 1999/00 and are projected to reduce this ratio to 87 per cent by 2002/03. In response to this decline, expenditure on school buildings, textbooks and teacher support programmes have increased. Provinces still face the challenge of reducing classroom backlogs, increasing quality of teaching, expanding early learning opportunities and furthering literacy programmes.

Provinces spend an average of 40 per cent of their budgets on education. The Northern Province, Eastern Cape and Mpumalanga spend above this average on education. Poorer provinces usually have a higher proportion of children than richer provinces and have inherited education systems that have higher repeater rates. Gauteng, Western Cape and Northern Cape have fewer children, higher pass rates and hence spend less of their budget on education. Despite these disparity, poorer provinces still spend less per child than do richer provinces with Gauteng spending R4 355 per learner and KwaZulu-Natal spending R2 943.

Provinces employ over 355 000 educators, making this group the largest component of public sector employment. Provincial education departments also employ over 90 000 non-educators supporting the delivery of education. The average cost of employees in education departments is R91 500, with the Western Cape and Gauteng spending more per employee due to the higher level of qualifications of educators. This average cost per employee is the most significant cost driver of education expenditure.

Health

Health expenditure has been one of the fastest growing areas of spending in government since 1995. The bulk of this spending takes place at provincial level. Spending grew by 7,6 per cent in 2000/01 and is projected to grow by 6,1 per cent over the MTEF period.

Personnel costs through automatic promotions still places undue pressure on provincial health budgets. Through the 2000 salary agreement, automatic promotions will terminate on 30 June 2001. This will allow health departments to balance personnel spending with other inputs. The key challenges that face provincial health departments are the impact of HIV/Aids, better hospital management and achieving greater equity in health delivery, while maintaining standards of quality.

The health sector faces the most difficult transformation and restructuring challenges. These include the prioritisation of primary health care being accessible to all, and the challenge of finding the optimal division between primary and specialised health care. For this reason, health budgets are dominated by large conditional grants, mainly for central hospitals and training of medical personnel. These conditional grants also serve the purpose of providing for cross-boundary usage of central hospital services and to expand high level of care to provinces that do not have these services. At the same time, the expansion of the primary and district health care system provides greater access to services. The information on actual expenditure of hospitals and clinics, and the challenge of securing appropriate mix of doctors, nurses and other skilled staff make a proper assessment difficult at this stage. The challenge facing the health grants is to better align policy to actual budgets, and putting in place the right incentives to enable this to happen. The health conditional grants are being reviewed by the national department,

Provinces that receive the bulk of the health conditional grants are the four provinces with large central hospitals. As a result of the structure of the health system, Gauteng, Western Cape, KwaZulu-Natal and Free State spend a higher proportion of their budgets on health care than other provinces. Provinces spend an average of 24 per cent of their total budgets on health care with Mpumalanga spending just 17 per cent and Gauteng spending 34 per cent.

Welfare

The social security grants are government's most significant poverty-alleviation programme at R18.2 billion in 2000/01. Social security grants make up 86% of provincial welfare expenditure, and benefits 3.1 million poor people, from the elderly (1.9 million), the disabled (611 000) and children. The new child support grant is targeted to reach 3 million of the poorest children by 2003/04. Other significant pro-poor programmes include the housing programme (R3 billion) and the child nutrition programme.

Welfare expenditure grew at 5% in 1999/00, and is projected to grow at 3,8% over the MTEF. Spending on welfare services have been increased, thus improving the overall services delivered by welfare departments. Provinces such as the Western Cape and Northern Cape inherited fairly well developed welfare systems with a high level of grants. As the old child maintenance grant is being phased out and welfare grants are being targeted at the poor, provinces such as the Western Cape will experience real declines in the welfare budgets, while poorer provinces will see faster rises. So while the variance between provinces on the percentage of welfare spending ranges from 25 per cent in

Northern Cape to 14 per cent in Gauteng, it is the trend that is important. This trend shows one set of provinces (Eastern Cape, KwaZulu-Natal, Northern Province) increasing its share of spending and another (Western Cape, Northern Cape) decreasing its share going to welfare.

As the take-up of the child support grant increases and the pressure to provide inflation-linked increases in welfare grants mounts, balancing the expansion of the social security net, while maintaining the real value of grants provides a major challenge. As a result of the increased rate of take-up of the child support grant, the 3,8 per cent increases in budget would have to be revised upwards in the 2001 budget from additional resources that the provinces will receive.

Other functions

The fruits of good financial management and prudent personnel management can be seen in large increases in provision for infrastructure at a provincial level. All provinces are able to increase spending on school buildings, the rehabilitation of health facilities and roads. The floods in the early part of 2000 place added pressure on the need to improve physical infrastructure. The R300 million conditional grant for infrastructure in 2000/01 has been allocated to provinces on the basis of claims in relation to flood damage and other natural disasters. Infrastructure and capital grants increase in 2000/01 by almost 13 per cent over the 1999/00 level. The main increases are for flood damage and hospital rehabilitation.

Improving infrastructure investment increases the likelihood of economic development by crowding in private sector investment and allows the public service to expand the array of services it delivers on the long term.

PROVINCIAL TRANSFERS (CHAPTER 3)

Transfers to provinces are in the form of equitable share and conditional grants, and they constitute about 95 percent of provincial expenditure. Equitable share is an unconditional allocation to provinces, which forms a major portion (88 percent) of transfers from national. Provincial governments have discretion on how to allocate the equitable share between functions assigned to them by the Constitution within the framework of government policy priorities. The equitable shares are supplemented by conditional grants to fund functions in support of national priorities.

This chapter focuses on conditional and other grants. It provides an overview of how the system of grants evolved and an analysis of the current grant system, how it operates and the teaching problems that have been identified. The chapter also looks at current efforts to improve the functioning of the conditional grant system.

Conditional grants were introduced with the 1998 Division of Revenue Act to enable provinces to meet nationally determined priorities. These grants also compensate provinces for cross-boundary flows and for provision of specialised services that are of nationwide benefit. Examples of the latter include training of medical professionals and effecting transition by supporting capacity building and structural adjustment within recipient administrations.

A total of R14,6 billion grants was transferred in 1998/99, increasing to R14,7 billion 1999/00. The Health Department administers more grants than any other department, amounting to R5,7 billion in 2000 or about 43 per cent of all budgeted grant transfers to provinces. The central hospital and professional training and research grants, which are targeted at provinces with academic and specialised health facilities, are the two largest health grants. Other departments administering significant grants to provinces are the National Treasury, Housing, Transport and Education.

Since conditional grants are designed to achieve certain policy objectives, different types of grants have emerged, with three broad categories, namely, recurrent, transitional and infrastructure grants. Recurrent grants, which constitute more than 40 percent of grants, mostly fund specialised and academic health services whose benefits spill over to other provinces.

Although significant progress has been made in developing the grant system, some problems have emerged over the past two years of implementation. Many of these problems manifest themselves in underspending of some grants. Problems with the implementation of grants are reflected in non-transfers by national departments and underspending by provincial (or local) governments. Non-transfers of grants amounted to R547 million in 1998/99, and R443 million in 1999/00. The integrated nutrition programme experienced problems in 1998/99 resulting in non-transfers of R245 million. In 1999/00 the non-transfers were mostly with infrastructure grants. The flow of most grants improved in 1999/00 as more grants were transferred on a predetermined payment schedule. The lack of an effective monitoring system to assess actual expenditure made it difficult to estimate actual expenditure per province in 1999/00 and the full extent of underspending on these grants.

The 2000 Division of Revenue Act includes new provisions, which are expected to promote better planning, improve reporting and monitoring of conditional grants, and clarifies the responsibilities of national and provincial officers. In addition to the changes, several reforms will gradually be introduced to address problems in the conditional grant system. A major review of some grants is underway which will inform the process of rationalisation and consolidation of grants to improve efficiency in the administration of grants and their effectiveness.

PROVINCIAL OWN REVENUE (CHAPTER 4)

Overview

The Constitution provides for the assignment of taxation powers to provinces, albeit, within a nationally regulated framework that is intended to ensure that all taxes are consistent with national economic policy. Although the process of drafting and passing national legislation to give effect to the constitutional provisions of section 228 is still underway, currently, provinces have authority to impose a limited range of taxes. These include motor car license and traffic fees, hospital fees, interest, gambling fees, and other user charges and levies.

Trends in provincial own revenue

Provincial own revenues constitute a very limited proportion (4 per cent) of total provincial revenues, and have been declining over time from R4 billion in 1996/97 to R3,4 billion 1998/99, and rose somewhat in 1999/00 mainly due to one-off collections of about R267 million in Western Cape and Mpumalanga.

With a share of 37,8 percent of actual collections in 1999/00 and a budgeted collection of 44,8 per cent in 2000/01, Road Traffic Act fees comprise the biggest source of provincial own revenue. The share of Road Traffic Act fees rose from 27,5 per cent in 1996/97 to 37,8 per cent in 1999/00. Following the legislative reforms in relation to gambling, it appears that gambling is increasingly becoming an important source of revenue for provinces. Its share of total provincial own revenue has increased from 9,8 per cent in 1996/97 to 14,5 per cent in 1999/00.

The decline in interest revenue is due to declining bank balances. Although budgeted collection of hospital patient fees show strong growth over the MTEF, they have also been on a steady downward trend over the last few years. The decline in interest rates is directly linked to movements in bank balances of provinces, while the decline in hospital patient fees is largely due to the introduction of free health care for children and expectant mothers, and competition between the public and private sector for patients with medical aid.

New opportunities

Although provincial own revenues represent a small proportion of total provincial revenues, the downward trend in collections is cause for concern, and could be considered to be a contributing factor to the budget constraint faced by provinces. In recognition of the need to strengthen provincial own revenue collection, government has embarked on a number of initiatives, which fall under two broad categories:

a) Improving the efficiency of provincial tax administrations. This includes:
   - Improving current collections, and reviewing the incentive system (eg hospital patient fees); and

   - Legislative reforms in relation to law enforcement and improving IT systems (eg transport's NATIS) in order to ensure compliance with tax and other regulations.

b) Expanding the provincial tax base, which would entail the passing of national legislation, giving provinces the authority to impose new provincial taxes. It is envisaged that new provincial taxes could be introduced in 2002.

LOCAL GOVERNMENT FINANCES (CHAPTERS 5-7)

Overview

The 2000 IGFR contains extensive information on local government finances, and represents a significant development in the content of the document. While information on local government is difficult to obtain, this review reflects the commitment of the National Treasury to enhance the quality and extent of available information. This information will be continually expanded and refined as reforms to municipal accounting practices are introduced.

The major trends in municipal finances identified in the Intergovernmental Fiscal Review are summarised below.

- Despite continuing financial instability in many municipalities, there are encouraging signs of progress in many municipalities. Given the 843 municipalities that currently exist, it is necessary to have some perspective of the problem.

- The biggest ten municipalities account for 65% of municipal budgets, and are improving their financial status, as can be seen with Johannesburg, Durban, Cape Town, and Port Elizabeth,. They are well positioned to deliver services to poor households.

- Most of the financial problems at the local government level are with the smaller, unviable municipalities. Many of these are being phased out under the new demarcation proposals. The challenge here is that the new consolidated municipalities will be more viable and fiscally healthier.

- Government's programme to reform municipal budgeting and finances as espoused in the Municipal Finance Management Bill, Generally Accepted Municipal Accounting Policies, and conditional grants, should result in significant improvements in the management of municipal finances.

- Government transfers to the local government sphere will continue to be restructured to become more predictable (ie three-year allocations), fair, and developmental to assist municipalities to expand service delivery.

- Problems in obtaining accurate and consistent municipal financial data continue, but this IGFR reflects Government's commitment to transparency on financial issues at all levels of government, and will be continually improved in coming years

Local government transition

Local government is entering the final phase of the transition, as outlined in the Local Government Transition Act. Newly demarcated municipalities, functioning within new structures, will be established immediately after the local government elections on 5 December 2000. Operational changes will be introduced in line with the recently approved Municipal Systems Act. The finances of local government are being reformed through the Municipal Finance Management Bill, municipal budget reforms, the introduction of generally accepted municipal accounting practice (GAMAP), and the Property Rates Bill.

The transition has not, however, always been smooth. Many municipalities still have financial problems – some due to inefficient service delivery and high levels of poverty among residents, others because of poor management and inadequate administrative and budget systems. Operating costs are often too high with the wage bills rising. These trends necessitate faster reforms and more far-reaching transformation.

Government's policy framework

The basic tenets of Government's policy framework for local government finances are:

- Local government is an independent and accountable sphere of government, with clear revenue and expenditure responsibilities. The role of national government in municipal finance is to provide an enabling regulatory environment within which municipalities can manage their financial affairs responsibly.
- The Local Government White Paper points out that own revenue is the primary source of municipal income.
- Municipal access to capital markets must be increased. This will enhance their independence from other spheres of government, introduce discipline to their financial management, spread the burden of funding for capital investment equitably over generations, and promote efficient financing of infrastructure and allocation of capital.

Local government reform programme

Government's proposed reforms for municipal finances will introduce the following:

- A system of multi-year budgeting to encourage better planning and to link budgeting and planning for measuring the medium- to long-term effects of policy choices
- Standardised, uniform budget formats to encourage comparisons between municipalities and make general benchmarks possible
- Greater involvement by councillors, the executive and citizens in the budget preparation process
- Improvements in the quality of budgets presented to councils and a better understanding of the trade-offs by the general public
- Budgets that contain meaningful information to encourage reporting against set objectives and performance measures
- An in-year reporting system for early diagnosis of financial problems, so that appropriate support programmes can be implemented before problems become crises

The proposed reforms will be tested in several pilot project municipalities in 2000-01. The goal of the overall financial reform programme is to build a strong financial foundation in municipalities. On that basis, advanced management capacities may be built for activities such as integrated development planning and performance management.

Municipal budgets

In 1999-00[1], municipal budgets totalled just over R57,4 billion. Of this, approximately 81 per cent supported the operating budget, i.e. delivery of services and overheads. The remainder was allocated to capital projects, primarily the extension of water and electricity infrastructure.

The current budgeting system is an antiquated line-item one-year budget, that undermines good management. Budgets are not comparable between municipalities because of the different classifications, and indeed, often not between two successive years in the same municipality. Most municipalities do not operate electricity and water as separate cost centers from all the other municipal activities. In reforming the budget formats, Johannesburg has been used to pilot the budget reforms. The Johannesburg case study indicates that much of the surplus in electricity or water is non-existent or very small, contrary to widely held expectations.

The information on municipal budgets does not necessarily reflect actual expenditure, and hence not very reliable. To the extent that the budgets reveal information, the following can be highlighted:

- Municipalities generate, in aggregate, approximately 92 per cent of their own revenue, with the remainder provided by transfers from the national and provincial spheres.
- In 1998-99 local governments, in aggregate, received 42 per cent of their revenue from utility fees, 15 per cent from property rates, 7 per cent from RSC levies, 8 per cent from intergovernmental transfers and 28 per cent from other sources.
- In 1999-00 transfers from the national government to the local government sphere exceeded R 5,8 million.
- The ten largest municipalities account for 65 per cent of total municipal expenditure with 1999-00 total budgets of R 37 billion.
- In 1998-99, Johannesburg had a R213 million deficit in its non-trading functions, resulting in an overall deficit of R54 million. The Metro was able to turn around this situation in 1999-00, projecting a year-end surplus of R101 million. This positive situation continues in 2000-01 with a budgeted year-end surplus of R2 million.
- Major metropolitan areas have experienced significant declines in their equitable share allocations. For example, from 1996-97 to 1999-00, Bloemfontein and Port Elizabeth experienced reductions of 50 per cent in their equitable share allocations.
- Lack of adequate revenue collection systems continues to be a major problem for municipalities. In a sample of five large municipalities, the level of outstanding debtors increased by 30 per cent from 1996-97 to 1999-00, from R741 million to R969 million.
- For 12 sample municipalities surveyed, the average monthly household payments (i.e. water, sewer, electricity, solid waste, and property rates) in July 1999 range from a high of R672,90 in Durban (KwaZulu-Natal) to a low of R449,71 in Reddersburg (Free State). The average monthly accounts increased by 10 per cent from 1996 to 1997 and again from 1997 to 1998, and growth slowed to 8 per cent in the following year.
- This study on average monthly household payments indicates the wide variance between municipalities in property taxes, electricity and water charges. For example,

[1] Local government fiscal years are shown with a (-) while national and provincial fiscal years are shown with a (/).

Property rates in the surveyed municipalities for a 1 000 m^2 erven with 150 m^2 of improvements ranged from a high of R260 per month in Durban to a low of R27 per month in Louis Trichardt. Conversely, Louis Trichardt had the highest electricity charges among the 12 municipalities surveyed.

- Resources directed toward capital expenditure as a percentage of total expenditure declined from 1996-97 to 1998-99. This decline in spending on capital infrastructure is a result of financial problems at the municipal level, as increasing operating expenditure and rising non-payment of rates and charges crowd out capital expenditure. Moreover, the long-term borrowing market, an important source of funds for capital projects, has stagnated with over 80 per cent of all new debt issued to municipalities between March 1998 and March 1999 being short term. This further reduced municipalities' ability to finance capital infrastructure.
- Salaries continue to take up a large portion of local government expenditure. In four cities surveyed, the average monthly minimum wage increased by 12 per cent from 1996-97 to 1997-98 and again in the next year, and 13 per cent from 1999-00. This translates to a cumulative increase over the four years of 41 per cent. Over the same period, the increase in the total budgets for these municipalities amounted to 29 per cent.

Intergovernmental transfers to municipalities

The fiscal reforms proposed for municipalities reflect Government's key policy principles. The systems of transfers inherited from the previous regime were highly fragmented and inequitable, with the bulk of funds directed to formerly white municipalities. Considerable progress has been made in improving the equity and transparency of these transfers in the last five years. In particular, they establish that intergovernmental transfers should:

- Be equitable, through promoting access to basic services by all households and treating municipalities fairly
- Promote the efficient production and allocation of municipal services, particularly by not compensating poor municipal tax effort
- Address the negative consequences of spillover effects, such as the underfunding of regional services
- Facilitate democracy, particularly through supporting institution-building at the local level
- Be predictable, to facilitate budgeting and borrowing
- Promote accountability by the recipient authority to avoid resource wastage
- Be as simple and transparent as possible

Current allocation mechanisms are fragmented and disbursement mechanisms invariably project-based and centralised. The plethora of transfers and the duplication of funding have raised concerns about the efficacy of the fiscal framework for infrastructure and current transfers. It has been argued that the approach to these transfers is incoherent, leading to current approaches to municipal infrastructure delivery and capacity building being fragmented and uncoordinated. Moreover, the current approach undermines integrated development and prevents effective planning at a municipal level, and is of particular concern due to the long lead-times associated with infrastructure development. Moreover, the current approach conflicts with the recent introduction of municipal budget reforms that encourage three-year budgeting by municipalities. In some cases, these problems have reduced the ability of municipalities to anticipate allocations or integrate development projects effectively.

Several reforms are gradually being introduced to address problems in the transfer system through the rationalisation of a number of infrastructure and current transfers. The outcome will be a single infrastructure transfer, a restructuring transfer and a capacity building transfer. These transfers will address the requirements of various aspects of national policy while encouraging an asymmetrical approach to the development of the local government system. However, transfers such as the bus subsidies are considerably more complex to transform. Nonetheless, the Department of Transport has made considerable progress in preparing for the devolution of public transport funding to municipalities.

Conclusion

This *Intergovernmental Fiscal Review* includes, for the first time, data on local government finances. Although the *Review* highlights serious financial challenges facing municipalities, Government's commitment to supporting reforms to municipal finances should result in major improvements to municipal financial positions. This should then lead to increased capacity over time to extend services to poor households.

Note on Annexures

Annexure C provides details on each provincial budget – it covers;

- total actual and budgeted revenue and expenditure by province;
- actual expenditure in education, health and welfare by province;
- the budget of each province by department, and in more detail for education, health and welfare.

Annexure D covers information on the major municipal and district council budgets from 1996/97 to 1999/00, as well as information on the rate and actual collection of RSC levies.