Fiscal and Fiscal Commission

Submission
Medium-Term Expenditure Framework 2004-2007

“Towards a Review of the Intergovernmental Fiscal Relations System”

April 2003

For an Equitable Sharing of National Revenue
FINANCIAL AND FISCAL COMMISSION

Submission
Medium Term Expenditure 2004-2007

“Towards a Review of the Intergovernmental Fiscal Relations System”

30 April 2003
Financial and Fiscal Commission

Private BAG X 69
HALF WAY HOUSE
1685 1ST FL

Montrse Place
Bekker Street
Waterfall Park,
Vorna Valley
Midrand, South Africa

Telephone: 086 1315 710
Fax: (+27) 011 207 2344
Website: wwwffc.co.za

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FOREWORD

The structure of the submission underscores the Commission’s anticipation of the ten-year milestone of our country’s democracy and indeed that of the life of the Commission itself.

In this submission, the Commission in Part A begins to discuss key issues for consideration in the inevitable review of the functioning of the intergovernmental Fiscal Relations System (IGFRS) which will obviously be on the agenda in 2004.

This submission builds on previous recommendations for the 2001/04 MTEF cycle and the subsequent submission on the Division of Revenue for 2002/03 and 2003/04 and responds to various comments by the Minister of Finance, Parliamentary Committees and the Budget Council.

Once again, great stock is placed on the need to ensure that the underlying principles of the system are strong and sustainable, continuing to draw on the primacy of the constitution. Nevertheless, as the content of the submission will reveal, the challenges faced by IGFRS are still immense.

The political and historical factors, rather than the fiscal considerations have been and will for the foreseeable future continue to be the dominant conditioning factors of the form and content of the system. It thus should come as no surprise that over the back of a relatively stable macroeconomic base expectations of even more speedier and efficient delivery have risen commensurately.

The Commission is naturally highly appreciative of the support it has received from, in the main, the national and provincial departments and treasuries and other agents of state. It has in fact been precisely because of the growing understanding by all stakeholders of the significance of chapter 3 of the Constitution that our task has progressively been made easier.
This submission is the product of considerable collaboration and research. The Commissioners would like to thank the members of all departments, intergovernmental forums, and the relevant Ministers who contributed to this document with their information, insights and criticisms.

In particular, the Commission also drew on the local and international expertise of technical advisers, of which the following merit special attention; Andrew Reschovsky (United States), Ronald Neumann (Canada), Robin Boadway (Canada), Govinda Rao (India), Jeff Petchey (Australia), Gary McDonald (Australia), Alex van den Heever (South Africa), David Solomon (South Africa), Yasmin Dada-Jones (South Africa), Philip van Ryneveld (South Africa), and Julia Du Pisani (South Africa).

The Commission would also like to express its gratitude to the Secretariat of the FFC, namely, Conrad van Gass, Bongani Khumalo, Hildegarde Fast, Myron Peter, Vincent Makinta, Veronica Mafoko, Robert Mabunda, Goodwill Ditlhage, and Rathipe Nhite. In addition, the logistical support from Antonette Smit, Annah Mosiane, Annaleeze Prosee, Lyn Desai, Mavuso Vokwana, Cindy Bruce, Deliswa Schoeman and Kim Biko was equally important in making sure that the processes to produce the document were on track.

As Commissioners and the Executive of the Financial and Fiscal Commission we, the undersigned, are pleased to submit this Annual Submission in accordance with the obligations placed upon us by the Constitution of the Republic of South Africa.
For and behalf of the Commission

Chairperson: Murphy Morobe

Deputy Chairperson: Jaya Josie

Date: 30 April 2003

Mr John Douw
Mr Philip Hourquebie
Prof. Lieb Loots
Dr Renosi Mokate
Mr Marius van Blerck
Prof Antony Melck
Mr Khehla Shubane
Ms Tania Ajam
Dr Pundy Pillay
Mrs Gugu Moloi
Mr Kamalasen Chetty
Mr Duncan Albertyn
Dr Haroon Bhorat
Mr Thabo Mosololi
Mrs Mmathebe Moja
Mr Marcus Lucas Mdhluli
Mrs Nosipho Damasane
ABBREVIATIONS

ABET  Adult Basic Education Training
AIDS  Acquired Immune Deficiency Syndrome
ALC  Adult Learning Centres
ASSA  Actuarial Society of South Africa
CBC  Community Based Care Programmes
CMBS  Constitutionally Mandated Basic Services
CMIP  Consolidated Municipal Infrastructure Programme
DOR  Division of Revenue
DPLG  Department of Provincial and Local Government
ECD  Early Childhood Development
FFC  Financial and Fiscal Commission
GDP  Gross Domestic Product
HIV  Human Immunodeficiency Virus
HSRC  Human Sciences Research Council
IDP  Integrated Development Plan
INCA  Infrastructure Finance Corporation
ISRDP  Integrated Sustainable Rural Development Programme
LES  Local (Government) Equitable Share
LSM  Learner Support Materials
MSP  Municipal Service Partnership
MTEF  Medium Term Expenditure Framework
NCOP  National Council of Provinces
OHS  October Household Survey
PCC  President’s Coordinating Council
PES  Provincial Equitable Share
PFMA  Public Finance Management Act
SRN  School Register of Needs
StatsSA  Statistics South Africa
SALGA  South African Local Government Association
TB  Tuberculosis
URP  Urban Renewal Programme
EXECUTIVE SUMMARY

This submission is presented in terms of Section 214(2) of the Constitution of the Republic of South Africa, read together with Section 9 of the Intergovernmental Fiscal Relations Act of 1997.

Taking into account the relevant provisions of the Constitution, the Financial and Fiscal Commission’s (FFC) responsibility is to make recommendations that inform the intergovernmental policy-making process. The FFC has noted in the past that it remains the role of the three spheres of government and their legislatures to determine fundamental policy objectives and priorities. The Commission continues to maintain this approach.

With respect to the Division of Revenue 2003/04, the Commission notes that government’s response was the culmination of substantive consultation with national, provincial, and local government, as well as other stakeholders. Consultative discussions were held during 2002 in national and provincial forums, the Budget Council, and the Budget Forum. The Commission also notes the role played by the legislatures and organized local government in facilitating the consultation process with stakeholders.

The Commission concurs with the view that the current revenue-sharing mechanisms need to be reviewed, as indicated in government’s response to the Submission on the Division of Revenue 2003/04. The imminent release of Census 2001 results presents a window of opportunity for reviewing the system, in particular with respect to the demographic data that is used in the revenue sharing formulae.

This submission takes into account the Commission’s recommendations for the 2001/04 MTEF Cycle and subsequent submissions on the Division of Revenue.
2002/03 and 2003/04. It also considers government’s response to all these recommendations. Furthermore the submission takes account of changes in government policy priorities, such as those in the areas of social security, the HIV/AIDS pandemic, and the rights of children.

Having considered the contributions of technical advisors and researchers, and of principal stakeholders in the spirit of Chapter 3 of the Constitution, and having considered the requirements listed in section 214(2)(a-j) of the Constitution, the Commission hereby submits its proposals for the fiscal year 2004/05. These are presented in the following page in summary form with the comprehensive text in Parts A and B of the main body of submission.

Part A: FFC Review of the Intergovernmental Fiscal Relations System in South Africa

With respect to expenditure assignment, the Financial and Fiscal Commission:

1. Proposes that a comprehensive poverty alleviation package be designed to align the system of social security cash grants and social insurance with the provision by the three spheres of government of free basic services.

2. Recommends that the role of provinces as the appropriate sphere of government for the functional and expenditure assignment of constitutionally mandated basic social services (education, health care and social assistance), as opposed to social security cash grants, be reaffirmed.

3. Recommends that the re-assignment of social security grants to the national sphere not be implemented until the National Social Security Agency is legally constituted and physically established.

4. Recommends that the National Social Security Agency be jointly accountable to national government and the provinces. The governing body should include representatives from both spheres of government. The agency should be able to administer province-specific grant programmes, should they arise in future. Moreover, the agency should be able to co-ordinate its delivery of grants with the provision of welfare services by provinces, where the same beneficiaries are involved.

5. Proposes that the assignment of responsibilities between the three spheres of government be further clarified to enable provision of water and housing. The delivery of housing and household infrastructure should be closely aligned to enable integrated development planning.
With respect to performance measurement, the Financial and Fiscal Commission proposes:

6. That national policy objectives be expressed as delivery programmes at the appropriate sphere of government for the appropriate government department, institution or enterprise. Delivery programmes should be directly linked to spending and funding programmes.

7. That the indicators of policy outcomes, delivery outputs, and financial inputs be used to evaluate the performance of these delivery, spending and funding programmes.

8. That consideration be given to both the capital and operational components of each of these indicators.

9. That government should clarify the definition of access to progressive realisation of constitutionally mandated basic services so as to minimise the need for judicial intervention in determining the provision of these services.

10. That the following indicators be used to describe the progressive realisation of norms and standards for the different CMBS:

   **Policy outcome indicators:**

   • Changes in general development indicators, such as poverty, literacy, and mortality rates;
   • Changes in function-specific indicators, such as educational status and morbidity and infection rates.
   • Changes in the proportion of the poor receiving CMBS benefits; and
   • Changes in the level of beneficiary satisfaction.

   **Delivery output indicators:**

   • Growth rate of beneficiaries of CMBS service and cash grant programmes;
   • Changes in the proportion of eligible populations receiving CMBS benefits;
   • Changes in the real value of personal income grants and service delivery packages by type of CMBS; and
   • Contributions to job creation, small business development, and black empowerment.
Financial input indicators:

• Real growth rates of actual and projected spending on CMBS programmes;
• Changes in the proportion of national, provincial, and municipal spending by type of CMBS;
• Changes in the proportion of GDP spent by type of CMBS; and
• Changes in input costs/prices of identified services.

With respect to constraints on the provision of constitutionally mandated basic services, the Financial and Fiscal Commission recognises:

• That government revenue is also used for purposes other than the provision of CMBS, such as infrastructure and economic development, the criminal justice system, security and protection, and administrative services;
• That the capacity to raise tax revenue faces collection efficiency, investment disincentive, and political accountability constraints;
• That the capacity for deficit financing is limited by investor perceptions of the public sector’s capacity and willingness to service and redeem debt; and
• That debt servicing crowds out resources that would otherwise be available for the provision of CMBS.

And therefore, with respect to poverty targeting, the Financial and Fiscal Commission proposes:

11. That the costs of poverty targeting to minimise errors of exclusion and inclusion be weighed against the costs of providing free basic services universally.

12. That ongoing studies on the impact of social security provision on income poverty, CMBS service provision, access to property, and asset poverty be carried out.

13. That the impact of user fees for the basic social services of education and health be considered carefully in terms of their impact on poverty alleviation.

14. That the impact of tariffs for the basic municipal services of water, electricity,
and public transport similarly be given careful consideration in terms of their impact on poverty alleviation.

With respect to norms and standards, the Financial and Fiscal Commission proposes:

15. That norm-setting take account of resource constraints and the need for flexibility in the event of emergencies and new policy challenges. Norms and standards can be adjusted according to resource availability, environmental factors and policy imperatives.

16. That current norms and standards for established public services be based on current or moving averages or on minimum international standards. Norms and standards for new public services in response to constitutional mandates, environmental factors, and other policy imperatives can usually be based on minimum international standards.

With respect to the collection of data to support the development of the intergovernmental fiscal system, the Financial and Fiscal Commission:

17. Recommends that provincial and municipal treasuries place their government budgets and financial statements on departmental and government websites.

18. Proposes that provincial (followed by municipal) treasuries should collate, publish and place their Provincial Growth and Development Strategies and Integrated Development Plans on departmental and government websites.

19. Proposes that all official and recognised data sources be identified and audited. A Census-planning group should be established and charged with developing a plan for identifying and filling information gaps relevant to the intergovernmental fiscal system and division of revenue.

20. Proposes that Census-related and regional GDP data collection and release cycles be co-ordinated with budgetary, capital and operational, and strategic planning cycles. These might further correspond with the electoral cycle. The cycles for national, provincial, and local governments could be staggered.

21. Proposes that greater effort be made to reduce the time lag between the collection and release of national statistics.

22. Proposes that national departments, in collaboration with Statistics South Africa,
collate, verify, and publish data on beneficiaries receiving Constitutionally Mandated Basic Services, as well as departmental complements of personnel, and capital assets for their relevant functions. Data should encompass the service delivery programmes of all three spheres of government.

23. Proposes that socio-demographic data collected during and between official Censuses identify the population eligible for receipt of social services and household infrastructure. Further, a methodology for updating and projecting eligible populations and household infrastructure backlogs should be established.

24. Proposes that socio-demographic data from the Census and other surveys should measure policy outcomes, notably of poverty indicators and access to Constitutionally Mandated Basic Services.

25. Proposes that Statistics South Africa collate various measures of the extent, cause, and alleviation of poverty to enable a comprehensive analysis of measures to alleviate poverty.

26. Proposes that a national effort be made to define, identify, and measure the value, level and rate of depreciation of public sector capital stock, using consistent standards developed by the Accounting Standards Board.

With respect to funding instruments, the Financial and Fiscal Commission:

27. Proposes that the provision of CMBS be funded through a mix of general purpose and specific purpose revenue sources.

28. Proposes that the design of conditional grants be negotiated between the transferring and recipient authorities.

29. Proposes that the role of special purpose grants be circumscribed so as to avoid distorting the horizontal (and vertical) distributions intended by the Equitable Share formulae.

30. Recommends that the design of capital grants be based on the progressive eradication of infrastructure backlogs through the use of a dedicated conditional grant, which recognises the link between the progressive provision of CMBS and the concomitant infrastructure requirement.
31. Recommends that the capital grant funds be allocated using an equitable sharing formula derived from the FFC’s proposed capital grants scheme\(^1\).

**With respect to fiscal capacity, the Financial and Fiscal Commission:**

32. Proposes that a national effort be made to measure the potential revenue base of provincial and municipal spheres of government.

33. Proposes that socio-demographic and regional economic data be collated for the municipal sphere and aggregated to equate with national socio-demographic and economic data. This type of data should be disaggregated to the lowest possible level.

**With respect to budgetary and strategic planning, the Financial and Fiscal Commission proposes:**

34. That linked programmes of delivery, spending, and funding attached to national policy objectives be outlined for and by national, provincial, and municipal governments for all identified Constitutionally Mandated Basic Services.

35. That the institutional implications of defining programmes in terms of the linkages between their delivery, spending, and funding components be researched.

**With respect to co-operative governance, the Financial and Fiscal Commission proposes:**

36. That the roles of the Budget Forum and Budget Council be reviewed so as to effectively coordinate the processes around integrated development planning and budgeting among the three spheres of government.

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\(^1\)See previous FFC proposals on financing infrastructure backlogs through the use of the FFC capital grants model (Submissions of May 2001 and June 2002). The FFC is currently refining the model in consultation with government.
Part B: FFC Submission for the 2004/05 Division of Revenue

National Government Proposals

With respect to financing HIV/AIDS programmes, the Financial and Fiscal Commission proposes:

1. That current national programmes directed at procurement of condoms, awareness campaigns, and specific research efforts be retained and strengthened.

2. That all existing conditional grants be reviewed with a view to converting them into a more efficient conditional grant mechanism. A clear and coordinated policy framework needs to be established at the national level.

3. That changes in social spending resulting from increases in the equitable share targeted at HIV/AIDS programmes be evaluated to establish the efficacy of HIV/AIDS-related increases to the provincial equitable share.

Provincial Government Proposals

With respect to the education component of the Provincial Equitable Share formula, the Financial and Fiscal Commission:

4. Proposes that the formula used to allocate the education component of the equitable share be revised to end the double weighting of “school age” children. The double-weighting penalises poorer provinces with the largest number of “out of age” learners.

5. Reiterates its proposal that the formula used to allocate the education component of the provincial equitable share formula be adjusted to incorporate the reception year (Grade R). In addition, the provincial allocation of funds should be based on a poverty-weighted count of the number of children aged five and six in each province.

6. Recommends that government establish a conditional grant programme for the financing of education programmes for increasing/improving adult literacy and numeracy.
With respect to the health care component of the Provincial Equitable Share formula, the Financial and Fiscal Commission:

7. Recommends that provincial population growth rates be incorporated into the health care component of the provincial equitable share formula.

8. Recommends that the age and gender variation in the population be taken into account in determining the relative need for health services. An acceptable index should be constructed making use of international and domestic data.

9. Proposes that the data used for the medical scheme population be based annually on the best available estimate, which could entail combining the latest October Household Survey information, averaged for a reasonable number of years. The current weighting applied by National Treasury of total to medical scheme populations needs to be reviewed.

With respect to the social development component of the Provincial Equitable Share formula, the Financial and Fiscal Commission proposes:

10. That populations of grant recipients in the current system should more closely reflect the actual take-up of the three grants in the provinces.

11. That the overall allocation to welfare in the current system be revised to reflect more accurately the share of aggregate provincial spending on social development.

12. That the allocation to welfare in the PES distinguish between social security grants and welfare services, and assigns amounts to each. The allocation for welfare services could be based on an indicator such as the proportion of the population below a poverty level.

13. That consideration be given to the ways in which the existing top-down methodology for allocating the social development share among provinces can be revised so that it more closely reflects the relative needs of the provinces.

With respect to the overall Provincial Equitable Share formula, the Financial and Fiscal Commission:

14. Proposes that the shares of the different components in the formula should ultimately be determined according to explicit policy guidelines based on minimum norms and standards.
15. Reiterates its proposal that social security grants be budgeted for and funded from a national level so as to avoid the crowding out of the other provincial service delivery mandates.

Local Government Proposals

With respect to the funding of institutional capacity, the Financial and Fiscal Commission:

16. Proposes that the Institutional (I) element of the Local government Equitable Share formula and conditional capacity-building grants to municipalities be assessed to ensure that they reflect the capacity needs of municipalities.

With respect to the urban and rural development nodes, the Financial and Fiscal Commission:

17. Proposes that the effectiveness of the ISRDP and URP should be carefully evaluated. This should include the collection of data on development indicators within nodes, so as to inform nodal policy development and implementation.

18. Recommends that funding for the urban and rural development nodes should not come from the Local government Equitable Share allocation.

With respect to significant variations in circumstances among municipalities, the Financial and Fiscal Commission:

19. Proposes that government should give consideration to developing a differentiated approach to municipalities in such areas as borrowing, revenue sources, and municipal service partnerships.
PART A

FFC REVIEW OF THE INTERGOVERNMENTAL FISCAL RELATIONS SYSTEM IN SOUTH AFRICA
Over the past three years, the FFC’s submissions have contained discussions and proposals for the review of the intergovernmental fiscal system. This part of the FFC’s submission synthesises and elaborates on these discussions as a contribution to government’s review of the existing intergovernmental system. Specific issues of significance, requiring specific attention going forward are numbered and highlighted in the text.
Chapter 1

Evolution of the Intergovernmental Fiscal Relations System

1.1 Overview

South Africa is a unitary state with a decentralised system of government of three spheres - national government, nine provinces, and 284 municipalities. The three spheres of government are distinctive, interdependent, interrelated, and subject to the principle of co-operative governance.

After it came to power in 1994, the new government restructured the intergovernmental system with a view to providing equity and responsiveness to people throughout South Africa. The racially-demarcated jurisdictions under apartheid were reorganised into nine provinces. Similarly, in 1995, municipalities were re-organised into 843 transitional units.

At the end of 2000, these were consolidated into 284 local government units comprising six one-tier metropolitan municipalities and 231 local municipalities falling within 47 district municipalities. In South Africa, political and historical factors informed by the imperative to eradicate the legacy of a colonial and apartheid past has served to shape the organisation of governmental and intergovernmental relations.

The structure of government and of intergovernmental relations is just now into its tenth year, though many current institutions and structures have an even shorter
history. It is appropriate, at this juncture in the nation’s evolution, to conduct an assessment of the intergovernmental system. This will examine successes and shortcomings with a view to establishing a prospective vision for intergovernmental relations.

Given its constitutional mandate, the vision of the FFC must focus on the system of intergovernmental fiscal arrangements and, in particular, the equitable sharing of national revenue.

1.2 The Constitution

South Africa enjoys the benefit of a modern Constitution, which was drafted to reflect the current and unique circumstances of the nation. The constitutional arrangement in South Africa is particularly distinctive in that it directly addresses many of the important features of the nation (where most nations rely more on interpretation and convention). It is also distinctive in that it provides for many areas of concurrent legislative competency shared by national and provincial and local governments.

The Constitution establishes rules for revenue and expenditure assignment, but with concurrent jurisdictional powers of national and provincial governments in many areas, including education, health and welfare.

1.2.1 The Bill of Rights

The Constitution further establishes some government operational objectives through the provisions of the Bill of Rights. The progressive realisation of these “Constitutionally Mandated Basic Services” (CMBS) is an important consideration for the FFC in developing its recommendations for the equitable division of national revenue.

Chapter Two of the Constitution (titled the Bill of Rights) identifies access to the following as progressively realisable within resource constraints:

- Housing (Section 26);
- Health care services, food and water, social security and social assistance (Section 27); and
- Basic [school], adult basic and further education (Section 29).
The Financial and Fiscal Commission defines the above as Constitutionally Mandated Basic Services (or CMBS). Section 28 implies that children’s rights to these services can be prioritised.

Chapter Two further identifies the following as rights, which de facto will also be progressively realisable within resource constraints:

- Environmental protection (Section 24);
- Secure title to property (Section 25);
- Access to information (Section 32); and
- Justice (Sections 33-34).

**Issue 1: The pace at which Constitutionally Mandated Basic Services (CMBS) are being progressively realised.**

**1.2.2 Assignment of Functions**

The balance struck in the Constitution of South Africa requires:

- A national government that is able to conduct foreign policy, defend the nation, maintain internal security, establish monetary and fiscal policy, and develop a national economic strategy. National government must also be prepared to accept responsibilities which might, in other circumstances, be conducted by provincial or local governments, but are determined to be more effectively delivered by the national government for any variety of reasons.

- Provincial governments that have the capacity to deliver those programmes most effectively delivered on a regional basis (such as education, secondary and tertiary health care, regional transportation and other infrastructure, and regional development programmes). Provinces should also co-ordinate their activities with each other such that it is unnecessary or less desirable to pass responsibilities to the national government in order to achieve national goals.

- Municipalities that have the capacity to effectively deliver to their residents all other services not deemed to be more effectively delivered by provincial or national governments. These include
essential local infrastructure and public services such as streets and roads, fire protection, water and sewerage, waste disposal, and local economic development initiatives. The extent and pattern of these services may reflect local preferences, but it is essential that equity considerations prevail and that the responsibilities carried by local governments not become (or, given the legacy of apartheid, remain) a means through which economic disparities in populations are perpetuated in the availability of public services.

Issue 2: Ensuring equity and efficiency through the appropriate assignment of functions and through the development of intergovernmental fiscal arrangements.

Issue 3: Sustainability of the intergovernmental system: the future role of provinces and district and local municipalities, given their capacity as it exists or is built in the future.

1.2.3 Section 214 of the Constitution

Most general government revenue is raised nationally. Section 214(1) of the Constitution requires an Act of Parliament to provide for an equitable division of revenue between the three spheres of government in accordance with their expenditure assignments and fiscal capacities.

The equitable division of revenue enables both (a) unconditional or general purpose transfers, and (b) conditional or specific purpose transfers to provincial and municipal governments from the national equitable share.

Provincial and local government equitable shares are unconditional, but their use will be guided by national policies, nationally-determined norms and standards, and by the consensus evolving from the intergovernmental institutions established to maintain co-operative governance.

Section 214(2)(a-j) of the Constitution provides a list of considerations that have to be taken into account when establishing the functions and financing of the three spheres of government. The FFC and national government must detail the manner in which these provisions have been considered in their recommendations and in the Division of Revenue. These are listed as follows:

a) the national interest;

b) any provision that must be made in respect of the national debt and other national obligations;

c) the needs and interests of the national government, determined by objective criteria;
d) the need to ensure that the provinces and municipalities are able to provide basic services and perform the functions allocated to them;  
e) the fiscal capacity and efficiency of the provinces and municipalities;  
f) developmental and other needs of provinces, local government and municipalities;  
g) economic disparities within and among the provinces;  
h) obligations of the provinces and municipalities in terms of national legislation;  
i) the desirability of stable and predictable allocations of revenue shares; and  
j) the need for flexibility in responding to emergencies or other temporary needs, and other factors based on similar objective criteria.

Issue 4: Maintaining the right balance between the progressive realisation of Constitutionally Mandated Basic Services and the considerations listed in Section 214(2)(a-j) of the Constitution.

1.2.4 Co-operative Governance

The Constitution provides that the National Council of Provinces (composed of provincial and local government representatives) has oversight on particular pieces of legislation in respect of intergovernmental arrangements. Importantly, the Constitution proclaims a commitment to co-operative governance, and it provides for a Financial and Fiscal Commission to advise the national parliament, provincial legislatures, and organised local government on intergovernmental fiscal arrangements.

National government, under Sections 100 and 139, may intervene in the administration of provinces and local governments in order to:

- Maintain essential or minimum national standards for rendering services;
- Maintain economic unity; or
- Maintain national security; or prevent a province or municipality from taking unreasonable action that is prejudicial to the interests of another province or municipality.
1.3 Expenditure and Revenue Assignment

1.3.1 Expenditure Assignment

Assignment of functions to the three spheres is prescribed in the Constitution, but many functions fall within shared competencies. Accordingly, national government looks after the criminal justice system (police, justice, prisons), defence, external affairs, higher education, and such other functions with nation-wide spill overs.

National government shares responsibilities for social services such as school education, health, welfare, and housing concurrently with the provincial governments. While national government may determine some policies relating to these sectors, the provinces implement these policies in terms of actually providing the services. In addition provinces have other responsibilities, such as constructing and maintaining provincial roads.

Municipalities have the responsibility of providing local services and infrastructure, including water and sanitation, municipal administration, streets and street lighting, refuse removal, and distribution of electricity.

1.3.2 Revenue Assignment

In terms of revenue assignment, the fiscal system in South Africa has opted in favour of fiscal uniformity, harmony, and efficiency even as it meant lower fiscal autonomy to sub-national governments. All broad-based taxes such as income and corporate taxes, VAT, excises, fuel levy and customs are assigned to the national government.

Provinces currently impose minor levies such as gambling taxes, motor vehicle license fees and user fees on hospital services. In terms of the Constitution, they can also impose surcharges on personal income tax and fuel taxes, but there must be enabling legislation passed by Parliament for provinces to implement these surcharges. Such legislation has been passed in the form of the Provincial Tax Regulation Process Act, but provinces have not yet made any proposals for taxes under this legislation.

Municipalities currently exercise greater revenue powers than provinces. In aggregate almost two-thirds of their expenditure requirements are met by their own sources of revenue. They can levy property taxes, turnover/payroll regional levies on businesses, and user charges on electricity and water.
Both provinces and municipalities can borrow for bridging purposes or for financing capital expenditures. The provinces have borrowed only for bridging purposes, mainly in the form of overdrafts. In the absence of national government guarantees, many local governments have limited ability to borrow for infrastructure.

### 1.3.3 Vertical Fiscal Imbalance

The intergovernmental fiscal system in South Africa is relatively decentralised on the expenditure side but highly centralised in terms of revenue-raising. In the context of Section 214(2)(a-j) of the Constitution, measuring vertical fiscal balance/imbalance would entail examining for all three spheres of government:

- All revenue transfers;
- Own revenue sources; and
- All expenditure responsibilities.

Because very little has been done in South Africa and in other countries to quantify the degree of vertical fiscal imbalance, inferences are often made with regard to its existence by reference to the number of unfunded mandates in the system.

The most common source of imbalance tends to be the lack of an adequate revenue base, autonomy, and/or capacity at sub-national levels. The reasons for this type of imbalance stem from:

- The reluctance, on the part of sub-national governments, to exercise their revenue-raising powers because of inadequate development of their tax bases;

- The centralisation of the administration of the significant taxes, i.e.
  - Assigning the most elastic revenue sources to national government while on the other hand that lower levels of government are assigned the public services whose income elasticity of demand is very high;

- Fear of tax competition or low management capacity among lower levels of government, which may be a reflection of the dominant political power of national government; and
An acceptance by regional governments that central government should be accountable and responsible for raising revenue.

The amount of revenue raised by provincial governments in South Africa is much lower than that raised by regional governments elsewhere in the world and disproportionately low when compared to their expenditure responsibilities. The primary “vertical fiscal imbalance” is large by international standards.

Table 1 Proportion of General Government Expenditure by Sphere (2001/02)

<table>
<thead>
<tr>
<th></th>
<th>National</th>
<th>Provincial</th>
<th>Local</th>
<th>GENERAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expenditure</td>
<td>48.7%</td>
<td>40.0%</td>
<td>11.3%</td>
<td>100.0%</td>
</tr>
<tr>
<td>(incl. Debt Servicing)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Revenue Raised</td>
<td>86.1%</td>
<td>1.6%</td>
<td>7.8%</td>
<td>95.5%</td>
</tr>
<tr>
<td>Revenue +/- Transfers</td>
<td>44.4%</td>
<td>41.2%</td>
<td>9.9%</td>
<td>95.5%</td>
</tr>
<tr>
<td>Deficit or (Surplus)</td>
<td>4.3%</td>
<td>-1.2%</td>
<td>1.4%</td>
<td>4.5%</td>
</tr>
</tbody>
</table>

Source: 2003 Budget Review

In 2001/02, sub-national governments undertook 51.3% of general government expenditure. According to the World Bank (1999), this is high by international standards, indicating that expenditure assignment in South Africa is relatively decentralised.

By comparison, sub-national governments raised only 9.9% of general government revenue in 2001/02. This is low by international standards and implies a low degree of revenue decentralisation.

For South Africa, in 1997, the degree of fiscal decentralisation, (a narrower measure of vertical fiscal imbalance) between sub-national government spending and revenue was the highest in the world. Table 2 provides some international comparisons of fiscal decentralization for 1997.
Table 2 Contribution of Sub-National Governments to Total Government Spending and Revenue (1997)

<table>
<thead>
<tr>
<th>Country</th>
<th>% of Total Government Revenue</th>
<th>% of Total Government Spending</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developed – Federal</td>
<td></td>
<td></td>
</tr>
<tr>
<td>USA</td>
<td>32.9%</td>
<td>46.4%</td>
</tr>
<tr>
<td>Canada</td>
<td>43.5%</td>
<td>49.4%</td>
</tr>
<tr>
<td>Germany</td>
<td>28.8%</td>
<td>37.8%</td>
</tr>
<tr>
<td>Australia</td>
<td>22.7%</td>
<td>47.9%</td>
</tr>
<tr>
<td>Developed - Unitary</td>
<td></td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>10.8%</td>
<td>18.6%</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>3.6%</td>
<td>27.0%</td>
</tr>
<tr>
<td>Sweden</td>
<td>31.4%</td>
<td>36.2%</td>
</tr>
<tr>
<td>Transitional – Large</td>
<td></td>
<td></td>
</tr>
<tr>
<td>China</td>
<td>51.4%</td>
<td>55.6%</td>
</tr>
<tr>
<td>India</td>
<td>36.1%</td>
<td>53.3%</td>
</tr>
<tr>
<td>Brazil</td>
<td>31.3%</td>
<td>36.5%</td>
</tr>
<tr>
<td>Russia</td>
<td>40.0%</td>
<td>37.6%</td>
</tr>
<tr>
<td>Transitional - Medium</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Malaysia</td>
<td>2.4%</td>
<td>19.1%</td>
</tr>
<tr>
<td>Argentina</td>
<td>41.1%</td>
<td>43.9%</td>
</tr>
<tr>
<td>South Africa</td>
<td>5.3%</td>
<td>49.8%</td>
</tr>
</tbody>
</table>


It must be noted that fiscal decentralisation on its own is not an adequate measure of vertical fiscal imbalance in that it excludes revenues from intergovernmental transfers which in South Africa are constitutionally allocated to sub-national governments from nationally collected revenue.

Studies conducted by the FFC and the Katz Commission respectively have proposed that decentralisation of revenue-raising capacity should be done with caution to ensure that the less wealthy provinces continue to be capable of fulfilling their programme delivery responsibilities. However, this does not preclude transfer of revenue-raising capacity to address the issue of promoting responsibility and accountability.

Provinces are currently restricted to very narrow sources of revenue and have seemingly little leeway to obtain marginal funds at their own discretion. This constrains provinces in the provision of basic social services in accordance with Constitutional principles. Given the inability to raise own-source revenues, there is no explicit means by which provinces can finance marginal increases in social services spending (such as from higher take-up of social security grants), except by
diverting resources from elsewhere. To the extent that equitable share transfers finance most of the expenditure needs of sub-national governments, accountability concerns arise.

Intergovernmental grants are usually the most common mechanism for addressing vertical fiscal imbalance, since it is usually difficult to achieve vertical revenue balance solely through adjustments to tax powers. Intergovernmental grants become particularly attractive to recipient governments (despite protestations) because they are a revenue source that can be utilised without any pressure from local constituents, unless a transparent process of accountability is developed.

On the other hand, grants may also be viewed as constituting an essential part of contractual payments for (in effect) traded functions between different spheres of government. In this context, intergovernmental transfers are the payment made by one government to another for renting or buying powers from it. When viewed in this way, transfers may improve the matching of assigned revenue and expenditure functions.

**Issue 5: Ensuring provincial governments have the ability to respond to preferences for public services from their individual populations, and that provincial governments are accountable and have incentives for efficiency, given low revenue-raising capacity.**

Two recent developments may shift the vertical fiscal imbalance as it pertains to provincial governments. The first is the passing of the Provincial Tax Regulation Process Act in 2002, which enables provinces to impose (with justification) new taxes. The second is the prospective establishment of the National Social Security Agency, the effect of which would be to transfer social security payments (approximately 20% of provincial spending in financial year 2001) from the provincial to the national sphere.

### 1.4 The Division of Nationally-Collected Revenue

The division of nationally-collected revenue is determined annually through the Division of Revenue Bill, tabled in Parliament by the Minister of Finance, after consultation with the provinces, local government, and consideration of the recommendations of the FFC.
1.4.1 Fiscal Policy

Allocations are set for a three-year period, resulting in budgetary certainty for the provinces, but giving limited flexibility to deal with changing circumstances. The process allows national government to ensure that its macroeconomic policy objectives are being addressed. Changes to allocations are possible only with additional resources available for distribution.

The underlying goals of fiscal policy in South Africa are economic growth, macroeconomic stability, employment creation, improved public service delivery, and an equitable distribution of revenue. In order to realise these goals, the fiscal policy framework must create a balance between several and sometimes competing objectives.

The important objectives include enhancing allocations to pro-poor social and developmental initiatives, increasing investment in infrastructure, evolving an efficient tax system with minimum distortions, and creating a climate to encourage investment and job creation.

1.4.2 The Vertical Division of Revenue

In South Africa, national government has revenue-raising powers in excess of its expenditure needs. The opposite is true for provinces and to a lesser extent for local government. Thus intergovernmental transfers play an important part in addressing the vertical fiscal imbalance.

If the requirements of Section 214 are correctly applied, vertical fiscal balance will be attained since each sphere of government will in essence have an equitable portion of total national revenue. “Equitable” in this sense is generally understood as being that amount required by each sphere of government to allow it to carry out its constitutional functions, given overall budgetary constraints.

This equitable share also takes into account any revenues raised by sub-national governments, given their assigned revenue raising powers. Vertical fiscal imbalance then occurs only if any sphere of government does not receive its equitable portion as defined above.

Issue 6: Establishing and maintaining vertical balance in the equitable division of revenue amongst the three spheres of government.
The vertical division of national revenue between the spheres is not formula-based and continues to evolve with new policy challenges and ongoing mediation of concurrent responsibilities. New policies and associated funding, spending and delivery programmes are being developed for, notably, HIV/AIDS, food provision, child welfare, and early childhood development services.

The decision in 2002 to transfer the social security component of the welfare function to the national sphere will alter the relative sizes of the provincial and national spheres. The proportion of nationally raised revenues transferred to local governments has risen over the past five years.

Not surprisingly, a lot of debate has arisen with respect to vertical equity in the division of revenue process.

1.4.3 The Horizontal Division of Revenue

Determining the equitable shares of provinces

The allocation of unconditional transfers to provinces occurs through a three-stage procedure (although the decision-making is not strictly sequential):

Stage 1. Vertical Split: The provincial equitable share (PES) is determined according to prevailing macroeconomic considerations and forecasts of spending requirements by the three spheres of government. The process is incremental in the sense that periodic changes are made according to identified priorities if additional revenues become available.

Stage 2. Allocation of the PES to categories: The PES is divided among seven categories (education, health, social security, basic, institutional, backlogs, economic), with incremental changes broadly reflecting changes in provincial spending patterns and priorities.

Stage 3. Horizontal Split: Within each category, the PES is allocated among provinces according to demographic and economic weights.
Table 3 outlines the criteria for the inter-provincial distribution of national revenues:

**Table 3 Criteria for Interprovincial Distribution of National Revenues**

<table>
<thead>
<tr>
<th>Sector</th>
<th>Variables chosen for distribution</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Weight Assigned (Percentage) 1998/99 2002/03</td>
</tr>
<tr>
<td>1. Education</td>
<td>(i) Size of school age population (6-17 years) (ii) Enrolment ratio</td>
</tr>
<tr>
<td></td>
<td>(i) Education 41 (ii) Enrolment ratio</td>
</tr>
<tr>
<td>2. Health</td>
<td>Proportion of population without access to medical aid</td>
</tr>
<tr>
<td>3. Social Security</td>
<td>Estimated number of persons entitled to social security payments (Old, disabled and children weighed with poverty index derived from 1995 Income and Expenditure survey.</td>
</tr>
<tr>
<td>4. Basic Share</td>
<td>Population share of the province.</td>
</tr>
<tr>
<td>5. Backlog Component</td>
<td>(i) Capital needs in the school register of needs (ii) Audit of hospital facilities (iii) Share of rural population.</td>
</tr>
<tr>
<td>6. Economic Output component</td>
<td>Distribution of total remuneration in the country</td>
</tr>
<tr>
<td>7. Institutional component</td>
<td>Equal division among provinces</td>
</tr>
</tbody>
</table>

Reference MTBPS 1997, Table 5.2 to MTBPS 2002, p80

Since funds are fully fungible, provinces retain discretion for choosing their own budget mixes, subject to the constitutional requirement to provide minimum basic social services.

**Determining the equitable shares of municipalities**

After the vertical division of revenue has been determined (as outlined in Stage 1 above), the equitable share to municipalities is distributed according to a formula that has two components: an S (basic services) component that is based on the estimated cost of delivering a package of basic service and the number of low-income households in each municipality, and an institutional (I) institutional
component based on population size and average income.

The local equitable share (LES) formula is being reformulated in response to the re-demarcation of municipalities in 2000 and the introduction of free-basic water and electricity services.

Issue 7: The appropriate methodology for determining the equitable division of revenue “horizontally” amongst individual provinces and municipalities.

1.4.4 Conditional Grants

Conditional grants comprise a relatively small proportion of provincial revenues. National government departments use conditional grants to effect implementation of national policy by provinces and municipalities. They are used for more specific purposes than the PES, including new infrastructure provision, institutional capacity building, the implementation of special initiatives of national priority (e.g. HIV-AIDS, child welfare, and school nutrition programmes), and the internalisation of spillovers.

The design of conditional grants has been somewhat variable and ad hoc in nature. A clear rationale is not always apparent, as in the case of funding of tertiary health care facilities.

The literature on public finance indicates that the simplest way of achieving this is to focus on the effects rather than the instruments used to achieve them. In many fiscal systems, South Africa included, the purpose of fiscal transfers is to close the fiscal gap, internalise externalities, and achieve national political objectives.

On the basis of the assessment presented above, the next sub-sections provide a review of spending and financing trends over the past five years.

1.4.5 Review of Government Spending and Financing Trends (1997/98 to 2001/02)

This review assesses spending and financing trends, taking into account the need to provide CMBS within the constraints listed in Section 214(2)(a-j) of the Constitution.

Over the past five years, economic growth has averaged 2.75% per annum and GDP inflation 7.0% per annum. Expectations of both inflation and (export-led) growth were adjusted upwards for the 2002 MTEF cycle in view of the nearly 40% depreciation of the Rand during 2001/02.
During the five years prior to 2001/02, the growth of nationally raised revenue exceeded that of nationally budgeted expenditure, thereby enabling the national deficit to fall to an estimated 1.52% of GDP in 2001/02. Real growth of nationally budgeted expenditure averaged 1.32% per annum over the previous five years.

Projections for next year suggest a significant real increase in budgeted spending, primarily deficit financed. Over the medium term though, revenue receipts are anticipated to grow faster than nationally budgeted expenditure (4% versus. 3.62% per annum), keeping the projected deficit below 2% of GDP.

Until last year, debt-servicing costs have been declining in real terms, thereby releasing funds available for division between the three spheres of government. Average real growth of funds available for division has been 2.05% per annum over the past five years. This is higher than the projected population growth of 1.96% per annum and enables real growth in spending per capita.

Of the funds available for division, approximately 58% was distributed to provincial governments and 3% to municipalities over the past five years. Transfers to municipalities have been growing and are projected to continue growing rapidly, in part to enable the consolidation of the new local government system. Over the medium-term, the provincial share is anticipated to rise relative to the national sphere so as to enable real increases in welfare and health spending.

Over 85% of provincial spending is funded through unconditional equitable share transfers from nationally raised revenue, and this proportion is set to rise over the medium-term. Provicially collected own revenue has declined from an average of 3.9% over the past five years to a projected 2.6% over the MTEF cycle. Provinces appear to be exhibiting little interest in taking up opportunities for new revenue sources presented by the enactment of the Provincial Tax Regulation Process Bill.

Provincial budgets have been declining in real terms over the past five years. Of all the provincial functions, only health and welfare spending have increased. This reflects take-up of the child support grant and the impact of the HIV/AIDS epidemic on health services. Spending on education, housing, and other services has declined in real terms. This is projected to change over the forthcoming medium-term, with real increases in all services assigned to provincial governments.
While conditional grants remain an important tool for driving specific earmarked programmes, there nevertheless has been a declining reliance on them relative to unconditional equitable shares due to increased capacity in provinces. Significant growth is indicated in some conditional grants to provinces, namely, the infrastructure, child nutrition, and HIV/AIDS grants.

Municipal budgets are difficult to analyse in the absence of financial data presented in standardised reporting formats. A growing concern for the intergovernmental fiscal system is the increase in municipal deficits over the past three years. It would appear that further increases are expected for the next two years.

Significant real increases in both unconditional equitable share and conditional grant allocations are anticipated this year and over the medium-term. This will assist in accommodating spending pressures in areas such as infrastructure, free basic water and electricity supply to low-income households, and institutional re-structuring.

1.4.6 Progressive Realisation of Constitutionally Mandated Basic Services Assigned to Provinces

In accordance with the Bill of Rights, the FFC defines Constitutionally Mandated Basic Services (CMBS) assigned to provinces in terms of school education, adult basic and further education and training, primary and secondary health care, social security, and housing programmes.

Progressive realisation of these rights can be measured in terms of financial inputs and, where data is available, to service delivery. Ultimately, progressive realisation should be evaluated in terms of policy outcomes (such as literacy and infant mortality rates).

Progressive realisation occurs within a context of resource availability. Compared to a real decline of 1.19% per annum in provincial government spending, provincial governments have, on average, shifted resources to enable a marginal increase in spending on Constitutionally Mandated Basic Services of 0.15% per annum between 1997/98 and 2001/02. Nevertheless, real per capita spending declined by 1.35% per annum over the period of the analysis. This is indicative of projected population growth (of 1.96% per annum) exceeding the real growth rate of fiscal resources to CMBS.
With respect to expenditure on education, a combination of declining enrolments and fiscal resource shifts towards basic education translate into a national average real growth in spending per learner of 1.94% per annum between 1997/98 and 2001/02.

On average, real primary and secondary health care spending per capita declined by 1.33% per annum between 1997/98 and 2001/02, despite higher than average real growth of spending on these basic health services.

Average annual take-up rates have generally exceeded the real rate of growth in social security spending. This is exhibited in a decline in real spending per beneficiary of 9.28% per annum. This simply indicates that proportionately more social security beneficiaries are taking up the Child Support Grant, which is less than a third of the value of other social security grants such as old age and disability pensions.

Approximately 3% of provincial government expenditure is on housing. Expenditure on housing has declined nationwide by an average of 7.32% per annum between 1997/98 and 2001/02. On average, 202,508 houses were delivered per annum nationwide over this period.

### 1.5 Co-operative Governance: Existing Structures for Intergovernmental Relations

The structures which have evolved in South Africa since 1995 recognise that the development of effective intergovernmental relations is required to manage the system of concurrent responsibilities, the vertical and horizontal fiscal imbalances between the division of revenue-raising authority and expenditure responsibility, and the exercise of cooperative governance.

Some elements of the intergovernmental fiscal relations system are provided for within the Constitution. The provisions of the Constitution are supported through legislation, including the Financial and Fiscal Commission Act and the Intergovernmental Fiscal Relations Act and through the development of other forums.

The extensive array of structures designed to promote co-operative governance has served to overcome many challenges to the effective functioning of the intergovernmental system. It is important to ensure that these structures continue to evolve and operate effectively.
Co-ordinating structures already in place include:

- Parliament
  - The National Assembly (Portfolio Committee of Finance)
  - The National Council of the Provinces (Select Committee of Finance)
- Executive Branch
  - The President's Coordinating Council (PCC)
  - Budget Council
  - Budget Forum
  - MinMECs
  - Department of Provincial and Local Government (DPLG)
- Other
  - Organised local government (both national and regional)
  - Integrated Development Plan teams

The creation of the Budget Council and Budget Forum provide opportunities for provinces and municipalities to work with national government on budgetary and fiscal policy. The Budget Council, the Budget Forum, and the FFC must be formally consulted on the Division of Revenue Bill, establishing the equitable shares of national revenue provided to the three spheres of government.

The establishment of MinMECs for various programme areas provides further opportunity for consultation and coordination of activities and for the consideration of appropriate norms and standards. The President’s Coordinating Council (PCC) provides the political guidance for the work of these intergovernmental structures.

Committees of officials support the Budget Council, Budget Forum, and MinMECs. National co-ordination will benefit from the development of the President’s Coordinating Committee and the processes of the NCOP, as the system becomes familiar with ways to best bring matters of co-ordination forward to these bodies.
Full participation of provinces in these fora is necessary to develop consensus, buy-in, and understanding of the basis on which responsibility is being placed and the outcomes on which progress will be evaluated.

With the restructuring of municipalities, efforts may be made to incorporate more effective participation of local government representatives within the intergovernmental structures. In particular, there are worldwide trends, which view urban areas as key to economic development and prosperity. Effective participation of local government with respect to decisions on such matters as infrastructure funding and economic development may be important to the nation’s future.

In the past, the Budget Forum has sometimes been regarded as a “poor cousin” to the Budget Council, with less time spent on issues of local government and a resulting deficiency in strategic planning and coordination. A number of steps could be considered to strengthen strategic planning and coordination with respect to local government:

- Co-ordination should include consideration of the processes as well as the substance;
- Co-ordination should cut across spheres, programme sectors, functions and geographic areas;
- National and provincial planning should include analysis of spatial impacts;
- Service delivery areas should be re-aligned with municipal boundaries when practicable;
- IDPs should be used as a key instrument for co-ordination as provided for by PCC and Cabinet decisions and under the Municipal Systems Act;
- Structures and processes, which have proven to be effective, should be strengthened so as to limit the proliferation of structures. Such proliferation causes duplication and higher administrative costs and makes co-ordination more difficult;
- Institutional capacity to match the functional responsibilities of governments in all spheres and in all regions should be built, and, as a corollary, responsibilities should be matched with realistic
Part A

The achievement of new constitutional mandates and the balancing of constitutional imperatives imply a rapid evolution of the intergovernmental fiscal system. This ongoing restructuring of public sector and intergovernmental fiscal relations places heavy demands on systems development, institutional capacity building, and skills development.

In its April 2002 Submission, the FFC proposed that Parliament and government consider the development of specific intergovernmental capacity-building programmes for effective service delivery. There is an urgent need to train and employ skilled professionals in the public service and to upgrade skills of current practitioners within all spheres of government. Building capacity in the provincial and local spheres will increase effective participation in intergovernmental...
processes and give effect to national policies in a manner sensitive to regional and local differences.

However, the legacy of the centralised apartheid regime is that there are relatively few external agencies, such as non-governmental organisations and academic bodies, which focus on intergovernmental fiscal issues and which can assist in the development of capacity.

It is recognised that intergovernmental structures have a decade or less of experience on which to draw, and that some are still developing their full potential. A full audit of these structures, involving participation from the national, provincial and local spheres of government, may reveal areas for improved interaction to deal with the issues of equitable financing, capacity-building and accountability.

**Issue 9: Developing required capacity in all spheres of government.**
Chapter 2

Towards a Vision of the Intergovernmental Fiscal Relations System in South Africa

While the structure of governance in South Africa is unique, it follows from a world-wide trend toward creating systems of government which balance the need for national strength, unity of purpose, and ability to compete in a globalised economy, with respect for diversity of local populations, responsiveness to their unique needs, and effectiveness in programme delivery.

At the Conference on Intergovernmental Relations, organised by the Department of Constitutional Development in March 1999, criteria for good governance were developed based upon South Africa’s experiences since 1994. Criteria included:

- Improvement in responsiveness to people;
- Strengthening of provincial and local governments;
- Progressive improvement of programmes, requiring effective administration and a development ethic;
- Giving shape to co-operative governance;
- Supporting a democratic culture through transparency, accountability and tolerance; and
Making a meaningful contribution to nation building.

These are criteria for use in an audit and against which past and proposed changes might be evaluated.

2.1 International Overview of Intergovernmental Fiscal Relations Systems

General principles for intergovernmental fiscal systems have evolved mainly in federal and quasi-federal states. In broad terms, an intergovernmental fiscal system should:

- Assign expenditure functions amongst the spheres;
- Assign revenue-raising responsibilities amongst the spheres;
- Provide a system of transfer payments or sharing of national revenue to address the virtually inevitable mismatches between expenditure responsibilities and revenue capacity available to spheres (the vertical imbalances) and within spheres (the horizontal imbalances); and
- Provide for a system of coordination, control, and accountability.

There are many studies of guiding principles and examples of how these principles are applied in practice. Boadway sums up his analysis of the relevant economic studies as follows:

“The main message of the literature is as follows: In nations with regionally diverse economies, there are sound economic arguments for decentralising fiscal responsibilities to the regions. This is especially true in the case of providing regional public goods and public services that must be delivered to households and firms. At the same time, decentralising the responsibility for raising revenue is not valuable in its own right, but mainly as a way of facilitating responsible fiscal decision-making at the regional level. Put differently, the case for decentralising expenditure responsibilities is much stronger than for decentralising taxation.”

1 See for example R. Bird, Intergovernmental Fiscal Relations: Universal Principles; Local Applications, or R. Watts, Comparing Federal Systems.
2.1.1 Assignment of Expenditure Responsibilities

Bird states that the basic rule of efficient expenditure assignment is to assign each function to the lowest level of government consistent with its efficient performance. Bird and others emphasise that this principle of decentralisation brings service delivery closest to the people, allows for the greatest responsiveness to actual needs, and thus fosters both efficiency and effectiveness in the delivery of government services.

As given effect in the Constitution of South Africa through Sections 100, 139, and 214(2)(a-j), this principle must respect the paramount requirements of national government in the areas of national security, management of the economy, and external relations and trade.

Also, there may be a distinction with respect to decentralisation in terms of legislative competency, administrative competency, and financial competency. These competencies may be shared, such that there may be national standards, provincial expenditure frameworks, and local delivery with some discretionary authority on “what to do” or “how to get it done”.

2.1.2 Assignment of Revenue-Raising Responsibilities

While accountability considerations would argue in favour of matching expenditure responsibilities with revenue-raising capacity, it is generally recognised that many taxes cannot be effectively and efficiently imposed at regional or local levels.

The division of revenue-raising responsibilities must consider the ability of a regional authority to “export” taxation to residents and businesses of other regions, which ultimately bear the burden of the tax. Both the administrative costs and the effects on economic activity of differential rates must be considered, together with the recognition of the ability of individuals, and especially of corporations, to effectively move incomes and asset values in order to avoid regional taxation.

User charges, business taxes and fees, and local property taxes are generally considered to be suitable revenue sources for local governments. Most suitable for provincial revenue-raising may be surcharges on national VAT or income taxes. These may be most efficiently administered by the national government or a national revenue collection agency.

3R. Bird, Intergovernmental Fiscal Relations.
2.1.3 Transfer Payments

Boadway notes that the fiscal arrangements encompassing the financial relations between the central and regional governments, as well as mechanisms for co-ordinating policies, can be viewed as devices for facilitating the benefits of decentralisation while reducing their costs.4

In the literature, arguments for general-purpose transfers are made on horizontal equity grounds.5 Accordingly, the economic objective of general-purpose transfers is seen as enabling the sub-national governmental units to provide a given normative package of public services at a given tax-price.

Thus, the residents of various jurisdictions, irrespective of their location, are able to receive their comparable package of public services by paying comparable tax rates.

Violation of horizontal equity in a multi-level fiscal system arises because of revenue and cost differences among different jurisdictions. While in some systems, an origin-based tax system can be a source of horizontal inequity. The principal reason for inequity is the differences in fiscal capacity among the jurisdictions. Thus, a poorer jurisdiction has to levy higher tax rates on its residents to provide the same level of public services provided by its richer counterpart. To enable it to provide the same package at a uniform tax rate, central transfers would be necessary.

Another source of horizontal inequity arises from the differences in the unit cost of providing public services. If cost differences are due to factors within the control of sub-national jurisdictions, there is no need to offset them.

However, when cost differences are due to factors beyond their control, it is necessary to offset these differences through intergovernmental transfers. Thus, the objective of unconditional transfers is to offset the differences in fiscal capacity and unit cost of providing public services due to factors beyond the control of sub-national jurisdictions.

In actual practice, however, there are very few regional government systems that have been designed to include offsetting revenue and cost disabilities. The closest to this ideal is in Australia; where the relative shares of the States are determined on the basis of “relativities” estimated by taking into account both revenue and cost disabilities. The equalisation payment in the Canadian transfer system only attempts to offset differences in fiscal capacity.
The normative standard is set at the average of five-province capacity, excluding the province of Alberta (high income with significant oil revenues) and the poorer Eastern Provinces. Among developing countries, the Indian transfer system comprises central tax devolution and the giving of grants to States. The distribution of central tax revenues to States is not done according to direct measures of revenue and cost disabilities, but the formula includes the factors that are assumed to be determinants of capacities and needs of the States such as population, per capita income, and area.\textsuperscript{6}

Limitations in terms of local and regional taxation, taken together with the efficiency of local service delivery, will almost inevitably result in a mismatch between revenue capacity and expenditure responsibilities amongst the spheres. Furthermore, the variations in per capita revenue capacity among various jurisdictions from revenue sources assigned to the provinces or municipalities must be addressed. Recognition that there are externalities in any system of public services, such that benefits provided in one jurisdiction can benefit others (for example, teaching hospitals), may factor into transfer payment decisions. Finally, there may be differences in the costs of providing standard services to a given population depending on demographic, socio-economic, geographic, historic, and other factors.

An adequate system of transfer payments is therefore essential to achieve the efficient assignment of expenditure and revenue authority and responsibilities to provincial and local governments. While such transfers blur the lines of responsibility and accountability, they cannot be avoided if the most valued principles of equity and efficiency are to be respected. However, there are at least four guiding principles to be considered:

- Transfer payments should not be used as a substitute for appropriate revenue assignment. The appropriate assignment of revenue-raising capacity will vary greatly from country to country, in particular related to disparities in per capita income, economic activity, and other factors, which impact on relative fiscal capacity. However, in some countries, national governments retain greater revenue-raising authority and provide higher transfer payments than efficient assignment would suggest, either as a tool to direct activity toward national goals, to achieve greater general acceptance of the system of transfer payments as one which benefits all citizens, for nation-building, and for political purposes.

- At a minimum, there must be revenue-raising capacity of the regional or local governments sufficient to provide incentives to

these governments to effectively manage the quantity and costs of service delivery. Effective management should result in better quality services or lower taxes. The transfer system must guard against discouraging initiative or rewarding inefficiency.

- The transfer system should provide predictable and stable revenue, preferably through a well-designed formula, rather than be subject to capricious changes. This is essential to planning and budgeting over the medium to longer term.

- There should be as much clarity and transparency as possible around the intergovernmental fiscal system in order to enhance accountability.

2.2 Establishing equitable shares (costed norms and standards): An overview of the FFC’s recommendations on the IGFR system in South Africa

Section 214 of the Constitution provides for the enactment of legislation to divide revenues equitably between the national, provincial, and local spheres every year. The process requires government to consult the FFC, and Section 10(5) of the Intergovernmental Fiscal Relations Act requires an explanatory memorandum in the Division of Revenue Bill to state how the FFC’s annual recommendations have been taken account in the revenue allocation. Of particular importance is the ability to ensure the progressive realisation of CMBS as mandated by the Bill of Rights in the Constitution.

2.2.1 The Financial and Fiscal Commission’s Costed Norms Approach

The FFC in 2000 recommended a number of changes both to the manner in which the PES is calculated and to other elements of the inter-governmental fiscal system. The centrepiece was the costed norms approach to determining PES allocations for basic social services.

The costed norms approach is really an example of adopting international best practices to the South African setting, albeit in a manner that is innovative. It is a
form of so-called “needs equalisation” whereby the distribution of transfers is determined by the reference cost of providing a given level of constitutionally mandated basic welfare, health, and education services to the various targeted demographic groups in each province.

1. Recommendation 1 of the Commission’s Submission for the 2001-2004 MTEF Cycle suggested that wherever possible, the costed norms approach should be used to ensure that all provinces could provide adequate levels of the three constitutionally mandated basic social services. This can be interpreted as referring not only to the horizontal division among provinces (stages 2 and 3 above) but also the vertical division among the three spheres of government.

2. Recommendation 2 presented specific formulas for the Education, Welfare, and Health components of the PES. These formulas require certain policy norms to be explicitly stipulated, such as the norm of basic health services, policy weights for particular groups of persons, and in the case of welfare, target take-up rates.

3. Recommendation 3 concerned the remaining components of the PES. It suggested aggregating the existing Basic, Economic, and Backlogs components into a single Basic component. The magnitude of this component would take into account the Medium Term Expenditure Framework, given the amounts already allocated to basic social services by the costed norms approach. This procedure effectively gives basic social services priority, thereby reflecting constitutional requirements. The Institutional element (an equal per-province grant) would remain, although much smaller in size than at present.

4. Recommendation 4 suggested that a Tax Capacity Equalisation component be included as part of the formula, but is set at zero for the time being (given that the provinces have limited revenue-raising responsibility).

5. Recommendation 5 was that a new conditional grant be created to address social infrastructure backlogs (rather than being part of the unconditional PES).

It is important to stress that these recommendations do not differ as much in spirit from the existing system as they do in form. They represent a refinement of the system. Whereas the existing system starts with aggregate amounts both for the total PES and for the different components, and uses basic demographic factors to allocate them among provinces, the FFC approach bases the allocations on standardised costs of providing the services to various demographic groups.
Thus, the costed norms approach in principle takes account of the relative costs of servicing various groups to whom provinces are responsible for providing basic services. As well, certain elements of the existing formula are left out, such as the proportion of persons who have their own medical aid coverage.

Government has not accepted the recommendations for a number of reasons. First, in a multi-year budgeting framework within the MTEF, changing the methodology of the transfer system could bring in an element of instability to the budgets of sub-national governments.

Second, the bottom-up approach implicit in the scheme is not considered appropriate to determine priorities. Political judgments and trade-offs have to be made. Third, adopting the costed norms approach for basic education, primary health care, and social security tends to impart bias against other functions. Fourth, although the FFC has suggested that the approach can be used for both the vertical and horizontal distribution of revenues, this is not possible at the present stage of information availability and identification of norms and standards. Finally, the data requirements for the practical application of the approach are enormous.

The costed norms approach that the FFC advocates has the potential to contribute more generally to the evolution of a more scientific approach to the fiscal transfer system in South Africa. Before highlighting the merits of the approach, it is useful to briefly point out the shortcomings of the approach currently adopted to distribute national revenues to the provinces and municipalities.

The major shortcoming of the prevailing approach is that it does not take into account all the relevant factors in determining the normative expenditures. Although the factors used to determine the allocation of seven functions are relevant, these are not the only determinants of cost beyond the control of provinces.

Each of the seven functions is constituted by composite functions comprising public services that benefit several target groups, and therefore the standard of public services will have to be judged by these target groups. The costed norms approach takes into account multiple factors affecting both unit costs of the services provided and other factors affecting the quantity and quality of public services. The Australian Commonwealth Grants Commission has successfully been estimating expenditure needs of a number of public services provided in the States, and the approach has received general acceptance.
2.2.2 Methodological Developments: Expenditure Norms

Methodological improvement in estimating expenditure needs over the current approach lies in two areas. First, instead of taking the cost disabilities exogenously based on judgements, it should be possible to employ multiple factors affecting cost and standards of public services and take account of all cost factors which are beyond the control of provinces. The cost disability can be estimated on the basis of actual expenditure differences in respect of individual functions across different provinces.

Second, norms can be developed on the basis of actual expenditures by relating them to the factors affecting the quantity and quality of public services. Developing the norms on the basis of actual expenditure patterns has the advantage of being practicable, for the norms will be based on the average behaviour of provinces and municipalities. For example, the FFC considers the poverty ratio or rural-urban population ratio as cost disability factors. It may be possible to estimate the cost disabilities based on the actual expenditures incurred and use these as weights rather than making judgements on them.

The Commonwealth Grants Commission in Australia adopts the approach of estimating expenditure needs based on actual cost disability factors in estimating the relativities. Conceptually this is similar to the approach adopted by the Ninth Finance Commission in India (1990) to estimate expenditure needs of the States in the Indian federation. In the Indian context, States’ expenditures were disaggregated into three categories:

- Those which can be related to public service provision in terms of cost, quantity, and quality of public services;
- Maintenance expenditures on items related to stock of assets (road and building maintenance, maintenance of irrigation works); and
- Expenditure items that are purely random.

In the case of the first category, expenditure needs were estimated by relating per capita expenditures of various services in different States on cost, quantity, and quality variables in cross-sectional econometric analysis.

Setting quantity and quality variables at normative levels and taking actual cost, expenditure requirements for providing normatively determined standards of services could be estimated. Expenditure requirements in respect of the latter were estimated on the stock of capital assets to be maintained (for example, expenditure

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on road maintenance was estimated on the basis of length of various types of roads).

Determining expenditure needs of States for education provides a useful example. In this case, the beneficiary age group of population, teacher–student ratio, ratio of administrative personnel to teachers, and ratio of salary expenditures to total can be taken to represent the factors affecting the standard of the service, whereas the salary differences of teachers, density of population, and urban-rural population ratio can be taken to indicate cost differences. This approach can be extended to cover a number of services.

The expenditure requirement of the second category of services can be estimated by applying engineering norms. The example of this is the maintenance expenditures on roads, irrigation works, and buildings.

The third category of expenditure relates to items like disaster relief. In these cases, the average expenditure of the last few years in real terms may be taken as the norm.

In the future, the costed norms approach utilised by the FFC may be improved on these lines. There is scope to determine the norms using econometric models. However, as there are only nine provinces, cross-section estimates may be constrained by technical difficulties. Of course, the approach is very data intensive and concerted efforts will have to be made to build the necessary information system. That would add to the quality of decision-making and help in imparting greater objectivity to the transfer system.

2.3 Revenue Capacity Equalisation

There are significant differences among the provinces in terms of their economic characteristics and variations in their ability to raise taxes, even from the few revenue sources assigned to them. At one extreme is the province of Gauteng, with the highest mean monthly household expenditure (R4270), which is over 2.5 times the expenditure of the poorest province of the Eastern Cape. Gauteng also rates the highest on the human development index and has the lowest poverty ratio and highest degree of urbanisation. This implies that there are significant differences in the ability to raise revenues among the provinces.
A major shortcoming of the transfer system in South Africa is that it does not consider the revenue side of the provinces or municipalities and takes account of the estimates of “expenditure needs” for the assigned functions in its design of unconditional transfers.

The principal reason for this is that provinces do not have significant revenue raising powers. Provinces can raise revenues only from motor vehicle licence fees, betting taxes in casinos and horseracing, and hospital fees. Unless provinces are assigned more important tax powers, it does not make much sense to design the transfer system to offset fiscal capacity differences. To that extent, inequities arising from fiscal capacity differences among provinces will continue.

It is important to explore additional revenue sources for provinces to augment their own revenue raising capacity. Linking revenue raising and expenditure decisions at the margin is important for reasons of efficiency and accountability. Unless provinces raise a substantial part of the revenues to finance public services provided by them, they may not get a sense of ownership and accountability to the taxpayers.
Of course, there could be a trade-off between fiscal autonomy and efficiency in the tax system, and the decision to provide additional tax powers to provinces should be weighed against the possible efficiency loss due to tax competition and disharmony.

Even with the prevailing assignment system, it would be useful to develop the information system and appropriate methodology for estimating the taxable capacity of provinces. The representative tax system approach could be employed to estimate the relative taxable capacity effort.

The data requirements for employing this methodology include information on the tax bases or their proxies and revenue from each of the sources. The Australian and Canadian federations have done considerable work in estimating revenue capacity and effort, and it should be possible to adopt this with appropriate modifications to take account of information availability and the nature of the taxes levied.

**Issue 10: The need to develop an information system and appropriate methodology to estimate the taxable capacity of provinces and municipalities.**

Another provincial issue relates to conditional transfers. Owing to minimal taxing powers, provinces receive most of their revenue by way of transfers. It may be necessary to incentivise the conditional transfer system by requiring matching contributions from the provinces. Even if the matching requirement were kept at 10-15% of the cost of the scheme, it would provide incentives to raise revenues and provide a sense of ownership and participation in service delivery.

**Issue 11: The need for a matching-grant requirement for conditional transfers to provinces.**

As mentioned earlier, in contrast to provinces, municipalities have significant powers to raise their own revenues. Municipalities raise almost 20% of total revenue collections in the country and this finances 78% of their expenditures.

It appears that fiscal capacity differences between municipalities are much greater than those between the provinces. This is natural, given the history of the previous apartheid system. Although attempts have been made to restructure the municipalities by combining the previously racially demarcated group areas, the six metropolitan municipalities account for more than 50% of the aggregated local budget, and the twenty biggest municipalities account for 80%. Most municipalities are very small with budgets of less than R100 million.
Unfortunately, paucity and unreliability of information makes it difficult to get a clear picture of fiscal capacity differences, the structure and operation of property taxes, and the ability of the municipalities to collect user charges on electricity and water supply from consumers. Nor is there any information on differences in institutional capacity to administer taxes and provide public services. It is extremely important to collect information on taxes, user charges, and the value of the tax bases to understand the degree of horizontal imbalances among municipalities in South Africa.

As noted above, it is important conceptually to offset both revenue and cost disabilities in designing a proper transfer system for both provinces and municipalities. This calls for the development of a proper information system to estimate differences in fiscal capacity and cost disabilities across different provinces and municipalities. The standard methodology available for estimating fiscal policy can be modified to apply to the particular situation obtaining in RSA. However, the viability of any approach ultimately depends on the availability of quality information on various tax bases and variables representing cost and standards of public services.

The standard method of estimating fiscal capacity of provinces or municipalities is to relate their tax revenues from different sources with relevant tax bases. Applying the average effective tax rate of the tax on the base of individual provinces or municipalities gives the estimate of potential from the tax. Summing up the estimate of potential for all the taxes levied at the provincial (municipal) level gives the taxable capacity of the province or municipality.

The percentage of actual tax revenue to the tax potential gives an estimate of tax effort (see box). Thus, in order to estimate the taxable capacity, it is necessary to identify the tax base of each of the taxes levied by the province or (municipality).
Presently, the main taxes levied by provinces are: (i) motor car licensing fees; (ii) casino and horse racing taxes; (iii) hospital fees. The relevant tax bases for these taxes are the number of motor cars, turnover from casino and horse racing, and turnover from chargeable services rendered by hospitals. To forecast these variables for a future date, either historical growth rate may be used or these variables may be related to household incomes/expenditures.

Similarly, in the case of municipalities, the major sources of revenue are: (i) property tax, (ii) (regional) turnover taxes levied on businesses, (iii) (regional) payroll taxes levied on businesses, and (iv) user charges on electricity and water. The relevant
bases for these sources of revenue can be identified as (i) capital value/rental value of property; (ii) value of business turnover, (iii) spending on salaries by business enterprises; and (iv) electricity and water consumed in the municipality by various categories of consumption (if the rates are differentiated according to the nature of use). Again, value of the bases can be projected on the basis of their historical trend or relationship with identifiable causal factors.

2.3.1 Revenue Capacity and the Equitable Share Formulae

If greater revenue-raising capacity were assigned to provinces, the PES formula would have to be re-considered. There are two dimensions to this issue:

- The quantum of revenue from the equitable share of national revenue to provinces would need to be adjusted to reflect greater provincial own source revenue; and
- The equalisation component of the formula (the “T” component) would need to be activated and calibrated to reflect uneven fiscal capacity across provinces resulting from the new revenue sources.

With respect to the local government equitable share formula, there are a number of dimensions, which must be dealt with, including:

- Establishing the roles of municipalities in areas such as health care, economic development, and the provision of free basic services; and
- Studying the structure of actual and potential revenues, considering the new demarcation and re-structuring of electricity and water services; and
- Exploring the relationship between conditional grants (such as that for municipal infrastructure) and the equitable share formula.
2.4 Indicators and Information for Planning, Performance Measurement, and Accountability

2.4.1 Budgetary and Strategic Planning

Information and systematic data collection are essential to the democratic and efficient functioning of the intergovernmental fiscal system.

Reporting formats can be effectively developed using a “bottom-up” approach, beginning with the smaller spatial units and then aggregating up to functions, to spheres, and finally to national level. This systematic approach requires movement toward common data sets for reporting (for example, with respect to provincial growth and development plans and municipal Integrated Development Plans).

2.4.2 Indicators for Measurement of Progressive Realisation of Basic Rights

Chapter 2 (Bill of Rights) of the Constitution obliges the state to take reasonable measures to ensure the progressive realisation of the rights of all citizens to basic services. These constitutionally mandated basic services (CMBS) include housing (section 26); health care, food and water, and social security and social assistance (section 27); and basic and further education (section 29).

The progressive realisation of these rights takes account of various circumstances and constraints, such as the budget constraint of the state, the capacity of the state to deliver these services, and the basic level of services to be provided.

These constraints are not well defined, since they involve matters of social and economic judgment. However, there are various sorts of indicators that can be used to inform political decision-makers and enable them to judge the rate of progress of achieving the progressive realisation of these key constitutional rights. The three categories of indicators suggested by the FFC are:

i) Financial indicators;

ii) Delivery indicators; and

iii) Policy outcome indicators.
In what follows, these are discussed in the context of welfare and poverty alleviation more generally. This includes not just welfare programmes but also other elements of CMBS such as water, food, and housing, as well as special emergency problems like HIV-AIDS.

(i) Financial Indicators

All three spheres of government share the constitutional commitment to the progressive realisation of CMBS. Financial indicators can apply at the national, provincial and municipal levels.

National government financial indicators

National priorities can be indicated by changes in the proportion of total national government spending notionally devoted to CMBS. This can be disaggregated into unconditional (equitable shares) and conditional transfers to the provinces and municipalities, as well as any direct spending of national government on CMBS. These figures are only notional because provinces and municipalities can reallocate equitable shares among categories.

In addition, changes in national government spending on social security and other CMBS as a proportion of GDP could also be presented. This would complement the above calculation, which is done as a proportion of total national government spending. Data should be readily available for these calculations.

Provincial government financial indicators

Similar indicators can be used with respect to provincial spending, except for the fact that spending on poverty alleviation is actual rather than notional. Relevant programmes encompass all CMBS, including welfare (grants and services) and provincial spending on housing and food.

Provincial priorities can be indicated by changes in the proportion of provincial spending devoted to poverty alleviation by type of CMBS. This is a measure of the difference between the growth in provincial spending and the growth in spending on the relevant CMBS, which are currently separately calculated and could continue to be presented. This can be disaggregated into provinces and types of CMBS programme, including those funded by conditional grants. This can also be presented as changes in real spending per capita on social security and other CMBS, although at this level of aggregation it indicates relatively little.
Given that HIV/AIDS is an item of national priority, separate financial calculations can also be done for this category. However, the calculation of HIV/AIDS spending is problematic since some of this is done through existing programmes of health and welfare services.

Municipal financial indicators

Municipalities are responsible for some constitutionally mandated basic services. Examples are water supply and emergency housing. Similar financial indicators to those used for the national and provincial governments could also be used for municipalities: the change in the proportion of municipal spending devoted to CMBS and changes in real spending on CMBS per capita.

(ii) Service Delivery Indicators

The growth in the number of beneficiaries served by type of CMBS programme would be an initial useful indicator of progressive realisation. (This is used by the FFC now.) This should include grant programmes, welfare service programmes and other CMBS components, such as housing, food and water.

However, this statistic does not indicate the extent to which the proportion of eligible beneficiaries is being increased. For that, it is necessary to track the evolution of take-up rates for different programmes over time.

These may be more easily calculated for transfer programmes than for welfare services, so a first priority could be to obtain the data needed to estimate take-up rates for grants. Even this is a difficult task since it is not easy to determine those who are eligible but not receiving benefits. Furthermore, for each grant programme, changes in real grant levels per beneficiary would be useful information.

Delivery indicators are much more difficult to come by for welfare services and other CMBS. Presumably at least some of those eligible for free basic services would also be eligible for grants. One could attempt to measure the proportion of those receiving free basic services that are also receiving social security grants.

As well as being a delivery indicator, this might also serve as an output indicator. If a large proportion of free basic service users do not receive grants, this would be at least a partial indicator of gaps in coverage, albeit an imperfect one. A particularly useful take-up rate to have at present would be the proportion of those diagnosed with HIV-AIDS who are receiving treatment.
(iii) Policy Outcome Indicators

Policy outcome indicators are much more difficult to construct, not just because the relevant data are harder to come by, but also because the output of government programmes is notoriously difficult to measure. Bearing that in mind, the following are a list of basic outcome indicators that might be developed for the purposes of evaluating the extent to which CMBS goals are being satisfied.

First and foremost, it would be useful to develop an indicator of poverty. A useful way to do this would be to construct a poverty line, which is a level of annual income below which one is deemed to be in poverty.

There is no objective way to do this. One procedure is to estimate the amount of income that would be necessary to meet the necessities of life, including (at least) food, clothing, shelter, utilities, transportation, and other amenities.

This could vary by family size and place of residence. A second procedure that might be simpler would be to determine the level of income such that a maximum proportion of income would be devoted to the basic categories of food, clothing and shelter. This proportion would be a matter of judgment (for example, 60%). Currently, a measure of R1100 per month per household is used by policy-makers in South Africa to identify low-income households.

Once a poverty line is obtained, an indicator of the extent to which CMBS are being satisfied would be the proportion of the population below the poverty line, taking account of any grants that persons have received. The ideal would be that all persons would be above the poverty line, so any shortfall would indicate the extent to which CMBS were not being provided.

A supplementary indicator of gaps in welfare coverage would be to calculate the proportion of those below the poverty line who were not receiving any welfare assistance from the state. Given that the grants currently offered only cover certain age groups, this would be a very revealing statistic. Of course, the reliability of these policy outcome indicators would be in question, at least initially.

The above indicators focus on income-based statistics. Some CMBS refer to specific types of needs or services. Thus, the Constitution requires that all persons have basic access to housing, food, and water. A crude output indicator of the extent of realisation of this objective would be simply the proportions of the population by province and municipality who have access to each of these three basic services at some level of adequacy. This is only a rough measure because it...
takes no account of the quality of each of the services.

In the case of water, presumably some indication of access to clean running water would be suitable. For housing, some minimum size housing accommodation would be suitable. In the case of food, measurement problems would be much more difficult. While housing and water supplies are in principle observable to those collecting data, measuring food access and intake is not straightforward.

### 2.4.3 Norms and Standards

National government is tasked with developing the necessary legislation and relevant norms and standards governing the exercise of expenditure and revenue responsibilities. National government can alter jurisdictional boundaries, revenue assignment, and expenditure assignments, so long as the relevant legislation is consistent with Constitutional provisions.

Currently, very few national departments have clearly established norms and standards for public service delivery, especially for those public services that are concurrent.

National policy objectives should be expressed as delivery programmes at the appropriate sphere of government. Funding should be from a mix of general purpose and special purpose revenue sources.

Norms should be described in the form of measurable policy outcome, delivery output, and financial input indicators. Standards express the quality of the service or user satisfaction with the service. Norms and standards should be progressively improved with resource availability and capacity improvement.

Reporting on the progressive realisation of national policy objectives through the various indicators assists in systems development in the public sector and helps define the institutional and human capacity requirements for achieving policy objectives.

The integrated, cross-sphere and cross-functional nature of implementing national policy objectives, notably poverty alleviation, imply that capacity can not be concentrated in any one sphere, function, or stage in the service delivery process.
2.5 Developing Complementary Data Systems

Chapter Two of the South African Constitution states that:

(1) Everyone has the right of access to -
   a. any information held by the state; and
   b. any information that is held by another person and that is required for the exercise or protection of any rights.

In its Submission for the Division of Revenue 2002/03, the FFC commented about the urgent need for a substantial improvement in data collection to enhance the development of an intergovernmental fiscal system that is consistent with South African constitutional requirements. Further, a key concern of government with respect to the FFC’s costed norms approach was the need for data.

Data are essential to support the political and technical work of institutions and forums that relate to the intergovernmental fiscal system. The Budget Council has noted the need for input and output information from Departments for accountability and “value-for-money” assessments. Monitoring, evaluation, and accountability processes have been improved since 1994. However, establishing full and transparent accountability, both with respect to financial auditing and to the conduct of programmes and evaluation of outcomes, requires continual effort.

Data availability can be measured by public access to government data (for example, through a government department’s website). The financial and some of the delivery or output data used in this document is readily available on the National Treasury’s and South African Reserve Bank’s websites.

The intergovernmental fiscal system has been in place for nearly a decade, and for this period data requirements have increased and changed. Not only is data now required for policy design, but to evaluate the impact of current intergovernmental budgeting on the realisation of socio-economic rights. While the Public Finance Management Act (PFMA) is increasingly permitting better tracking of public sector service delivery outputs, very little work has been done on data around policy impacts and outcomes.

Issue 12: Availability of required financial and other data to meet the accountability frameworks for intergovernmental reporting on programmes and outcomes for effective results-based strategic planning and management.
The FFC supports the key role played by statistics South Africa in the improvement of data through establishment of data collection methodologies, collation and verification of data, and the promotion of access to information in accordance with the Bill of Rights.

Statistics SA should be supported in developing a common approach to the collection of output data by national, provincial, and local government. All indicators should be collated by Statistics SA at the most disaggregated level (or spatial unit) feasible, but at least at the level of the local municipality.

### 2.5.1 Data Gaps in the Intergovernmental Fiscal System

Building an information system is critical to estimating expenditure requirements and equitable shares of provincial and local governments. The local government system is still evolving. Building a proper information system on the standards of municipal services, tax bases, and own revenues is critical to developing an appropriate approach and methodology for determining the expenditure needs of municipalities.

Specific data required to measure local government revenue-raising capacity include:

- Regional GDP indicators to track economic development outcomes;
- Once the Property Tax Bill is enacted, a common property valuation methodology should be established and implemented to measure the value of taxable properties in all municipalities; and
- Consumption of water and energy should be measured by municipality.

With respect to infrastructure planning:

- A common definition of and data on capital investment is required;
- A national effort is required to measure the value, level and rate of depreciation of public sector capital stock, using consistent standards developed by the Accounting Standards Board.
Chapter 3

Summary of Proposals: Review of the Intergovernmental Fiscal Relations System

3.1 Introduction

In its submission for the 2003/04 Division of Revenue, the Commission proposed that in anticipation of a review of intergovernmental fiscal systems and processes, Parliament and government should consider:

(a) The possible incorporation of elements and parameters in the intergovernmental transfer formulae that will balance the need to provide constitutionally mandated obligations with the considerations listed in section 214(2)(a-j) of the Constitution;

(b) The need for a substantial improvement in data collection to enhance the development of intergovernmental fiscal mechanisms consistent with Constitutional requirements; and

(c) The development of specific intergovernmental fiscal capacity-building programmes, both inside and outside of government.
This year’s submission develops this proposal by defining constitutionally mandated obligations against the constraints implied in Section 214(2)(a-j) and identifying data requirements and concomitant capacity building programmes.

Other proposals and recommendations in this section also derive from FFC motivations for a review of the intergovernmental fiscal system presented successively in its previous three annual submissions (May 2000; June 2001; April 2002).

### 3.2 Expenditure Assignment

#### 3.2.1 Defining CMBS

Chapter Two of the Constitution defines access to housing; health care; food and water; social security and social assistance; basic, adult basic and further education as rights that are progressively realisable within resource constraints. Chapter Two also identifies rights to environmental protection, secure title to property, and access to public information and justice as rights.

There is considerable coincidence between these CMBS and the measures outlined in Chapter 3 of the Report of the Committee of Inquiry into a Comprehensive System of Social Security for South Africa for alleviating income, capability and asset poverty (see the FFC Submission for the Division of Revenue 2003/04).

**Proposal:**

A comprehensive poverty alleviation package could be designed to align the system of social security cash grants and social insurance (which address income poverty) with the provision by the three spheres of government of free basic services (which address capability and asset poverty).

#### 3.2.2 National–Provincial Concurrent Functions

Welfare, health care, education, housing, agriculture, environmental protection, and disaster management are identified in Schedule 4 of the Constitution as concurrent responsibilities of the national and provincial spheres.

**Recommendations:**

- The role of provinces as the appropriate sphere of government for the functional and expenditure assignment of constitutionally mandated basic social services (education, healthcare and social
assistance), as opposed to social security cash grants, should be reaffirmed.

- To minimise disruption, the reassignment of social security grants to the national sphere should not be implemented until the National Social Security Agency is legally constituted and physically established.

- The National Social Security Agency should be jointly accountable to national government and the provinces. The governing body should include representatives from both spheres of government. The agency should be able to administer province-specific grant programmes, should they arise in future. Furthermore, the agency should be able to co-ordinate its delivery of grants with the provision of welfare services by provinces, where the same beneficiaries are involved.

3.2.3 National–Local Concurrent Functions

Schedule 4 of the Constitution identifies water, sanitation, electricity, public transport and some elements of health, emergency services and environmental protection as concurrent competencies of national and local government.

Proposal:

The assignment of responsibilities between the three spheres of government to enable provision of water and housing could be further clarified. The delivery of housing and household infrastructure (e.g. water, sanitation, electricity, and transport) should be closely aligned to enable integrated development planning.

3.3 Performance Measurement

3.3.1 Budgetary and Strategic Planning

Performance can be measured in terms of policy outcome, delivery output, and financial input indicators.

Proposals:

- National policy objectives should be expressed as delivery programmes at the appropriate sphere of government for the appropriate government department, institution or enterprise. Delivery programmes should be directly linked to spending and funding programmes.
Indicators of policy outcomes, service delivery outcomes, financial inputs be used to evaluate the performance of these service delivery, spending and funding programmes.

Consideration should be given to both the capital and operational components of each of these indicators.

### 3.3.2 Defining Progressive Realisation

**Proposals:**

- Government and the legislatures should clarify the definition of access to progressive realisation of CMBS so minimising the need for judicial intervention in determining the provision of CMBS;

- The following indicators could be used to describe the progressive realisation of norms and standards for the different CMBS:

#### Policy outcome indicators:

- Changes in general development indicators, such as poverty, literacy, and mortality rates;

- Changes in function-specific indicators, such as educational status and morbidity and infection rates.

- Changes in the proportion of the poor receiving CMBS benefits; and

- Changes in the level of beneficiary satisfaction.

#### Delivery output indicators:

- Growth rate of beneficiaries of CMBS service and cash grant programmes;

- Changes in the proportion of eligible populations receiving CMBS benefits;

- Changes in the real value of personal income grants and service delivery packages by type of CMBS; and

- Contributions to job creation, small business development, and black empowerment.
Financial input indicators:

- Real growth rates of actual and projected spending on CMBS programmes;
- Changes in the proportion of national, provincial, and municipal spending by type of CMBS;
- Changes in the proportion of GDP spent by type of CMBS; and
- Changes in input costs/prices of identified services.

### 3.3.3 Defining Resource Constraints

Following from Section 214(2)(a-j) of the Constitution, the following constraints on the provision of CMBS are recognised:

- Government revenue is used not only for the provision of CMBS, but also for other things such as infrastructure and economic development (which enables future economic and hence revenue growth with which to fund progressive realisation of CMBS); the criminal justice system, security and protection, and administrative services;\(^8\)
- The capacity to raise tax revenue faces collection efficiency, investment disincentive, and political accountability constraints;
- The capacity for deficit financing is limited by investor perceptions of the public sector’s capacity and willingness to service and redeem debt; and
- Debt servicing crowds out resources that would otherwise be available for the provision of CMBS.

### 3.3.4 Therefore the FFC with Respect to Poverty Targeting Proposes that:

- The costs of poverty targeting to minimise errors of exclusion and inclusion should be weighed against the costs of providing free basic services universally.

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\(^8\) See previous FFC proposals on the financing of infrastructure backlogs in the FFC Submissions of May 2000 and June 2001.
• Ongoing studies on the impact of social security provision on income poverty, CMBS service provision, access to property, and asset poverty should be carried out.

• The impact of user fees for the basic social services of education and health should be considered carefully in terms of their impact on poverty alleviation. The FFC would be prepared to participate in a study on education and health care user fees.

• The impact of tariffs for the basic municipal services of water, electricity, and public transport (which ensures access to social service facilities) should similarly be given careful consideration in terms of their impact on poverty alleviation. The FFC would be prepared to participate in a study on water and electricity user fees in South Africa.

3.3.5 Norms and Standards

Proposal:

Norm-setting should take account of resource constraints and the need for flexibility in the event of emergencies and new policy challenges. Norms and standards can be adjusted according to resource availability, environmental factors and policy imperatives.

Norms can be defined in terms of:

(a) The policy outcome desired,
(b) The relationship between (individual or household) beneficiaries and
   (i) the personnel and complementary inputs required to deliver the
   service, (ii) the unit of infrastructure required to enable the delivery
   of that service, and (iii) other complementary inputs; and
(c) The costs of providing a service at a defined standard.

Standards can define the quality of service.

Proposal:

Current norms and standards for established public services can be based on current or moving averages or on minimum international standards. Norms and standards for new public services in response to constitutional mandates, environmental factors, and other policy imperatives can often be based on minimum international standards.
Part A

3.3.6 Data Gaps for Performance Measurement

Proposals:

National departments, in collaboration with Statistics South Africa, should collate, verify, and publish data on beneficiaries receiving Constitutionally Mandated Basic Services, as well as departmental complements of personnel, and capital assets for their relevant functions. Data should encompass the service delivery programmes of all three spheres of government.

- All official and recognised data sources should be identified and audited. A Census-planning group should be established and charged with developing a plan for identifying and filling information gaps relevant to the intergovernmental fiscal system and division of revenue. The FFC is prepared to play an appropriate role within the data-planning group.

- Census-related and regional economic data collection and release cycles should be co-ordinated with budgetary, capital and operational, and strategic planning cycles. These might further correspond with the electoral cycle. The cycles for national, provincial, and local governments could be staggered.

- Greater effort should be made to reduce the time lag between the collection and release of national statistics.

- Socio-demographic data collected during and between official Censuses should be able to identify the population eligible for receipt of social services and household infrastructure. Further, a methodology for updating and projecting eligible populations and household infrastructure backlogs should be established.

- Socio-demographic data from the Census and other surveys should measure policy outcomes, notably of poverty indicators and access to Constitutionally Mandated Basic Services.

- Statistics South Africa should collate various measures of the extent, cause, and alleviation of poverty to enable a comprehensive analysis of measures to alleviate poverty. These could include measures of consumption (as opposed to expenditure) on basic needs and measures of asset poverty.
3.4 Funding Instruments

Proposal:
The provision of CMBS should be funded through a mix of general purpose and specific purpose revenue sources.

3.4.1 Conditional Grants

Conditional grants can be aimed at (a) providing for capital goods (e.g. infrastructure and equipment), and (b) building institutional capacity. Capital development and institutional capacity building have implications for operational spending.

Proposals:

• The design of conditional grants could be negotiated between the transferring and recipient authorities. A measure of the degree of participation might be the extent to which the recipient authority matches funds relative to its fiscal capacity.

• The role of special purpose grants should be circumscribed so as to avoid distorting the horizontal (and vertical) distributions intended by the Equitable Share formulae.

Recommendations:

• The design of capital grants should be based on the progressive eradication of infrastructure backlogs through the use of a dedicated conditional grant, which recognises the link between the progressive provision of CMBS and the concomitant infrastructure requirement.

• The capital grant funds should be allocated using an equitable sharing formula based on the FFC’s infrastructure backlogs capital expenditure model.9

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9 See previous FFC proposals on financing infrastructure backlogs through the use of the FFC capital grants model (Submissions of May 2001 and June 2002).
3.5 Institutional Capacity

3.5.1 Fiscal Capacity

South Africa’s vertical fiscal imbalance, as measured by the ratio of revenue raised relative to spending by provincial and municipal governments, is the highest in the world. While the imbalance is dealt with through the intergovernmental grant system, provinces in particular are heavily dependent on such grants. Municipalities raise most of the revenue for their expenditure needs as a sphere, although there are horizontal differences.

Issue of accountability become important in a decentralised system of government and the less revenue sub-national government raise through taxing their constituents, the less accountable they are to their constituents.

Proposals:

- A national effort should be made to measure the potential revenue base of provincial and municipal spheres of government.
- Socio-demographic and regional economic data should be collated for the municipal sphere and aggregated to equate with national socio-demographic and economic data. This type of data should be disaggregated to the lowest possible level.

3.5.2 Budgetary and Strategic Planning

Reporting on the progressive realisation of national policy objectives through policy outcome, delivery output, and financial input indicators assists in the systems development of the public sector and helps define the institutional and human capacity requirements for achieving these policy objectives.

Proposals:

- At an early stage of the process of integrating strategic and budgetary planning, linked programmes of delivery, spending, and funding attached to national policy objectives should be outlined for and by national, provincial, and municipal governments for all identified Constitutionally Mandated Basic Services.
• The institutional implication of defining programmes in terms of the linkages between their delivery, spending, and funding components should be researched.

3.5.3 Co-operative Governance

Proposal:

• That the roles of the Budget Forum and Budget Council be reviewed so as to effectively coordinate the processes around integrated development planning and budgeting among the three spheres of government.
SUBMISSION FOR THE DIVISION OF REVENUE 2004 – 2005
SUBMISSION FOR THE DIVISION OF REVENUE 2004/05

The FFC submitted its proposals on the Division of Revenue for 2003/04 in April 2002. Government responded to the proposals in Annexure E of the Division of Revenue Bill 2003/04. This submission addresses a number of issues, some flowing directly from the 2002 Submission and others arising from the submission made by the FFC in May 2000 (FFC Recommendations for the 2001/04 MTEF Cycle).

This submission addresses issues relevant to the national, provincial, and local spheres of government. With respect to the national sphere, the FFC addresses two main issues, namely, the financing mechanisms for HIV/AIDS and health care conditional grants. With respect to the provincial sphere, the FFC addresses issues around the review of the provincial equitable share formula, with specific reference to the social sector (education, health and social development).

With respect to the local sphere, this submission addresses the funding of institutional capacity building and maintenance, the funding of development nodes, and the development of a differentiated approach to various aspects of local government.
Chapter 1

1.1 HIV/AIDS Conditional Funding

In its submission on the Division of Revenue 2003/04, the FFC made a proposal that the financing of HIV/AIDS programmes should not be through the equitable share mechanism but rather that HIV/AIDS programmes be financed through a conditional grant.

Government concurs with the FFC that conditional grant funding for HIV/AIDS should be increased, but notes that there is also a need to accelerate funding for HIV/AIDS through the equitable share in order to allow provinces the flexibility to deal with HIV/AIDS through the various existing programmes. The following discussion focuses on the current funding mechanisms for HIV/AIDS.

The government strategy for dealing with HIV/AIDS is complex, reflecting the nature of the disease and its impact. There is a need to respond cross-functionally, inter-departmentally, vertically (between national, provincial and local government), and to involve the private sector.

This response needs to find the most efficient mechanisms within the system of intergovernmental finance to ensure rapid and sustainable implementation of responses. These financial mechanisms also need to take account of organisational requirements and capacity needs of provincial and local government.
1.1.1 Estimates of the Epidemic

The impact on provinces of HIV/AIDS is not certain, despite the existence of projections. Routinely collected data from the antenatal clinic surveys performed annually by the Department of Health, which have to date represented the only source of hard information on the epidemic, are too limited to provide reliable planning information. A recent survey carried out by the Human Sciences Research Council (HSRC) in 2002 casts doubt on the numbers arising from the antenatal clinic surveys.

The HSRC study surveyed a national sample of the population by age, gender and socio-economic status. This differs from the antenatal clinic survey, which only samples pregnant women attending public sector antenatal clinics. The antenatal clinic survey is not directly comparable to the HSRC study and has to be extrapolated onto the total population before this can be done. This has been performed using the Actuarial Society of South Africa (ASSA) 2000 demographic model, which generates HIV prevalence, AIDS sickness, AIDS mortality, non-AIDS mortality, and population estimates and projections.

The ASSA 2000 provincial estimates (ASSA 2000, 2002) differ substantially from those published in the HSRC report. The ASSA model produces a prevalence of 23.8 percent versus 15.6 percent from the HSRC study for the age group 15 to 49. There are also significant differences by province. HIV prevalence in KwaZulu-Natal is estimated to be 15.7 percent in the HSRC study compared to 32 percent projected by the ASSA 2000 model for those aged 15 to 49. High prevalence rates for Gauteng, Free State, and Mpumalanga suggested by the antenatal clinic surveys are however confirmed in the HSRC study, although they differ in magnitude.

The HSRC found the highest prevalence rates within the urban informal sector (28.4 percent for 2002), with the next highest in urban formal areas (15.8 percent in 2002). Farms and tribal areas had the lowest prevalence rates at 11.3 percent and 12.4 percent respectively. If this survey is a true reflection of the epidemic, the highest priority areas for intervention are urban areas.

Government’s approach to service and financial planning for the disease is therefore quite complex. If the impact of the disease is lower, as suggested by the HSRC study, many services could be supplied that were previously thought to be too expensive.

1.1.2 Public sector Healthcare Cost of HIV/AIDS

Estimates of potential new demand for public health services owing to HIV/AIDS point to a significant impact for South Africa over the next 10 years. However,
limited budget or expenditure change is occurring in the aggregate provincial health budget. Consequently, either non-AIDS related health services are being crowded out or a high degree of implicit rationing\(^1\) is occurring.

**Table 1** Average cost of care per infected person per year by stage and sector

<table>
<thead>
<tr>
<th>Stage</th>
<th>Public sector</th>
<th>Private sector</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Inpatient</td>
<td>Outpatient</td>
</tr>
<tr>
<td>Stage 1 and 2</td>
<td>700</td>
<td>600</td>
</tr>
<tr>
<td>Stage 3</td>
<td>5,200</td>
<td>1,100</td>
</tr>
<tr>
<td>Stage 4</td>
<td>15,500</td>
<td>1,400</td>
</tr>
</tbody>
</table>


The Department of Health’s own estimates of the cost impact of HIV/AIDS is R5.3 billion for 2002 based on analyses by Abt & Associates. However, there is a R2.6 billion difference between a straight-line extrapolation of Abt & Associates costs onto projected stage 4 cases and Abt & Associates own estimate of stage 3 and 4 costs on the public sector. The reasons for this difference are unclear.

### 1.1.3 Public Sector Social Development Cost of HIV/AIDS

**Foster Care Grant**

There should be an increasing take-up of the foster care grant as a consequence of HIV/AIDS. However, expenditure and take-up to date is far below what model projections suggest. In 2001 the foster care grant was valued at R410 per beneficiary per month. The estimated annual expenditure is around R585 million (118,916 beneficiaries), compared with projected number of orphans of 555,684 in 2001 and an expenditure requirement of R5.6 billion.\(^2\)

The number of eligible beneficiaries for the foster care grant is estimated by Treasury stands at 316,067, which is below the number of projected AIDS orphans. It is however not an unreasonable view for the year in question.

The foster care grant is a statutory entitlement, access to which is slowed because of weak administrative systems. A further hurdle in gaining access to the grant is the requirement for children to be placed in foster care by the courts with the assistance of a social worker. Once a child has been adopted, however, eligibility for the grant ceases.

**Disability Grant**

The disability grant can be accessed by individuals in the advanced stages of AIDS through a medical assessment. There have not been significant increases in the take-up of this grant for the period 1999 to 2001. There is however significant

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\(^1\)This refers to instances where medical staff make rationing decisions outside of a clear set of guidelines or protocols. Although not necessarily arbitrary, such rationing could result in a wide variety of clinical.

\(^2\)The projected number of orphans is from ASSA 2000 while the projections of beneficiaries are from National Treasury IGFR 2001.
upward potential if it is used as an unofficial AIDS grant, for which it was not designed. There is some indication from the 2001 take-up that this may be happening.

National Treasury is currently working with an estimated eligible population of 1.2 million. Thus, just over 50% of the population eligible to collect the grant do so.

The estimate of eligible beneficiaries does not take HIV/AIDS into account. The potential for an explosion in this grant exists if a medical assessment of disability persists and no treatment programme for AIDS is delivered.

1.1.4 Financing HIV/AIDS Programmes

The Enhanced Response Programme

Government has made funds available for an enhanced spending programme on HIV/AIDS. Apart from improved funding for the national Department of Health and through conditional grants, there is substantial new funding being channelled through the equitable share allocation for provinces (R400 million to R900 million from 2002/03 to 2004/05).

Table 2 Estimated Combined Intervention Package – Total Cost: Department of Health Estimate

<table>
<thead>
<tr>
<th></th>
<th>2002/3</th>
<th>2003/4</th>
<th>2004/5</th>
</tr>
</thead>
<tbody>
<tr>
<td>National DoH</td>
<td>87,494</td>
<td>106,386</td>
<td>102,643</td>
</tr>
<tr>
<td>Conditional grants</td>
<td>36,709</td>
<td>121,386</td>
<td>226,386</td>
</tr>
<tr>
<td>Equitable share</td>
<td>400,000</td>
<td>600,000</td>
<td>900,000</td>
</tr>
<tr>
<td>Total</td>
<td>524,203</td>
<td>827,772</td>
<td>1,254,029</td>
</tr>
</tbody>
</table>

Source: National Treasury, provided on request, 2002.
An overall assessment of the actual allocated budget for HIV/AIDS is difficult due to conflicting sets of information in various official data sets.

**Conditional Grants**
According to the Division of Revenue Act for 2002/03, a total of R157 million was allocated to provinces for HIV/AIDS to enhance the public health response. A further R46.5 million was allocated through the Department of Social Development to “advance the development of community-based care (CBC) programmes in communities”. A total of R142 million was allocated via the Department of Education to “promote HIV/AIDS education in primary and secondary schools”.

The criteria for allocating the conditional grants differ, suggesting that the policy weighting by province is distinct for each of the grants. The reasons for the differences are unclear. The education conditional grant is allocated using the equitable share formula for the education function, whereas the social development and health conditional grants are not allocated according to their respective equitable share formulae.

**Equitable share funding**
Provision has been made for an increment to the provincial equitable share allocation of R400 million in 2002/03, R600 million, in 2003/04, and R900 million in 2004/05 for funding some of the additional costs of HIV/AIDS.

The allocation of the provincial equitable share increment does not appear to be distributed in accordance with the provincial equitable share, the ASSA prevalence estimates, the HSRC prevalence estimates, or the provincial population adjusted down for the medical scheme population.

The fact that the HIV/AIDS increment to the provincial equitable share is not ring-fenced in any way raises concerns that the allocation may not be used to cover the direct costs of HIV/AIDS. Investigations carried out by the FFC could not find any indication in key provinces, such as KwaZulu-Natal and Eastern Cape, that any allocation to any function affected by HIV/AIDS directly received this money. An evaluation of expenditure outcomes may be necessary to ensure that the increments do indeed result in increases in HIV/AIDS spending.

**1.1.5 Appropriateness of Funding Vehicles**

Different options are available to government to fund an expanded response to HIV/AIDS. The National Department of Health lists four:

1. Direct expenditure/procurement by the National Department of Health;
2. Expansion of the current HIV/AIDS conditional grants;

3. Creation of new recurrent conditional grants for HIV/AIDS and tuberculosis funding for provinces; and

4. Expansion of the health component of the equitable share revenue pool.

However, the Department has experienced problems with the conditional grant framework due largely to its restrictive and time-consuming procedural requirements, and it is unlikely to be a suitable vehicle by which to channel larger sums of money to provinces. Creation of (or conversion to) a new HIV/AIDS and TB recurrent grant which is subject only to broad output/outcome targets would allow earmarking of funds, but may cause artificial divisions between “AIDS” and “non-AIDS” services.

According to the Department of Health, expanding the equitable share allocation would require the development of provincial allocation formula which should be more or less directly based on HIV/AIDS-related service needs.

In responding to the FFC’s recommendations for the Division of Revenue Bill 2003/04, Government indicated the need to increase allocations to provinces through the equitable share in order to allow for flexibility in spending on HIV/AIDS programmes, while also accepting the need to increase conditional grant funding for the same purpose. Government noted that funding through conditional grants only might create inflexibility.

An alternative route is to move in the direction of a more “open ended” conditional grant such as that proposed by the national Department of Health. The need for a nationally co-ordinated and funded response is most appropriate in the case of HIV/AIDS as it requires funding and programmes that are different from those that existed in the past.

1.1.6 Proposals: HIV/AIDS Programme Funding

To accelerate the implementation of HIV/AIDS priority programmes, the Financial and Fiscal Commission proposes:

- That current national programs directed at procurement of condoms, awareness campaigns and specific research efforts should be retained and strengthened;

- That all existing conditional grants be reviewed with a view to converting them into a more efficient conditional grant mechanism—a clear and coordinated policy framework needs to be established at
the national level; and

- That social spending outcomes resulting from the increases in the equitable share targeted at HIV/AIDS programmes be evaluated to establish its effectiveness.

1.2 Health Care Conditional Grants

Conditional grants for health are significant and represent 27.2% of overall provincial health expenditure. The conditional grants serve as a "unifying" mechanism for the public health system by ensuring that provinces meet certain national priorities and that spillovers are mitigated.

1.2.1 Current Conditional Grants

There are a total of seven conditional grants for health with a total value of R6.4 billion in 2002/03. The most significant grants are the National Tertiary Services Grant (R3.7 billion) and the Health Professional Training and Development Grant (R1.3 billion). Together these two grants account for 77% of all the health conditional grants.
1.2.1.1 National Tertiary Services Grant

The current National Tertiary Services Grant evolved from what was originally called the “Central Hospital Services” grant. The intention of the grant was to contribute to the costs (spillovers) incurred by provinces that provide referral services, which include highly specialised services.

The conditional grant for central hospitals was initially (1998/99) allocated to 10 central hospitals that provided specialist services to patients from other provinces. These were:

- Western Cape: Groote Schuur Hospital, Red Cross Hospital, and Tygerberg Hospital;
Part B

- **Kwazulu Natal**: King Edward VIII Hospital and Wentworth Hospital;
- **Free State**: Universitas Hospital; and
- **Gauteng**: Chris Hani-Baragwanath Hospital, Ga-Rankuwa Hospital, Johannesburg General Hospital, and Pretoria Academic Hospital.

The total value of the grant was set at R3,021 billion in the 1998/99 budget allocation and was based on 75% of the costs of providing inpatient and outpatient services at these specified central hospitals. From 2000/01 the Central Hospital Grant was expanded to 11 hospitals, with the addition of one in the Eastern Cape. This expansion appears to have been funded from an initial provincial top slice and consequently reflects redistribution from the funding for the initial 10 central hospitals.

For the 2002/03 financial year and thereafter the grant was changed into a "National Tertiary Services Grant". This grant funds highly specialised services wherever they are offered and is not linked to the 11 central hospitals. Thus the objectives of the grant and what it seeks to fund have materially changed. There has however been little change in the allocation of the grant (that is, 75% of the actual expenditure for the 10 original central hospitals). The allocation now extends to all provinces and has an explicit redistributive intention in addition to accommodating a spillover problem.

**Table 4 Conditional grant allocations in respect of the Central Hospital Grants (1998/99 to 2001/02) and the National Tertiary Services Grant (2002/03 to 2004/05) (2002/03 Prices) (R’000)**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Cape</td>
<td>0</td>
<td>0</td>
<td>14,653</td>
<td>14,125</td>
<td>181,444</td>
<td>181,444</td>
<td>239,731</td>
</tr>
<tr>
<td>Free State</td>
<td>287,895</td>
<td>282,921</td>
<td>267,736</td>
<td>267,300</td>
<td>312,300</td>
<td>312,300</td>
<td>338,544</td>
</tr>
<tr>
<td>Gauteng</td>
<td>1,809,355</td>
<td>1,778,095</td>
<td>1,682,652</td>
<td>1,678,771</td>
<td>1,558,954</td>
<td>1,558,954</td>
<td>1,522,562</td>
</tr>
<tr>
<td>KwaZulu-Natal</td>
<td>492,853</td>
<td>484,339</td>
<td>458,341</td>
<td>457,452</td>
<td>512,145</td>
<td>512,145</td>
<td>545,898</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>37,369</td>
<td>37,369</td>
<td>36,507</td>
<td></td>
</tr>
<tr>
<td>Northern Cape</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>30,526</td>
<td>24,062</td>
<td>37,105</td>
<td></td>
</tr>
<tr>
<td>Limpopo</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>42,968</td>
<td>44,838</td>
<td>41,311</td>
<td></td>
</tr>
<tr>
<td>North West</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>32,483</td>
<td>34,189</td>
<td>30,940</td>
<td></td>
</tr>
<tr>
<td>Western Cape</td>
<td>1,165,880</td>
<td>1,145,738</td>
<td>1,084,239</td>
<td>1,084,239</td>
<td>999,288</td>
<td>1,030,510</td>
<td>972,973</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>3,755,984</strong></td>
<td><strong>3,691,094</strong></td>
<td><strong>3,507,621</strong></td>
<td><strong>3,507,621</strong></td>
<td><strong>3,707,475</strong></td>
<td><strong>3,666,842</strong></td>
<td><strong>3,765,571</strong></td>
</tr>
<tr>
<td></td>
<td>-1.7%</td>
<td>-5.0%</td>
<td>-0.2%</td>
<td>1.1%</td>
<td>4.8%</td>
<td>1.6%</td>
<td></td>
</tr>
</tbody>
</table>

Source: Division of Revenue Acts from 1998/99 to 2002/03
An attempt to estimate the value of level 2 and 3 services within the public health sector and to evaluate the extent of the spillover resulting from the uneven inter-provincial distribution of these services produced results that suggested a very substantial spillover with respect to both level 3 services (R1.5 billion in 2002/03 prices) and level 2 services (R3.4 billion in 2002/03 prices). The extent of the spillover effect was thus found to be greater overall, when level 2 services are included, than that for level 3 services.

The size of the spillover for both level 3 and 2 services is very significant. It suggests that there is a major spillover effect that is not addressed in any way via the system of intergovernmental finance. The exercise also estimated the total value of level 2 and 3 services in 2002/03 prices to be R7 billion. The tertiary services grant is however valued at R3.7 billion in 2002/03.

<table>
<thead>
<tr>
<th>Province</th>
<th>Total estimated value of service</th>
<th>TS Grants</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Level 3</td>
<td>Level 2</td>
</tr>
<tr>
<td>Eastern Cape</td>
<td>101</td>
<td>172</td>
</tr>
<tr>
<td>Free State</td>
<td>188</td>
<td>280</td>
</tr>
<tr>
<td>Gauteng</td>
<td>1,331</td>
<td>1,638</td>
</tr>
<tr>
<td>KwaZulu-Natal</td>
<td>463</td>
<td>574</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>28</td>
<td>78</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>8</td>
<td>24</td>
</tr>
<tr>
<td>Limpopo</td>
<td>11</td>
<td>59</td>
</tr>
<tr>
<td>North West</td>
<td>16</td>
<td>47</td>
</tr>
<tr>
<td>Western Cape</td>
<td>849</td>
<td>1,201</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td>2,994</td>
<td>4,073</td>
</tr>
</tbody>
</table>

The above findings have fairly serious implications for the continued use of the Tertiary Services Grant, as its redistribution does not bear any direct relationship to the removal over time of the spillover problem nor does it appear to have been costed appropriately.

1.2.1.2 Health Professions Training and Development Grant

The health professions training and development grant is intended to compensate provinces for the additional service costs associated with training health professionals and carrying out research.

The size of the grant for teaching, training, and research was put at R1 billion in the 1997/98 fiscal year by the Department of Health. The Department of Health proposed in 1997 that the grant’s objectives compensate a province for the additional service costs of students (medical, dental, allied, and nursing), as well as time cost for qualified staff participating in teaching services and research activities.

Research to estimate the actual cost of operating provincial academic hospitals was done by the FFC in 1998. The results showed that the value of the proposed grant, based on the previous allocation valued at R1 billion, was substantially in excess of what was required. The estimated requirement was closer to R123 million in 1997/98 prices. The comparison in 2002/03 prices is R165 million compared to the allocation of R1.3 billion.

The redistributive allocations to provinces with limited teaching and research capability were uniform for a number of years, suggesting that there was little underpinning the allocations. Provinces that have fairly extensive training capability, such as Gauteng and Western Cape, show very significant declines in this conditional grant over the period 1998/99 to 2004/05.

This analysis indicated that the grant is incorrectly specified. It also showed that it is possible to link certain costs to specified student types and selected output indicators. Nevertheless the estimated expenditure requirement of the grant is at best half the amount of the existing grant. Medical students on their own probably only cost the public hospital budget an additional R142 million per year (2002/03 prices).

**1.2.1.3 Other Grants**

A feature of the conditional grants for health outside of the National Tertiary Services Grant and the Health Professions Training and Development Grant has been the low expenditure relative to budget allocations.

There are problems that make the conditional grant system difficult to implement. The following are some comments concerning the conditional grants and their use in the future.

*Integrated nutrition programme*

This grant directs funds primarily toward schools to fund the school-feeding programme. The funds are allocated via a national conditional grant from the national Department of Health to provincial health departments, and from there to schools that fall under the provincial departments of education. The route is cumbersome. Consideration should be given to shifting the funding responsibility to the Department of Education. The value of the grant is also not logically linked to any quantitative objective.

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Capital grants
The process for spending capital allocations within the public sector is difficult with multiple overlapping responsibilities at a provincial level. Where pressure to spend allocations is placed on a department where no adequate policy framework exists to spend the funds, allocations are directed toward the easiest spending channels rather than areas of greatest need. At the project level, capacity weaknesses within public works departments and the lack of appropriate service-level agreements severely constrain the pace and quality of delivery. Improvements here involve the development of a revised capital spending delivery framework which links into the development of provincial strategic plans.

Redistribution of Specialised Services Grant
This grant was a capital grant derived from reductions in the Central Hospital Grant (a recurrent allocation). The funding source and purpose of the grant were always incompatible. For it to operate correctly, the grant should have funded the recurrent costs of implemented specialised services, and not their capital costs. Provinces would naturally be slow to introduce new services without a clear commitment to fund the recurrent costs. Combining the Specialised Services Grant with the Central Hospital Grant to become the National Tertiary Services Grant would eliminate the contradictory nature of the Specialised Services Grant.

1.2.2 Conclusions

The health conditional grants are an extremely important tool for the realisation of national health policy. Provincial health budgets are heavily influenced by these allocations. However, the most substantial grants, allocated as bloc conditional grants, are characterised by flaws that should be addressed.

The Tertiary Services Grant is problematic in that there is very little underpinning its redistributive allocations, especially to provinces with limited teaching and research capability. It is also not appropriately costed and under-funding thus results.

The Health Professions Training and Development Grant has been “over-costed” and is not in any clear and transparent way linked to the services and functions it is intended to fund. Depending upon what is assumed to be included in the grant, it could be valued at between half to a tenth of the budgeted value. It is possible, however, to create a production function for each student type and to allocate appropriate funds to provinces with these functions.

The previous grant for the Redistribution of Specialised Services is now apparently included in the Tertiary Services Grant. However, no clarity is provided as to how the new grant differs from the original flawed grant. The problem with the previous grant was that it derived its funding from the Central Hospital Grant, which funded the recurrent budgets of the relevant provinces, and allocating these to capital...
projects without any commitment to recurrent funding.

The Integrated Nutrition Programme has no explicit policy foundation justifying its costing or the mechanism used for its distribution. This grant needs to be revised. This should include funding it through the education budget rather than the health budget, and re-costing the grant to achieve some specified and quantifiable purpose (for example, reduce child poverty or malnutrition by a certain amount).
2.1 The Education Component of the Provincial Equitable Share Formula

2.1.1 Overall Assessment of the Education Component

In its submission for the Division of Revenue 2003/04, the FFC proposed that the financing of Early Childhood Development (ECD) should be phased into the education component of the provincial equitable share.

Government concurred with the FFC proposals and further indicated that the modalities of how that happens would be considered as part of the overall review of the equitable share formula. In this section the FFC reviews some aspects of the education component and makes further comments on the financing of ECD, ABET, and learner support materials (LSM).

Although the Provincial Equitable Share (PES) formula used by the National Treasury to determine each province’s equitable share allocation has been adjusted several times, the basic structure of the formula established in fiscal year 1997/98 has remained unchanged. The PES formula has seven components, namely education, health, social development, basic, economic activity, backlogs and institutional components.
In 2002/03, 41% of the R119.5 billion total provincial equitable share was allocated through the education component. The distribution of this component among provinces is made more or less on a per learner basis. The actual formula is:

\[ E_i = \left[ \frac{(S + 2P_i)}{\sum_i (S + 2P_i)} \right] A_{educ} \]

where,

- \( E_i \) = education component equitable share allocation to province \( i \),
- \( S_i \) = primary and secondary school enrolment in province \( i \),
- \( P_i \) = population between the ages of 6 and 17 in province \( i \), and

\( A_{educ} \) is the total education component of the provincial equitable share (R48,975 million in 2002/03).

“Out-of-age” learners

The formula double-weights the school-age population to provide an incentive for provinces to reduce school enrolment by children who are entering first grade at younger than age 6 and learners who remain in school after the age of 17, generally because they are repeating grades.\(^5\) This weighting scheme is equivalent to counting each school-age learner as one learner and each “out-of-age” learner as a third of a learner.

Table 6 displays the data used in the education component of the 2002/03 equitable share allocations. It reveals that the Rand allocations to each province are approximately proportional to each province’s share of enrolled learners.

However, there is no direct relationship between enrolment and distribution. For example, while KwaZulu-Natal has 22.6% of all enrolled learners, its equitable share allocation is only 22.0% of the total educational component. Likewise, while the Western Cape has 7.6% of learners, it receives 8.0% of the education portion of the provincial equitable share.

\(^5\) To graduate from high school in South Africa, learners must pass a set of matriculation exams. Thus, learners have a strong incentive to repeat grades if they are not prepared for exams or have taken the exams and failed. The fact that the unemployment rate among young persons is over 50 percent provides a further incentive for grade repetition.
Part B

Table 6 Provincial Allocation of Education Component, 2002/03 Impact of an Alternative Allocation Based on Enrolment

<table>
<thead>
<tr>
<th>Province</th>
<th>1998/2000 Average</th>
<th>School Age (6-17)</th>
<th>Provincial Share of Education Component</th>
<th>Change in Education Component of Allocation Based on Enrolment (in millions of rands)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number (thousands of learners)</td>
<td>Percent of Total</td>
<td>Number (thousands of learners)</td>
<td>Percent of Total</td>
</tr>
<tr>
<td>Eastern Cape</td>
<td>2,253</td>
<td>18.5%</td>
<td>2,010</td>
<td>18.4%</td>
</tr>
<tr>
<td>Free State</td>
<td>784</td>
<td>6.4%</td>
<td>680</td>
<td>6.3%</td>
</tr>
<tr>
<td>Gauteng</td>
<td>1,508</td>
<td>12.4%</td>
<td>1,394</td>
<td>12.6%</td>
</tr>
<tr>
<td>KwaZulu-Natal</td>
<td>2,749</td>
<td>22.6%</td>
<td>2,377</td>
<td>22.0%</td>
</tr>
<tr>
<td>Limpopo</td>
<td>1,904</td>
<td>15.6%</td>
<td>1,665</td>
<td>15.2%</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>922</td>
<td>7.6%</td>
<td>789</td>
<td>7.2%</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>222</td>
<td>1.7%</td>
<td>223</td>
<td>2.0%</td>
</tr>
<tr>
<td>North West</td>
<td>934</td>
<td>7.7%</td>
<td>896</td>
<td>8.2%</td>
</tr>
<tr>
<td>Western Cape</td>
<td>928</td>
<td>7.6%</td>
<td>895</td>
<td>8.2%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>12,184</td>
<td>100.0%</td>
<td>12,184</td>
<td>100.0%</td>
</tr>
</tbody>
</table>

Source: Budget Review 2002

The data in the last column of Table 6 indicate that the current practice of double-weighting school-age children has a substantial impact on the allocation of the educational component of the equitable share. Compared to an equitable share allocation based purely on enrolment, the 2002/03 formula is most favourable to the Western Cape, the North West, and the Northern Cape.

On the other hand, the current formula provides fewer resources to KwaZulu-Natal and Limpopo, two relatively poor provinces. If the 2002/03 education allocation of the equitable share had been based purely on enrolment, KwaZulu-Natal’s allocation would have been R256 million higher, while the Western Cape’s allocation would have been R180 million lower.

While the Treasury formula provides a strong incentive for provinces to take steps to reduce the number of out-of-age learners, it does nothing to address the underlying reasons why so many learners need to repeat grades in some provinces.

Learners currently attending secondary school received at least some of their primary school education in apartheid-era schools. At least some of these learners may be repeating grades and having difficulty passing the matriculation exam precisely because of their poor academic preparation in the early grades. In effect, the current formula may be penalising those provinces that face the heaviest burden of redressing the educational deficiencies created by apartheid-era schools.
As soon as data on the age distribution of the population is available from the 2001 census, it will be possible to see how successful provinces have been in reducing the number of out-of-age learners.

Anecdotal evidence suggests that provincial Departments of Education are generally not able or willing to prevent out-of-age learners from attending school. If this is in fact the case, then penalising provinces with above average numbers of out-of-age learners has the effect of providing fewer resources to those provinces that probably have the worst quality schools, and arguably need additional resources to increase the academic performance of their learners.

*Moving towards equity in education funding*

Ignoring the differential weighting of "out of age" learners, the current education component of the provincial equitable share formula provides an equal amount per learner to each province. This represents a significant step in achieving equity in the funding of education.

Furthermore, in recent years the differences in expenditures per pupil across the nine provinces have been shrinking. As illustrated by the data in Table 7, in 1995/96 the two provinces with the highest poverty rates (Eastern Cape and Limpopo) had the lowest per pupil expenditures, while the three provinces with the lowest poverty rates (Gauteng, Northern Cape, and Western Cape) had the highest levels of per pupil spending.

Although the "richer" provinces still had higher levels of spending per pupil than poorer provinces five years later, the differences in spending levels have been dramatically reduced.
Table 7 Provincial Government Expenditure per Full Time Equivalent Learner

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Cape</td>
<td>1.98</td>
<td>2.57</td>
<td>2.63</td>
<td>2.74</td>
<td>3.49</td>
<td>75.9</td>
</tr>
<tr>
<td>Free State</td>
<td>2.35</td>
<td>2.93</td>
<td>2.91</td>
<td>3.02</td>
<td>4.25</td>
<td>80.3</td>
</tr>
<tr>
<td>Gauteng</td>
<td>3.13</td>
<td>3.63</td>
<td>3.61</td>
<td>3.67</td>
<td>4.47</td>
<td>42.8</td>
</tr>
<tr>
<td>KwaZulu-Natal</td>
<td>2.21</td>
<td>2.47</td>
<td>2.67</td>
<td>2.43</td>
<td>3.15</td>
<td>42.5</td>
</tr>
<tr>
<td>Mophumalanga</td>
<td>1.84</td>
<td>2.30</td>
<td>2.86</td>
<td>2.87</td>
<td>3.51</td>
<td>90.4</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>2.96</td>
<td>2.53</td>
<td>2.66</td>
<td>2.74</td>
<td>3.27</td>
<td>58.7</td>
</tr>
<tr>
<td>Limpopo</td>
<td>4.02</td>
<td>3.82</td>
<td>3.96</td>
<td>4.25</td>
<td>4.86</td>
<td>20.8</td>
</tr>
<tr>
<td>North West</td>
<td>2.25</td>
<td>2.80</td>
<td>3.20</td>
<td>3.26</td>
<td>3.95</td>
<td>75.5</td>
</tr>
<tr>
<td>Western Cape</td>
<td>3.85</td>
<td>4.53</td>
<td>4.17</td>
<td>3.26</td>
<td>4.46</td>
<td>13.5</td>
</tr>
<tr>
<td>National Average</td>
<td>2.34</td>
<td>2.61</td>
<td>3.02</td>
<td>3.03</td>
<td>3.71</td>
<td>58.4</td>
</tr>
</tbody>
</table>

Over those five years, expenditures per pupil grew by 76% in the Eastern Cape and by 90 percent in Limpopo. These rapid rates of increase contrast with the 14 percent and 21% rates of increase in the Western Cape and Northern Cape respectively.

2.1.2 Incorporating Early Childhood Development into the Education Component

In the White Paper on Early Childhood Development issued in May 2001, the National Department of Education defines Early Childhood Development (ECD) in terms of a broad package of policies and programmes targeted at the development of children from birth through age nine. The White Paper emphasises the importance of ensuring that all children are fully prepared to enter primary school. With that goal in mind, the Department of Education has proposed that all children in South Africa participate in an "accredited" reception year programme (Grade R) prior to entering Grade One.

Arguments can be made for inclusion of ECD funding in the education component of the equitable share formula, or alternatively providing ECD funding through a conditional grant. It could be argued that including ECD funding in the equitable share would allow provincial governments to shift resources away from ECD programmes in favour of other pressing needs. On the other hand, conditional grants would restrict the expenditure autonomy of provincial governments and may in effect serve as a ceiling on provincial government spending on ECD.
In its 2003/04 Division of Revenue submission, the FFC indicated its preference for allocating funds for ECD through the equitable share formula. In its response, government concurred with the FFC. In fulfilling its constitutional mandate, each province’s Department of Education must determine how to provide each learner in grades R to Nine with the opportunity to receive the best possible education. The FFC believes that each province must be given the freedom to determine how best to allocate education resources in fulfilment of its constitutional mandate to provide basic education (including ECD).

In designing a revised education formula, it is important that nothing in the formula should restrict provincial governments from ensuring that ECD is provided in the most efficient and cost-effective manner. The starting point would be the determination of norms and standards for Grade R programmes by the Department of Education. The focus should be on outcome standards specified in terms of the specific skills every learner should possess prior to entering Grade One.

An important advantage of designing norms and standards for ECD in terms of outcome standards is that provincial departments of education would then be free to meet those standards in the most cost-effective way possible. This would mean that neither the equitable share formula nor the ECD norms and standards would stipulate whether Grade R programmes must reside in public primary schools, community-based centres, or independent schools. Thus, as long as children receive an appropriate Grade R education, provincial governments should be free to provide that education as inexpensively as possible.

A basic approach to the design of a formula for Grade R funding would be to base the allocation on a poverty-weighted count of eligible children in each province, where eligibility is defined as all children between the ages of five and six. Statistics South Africa could be asked to provide data from the 2001 census on the number of five- and six-year old children in each province. Furthermore, data should be available to classify these children as coming from poor or from non-poor families. Alternatively, the children could be divided into more than two household income categories.6

In principle, a “poverty weight” for ECD should reflect any additional resources that might be needed to prepare a child from a poor family for primary school relative to the resources needed to prepare a non-poor child. There may currently be no data available to provide a basis for determining this weight. In this respect, it would be necessary to work closely with education planners and to study existing ECD programmes.

Even if it is determined that there are no extra costs of providing Grade R programmes for poor children, there may be a good reason to consider allocating the ECD funds among provinces using a poverty-weighted count of eligible children.

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6 The measurement of income and of poverty is a complex issue. It is widely recognized that the census income measure tends to undercount total income. Statistics South Africa has proposed an alternative measure of income that is based on expenditure data. For the past two years, this expenditure-based measure of income and poverty is being used in the formulas that allocate the local government equitable share.
Private fees paid by families currently play an important role in the financing of ECD. It is to be expected that fees will continue to play a large role. If fees are used in financing the reception year, guaranteeing access to a reception year to all children will require larger subsidies for programmes (whether based in community centres or public schools) that serve primarily children from poor families. Provincial departments of education may consider allocating funds for Grade R programmes based on the number of eligible learners and on an assessment of the ability of parents to pay fees.

Assuming that a “poverty weight” can be determined, then the supplemental equitable share allocation for each province would be determined by multiplying the weighted number of age-eligible children with a figure representing an estimate of the national average ECD programme cost per child. The Department of Education’s White Paper on ECD proposes the goal of providing all children with ECD programmes by the year 2010. It will thus be important to include a phase-in parameter in any formula.

It is important that discussions of the funding of ECD be integrated into a larger discussion of education funding. In the Department of Education’s White Paper on Early Childhood Education, it is predicted that declining enrolment in primary and secondary schools over the next few years will allow for spending cuts for ordinary schools\(^7\). The White Paper suggests that the “fiscal space” created by reduced spending on primary and secondary education can be used to finance ECD.

However, there are problems with this claim. First, reduced enrolments do not automatically translate into budgetary savings. For example, assume that in a rural school enrolment drops by 4 learners at each grade level. The implication is that the learner-teacher ratios fall at each grade level. The decline in the learner-teacher ratio may be beneficial for the quality of education that can provided, but it will do very little to reduce spending. Each grade will still need a classroom and the number of teachers cannot be reduced. The costs will essentially be unaffected, but the falling enrolment would lead to a lower equitable share allocation.

Second, the quality of primary and secondary education is very low in many schools. In a self-assessment conducted in 1999, the Department of Education concluded that the education system was still characterised by inequality and that too many families received an unacceptably low standard of education delivery. The implication is that the fiscal needs of the education system are large and to a significant degree unmet. According to the 2000 School Register of Needs (SRN), there remain many schools in South Africa with large physical deficiencies. These include a lack of running water, toilet facilities, heating, and desks. Furthermore, although there have been improvements in these indicators of need over time, the SRN also reports a growing problem of school building deterioration and deferred maintenance. Data also indicate that many teachers are poorly trained, and

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\(^7\) See FFC, Submission on the Division of Revenue for 2003/04, April 2002.
improving the quality of education will require additional resources being devoted to teacher training.

Thus, unless government commits itself to an increase in the share of national revenue devoted to education, it is unlikely that expansions in ECD can be funded without reducing the quality of primary and secondary public education. Declining enrolment might, however, provide an opportunity to invest in improving the quality of primary and secondary education.

2.1.3 Incorporating Adult Basic Education and Training into the Education Component

Adult Basic Education and Training (ABET) refers to a large number of education and training activities and programmes. It includes programmes to combat adult illiteracy, provide basic mathematics training, provide adults with the equivalent of a secondary school education, and provide vocational training in a wide variety of occupations.

Many of the existing programmes provide substantial benefits to those directly receiving education and training, as well as providing benefits that extend beyond the individuals receiving training. By increasing the employability of individuals receiving ABET services, ABET programmes are likely to increase the well-being of families and reduce the need for public subsidies. Most public health experts agree that increased education is a very important ingredient in reducing the spread of HIV/AIDS. Finally, there is ample evidence that parental literacy plays an important role in increasing the educational performance of children.

The Bill of Rights provides that “everyone has the right to a basic education, including adult basic education” (Section 29 (1)(a). What is unclear from the Constitution is exactly what aspects of ABET activities should be identified as Constitutionally Mandated Basic Services (CMBS).

It can be argued that given the extremely high rate of unemployment among working-age South Africans, a high priority of the government should be to enhance the employability of the adult population. The target population for these basic education programmes might be those adults who are functionally illiterate or who lack numeracy skills. Data from the World Bank’s 2001 World Development Indicators database indicate that in 1999, 15% of South African adults (defined as age 15 or above) were illiterate.

Most ABET programmes in South Africa are provided in Adult Learning Centers (ALCs). These ALCs are either public or private, although irrespective of ownership, programmatic funding may come from a mixture of private and public sources. Although comprehensive national data are hard to come by, according to one
estimate these ALCs are currently serving about 200,000 individuals.

If government were to decide to expand the funding of education programmes for illiterate adults, it would be necessary first to identify which individuals would be eligible for these programmes. It might be possible to develop an estimate of the potential client base for adult literacy programmes by conducting a national sample survey in which questions of educational skills and literacy are addressed.

Designing a grant formula for ABET is further complicated by the fact that not every adult who is illiterate and innumerate may have an interest in participating in ABET programmes. Primary and secondary education is compulsory, so there is a direct link between those eligible for public education (by virtue of their age) and those actually receiving educational services. The same cannot be said for ABET. Providing an equitable share allocation based on the number of illiterate adults per province could be an inefficient use of resources if the demand for adult literacy programmes varied substantially across the provinces.

There are good conceptual reasons why basic adult education should be funded through the mechanism of conditional grants rather than through the equitable share. As indicated above, adult education programmes aimed at combating illiteracy and innumeracy have benefits that accrue not only to the individual participants in these programmes, but to their families and to the nation as a whole. As these education programmes are in their infancy in most provinces, it is appropriate for national government to establish a modest conditional grant programme designed to finance literacy programmes for adults living in areas with particularly high unemployment.

In the absence of data on the illiteracy rate by province, the allocation of the conditional grant among the provinces should be on a population basis, or alternatively on the basis of population weighted by poverty.

In light of the fact that the national Department of Education has yet to identify norms and standards on the funding of ABET programmes, government should proceed incrementally with respect to national funding of ABET programmes. Because there may be substantial start-up costs in developing literacy and other ABET programmes, government should commit to the funding of a modest grant programme for a period of about five years.

It is important that government take steps to see that these programmes are carefully evaluated. Particular emphasis should be given to the assessment of these programmes in terms of their success in reducing adult illiteracy. It will also be important to try to assess whether increases in adult literacy lead to reductions in unemployment and increases in earnings.
In allocating conditional grants to provincial departments of education, government should encourage maximum flexibility in the use of grant funds. ABET programmes, including programmes designed to combat adult illiteracy, can take place in publicly operated Adult Learning Centres as well as in centres operated by non-profit organisation and by for-profit enterprises.

Except in the case of extreme poverty, adult learners should be required to pay some sort of fee (or tuition) to participate in the programmes. Success of literacy and other adult education programmes depends on both the quality of the instruction and on the commitment to learning on the part of the adult learners. The payment of a fee is likely to provide an added incentive to adult learners to commit themselves to their educational programme. The ABET Act of 2000 envisions some form of fees to be paid by adult learners.

2.1.4 Financing Learner Support Materials in the Education Component

For a number of years, a major concern of those interested in primary and secondary education in South Africa has been the inadequacy of learner support materials (LSM) in many schools. LSM includes textbooks and other educational materials that are an important element in providing learners with an education. It appears that personnel expenditure tends to crowd out spending on LSM.

One response to this problem has been the requirement, articulated in the National Norms and Standards for School Funding (Government Gazette, October 1998), that provincial departments of education allocate funds to schools for LSM and other non-personnel expenditure using formulas that explicitly favour schools with concentrations of learners from poor households. The assumption is made that schools with learners from non-poor families will be more able to finance LSM through the use of private fees. Despite these allocation formulas, it appears that the funds available for the purchase of LSM in poor communities remain substantially below the level of funding in wealthier communities.

It has been suggested that funds for LSM be accommodated within the education component of the equitable share in response to the low level of funding for the purchase of LSM. It would not be desirable to include an explicit LSM factor in the equitable share formula. It is important that provincial departments of education retain considerable flexibility in how they choose to use their available funds, within the parameters of the norms and standards set by government.

Determining an appropriate response to the lack of LSM requires that data be collected on a per school basis on the availability and adequacy of learner support material. If these data show that in most schools there are inadequate resources devoted to LSM, then a strong argument could be made that more resources need
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to be devoted to primary and secondary education. These new resources will presumably come from an increase in the size of the educational component of the equitable share.

The problem of inadequate LSM resources may be occurring in only a few provinces. If this is the case, the solution may possibly lie in the inter-provincial allocation of the equitable share. Alternatively, the root of the problem may reside in the allocation choices made by provincial departments of education and/or by individual schools. In the latter case, the issuing of norms and standards concerning the minimum provision of LSM may be appropriate. In addition, provincial departments of education may have to take steps to enhance the administrative capacity of schools that are providing inadequate learner support materials to their learners.

At present there is inadequate information on the availability of LSM in individual schools, and very little knowledge of the causes of LSM shortages. Further study and data analysis are required before firm recommendations can be made.

2.1.5 The Identification of Education Performance Indicators

The ultimate test of any school funding system is how well public schools educate the nation’s children. Student performance can be measured in various ways, although throughout the world the most common measures used are performance on standardised tests given to learners at various grade levels or at the completion of secondary school. In South Africa, the only measure of student performance that is currently available for learners in all provinces is the pass rate on the matriculation exam.

Unfortunately, a comparison of matriculation pass rates across provinces does not provide a valid measure of the performance of the public education system within each province. First, to evaluate how well schools are doing in educating children, it is important to test learners in multiple years so that one can calculate the value added by the schools. Second, there are two versions of each examination, “standard grade” and “higher grade”. Without knowing the pass rates and number of learners taking each version of the exam, comparisons are difficult.

Third, although learners are required to pass exams in six or more subjects, the overall pass rates do not reflect differences in the difficulty of the mix of exams actually taken. Fourth, until 2001, learners in different provinces often took different versions of the same exam. Finally, taking the exam is optional and some learners who are unlikely to pass may be discouraged from taking the exams or prevented from retaking them.
The Department of Education is aware of the shortcomings of the matriculation exams as a foundation on which to base an assessment of student progress. Efforts have begun to implement a system of standardised examinations in grades 3, 6, and 9. The exam results have the potential to provide a valuable tool to assess the quality of public schools in South Africa, and to allow, for the first time, an analysis of the importance of various factors in determining the costs of providing a basic education.

A substantial amount of data is available at a provincial level on various educational inputs such as class size, teacher qualifications, and per learner spending. However, relatively little is known about the distribution of educational resources within provinces. In order to assess the progress in reducing funding inequalities among learners characterised by race and by economic circumstance, data will need to be collected on a school-level basis.

The primary objective of the equitable share is to provide provinces with adequate resources to fulfil their constitutionally mandated obligations. An integral part of assessing the intergovernmental fiscal system in South Africa is the careful monitoring of the effectiveness of provincial and local government public institutions, including schools, in the delivery of basic public services. The results of these evaluations will help assess the success or failure of any equitable share formula in achieving its primary goal of assuring the provision of basic services for all South Africans.

2.1.6 Proposals: Education Component of the Provincial Equitable Share

The Financial and Fiscal Commission:

- Proposes that the formula used to allocate the education component of the equitable share be revised to end the double weighting of “school age” children. The double-weighting penalises poorer provinces with the largest number of “out of age” learners.

- Reiterates its proposal that the formula used to allocate the education component of the provincial equitable share formula be adjusted to incorporate the reception year (Grade R). In addition, the provincial allocation of funds should be based on a poverty-weighted count of the number of children aged five and six in each province.

- Recommends that government establish a conditional grant programme for the financing of education programmes for increasing/improving adult literacy and numeracy.
2.2 The Health Care Component of the Provincial Equitable Share Formula

2.2.1 Introduction

According to the Intergovernmental Fiscal Review 2001, the health care component of the provincial equitable share formula is intended to address the need for provinces to deliver primary and secondary health services. Provinces also deliver tertiary services, which are mainly addressed through the conditional grant mechanism. In its submission on the Division of Revenue 2003/04, the FFC indicated the need for government to clearly define the package of services that constitute the basic services that provinces need to deliver. The FFC also noted that there were efforts under way in government to address the issue of basic service provision. This section focuses on the health care component of the provincial equitable share formula as currently applied by National Treasury.

The current health care component of the equitable share formula assumes that people without medical aid are more likely to use public health facilities, and are therefore weighted four times higher than those with medical aid support. However no distinction is made between the potential uses of primary versus hospital services. The health component of the overall equitable share allocation has remained constant at 19 percent. This weighting is intended to be broadly in line with expenditure patterns, which provides an indication of "relative need".

Table 8 Treasury weighting of the Health Component of the Equitable Share Formula for the Fiscal Years 1999/00 - 2002/03

<table>
<thead>
<tr>
<th>Province</th>
<th>With medical aid</th>
<th>Without medical aid</th>
<th>Weighted share %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>Eastern Cape</td>
<td>510</td>
<td>5,793</td>
<td>17.0%</td>
</tr>
<tr>
<td>Free State</td>
<td>467</td>
<td>2,166</td>
<td>6.5%</td>
</tr>
<tr>
<td>Gauteng</td>
<td>2,958</td>
<td>4,390</td>
<td>14.7%</td>
</tr>
<tr>
<td>KwaZulu-Natal</td>
<td>1,103</td>
<td>7,314</td>
<td>21.7%</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>392</td>
<td>2,409</td>
<td>7.2%</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>175</td>
<td>665</td>
<td>2.0%</td>
</tr>
<tr>
<td>Limpopo</td>
<td>376</td>
<td>4,554</td>
<td>2.0%</td>
</tr>
<tr>
<td>North West</td>
<td>457</td>
<td>2,897</td>
<td>13.3%</td>
</tr>
<tr>
<td>Western cape</td>
<td>1,127</td>
<td>2,830</td>
<td>8.6%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>7,565</strong></td>
<td><strong>33,018</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>
2.2.2 Base Population

The approach to weighting the health component, including the weighted shares, has remained the same from 1999/00 to 2002/03. The Treasury formula makes use of the Census 1996 division of the population without adjustment. No account is taken of population growth by province, age, or gender through time, and how this may reflect the public sector user population and health care need relative to the medical scheme population.

Table 9 provides the provincial population growth rates based on the ASSA 2000 population model. These suggest distinctly different population changes through time. These estimates are generated by age and gender, and include births, mortality, and the effect of AIDS. The estimates show higher than average growth rates for provinces such as Gauteng, KwaZulu-Natal, and Western Cape.

Table 9 Population Growth Rates by Province from 1997 to 2004

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Cape</td>
<td>2.08%</td>
<td>1.97%</td>
<td>1.93%</td>
<td>1.85%</td>
<td>1.77%</td>
<td>1.66%</td>
<td>1.52%</td>
<td>1.52%</td>
</tr>
<tr>
<td>Free State</td>
<td>1.35%</td>
<td>1.34%</td>
<td>1.26%</td>
<td>1.14%</td>
<td>1.00%</td>
<td>0.81%</td>
<td>0.60%</td>
<td>0.36%</td>
</tr>
<tr>
<td>Gauteng</td>
<td>4.39%</td>
<td>3.59%</td>
<td>2.90%</td>
<td>2.33%</td>
<td>1.85%</td>
<td>1.40%</td>
<td>0.99%</td>
<td>0.60%</td>
</tr>
<tr>
<td>KwaZulu-Natal</td>
<td>2.16%</td>
<td>2.03%</td>
<td>1.88%</td>
<td>1.70%</td>
<td>1.49%</td>
<td>1.24%</td>
<td>0.97%</td>
<td>0.69%</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>1.93%</td>
<td>1.80%</td>
<td>1.68%</td>
<td>1.53%</td>
<td>1.34%</td>
<td>1.14%</td>
<td>0.92%</td>
<td>0.69%</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>3.22%</td>
<td>2.92%</td>
<td>2.64%</td>
<td>2.39%</td>
<td>2.16%</td>
<td>1.94%</td>
<td>1.72%</td>
<td>1.51%</td>
</tr>
<tr>
<td>Limpopo</td>
<td>1.58%</td>
<td>1.59%</td>
<td>1.65%</td>
<td>1.67%</td>
<td>1.67%</td>
<td>1.62%</td>
<td>1.53%</td>
<td>1.43%</td>
</tr>
<tr>
<td>North West</td>
<td>2.42%</td>
<td>2.23%</td>
<td>2.02%</td>
<td>1.81%</td>
<td>1.59%</td>
<td>1.35%</td>
<td>1.10%</td>
<td>0.84%</td>
</tr>
<tr>
<td>Western Cape</td>
<td>2.85%</td>
<td>2.56%</td>
<td>2.26%</td>
<td>2.02%</td>
<td>1.80%</td>
<td>1.61%</td>
<td>1.43%</td>
<td>1.26%</td>
</tr>
<tr>
<td>Total</td>
<td>2.53%</td>
<td>2.29%</td>
<td>2.07%</td>
<td>1.85%</td>
<td>1.63%</td>
<td>1.41%</td>
<td>1.17%</td>
<td>0.93%</td>
</tr>
</tbody>
</table>

Source: Actuarial Society of South Africa, Provincial Population Estimates based on the ASSA 2000 population model

It is possible that the provincial growth rates may underestimate the growth from urbanisation expected for regions such as Gauteng and Western Cape. This will only be verified with the latest census and further surveys.

There are material discrepancies between the estimates arising from the ASSA 2000 model and those provided by Statistics South Africa (StatsSA). These are compared in Table 10, which shows estimates with and without the impact of HIV/AIDS for StatsSA. Relatively important differences occur in Free State, Mpumalanga, Northern Cape, and Limpopo.
Table 10 Population growth rates, by gender, inferred from the projected population, 1996-2001, by Stats SA, compared to the 2001 inferred overall growth rate from the ASSA 2000 model

<table>
<thead>
<tr>
<th>Province</th>
<th>Male (Stats SA)</th>
<th>Female (Stats SA)</th>
<th>Overall 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Cape</td>
<td>2.32%</td>
<td>2.01%</td>
<td>2.39%</td>
</tr>
<tr>
<td>Free State</td>
<td>1.39%</td>
<td>1.46%</td>
<td>1.50%</td>
</tr>
<tr>
<td>Gauteng</td>
<td>1.57%</td>
<td>1.85%</td>
<td>1.69%</td>
</tr>
<tr>
<td>KwaZulu-Natal</td>
<td>1.60%</td>
<td>1.57%</td>
<td>1.76%</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>2.08%</td>
<td>2.08%</td>
<td>2.21%</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>0.85%</td>
<td>1.08%</td>
<td>0.90%</td>
</tr>
<tr>
<td>Limpopo</td>
<td>3.29%</td>
<td>2.69%</td>
<td>3.34%</td>
</tr>
<tr>
<td>North West</td>
<td>1.49%</td>
<td>1.55%</td>
<td>1.60%</td>
</tr>
<tr>
<td>Western Cape</td>
<td>1.42%</td>
<td>1.59%</td>
<td>1.41%</td>
</tr>
<tr>
<td>Total</td>
<td>Not Provided</td>
<td>Not Provided</td>
<td>1.98%</td>
</tr>
</tbody>
</table>

Source: Stats SA, 2 July 2002, Table E, and ASSA 2000 population model.

There are also material discrepancies between the population estimates (including HIV/AIDS) for 2001. Overall the ASSA 2000 estimates are 1.6 million higher than Stats SA (a 3.6% difference). The most important variances occur in Gauteng (-12.1%) and Northern Cape (-10.9%).

Given the importance of the base population in the determination of resource allocation, such large discrepancies need to be examined.

2.2.3 Age and Gender Weights

The current formula does not take account of population growth by province, age, and gender through time, and how this might reflect the public sector user population and health care need relative to the rather unchanging medical scheme population.

Taking account of gender and age is supported within a South African context in Doherty et al:

“…whereas the underlying size of the population is the starting point in constructing a needs-based formula, accounting for variations in utilisation due to age and sex differences is the most important part of weighting per capita estimates for relative need. For example, relative to other age and sex categories, there tend to be higher utilisation rates for children aged 0-4, women of child-bearing age (that is from the ages of 15 to 44) and especially the aged. Provinces which have relatively higher proportions of these vulnerable groups should receive more resources.”

Age and gender tends to vary in a fairly consistent manner with health service use.
2.2.4 Medical Scheme Population

The National Treasury formula makes use of the 1996 October Household Survey (OHS) upon which to base its estimate of the medical aid population. This has not varied since 1998/99 despite several further Surveys. This raises a number of concerns in relation to reported data on medical scheme membership and later OHS surveys.

The total number of people on a medical scheme is taken at 7.5 million for the Treasury formula. The OHS for 1998 indicates 5.9 million, with some distinct provincial differences.

The Council for Medical Schemes puts the total medical scheme population at 6,698,662 for 2002. At no stage has the number of medical scheme beneficiaries, including exempted schemes, ever significantly exceeded 7 million (see Figure 1).

Figure 1 Medical Scheme Beneficiaries from 1988 to 2001

Source: Council for Medical Schemes, the data is based on the annual returns submitted to the Council by both registered and exempted schemes for the period 1988 to 2001.

The cover offered by medical schemes is incomplete, and a degree of reliance is still placed on the public sector when benefit limits are exceeded for hospitalisation. This utilisation is difficult to pick up due to poor public sector billing of medical schemes.
Part B

The relative weighting between provinces differs between the 1996 OHS and later ones. Figure 2 shows that a dramatic variation occurs for Gauteng between the 1996 OHS and the 1998 OHS. Lesser variations occur for other provinces. This may occur because of an anomalous year, the small sample size, or differences in the questionnaires. In any case, the continued use of the 1996 OHS to weight the medical scheme populations is questionable when more up-to-date information is available.

**Figure 2: Census Population Adjusted for Medical Scheme Population (OHS98) Compared to Treasury Formula (OHS 96)**


A further concern with the weighing criteria used in the formula involves the use of the 1:4 ratio of public to private sector populations. This ratio allows for the potential use of public sector services by the private sector. However, recent changes to the Medical Schemes Act ensure that all use of public hospital services must be fully funded by medical schemes (Section 29(3)(p) of the Medical Schemes Act No.131 of 1998). Thus, although there might be use of the public sector by members of medical schemes, provincial governments are entitled to claim full compensation. Consideration therefore needs to be given to removing this element from the formula.

The age and gender variations between the population served by the public sector and those covered by medical schemes is quite different (see Figure 3 for the difference by age only). The medical scheme population has a greater proportion of older people than the public sector population. This structural difference is also likely to vary by province. Consideration therefore needs to be given to differentiating between the public and private sector populations by age and gender to account for
the likely differences in service needs.

Figure 3 Age structures compared for the populations served by the public sector and medical schemes (estimated 2002)


2.2.5 Conclusions

There appear to be significant problems with the criteria used to weight the equitable share formula for health. This involves the population weighting elements and the fixed shares.

2.2.6 Proposals: Health Care Component

The Financial and Fiscal Commission:

- Recommends that provincial population growth rates be incorporated into the health care component of the provincial equitable share formula.

- Recommends that the age and gender variation in the population be taken into account in determining the relative need for health services. An acceptable index should be constructed making use of international and domestic data.

- Proposes that the data used for the medical scheme population be
based annually on the best available estimate, which could entail combining the latest October Household Survey information, averaged for a reasonable number of years. The current weighting applied by National Treasury of total to medical scheme populations needs to be reviewed.

2.3 The Social Development Component of the Provincial Equitable Share Formula

2.3.1 Introduction

This section addresses issues surrounding the social development component of the Provincial Equitable Share (PES). It takes account of the proposals put forth by the FFC in 2000, especially the proposal for adopting a costed norms approach and government's response to them.

Social development constitutes a unique element in the PES. Among basic social service programmes, it is arguably the one that is of prior importance, a point of view that Report of the Committee of Inquiry into a Comprehensive System of Social Security for South Africa (Taylor Report) has stressed. It differs significantly from education and health in three main respects. First, a high proportion of expenditures are transfers rather than expenditures on goods and services. Second, the transfers are subject to eligibility conditions and are means-tested, and a major administrative role of the provinces is in applying the relevant criteria to the determination of grants. Finally, the rate of take-up of grants among eligible recipients is a matter of on-going change, and is critical for the progressive realisation of Constitutional mandates. Not only do eligibility rates differ across provinces, but also take-up rates, which constitute an important consideration in evaluating the PES formula.

2.3.2 Problems with the Current Formula

The vertical division of revenue determines the total amount of money available for the Provincial Equitable Share. The PES is then allocated to the seven components according to given weights, where the weights are meant to be more or less in line with the composition of aggregate provincial expenditures. Thus, social development has a weight of 18%, compared with its share of average expenditure across all provinces (excluding that financed by conditional grants) of just over 20%.

Within the social development category, the shares accruing to the provinces are determined by both demographic and income distribution factors. Thus, three-quarters is allocated according to provinces’ eligible populations for old-age pensions, disability grants, and child-care grants. The weights given to each of
these three categories is roughly based on the expenditure shares of provinces in the aggregate on these three types of grants. One-quarter of the allocation is based on provincial shares of the population in the two lowest quintiles of the population distribution. This is intended to reflect the fact that grants are means-tested.

The PES formula has the merit of simplicity and relative ease of calculation. That is partly because shares are first allocated vertically, then the provincial share is allocated among categories, and then each category is broken down into sub-categories, and finally sub-categories are allocated among provinces using basic demographic and economic indicators. There are a number of problems with this procedure. Those applying to the welfare component include the following.

- **Allocations to categories.** The overall allocation to the seven categories is done on an aggregate provincial basis. The intention is that the allocations should roughly correspond with provincial expenditure shares. The problem is that provinces presumably have differing proportions of expenditure shares among these same categories (something that could be documented). As a result, it will be unlikely that the allocations that are ultimately made to the provinces will correspond with needs.

- **Allocations to sub-categories.** A similar problem arises with respect to the allocation of the social development component among its sub-components — the three-quarter share based on the three broad demographic groups and the remainder based on income distribution statistics. The weights of the demographic categories are based on aggregate provincial expenditure shares, and these weights may also vary considerably across provinces. It should also be noted that the income distribution component serves double duty. It captures the fact that grant amounts are responsive to incomes because of means testing, and also that the need for welfare services increases with poverty.

- **Number of grant categories.** The demographic categories are limited to three categories, whereas there are twice that many significant types of grants. This leads to possible aggregation problems to the extent that different grant types are of differing degrees of importance to different provinces.

- **Take-up rates.** The data used for the eligible populations in the three demographic categories do not fully reflect take-up rates. To the extent that take-up rates differ among provinces and programmes, the provincial shares will differ from their relative needs. The influence of provincial welfare administrators on take-up rates is,
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along with means testing, the most important source of discretion they have.

- **Means testing.** All major social security transfers are means-tested, but this is not carefully reflected in the formula. Rather crude income distribution statistics are meant to capture the extent to which means testing is potentially necessary. It does not reflect the extent to which means testing is actually applied, which differs among provinces and categories of grants.

- **Incentive effects.** The issue of incentive effects is always an important one in the design of needs-based equalisation grants. There are two relevant dimensions to this.

  - The first is the desire to avoid giving provinces the opportunity to manipulate their transfers by changing their expenditure patterns. This is the motivation for using province-wide expenditure aggregates rather than province-specific ones. Unfortunately, as mentioned above, this procedure is not suitable for properly associating transfers with needs.

  - The second involves the desire, as part of the progressive realisation of constitutional mandates, to ensure that provinces efficiently pursue both eligibility (take-up) and means testing. The current formula is neutral with respect to both take-up and means testing. If a province increases its take-up rate, its allocation does not go up, while if it pursues means testing more vigorously, its allocation does not go down. A major issue is whether the grant ought to be responsive to a province’s take-up rate and/or its means testing. On the one hand, if grants are responsive to either, this will give provinces an incentive to react, which can be a good or bad thing: good if it encourages take-up; bad if it discourages means testing. Moreover, in the absence of an incentive, provinces may be reluctant to increase the take-up because that will mean diverting its fixed financial resources from other programmes. On the other hand, if grants are responsive to take-up or means testing, provinces may engage excessively in them.

While the PES formula has some good properties—it takes account of demographic and economic factors that account for need for welfare spending, it is not prone to provincial manipulation, and, to the extent that it is desirable, it is neutral with respect to administrative incentives—its design only very crudely associates transfer...
amounts to actual need. It is possible that these differences wash out in the process of aggregation. It may be useful to compare the allocation of social grants (and those for other basic social services) under the current PES formula with those that would occur under the FFC costed norms approach, taking either the vertical split or the total amount allocated to basic social services as given.

The issue of the incentive effects of PES welfare transfers on provincial take-up rates and means testing is an important one and goes to the heart of the issue of decentralisation. However, the issue differs with respect to the two dimensions. In the case of take-up rates, the progressive realisation of constitutionally mandated levels of basic social services would suggest that take-up rates be gradually improved until virtually all of the target population is covered. That will be less than 100% because of the constant flux in the eligible population. Those in the eligible demographic classes will change because of aging, deaths, migration, changes in family circumstances, and so on. They will also change due to changes in means because of income and dependency. For these reasons, as long as grants are targeted by need and means, provinces will need some discretion.

The question is whether some positive incentive is required for grant programmes whose take-up rates are still much too low and vary considerably across provinces. To the extent that there are reasons beyond the control of provinces for take-up rates to vary significantly among them, province-specific target rates could be set for various grants, and these could be used in the PES formula. These could be included in nationally set norms and standards along with the grant amounts. The danger is that the provinces may be able to manipulate these target rates by their own behaviour.

With respect to means testing, the issue is quite different. Here the deviations by provinces seem to be in the direction of applying means testing too leniently rather than too vigorously. That is, provinces allow certain grants to be more generous than those set by national standards. It can be argued that provinces should be able to err in this direction. This would be the case if one thought of the national norms and standards as being minimum ones that provinces must meet. As long as they meet those standards, they might be free to supplement them out of their own revenues if they so desire. The basic principles of decentralisation would support this argument. The main problem with it in the South African context is that provinces are constrained in their abilities to exceed minimum national norms and standards by their fixed budgets. This constitutes an argument for raising the proportion of revenues that provinces raise from their own taxation sources.

2.3.3 Building on the Costed Norms Approach

The costed norms approach was designed specifically to address the problems of aggregation mentioned above. In the case of welfare, several features of the approach should be noted. First, the social development component of the PES is
calculated by a “bottom-up” needs-based approach. The eligible populations for each of the six major grants are weighted by a province-specific grant amount as well as by a national-average take-up rate. Means-testing norms are based on income distribution statistics and incorporated into the province-specific grant amounts, which is why they vary across provinces. There is also a mark-up applied to all entitlements reflecting administrative costs.

Second, the costs of providing welfare services are incorporated into a consolidated basic grant. This is not costed as in the social development component. Instead the allocation takes account of need indirectly by weighting population shares by a poverty index reflecting the proportion of each province’s population that falls below some minimum income level. The FFC proposed that initially the weighting be relatively low.

Third, infrastructure backlogs would be removed from the PES formula, and a new conditional grant would be set up to deal with social infrastructure backlogs. While the social infrastructure grant is meant to address backlogs, once the backlogs are cleared up, capital spending could be folded into the PES either as part of the costed norms for basic social services or as a presumed element of the basic component. Once the necessary infrastructure is in place, there is no reason why provinces should not have discretion over their own future operating, maintenance, and replacement costs.

2.3.4 Other Issues

The Report of the Committee of Inquiry into a Comprehensive System of Social Security for South Africa (Taylor Report) is a proposal for a national system of social security, with almost no attention being devoted to the role of the provinces. In fact, if the proposals were adopted, the provinces would have little discretion. To the extent that they were involved, it would be mainly as administrators of national programmes.

In the case of social development, changes to current programmes would be profound. Most means-tested transfers would be subsumed into a new universal basic income grant that would not be means-tested, but would be subject to tax-back, presumably in the income tax system. Relatively few details are given of the rate of tax-back, or of the mechanism by which payment of the grant would occur, whether as a demo-grant up-front or a refundable tax credit. In either case, the role of the provinces would be minimal. It would be counterproductive to use the provinces to deliver grants if they had no discretion over eligibility and grant amounts. Provincial participation in the social development area would be limited mainly to the provision of welfare services, which is a small proportion of their current responsibilities.
The proposal for the basic income grant is largely motivated by two considerations. The first is that the coverage of the existing grant system is narrow. It misses most poor adults, whether working or not, as well as children of school age. Second, it avoids means testing, which is taken to be stigmatizing and as such discourages take-up.

The counter-arguments are twofold. One is that universality makes the grant very expensive unless income tax-back rates are very high, in which case incentives to earn income are considerably blunted. The second is that income is not the sole criterion of need. For example, employability or demographic circumstances might be as important. For these reasons, in most countries there is a combination of needs-related grants and income-tested grants. The latter tend not to be distributed as a demo-grant and then taxed back, especially since this carries administrative costs. Rather they tend to be delivered as refundable tax credits. There seems no reason for these not to be a national responsibility. Needs-related grants, along with complementary welfare services, remain in place for dealing with certain segments of the population, especially the long-term unemployed, the disabled, and children in disadvantaged situations. Moreover, in multi-jurisdictional settings, it is typically lower-level jurisdictions that are given responsibility.

Given the importance and the far-reaching nature of the Taylor Report proposals and their profound implications for provinces, the FFC will devote considerable attention to them. The impact of adopting the proposals would be to change the structure of the partnership between spheres of government in pursuing constitutionally mandated basic social services. As such, it is very germane to the FFC’s advisory mandate.

### 2.3.5 Proposals: Social Development Component

The Financial and Fiscal Commission proposes that:

- That populations of grant recipients in the current system should more closely reflect the actual take-up of the three grants in the provinces;
- That the overall allocation to welfare in the current system be revised to reflect more accurately the share of aggregate provincial spending on social development;
- That the allocation to welfare in the PES distinguish between social security grants and welfare services, and assigns amounts to each. The allocation for welfare services could be based on an indicator such as the proportion of the population below a poverty level; and
• That consideration be given to the ways in which the existing top-down methodology for allocating the social development share among provinces can be revised so that it more closely reflects the relative needs of the provinces.

### 2.4 The Overall Provincial Equitable Share Formula

The current formula fixes the weights by component (fixed share component). Although these weights intentionally reflect historical levels of expenditure, the proportions deviate materially from the fixed shares over time. In 1999/00 overall provincial health expenditure, less conditional grants, amounted to 18.9% of the overall allocation compared to 19% as used in the formula. By 2002/03 this had declined to 18.0%. By the end of the MTEF period (2004/05) actual expenditure declines to 17.9%.

The fixed share component defined as “other” in Table 11 (that is, it excludes education, health and social security) also varies from the actual expenditure trend. The combined basic share, backlog, economic output and institutional components grow from 22.3% in 1989/99 to 24.4% by 2004/05, compared to 22.0% for the combined fixed share for these components.

Social security expenditure varies quite dramatically from the 18.0 percent in the fixed share. It grows from 19.0% in 1998/99 to 21.4 percent in 2004/05. Education expenditure shows a significant decline relative to the fixed share of 41 percent, moving from 39.8% in 1998/99 to 36.4 percent by 2004/05.

### Table 11 Actual allocations, excluding conditional grants, expressed as a percentage of the total provincial allocation and the MTEF compared to the percentage weighting used in the equitable share formula (1998/99-2004/05)

<table>
<thead>
<tr>
<th>Components</th>
<th>Percentage share</th>
<th>1998/99</th>
<th>1999/00</th>
<th>2000/01</th>
<th>2001/02</th>
<th>2002/03</th>
<th>2003/04</th>
<th>2004/05</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>41%</td>
<td>39.8%</td>
<td>39.6%</td>
<td>38.9%</td>
<td>38.0%</td>
<td>37.0%</td>
<td>36.5%</td>
<td>36.4%</td>
</tr>
<tr>
<td>Health</td>
<td>19%</td>
<td>18.9%</td>
<td>18.8%</td>
<td>18.5%</td>
<td>19.3%</td>
<td>18.0%</td>
<td>17.9%</td>
<td>17.9%</td>
</tr>
<tr>
<td>Social security</td>
<td>18%</td>
<td>19.0%</td>
<td>19.3%</td>
<td>18.9%</td>
<td>17.8%</td>
<td>20.5%</td>
<td>21.1%</td>
<td>21.4%</td>
</tr>
<tr>
<td>Basic Share</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
</tr>
<tr>
<td>Backlog component</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
<td>3%</td>
</tr>
<tr>
<td>Economic output</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
<td>7%</td>
</tr>
<tr>
<td>Institutional</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
<td>5%</td>
</tr>
<tr>
<td>Other</td>
<td>22%</td>
<td>22.3%</td>
<td>22.3%</td>
<td>23.7%</td>
<td>24.9%</td>
<td>24.5%</td>
<td>24.5%</td>
<td>24.4%</td>
</tr>
<tr>
<td>Total</td>
<td>100%</td>
<td>78%</td>
<td>78%</td>
<td>76%</td>
<td>75%</td>
<td>76%</td>
<td>76%</td>
<td>76%</td>
</tr>
</tbody>
</table>

Source: Compiled from the Medium-term Budget Policy Statements by Province.
The underlying weights used to determine the equitable share portions vary from the national and provincial policy on social spending. Funding levels are consequently not correlated with service demand and need. These trends suggest that the policy and purpose underpinning the fixed shares needs to be revisited.

### 2.4.1 Crowding Out

At least one of the social expenditure components is directly linked to demand, namely that of social security. Expenditure is increasing significantly relative to the fixed share. The formula for weighting the division of social security spending between provinces correlates poorly with actual demand, resulting in relative over- and under-allocations to provinces in respect of this component.

When this occurs, provincial spending on other social services faces the risk of being crowded out. Both health and education expenditure are declining as a percentage of the total allocation relative to social security and “other”. This strongly suggests that both health and education are effectively receiving a lower priority over time. It is however not clear that this is the intention of national policy. Instead the shift in priority appears to be the consequence of the fear of litigation and an incremental trend occurring largely as a consequence of budget structure rather than policy design.

According to the Intergovernmental Fiscal Review 2001 (page B14),

“[Data] from the Department of Welfare on actual expenditure by grant type indicate that the current weightings are still appropriate. Nevertheless, these weights do not make explicit provision for the child support grant, although the vertical division of revenue takes this into account.”

The evidence does not support this view, however. Table 12 compares the Treasury formula outcome with actual expenditure for social security for the years 2000/01 and 2001/02. Overall actual expenditure on social security grants exceeded the formula outcome by 2.5 billion in 2000/01 and 2.3 billion in 2001/02. Very substantial discrepancies occur by province, with Eastern Cape receiving R585 million less than actual expenditure in 2000/01 and R785 million less than actual expenditure in 2001/02. KwaZulu-Natal is under-compensated by the formula by R827 million in 2000/01 and R701 million in 2001/02. Only Gauteng and Free State received more than was required to fund actual expenditure. Furthermore, in 2001/02 the formula distributes R18 billion instead of R20.4 billion.
Table 12 Formula Outcome Compared to Actual Expenditure Outcomes for Social Security (2000/01 to 2001/02) (R'000)

<table>
<thead>
<tr>
<th>Province</th>
<th>Formula 2000/01</th>
<th>Expenditure 2000/01</th>
<th>Difference</th>
<th>Formula 2001/02</th>
<th>Expenditure 2001/02</th>
<th>Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Cape</td>
<td>3,239,201</td>
<td>3,824,225</td>
<td>-585,024</td>
<td>3,537,789</td>
<td>4,322,215</td>
<td>-784,526</td>
</tr>
<tr>
<td>Free State</td>
<td>1,176,385</td>
<td>1,091,358</td>
<td>85,027</td>
<td>1,128,824</td>
<td>1,202,751</td>
<td>82,073</td>
</tr>
<tr>
<td>KwaZulu-Natal</td>
<td>3,247,485</td>
<td>4,074,655</td>
<td>-827,170</td>
<td>3,546,837</td>
<td>4,248,096</td>
<td>-701,259</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>1,076,972</td>
<td>1,243,995</td>
<td>-167,023</td>
<td>1,176,247</td>
<td>1,448,029</td>
<td>-271,782</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>364,514</td>
<td>589,085</td>
<td>-224,571</td>
<td>398,114</td>
<td>582,960</td>
<td>-184,846</td>
</tr>
<tr>
<td>Limpopo</td>
<td>2,269,926</td>
<td>2,544,731</td>
<td>-274,805</td>
<td>2,479,167</td>
<td>2,605,042</td>
<td>-125,885</td>
</tr>
<tr>
<td>North West</td>
<td>1,441,486</td>
<td>1,693,081</td>
<td>-251,595</td>
<td>1,574,362</td>
<td>1,799,042</td>
<td>-224,680</td>
</tr>
<tr>
<td>Western Cape</td>
<td>1,458,054</td>
<td>1,810,241</td>
<td>-352,187</td>
<td>1,592,458</td>
<td>1,920,132</td>
<td>-327,674</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>16,568,801</strong></td>
<td><strong>19,045,562</strong></td>
<td><strong>-2,476,761</strong></td>
<td><strong>18,096,109</strong></td>
<td><strong>20,434,808</strong></td>
<td><strong>-2,338,699</strong></td>
</tr>
</tbody>
</table>

Source: For Social Security Expenditure: Division of Revenue Bill 2002, Appendix III, Table 1.c.2, for formula outcomes – FFC estimate.

Social security expenditure is rising to such an extent that it is crowding out budgets and expenditure for other constitutionally mandated basic social services.

This problem was given some recognition in the budget allocation for 2002/03, where in the Budget Review 2002 it is stated that based on

“social service spending trends reported in the 2001 Intergovernmental Fiscal Review, the weight for the welfare component is increased by one percentage point and the weight for the economic component decreased by one percentage point. This adjustment does little to deal with the problems arising.”

The increase in social security expenditure represents the full funding of a national mandate with no provincial discretion. However, no adjustment occurs to the overall allocation to provincial government to reflect this changing mandate. Other social service expenditures are therefore a residual allocation after the full funding of social security.

Social security grants are therefore incorrectly specified in the equitable share formula. Far from resulting in trivial variations from actual expenditure, these differ considerably from what the results of the National Treasury formula suggest these allocations should be. This strongly suggests that social security grants need to be treated differently within the budget allocation process. Not to do so will result in the arbitrary crowding out of other social sector budgets.
2.4.2 Proposals: Overall equitable share formula

The Financial and Fiscal Commission:

- Proposes that the shares of the different components in the formula should ultimately be determined according to explicit policy guidelines based on minimum norms and standards; and

- Reiterates its proposal that Social Security grants be budgeted for and funded from a national level so as to avoid the crowding out of the other provincial service delivery mandates.
Chapter 3

Local Government

3.1 The Funding of Institutional Capacity

3.1.1 Introduction

The Constitution requires that all municipalities provide services to their residents. However the ability of municipalities to carry out their responsibilities varies tremendously owing to the historically uneven development of South Africa. Generally, urban municipalities that served white residents of South Africa during the apartheid era have an established governmental infrastructure that allows them to provide a wide array of public services. On the other hand, municipalities serving primarily non-white residents are often located in areas that have had limited delivery of basic services.

Although one of the goals of the demarcation process was to reduce the tremendous disparities between municipalities by combining urban and rural jurisdictions into single units, large differences in the capacity to provide services continue to exist.
3.1.2 Reasons for Poor Service Delivery

There are two main reasons why municipalities differ in their ability to deliver basic municipal services:

- The lack of an economic base to provide income to finance the delivery of services; and
- The lack of administrative capacity to implement the collection of revenue and the provision of public services.

Understanding these impediments to the effective delivery of public services is a prerequisite for developing a strategy to overcome them.

Lack of an economic base

South Africa contains a number of areas, both rural and urban, that are extremely poor. Not only is the income of residents of these areas very low, but also these areas tend to have very little in the way of economic activity. In many cases, these areas have few natural resources and are spatially removed from regions of the country where economic activity is concentrated. Many residents are barely surviving at subsistence levels.

Economic development, especially in areas of concentrated poverty, will at best be a slow process. In the short and medium term, the provision of basic services will need to be financed almost entirely through the local government equitable share or national funding programmes. Even complete funding through intergovernmental grants would not guarantee service delivery unless the municipality has the basic administrative capacity to deliver basic services.

Lack of administrative capacity

The second impediment to the provision of basic municipal services is the lack of the administrative capacity both to generate municipal revenue and deliver public services.

The establishment of new tax and revenue instruments is a difficult, complex, and expensive task. Establishing a working property tax system in locations where no previous system ever existed is a particularly difficult task, one that will undoubtedly take a number of years and will require both technical and financial assistance from national and provincial government.

Government is taking explicit steps to increase the administrative capacity of municipalities. Project Viability and other efforts of the Department of Provincial and Local Government are aimed at enhancing the administrative capability of municipalities. In the current financial year, several hundred million rands are being
allocated to municipalities for the purpose of institutional capacity building.

Institutional capacity has many dimensions. In part it involves hiring and training municipal employees to conduct various tasks necessary to collect revenue and provide services. It also involves the establishment of various computer, financial control, and accounting systems.

More than a skilled workforce and modern technology are required. Municipalities that can effectively administer a revenue system and deliver services must be capable of solving a great many problems and responding to a frequently changing environment. For example, developing a strategy to improve property tax collection requires that a municipality have a skilled and imaginative leadership.

Infusions of money may be a necessary requirement for enhancing municipal government capacity, but the process of increasing capacity will be incremental. Skills will have to be learned, and experiments with various policies will have to take place. Institutional capacity is something that will take time - measured in years - to develop.

3.1.3 Developing a Strategy for Institutional Capacity Building

The above discussion suggests that while many municipalities need to undertake institutional capacity building, the exact type of capacity building that is needed in each municipality will depend on its stage of development. Thus, the poorest, most spatially isolated, and least developed municipalities will require both substantial financial assistance and considerable technical assistance as a prerequisite for building basic institutional capacity. In these communities, the focus of institutional capacity building should be on developing general governance skills and developing the capacity to deliver basic municipal services.

In municipalities that have some potential revenue-raising capacity, institutional capacity-building should include developing the capacity to raise revenue through the development of tax instruments, or increasing the effectiveness of taxes, tariffs, or fees that are already established.

The strategy for the development and maintenance of municipal capacity should therefore take account of the differing needs of municipalities so as to ensure that the assistance (financial and otherwise) is accurately targeted.
3.1.4 The Intergovernmental Financing of Institutional Capacity

From its introduction in 1998, the local government equitable share (LES) included an Institutional grant, referred to as the I grant. The I grant was designed to fill the gap between the funds needed to “…provide and maintain basic facilities for the operation of “local government” and municipal own revenue”\(^9\).

Although municipalities are not permitted to tax the income of residents, average per capita income within each municipality is used as a measure of the revenue-raising capacity of municipalities. Among municipalities of any given population size, municipalities with higher levels of average income receive smaller I grants. Relatively high-income municipalities are considered to have sufficient revenue-raising capacity to finance the basic operations of government on their own, and hence they do not receive an I grant.

During the 2002/03 financial year, R307.1 million is being distributed to local municipalities through the I grant formula\(^10\). Table 13 provides an analysis of the distribution of I grants to municipalities. I grants go to about two-thirds of all municipalities, but because the grants are targeted to smaller jurisdictions, only a little over one-third of the nation’s population reside in municipalities receiving I grants.

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\(^9\) Department of Finance (1998), The Introduction of an Equitable Share of Nationally Raised Revenues for Local Government, Pretoria, SA, Department of Finance (now the National Treasury).

\(^10\) The one relatively high income municipality receiving an I grant of over R11,000 per capita is the Schuinsdraai Nature Reserve with a total population in 2002 of 35.
Table 13 Per Capita Equitable Share (I Grant) Allocations to Local Governments, Financial Year 2002/03 by Population Size and Governments and Average Per Capita Monthly Household Expenditure

<table>
<thead>
<tr>
<th>Population Size</th>
<th>Number of Local Governments</th>
<th>Average I Grant</th>
<th>Avg. Per Capita I Grant</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total Receiving I Grants</td>
<td>(Rand)</td>
<td>(Rand)</td>
</tr>
<tr>
<td>Less than 10,000</td>
<td>27</td>
<td>1,248,167</td>
<td>235.6</td>
</tr>
<tr>
<td>10,000 - 24,999</td>
<td>25</td>
<td>1,138,613</td>
<td>71.7</td>
</tr>
<tr>
<td>25,000 - 49,999</td>
<td>43</td>
<td>1,287,064</td>
<td>27.7</td>
</tr>
<tr>
<td>50,000 - 99,999</td>
<td>48</td>
<td>1,491,029</td>
<td>11.4</td>
</tr>
<tr>
<td>100,000 - 199,999</td>
<td>62</td>
<td>2,601,217</td>
<td>13.1</td>
</tr>
<tr>
<td>200,000 - 499,999</td>
<td>42</td>
<td>2,780,180</td>
<td>5.1</td>
</tr>
<tr>
<td>500,000 and more</td>
<td>15</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total/Average</td>
<td>262</td>
<td>307,099,990</td>
<td>19.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Monthly Expenditures Per Capita</th>
<th>Number of Local Governments</th>
<th>Average I Grant</th>
<th>Avg. Per Capita I Grant</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total Receiving I Grants</td>
<td>(Rand)</td>
<td>(Rand)</td>
</tr>
<tr>
<td>Less than R300</td>
<td>77</td>
<td>3,592,225</td>
<td>19.4</td>
</tr>
<tr>
<td>R300 - R499</td>
<td>63</td>
<td>1,625,403</td>
<td>14.1</td>
</tr>
<tr>
<td>R500 - R749</td>
<td>70</td>
<td>936,643</td>
<td>31.3</td>
</tr>
<tr>
<td>R750 - R999</td>
<td>45</td>
<td>841,895</td>
<td>58.6</td>
</tr>
<tr>
<td>R1000 - R1,499</td>
<td>29</td>
<td>365,796</td>
<td>18.4</td>
</tr>
<tr>
<td>R1,500 - R1,999</td>
<td>6</td>
<td>393,181</td>
<td>11,186.7</td>
</tr>
<tr>
<td>R2,000 and more</td>
<td>2</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total/Average</td>
<td>262</td>
<td>307,099,990</td>
<td>19.5</td>
</tr>
</tbody>
</table>

Note: The local governments included in this table include all Category A and Category B governments plus all Districts Management Areas. No Category A government receives an I grant. Average I grant amounts are calculated using data only for local government receiving grants.

Source: Calc. based on data provided by the Department of Provincial and Local Government.

Among municipalities eligible for I grants, the average I grant per capita is only R19.50. As shown in the top panel of Table 13, the largest per capita grants go to small jurisdictions. The data in the bottom panel to Table 13 show that I grants are concentrated among low income (expenditure) municipalities, with very few municipalities with average monthly per capita expenditures over R1,000 receiving I grants11.

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11 The one relatively high income municipality receiving an I grant of over R11,000 per capita is the Schuinsdraai Nature Reserve with a total population in 2002 of 35.
Part B

Table 14: Per Capita Equitable Share (I Grant) Allocations to District Councils, Financial Year 2002/03 by Population Size and Governments and Average Per Capita Monthly Household Expenditure

<table>
<thead>
<tr>
<th>Population Size</th>
<th>Number of Local Governments</th>
<th>Average I Grant</th>
<th>Avg. Per Capita I Grant</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Receiving I Grants</td>
<td>(rand)</td>
</tr>
<tr>
<td>Less than 250,000</td>
<td>8</td>
<td>5</td>
<td>1,900,218</td>
</tr>
<tr>
<td>250,000 - 499,999</td>
<td>10</td>
<td>3</td>
<td>3,058,123</td>
</tr>
<tr>
<td>500,000 - 749,999</td>
<td>11</td>
<td>4</td>
<td>2,673,941</td>
</tr>
<tr>
<td>750,000 - 999,999</td>
<td>10</td>
<td>4</td>
<td>2,674,106</td>
</tr>
<tr>
<td>1,000,000 - 1,499,999</td>
<td>6</td>
<td>3</td>
<td>5,182,547</td>
</tr>
<tr>
<td>1,500,000 and more</td>
<td>2</td>
<td>1</td>
<td>7,272,924</td>
</tr>
<tr>
<td>Total/Average</td>
<td>47</td>
<td>20</td>
<td>62,900,010</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Monthly Expenditures Per Capita</th>
<th>Number of Local Governments</th>
<th>Average I Grant</th>
<th>Avg. Per Capita I Grant</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
<td>Receiving I Grants</td>
<td>(rand)</td>
</tr>
<tr>
<td>Less than R350</td>
<td>6</td>
<td>6</td>
<td>4,700,586</td>
</tr>
<tr>
<td>R350 - R449</td>
<td>14</td>
<td>7</td>
<td>4,221,418</td>
</tr>
<tr>
<td>R500 - R649</td>
<td>10</td>
<td>4</td>
<td>1,684,627</td>
</tr>
<tr>
<td>R650 - R799</td>
<td>7</td>
<td>1</td>
<td>844,842</td>
</tr>
<tr>
<td>R800 - R999</td>
<td>2</td>
<td>1</td>
<td>1,254,676</td>
</tr>
<tr>
<td>R1,000 and more</td>
<td>8</td>
<td>1</td>
<td>1,236,586</td>
</tr>
<tr>
<td>Total/Average</td>
<td>47</td>
<td>20</td>
<td>62,900,010</td>
</tr>
</tbody>
</table>

Note: Average I grant amounts are calculated using data only for district councils receiving grants.
Source: Calc. based on data provided by the Department of Provincial and Local Government.

In part because of the shifting of some important powers and functions to district municipalities, for the 2002/03 financial year Government allocated R62.9 million in I grants to district municipalities using the same formula used to allocate I grants to Category B jurisdictions. The data in Table 14 show that 20 of the 47 district municipalities received I grants, with the average per capita grant equal to R4.90. The data indicate that there are few systematic differences in per capita grants between small and large and rich and poor district municipalities. The fact that the allocation of I grants to district municipalities uses the same formula used to allocate I grants to the local municipalities may explain the absence of targeting of I grants to district municipalities according to size or economic condition.

3.1.5 Assessment of the Institutional Funding Mechanisms

Various government bodies have sought to assess the institutional capability of municipalities, including the Municipal Demarcation Board and the Department of Provincial and Local Government. It would be useful to undertake a careful assessment of their methodologies, as their classification scheme could form the basis for an evaluation of the distribution of I grants.

Conditional grants to municipal governments designed for building institutional
capacity should also be considered. Funding should be available for a menu of activities by municipalities that would qualify as enhancing institutional capacity.

The Department of Provincial and Local Government is in the process of developing a framework to co-ordinate all local government training and capacity-building efforts. In developing and implementing this framework, it would be important for government to ensure that the assistance is appropriately targeted.

3.1.6 Proposal: Municipal Institutional Capacity

- The Institutional (I) element of the local government equitable share formula and conditional capacity-building grants to municipalities should be assessed to ensure that they reflect the capacity needs of municipalities.

3.2 The Financing of Development Nodes

3.2.1 Introduction

The Integrated Sustainable Rural Development Programme (ISRDP) and the Urban Renewal Programme (URP), now under the direction of DPLG, are designed to target and coordinate government-wide efforts to achieve economic development and poverty alleviation in 13 rural and 8 urban areas. They are meant to re-direct government investments to these development nodes and to co-ordinate efforts of various government departments and the provinces to enhance economic development in these areas.

Intergovernmental grant policy generally spreads out available fiscal resources throughout the country in an equitable manner. A consequence of this policy is that any given municipality will receive relatively few resources with which to finance new investments and provide basic services. The net result may be that, especially in places with little existing public infrastructure, most of the money is used ineffectively. This inefficient use of funds can occur in part because basic service delivery is impossible without prior investment in capital infrastructure.

The idea behind the ISRDP and the URP is therefore to target areas of the country where it is highly unlikely that economic development would occur if left to market forces alone. Only with the concerted and co-ordinated efforts of a wide range of government departments, non-profit organizations, and private investors can one hope to “jump start” economic development in these areas.
3.2.2 The Intergovernmental Funding of Development Nodes

Experience in other countries and in South Africa suggests that government exhortations to redirect investments to the development nodes are not likely to be successful. What is needed is an explicit policy to target funds to the development nodes. This involves re-directing government funds that would otherwise have been distributed through normal channels.

Starting in 2002/03, some of the funding for the rural development and urban renewal nodes is being channelled through the equitable share formula. The funding is being channelled through the S (Services) Grant of the formula, which is being weighted in favour of nodal areas. In addition to these equitable share funds, DPLG will redirect R200 million per year of capital funding to the nodes through the Consolidated Municipal Infrastructure Programme (CMIP).

Government decided to channel nodal funding through the equitable share mechanism for a number of reasons:

• While additional funding is already being directed to nodal areas through CMIP transfers, not all additional nodal funding is for infrastructure.

• National and provincial governments have not re-directed budgets toward funding the nodal areas, despite being requested to do so for 2001/02. In addition; and

• It is government policy that the numerous conditional grants to municipalities should be consolidated, and the creation of a separate fund for the nodal areas would appear to contradict this policy.

3.2.3 Evaluation of Equitable Share Funding

The Commission is of the view that it is inappropriate for nodal funding to come from the equitable share allocation. This is for the following reasons:

1. The equitable share should be equitable, and should therefore be distributed according to criteria that apply to all municipalities. The equitable share formula no longer applies uniformly to all municipalities, but rather gives special treatment to a group of municipalities identified by government. This undermines the clarity and transparency of the formula.
Part B

2. The implication of this decision is that there are different standards of “basic service provision”. The Budget Review 2002 states explicitly that the extra funding to the nodes is intended to enhance basic service provision. This implies that the standards of basic service provision will be higher in the nodal municipalities than in other municipalities.

3. Issues of national priority are best dealt with through national grants. The FFC has stated this principle on previous occasions, for example with reference to HIV/AIDS funding (see Submission for the Division of Revenue 2003/04, page 60).

4. The equitable share formula should be distributed according to objective criteria that are agreed upon through appropriate processes and are then beyond direct political control. While the motivation for channelling nodal funding through the equitable share is positive, the process by which the decision was taken was ad hoc and not subject to a consultative process. This establishes a precedent. It is conceivable that government could, in future, be tempted to direct funding to certain municipalities for reasons of political gain.

The Commission therefore strongly advises that nodal funding should not come from the local government equitable share allocation.

Nevertheless, the formula for the equitable share could still be used to distribute nodal funding, as it is reasonable to use a formula that allocates funds in proportion to the number of poor households in each node.

If the nodal funding is not from the equitable share allocation, this does not imply that it must be a conditional grant. Section 227(1)(b) of the Constitution indicates that national government can provide unconditional grants in addition to the equitable share allocation. Government’s concern that another conditional grant will be created can thereby be addressed, as these unconditional grants will require minimal administrative resources.

However, for those development nodes that fall within a broader boundary, such as Khayelitsha in the Cape Town Metropolitan Municipality, there should be a minimum condition that the funding be directed to that particular nodal area.

3.2.4 Implementation Issues

It is desirable that the funding to the development nodes allow for flexibility. By design, the path to sustainable development will be different in each node, reflecting local circumstances, priorities, and capabilities. In order to facilitate this flexibility, it is important that the nodal municipalities be given discretion in how best to use intergovernmental transfers such as infrastructure funding.
Nevertheless, it will be important to carefully monitor how the funds are being used, and more importantly, the progress that is being made within each development node in improving the delivery of basic municipal services and in achieving sustainable economic development. In the short term, efforts should be made to collect baseline data on the development nodes. These data should include detailed economic and demographic data, plus data on existing public investments and public service provision. Without these data, an accurate assessment of the success of the ISRDP and the URP will be impossible.

### 3.2.5 Proposals: Financing of Development Nodes

- The effectiveness of the ISRDP and URP should be carefully evaluated. This should include the collection of data on development indicators within nodes, so as to inform nodal policy development and implementation.

- Funding for the urban and rural development nodes should not come from the local government equitable share allocation.

### 3.3 Development of a Differentiated Approach to Municipalities

#### 3.3.1 Introduction

In its Submission for the Division of Revenue 2003/04, the Commission proposed that there should be a differentiated approach to the borrowing market, with classes of municipalities being treated differently according to objective criteria.

The key reason for differentiating between municipalities is that municipal circumstances vary considerably. The assessment of the Municipal Demarcation Board in Table 15 illustrates two aspects of this variation, namely capacity and average municipal expenditure per person:
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Part B

Table 15 Average expenditure by class of municipality, 2000/00
Classification Status Number of Municipalities in Class Average municipal expend per person 2000/01

<table>
<thead>
<tr>
<th>Classification</th>
<th>Status</th>
<th>Number of Muns in class</th>
<th>Average municipal expend per person 2000/01</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metros</td>
<td>Metros</td>
<td>6</td>
<td>R 2525</td>
</tr>
<tr>
<td>Class 1</td>
<td>Aspirant Metros</td>
<td>5</td>
<td>R 1275</td>
</tr>
<tr>
<td>Class 2</td>
<td>Significant and Large Category B</td>
<td>17</td>
<td>R 1379</td>
</tr>
<tr>
<td>Class 3</td>
<td>Significant Category B</td>
<td>22</td>
<td>R 1062</td>
</tr>
<tr>
<td>Class 4</td>
<td>Strong Category B</td>
<td>85</td>
<td>R 520</td>
</tr>
<tr>
<td>Class 5</td>
<td>Weak Category B</td>
<td>28</td>
<td>R 313</td>
</tr>
<tr>
<td>Class 6</td>
<td>Very limited Capacity -</td>
<td>44</td>
<td>R 82</td>
</tr>
<tr>
<td>Class 7</td>
<td>Almost Completely New Municipality</td>
<td>30</td>
<td>R 2</td>
</tr>
<tr>
<td>New</td>
<td></td>
<td>13</td>
<td>R 13</td>
</tr>
<tr>
<td>DMA’s</td>
<td>District</td>
<td>28</td>
<td>R 520</td>
</tr>
</tbody>
</table>


To promote a dynamic system that sees continuous improvement in service delivery, these differences between municipalities should be recognised. This section explores the possibility of developing a differentiated approach (or classification system) by posing the following questions:

- Is there a basis for extending the differentiated approach to municipal borrowing to other aspects of local government finance?
- If there is such a basis, how can the intergovernmental fiscal system reflect such a differentiated approach?

### 3.3.2 Possible Approaches

There appear to be three broad options for classifying municipalities, namely:

1. An over-arching classification system that applies to the entire local government sphere and is used for a variety of purposes.

2. Application of different classification systems to suit different needs.

3. Continuation of the current system, where differentiation takes place in an ad hoc manner.

It is important to understand the purpose of any particular classification scheme. If government were interested in prioritising capital investments in potable water delivery systems, it might classify municipalities in terms of the number of residents without access to potable water and population density. Alternatively, if the purpose
of a classification scheme were to determine where to locate new district health centres, the classification scheme would need to focus on health status of residents and the existing access to health services.

As a result, it would be difficult to develop one classification system that could be used for a variety of purposes. At the same time, the current ad hoc differentiation means that there may not be a coherent approach to certain issues. For example, intergovernmental transfers such as capacity-building funds may not be accurately targeted if they do not take adequate account of the types and degrees of capacity differences between municipalities.

Options 1 and 3 therefore do not seem feasible. However, there may well be reasons for differentiating among municipalities for specific purposes, which is explored below.

### 3.3.3 Possible applications of a Differentiated Approach

#### 3.3.3.1 Local Government Borrowing

Municipalities in South Africa can roughly be grouped into three categories: those who have access to capital markets at relatively favourable rates, those who struggle to obtain loan finance and pay significant risk premiums when they do, and those who simply cannot obtain loans owing to their weak fiscal capacity and/or poor human resource capacity.

In its Submission for DOR 2002/03, the FFC proposed that Government consider the extent to which different categories of municipalities may pledge their equitable share revenue to access debt. Further details were provided in the FFC Submission for DOR 2003/04, in which the FFC proposed that there should be an asymmetric approach to the borrowing market, with different categories of municipalities being treated differently.

If municipalities were classified for borrowing purposes, the motivation for such a classification would have to be clear. It could be for two reasons:

- To encourage municipalities to gain access to loan finance; and/or
- To prevent municipalities from getting into serious financial problems through imprudent borrowing.

If the first reason only applies, then the FFC’s previous recommendation would remain as is, namely that government should put policy measures in place to strengthen the debt management capacity of municipalities and increase their access to loan finance.
If the second motivation applied, then one would wish to consider various international regulatory frameworks that would assist in discouraging imprudent borrowing practices in municipalities. A list of possible borrowing restrictions is provided in Table 16. The restrictions need not apply to all municipalities, but to those falling within a certain category.

Table 16 Local Borrowing Restrictions

<table>
<thead>
<tr>
<th>Type of Restriction</th>
<th>Description</th>
<th>Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Affordability Formulae</td>
<td>Ceilings on (i) debt service / local revenues; (ii) debt service / local current</td>
<td>Argentina, Brazil, Italy, Japan, Spain, Lithuania, Poland, Colombia</td>
</tr>
<tr>
<td>Indebtedness Formulae</td>
<td>Limit on total outstanding debt / net revenues</td>
<td>Brazil, Colombia, Italy</td>
</tr>
<tr>
<td>Local Approval</td>
<td>Local councils are required to approve borrowing for individual projects</td>
<td>Canada, Switzerland, USA</td>
</tr>
<tr>
<td>Prudential Regulations on Net Worth</td>
<td>Ceiling imposed on lender’s net worth / subnational loan portfolio</td>
<td>Colombia, Mexico, Brazil</td>
</tr>
</tbody>
</table>


To the above list one could add the pledging of equitable share revenue in South Africa. There are currently no restrictions on this, and FFC proposed in its DOR 2002/03 Submission that government should consider the extent to which different categories of municipalities should be able to cede their future equitable share allocations as security to obtain loan finance.

Whether one classifies municipalities to encourage them to access capital markets or to refrain from imprudent borrowing, it would be important to identify which municipalities have the capacity to manage their debt obligations.

The Infrastructure Finance Corporation (INCA) has developed a sophisticated model for assessing the debt absorption capacity of local authorities. INCA assesses whether the particular asset being financed is a capital asset and can be paid for from income. They assess technical delivery capabilities, including the quality of infrastructure provided, and also the operation and maintenance capabilities of the local authority. The collapse of the latter is considered an early danger signal of more serious viability problems.

Norms have been developed by INCA as benchmarks for assessing municipalities, for example, the percentage of the municipal budget allocated to salaries, which INCA assesses against a benchmark of 32% for larger local authorities and 35% for the smaller local authorities.
It is suggested that the indicators used by INCA be explored further, with a view to developing an objective basis for differentiating between municipalities.

The possible intergovernmental implications of a classification system for municipal borrowing are:

- Targeted support to build debt management capacity;
- Concessionary loans to municipalities with limited or no access to loan finance; and
- Regulatory framework for municipal borrowing.

3.3.3.2 Revenue Sources

A recent paper on regional levies commissioned by DPLG suggests that one of the options for reforming the levies is to develop a two-tier system: metros would be given taxing powers (for the current payroll levy), rural areas would receive grants, and urban areas would be given the option to join either system. While the urban / rural division is not so relevant now given the recent demarcation process, this option does present the possibility of a system that takes account of current realities but also allows for change over time.

Many municipalities have insufficient capacity to develop their local fiscal instruments and to collect revenue. They should in the first instance be empowered to deliver Constitutionally Mandated Basic Services, and there should be scope for varying the mix and nature of revenue sources for municipalities in the meantime.

There are two aspects to this:

- The type of revenue source could differ according to the municipality (e.g. local tax versus intergovernmental grant). The example of regional levies was given above: district municipalities with a limited revenue base and weak revenue collection capacity could receive a grant instead of collecting regional levies, but could develop the fiscal instrument in future if certain criteria were met.

Presumably a municipality would move from a grant to an own revenue source only if:
- The amount of revenue generated increases;
- The transaction costs decrease; and
- Autonomy of expenditure increases.

- The nature of one particular revenue source could differ.
For example, the conditionality of an intergovernmental transfer could change. Where a municipality has adequate political, corporate, and financial governance systems in place, conditionalities for certain grants could be relaxed or removed.

Municipalities would thereby have the following incentives to improve their institutional capacity:

- They would have increased decision-making around spending; and
- They would be relieved of application processes and other bureaucratic controls.

The possible intergovernmental implications of a classification system for revenue sources are:

- A review of the various revenue sources available to local government, in order to assess the extent to which a “graduated approach” is applicable to any of them; and
- A review of the conditionalities of infrastructure and capacity-building transfers, in order to assess whether conditions should be changed for different classes of municipalities.

The indicators for deciding on type of revenue source would include revenue base and capacity to develop local fiscal instruments and collect revenue. Those for deciding on grant conditionalities would relate primarily to institutional capacity (e.g. planning and financial management capacity).

### 3.3.3.3 Salary scales

In the past year, there has been much discussion of the salaries of municipal employees and councillors. There are reports that some municipalities with a limited revenue base are spending a substantial proportion of their revenue on the salaries of executive mayors / councillors and municipal managers.

There are a number of factors to consider:

- Government has indicated that it is considering the incorporation of municipal employees into the public service. However, it is likely that this will not occur in the short- to medium-term; and
- It is difficult to attract skilled municipal managers to areas outside the major urban centres. High salaries are offered as an inducement,
and therefore predominantly rural municipalities with limited revenue bases may have to spend a relatively high proportion of their revenue to ensure that a good management team is in place.

One possible approach would be to develop a classification system that would inform the reasonable “bands” of salaries. The possible criteria to classify municipalities would be:

- Revenue base: It should be possible to relate salary scales to the ability of a municipality to raise its own revenue. However, the developmental challenges in fiscally weak municipalities are daunting and require considerable leadership and skill. Revenue base should therefore probably not be considered as a criterion; and

- Population size of the municipality: This would give an indication of the complexity of the administration required. One disadvantage of this approach is that newer municipalities have relatively small administrations, as many of their activities are out-sourced; and

- Number of employees: This would provide some indication of the complexity of the municipal administration. However, it would have the perverse incentive of encouraging municipalities to hire more staff in order to influence their classification.

The most significant challenge of classifying municipalities for salary purposes would be the inclusion of incentives to encourage managers to locate to more remote areas.

The inclusion of such incentives might in fact undermine the classification system. In addition, one of the reasons for the lack of popularity of the previous “grading” system was that it was used as the basis for salary determinations. Given this and the difficulties in classifying as noted above, classifying municipalities for salary scale purposes may not be desirable.

### 3.3.3.4 Municipal service partnerships

DPLG’s White Paper on Municipal Service Partnership (MSP) arrangements indicates that MSPs increase in complexity. With service contracts, for example, the service provider receives a fee from the Council to manage one aspect of a municipal service, whereas with a concession, the service provider undertakes the management, operation, repair, maintenance, replacement, design, construction, and financing of a municipal service facility or system. As the complexity increases, so does the required financial and management capacity to draw up, implement, and monitor the arrangements.
Generally, private sector stakeholders who enter into complex arrangements have considerable capacity to enter into negotiations. If municipalities do not have similar capacity, they may enter into partnerships that can financially cripple them.

It is not only capacity that is important, but also the economic base of municipalities. The ability to pay is weakest in municipalities where increased service delivery is most needed, and it is difficult for MSPs to operate in areas where the ability to generate surpluses is so constrained.

There may therefore be circumstances where certain kinds of MSPs are not appropriate, and a classification system could serve to identify municipalities in which these circumstances prevail.

As with municipal borrowing, the purpose for developing a “partnership” classification could be one or both of the following; and

- To encourage municipalities to enter partnerships, and therefore develop a more targeted capacity-building programme; and
- To prevent municipalities from entering into certain types of partnership until the minimum institutional capacity is in place.

The primary indicators for classifying municipalities for this purpose would be capacity indicators. There may soon be some guidelines in place: the latest revisions to the Municipal Finance Management Bill indicate that any municipality wishing to enter into a service partnership needs to demonstrate that a contract management unit is in place.

The difficulty is that there are different kinds of partnerships and the complexity of contract management will vary considerably. This will therefore only be a minimum requirement and may have little impact.

**3.3.4 Proposal: Differentiated Approach to Municipalities**

- Government should give consideration to developing a differentiated approach to municipalities in such areas as borrowing, revenue sources, and municipal service partnerships.
GLOSSARY

**Basic education**
Ordinary primary, secondary, and special education

**Basic health care**
Primary and secondary health care packages

**Budget Council**
The consultative body consisting of national Minister of Finance and the nine provincial MECs for Finance

**Budget Forum**
The consultative body consisting of the members of the Budget Council and representatives of organised local government

**Capital expenditure (Capex)**
Spending on new or existing durable goods with a normal lifespan of more than one year, to be used for (socially/economically) productive purposes

**Conditional grants**
Transfers from one sphere of government to another, conditional on certain services being delivered or in compliance with specific requirements

**Constitutionally mandated basic services (CMBS)**
Public services listed in the Bill of Rights and mandated to a minimum standard

**Contingency reserve**
The amount of nationally collected revenue that is not allocated for any specific purpose in advance in order to accommodate adverse and unforeseen macroeconomic or natural events

**Division of Revenue**
The allocation of funds vertically between the three spheres of government or horizontally amongst provinces or municipalities as required by the Constitution

**Economies of scale**
The technological relationship in which per unit costs of production (of goods or services) fall as the scale of production increases
**Equity**
The application of principles of justice to the recognition of rights or division of resources: (1) among individuals or governments in the same sphere (horizontal equity), or (2) between classes of people or different spheres of government (vertical equity)

**Equitable share**
The allocation of revenue to the national, provincial, and local spheres of government in a manner that ensures equity as required by the Constitution

**Extrapolate**
To infer or estimate by extending or projecting known information

**Fiscal capacity**
A measure of the ability of a jurisdiction to finance government services

**Fiscal dependence**
The extent to which one sphere of government relies on another for revenue to finance its functions

**Fiscal equity**
The ability of various governments in the same sphere to provide comparable levels of services to their citizens with similar revenue sources

**Horizontal division**
The division of revenue among provinces or among municipalities

**Inflation**
The rate of increase in the general price level

**Institutional element (I)**
The element in the equitable share formulae designed to finance the operation of provincial and local government institutions

**Levies**
Compulsory payment made in exchange for indirect benefits received (for example, a fuel levy)

**MinMEC**
A committee comprising the Minister of a national line function department and the provincial MECs responsible for that function in the provinces (for example, education)
Moral hazard
A situation when economic behaviour adjusts to incentives in a manner that increases the likelihood that an event insured against will actually occur.

MTEF cycle
The Medium Term Expenditure Framework is a three-year spending plan of national and provincial governments published at the time of the budget.

National revenue
State income from taxes, levies and other charges

Revenue elasticity
The automatic response of revenue to changes in economic activity

Service authority
The organ of state accountable for ensuring that services are delivered

Service provider
The institution authorised by a service authority to deliver a service

Social costs
The impact of non-delivery of public services on society

Social security grants
Non-contributory financial assistance or direct income support to qualifying individuals as prescribed by the Constitution

Soft budget constraint
Exists when subnational governments perceive that national government will intervene in cases of financial crisis

Specific tax
A levy of a fixed amount per unit of a good or service exchanged in a market

Tax base
The activity or commodity upon which a tax is levied

Tax incentives
Specific provisions in the tax code that provide favourable tax treatment to economic agents to encourage specific behaviour, for example to encourage investment
Top slicing
The practice by governments through which, prior to allocating revenue, an amount is set aside for special purposes such as national debt payments or contingencies

Unfunded mandates
The assignment of expenditure responsibilities by one sphere of government to another without commensurate assignment of revenue sources to fund the expenditure responsibilities

User charges
Prices for the use of public services determined by political rather than market interaction

Vertical division
The division of revenue between the three spheres of government

Vertical fiscal imbalance
The mismatch between expenditure responsibilities and the necessary revenue sources
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For an Equitable Sharing of National Revenue

FINANCIAL AND FISCAL COMMISSION

MIDRAND
Private BAG X 69, HALF WAY HOUSE 1685 1ST FL, MONTROSE PLACE , BEKKER STREET, WATERFALL PARK, VORNA VALLEY, MIDRAND, SOUTH AFRICA
TEL: 086 1315 710 FAX: +27 011 207 2344
Website: wwwffc.co.za

CAPE TOWN
P.O. BOX 1505, CAPE TOWN, 8000, REGIS HOUSE, ROOM 1202, 12TH FL, 124 ADDERLEY STREET, CAPE TOWN, SOUTH AFRICA
TEL: 086 1315 710 FAX: +27 021 426 4935
Website: wwwffc.co.za

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