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Abbreviations

CBPWP  Community-based Public Works Programme
CSR    Cost of service responsibilities
CMIP   Consolidated Municipal Infrastructure Programme
CMBS   Constitutionally Mandated Basic Services
CWSS   Community Water Supply and Sanitation Programme
DBSA   Development Bank of Southern Africa
DPLG   Department of Provincial and Local Government
DWAF   Department of Water Affairs and Forestry
FFC    Financial and Fiscal Commission
INCA   Infrastructure Finance Corporation
JSB    Joint Services Board
LED Fund Local Economic Development Fund
MEC    Member of the Executive Council
MinMEC (Meeting of the) Minister and Members of the Executive Councils
MTEF   Medium-term Expenditure Framework
PES model Provincial Equitable Share model
RDP    Reconstruction and Development Programme
RRC    Revenue-raising capacity
RSC    Regional Services Council
SARS   South African Revenue Service
TLC    Transitional Local Council
TNR    Total national revenue
TRC    Transitional Rural Council
TRepC  Transitional Representative Council
This Report marks yet another milestone in the Financial and Fiscal Commission’s (FFC’s) contribution to the evolving intergovernmental fiscal system in South Africa. This submission makes proposals for the 2002/03 Division of Revenue Bill and relates closely to the FFC Recommendations for the 2001/04 Medium-Term Expenditure Framework submitted in May 2001. A particular feature to note is that the fiscal issues dealt with in the current Report flow from the Commission’s consideration of concerns raised by key stakeholders during consultations in the 2000-2001 fiscal year. In addition, some of the issues covered in the Report respond to recent developments of which the restructuring of local government takes prominence.

The proposals in this submission take account of Government’s views with respect to the 2001 recommendations. The Commission is pleased that Government supported the importance of the FFC’s first recommendation that provincial governments are mandated by the Constitution to provide basic services. Proposals for the development of this recommendation are submitted for consideration in this Report. In this regard the Commission has recognized the need to review the equitable share mechanism and seek ways in which the approach can be consistently applied across all spheres of Government.

In 2001 the FFC also recommended, in view of the urgent need, that National Government provide a conditional grant to provinces to support the reduction or elimination of social infrastructure backlogs. The Minister of Finance accepted this
recommendation and funds were made available for this purpose in the 2001 Budget. However, there is currently no analytical mechanism for allocating the grant in a consistent manner. In this Report the FFC proposes a capital grant scheme mechanism that takes account of inherited backlogs, on-going capital needs, maintenance and depreciation.

The proposals in this submission address issues and concerns of all three levels of Government. Through the process of consultation with stakeholders many other issues and concerns were raised, some of which are discussed in this Report. During the current and subsequent budget cycles the FFC will be dedicating time and resources to providing Government and Parliament with recommendations and proposals pertaining to these issues.

The Report is the product of considerable collaboration and research. The Commissioners would like to thank the members of all the departments, intergovernmental forums and relevant Ministries who contributed to this document with their information and insights. We would like to note our appreciation for the insights, suggestions and criticisms from various stakeholders. Of particular importance are the Minister of Finance, officials of the National Treasury, the Portfolio Committee on Finance, the National Council of Provinces’ Select Committee on Finance, the Portfolio Committee for Provincial and Local Government and the South African Local Government Association.

In the development of the Report, there was considerable interaction between the FFC and its technical advisors, whose wealth of international experience greatly contributed to and enriched the approach of the Commission to the wide variety of fiscal issues addressed in the Report. These advisors included Andrew Reschovsky (United States), Howard Chernick (United States), Jeff Petchey (Australia), Ronald Neumann (Canada), Raja Chelliah (India), Guy Gilbert (France) and Mark Blecher (South Africa).

The Commission would also like to express its gratitude to the Secretariat of the FFC, namely, Dr. Nkem Abonta, Dr. Hildegarde Fast, Myron Peter, Conrad von Gass, Bongani Khumalo, Rossana Achterberg, Partrick Mabuza, Betty Kaseke and Vincent Makinta. Their work and dedication provided the foundations for this Report.

While the Report reflects the Commission’s approach to the fiscal issues addressed, it is our belief that it should be viewed as a living document that is subject to intensive debate and interrogation by all stakeholders, particularly, during the Parliamentary Public Hearing Process.
As Commissioners and the Executive of the Financial and Fiscal Commission we, the undersigned, are pleased to submit this Report in accordance with the obligations placed upon us by the Constitution of the Republic of South Africa.

For and on behalf of the Commission

Chairperson
Murphy Morobe

Deputy Chairperson (Acting)
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Commissioner
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Executive Summary

This Report is presented in terms of Sections 214(2), 228(2b), 229(5) and 230(2) of the Constitution of the Republic of South Africa, read together with section (9) of the Intergovernmental Fiscal Relations Act of 1997.

In taking account of the relevant sections in Chapter 13 of the Constitution, the Financial and Fiscal Commission (FFC) seeks to make recommendations that inform the intergovernmental policy making process. The FFC reiterates the fact that it is ultimately the role of the three spheres of government and their relevant legislatures to determine fundamental policy objectives and priorities and set the targets, given the existing constraints for achieving the objectives and priorities.

The role of the FFC in this process is to make recommendations that will ensure an equitable division of nationally collected revenues such that all three spheres of government are able to meet any legal requirement in the provision of constitutionally mandated basic services. The FFC is also expected to assess the financial and fiscal implications of new policies (such as those emerging with the new local government dispensation) and to develop mechanisms to support the equitable, efficient and effective funding of these policies.

The proposals made in this Report follow closely on recommendations made in May 2000 for the 2001-04 MTEF cycle. The FFC notes that its submission for this
cycle and Government’s response to it in the Budget Review 2001 represented the culmination of a long process of consultation with national and provincial governments and legislatures, as required by Chapters 3 and 14 of the Constitution, the FFC Act, the Intergovernmental Fiscal Relations Act, and other legislation. These consultations were organised during the course of 2000/01 through national and provincial parliamentary fora; the Budget Council; the respective MInMECs for education, health, and welfare; and government departments. The consultations clearly set in motion a process for preparing the framework for the FFC’s submission for the 2002/03 Division of Revenue. The proposals in this submission take into consideration the responses from all FFC stakeholders, including Government, legislatures, organised civil society and non-governmental organisations.

Following stakeholder consultations after the 2001-04 MTEF recommendations, the current submission focuses on all three spheres of government.

Litigation and court judgements over the past year underline growing concerns that the current equitable share formula does not adequately address the obligation on all three spheres to provide constitutionally mandated basic services as per the Bill of Rights. In this submission, the Commission proposes a coordinated study by all major stakeholders to identify and determine nationally accepted norms and standards for the provision of constitutionally mandated basic services across all spheres of government.

With respect to the provincial equitable shares, this submission focuses on the issue of provincial own revenues. The FFC has in the past made recommendations on this matter and identified certain taxes that would generate significant amounts of revenue for provinces. The Commission reiterates its earlier recommendations and emphasises the importance of ensuring equity, efficiency, revenue sufficiency and effective administration in implementing provincial taxes.

An important development flowing directly from the May 2000 recommendations deals with the FFC’s capital grants model. The model was presented last year as a conceptual framework. The FFC has made significant progress with the model and believes that it should now be used as a method for distributing capital grants to provinces, together with certain administrative support measures.

While the local government restructuring process is still ongoing, it is important to articulate a vision for the final system of local government finance and then to develop a “road map” for moving toward such a system over time. Certain challenges that will face Government with respect to the local sphere have begun to emerge and it is important that principles be specified.
In this submission the FFC proposes a framework for local government finance, which includes:

- A formula for the local government equitable share
- The identification of municipal basic services
- The financing of municipal services
- Own revenue (including the borrowing framework)
- Infrastructure financing issues

**FFC Submission for the 2002/03 Division of Revenue**

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 to j) of the Constitution, the Commission hereby submits its proposals for the fiscal year 2002/03, within the framework of its 2001-2004 MTEF Recommendations.

**Towards an Equitable Sharing of National Revenue**

1. As a first step in the review of the current FFC/Treasury equitable share formula, the FFC intends to involve relevant role players in a study project aimed at providing clear definitions of constitutionally mandated basic services and other constitutional obligations. This would assist the Commission and Government in determining the equitable share necessary for the provision of constitutionally mandated obligations.

2. As part of the review the FFC proposes that the division of total national revenue available for equitable sharing (net of debt service obligations and contingency reserves) take account of:

- Constitutionally mandated obligations in general and the provision of basic services in particular
- The institutional element for each sphere of government
- Other constitutional functions for which norms and standards should also be specified
- Obligations other than constitutional functions, that may be funded through conditional grants, own revenue and borrowing
- The need for infrastructure funding, which should vary according to policy priorities
National Government

With respect to the obligations of National Government

1. The FFC holds that the determination of the equitable shares of nationally collected revenue must proceed from the principle that constitutionally mandated basic services and other constitutional obligations should be prioritised and progressively realised.

2. The FFC proposes that a study be undertaken to determine a set of objective criteria for the utilisation of contingency reserves.

Provincial Government

Provincial Own Revenue proposals

1. The FFC proposes a review of the current equitable share formula to take account of the pending legislation relating to section 228 (Provincial Taxes) of the Constitution and the proposed introduction of a capital grants scheme.

2. The Commission reaffirms its previous recommendation, based upon the current constitutional provisions, that the following taxes constitute the most feasible form of provincial own revenue sources: a surcharge on personal income tax, fuel levies, and gambling and betting taxes. The surcharge on personal income tax is the most significant of these revenue sources.

3. Provinces should be allowed the flexibility to determine their own tax rates within the bands determined by the Minister of Finance.

4. To implement any of the provincial own revenue measures, tax room should be created in order to maintain the tax burden within nationally determined targets.

Capital grants proposals

1. The FFC proposes that its capital grants model be used as a method for allocating infrastructure grants.

Local Government

Local Government equitable share proposals

1. The FFC proposes a formula that takes account of the cost of service responsibilities, institutional costs and fiscal capacity. The various formula components should be operationalised as data become available.
2. The FFC proposes that Government identify and define basic municipal services and that existing constitutional and legislative provisions guide this process.

Proposals for funding basic municipal services
1. The FFC proposes that national government should fund lifeline tariffs as these are intended to benefit low-income households and are an important instrument of redistribution.

Proposals for municipal powers and functions
1. The FFC proposes that funding, including lifeline tariff funding, be directed to the relevant service providing authority.

2. The Commission proposes that the reform process ensure that the revenue accruing to district municipalities through regional service council levies be retained within the local government sphere, and that any new revenue instrument chosen be subject to local control.

3. The FFC proposes that regional levies be converted into a general revenue source for funding the municipal services assigned by legislation, and that infrastructure should be financed through national government’s infrastructure programme and own revenue sources. Should any additional functions be transferred to district municipalities by the relevant MEC for local government, appropriate revenue-sharing instruments will have to be instituted.

4. Conscious of the need for clarity, as expressed by stakeholders, on the division of powers and functions between district and local municipalities, the FFC will submit its views on this matter in the near future.

Municipal health services provision proposals
1. In the long term, the FFC proposes that the funding of municipal health services be included in the equitable share.

2. The FFC proposes an interim measure whereby the provincial allocation to local government for primary health care provision would be disaggregated to district level using a formula. Municipalities may supplement any proposed-allocation from own revenues in order to achieve or maintain a higher level of service.
Proposals for Local Government

Infrastructure funding

1. The FFC supports a formula-based approach to Government’s infrastructure funding. The formula should take account of existing infrastructure backlogs, the number of poor households, and the outcomes of previous infrastructure spending.

2. Owing to the complexities of funding capital infrastructure in district and local municipalities, the FFC proposes a study to determine the nature and mechanisms for capital grant disbursement to non-metropolitan municipalities.

Proposals for Local Government

Borrowing

1. The FFC proposes that Government create the conditions necessary for the emergence of a local government borrowing market through:

   • Enhancing local government debt management capacity
   • Implementing a rules-based approach to complement market discipline
   • Ensuring that municipalities with limited own revenue bases have access to steady and predictable revenue streams

2. The FFC proposes that Government give consideration to the extent to which different categories of local governments may pledge their equitable share revenue to access debt. In this regard, Government may wish to consider an effective regulatory framework.
1.

Towards an Equitable Sharing of National Revenue

1.1 Overview and context

The Constitution of the Republic of South Africa requires the three spheres of government to work cooperatively for the promotion of economic and social progress for all. The country’s fiscal arrangements aim to ensure that the responsibilities of each sphere are carried out in the spirit of cooperation, fairness and efficiency. In the end, the welfare of individual citizens (and equity among them wherever they reside) is the ultimate objective of decisions on fiscal arrangements.

In terms of the Constitution, national government has the overriding responsibility for economic and fiscal affairs, and national programmes such as defence and security. It shares responsibility with the provinces for the provision of basic social services. National government is furthermore empowered to mandate appropriate basic levels and standards of service. Provinces are responsible for delivering basic services such as education, health and welfare. Municipalities, on the other hand, must provide essential local infrastructure and services, as per Schedules 4 and 5 of the Constitution.

The Commission is mindful of the constitutional and institutional context within which it operates and seeks to promote sound and cooperative governance within and among the three spheres of government.

1.1.1 Provisions of the South African Constitution

The core function of the Commission is to make recommendations on the equitable division of national revenue. The recommendations on the Division of Revenue Bill
are a major part of this role. Chapter 13 of the Constitution outlines a financial framework for the country and section 214 in that chapter reads as follows:

(1) An Act of Parliament must provide for -

a) The equitable division of revenue raised nationally among the national, provincial and local spheres;
b) The determination of each province’s equitable share of the provincial share of that revenue; and
c) Any other allocations to provinces, local government or municipalities from the national government’s share of that revenue, and any conditions on which those allocations may be made.

(2) The Act referred to in subsection (1) may be enacted only after the provincial governments, organised local government and the Financial and Fiscal Commission have been consulted, and any recommendations of the Commission have been considered, and must take into account -

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.

The FFC’s role extends beyond commenting on Parliament’s Division of Revenue Bill. The Constitution states that the Commission must be consulted and its recommendations considered before any legislation is passed regarding provincial or municipal fiscal arrangements, powers and functions (see sections 228 and 229 of the Constitution in Appendix A).
1.1.2 Legislative provisions and other processes
The system of intergovernmental fiscal relations has been developing since 1994, supported by legislation, protocols and practices that aim at enhancing stability, transparency, accountability, efficiency and effectiveness.

The Intergovernmental Fiscal Relations Act of 1997 governs the process of determining the equitable division of revenue. The Act outlines the roles of various parties, including the Minister of Finance, the FFC, Parliament, the Budget Council, the Budget Forum, provincial governments and organised local government.

The Act establishes the framework for the budget process, which culminates in the Minister of Finance tabling the annual Budget in Parliament. Ten months earlier, the FFC tables its recommendations on the division of revenue. The Act also requires that the FFC be consulted before the Division of Revenue Bill is introduced in the National Assembly (see sections 9 and 10 of the Act, Appendix A).

To obtain all information relevant to its mandate, the FFC participates in various forums dealing with intergovernmental fiscal relations, the equitable division of revenue and related matters. During the past year, it has used several opportunities to discuss its programme parameters and needs with national, provincial and local government stakeholders.

1.1.3 The role of the FFC
The Constitution provides for the establishment of an independent and impartial Financial and Fiscal Commission. However, the FFC is keenly aware that it is part of a complex mechanism for establishing policy and balancing the diverse interests of a democratic nation. Given its unique position and the role assigned to it by the Constitution and legislation, the FFC has a key role in the dialogue on the equitable sharing of national revenue. To this end, it objectively considers the interests of each sphere of government.

In making its recommendations, the FFC:

- Respects the constitutional status of each sphere of government
- Adheres to constitutional principles
- Is mindful of the fact that the Constitution's Bill of Rights mandates the provision of basic services
- Considers other principles of good intergovernmental relations2
- Undertakes extensive research to inform the basis of its recommendations
- Considers stated government programme objectives and priorities

2These principles are presented in detail in the FFC Recommendations for the 2001-2004 MTEF Cycle.
The Commission may at times make recommendations that differ from aspects of the Division of Revenue Bill. It, however, believes that it is particularly important to work cooperatively with Government and to respect the political processes that ultimately establish the policies of the three spheres of government. In this regard, the Commission is strengthening its processes for consultation with stakeholders.

1.2 A framework for the equitable sharing of national revenue

This section outlines a framework for the equitable division of national revenue in accordance with the provisions of the Constitution (sections 214(1) and 214(2)).

1.2.1 National revenue

The starting point for the division of revenue has to be an analysis of "national revenue". Notwithstanding the roles and responsibilities of the other spheres of government, national government has the overall responsibility for economic and fiscal policies. These policies ultimately yield the amount of national revenue available for equitable division, depending on national tax bases and tax rates, other national non-tax revenue, provisions for national debt, contingency reserves and the net fiscal balance.

It is important to distinguish between decisions on the equitable division of national revenue and decisions that determine the amount of national revenue to be shared. The framework presented here assumes that the total national revenue for equitable division results from the economic and fiscal decisions of national government. For budgetary purposes, this amount is fixed in any given year, but it may subsequently change depending on economic and fiscal policy decisions.

At times, the FFC may be asked to comment on issues that affect economic or fiscal policy and, by implication, the total national revenue to be shared equitably. However, it respects the role of national government to manage economic and fiscal policy. Therefore, as things currently stand, the provision of equitable shares follows from the establishment of the total national revenue available for equitable division, rather than the equitable share requirements determining economic and fiscal policy.

Total national revenue available for equitable division, TNR, can be determined as follows:

\[
TNR = TR + OR + DF - DSC - CR
\]  

Where:  

<table>
<thead>
<tr>
<th>Symbol</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>TR</td>
<td>Nationally collected tax revenue</td>
</tr>
<tr>
<td>OR</td>
<td>Nationally collected other revenue</td>
</tr>
<tr>
<td>DF</td>
<td>Overall deficit financing</td>
</tr>
<tr>
<td>DSC</td>
<td>Cost of servicing the national debt</td>
</tr>
<tr>
<td>CR</td>
<td>Contingency reserve</td>
</tr>
</tbody>
</table>
As noted, national government is responsible for managing economic and fiscal affairs, and determining the tax bases, tax rates, the level and cost of servicing the national debt, and the overall borrowing requirement. The deduction of debt servicing costs and contingency reserves from total revenue collections reflects the provisions of subsection 214(2)(b) and (j) of the Constitution. Some may prefer to characterise these amounts as part of the national equitable share. However, in either formulation, it is desirable to separate these amounts from the remainder of total revenue collections.

1.2.2 The equitable shares: A basic formula

The basic formula for the equitable division of national revenue is as follows.

\[ TNR = NES + PES + LES \]  

Where:
- \( NES \): National government equitable share
- \( PES \): Provincial government equitable share
- \( LES \): Local government equitable share

Since the total national revenue (TNR) available for equitable division, is a fixed amount, once two portions of the equitable share are established, the third is automatically determined. In addition, if one share is subsequently increased, one or both of the others will decrease. On the other hand, if TNR is increased or decreased, so too will any or all of the three equitable shares. This is particularly important when considering issues such as the sharing of tax bases and conditional grants. Each of these issues will be discussed within this framework, as will the establishment of each of the equitable shares.

1.2.3 The FFC approach to the determination of equitable shares

Litigation and court judgements over the past year underline growing concerns that the current equitable share formula does not adequately address the obligation on all three spheres to fulfil constitutionally mandated basic service obligations, as per the Bill of Rights.

A review of the current equitable share mechanism should therefore be considered as a matter of urgency. The review should seek to design a formula that can:

a) Distinguish between the execution of constitutionally mandated basic service obligations and other functions financed through the equitable share allocations
b) Provide the legislatures, judiciary and other organs of state with a means of assessing whether constitutional mandates regarding service provision are being fulfilled
c) Provide a point of departure for determining the equitable shares for all three spheres of government by rationally considering the costs of fulfilling
constitutionally mandated basic service obligations and other obligations
d) Serve as an effective tool for all three spheres to prioritise policy objectives and
targets, efficiently allocate resources and identify fiscal resource gaps
e) Take into account the progressive realisation of the provision of basic rights

Any changes to the existing equitable share formula should reflect current priorities as
determined by a political process. Nonetheless, the FFC believes that the rationale for
decisions that determine budget priorities should be as explicit as possible and include
due regard for constitutional obligations. The FFC does not follow a “bottom-up”
approach, but seeks to reconcile decisions on economic and fiscal policy with the
constitutional obligations of national, provincial and local governments. In this
regard, the provisions of subsection 214(2)(a), (b), (c), (d), (f), and (l) of the
Constitution are particularly relevant.

1.2.4 FFC research on constitutionally mandated basic service obligations
The FFC intends to involve relevant role players in a study project aimed at providing
clear definitions of constitutionally mandated basic service obligations and other
constitutional obligations. This would assist the Commission in considering proposals
on the determination of nationally approved policy parameters, norms and standards,
and on data requirements for determining the minimum costs of the progressive
realisation of constitutionally mandated basic service obligations. The study would
also support the development of a framework for the analysis of budget programmes.

1.2.5 Proposals: equitable sharing of national revenue

- The FFC holds that the determination of the equitable shares of nationally
collected revenue must proceed from the principle that constitutionally mandated
basic service obligations and other constitutional obligations should be progressively
realised.
- The FFC proposes that the division of total national revenue available for equitable
sharing (net of borrowing, debt service obligations and contingency reserves) be
based on the following:
  - The priority claim should be for meeting constitutionally mandated basic service
    obligations.
  - A further claim should be an institutional element for managing and administer-
    ing each sphere of government.
  - The remainder should be allocated to other constitutional functions. As with
    basic services, these more discretionary elements might be determined through a
    process of defining norms and standards.
Constitutionally mandated basic service obligations and other constitutional functions should be financed through unconditional grants, own revenue and borrowing.

The proportion of capital (and especially infrastructure) spending will vary according to the policy priorities.

### 1.3 Additional considerations in the development of equitable sharing

Some of the considerations that affect the framework for the equitable division of revenue are briefly presented below.

#### 1.3.1 The effect of assigning taxing powers to provincial and local governments

International experience and principles of good management suggest that responsibility and accountability are enhanced when governments are responsible for raising significant proportions of their revenues. It could, therefore, be beneficial for a national government to create tax room for subnational governments. As they have different priorities, the subnational governments will utilise their tax room to greater or lesser degrees, thus fostering efficiency and healthy competition.

Given any fixed set of macroeconomic and fiscal policies, the effect of assigning taxation powers to provincial and local governments can be established. When portions of the tax base and tax rates (the tax room) are assigned from national government to subnational governments, TNR will decrease, resulting in lower equitable shares.

The national tax collections are:

\[
TTC_n = TB_n \times TR_n
\]

And provincial tax collections are:

\[
TTC_p = TB_p \times TR_p
\]

While local tax collections are:

\[
TTC_l = TB_l \times TR_l
\]

Where:

- \(TTC_n, TTC_p\) and \(TTC_l\) total tax collections for national, provincial, and local governments respectively
- \(TB_n, TB_p\) and \(TB_l\) totality of tax bases of national, provincial, and local governments, respectively
Thus, \( \text{TTC}_n + \text{TTC}_p + \text{TTC}_l = \text{TTC} \) before the transfer of tax room. This indicates that there has been no change in the overall fiscal policy. Because the \( \text{TTC}_n \) is smaller than \( \text{TTC} \) before the assignment of tax room, \( \text{TNR} \) is also smaller. The additional tax room is likely to be reflected in an increase in own revenues and a commensurate decrease in the equitable share of the recipient sphere (provincial or local).

### 1.3.2 The effect of conditional grants on the equitable division of national revenue

Conditional grants are used to support shared policy responsibility and cooperative governance among the three spheres of government. To calculate their effect, it is assumed (as in the previous section) that total national revenue distributed through equitable shares is fixed by macroeconomic and fiscal policy. Furthermore, the amount necessary for national programmes is also assumed fixed.

Using the basic formula in equation (3) and allowing for the use of conditional grants \( (CG) \), \( \text{TNR} \) is then written as:

\[
\text{TNR} = (\text{NES} - \text{CG}_p - \text{CG}_l) + (\text{PES} + \text{CG}_p) + (\text{LES} + \text{CG}_l)
\]

The revenue available to fund national, provincial and local government programmes remains unchanged.

Although conditional grants may enhance transparency, extensive use of such grants may diminish the autonomy of subnational governments and increase administrative costs for the national sphere. Consequently, the FFC proposes to review the use of conditional grants and their relationship to the unconditional equitable shares.

### 1.3.3 The effect of contingency reserves

The establishment of contingency reserves may have been contemplated in subsections 214(2)(i) and (j) of the Constitution. These sections highlight the need for stability, predictability and flexibility in the development of the Division of Revenue Bill. Therefore, the value of contingency reserves is not in question.

Any use of contingency funds would either be through national expenditure or through grants to subnational governments. The purposes for which these reserves will be applied cannot be known in advance, although they should parallel those described in the above subsections.
However, any earmarking of contingency reserves reduces the revenue available for equitable shares. For this reason, objective criteria for the use of contingency reserves should be established and agreed to by all stakeholders (as they are affected by the disbursement of these reserves).

### 1.3.4 Summary: utilisation of total national revenue

The following matrices indicate the uses of the equitable shares and the sources of revenue, including subnational sources. They may be used as a basis for a budget programme analysis framework.

#### Utilisation of total revenue, net of debt servicing costs and the contingency reserve

<table>
<thead>
<tr>
<th></th>
<th>National sphere (current/capital)</th>
<th>Provincial sphere (current/capital)</th>
<th>Local sphere (current/capital)</th>
<th>Total (current/capital)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equitable share</td>
<td>NES +</td>
<td>PES +</td>
<td>LES =</td>
<td>ES</td>
</tr>
<tr>
<td>S-element</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Constitutionally mandated basic service obligations)</td>
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</tr>
<tr>
<td>I-element</td>
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<tr>
<td>(Institutional and administrative)</td>
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<tr>
<td>B-element</td>
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<tr>
<td>(Other constitutional functions)</td>
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<td></td>
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<tr>
<td>Conditional grants</td>
<td>− PCG − LCG</td>
<td>+ PCG</td>
<td>+ LCG =</td>
<td>CG = PCG + LCG</td>
</tr>
<tr>
<td>Total</td>
<td>(NES − PCG − LCG) +</td>
<td>(PES + PCG) +</td>
<td>(LES + LCG) =</td>
<td>TNR</td>
</tr>
</tbody>
</table>

#### Sources of revenue

<table>
<thead>
<tr>
<th></th>
<th>National sphere</th>
<th>Provincial sphere</th>
<th>Local sphere</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes</td>
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<tr>
<td>User charges</td>
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<tr>
<td>Borrowing</td>
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1.3.5 Proposal: equitable shares

The FFC recommends that a study be undertaken to determine objective criteria for the use of contingency reserves.

1.4. A functional view of the basic framework

Sections 1.2 and 1.3 focused on the provision of equitable shares. A different analytical framework emerges if decisions are examined from the perspective of particular programmes; the following example focuses on provincial programmes. If total national revenue is viewed as funding for particular programmes, an alternative formulation is as follows:

\[ TNR = RES_e + RES_h + RES_w + RES_{hs} + \ldots \]

Where:

- **TNR**: Total national revenue as previously determined
- **RES_e**: Total resources allocated to education
- **RES_h**: Total resources allocated to health
- **RES_w**: Total resources allocated to welfare
- **RES_{hs}**: Total resources allocated to housing
  
  and so forth

The formula can be broken down for education as follows:

\[ RES_e = PES_e + CG_e + NES_e \]

Where:

- **PES_e**: Portion of the provincial equitable share allocated to education
- **CG_e**: Sum of conditional grants for education
- **NES_e**: Portion of the national equitable share spent directly on education by the national government

Furthermore, the MTEF will allocate funds to a programme through the provincial equitable share (PES), which is a combination of S (basic services) grants and a portion of the B (other constitutional responsibilities) grants. Therefore:

\[ PES_e = S_{ep1} + S_{ep2} + S_{ep3} + \ldots + B_{ep1} + B_{ep2} + B_{ep3} \]
Decisions on programmes can then take account of the costing of norms and standards for the programme. By looking at the totality of funding by programme area, the support of norms and standards in the functional area can be examined, as well as whether those norms and standards support basic or broader service standards.

This is particularly useful in the context of joint responsibilities and cooperative governance:

- Through examining the components of funding for particular programmes, differences in the needs and priorities of national and subnational governments may become apparent. Such information can help refine the parameters of the health, education and welfare formulae.
- In addition, it can inform national or subnational governments’ political decisions on budgets.
- It may give guidance to decisions on assigning tax room, the use of conditional grants and borrowing powers. These decisions may reflect subtle changes in the priority of specific initiatives, or mark a shift between decentralised and centralised decision-making in specific programme areas.

The use of conditional grants may be necessary or desirable for a number of reasons. First, they may address spillover effects, for example with teaching hospitals, where the benefits may extend beyond the boundaries of the province in which they are located. Second, indivisible projects and projects that address historical backlogs would more appropriately be funded by conditional grants. Third, national government may choose to emphasise certain national priorities by earmarking funding in a specific manner.

1.4.1 Conclusion

The FFC believes that a programme analysis framework could complement and guide the decisions on the equitable division of national revenue to the three spheres of government.
2. Establishing the National Equitable Share

The FFC has generally concentrated on the areas that consume the most resources and are most critical to service delivery, as demonstrated by the focus on the provincial health, education and welfare sectors in the FFC Recommendations for the 2001-2004 MTEF Cycle. In this report, the FFC expands its recommendations on the local and national equitable shares.

2.1 An approach to the national equitable share

As noted, the FFC assumes that national economic and fiscal policy is designed to accommodate the needs of national government, while factoring in the spending requirements of provincial and local government. In this sense, it regards the establishment of the national equitable share as part of the policy role of national government.

National government must balance the need for service delivery with the current fiscal realities. In this regard, it must consider the long-run benefits of service provision, which include creating the conditions for stronger economic growth and a healthier future fiscal environment.

The basic formula, \( TNR = NES + PES + LES \), suggests that if provincial and local equitable shares are reasonably well established, the national equitable share is the factor most likely to absorb changes that cannot be accommodated elsewhere in the fiscal policy framework.
As noted in section 1.2, fiscal policy can change total national revenue by changing deficits/surpluses or taxes. Provincial governments have limited scope in both areas: their tax room is small, they cannot significantly augment provincial revenues through simple rate changes and their borrowing powers are constrained by the Constitution and legislation. Similarly, local government budget decisions are not primarily based on national fiscal policy, except to the extent that national grants and programmes affect them. Therefore, it is appropriate that national government is responsible for deciding whether to alter the volume of service provision or to exercise other fiscal options.

2.2 Elements of the national equitable share

Section 214(2) of the Constitution indicates that in determining the equitable share and the allocation of revenue to the national sphere, the following must be taken into account:

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.

National interest is a broad concept – many provincial and local government competencies cover areas in which the national government has a legitimate stake and which could be considered of national interest. However, it is necessary to distinguish between “national interest”, as described in subsection 214(2)(a) and “the needs and interests of the national government” set out in subsection 214(2)(c):

- National interest: This subsection lists issues in which the national government should have an interest, although some of these fall under the competence of subnational governments. National interest may cover functions such as defence, internal security, foreign affairs, social security, tertiary education and macroeconomic management.
- The needs and interests of national government are distinct from national interest but also have a priority claim on national revenue, as they express the national aspiration for equity, equality and socio-economic progress for all citizens.
The Constitution prescribes the progressive realisation of certain norms and standards in the areas of health, welfare and education, among other services. It does, nonetheless, indicate that this should depend on the availability of resources, and that national government should determine the norms and standards. The “availability of resources” may have more than one interpretation. The preferred one recognises the primary nature of national interest, debt repayment and the other needs and interests of the national government, and factors them into the equitable share equation as “constants” rather than “variables”.

2.3 Research on the national equitable share

Costing studies could be done on those aspects of national programme delivery that lend themselves to the concept, which would make it possible to establish some segments of the national equitable share. Internal security services may be one example. In addition, the research of the FFC could prove useful in determining the requirements of the national departments in coordinating education, health, welfare, housing and other initiatives.

The FFC Act provides for the FFC to respond to any request by national government to examine programmes and priorities. It could provide information and analysis on various issues, for example on the cost of delivering services effectively and efficiently.
3. Establishing a Framework for Provincial Government Finance

3.1 Allocations of the Provincial Equitable Share

3.1.1 Review of FFC Recommendations for the 2001-2004 MTEF Cycle
In May 2000, the FFC submitted a set of five recommendations for the 2001-2004 MTEF cycle. Government’s response to the FFC submission was presented by the Minister of Finance in Annexure E of the Budget Review 2001, as summarised briefly in Appendix B.

The Commission welcomes Government’s concurrence with the importance of its first recommendation, namely that constitutionally mandated basic levels of social services be provided for in the provincial equitable share allocations, and that the costed norms approach be explored further. The Commission acknowledges Government’s concerns, as it recognises that dramatic changes to provincial allocations may be detrimental to the development of predictable allocations to provinces in the short term.

Nonetheless, the Commission notes that the possibility of litigation underlines the need to examine mechanisms for addressing the constitutional requirement of a progressive realisation of basic rights. Through its research, the FFC is gearing itself for establishing the affordability of the norms and standards determined by Government. Far from undermining provincial budgetary autonomy, the FFC believes that its approach facilitates decisions around the trade-offs between basic services and provinces’ other constitutional functions.
In view of the concerns highlighted by Government and other stakeholders, it is important to advance areas of agreement and common interest between Government and the FFC. These include:

a) Considering means by which the provision of basic services, as envisaged in the Constitution, can be highlighted in MTEF budget and planning processes
b) Supporting measures of efficiency and effectiveness in subnational government operations
c) Utilising projections of costed norms as analytical tools for evaluating provincial allocations and performance
d) Investigating the possibility of developing and having access to common databases
e) Investigating a capital grants scheme

Government agrees that the current budgeting and planning processes should more explicitly take account of constitutional requirements to provide basic services. Therefore, the Commission proposes a process to assess the practical incorporation of these requirements into the current equitable sharing mechanism (see proposals in section 1.2.4 above).

3.1.3 FFC’s ongoing research into the Provincial Equitable Share

Certain assumptions and criteria of the FFC’s Provincial Equitable Share (PES) model for 2001 need further research to concretise the criteria listed in the FFC’s second recommendation of May 2000.

Specific suggestions include the following:

a) The portion calculated to ensure the provision of basic education should be based on a cost per learner for four target groups of learners defined as above or below the poverty line in either urban or rural locations. It should also take account both of national policy on the funding of out-of-age learners and of provincial variations in educator remuneration. Ongoing FFC research in the education sector suggests that
   - Provinces tend to differentiate per capita costs by income group but pay less attention to urban-rural distinctions
   - Provinces appear to recognise the importance of non-personnel expenditures in providing quality education
   - Provinces tend to favour their poorest schools in the allocation of their non-personnel budget
b) The portion calculated to ensure the provision of primary health care should be based on:

- A per capita cost for four age and gender target groups
- The anticipated degree of utilisation, poverty levels and population dispersion

Ongoing FFC research in the health sector suggests a need for the definition of primary health care to cover out-of-hospital primary health care (including ambulatory services to patients at clinics and community health centres), public health programmes, and the portion of district hospital services that deals with outpatients. Per capita expenditures on primary health care are highly unequal across provinces.

c) The portion calculated to ensure the provision of social security must be based on:

- Average per capita grant amounts for the six social security programmes (means tested by poverty, age, gender and disability)
- Allowance for progressive phase-in rates

3.1.3.1 Further development of an FFC Framework for the PES

In addition to their constitutionally mandated basic service obligations, provinces also share service delivery obligations with other spheres. These include public works, secondary health care, social welfare, safety and security, and economic affairs. In its Recommendations for 2001-2004, the Commission proposed the merging of the “backlogs”, the “basic” and the “economic activity” elements into a combined “basic” element.

In order to integrate these various elements into a framework for the PES, the FFC has developed a computer model which allows for the evaluation and analysis of alternative scenarios in the provision of CMBS obligations.

The recent Provincial Tax Regulation Bill will see provinces being assigned the authority to impose taxes in accordance with section 228 of the Constitution. The implementation of this policy will require a fresh approach to the economic activity element – most taxes are likely to be related to provincial economic activity and the provincial equitable share formula may need revision. The “T” element may need to be activated and used to equalise tax revenue capacity. A framework for the implementation of section 228 is suggested in section 3.2 below.

Concerning the “backlogs” element, the FFC has developed a Capital Grants model (see section 3.4 below). The Commission re-emphasises that a formula-based
approach will be appropriate for addressing capital spending in the economy, especially in the absence of significant provincial borrowing for capital spending.

3.1.4 Proposal: provincial equitable share

With the pending enactment of legislation relating to section 228 (provincial taxes) of the Constitution and the proposed FFC capital grants formula, consideration should be given to revising the equitable share formula to take account of these developments.

3.2 Provincial revenue powers

3.2.1. Introduction

International literature reveals a tendency for national governments to prescribe very limited tax bases for subnational governments.\(^3\)

This section examines approaches to strengthening provincial tax authority and proposes one that takes account of constitutional requirements and the general principles of tax design. It also examines the appropriateness of some of the taxes proposed by the National Treasury.

3.2.2 The debate on provincial revenue assignment in South Africa

The enabling legislation around provincial revenue powers is still being developed. According to the Constitution, provinces may impose certain kinds of taxes, levies and duties (excluding the more productive taxes such as income tax and general sales tax), as well as surcharges on certain nationally legislated taxes.

Currently, national government levies the most productive taxes. In its Recommendations for the 1998/99 fiscal year, the FFC recommended a surcharge on personal income tax, accompanied by an equalisation system and the creation of tax room at national level.\(^4\) However, in its Seventh Interim Report the Katz Commission subsequently recommended a more cautious approach, given apparent economic and capacity constraints. The National Treasury emphasised that budgeting and expenditure management should be improved before taxing powers are expanded.

The National Treasury has instead proposed an evolutionary approach whereby provinces levy taxes from an “allowed list”. This list includes selective sales taxes on specific goods and services, environmental taxes, presumptive business taxes, betterment taxes, tourism taxes, mineral extraction taxes and a surcharge on the fuel levy. However, the provinces must carefully consider which taxes to levy, given the varying

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sizes of tax bases and economic activity. More research is needed to show the revenue yield of the “allowed list” taxes, as some may yield little revenue compared to their costs.

Appendix D contains an evaluation of the various taxes on the allowed list. It examines the different approaches to tax authority assignment and establishes the criteria against which the proposed taxes can be assessed. Its main findings are set out below:

3.2.2.1 Approaches to tax authority assignment
The different approaches to tax authority allocation in decentralised systems require different degrees of coordination among national and subnational governments, and have different costs and benefits. One such approach is a “harmonised” tax system, which limits the total burden of national and provincial taxes on similar or shared tax bases or maintains some similarity of rates across provinces. “Strong form harmonisation” requires a uniform collection mechanism, with tax bases or rates largely determined by one authority (with minor variations across jurisdictions).

South Africa currently uses a variation on the “centralised” system, where national government identifies tax bases, sets tax rates and collects tax revenue. Revenues are then shared between national and subnational governments according to an agreed formula.

3.2.2.2 Criteria for the assessment of proposed taxes
When assigning tax authority to different levels of government, the relevant criteria are:

• Efficiency: This can be compromised when tax rates differ across jurisdictions, when one province’s fiscal decisions influence the welfare of another, or when a province’s tax rate affects national revenue. The purpose of tax harmonisation is to address these issues. Because of constitutional limitations on provincial taxing powers, “strong form harmonisation” may be the best approach, as it minimises the costs of independent subnational tax policies.

• Equity or fairness: The combined effects of national and provincial taxes on equity may differ. The Constitution imposes minimum standard requirements for all South Africans and thus, to some extent, implies the strong form harmonisation approach.

• Administrative feasibility and compliance: Compliance with more than one tax system is costly and inconvenient for the taxpayer; this could encourage evasion or avoidance. Some form of coordination and harmonisation may be required to minimise administrative costs.
Sufficiency and stability of provincial tax revenues: The adequacy criterion requires the devolution of broad-based taxes, such as surcharges on income tax, sales tax and payroll taxes. Good subnational taxes should provide sufficient revenue for richer provinces to be fiscally autonomous. They should also impose fiscal responsibility at the margin on subnational governments. This can best be achieved by allowing for reasonably flexible rate setting on major tax bases.

3.2.2.3 Evaluation of the proposed taxes

The taxes proposed in the National Treasury’s “allowed list” can be evaluated according to the approaches and criteria set out above:

- Excise taxes on goods and services are a potentially significant source of revenue and lend themselves to differential rates across provinces. However, these taxes may not be easy to administer when they are destination-based. If a system were to be developed whereby relevant manufacturers and importers could be identified, provinces could rely on the South African Revenue Service (SARS) to collect the revenue on their behalf.

- Tourism taxes are a potentially substantial source of own revenue but are currently not generally utilised. They are relatively easy to administer because they can be levied directly on the final consumers of relatively immobile tax bases. The administration of these taxes can be either devolved to provinces or left with SARS, with provinces determining their own rates in consultation with the national department.

- Fuel taxes: The potential revenue of a fuel surcharge is relatively significant. However, the tax may be regressive. A recent study by the National Treasury demonstrated that the distribution of fuel sales and gross geographic product across provinces is significantly different from the distribution of the population. Provinces with higher economic activity would benefit if the surcharge were to replace a portion of the equitable share allocation. However, if the “economic activity” element of the current provincial equitable share formula were eliminated, the impact would be more equitable. Given differences in economic activity, some equalisation mechanism may be needed.

- Environmental taxes: These taxes are not designed to raise revenue but rather to protect the environment or to compensate for the exploitation of certain resources. They also require considerable sophistication. It is inappropriate to extend provincial authority to environmental taxes, for efficiency and administrative reasons.

- Other taxes: Various smaller taxes and user charges and fees have a direct impact on provincial economic activities, but their revenue potential is unlikely to be significant and will vary across provinces according to economic activity. Thus, they will need to be evaluated against the costs of administration and collection, incentive effects, effect on the local economy, and impact across provincial boundaries.
3.2.3 Conclusions
Taxes on the proposed “allowed list” are unlikely to generate significant revenue for provinces, and more broad-based taxes should be included in the list of potential revenues are to contribute significantly to expenditure responsibilities. Further work is needed on the revenue, economic activity and equity implications of the proposed taxes. It is also necessary to examine how the introduction of provincial taxing powers would affect the provincial pool of revenue, should tax room be created to maintain the overall tax burden within national targets.

3.2.4 Proposals
- The Commission reaffirms its previous recommendation, based upon the current constitutional dispensation, that the following taxes constitute the most feasible form of provincial own revenue sources: a surcharge on personal income tax, a fuel levy, and betting and gaming taxes. The surcharge on personal income tax is the most significant of these revenue sources. Decisions on the provincial tax structure should take account of revenue assignment in the local government sphere.
- Provinces should be allowed the flexibility to determine their own tax rates within the bands determined by the Minister of Finance.
- To implement any of the provincial own revenues measures, tax room must be created in order to maintain the tax burden within nationally determined targets.

3.3 Provincial borrowing

3.3.1 Introduction
The FFC’s position on subnational government borrowing is spelt out in the Framework Document of 1995. This section briefly reiterates some of the principles in this document and highlights issues that have emerged since its publication.

3.3.2 Principles
In principle, there is no reason to deny subnational governments access to borrowing, especially for financing projects that benefit more than one generation. This spreads the debt burden across generations, making it more likely that the generation that enjoys the benefits pays for them. However, such debt should be discharged within the active life of the project. Alternatively, by the end of its life, the project should have built up a depreciation fund equal to the amount of the debt.

Borrowing is an important macroeconomic policy instrument, and uncoordinated borrowing by subnational governments may have undesirable economic consequences. For example, they may be tempted to use borrowing as a substitute for taxing their citizens. Therefore, the Constitution limits subnational government borrowing powers. Within the overall fiscal deficit target for the country, subtargets may be specified for subnational governments so that their net borrowing does not exceed a specified percentage of gross domestic product in any year.

As subnational governments cannot monetise their debt through printing money, they can conceivably default on their debt obligations. Consequently, subnational securities are inherently riskier and the interest rates correspondingly higher. The risk premiums demanded by the market depend on the guarantees and controls that Government places on subnational borrowing.

Borrowing “imports” funds into a jurisdiction, but paying it back “exports” purchasing power. Thus, an excessive use of debt may redistribute future income away from the area. Borrowing must therefore be used mainly for projects that will yield benefits in the future.

3.3.2.1 Subnational debt management issues

Two types of securities can be used for issuing subnational government debt:

- **General obligation bonds:** These are usually backed by the taxing power of the subnational government. In South Africa, general local government debt is no longer guaranteed by the national government. Investors normally consider general debt a safer option as it is based on the revenue flows of the jurisdiction. However, because such flows also depend on the level of economic activity and (partly) on the flow of intergovernmental grants, default risk is often present. As economic activity is very unevenly distributed in South Africa, subnational government borrowing should only occur within a sound regulatory framework.

- **Revenue bonds:** These are backed by a promise of revenue generated from the facility being financed by the debt. They are typically used to finance roads, bridges and other infrastructure whose services are paid for through user charges. It may be unwise to secure debt for basic services infrastructure, since creditors may seize the assets in case of default (except where there is no market for the assets).

3.3.3 Regulating subnational government borrowing

The literature on subnational government borrowing suggests certain regulatory
instruments. In South Africa, where nation building is an important goal of government, three objectives are important:

- To align the overall level of borrowing by subnational governments with national macroeconomic objectives
- To enhance fiscal responsibility on the part of subnational governments by subjecting borrowing to certain conditions
- To guard against the concentration of resources in richer jurisdictions; this does not imply that richer subnational governments have to be “levelled down”, but rather that disadvantaged areas must be strengthened

Some of the instruments that may be used are the following:

a) Market discipline: In this case, the market forces of supply and demand determine the amount of borrowing and lending in the borrowing market. Market efficiency alone cannot address the broader objectives of Government, such as redistribution. The use of market discipline in conjunction with a national government role might be more appropriate. However, market assistance measures may conflict with market discipline and impose certain trade-offs. Markets will favour quasi-private facilities that generate a stream of revenue, as opposed to pure “public good” infrastructure, such as regional sewerage plants.

b) Intergovernmental cooperation: This aims to reach negotiated agreements among the spheres on overall debt targets for Government and on how the targets are to be assigned to different jurisdictions. Specific limits may be agreed upon for different subnational governments. This approach is, to some extent, implied in the Borrowing Powers of Provincial Governments Act (1996).

c) Rule-based controls: Some rule-based controls may be implied in the Constitution or legislation. The most common rules relate to measures of debt service capacity, such as debt service-to-revenue ratio or debt stock-to-revenue ratio. The rule-based approach, if applied uniformly, is both transparent and equitable, but tends to generate administrative costs.

d) Administrative controls: South Africa currently uses some administrative controls. For example, the Minister of Finance requires that the debt service obligation of a province may not exceed a specified proportion of its current revenue. The Minister also determines reasonable conditions and criteria for municipal debt.
In choosing an instrument of control, a range of issues needs to be considered; the optimal option may be a combination of different aspects of all these instruments.

### 3.3.4 Provincial borrowing in South Africa

Section 230 of the Constitution states the following:

(1) A province or a municipality may raise loans for capital or current expenditure in accordance with reasonable conditions determined by national legislation, but loans for current expenditure -
   a) may be raised only when necessary for bridging purposes during a fiscal year; and
   b) must be repaid in twelve months

(2) National legislation referred to in subsection (1) may be enacted only after any recommendations of the Financial and Fiscal Commission have been considered.

The Borrowing Powers of Provincial Governments Act sets out norms and conditions for provincial borrowing. Provincial governments are required to provide security for loans, and interest payable in any financial year may not exceed a specified percentage of their total budgeted current revenue for that year. This is a rule-based safeguard for fiscal discipline.

The Act also provides for a Loans Coordinating Committee, which consists of the Minister of Finance and Members of the Executive Councils (MECs) for finance or their authorised representatives. The Committee coordinates provincial borrowing requirements after factoring in aggregate demand for capital market funds, provincial debt liability, risk and debt service ability.

Information on the borrowing activities of provincial governments in South Africa is not easily accessible. In the past, several provinces utilised bank overdrafts extensively and often failed to meet specified repayment terms. Moreover, some accumulated substantial amounts of hidden debt, to the extent of failing to pay social security beneficiaries and being subject to litigation by the public.

Provincial governments often cannot borrow for long-term capital projects because they do not generate sufficient own revenue to meet debt obligations. (Around 96 per cent of provincial revenues are grant transfers from national government, mostly from the equitable share.) However, these governments could still borrow, provided that their interest liabilities on permitted borrowing were assessed as part of their
expenditure for purposes of determining their equitable share. There is no reason why equitable shares should not include interest assessed, since such interest reflects the costs of building capital stock.

3.3.5 Conclusions
While borrowing could be a justifiable way of addressing provincial infrastructure backlogs in order to meet delivery objectives, provinces lack the capacity to borrow and to accept full liability for such borrowing from their own resources.

The cautious approach adopted by Treasury should therefore be maintained until the capacity for debt management is developed and a more comprehensive regulatory framework is created. This framework should ideally be based on a combination of market discipline and a rule-based approach.

In the absence of provincial borrowing, the national sphere should make capital grants available to provinces. Alternatively, national government should take responsibility for the bulk of capital expenditure, even in the provinces.

3.4 The Capital Grants model and its implementation

3.4.1 Introduction
The current rate of infrastructure spending by provinces is insufficient to redress inherited backlogs and meet ongoing demand for capital. Provinces are unable to meet their infrastructure financing needs as they have limited access to capital markets and little own revenue. Moreover, a large proportion of their equitable share allocation is taken up by current expenditure, leaving them with insufficient funds for infrastructure investment.

Consequently, the FFC recommended in 2000 that national government should supplement provincial capital spending through a conditional capital grant. The Minister of Finance has accepted the recommendation and the National Treasury has provided funds for a provincial infrastructure grant.

There is currently no analytical model for allocating the grant in a consistent and objective manner. The FFC has developed a Capital Grants model for the education, health and welfare sectors. The model takes account of provinces’ inherited capital backlogs, ongoing capital expenditure needs and depreciation. In its Recommendations for the 2001-2004 MTEF Cycle, the FFC presented the conceptual version of the model.

*The conceptual version of the model was discussed in some detail in FFC Recommendations for the 2001-2004 MTEF Cycle, May 2000, pp 75-87.
The model can now be used to calculate service and province-specific capital needs for the education, health and welfare sectors, as well as the relative shares for each of these services per province. The model will be extended to other sectors.

3.4.2 Outline of the grant scheme

The Capital Grants model is explained in detail in Appendix E. Its first stage is to determine the efficient and actual capital stocks required to raise South African provincial capital stock levels to an international capital stock benchmark – the “initial transition path”. Once the “ideal needs” have been calculated, it is possible to calculate the actual transition path, which depends on the actual capital expenditure by provinces and the grants received over the period of the grant scheme. If the pool of funds were insufficient, the actual transition path would fall below the initial transition path. However, if the pool were large enough, the actual transition path would coincide with the initial transition path. In this case, the calculated needs would equal the ideal needs in each period of the scheme, and South African capital stock levels would reach the international benchmark at the end of the scheme.

In the model, the calculated needs for any period are determined by the backlog, future needs (required to meet the international benchmark), and grant funds received in the previous periods (except the first). The model assumes that the scheme runs for a 10-year period, commencing in 2001/02. The required input data are:

- Actual capital expenditure from 2001/02 to 2010/11 for each service and province
- Efficient capital expenditure from 2001/02 to 2010/11 (by service and province)
- Actual capital stock in 2001/02 for each service and province
- Efficient capital stock in 2001/02 for each service and province
- Rate of depreciation from 2001/02 to 2010/11

Appendix E sets out the data sources and methodology, and provides a sample of the model’s results. It indicates how the pool of funds allocated to the provincial infrastructure grant for 2001/02, 2002/03 and 2003/04 could be distributed among the nine provinces and, in each province, among education, health and welfare.

3.4.3 Conclusions

In its Recommendations for the 2001-2004 MTEF Cycle, the FFC recommended that conditional grants be allocated to provinces to support the reduction of social infrastructure backlogs. The Commission notes that Government has made such conditional grants available to provinces as from 2001/02.
To support the infrastructure programme, the Commission has developed a methodology for distributing the provincial infrastructure grant. The model can already be used to distribute infrastructure funds for education, health and welfare, and it can easily be extended to include a mechanism for distributing infrastructure funds to other provincial sectors.
4. Establishing a Framework for Local Government Finance

Since the introduction of the 1996 Constitution, the intergovernmental fiscal system has gradually taken shape. Due to the transitional nature of the local government sphere, many fiscal reforms have focused on national and provincial issues.

Since the local government elections of 5 December 2000, the final phase of the local government transition has been under way. It is now appropriate to evaluate the current system of local government finance and to move toward a coherent system that will assist in stabilising the local sphere and integrating it into the broader fiscal system.

Underpinning South Africa's intergovernmental fiscal system is the constitutional principle that nationally collected tax revenues must be distributed equitably to the national, provincial and local spheres. The concept of the equitable shares is therefore fundamental to a coherent system of local government finance. For this reason, the FFC is suggesting a framework for the local government equitable share. The building blocks for such a framework include the following:

- Articulation of the constitutional requirements for the local government equitable share
- Definition and identification of basic municipal services and other municipal functions
- Development of the principles that should underlie the funding of basic municipal services, other municipal functions and lifeline tariffs
• Investigation of the implications of these principles for:
  - The equitable share formula
  - The funding of district and local municipal functions
  - The funding of local government infrastructure
  - Local government borrowing

Each of these building blocks is discussed in turn, with a summary of the proposals at the end of each section.

4.1 A conceptual framework for the local government equitable share

4.1.1 The Constitution and the local government equitable share

According to section 214(1) of the Constitution, an Act of Parliament must provide for an equitable division of nationally collected revenue among the national, provincial and local spheres, and for any other conditional allocations to provinces or municipalities.

Section 214(2) states that the division is should be informed by, among other factors:

• The need to ensure that the provinces and municipalities can provide basic services and perform the functions allocated to them [214(2)(d)]
• The fiscal capacity and efficiency of the provinces and municipalities [214(2)(e)]
• The developmental and other needs of provinces, local government and municipalities [214(2)(f)]
• The obligations of the provinces and municipalities in terms of national legislation [214(2)(h)]

The current equitable share allocation comprises two grants: an S (services) grant, which is meant to provide each municipality with the resources to provide “basic services” to all residents in poor households; and an I (institutional) grant, to assist municipalities in maintaining a functioning administration. The S grant factors in the number of low-income households in each municipality and is therefore not related to the average income level, owing to wide variations in personal income. The I transfer is tiny (only R4.30 per capita), but for some municipalities, especially those in the middle of the income spectrum, allocations are higher than those paid from the S transfer. (For a description and brief evaluation of the S and I grants of the current equitable share formula, see Appendix F.)
The following can be deduced from the provisions of the Constitution and an analysis of the current equitable share formula:

- Basic and developmental needs should be prioritised. The current formula estimates the cost of four services; the question is whether these services are indeed “basic” and whether additional functions should be added. Municipal services that meet basic and developmental needs must be identified and a methodology for costing such services developed, to incorporate them into the equitable share formula.
- The equitable share should ensure that municipalities can perform the functions allocated to them, including those assigned by national legislation. This suggests that the equitable share should include an element that caters for “other” functions not classified as basic municipal services. It should also comprise an institutional element to ensure that municipalities can maintain a functioning administration.
- The equitable share should consider the fiscal capacity of municipalities. At present, this occurs only to a limited extent. The tax bases of municipalities must be measured more accurately to ensure that an equitable distribution is achieved.
- Efficiency of expenditure should be taken into account in developing a costing methodology. Due to the restructuring of local government and the lack of data, detailed measures of costs and efficiencies will only be possible in the longer term.

These components suggest the following formula, which is consistent with the FFC’s formula for provinces and similar to the National Treasury’s formula for local government:  

\[
LES = (S + B) + m + T + I
\]

Where:  
- LES: Local government equitable share allocation  
- S: Grant to support the delivery of basic municipal services  
- B: Grant to fulfil other constitutional and legislative responsibilities  
- m: Spillover grant to provide financing for services with intermunicipal spillover effects  
- T: Tax capacity equalisation grant  
- I: Institutional grant to finance core administrative functions

The S and B elements are bracketed together to indicate that they represent the full range of local government functions assigned in Schedules 4B and 5B of the Constitution. The difference between them is that the S element represents functions identified by Government as “basic municipal services”, and these include functions given particular emphasis in the Constitution, as set out in section 4.1.2 below.

The Commission proposes that the above formula be implemented as follows:

- The S (basic services) and T (tax capacity) elements should be implemented by the beginning of the 2004/05 MTEF cycle. These elements are discussed in sections 4.2.1 and 4.2.2 below.
- The m (spillover), I (institutional) and B (other responsibilities) elements of the formula should be implemented after the next MTEF cycle. More specifically:
  - Institutional element: The FFC proposes that, in the medium term, the institutional grant be folded into the S grant. The size and sophistication of municipal administrations and infrastructure vary significantly, and the lack of data makes it difficult to design an institutional grant that reflects these differences. As research continues, this element can more accurately be determined.
  - Basic element: Similar considerations apply to the basic element, which should provide the resources to:
    - Perform the municipal functions (in addition to basic municipal services) assigned by the Constitution (subsection 214(2)(d)): These may include functions performed only by some municipalities (such as municipal airports).
    - Execute the obligations required by national legislation (subsection 214(2)(h)): Given that the first priority will be to develop an index of service costs for basic municipal services, the benchmarking of these “other” functions is a long-term objective.
  - m (spillover) grant: The Department of Finance noted in 1997 that the existence of metropolitan and district municipalities greatly reduced the need for spillover transfers, as they could undertake spillover projects with regional levy income. While this observation no longer applies to metropolitan areas owing to the introduction of the unicity model, it holds true for district municipalities. However, it will remain important to identify the main generators of spillovers, measure their financial impact on municipalities, and assess whether regional levies adequately address these spillovers.

4.1.2 Towards a definition of “basic municipal services”

To give effect to the constitutional requirements for the equitable share, a framework should be designed for identifying “basic municipal services”. Current policy and legislation on local government fail to clarify the definition of these services. It is the role of Government to identify the “basic” municipal services. The Constitution suggests some of these services and national policy and legislation provide further guidance.
To facilitate the process of identifying these services, the following criteria are proposed:

- The service is classified as a function of local government in Schedules 4B and 5B of the Constitution.
- Access to the service is a basic right, as identified or implied in the Bill of Rights.
- The municipal service is essential for life, as per the Municipal Systems Act definition of “basic municipal service”:
  “a municipal service that is necessary to ensure an acceptable and reasonable quality of life and, if not provided, would endanger public health or safety or the environment”.
- The municipal service conforms to section 153(a) of the Constitution, which links “basic needs” to the promotion of development by stating that:
  “A municipality must structure and manage its administration and budgeting and planning processes to give priority to the basic needs of the community, and to promote the social and economic development of the community”.
- The municipal service is highlighted in policy and legislation as an essential service.

Municipal services meeting at least three of the above criteria may be categorised as “basic municipal services” – a list of such services is provided in section 4.1.2.1 below.

These criteria allow the identification of basic municipal services to adapt to changes in circumstances or policy prerogatives. Municipal services can be seen as being on a continuum between “basic” and “less basic” services, with the cut-off point indicating the subset of services meeting these criteria. If a particular service is not emphasised in the Constitution and Government wishes to prioritise it, it can be placed within the subset of basic municipal services. For instance, electricity supply is not mentioned in the Bill of Rights, yet Government’s increasing emphasis on electricity suggests that it can be placed in the “basic” set of municipal services.

Three broad approaches should be applied to municipal services identified as “basic”:

- The extent to which a municipality prioritises a basic municipal service will depend upon local circumstances. For example, low-income residents in rural areas generally do not see electricity as a critical issue, as they can access alternative energy sources. The absence of roads, on the other hand, severely affects their daily activities, mobility and safety. In urban areas, infrastructure for water and transport is often present, while alternative energy sources and materials for shelter are less readily available. This necessitates flexibility within the list of basic municipal services, which is facilitated by the unconditionality of the equitable share allocation.
The identification of a service as “basic” means that residents in a given jurisdiction have the right to a basic level of service provision. However, standards of service delivery may differ owing to the nature of the technology required. For instance, the installation of water-borne sewerage systems in remote areas is difficult and expensive. In densely populated urban areas, on the other hand, water-borne sewerage is a prerequisite for a healthy environment. This principle should inform the development of the costing methodology applied to basic municipal services (see section 4.2.2 below).

Some municipalities, particularly in predominantly rural areas, may not deliver the full range of basic municipal services in the short to medium term, owing to a lack of capacity. The question is whether they should receive equitable share funding if they do not deliver the full range of basic municipal services. Government has responded to this issue in the past by introducing phase-in parameters for equitable share allocations, with longer-term phase-in parameters for rural municipalities. A similar approach may be needed in this case.

### 4.1.2.1 A proposed list of basic municipal services

By applying the above criteria to the functions stipulated in Schedules 4B and 5B in the Constitution, a possible list of eight basic municipal services is produced, as evaluated in the matrix below.

<table>
<thead>
<tr>
<th>Service</th>
<th>In Bill of Rights? (Chapter 2 of Constitution)</th>
<th>Essential to life? (Systems Act definition)</th>
<th>Contributes to social and economic development? (S153a of Constitution)</th>
<th>In policy of legislation?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potable water</td>
<td>Yes: s27</td>
<td>Yes</td>
<td>Yes: improves health of workers, facilitates economic activities</td>
<td>Yes: Water Services Act of 1997; Health Act of 1977</td>
</tr>
<tr>
<td>Municipal health</td>
<td>Yes: s27</td>
<td>Yes</td>
<td>Yes: improves health of workers</td>
<td>Yes: Health Act of 1997</td>
</tr>
</tbody>
</table>
For most of these services, basic standards have been outlined in policy and legislation; these will facilitate the development of a costing methodology.

Electricity is the only service that failed to meet three criteria. Although it is mentioned in the RDP and Housing Act, there are alternatives to electricity supply, such as wood and paraffin. However, certain categories of consumers, such as high-income residential and high-consumption industrial customers, cannot easily substitute electricity. While electricity promotes economic activity and saves labour, its environmental impacts are contested. Electricity has been given particular emphasis by Government: the RDP set a goal of 72 per cent electrification in 1994, while the current government has recently set the target at 100 per cent. There is therefore a strong case for identifying electricity as a basic municipal service.

Two municipal services, namely transport and street lighting, come close to being defined as basic. Transport is specifically mentioned in the RDP and Housing Act, but alternatives to municipal transport exist in most areas, particularly private minibus taxi services. Street lighting could be regarded as affecting the health and safety of communities as it discourages crime and reduces road accidents associated with darkness. It is not specifically mentioned in the RDP or Housing Act, but the categorisation of electricity as a basic municipal service could imply that street lighting is also a basic service.
4.1.3 Principles for the funding of basic municipal services

4.1.3.1 The funding of lifeline tariffs

The next consideration is the funding of these services. Two of these, namely water and electricity, are more private than public in nature. They are consumed individually, consumption can be accurately measured and invoiced, and access can be denied. It is proposed that water and electricity be treated separately from the other basic municipal services for the following reasons:

- Government has repeatedly emphasised the need to facilitate the access of all South Africans to electricity and water. The White Paper on Water Policy (1997) established the principle of meeting basic water needs free of charge through the implementation of lifeline tariffs. In recent months, the Department of Water Affairs and Forestry (DWAF) announced that every household should receive the first 6kL of water free of charge, and draft regulations have been drawn up to this effect. Subsequent policy statements have indicated that this policy will be extended to electricity. If the directive to provide a free basic level of service comes from the national sphere, then it is the responsibility of this sphere to provide the requisite funding.

- The proposed lifeline tariffs are intended to benefit low-income households and, as such, they represent income transfers to the poor. A principle of public finance is that poverty alleviation should be financed through national tax revenues, because the base of national taxes is much broader than that of local jurisdictions. The tax incidence on any particular region or group is thereby minimised and economic distortions avoided.

For water and electricity, then, national government should fund lifeline tariffs either through the equitable share formula (see section 4.2 below) or through a national conditional grant. The amount needed to fund lifeline tariffs could be calculated according to the current equitable share formula, which incorporates the cost of service provision and the number of low-income households in each municipality.

The national lifeline funding may be in the form of conditional or unconditional (equitable share) grants. The Municipal Systems Act of 2000 indicates that poor households must have access to basic services through various mechanisms, including direct or indirect subsidisation of tariffs. These subsidies can be in the form of national and provincial grants to municipalities (see sections 74(2)(c)iii and 94(1)(b)iii).

Both conditional and unconditional lifeline funding have certain advantages. With a conditional grant, national government would have a mechanism to ensure that the subsidy for basic services is targeted at the poor. However, conditional grants carry
administrative costs and they hold municipalities accountable to another sphere of government rather than to their constituencies.

4.1.3.2 The role of consumer cross-subsidies

The draft Municipal Tariff Policy Statement examines whether the subsidy for electricity and water should come exclusively from this lifeline tariff funding, or whether some internal cross-subsidisation should occur.¹⁰

The primary concern of national government remains the need to prevent excessive price rises, and to ensure the maximum possible benefit to consumers. The pursuit of greater efficiencies in the production and allocation of services, applied together with the development of appropriate subsidy mechanisms, will provide the greatest benefit to the poor... While this does not remove the need for extensive subsidisation in poor localities or of poor households, it does place equity considerations within the overall drive to improve the efficiency of expenditure on service delivery... It recognises that poverty alleviation, while critical, is not the primary goal of the tariff system.¹¹

Each of these options also has disadvantages: increasing the national subsidy for electricity and water will increase national expenditure requirements, while the excessive use of cross-subsidies can compromise efficiencies in the production and allocation of services. In addition, cross-subsidies have a limited application in many municipal jurisdictions owing to the socio-economic profile of the population. Ultimately, it falls on Government to weigh up the trade-offs and determine the relative proportions of national subsidy and consumer cross-subsidy in the overall subsidy to poor consumers.

4.2 Towards a formula for the equitable share

The purpose of fiscal transfers to municipalities is twofold:

• They should finance any fiscal imbalance between the spheres of government.
• They should finance any fiscal disparities among municipalities. As Reschovsky and Smoke have noted, fiscal disparities can lead to economic inefficiencies, as individuals and businesses choose locations based on the fiscal condition of municipalities rather than on minimising private or social costs.¹²

Ideally, a consideration of fiscal imbalances should begin with the costing of the constitutional responsibilities of local government, and then develop a revenue-generating strategy to match the expenditure requirements.

¹⁰ In terms of electricity, if the PriceWaterhouseCoopers electricity restructuring proposals are accepted in principle, then there will be a “consumption levy” paid by high-consumption users to subsidise low-consumption users. Until this is implemented, however, the “S” grant should still comprise an electricity component.
As noted, municipalities should be expected to recover the costs of service provision of electricity and water from tariffs (including consumer cross-subsidies) and national funding for lifeline tariffs. The six other basic municipal services, namely sanitation, refuse removal, stormwater drainage, firefighting, municipal health and municipal roads, would comprise the remaining service responsibilities in the formula. Due to their more public nature, cost recovery based on use is not possible for these services, but municipalities can collect some revenue, for example through property rates, levies and user fees. Their capacity to collect such user charges can be measured through the revenue-raising capacity element in the formula.

The formula can be represented as follows:

\[
ES = CSR - CR - RRC
\]

Where, for any given municipality:

- **ES**: Equitable share
- **CSR**: Total cost of all service responsibilities for a municipality (each service may comprise a number of categories of basic service provision, each of which represents the type of technology required)
- **CR**: Maximum possible cost recovery for electricity and water, as determined by an objective assessment
- **RRC**: Revenue-raising capacity

And:

\[
CR = CCR + Li
\]

Where:

- **CCR**: Cost recovery for electricity and water from all consumers through tariffs (including consumer cross-subsidies)
- **Li**: Low-income subsidy (national lifeline funding)

Note:

It is assumed that the formula will not generate a negative number; that is, **RRC** will never be greater than **CSR - CR**.

4.2.1 Measuring the cost of service responsibilities (CSR)

The development of the local government finance system has been ad hoc, due largely to the vastly different systems and circumstances of local governance before 1994 and the absence of a coordinated approach to local government among the national line departments. Consequently, the revenue side of the equation has been developed ahead of any thorough costing of local government functions. This has been reinforced by
the demarcation and restructuring process, which hampers the costing of local government services at this stage. Furthermore, expenditure needs are usually more difficult to define and measure than tax capacity.

The FFC has developed a methodology for costing the basic services delivered by provincial governments, which assumes that the starting point is a set of nationally determined norms and standards. Should this approach be applied to the local government sphere, the norms and standards for the basic municipal services are as follows:

<table>
<thead>
<tr>
<th>Service</th>
<th>Basic standard</th>
<th>Source of specification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Water supply</td>
<td>20-30 litres per person per day within 200m of all households</td>
<td>RDP (1994)</td>
</tr>
<tr>
<td>Sanitation</td>
<td>Ventilated improved pit latrine</td>
<td>National Sanitation White Paper</td>
</tr>
<tr>
<td>Electricity</td>
<td>Access for all households; 2.5 amp limited supply (free of charge), 20 amp supply (R150 connection fee)</td>
<td>Department of Mineral and Energy Affairs, 2000</td>
</tr>
<tr>
<td>Municipal roads</td>
<td>All-weather access to within 500m of dwelling</td>
<td>Municipal Infrastructure Investment Framework (DPLG)</td>
</tr>
<tr>
<td>Stormwater drainage</td>
<td>Open channels capable of draining flow from a storm with intensity likely to occur only biennially</td>
<td>Guide to Municipal Service Options (DPLG)</td>
</tr>
<tr>
<td>Solid waste removal</td>
<td>Removal from an area on a weekly basis</td>
<td>Guide to Municipal Service Options (DPLG)</td>
</tr>
<tr>
<td>Municipal fire services</td>
<td>Various response times</td>
<td>SABS 090</td>
</tr>
</tbody>
</table>

This does not suggest that there is only a single basic standard of delivery for every service. As noted, different standards must be specified within each basic level of service, based on the technology that is appropriate in different circumstances. For instance, sanitation options range from ventilated improved pit latrines and septic tanks to water-borne sewerage. Population density is likely to be a significant factor in this respect: water-borne sewerage is advisable in built-up areas and areas close to sources of fresh water, while ventilated improved pit latrines are more appropriate in remote areas where sewerage works are not in close proximity. Methodologies must be developed for each basic municipal service, which take adequate account of such factors. In the interim, the development of estimates would be useful; these could be based on existing service standards and estimated service costs across all municipalities.
Although the equation above does not include actual service costs, it is still important to propose an equitable share formula at this point, for two reasons:

- The revenue framework should be designed to accommodate the expenditure patterns that will emerge from future costing studies.
- The vision for equitable share transfers through an ideal formula has to be articulated, followed by a move toward its realisation through interim measures.

**4.2.2 Measuring revenue-raising capacity (RRC)**

The current local government formula (see Appendix F) does not sufficiently consider tax capacity. The I grant in the current formula has a tax capacity component; however, the grant is relatively small. The S grant addresses the inability to pay for services; however, section 4.1.3.1 proposes that national funding of lifeline tariffs should be used for this purpose. The formula proposed by the Department of Finance in 1997 included a T (tax capacity) element for intra-metropolitan tax equalisation, but this was not operationalised and is no longer relevant in the context of the unicity.

The equitable share has to consider the tax base of municipalities. The I grant formula currently takes account of fiscal capacity by incorporating the use of per capita income for each municipality. It is proposed that this be replaced by a measure of the revenue-raising capacity of a specific revenue source, namely property rates, for the following reasons:

- Transfers should encourage tax effort for each revenue source. If a municipality is incorporating significant areas of previously untaxed agricultural land, the time and cost of rating such land should be recognised. Still, a suitable revenue-raising measure would encourage the municipality to speed up the process.
- The fiscal capacity of other revenue sources for local municipalities need not be measured. Income from electricity and water supply will be derived from consumer cost recovery and a national lifeline subsidy.

The fiscal capacity measure can be extended to include additional revenue sources, particularly those that represent revenues that have been foregone. This would apply to the proposed local government levy on electricity, which would replace the revenue from electricity surpluses generated in the past. This proposal is consistent with the FFC’s 1997 report, which argued that the tax capacity of each municipality should be one of the major factors determining intergovernmental transfers to municipalities. The report recommended that the tax capacity of property rates should be measured, and the FFC proposes that a similar measure be incorporated into the local government equitable share formula in future.
The variation in the fiscal capacity of district municipalities remains an issue, with some collecting substantial revenues from regional levies and others gaining only minimal revenue owing to poor economic infrastructure. A discussion of this issue is provided in section 4.3.5.

4.2.2.1 Interim measures

Two obstacles to the implementation of the formula proposed in section 4.2 are:

a) The data to measure municipal tax capacity for property rates are insufficient, owing to:
   - The current state of municipal records, which often do not provide details of the categories and value of immovable property
   - Varying definitions of property tax bases in different parts of the country
   The Property Rating Bill will place the system of assessment on a more uniform basis, but will probably only be enacted in the latter half of 2001. Moreover, the data submitted by municipalities to the National Treasury do not follow consistent reporting formats, and data generated through budget reforms will only be available after 2003.

The service responsibilities of a municipality need to be weighed against its capacity to meet these costs from its own revenue sources. It would be inappropriate to introduce an interim tax capacity measure without analysing data on the cost of service responsibilities, as adverse distribution effects could result. Research into both municipal tax capacity and the costing of basic municipal services forms part of the FFC’s research programme, and it is proposed that a fiscal capacity measure be introduced when the results of these costing studies become available.

b) Despite the (probably medium-term) absence of data on the cost of service responsibilities, the size of the equitable share to be disbursed must still be estimated. Government introduced three-year equitable share allocations for municipalities as from 2001/02. These allocations will be based on its existing equitable share formula, which includes phase-in arrangements for urban and rural areas.

In the interests of stabilising the local sphere, the FFC recommends that this formula remain in place until the end of the current MTEF cycle (2003/04). As costing studies on basic municipal services are carried out and the results incorporated into the proposed equitable share formula, the direction in which the size of the equitable share should move will become clear.
4.2.3 Proposals: local government equitable share formula

- Permanent formula: In the long term, the local government equitable share should be calculated as follows:

\[
LES = (S + B) + m + T + I
\]

Where:
- \( LES \): Local government allocation
- \( S \): Grant to support the delivery of basic municipal services
- \( B \): Grant to fulfil other constitutional and legislative responsibilities
- \( m \): Spillover grant to provide financing for services with intermunicipal spillover effects
- \( T \): Tax capacity equalisation grant
- \( I \): Institutional grant to finance core administrative functions

- Intermediate formula: In view of the lack of data for implementing the permanent formula, the \( S \) and \( T \) elements should be operationalised at the beginning of the 2004/05 MTEF cycle, as follows:

\[
ES = CSR - CR - RRC
\]

Where, for any given municipality:
- \( ES \): Equitable share
- \( CSR \): Total cost of all service responsibilities for a municipality (each service may comprise a number of categories of basic service provision, each of which represents the type of technology required)
- \( CR \): Maximum possible cost recovery for electricity and water, as determined by an objective assessment
- \( RRC \): Revenue-raising capacity

And:
\[
CR = CCR + Li
\]

Where:
- \( CCR \): Cost recovery for electricity and water from all consumers through tariffs (including consumer cross-subsidies)
- \( Li \): Low-income subsidy (national lifeline funding)
Note:
It is assumed that the formula will not generate a negative number; that is, 
RRC will never be greater than CSR – CR

- The local government equitable share formula should be based on the following principles:
  - Electricity and water providers should be expected to recover the costs of service provision from tariffs (including consumer cross-subsidies) and lifeline tariff subsidies.
  - National government should fund part of the cost of providing lifeline tariffs for electricity and water for low-income consumers, either through the equitable share formula or through a national conditional grant to municipalities.
  - Consumer cross-subsidies could make up the shortfall between national funding for lifeline tariffs and the required subsidy for lifeline tariffs. Government has to determine the relative proportions of national subsidy and consumer cross-subsidy in the overall subsidy.

- It is recommended that revenue-raising capacity be included in the local government equitable share formula to measure a specific revenue source – property rates. If a local government levy on electricity supply were to be introduced, it should be included in an extended fiscal capacity measure.

- In view of the data constraints, it is proposed that research be conducted into the measurement of revenue-raising capacity and the cost of service responsibilities. These two elements should be operationalised together to avoid potentially adverse distributional outcomes from introducing only one element.

- The following criteria should form the basis for identifying basic municipal services:
  - The municipal service is classified as a function of local government in Schedules 4B and 5B of the Constitution.
  - Access to the municipal service is a basic right, as per the Bill of Rights.
  - The service is essential for life, according to the Municipal Systems Act definition of “basic municipal service”.
  - The service conforms to section 153(a) of the Constitution, which links “basic needs” to the promotion of development.
  - The municipal service is highlighted in policy and legislation as an essential service.
Three principles should govern the funding of basic municipal services:
- The extent to which a municipality prioritises a basic municipal service will depend on local circumstances.
- Residents in a given jurisdiction have the right to a basic level of service provision. There will be different standards of service delivery owing to the nature of the technology required.
- Where municipalities do not yet deliver the full range of basic municipal services owing to a lack of capacity, equitable share allocations could be phased in.

4.3 The funding of district and local municipal functions

4.3.1 Background
The Regional Services Council Act of 1985 provided for Regional Services Councils (RSCs), 42 of which were subsequently established in the former four provinces. (RSCs in the former Natal and KwaZulu were called Joint Services Boards.) The RSCs/JSBs were mandated to ensure the provision of infrastructure in both urban and rural areas.

The Local Government Transition Act of 1993 decreed that the RSCs and JSBs were to be replaced by “district, subregional or services councils” in non-metropolitan areas and by metropolitan councils in metropolitan areas. These new councils also became operative in the former “homelands” and “self-governing territories”.

Within district council areas, there were essentially two kinds of local structures:

- Transitional Representative or Rural Councils (TRepCs and TRCs) had elected councils but had almost no powers and functions. The district councils generally provided direct services to these councils, in many cases drawing up their budgets.
- Transitional Local Councils (TLCs) had executive powers and functions. However, their size and capacity varied substantially. District councils often provided services to the smaller or poorly capacitated TLCs, whether of an administrative, financial management or service delivery nature.

The administrative responsibility for rural councils therefore rested primarily with the district councils. The district councils received a portion of the equitable share of these councils and usually charged an administrative fee for fulfilling functions on their behalf. In many cases, weaker local councils received administrative and/or
financial support from their district councils, and the extent to which district councils required a fee for these services depended on the council concerned.

In addition to providing bulk services to the district, some district councils have also rendered agency services (most notably health and road maintenance services) on behalf of provincial governments, particularly in the Eastern Cape, Western Cape, Northern Cape and North West. These arrangements are causing problems, with many district councils arguing that the provincial governments are not providing sufficient funds.

The system changed substantially after the December 2000 local government elections, when wall-to-wall local municipalities were created. It is likely that many of the current arrangements will continue at least in the short term, especially agency services on behalf of the provinces.

4.3.2 Legislative and policy framework for revenue assignment

District municipalities will continue to play an essential role in the delivery of services in non-metropolitan areas. The capacity of many local municipalities—especially those comprising primarily “rural” areas—is insufficient for the delivery of basic services. Policy and legislation such as the Local Government White Paper noted the lack of capacity in many parts of South Africa. The White Paper recommended that district municipalities be actively encouraged to provide and maintain appropriate levels of municipal services in such situations and to provide technical support to local municipalities (for example, in the preparation of budgets).

The Municipal Structures Act of 1998 spelt out the division of functions between district and local municipalities, and assigned primarily bulk service and district-wide functions to district municipalities. Section 85 empowered the provincial MEC for local government to adjust the division of powers and functions, with the capacity to perform a function being the most important determinant.

The Municipal Structures Amendment Act of 2000 signals a shift in this regard. The functions of municipal health services, water supply, sanitation and electricity are now vested in district municipalities, although the national Minister for local government can assign any of these to a local municipality. This assignment of functions carries significant fiscal implications, which the Commission will investigate in the near future.

Both Category B (local) and C (district) municipalities have the power to impose rates on property and surcharges on fees. The current practice is for local municipalities to

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14 There are exceptions to this, namely District Management Areas with very sparse populations; a very small proportion of the country’s population lives within these areas. District Management Areas are under the direct jurisdiction of district municipalities.

collect property rates, with district municipalities relying on regional levies. Section 229(3) of the Constitution stipulates that national legislation is required where two municipalities have the same fiscal powers and functions, and this division must be based on the following criteria:

a) The need to comply with sound principles of taxation
b) The powers and functions performed by each municipality
c) The fiscal capacity of each municipality
d) The effectiveness and efficiency of raising taxes, levies and duties
e) Equity

Section 229(4) adds that revenue-sharing arrangements between Category B and C municipalities are an option.

Clearly, the powers and functions assigned to district and local municipalities will determine revenue assignment. The developing revenue framework must distinguish between electricity and water on the one hand, and sanitation, refuse removal, municipal roads, municipal health, stormwater drainage and firefighting on the other, as argued in section 4.1.3.1 above.

4.3.3 The provision of electricity and water by district and local municipalities

The Municipal Structures Amendment Act of 2000 reassigned the functions of electricity and potable water supply from local to district municipalities. In certain cases, however, the Minister of Provincial and Local Government can authorise a local municipality (most likely a larger municipality) to continue providing one or both services.

The assignment of these functions to either district or local municipalities has significant fiscal implications:

a) The FFC proposes in section 4.1.3.1 above that lifeline tariffs for electricity and water be funded by national government, through either a conditional grant or an element of the equitable share formula. The question is then whether the district or the local municipality should receive the funds. In principle, the service authority should receive such funds. Both the Municipal Systems Act and Water Services Act distinguish between a “service authority” and “service provider”: a service authority is responsible for ensuring that a service is provided, but it may authorise another body (which may be a local municipality) to deliver the service. The FFC recommends that funding, including lifeline tariff funding, be directed to the relevant service authority. This authority should ensure that the service provider has sufficient funds to implement lifeline tariffs.
In some cases, a district municipality may be the service authority for potable water supply and the local municipality in its jurisdiction may be the service authority for electricity. In such cases, the lifeline tariff funding would be divided between the district and local municipalities according to the respective proportions of funding.

b) Electricity and water generally produce surpluses for local municipalities, which are used to fund the delivery of other municipal services. The transfer of either function to district municipalities may therefore result in a loss in revenue. It is unlikely that district municipalities will become actively involved in electricity reticulation, given the pending restructuring of the electricity distribution industry. However, as the service authority for electricity, they should receive the local government levy for electricity (should the FFC’s recommendation that funding be directed to the relevant service authority be accepted). In terms of lifeline tariff funding, once electricity undertakings are restructured into Regional Electricity Distributors, the electricity portion of the lifeline funding could be transferred to these distributors to subsidise low-income consumers.

Concerning the surpluses generated by water and electricity, the following is relevant:

- Many municipalities generate surpluses owing to unusually high tariffs. These tariffs will increasingly be regulated and made uniform through national organs of state, most notably the National Electricity Regulator and DWAF. Section 74(2)(d) of the Municipal Systems Act of 2000 stipulates that tariffs must reflect the costs associated with rendering a service. Local municipalities may object that they are losing a lucrative source of revenue (which subsidised other services). However, the introduction of cost-related tariffs would have a similar effect.
- The transfer of water and electricity will benefit local municipalities that are running losses on these accounts.

In the long run, then, the generation of surpluses will be constrained by national tariff frameworks and by the requirement that tariffs reflect cost.

4.3.4 Regional levies
The current source of district funding for infrastructure is regional levies, which have been levied in South Africa since 1987. The total revenue from these levies exceeded R3.4 billion in 1999/2000, which represents 11 per cent of local government revenue.16 The regional services levy is a tax on payroll, is paid by employers (including all three spheres of government) and accounts for approximately a third of total levy income. The regional establishment levy makes up the remainder, and is determined in relation to transactions by any person conducting an enterprise within a region.17
Levy-payers can deduct levies as an operating expense for purposes of income tax. This implies that some of the incidence of these levies is shifted onto personal and corporate income-taxpayers at national level.

Section 12(6) of the RSC Act stipulates that levy income may be utilised for:

- Payment of the costs incurred in the performance of any function entrusted to the council
- Payment of the costs resulting from the collection of the levies (includes administration and finance departments)
- Payment for the establishment, improvement and maintenance of infrastructure for transport services for commuters
- Any other purpose approved by the Minister of Finance

However, district and metropolitan municipalities must prioritise infrastructure investment – such investment should be channelled where the need is greatest.

Regional levies have several advantages:

- The levy system is relatively efficient in terms of collection cost, and is simple and productive.
- Significant successes have been recorded in the use of private collection agencies, with income increasing significantly where such agencies have been introduced.
- In terms of allocative efficiency, while the turnover levy has cascading effects, overall tax rates are generally low and therefore do not have a meaningful impact on a levy-payer’s decision to locate in a particular tax jurisdiction.
- Some district councils have utilised RSC revenue in a redistributive manner, collecting most of the revenue in urban areas and spending it mainly in poorer rural areas.

However, the levies also have certain drawbacks:

- The RSC Levy Act provides that only SARS can furnish an estimated assessment, and working through SARS can be time consuming. Unless metropolitan and district councils are authorised to estimate liability for RSC levies, the levies will remain largely a “voluntary tax” on businesses and effective credit control will be hampered.
- The turnover tax is generally passed on to the consumer; such a tax is generally regressive in its impact.

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Options for the reform or replacement of regional levies include:

- Improvement of the existing system, such as empowering district municipalities to issue assessments
- Reform of the existing system, such as the collection of levies by SARS
- Replacement of the levy system with a new instrument, such as a grant funded by a 1 per cent add-on to value added tax

Concerning these options, the Commission proposes:

- That the revenue accruing to district municipalities through regional levies be retained within the local government sphere
- That the revenue instrument chosen be subject to local control, allowing district municipalities to vary the rate and thereby be directly accountable to the electorate for the rate and the subsequent use of the revenue

4.3.5 The funding of basic municipal services delivered by district municipalities

The revenue provided by regional levies is a valuable revenue source despite the above limitations. The RSC Levy Act stipulates that the main purpose of the levies is to fund infrastructure in areas that need it most. The question is whether the levies should be retained for this purpose.

District municipalities are currently responsible for bulk service delivery and have also been assigned water, sanitation, electricity and health services. In some cases, local municipalities may be authorised by the Minister to deliver the latter services. In many others, the remaining municipal functions will be assigned to district municipalities by the relevant MEC for local government, in consultation with the Municipal Demarcation Board. The challenge is therefore to design a system that is flexible enough to deal with these variations, while adhering to the principle that finance should be directed to the service authority. There are two broad options:

- Regional levies continue to be earmarked primarily for infrastructure provision, and district municipalities receive funding for the delivery of basic municipal services through a revenue-sharing arrangement with local municipalities. The local revenue sources to be shared will have to be identified, as will the manner in which the revenue is divided. Note that a mechanism had been developed for sharing revenue from property rates between metropolitan councils and metropolitan local councils before December 2000. The proportion of local revenue to be paid to the district municipality will depend on the local functions assigned to district municipalities.
This will require detailed accounting and negotiation processes, which would greatly be enhanced by specific information on service levels and costs.

- Regional levies are converted into a general revenue source for funding the municipal services assigned by legislation. Funding for infrastructure is provided via national government's infrastructure programme (including the Consolidated Municipal Infrastructure Programme – CMIP) and own revenue sources. If any additional functions were transferred to district municipalities by the relevant MEC for local government, revenue-sharing arrangements would again be necessary. Where the local municipality is the service authority but wishes the district municipality to deliver the service, it would enter into an agreement with the district municipality regarding the funding and service level.

The FFC proposes the second option. It is the policy of Government that the relative fiscal autonomy of the local sphere of government be strengthened, and the creation of a genuine source of own revenue for district municipalities would support this. The earmarking of regional levies for infrastructure would thus be removed, and district municipalities would be free to direct expenditure to capital or current expenditure, depending on district priorities.

For both options, the tremendous variation in regional levy income would have to be addressed. As Franzsen et al have noted, geography, demography, economic activity, size and the provision of services all affect a council's ability to raise its own revenue.\(^{20}\) The district councils with the lowest levy income were typically created in 1996, but their levy income has risen as their administrative capacity grew. There are real limits to this growth, as most are in areas with relatively little formal business activity. The FFC therefore recommends the introduction of an equalisation grant for regional levies.

4.3.6 The funding of district health services

While the Constitution states that “municipal health services” and “health services” are functions of local government and provinces respectively, it does not define these terms. This has created confusion about the allocation of functions and funding between the two spheres.\(^{21}\) The Health Act of 1977 reinforces this ambiguity by allocating the provision of curative primary health care services to both provinces and local authorities.\(^{22}\) This has led to function overlaps and fragmentation in service provision.

Provincial governments fund most district health services (including district hospitals and management, and primary health care services), and a substantial proportion of local municipal health services. The situation varies among provinces and among

\(^{20}\)Franzsen et al, op. cit.
\(^{21}\)Report of the Bi-Ministerial Task Team on the implementation of a Municipality-Based District Health System in the Western Cape, April 2000.
\(^{22}\)Sections 16(1) and 20
\(^{23}\)Interview with CFO and Fiscal Reform Project questionnaire, Robertson TLC, 11 July 2000.
individual municipalities within a province, as the provision and funding of these services has developed in an ad hoc manner. Given the resulting controversy and the complexity of the issues, the current situation is outlined below, followed by proposed interim and long-term solutions.

4.3.6.1 Funding and trends
The extent to which local municipalities fund health services from own revenue varies considerably, with some receiving full funding from district or provincial authorities and others using mostly own revenue. In Robertson TLC in the Western Cape, for example, the municipality received a health subsidy from the province of R45 000, while spending R1,1 million during the 1998-99 financial year – an own revenue contribution of 96 per cent.\(^23\) By contrast, the nearby Montagu TLC, which likewise generates significant own revenue and shares a similar socio-economic profile, made an own revenue contribution of only 33 per cent.\(^24\) In Phalaborwa TLC (Northern Province), which has high poverty levels and generates only modest revenues, no funds were received for health services while R1,9 million was spent in that year.\(^25\) These cases reveal no particular pattern with respect to need or fiscal capacity.

In general, concerning the funding of health services delivered by district councils, it seems that district councils either do not provide health services at all owing to a lack of capacity, or they provide health services largely on an agency basis for provincial authorities. Two examples of the former are the Northern District Council (Northern Province) and Kei District Council (Eastern Cape), where health services are provided by provincial authorities.\(^26\) By contrast, in the Breede River District Council (Western Cape), R10,3 million was received from the province in 1998-99 for the Council to provide health services on an agency basis.\(^27\)

4.3.6.2 Expenditure trends
District health expenditure reviews were developed as a tool for examining resource allocation and use. Daviaud et al studied the first five reviews, showing differences across and within provinces and districts.\(^28\) The analysis and findings focused on inter-district comparison in terms of equity, resource allocation, efficiency and sustainability indicators.

Concerning equity, expenditure per capita varied significantly between urban and rural districts, with urban areas having higher expenditures. On resource allocation, high expenditure on hospitals crowded out expenditure on primary health care, resulting in the overuse of hospital facilities. High levels of overexpenditure are a result of under-budgeting, inefficient allocation and use, inadequate or non-existent billing systems, and a lack of administrative support.

\(^{23}\)Interview with CFO and Fiscal Reform Project questionnaire, Montagu TLC, 4 July 2000.
\(^{24}\)Interview with CFO and Fiscal Reform Project questionnaire, Phalaborwa TLC, 2 August 2000.
\(^{25}\)Interview with CFO, Northern District Council, 3 August 2000; interview with CFO, Kei District Council, 20 July 2000.
\(^{26}\)Interview with CFO and finance staff, Breede River District Council, 12 July 2000. District councils have contributed small amounts of their own funding to health services in the Western Cape; however, the National Treasury has consistently opposed increases in these revenue contributions.
4.3.6.3 Summary of issues

Several trends emerge from the above:

• Primary health care services have generally only developed where a municipality has taken the initiative or funded a portion of these services. The variety of funding arrangements obscures the extent to which municipal health services are funded by own revenue.

• Provincial and district subsidisation of (local) municipal health services occurs on an ad hoc basis and is not directly related to population size or socio-economic circumstances. District municipalities that provide health care services are almost fully funded by provinces.

• The significant differences in per capita expenditure across and within provinces are indicative of a highly inequitable system that fails to use its scarce resources efficiently and effectively.

The underlying problem is the absence of a definition of “municipal health services”. The national definition of the “basket of goods” that forms primary health care services does not indicate which of these are the responsibility of local government, and thus what elements local government must fund.

4.3.6.4 Long-term solution

From a health perspective, the new system of wall-to-wall local municipalities is well suited to district health service delivery. It will form the basis for rational community-oriented primary health care and generate economies of scale.

The goal of the health decentralisation process is to devolve all primary health care services to local government. The extent of the own revenue contribution will then be influenced by the fiscal capacity of the municipality, and there would be no reason (in the longer term) to exclude health services from the proposed equitable share formula.

In the long run, the formula for funding primary health care services by district (and some local) municipalities should be the same as the provincial health formula, since it comprises the same package of services. It would then be necessary to determine:

• The basic level of primary health care that everyone has a right to receive

• The cost of providing primary health care at the basic level of service determined by Government

The national Department of Health has to develop uniform definitions and minimum standards of service provision. The FFC has conducted research on the costing of
primary health care services and has recommended a formula for primary health care services in its Recommendations for the 2001-2004 MTEF Cycle. However, follow-up research is needed to confirm the cost drivers in the provision of such care. In addition, data on some formula parameters, such as utilisation rates, must also be collected.

Given the early stage of decentralisation of health care and its unevenness around the country, funding for municipal health services should not be channelled through the local government equitable share in the short or medium term. Even when adequate information becomes available, it would take considerable time to implement mechanisms for the transfer of responsibilities and resources.

4.3.6.5 Interim solution

Given that significant portions of municipal health services are funded by the own revenue of local municipalities, district municipalities are unlikely to take over local health service delivery without securing additional funding. Yet it is difficult to guarantee such funding: as noted before, the local municipalities that have funded significant portions of their health services have done so on their own initiative, and the extent of their contribution has not been guided by policy or legislation.

The Municipal Systems Act distinguishes between “service authority” and “service provider”. A large local municipality such as East London would be the service authority within its jurisdiction, and the district municipality would play no role in municipal health provision within that local jurisdiction. The status quo will probably continue in the short term, and the challenge will be to determine what portion of primary health expenditure provinces and municipalities should fund.

Local municipalities falling under the service authority of the district municipality would be in a different situation. In the short term, local municipalities delivering health services could continue as service providers on behalf of district municipalities. In the longer term, equity issues would arise, since residents in a local municipality should have access to the same minimum level of primary health care services as other residents in the health service authority area and, indeed, throughout the country.

To provide a benchmark against which equity in spending could be measured, it would be necessary to estimate the per capita cost of providing health services within a district area. However, as already indicated, this can only be done in the long run. In the short term, the per capita expenditure in the district may be used to gauge the level at which the provision of health services meets equity requirements throughout a health service authority area.
As FFC research has indicated, the same level of service provision requires different amounts of resources, depending on the poverty, age and gender profile of the recipient population. Census statistics on these variables are available for each district and local municipality, allowing the calculation of the relative per capita expenditure within the district municipality as a whole and in the local municipality. The contribution to health care services by local municipalities must also be factored in. Own revenue contribution is a valuable source of health care funding and should be retained in the system. As noted, some local municipalities have fully funded health care services, while others have not contributed.

One solution is to proceed as follows:

- The provincial primary health care subsidy to local government would be calculated for the previous financial year and adjusted for inflation for the current year. To ensure that interdistrict equity is created, this total would be divided among the districts according to the FFC health formula, to incorporate population, age, gender and poverty profiles. This would provide provinces with a guideline for primary health care allocations.
- Given the sizeable imbalances in funding across districts, equitable allocations would need to be phased in. Nevertheless, the move towards equity in the funding of primary health care services would already be significant.
- For the district allocation to local municipalities, per capita amounts would then be calculated for each local municipal area, again using the FFC health formula. The resulting allocation would provide a guideline for primary health care allocations in each local municipal area.
- In many cases, the local municipality may wish to supplement this amount with own revenue to achieve or maintain a higher level of service. The local municipality may either act as a service provider on behalf of the district municipality, receiving its subsidy from the district and contributing own revenue for a higher level of service. Alternatively, the district municipality may provide health care services in the local municipal area, or appoint a service provider other than the local municipality. The local municipality would contribute some of its own revenue to the district municipality in order to fund a higher level of service.

This arrangement would ensure that local municipalities retain the option of spending more on health care services. The extent to which they do so will reflect both their fiscal capacity and the priority they place on health services. This would also satisfy the criterion of equity – each local jurisdiction would be allocated a subsidy according to a formula that reflects its population profile.

30Alternatively, this amount could simply be the total subsidy that the province makes available to a district as a whole; however, the aggregation exercise is useful as it shows the subsidy previously available within the entire district.
However, the practice of supplementing health expenditure could reinforce past inequities, as poor, mostly rural municipalities will probably be unable to do so. This problem can be addressed by ensuring that the equitable share formula for local government adequately captures fiscal capacity.

4.3.7 Proposals: funding of district and local municipal functions

- In developing mechanisms to fund the delivery of municipal services by district and local municipalities, a guiding principle should be that the funding should be directed to the service authority.

- The national funding for lifeline tariffs for electricity and water supply should be divided between the relevant district and local municipalities, so that the municipality designated as the service authority receives the funding for the service.

- Where the electricity or water functions are transferred to district municipalities, local municipalities should not be compensated for the surpluses generated by these services in the past.

- Any change to the regional levy system should adhere to the following principles:
  - The revenue accruing to district municipalities through regional levies should be retained, in some form, within the tax system.
  - The revenue instrument chosen should be subject to local control, so that district municipalities can vary the rate and thereby be directly accountable to the electorate for the rate and the expenditure of the revenue.

- The FFC recommends that regional levies be converted into a general revenue source for the district municipalities to fund the municipal services assigned by legislation. Funding for district-wide infrastructure would come via national government’s infrastructure programme (including CMIP) and loan finance. Should any additional local municipal functions be transferred to district municipalities by the relevant MEC for local government, revenue-sharing arrangements would be necessary.

- Government should determine the basic level of primary health care services to which everyone has a right. This will facilitate research into the costing of primary health care services.
• As an interim measure, the provincial allocation to local government for primary health care provision in each province should be disaggregated to district level, using the FFC health formula. This would give provinces a guideline on primary health care allocations.
  - With the district allocation, per capita amounts should then be calculated for each local municipal area, again using the FFC health formula.
  - Municipalities could supplement this amount from own revenue to achieve or maintain a higher level of service.

• It would be desirable to include health services in the local government equitable share formula. However, given the current transformation of local government and its capacity limitations, this should occur only in the longer term.

4.4 The funding of local government infrastructure

4.4.1 Legislative environment
The broad policy framework for future legislation on local government is outlined in the White Paper on Local Government (1998). Based on the White Paper and the Constitution, new legislation is replacing the many and outdated laws, ordinances, regulations and by-laws governing municipal affairs:

• The Municipal Systems Act of 2000 provides a legal framework for exercising the functions assigned to local government by the Constitution. It specifies that municipalities can act as the service authority or service provider, and encourages them to use a range of delivery alternatives.
• The Municipal Finance Management Bill requires municipalities to establish a municipal revenue fund, controlled by the municipal manager. Consolidated financial statements must be prepared on an annual basis within a limited period and must be audited by the Auditor-General. Financial statements will be prepared in accordance with generally accepted municipal accounting practices.

4.4.2 Municipal infrastructure transfers: an evaluation

4.4.2.1 Introduction
Local government must ensure the sustainable provision of services to communities. In poorer municipalities, however, existing infrastructure is often either inadequate or non-existent. In 1998, the Government’s Investment Review Team estimated the total infrastructure service backlog for a period of five years to be R47-R53 billion, with an average annual deficit of R10,6 billion.
A capital grant system was implemented after 1994 to encourage the move towards national norms and standards of service delivery and to address backlogs and regional disparities. Transfers financed 13 per cent of the total capital spending by municipalities in financial year 1999-2000.

Infrastructure provision stimulates economic development. The provision of services such as electricity, water, waste removal and roads has a significant impact on the standard of living of residents. National government is therefore justifiably involved in infrastructure provision as this generates significant benefits and reduces inequalities in infrastructure and service provision. Grants from national government are generally targeted at poor communities.

4.4.2.2 The existing framework

Given the current fiscal constraints, the existing system of municipal infrastructure grants should be evaluated to determine whether it delivers the best possible outcome. Each of the infrastructure programmes is described below.

- The Consolidated Municipal Infrastructure Programme (CMIP) was introduced by the Department of Provincial and Local Government (DPLG) in 1998. CMIP combined the existing infrastructure grants, including grants from DWAF and the Department of Housing, into a single funding process. CMIP funds can be used for building new or upgrading and rehabilitating existing infrastructure for water, sanitation, roads, stormwater drainage, solid waste disposal sites and street lighting.

  CMIP was designed to run for a 10-year period, from the 1998/99 financial year. It provides a grant of R3 000 per site for each low-income household and R7 000 per site for households in rural areas (who do not benefit from the housing programme). To receive CMIP funds, municipalities must apply through their provincial government. Once a project has been approved, funds are disbursed on a monthly basis from DPLG to the provinces.

  When assessing the progress of a CMIP project, DPLG evaluates performance indicators such as the number of jobs created, the use of affirmative business enterprises, the level of training provided, and the use of local labour, plant and materials.

- The Community Water and Sanitation Capital Grant forms part of the Community Water Supply and Sanitation (CWSS) Programme run by DWAF. It funds bulk, connector and internal infrastructure for basic water services, focusing on communities where the municipality lacks the capacity to run such a project.
(The DWAF and the municipality must reach a formal agreement regarding the support for the project.) The programme aims to provide water to 90 per cent of the currently unserviced population by 2004.

- The Community-based Public Works Programme (CBPWP) has a broader focus than CMIP, and funds projects such as taxi ranks, business centres, market stalls, community gardens and service roads. It is administered by the Department of Public Works and operates in three provinces – Eastern Cape, KwaZulu-Natal and Northern Province – through 12 district councils. The programme currently focuses on female-headed households and poverty pockets in rural areas. The emphasis is on locating productive assets within a short distance of one another ("clustering"), which results in sustainable employment creation.

- The Local Economic Development (LED) Fund was set up in 1999 to create jobs and alleviate poverty. Some of the funds are made available for infrastructure projects. As with CMIP, funding is granted on a case-by-case basis on the submission of a business plan. Monitoring and evaluation take place at a national and provincial level. Projects must meet the objectives of the LED Fund, which include employment generation, targeting disadvantaged communities and leveraging private sector investment. Unlike CMIP, LED funds are transferred directly to the municipality by DPLG.

- The Urban Transport Fund promotes integrated land use and land transport planning, and is allocated only to metropolitan and large Category B municipalities. The Department of Transport enters into contracts with municipalities, and the transfers must be shown on municipal budgets.

- The South African Housing Fund: Housing is a joint national and provincial responsibility, but municipalities must provide the accompanying infrastructure. The housing subsidy may be used to provide certain basic internal municipal services, although there is a limit of R7 500 for service provision and land acquisition. CMIP funds usefully complement the housing subsidy by financing bulk and connector infrastructure services.

- The National Electrification Fund: Eskom has undertaken the bulk of capital electrification in recent years and has provided funds to municipalities for electrification projects. From 2001/02, electrification will be funded through the national fiscus and be on budget. The electricity industry is currently undergoing a restructuring process, which could result in further changes to the national electrification programme. Electrification is not covered by any other infrastructure grant.
4.4.2.3 Proposals for reforming the capital grant system

The National Treasury’s proposals for reforming the existing capital grant system include:

a) A single, integrated grant, incorporating CMIP, CWSS and the CBPWP. A second phase of consolidation could include the LED Fund and others, such as the Urban Transport Fund.

b) A formula-based grant, which would be allocated to individual municipalities on a three-year basis to correspond with Government’s medium-term budgeting strategy. The envisaged capital grant formula would be based on the following variables:
   - Existing infrastructure backlogs and the number of poor households
   - Maintenance of existing infrastructure
   - A performance portion

c) Project selection and grant disbursement would take place at the metropolitan, district and (large Category B) municipal level. The role of national and provincial government would be to support and evaluate municipal programmes.

Source: Schedule 5, Division of Revenue Act, 2001

<table>
<thead>
<tr>
<th>Grant</th>
<th>Used for</th>
<th>MTEF 2001/02 (R million)</th>
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<tr>
<td>Consolidated Municipal Infrastructure Grant</td>
<td>Bulk and connector infrastructure, upgrading and rehabilitation</td>
<td>994</td>
</tr>
<tr>
<td>Local Economic Development Fund</td>
<td>Job creation and poverty alleviation, with a focus on social infrastructure</td>
<td>75</td>
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<tr>
<td>Community-based Public Works Programme</td>
<td>40 per cent roads, rest for social or agricultural infrastructure</td>
<td>374</td>
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<tr>
<td>Community Water Supply and Sanitation capital grant</td>
<td>Water: bulk, connector and internal</td>
<td>821</td>
</tr>
<tr>
<td>Community Water Supply and Sanitation operating grant</td>
<td>Water: operating costs of infrastructure owned by the Department</td>
<td>691</td>
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<tr>
<td>Urban Transport Fund</td>
<td>Roads, taxi ranks, stations</td>
<td>81</td>
</tr>
<tr>
<td>National Electrification Programme</td>
<td>Implementation of national electrification programme</td>
<td>To be gazetted</td>
</tr>
</tbody>
</table>

These proposals are taken from the following: Department of Finance (May 1999), Rationalisation of Housing and Infrastructure Capital Grant Mechanisms; Department of Finance (29 August 2000), Rationalisation of Conditional Grants for Municipal Infrastructure; and an interview with D. Savage at the National Treasury (12 December 2000).
d) The formula-based approach would not immediately be implemented in full. A transition mechanism would have to be developed to support municipalities that lack the capacity to manage the grant.
e) Outcomes rather than processes would be monitored as performance indicators.
f) Grant-matching contributions by households could be considered, although the percentage required is likely to be low.
g) A single grant devoted exclusively to capacity building should be put in place, rather than the fragmented system that currently exists.

The National Treasury proposes that the Municipal Infrastructure Task Team implement this system in financial year 2001/02. As a first step, it has established the Municipal Systems Improvement Programme for the 2001 Budget. This programme is meant to provide a framework for consolidating all transfers for municipal capacity building.

4.4.2.4 Evaluation of current system and Treasury proposals
Capital transfers to municipalities account for only a small proportion of local government spending on infrastructure. Most capital expenditure is financed through own revenue sources, such as rates and taxes. Since government policy is to promote the self-sustainability of municipalities, it has no plans to change this situation. However, little progress has been made in the supply of essential public services in recent years. Backlogs are not being reduced – some are even rising. Municipalities in financial difficulty tend to cut back particularly on their capital budgets and on maintenance, since the effects are not felt immediately.

It is difficult to evaluate the impact of the current system, since infrastructure has a long lead time. Nevertheless, issues such as the pace and efficiency of infrastructure investment, equity in service provision and sustainability can be considered.

a) Pace of delivery
The National Treasury states that, in spite of the growing backlog, the existing framework for capital transfers to municipalities has reached “saturation point”.

DPLG states that bottlenecks in the disbursement process occur at municipal rather than provincial or national level, owing to a lack of capacity at local government or contractor level. DPLG also indicates that turnaround times (for CMIP projects, at any rate) are not unreasonable by international standards.

34National Treasury, Budget Review 2001, Table E14.
36Ibid.
A move to a formula-based approach is likely to speed up the process, but may hamper the monitoring of infrastructure projects. A formula-based approach will promote flexibility in terms of the amounts that can be disbursed, but the existing mechanisms may not be able to cope with such increases.

**b) Fragmented grant system**

The aim of CMIP was to integrate a number of different grants into a single grant programme. However, the capital grant system is not fully integrated and some duplication remains. For example, CMIP covers water and sanitation projects, but so does CWSS. Even if such grants were to have different target groups, some overlap would occur. These grants are administered by separate national departments with disparate institutional arrangements; this contributes to the confusion.

The current fragmentation cannot promote integrated development. Services cannot be viewed in isolation, not only because some cross-subsidisation between revenue-generating and non-revenue-generating services may be needed, but also because some services are interrelated. For example, developing a system of water-borne sewerage may require the upgrading of local wastewater treatment works, and new or upgraded roads can facilitate the provision of services such as refuse collection.

Because of the fragmentation of the capital grant mechanism, duplication can occur in some services while others are underfunded. Municipalities may be exploiting the grant system by devising projects to suit the available grants, rather than by identifying a need in the local community.

The National Treasury argues for a single, integrated grant. Similarly, DPLG notes the problems inherent in a fragmented capital grant system. However, its view is that Integrated Development Plans will need to be in place before a single, integrated grant system can be implemented.

The Municipal Infrastructure Investment Framework should provide an overarching policy framework, and coordination could take place under the Municipal Infrastructure Task Team. Currently, however, there is little incentive for the different departments to coordinate their efforts. Before a single grant mechanism is implemented, some encouragement from Government is required in this regard.

**c) Project versus formula-based approach**

Infrastructure investment requires long-term planning. The project-based process has complicated long-term municipal planning, since funding is ad hoc and is generally based on a one-year horizon. The fragmented infrastructure grant system makes it difficult to predict how, where and when funding for infrastructure will be made available.

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37Ibid.
39Each municipality is expected to develop its own Integrated Development Plan, which sets out its plan for bridging the gap between the current development reality and the vision of equitable and sustainable development and service delivery.
Furthermore, provinces do not have a consistent set of criteria for assessing a particular application for infrastructure funding. Thus, municipalities that are more skilled in "grantsmanship" may have an unfair advantage. There may be an argument for municipalities to present their applications for infrastructure grants within the context of their Integrated Development Plans. However, few municipalities have prepared such plans, and most lack the capacity to do so.

The project-based approach also does not encourage efficient spending by municipalities. Contractors, knowing the ceiling amounts of the grants, are likely to charge according to what they know municipalities can afford.

The CMIP allocation per household assumes that no poor household has any access to any service. The Municipal Infrastructure Investment Framework points out that if the demand for services were calculated in this manner, R38,5 billion would be needed to cover the backlog; based actual levels of access, only R24 billion is required. The National Treasury would therefore not calculate allocations based on a certain amount per household.

d) The roles of the three spheres of government

A formula-based approach would give municipalities greater discretion over the kind of infrastructure programmes they implement. Currently, CMIP projects must be prioritised and approved by the relevant province and national government, although municipalities are given the freedom to design and implement projects. This may contribute to "grant-seeking behaviour", with a municipality submitting many applications for capital grants without knowing which projects will be approved.

Making municipalities responsible for prioritising and designing infrastructure projects should therefore result in more demand-responsive infrastructure provision. Such a system is also likely to speed up the disbursement process, since there will be no need for national or provincial government to appraise business plans, as with CMIP.

e) Conditionality

Monitoring is more difficult with a formula-based approach. It must be asked whether municipalities have the capacity to spend their funds effectively without the guidance of national and provincial government.

In the existing grant system, certain social objectives are emphasised through grant conditionality. These include gender equity, job creation and local economic development. DPLG reports that up to the end of September 2000, 4,76 million person-days of employment had been created on CMIP projects.
However, where national and provincial governments are involved in the selection process, the primary objective of the capital grant mechanism (funding infrastructure) may be subsumed by secondary objectives. National and provincial officials are not the best position to evaluate the trade-offs between these various objectives.

The National Treasury argues in favour of “outcome conditionality” as opposed to “process conditionality”. The former would require the monitoring of outcomes, such as the number of new households with access to electricity or water. Process conditionality is currently required by CMIP, hence the need for municipalities to report monthly. The Treasury notes that encouraging municipalities to adopt the priorities of national government (such as gender equality and promoting small, medium and microenterprises) may be a more effective way of achieving such objectives.42

f) Capacity issues
The issue of capacity is crucial in local government. According to the recent Harvard University review of the Municipal Infrastructure Programme, “the lack of technical and managerial capacity at the local level emerges as the single most critical constraint impeding performance on the ground”.43 For example, Amatola District Council did not claim funds on housing development projects for a number of years because they did not have the capacity to do so. In Tsolo District Council, a contractor for a water supply project was paid for work that was not done. DPLG has reported several similar cases.44

As noted, a formula-based approach may hamper monitoring and reporting. Without stringent reporting requirements, municipalities would have little incentive to report on their infrastructure projects. Furthermore, in CMIP, the selection and approval role of provincial and national governments provides a system of checks and balances, which incorporates criteria such as the sustainability of the project.

Currently, 10 per cent of CMIP funds are allocated to capacity building. However, these allocations are often not targeted at the development of project management capacity. The National Treasury proposes a consolidation of the various amounts currently allocated to capacity building in local government in order to address this concern.

g) Sustainability
Sustainability needs to be taken into account when assessing the viability of an infrastructure project. The cost of the project over the full life cycle (that is, including operating and maintenance costs) may be as much as 250 per cent of the initial outlay.45
The National Treasury contends that, since the investment decision is not made by the organisation responsible for operating the project, the issue of sustainability is not adequately considered in the decision-making process. CMIP may be the exception, since CMIP projects are not approved unless the relevant municipality accepts full responsibility for project maintenance and operation. The CWSS works differently - the infrastructure is built by DWAF and then transferred to the municipality. Although an operating grant is also available from DWAF, this compromises Government’s principle that municipalities should be self-sustaining in the long run.

One solution could be a grant-matching system, requiring municipalities to fund a proportion of each project from their own revenue (including loan finance). The municipality’s commitment would imply that it regarded the project as sustainable. The proportion of own revenue would be calculated according to the fiscal capacity of the jurisdiction - as fiscal capacity decreases, so does the required own contribution.

4.4.3 District municipalities and regional levies
Section 4.3.4 outlined the debates around regional levies, and section 4.3.5 presented two broad options for the funding of municipal services in non-metropolitan areas. If the second option is chosen, namely the conversion of regional levies into a general source of own revenue, then the capital grant will have to be extended to district municipalities.

This will produce a rather complex situation, for two reasons:

- District infrastructure projects are often different in nature to local projects, and a single grant may not take account of these differences.
- In section 4.3.3, the FFC proposed the principle of directing funding to service authorities. Furthermore, a capital grant should relate directly to the functions for which a district or local municipality is responsible (for example, municipal roads). The allocation of grant funding should take account of these principles.

The FFC therefore proposes a study to determine the nature and mechanisms for capital grant disbursement to non-metropolitan municipalities.

4.4.4 Proposals: municipal infrastructure

- The FFC supports the principle of a single, integrated conditional capital grant to local government. Until the new system is fully implemented, a mechanism to promote coordination between various national departments should be developed to harmonise the relevant infrastructure investment grants.
• The FFC supports the introduction of a capital grants formula and proposes that:
  - The formula allocations should be made on a three-year basis to ensure predictability and to facilitate proper planning and budgeting.
  - A study is required to determine the mechanisms for grant disbursement to non-metropolitan municipalities, according to the principle that funding should be directed to service authorities.
  - The envisaged capital grants formula could be based on the following variables:
    • Existing infrastructure backlogs and the number of poor households
    • Maintenance of existing infrastructure
    • A performance portion (e.g. compliance with good financial management practices, outcomes of previous infrastructure spending)
  - Consideration should be given to monitoring infrastructure investments on an outcomes basis rather than the current CMIP practice of process monitoring. Municipalities that do not produce certain outcomes could have their capital grant funding withheld and would have to submit business plans to either national or provincial government before future allocations are made.

• The FFC proposes that consideration be given to a grant-matching system for infrastructure grants. Municipalities would be required to add own revenues (including loan finance) to the allocation in proportion to their fiscal capacity.

• The FFC supports a coordinated framework for municipal building and welcomes the introduction of the Municipal Systems Improvement Programme as the first step toward implementing a rationalised programme of local government capacity building.

4.5 Local government borrowing for infrastructure provision

Although borrowing has been an important source of municipal finance, access to municipal borrowing has been limited owing to the weak fiscal capacity and the uncreditworthiness of many jurisdictions. Challenges for the future include the following:

• Dealing with investor uncertainty generated by the new municipal boundaries
• The role of national and provincial government in the borrowing activities of municipal authorities
Capacity issues in the local sphere, relating to financial, planning, accounting, investment, reporting and other decision-making processes

The local sphere’s growing responsibility for service delivery

4.5.1 Trends in local government borrowing

The last few years have seen a general holding back of lenders, with even the Development Bank of Southern Africa (DBSA) reducing its activities in the municipal borrowing market. The problem is more than simply a lack of creditworthy municipalities – it includes a lack of lenders, in part because of uncertainty after the restructuring process.

The composition of the borrowing market is changing in terms of lenders, clients and loan instruments. As at March 1998, estimated outstanding debt to public lenders was R14.4 billion and only R7.5 billion was outstanding to the private sector. The biggest portfolio of public sector debt is held by the DBSA. Private municipal debt declined by 8 per cent, and there has been a steady shift towards the Infrastructure Finance Corporation (INCA), with unit trusts playing an insignificant role. Banks are substituting direct loans for securities, while insurance funds have tended to hold back. The client base is also changing, with an increasing proportion of loans being granted to metropolitan municipalities.

The general concentration of debt within a narrow range of private sector institutions tends to subject borrowers to the decisions of a small group of lenders. A larger and more diverse group is required if the borrowing market is to be a viable source of finance for municipalities.

The volume of outstanding municipal debt is unknown, due partly to the demarcation of new boundaries and the integration of municipalities from 843 to 284 jurisdictions. According to some estimates, the officially registered debt is no cause for concern if measured against the total budgeted municipal revenue. However, as municipalities use different budget formats, it is particularly difficult to determine the amount of their hidden debt, which may well be substantial.

4.5.2 Impact of new boundaries

The amalgamation of municipalities has created uncertainty in the municipal lending market. This has led to the virtual withdrawal of contractual savings institutions and commercial banks, thereby compounding municipal cash flow problems. A partnership between Government and the private sector to provide stabilisation loans or private sector debt rescheduling may reassure private sector investors about the financial outcome of the transformation process.


\(^{49}\)Ibid.
One question is whether new municipalities will be able to participate in private markets to raise funding. Municipal demarcations could, by negatively affecting municipal creditworthiness, undermine this broader goal. The National Treasury conducted two studies in 2000 to determine the likely impact of the new demarcations on municipal socio-economic, fiscal and financial positions. The studies are limited in design and only give a partial indication of the financial impact on two sample groups.

The studies concluded that a significant number of non-metropolitan (Category B) cities and towns would probably face a marked structural decline in their fiscal position because of the new boundary demarcations. The resultant diminished creditworthiness will increasingly mean that the only source of capital available for infrastructure investment in such municipalities will be government transfers.

The extent of the erosion of creditworthiness has not been quantified. If indeed the creditworthiness of certain municipalities has been eroded, it may be necessary to adopt support measures. These measures would need to be carefully designed to ensure that municipalities do not make imprudent decisions in the expectation of national assistance.

4.5.3 Policy and legislation

Government is of the view that:

- In order to meet infrastructure backlogs and secure access to basic services, additional investment in municipal infrastructure is required from the private and public sector financial intermediaries.
- Ultimately, vibrant and innovative primary and secondary markets for long- and short-term municipal debt should emerge. To achieve this, national government must clearly define the “rules of the game”.
- National or provincial government should not face an undue transfer of risk.

Government is finalising a detailed policy and regulatory framework on municipal borrowing. The framework prescribes the mode of selective executive intervention in municipalities in severe financial distress. This framework is outlined in the Municipal Finance Management Bill, which provides details on the competence to incur debt, conditions on which municipal debt may be incurred, and security for such debt. The thrust of the Bill is to restore capital market access by providing certainty and clarifying the rights of borrowers and lenders.

4.5.4 Evaluation of the borrowing system
In view of human and fiscal capacity differences within the local sphere, a new regulatory approach to local government borrowing powers is needed. The role of Government should be to create the conditions necessary for the emergence of a borrowing market.

4.5.4.1 Stabilising the borrowing environment
Local authority credibility could be enhanced if long-term loans were extended at market or near-market rates, by reinforcing the principle of sound financial management and reducing the cost to the fiscus. However, a fund to stabilise current debt repayments should be established. Such stabilisation loans should ideally be managed by the private sector, but it is unlikely that the private sector would accept this risk, and national government may have to step in. The fund would be a once-off budget allocation to be used as a conditional grant by municipalities and would enable them to restructure existing debt and improve their cash flow.

4.5.4.2 Role of the DBSA
The DBSA has shifted its focus to co-financing projects with the private sector. As it specialises in this type of lending, it is building up expertise and encouraging private lenders to enter the market on a co-financing basis. The Bank now administers the Local Authority Loans Fund previously operated by the Department of Finance.

The future role of institutions such as the DBSA in the capital market needs to be clarified. The DBSA has two conflicting missions: it is to be self-sufficient, which means that it must not spend its own capital, but it also funds socially desirable investments for which private capital is not available. If the DBSA were to adhere to its first mission, it would fund well-organised cities at market rates and preserve its capital. However, if the DBSA acts as a concessional lender, funding projects that cannot attract private capital, it will eventually run down its capital when some projects default. By lending at rates that do not reflect the risk involved, it could inject an addictive flow of low-cost money into the system, thereby thwarting market discipline.

Competition in the borrowing market is healthy. However, “cheap” government money lent at below-market rates could encourage anti-competitive practices and keep both potential borrowers and potential lenders from engaging fully in the market. If the DBSA is to play an active role in the market, it has to, in the end, get its capital from the capital markets and price its loans accordingly.

4.5.4.3 Assisting fiscally weak municipalities
The perception that the local government sphere is fiscally autonomous may be true for certain municipalities, but many more have very limited own revenue bases. These
municipalities tend to rely largely on equitable share transfers and conditional grants from national government. Improved managerial and administrative capacity, and access to predictable revenue streams will increase their access to debt finance.

Such an approach would be preferable to direct assistance through subsidised interest payments or loan guarantees, which could create problems of moral hazard. The private sector would prefer national government guarantees in case of default, but Government has stressed that none will be forthcoming. (The Constitution also restricts the extent to which such guarantees can be given.) Guarantees are a form of subsidy and can easily lead to spiralling liabilities for the national fiscus.

4.5.4.4 Off-the-shelf loans
Complementary measures, such as off-the-shelf loan funds applied outside the regulatory environment, may also be considered for weaker municipalities, but selection criteria must be developed with caution. Ideally, this assistance should apply to capital projects that relate directly to the delivery of constitutionally mandated basic municipal services. A clear set of minimum norms and standards of service delivery for municipalities should be specified.

4.5.4.5 Market discipline and the rule-based approach
The heavy reliance on market discipline implied in the Municipal Finance Management Bill would not be suitable for most municipalities, except fiscally strong metropolitan municipalities. The International Monetary Fund has recently argued for a rule-based approach that can mimic the market. Such rules are discussed in section 3.3.3 above, and relate to optimising the burden of debt service relative to annual revenue flows.

Considering the disparities in fiscal capacity in the local sphere and the fact that Government is a role player through institutions such as the DBSA, a rule-based approach would be a reasonable complement to market discipline. The DBSA, while not directly assuming the role of a development instrument of Government, may be encouraged to provide more support to excluded municipalities. Such encouragement should not involve government interference in the normal operation of the market, but should rather create awareness of Government's intention to increase borrowing access for weaker municipalities.

The rules would include measures such as debt service-to-revenue ratios. The measures could be applied differently for different types of municipalities – those that are overly dependent on equitable share transfers could be assigned lower ratios.

*International Monetary Fund (1997), Fiscal Federalism in Theory and Practice, Washington D.C.*
4.5.4.6 National intervention
Over time, certain factors may be identified that qualify municipalities for national intervention. However, Government should guard against the disincentive effects of dependence on national intervention at the expense of revenue effort.

4.5.5 Proposals

- As a matter of urgency, programmes aimed at the development of human resource capacity (such as debt management, decision-making and investment) and systems capacity (such as information systems) should be implemented.
- Municipalities should be prohibited from pledging equitable share revenues to access debt.
Appendix A

Constitutional and legislative provisions relating to the role of the FFC

Constitutional provisions

228. (2) The power of a provincial legislature to impose taxes, levies, duties and surcharges -
  a) must be regulated in terms of an Act of Parliament, which may be enacted only after any recommendations of the Financial and Fiscal Commission have been considered.

229. (1) Subject to subsections (2), (3), and (4), a municipality may impose -
  a) rates on property and surcharges on fees for services provided by or on behalf of the municipality...
  (5) National legislation envisaged in this section may be enacted only after organised local government and the Financial and Fiscal Commission have been consulted, and any recommendations of the Commission have been considered

Intergovernmental Fiscal Relations Act of 1997

9. (1) At least ten months (or a later date agreed to between the Minister and the Commission) before the start of each financial year, the Commission must submit to both Houses of Parliament and the provincial legislatures, for tabling in the Houses and the legislatures, and also to the Minister, recommendations for that financial year regarding -
  a) an equitable division of revenue raised nationally, among the national, provincial and local spheres of government;
b) the determination of each province’s equitable share in the provincial share of that revenue; and

c) any other allocations to provinces, local government or municipalities from the national government’s share of that revenue, and any conditions on which those allocations should be made.

10. (1) Each year when the Annual Budget is introduced, the Minister must introduce in the National Assembly a Division of Revenue Bill for the financial year to which that Budget relates.

(2) The Division of Revenue Bill must specify –

a) the share of each sphere of government of the revenue raised nationally for the relevant financial year;

b) each province’s share of the provincial share of that revenue; and

c) any other allocations to the provinces, local government or municipalities from the national government’s share of that revenue, and any conditions on which those allocations are or must be made.

(3) After receiving any recommendations of the Commission in terms of section 9(1), but before the Division of Revenue Bill is introduced in the National Assembly, the Minister must consult –

a) the provincial governments, either in the Budget Council or in another way;

b) organised local government, either in the Budget Forum or in another way; and

c) the Commission.

(4) The Commission must be consulted in terms of subsection (3) at least 14 days before the Division of Revenue Bill is introduced.

(5) When the Division of Revenue Bill is introduced, it must be accompanied by a memorandum explaining –

a) how the Bill takes account of each of the matters listed in section 214(2)(a) to (j) of the Constitution;

b) the extent to which account was taken of any recommendations of the Commission submitted to the Minister in terms of section 9 or as a result of consultations with the Commission in terms of subsection (3) of this section; and

c) any assumptions and formulae used in arriving at the respective shares mentioned in subsection (2)(a) and (b).
Summary of FFC Recommendations for the 2001-2004 MTEF Cycle and Government's response


First recommendation: that constitutionally mandated basic levels of service in basic education, primary health and social security be provided for in the provincial equitable share allocations, and that provinces be held accountable for the delivery of such services. Furthermore, that, where possible, the costed norms approach be used to ensure the adequate fulfilment of constitutionally mandated basic service obligations.

Government agrees that the current budget and planning processes should more explicitly take account of constitutional obligations to provide basic services. However, Government believes that it is more appropriate to highlight these obligations as part of the MTEF planning and budget processes, particularly at provincial level.

Second recommendation: that a costed norms approach be used to arrive at formulae for constitutionally mandated basic social services in education, health and welfare.

Government acknowledges the potential benefits of the costed norms approach as an analytical tool for evaluating sectoral budgets for the provision of basic services.
However, it has decided not to adopt the costed norms approach – should changes to the current formula significantly alter the allocations, they may destabilise provincial budgets.

Third recommendation: that each province should be allocated a share (called the “basic” element) to provide for all the other obligations that are not defined as constitutionally mandated basic services, as well as any other functions. This allocation should be based on clear and transparent norms and standards where possible, and should be net of the “institutional” element. In addition, it was recommended that the institutional allocation be set to equal the minimum cost of operating government institutions.

No explicit responses were made to this recommendation in the Budget Review 2001.

Fourth recommendation: that the provincial own revenue and taxation element of the allocation formula be treated as part of the formula, but currently remain at zero. Further, it was proposed that the economic activity allocation be dropped from the formula and be provided through other elements of the formula or through various conditional grants.

No explicit responses were made to this recommendation. However, current work by Government and the FFC is geared towards addressing issues around the own revenue of subnational governments.

Fifth recommendation: that conditional grants from the national equitable share be allocated to provinces to support the reduction of social infrastructure backlogs.

Government has adopted this recommendation for the new MTEF and agrees that a framework around capital grants is needed.
### Summary of provincial formula (National Treasury) and FFC proposals for the 2001-2004 MTEF cycle

<table>
<thead>
<tr>
<th>Sphere</th>
<th>Dept of Finance (2000)</th>
<th>FFC Proposals for 2001</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provincial</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td>40%</td>
<td>Education</td>
</tr>
<tr>
<td>Social welfare</td>
<td>17%</td>
<td>Social welfare</td>
</tr>
<tr>
<td>Health care</td>
<td>18%</td>
<td>Health care</td>
</tr>
<tr>
<td>Institutional</td>
<td>5%</td>
<td>Institutional</td>
</tr>
<tr>
<td>Economic activity</td>
<td>8%</td>
<td>Basic share</td>
</tr>
<tr>
<td>Basic share</td>
<td>9%</td>
<td></td>
</tr>
<tr>
<td>Backlogs</td>
<td>3%</td>
<td></td>
</tr>
<tr>
<td>National</td>
<td></td>
<td>Conditional capital grant: Infrastructure</td>
</tr>
</tbody>
</table>

1. The percentage share of each of these FFC equitable share “S” components depends on the establishment of national norms and standards.
2. The institutional component is derived from the cost of operating basic government institutions.
Appendix D

Provincial revenue assignment

1. Approaches to tax authority assignment
The different approaches to tax authority allocation in decentralised systems of government require different degrees of coordination among national and subnational governments, and have different costs and benefits.\(^5\)

- **Uncoordinated co-occupancy** is the highest form of decentralisation of tax authority and allows subnational governments to choose their preferred tax system with no constraints. It is possible for national and subnational governments to occupy the same tax field with no coordination. Section 228 of the Constitution precludes this option for South Africa.
- **Compartmentalised system**: National and subnational governments agree to occupy the same tax field and each level/sphere is allocated specified taxes. Some constraints are imposed to ensure vertical and horizontal coordination.
- **Harmonised tax system**: Harmonisation is required to limit the total burden of national and provincial taxes on similar or shared tax bases, or to maintain some similarity of rates across provinces. Such harmonisation is of three types:
  - *Weak form* harmonisation exists when the different levels of government agree to reduce double taxation, to ensure that tax burdens are similar across all subnational governments.
  - *Similar form* harmonisation exists when taxes are applied on similar tax bases and/or rates between the spheres of government, outside any formal agreement.

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In this case, minor deviations from the norm may occur, depending on the decisions of different tax authorities.
- Strong form harmonisation requires that governments agree to a uniform collection mechanism, with tax bases and/or tax rates largely determined by one authority, although minor variations across jurisdictions may be allowed.
- Centralised system: National government is allowed to identify tax bases, set tax rates and collect all tax revenue. Revenues are then shared between national and subnational governments according to an agreed formula, as is largely the current practice in South Africa.

2. Criteria for the assessment of proposed taxes
Certain criteria need to be considered when assigning tax authority to different levels of government. In this section, four are examined.

a) Efficiency: This can be compromised in various ways in uncoordinated tax systems:
- Inefficiencies can arise when tax rates differ across jurisdictions. This may result in competition among provinces for lucrative, mobile tax bases.
- One province’s fiscal decisions may influence the welfare of another. These horizontal fiscal externalities can be either positive, where decisions in one jurisdiction benefit residents in another, or negative, where the burden of a province’s fiscal decisions is exported to residents of another jurisdiction.
- Vertical fiscal externalities may result. For example, a negative externality results when an increase in a province’s tax rate results in a fall in revenue to national government if the tax base is shared between national and provincial government.

The purpose of tax harmonisation is to address these issues. The “best” approach to tax assignment would be to choose provincial taxes with immobile bases and to avoid taxes on capital. Because of constitutional limitations on provincial taxing powers, a “second best” approach would be strong form harmonisation, as it minimises the costs of independent subnational tax policies. This may need to be adopted if the efficiency criterion has to be met.

b) Equity or fairness: In general, equity relates to income distribution (vertical equity) and equal tax burdens for individuals of similar circumstance (horizontal equity). The combined effects of national and provincial taxes on equity may differ; this is an inevitable result of decentralisation. The Constitution imposes minimum standard requirements for all South Africans and thus, to some extent, implies the strong form harmonisation approach. The mobility of capital and labour limits subnational governments’ direct pursuit of income distribution via taxation. Where labour is immobile, it may be possible to pursue such objectives at a provincial level.
c) Administrative feasibility and compliance: Taxpayers would have to comply with more than one tax system. Being costly and inconvenient, this could encourage evasion or avoidance of taxes. Joint collection minimises compliance and administrative costs. Complex tax bases (such as income tax) impose significant collection costs, especially where income may be earned in different jurisdictions with different tax rates. Taxes on sales may also be difficult to administer, especially where the application of the destination principle is complicated due to cross-border shopping. Some form of coordination and harmonisation may be required to minimise administrative costs.

d) Sufficiency and stability of provincial tax revenues: It is not advisable to include a variety of taxes that generate little revenue. Narrow and selective tax bases tend to distort the tax structure or push tax rates too high. The adequacy criterion requires the devolution of broad-based taxes. Some broad tax bases are available for assignment to provinces, such as surcharges on income tax, sales tax and payroll taxes. Taxes that change with the economic cycle must be avoided, as their revenues may not be stable.

In principle, good subnational taxes should provide sufficient revenue for richer provinces to be fiscally autonomous. They should also impose fiscal responsibility at the margin on subnational governments. This can best be achieved by allowing for reasonably flexible rate setting on major tax bases.

3. Evaluation of the proposed taxes
This section describes the taxes proposed in the National Treasury’s “allowed list” and evaluates them according to the approaches and criteria set out above.

3.1 Excise taxes on goods and services
Excise taxes are a potentially significant source of provincial revenue and lend themselves to differential rates across provinces. These taxes are imposed on consumption either per unit or in ad valorem form. They can also be levied on services of local coverage, such as betting, gaming and roads. Where these taxes are currently applied, they are generating less than their potential revenue, except where casinos are sufficiently large.

These taxes may not be easy to administer at a subnational level when they are destination-based, since it would be necessary to determine in which province final consumption took place. If it were possible to develop a system whereby relevant manufacturers and importers could be identified, provinces could rely on SARS to collect and distribute the revenue on their behalf.

54Bird, op. cit.
3.2 Tourism taxes
These taxes on tourism-related services may be levied on car hire, game reserves and accommodation at lodges, hotels and guest houses. They present a potentially substantial source of provincial own revenue but are currently not generally utilised. Tourism taxes are relatively easy to administer because they can be levied directly on the final consumers of relatively immobile tax bases. An example of such taxes is the current bed levy paid on a “voluntary” basis to Tourism South Africa.

The administration of these taxes can be devolved to provinces if they have the administrative capacity, or alternatively the collection and administration can be left with SARS, with provinces determining their own rates. Such rates may need to be negotiated with the national department to ensure that they do not hamper the national objective of promoting tourism and the general efficiency and equity objectives of Government.

3.3 Fuel taxes
Currently, South Africans pay five national taxes on fuel, and the Constitution empowers provinces to impose surcharges on such taxes or levies. The potential revenue of such a surcharge is relatively significant.

A major issue is whether the tax is regressive, taking a greater share of income of the poor relative to that of the rich. In a recent study of the incidence of the United States gasoline tax, Reschovsky and Chernick demonstrated that its income is relatively stable over time, and thus the gasoline tax is always regressive. In choosing to assign tax authority on fuel to provinces, then, the equity implications of such a tax should be duly considered.

It would also be impossible to track the final destination unless pump prices actually reflect the surcharge. The administrative costs may thus require the increased capacity of the collection agent.

A recent study by the National Treasury demonstrated that the distribution of fuel sales and gross geographic product across provinces is significantly different from the distribution of the population. The study concluded that, in 1999-2000, the proceeds from a fuel levy would have been around R14.4 billion.

It then demonstrated the results of the imposition of provincial surcharges at different levels. The provinces with higher economic activity would benefit if the surcharge were
to replace a portion of the equitable share allocation. With a 1c surcharge, for example, Gauteng would receive 43,2 per cent of fuel levy revenues, as against 15,0 per cent of equitable share totals, while the total income of provinces such as the Eastern Cape and the Northern Province would decline.\(^{54}\)

If the “economic activity” element of the current provincial equitable share formula were eliminated, the impact would be different. Gauteng’s share from fuel levy revenue would fall to 29,9 per cent (from 43,2 per cent), while the Eastern Cape and Northern Province would receive larger shares.\(^{57}\) Gauteng might need to raise its surcharge rate above the tax room average in order to recoup falling income.

The tables below illustrate comparative provincial distributions and revenue potential from different surcharge levels.

<table>
<thead>
<tr>
<th>Province</th>
<th>1998 Fuel sales (%)</th>
<th>1994 Gross geographic product (%)</th>
<th>1999/00 Economic activity (%)</th>
<th>1999/00 Equitable shares (%)</th>
<th>1996 Population (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Cape</td>
<td>7,1</td>
<td>7,6</td>
<td>5,9</td>
<td>17,6</td>
<td>15,5</td>
</tr>
<tr>
<td>Free State</td>
<td>7,2</td>
<td>6,2</td>
<td>5,1</td>
<td>6,8</td>
<td>6,5</td>
</tr>
<tr>
<td>Gauteng</td>
<td>29,9</td>
<td>37,7</td>
<td>43,2</td>
<td>15</td>
<td>18,9</td>
</tr>
<tr>
<td>KwaZulu-Natal</td>
<td>16,6</td>
<td>14,9</td>
<td>18,9</td>
<td>19,8</td>
<td>20,3</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>8,7</td>
<td>8,1</td>
<td>4,7</td>
<td>6,7</td>
<td>7,0</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>2,9</td>
<td>2,1</td>
<td>1,6</td>
<td>2,5</td>
<td>2,0</td>
</tr>
<tr>
<td>Northern Province</td>
<td>5,7</td>
<td>3,7</td>
<td>1,7</td>
<td>13,3</td>
<td>10,9</td>
</tr>
<tr>
<td>North West</td>
<td>6,2</td>
<td>5,6</td>
<td>5,1</td>
<td>8,6</td>
<td>8,0</td>
</tr>
<tr>
<td>Western Cape</td>
<td>15,9</td>
<td>14,1</td>
<td>13,7</td>
<td>9,8</td>
<td>10,9</td>
</tr>
</tbody>
</table>

Given the inequalities in economic activity, some equalisation mechanisms may be needed. While accepting the administrative difficulties that may arise, it should be noted that a surcharge on fuel taxes represents the next best reasonable revenue source (after the surcharge on personal income tax).

### 3.4 Environmental taxes

These taxes are designed to protect the environment or to compensate for the exploitation of certain resources. Entities that produce externalities must be identified and monetary values attached to the damage caused; this requires considerable sophistication. Furthermore, an activity’s impact on the environment may transcend provincial boundaries.

In principle, the primary purpose of environmental taxes is not to raise revenue but rather to alter behaviour by ensuring that polluters bear the full social cost of their activities. It is thus inappropriate to extend provincial authority to environmental taxes, for both efficiency and administrative reasons.

<table>
<thead>
<tr>
<th>Province</th>
<th>1c surcharge</th>
<th>5c surcharge</th>
<th>25c surcharge</th>
<th>40c surcharge</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eastern Cape</td>
<td>11</td>
<td>57</td>
<td>284</td>
<td>454</td>
</tr>
<tr>
<td>Free State</td>
<td>12</td>
<td>58</td>
<td>288</td>
<td>461</td>
</tr>
<tr>
<td>Gauteng</td>
<td>48</td>
<td>238</td>
<td>1 188</td>
<td>1 900</td>
</tr>
<tr>
<td>KwaZulu-Natal</td>
<td>27</td>
<td>133</td>
<td>664</td>
<td>1 062</td>
</tr>
<tr>
<td>Mpumalanga</td>
<td>14</td>
<td>70</td>
<td>348</td>
<td>557</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>5</td>
<td>23</td>
<td>116</td>
<td>186</td>
</tr>
<tr>
<td>Northern Province</td>
<td>9</td>
<td>46</td>
<td>228</td>
<td>365</td>
</tr>
<tr>
<td>North West</td>
<td>10</td>
<td>50</td>
<td>248</td>
<td>397</td>
</tr>
<tr>
<td>Western Cape</td>
<td>25</td>
<td>127</td>
<td>636</td>
<td>1 018</td>
</tr>
<tr>
<td>Total</td>
<td>160</td>
<td>800</td>
<td>4 000</td>
<td>6 400</td>
</tr>
</tbody>
</table>

3.5 Other taxes

Various smaller taxes and user charges and fees have a direct impact on provincial economic activities. Among these are presumptive taxes, which may be applied in the form of annual licences on hard-to-tax and informal businesses; betterment taxes, which may be directed at specific sectors of provincial economies; and road tolls, which may be earmarked for the maintenance of provincial roads. The revenue potential of these taxes is unlikely to be significant and will vary across provinces according to economic activity. Thus, they will need to be evaluated against the costs of administration and collection, incentive effects, effect on the local economy, and impact across provincial boundaries.

4. Conclusions

Taxes on the proposed “allowed list” are unlikely to generate significant revenue for provinces, and more broad-based taxes should be included in the list if potential revenues are to contribute significantly to expenditure responsibilities. Further work is needed on the revenue, economic activity and equity implications of the proposed taxes. It is also necessary to examine how the introduction of provincial taxing powers would affect the provincial pool of revenue, should tax room be created to maintain the overall tax burden within national targets.
Appendix E

Capital Grants model

1. Outline of the scheme
The first stage of the model’s development involves determining the efficient and actual capital stocks in order to establish the initial transition path. The initial transition path indicates the ideal needs which, if fully met by grant funds, would raise South African provincial capital stock levels to an international capital stock benchmark.58

Once the ideal needs have been calculated, it is possible to calculate the actual transition path. This path depends on the actual capital expenditure by provinces and the actual grants received over the period of the grant scheme. Should the pool of funds be insufficient to meet the ideal needs associated with the initial transition path, the actual transition path will fall below the initial path.

However, should the pool be large enough to meet the ideal needs in full, the actual transition path would coincide with the initial transition path. In this case, the calculated needs would equal ideal needs in each period of the grant scheme, and South African capital stock levels would reach the international benchmark at the end of the scheme.

In the model, the calculated needs for any given period are determined by the backlog, future needs (required to meet the international benchmark), and grant funds received in the previous periods (except for the first period).

58The conceptual version of the model was discussed in some detail in FFC’s Recommendations for the 2001-2004 MTEF Cycle, May 2000, pp 75-87.
2. Input data for South Africa
The model assumes that the scheme runs for a 10-year period, commencing in 2001/02. The required input data are:
• Actual capital expenditure from 2001/02 to 2010/11 for each service and province
• Efficient capital expenditure from 2001/02 to 2010/11 (by service and province)
• Actual capital stock in 2001/02 for each service and province
• Efficient capital stock in 2001/02 for each service and province
• Rate of depreciation from 2001/02 to 2010/11

a) Actual capital expenditure: The National Treasury provided the official data on the capital expenditure of provinces for each of the required services from 1997 to 2003. MTEF estimates were used as the actual expenditure data for the first two years of the scheme and extrapolated over the remaining years of the transition period to provide forecasts of service and province-specific capital expenditure per year of the scheme. The assumption was that capital expenditure grows at a nominal annual rate of 10 per cent from 2003 to the end of the period.

b) Efficient capital expenditure: Australian capital stock data were used as an international benchmark for two reasons. First, the Australian system of public finance is similar to South Africa's in that education and health are provided by states (roughly equivalent to provinces in South Africa). Second, accurate estimates of service and state-specific capital expenditures are readily available for the Australian states. The methodology used to construct the efficient capital expenditures was as follows:
- State-specific data on net capital expenditure for health, education and welfare for the years 1961-62 to 1998 - the latest available year - were obtained from the Australian Bureau of Statistics.
- The service-specific data were then aggregated over all states to obtain a series for total state expenditure on each of the three services for these years. This was converted into per capita terms using population data for Australia for 1998, yielding an estimate of per capita state expenditure on each of the three services.
- The figures obtained were then multiplied by the population of each South African province. This provided an estimate of the South African province and service-specific efficient capital expenditure. The average exchange rate for 1999 was used to convert the figures into rand.

c) Actual capital stock: Official estimates of the aggregate capital stock for the provincial sector were obtained from the Reserve Bank of South Africa. Service and province-specific weights were constructed from the actual capital expenditure data for 1997 to 2003. For each service and province, the year-specific weights
were averaged to obtain an average weight. This was applied to the last available estimate of the aggregate provincial capital stock for South Africa (1999) to obtain an estimate of the initial capital stock for service s in province i for the year 2001/02, the first year of the scheme.

d) Efficient capital stock: In addition to estimates of the actual capital stocks for the first year of implementation, the model requires estimates of the efficient capital stocks, again for the first year of implementation. As with efficient capital expenditure, Australian data were again used to construct the benchmark for efficient capital stocks for the reasons outlined above. The methodology was also similar – estimates of capital stock for the services were first aggregated across all states. The last available observation for each service was then divided by the Australian population for 1998 and multiplied by the population of each South African province for 2000 to obtain an estimate of the service- and province-specific efficient capital stock for South Africa for 2001/02. The average exchange rate for 1999 was used to convert the data into rand.

e) Rate of depreciation: A time, province and service-invariant depreciation rate of 4 per cent a year was used. Although international studies suggest annual depreciation rates of 2-3 per cent, it was felt that South Africa would have a slightly higher rate.

3. Simulation scenarios
The model was used to simulate the following three scenarios:

• Scenario 1: The pool of funds for the first three periods (years) of the scheme is set at R800 million, R1 550 million and R2 314 million respectively, based on the MTEF estimates for provincial infrastructure. Thereafter, the pool of funds grows at a constant rate of 63 per cent for each of the remaining periods (this is the average annual growth rate between periods 1 and 3).

• Scenario 2: The pool of funds is the same for the first three periods. Thereafter, the fund grows at a constant 63 per cent a year for periods 4 to 6 and then at a lower constant rate of 20 per cent a year for periods 7 to 10.

• Scenario 3: The pool of funds is the same for the first three periods, but increases at a constant 40 per cent a year in periods 4 to 6 and then increases at a lower constant rate of 10 per cent a year for periods 7 to 10.

Results of the simulation exercises are available on request from the FFC.
Based on scenario 1, the table below indicates how the pool of funds allocated to the provincial infrastructure grant for the years 2001/02, 2002/03 and 2003/04 could be distributed among the nine provinces, and, in each province, among education, health and welfare services only.

<table>
<thead>
<tr>
<th>Province</th>
<th>Service</th>
<th>2001/02</th>
<th>2002/03</th>
<th>2003/04</th>
</tr>
</thead>
<tbody>
<tr>
<td>Western Cape</td>
<td>Education</td>
<td>37 759</td>
<td>73 146</td>
<td>109 758</td>
</tr>
<tr>
<td></td>
<td>Health</td>
<td>39 748</td>
<td>78 401</td>
<td>118 333</td>
</tr>
<tr>
<td></td>
<td>Welfare</td>
<td>4 513</td>
<td>8 737</td>
<td>13 113</td>
</tr>
<tr>
<td>Eastern Cape</td>
<td>Education</td>
<td>53 958</td>
<td>104 442</td>
<td>156 305</td>
</tr>
<tr>
<td></td>
<td>Health</td>
<td>66 301</td>
<td>128 741</td>
<td>193 237</td>
</tr>
<tr>
<td></td>
<td>Welfare</td>
<td>7 689</td>
<td>14 897</td>
<td>22 367</td>
</tr>
<tr>
<td>Northern Cape</td>
<td>Education</td>
<td>8 425</td>
<td>16 335</td>
<td>24 533</td>
</tr>
<tr>
<td></td>
<td>Health</td>
<td>8 640</td>
<td>16 654</td>
<td>24 932</td>
</tr>
<tr>
<td></td>
<td>Welfare</td>
<td>909</td>
<td>1 753</td>
<td>2 623</td>
</tr>
<tr>
<td>Free State</td>
<td>Education</td>
<td>26 137</td>
<td>50 636</td>
<td>76 012</td>
</tr>
<tr>
<td></td>
<td>Health</td>
<td>27 954</td>
<td>54 113</td>
<td>81 168</td>
</tr>
<tr>
<td></td>
<td>Welfare</td>
<td>3 091</td>
<td>5 990</td>
<td>8 990</td>
</tr>
<tr>
<td>KwaZulu-Natal</td>
<td>Education</td>
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<td>154 792</td>
<td>232 451</td>
</tr>
<tr>
<td></td>
<td>Health</td>
<td>61 676</td>
<td>120 715</td>
<td>171 877</td>
</tr>
<tr>
<td></td>
<td>Welfare</td>
<td>9 498</td>
<td>18 404</td>
<td>27 607</td>
</tr>
<tr>
<td>North West</td>
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<td>30 624</td>
<td>58 872</td>
<td>88 025</td>
</tr>
<tr>
<td></td>
<td>Health</td>
<td>35 525</td>
<td>68 969</td>
<td>103 572</td>
</tr>
<tr>
<td></td>
<td>Welfare</td>
<td>4 214</td>
<td>8 169</td>
<td>12 273</td>
</tr>
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<td>Gauteng</td>
<td>Education</td>
<td>66 368</td>
<td>127 947</td>
<td>191 484</td>
</tr>
<tr>
<td></td>
<td>Health</td>
<td>58 559</td>
<td>111 723</td>
<td>165 815</td>
</tr>
<tr>
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<td>Welfare</td>
<td>9 198</td>
<td>17 823</td>
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<td>Mpumalanga</td>
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<td>48 767</td>
<td>73 046</td>
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<tr>
<td></td>
<td>Health</td>
<td>26 900</td>
<td>51 799</td>
<td>77 457</td>
</tr>
<tr>
<td></td>
<td>Welfare</td>
<td>3 256</td>
<td>6 276</td>
<td>9 397</td>
</tr>
<tr>
<td>Northern Province</td>
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<td>50 081</td>
<td>97 078</td>
<td>145 758</td>
</tr>
<tr>
<td></td>
<td>Health</td>
<td>48 119</td>
<td>93 234</td>
<td>139 697</td>
</tr>
<tr>
<td></td>
<td>Welfare</td>
<td>5 981</td>
<td>11 587</td>
<td>17 394</td>
</tr>
<tr>
<td><strong>Total provincial grant pool</strong></td>
<td>R800 000</td>
<td>R1 550 000</td>
<td>R2 314 000</td>
<td></td>
</tr>
</tbody>
</table>
Current local government equitable share formula

1. Background

The FFC presented its initial thinking on local government finance in its document, Local Government in a System of Intergovernmental Fiscal Relations in South Africa, 1997. The paper proposed an unconditional operating transfer, and the horizontal formula included a tax capacity (equalisation) component. The Department of Finance's subsequent research process culminated in the document, Proposals for the introduction of an equitable share of nationally raised revenue for local government in October 1997. The document built on the FFC recommendations and made provision for two transfers, namely an “S” (services) transfer and an “I” (institutional) transfer. Based on these recommendations, the equitable share was distributed to local government for the first time during the 1998/99 fiscal year. The services and institutional transfers are described and evaluated below.

2. The current formulae

2.1 Institutional (I) grant

The purpose of the I grant is to assist municipalities in maintaining a functioning administration. For the 1999/2000 fiscal year, Government distributed approximately R206 million through the I grant, which was allocated using the following formula:

\[ I_i = \text{MAX} \{0, I^*P_i - R_i \} \]  

(1)
Where: $I_i$  
$\gamma$  
$R_i$  
$y_i$  
$P_i$  

The formula is characterised by the following:

- Among municipalities of any given population size, those with higher levels of average income receive smaller $I$ grants. Per capita income within each municipality is used as a measure of the revenue-raising capacity.
- Eligibility for the $I$ grant is limited to those municipalities with populations of more than 2,000 people (below this size, jurisdictions are considered too small to provide efficient public services).

2.2 Services (S) grant

The largest portion of the equitable share is allocated in the form of $S$ grants, which totalled R870 million for the 1999/2000 fiscal year. The purpose of this grant is to provide each municipality with a block grant that is equal to the estimated costs of providing “basic services” to all residents living in poor households (where income is below R800 per month). An $S$ grant to municipal jurisdiction $i$ ($S_i$) is calculated using the formula below:

$S_i = \alpha \beta L H_i$

Where: $\alpha$ A phase-in parameter with $0 < \alpha \leq 1$
$\beta$ A budget-adjustment parameter, set to adjust the size of the grants to the available budget
$L$ An estimate of the annual per capita cost of providing basic public services
$H_i$ The number of households living in poverty

Because rural municipalities will require time to develop their capacity for providing a full range of basic services, the $S$ grants are being phased in over seven years for rural municipalities and five years for urban and metropolitan municipalities. Although the
recent demarcation process has dispensed with the distinction between urban and rural municipalities, it is still possible to determine the proportion of a municipal population that can be classified as urban or rural. Thus, phasing-in parameters could still be applied. To prevent disruptions in municipal services for those municipalities that used to receive larger allocations, Government has decided to phase out previous allocations. It guarantees that, during the phase-in period, each jurisdiction will receive at least 70 per cent of the transfer amount it received in the previous year.

2.3 Analysis of the current formulae

In terms of the aggregate S transfer, the average income level of the population of the municipality does not influence the per capita amounts (up to the R900-R1 260 monthly category). This is because, as is usual in both developed and developing countries, the incidence of poor people in the total population is weakly correlated with the average income level. In addition, every income class of municipalities receives some amount from this transfer. For example, the average per capita transfer for the richest class of urban municipalities is R18,60, which is only slightly less than the average transfer for all local governments, namely R22,00.

The I transfer is tiny: the average per capita allocation is only R4,30. However, for some municipalities, particularly those in the middle of the income scale, allocations are sizeable and higher than those paid from the S transfer.

The allocations will change significantly as the system is fully phased in. Eventually, the horizontal distribution of the equitable share will result in large increases in the allocations to rural jurisdictions and decreases in those to the urban and metropolitan jurisdictions. The reduction in allocations to urban and metropolitan governments will only be feasible if mechanisms are found to increase their sources of own revenue substantially.