

**EQUITY & LOCAL  
GOVERNMENT  
EQUITABLE SHARE**

**FFC CONFERENCE**

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**Lieb J Loots**

# INTRODUCTION

- Local Government Equitable Share (LGES) formula currently under review
- Appropriate time to investigate aspects of the LGES formula
- This paper focuses on one aspect: the application of “equitably” in the formula
- What is ‘equitable’?
- How did LGES allocations compare with it?

# THE CONSTITUTION

- 214 (1) “An Act of Parliament must provide for (a) the equitable division of revenue raised nationally ...”
- Constitution offers some guidance as to the context within which ‘equitable’ should be understood
  1. Broader heading of “General Financial Matters”
  2. FFC must be consulted & considered
  3. Factors to be considered (clauses a to j) are aligned with the principles of sound fiscal management

# DEFINITION OF EQUITY

- In economic literature ‘equity’ associated with Adam Smiths four canons of taxation
- Numerous authors have elaborated on the theme of ‘equity’ in fiscal matters
- General agreement – two approaches to equity:
- ‘Benefit’ principle & ‘Ability-to-pay’ principle
- Relevant for this paper is the ‘ability-to-pay’
- Seen as a tax matter, viewed independently of expenditure determination

# ABILITY-TO-PAY

- Calls for equal amounts of tax to be paid by taxpayers with equal abilities to pay
- Also referred to as ‘horizontal equity’
- Tax dispensation that compromises horizontal equity is arguably not ‘equitable’
- But this is a tax principle, how is it relevant to a system of intergovernmental transfers?

# HORIZONTAL EQUITY

- Argued here: horizontal equity should also apply in a system of intergovernmental transfers:
- Combination of national standards (free basic services) and revenue sharing can result in horizontal equity being undermined
- Local authorities must provide basic services free according to national standards as well as other ‘functions assigned to them’
- LGES allocations partially finance municipal services

# EXAMPLE: INEQUALITY

	Municipality A	Municipality B
<b>Total Population</b>	<b>100</b>	<b>100</b>
<b>Indigent Population</b>	<b>20</b>	<b>80</b>
<b>Tariff Paying Population</b>	<b>80</b>	<b>20</b>
<b>Cost of Free Basic Services per person</b>	<b>10</b>	<b>10</b>
<b>Total Cost of Free Basic Services (indigent)</b>	<b>200</b>	<b>800</b>
<b>Equitable Share (8 x indigent)</b>	<b>160</b>	<b>640</b>
<b>Cost Financed by Cross-subsidisation</b>	<b>40</b>	<b>160</b>
<b>Per Capita burden on Tariff Paying population</b>	<b>0.5</b>	<b>8</b>
<b>Equitable Share for equal per capita burden</b>	<b>40</b>	<b>760</b>

# INEQUITY IN CROSS-SUBSIDISATION

- Initially appear ‘equitable’ – equal per capita allocation to each municipality on basis of indigent population
- But results in a differential impact on cross-subsidation (even if free basic services covered)
- Thus imposes different tax burdens on people with the same ability-to-pay
- Compromises horizontal equity: not ‘equitable’

# LGES: HOW EQUITABLE?

- Used actual formula to calculate ‘services components of LGES (S-Grant, FBS, FBE)
- Estimated cost of providing those services
- Subtracted second from the first to obtain:
- ‘Deficit’ – must finance shortfall through cross-subsidisation
- ‘Surplus’ – enough left to cross-subsidise other services

# SUMMARY: IMPACT OF LGES

	Municipalities in First decile	Municipalities in Tenth decile
average S-Grant component	10,221,372	9,368,955
average Free Basic Services (FBS) comp.	7,262,050	2,469,713
average Free Basic Electricity (FBE) comp.	2,132,376	1,677,466
average combined basic services ES comp.	19,615,798	13,516,133
average total cost of free basic services	22,374,607	375,673
average Surplus (+) / deficit (-)	-2,758,809	13,140,460
surplus/deficit per capita (total population)	-17	+75
surplus/deficit per tariff paying household	-111	+1792

# COMPROMISING HORIZONTAL EQUITY

- First decile (‘deficit’) municipalities – had to impose an additional R111 per year on tariff paying households (or R17 per capita)
- Last decile (‘surplus’) municipalities – had extra funds of R1792 per year to cross-subsidise the tariffs of households (or R75 per capita); or spend on ‘non-essential’ items
- Thus operation of LGES imposed differential tax requirements on citizens who may have been in the same economic conditions

# CONSEQUENCES

- If LGES compromises ‘horizontal equity’ it can result in:
  - The level/quality of services to the poor in ‘deficit’ municipalities can be reduced
  - Services can be provided in full, but financed through cross-subsidisation, ie higher rates and tariffs
  - Latter: long term danger of capital moving out, slow economic growth, greater unemployment and poverty, and declining services to the poor

# SOLUTION

- It is not the objective of this paper to address the solution, but a solution is readily at hand:
- Introduce an appropriate Revenue Raising Capacity (RRC) into the LGES formula
- And possibly refine it further with a measure of income distribution in the LGES formula
- Whatever the solution – test for horizontal equity

# CONCLUSION

- Consider the relevance and application of the principle of ‘horizontal equity’ in the system of revenue sharing in South Africa
- If not, the LGES formula may well impose differential tariff burdens on municipalities – arguably then not ‘equitable’
- May therefore have to incorporate RRC and perhaps even income distribution measures into the LGES formula