Financial and Fiscal Commission

Recommendations and Comments – The Allocation of Financial Resources to National, Provincial and Local Governments for the 1998/99 Fiscal Year, Submitted in terms of Section 9 of The Intergovernmental Fiscal relations Act, 1997

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For an Equitable Sharing of National Revenue

9 January 1998

The Allocation of Financial Resources to National, Provincial and Local Governments for the 1998/99 Fiscal Year

Submitted in terms of Section 9 of the Intergovernmental Fiscal Relations Act, 1997

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INTRODUCTION AND SUMMARY

This set of Financial and Fiscal Commission recommendations is intended to bring the Financial and Fiscal Commission (FFC) in line with the legal requirements of section 9(1) of the Intergovernmental Fiscal Relations Act which became effective on 1 January 1998.

Although the Constitution has been in operation for over two and a half years, 1998 sees the introduction of a number of laws pertinent to the effective functioning of the Finance Chapter of the Constitution (Chapter 13) whose full implementation had been delayed by direction of the Constitution. This staggered introduction of financial legislation has been designed to allow for proper planning and considered law-making.

One of the delayed processes is that of the new budgeting process and the associated clarification of roles of the relevant institutions, which are meant to play a role in it. The Intergovernmental Fiscal Relations Act referred to above, requires certain institutions to discharge their responsibilities within the context of the new budgetary system. It has clarified to a great extent the initially vexing question of roles, responsibilities and relationships in the new system. According to this Act, the Financial and Fiscal Commission has to submit, at a certain time in the current fiscal year, to both Houses of Parliament, the provincial legislatures and to the Minister of finance, recommendations concerning the allocation of revenues to governments and related matters, for the subsequent year.

Under normal circumstances the Commission is required to submit its recommendations at least ten months prior to the introduction of the Division of Revenue Bill in the National Assembly for the next fiscal year. However, recognising the fluidity of real life situations in budgeting, the Act has also provided for a later submission date of the Commission's recommendations, as negotiated between the Chairperson of the FFC and the Minister of Finance, provided that this will be no more than sixty days before the Bill's tabling in Parliament.

To facilitate the transition into this new legislative framework and process, it was agreed between the Chairperson and the Minister on 12 December 1997, that the Commission would resubmit its recommendations for the 1998/99 fiscal year by the 9 of January 1998. In terms of the Act, this arrangement (submitting our recommendations in January) will be a once-off transitional measure, to be applicable only to the 1998/99 fiscal year. The Commission will

come into full alignment with the Act when it submits a comprehensive set of recommendations for the 1999/2000 fiscal year in May 1998.

The subsequent recommendations are therefore consistent with the requirements of section 214(1) of the Constitution and section 9(1) of the Intergovernmental Fiscal Relations Act. The recommendations and comments contained in this submission have been designed to ensure an effective and efficient system of intergovernmental fiscal relations such that:

- national, provincial and local governments have equitable financial resources to perform -the functions assigned to them and to exercise their requisite fiscal autonomy;
- minimum levels of basic services are provided, so-called unique national services are catered for and there is compensation for inadequate tax bases;
- poverty, backlogs, developmental needs and economic disparities are addressed;
- the system promotes the development of democratic and accountable government;
- the allocations are objective and predictable; and
- the budgeting process becomes more transparent.

The recommendations and comments contained in the this submission reiterate many of the Commission's previous ones. Where differences do occur from the original submissions, these are largely the result of refinements over time and other considerations that have been brought to bear on the original ideas of the Commission. Suffice it to say, however, that the basic principles promoted by tile Commission remain largely the same in this submission.

A significantly revised and updated set of recommendations, taking into account the evolution of the process and current data and thinking, will be submitted in May 1998 for the 1998/2000 fiscal year. This submission, as mentioned earlier, will be in terms of the abovementioned Act and new budget cycle, requiring tile Commission to submit its recommendations ten months before the introduction of the Division of Revenue Bill in Parliament every year.

The set of recommendations and comments which follow contains four major parts, namely:

1. The first part contains a summary of the Financial and Fiscal Commission's general recommendations from previous years.

2. Part two is an FFC commentary on the Department of Finance's recommendations, as reflected in their May 1997 submission to the Budget Council and the version found in the Department of Finance's Medium Term Budget Policy Statement, 2 December 1997. The Financial and Fiscal Commission's submission in July 1997 dealt extensively with the Department of Finance's May 1997 recommendations. As these have changed somewhat the FFC comments have been adjusted to deal with the changes. Also in this part are passing comments on the Growth, Employment and Redistribution Strategy and the Medium Term Expenditure Framework.

3. The third major part is a recommendation for the introduction of national legislation to regulate the imposition of a provincial surcharge on the national personal income tax base. This part spells out in some detail the implications for the national and provincial government spheres of the introduction of the surcharge on personal income tax by creating tax room at the national level. A rationale for the introduction of this form of provincial own revenues is also presented.

4. The last major part provides an overview of the FFC's recommendations for the financing of local government and municipalities. The key recommendations are that the current level of transfers to local government should be the point of departure in the first year that the system is operationalised. Thereafter the amount allocated to local government could be increased. Also, the purpose of the transfers is to render financial assistance to those municipalities which have relatively low tax capacities, relative to the basic service needs of the communities. The secondary "tier" municipalities are the administrative entities which will initially be recipients of the transfers, and will be responsible for on-transferring the allocations to primary municipalities. This Will be done for both operating and capital expenditure.

CHAPTER 1

The Financial and Fiscal Commission Recommendations for the 1997/98 Financial Year The Financial and Fiscal Commission's (FFC) recommendations for the 1997/98 fiscal year (as described in the May 1996 document, "Recommendations for the Allocation of Financial Resources to the National and Provincial Governments for the 1997/98 Financial Year") fell into two categories:

- the division of resources between national government and provincial governments (this addresses the problem of `vertical fiscal imbalance');
- the division of resources amongst the provincial governments (`horizontal fiscal imbalance').
  (Note: recommendations for the local government sphere were not considered in this earlier document, but are included as chapter 4 below)

With regard to the vertical division, the share of the total available resources between the national and provincial governments is largely based on the constitutional assignment of functions. The delivery of a number of major services to the public, such as education, health-care and welfare, is the responsibility of provincial governments, while largely non-population-driven functions such as defence, police and foreign affairs are national government functions. The FFC also recognises that both levels of government have existing commitments, carried over from the past, which must be honoured in the short term.
Although government expenditures will increase over time, this will occur at different rates between the national and provincial governments. One rationale for this is that the services of only a limited number of national departments are related to the increase of the population (and some could decrease over the period), allocations to the national government should grow more slowly than those to the provincial governments over this period. This would enable the current extremely unequal provision of public services amongst provinces to be corrected in the reasonably short period of six years.
It was proposed that an appropriate intergovernmental body such as the Budget Council determine the vertical division on the basis of the FFC recommendations.
The total provincial allocation (P) was to be divided among the provinces by means of a provincial revenue sharing (grants) formula comprising the following elements:

- a minimum national standards grant (S) to enable the provinces specifically to provide primary and secondary education and primary and district health-care to their residents;
- a spillover grant (m) to provide for the. financing of those services which have inter-provincial spillover effects;
- a fiscal capacity equalisation grant (T) to ensure that provincial functions are financed from an equitable provincial taxing capacity and to encourage accountability and democratic institutions associated with the establishment of provincial legislatures;
- an institutional grant (I) to provide funds for each province to finance the core of its legislature as required by the Constitution; and
- a basic grant (B) to enable provinces to establish and maintain the institutions necessary for the fulfilment of their constitutional obligations according to their own priorities.

The relationship between these components was expressed in the form of an equation, namely:

P=S+m+T+I+B

The **education** component (Sed) of the national standards grant (S) was **determined** by calculating the cost of providing a nationally acceptable level of education to the residents of a province, between 5 and 17 years of age, using the national Department of Education's guideline of one teacher for every thirty-eight pupils.

The value of the **health-care** component (She) of the national standards grant (S) **was determined** by calculating the costs, firstly, of providing within ten years an average of 3.5 visits per year to a primary health-care clinic by people who do not have access to medical aid schemes, and 0.5 visits by those who do have access to such schemes; and secondly, of providing services by district hospitals.

A **spillover grant**, "m", **was recommended** for provinces with academic hospitals to compensate them for the costs of medical training and the provision of "unique" health services such as heart transplants.

It was recommended that national legislation should be introduced to regulate provincial taxing powers, specifically the imposition of a surcharge on personal income tax. In order to maintain the current tax burden, national government should reduce its individual income tax rates by 7 percentage points, thereby creating tax room. Such **tax room** would be phased-in, beginning with 1 percentage point in 1997/98 and increasing to 7 percentage points six years later.

In the absence of appropriate legislation enabling provinces to levy such surcharges in 1997/98, a proxy for own revenue equal to the tax room created was allocated as a grant to the provinces. This grant was termed the **transitionally assigned surcharge (TAS).**

A zero-sum system of **tax capacity equalisation grants (T)** (which can be either positive or negative, for a given province) was proposed to compensate partially for horizontal tax disparities, as reflected in differences in the taxable capacity of the provinces. To comply with Section 227 (2) of the Constitution this grant is not, however, dependent on the provincial tax rate actually chosen (or on other allocations the province receives).

An institutional grant (I), established by estimating the cost of running a basic administration in terms of the Constitution, was recommended for each province.

The basic grant (B) was determined on the basis of weighted population figures for each province. A weight of 25 per cent was given to rural people in each province, because "ruralness" is considered to be a well-suited proxy for differences in wealth, a good indicator of deprivation and presented relatively few data-related problems.

It was recommended that the provincial grants formula should be set initially for a period of three years. Annual updates of the independent variables such as population and economic growth data would be necessary as new figures became available. **It was also proposed that, initially, the vertical division should be determined annually** because of the uncertainties associated with the transitional period.

The provincial grants formula did not address the issue of whether some provinces should be compensated for infrastructural backlogs, other than through the higher weighting given to the rural population numbers. It was felt that this should be done through ad hoc (conditional) grants from the national government in terms of section 214 (1)(c).

Given the lack of consensus amongst South African researchers on population data, the FFC, after careful examination of the various data sources, decided to make use of the figures of the Central Statistical Services (CSS) as adjusted by the Demographic Information Bureau, a group of independent demographers. This decision was supported by the CSS.

It was recommended that the formula be phased in over a period of six years (commencing with the 1997/98 financial year), so as to ensure that those provinces which are projected to receive real cuts in their budgetary allocations, are given sufficient time to make

the necessary adjustments, either to their expenditures or to their own revenues, and that those provinces which would receive significantly greater allocations would have time to adjust their spending effectively.

CHAPTER 2

The Department of Finance's Recommendations for the 1998/99 Financial Year: A Summary and Discussion

This chapter sets out the Commission's comments on the recommendations of the Department of Finance (DoF), published as the Medium Term Budget Policy Statement and accepted by the Budget Council at its December 1997 meeting, on the allocation of resources to national, provincial and local governments. This chapter is divided into three sections:

1. The Department of Finance's Recommendations for the 1998/99 Financial Year: A Summary
2. FFC Comments on the Department of Finance Recommendations
3. Comparison of the indicative allocations delivered on 5 May to the December allocation

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1. The Department of Finance's Recommendations for the 1998/99 Financial Year: A Summary

These recommendations are contained in a document submitted to the Budget Council meeting in December 1997, and published as the Medium Term Budget Policy Statement on 2 December 1997.

The division of revenue is provided for each sphere of government as well as each province for the period 1998/99 to 2000/01 this excludes the policy and the contingency reserves. The division of revenue determines the envelope for each province's and all national departments' Medium-term Expenditure Framework's (MTEF), excluding other own revenue and user charges.

1. Resources Available

The **macroeconomic assumptions** underlying the DoF (DoF) recommendations include the projected decline of the **tax to GDP ratio** from 26.2% in 1997/98 to 25.6% in 2000/01 and the projected decline of the **budget deficit** 4% to 3% during the same period. However, real economic growth rates projected in the model are lower than those contained in the Growth, Employment and Redistribution document (GEAR), with growth projected to increase from 3% to 5% for the period under consideration (the GEAR growth rates were 3.8% and 6.1 %).

2. The Top Slice

A number of items are "top-sliced" before revenues are divided amongst the 3 spheres of government. These include:

- a policy reserve and a contingency reserve
- "standing appropriations" which are a legally binding first call on expenditure, such as South Africa 'subscription to the IMF; and
- projected national debt servicing costs. A reserve is created to address the increased uncertainty of budgets over longer time periods, the reserve consist of a policy reserve and a contingency reserve.

The **policy reserve** has been created to "meet specific policy priorities without compromising the proposed budgets of other services". The **policy reserve is set at R3 billion** for the next three years.

A contingency reserve is also proposed, **about R2 billion in 1998/99 (R4 billion in 1999/2000 and R7 billion in 2000/01)**, but is unallocated in this year's budget. It is intended to deal with unforeseen disasters, without compromising the overall expenditure ceiling. A component of the contingency reserve may be used to address "emerging policy priorities" or changes in economic circumstances in future years, and will therefore be applied in a similar manner as the policy reserve.

The rationale for the reserve to be included in the "top slice" is because it is not clear whether the reserve fund would be allocated to national, provincial or local government.

3. The Vertical Division

The vertical division of resources to determine the national, provincial and local government slices is made on the basis of the ratio in 1997/98, namely **45.7% (national departments), 53.5% (provinces) and 0.8% (local government)**. The division remains broadly stable over time, apart from identified function shifts and the allocation of the reserve (reflecting broad government priorities). The changes to the shares reflect a once-off transfer of staff to municipalities, and the effect of conditional grants.

Improvements in conditions of service: Both national departments and provincial governments are expected to fund improvements in conditions of service from their budget allocations. The provincial budget allocations will exclude the provision for the improvement if this function is kept on the national budget.

4. Horizontal Division: Equity Amongst Provinces

The provincial "equitable share", in terms of section 214 of the Constitution, is comprised of an unconditional, formula driven allocation which is determined in six parts:

- an education share, based on an average of the school-aged population and the number of learners enrolled, which is weighted at 39% of the provincial equitable share;
- a health share, based on the proportion of the population without private health insurance and weighted in favour of women, children and the elderly, which is weighted at 18% of the provincial equitable share;
- a social security component based on the estimated numbers of people entitled to social security grants, which is weighted at 16% of the provincial equitable share;
- a basic component, based on the total population, with an additional 50% weighting in favour of rural communities, and is weighted at 15% of the provincial equitable share;
- an institutional component, allocated equally to all provinces and is aimed at provincial costs associated with services not directly related to a provinces demographic or socio-economic profile, which is weighted at 4% of the provincial equitable share;
- a tax share which directs a proportion of nationally collected revenue back to the province where the revenues are generated (i.e. a proxy for provincial own revenue), which is weighted at 8% of the provincial equitable share. The basis for the division is the estimated gross geographic product (GGP).
- The horizontal formula is phased in over five years to ensure that it is manageable.

5. Conditional Grants

It is proposed that the following services should be supported by conditional grants:

- Health services, which includes three components, namely, medical research and training, central hospital services and the redistribution of tertiary services. As academic services become more equally distributed, the conditional grant will be reduced and the funds returned to the equitable share. The conditional grant for health services will increase from 84.19 billion in 1998/99 to 84.61 billion in 2000/01.
- The primary school nutrition programme receives 8496 million and has been funded as a conditional grant since being initiated as a presidential lead project, this is expected to continue. The demographic basis of the formula is determined from the preliminary 1996 Census

results. The proposed indicative allocations for 1998/99 are set out in Table Ia and Ib alongside the FFC recommendations:

TABLE 1 a
Percentage Shares of Revenue: 1998/99

	DoF (%)	FFC(%)
Western Cape	9.9	10.3
Eastern Cape	17.7	17.2
Northern Cape	2.5	2.1
KwaZulu-Natal	19.4	19.8
Free State	6.9	6.8
North West	8.7	8.6
Gauteng	15.0	16.5
Mpumalanga	6.5	6.1
Northern Province	13.4	12.6

TABLE 1b
Percentage Shares of Revenue: 2000/2001

	DoF (%)	FFC (%)
Western Cape	9.7	9.5
Eastern Cape	17.3	16.6
Northern Cape	2.4	1.9
KwaZulu-Natal	19.8	20.1
Free State	6.7	6.7
North West	8.5	8.5
Gauteng	15.6	17.8
Mpumalanga	7.1	6.3
Northern Province	12.9	12.6

Since there are a number of inherent differences between the FFC allocations and those of the DoF, they are not strictly comparable. As will be shown below, it is possible to adjust weightings and variables to achieve predetermined outcomes in a number of ways and for different reasons, it is therefore the rationale behind the changes and areas of confusion which require discussion. **It is therefore important to analyse the outcomes as well as the manner in which the outcomes are achieved.**

6. **Local Government's equitable share**

An "equitable share", in terms of section 214 of the Constitution, of resources is proposed for local government. This would replace the patchwork of intergovernmental transfers for operating expenditure for local governments. Capital transfers will continue to be financed from the national share as conditional grants. A formula will allocate resources to municipalities and is aimed to support the provision and extension of services to the low income communities. Transitional measures are intended to support the financing of the so-called 8293 (former homeland) towns.

2. FFC Comments on the Department of Finance Recommendations

1. Acceptance of the FFC's Recommendations

The overall approach, of the MTEF, draws on the FFC's recommendations as the basis for their allocations. This is welcomed and is, generally, in compliance with the constitutional provisions. There are, however, a number of areas which require more clarity and where agreement still needs to be reached between the FFC and the DoF. Some of these problems do not have simple solutions and it is essential that the roles and responsibilities as well as the dialogue between the Commission, the DoF and other relevant players (including provincial treasuries and local government) becomes a dynamic source of debate and improvement in the system.

The comments which follow are, therefore, made in the context of the Commission's desire to improve the system and mechanism for allocating resources to attain equity and efficiency as demanded in the Constitution.

2. The Macroeconomic Context

The GEAR provides a macroeconomic framework which defines the fiscal boundary within which the MTEF should operate (a slightly updated version of the macroeconomic model is used in the MTEF). The GEAR sets explicit limits on the level of borrowing (3% by the end of the decade - reduced on a straight line basis) and the tax burden (again calculated to achieve the goal on a straight line basis). The implication of these proportions being capped and decreasing as a proportion of GDP is that public expenditure declines in a similar fashion over the short term.

The aims of the strategy are laudable; increased domestic savings and investment, elimination of government dissaving, greater efficiency of service delivery, higher growth (with job creation) and more scope for spending on capital and other non-interest items in the public sector. To avoid inflationary pressures, a tight fiscal policy is necessary. In this way, inflationary pressures can be kept in check and domestic resources will be released for financing capital formation. The assumptions of a macroeconomic model are different to reality. Where, for instance, the revenue estimates and deficit target are not achieved (under or over), a principled method for dealing with these outcomes is required.

Two crucial assumptions that are made, as far as public finance is concerned, are firstly, the cutting back of consumption expenditure and secondly, wage restraint in the public and private sectors.

The FFC has quantified and argued elsewhere (The Recommendations of the Budget Council: Implications for the Provision of Public Services during the 1997/98 fiscal year, FFC, August 1996) that the significant financial implications of the improvements in the conditions of service announced in 1996 highlighted a sequencing problem with respect to the GEAR assumptions. Some of the conclusions of the FFC document were:

- The sequencing of public sector policy actions should be considered carefully. First, the substantial decrease in the deficit cannot occur simultaneously with a huge increase in the resources made available for the improvement in the conditions of service given the ceiling on the revenue side. Second, a revenue programme (including a plan for the expected revenue from the restructuring of state assets) should be linked to the expenditure plan for the public sector prior to finalisation of the macroeconomic framework. Third, the macroeconomic model should include a practical time frame within which to achieve the required institutional adjustment to the public service to manage the necessary changes.
- The macroeconomic framework needs to determine priorities for functional expenditure and also address the questions of minimum national standards and conditional (capital) grants. The risk is that capital spending will be adversely affected by a relative increase in consumption spending as the overall available resources decrease.
- The macroeconomic framework needs to include a vision of the role of the state that brings together a macro-plan

with a feasible expenditure plan. This process has been started with the introduction of the MTEF.

Because these points have not been taken into account adequately, the result of the macro-programme has been cuts in capital spending and general overspending by government (in relation to the budget). Cuts in overall expenditure are mainly-secured through significant reductions in capital expenditures. Total current expenditure for. 32 out of 37 Votes, whose relevant data were available for 1996/97 and 1997/98, are reduced by 8884 million (reduction of 0.6%), while their total capital expenditure is cut by R5.6 billion (reduction of 33.6% relative to last year's budget). The share of current expenditure of total expenditure is to increase from 89.5% in 1996/97 to 92.8 in 1997/98. The share of capital expenditure. on the other hand, is to decrease from 10.5% of total expenditure in 1996/97 to 7.2% in 1997/98 (Adelzadeh, et al. 1997). The over-expenditure mentioned above is far more worrying in the context of this substantial decline of capital spending.

The FFC is in agreement with the DoF that containing the level of public spending is critical for a successful macroeconomic strategy. The approach adopted in the MTEF is that success in this regard is not reliant on the overall administration of spending by national government, but upon the adoption, within a set of intergovernmental fiscal relations, of financing mechanisms that provide appropriate incentives for control (it is noteworthy that countries with centralised control are as prone as countries with decentralised systems to lose macroeconomic control). The FFC is in general agreement with the incentive based approach. However, systems with decentralised administration featuring poorly defined priorities, policy goals and lax financial and management systems almost invariably lead to a loss of macroeconomic control. These systemic problems need to be addressed to ensure the stability and success of the macro programme.

There is agreement that overall expenditure control and management, rather than allocation of responsibilities is the primary concern of the macroeconomic perspective. Reshuffling of expenditure responsibility as a means to improve macroeconomic management is seldom warranted. The existing intergovernmental system should be enhanced and maintained to ensure compatibility between expenditures and financing. This introduces a number of significant challenges for the years ahead.

To achieve such goals, information and management systems are required and a major effort is required to generate the necessary data at all levels of government. While some of the

MTEF task teams have progressed on the standardisation of the information to be collected, the base systems from which this information will be drawn require substantial improvement. The system to ensure appropriate budget information and other data at all levels of government needs to be developed as a first phase in the overall system. The FFC has argued elsewhere ("Public Expenditure on Basic Social Services in South Africa', FFC forthcoming January 1998) that this may necessitate additional spending on systems, management personnel and clarity over the priorities and service levels which are required for the public sector. The former requires a national strategy for organisational restructuring and the latter the incorporation of improved procedures for policy development (such as policies being properly piloted and costed out, prior to legislation being passed).

There is an additional concern that insufficient work has taken place to assess alternatives to funding the GEAR in a manner which could reduce the impact of the spending cuts during the transition period, which could result in improved service outcomes (over and above greater consideration of sequencing issues). There are a number of possibilities:

- slowing the pace of the deficit adjustment might avoid the once-off decreases in expenditure,
- additional revenue can be generated from privatisation, and
- finance and cash flow options should be further investigated:

In the latter category, the short and medium term funding of the pension funds must be investigated and realistic alternatives proposed (see Duffy, 1997; Smith Committee, 1995.

3. Medium Term Expenditure Framework

The introduction of the Medium Term Expenditure Framework is **welcomed as part of a shift towards a multiyear approach to fiscal planning**. It represents a significant departure from the "ad hocisn:" that characterised budgeting in the past, allows for rolling budgets, greater transparency and public participation and national prioritising and effective planning in the usage of the country's limited financial resources. The MTEF can be characterised by the use of longer term budgets in a transparent manner for achieving the goals of government. In other words, it is a tool for presenting tile spending plans of government over time and matching these plans with the fiscal resources available. The implicit process is to develop a competitive budget wherein resources are allocated for projects and programmes along a priority list based on national interests and

local concerns. A top down and a bottom-up processes are therefore self evident in this system. Provinces and local government, as well as national departments determine their "needs" in order to attain certain policy goals. Priorities are determined in a process of departments bidding against each other for revenues. National Government can establish priorities and objectives through national plans and thereafter monitor sub-national expenditure in those functions which are the responsibility of the provinces.

There are, however, several concerns that the FFC wishes to bring to the attention of the Parliament, the provincial legislatures, local government and the DoF with respect to the implementation of the MTEF. It is recognised that the development of the MTEF is in its preliminary stages and that since the writing of the DoF document some of these issues may have been addressed or clarified.

The first concern relates to the **relationship between fiscal and broader economic planning**. The FFC has observed that the MTEF is being planned and implemented in the virtual absence of any broader economic or developmental planning, which raises questions about South Africa's capacity to attain the expected development goals (employment creation, eradication of poverty, narrowing of income inequalities) when economic policy is limited largely to fiscal planning in the absence of a clearer definition of society's broader goals. In the absence of a broader development plan the impression may be given that the MTEF is not intended to enhance national and provincial planning and developmental goals but rather only to ensure fiscal discipline within the "fiscal envelope" provided to spending agencies. If the MTEF is therefore going to be a tool for bringing the macroeconomic programme and the government's spending plans together, then the dialogue (concerning policy, funding and planning) and process of planning and prioritising has to be rapidly enhanced.

Formula funding and the MTEF. As with the current budget, the **FFC formula** will be used to determine the global amounts for each province. The relationship between the MTEF and the FFC formula and related process is not clear. In most countries that undertake some form of fiscal and development planning, the process is usually "bottom-up" with sub-national governments drawing up their plans and submitting these to the national government. The national government then decides, sometimes in consultation with sub-national governments, what resources will be made available to each lower level government after evaluation of the submitted plans. In the South African situation, the resources for each province for a three-to-five-year period will be pre-determined by a formula. Clarity needs to be

obtained about the role of the MTEF and how to ensure that priorities are funded, and the mechanism/s to enforce particular patterns of expenditure in provinces. This requires **resolution of an appropriate balance between national priorities and provincial autonomy.**

An example of the confusion is the **relationship between the expenditure priorities and the vertical division**. "The division of funds between the spheres of government must reflect the nation's priorities. If the share of expenditure going to social services is increased, this will take effect through the equitable share of provinces, or additional grants to provinces from the national share.." (Department of Finance, Afedium Term Budget Policy Statement, 2 December 1997, p.40). Yet, the vertical division is held stable, while the MTEF also proposes that education, health and welfare be increased at a pace faster than the budget in general (ibid. Table 6.2, p. 60). It is therefore unclear how these alternatives are reconciled, as it is unrealistic for this additional expenditure to be met just from savings in other provincial functions (at least a mechanism to ensure a shift at the provincial level is required). In essence, the vertical division does not take into account the policies outlined in either the MTEF or the GEAR. The MTEF document acknowledges that more resources are required in the short term in order to reduce infrastructural backlogs in social services. If this is to be achieved through the reserves, then the transmission mechanism through which the reserves relate to the formula must be established in the MTEF and built into the formula.

Implementing the MTEF in a decentralised political framework. Fiscal planning of the type characterised in the MTEF has worked well in unitary states where little power is vested in the lover levels of government (e.g. Indonesia) and in centralised federations (e.g. Malaysia). The South African Constitution, however, confers a considerable degree of spending power to the provincial governments, particularly with respect to important functions such as Education and Health. A prerequisite for the success of the MTEF would appear to be the attainment of consensus in institutions such as the Budget Council and the Inter-Governmental. Forum rather than legislated co-ordination. Whether this could be anything more than a short-term solution remains to be seen. A decentralised system does not preclude medium term planning, nor does medium term planning preclude a decentralised system. What is required is that a mechanism is established to translate national priorities into implementable provincial programmes, without precluding the ability of provinces to determine their own priorities.

MTEF and sectoral planning. The establishment of an MTEF and the transfer of block grants to the provinces raise specific questions relating to sectoral planning. It is not clear now how sectoral planning will occur, if at all. National departments may wish to develop norms and standards for particular programmes with a view to promoting equity and development nationally. The extent to which such elements of sectoral planning could be accommodated in the MTEF is not clear, although the MTEF should be the mechanism where the financial consequences of such norms and standards are assessed.

The MTEF notes the need for **provinces to have greater control and decision making over personnel, and their spending in general.** The favoured mechanism to achieve this is a retrenchment tool and extending bargaining to incorporate the provinces. The FFC cautions against using a single tool to solve a number of problems. While there are undoubtedly surplus personnel, additional thought of the impact on service delivery should be considered. Experience (e.g. with the voluntary severance package) has already shown that retrenchment is not a simple panacea. Retrenchments are not solely about the reduction in public employee numbers, but should be a part of the overall vision for the state and the public sector. One of the critical elements is to have a strong management capacity prior to retrenchments. Additional tools and a plan to fund retrenchments should be developed. Since many of the supernumerary staff are inherited from the past it may be sensible for national government to fund the retrenchments as a once-off exercise in a manner similar to the way the debt has been handled.

1. The Approach Adopted in the Formula

There are three overarching strategic issues concerning the approach adopted in the DoF formula and the manner in which it is operationalised (in addition to the link to the MTEF described above).

1. The Weightings of the Unconditional Components

   The FFC established a package of grants which were aimed at meeting minimum standards requirements, addressing spillovers, tax incentives, equitable funding and addressing non demographically related responsibilities. These are shared by the DoF. **Where the two approaches differ,** however, it is in the nature of the minimum standards component and the tax share (the tax share is discussed below). As far as the minimum standards component is

concerned, the **FFC created a proxy for costs** which could be assessed as an input cost norm (i.e. costed up). The **DoF uses a weighted share** of the provincial pool (e.g. 39% for education). The FFC recognises the need to shift from a cost based norm (in the absence of a clearly functioning planning and financial management system) and supports the notion that "The elements of the equitable division formula are not indicative budgets" (ibid. p41), yet there are limitations to the use of weightings. These include a shift from the minimum standards basis to a link to past expenditure. It is not clear why the 39% weighting for education should remain at that level and whether the level is appropriate in the first place. This raises two of the other general concerns, the base and the manipulation of the weightings.

2. The base for the formula

   This is an extremely important and difficult issue which must be addressed to stabilise the intergovernmental allocation system. To institute any formula for intergovernmental funding or expenditure planning process, it is important to know what the starting point is. That is, what amounts are presently being given to the respective spheres of government (whether this is the desirable level or not is not important at this point). This issue becomes even more significant when a formula is being phased in over more than one year. The DoF proposals take the 1997/98 budgets as the starting point for both the vertical division and the horizontal division of resources.

   There are a number of advantages to taking budgeted amounts into account. A budget is the plan approved by government and reflects its priorities and desires. Budget data are easy to obtain and can be obtained well in advance of a budget cycle. Taking budgeted figures into account may also reward efficiency.

   There are, however, disadvantages to using budgeted figures. If budgeted figures do not represent the reality of what is being spent, then the formula would not make much sense since management plans for the spending agencies

would not be able to adjust to the new targets from this incorrect base (thus exacerbating the inability to manage spending, especially during major policy and structural changes). At the moment, some provinces and national departments are spending more than their budgeted allocation. If these spending agencies are phased down from the budgeted amount, it would be impossible for them to adjust to the new funding level as they are spending at a higher level than budgeted for.

To solve problems of large-scale persistent overspending, it is recommended that a once-off adjustment to the base figures needs to be made to take into account the actual levels of expenditure (and to ensure that future budgets and actual spending coincide). The FFC is not suggesting that actual expenditures be taken into account on an annual basis but merely as a once-off measure to reflect realistic levels of funding for a sphere of government. This links to the analysis of over-expenditure by provinces and the incentives for effective and efficient management and realistic budgeting.

In the opinion of the FFC, informed by the DoF report into provincial over-expenditure, there are four main reasons for the over-expenditure:

- the original base is wrong;
- provinces have unfunded mandates (finance has not followed or fully followed expenditure responsibilities);
- budget gaming (where provinces deliberately under-budget in anticipation of a bail-out); and
- poor financial management.

As outlined above, an incorrect base can be the cause of the inability to manage within a budget. This problem was inherited from the incomplete budgeting from zero exercise when the spending levels of the new provinces were first estimated. Some adjustments have been made since that exercise, but it has been insufficient and has not fully accounted for realistic growth within the provinces.

A very large proportion of a provincial budget is out of the control of the province. Personnel expenditure and social security contributions comprise almost 90% of a province's budget. The level of salaries and the size of the social security grants are determined at national level either in national bargaining chambers or by national departments. Even if provinces wanted to reduce their expenditure, control over these large items is not in their hands. The solution, of a retrenchment tool, proposed in the MTEF is insufficient. Refer discussion below.)

In the past, policy and wage agreements were adopted at national level and provinces were asked to bear the cost of these policies with no regard for their cost or impact on provincial budgets. Although the new legislative framework requires all policy to be carefully costed, it is previous agreements and policies that are placing undue strain on provincial budgets. The DoF proposals for the 1998/99 budget do not take these unfunded obligations into account.

In some provinces, politically sensitive functions such as welfare, education and health were under-budgeted in the last budget year (1997/98). These provinces assumed that national government would avoid the politically sensitive task of stopping welfare grants, dismissing teachers or closing down hospitals. They hoped that national government would bail them out, even though the levels of over-expenditure in welfare, education and health rose dramatically.

This problem reflects weaknesses in the budget process at both national and provincial level. Because the budget determining base has been wrong, there is an incentive for departments to overspend. A number of additional weaknesses emerge in the budget process. The link between planning and budgeting is weak in most provinces as is the link between planning and formula funding at national level. A concern about the reserve (discussed below) is that the fund is open to gaming of this nature, in the absence of a realistic base.

The fourth reason for over-expenditure in certain provinces is poor management capacity, especially financial management. Some provinces lack the basic capacity to plan, to budget and then to manage the budget. At the

middle management level, there is little regard for financial accountability.

While the budget process must be enhanced to reward efficiency in government, this process is not a short-term one. Improving management, designing and implementing new systems and enhancing accountability are all medium to long-term goals. In fact, improving management capacity may cost money in the short term in order to ensure savings and better services in the long term. If either forced or voluntary retrenchment is conducted without adequate management capacity, no improvements in efficiency or effectiveness will be forthcoming (*"Public Expenditure opt Basic Social Services in South Africa"*, FFC forthcoming, January 1998).

3. The Potential for manipulating the Weightings of the Unconditional Grants

The changes to the formula introduced between the May indicative allocation and the December 1997 allocation are analysed below. Because new Census figures became available between these two dates, changes in the relative allocations to provinces were expected. Without suggesting bad faith on behalf of the DoF, the use of arbitrary weightings can be open to manipulation. In the changes made this year, care was taken by the DoF to maintain stability in the system and ensure that the allocations were similar to those proposed in May 1997. The weightings were adjusted to this end, but are not fully reflected in the first year, as the entire adjustment is phased in. Over time, any change to the population shares will also lead to growth in the overall allocation of a province. The danger is that because formulae of this nature have many interacting variables, it is very difficult to establish what is causing the overall changes to the shares *per se*. **In this regard, a method for reporting adjustments and a principled basis to the components are required. The FFC will pursue this matter in detail in the recommendations due in May 1998.**

5. The Top Slice, Removed Before the Vertical Division

A number of budget items are top sliced from the pool of revenue before the resources are divided up amongst national, provincial and local governments. "Before expenditure is equitably divided among the three spheres of government, three items are set aside from the total. These are: debt service costs, standing appropriations and a reserve" *(ibid. p. 33)*.

In principle, the FFC does not agree with the use of the top-slice. The Commission acknowledges that there are indeed fiscal obligations in terms of Section 214(2)(a)-(j) of the Constitution, that must be accorded priority, such as debt redemption and "standing appropriations" but believes that these should be computed on an annual basis and included in the national government's share as these are national government responsibilities. Similarly, the amounts for conditional grants and the policy and contingency reserve should be included in the national. However, due to the prevailing complexities with respect to ownership of the debt and loans, a case can be made for this item to remain as the "top-slice" until provincial borrowing ensues. This is because the current borrowings and the associated interest payments have been made on behalf of government, i.e., national and provincial governments.

1. Policy and contingency reserves

The reserve is divided into two portions:

i. a contingency reserve to cater for unforeseen circumstances such as drought or floods, and
ii. a policy reserve which would be allocated by national government on an annual basis depending on its own policy imperatives and priorities.

In terms of the **policy reserve**: while it is appropriate for national government to be able to fund new projects and its particular priorities from this reserve, a number of issues need to be borne in mind. The division of this policy reserve will affect the vertical division. It will give either national, provincial or local government more resources than the initial vertical division would recommend. It is UNclear whether this reserve will be allocated on a project basis (such as a school building programme) or to functions in line with government priorities (say to education). It is

unclear who will fund the carry-through costs of additional operating expenditure from this reserve.

The policy reserve is to be top-sliced, i.e. as a first claim against the budget. Redirecting expenditure through the reserve will allow priorities to be expressed through increased budget allocations to functions, nationally and/or provincially and/or locally. It is not evident why the policy and contingency reserve should be included in the top-slice. It would be more logical and in tune with the Constitution to include this element in the national government's share. The national government could then allocate these resources as part of the equitable share or as a Section 214(1)(c) grant in terms of national development priorities.

Since additional funds are being made available for specific priorities, it is not clear how the DoF intends ensuring that the additional money is actually spent on those areas. Moreover, no explanation is provided for the decision to set aside these specific amounts for the policy reserve. If it is initially to be used to fund the legitimate overspending, then the base for the formula should rather be recalculated. If this reserve is to be allocated on the basis of bids from departments or provinces, it may have adverse consequences on equity, where well organised provinces take up the lion's share of the reserve and little expenditure takes place where it is needed most.

Keeping the policy reserve as a top-slice item raises questions about the appropriate funding of national priorities across regions. If Cabinet, on the basis of the Budget Council recommendations, decides that education, for example, is a top priority for the next fiscal year, it will then allocate funds to provinces based on the education component of the formula. If, however, some provinces have prioritised education and budgeted adequately for the function (in terms of national priorities), additional funds will be used for other (lower priority) provincial expenditures.

Adjusting the vertical division and the size of the unconditional "weightings" to reflect priorities

could be considered as a simpler mechanism for achieving the same goals. The priorities should be established prior to the indicative allocations to prevent gaming and ensure that provinces can reflect the correct emphasis in their budgets.

The MTEF document states that it is not clear whether the policy reserve will be allocated to national, provincial or local spending. This implies that all of it may go for national spending, leaving less for provincial governments because this amount is being top-sliced before the vertical division is made. Also, no mention is made of the local government sphere having access to the policy reserve.

It is unclear whether the recurrent implications of the portion of the reserve allocated to development expenditure (and one assumes that capital spending will be a significant component thereof - to ensure that macro priorities and goals are achieved) are accounted for - including the mechanism for ensuring this funding. This problem of planning, budgeting and the MTEF is raised above.

Budgeting for a contingency reserve is prudent for meeting fiscal objectives as no additional shocks appear in the budget. There is, once again, an issue of sequencing. Since the introduction (or increase) of this reserve means a once-off expenditure cut, the growth of the reserve during a period of structural adjustment must be considered carefully. It is understandable that uncertainty increases over time, but this does not translate into a greater chance of natural disasters. The rapid and dramatic growth of the reserve is only justifiable if a large portion thereof is allocated before each of those years.

Related to this is the potential of the reserve for creating incentives for budget gaming. This is particularly important if the provinces have claims for unfunded mandates and if a portion of the reserve is used to fund over-expenditure.

At present, as in the past, government debt is used to finance expenditure at all levels of government, including provincial expenditure as the provinces have not begun to make loans yet. Money is borrowed by national government and then apportioned to different spheres of government through the national revenue account and budget process. Hence, it is appropriate for all three spheres of government, to meet the costs of servicing the debt. The FFC supports the principle that the present debt be managed centrally by the DoF.

Once provinces begin to borrow money in terms of the Borrowing Powers of Provincial Governments Act, national government will be able to reduce its level of borrowing. In this process of redistributing borrowing

and debt, the debt servicing obligations of the public sector as a whole would become more evenly spread between national and provincial governments. When debt servicing becomes a significant item on provincial budgets, the top slicing of this item will need to be reconsidered.

2. Standing Appropriations

Standing appropriations comprise a small amount and are generally considered to be an obligatory part of national government expenditure. It thus seems inappropriate for this item to be top-sliced before the equitable division of resources can take place. Standing appropriations are a National government responsibility, since it is the custodian of international relations.

6. The Vertical Division

The vertical division is the allocation of nationally raised revenue amongst the three spheres of government. There are three variables which influence the determination of the vertical division, namely,

i. defining what revenues are in (or out of) the "nationally raised revenues";

ii. determining the base; and

iii. the apportioning of expenditure responsibilities, which refers to the relative powers, functions and responsibilities of each sphere, national imperatives, relative tax capacities and political priorities. Once the so-called revenue pool has been established these factors determine the three-part division.

The FFC and the DoF have taken somewhat different approaches to how these variables are defined and interpreted. Although it may appear that these differences are mere semantics, it is suggested that there could be fundamental implications for public sector finance and particularly budgeting, as a result of using different approaches. This should become clear in the arguments which follow. At the outset, the FFC is pleased that local government is now an explicit part of the vertical division in the DoF's proposals for the 1998/99 fiscal year. The FFC, however, would like to raise a number of concerns in regard to the manner in which the vertical division has been determined. The DoF has defined the national revenue pool as follows:

- all resources accruing at the national level is the gross pool or base; and

- the top slice items are deducted from the gross pool to determine the net pool.

The FFC has maintained that there should in principle be no "top slicing" or "below the budget items". The net pool should in fact be what the DoF defines as the gross pool. It is acknowledged, however, that in the interim, prior to the provinces borrowing, there may be some rationale for the debt to be deducted from the gross pool.

Two other key determinants of the vertical division are the base year and the use of budgeted or actual expenditure data. In the DoFs proposals for 1998/99, the vertical division is based on the 1997/98 budgets. The first concern the FFC has, relates to the use of budget data to determine the vertical division. Actual expenditure has not reflected budgeted expenditure for any- of the previous three financial years and it therefore does not seem to be a good basis to do this division. This is explored above.

Finally, the budget proposal of the DoF does not mention non-annual recurrent expenditure items such as a general election or a census. These large items will not only affect the vertical division but will also affect budget planning at all levels. The FFC proposes that both the revenue and deficit levels be adjusted in such years so that the impact of these items can be smoothed over a number of years. This will not require a shift in overall macroeconomic targets but requires a shift away from straight line phasing.

7. Improvements in Conditions of Service

The decision to include the amounts for improvements in the conditions of service in the national and provincial budget shares is in line with the decentralised framework embodied in the Constitution. However, it is important to stress to provinces that these amounts are included in their budgets and that this brings additional duties, including the need to budget for this function.

TABLE 2
Improvements in Conditions of Service for 1996 to 1998

	Division of Wage Bill as of 30/9/97	Division of Salary Improvements in 1996/98	% Shares Wage Bill	% Shares Salary Improvements	% Equitable Shares as per Horizontal Division
Western Cape	3,499,563	731,255	12.7	9.9	9.6
Eastern Cape	6,197,822	785,359	13.6	17.6	16.9

Northern Cape	679,300	103,760	1.8	1.9	2.3
KwaZulu-Natal	6838,156	1,021,312	17.7	19.4	20.3
Free State	2,580,928	411,981	7.2	7.3	6.6
North West	2,785,453	393,396	6.8	7.9	8.2
Gauteng	5,477,969	997,170	17.3	15.5	16.2
Mpumalanga	2,224,166	269,951	4.7	6.3	7.6
Northern Province	4,996,933	1,043,011	18.1	14.2	12.5
TOTAL	**35,280,290**	**5,757,195**	**100.0**	**100.0**	**100.0**

As can be seen from the table above the division of the Vote amongst the nine provinces differs if the historical shares of the Vote or if the equitable share determined by DoF is used.

Historically, following central negotiations on salaries and other improvements in conditions of service, the Vote was divided between departments. State Expenditure then included the amount allocated to each department in the following budget, to cover carry through costs.

Clearly, the current formula allocation does not treat the Vote in the same way. Yet as long as provinces cannot shed employees, they cannot downsize to compensate for higher costs due to improvements in pay or conditions. As a result, they may face severe fiscal difficulties and decreasing ability to deliver services, especially to the poor. It is therefore recommended that the costs of retrenchments (of supernumerary personnel inherited from the past) be funded from national government - in a similar way to which the provincial debt has been handled. Once the initial "right-sizing" is complete, the provinces will be responsible for future retrenchment costs.

Conditional Grants: General Comments

The DoF recommendations introduce the concept of conditional grants for; health, transfers to local government and RDP expenditure on the primary school nutrition programme. The general concept of conditional grants is desirable for reasons relating to equity, national development and policy priorities. However, there are several concerns relating to the way in which the specific conditional grants are determined and structured. (The FFC's proposals on local government are presented in Chapter 3 of this Report.)

The general difficulty with conditional grants is the administrative costs involved. The national government needs to have the monitoring capability to ensure that tile grants are used for the purposes for which they have been stipulated. No provision is made in the DoF proposals for the development of mechanisms to monitor outcomes and enforce compliance (although a line item is created for the central hospitals which are funded through the conditional grant in the standardised budgets).

It is critical that the introduction of conditionality incorporates the plans of the relevant national departments, in consultation with the provincial departments. The role of the Budget Council should be confined (in consultation with the relevant national departments) to determining the value of such grants within the context of the overall budgetary framework.

In terms of the Constitution, legislation is required to enable conditional grants to be provided. Section 213(1)(c) states that: "An Act of Parliament must provide for - 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."

1. T
he Conditional Grant for Health

The conditional grant for health requires reconsideration, since the objectives are unclear and the costing has not been done. There are a number of objectives of this grant, including compensation for spillovers, cross boundary usage of facilities, the need to plan and control national services, and training and research. This is to be provided by 10 central academic hospitals. The amounts are based on the base year expenditure plus an increment, and do not include all hospitals which are presently regarded as academic hospitals.

Without clarity on which objectives are being met, and with conditions which do not enforce the use of the grants at those hospitals, the effect of the grant is largely to ensure a redistribution towards Gauteng and the Western Cape where a bulk of these facilities exist. If the aim was to increase funding to these provinces, a far simpler mechanism based on expanding the weighting of the tax share could have been used. If, however, the aim was to achieve health outcomes, then the grant is inadequate. For example, if the full amount of the conditional grant is applied to the central hospitals, then in the context of a decreased overall provincial budget - cuts would occur in priority health services (this is already apparent in the Western Cape). In addition, there is duplication since provinces are "double funded" for the provision of non-tertiary service delivery in the central hospitals - creating an incentive to continue doing so in an inefficient manner. Both alternatives are contrary to stated health sector goals.

The institutional concerns of splitting the responsibility for managing different aspects of the hospital system between national and provincial government must be carefully considered and properly planned before any decision is taken. In the absence of the piloted and proven ability to manage the facilities, stability should be maintained. The amount set aside for redistribution to the other provinces has no basis in planning Nor clarity of objectives. Once again in the absence of the ability to ensure the effective use of the funds, stability should be prioritised.

Finally, there is no discussion of measures aimed to increase revenue into the health sector. This can be achieved through revenue retention at the facilities. There are difficulties concerning revenue retention in these facilities, which include equity implications, (since the revenue is raised in only four provinces) and whether the intended incentives are confused since the treasuries may opt to decrease allocations to the hospitals as tile hospitals' revenue increases. (For a full discussion on the issues see- *"Public Expenditure or: Basic Social Services in South Africa"*, FFC forthcoming, January 1998).

9. The horizontal division: the unconditional "equity" grant

The composition of each of the formula elements raises some questions:

- The education component (weighting of 39%)

39% of the revenue sharing component of the formula is set aside for school education. This percentage is meant to give an indicative weighting for the education grant and is not a specific level or ceiling of expenditure at a provincial level. Provinces are free to budget any percentage of their revenue towards education, informed by there own process of prioritising provincial budgets.

There are two main factors used to distribute the education component of the revenue sharing formula. They are school enrolment figures and school age population figures. A simple average of these two figures are used to provide the weightings. Using school enrolment figures on its own has the advantage of funding exactly how many pupils receive an education from the government. The disadvantage of this approach is that it penalises provinces that are trying to increase their school population by decreasing the out-of-school population. Provinces need to be given the resources to achieve this objective. Simply using school age population figures would give provinces the resources to expand their education system but penalises provinces that have a high number of repeaters in the school system. An average of the two figures achieves both objectives.

School enrolment figures for both public schools and independent schools are used. Provinces have adopted vastly different funding arrangements for independent schools. They are entirely within their powers to adopt different funding approaches.

- The health component (weighting of 18%)

The revenue sharing formula includes a health weighting which aims to support provincial budgeting for the delivery of health-care on an equitable basis.

A needs-based, or weighted capitation, formula is used. This means that the provincial population is the basis of the needs driven formula. Thereafter, the, variation in utilisation due to age and sex differences in the provinces is accounted for. The weighting involves three steps:

- weighting the allocations for relative population share: the CSS 1996 Census is the basis from which the health formula is developed.
- adjusting the population figures for private sector utilisation: the proportion of people from each province with access to private medical-aid (October Household Survey 1995) are removed from the base population. In all provinces, individuals with the ability to afford their own health care should be subtracted from the population, to create a more accurate reflection of the use of public sector health services.
- the proportion of people using public health services is adjusted for utilisation differences due to age and: the OHS 95 survey is used to adjust the Census figures to construct age and sex differentials. The population is then weighted for the expected higher utilisation rates of women of childbearing age (ages 15-44), children (0-4) and the elderly (over 65 years). The three weightings are applied equally.

This equal weighting for the entire health component is intended to be simple. Over time it can be improved and made more complex. In future, changes will be made, subject to research. For example, (van den Heever and Doherty 1997) have argued for a more complex formula with different types of health services being. treated in distinct ways. In their example, the unclear relationship between non-personal. primary health care services and the age and sex distribution of the uses of these services requires a different weighting.

- The social security component (weighting of 16%)

The welfare (social security) component of the unconditional grant is determined by using a similar method to that used for the health and education components. The underlying population shares of each province are used to determine the initial proportions. These proportions are then weighted in a reasonable manner for each function. Welfare is weighted for the elderly who presently have access, Old Age Pensions (OAP), children intended to access the child grant and for

disabled individuals. Similarly to health, three steps are required to achieve the weighting:

i. Weighting the allocations for relative population share in the CSS 1996 Census is the basis from which the health formula is developed.
ii. Weighting the population for the intended distribution of the grants: the population is weighted to reflect the intended recipients of social security:

    a. the base population for the OAP is determined by all the males over 65 and females over 60 years. This is taken from the Census 1996 with the age proportions determined from the OHS 95;
    b. the base population for the Child Grant is all children 0-6 which is a proxy of the intended recipients of the new grant; and
    c. the base for all other grants, including disabilities is the population as a whole.

iii. These three components are then weighted to reflect the relative size of each of the grants. The 1997/98 budget (and estimates of actual expenditure) reflect that the OAP absorbs a little under 65% of the social security budget, child and family care a little over 10% and, disabilities and other grants about 25%. It is important to note that in the longer term, the size of the child grant component will increase to reflect the introduction of the new child benefit.
iv. An adjustment is made to reflect that the intended recipients are of low income: since the aim of social security payments is for income support, they are means tested. Thus, the poor are the intended recipients and an adjustment is made to reflect this. The outcome is that provinces which have more rich individuals get a lower weighting than those with poorer individuals. A 25% adjustment is made to reflect the intended functioning of the means test and the targeting for the new child support. Research is required to refine this figure in line with the improved application of the means test and once there is clarity over the functioning of the child support.

The remainder of the welfare budget is weighted according to the basic share i.e. with a 50% proxy for poverty. This reflects the intention of stated welfare policy.

In the earlier formula presented to the Budget Council, there were two alternatives presented for this component of government spending. One was leaving social security in the

provincial pool (as is described here), the other is for social security to be treated as a conditional grant. At present, legislation has not been passed nor have plans been finalised concerning the use of a conditional grants mechanism for social security. Thus, the social security component remains a provincial competence for which provincial treasuries are accountable.

The location of responsibility for social security (national or provincial government). The ambiguity over roles and responsibilities occurs, primarily because the financing (determined by the norms set nationally) and management (by the province) are the responsibility of different spheres. Provinces cannot be expected to manage social security properly if costs can be passed to the national Fiscus. Conversely, provinces cannot maintain financial responsibility if they have no managerial or regulatory discretion. It is recommended that, in resolving the assignment of responsibilities for social security, financial and managerial responsibilities should be located together. Since it is not possible to transfer all the administrative responsibilities immediately, provinces will continue to budget for social security in 1998/99 fiscal year. This is an interim arrangement until an effective solution is agreed.

It is recommended that a once-off adjustment be made to reconcile budgeted expenditure with actual expenditure. Research is required to immediately clarify the amount. Where provinces have not shown reasonable controls, some of the burden should fall onto the province concerned and found from within provincial budgets. If there are insufficient funds for the vote in total in the 1998/99 fiscal year, the size of the grant will have to be adjusted.

The problems experienced in budgeting and accountability for social security suggest the need for greater oversight of the social security Vote to manage these risks. It is recommended that an appropriate committee be constituted immediately to review the budgets for social security. This committee must furnish a report to the national ministers outlining the implication for the maximum size of the grants and indicative budgets for the provinces for 1998/99.

In a case where the function is shifted from one sphere to another, great care would have to be taken to ensure that the correct amounts are removed from the one budget and placed in the other budget. (Refer discussion about the base.)

- The basic share component (weighting of 15%)The 50% weighting in favour of rural areas is used as a proxy for

poverty. It is important to note that this component is far smaller than the FFC's basic grant which constitutes half the provincial share.

The 50% is therefore a higher value on a lower base. The adjustment of the variables and weightings to be similar to the May and FFC allocations is evident. The principles underlying the components of the basic share reflect the need to balance growth and equity incentives in the formula - the analysis of this balance is absent due to the approach adopted by the DoF (also reflected in the economic component).

- The economic output component (weighting of 8%)

Neither the size nor the operation of the economic components are clear. At 8% of the provincial share of the budget this represents roughly R6 billion. Surely this has a countervailing effect on all the equity based shares which then runs contrary to devising a formula that redresses the inequities amongst provinces.

The DoF includes what they call a "proxy for provincial own revenue", namely, an origin-based, fixed share of the provincial revenue pool. The amount for each province is determined according to the ratio of its gross the GDP. In the 1997/98 fiscal year this amount would have been just geographic product (GGP) over 7% of total provincial allocations. It remains at this level in subsequent years.

The FFC is concerned that the DoF approach to provincial own revenues does not recognise the critical important this aspect of the intergovernmental fiscal relations system. The rationale for creating a system which actually provides provinces with real own revenues is crucial to the development of fiscally accountable and democratic provincial government. Real own revenues are characterised by the taxing authority being able to vary, the tax rate, if not the tax base. In addition, the base should be of such a nature that changing the rate will impact on as broad an electoral base as possible. As recommended by the FFC, the personal income tax base has all these characteristics.

It would appear that as a first step in the process of providing provinces with own revenues it should be a source which provides as many benefits and positive incentives as possible. The long-term use of an own tax proxy as done by the DoF seems to have marginal benefits, at most.

In addition, the use of GGP as the factor for determining the tax base has significant problems, in general and in South Africa in

particular. If one is attempting to determine the tax raising capacity of a jurisdiction then GGP is probably the weakest indicator thereof. For this reason the FFC used a three-way average of GGP, RSC/JSB levies on remuneration and the labour component of GDP, which evens out the inherent problems visa of using just GGP.

The DoF formula to determine the equitable shares uses economic activity as a proxy for own revenue. If provinces are given substantial revenue raising powers or if a proxy for revenue is used which is based on origin, then this must be balanced by some degree of fiscal capacity equalisation. Section 214 2(e) of the constitution requires the revenue sharing formula to take the fiscal capacity of provinces into account. In order to achieve a balanced intergovernmental fiscal system, the ability to raise own revenue, either through taxing powers or by proxy; must be balanced with the requirement to compensate provinces with tax capacity below the national average. Without this balance, the system of intergovernmental fiscal relations become distorted.

In this regard, to compensate provinces that have a low tax capacity, the FFC has developed a zero-sum system of fiscal capacity equalisation grants (which can be either positive or negative, for a given province). This grant is not, however, dependent on the provincial tax rate actually chosen or on other grants the province receives. Although section 214 of the Constitution specifies that fiscal capacity should be taken into account, this is not done in the DoF formula.

- The institutional component (weighting of 4%)

It is unclear why the institutional weighting is so large. At 4% of the provincial share of the budget this represents R3 billion i.e. roughly 8333 million per province. The FFC recommendations for this element in 1997/8 was 8286 million for all the provinces. The calculation was based on the estimated cost of running a basic administration consisting of 10 MEC's, 10 heads of departments and a basic infrastructure to support them.

10. The DoF's Treatment of Local Government

To reiterate what was stated in the section on the vertical division, the FFC is pleased that local government has been included in the system of intergovernmental fiscal relations, as reflected in the vertical division. There is clearly some way to go to fully integrate local government and municipalities into the evolving system but this is seen as a definitive start.

The DoF approach deals only with local government in the vertical division, and also only for operating expenditure. The inter-municipal or horizontal allocations are going to be dealt with during the early part of 1998 and the system as a whole will be incorporated fully on an ongoing basis during the course of the next few years. The capital component is treated as a conditional grants from national government to local government, in the same manner as provincial conditional grants are treated.

The amounts set aside for local government in the vertical division have been largely "extracted" from other spheres' budgets, thus there are implications for the vertical division. Provincial and national proportions of the national pool will have to decline as the local government component is created. This approach once again undermines the possibility of having the vertical division being static over the short term.

The FFC will be submitting a comprehensive comment on the horizontal division recommendations of the DoF in its May 1998 submission.

3. A comparison of the indicative allocations published in May and the allocations published in December

The Budget Council in May 1997 received a set of recommendations from the DoF. These recommendations included indicative allocations for the division of resources amongst the provinces. In December 1997, a different set of allocation were presented to the Budget Council and it is these new revised allocations or shares that are contained in the MTEF document. The FFC would like to acknowledge the efforts, and complement the DoF for significant improvements in the MTEF and the formula between the May document and the December publication.

A set of indicative allocations was made in May 1997 to the Budget Council, which was to become the basis of the provincial allocations. The independent variables were to be updated with the Census figures, which only became available after May 1997. In addition, a number of adjustments were made to the formula. The discussion below assesses the changes which were made for consistency with the stated goals and to assess whether an objective methodology has been applied by the DoF.

It is important to note **that formulae of this nature are not inherently "objective"**. They comprise a set of weightings and variables which may favor one province over another. The outcome can be assessed in general, but the interaction of all the components are not always easily identifiable. In the context of a phased approach and with a country and budget process in transition, these difficulties are enhanced. Tables 3a) and 3b) shows the absolute impact of changes to a number of variables (since they all interact together, the actual influence of any single variable cannot be computed). The

methodology adopted here is to keep all other variables constant and review the impact of changes to a single variable).

TABLE 3a
Comparing the May and December Allocations for 1998/99 and 2000/01

1998/99	Indicative Allocation %Shares	Census (R'm)	Revised Economics (R'm)	Local Govt (R'm)	All other Changes (R'm)	Total Changes (R'm)	Revised Allocation
Western Cape	10.61 %	210	2	-206	-70	-64	10.67%
Eastern Cape	16.82%	-14	13	-268	128	-142	16.88%
Northern Cape	2.33%	25	2	-37	18	8	2.37%
KwaZulu-Natal	19.64%	-111	12	-145	17	-226	19.64%
Free State	6.84%	-9	4	-96	10	-91	6.83%
North West	8.16%	39	6	-83	91	53	8.32%
Gauteng	16.33%	229	2	-193	-303	-265	16.24%
Mpumalanga	6.16%	-30	5	-91	109	-7	6.23%
Northern Province	13.11 %	-339	10	-94	29	-394	12.83%
Total	**100.00%**	**0**	**561**	**-1213**	**29**	**-1128**	**100.00%**

TABLE 3b
Comparing the May and December Allocations for 1998/99 and 2000/01

2000/01	Indicative Allocation% Shares	Census (R'm)	Revised Economics (R'm)	Local Govt (R'm)	All Other Changes (R'm)	Total Changes (R'm)	Revised Allocation
Western Cape	9.85%	7491	-264	-265	-14	207	10.54%
Eastern Cape	16.58%	-51	-417	-443	137	-775	16.65%
Northern Cape	2.13%	91	-58	-42	69	60	2.30%
KwaZulu-Natal	20.03%	-394	-489	-768	109	-1543	19.53%
Free State	6.78%	-33	-169	-183	-3	-388	6.74%
North West	7.83%	138	-204	-208	199	-76	8.14%
Gauteng	16.85%	816	-421	-262	-1002	-869	16.84%
Mpumalanga	6.65%	-107	-170	-163	246	-194	6.79%

Northern Province	13.30%	-1208	-313	-289	275	-1535	12.47%
Total	**100.00%**	**0**	**-2504**	**-2624**	**17**	**-5112**	**100.00%**

The tables above indicate the effect in rand terms of adjusting one variable at a time using the indicative allocations as outlined in May 1997 as the starting point. Both the 1998/99 (Table 3a) and the 2000/01 (Table 3b) allocations are shown. The new Census figures have no net difference to the provincial allocations but they do shift the allocations of each province. The new macro-economic forecasts and the removal of the local government shares decrease the pool of revenue going to the provinces while changes brought about by other adjustments to the formula are combined in the column headed other changes.

There are five broad reasons for the differences (or similarities) in the two sets of allocations.

1. The preliminary 1996 Census results were used in the revised allocations whereas CSS data from the 1991 Census was used in the May allocation. The new figures reflect a shift in population towards tile Western Cape and Gauteng from poorer rural provinces. These changes have had a major impact on the final shares of provinces.
2. The new allocations contain revised macroeconomic forecasts which marginally reduce the amount of money available in subsequent years. The changes in the macroeconomic assumptions reflect a projected decrease in growth and inflation as well as a slightly lower interest burden.
3. The intergovernmental grants to local governments are now not part of the provincial allocations but are an explicit share of nationally collected revenue that goes to local government. This change has had the impact of reducing the pool of revenue going to the provinces with different provinces losing different shares of the local government grants.
4. The formula used to do the May allocation did not have social security as an explicit item but rather as part of the pool of revenue. In the revised allocation, social security is weighted 16% of the equitable share that goes to provinces. The components used to divide this portion of revenue includes age cohorts and poverty levels, with older and poorer provinces getting a larger share of the social security portion.
5. To accommodate the social security element of the equitable share, the shares of the remaining components had to be reduced. Due to the nature of the data used to calculate each component, shifting these proportions had the effect of adjusting the outcomes of the formula.

The methodology used by the DoF to adjust these components is difficult to follow. It appears as though the weightings were adjusted to achieve an outcome not too dissimilar from the original May allocations. While predictability

in the budget process is important, the manipulation of a formula to achieve this predictability undermines the integrity of formula funding.

If the new Census figures or some of the other adjustments led to huge changes in the equitable share due to provinces, then it would have been more advisable to re-examine the phasing period or alternatively, to introduce concepts of ceilings and floors in budget allocations. These steps would have had the effect of cushioning the impact of the new data without damaging the integrity and transparency of the formula.

CHAPTER 3

Provincial Revenue:

A Provincial Surcharge on the National Personal Income Tax Base

Recommendation

The Financial and Fiscal Commission recommends that national legislation be promulgated to regulate the provincial imposition of a surcharge on the national personal income tax base, in accordance with the Constitution and also in support of greater provincial fiscal accountability, autonomy and democracy. The legislation should regulate the surcharge as follows:

- the national personal income tax (PIT) base in each province is the provincial PIT base, and no other base may be used;
- the South African Revenue Service will collect the surcharge yield on behalf of the provinces;
- provinces must pass their own legislation dealing with this revenue source;
- the surcharge will be calculated on the taxable income in percent or the tax yield in percentage points;
- the surcharge will be phased in over six years, the first four years at one percent per year and the last two years at one and half percent per year;
- the surcharge may only be a maximum of seven percent of the taxable income base in the last year of the phasing-in period;
- provinces may choose to impose a surcharge rate smaller than the rate applicable for that year; and
- tax room, equivalent to the percentage of the surcharge, will be phased in over the six years.

It is furthermore recommended that both the national and provincial legislation be enacted as soon as possible in 1998 in order for all the necessary administrative arrangements to be made in anticipation of implementation in the 1999/2000 fiscal year.
In addition, it is advised that the first step in providing provinces with own sources of revenue which are likely to increase their accountability and support democratic government, is the surcharge on the national personal income tax

1. Introduction

This is a Financial and Fiscal Commission recommendation motivating for the implementation of national legislation to regulate the provincial imposition of a surcharge on the national personal income tax base, in accordance with the Constitution, related legislation, and also in support of greater provincial fiscal accountability, autonomy and democracy.

2. Rationale for Implementing Surcharges

1. Provincial Revenue Sources

Provinces currently derive their revenues or have the right to do so from (i) so-called own revenues, (ii) revenue sharing with national and local governments, (iii) grants from national government and (iv) proceeds from loans (both for "bridging" finance and for capital expenditure). This is the standard portfolio of revenue sources which "regional-type" governments generally have. The issue which is of real interest is the relative yields of each of these categories of revenue sources. This is dealt with below.

Own revenues accrue mainly from the following sources: user charges (for example, the provision of health services at provincial hospitals), motor vehicle licences, horse racing and gambling, and a range of licences (Table 1 lists the four major own revenue sources for provinces in the 1996/7 fiscal year. The estimated revenue from these sources for 1997/98 is R3.8 billion in 1997 rand (Table 2). It is evident that revenues from provincial own revenues constitute only a small fraction of total revenue in each province, with the range extending from a low of 2.1% in the Eastern Cape to a high of 5.7% in Gauteng. On average, only 4.4% of provincial revenues is actually own revenue.

2. Why Provinces Need to Raise More Own Revenue

The fact that own source revenues make up only a small proportion of total provincial revenue is not in itself sufficient reason to advocate increased revenue-raising powers for provinces, although governments should not merely be expenditure governments but also tax raising entities.

It seems that a much more compelling reason is that relating to the promotion of democratic and accountable government. There is the notion which suggests that governments which are totally or almost totally reliant on revenues other than those they have to raise from their own electorate, are not as accountable as those which have to raise substantial revenues (even if only at the margin) from their electorate.[1] It is also suggested that a government which is not accountable is not democratic. Thus, it would seem to be prudent to begin to develop a government's

own revenue raising capacity to promote both accountability and thereby democracy.

With provinces currently deriving less than five per cent of their revenues from their own electorate there is little or no incentive for provincial governments to be fiscally accountable. Provinces spend a large proportion of nationally collected tax revenue but are not accountable to their individual electorates for it. One possible implication of such a situation is that provinces which are largely dependent on transfers from the national revenue pool can be fiscally irresponsible.

Implementing policies that will ensure that sub-national governments in general and provinces in particular are responsible for raising a larger share of their revenue, it is suggested, will promote provincial fiscal accountability and the fiscal autonomy provided for in the Constitution.

Provinces are fully fledged political entities and should be able to act as such. To further facilitate accountability and ensure that the specific needs of its electorate are being met, provinces should have at their discretion the power to vary the amount of revenues collected from their citizens. Specifically, in the case of publicly provided private goods, should the citizens choose to have a higher level of service delivery then the norm, then provinces should be able to raise own revenues to finance such delivery. In the case of surcharges, provinces should have the prerogative to vary the rate of the surcharge within a set band. Should provinces tax at the national average (as created by the tax room) then there will be no increase in overall tax burden. However, should they choose to tax at a rate that is different to the national average, then the aggregate tax rate will increase, but within limits that will be set nationally.

3. The Constitutional Provisions with Respect to Own Revenues

Section 228 of the Constitution sets out the rights of provinces with respect to the imposition of taxes. Section 228 (1), for instance, states that:

"A provincial legislature may impose -

a. taxes, levies and duties other than income tax, value-added tax, general sales tax, rates on property or customs duties; and
b. flat-rate surcharge on the tax bases of any tax, levy or duty that is imposed by national legislation, other than the tax bases of corporate income tax, value-added tax, rates on property or customs duties."

It is apparent that surcharges are likely to be an important source of provincial own source revenues. The FFC thus recommends the implementation of national legislation to regulate the provincial imposition of a surcharge on the national personal income tax base.

3. The Surcharge on Personal Income Tax

1. Constitutional Provisions

1. National Government's Responsibility

Section 228(1)(b) provides for a flat-rate surcharge on the national personal income tax base (and any other permitted national tax base). The imposition of such a provincial surcharge should occur in such a manner that it does not prejudice national economic policy or lead to "beggar thy neighbor" polices across provinces.

Therefore, section 228(2) states that:

"(The power of a provincial legislature to impose taxes, levies, duties and surcharges-

a. may not be exercised in a way that materially and unreasonably prejudices national economic policies, economic activities across provincial boundaries, or the national mobility of goods, services, capital or labour; and
b. 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."

The FFC interprets section 228 as follows: Provinces have the constitutional right to impose a flat rate surcharge on the national PIT base. A province does not require authorisation from national government to do so, but it does require national legislation to regulate this activity.

In its previous recommendations the FFC recommended that national legislation be in place prior to 1 January 1998 to ensure that there is a framework for regulating provincial taxation, especially the flat rate surcharge on the national PIT base for the 1998/99 fiscal year. This is not

practically possible now. However, it is imperative for the legislation to be passed as soon as is reasonably possible in 1998 as the provinces' constitutional right would be infringed if this issue is not expedited.

2. Provincial Responsibility

The provinces also need to prepare draft legislation to enable them to institute the surcharge as soon as the national legislation is passed.

The Constitution also ensures that provinces will not be penalised in the revenue sharing process from the national pool, for any additional revenue they may raise. Section 227(2) states:

"(Additional revenue raised by provinces or municipalities may not be deducted from their share of revenue raised nationally, or from other allocations made to them out of national government revenue. Equally, there is no obligation on the national government to compensate provinces or municipalities that do not raise revenue commensurate with their fiscal capacity and tax base."

To comply with this section any system of tax capacity (base) equalisation would not permit a deduction from one jurisdiction's own revenues to subsidise another jurisdiction's revenues. The tax base equalisation would have to be developed around adjusting the size of revenue transfers, taking account of relative tax bases.

However, in the case where provincial surcharges are placed on national tax bases and "tax room" is created the "pool" of revenues accruing at the national level will shrink. The consequence of this is that the amount 27 available for the provinces will shrink by the amount of tax room created. The other two portions, for national and local governments will not be affected in money terms.

3. Administration of PIT

According to the South African Revenue Service Act, 1997 (SARS Act) the provisions relating to the enforcement of provincial legislation

concerning the flat-rate surcharge were deleted to prevent any possible delays in the passing of the SARS Bill. The Bill provided for the enforcement by SARS of all national legislation, as well as all provincial legislation concerning the possible imposition and collection of provincial flat-rate surcharges on the tax bases of any national taxes, levies or duties as envisaged in section 228 of the Constitution. The intention is for these measures to be re-introduced after promulgation of the SARS Act.

Legislation relating to the regulation of the power of provinces to impose flat-rate surcharges, as envisaged in section 228 of the Constitution, is currently being drafted and it is the intention to amend the South African Revenue Service Act, 1997 to provide that SARS should secure the collection of these provincial flat-rate surcharges. It appears that this will also constitute a regulating measure as envisaged in section 228(2)(b) of the Constitution, as section 228(1) grants the power to provinces to impose taxes, which power also includes certain incidental powers such as the power to collect such a surcharge.

2. Recommendations and Estimated Yields

The FFC recommends that the required national legislation be passed as soon as possible to regulate provinces imposition of a surcharge on the national PIT base.

The FFC recommends further that this surcharge be implemented within the context of the tax room being created. This would ensure that there is no increase in the overall tax burden with the imposition of the surcharge.

In addition, the yield from personal income tax is the largest revenue source accruing to the national revenue pool, by a margin of 60% more than the next largest source which is VAT. It is thus a critical element in economic stabilisation and distribution. However, the FFC is of the firm opinion that limiting the surcharge as it suggests will not undermine national government policy imperatives. In addition, the rationale for providing provinces with the surcharge has to be balanced against the slightly diminished total PIT yield.

The national revenue pool, into which all nationally collected revenues accrue, will shrink by the amount of the provincial surcharge. For example, in the first year (if it had been 1997/98)

the revenue pool would have been smaller by R2.227b, from a total of R163.058b (or 1.24%).

1. **Estimated Provincial Revenue from the Surcharge on the National PIT Base**

   It is necessary to know the magnitude of revenue the imposition of a surcharge would generate in each province. The first step to obtaining these surcharge revenues, in the absence of suitable data, is to estimate the provincial tax bases or taxable incomes. This can be done by determining, firstly, the personal income tax yields per province and "reverse engineering" the related tax bases. The FFC has calculated the estimates of provincial tax yields on the based on the national yield. The national yield has been apportioned amongst provinces by an average of three indicators of tax capacity, Gross Geographic Product (GGP), Labour Remuneration (LR) and Remuneration of Employees (RE) per province. These figures are shown in Table 3.

   In order to estimate the tax base, the average tax rate was estimated for each tax bracket and then an aggregate rate calculated. Given the lack of clarity over the data, what is considered to be a conservative adjustment has been made to estimate the tax base. This means that any initial error will result in a once-off windfall for provinces, rather than a cut for them when actual data are available.

   This is done as follows: (i) The aggregate (average) PIT rate is estimated to be between 20% and 25%; which implies that the yield should be multiplied by between 5 and 4 to determine the tax base (i.e. using a multiplier of 5 (on the estimated yield of 865.069 billion for 1997/98) the tax base would be 8325.345 billion, while a multiplier of 4 would result in a base of 8260.276 billion. Refer to Table 4 which illustrates the range of PIT bases using different multipliers. To err on the conservative side a lower multiplier was used, namely 3.5, which results in the tax base estimated in Table 5.

   The implication of the lower estimate is that it probably underestimates provincial revenue,

which implies that the tax room vacated at the national level is smaller, initially.

3. Creating Tax Room

1. The Rationale for Tax Room What is being suggested here is that the national rate on PIT should be lowered concomitant with the institution of the provincial surcharge. This would be subtracted from every tax bracket at a nationally determined "noun" rate so that for the tax payer there would be no increase in tax liability.

   The implications of creating tax room can be explained in its simplest form thus:

   i. Suppose that the national average tax rate for PIT is 25%. At the present time all of PIT is collected at the national level and accrues to the national revenue pool.
   ii. Assume that provinces are "authorised" to impose a surcharge of 5 percentage points on the PIT yield (or 5% on the PIT base).
   iii. If no tax room were created and all provinces imposed the surcharge, the national tax yield would increase by 5% points, thus, in aggregate, the burden for PIT would rise by 5% points.
   iv. However, if the national government agreed to the creation of tax room equivalent to 5% points, the overall tax burden for PIT would remain unchanged from the original position.
   v. Thus, in a scenario where provinces were given 5% points surcharge and tax room were created, then, 20% points would accrue at the national level (to the national revenue pool) and 5% points directly to the provinces.
   vi. A consequence of creating tax room is the change in the relative distribution of revenues at the national level amongst national government, provinces and local government. All nationally collected revenue, including PIT, is shared amongst the national, provincial and local governments. Thus, the creation of tax room of say, 5% points at the national level, will not lead to a fall in revenues accruing to the national or local governments.

vii. What in effect occurs is a redistribution of the share of tax revenue accruing to provinces between that amount being distributed according to a revenue-sharing formula and that generated by the surcharge. In the absence of a surcharge, all revenues accruing to provinces will be derived from taxes collected nationally and distributed through a revenue-sharing formula, "other" own revenue and loans. When a surcharge is introduced, the total pool of revenue going to the provinces as a whole remains the same; however, each province now receives its revenue from an additional (own) source - the surcharge on the national PIT base, concomitant with a decrease in its revenue sharing component. Also, as the method or calculating the revenue sharing component is different to the method for calculating the surcharge, the ratios amongst the provinces will change.

viii. The net effect amongst provinces in comparison to a revenue sharing situation only is that some provinces receive relatively more and others relatively less if the revenue sharing amounts and the surcharge are added. In essence, the provinces with relatively greater tax bases will benefit to the detriment of those with lower tax bases. This is seen to be fair as the revenue sharing component is very redistributive and remains the largest revenue component. In addition, the slight adjustment of the redistributive component by the surcharge is an important element for developing appropriate incentives.

2. How the Tax Room Works

The FFC supports the growth of the tax room, up to 7 percent of the PIT base (equivalent to 7 percentage points of the PIT yield) - to be phased in over a six year period. This prevents any large once-off effects from occurring with the introduction of the surcharge and also enables an incrementalist approach to ironing out administrative problems.

The creation of tax room does not lead to an increase in the tax burden, as illustrated in Table 6 and Graphs 1 & 2.

In the first year, it is recommended that tax room of 1 percent (of the PIT Tax Base) should be made, which amounts to R2.277 billion, out of a total tax base of R227.741 billion (Table 7).

On average the surcharge per capita would be R60. Gauteng and the Western Cape would generate per capita surcharges above this average, respectively 8129 and R79. The Northern Province would have the lowest per capita yield, being about 31% of the average yield. (Table 7 and Graph 3)

It is proposed that the tax room should increase by I percentage point per annum, (1.5 points in each of the last two years), until it reaches 7 percentage points, so that in the last year the national rate is 18 percentage points and the provinces have access to 7 percentage points, as illustrated in Table 8 and Graph 2.

4. Conclusion

i. It is evident that at present, revenues from provincial own sources constitute only a small part of total revenue, ranging from just over 2% to almost 6% of provincial budgets
ii. The case for giving provinces the capacity to raise more own source revenue is made on the grounds of promoting fiscally accountable and democratic governments in the provinces. It is also consonant with the prescriptions of the Constitution that provinces be empowered «-with additional own revenue sources.
iii. The FFC recommends that national legislation be instituted to regulate the provincial imposition of a surcharge on the national personal income tax base.
iv. The FFC recommends further that the surcharge be implemented within the context of tax room being created, thus ensuring that there is no increase in the general tax burden. v. The FFC supports the growth of tax room, up to seven percentage points of the PIT base, to be phased in over a six year period.
v. The amount of revenue available for national and local governments will not be affected in money terms by the surcharge. In percentage terms they will receive more from the national allocations as provinces will receive less from a smaller pool.
vi. In effect, what occurs is a redistribution of tax revenue received by provinces between that amount being distributed according to a

revenue sharing formula (for taxes collected by national government) and that generated by the provincial surcharge.

vii. The FFC is confident, that the tax collection capacity exists in South Africa for the successful implementation of the surcharge, although some changes would have to be made to the manner in which PIT is administered at present. It is envisaged that the South African Revenue Service (SARS) will collect the provincial surcharge on behalf of the provinces.

5. Surcharges on other National Tax Bases

The National DoF has recommended that provinces be "given"' access to the national fuel levy via a surcharge. The recommendation seems to be that this surcharge would be instead of the surcharge on the national PIT base.

Firstly, the FFC would like to suggest that the two types of surcharges should not be seen as mutually exclusive but rather as a package. In addition, it seems that only one significant change to the existing tax regime should be made at a time, which implies that one of the surcharges should be implemented first. If this is the case then it is the position of the FFC that the surcharge on the national PIT base be the first one to be implemented.

The rationale for suggesting the sequencing of these surcharges (PIT before Fuel Levy) is as follows:

- stronger relationship between the type of taxation and political accountability;• wider base (greater numbers of those who are tax liable);
- larger base and yield;
- more buoyant base; and
- fewer economic distortions. It is thus recommended that the first step in providing provinces with own sources of revenue which are likely to increase their accountability and support democratic government, is the surcharge on the national personal income tax.

ANNEXURE: Chapter 3

TABLE 1 Four Largest Own Revenues as % of Total Own Revenues: 1996/97

Source	**WC**	**EC**	**NC**	**KN**	**FS**	**NW**	**GAU**	**MPU**	**NP**	**TOTAL**
[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]	[11]
i. Motor Licenses	49.73%	38.54%	52.68%	20.96%	24.70%	20.24%	46.89%	0.00%	19.13%	31.19%
ii. Hospital Fees	27.35%	23.36%	30.75%	10.91%	22.67%	9.45%	16.47%	6.28%	2.63%	14.57%
iii. Casino Licenses	0.00%	0.00%	0.00%	0.00%	0.00%	38.44%	0.00%	0.00%	0.00%	4.70%

iv. "Betting"	7.59%	0.00%	1.15%	6.14%	3.37%	1.24%	16.58%	6.28%	1.43%	6.78%
v. Sum of i to iv	84.67%	61.90%	84.58%	38.01%	50.74%	69.37%	79.95%	12.55%	23.20%	57.24%

Source: Provincial Budgets

TABLE 2 Provincial Own Revenue (OR): Estimated 1997/98 in 1997 R'000				
Provinces	**Provincial Own Revenue (1997/98) R'000**	**Revenue Sharing Allocations to Provinces (1997/98) R'000**	**Provincial Total Revenue Budget (1997/98) R'000**	**Own Revs as % Total Revs (1997/98)**
[1]	[2]	[3]	[4]	[5]
Western Cape	502,191	9,178,000	9,680,191	5.2%
Eastern Cape	308,171	14,219,000	14,527,171	2.1%
Northern Cape	70,533	2,038,000	2,108,533	3.3%
KwaZulu-Natal	759,805	16,286,000	17,045,805	4.5%
Free State	275,836	5,770,000	6,045,836	4.6%
North West	412,740	7,005,000	7,417,740	5.6%
Gauteng	811,126	13,454,000	14,265,126	5.7%
Mpumalanga	200,194	4,969,000	5,169,194	3.9%
Northern Province	498,930	10,968,000	11,466,930	4.4%
Total Provincial	3,839,526	83,887,000	87,726,526	4.4%

Note: TR = OR plus budgeted transfers from nationally-collected revenues
Source: [2] Provincial Budget Estimates of ORs for 1997/98 and [3] National Department of Finance

TABLE 3
Estimate of PTT Yield per Province: 1997/98

Provinces	**Estimate of PIT Yield per Province R'**

Western Cape	9,288,030,518
Eastern Cape	4,683,518,585
Northern Cape	1,277,757,901
KwaZulu-Natal	10,016,591,191
Free State	3,819,987,741
North West	3,146,100,797
Gauteng	26,406,054,948
Mpumalanga	4,211,031,167
Northern Province	2,222,096,119
Total	65,069,000,000

Source: FFC & Department of Finance Budget Review, 1997

TABLE 4
Determination of the Tax Base for PIT: 1997/98 Estimates (2nd Print)

Tax Yield for 1997/98	**R65,069,000,000**
Multiplier	**Estimated Tax Base R'**
[1]	[2]
1	65,069,000,000
2	130,138,000,000
2.5	162,672,500,000
3	195,207,000,000
3.3	216,679,770,000
3.5	227,741,500,000
4	260,276,000,000
4.5	292,810,500,000
5	325,345,000,000

Source: FFC and National Department of Finance Budget Review, 1997

TABLE 5: Estimated Tax Base for PIT per Province (1997/98).

Provinces	**Estimate of PIT Base (Multiplier of 3.5)**
[1]	[2]
Western Cape	32,508,106,812
Eastern Cape	16,392,315,047

Northem Cape	4,472,152,654
KwaZulu-Natal	35,058,069,170
Free State	13,369,957,094
North 'West	11,011,352,790
Gauteng	92,421,192,318
Mpumalanga	14,738,609,083
Northern Province	7,777,336,415
Total Provincial	227,741,500,000

Source: FFC

TABLE 6						
Years/Phasing	1	2	3	4	5	6
Accumulative % Points	1	2	3	4	5.5	7
National Pool	24/25	23/25	22/25	21/25	19.5/25	18/25
Provincial share	1/25	2/25	3/25	4/25	5.5/25	7/25
Total	25	25	25	25	25	25

TABLE 7
One Percentage Point Tax Room for Provincial Surcharges on PIT Base (1997/98)

Provinces	**Population (1996 Census)**	**Estimate of PIT Base for 1997/98 (Xier of 3.5) R'**	**1 % of PIT Base R'**	**Surcharge Yield per capita R'**
[1]	[4]	[3]	[4]	[5]
Western Cape	4,118,000	32,507,023,209	325,070,232	R79
Eastern Cape	5,865,000	16,391,768,637	163,917,686	R28
Northern Cape	746,000	4,472,003,582	44,720,036	R60
KwaZulu-Natal	7,672,000	35,056,900,568	350,569,006	R46
Free State	2,470,000	13,369,511,429	133,695,114	R54
North West	3,043,000	11,010,985,745	110,109,857	R36
Gauteng	7,171,000	92,418,111,611	924,181,116	8129
Mpumalanga	2,646,000	14,738,117,796	147,381,178	R56
Northern Province	4,128,000	7,777,077,171	77,770,772	R19
Total/Prov/Average	37,859,000	227,741,499,747	2,277,414,997	R60

Source: [2] FFC & CSS

TABLE 8
Provincial Revenues: Surcharge on national PIT Base: 1997/98 to 2002/03

Provinces	**1 % of PIT Base [Year 1]R**	**R 2% of PIT Base [Year 2]R**	**3% of PIT Base [Year 3] R**	**4% of PIT Base [Year 4]**	**5.5% of PIT Base [Year 5]R**	**7% of PIT Base [Year 6] R**
[1]	[2]	[3]	[4]	[5]	[6]	[7]
Western Cape	325,070,232	669,644,678	1,034,601,028	1,420,852,078	2,012,281,755	2,637,918,447
Eastern Cape	163,917,686	337,670,434	521,700,820	716,469,127	1,014,699,401	1,330,178,669
Northern Cape	44,720,036	92,123,274	142,330,458	195,467,162	276,830,369	362,899,447
KwaZulu-Natal	350,569,006	722,172,152	1,115,755,974	1,532,304,871	2,170,126,774	2,844,838,917
Free State	133,695,114	275,411,935	425,511,440	584,369,045	827,612,659	1,084,924,959
North West	110,109,857	226,826,306	350,446,643	481,280,057	681,612,880	893,532,521
Gauteng	924,181,116	1,903,813,099	2,941,391.238	4,039,510,634	5,720,956,935	7,499,654,455
Mpumalanga	147,351,178	303,605,227	469,070,075	6,14,189,570	912,333,478	1,195,986,2511
Northern Prov.	77,770,772	160,207,790	247,521,035	339,928,888	481,424,288	631,103,476
Total Provincial	**2,277,414,997**	**4,691,474,895**	**7,2,18,328,712**	**9,954,371,432**	**14,097,878,540**	**18,481,037,141**

Note: Tax Base increases by 3% per annum
Source: FFC

Footnote

1 There is no definitive empirical evidence to "prove" this notion, but it makes intuitive sense. Also, the threshold at which accountability is achieved in terms of the balance between own and other revenues is certainly not clear and may not be generally applicable either. In addition, in states which are characterised by considerable functional decentralisation without the concomitant financial decentralisation a condition of "consumption federation" tends to develop. In such a case, there is no nexus between spending decisions, the resource requirements for such spending and the taxation of those receiving the service.

CHAPTER 4

Revenue Sharing & Grants for Local Government & Municipalities

Recommendation

The Financial and Fiscal Commission recommends that local government and municipalities are:

- in*corporated into the system of intergovernmental fiscal relations;*
- *formula funded in terms of their constitutional right to an equitable share of the national revenue pool and for any grant which national government may make available;*
- *elig ible for revenue sharing and grants in terms of relative poverty and infrastructure backlogs;*
- *required to maximise their tax capacity;*
- *encouraged to be as economically efficient as possible;*
- *in the fiscal ,year 1999/2000 allocated at least an equivalent amount from the nationally collected revenues as they have been receiving, on average, in the previous three years;*
- *allocated an increasing amount of nationally collected revenues in subsequent years, commensurate with their increased responsibilities;*
- *allocated their shares of revenue via district councils and metropolitan councils, until further notice;*
- *able to spend their revenue sharing funds in tern ns of their own needs and priorities vis-à-vis basic services;*
- *monitored to ensure that conditional grants are appropriately spent and that penalties are implemented for non-compliance;*
- *ma*de responsible for developing the capacity to administer the system of revenue sharing and grants;

1. Introduction

The above recommendations are based on a set of key principles and arguments which the Financial and Fiscal Commission has developed in its discussion document, Local Government in a System of Intergovernmental Fiscal Relations ii) South Africa. The principles and arguments are presented in brief below, followed by a presentation of the themes elicited from comments on the discussion document.

2. Constitutional Provisions

The Constitution creates three spheres of government, one of them being local government. Local government is made up of municipalities, which may fall into one of three categories. National legislation must define the types of municipality that may be established within each category and the appropriate division of powers and functions between categories. This is currently done via the Local Government Transition Act, 1993. This Act remains in force until 30 April 1999 or until repealed, whichever is sooner.

The Act currently distinguishes between two main categories of local government, viz. urban and rural local governments. Urban local governments may be metropolitan councils, their constituent metropolitan local councils, or

local councils. Rural local governments may consist of district councils, rural councils, representative councils, local councils or local area councils, all of which appear to be consistent with the Constitution.

In Chapter 13 of the Constitution it is stated that the local government sphere is entitled to an equitable share of revenue collected nationally. Furthermore, provision is made for municipalities to raise own revenues and to raise loans subject to certain conditions.

3. A partial Two-tier System

Although the existing local government system encompasses an enormous range of disparities in terms of physical size and economic capacity, it lends itself analytically to a further (albeit incomplete) two-part characterisation. The first of these parts is a two-tier group of local governments into which many, especially rural, municipalities fall. In the major urban areas, the upper tier of this two-tier group consists of metropolitan councils, and the lower tier the constituent metropolitan local councils; in the rural areas, district (or regional or services) councils form the upper tier and a variety of local councils is to be found on tile lower level. The second part of the characterisation consists of municipalities that form a single-tier. Many of the municipalities that fall into this category are towns that do not have metropolitan status (but do fall within the geographical borders of a district council).

4. Local Government Functions

In terms of section 156 of the Constitution a municipality has executive authority in respect of, and has the right to administer matters such as building regulations, electricity and gas reticulation, fire-fighting services, municipal planning, municipal health services, municipal public transport, and water and sanitation services, cemeteries, cleansing, local amenities, markets and abattoirs, municipal parks and roads, refuse removal, street lighting, traffic and parking.

5. Sources of Revenue

In contrast to the provinces, the so-called traditional municipalities in former white areas have historically been able to finance a significant proportion of their expenditures from own revenues. This was not necessarily the case in Black, Indian and Coloured townships in the former RSA, TBVC-states and self-governing territories. As a consequence of the demarcation of new municipal boundaries in 1995, whereby former Black, Coloured, Indian and White areas have been amalgamated, the above-mentioned historical patterns have ceased. Moreover, important disparities exist between the municipalities themselves, both in terns of fiscal capacities and levels of service provision. The main revenue sources of the upper-tier municipalities (i.e. metropolitan councils and district, regional or service councils) are the (payroll, turnover and fuel) levies of the former regional services councils (and joint services boards), cost recovery fees, and, in the case of the metropolitan councils, surcharges on their constituent metropolitan local councils' revenues. The main revenue

sources of the remaining (urban) municipalities are property rates; "surpluses" on trading in electricity, water, solid waste collection and sewerage; and other sources such as licences and fees.

6. Intergovernmental Transfers

The local government sphere is constitutionally entitled to an equitable share of revenue collected at the national level. In the past, intergovernmental (grants) transfers were paid to some (former black) local authorities to cover operating expenditures. In addition, in some cases "subsidies" were paid by provincial governments to local governments for performing agency functions; allocations were made to the so-called "R293 towns'"; and certain grants were made for financing capital expenditure by various national government departments, most of which have now been consolidated into the Municipal Infrastructure Programme.

7. The Importance of Own Revenues and Payments for Services Received

Despite the relative significance of intergovernmental transfers for some jurisdictions, it is important that all municipalities should generate own revenue and maximise their tax effort. If a sector of government is required to raise (part of) its revenue, its accountability is increased, because of the resulting obligation to justify to its electorate the taxes it raises in terms of the services the revenue will pay for. This process also enhances efficiency and effectiveness, because taxpayers tend to be critical of 38 expenditure programmes when their own money is involved. Similarly, consumers only use services efficiently by weighing up the costs of the resources they use, if they are required to pay for them.

In principle, therefore, municipalities should raise as much own revenue as possible by, inter alia, charging fees for the services they provide and levying the taxes to which they are constitutionally entitled. There is the obligation on service recipients to pay for the services rendered. Long term sustainability of service provision is not possible without high levels of cost recovery from service recipients. However, in reality the tax capacity of a jurisdiction moderates cost recovery, especially where service recipients are simply unable to pay for even basic services. Grants cannot be used as a substitute for non-payment of services and or rates and taxes levied.

8. Vertical and Horizontal Equity In addition to the general principles contained in the previous paragraph, many sound reasons exist for making intergovernmental transfers to municipalities under certain circumstances. Firstly, while some municipalities are able to meet all their obligations out of their own revenues, many are unable to do so. This is because their revenue sources do not match the services they are required to deliver. In such cases, intergovernmental transfers are necessary to ensure vertical equity between the different spheres of government.

Secondly, in the interests of horizontal equity, persons in different jurisdictions should receive reasonably comparable levels of public services at reasonably comparable levels of tax effort. In order to achieve this under current

circumstances, where disparities are severe, intergovernmental transfers are also required.

9. Minimum Levels of Service Provision and Spillovers Equity means that certain minimum levels of service provision must be attained for all citizens. In this regard, sections 214 and 227 of the Constitution refer to "basic services", which in the case of municipalities are generally regarded to be access to clean water within a reasonable distance of one's dwelling, basic sanitation, and in some cases, limited access to electricity and roads with storm water drainage.

   The level at which the minimum provision of each of these services is defined, is influenced by the "spillovers" that arise from each. Spillovers are the indirect benefits or costs that other persons get from the use of the services by their neighbours. For example, the absence of clean water or adequate sanitation, leading to disease, would clearly affect not only those too poor to afford those services, but would also expose other members of the community to the danger of infection. Similarly, in an urban setting, the absence of electricity and the consequent use of open fires or paraffin stoves for cooking and heating by the those individuals and communities without access to electricity would adversely affect that section of the community which has access to electricity by subjecting them to the pollution of the former's smoke and fumes.

   In their own interest, the relatively rich communities should ensure that the poorer neighbourhoods receive sufficient services to meet the minimum standards described above. This they should do, if necessary, by subsidising the levels of service consumption in their vicinities. Nevertheless, in some cases the attainment of the minimum levels of service provision will require assistance to the local community in the form of intergovernmental transfers.

   The question therefore becomes one of identifying firstly, which communities would qualify for transfers, secondly, the level at which this assistance should be given, and thirdly, the manner in which the transfers should be determined.

10. Which Communities Qualify for Transfers?

The principles referred to above (namely that transfers should not undermine accountability and that efficiency requires services to be priced and paid for), suggest that transfers should only be made available to those communities that are unable to afford the minimum levels thought to be necessary. Furthermore, the analysis of spillovers brings one to the conclusion that, as far as possible, communities should be prepared to cross-subsidise the relatively less wealthy communities so as to maximise their own benefits.

Taken together, these results imply that, in general terms, the subsidies made available for municipalities from national revenues should be calculated after taking into account the circumstances of each municipality as a total entity, rather than those of the poor communities within a (possibly rich) municipality. In other words, the tax capacity (not tax effort) of each municipality must be one of the major determining factors in the calculation of intergovernmental transfers to municipalities, even if the allocations are made subject to the

rationale that they be used for providing minimum levels of basic services to specific poor members of those municipalities. The implication of this approach is that jurisdictions where tax effort is low will be indirectly penalised. In other words, low tax effort will not be rewarded.

11. At Which Administrative Level Should the Assistance be Given?

Several options could be considered for the administrative point at which the intergovernmental transfers could be given: namely, the provincial level, the metro or district council level, or the primary municipal level. The Financial and Fiscal Commission recommends that the allocations be directed at the metro or district council level (in the medium term). The reasons for this are as follows.

Municipal transfers should not be directed at the provincial level, unless they are made conditional upon being transferred to those municipalities specifically identified as recipients. The Constitution establishes three spheres of government, namely national, provincial and local, each of which is entitled to its own "equitable share of revenue collected at the national level" and each of which is entitled to a reasonable level of independence. Therefore, even if the municipal allocations were to be channelled through the provinces, this would have to be done in the form of conditional grants and the provincial treasuries would be no more than conduits. Section 226 of the Constitution specifically states that revenue allocated through a province to municipalities in that province is a direct charge against that province's revenue fund. Secondly, the spillovers that are relevant at the local government level accrue to the local communities themselves and should be evaluated in light of the tax capacity of each community in determining whether allocations should be made. This cannot be done at the level of aggregation implied by provincial transfers. Furthermore, the allocation of funds can be done more efficiently at lower levels (such as municipalities rather than provinces), where the specific needs and constraints of local communities can be evaluated more accurately. These arguments imply that the transfers should flow directly to the local government sphere.

The transfers (and grants) should be directed at the metro or district council level rather than at the primary level for a number of reasons. Firstly, although in principle allocations should be devolved to the lowest possible level, they are blunt instruments that cannot currently be targeted at the primary municipal level from the central fiscus with sufficient accuracy. In contrast, metro and district councils have sufficiently intimate knowledge of local conditions within their jurisdictions to be able to reflect local priorities with a justifiable degree of confidence. Secondly, Schedule 2 of the Local Government Transition Act confers redistributive powers on metropolitan councils, whereby the principle of and mechanism for allocations at the second municipal tier have already been established; and thirdly, the current dearth of relevant data at the primary level makes the direct formula-funding of such municipalities difficult at this stage..

12. How Should the Allocations be Determined?

In line with its proposals for the financing of the provinces, the FFC recommends that a funding formula be adopted to determine allocations to the metro and district councils, for both operating and capital expenditure. The allocations for operating expenditures should be distributed to the primary municipalities according to the metro and district councils' knowledge of local conditions, taking into account the constitutional rationale for all citizens to have access to "basic services". Although the FFC proposes that these transfers, based oil the revenue-sharing principle, should be unconditional, it would clearly be contrary to the criteria, used to calculate the transfers, and to the spirit of the Constitution, if funds were allocated on the basis of dissimilar equity criteria or used for purposes other than subsidising "basic services".

The allocation formula will enable the total amount allocated to the local government sphere to be calculated, from which the vertical division can be deduced, and subsequently the horizontal division amongst the second-tier municipalities. determined .

Three approaches to these issues can be adopted. The first is to base operating transfers (inversely) on the revenue-raising potential, or tax capacity, of a municipality; the second is to use the expenditure needs of a jurisdiction for this purpose; and the third is to apply a combination of these two, juxtaposing need with tax capacity.

The third option is the one advocated by the FFC. It is argued above that tax capacity should be an integral part of the formula. In addition, expenditure needs should be accommodated by taking into account the current expenditures necessary to meet the minimum standards for those who qualify.

The FFC recommends that the capital allocations should be conditional grants allocated by national government to local government and municipalities. Such funds would fit into the policy imperatives of national government and be allocated on the basis of a formula to metropolitan councils and district councils. The existing backlogs in the provision of basic infrastructure are the criteria used to determine these grants.

13. The Vertical Division

A number of possibilities for determining the vertical division exists, ranging from the quantification of the present transfers to municipalities to a detailed calculation of municipalities' needs. Each of these possibilities has particular political, financial and data implications. On the one hand, overall financial constraints and the requirements of the other spheres of government make it extremely difficult to increase the total amount flowing to the local government sphere rapidly; on the other hand, the political consequences of long delays in delivering services to those who have been promised them, must be considered.

The FFC recommends that, as an initial step, the coefficients of its horizontal division formula be set so that the annual total transfers generated equal the amount(s) of the present transfers. The second step, which is inherently

political, is to evaluate the time period, derived from the first step, for eliminating backlogs in the provision of basic services to all citizens. The third step is to consider the implications of increasing the transfers to the local government sphere, thus decreasing the time required to eliminate the backlogs.

In terms of the FFC's proposals for the revenue-sharing (operating) component, the sum of the transfers to the local government sphere will be in the local government vertical division share of nationally collected resources. For the national government's capital grants to municipalities, the sum of these amounts will be in the national government component of the vertical division. This separation allows conditions to be set for the capital grant in terms of section 214(I)(c) of the Constitution.

14. The formula for the Horizontal Division (nationally and locally)

The FFC's recommendations for the funding of municipalities are based on the use of a formula for the horizontal division of the transfer to local government amongst tile metropolitan councils and district councils. The use of a formula will ensure both revenue stability and objective allocations. The proposed formula takes into consideration both indicators of need and-tax capacity for operating transfers and infrastructure backlogs for capital grants.

The transfers are based on a two-part formula with three components:

i. a conditional capital grant (which is dealt with horizontally in the national government share);
ii. an unconditional operating transfer (which is dealt with horizontally as part of the local government share); and
iii. a tax capacity (equalisation) component, related to (ii).

Both the capital and operating "grants" are designed to address the basic needs of the poorest section of the population. The capital grant is aimed at eliminating backlogs in the provision of basic municipal services. The operating transfer is to enable the poor to purchase the minimum quantities of certain essential services, such as clean water, adequate sanitation, suitable roads and/or electricity.

One of the most commonly-stated rationales for the use of transfers, and of particular relevance to South Africa, is the need to address inter-jurisdictional fiscal disparities. This must be done in a fiscal context where there are simply not enough public resources to allocate funds for these basic services to all indiscriminately. Therefore, the funds generated by the first two transfers are tempered by the criteria discussed above: if a jurisdiction has the capacity to raise its o«-n revenue and should therefore itself be capable of addressing the needs of its inhabitants, the money made available to it through the transfer system, is reduced. The FFC recommends that at present only the revenue-sharing transfers be adjusted according to a jurisdiction's tax capacity.

1. **CapitalGrant**
   (Sections 214(1) (c) & 227(1) (b) transfers)

   The capital grant is seen as a conditional grant from national government to local government. In terms of the vertical division, this amount would be calculated as part of the national government component, requiring that these funds be used for addressing infrastructural backlogs only. In line with national government policy objectives of developing local government infrastructure to ensure that all South Africans have access to basic services, national government will be able to apply such grants to address these capital expenditure requirements. The Constitution requires that the actual disbursement of these grants must be based on equity.

   In the interim, a crude measure of "access to basic services backlogs" has been adopted to formulate the capital expenditure component of the formula. Mainly because of the inadequacy of other data, the measure focuses on the provision of two basic services - water and sanitation.[2] Weights are attached to the two services to derive a composite index of backlog/need. The assumption underlying the choice of variables making up the composite index, is based on backlog/need, not on financial implications. In other words, although municipalities are. responsible for providing a number of services, some of which could be self financing, for example water and electricity, it is necessary to identify those services which could be indicative of backlogs/need. For this reason, the lack of water and sanitation, combined into a single index (I), are chosen as being indicative of backlog/need. They must not be seen as excluding other basic services.

   The total allocation for capital expenditure (Gi) to a municipality is calculated on the basis of the cost to provide infrastructure to the qualifying population (i.e. the number of individuals or households below a defined poverty line)[3] that do not have access to basic services. This is weighted by a combined index "I" in order to determine the allocation to each metropolitan council or district council. The real cost of providing

   basic infrastructure services needs to be spread out over a period of time since it would be impossible to provide the total amount in one year.

The allocation of grants for capital expenditure, G_i, to the ith MC or DC is as follows:

Capital Grant (G_i) - $\{1- I_i / \sum(1- I_i)\}*1/n(x*H_{qi})$;

Where:

I_i = combined index for i^{th} MC or DC
x = real average cost per household of providing infrastructure for basic services
H_{qi} = qualifying number of households in i^{th} MC or DC
n = number of years (phasing)

The composite index "I" will be constructed following the methodology used by CSIR in the construction of its Development Indicators Monitoring System (DIMS) index. Observations for each variable will be scaled from 0 (the worst-off) to l (the best-off). For example, if the percentage of the population without access to the minimum level of water ranges between 20% and 60%, a place with 20% of the people having no access to water would have an index score of 0 while a place with 40% of the people having no access to water would receive an index score of 0.5. The composite index will then be calculated on the basis of a linear scale transformation of the average of the index scores for all variables. It will range in value from 0 (greatest need) to 1 (least need).

The composite index can be broken up as follows:

- Level: MC or DC
- Values: Absolute (based on absolute numbers of housing units in need)
  Relative (based on relative proportion of housing units in need)
- Categories: Water Sanitation
- Indicators: Water: (number of housing units without access to on-site water)
  Sanitation: (number of housing units without access to adequate sanitation)

The real average cost per household of providing basic infrastructure services, "x", will be calculated on the basis of how much it would cost to install bulk and connector infrastructure for basic services in the different jurisdictions under consideration. At present, the only information available is from the EMIP which uses the Combined Services Model from the DBSA to calculate infrastructure costs for urban and rural areas.

Once each MC and DC has received its capital allocation, it will be responsible for redistributing the funds to municipalities within its boundaries or for metro-/district-wide capital expenditure purposes. The distribution procedure followed would be application-driven, with individual municipalities submitting applications for projects. Stringent criteria need to be applied to ensure that the funds are equitably distributed by the MCs and

DCs. An effective monitoring system also needs to be put in place to ensure that conditional funding is appropriately applied by the spending agencies.

2. **Operating Transfers (Revenue Sharing) (Sections 214(1)(a)& 227(1)(a) transfers)**

   The allocation for current expenditure is intended for subsidising access to basic services for those who cannot afford to pay for these services. At this stage, the two basic services under consideration are water and sanitation.[4] The operating grant is based on the cost to the qualifying consumer (i.e. a household below the poverty line) of the minimum amount of water needed for annual consumption and the operating cost of providing the basic level of sanitation.

   (The minimum levels of water and sanitation need to be defined. The cost to the qualifying consumer would be based on the average price per unit of household water consumption across jurisdictions. A similar process will be used to estimate the cost of sanitation.)

$$RS_i = (a*p_w + b*c_s)*H_{qi};$$

Where:

a = minimum household annual water consumption;
p_w = unit price of water;
b = minimum level of sanitation;
c_s = unit cost of sanitation
H_{qi} = qualifying population in ith MC or DC

   Here again, once each MC and DC has received its operating transfers allocation, it will be responsible for distributing the funds to the primary municipalities. A monitoring system will need to be implemented.

3. **Tax Capacity Equalisation Component**

   As mentioned earlier, fiscal equalisation encompasses both equalisation of expenditure need and of tax capacity. The first aspect is dealt with in the allocation for operating and capital expenditure. The latter deals with the revenue-raising capacity of the jurisdictions under consideration and uses measures such as personal income, property taxes and other standard municipal taxes.

   Of critical importance is that the tax capacity measure (even if it is a proxy measure) has to be part of the operating transfer

formula. A core principle in any system of intergovernmental fiscal relations is developing incentives for all governments to maximise the use of their own resources. The corollary to this is that governments should not be "subsidised" in such a manner that their tax effort is less than their tax capacity. If this component of the formula were not to be implemented, then the latter condition could prevail, which would be ineffective, unfair and unconstitutional.

In the case of South Africa, tax capacity at the MC and DC level could be reflected in a representative tax system through a combined index which takes account of personal income, property taxes and RSC levies (and possibly other tax/revenue sources as data systems develop). At present, there are severe data restrictions with regard to both personal income and property taxes. While data for personal income are available at the national level, it is extremely difficult to disaggregate the data to the MC or DC levels currently. With regard to property valuations, the data is both dated and incomplete in its geographical coverage and property valuation methods are not uniform across jurisdictions. If no national norms are imposed for property taxation it would be well-nigh impossible for this source to be used as a tax capacity measure, on its own or in combination with other sources.

As stated above, the tax capacity measure is directly related to the operating or current transfer component. With reference to the operating expenditure formula, "RSi" what is measured is the relative cost to an MC or DC of providing a minimum level of service to that target population needing financial assistance due to poverty. What the tax capacity component does is to measure the relative ability of the MC or DC to "subsidise" its own "poor". If the "wealth profile" of the MC or DC is of such a nature that relative wealth fully compensates for the relative need then it will receive no operating transfer. In other words, if the aggregate wealth is equal to or more than the aggregate need of the jurisdiction, then that jurisdiction is considered able to provide for its own needs.

Clearly, as the profile's balance changes to reflect a relatively poorer jurisdiction, then the operating transfer becomes positive. The tax capacity component must be constructed in such a manner that it would not result in a negative amount large enough for the MC or DC to forfeit its own revenues in contravention of section 227(2) of the Constitution. Thus, while T_{Li} may be ≤ 0, $(RS_i + T_{Li}) \geq 0$.

The tax capacity of each MC or DC (Xi_{t-1}) would be calculated using property taxes and RSC service and establishment levies. The tax capacity for each component will be calculated by

applying a normative national average tax rate to each tax base to give the per capita yield for each tax. These will be converted into per capita tax capacity figures and then aggregated to get each MC or DC's actual tax capacity, XI_{t-1}. The national average tax capacity, X^*_{t-1}, will then be calculated from the aggregates.

The entire tax capacity formula would be:
$T_{Li} = \alpha (X^*_{t-1} - X^i_{t-l}) P_i$
which can be written: $T_{Li} = L(X^*_{t-l} / Xi_{t-1}) - II (\alpha *. Xi_{t-1})P_i$
subject to the additional constraint that $\sum T_{Li} = 0$ and $(RS_i + T_{Li}) \geq 0$
Where:
T_{Li} = the tax capacity transfer to the ith MC or DC
α * = the proportion of the tax capacity to be equalised
X^*_{t-1} = the norm/national average tax capacity per capita in year t-1
Xi_{t-l} = the ith MC or DC's actual tax capacity per capita in year t-1
P_i = the population of the ith MC or DC

Of course, in the short run, it will not be possible to calculate the tax base for property taxes due to the data limitations described earlier. Personal income may have to be used as a proxy. In the absence of reliable personal income figures at the MC or DC level, it may be necessary to use only the RSC levies to estimate the tax base for each MC and DC.

In order to fulfill the condition that $RS_i + T_{Li} \geq 0$, it may be necessary to have equalisation only to a certain proportion, α * , of each MC or DC's per capita tax capacity. This means that the per capita tax capacity of each richer MC or DC will be reduced to the proportion α * of the national average while that of each poorer MC or DC will be raised to α * of the national average, where $0 < \alpha * \leq 1$.

The allocation of revenue sharing transfers for current expenditure (RS_i) adjusted for tax capacity to the ith MC or DC is as follows:

$RST_i = RS_i + T_{Li}$
Where:
RS_i = Allocation for Current Expenditure; and
T_{Li} = Tax Capacity Equalisation Component

4. The Combined Formula

The combined formula would be:
$IGT_i = G_i + RS_i + T_{Li}$
Where:
IGT_i = Intergovernmental Transfer;
RS + T = RST = Revenue Sharing Transfer;
G = Capital Grants;
and T = Tax Capacity Component.

15. The Conditions Applicable to the Transfers

The intergovernmental transfers to municipalities should be subject to a number of conditions and guidelines. The capital (conditional) grant may only be used for financing the construction of infrastructure necessary for delivering basic services. The allocation of capital should be on the basis of scientific appraisals of infrastructural projects to address backlogs in basic service provision.

Metro and district councils will be expected to adhere to the general guidelines that the operating transfers are to subsidise "basic services" within the set of services defined as "basic". The needs and priorities of each jurisdiction will determine which service or services will be subsidised. More specific guidelines than this cannot be prescribed as this would undermine the unconditional nature of the operating transfers. If services cannot be provided, because of the absence of infrastructure, the operating allocations could also be used temporarily to add to the capital grants.

16. Data Requirements

The data required for the application of the FFC's proposals are not currently available. However, they will become so once the national census returns have been processed and the forthcoming municipal census conducted. This means that the vertical division, which is required by mid-1998, will have to be made on an incremental basis as a transitional measure; the horizontal division, which is required before the commencement of the new municipal financial year which begins in July 1998, may have to be done on the basis of the October Household Survey data if the processing of the municipal census has not been completed in time.

17. Feed-back from Consultations with Role-players and Interested Parties

Since the publication of the abovementioned FFC's discussion document in July 1997 a number of initiatives have been instituted to garner comments and responses to the document. These initiatives have included wide distribution to all municipalities, provincial departments responsible for local government and financial 46 matters, national departments, financial institutions, business and other interested parties. Also, the document has been presented to and discussed at conferences, provincial local government associations and governmental forums such as tile Local Government MINMEC.

The FFC is appreciative of all those institutions and individuals who made an effort to submit comments, make suggestions and provide opportunities for discussion.

In general, most official responses to the discussion document have been positive. The idea that local government and municipalities become part of a clearly defined system of intergovernmental transfers and grants is welcomed. The queries and matters of concern are really about how to design such a system, i.e., the detail rather than the principles.

A number of common themes can be identified from the comments and suggestions which have been received. These are dealt with below. The FFC responses to the comments and suggestions will be included in the new draft of the document to be published in May 1998.

i. There is an apparent need for general definition and additional detail by local government administrators and politicians on matters such as definitions of "basic services", a "poverty line" and "tax capacity". The document is seen as too theoretical and principles-based, rather than operational. FFC Comment: It is apparent that many of the matters referred to need to he clarified. However, it is a problem which has to be addressed by government as a whole, rather than the FFC which is not an executive institution. It is foreseen that as the system of intergovernmental fiscal relations develops many of these issues will be defined more clearly.

ii. The FFC has proposed that the transfers are made to the "second level" of local government, namely, metropolitan councils and district councils. Arguments against this approach have taken two quite different views. The one opinion is that transfers should be made directly to the primary municipalities, and the other argument has been for transfers to go to provinces and thence be redistributed. *FFC Comment: The FFC is still of the opinion that transfers going to provinces, from which point they would he re-allocated, is not an option at all. It is suggested that at this stage of the development of the system and for the reasons cited above the second sphere municipalities are the most appropriate point for initial allocation. It is envisaged that in the long-run transfers would be made directly to each municipality.*

iii. The role of provinces in the allocations of transfers to municipalities. FFC Comment: The FFC understands the role of provinces vis-à-vis municipalities as one of "supervision" in cases where a municipality does not or cannot perform its functions. This does not mean that a province should play a role in the allocation of fiscal transfers, either to reward or penalise a municipality.

iv. Questions of the vertical division, i.e., how much of the nationally collected revenues should be allocated to local government? It is not surprising that a powerful theme concerns the matter of "what is the equitable share to which local government is entitled"? Here again there are two different opinions. The one position is that government as a whole should recognise the importance of service provision at the local level and ensure that its share of national resources is significantly greater than what it has been and is currently. The argument is that municipalities have additional responsibilities for an entire nation and that it, therefore, cannot meet these responsibilities without additional transfers. The second position is similar, but recognises the prevailing fiscal parameters and thus seeks alternative means for increasing local government resources. *FFC Comment: There is sympathy for the former position, but it is an option which does not seem to be practically viable. The FFC position, that we start off where we are and then incrementally move in the right direction is still the practical option. Given the current difficulties, the path to he taken will need to he*

travelled as rapidly as possible so as not to compromise the success of local government.

v. What is included, or should be included in the context of "basic services"? The FFC has defined the term basic services to include five services, namely, water, sanitation, refuse removal, roads and storm water drainage and electricity. The level of actual service provision is not clearly defined, either by the FFC or elsewhere in government. The FFC has used two of these basic services, water and sanitation, as representative indicators for the full package. The two-service indicators are then used to determine the relative entitlement which a municipality has to the available funds. *FFC Comment: Firstly, additional services, such as "basic municipal health services" could be defined into the basic services package. However, this would not change the outcomes in the sense that municipalities would still be able to use their allocated funds for their basic services, as defined by their. The FFC approach is merely to use the basic services as a quantifiable means to "slice the cake ". The operating transfers are not conditional and thus a municipality which can justify basic health services as a basic service, could use the funds thus. Increasing the number of services in the basic services basket does not lead to an increase in available funds, as may be thought by those holding the former opinion. Secondly, only two services are used to "slice the cake " in the FFC approach as there are only data for the abovementioned services. It would appear that there is a reasonably strong correlation amongst the five services in the contexts of both access to services and backlogs. What should be kept in mind when defining basic services is the fiscal context which prevails, which is likely to moderate the number of services included and/or the level of service provision.*

vi. The "regional health system" is beginning to take shape and there is concern that the financing of local government, which has municipal health service responsibilities, does not take or will not take into account this development at a sub-provincial level. *FFC Comment: The FFC recognises the possible challenges which may develop in this context. The current formula and work on local government financing does not take these matters into account but will be addressed in due course.*

vii. The FFC's recommendation that the transfer for operating expenditure be determined by two factors, need and tax capacity has elicited some opposition. What the FFC proposal suggests is that there has to be intra-municipal cross-subsidisation, between relatively wealthier areas and relatively less wealthy. Thus, the aggregate need and the aggregate capacity of the municipality should be taken into account, not just the need and capacity if the poorer area. *FFC Comment: The FFC continues to promote this position.*

viii. Tax capacity versus tax effort. There is some confusion between how the FFC uses the tax capacity measure. *FFC Comment: What is to be measured is not the tax paid but the potential to pay tax. There is thus a powerful incentive for municipalities to exploit their tax bases, rather than an incentive to collect as little as possible with the intention of being "subsidised" for not performing.*

ix. The FFC has suggested that the two levies imposed by the former RSC/JSB system be included in the measure of district council and

metropolitan council tax capacity. The business community has expressed its strong opposition to these levies and called for them to be replaced by a less distortionary tax. *FFC Comment: There are two comments that could be made in this regard. Firstly, there is no substitute revenue source immediately available. Secondly, it would seem that at the very low rates which are imposed the potential economic distortions do not appear to be too severe.*

x. The "two-level" structure of local government in South Africa, as used for analytical purposes by the FFC is called into question. *FFC Comment: The FFC does not see the primary and secondary types of municipalities as a hierarchical in structure, and nor should it be. Differentiation between metropolitan councils and the related metropolitan local councils is really based on functional differentiation and responsibilities.*

xi. Data limitations. *FFC Comment: The FFC again acknowledges the problems associated with the paucity of data. The system will be developed and refined as the appropriate data becomes available.*

xii. A general requirement for the formula to solve all problems. *FFC Comment: A formula-funding approach to intergovernmental transfers is not a panacea for eves y problem within local government.*

Structural and area-specific problems, amongst others, cannot be addressed through a funding formula, no matter how complex the formula may be made.

Footnote

2 Although two services are used to "slice the cake" and are regarded as sensible proxies for a package of basic set-vices, sight is not lost of the importance of other services such as solid waste removal, roads and storm water drainage and electricity. '

3 The poverty line is defined in terms of relative poverty i. e. the poorest -10% of households (ranked by adult equivalence) in the county. This definition is taken from an October 1995 RDP report.

4 Similar to the capital grant, only two services are used as indicative of needs. This does not imply that transfers are applied to only these two services but for any service which is included in the definition of "basic services ".

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