Fiscal Decentralization and the Provision of Constitutionally Mandated Basic Services (CMBS): A Review of the South African System

By

Margaret Chitiga (EPD/HSRC), Jaya Josie (EPD/HSRC),and Annette Verryn (HSRC)

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Contact Person:
Margaret Chitiga
Economic Performance and Development (EPD)
mchitiga@hsrc.ac.za
Tel +2712 302 2406

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HSRC
Human Sciences
Research Council

Abstract

Concerns about growing inequality and its possible social repercussions have recently prompted the South Africa government to adopt a strategy aiming to ensure that the benefits of growth as reflected in nationally collected revenues areshared equitably across sub-national governments in a way that addresses socio-economic disparities. The equitable sharing of nationally collected revenues hinges on the ability of subnational governments, which are largely responsible for the delivery of public services and the implementation of social policies, to undertake the planned fiscal decentralisation programs. In the absence of reforms, however, the current system of intergovernmental fiscal relations (IGFR) system may not be sufficiently robust to support significant changes in spending mandates. This paper reviews and analyses the fiscal balance with respect to all revenues and expenditures. The review will include an assessment of the fiscal and institutional arrangements that underpin the current IGFR arrangements. Following the review the paper presents recommendations for the reform of the IGFR system that policymakers may wish to consider. Following from the suggested recommendations reforms to the cooperative IGFR system in South Africa must take account of the constitutionally mandated basic services (CMBS) as prescribed in the Constitution to attain the goal of redistributive justice. In this regard the most important questions relate to the way in which the size of the grants should be fixed and questions concerned with their economic and welfare consequences. It is suggested that, periodic monitoring and evaluation of the system be done to improve the system over time.

Key Words: *Allocation, Budget, Cooperative, Constitution, Equitable, Fiscal, Intergovernmental, Macroeconomic, Provinces, services*

Introduction

A central priority of national government in South Africa is to progressively provide basic services to all South Africans within the constraint of available resources. This objective is set out in the Constitution's Bill of Rights (The Constitution, 1996) and is a fundamental responsibility of government. Rights to which all citizens are entitled are in areas such as freedom of movement; a protected environment that is not harmful to health and well-being; housing; health care; food; water and sanitation; social security, and education. Responsibilities in respect of realising these rights are shared amongst national, provincial and local governments, with each sphere of government charged with fulfilling its assigned functions.

Under the Constitution, national government also has over-riding responsibility for the management of the country's affairs and shares responsibility with the provinces and local governments for the provision of basic social services. National government may mandate appropriate essential or minimum levels and standards of services. Provinces are responsible for delivering most of the range of social services, which fall in the areas of education, welfare, and health. Local governments carry responsibility for provision or local infrastructure and basic services such as sanitation and water reticulation.

The objective of South Africa's intergovernmental fiscal arrangements is to ensure that these inter-governmental responsibilities are carried out in the spirit of co-operation (Chapter 3 of the Constitution) and, take account of equity and efficiency. Ultimately, it is the well being of all citizens, wherever they reside, that should be the main goal guiding intergovernmental decisions around fiscal arrangements amongst the three spheres of government. This principle of the interrelationship between fiscal responsibility and meeting the constitutional requirements for the provision of basic services is illustrated in Figure 1 below.

Under South Africa's intergovernmental fiscal relations system (The Constitution, 1996 and the Intergovernmental Fiscal Relations Act, 1997) national, provincial and local government spheres of government are entitled to an equitable share of nationally collected revenues for the provision of services to communities. However, combining distributive justice and the raising of adequate levels of revenues for redistributive purposes is a function of sustained investment, growth and development. Thus striking a balance between the need to provide constitutionally mandated basic services (CMBS) within macroeconomic constraints that limit the available resources is a fundamental problem that underpins South Africa's intergovernmental fiscal relations system. In Petchey *et al* (2007), this problem was discussed and a model to address equitable intergovernmental redistribution of nationally collected revenues was proposed as a solution to the dilemma.Furthermore, as sub-regional governments have limited tax raising powers their own revenues are inadequate to carry out their mandates, and they are mostly reliant on equitable shares of nationally collected revenues for the delivery of CMBS.In a sense, therefore South Africa's IGFR system is faced with an institutionalized and structural form of a vertical fiscal imbalance. It is in this context that the literature on fiscal federalism and intergovernmental fiscal relations has been grappling to characterize South Africa's IGFR system.

The standard approach has been to situate South Africa's IGFR system as a form of cooperative federalism (Shah, 2014). The notion of cooperative federalism is discussed extensively in the literature (Cameron and Simeon, 2002; Painter, 1998; Saunders, 2002; Wanna *et al*, 2009).Cooperative federalism is juxtaposed against the conventional notion of fiscal federalism (Tiebout, 1956; Oats, 1969) in which sub-regional governments in a country compete with each other on the basis of their fiscal policy stance with respect to taxation and expenditures, and attractiveness to capital and labour. Although this notion has been challenged (Shah, 1992; Bruecker, 1982)it is still the framework that determines assessments of IGFR systems in developing transitional economies (DTEs). In South Africa the debate has focused on whether the IGFR system is adopting a more centralized fiscal policy and thus limiting the ability of provinces to exercise autonomy with respect to economic decisions to the benefit of their residents (Calitz andEssop, 2012). Except for Shah (2014) there has been no in-depth analysis as to why South Africa's IGFR system may be characterized as cooperative. Chitiga *et al* (2014) argue that despite the cooperative form of the system in South Africa,reforms must be taken to enhance the efficiency of IGFR system to ensure the optimal balance between achieving equity and economic growth.

Over the past ten years, concerns about growing inequality and its possible social repercussions have prompted the South Africa government to adopt a strategy to ensure that the benefits of growth as reflected in nationally collected revenues are shared equitably across sub-national governments in a way that addresses socio-economic disparities. Reforms would be necessary if the the current IGFRsystemis to support significant changes in spending mandates. This paper reviewsand analyses the fiscal balance in South Africa's IGFR with respect to all revenues and expenditures. The review will include an assessment of the fiscal and institutional arrangements that underpin the current IGFR arrangements.

In particular, the review will identify and analyse the socio-economicdisparities that differentiate communities from each other, with special focus on disadvantaged communities that are excluded from accessing public resources and economic opportunities that deny them the right to full participation in economic development. Secondly, the paper reviews the South African experience of fiscal decentralisation since 1996, and assesses the role of fiscal decentralisation as a possible investment vehicle that targets sustainable economic development programmes. Thirdly, the paper reviews and analyses basic public services and institutions, policies and programs that require targeted investment finance that enhances the links between productivity, entrepreneurship and employment creating economic growth and development.

During the 1990s, South Africa adopted a constitution that set in motion a process of decentralisation of core expenditure responsibilities to its provinces and municipalities. Two decades later, although the country has achieved a high degree of decentralisation in public services, the South African IGFR system still has some shortcomings. Provinces and municipalities have formal responsibilities over major categories of spending and account for more than half of government spending, including in key areas such as basic services, health and education. However, in practice, the implementationof fiscaldecentralisation policies for the delivery of public services has not met the objective of more efficient and effective public service delivery, as it was envisaged in Section 214 (2) of the South African Constitution.

Similarly, and in keeping with South Africa's constitutional mandates in Chapters 2 and 13 of the Constitution, neither have the wide regional disparities in public services narrowed to levels envisaged at the onset of South Africa's post-apartheid democratic dispensation.[1]

Given shared responsibilities for implementation and finance across the three spheres of government, there is a great danger of duplication, wasteful use of resources and avoidance of responsibility for delivering outcomes. These factors reduce public sector efficiency, public and business confidence, and more broadly the efficient use of resources that are essential for the economy to develop and grow. With slow growth and large economic disparities, South Africa needs to spend wisely to address its human resource potential, health and infrastructure gaps and enhance its economic growth and development prospects. Fiscal policy is expected to be at the forefront of the equitable allocation of national revenues, particularly for the planned increase in the provision of social services (health care, social security, and education) and economic infrastructure.

While social policy priorities have been clearly identified, their implementation is, however, far from assured. The success of the IGFR hinges on the ability of subnational governments, largely responsible for the delivery of public services and the implementation of social policies, to effectively and efficiently provide basic services. In the absence of reforms, however, the current system of IGFR may not be sufficiently robust to support significant envisaged changes in spending mandates.This study is concerned with making an assessment of how to make the system more robust.Part one of the paper presents a theoretical framework for IGFR in South Africa, andpart twogives an analysis of of IGFR in South Africa since 1996 focussing on equity and efficiency effects. Part threeoffers policy suggestions and concludes the paper.

1 Theoretical Framework for Intergovernmental Fiscal Relations in South Africa

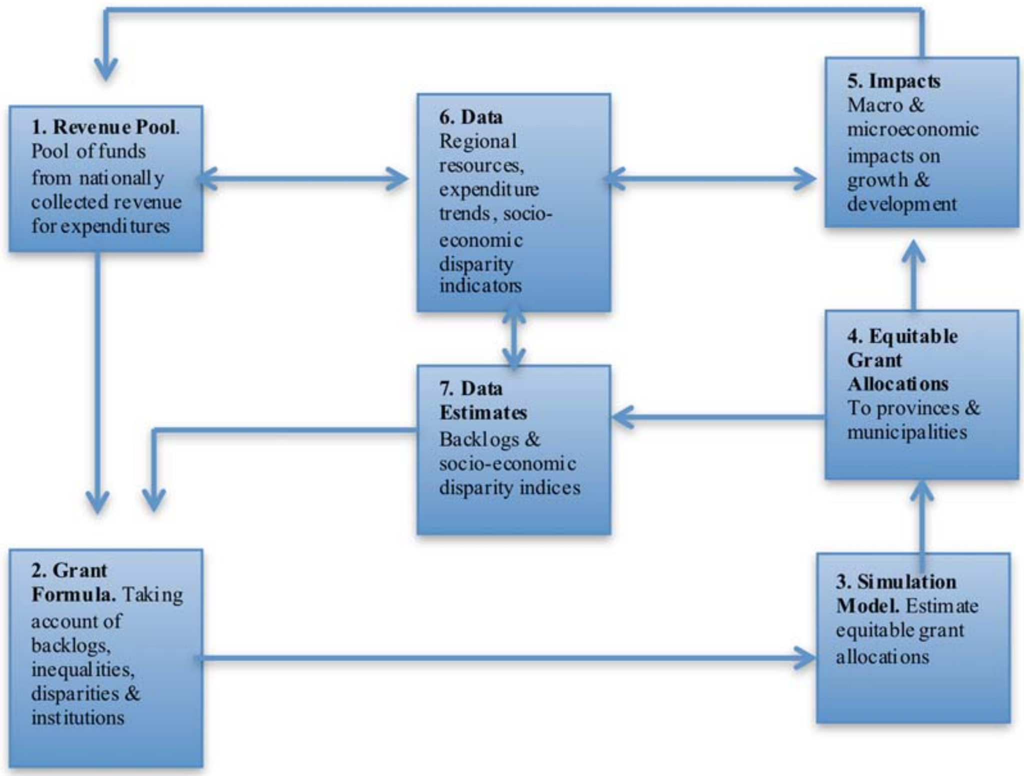
1.1 Context

The standard approach in developed IGFR systems aims to balance equity with static and dynamic efficiency so as not to destabilize the prospects of economic growth. In particular the objective is to limit the excessive outward migration of skilled labour and productive capital. However, in developing transition economies (DTEs) such as South Africa, the main aim of

[1] The Bill of Rights in the Constitution prescribes that access to basic services is a fundamental right to which everyone is entitled. Certain rights must be subject to progressive realization, as governments must operate within available resources. Chapter 13 Section 214 (1) and (2) a-j and Section 227 (1) of the Constitution prescribes that local government and each province is entitled to an equitable share of revenue raised nationally and, that equitable shares include an entitlement to enable the provision of basic services by provinces and local governments and, that the allocations should take account of fiscal capacity, disparities and economic efficiency.

IGFR policies is to ensure the equitable provision of basic public services for achieving national equity goals in general, and reducing socio-economic and spatial disparities in particular. These, explicitly stated or not, include the aim that citizens ought to have equal access to food, educational opportunities, health care, water and sanitation, housing, job opportunities and socio-economic security regardless of where they reside. The role of the fiscal transfer system is to facilitate the decentralisation of fiscal responsibilities in a way that leads to efficient and responsible sub-regional decision-making, while at the same time, respecting developmental and macroeconomic policy objectives. An effective, equitable sharing system must be able to effectively balance the competing demands for macroeconomic stability against the need for equity and redistribution in developing nations with high levels of socio-economic and spatial disparities. Figure 1 illustrates this virtuous cycle to show how a DTE attempts to resolve the balance between developmental and macroeconomic policy objectives. The efficient application of IGFR principles will contribute to an effective IGFR system.

Figure 1: A structural view for the equitable sharing of transfers to regions with high levels of disparities



Source: Adapted from Petchey et al,2007

1.2 IGFR Principles Defining the South African system

In the literature, Shah (1994) presents a set of IGFR principles against which policies for the equitable sharing of nationally collected revenues may be assessed. These principles include:‘fiscal autonomy of sub-regional governments; revenue sharing for fiscal equity; formula driven rather than discretionary grants; transparent processes for determining grants; unconditional major grants; sub-regional accountability for expenditures; avoidance of bailouts; norms and costs as elements of the grant formula; macroeconomic management; sub-regional revenue raising powers; and sub-regional government financial management’(Josie, 2012, p. 9). The equitable sharing of national revenue is implemented through an equalisation mechanism that, in practice, should satisfy the IGFR principles.

1.3 Application of IGFR Principles for Equitable Sharing of Revenue

Almost all decentralized states have an equalisation mechanism for the fair sharing of resources among provinces/states and local governments. Sharing entails affording sub-national government sufficient resources, such that each can provide comparable levels of public services using similar revenue-raising effort. This is what is referred to as fiscal equity. For, instance, it is an explicit objective of the Australian federal system, and is built into the Canadian constitution as a requirement of the equalisation system (Petchey, 2011; Boadway, 2003; Dahlby, 2004; Freebairn, 2011). Equitable shares are unconditional grants and discretionary to the extent that sub-national governments choose the exact mix of services preferred by their constituents, provided they met the basic national norms and standards set nationally for health, education, water and sanitation, and welfare. Stability, certainty and avoidance of budget shocks of allocations are ensured by the use of formulae over a medium term planning cycle.

1.4 Fiscal Decentralisation Principles and Practices for an Optimal IGFR System

In most developing and developed countries that have adoptedfederal or IGFR systems, the assignment of powers, responsibilities and functions to the different tiers or spheres of governments is formalised and institutionalised in the Constitution and/or other legislation. However, in DTEs the constitutional formalisation of the assignment of powers, responsibilities and functions specificallyincludes addressing socio-economic disparities and inequalities as part of pro-poor policies for poverty reduction (see for instance, South Africa, Ethiopia and Nigeria).

Conventionally, the national, central or federal government has over-riding responsibility for the macroeconomic management, and management of the country’s political, security and foreign affairs, and shares responsibility with sub-national or regional governments for the provision of public services and the collection of revenues. Macroeconomic management is a key ingredient in fiscal decentralisation, and figure 1 presents a framework for balancing macroeconomic objectives against policies for targeting pro-poor and poverty reduction objectives. National, federal or central government may also mandate appropriate essential or minimum levels, norms and standards of services. To repeat, state or provincial governments are responsible for delivering most of the range of public social services, which fall in the areas of education, welfare, and health, transport, and sometimes, housing. Local governmentscarry responsibility for provision of local infrastructure, housing, public transport, and basic services such as sanitation and water reticulation among others. Drawing on the example of South Africa (table 1) presents an adapted framework illustrating how constitutional and legal obligations may be balanced and coordinated with institutional IGFR arrangements for the delivery of service mandates against prescribed constraints.

South Africa's system of IGFR did not evolve organically as is the case with other federal nations that came into existence as part of a political agreement between relatively independent and economically self-sufficient regional states. In South Africa, none of the provinces existed as self-sufficient entities before 1994. The current fiscal decentralisation and, the intergovernmental system was the outcome of protracted national negotiations in the Constituent Assembly that led to the demise of white minority rule, the end of apartheid and the emergence of a democratic state in which the Constitution is the supreme law of the land.

The Constitution (1996) defines South Africa as 'one sovereign, democratic state' with three spheres of government with relative degrees of autonomy and that includes national, provincial and local government. There are nine provinces, each with its own legislature, premier and executive councils and, 283 local governments divided into three municipal categories. The categories are the metropolitans (category A), the local municipalities (category B) and, the district municipalities (category C).

Table 1: A stylized view for an IGFR fiscal framework in South Africa

Expenditure shares in terms of Bill of Rights & Section 214 (1 & 2) of Constitution for:	**Governance and institutional responsibility of:**			**Considerations in terms of Bill of Rights & Chapter 13, Section 214 (2) clauses (a to j) of Constitution**
	National Government	**Provincial Government**	**Local Government**	
National Interests (e.g. Defence and foreign)	Sole	No	No	Progressively provide basic services within available resources (Bill of Rights);
National Debt	Debt service and Deficit limits	Limited borrowing	Borrowing and bond issue	
Needs and interests of national government	Public service personnel, capital and operational, other	Agency role	As delegated	Provincial and municipal fiscal capacity;
Education	Higher, adult and technical; science and technology	Basic and early childhood	No	Provincial and municipal efficiency;

Health	Teaching hospitals and medical research	Basic and primary health care	Some primary health care	Economic disparities; Stability of allocations; Predictability of allocations; and Need for flexibility.
Welfare services	Support for non-governmental agencies	Full	No	
Social Security	Full	Agency role	No	
Housing	Subsidies to province and municipalities	Concurrent with national and local	Concurrent and as delegated by national and province	
Water and Sanitation	Infrastructure grants to municipalities	No	Provision and service delivery	
Transport and Roads	Funding of transport parastatal, network and national roads	Concurrent with national and local, for provincial roads	Urban roads and transport	
Electricity	Generation through parastatal (Eskom)	No	Local distribution	
Safety and Security	Full	No	Metro Police	
Emergencies	Concurrent	Concurrent	Concurrent	
Contingency Reserve	Sole	No	No	

Source: Adapted from Petchey et al, 2007

The Constitution includes a Bill of Rights (Chapter 2) that sets out the human and socio-economic rights to which South African citizens are entitled. The Constitution also (in Chapter 3) makes provision for intergovernmental relations to be mediated by prescribed principles of co-operative governance and legislation. The objective of South Africa's intergovernmental fiscal arrangements is to ensure that these inter-governmental responsibilities are carried out in the spirit of co-operation, fairness, and efficiency.

A central priority of the South African government is to provide basic services to all citizens within the constraint of available resources. In South Africa, this objective is mandated in the Constitution and is a fundamental responsibility of government. Rights to which all citizens are entitled are in areas such as housing, health, social security and education. Responsibility for the delivery of such services are shared amongst different spheres of government, with each level of government mandated with certain powers and charged with fulfilling its assigned functions.

As mentioned earlier, under the Constitution and other legislation, the national government has over-riding responsibility for the management of the country's affairs and shares responsibility with sub-national or regional governments for the provision of public services and the collection of certain revenues. South Africa's IGFR system is an eclectic mix of several international experiences.

In the last two decades, South Africa has witnessed restructuring of provinces and municipalities after 1994 in a bid to ensure equality of opportunity for all. The current system of public finance and IGFR largely reflects the arrangements introduced by a major reform undertaken just before and following democracy in 1994. South Africa's system of decentralisation has been categorised as a form of cooperative federalism in a unitary state because IGFR are determined by its constitution (Shah, 2014).

Thus the IGFR system is characterised by Constitutionally prescribed (Chapters 2, 3 and 13) fiscal decentralisation principles that are given effect through a plethora of legislative (the 1996 Intergovernmental Fiscal Relations and Financial and Fiscal Commission (FFC) Acts), institutional (the FFC and various intergovernmental fora) and administrative policy instruments (Treasury rules and regulations). Major reforms were based on the following main elements:

- A new value added tax (VAT) was introduced in 1991 to replace the old General Sales Tax (GST).
- Redesign of the transfer system to move away from what had been ad-hoc negotiated arrangements toward more rule-based and transparent mechanisms.
- Designation of the South African Revenue Services (SARS) as the agent responsible for the collection of central and shared taxes; while the collection of local taxes remained under local governments' agencies.

1.5 Principles, Design and Practices for Effective Allocations

In principle, it is the role of the grant structure, and fiscal arrangements more generally, to facilitate the decentralisation of fiscal responsibilities and equalisation transfers in a way that leads to efficient and responsible provincial or regional decision-making, while at the same time respecting national goals and objectives (Bahl, 1999). This virtuous cycle is illustrated in figure 1. Fundamentally, a grant system is about the equitable, efficient and effective allocation of nationally collected revenues and resources to meet national redistributive policy objectives. The allocation rule, together with stabilisation and redistribution rules, is the key policy principle for management of IGFR systems. 'In general an allocation rule is a method, process, or formula that allocates any given supply of goods among any potential group of claimants according to the salient characteristics of those claimants' (Young, 1994, p. 8). In IGFR practice, this definition must be consistent with the general equitability principles of *parity, proportionality with consistency,* and *priority* (Young, 1994, pp. 8-9).*Parity* means that all claimants should be treated equally; *proportionalitywith consistency*recognizes that goods and services must be divided consistently according to the established differences amongst claimants; and, *priority* affirms that the person with the greatest need is entitled to a first claim on the goods or services.

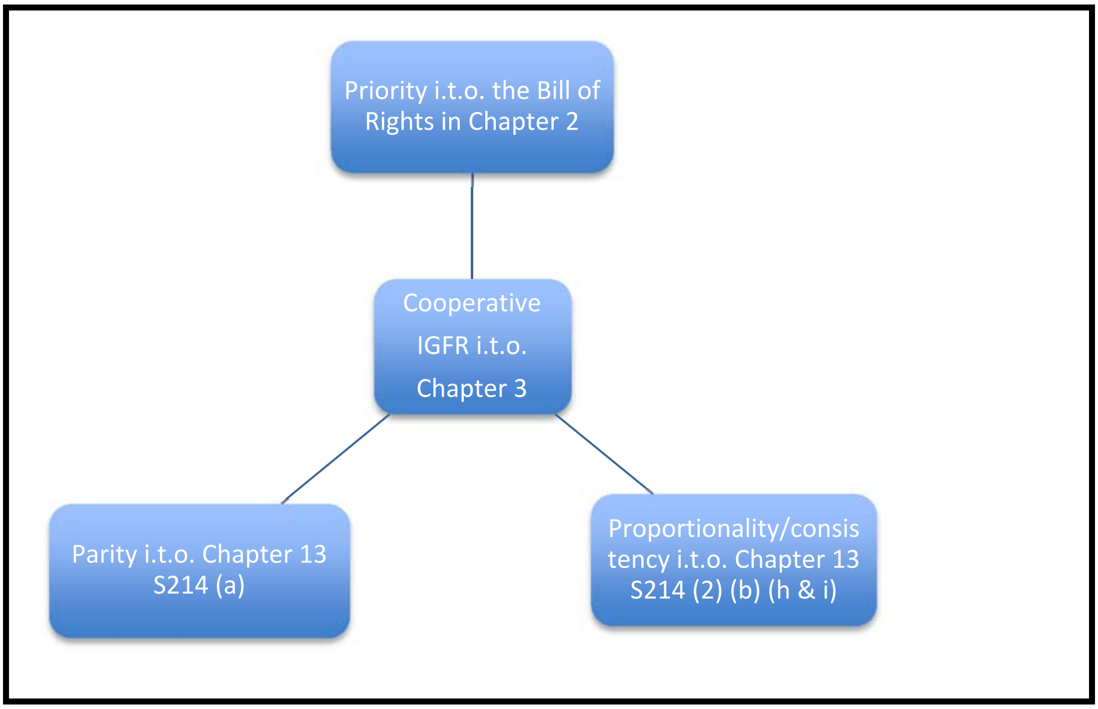
The content of an allocation rule according to Young (1994, p. 9) requires normative principles that emerge from empirical rules based on institutional choices, judgments and compromises between competing principles. The reason for this is because an allocation problem emerges when a set of resources, rights, burdens or costs are temporarily and collectively controlled by a group of individuals (government or legislatures) who also have individual entitlements to the resources, rights, burdens or costs. Therefore an allocation is the decision made by a group or institution acting on behalf of the group about who gets the good or who bears the burden. A decision may be about allocating a good, a service or a burden.

Goods, services or burdens may be classified into different types. They may be homogeneous and divisible such as money or water, or it may be heterogeneous and divisible like land. A good, service or burden can also be homogeneous and indivisible like seats in parliament or exemptions from obligations. Others may be heterogeneous and indivisible such as in allocating kidneys for transplant, or places in universities, or jobs for designated groups. Whatever they are the goods, services or burdens may be fixed (by law), or variable in the sense that the required resources may not be readily available at a given time (Young, 1994,pp. 7-8).Young's principles provide a sound basis for achieving redistributive justice through the equitable allocation of nationally collected revenue envisaged in South Africa's cooperative IGFR system.

Applying the principles of parity, proportionality with consistency and priority is possible because all three of these principles resonate with the constitutional requirements that define South Africa's system of cooperative intergovernmental fiscal relations. This application is illustrated in Figure 2 below. In the South African Constitution (1996) cooperative IGFR is defined in Chapter 3 (see Appendix). Former Minister of Finance, Mr. Trevor Manuel (2007), neatly summarized the seven key constitutional principles that define South Africa's cooperative IGFR system. These include accountability and autonomy to carry out responsibilities; good governance defined by accountability and transparency of the elected to the electorate; redistribution through the provision of constitutionally mandated basic services (CMBS) to address the legacy of socio-economic inequalities and disparities; the vertical division of national revenue through negotiations and budget processes determined policy priorities, and issues of governance and service delivery; revenue sharing that takes account of efficiency, fiscal capacityand the assignment of powers and functions;access to the provision of CMBS to all South Africans, and determination budgets and responsibility to comply with regulations governing budget management.

Each of the key constitutional principles listed above are derived from different sections of the Constitution. The principles of cooperative IGFR are prescribed in Chapter 3 of the Constitution. Around theseIGFR principles the allocation rule of parity, proportionality with consistency and priority may be applied. For example the provision of CMBS define fundamental priority policy objectives as prescribed in Chapter 2 (The Bill of Rights); parity speaks to the notion of equity and the equitable allocation of nationally collected revenue to all spheres of government as prescribed in Chapter 13 Section 214 (*a*), and proportionality with consistency addresses the considerations listed in Section 214 (2) (*b, h, and i*). In order to work within this allocation rule in the South African system grant allocations are made using specific formulae.

Figure 2: Young's Allocation Rule for CMBS Provision in South Africa's Cooperative IGFR System



Source: Developed by Author, based on Young (1994

As is the case in most systems of fiscal federalism grant allocations are determined by a well-specified formula and have a number of advantages over those that are determined on an *ad hoc* discretionary basis by national government. Formula-driven grants are more transparent, reliable and predictable, and are less subject to short-term fiscal constraints and day-to-day political considerations. Formula-driven grants are designed to be in place for intervals of several years. In some countries they are also designed so that risks of unexpected changes in revenue are borne by national government, which maybe especially important where provincial governments have little revenue-raising ability, and where they cannot use debt as a method of insuring themselves against revenue fluctuations.

In South Africa and Australia major grants, especially those that play an equalizing role, tend to be largely unconditional and non-matching. This ensures that sub-regions are able to exercise the utmost discretion. Of course, there may be some requirement to ensure that when sub-regions use these grants to deliver important social programmes, they adhere to national norms and standards. Formula-driven, unconditional grants have one further benefit because provinces bear responsibility for the consequences of their expenditure. The benefits of well-designed formula-driven grants arise from the fact that sub-regions may bear responsibility for the consequences of their expenditure. The grants help to avoid the potentially serious problem faced by many federations with large vertical fiscal imbalances – the problem of bailouts of irresponsible (or over-zealous) provincial governments. This is the so-called 'soft budget constraint problem'.

Two elements facilitate the design of equalisation grants. One is a component that compensates for differences in the ability of provinces to raise their own revenues. This is relatively straightforward to implement, and equalisation systems in established federations tend to do so (e.g., Canada and Australia). The other involves differences in the resources required to achieve comparable service levels. These differences arise due to variations in demography and geography among provinces and municipalities. Historically inherited inequality in levels of development, including critical capital backlogs, is a major determinant of sub-regional disparities.

An additional challenge for estimating unit costs is that the microeconomic demands of sub-regions may conflict with the macroeconomic constraints determining the available pool of funds from the nationally collected tax revenue and other sources. If each sub-region has to take account of its real unit costs (including backlogs, inequality and other disparity factors) for the provision of basic services and economic development, and these amounts are aggregated across all regions, then the total sum may be greater than the national expenditure budget pool available for equitable allocation funds. Thus, in public finance parlance, if this *hard budget constraint* limits the actual amount of funds available why would it be necessary to estimate unit costs in any case?

Finally, costing services using a production or cost function approach is extremely complicated and data intensive and requires long run time series data. Not many developing countries have access to such data. For these and other reasons, in South Africa, the nationally collected revenue is macro-economically estimated and the pool of funds available for equitable shares is determined via consensus achieved through a process of cooperative governance (stipulated in Section 41 Chapter 3 of the Constitution). The consensus is achieved through negotiations within intergovernmental fora such as the Budget Council and the Budget Forum. The decisions made are supported by extensive technical research. The Shah (2005) study discussed above supports this consensus building approach.

Another issue to highlight when designing formulae is how to include norms and cost differences in a grant formula. In this regard, it is important that the inclusion of norms and costs are done in such a way that sub-regional spending does not directly influence the amounts transferred. Otherwise, sub-regional authorities are likely to distort their spending priorities in order to influence the amount of grants they are to receive. Grants could be designed so that norms are able to reflect the objective features of the regions that affect the amount of money needed to provide standard levels of public services.

In the South African context, designing grants is complex because the norms and costs of providing basic services, inform not only the horizontal division of funds across provinces, but also the vertical division of the equitable share. Although it is the prerogative of national government to determine the vertical division of national revenue, it must nonetheless be done in a way that satisfies the requirements set out in the Constitution. These involve ensuring that the provinces and local governments can provide basic services up to national norms and standards.

In many DTEs, the case for decentralizing expenditure functions is much stronger than for decentralizing taxation functions. Nonetheless, the advantages of sub-regional levels of government having reasonablerevenue-raising responsibilities are compelling. This need not imply a separate taxing authority. Sub-regional governments can have taxing responsibility without disrupting a harmonised national tax system by simply 'piggybacking' onto the national system at their own chosen rates. The ability to raise their own revenues offers sub-regional governments a valuable degree of freedom that allows them to implement programmes of their own choice and size. This is an important aspect of sub-regional autonomy.

South Africa is an example of fiscal imbalance where much of national tax revenues available for equitable sharing areraised by the national government through various tax regimes. This imbalance is illustrated in the table 2 below. Table 2 presents the tax revenues that are allowed by legislation for national, provincial and local governments.

Table 2: Revenues allowed for National, Provincial and Local Governments

Categories	National	Provincial	Local Government
Taxes	Personal Income; Value Added Tax (VAT); Corporate tax; Tariffs	Some surcharges on existing taxes; Tourism levies; Fuel levies; Gambling.	Property rates; Motor vehicle license; other
User Charges	Electricity generation; Airport and harbour fees; Rail transport; National toll roads; other.	Hospital fees; School fees; Provincial toll roads; other.	Water and sanitation; electricity distribution; other.
Borrowing	Treasury bond issue; national and international financial markets and institutions.	As per legislation and approval of national minister of finance.	Municipal bond issue; national financial markets; Development Bank of Southern Africa(DBSA); other.

Source: Adapted from Petchey et al, 2007

Table 3 below presents a view of how the tax revenues collected are shared amongst the three spheres of government in South Africa according to the types of allocations (unconditional or discretionary, conditional, specific purpose).

Table 3: View of revenue shares for National, Provincial and Local Governments

Types of Allocation	National Share	Provincial Share	Local Government Shares	Total Expenditures
Unconditional	*NEA*	*PEA*	*LEA*	*ES*
Conditional Grants	*-PCG-LCG*	*PCG*	*LCG*	*CG=PCG+LCG*

Specific Purpose Grants	*-PSP-LSP*	*PSP*	*LSP*	*SP=PSP+LSP*
Total	*NEA - (PCG+LCG+PSP+LSP)*	*PEA+PCG+PSP*	*LEA+LCG+LSP*	*TNCR*

Source: Adapted from Petchey et al, 2007

Where:

- **TNCR** *= NEA - (PCG + LCG + PSP + LSP) +PEA +LEA*
- **NEA** *= National equitable allocation*
- **PEA** *= Provincial equitable allocation*
- **LEA =** *Local Equitable Allocation*
- **ES** *= Equitable shares*
- **CG** *= Conditional grants*
- **SP** *= Specific purpose grants*
- **PSP** *= Provincial specific purpose grants*
- **LSP** *= Local government specific purpose grants*
- **PCG** *= Provincial conditional grants*
- **LCG** *= Local government conditional grants*
- **TNCR** *= Total nationally collected revenues*

1.5.1 Sources of nationally collected revenue[2]

Table 2 presents the current sources of tax revenue for all three spheres of government. For revenue, the national government relies on the broad based taxes, such as income, VAT, excise and customs taxes, and fuel levies. The thorough overhaul of tax administration and collection in the second half of the 1990s and sustained positive economic growth from 1994 until 2008 were the main reasons why tax ratios have increased significantly. The consequent rapid growth in tax revenues has enabled the Government to steadily expand social grants spending while reducing budget deficits and the public debt burden during the second half of the 1990s and keeping these aggregates at manageable levels thereafter. Revenue for provinces mainly comes from minor taxes such as gambling taxes, user fees, hospital user fees and motor vehicle licence fees. They could also conceivably impose a surcharge on income and fuel taxes. The local and regional governments are allowed to borrow for bridging finance or for capital projects. Provinces have historically relied on transfers from the national government to finance up to 96.5% of their expenditures. Local governments on the other hand have managed in general to finance 85% of their expenditure through own revenue sources, although there are wide disparities across municipalities.

Benchmarked against international practice with regard to revenue assignments, one can argue that South Africa currently has a weak assignment of revenue sources particularly to

[2]*See section below on transfers for a list of the main revenue sharing arrangements between the central, provincial and local governments.*

provincial governments. The gap between subnational spending assignments and their own resources in South Africa is met by large transfers. Lack of significant revenue sources and effective use of assigned sources raise the key issue of overall discretion that provinces and municipalities can exercise over national transfers and allocative efficiency. International experience suggests that greater levels of revenue autonomy tend to bring significantly higher benefits than costs (Martinez and Alm, 2008). A counter argument would be that revenue autonomy is not important because the functions assigned to provinces are basic social services (education and health) that are more amenable to funding from central transfers to avoid creating distortions in equity.

As previously argued by the FFC in 2009, regardless of the appropriateness of the level of revenue autonomy and its use by the provincial governments, currently the formula used to determine the equitable shares is perceived to be biased against fiscal (revenue) capacity (FFC, 2009, Submission for the 2010-2011 Division of Revenue). The economic activity component only accounts for 1% of the equitable share to provinces. Although there are other countries that disregard revenue-capacity issues in their transfer systems, many other decentralised systems, in which provincial governments have their own-revenue sources, do equalise not only expenditure needs but also differences in fiscal capacity. Therefore, these systems are able to equalise more intensively across sub-national jurisdictions (FFC, 2009, Submission for the 2010-2011 Division of Revenue).

1.5.2 Trends in expenditure allocations

Table 1above gives an overview of institutional arrangements and expenditure responsibilities in South Africa.While all socio-economic rights listed in the Bill of Rights may be provided progressively over time the right to basic education is the only right that is not qualified by a requirement for the progressive realisation dependent on the reasonable availability of funds. All other CMBS should be provided against a set of norms and standards (sometimes defined as the millennium development goals) over time and within the reasonable constraints of available resources. Chapter 13 S214 (2) of the Constitution requires that budget allocations be predictable and stable over time so that services can be progressively realised. Balancing the obligation to progressively provide basic services against the constraint of available resources is the fundamental problem that confronts policy implementation.

South Africa's public expenditure is characterised by shared responsibilities for implementation and finance across the three spheres of government, which make for a system of quite complex overlapping competencies. A critical challenge is that there is no clear separation of concurrent responsibilities with respect to 'own' responsibilities, for which subnational governments can make decisions with substantial autonomy, and 'delegated' responsibilities, for which subnational governments have to comply with standards of provision dictated by the national sphere. Although the Constitution is clear on functional assignments across spheres, overlapping responsibilities amongst governments creates distortions in funding and accountability. It is no wonder that national departments of Basic

Education and Health are always discontent with deviations between the ‘agreed’ funded priorities and the provincial budget outcomes. In other instances, national departments argue that they are held accountable for policy outcomes over which they have little control on the required funding[3]. These are the results of an incomplete system where expenditure responsibilities are neither clarified nor defined, and quantification of the expenditure needs remains incomplete.

Expenditure is determined via targets and parameters as laid out in a three-year cycle of the Medium Term Expenditure Framework (MTEF). Table 4 shows a healthy growth in expenditure over the period. Nationally raised revenue is shared amongst the three spheres of government, according to government policy priorities. The vertical division of revenue is a cabinet decision (in consultation with various groups and stakeholders), thus it is political. National government consistently gets the lion’s share while provincial allocations are the second biggest. The shares between these two spheres have narrowed over time as the national government’s share has reduced marginally. The local government’s shareis by far the smallest of the three, but has however been increasing over time.

Table 4: Expenditure trends and division of nationally raised revenue

	2007/08	**2008/09**	**2009/10**	**2010/11**	**2011/12**	**2012/13**	**2013/14**
In Rand million	**Outcome**			**Revised estimate**	**Medium-term estimates**		
Debt-service cost	52 877	54 394	57 129	66 570	76 579	90 808	104 036
Non-interest expenditure	488 566	581 560	690 068	743 353	812 345	877 324	948 992
Percentage increase	*16.9%*	*19.0%*	*18.7%*	*7.7%*	*9.3%*	*8.0%*	*8.2%*
Total expenditure	**541 443**	**635 953**	**747 197**	**809 923**	**888 923**	**968 132**	**1 053 029**
Percentage increase	*15.2%*	*17.5%*	*17.5%*	*8.4%*	*9.8%*	*8.9%*	*8.8%*
Unallocated					40	330	530
Contingency reserve	–	–	–	–	4 090	11 405	23 375
Division of available funds							
National departments	**242 580**	**289 236**	**345 366**	**359 120**	**380 154**	**408 439**	**439 049**
Provinces	**207 504**	**246 836**	**293 164**	**323 080**	**357 929**	**380 450**	**404 251**
Equitable share	171 054	201 796	236 891	265 139	288 493	305 725	323 604
Conditional grants	36 451	45 040	52 073	57 941	69 436	74 724	80 647

[3] *The Limpopo textbook distribution saga (2012) illustrated, that there is no clarity regarding whether general education and health services constitute ‘own responsibilities’ or ‘delegated responsibilities’, and the system continues to debate the desirability of both.*

Gautrain loan	–	–	4 200	–	–	–	–
Local government	**38 482**	**45 487**	**51 537**	**61 152**	**70 171**	**77 029**	**82 317**
Equitable share[1]	20 676	25 560	23 845	30 559	34 108	37 573	39 960
General fuel levy sharing	–	–	6 800	7 542	8 573	9 040	9 613
Conditional grants	17 806	19 928	20 892	23 051	27 490	30 416	32 743
Total	**488 566**	**581 560**	**690 068**	**743 353**	**808 254**	**865 919**	**925 617**
Percentage shares							
National departments	49.7%	49.7%	50.0%	48.3%	47.0%	47.2%	47.4%
Provinces	42.5%	42.4%	42.5%	43.5%	44.3%	43.9%	43.7%
Local government	7.9%	7.8%	7.5%	8.2%	8.7%	8.9%	8.9%

Source: Budget Review

The current lack of clarity in the assignment of powers and functions of concurrent responsibilities among the three spheres of government may introduce the risk of greater inefficiency and lack of accountability in spending.Furthermore, the inadequate norms and standards that inform subnational expenditure and determine funding needs of provinces and municipalities compound the levels of inefficiency. Rather than seeking a complete reorganisation of assignments to achieve an optimal allocation of spending functions, South Africa should seek instead to clarify spending responsibilities for each level of government. This would be particularly useful in the areas of education and health, which account for the lion's share of regional spending, and where there is also a substantial degree of overlap, as discussed above (for further elaboration of this point see also FFC, 2009, Submission for the 2010-2011 Division of Revenue).

2 Equalisation Transfer Mechanisms Accounting for Sub-Regional Socio-Economic Disparities

Following from the equity principles discussed by Young (1994) an important component in the design of grant systems is accounting for cost differences in the resources required to achieve comparable service levels. These differences arise due to variations in demography, geography and socio-economic disparities among sub-regions. However, determining normative principles of *parity, proportionality and priority* to account for cost disparities in grant formulae from institutional choices remains the biggest challenge. As discussed earlier structural inequality in levels of development is a major determinant of regional disparities.

Even though a country's constitutional and legislative framework may provide a firm foundation for making rule based institutional choices, regional disparities are difficult to prioritise and measure and very few countries attempt to do so in a detailed way. Reschovsky (2007) makes the point that estimating the differences in sub-regional input costs that should be incorporated in a grant model can be controversial and highly political because parochial considerations play a crucial role in determining what sub-regional features, characteristics and indicators are prioritised and taken into account. In the absence of clear normative principles based on institutional choices, any judgments and compromises between competing principles will be perceived as less than objective. Explanations as to how the parameters in grant allocations were estimated would most likely raise suspicions that the weights were chosen based on political and/or parochial considerations.

In many DTEs, the legacy of the structural inequalities inherited from the past inhibits the ability of governments to deliver the concomitant public services. Among the key challenges facing sub-regional governments are disparities in the quality, availability and adequacy of public services across sub-regions. Associated with this challenge is the requirement for government to allocate adequate and equitable levels of grants to sub-regions to eradicate and eliminate the socio-economic disparities that limit their capacity to promote growth and development in the quest to eradicate inequality and poverty.

The inadequate provision of basic services and the lack of physical access to these services seriously handicap disadvantaged communities. In this regard, national government has a responsibility and obligation to ensure that sub-regional governments provide the necessary public services for their citizens in general and, more specifically, for those communities that still suffer the consequences of a legacy of past structural economic disparity.

To more effectively take account of disparities in an equalisation grant several composite cost disparity indices for disadvantage and socio-economic inequality may be constructed from sets of sub-indicators. International best practice shows how other countries have captured the disparity costs in formulae for delivering services to regions with varying degrees of disparities. In Switzerland, e.g. (Dafflon and Toth, 2005; Petchey *et al*, 2004; Reschovsky, 2007), residential location in remote and inaccessible geographical areas is used as a factor to calculate grant subsidies to these sub-regions. The first such sub-indicator may be population dispersion.

Consider, e.g., a geographically large sub-region with a dispersed population. The cost of providing a school or hospital in such remote regions is higher than the cost of providing the same school or hospital in an urban metropolitan area with a predominately city-based population. This is so because, to provide a school or hospital in a remote location, it is also necessary to incur the cost of providing access roads, extending electricity and water systems and other infrastructure. As a result of such 'population dispersion disparity', the *per capita unit* cost of the flow of capital services in such a region may be relatively high. However, Reschovsky (2007) argues that the key problem in estimating the costs of such inputs in the provision of public services is 'identifying which factors are likely to play a role in influencing the costs of services and then determining the quantitative importance of those factors.' (Reschovsky, 2007, p. 404).

A second example of a composite cost disparity measure that may be relevant in some DTEs such as South Africa relates to debilitating diseases. If a sub-region has a relatively high incidence of debilitating diseases such as HIV/Aids ortuberculosis(TB) in its population, then the cost of each unit of health service may be high compared to a sub-region with a relatively lower incidence of such diseases. This is because HIV/Aids and TB require more social infrastructure resources to manage services.

Another example is that the cost of achieving given educational and health outcomes for people from poor families may be higher than the cost of achieving the same educational or health outcomes for people from richer backgrounds. Sub-regions with more poor people (unemployed, lower incomes) and victims of past socio-economic discrimination might, therefore, be expected to incur higher costs in achieving given health and educational outcomes. Thus, some aggregated measure of socio-economic inequality and debilitating disease sub-indicators may be included in a composite cost disparity index.

Australia is an example where the equalisation grants formula attempts to incorporate needs and disparity factors (called disabilities) in a sophisticated way to determine the horizontal allocation of grants among states. Petchey*et al* (2000) developed a model demonstrating how to capture differences within fiscal equalisation formulae in capital costs across Australian states.

Despite the challenges and difficulties of doing so, there is general agreement amongst public finance practitioners that, in principle, differences in fiscal requirements ought to be included in equalisation grants targeting disadvantaged communities. This is especially true in systems where sub-regions have little revenue-raising capacity of their own. More particularly, taking account of disparity cost indicators would ensure compliance with the equity rules of parity, proportionality and priority in allocation formulae.

Some perspectives on the inclusion of disparity cost indicators for ensuring parity, proportionality and priority in grant allocations are illustrated in the IGFR formulae used in South Africa. Particular attention is focused on how disparity indicators can be used for prioritising the persons with the greatest need because such claimants have been the victims of established structural disparities, and are therefore entitled to a first claim on the goods or services provided by the state.

2.1 Accounting for Disparities in South Africa's IGFR System

The equitable division of national revenue at the heart of cooperative IGFR financial arrangements in South Africa is determined in Chapter 13 of the Constitution and prescribed in Sections 214 (1) and (2). Section 214 (2) (g) in particular specifies that *"economic disparities*[4]*within and among the provinces"* be taken into account before equitable allocations

[4]*Disparities refer to the great socio-economic, demographic and geo-spatial inequalities that differentiate regions from each*

are made to sub-regional government (The Constitution, 1996). The provincial demographic context within which this system operates is characterized by variations that have their roots in the apartheid past where communities were located according to race.

South Africa is made up of many different population groups, languages and cultures. In 2011, the statistics agency, Statistics South Africa (StatsSA), estimated that South Africa's population was 50 586 757 people. Of this total Africans[5] are in the majority at 40 206 275 or 79.5%. The white population is 4 565 825 (9.0%), the coloured population, 4 539 790 (9.0%) and, the Indian/Asian population at 1 274 867 (2.5%). Of the total population females make up 52% and males 48%.Table 5 gives the figures of population by province, where it can be seen that there are glaring inequalities among provinces. In this context addressing the constitutionally mandated basic services (CMBS) using the system of cooperative IGFR system as described earlier is indeed a daunting task. Some of the more recent trends in this regard are discussed in the next few paragraphs.

Table 5: Population by Province

Eastern Cape	6,562,053	12.70%
Free State	2,745,590	5.30%
Gauteng	12,272,263	23.70%
KwaZulu-Natal	10,267,300	19.80%
Limpopo	5,404,868	10.40%
Mpumalanga	4,039,939	7.80%
North West	3,509,953	6.80%
Northern Cape	1,145,861	2.20%
Western Cape	5,822,734	11.20%
Total	51,770,560	100.00%

Source: Statistics South Africa (2012), Census 2011

2.1.1 Expenditure Allocation Trends Accounting for Disparities

Notwithstanding the relatively high levels of public expenditure,there remaines wide socio-economic disparities and variations in economic performance among provinces and local municipalities. It is common knowledge that socio-economic disparities among different geographic regions in South Africa have their origins in the apartheid past. For example policies promoted the exploitation of natural resource endowments located in varying degrees of abundance across all provinces. About 40 percent of GDP is produced in the Gauteng Province alone, while minimal commercial activity and poor infrastructure characterized the former apartheid-created tribal reservations or Bantustans. Many of these Bantustans were located in the provinces of the Eastern Cape, KwaZulu-Natal, Mpumalanga, Limpopo and the North West

other. In the Australian IGFR grant system they are called disabilities.

[5]*Population race groups are defined in terms of the labour and employment legislation and referred to as designated groups.*

Province. Government pronouncements indicate that the envisaged new infrastructure investments will be targeted to unlock and realize the economic potential in these mineral resource rich areas.

In the 2012/13 to 2014/15 medium term expenditure framework (MTEF) government has projected to increase infrastructure spending to over R845 billion as part of an infrastructure investment drive towards rapid economic growth and sustainable employment creation (Hon. Pravin Gordhan, Minister of Finance, 2012 Budget Speech, 22 February, 2012). Of the budgeted R845 billion about R300 billion is earmarked for energy related infrastructure projects and, R262 billion for transport and logistics. In the past the economic growth in South Africa was characterized as "jobless growth" as it has not had the desired positive impact on unemployment, poverty and inequality in the provinces and within municipal boundaries. Twenty years into democracy addressing the historical socio-economic disparities within and between provinces and municipalities remains the greatest challenge facing the government of South Africa. Underpinning this challenge is the high rate of unemployment, poverty and income and wealth inequality in the South African economy.

Trends in unemployment and income inequality show that the African majority is most affected, and the highest rates of unemployment and inequality can be seen in the provinces with large rural populations. (See Appendix 1, tablesA3, A4, A5, and A6). In July 2014 Statistics South Africa's *Quarterly Labour Force Survey* (StatsSA, 2014) reported that the total narrowly defined unemployment rate for South Africa was 25.5% while the rate for the expanded definition of unemployment was 35.6%. The expanded definition of unemployment covers all unemployed and discouraged job seekers who had given up looking for work in the past four weeks before the survey interview because of reasons related to disillusionment, the costs of traveling, the absence of transport and personal circumstances. The demographic and provincial profiles of the unemployed (See Appendix 1, table A3) underscore the regional and racial nature of the spread of socio-economic disparity in South Africa.

In addition to unemployment the socio-economic disparities of poverty and income inequality by race group and sub-region further exacerbate the differences within and between provinces and municipalities. The Income and Expenditure Surveys (IES) (See Appendix 1, table A4)conducted by StatsSA between 1995 and 2008 indicate a significant decline in the percentage of the population in provinces living below R283 per month. However, the data also serves to show the difference in the distribution of poor people between the richer urbanized provinces such as Gauteng and the Western Cape and the other poorer rural provinces. For example while the Eastern Cape saw a massive decrease in poor people from 50% to 29% it was still much higher than the percentage in Gauteng that remained relatively constant at 7% to 6% and, the Western Cape that fluctuated between 9% and 10%. It is important to note that most of the people living in these poorer rural provinces are African. Consequently, it is not difficult to see why income inequality indicators from a study by Leibbrandt *et al* (2008)show that per capita income inequality as represented by the Gini coefficient for the African population rose from 0.54 in 1993 to 0.60 in 2000 and, to 0.62 in 2008 (See Appendix 1, tablesA5and A6). The Leibbrandt *et al* (2008) study showed that overall South Africa remained one of the most unequal economies in the world with the Gini coefficient increasing from 0.66 in 1993 to 0.68

in 2000 and, to 0.70 in 2008.

It is within the context of the past history and the current political economy the paper assesses how the country's cooperative intergovernmental fiscal relations system takes account of disparities.

South Africa's transfer system is based on three main pillars as follows:

- General-purpose grants (subsidy transfers) that aim to help equalise resources across provinces and municipalities. They are rules-based and depend on variables such as provincial GDP, student-teacher ratios, number of civil servants, and population density, etc.
- Specific purpose grants are earmarked transfers allocated on an ad-hoc basis.
- Phasing in arrangements ensure that there is no abrupt disruption to service delivery from changes in sharing arrangements.

Once the vertical split has been determined, the amounts are shared horizontally for provinces and municipalities using the relevant formulae. The provincial equitable allocation (PEA) is made up of the unconditional equitable share (ES) and any other conditional grants and specific purpose grants (SPG) from the national equitable allocation (NEA). The local government equitable allocation (LEA) consists of the unconditional local government equitable share (LES) for operational functions; the municipal infrastructure grant (MIG) for municipal infrastructure and, a capacity building (CB) grant for institutional support.

The provincial equitable share (PES) [6] is an unconditional allocation to provinces that distributes the grants among the nine provinces based on demographic and economic profile, while at the same time addressing vertical and horizontal imbalances as shown in appendix 2. The current design and structure of the formula was initially proposed by the FFC in 1996[7]. Its design and application has critical implications for the delivery of social services and other functions allocated to provinces. While it accepted the principles as per the FFC's recommendations on the nature of the formula, Government opted for a formula that is less driven by inputs, but is rather a proportional approach driven by need, approximated primarily by the demographic and economic profile of provinces.

Over the years since inception, the IGFR formulae have been subjected to several reviews in response to the evolving nature of the intergovernmental fiscal system. The most notable reviews include the costed norms approach by the FFC in 2000 and the review done by the Budget Council in 2004, which resulted in the removal of the backlog and the social development components following the devolution of the social security function to the South African Social Security Agency (SASSA). These were replaced by the poverty component and a separate conditional grant to deal with infrastructure backlogs. Other minor reviews include updating of data resulting from exogenous policies (outside the fiscal framework), such as the re-demarcation of provincial boundaries. In all these instances, issues were raised by key

[6] *See Appendix 2 for the formulae used for revenue allocation.*

[7] *See Framework Document for Intergovernmental Fiscal Relations (IGFR) in South Africa, 1996.*

stakeholders with respect to what the formula can achieve against the criteria that the horizontal division of revenue must satisfy, as outlined in section 214(2) a-j of the Constitution. In table 1 above, listed in column five, macroeconomic issues and other considerations are taken into account in the South African government's IGFR formula for equitable allocations to provincial and local governments. Among these considerations, prominence is given to provincial and municipal fiscal capacity, efficiency and economic disparities.

Apart from equitable shares, there are also conditional grants flowing to provinces and municipalities. Conditional grants supplement programmes that are partly funded by provinces themselves, e.g., housing, health, etc. (schedule 4) or are specific, e.g., Gauteng Rapid Rail Link Grant (schedule 5). These are meant to speed up national priority programmes that are aimed at achieving basic social rights. For instance, priority is placed on HIV and Aids programmes, national schools nutrition programmes, and infrastructure backlog alleviation.

The tables in appendix 1 give further important information on conditional grants and spending, and shows the effects of conditional grants on different regions and on the whole economy and the likely impacts of tax revenue on the economy. Taken together, the information contained in the tables show that specific purpose grants comprise many different earmarked grants, allocated on an ad-hoc and negotiated basis. They have been frequently used as a response to emergencies, such as droughts or hosting of 2010 FIFA World Cup. Their increasing share reflects a shift towards specific purpose grants as opposed to unconditional discretionary allocations. However, by their nature, these grants make the transfer system less transparent and more difficult to monitor, as the centre lacks the ability to track actual spending (table A2), and they undermine the rules-based character of the transfer system.

Conditional or ad hoc tied grants are a challenge in most developed and developing IGFR systems because sub-regional expenditure responsibilities are not clearly defined. The lack of clear expenditure responsibilities has resulted in a proliferation of conditional grants in recent times. This has been a matter of concern for the FFC. For example the FFC has highlighted some of the problems arising from the assignment of concurrent functions for the delivery of housing among the three spheres of government and the resultant confusion and paralysis in the delivery of this constitutional mandate. However, in South Africa, problems cannot only be attributed to the choice between using conditional grants as opposed to using the equitable share formula. As in many other countries conditional and ad hoc grants are often driven by decisions aimed at achieving advantages for political gain. This is often referred to as "pork barrelling". In South Africa where redistribution is the key driver of the IGFR system, conditional and specific purpose grants have been an important instrument in the provision of constitutionally mandated basic services.

To overcome the problems associated with allocations of conditional and specific purpose grants it may be worth considering the Australian equalization approach that incorporates the effects of these grants on sub-regional fiscal capacities. Applying this principle will in fact take account of provincial fiscal capacities as required in the Section 214 of the Constitution. An impression has been created that infrastructure should be primarily funded through conditional grants. This also implies that the equitable share is only meant to fund operational expenditure. In addition, allocation is based on formulae for which either reliable information does not exist for many provinces, or for which there is no clear definition, like education quality and health spending efficiency. A case to be made is that the allocation of these funds should be reformed so that it is more closely related to need and quality of spending. More effort needs also to be made to assess the use of conditional transfers based on outcomes data and information from the Department of Performance Monitoring and Evaluation's output based approach.

The remaining conditional grants particularly for municipalities have mostly an equalisation purpose seeking to improve services in the poorest municipalities. For instance, to address infrastructure gaps in an effort to reduce poverty and promote regional development and finances (basic infrastructure projects in municipalities, such as potable water, sewers, drainage, urban renewal,etc.). A possible drawback is that its distribution does not take into account regional externalities and spill-over effects. Specific examples of externalities and spill-over effects are infrastructure projects such as roads, electricity distribution facilities, primary health centres, etc. that are financed by one municipality but may benefit the ratepayers of surrounding or adjacent municipalities. The Municipal Infrastructure Grant (MIG) formula is a typical case in point. About 90% of municipal grant transfers are allocated to municipalities on a project basis. While in principle, it is highly desirable that the provision of municipal goods and services is administered at the local level, where needs are, many of these goods have regional externalities and would be more suitably managed at the regional District Municipality level.

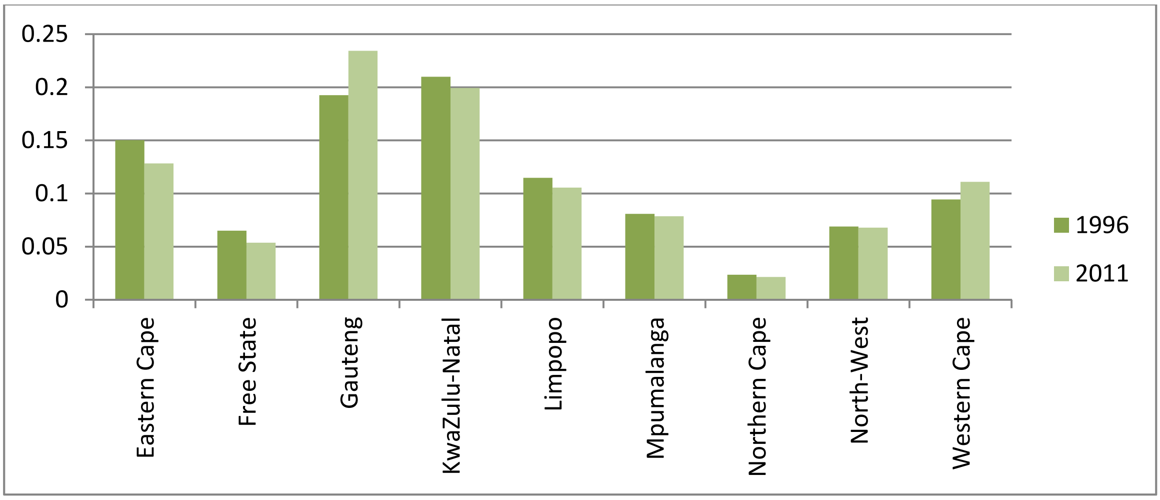
2.2 Equity and Efficiency Effects of Accounting for disparities in allocations

Given the constitutional requirement that nationally collected revenues must be equitably shared amongst the three spheres of government, this section assesses the equity and efficiency effects of the allocations as a function of the criteria discussed above. Theequitable shares, and grants from the National share are the most important source of revenues for provinces whereas local governments have the possibility of raising significantly higher own revenues, and benefiting from grants from the national share.In summary Section 214(2) (b) (a-j) of the Constitution requires that the division of resources must take account of:

- The national interest and Government's priorities
- The provision of basic services and meeting developmental needs
- Fiscal capacity and efficiency of each sphere of government
- Socio-economic disparities
- The desirability of stable and predictable allocations
- Flexibility in responding to emergencies or other transitional needs.

Given these considerations what has been the impact of IGFR fiscal transfers and revenue sharing arrangements on efficiency and equity over the immediate past? The point of departure for the impact of fiscal transfers in exploratory data analysis is the year 2012 that saw the release of the 2011 Census by Statistics South Africa. After correcting for an estimated undercount of 14.6%, the census estimated that the population was at 51.8 million. In several respects the results of the census were not as expected, and may well significantly impact on intergovernmental transfers. There were significant relative gains in population by Gauteng and Western Cape with smaller gains or stability in Mpumalanga and North West (figure 3). Loss of relative population share was experienced in Eastern Cape, Northern Cape, Free State and Limpopo.

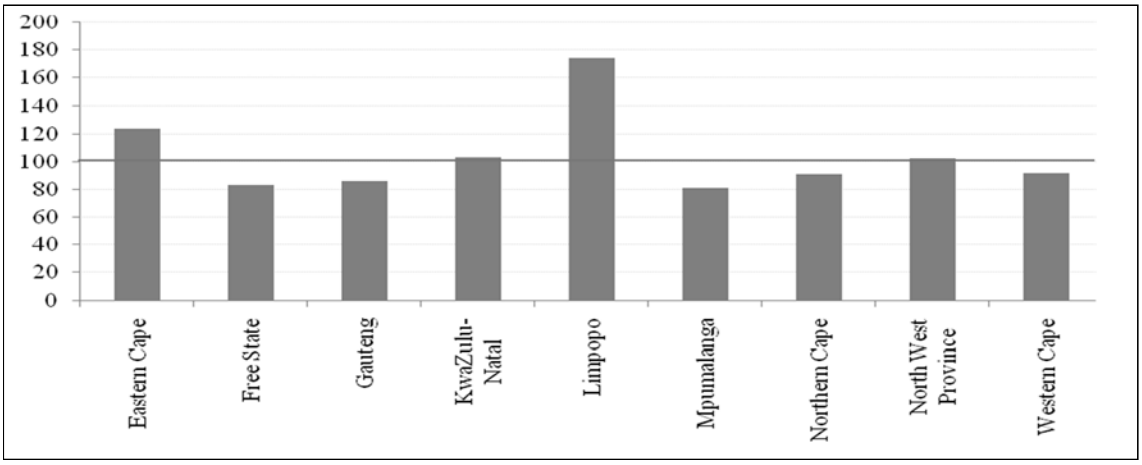
Figure 3: Shifts in distribution of population among provinces



Source: Own computations based on Statistics South Africa, 2012

To understand the potential impacts of intergovernmental equitable share allocations to provinces,figure 4 presents the differencesin revenues contributed by provinces against national government allocations to all provinces. Provinces are deemed to have received a net transfer when their contributions to nationally collected revenues are lower than their equitable share allocations received from national government.Limpopo and the Eastern Capeprovinces receive the greatest net equitable share transfers from the national government. For every R100 collected in these provinces national government spends R174 and R124 respectively. To a lesser degree KwaZulu-Natal and North West provincesalso receive net transfers from the national government that represent R103 and R102 respectively for every R100 collected. By contrast, national government allocations are less than the collected revenues in Mpumalanga, Free State, and Gauteng where spending isrespectively R81, R83, and R86 for every R100 collected. This is also true for theNorthern Cape and Western Capeprovinces where allocations are R91 and R92 for every R100 collected.

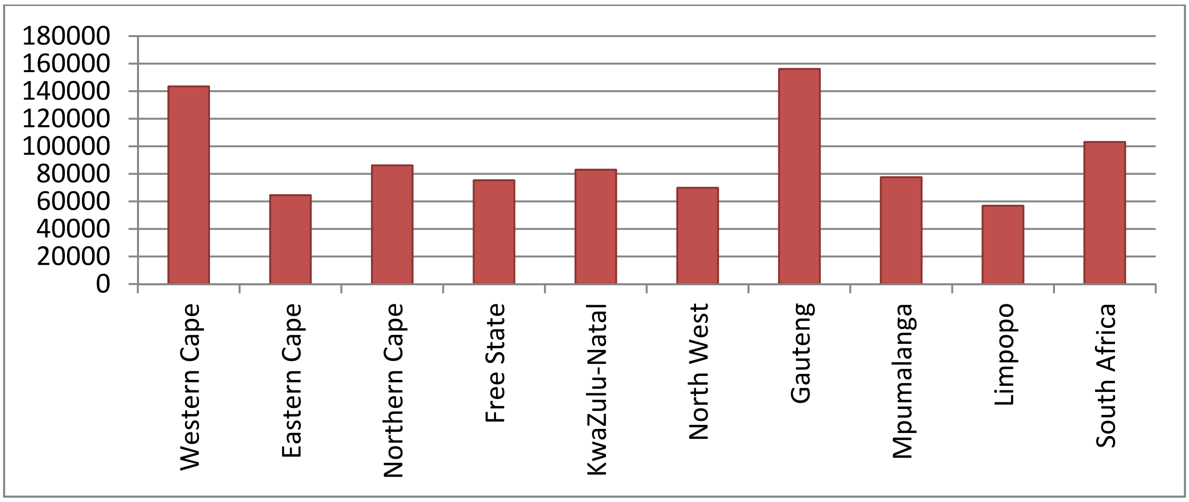
Figure 4: National government spending to income ratio by province (%)



Source: Own computations from Regional Social Accounting Matrices for 2006.

Figure 5 shows differentials in household income by province. There are certainly very high differentials in household income suggesting that disparities are still a major issue, despite the substantial transfers to provinces and municipalities and expenditure on public services.

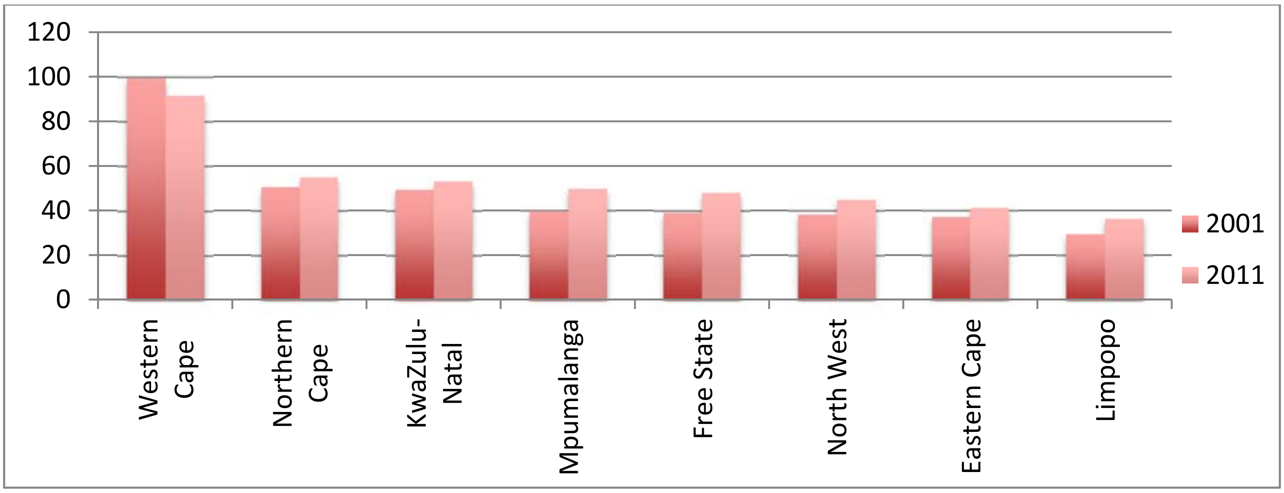
Figure 5: Disparities in household income by province



Source: Own computations based on Statistics South Africa (2012)

To get a sense of how household income disparities across provinces have been trending, we compute average household income by province for 2001 and 2011 as a proportion of average household income in Gauteng. The results are shown in figure 6. They show that household income disparities though high by province, are actually reducing, albeit slowly. The reason for the reduction could be migration.

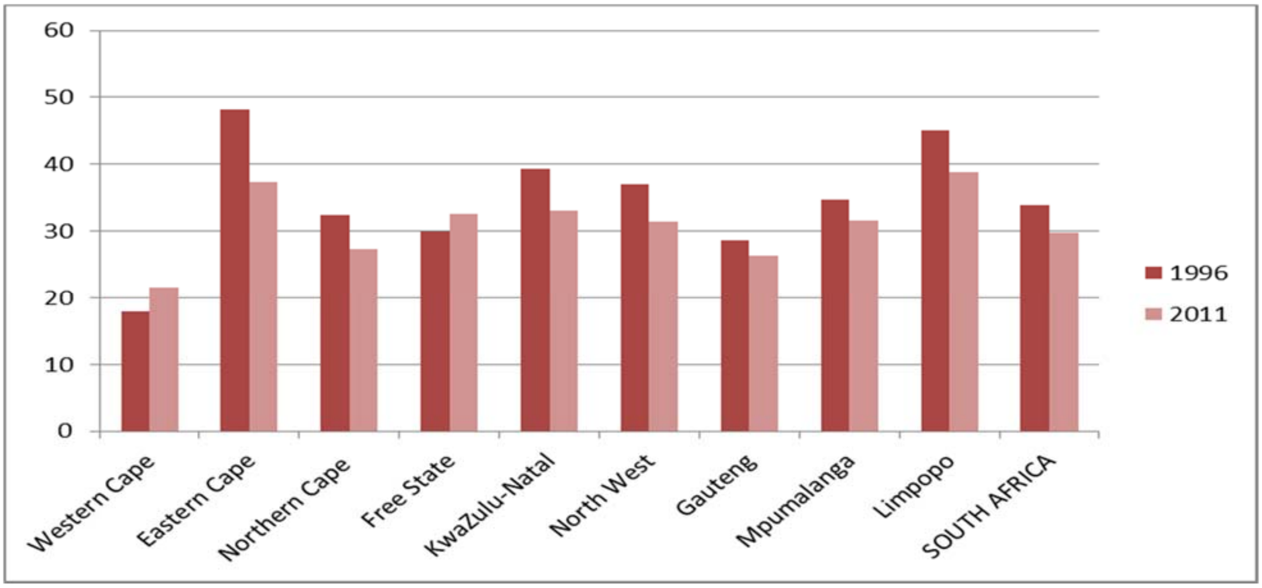
Figure 6: Shifts in average household income over time, among provinces as a percentage of Gauteng household income



Source: Own computations based on Statistics South Africa (2012)

Similarly, unemployment is dropping in all provinces except the Free State and Western Cape. However, it remains stubbornly high in absolute terms (figure 7), consistently above 20% in all provinces in 2011.

Figure 7: Official unemployment rates by province



Source: Own computations based on Statistics South Africa

Summing up on equity and efficiency impacts of transfers, overall, the distribution of transfers has remained relatively regressive, with the richer provinces receiving larger shares of the transfers than the poorer ones, although less so over time. The provision of services also varies significantly across the country because of several factors such as an inadequate accounting for disparities, differences in fiscal, institutional and human resource capacity among provinces. Not surprisingly, the largest per capita expenditure levels are recorded in those provinces, which enjoy the strongest revenue performance and highest implementation. This analysis suggests there are large economic disparities between provinces, for instance differences in sub-national GDP per capita and unemployment across provinces are quite large. Moreover, disparities are substantial across average household income[8]. Policies aimed at improving human capital in disadvantaged regions not only make sense from an equity perspective in such a situation, but also from an efficiency perspective. The key drivers of growth vary according to a region's level of development, but education and training, above all, are critical for the growth of all regions (OECD, 2012).

3 Recommendations for Reform and Conclusions

3.1 Recommendations

To effectively address the main weaknesses of the present system of IGFR, and to share in the benefits of sustained growth, a comprehensive and integrated approach is necessary. This is especially the case because some of the critical reforms will inevitably affectricher provinces in an adverse manner, necessitating adequate compensation if sufficient political support to their implementation is to be secured. It is clear that any reform to the IGFR system in general must take account of all the considerations listed in Section 214 (2) a-j of the Constitution. In a general sense, this implies reforming and refining the current system so as to balance the progressive provision of basic services (The Bill of Rights) to address socio-economic and regional disparities against national macro- and microeconomic constraints. Figure 1illustratesschematically (see box 5) the possibility of modeling the macro- and microeconomic impacts of accounting for disparities in South Africa's IGFR system. In this regard, **firstly**, it is strongly recommended that Government consider developing an integrated framework and model that will inform the allocations of equitable shares in such a way that balances the provision of CMBS against the macro and microeconomic constraints. If, within such a framework, allocations are made according to the principles of parity, proportionality with consistency, and priority, Government will make considerable progress towards the progressive realization of basic services within available resources.

Effective and efficient sources of revenue will ensure there is an adequate source of nationally collected revenues available for redistribution. **Secondly**, therefore this paper recommends that government take the opportunity of the newly established Davis Tax Commission to explore a range of taxes currently not in the system but may be viable for generating more revenue for equitable sharing to provide for CMBS. In the interim, however, Government should consider efficiency improvements to the equalisation properties of its revenue sharing transfers so they follow simple and more equalising criterion, such as population or income per capita. Furthermore, based on international experience it may be appropriate to separate redistribution from tax raising incentives for the sake of transparency and simplicity

[8]*This is especially so in terms of African and coloured populations, whom are characterised by worse health and education outcomes (NDP, 2012)*

(Blöchliger *et al*, 2007). Key principles are that transfers are based on clear distribution rules (Young, 1994) and on simple and hard to influence criteria, such as GDP per capita, and that marginal equalisation tax rates are not excessively high. A too high equalisation tax (the rate at which additional own tax revenue is equalised away) can reduce a jurisdiction's effort to develop its economic and fiscal base and can also slow down regional convergence within a country (Blöchliger *et al*, 2007).

Successfully reforming South Africa's intergovernmental fiscal system will require a consistent and well-coordinated package of measures and substantial political will, given the complexity of the current system and vested interests. Reforming the current revenue sharing system may also be politically difficult, given that it was recently reformed and this required substantial negotiation. **Thirdly**, from this perspective the paper recommends that frequent changes to formula be limited to ensure stable and predictable sub-national governments' budget planning. This suggests that reform of this type would be a medium- to long-term project. Anypossible economy wide implications of reforms can therefore be tested using the economy wide framework and model proposed in the first recommendation.

In terms of the provision of CMBS, poor provinces have generally fallen short of spending targets in key areas with a strong link to poverty reduction. The result is that the outcomes of these service categories are also dismal. Analysis shows that poor provinces paid less attention to the delivery of key services related to housing, electricity and sanitation. This analysis also suggests that the poorest provinces grapple with (skilled) staff attraction and retention. The key problem seems to be that staffing is not sufficiently prioritised in sub-regional spending decisions. This in turn jeopardises the effectiveness of spending on key poverty reduction programmes.Given this disjuncture the paper **fourthly** recommends that the cooperative foundations governing South Africa's IGFR system should inform intergovernmental fiscal reformswith particular focus on the following:

- **A redefinition of sub-regional spending responsibilities.** As indicated in the previous sections, the very high degree of decentralisation of spending in South Africa is more the result of historical developments—in particular the drafting of the Constitution—than of a well thought-out decision, reflecting prevailing conditions and comparative advantages of each level of government in carrying out different spending functions. Specifically, a re-definition of spending responsibilities could be warranted along lines that led to a centralisation of redistributive justice in social security, since—as demonstrated by prevailing practice in other countries—the pooling of risks related to old age, disability, and unemployment is more efficiently carried out at the national than at sub-national levels.
- **The creation of enhanced own-revenue sources for sub-regional governments.** The granting of more significant own-revenue-raising powers to the provinces and localities would be desirable not only from an efficiency standpoint (to strengthen fiscal responsibility at the sub-national level) but also to compensate the richer provinces that would lose from a more equalisation-based system of transfers. Increased own-revenue generating capacities could be achieved, for instance, by allowing provinces to levy, with limits, a surcharge on the fast-growing personal income tax, or by shifting to them the

power to levy domestic excises. While property taxes are already assigned to the local governments, increased freedom in setting their rates—as well as improved property valuation methods—could also boost this source of revenue, especially for the more urban and prosperous localities. Over time, the growth of more efficient own-revenue sources for local governments would also facilitate a desirable replacement of the Regional Services Council(RSC) levy with the local business tax.

- **A redesign of the transfers system.** In order to enable it to better address regional inequalities, this would likely involve an increase of the general-purpose transfers, which have equalisation objectives. A review of the existing special-purpose grants should also be undertaken, with the aims of limiting their use to the support only of priority programs, and increasing transparency in their allocation and utilisation. The re-design of the transfer system should also aim at ensuring better vertical balance across different levels of government, taking into account the re-defined spending responsibilities, as well as revenue reforms.
- **Better programming of the provision of CMBS.** Sincepoor provinces have generally fallen short of spending targets for CMBS in key areas (electricity, water and sanitation), it is imperative that programmes be more focused and targeted to these key areas. In addition, local governments need to invest heavily in attracting skilled staff as well as retaining it.
- **Enhance capacity building at the local and provincial level.** Consider more targeted training programmes for staff responsible for implementing the country's cooperative IGFR system
- **Defining fiscal policy allocation rules.** Based on the general allocation rule presented in section 1 of this paper it is imperative that policy makers and officials clearly define the normative allocation rules within available resources to ensure the provision of CMBS according to the principles of parity, proportionality with consistency, and priority.
- **Debt and borrowing.** Give serious consideration to a review of the debt and borrowing powers of sub-regional governments as a way to supplement the capital expenditure resources available for the provision of infrastructure related CMBS in particular.

3.2 Conclusion

Among the most important challenges faced by South Africa are its high levels of unemployment, poverty and inequality. South Africa has made remarkable progress in reducing poverty and inequality over the past twenty years. However, poverty and inequality remain high by international comparison. South Africa's regional disparities are also high. Differences in sub-national GDP per capita, are high and have shown a tendency to increase over time (see Mabugu *et al,* 2011). From the discussion in the preceding sections of the paper it is clear that unemployment, poverty and inequality define the socio-economic and spatial disparities that differentiate communities and sub-regions from each other. Effectively and efficiently using the system of cooperative IGFR for achieving redistributive justice will accelerate the provision of CMBS and strengthen the country's fiscal decentralisation system in keeping with the constitutional requirements for taking account of disparities, fiscal capacity and efficiency to make it more effective and responsive to the public services needs of citizens regardless of their region of residence. In this regard if schools or health services in poor regions are of poor quality, cash transfersto the poor alone will not be effective in reducing poverty.From the above analysis it is clear that the poorest provinces may not have the capacity to deliver on their mandates.

A similar scenario is likely for employment creation in general and large and small industries (agriculture, manufacturing and services) in particular given, for example, the instability and unpredictability of electricity and water supply to many sub-regions because of low levels of infrastructure investment in these services. Another example is in the unequal access to health services in the most disadvantaged provinces. For an effective functioning of health systems in general, and disease prevention in households in particular, it is important for the poor provinces to pay attention to the provision of this CMBS.Furthermore, the role of water and sanitation in the building of health human capital is important and thusthe low share of expenditure on this component for Limpopo is a concern. In addition,due to the significant proportion of household spending that the poor often devote to housing, one may conclude that these key services are not prioritised in spending decisions of poor provinces.

Following from the recommendations reforms to the cooperative IGFR system in South Africa must take account of the CMBS as prescribed in the Constitution to attain the goal of redistributive justice. In this regard the most important questions relate to the way in which the size of the grants should be fixed and questions concerned with their economic and welfare consequences. Of course, periodic monitoring and evaluation of the system is critical to improve the system over time.

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APPENDIX 1: ANCILLARY DATA

Table A1: Public Sector Infrastructure Expenditure and Estimates by Sector

R million	2010/11 Revised estimate	2011/12	2012/13	2013/14	MTEF Total	% of total
		Medium-term estimates				
Economic Services	**228 657**	**216 181**	**219 380**	**228 507**	**664 067**	**82.1%**
Energy	102 782	96 500	98 140	96 769	291 409	36.0%
Water and sanitation	20 990	26 836	25 367	28 196	80 400	9.9%
Transport and logistics	80 530	67 452	69 096	75 554	212 102	26.2%
Other economic services[1]	24 356	25 393	26 777	27 987	80 157	9.9%
Social services	**26 249**	**29 519**	**34 932**	**44 268**	**108 719**	**13.4%**
Health	8 546	10 256	15 114	20 624	45 993	5.7%
Education	6 757	9 155	10 092	11 487	30 735	3.8%
Community facilities	6 045	6 360	5 873	7 952	20 185	2.5%
Other social services[2]	4 902	3 749	3 853	4 205	11 806	1.5%
Justice and protection services[3]	**3 100**	**3 322**	**7 080**	**10 171**	**20 573**	**2.5%**
Central government administrative and financial services	**2 104**	**3 827**	**7 946**	**3 474**	**15 248**	**1.9%**
Total	**260 109**	**252 850**	**269 337**	**286 420**	**808 608**	**100.0%**
Percentage of GDP	9.8%	8.7%	8.4%	8.1%		
Gross domestic product	2 666 894	2 914 862	3 201 299	3 536 002		

Source: In Josie 2011, Adapted from Budget Review, 2011

1. Other economic services include agriculture, environmental infrastructure, telecommunications, housing and industrial development zones.
2. Other social services include labour centres, heritage institutions and national libraries.
3. Other justice and protection services includes the Legal Aid Board and private security industry regulatory authorities.

Table A2: Major State Owned Entities' Capital Expenditure

	2009/10	2010/11		2011/12	2012/13	2013/14	2014/15
R billion	**Outcome**	**Budget**	**Revised**	**Medium-term estimate**			
Capital expenditure	**88.6**	**149.5**	**136.2**	**136.5**	**122.7**	**104.3**	**123.9**
Eskom	48.4	96.3	86.8	93.7	85.2	67.0	88.9
Transnet	18.4	19.4	22.8	21.9	17.1	16.2	15.2
Central Energy Fund	1.4	5.8	6.8	4.3	8.2	10.1	5.5
South African National Roads Agency Limited	11.6	13.5	8.4	2.6	2.0	1.5	1.5
Trans-Caledon Tunnel Authority	0.4	7.1	5.0	9.0	4.8	4.8	2.9
Airports Company of South Africa Limited	5.2	1.6	1.3	0.8	1.1	–	–

Source: In Josie 2011, Adapted from Budget Review, 2011

Table A3: South Africa Unemployment Rate by Population Group and Province April/June 2013 – April/June 2014[9]

Category	Apr-June 2013	Jul-Sept 2013	Oct-Dec 2013	Jan-March 2014	Apr-June 2014
Population group					
African	28.6	27.5	27.1	28.5	28.3
Coloured	25.3	24.5	23.0	23.5	25.3
Indian/Asian	12.9	11.5	12.5	12.4	12.1
White	6.0	6.7	7.2	6.6	8.1
Province	*Narrow/Broad Definitions of Unemployment*				
Eastern Cape	30.2/44.7	30.4/44.2	27.8/43.3	29.4/44.2	30.4/44.4
Free State	32.8/39.0	33.7/40.8	33.0/40.9	34.7/41.5	35.0/41.2
Gauteng	24.9/30.0	24.3/29.1	25.2/28.9	25.8/29.8	24.6/29.0
KwaZulu-Natal	22.2/39.3	20.6/37.2	19.9/36.2	20.7/37.4	23.7/39.7
Limpopo	17.8/41.8	17.2/38.9	16.9/36.1	18.4/39.2	15.9/36.9
Mpumalanga	29.0/41.8	26.5/40.2	27.2/40.2	30.4/41.9	29.5/42.2
Northern Cape	29.5/36.3	27.9/35.9	24.9/34.8	29.0/39.8	32.3/41.7
North West	26.7/43.2	26.5/42.6	27.3/42.2	27.7/42.6	26.0/42.3
Western Cape	23.6/26.2	23.1/25.3	21.0/22.1	20.9/22.6	23.5/25.4
TOTAL	25.3/36.1	24.5/34.9	24.1/34.0	25.2/35.1	25.5/35.6

Source: Statistics South Africa, Quarterly Labour Force Survey, Quarter 4 2013, Quarter 1 2014, Quarter 2 2014

[9] *Unemployment data is for the working age population between 15 to 64 years actively seeking work and, Statistics SA method provides a narrow and expanded definition for unemployment for the survey. Narrowly, unemployment is defined for the survey period as 1) the unemployed during the survey week; 2) work seekers; 3) those available for work and, 4) those not actively seeking work for the past four weeks. The expanded definition covers unemployed and discouraged work seekers who, for various reasons have given up looking for work in the four weeks before the interview. The unemployment rate for the expanded definition for provinces is given as the second number in the cells in Table A3.*

Table A4: Percentage Population by Province Living below a R283 Month Poverty Line (constant 2008 Rand) – Statistics SA Income & Expenditure Surveys (IES)

Province	1995 IES (%)	2005 IES (%)	2008 IES (%)	2012 (%)[10]
Eastern Cape	50	29	29	35.7
Free State	45	16	16	24.6
Gauteng	7	7	6	10.1
KwaZulu-Natal	31	33	33	33.0
Limpopo	41	34	34	48.5
Mpumalanga	34	28	28	32.1
Northern Cape	40	28	27	26.3
North West	34	24	23	26.0
Western Cape	9	10	9	9.0
Total	**31**	**23**	**22**	**26.3**

Source: Adapted from Development Indicator, 2009, The Presidency, Government of South Africa

Table A5: Gini Coefficients per Capita Income by Race and Urban/Rural

Population	1993	2000	2008
African	0.54	0.60	0.62
Coloured	0.44	0.53	0.54
Asian/Indian	0.47	0.51	-
White	0.43	0.47	0.50
Rural	0.58	0.62	0.56
Urban	0.61	0.64	0.67
Overall	**0.66**	**0.68**	**0.70**

[10] *The new poverty line of R305 is used at 2011 constant Rand prices. The R305 food poverty line refers to the amount of money that an individual will need to consume the required energy intake. Based on the StatsSA's data for 2009 based on Living conditions survey 2007/08.Hence, this last column should not be directly compared to the other three.*

Source: Adapted from Murray Leibbrandt et al, 2009.

Table A6: Income Inequality and Poverty Scorecard

TransformationGoal	**Reduced income poverty and inequality**				
Desired outcome	**Indicator**	**Status 1990–1994**	**Status 2007**	**Status 2008**	**Status 2009**
Reducing income poverty	*Percentage of the population below the poverty line*	50.3%	45.5%	43.1%	41.6%
Creating wealth	*Percentage of the population above an 'affluence' line*	9.2%	9.6%	10.5%	10.4%
Reducing inequality	*African per capita income as a percentage of white per capita income*	10.2%	13.0%	12.9%	15.4%
	Earnings of female formal sector workers as a percentage of those of males	74.8%	86.1% (2006)	83.7% (2007)	80.9% (2008)
	Gini coefficient for overall SA population	0.67	0.68	0.68	0.66
	Gini coefficient for black population.	0.55	0.62	0.59	0.59

Source: Adapted from Murray Leibbrandt et al, 2009.

APPENDIX 2: ALLOCATION FOMULAS

Allocations in the formula are driven by a policy-weighted series of different population components and other factors and, can be written as:

$$PES = 0.5E_{p(\text{school age, enrolment ratio})} + 0.26H_{p(\text{proportion without medical aid})} + 0.14B_{p(\text{share of national population})} + Pov_{p(\text{provinces share of poor})} + 0.01EO_{(\text{share of total employee remuneration})} + 0.05Ins$$

Where:

- ***p*** represents population.
- ***E***is the education component determined by the population of school age (6-17 years) and the enrollment ratio.
- ***H***is the health component determined by the proportion of population without medical aid.
- ***B*** is a basic allocation for all provinces based on each province's share of the national population.
- ***Pov***represents each province's share of the national poor population defined as those who have incomes in quintiles 1 and 2 in the *Income and Expenditure Surveys(IES)*.
- ***EO*** represents a province's economic output given as its share of total employee remuneration.
- ***Ins*** is the institutional component and is weighted equally for all provinces.

The policy weights for each component is assigned following consultation between national and provincial government policy-makers in various IGFR fora [See *Department of Provincial and Local Government (DPLG), Practitioner's Guide to the IGR System in South Africa: 2007*][11].

The local government equitable allocation (LEA) is determined on the basis of a formula (*DPLG: 2007*) and can be written as:
LEA = LES + MIG + CB

Where

- ***LEA*** is the local government equitable allocation.
- ***LES*** is the local government equitable share grant to fund municipal operations.
- ***MIG*** is a municipal infrastructure grant
- ***CB***is capacity building grant for supporting institutional development in municipalities with little or no revenue raising capacity to fund institutional development.

The ***LES*** prior to 2013 was defined as:
$LES = BS + D + I + R \pm C$

Where:

- ***BS***is a component for the provision of basic services such as water, refuse removal, sanitation, electricity and environmental health care and, free basic services to poor households earning less than R800 per month (in 2007),

[11]*The DPLG was subsequently renamed Cooperative Governance and Traditional Affairs (COGTA).*

- ***D*** represents a component for the development needs of municipalities and was set at zero on the recommendation of the FFC (2007/08) to avoid the risk of perverse incentives,
- ***I*** is an institutional support component to assist poor municipalities without revenue raising capacity to fund administration,
- ***R*** is a correction component for revenue raising capacity and measures the fiscal capacity of municipalities to raise own revenues from taxes, surcharges and user fees and,
- ***C*** is a general correction and stabilisation factor.

The equitable share allocation to local governments considers fiscal capacity, fiscal efficiency, developmental needs, the extent of poverty and backlogs in municipalities, (Annexure to 2008 Budget Review, pp22). Similar to its provincial counterpart, the local government equitable share is also an unconditional transfer of nationally raised revenue to municipalities that is allocated among the country's 278 municipalities using a formula. A new formula was introduced in 2013.

This formula was reviewed during 2012. The main objectives of the new formula are to (a) enable municipalities to provide basic services to poor households and (b) enable municipalities with limited own resources to afford basic administrative and governance capacity and perform core municipal functions. The structure of the new formula is as follows:

LES = BS + (I + NTS) *x* ***RA ± C***

Where:

- ***LES*** is the local government equitable share
- ***BS*** is the basic services component
- ***I*** is the institutional component
- ***NTS*** is the non-trading services component
- ***RA*** is the revenue adjustment factor
- ***C*** is the correction and stabilisation factor

Like the old formula, the new formula has basic services, institutional and correction components but while the old formula subtracts a revenue-raising capacity correction from the whole formula, the new formula applies a revenue adjustment factor to the institutional and non-trading services components only. The non-trading services component is a new addition to the formula. The development component in the old formula had never been activated.

Of all the factors in the LEA the municipal infrastructure grant (MIG) is the most significant. It is a conditional grant and allocations to municipalities are formula driven. The formula consists of percentage allocations for five different components representing different municipal infrastructure needs.

Summary of the Municipal Infrastructure Grant (MIG)Formula

The formula can be written as:

MIG = B + P + E + N + M

Where:

- ***B*** represents the allocation for basic residential infrastructure such as water, sanitation, roads, electricity, street lighting and solid waste removal.
- ***P*** denotes funds for new and rehabilitated municipal service infrastructure.
- ***E*** is the allocation for the construction of social service institutions and micro-enterprises.
- ***N*** is the allocation for nodal development and renewal programmes in targeted urban and rural municipalities and;
- ***M*** is a performance related adjustment to the total MIG allocation for a municipality.

In addition, each component is weighted by an identified socio-demographic disparity parameter that reflects differences among metropolitan and local municipalities. The disparity weights for each of the five components are represented respectively by

χ, ϕ, ε, ν and μ

such that each parameter is a weighted adjustment for the corresponding service allocation component. The adjustments are supposed to take account of the costs of socio-demographic disparities that distinguish the metropolitan municipalities (Category A) from the local municipalities (Category B). The parameter values were estimated from the 2001 Census data (*StatSA, 2001*). The five components represent the generic costs of the broad categories of infrastructural services. The socio-demographic disparity parameters are adjustment weights associated with sub components of these broad categories. The socio-demographic disparity weights may be designated as follows:

- χ_1 for inadequate household water and sanitation,
- χ_2 for households in informal settlements with no access roads,
- χ_3 for inadequate household refuse and waste removal,
- ϕ for public facilities for households earning less than R1100 per month,
- ε for small business areas with households earning less than R1100 per month,
- ν for development areas with households earning less than R1100 per month,
- μ is a performance related adjustment

Thus the full MIG formula will be:

$$MIG = \sum_{\chi_{i=1}}^{3} \chi_i B + \phi P + \varepsilon E + \nu N + \mu M$$

Where *i* is an index for the three disparities (χ_1, χ_2, χ_3).

The South African system of equalisation grants was informed by many expert inputs. One of the key contributions for the development of the local government equitable share model was from Inman, Petchey and Rubenfeld (1997). The model for South Africa developed a formula for allocating a variety of targeted equalisation grants to municipalities in South Africa. The model developed the formula for the allocation of four different grants from a total recurrent intergovernmental grant pool.

APPENDIX 3: CONSTITUTIONAL BASIS FOR COOPERATIVE IGFR IN SOUTH AFRICA - CHAPTER 3 CO-OPERATIVE GOVERNMENT – SECTION 41

Principles of cooperative government and intergovernmental relations

41(1) All spheres of government and all organs of state within each sphere must: -

a) preserve the peace, national unity and the indivisibility of the Republic; secure the well-being of the people of the Republic;

b) provide effective, transparent, accountable and coherent government for the Republic as a whole;

c) be loyal to the Constitution, the Republic and its people;

d) respect the constitutional status, institutions, powers and functions of government in the other spheres;

e) not assume any power or function except those conferred on them in terms of the Constitution;

f) exercise their powers and perform their functions in a manner that does not encroach on the geographical, functional or institutional integrity of government in another sphere and

g) co-operate with one another in mutual trust and good faith by:-

    i. fostering friendly relations;

    ii. assisting and supporting one another;

    iii. informing one another of, and consulting one another on, matters of common interest;

    iv. co-ordinating their actions and legislation with one another; adhering to agreed procedures;

    v. and avoiding legal proceedings against one another.

(2) An Act of Parliament must-

1. *(a)* establish or provide for structures and institutions to promote and facilitate intergovernmental relations; and

2. *(b)* provide for appropriate mechanisms and procedures to facilitate settlement of intergovernmental disputes.

(3) An organ of state involved in an intergovernmental dispute must make every reasonable effort to settle the dispute by means of mechanisms and procedures provided for that purpose, and must exhaust all other remedies before it approaches a court to resolve the dispute.

(4) If a court is not satisfied that the requirements of subsection (3) have been met, it may refer a dispute back to the organs of state involved.