Review of Transfers in the Intergovernmental Fiscal Relations System in South Africa

Research Reports in support of the FFC submission for the Division of Revenue 2007/08

FINANCIAL AND FISCAL COMMISSION

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Editors

Jaya Josie, Bongani Khumalo and Tania Ajam

May 2006

FINANCIAL AND FISCAL COMMISSION

"For an Equitable Sharing of National Revenue"

Financial and Fiscal Commission
Private Bag X69
Halfway House
1685

2nd Floor Montrose Place
Bekker Street
Waterfall Park
Vorna Valley
Midrand

Tel: +27 (86) 131 5710
Fax: +27 (11) 207 2344

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Abbreviations

BER	Bureau of Economic Research
CASP	Comprehensive Agricultural Support Programme
CMBS	Constitutionally Mandated Basic Services
DoRA	Division of Revenue Act
DPLG	Department of Provincial and Local Government
FET	Further Education and Training
FFC	Financial and Fiscal Commission
HPTDG	Health Professions Training & Development Grant
HSRG	Human Settlement Redevelopment Grant
IHHSD	Integrated Housing and Human Settlement Development Grant
JSB	Joint Services Board
LES	Local Government Equitable Share
MEC	Member of Executive Council
MFMA	Municipal Finance Management Act
MIG	Municipal Infrastructure Grant
MTEF	Medium Term Expenditure Framework
MSA	Municipal Systems Act
MTS	Modernisation of Tertiary Services
NCOP	National Council of Provinces
NDoH	National Department of Health
NGO	Non Governmental Organisation
NHAF	National Housing Allocation Formula
NHLS	National Health Laboratory Services
NTSG	National Tertiary Services Grant
PES	Provincial Equitable Share
PFMA	Public Finance Management Act
PIT	Personal Income Tax
RAF	Road Accident Fund
RRP	Recommendations Research Programme
RSC	Regional Services Council

About the contributors

Alex van den Heever is currently employed as the Advisor to the Registrar of the Council for Medical Schemes. He consults in his professional capacity in the area of health financing and social security. He holds a Masters degree in Economics from the University of Cape. From 1994 he was attached to the Centre for Health Policy. Among some of the work he did at the Centre for Health Policy was participation in the Commission of Inquiry into Medical Schemes, the Development of the Medical Schemes Act 131 of 1998, Resource Allocation, Social Health Insurance, and the assessment of the Health Conditional grants for supra-regional and academic services.

He has also worked with the government of Gauteng, the Office of the Registrar of Medical Schemes and was also a member of the technical team that prepared the Taylor Report on the Comprehensive Review of the Social Security System.

Andrew Reschovsky is a Professor of Public Affairs and Applied Economics in the Robert La Follete School of Public Affairs at the University of Wisconsin – Madison, where he teaches courses on Public Finance and Public Policy Analysis. Professor Reschovsky has written numerous scholarly articles on topics related to public finance, intergovernmental fiscal relations and tax policy. Since 1999, he has served as a technical advisor to the Financial and Fiscal Commission. His work in South Africa has also included service as an advisor to the Department of Provincial and Local Government (DPLG). Professor Reschovsky has also worked as a consultant to the Territorial Development Service of the Organization for Economic Cooperation and Development (OECD) and also serves as a member of the state of Wisconsin's Share Revenue Taskforce.

Bongani Khumalo is Program Manager (Fiscal Policy Analysis) in the Financial and Fiscal Commission. He joined the Commission in 1999 as a Researcher and has worked on the development of the intergovernmental transfer formulae and also on sub-national revenue sources. On completing his MSc. Economics Degree at the University of Zimbabwe in 1991, Bongani was offered a lectureship in the Department of Economics and he lectured there until 1993 when he moved to take up a position as lecturer in Public Policy at Rhodes University in Grahamstown. He taught at Rhodes until June 1999 when he took up the position with the Financial and Fiscal Commission.

Denver Kallis is currently a Senior Researcher at the FFC, within the Macroeconomics and Public Finance Unit. He holds a Masters degree in Economics from the University of the Western Cape. Before joining the FFC, he lectured Macroeconomics, Microeconomics and International Trade in the Department of

Economics at the University of the Western Cape from 2001 to 2003. During that time, he was also involved in research at the Finance and Development Training Research Unit within the Department of Economics.

Goodwill Ditlhage is a Senior Researcher in the Fiscal Policy Unit of the Financial and Fiscal Commission. He holds a Master Degree in Politics from the University of the Witwatersrand and is currently studying for an MPhil Degree in Economic Policy with Stellenbosch University. Before joining the Financial and Fiscal Commission, Goodwill worked as a researcher for the Gauteng Legislature. Since joining the Financial and Fiscal Commission as a Researcher in 2002, he has conducted research on social development expenditure issues including the funding of social security grants and the implications of transferring this function to national government. His recent research has been on developing mechanisms for the sustainable financing of social welfare services.

Hammed Amusa is a Senior Researcher in the Fiscal Policy Unit of the Financial and Fiscal Commission, where he deals with fiscal issues and policy analysis related to South Africa's intergovernmental fiscal relations.

Under the Collaborative Masters Program (CMAP) of the African Economic Research Consortium (AERC), he earned an M.A. in Economics from the University of Botswana in 2000. Prior to joining the Financial and Fiscal Commission in 2003, Hammed Amusa served as a lecturer in the Department of Economics at the University of Pretoria.

Jaya Josie, is the Deputy Chairperson of the Financial and Fiscal Commission. He is responsible for the recommendations research program of the Commission and has been a Commissioner since 1994. Prior to his appointment as Deputy Chairperson he was Director of Development Economic Services with Ernst and Young. He was head of the Macroeconomic Research Group (MERG) and later Executive Director of the National Institute for Economic Policy (NIEP). Mr. Josie has published several research reports and articles on public finance and macroeconomic policy in South Africa. He did post-graduate studies at the School of Oriental and African Studies (SOAS), University of London and the International Institute of Public Administration (IIAP); National School of Administration, Paris. He lectured in Public Finance and Macroeconomic Policy at School of Government (University of Western Cape) and the Institute of Government, (University of Fort Hare). He currently holds a part-time research fellowship from the Belgium Interuniversity Council and the University of the Western Cape (UWC).

Nomonde Madubula is a Research Assistant in the Fiscal Policy Unit of the Financial and Fiscal Commission. She is largely responsible for research on the financing of education. Her current work focuses on the financing of Learner

Support Materials in Public Ordinary Schools.

Nomonde has an Honours Degree in Economics from the University of Cape Town and is currently working on her Masters Degree in Economics with the University of the Witwatersrand. Prior to joining the Financial and Fiscal Commission, Nomonde was an intern at National Treasury's Tax Policy Directorate.

Rathipe Nthite is a Senior Research Specialist in the Fiscal Policy Unit of the Financial and Fiscal Commission. He is largely responsible for research on public infrastructure expenditure and implementation issues. His past work focused mainly on the development of the Capital Expenditure Model. He has also been responsible for coordinating research focused on the two health conditional grants, namely, the Health Professions Training and Development Grant and the National Tertiary Services Grant.

Rathipe has academic training in mathematics, statistics, investment management and recently, economics. Prior to joining the Financial and Fiscal Commission, Rathipe worked at the Knowledge Factory as a Business Intelligence Analyst.

Servaas van der Berg is Professor of Economics at the University of Stellenbosch. His research and publications focus mainly on economic development issues, with a particular emphasis on income distribution and poverty, the economics of education, the economic role of social grants, and benefit incidence analysis. His main research programme currently is on Poverty, Affluence and Mobility, investigating both inclusion and exclusion from the economic mainstream in South Africa. He has done consultancy work for a wide range of institutions, including the World Bank and a large number of South African Government departments and other Organisations.

Tania Ajam is a public finance economist. She is the Director of the Knowledge Centre at the Applied Fiscal Research Centre (AFReC (Pty) Ltd, a University of Cape Town (UCT) affiliated company and the Managing Director of PBS (Pty) Ltd. She is a Commissioner in the Financial and Fiscal Commission. She lectured at the School of Economics, UCT, and is the author of several publications and papers on intergovernmental fiscal relations, performance budgeting and budgeting systems.

Vincent Makinta is the Manager, Data and Information Unit at the Financial and Fiscal Commission of South Africa. Before joining the FFC in 2000, he worked at the Human Sciences Research Council (HSRC) as Geographic Information System's (GIS) Analyst. He has also served as a GIS Geographer at the Department of the Premier North West as well as a consultant to the Settlement Planning Services in Mafikeng.

On completing his undergraduate studies in sciences, Vincent Makinta enrolled for his Honours degree in GIS at the University of North-West. In 2004, he earned a Masters degree in Population and Demographic Modelling from Wits University.

Foreword

For the past three years the FFC has been at the cutting edge of reviewing the intergovernmental fiscal relations (IGFR) system in SA. The stable and firm foundations of the current equitable sharing and budget mechanisms have ensured sustainable and predictable allocations to the three spheres of government. However, over the years the problem for spending departments in all three spheres of government has become less the lack of funds and more the capacity to spend allocations efficiently and effectively as prescribed.

In the 2006 Budget Review the Ministry of Finance and National Treasury responded positively to the FFC recommendations indicating acceptance and implementation of certain proposals and areas that require further development. In particular Government indicated a need for a comprehensive review of conditional grant transfers to provinces and municipalities.

Conditional transfers and specific purpose grants have been the subject of much debate and controversy. Provinces and municipalities are concerned about the loss of sub-national budget autonomy as the attached conditions and rationale for grants become more onerous and difficult to meet.

On the other hand National Government is concerned about balancing sub-national autonomy with the need to ensure effective and efficient delivery of basic services, nationally determined policy objectives and accountability for money spent.

The 2006 FFC submission for the 2007/08 Division of Revenue presents a set of the Commission's recommendations on conditional grants and certain aspects of the provincial and local government equitable share formula. The recommendations in the submission were informed by extensive research work that was conducted by the FFC staff that could not be captured in the submission. Recognising the complexities within the IGFR system, the Commission agreed to publish this volume of all the technical reports that informed its recommendations for 2006.

This volume constitutes the research papers that can be read together with the recommendations of the Commission. It should be noted that the views expressed in the reports are primarily those of the authors and not necessarily of the Commission.

Dr. Bethuel Setai
Chairperson, Financial and Fiscal Commission

June 2006

Introduction

At its review meeting in November 2005 the Financial and Fiscal Commission (FFC) agreed to publish the technical research reports that inform its annual submission of recommendations for the Division of Revenue. The recommendations were submitted in terms of Sections 214 (2) and 220 of the Constitution and the Intergovernmental Fiscal Relations Act (19) in May 2006.

The FFC recommendations and advisories are based on extensive research carried out by the Commission's Recommendations Research Programme. While much of the research is undertaken by FFC researchers some specialized areas of research are commissioned to outside experts recognized in the relevant fields of study.

After careful consideration the Commission agreed that the format of its annual submission of recommendations for the Division of Revenue does not do justice to the extensive in-depth research that informs its recommendations. By its very nature public finance and policy related research depends on technical analysis, empirical methods and evaluations of differing arguments and debates. A key element in such research is the assessment and use of official statistics, data and other information.

The FFC annual submission of Division of Revenue recommendations only presents the recommendations themselves, their rationale, motivation and background as approved and authorized by the Commission. The details of the technical analyses and discussion are not included in the submission presented to Parliament and Government.

This volume of the technical research reports is therefore published as a companion document to provide stakeholders with the technical analyses on which the recommendations are based.

The main focus of the FFC's submission for the 2007/08 Division of Revenue is the review of National Government's conditional transfers to sub-national governments in South Africa. FFC research in this regard covered a review of the conditional and specific purpose grants. The research also covered some outstanding issues relating to the provincial and local government equitable share formulae. A key question that resonates in the reports is how to assess sub-national governments' right to budget autonomy against National Government's need to ensure effective and efficient delivery of basic services and accountability for money spent.

Conditional transfers and specific purpose grants are often used where key public services such as health, education and supporting infrastructure is decentralized to sub-national governments. Grants may also target specifically defined projects in order to achieve more effective decision making.

The FFC's research into conditional transfers is informed by key principles that provide the rationale for the use of such grants. In general the design of grants depends on the legal, institutional and fiscal circumstances of the country. Very often such grants are used to influence sub-national fiscal decisions to achieve national policy objectives. Other principles explored in the technical reports include whether spending programmes of one province or municipality benefits residents of other jurisdictions. In these cases "spillover" grants are used to compensate for such situations. In South Africa a key consideration is the achievement of equity or fairness. In this context conditional transfers are mechanisms for the pursuit of redistributive policy objectives.

Three research reports in this volume examine most of the conditional transfers in the South African intergovernmental system. The first report reviews in a comprehensive way all conditional grants currently in use in South Africa except the two major health conditional grants, namely, the National Tertiary Services Grant and the Health Professions Training and Development Grant. These are covered in the second report. The two latter grants are given special attention as they are meant to address spillovers and constitute a significant share of the conditional grants to provinces.

Finally, the third report in the context of conditional transfers reviews the National Housing Allocation Formula (NHAF). The research in this report takes forward the FFC's previous investigation into the financing and delivery challenges in housing with a specific focus of the housing funding formula. The review analyses the institutional and funding framework and evaluates the delivery and financing trends.

The findings of the research focus on the need for equity in funding housing delivery with specific reference to recognizing variations in sub-regional costs; improving rural development and, monitoring compliance with minimum quality building standards.

With respect to equitable share issues, a key FFC recommendation that was accepted and implemented by Government was the proposal to fund social security grants through a National Social Security Agency rather than through the provincial equitable share. The consequence of implementing this recommendation was that the welfare services component of the social development function remains to be funded through the provincial equitable share formula. Accordingly, the fourth research report in this volume investigates the level of provincial demand for welfare services and proposes ways in which the current provincial equitable share formula may be revised to take account of such demand.

With respect to the review of the local government equitable share formula, a report is included in this volume that assesses local government equitable share allocations to municipalities. This assessment focuses attention on three key issues. Firstly, it addresses whether the current estimated cost of municipal basic services is a true reflection of current realities. Secondly, it explores the possibility of raising the estimated cost of basic services so that poorer municipalities may carry out their constitutional mandates. Thirdly, it explores measures that can enhance the longer term efficiency of the formula.

The final report focuses on trends in provincial own revenues and the progress with the implementation of the Provincial Tax Regulation Process Act. The report concludes that while provinces have not moved very far with respect to implementing the Act, the majority of them are currently implementing past recommendations of the FFC and National Treasury. Many provinces are also engaged in the processes of preparing provincial revenue strategies and conducting research into potential new revenue sources. The report emphasizes the need for provinces to improve collection on existing revenue sources so as to augment their resources.

Jaya Josie

Deputy Chairperson and Director, Recommendations Research Programme, Financial and Fiscal Commission

June 2006

Chapter 1

A Comprehensive Review of Conditional Grants in the South African Intergovernmental Fiscal Relations System

Rathipe Nthite, Goodwill Ditlhage, Nomonde Madubula,
Hammed Amusa and Bongani Khumalo

Abstract

Over the past years, detailed attention has been given to the review of the unconditional transfers flowing to provinces and municipalities via the Provincial Equitable Share (PES) and the Local Government Equitable Share (LES). To date, an equally comprehensive review on the design and use of conditional transfers to provinces, and especially municipalities, has not been carried out.

A comprehensive review of all conditional grants in the system is vital in several ways. For example, the review of the LES resulted in a proposed Development Component being temporarily kept at zero pending further research. Similarly, work is currently underway on the review of the PES with regard to the Poverty Element following the removal of the social security grants component from the PES. Due to the fact that most conditional grants do have elements of poverty alleviation and development built into them, the Financial and Fiscal Commission (FFC) decided on a comprehensive review of all the conditional grants transfers in order to ensure, amongst other things, that there are no transfers in the system, conditional or otherwise, that duplicate each other.

This report focuses on the review of conditional grants administered by the Health, Education, Agriculture, Water Affairs departments, as well as those related to broad local government basic service delivery areas such as water and electricity. Poverty relief grants in Social Development have been discontinued from 2006/07 and hence were not the subject of this analysis. Discontinued grants are listed in a table without being analysed.

From this review, the following recommendations are proposed:

- *HIV/AIDS grant in the Health department should remain.*
- *The Hospital Revitalisation grant should be incorporated into the Provincial Infrastructure grant.*
- *The Land Care Programme and the Comprehensive Agriculture grant should be merged into one Schedule 4 grant.*
- *With regards to the Integrated School Nutrition Grant, conditions relating to the development, submission and approval of business plans should be refined to ensure that minimum time is spent on the process.*

Keywords:

Conditional Grants, Grant Design, Grant Performance and Monitoring, Grant Purpose and Objectives, Intergovernmental Fiscal Relations System, Norms and Standards

1.1 BACKGROUND

1.1.1 Introduction

Conditional grants are provided by national government to provinces and municipalities in order to achieve specific objectives. The decentralisation of fiscal responsibilities entails various spillover costs that are sometimes referred to by economists as fiscal externalities. These externalities appear in three forms.

Firstly, there are the inefficiencies and inequities that result from the fact that decentralisation highlights differences in fiscal capacities among provinces and municipalities. These differences affect their ability to provide public services at comparable tax rates. This means that the net fiscal benefits (NFBs), i.e. benefits less tax paid, differ between jurisdictions. Such differences create incentives for both households and firms to relocate to where NFBs are higher or create horizontal inequities where relocation does not occur[1].

Secondly, horizontal fiscal spillover costs arise from tax and expenditure competition, as well as the export of the burden of fiscal policy decisions by one province (municipality) to another. This simply means a province's or municipality's fiscal decisions serve partly to achieve objectives at the expense of other jurisdictions. This is normally associated with revenue-side incentives that different sub-national jurisdictions may be offering to attract businesses. Horizontal fiscal externalities can be both positive and negative, incentivising sub-national governments to set either too high or too low levels of taxes or expenditures. Because they interfere with the national allocation of resources, they are also sources of inefficiency for the country in general.

Thirdly, there are the vertical fiscal spillover costs that arise as a result of one sphere of government exporting its tax or expenditure burden to another. An example would be a decision by national government to raise the standard of service delivery on a service that is a provincial competence, without the concomitant increase in financial resources. The higher standard may require an increase in the amount of revenue required by the province and hence, if no new revenue is made available, there will be a negative impact on the province and the service.

The above discussion summarises what can be termed limits to decentralisation. These limits provide the rationale for provisions to offset the adverse effects of decentralisation such as constitutional limitations on provincial policy or the ability of national government to pursue policies that correct the fiscal externalities. The fiscal arrangements, including transfers, are thus designed to deal with these issues.

1. See Boadway RW (1998) for a fuller discussion of fiscal benefits and externalities.

It is almost inevitable that as decentralisation deepens, there will be a stronger need to correct these externalities. In many countries, there has been a tendency to push for tighter national management of the overall affairs of government. While this is natural and reasonable, there have to be trade-offs between the perceived costs and benefits of decentralisation and the national government activism required to ensure that national objectives are met. In deciding on these trade-offs, it is important to understand national government's role in meeting the objectives of redistributive equity. Most arguments for national oversight rest with national government's responsibility for redistributive equity.

The discussion above focuses on the general limits to fiscal decentralisation. An important aspect in the context of conditional grants in South Africa relates to expenditure spillovers. The cost effects of certain expenditure programmes sometimes spill over across provinces. For example, expenditure on some roads may benefit users from neighbouring regions; higher education and specialised health facilities may be used by non-residents; and further education and training may be provided to workers who change provinces. These spillovers or fiscal externalities have been used to justify the use of certain categories of grants.

1.1.2 Principles in the Use of Conditional Grants

The discussion above highlights two key issues that may lead to the use of conditional grants in a fiscally decentralised country. The first is the need to deal with national priorities (the redistributive equity role of national government in a decentralised system of government). The second is the need to deal with the horizontal and vertical fiscal spillovers or externalities associated with decentralisation.

Conditional grants, sometimes called specific purpose grants or categorical grants, are those grants where the transferring government specifies the purpose, conditions, or both, under which the recipient government should use the grants. Conditional grants can either be matching or non-matching. Matching grants require the recipient government to match the contribution by the transferring government.

An argument that has often been advanced for the use of matching grants is that the recipient government contribution ensures a certain degree of ownership of the programme. If provincial programmes result in spillovers, provinces will have little incentive to take into account those spillovers when making their expenditure decisions. In other words, it is unlikely that provinces will voluntarily take on the costs of such spillovers. Where such spillover benefits are positive, there is a likelihood of under-provision and an equal likelihood of over-provision where they are negative. Matching grants are therefore often proposed in these cases.

However, since the identification and measurement of the costs and effects of spillovers is a complex exercise, simpler techniques are generally applied to matching grants. For example, an approach that could be adopted is one where central government's contribution to the sub-national government on a particular programme depends on the recipient government's spending behaviour. The conditions for accessing the grant might then stipulate that whenever a sub-national government spends R1 on Healthcare, the central government will contribute R2.

While the matching requirement is used in most countries, it is going out of fashion in others such as Canada. This is because the implementation of the optimal matching requirement for horizontal spillovers is difficult to measure. Matching grants justified on the grounds of spillovers can introduce adverse effects into the transfer system with provinces chasing 'cheap money'.

A second form of conditional grant is the non-matching grant or conditional bloc grant. It has been found that most of the objectives of matching grants can be achieved through the latter while also avoiding the adverse effects of the former. The size of the conditional bloc grants can be designed to reflect both need and the perceived spillover benefits.

The advantage of bloc grants is that they can serve a much broader purpose. They can be used as vehicles through which provincial expenditure programmes can be induced to conform to national priorities. These would include, for example, achieving efficiency and equity and the internalising of any vertical fiscal spillovers. These types of grants usually have specific conditions such as the non-discrimination of non-residents of a province (municipality) and access criteria.

A key ingredient is that the grants should be designed in such a way that decentralised decision-making does not result in the violation of national government's central objectives, viz. equity and the efficient allocation of resources. In the event of non-compliance, the size of the grant could even be reduced. In the South African context, conditional bloc grants should be viewed as complementing the equitable share rather than as a substitute for it. The equitable share allows sub-national governments to carry out their constitutional mandates, while the conditional grants are there to deal with the potential violations of efficiency and equity resulting from the process of fiscal decentralisation.

In principle, the use of conditional grants is an exercise of national government's spending authority. A potential problem is that such spending authority may be in contradiction to the exercise of the legislative powers and functions of sub-national governments. In fact, where the intergovernmental fiscal relations system is based on an equitable sharing of nationally raised revenue between and among the three spheres of government (as is the case in South Africa), the use of conditional grants involves some trade-offs in the amounts available for equitable sharing. An increasing use of conditional grants may result in a reduced amount of transfers flowing through the discretionary equitable share (PES and LES) and therefore may impact on the flexibility of sub-national governments to implement programmes according to their constitutional legislative mandates.

In sum, the increased use of conditional grants may be interpreted by sub-national governments as an intrusion by national government in their areas of competence. This is especially true when conditional grants are relatively large in proportion to total sub-national revenues. The reporting requirements on conditional grants can also be strict and tend to impose an extra burden on sub-national governments.

In this respect, the FFC has in the past recommended that the use of conditional grants should be introduced only when it is not possible to finance the relevant programmes through the equitable share. Indeed, in its submission to the Select Committee on Finance made in February 2002, the Commission proposed that, where conditional grants are used, there should be strong reasons to suggest the existence of spillover benefits or they should be used to deal with programmes of national priority. In the latter event, such use of conditional grants should be allocated in order for sub-national governments to institutionalise programmes that eventually will be funded through the equitable share.

1.1.3 Issues in the Design of Conditional Grants

1.1.3.1 Conditionalities of grants

Once a case has been made for the use of conditional grants, the next question that has to be addressed is the conditions that should accompany the grant. Public finance literature has devoted substantial attention to the 'interjurisdictional spillover' rationale for conditionality. Some forms of conditionality, however, may lead to problematic incentives. Overly strict conditions may prevent sub-national governments from achieving the goals of the conditions in more efficient ways.

The conditions should respect individual province's priorities and local conditions. For example, different sub-national governments may be able to satisfy the same conditions in different ways - ways that relate to the social, cultural and economic needs of their respective constituencies. This does not argue for a 'one size fits all' approach to conditionality, but rather for conditionality defined in terms of 'equivalence'. This means that sub-national governments should be allowed sufficient flexibility to design their own bundles of goods and services, consistent with agreed conditions or, preferably, equivalencies. This form of arrangement would tilt the government in the direction of dynamic efficiency.

In most developing countries, some conditionality on grants seems desirable, particularly when national services such as education and healthcare are provided by sub-national governments. Money is fungible. Thus, transfers based solely on need may not ensure that the recipient government in fact uses the funds as central government may wish, unless the receipt is conditioned on performance and compliance is adequately monitored. In a country where a significant proportion of own-revenue source would come from revenue sharing, as is the case in South Africa and the German-type decentralisation model, there would be substantial vertical imbalance.

Conditional transfers, designed to ameliorate negative effects of spillovers associated with both vertical and horizontal imbalances could be very useful. Legislation relating to the spending programme could be national, while the implementation is delegated to sub-national governments (i.e. decentralisation of implementation rather than policy-making). The grants themselves should be targeted to specific spending programmes with associated conditions. Over time, these conditions could be relaxed to allow for more sub-national autonomy on the spending front and eventually made non-conditional.

As mentioned above, overly strict conditions may prevent sub-national governments from achieving the goals of the conditions in more efficient ways. In Canada[2], for instance, there are no formal conditions applying to provincial post-secondary education but it is assumed that equal access to provincial education is given to all Canadian residents.

1.1.3.2 Minimum Norms and Standards

One of the issues worth considering in designing effective conditional transfer systems is the issue of norms and standards. It could be argued that where the national government wishes to ensure 'minimum standards' in areas that broadly fall within the constitutional responsibility of sub-national governments, it is often the case that conditional transfers are preferred. Such conditional grants need not be matching, so that recipient governments (especially poorer ones) are not overwhelmed with matching requirements.

Transfers designed to finance particular types of services (e.g. road maintenance or education) are often linked to measures of need, e.g. length of roads or number of students. This approach often leads to the same 'norms'. Using this approach requires some level of circumspection. Given inadequate attention,

2. In Canada, national conditions with respect to provincial health care programmes, for instance, are generic, based on the following broad principles e.g.: universality (all residents of Canada must be entitled to services), comprehensiveness (means that all medically necessary services must be covered), accessibility (means that services must be provided on uniform terms and conditions and that reasonable access to services must not be impeded), portability (means that persons must remain covered while temporarily absent from their provinces and for three months by the original province while relocating to the new province) and public insurance (means that health plans must be insured by a non-profit public agency). The law also requires the federal government to withhold funds if any of these conditions are not met. See Shah: 1995 for fuller discussion.

it can give rise to measures that reflect past political decisions rather than current needs.

1.1.3.3 Infrastructure Grants

There are a number of reasons why central governments have an interest in financing sub-national capital expenditure. Firstly, some sub-national infrastructure projects may involve significant spillovers or externalities. Secondly, such projects may constitute essential elements of national development programmes. Infrastructure related to the provision of basic education and health services, for example, may qualify for both reasons, as may projects improving the level and quality of water supply and sewerage treatment. Thirdly, central governments have an interest in improving the economic productivity of poor rural areas. Financing large infrastructure projects from sub-national government funds may be impeded by a number of factors, e.g. the issue of inadequate resources, inadequate access to private capital markets and heavy reliance on central transfers[3].

Capital grants should also pursue sectoral objectives. The use of matching arrangements can encourage sub-national government to act with a sense of ownership in managing the funds. However, a significant level of flexibility in the use of capital grants is important to take into account inevitable time lags in implementation. These grants should be project-managed, closely administered and monitored by line ministries.

There are a number of preconditions for the successful implementation of capital projects funded through conditional grants. Firstly, the recipient government should be required to prepare adequate investment plans as well as maintenance plans. Secondly, the government receiving these grants should be selected not by political criteria but by an objective and systematic process that pays attention to both needs and capacity, as well as economic and environmental evaluation (such as a cost-benefit analysis). Thirdly, adequate technical assistance should be made available to the receiving governments to permit them to develop plans, arrange financing, manage construction and operate the facility in the most efficient manner possible. The execution and operation of grant-aided work should be monitored and evaluated, with periodic progress reports, field inspections and formal evaluation of outcomes.

3. See Bird et al 2001, for a fuller discussion.

1.1.3.4 Administrative Challenges

Conditional grant transfers often impose administrative costs on both national and sub-national governments. The manner in which the grants are designed can either reduce or increase the probabilities of administrative burdens. Where the recipient governments are accorded adequate decision space, administrative burdens are reduced substantially. This, however, may be at the expense of compromised efficiency. These issues therefore need to be taken into account and an appropriate balance struck.

National government also needs to have adequate monitoring capacity. This capacity is required to ensure that compliance with the conditions and purposes of the grants is assessed on an ongoing basis. Such capacity would also assist in ensuring that the grants have been utilised in the stipulated manner and that the grants did not merely substitute for resources that might have been allocated by the sub-national government. The latter requirement is particularly difficult to monitor, although more or less objective and verifiable criteria could be established under the first two criteria.

1.2 Health Conditional Grants

1.2.1 Comprehensive HIV and AIDS Grant

Purpose

The HIV/AIDS grant was introduced in 2001. This grant has evolved significantly. This is, understandably, due to the complex nature of the HIV/AIDS pandemic in South Africa. The manner in which the purpose of this grant was articulated by government suggests that it is one of government's key strategies to direct the broader social sector towards an effective integrated response to HIV/AIDS. The focus of the grant was initially narrow – focusing on children infected and affected by the virus. In 2001, the grant was reconceptualised and given a broader scope, focusing on community mobilisation and voluntary HIV counselling and testing.

The 2002/03 budget also saw the expansion of the grant, covering other areas such as Mother to Child Transmission (MTCT) at two pilot sites, the strengthening of provincial management teams, the implementation of home based care and the implementation of step-down care as a management option. The 2003/04 budget also added two important functions to the grant, viz. post-exposure prophylaxis (PEP) and home-based care. Most recently, in an endeavour to align with national policy, the 2004/05 budget introduced the requirement that provincial programmes be synchronised with the National Operation Plan for the Comprehensive HIV/AIDS Treatment and Care.

Conditions

In the 2001 framework, the conditions attached to this grant were not specified in the Division of Revenue Act (DoRA). The conditions of this grant, first introduced with the 2002 DoRA, were of a general operational and administrative nature. This included the submission of progress reports, rendering of ante-natal care (ANC) and the establishment of expenditure codes on financial systems to monitor expenditure. The 2003 framework added some further conditions, including the submission of business plans and, that provinces should budget for long-term recurrent funding of home-based care and step-down care (once projects have matured).

The first comprehensive set of conditions was introduced in 2004, including the possibility of shifting funds from provinces that are not spending their allocations to those that are showing spending ability. In the main, the conditions introduced in 2004 sought to make the operational and administrative environment clear. This included the procurement policies (for example, the deliberate inclusion of National Health Laboratory Sciences (NHLS) for the procurement of all laboratory and diagnostic monitoring services).

The 2005 framework also introduced several new conditions for the grant. Some of them are administrative (e.g. certification of business plans, submission of financial reports, quarterly reports) while others attempt to consolidate better performance monitoring and planning for the grant (e.g. that the provincial strategic plans over the MTEF indicate measurable objectives and performance as agreed with the DoH).

Grant Design

The HIV and AIDS grant is a Schedule 5 specific purpose allocation to provinces. The grant has very clear measurable outputs, ranging from the accreditation of service points to the training of home-based care-givers.

Monitoring of the grant, which has recently been tightened, requires the submission of quarterly performance reports in a prescribed format, monthly financial reports and quarterly provincial liaisons. The National Department of Health is required to monitor the implementation of the grant and to provide any necessary support. It also has to provide guidelines and criteria for developing business cases and agree on targets with provincial departments.

Funding for the programme comes via a conditional grant due to the high national priority accorded to the condition and with the diverse factors affecting the distribution of the funds – factors that are significantly different to those that influence the equitable share distribution. These factors include: ante-natal HIV prevalence, estimated share of HIV births, estimated share of HIV cases, share of reported rapes and the need to establish one treatment point per district.

The 2005 DoR Bill does not specify the expected lifespan of the grant but it was stated in previous Bills as being 'for the duration of the allocations'. It is not clear what this really means.

Until the HIV/AIDS grant in Social Development was incorporated into the PES, there were three grants dealing with HIV/AIDS-related matters, the third being in the Education Department. Although the grants focused on different aspects of the condition, it would be beneficial to have implementation of the HIV/AIDS grants co-ordinated in some way.

Following the accessing of these grants at the beginning of 2002/03, recipient municipalities were required to submit 'capacity-building' frameworks. Where the receiving authority is a district council, Planning, Implementation and Management Support (PIMS) centres, in collaboration with local municipalities, play a central role in developing these frameworks. At present, most of these conditions are still in place and to these have been added additional requirements related to the submission of council resolutions on approved (and measurable) action plans, submission of PIMS centre annual work plans and submission of impact reports on past performance of the grant.

Finally, discussions with officials at the Department of Health have confirmed that this grant is burdened with substantial operational expenditure difficult to isolate for accounting purposes. The grant focuses on too many programmes making it difficult to give adequate attention to all of them. In reviewing and reconfiguring the grant, it would be advisable if only priority programmes are funded through the grant and others are institutionalised. A conditional grant by its very nature is supposed to address specific objectives or programmes. It may not be very realistic to target a wide range of programmes and still expect to address the objectives of the grant effectively.

Monitoring and Performance

The budget for the grant has experienced an average annual growth rate of 134 percent, while expenditure grew by 169 percent over the period 2001 to 2004. The entire budget over the period was spent and annual expenditure levels for the grant were generally very high. The current spending level for the grant is 74 percent up to the third quarter of the 2005/06 fiscal year.

So far, 650 sites have been established to provide mother to child preventative intervention to about 80 000 women. Full coverage in the implementation of post-exposure prophylaxis has also been attained in Gauteng, KwaZulu-Natal and the Western Cape. More than 1625 sites were established to provide voluntary counselling and testing for HIV and AIDS.

1.2.2 Hospital Revitalisation Grant

Purpose

This grant, formerly known as the Hospital Rehabilitation Grant, was introduced in 1999/00 with the purpose of funding the rehabilitation of hospitals. Funding for maintenance was introduced into the grant in 2001. In 2003 the purpose of the grant was changed to *'transform and modernise hospitals in line with the national planning framework'*. Currently, the grant funds the modernisation and transformation of both the hospital infrastructure and medical equipment in hospitals. Save for the modernisation of medical equipment, the purpose of the grant is not dissimilar to that of the Provincial Infrastructure Grant, which funds the rehabilitation and construction of roads, health, agriculture and schools facilities, with the emphasis on provinces with large infrastructure backlogs.

Conditions

Initial requirements for funding were the submission of health services plans showing detailed information on hospital capital and maintenance projects. Since the 2003/04 fiscal year, allocations also depend on progressive increases in spending on maintenance up to targets set by the Integrated Health Planning Framework (IHPF). Further conditions include the submission of a prioritisation schedule for all hospitals reflecting an order of implementation, alongside compliance with provincial priorities for sustainable service delivery as identified in the Strategic Statements. Compliance with the IHPF is also required.

From 2005/06, submission of business plans and project implementation plans to the National Department of Health is required before funds can be released. The submission of Provincial Strategic plans with hospital plans and an indication of measurable objectives in departmental strategic plans is also a necessary condition.

Grant Design

This is a Schedule 5 grant or a specific purpose allocation to provinces. Measurable outputs of the grant are expressed in terms of the number of projects that will eventually result in revitalised hospitals with modernised infrastructure and up-to--date machinery and management systems.

The National Department of Health is responsible for monitoring implementation of the grant and providing the necessary support to provincial health departments. It also has to provide guidelines for developing business plans and facilitate agreements on outputs with provincial departments. The grant is monitored by submission of quarterly performance reports, monthly financial reports and quarterly visits to provinces.

Allocation of the grant is based on past expenditure performance, projected cash flow figures for projects and the requirement to sustain at least four active sites per province. The duration of the grant is likely to depend on the pace of revitalisation of hospitals and the rate of funding. From 2006/07, the Hospital Management and Quality Improvement grant will be consolidated into the Hospital Revitalisation grant.

Monitoring and Performance

Spending for the grant is impacted upon by, amongst others, the following factors:

a) Cashflow problems experienced by small contractors.
b) A dysfunctional relationship between the provincial Health and Public Works departments.
c) The boom in the construction sector leading to major construction companies being selective about the projects they choose.
d) The tendering process – projects being delayed due to litigation by bidders who could not secure tenders.
e) The appointment of contractors without the capacity to deliver.
f) The splitting of the project to bring in black empowerment contractors, resulting in delays in delivery.
f) The involvement of multiple departments in the implementation process leading to the stalling of projects.

The implementation challenges mentioned above are similar to those experienced with the implementation of the Provincial Infrastructure Grant and other infrastructure grants. The purpose of the Hospital Revitalisation grant is not very dissimilar to that of the Provincial Infrastructure grant, save for the fact that the former is intended for the upgrading of hospitals. The latter funds the upgrading of clinics. Existence of these two infrastructure grants imposes an additional reporting and administrative burden on provinces. The lack of co-ordination between the Hospital Revitalisation and the Provincial Infrastructure Grants has also led to some revitalised hospitals being surrounded by satellite health clinics of poor quality. The hospital is then burdened with referals that could have been treated at the clinics.

Since the start of the grant, 210 hospitals have so far been upgraded and it is expected that 59 hospitals will be rehabilitated and upgraded over the next three years.

Spending for the grant is generally high but shows a declining trend over the period 2001 to 2004. Over the period, 89 percent of the cumulative budget was spent. Spending for the grant increased by an annual average of 7 percent as opposed to the budget growth of 20 percent. It is thus apparent that spending is not keeping up with increasing budgets owing to a number of factors, some of which have been discussed above. For the 2005/06 fiscal year, up to the third quarter, spending for the grant was 58 percent.

1.3 Water Affairs Conditional Grants

1.3.1 Implementation of the Water Services Projects Grant

Purpose

This grant was set aside as a capital (in-kind water capital) grant in 2001 and transferred to municipalities via the Department of Water Affairs and Forestry (DWAF). Its objective was to aid local authorities, especially rural municipalities lacking dedicated municipal institutional capacity in planning and implementing the provision of bulk, connector and internal water services infrastructure at a basic level of service. Where necessary, the implementation of such capital projects can be carried out by DWAF on behalf of incapacitated municipalities. Once such projects are completed, the grant helps facilitate transfer (with no staff or operating budgets) to receiving municipalities. The operating component has been phased into the local government equitable share (LES) formula and will terminate in 2011. The capital component of the grant was terminated in the 2005/06 financial year and has been incorporated into the Municipal Infrastructure Grant (MIG) programme.

Conditions

The initial requirements were that funds could only be committed to new projects after formal agreements were reached between DWAF and recipient municipalities with respect to the ownership of water assets, as well as the financial responsibilities related to the operation and maintenance of the project. The conditions attached to accessing the above grants have since evolved and, at present, conditions require that municipalities achieve a number of outputs. These include: developing and submitting service plans and budgets (detailing implementation, operation and maintenance costs); demonstrating an acceptable level of expertise in the management of water services projects and entering into formal service provision agreements (including provision for payment of services rendered by DWAF) with DWAF.

Grant Design

The grant is listed under Schedule 7 of the DoRA and is therefore an in-kind allocation to municipalities for designated special programmes.

Measurable outputs for the grant include the number of people to be served with water – 45 000 (targeted); the number of jobs to be created - 3 200 for all categories; the number of people to be impacted through the health and hygiene programme – 68 000 (targeted) and the number of toilets to be constructed - 17 100.

The allocation criteria are that the following should be prioritised for funding: ongoing projects; operational projects; capacity building projects and completed projects requiring transfer. No new infrastructure projects will be implemented and only projects previously approved by the Minister will be implemented.

The responsibilities of the national department are to ensure that ongoing projects are completed and transferred to the appropriate municipalities; identifying any corrective steps to be taken for any problems with this grant identified during the auditing process, as well as problems with outputs achieved in the financial year. The department must also provide detailed information on the allocation formula, the data and the monitoring systems used.

Amongst the most important of the conditions of the grant is the need to ensure the sustainability of projects and buy in from implementing municipalities. To achieve this, beneficiary municipalities are required to budget for the maintenance and operational costs of the water projects. An additional important design feature of the grant is the existence of management capacity and reporting mechanisms in municipalities.

1.3.2 Water Services Operating Subsidy[4] (WSOS) & Water Services Operating and Transfer Subsidy (WSOTS)

Purpose

Introduced in 2002, these allocations provide funding for the operation and maintenance of water schemes that are owned and/or operated by DWAF or by other agencies on behalf of the department. The grants also help facilitate the transfer of water schemes, with appropriate staff and budgets, to recipient municipalities. The grant remained a direct conditional grant untill the 2004/05 financial year, after which it was incorporated into the local government equitable

4. This subsidy is funded by the augmentation of the Water Trading Account.

share formula (LES), although in some cases, transfers are made to water service providers such as water boards. It is expected that this grant will terminate in 2011.

Conditions

The Division of Revenue Act (DoRA) specifies an exhaustive list of conditions related to water grants. This section summarises the crucial conditions attached to grants administered by DWAF. These include the requirement that all recipient municipalities enter formal service provision agreements (including provision for payment of services rendered by DWAF). In addition, DWAF stipulated that by the 30 of June 2005, all receiving water services authorities/providers needed to have concluded formal transfer agreements[5]. In terms of the operating subsidy, conditions attached stipulate that the operating subsidy will cover staff-related costs (HR component), direct operating and maintenance costs (O component), as well as facilitate the transfer of schemes in terms of scheduled milestones. In addition, the grant will be structured to cover the costs of refurbishing water services schemes, processes to facilitate transfers, sustainability assessments and land and legal costs.

Grant Design

The WSOTS is a recurrent grant to municipalities and is classified as a Schedule 6 grant while the WSOS, an in-kind/indirect grant, is classified as a Schedule 7 grant. Focusing on the WSOTS, the grant is designed to fund over 300 water schemes in municipalities via the water trading account on the vote of the Department of Water Affairs (DWAF). DWAF is currently in the process of transferring these schemes to local governments over the next three years. Funding will cease from 2007/08.

The design of the grant involves the transfer of assets, staff and the resulting operating costs of salaries and free basic services from DWAF to municipalities. The operating component of the grant is designed to cover three aspects – staff-related costs (HR component), direct operating and maintenance costs and the refurbishment of infrastructure. Both the operating and transfer components of the grant are treated as a grant in kind till the effective date of the transfer. Thereafter, it will be phased into the equitable share.

Research (see Whelan, 2003), however points to administrative design practices impacting negatively on the transparency and legibility of the grants. Firstly, there is ambiguity regarding the 'sustainability' and 'refurbishment' elements of the WSOTS grant. The grant contains a number of sub-allocations intended to cover the costs of physical upgrades and capacity building activities. The DoRA 2005 gives no indication of such sub-allocations. In addition, there is very little information about

5. The Commission is currently engaged with DWAF to get pertinent data including the number of formal agreements concluded by water services providers

the subdivision of the refurbishment allocation; nor is much known about the information benefiting municipalities have received regarding grant flows.

Secondly, the design of the grants seem ambivalent to the pressing issue of the successful transfer of schemes to local governments. It has been argued that while municipalities are aware that these schemes will be transferred to them, many lack the capacity and the necessary resources to operate and maintain transferred schemes. While DWAF has carried out capacity-building exercises (especially in relation to pre-1994 schemes), poor cost recovery on these schemes indicates that such interventions are not necessarily yielding the expected results. Perhaps, a design framework that explicitly states that municipalities are made aware of the allocations involved and the purpose of the grant is needed.

Lastly, the DoRA includes some operating elements as in-kind water capital grants, and some capital expenditure as operating costs. This factor obscures the purpose of grants, makes oversight difficult and inhibits municipal planning.

1.4 Poverty Relief Conditional Grants

The above term is used to describe a range of grants whose design has, as an underlying theme, the alleviation of poverty in disadvantaged areas of South Africa. A majority of these transfers are funded from the national poverty relief fund and can thus be classified as poverty relief grants. These include:

1.4.1 Community Based Public Works Grant (CBPWG)

Purpose

Set up in 2001 and similar to the Local Economic Development (LED) and Social Plan Measures (SPM) grants, the CBPWG was classified as an infrastructure/capital grant with its primary objective defined as poverty alleviation for poor rural communities. An intended spin-off or secondary objective of the grant was that it could also help fund projects that enhanced job creation.

Conditions

The programme's initial conditions stipulated that 30 percent of the grant be spent on community labour, where the community labour employed consisted of 50 percent women, 15 percent youth and 1.5 percent disabled people. In addition, a minimum of five indigenous trees was required to be planted per project. By 2002, the conditions of the grant had changed to include: compliance with the

Programme Management System; meeting employment targets; maintenance and operation of facilities; and sustainability planning. Furthermore, the grant had to be reflected in the budgets of recipient municipalities.

Grant Design

One of the secondary objectives of the CBPWG grant was to generate employment opportunities via expanding projects that required the use of labour-intensive production techniques. To achieve this, the grant was designed as a capital transfer in order to place emphasis on the recreation of an asset that addressed some aspect of poverty and employment creation. In order to determine which municipalities and districts were in most need of the grant, the Department of Public Works used a combination of poverty indicator-based targeting at various scales, municipal applications as well as recommendations by project design and selection teams. In addition, provincial and district based project teams played a key role in identifying projects and, in some cases, determining municipal allocations.

Although the aims and objectives of the grant were clear, a major design problem of the grant was that the choice of recipient municipalities and the approval of project funding was determined by a central body. Often, such centralisation meant that an understanding of local areas of acute poverty was lacking. In addition, the central processing of applications resulted in lengthy approval times adversely affecting project design and making implementation of poverty relief programmes unpredictable.

1.4.2 Municipal Infrastructure Grant (MIG)

Purpose

Approved by Cabinet in March 2003, the MIG is a consolidated grant mechanism that replaced capital grants for municipal infrastructure and merged seven previous infrastructure programmes – the Consolidated Municipal Infrastructure Programme (CMIP), the Local Economic Development Fund (LED), the Water Service Capital Grant, the Community Based Public Works Programme (CBPW), the Building for Sports and Recreation Programme (BSRP), the Urban Transport Grant (UTF)[6] and the INEP grant implemented by both municipalities and ESKOM. However, owing to ongoing reforms and the restructuring of the electricity distribution industry, current capital spending related to electrification funding will be incorporated into the MIG programme once the restructuring framework is finalised[7].

The main purpose of the grant is to supplement municipal capital projects to eradicate backlogs in basic municipal infrastructure utilised in the provision of basic services for the benefit of the poor. In addition, the grant is designed to

6. The CMIP and LED programmes were managed by DPLG; the water services grant was managed by DWAF; the CBPW was managed by Department of Public Works, while the BSRP and UTF were managed by Sports & Recreation and Department of Transport respectively.

7. It is anticipated that the restructuring framework will be finalised by the 2008/09 fiscal year.

ensure that an overall target for removing backlogs for accessing basic municipal services is attained over a ten year period. Given these objectives, the key principles underpinning the design of the MIG are:

a) Focusing on the infrastructure required for a basic level of service.
b) Providing services to the poor.
c) Maximising local economic spillovers such as employment creation and enterprise development.
d) Ensuring equitable access to MIG funds by the poor to ensure that uniform progress is made in addressing infrastructure shortages.
e) Decentralising spending authority within national standards.

Conditions

As a conditional grant, the MIG is intended to allocate funding in line with Government's policy priorities. Given that the MIG is intended to assist the poor in gaining access to infrastructure that could help improve their economic opportunities, the conditions attached to the grant require that receiving municipalities prioritise residential infrastructure for water, sanitation, electricity, refuse removal, street lights, solid waste, connector and bulk infrastructure. In addition to these, they also require that municipalities pay particular attention to other municipal infrastructure like roads. This should be in line with any MIG or government sector policies established before the start of the municipal financial year.

Beyond focusing on the above priority areas, municipalities must also adhere to proper planning and accountability guidelines. Conditions related to planning and accountability are divided into two groups – cross-cutting conditions that relate to overall performance of the municipality and all its projects and sector-specific conditions. Examples of such cross-cutting conditions include the attainment of specified basic services coverage targets, the development of integrated development plans (IDPs) and the detailed reporting and registration of MIG project business plans. On the other hand, sector-specific conditions encompass conditions established by a sector department (such as DWAF, DoT and DME) and endorsed by the Municipal Infrastructure Task Team. Specific conditions include specified targets such as adherence to labour-intensive construction methods; the submission of reports according to the framework specified in sections 71 and 72 of the MFMA (and complying with sections 16, 20 and 24 of the 2005 DoRA); the quality of basic service provided and the profile of companies issued with contracts for infrastructure development.

Grant Design

Classified as a Schedule 4B grant, the MIG was designed to address the problems arising from the fragmented management of infrastructure grants by different departments. The design of the grant primarily aims to ensure cost-effective and improved accountability, as well as integrated service delivery, which will give municipalities greater control over infrastructure programmes within their jurisdiction. In addition, the MIG is designed to ensure that municipalities have adequate resources to cater for the maintenance and operation over the life-cycle of the infrastructure assets. The design of the MIG encompasses an extensive range of issues covering the phasing in of financial responsibilities, together with the role of municipalities and national departments in the management of MIG programmes and funds. There are also clearly outlined monitoring and control frameworks covering utilisation of MIG funds and funding arrangements.

Although primarily distributed via a funding formula, a portion of MIG funds is retained to fund project-based applications by municipalities that meet pre-determined criteria. This non-formula based portion of the MIG grant is disbursed through a Special Municipal Infrastructure Fund (SMIF). To ensure a horizontal division of the MIG funds, the funding of MIG using a formula approach is:

$$\mathbf{MIG_{(T)} - Management\ Costs - SMIF = MIG_{(F)}}$$

where $MIG_{(T)}$ denotes the total allocation made to MIG via the national budget process, plus management costs related to those of the national MIG unit, while $MIG_{(F)}$ denotes MIG allocations transferred via the formula mechanism. The $MIG_{(F)}$ is allocated as follows:

$$\mathbf{MIG_{(F)} = B + P + E}$$

where

- B is the amount allocated for *basic residential infrastructure*: this component consists of proportional allocations for water supply and sanitation, electricity, roads and other services such as street lighting and solid waste removal.
- P is allocation aimed at funding new and rehabilitated public *municipal service infrastructure.*
- E is the amount allocated to building infrastructure related to *social institutions and micro-enterprises.*

Monitoring and Performance of the MIG Programme

Although approved in 2003, the full implementation of the MIG programme only began in the 2004/05 financial year. In this period, an amount of R4.4 billion was allocated to a total of 88 municipalities, with most recipient municipalities being district councils and high capacity municipalities. In the second year of MIG rollout, i.e. 2005/06, the number of recipient municipalities increased to 170 (of which 47 were district municipalities), while the overall MIG envelope increased by 21.6 percent to over R5 billion. The implementation of MIG has brought about a number of successes. As at June 2005, the number of households serviced on MIG projects countrywide was estimated at 875,861[8] while the amount of employment on MIG projects in terms of person days amounted to 6 million (DPLG, 2005).

Despite these achievements and the increase in overall allocations, there still remain a number of outstanding issues regarding the spending of MIG funds. In the first year of allocation, virtually all provinces spent their entire allocations of MIG funds, with total transfers and overall spending averaging 99-100 percent (across all provinces) respectively. However, in the 2005/06 financial year, it is observed that across all provinces, transfer of MIG allocations averaged just over 41 percent while the spending of transferred funds was on average 42 percent.

The main reason for the under-expenditure of transferred funds in the 2005/06 fiscal year has been attributed to continued spending by many municipalities of MIG funds carried over from the 2004/05 financial year. There are a number of underlying factors including lack of proper project planning, ineffective management of project life cycles, lack of capacity in managing MIG funds, as well as late approval of projects and budgets by council officials.

In addition, there are also some outstanding design issues carried over from incorporated grants. For instance, CMIP funds and project selection followed a complex chain of transactions before ending up at the DPLG. This meant that municipalities received funds towards the end of their financial year, causing rollovers in cases where municipalities lacked bridging finance. Such rollovers and delays in transfers in a fiscal year tended to impact on project implementation and grant spending in previous years, escalating administration costs of the grants. The design of the MIG does not explicitly state how these issues will be addressed such that, over the past year (2004), many municipalities have expressed concern that the problem appears to have been left unresolved.

1.5 Capacity-Building Grants/ Recurrent Grant Allocations

1.5.1 Local Government Restructuring Grant (LGRG)

Purpose

In the context of the need for transition and reform within the local government sphere in the post 1994 period, the LGRG was introduced in 2000 with a stated

8. According to data obtained from DPLG, of the over 870,000 households benefiting from MIG projects, 738,436 were serviced on the B component projects, 40,755 were serviced on P component projects while 1,673 households were serviced on non-public municipal services projects.

objective of modernising large municipalities in order to enhance effectiveness and efficiency in service delivery. By 2005, the grant had been extended to cover 'large budget municipalities'. To achieve this objective, the funds from the grant are directed towards organisational and functional restructuring, while also improving the fiscal positions of the targeted municipalities.

Conditions

In view of the importance of the large metropolitan areas to economic growth and development, large municipalities applying for this grant were required to show sufficient progress towards the implementation of restructuring plans and the addressing of any fiscal crises that they could face. In addition, the renewal of funding is contingent upon the achievement of financial performance benchmarks. In 2004, these conditions were augmented by requirements to show commitment towards implementing locally-owned restructuring plans that address fiscal challenges in a sustainable manner, as well as the provision of quarterly reports measuring progress towards achieved milestones.

Grant Design

The grant is listed as a recurrent grant allocation to municipalities or a Schedule 6 type grant in the DoRA. The LGRG is funded under the National Treasury budget vote and is designed to modernise financial management practices at local government level. This modernisation includes building in-house capacity to implement multi-year budgeting, providing timely and quality annual reports and linking local Integrated Development Plans (IDPs) to budgets.

The LGRG is a demand-driven grant for which only large municipalities are eligible. It is designed to fund municipal restructuring initiatives of a financial, institutional and developmental nature, where such initiatives are locally designed and supported. The design of the grant requires that affected municipalities should be able to predict whether they will receive the funding and when they will receive the allocations. As the flow of grants is determined by the performance of receiving municipalities, it is difficult for transferring departments to predict allocations.

1.5.2 Local Government Financial Management Grant (LGFMG)

Purpose

Initiated in 2000, this grant is intended to build financial management capacity and assist municipalities in implementing budget, accounting and financial management reforms. In 2002, the grant's purpose was extended to include supporting reforms to budgeting and financial management practices, as well as to assist municipalities in the implementation of the Municipal Finance Management Act (MFMA).

Conditions

The key process condition is that the Council passes a resolution in which the municipality commits to employ an appropriately skilled chief financial officer tasked with the responsibility for implementing accounting and reporting reforms. The accounting officer will also submit quarterly reports detailing progress towards attaining the programme's performance milestones. For the grant to be renewed, adequate financial management performance must be shown by the applying municipality.

1.5.3 Municipal Systems Improvement Grant (MSIG)

Purpose

Introduced in 2001, the aim of this grant is to provide support to municipalities in developing their systems and capacity for integrated spatial planning in line with their budgetary framework. Between 2002 and 2003, the objectives of the grant changed slightly and were intended to support municipalities in implementing new systems as provided for in the Municipal Finance Management Act (MFMA) of 2003. It also aimed at enhancing development planning. By 2004, the stated purpose of the grant was specified as 'assisting municipalities in building in-house capacity to perform their functions'. As listed in the Division of Revenue Act (DoRA) 2005, the stated purpose of the grant is to 'assist municipalities in building in-house capacity to perform their functions and stabilise institutional and governance systems as required in the Local Government Municipal Finance Systems Act of 2000'.

Conditions

Following the accessing of the grant by most district councils and the municipalities of some large cities at the beginning of 2002/03, recipient municipalities were required to submit 'capacity-building frameworks'. Where the receiving authority is a district council, Planning, Implementation and Management Support (PIMS) centres play a central role in developing these frameworks, in collaboration with local municipalities. At present, most of these conditions are still in place. To these have been attached additional requirements with respect to the submission of council resolution on approved (and measurable) action plans, the submission of a PIMS-centred annual work plan and the submission of an impact report on past performance of the grant.

Grant Design

At present, there are two capacity-building grants – the Local Government Financial Management Grant (LGFMG) and the Municipal Systems Improvement Grant (MSIG). The two grants are listed as recurrent grant allocations to municipalities or Schedule 6 type grants in the DoRA.

The MSIG is funded under a DPLG budget vote and was initially designed to enhance capacity building at local government level. However, emphasis around design of the grant has shifted towards developing new skills in financial management and improving service delivery. The design of the grant envisages the establishment of Planning, Implementation and Management Support (PIMS) centres that will assist in stabilising municipal governance systems, enhancing the capacity of selected municipalities to review Integrated Development Plans (IDPs) and implement the Municipal Systems Act.

From the DoRA, the design of the two capacity grants is clearly outlined in terms of their monitoring systems, measurable outputs and allocation criteria. However, a significant drawback in the design of the grants remains the lack of a coherent and strategic understanding of capacity building in local government, including what needs to be done to develop such capacity. The FFC's 2005/06 submission document notes that institutional capacity needs to be classified into two distinct catergories at local government level: capacity maintenance and capacity building. Capacity maintenance refers to the maintenance of the minimum institutional infrastructure[9] required for effective municipal governance. Capacity building, on the other hand, assumes that minimum institutional infrastructure is not in place and needs to be established. The design of the grant gives transferring departments the ability to set up application-based grants and requires municipalities to apply to the transferring departments for the grants. However, to date, recipient local authorities have no clear indication of the framework used in evaluating municipal applications.

1.6 Education Conditional Grants

The Department of Education (DoE) administers three conditional grants: the National School Nutrition Programme, the Recapitalisation of Further Education and Training (FET) Colleges and the HIV/AIDS Life Skills Education Grant. The Recapitalisation grant will only be implemented in 2006/07, so no details are available to make any informed assessment of the grant at this point in time.

9. Such as administrative buildings, as well as the training of municipal officials.

1.6.1 National School Nutrition Programme Grant

Purpose and Conditions

This conditional grant was introduced in September 1994 under the administration of the national Department of Health (DoH). It was then called the Primary School Nutrition Grant. Originally, the purpose of the grant was to fund primary school nutrition programmes[10]. In 2004/05 the grant shifted to the Department of Education (DoE) and the name changed to the National School Nutrition Programme.

The purpose of the grant changed over time, although not significantly. Currently, its purpose is; 'to contribute to enhanced learning capacity and school attendance'.

The conditions and monitoring mechanisms of the grant have been tightened over time. While this is the case, not all provinces have been consistent in complying with some of the conditions of the grant framework. For example, monitoring reports have shown that, from time to time, provinces have served meals that do not comply with the menu options and food safety standards of the Department of Health. This is partly as a result of the general unavailability of equipped kitchens or storage facilities in the schools to support the efficient implementation of the grant programme. As part of the strategy to address food safety challenges, the Department of Education has trained 240 Master Trainers in provinces to teach food handlers about the hygienic handling of food and healthy cooking. Furthermore, the DoE is moving towards approaches that involve communities in the programme and tendering procedures that would strengthen accountability and transparency.

Grant Design

The grant is classified under Schedule 5, implying that it is a specific-purpose allocation to provinces although its classification has seemingly changed several times over the period. This could have been because of the lack of specificity when the grant was designed, and because the initial purpose was not linked to the measurable objectives of the grant. Currently, the grant has clear measurable outputs and monitoring mechanisms. However, some provinces have been unable to achieve all the objectives due to several implementation problems.

In some provinces, there is flexibility in terms of the feeding programme. During the examination period, learners are given lighter meals than during normal school days. In these cases, the targeted four days' feeding per week is met through innovation rather than through an increased allocation of funds.

10. See Health grants above.

The allocation criteria that were used by the Health Department were retained when the grant was transferred to the Education Department. The question that this raises is whether these criteria are in line with the purpose for which the grant was designed. The DoE has acknowledged that the current criteria will result in targeting problems. This is indeed the case as targeting must be able to identify those schools and children that will benefit most. It must also be applied at two levels: by the economic status of a school's geographic location and by individual school[11]. The current allocation criteria are based on three indicators, namely the poverty gap (1996), the population census (1996) and anthropometric indicators for children (2000). From 2007 the department envisages using their own allocation criteria and distribution based on the poverty quintiles of each school. However, there is again a potential challenge for schools and learners that benefited from the old criteria and might now fall outside the criteria under the new approach. A Baseline Study commissioned by the Department of Education and the National Treasury is being conducted. The first phase of the study focuses on databases and targeting criteria in provinces.

Due to the high poverty levels in the country, it is envisaged that the need for this grant will persist for at least another eight to ten years. The justification for funding the programme through a conditional grant is that the funding of the programme must not be left to provincial discretion but be funded directly through a conditional grant until the programme has been fully institutionalised. The FFC has always maintained that the use of conditional grants should be used to achieve specific objectives that are of national priority or to compensate for spillover effects. In this case, the programme is a national priority but also results in vertical fiscal externalities. The vertical fiscal externalities arise due to the fact that the government imposes certain standards of service delivery on a service that is a provincial competence without the necessary resources being made available to meet those standards. The Department is aware of the purpose of funding the programme through a conditional grant, as can be seen in their strategic objectives to encourage sustainable food production projects in schools and nutrition education in the curriculum. These objectives aim to support the programme and contribute to stimulating the local economy and knowledge about food production.

A reasonable inference can therefore be made that the framework of this grant still requires refining to take account of some of the challenges. These challenges include limited funds and capacity for provincial planning and implementation, and problems of alignment between national and provincial planning. Further problems include non-compliance with business plans; hygiene and safe-keeping of food; flawed targeting; late delivery of meals; breach of contracts between suppliers and provincial education departments and also delayed payments to suppliers. The problem of lack of kitchen facilities in some provinces is being addressed by using local communities to provide meals.

11. An evaluation of South Africa's Primary School Nutrition Programme: Child Health Unit, UCT

Monitoring and Performance

In terms of monitoring as stated in DoRA 2005, provinces are required to report monthly on expenditures and risk management and to submit quarterly reports on progress on indicators. Furthermore, the national department has to visit provinces to track progress against business plans, to monitor implementation and also to monitor nutrition quality, quantity and food safety. In terms of the monitoring mechanisms as stated in the DoRA, there are instances of non-compliance. This is attributed to cumbersome invoicing procedures, late submission of business plans and delays resulting in late delivery of supplies. Late submission of business plans is attributable to a lengthy and iterative process that provinces have to go through before being finally approved by the national Department of Education (DoE). Other monitoring mechanisms include Quarterly Performance reports and provincial visits undertaken by the DoE.

From the 2002/03 financial year to the 2003/04 financial year, the budget increased from R669m to R824m. In 2002/03, R641m was spent whereas in 2003/04 R786m was spent. The overall total budget for the period 2001-2004 was R2 943 million with total expenditure at R2 762 million translating to 94 percent expenditure. The annual average budget growth rate for the period 2001-2004 was 10.4 percent. Thus, in terms of spending, the grant has been well used and currently some provinces are topping up their budgets. The grant makes provision for up to 7 percent of the provincial allocation to be used for administration

There is a need for the national Department of Education and provinces to strengthen co-planning and reconciliation and relevant clauses in the DoRA should be enforced to deal with non-compliance. Furthermore, efforts should be made to improve budgeting, financial systems and procurement problems.

1.6.2 HIV/AIDS Life Skills Education Grant

Purpose and Conditions

This grant was introduced in 2001/02. The purpose of the grant as stated in the DoR Bill (2001) was to deliver and promote life skills and HIV/AIDS education in primary and secondary schools. Furthermore, it is to ensure access to an appropriate and effective integrated system of prevention, care and support for children infected and affected by HIV/AIDS. The conditions of this grant have remained unchanged since inception.

Grant Design

The grant is classified under Schedule 5 as a specific purpose allocation to provinces. Spending guidelines are given to provinces even though some discretion is allowed with the permission of the national accounting officer. This discretion was introduced to accommodate diverse programme needs and priorities in provinces. Effective monitoring of the grant is ensured by the requirement that the grant be kept as a separate programme responsibility with objective codes.

The grant has clear, measurable objectives and allocations to provinces are made based on the education component of the equitable share formula. The FFC has in the past indicated that this allocation mechanism is not appropriate and this was highlighted in its submission to the Select Committee on Finance in 2004. The submission indicated that there was no direct link between the spread of HIV/AIDS in a province and the education component of the PES formula. Using the education component of the PES assumes that a province with a high number of school age children (whether enrolled or not) has a higher need and therefore should get a higher allocation.

Futhermore, gaps in the implementation process affect the achievement of measurable objectives. For example, the implementation process takes place mostly during school holidays or weekends. There is also a mismatch between the transferring of funds and the expected reporting on spending, particularly in the first quarter of the fiscal year. First quarterly reports on expenditure reflect either no expenditure or very low expenditure due to late receipt of funds by Provincial Education Departments (PEDs).

Although the programme is now considered to be fully integrated into the school system[12], it is recommended that the programme should continue to be funded through a conditional grant mechanism[13].

As the funding for the programme is not done through the equitable share the national Department of Education can play an oversight role to ensure congruency with and adherence to its strategy for HIV and AIDS.

Monitoring and Performance

When the grant started, there was general non-compliance by provinces with respect to submitting business plans and reports. This was attributable to the fact that some provinces did not consider the programme to be a priority relative to other problems they were encountering. For example, in the Free State, Northern Cape and Western Cape, substance abuse is a priority in the education sector, while in the Eastern Cape and KwaZulu-Natal the high prevalence of HIV/AIDS may be considered a greater priority.

The budget for the financial year 2001 was R74 million of which 28.4 percent was not spent. Underspending of the grant in subsequent years has been declining, albeit at a

12. Annexure E: Explanatory memorandum to the 2006/07 Division of Revenue.
13. FFC Submission 2002/03.

slower rate. Underspending was at its lowest in 2004 at 15.1 percent. The overall total budget for the period 2001-2004 was R512 million with an aggregate underspend of 20 percent. The budget increased on average by 29 percent per annum over the period.

1.7 Agriculture Conditional Grants

1.7.1 Land Care Programme

Purpose and Conditions

This grant was introduced in 2001/02 when it was known as the Poverty Relief and Infrastructure Development Grant. Its purpose is to address the problems of the degradation of agricultural resources and to improve the socio-economic status and food security of rural communities. Up to 2004/05, the grant had only one condition. The condition required that the implementation of approved projects be according to the project schedule. In 2005/06, three new conditions were added to the grant. Firstly, there must be confirmed capacity to implement projects and operational funding to support such capacity. Secondly, quarterly reports must be agreed to between provinces and the national department. Lastly, strategic plans from provinces have to indicate measurable objectives and performance targets clearly, as agreed with the national department. These three new conditions should, amongst other things, ensure that departments do not take on projects without the capacity to run them. The conditions should also lead to tighter monitoring by the national department.

Grant Design

This is a Schedule 5 grant and its allocation is meant for a specific purpose. In its first two years of existence, the design of the grant raised concerns as it had only one condition. However, over the years, more conditions were introduced. When allocating funds, an objective mechanism is used that takes into account, amongst others, the weighted average of communal land capability, areas of severe degradation and households living below the minimum poverty level. The fact that the factors used cannot be influenced by the recipients in any way is a good design feature of this grant. The grant was part of a national government initiative on special poverty allocations. The grant is projected to last for five years but the lifespan would be dependent on the quality of business plans submitted and the performance of the programme. Subjecting the lifespan of this grant to business plans and the performance of the programme could be aimed at motivating provinces to devise good business plans that will do well over the duration of the grant.

The responsibilities of the national department include evaluating annual reports for submission to the NCOP and National Treasury; ensuring agreement on outputs and targets with provinces; providing guidelines for business plans; monitoring and submission of quarterly reports to Parliament and National Treasury. The national department is also responsible for submitting the allocation criteria and approved business plans to National Treasury on time. In this regard, the grant appears to be well-designed, as national government has clearly defined responsibilities and is also providing support and guidance to provinces on the development of business plans. Performance and monitoring issues on this grant and those on the Comprehensive Agricultural Support Programme are discussed after the next section.

1.7.2 Comprehensive Agricultural Support Programme (CASP)

Purpose and Conditions

This grant was introduced into the system in 2004/05. At inception, its purpose was stated as enhancing the provision of support services that will promote and facilitate agricultural development. It was targeted at beneficiaries of land and agrarian reform programmes and resource-poor land users. In the next year of its existence, 2005/06, only individuals benefiting from land and agrarian reform programmes are mentioned as beneficiaries. In terms of the conditions, the funds for this grant are meant to supplement provincial budgets in the improvement of farmer support.

Submitted business plans are expected to show how funds would be used in line with the objectives of the grant. Additional inputs to be acquired and services to be improved also formed part of the information to be indicated. In addition, quarterly reports have to be agreed to by both the province and the national department. Lastly, provincial departmental strategic plans are expected to indicate clear, measurable objectives for the coming financial year and over the MTEF. In 2005/06, the condition on business plans was modified to read that there be confirmed capacity to implement projects, as well as operational funding to support such capacity.

Grant Design

This grant is a Schedule 4 grant intended to supplement what provinces are already spending out of their equitable share allocation. It is not included in the equitable share because national government considers the enhancement of productive capacity and the economic success of its beneficiaries to be a priority. The grant is well-designed as it has measurable objectives. In addition, the allocation criteria for this grant takes into account relevant factors such as the size of agricultural land; the nature of agricultural activities; the number of targeted emerging farmers and the rural population as determined by Statistics South Africa 2001 Census. These will ensure that there is objective determination of allocations to provinces. The projected lifespan of the grant is five years. Whether after five years all beneficiaries of the land reform programme would have been supported and the programme cease to exist is not clear considering the slow pace of land reform in the country.

Monitoring and Performance of the CASP and Land Care Programme[14]

Since inception and until 2004/05, a total of R102 million was allocated to the Land Care Programme. Of this total amount, what has been spent translates to 80 percent over the period. On average this grant contributes a 24 percent share to overall agriculture conditional grant funding. In 2003/04, Land Care had the highest share out of all conditional grants for agriculture at 56 percent. Average expenditure translates to 63 percent over the four year period. Trends in expenditure show a decline over the period. On average, expenditure has declined by 34 percent over the period under consideration. This may indicate a lack of capacity in provinces to improve spending on this grant.

Due to the relatively new nature of CASP, data at the disposal of the FFC when this report was written was only for one financial year, 2004/05, the year in which the grant was introduced. The least that can be said is that R200 million was allocated to this grant and it contributed a 58 percent share out of all the funding set aside for all agriculture conditional grants in 2004/05. Expenditure in the first year of CASP's existence translates to 71 per cent. The National Department of Agriculture[15] raised concerns that although the Land Care grant has been in place for a long time, spending performance between it and CASP is almost the same. The expectation was that by now, expenditure on Land Care would be far ahead that of CASP. Below we discuss some of the factors underlying spending performance.

In relation to their ability to monitor grants, the national department maintains that the laws governing conditional grants and the way these grants are designed limits the national department's intervention in provinces. The extent of intervention that the national department can exercise depends on the type of conditional grant involved. In relation to Schedule 4 grants that supplement what provinces are already spending out of the equitable share such as CASP, the national department only transfers funds and provides support where it is needed. The national department cannot impose its views. As such, the national department is limited in what it can do. In comparison to Schedule 5 grants meant for specific purposes such as the Land Care grant, the national department holds that it has more control as it actually decides the full programmes of the grant. While this may be good for monitoring purposes and for ensuring that funds are spent in line with

14. Information in this section was drawn from the discussions the FFC had with officials from the Department of Agriculture on 3rd March 2006.
15. Meeting with the Department of Agriculture: 3rd March 2006.

the stated purpose, it is important to note that in the period it has been in existence, conditions attached to Land Care have not been relaxed to improve spending.

Although the national department, in meeting its monitoring responsibilities, has put structures in place both at the national level and within districts, challenges remain. Some of the challenges that are still hampering provinces, although too numerous to enumerate here, include skills shortages and limited implementation capacity. In particular, lack of engineering and project management capacity has undermined the ability of some provinces to implement projects. National government proposes that as one way of improving the implementation of Land Care grants, timely planning and shortened project cycles are necessary. The centralised nature of procurement was also mentioned since it results in under-expenditure and delays in implementation. Another factor that results in under-expenditure is inadequate capacity to operate the early warning system - a provincial function.

The national department noted another problem that affects spending – especially spending on CASP; is the disjuncture between the way provinces use funds for this grant and the purpose for which the grant was intended. Although CASP was not created for the purpose of funding inputs, since provinces are assumed to already be doing this out of their equitable share, it has in some instances, been found to be used for this purpose. Thus, by spending this grant on an area outside its intended purpose, provinces are deviating from the policy intention of national government to increase spending in a specific area.

More specific concerns on CASP and its implementation include the fact that integration is still lacking as provinces tend to concentrate on infrastructure to the exclusion of other spending areas (viz. information and management, training and capacity building, market and business development support, advisory and financial support). Focus on other areas may witness further increases in spending on this grant. The national department states that CASP, intended to provide agricultural support to beneficiaries of land and agrarian reform, still has backlogs that are far from being addressed. Also, the needs of farmers such as purchasing of inputs, go beyond the spending areas intended for the grant.

The National department mentioned that the lack of a comprehensive assessment before a grant is introduced is a glaring ommission in the general design of conditional grants. The bigger problem of land reform that the grant is trying to address is a critical issue that requires consideration. CASP for instance, is a land reform issue and cannot be viewed in isolation. Thus, in its design, cognisance of this fact must be taken into account. Another important issue is the phasing or folding of a conditional grant into the provincial equitable share. The national department maintains that phasing into the equitable share must happen only when provinces perform well. The definition of good performance, however, still remains open to interpretation. Overall, the national Department of Agriculture is of the view that there is gradual momentum towards buy-in at the provincial level.

Finally, the significance of Land Care and CASP is also affected by the level of agricultural activity in a province and its contribution to that province's economy. For those provinces that are not agriculturally dependent these grants and their small size bring added administrative burdens. However, they mean a lot to those provinces where agriculture makes a significant contribution to the economy. The purpose and measurable outputs of the two grants are also not diametrically opposed but, in some instances, overlap. A single grant may reduce the administrative burdens and the duplication of measurable outputs that attend these grants.

1.8 Additional Infrastructure Conditional Grants

1.8.1 Provincial Infrastructure Grant

Purpose

This Schedule 4 grant was introduced in 1999/00 with the purpose of funding provincial infrastructure in the education, health, agriculture and roads sectors. Reconstruction of infrastructure damaged by the 1999/2000 floods was added as part of the purpose of the grant in 2001. From 2003, the grant has narrowed its purpose to accelerating construction, maintenance and rehabilitation of infrastructure in roads, education, health and agriculture. Part of the purpose is also to enhance capacity to deliver infrastructure and gradually increase labour-intensive projects through the Expanded Public Works Programme.

Conditions

The conditions in 2001 were the submission to National Treasury of detailed spending plans, indicating the extent to which the province could match the grant and how the implementation plan fitted into the overall strategy of the sector. Progressive increases in budget for maintenance in education, health and roads infrastructure also needed to be indicated. For the Flood and Rehabilitation part of the grant, funds used for that purpose had to be verified by the National Treasury.

Quarterly reports, indicating physical progress on projects, in addition to monthly in-year expenditure monitoring reports, have been required since 2003. Strategic plans indicating measurable objectives and targets as agreed with the National Treasury had to be included in the reports.

Grant Design

This grant is classified under Schedule 4A, meaning that it is intended to supplement provincial budgets. It is targeted at the construction, rehabilitation and maintenance of roads, schools, health and agriculture infrastructure only. Grant allocations are based on the following criteria: 40 percent for each of education and roads, 13 percent for health and 7 percent for agriculture. For 2005/06 and 2006/07, set allocations have been top-sliced for the Northern Cape to take account of the vastness of the area and the resulting length of roads.

Provinces are required to submit quarterly reports indicating full details of the projects, expenditure and outputs achieved. Monitoring of the grant is, however, not easy as projects also involve donor and private sector funding. Funding is conditional to ensure that provinces give priority to infrastructure maintenance, rehabilitation and construction and also to give support to the rural development initiatives of national government.

Since this is a Schedule 4 grant, allocations are meant to supplement provincial infrastructure budgets and are also not sector-specific. Coverage of several sectors allows for single reporting on infrastructure. The exception to this is for health expenditure. Health has to report under the Health Revitalisation grant. Single reporting for infrastructure facilitates better infrastructure planning and execution of projects.

Monitoring and Performance

Spending on the grant continues to be affected by the following factors:

- Delays in the procurement process.
- Capacity contraints in departments – specifically Public Works – including the challenges of retaining skilled personnel, appointing appropriately skilled people to permanent positions and having people in acting positions.
- Weakness in reporting as reflected in the discrepancy between figures in the In-Year-Monitoring (IYM) system and the site bills.
- Dysfunctional relationships, in most provinces, with delivery agents and Public Works Departments.

Indications from parliamentary submissions by provinces are that efforts are being made to address the above listed challenges. In particular, relationship with the

Department of Public Works is reported to be improving and service level agreements are being put in place. However, the challenge of retaining and recruiting skilled personnel remains in most provinces.

The grant increased by 12 percent between 2004/05 and 2005/06 and is expected to nominally increase by 43 percent between 2005/06 and 2007/08. As the allocations from the grant are subsumed into provincial budgets, provinces do not report separately on the grant expenditure but on total project expenditure.

1.8.2 Alexandra Renewal Project Grant

Purpose and conditions

This is a Presidential project that started in 2004/05 and is expected to be completed by 2007/08. The purpose of the grant is to contribute towards the purchase of land and for the relocation and settlement of Alexandra residents and other qualifying beneficiaries.

The funds have to be used for the sole purpose of land acquisition for settlement and the province has to account to national department and lawful state organs on expenditure of funds. All funds have to be used in full before the financial year end and the province must report in writing when funds are being expended. It must also continue to report until the housing project has been completed. The provincial strategic plan has to indicate measurable objectives and performance targets as agreed with the national department.

1.9 Discontinued Conditional Grants

Listed in the table on the next page are the grants that have, over time, been either terminated or folded into the Provincial Equitable Share (PES) or the Local Government Equitable Share (LES) or incorporated into other grants.

GRANT	Start Date	End Date	Status
Integrated Nutrition Programme (Health)	1998/99	2005/06	Folded into the PES
Redistribution of Specialised Health Services Grant	1998/99	2001/02	Folded into the NTSG
Consolidated Municipal Infrastructure Programme	1998/99	2003/04	Folded into the MIG
Urban Transport Fund	2001/02	2003/04	Terminated
Integrated National Electrification Programme	2002/03	2005/06	Folded into the MIG
Water Supply and Sanitation Capital Programme	2000/01	2002/03	Terminated
GRANT	**Start Date**	**End Date**	**Status**
Water Supply and Water-borne Sewerage Disposal Schemes Grants	2001/02	2002/03	Terminated
Local Economic Development (LED) Fund and Social Plan Measures (SPM) Grant	2000/01	2003/04	Terminated
Building for Sports and Recreation Programme	2002/03	2003/04	Folded into the MIG
Local Government Transition Grant	1998/99	2003/04	Terminated
Integrated Sustainable Rural Development Strategy	2002/03	2002/03	Terminated
Local Government Support/Local Government Capacity Building Grant	1999/00	2004/05	Folded into the MSIG
GRANT	**Start Date**	**End Date**	**Status**
Developmental Programme for Unemployed Women with Children Under 5 Years of Age	1998/99	1999/00	Terminated
Poverty Relief Grant	2002/03	2003/04	Terminated
Special Food Security Projects Grant	2003/04	2003/04	Terminated
Poverty Alleviation Grant	2002/03	2002/03	Terminated
HIV/AIDS Grant (Social Development)	2000/01	2005/06	Folded into the PES
Integrated Social Development Services Grant (Food Relief Grant)	2003/04	2005/06	Folded into the PES

1.10 Conclusions

The following are key observations and conclusions:

- The conditions and lifespan of conditional grants are, in some cases, not sufficiently comprehensible.
- It is observed that implementation challenges encountered for most grants were possibly not anticipated. This suggests that the magnitude of potential risks may have been underestimated before implementation, resulting in an ad hoc approach to resolution of those problems during implementation.
- In particular, the administrative requirements of the grant on the recipients and transferring department should be established in advance and any related issues dealt with as part of the pre-implementation planning and not on an ad hoc basis during implementation.
- Risk identification and a management plan should be the two pillars of motivating for the establishment of any new conditional grant.
- With changes to the DoRA, conditions and reporting have become more stringent and this results in an additional administrative burden on grant recipients.
- Some grants have a multitude of programmes or purposes and this poses a risk of the grant focusing only superficially on each of the stated objectives.
- If the intention is ultimately to institutionalise a grant into a provincial or municipal programme, an exit or continuation strategy needs to be developed to ensure that spending on the programmme continues.
- Sufficient support capacity does not always exist in the national department to assist provinces and municipalities.
- While it is ideal to relax conditions so as to facilitate spending, national departments are reluctant to do so as they end up with qualified reports from the Auditor General for any irregularities perpetrated by provinces or municipalities.
- It is critical that before a grant is incorporated into the PES or LES, certainty be established that it is already entrenched as a provincial or municipal programme and that the level of spending for the grant reflects that fact.
- The allocation mechanism for a grant must be strongly supportive of the purpose for which the grant was established.
- Grants are sometimes consolidated without correcting design defects, e.g. the incorporation of the CMIP into the MIG, with its process of project selection that involved a complex chain of transactions, resulted in municipalities receiving funds only towards the end of the financial year.

- There is a strong case for finding alignment with different grants that fund common areas. A number of them could be merged. A conditional grant must not be introduced for a purpose already served by another grant. Extension and expansion of existing grants should rather be encouraged and investigated.
- A particular trend is observed in relation to government's effort to deal with poverty in the form of conditional grants. Quite often, new grants are introduced on an ad hoc basis and subsequently phased out, only to resurface in another form sometime later.

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Meeting with the National Department of Agriculture: 3rd March 2006.

Meeting with the National Department of Health: 13th March 2006.

Chapter 2

A review of the National Tertiary Services Grant and the Health Professions Training and Development Grant

Rathipe Nthite, Bongani Khumalo
and Alex van den Heever

Abstract

This report assesses two of the largest conditional grants in the South African intergovernmental transfer system, namely the National Tertiary Services Grant (NTSG) and the Health Professions Training and Development Grant (HPTDG). Both of these grants are administered by the National Department of Health and are implemented at the provincial level. The report reviews these grants as a follow-up to the work that was done by the Financial and Fiscal Commission (FFC) in 2004. It begins by assessing the NTSG in the context of the findings and recommendations of the modernisation of the tertiary services plan. The assessment concludes that the grant is currently too loosely defined and as a result there are significant differences between what the grant is meant to fund and what it actually funds in practice. However, in the context of the Modernisation of Tertiary Services (MTS), the report concludes that the MTS plan should be able to address some of the significant weaknesses associated with grants and provides detailed recommendations on what should be done in order to improve the implementation problems associated with the grant. The report also assesses the HPTDG. The main finding is that the grant is currently not adequately costed and in general lacks a clear policy framework that is linked to a clearly stated human resources strategy for the health sector. In conclusion, the report recommends that the two grants should be retained as conditional grants. However, it *advises that government needs to tighten the frameworks; develop norms and standards; and set clear objectives and targets that provinces need to achieve in their implementation of the programmes funded through these grants.*

Keywords:

Conditional, Costing, Development Grants, Modernization, Needs Analysis, Services, Tertiary, Training, Transfer

2.1 Introduction

2.1.1 Background

The Department of Health administers a number of inter-related conditional grants which are significant both in their fiscal and policy importance. Two of these, the Health Professions Training and Development Grant (HPTDG) and the National Tertiary Services Grant (NTSG) account for the majority of the funds (R1.5 billion and R4.7 billion respectively for 2005/06) and are the focus of this review.

Although the grants are inter-related, they have distinct areas of focus. The HPTDG has a close relationship to the funding of health professional training through providing for the 'additional costs of training' experienced by the public health system. The purpose of the NTSG is to fund the additional costs experienced by some provinces for providing services that are supra-regional in nature, i.e. specialised and highly specialised services.

Although both the HPTDG and the NTSG theoretically fund service costs, certain training of health professionals occurs entirely as expenses for provincial departments of health. These include nurse and ambulance colleges. Given the inter-provincial unevenness in training platforms (represented by the main hospitals with academic staff), the distribution of the associated teaching functions vary by province. This variation is currently not accounted for in the existing grant.

Although the grants have officially been in place since 1998 (equivalent financial configurations were actually in place from 1995), only the NTSG has undergone any serious review in recent years. The NTSG review, begun in 2002 and undertaken by the Department of Health, has not been implemented as the review process is incomplete. The HPTDG, which lacks any serious linkage to policy goals or technical criteria, has never been the subject of a detailed review.

The absence of a strong analytical framework underpinning the two conditional grants is a cause for concern and has consequently become the subject of review by the Financial and Fiscal Commission (FFC) in both 2004/05 and 2005/06. At issue is whether the grants are achieving the purpose for which they were established. If they are defective in their current form, it is necessary to identify a more efficient configuration.

Aside from technical and analytical features of the grants, their very nature is tied up with the definition of policy goals and the expression of those goals using some concrete measure. Intrinsic to the establishment of such a measure is the process and support structure required to arrive at, implement, monitor and improve on any policy goal. A significant weakness in the present grant system is the absence of any process equal to the task of defining explicit and measurable policy goals and seeing to their implementation.

Although there are limits to the technical detail into which this review could go in assessing both grants, a limited degree of modelling has been performed to assess the feasibility of expressing complex health policy goals using measurable criteria.

2.1.2 Terms of Reference

2.1.1.1 Overview

The terms of reference for this report involve a continuation of the issues raised in reviews performed in 2004/05 for the Commission. For the sake of completeness, where appropriate, this report consolidates the findings of the earlier work. The specific terms of reference underpinning this review are indicated below.

2.1.1.2 Health Professions Training and Development Grant

The review covers the following areas:

Funding options

A variety of funding/transfer options for this grant are considered, including, but not limited to:

- A single funding approach, either from the education or the health sector.
- A dual funding approach, from both the education and health sectors.
- A triple funding approach, from national education and health sectors, together with the provincial contribution.
- Transferring the grant (with revised grant framework) directly to higher education institutions themselves, rather than through provincial structures.
- Merging the NTSG and HPTDG together.
- Phasing the HPTDG into the PES.

Spillovers

In view of the rationalisation of higher education institutions, the review provides an estimate of the extent to which such a rationalisation will have an impact on the inter-provincial referrals.

Higher Education

Owing to the fact that some of the health professionals are not trained in universities (for instance some diploma students are trained in colleges), the review investigates the extent to which this could be taken into account when the financing framework is developed. The review also considers the funding and other implications arising from the fact that some of the universities have satellite hospitals/teaching facilities in other provinces.

Grant utilisation

The review assesses whether there are leakages with respect to the grant not being used for the purposes for which it is designed. The review also covers the extent to which various role players participate in the grant utilisation process, e.g. universities and colleges.

2.1.1.3 National Tertiary Services Grant

The review of this grant covers the following areas:

Spill-overs

Assessment of the current and future potential spillovers with respect to the grant, and its costing implications.

Allocation criteria

Assessment of the credibility of the allocation method and/or criteria used in allocating the grant among provinces.

Grant utilisation

Assessment of the extent to which there could be leakages with respect to the grant.

Policy framework

A review of the extent to which the conditions of the grant are in line with the underpinning policy objectives for the grant; a review of the implications of the National Department of Health's Modernisation of Tertiary Services plan for the grant in particular and a review of the tertiary services sector in general.

2.1.3 Approach to this Report

The analysis and findings of this report are underpinned by technical reports produced in both 2004/05 and 2005/06. All the technical reports were presented to public sector stakeholders, whose views and input have been taken into account.

The stakeholder feedback was facilitated through three consultative workshops.

This report consolidates all the key aspects and findings of the work to date and makes specific recommendations on the way forward. The HPTDG and NTSG are discussed separately with key findings and recommendations provided at the end of each evaluation.

The recommendations focus on options for improving the configuration of the two grants. These recommendations are intended as a constructive point-of-departure for revising the grants and taking the process forward.

2.2 The National Tertiary Services Grant

2.2.1 Introduction

Although certain aspects of the NTSG methodology have changed since 1995/06, the grant has de facto remained largely unchanged for the past 10 years. The specific purpose of the grant is to fund tertiary (highly specialised) services to ensure equitable access to these services for all people dependent on the public sector. The grant is recurrent in nature and consequently funds these services on an ongoing basis.

The NTSG evolved from what was originally called the 'Central Hospital Services Grant' with the express purpose of supporting those hospitals and services most affected by *structural* inter-provincial patient referrals. These services are not distributed equitably on a regional basis and face medium-to long-term structural constraints in the achievement of such equity.

A material change has occurred over time in the definition of what the grant funds. It initially contributed towards the funding of so-called supra-regional services, which could include:

1) General specialist services (Level 2).
2) Highly specialised services (Level 3).

The above objective was achieved by providing funding for a substantial portion of the overall budget of specific hospitals. However, these hospitals did not necessarily contain all the Level 2 and 3 services provided in a province. This situation effectively persisted throughout the period from 1995/06 to 2002/03. When the conditional grant funded so-called 'central hospital services' it referred initially to 10 central hospitals, growing subsequently to 11.

From 2003/04 onwards the grant was de-linked from specific hospitals and purported to fund the entire cost of 'tertiary services'. Currently, therefore, the grant specifically excludes Level 2 services, at least by definition, and funds only Level 3 services. In reality the grant roughly funds the spillover (the inter-provincial patient referrals) for both Level 2 and 3 services, rather than the full cost of level 3 services.

2.2.2 Purpose of the Grant

The following reflects a consolidation of all the views expressed on the purpose of the grant:

1) The grant should support healthcare activities that are of importance beyond provincial boundaries.
2) The grant framework should allow for the feasible redistribution of such services over time, i.e. the grant should not entrench the status quo.

The rationale for the grant is consequently linked to the degree to which service provision varies inter-provincially relative to the served population. If there were no variations, there would be little need for such a grant.

However, the above does not make explicit a central issue related to the underlying service level required. The issue of 'absolute' versus 'relative' need is not clearly isolated in the current purpose of the grant. It is, however, an issue recognised in the Modernisation of Teriary Services (MTS) process, which is not yet approved Government policy.

2.2.3 'Absolute' versus 'Relative' need for Hospital Services

2.2.3.1 Overview

A central question of policy in relation to the public health system is the determination of the minimum absolute 'level' of service required to meet the needs of the population. This is related to, but distinct from, the issue of regional equity and access. If the overall level of health service is inadequate, redistributing the funding, particularly in the absence of a coherent service plan, could significantly undermine general access to the public health system.

The determination of the absolute level of service required ideally involves an optimisation *process* subject to a budget constraint. No definitive comment can be made here about what this level should be. However, in the absence of a process which sets out to establish such a level, it is reasonable to assume that services will not be optimal for the existing budget allocation and that an alternative, more appropriate and affordable service configuration will not be identified and implemented.

To assess the relevance of this issue within the South African context, one approach used here, is to compare existing public sector norms with alternative benchmarks. The existing public sector unit costs are therefore compared to those in the private sector hospital market and a hospital planning model with staff norms roughly typical of a staff-model mine hospital (hereafter referred to as the 'benchmark model' see "Appendix E" for a highlighted summary of the model).

The exercise also looks at *needed* beds (which can be regarded as the planned demand for beds) versus the *supplied* beds in the public sector.

The 'benchmark model' assesses three realtionships. It relates service requirements to population needs (distinguishing between the populations served by the public and private sector) based on existing utilisation benchmarks. Secondly, it relates staff and non-staff resource requirements to particular health service components. Thirdly, it calculates the ultimate cost of the required health services in relation to: current public sector conditions of employment; or private sector conditions of employment; or selected values between public and private sector conditions of employment.

For the purposes of this analysis, the model does not make service choices for each region. It only quantifies the 'needed' health service resource requirements by region. The *estimated service need* by province is then compared with *actual services available* by province. (All costs are reflected in 2004/05 prices to enable comparison with the MTS report.)

2.2.3.2 Results

The results of the modelling exercise is discused below.

Expenditure on acute hospital services is roughly the same in both the public and private sectors at around R20 billion each. However, the acute bed distribution is very different, with 25,048 and 82,288 for the private and public sectors respectively. This translates into a vastly different unit cost per bed of R815,165 and R246,915 for the private and public sectors respectively.

The 'benchmark model' shows a total hospital expenditure requirement of R42.4 billion relative to existing expenditure of R20.3 billion, i.e. a difference of R22 billion over–and above current expenditure. This includes an adjustment in conditions of employment of roughly 50 percent towards private sector benchmark conditions of service. If the conditions of employment are left unchanged, total expenditure of R35.9 billion (not shown in the table) is required in terms of the 'benchmark model', i.e. R15.6 billion in excess of existing expenditure.

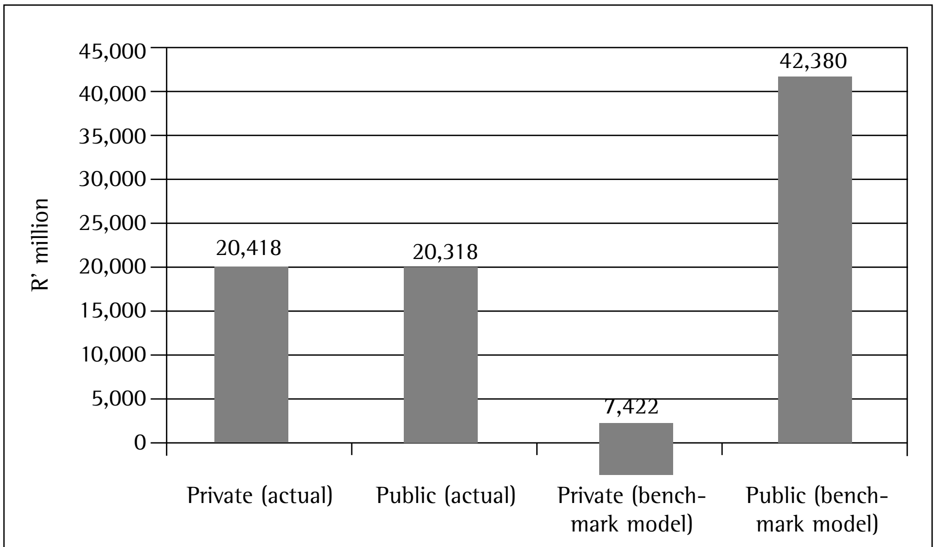
The 'benchmark model' suggests, by contrast, that the private sector should only spend around R7.4 billion on hospital services, while the public sector should rise to R42.4 billion. The private sector should also have only 16,477 acute beds while the public sector should rise to 91,876. The 'benchmark model' is nearly *double* the existing public sector unit cost and nearly *half* that of the private sector.

Table 2.2 compares the 'benchmark model' estimation of total acute bed requirements with actual acute beds. Interestingly, the results show that Gauteng is below the benchmark by 2,336 beds and the Western Cape by 1,854. Thus, provinces assumed conventionally to have sufficient services, with current inequitable inter-provincial distributions, are in fact potentially unable to adequately serve their populations. Limpopo and Mpumalanga also appear to have a material under-provision of hospital beds. This under-provision, however, does not take account of the under-resourcing of beds which is suggested in the costing assessments.

Table 2.1: Comparison of expenditure, acute beds and cost per acute bed in the public and private sector in 2004/05, and between the actual situation and the benchmark model for the same year (2004 prices)

	Actual		Model	
	Private	Public	Private	Public
Expenditure (R million)	20,418	20,318[16]	7,422	42,380
Acute beds	25,048	82,288	16,477	91,876
Cost per acute bed (Rands)	815,165	246,915	450,485	461,268

Figure 2.1: Actual versus benchmark requirements for hospital services in the public and private sector: Expenditure (2004 prices)



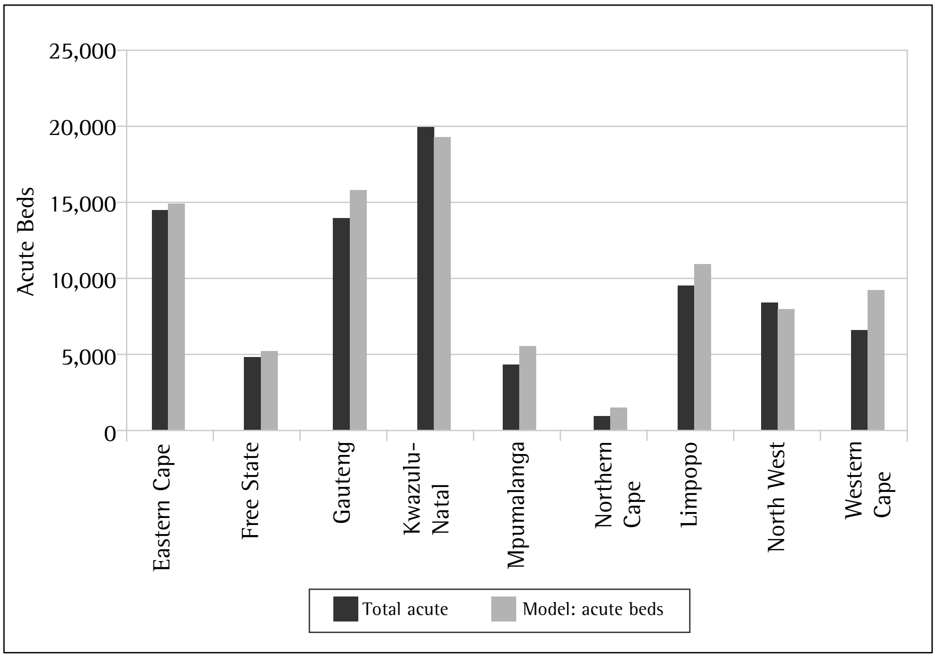
16. The MTS review estimates public hospital expenditure at R24 billion. The estimate provided here excludes all non-acute beds and day hospitals.

Table 2.2: Actual public sector bed distribution compared to the 'benchmark model' distribution of acute beds

Hospital beds	RSA total	E/Cape	F/State	Gauteng	KZN	M/langa	N/Cape	Limpopo	N/West	W/Cape
Total acute	82,288	14,210	4,824	14,128	20,057	4,192	1,113	9,368	7,891	6,505
Tertiary	15,398	795	505	6,503	2,734	361	0	1,515	0	2,985
Regional	25,901	4,067	1,991	5,745	6,470	1,765	492	1,475	1,856	2,040
District	40,989	9,348	2,328	1,880	10,853	2,066	621	6,378	6,035	1,480
Psychiatric	14,853	2,543	764	2,367	3,016	0	107	2,053	1,520	2,483
Model: acute beds	**91,876**	**15,154**	**5,539**	**16,464**	**19,065**	**6,033**	**1,962**	**11,529**	**7,771**	**8,359**
Difference	-9,588	-944	-715	-2,336	**992**	-1,841	-849	-2,161	**120**	-1,854

Source: Department of Health database of hospital beds (2001), Council for Medical Schemes, 2003.

Figure 2.2: Actual versus estimate of needed acute beds by province



The needs-based estimates were generated from a sample of hospital in-patient utilisation of 1.3 million medical scheme beneficiaries. Although the private sector will experience a degree of over-utilisation, existing fee-for-service rates are high, reducing the incentive to raise volume to excessive levels artificially. Many medical schemes also directly manage elective in-patient utilisation. Overall activities are well within international norms. The bed requirement is based on 80% occupancy, which is reasonable for the purposes of public sector planning.

2.2.3.3 Review findings of Actual Acute Hospital Services in the Public Sector

A significant difference appears to exist between the actual acute hospital services provided in the public sector and estimated benchmarks of what should be provided. These benchmarks not only look at the number of units required (i.e. beds), but also the required resourcing.

The under-provision of beds is over-shadowed by the estimated under-resourcing of the beds in position. These are the under-provision of acute beds in the public sector (10.4 percent) and the under-resourcing of public hospitals (52.1 percent).

Provinces assumed to be over-resourced for their population sizes, even including the conditional grant funding, such as Gauteng and Western Cape, are assessed as under-resourced as in 2004/05 against the benchmark model. Thus, although their position relative to other provinces may be better, they are themselves under-providing hospital services, not accounting for inter-provincial referrals.

The benchmarking exercise, when applied to both public and private sector populations, reveals substantial distortions in unit costs, availability of acute beds and total expenditure. The extent of these distortions suggests that great care should be exercised in the restructuring of hospital services in South Africa.

2.2.4 Modernisation of the Tertiary Services Process

2.2.4.1 Overview

In 2002, the national Department of Health initiated a process to review the status of South Africa's tertiary health services in the public sector. (Department of Health, May 2003). Between August and September 2002, a task team set up for the purpose convened a series of workshops involving fifty medical specialities and sub-disciplines. Out of this process fifty separate reports were generated. These reports provided information on the strategic direction required by each unit or discipline/sub-discipline.

Each working group was required to assess a number of issues and to report on them in a standardised format. Aside from looking at epidemiological factors resulting in the demand and need for particular services, each group came up with an organisational model based on three basic scenarios: Ideal, Optimistic and Pessimistic. These corresponded to a range from 'best practice' to 'resource constrained' positions. Each of these outputs for each discipline is available in summarised form within a discussion document (Department of Health, May 2003) and in detailed form on the Department of Health website (www.doh.gov.za).

The Moderniation of Tertiary Services (MTS) process was first and foremost a service prioritisation exercise which, once complete, would provide clarity on the required resource allocations over time. Decisions on the future nature and structure of the NTSG would be contingent on the outcomes of this process.

The MTS process operated from the valid assumption that the level of absolute service need had to be identified as a basis for any modification of the funding framework.

A further element of the plan involves engineering a convergence of the service mix of regional and tertiary hospitals into a number of standard types. This theoretically reduces the complication resulting from the extreme variations in service mix between hospitals according to their existing classification. Currently, a regional hospital bed in the Western Cape cannot be compared to a regional hospital bed in Mpumalanga. The same applies to tertiary hospitals. If the proposals of the national Department of Health were implemented, acute beds by hospital type would be comparable.

2.2.4.2 Assessment of the Equity Implications of the MTS Plan

The Department of Health, through the MTS process attempted to create the underlying policy framework against which a budget plan and funding framework could be determined. Although the rationale for the budget plan is quite well developed, the specifics remain sketchy insofar as a funding modality and its pre-requisites are outlined.

In terms of the MTS plan, approximately, over 10 years specified target levels of health service would be implemented via the full funding of a specific service plan. The plan does not propose to 'redistribute' existing services, but rather to achieve a reasonable degree of inter-provincial equity over time by growing all services to a level regarded as needed and affordable.

To assess the equity implications of the plan, the current and proposed MTS expenditure for regional and tertiary services are expressed relative to the population for each province *weighted for relative need*, i.e. the 'ideal' distribution based on the results of the 'benchmark model'. This shows the variation from pure equity both before and resulting from the proposed MTS plan[17].

When both regional and tertiary hospitals are combined, the variation from the *ideal distribution* (based on the benchmark model) would reduce, with the final result within a range of 10 percent, plus or minus.

Within this range, Gauteng moves from 17.4 percent above the ideal to 8.8-percent. Aside from Gauteng, the Western Cape and the Eastern Cape, all provinces vary from the ideal (based on the benchmark model) distribution by less than 4 percent.

When tertiary hospitals are considered on their own, the MTS plan moves Gauteng from 25.4 percent above the ideal distribution (based on the benchmark model) to 8.6 percent[18]. Western Cape moves from 10.4 percent above the ideal distribution to 6 percent. The more rural provinces all improve their position significantly, moving to within 6 percent of the ideal distribution. By the end of the reform period no province varies from the ideal distribution by more than 10 percent. (See Figure 2.3).

The inter-provincial variation in regional hospital services, according to the Department of Health, shows less variation than for tertiary hospitals, with no province outside of the 10 percent band[19]. The final plan shows Gauteng increasing its variation from 7.5 percent above the ideal distribution to 9.1 percent. Western Cape also moves up, from 0.5 percent above to 6.3 percent above. Eastern Cape worsens its position, moving from 6.8 percent below to 8.2 percent below. All other provinces, however, show a strong convergence of the ideal distribution, with large improvements in North West and Limpopo. (See Figure 2.4).

17. It should be noted that provincial boundaries are not coterminous with true catchment areas for acute hospital services. Given this, it is possible that the full regional equity could be achieved despite some residual requirement for cross-boundary flows. This qualification is not taken into account in the analysis as it is irrelevant to the issue under review. The central issue is to assess the extent of inter-provincial patient flows for the purposes of budgeting for the conditional grant.
18. The service mix between tertiary hospitals is not uniform in the current period and the analysis consequently needs to be qualified in this respect. In the final period, however, the service mix by tertiary facility is assumed to be uniform. This also applies to regional hospitals.
19. See footnote 2.

Figure 2.3: Tertiary Hospitals: variation from the ideal distribution

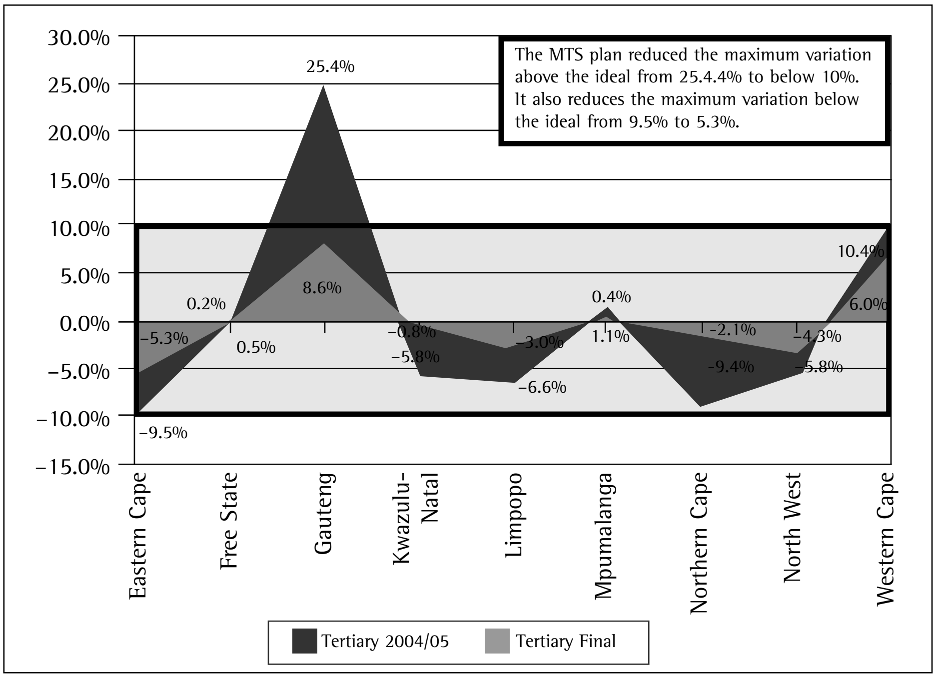
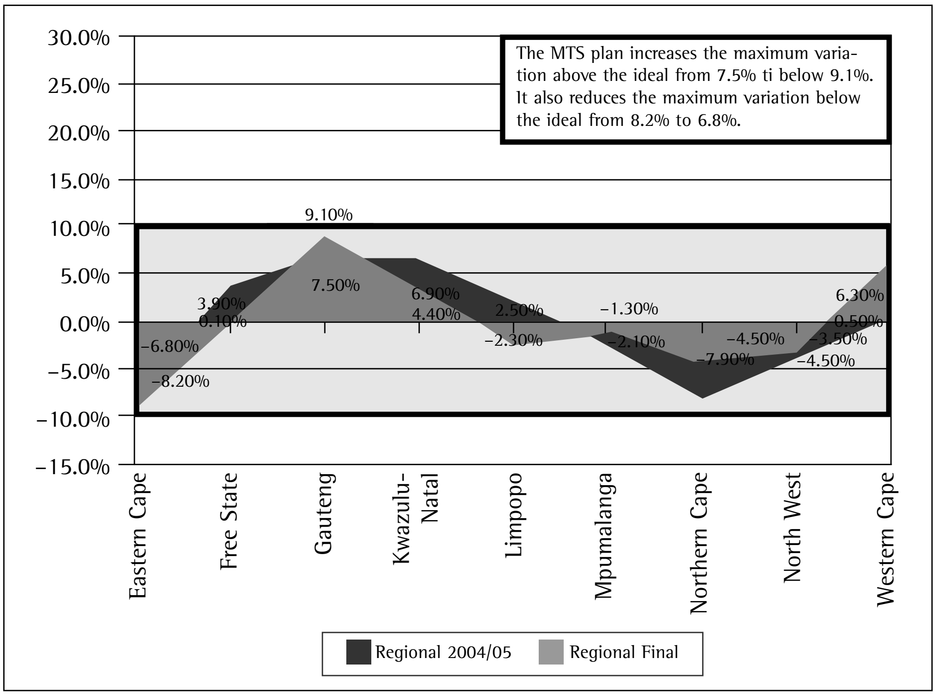


Figure 2.4: Regional Hospitals: variation from the ideal distribution



An assessment of the MTS service plan reveals that hospital services will be improved in both absolute terms and through a reduction in variations by province. However, provincial variations will not be eliminated. The more extreme variations will continue to exist in tertiary services, with regional hospitals distributed far more evenly. Consequently, consideration could be given to ultimately funding regional hospital services from the PES. However, the variation in tertiary services suggests it should continue to be funded via a conditional grant, even after the full service plan is implemented. This option is further qualified by the possibility that for structural reasons the Department of Health is unable to achieve the ideal service mix by hospital type that it is proposing.

2.2.4.3 Assessment of the MTS Process

Generally, if implemented, the MTS recommendations would meet many of the concerns raised in the 2004 FFC review of the NTSG. However, some important issues are still not adequately addressed and will require further investigation.

Further work is still required on resource requirements and the input norms underpinning these requirements. Recommendations relating to the funding framework are fairly general and require further clarification. For instance, the following still needs to be identified:

a) Transitional grant structures.
b) Allocation criteria.
c) Conditionalities.
d) Where the funding is to occur through the PES, whether or not this will require a costed norms approach.
e) How national policy will deal with variations from national norms where services are funded through conditional grants.

Finally, a clear indication of progress on the implementation of the revised service plan over time requires urgent attention.

2.2.5 Discussion on the Funding Framework

The funding framework can be seen as an outcome of decisions around the service plan and the best method of achieving technical efficiencies. Within the context of the NTSG this discussion revolves around the most appropriate roles and responsibilities for national and provincial governments.

Existing financial arrangements decentralise both policy (service planning against norms and standards) and budgeting. This has resulted in a deviation from reasonable, nationally determined, benchmarks for the appropriate delivery of specialised and highly specialised services.

Essentially there is no nationally required minimum policy requirement in place. This is inconsistent with the established policy positions of Government. The existence of conditional grants, the allocation of funds for the improvements of public hospitals and the development of the MTS plan all strongly suggest the desire for a national policy framework. The central issue is the form this framework should take, rather than whether it should exist.

Given the above, certain responsibilities for the planning of these services should of necessity become the policy responsibility of national government, through the national Department of Health. This involves *inter alia*:

a) The development of reasonable national norms and standards for the relevant services and their regional and facility-level distribution.
b) The assessment of the service gaps against these norms.
c) The development of a structured funding framework to phase in the norms.
d) The monitoring of the achievement of provinces against the required norms and standards.
e) The imposition of remedial measures to deal with non-compliance with the norms and standards.

The responsibilities of the provinces are:

a) To create and implement service plans at least consistent (not necessarily similar) with the nationally determined norms and standards.
b) To ensure that hospitals comply with agreed provincially determined service plans.

Provincial governments can provide services over–and-above the minimum norms and standards with their own revenue sources. This division of responsibility would remain irrespective of whether the funding for services originates through a conditional grant or the PES. Given that the allocations are underpinned by national norms and standards, once they become official government policy, funding and adherence become mandatory. Where these services, underpinned by official norms and standards, are funded from the PES, the use of a costed norms approach could assist in ensuring that no unfunded mandates occur as a result of national government setting the minimum norms and standards too high. Government has in the past accepted that the costed norms approach can be useful as an analytical tool to check how departments are performing against objectives, given the resource constraints.

It should be noted that the MTS plan is not yet official government policy, and is thus not yet defined in any enforceable manner. The MTS Plan estimated the total value of regional and tertiary hospital services at present at around R15 billion, which is more than double the value of the existing NTSG. Given that the plan envisages real increases in funding to R27 billion, both the NTSG and the PES would need to be increased in a consistent manner.

The MTS plan envisages that tertiary services will ultimately be solely funded through the NTSG, with total funding for regional hospital services coming from the PES[20]. This approach will eliminate a key existing inconsistency with the grant identified in the 2004 FFC review of the NTSG:

> *The NTSG is poorly specified. It explicitly attempts to provide a compensating mechanism for level 3 (tertiary) services, while doing nothing to compensate for an even larger spill-over problem in respect of level 2 services. (van den Heever, 2004, p. 52).*

The approach recommended by the Department of Health via the MTS report is consequently supported in this review, with the following qualifications:

a) The service plan developed by the MTS should be converted into an explicit framework of norms and standards.
b) The norms and standards should become official government policy.
c) Where a significant portion of the norms and standards would have to be funded via the PES, the norms and standards should be published in a government gazette (including any phasing in process).
d) The PES will need to take into account these norms and standards for any service not funded via the NTSG.

2.2.6 Findings from the Review of the Modernisation of Tertiary Services Plan

1. The Department of Health, via a Modernisation of Tertiary Services (MTS) task group has provided a plan for the improvement of specialised and highly specialised hospital services. This has involved a fairly detailed review of existing services, as well as the assessment of what is needed to eliminate the gap. This plan does not yet have official status and is consequently not accommodated in the Medium-term Expenditure Framework (MTEF). The approach taken by the MTS process in attempting to develop a national policy framework for specialised and highly specialised services, against which a funding framework is framed, is supported by this review.
2. The MTS recommended framework sees the NTSG initially expanding to improve funding for both Level 2 and 3 services. The service plan, however, makes provision for the creation of pure Level 2 and 3 hospitals. Ultimately, this will allow the NTSG to be modified to fully fund tertiary hospitals (and not just the spillover) with regional hospitals funded from the PES. Currently, the NTSG

20. This is contingent upon the standardisation of service mix within defined hospital types. If this does not occur the idealised funding separation between regional and tertiary hospitals cannot occur in reality.

funds the value of the 'spillover' of both Level 2 and 3 services without fully funding the services. An indicative costing of the required structural change in the budget framework is provided by the MTS (Department of Health, 2004).

3. Although the MTS, if implemented, would meet many of the concerns raised in the 2004 FFC review, a number of outstanding issues remain, aside from the fact that the MTS plan is largely still on the drawing board. Outstanding issues include:
    a) Further work is required on the resource requirements and the input norms underpinning these requirements.
    b) The recommendations relating to the funding framework are high-level and require further significant clarification.
    c) It is unclear what process is to be used to institutionalise the implementation and maintenance of the required structural changes to the public hospital system.
4. Even after implementation of the full MTS plan, it should be emphasised that full inter-provincial equity will not exist, particularly in tertiary services. It is for this reason that the Department of Health motivates for the retention of a conditional grant funding approach for tertiary services. However, Level 2 services will potentially be far closer to inter-provincial equity, making it feasible for them to be incorporated in the PES.
5. However, the overall MTS framework falls short of what is required to move forward as it lacks sufficient technical completion for the implementation of a funding framework equal to the requirements of the indicated service plan. These are:
    a) The service plan developed by the MTS must still be converted into a framework of norms and standards.
    b) The norms and standards must become official government policy.
    c) Where a significant portion of the norms and standards would have to be funded via the PES, the norms and standards should be legislated (including any phasing-in process).
    d) The PES will need to be adjusted to a costed norms approach for any service that is underpinned by legislated norms and standards and not funded via the NTSG.
6. In deciding on the resource allocation requirements of each province for hospital services, it is essential that consideration be given to both the relative and absolute need for a policy-determined minimum essential package of hospital services.
7. There is currently a significant difference between the actual services provided today and reasonable benchmarks of what should be provided. The under-provision of hospital services in the public sector is estimated as follows:
    a) Under-provision of acute beds: 10.4 percent.
    b) Under-resourcing of public hospitals: 52.1 percent.

8. Provinces assumed to be over-resourced such as Gauteng and Western Cape are potentially under-resourced when a benchmark analysis is performed. This assessment corroborates the MTS findings which are broadly similar.
9. The benchmark analysis when applied to both the public and private sector populations reveals substantial distortions in unit costs, availability of acute beds and total expenditure. The extent of these distortions suggests that great care should be exercised in the overall restructuring of health services in South Africa.

2.2.7 Recommendations

1. **Allocation criteria for the NTSG.** The criteria currently in use cannot fulfil the required purpose of the grant in the medium- to long-term. It can provide a temporary mechanism for ensuring that specialised and highly specialised services are not unduly undermined. However, in the medium- to long-term it is recommended that a funding framework based on approved policy norms and standards, underpinned by an explicit service plan, needs to be introduced. Within this framework the funding should flow in accordance with the calculated full cost of the norms and standards in accordance with their achievement.
2. **Norms and standards.** It is recommended that consideration be given to specifying norms and standards in accordance with the following:
   i) **Health care services** in relation to the population:
      a) Acute beds by level of care and/or discipline
      b) High Care and ICU beds
      c) Acute Psychiatric beds
      d) Chronic Psychiatric beds
      e) Maternity beds
      f) Theatres
      g) Support services, e.g. Radiology, Pathology, Pharmacy
      h) Casualty
      i) Outpatients.
   ii) **Resource requirements** per healthcare service:
      a) Staff ratios and requirements
      b) Non-staff costs and requirements.

   All the above can be reported on by hospitals, including activities. Expenditure need not be reported on at that level of detail. Costings can be performed on a sample basis. Global expenditure by hospital can be assessed relative to predicted expenditure based on the costed norms. Changes in these norms can be used to incorporate planned upgrading or downgrading of any service in any area. This approach has been tested and found to be technically feasible.

It is further recommended that these norms and standards be incorporated into national legislation.

3. **Service planning.** A service plan establishing the minimum national package required to provide specialised services in each province is an essential requirement if the obligation to provide an adequate level of health service for all is to be implemented. Such a plan should have broad consensus, involve the general public and ultimately become national policy. However, the Commission notes that such an exercise has thus far only been partially completed (as it still has not been elaborated in a manner that can be properly implemented and has not been formalised as government policy). It has, moreover, omitted mention of Level 1 hospital services. It is recommended that the development of a national service plan for hospital services, including Level 1 services, be completed as soon as possible and incorporated into government policy.

4. **Spillover effect.** For the foreseeable future there will continue to be inter-provincial referrals for specialised and highly specialised services. It is consequently recommended that the conditional grant mechanism be retained to ensure that incentives are not generated within provincial governments to unilaterally downgrade referral services required as part of a package of public sector services.

   There is an open question as to whether the conditional grant should fund the full cost of the services or whether merely the spillover (cost of inter-provincial patient referrals) should be funded. Currently, the grant purports to fund tertiary services fully (Level 3 services), but de facto funds the spillover of Level 2 and 3 services. The MTS plan proposes to shift to fully funding Level 3 services (as they will be concentrated into tertiary hospitals with a definable budget) with Level 2 to be funded from the provincial equitable share (PES). It is, however, questionable as to whether the proposed changes to the service mix of public hospitals will proceed smoothly. It may not even exist after a 10 year period. It is consequently recommended that the NTSG be re-specified to explicitly compensate for inter-provincial patient referrals, whether Level 2 or, 3 until such time as an alternative configuration appears feasible.

   It is further recommended that the option of fully funding services not be considered as this amounts to the determination of a budget at the national level for a service provided at the provincial level. Provincial governments actually have this responsibility. It is merely the responsibility of national government to ensure that there are no unfunded mandates in relation to a national policy requirement. This objective is sufficiently served by only funding for the spillover. Unless a function is fully transferred to the national level it is recommended that only the extent of the planned inter-provincial patient referrals be considered for funding.

5. **Supporting framework for administering the NTSG.** From the review it is evident that insufficient capacity exists within the national Department of Health to support the conditional grant allocation mechanism effectively. Given this, the achievements of the grant are at a minimum. To engender greater policy content into the allocation mechanism it is recommended that the national Department of Health establish a unit dedicated to the provision of ongoing technical support in this area. It is likely that all the shortcomings identified in the design and application of this grant result from this specific weakness.

   It is further recommended that the unit be given sufficient seniority to permit the retention of appropriate technical capacity. This unit should at the minimum provide for a technical post at the level of a Chief Director.

6. **Achievement of equity.** Over time, it is appropriate that specialised services be distributed as equitably as possible. The NTSG allocates the recurrent spending requirement for specialised and highly specialised services. As a consequence, in itself, it is not redistributive. It funds services where they are situated. The implementation of new services in new areas requires a capital allocation, which is inconsistent with the nature of the NTSG. It is, therefore, recommended that the redistribution of services be achieved through separate capital allocations, either via conditional grants or funds appropriated at a provincial level. Once these allocations have established new services, the NTSG can be appropriately directed or re-directed. Such an approach calls for a degree of planning integration that currently does not occur. Such an approach will become even more important if services are being generally upgraded, as proposed by the MTS process. Although specific purpose grants exist for capital allocations to upgrade and develop public hospital services, and are appropriate for this purpose, the degree to which they fit into an integrated national planning framework is fairly limited, although improving.

7. **Nature of the grant.** It is recommended that the NTSG be retained as a 'conditional bloc grant' given that it will not fund specific projects or budgets. The value of the allocation should be determined in relation to *costed inputs and outputs as specified in norms and standards.* Provided the norms and standards are achieved by a province, and assuming that the costings are reliable, it can be assumed that funds have been allocated appropriately at the provincial level. If a provincial administration is inefficient, it may spend in excess of the required cost to achieve the norms and standards. In this instance, they would have to account for this inefficiency at a provincial level, as other

provincial funds would have been used to pay for the inefficiency. National government's primary responsibility ends with the achievement of the norms and standards and ensuring that there is no unfunded mandate.

2.3 Health Professions Training And Development Grant

2.3.1 Introduction

The HPTDG has been in existence for a number of years and is required to compensate provincial governments for the 'additional service costs associated with training health professionals. It is structured as a 'conditional bloc grant' and consequently is not allocated in relation to specific deliverables or performance measures.

In 1997, the Department of Health proposed that the grant have the following four objectives (Department of Health, 1997). It must:

i. Compensate a province for the additional service costs of students (medical, dental, allied, and nursing).
ii. Compensate for any reduced service time of qualified staff participating in teaching activities.
iii. Compensate for any reduced service time of qualified staff resulting from research activities intended as part of their normal activities (applies exclusively to specialists).
iv. Provide for a redistributive component which could be used to develop capacity to train medical students where this did not exist before (this applies exclusively to medical students).

From its inception in 1997, the grant has had no relationship to the actual cost of any service or function related to teaching and training. However, as the grant was created through *carving out* a chosen value[21] from the relevant provincial budgets, it had no significant impact in respect of the budget process, apart from preserving the status quo in terms of hospital funding.

From its inception in 1997, no attempt has been made to improve the grant's specificity significantly in relation to the stated objectives. A potential consequence has been the fragmentation of decision-making and funding of health professional training, resulting in unplanned shortfalls in the required numbers of health professionals.

21. The allocations for the period from 1997/98 onward and their basis of determination are summarised in van den Heever (2004, p.29).

Given the inter-linked nature of human resource planning with the HPTDG, comment is required on both the technical and process aspects of an integrated human resource strategy. In the absence of a process or policy framework which identifies required health professional to population ratios, the planning of minimum enrolment requirements and their associated resourcing requirements lacks any grounding.

2.3.2 Components of a Rational Human Resource Planning Process

2.3.2.1 Overview

Work in reviews produced for the FFC in both 2004 and 2005 focused on testing the technical aspects of an 'idealized' human resource planning process. This exercise was an attempt to isolate the key focal areas of such a strategy as well as to test a methodological framework. The conclusions from this work inform the discussion on the required process and its component elements presented below.

The process by which decisions are made about the training of health professionals can broadly be broken down into the following areas:

a) **Needs analysis.** This focuses on the minimum numbers of all types of health professional required for the country.
b) **Enrolment requirements.** This emanates from the needs analysis and involves the determination of planned enrolment levels for graduate entrants into each professional category.
c) **Budget framework.** This covers the reporting of the target enrolment requirements with the following components:
   - Costing
   - Flow of funds.
d) **Mandating and enforcing specified national policy requirements.** Here various tools exist from conditional grants to minimum norms and standard.
e) **Supportive process.** To maintain the technical integrity, quality and responsiveness of the policy framework, a properly resourced ongoing supportive process is required.

The above elements are discussed further below.

2.3.3 Needs Analysis

The needs analysis is in essence a policy process which should logically involve the following elements:

a) Identify existing health professional to population ratios.
b) Determine the net entrants and exits from the professional category.
c) Identify target health professionals to population ratios.
d) Determine the overall *replacement requirements* accounting for the net attrition rates and target ratios.

2.3.4 Enrolment Requirements

The determination of *enrolment requirements* involves the *replacement requirement* as an input. The replacement requirement is based on the required number of newly qualified health professionals to achieve and maintain minimum target levels.

The enrolment requirement is based on the number of new and existing enrolments, accounting for pre-service loss rates, required to achieve a predetermined target number of graduates.

2.2.5 Costing

On the costing side, the following needs to be determined:
a) The staff required for training.
b) The non-staff costs.
c) The costs of any service platform for on-site training (this should be distinct from the other costs).

The cost of the service platform per enrolee will need to be calculated as an increment over-and-above the standard cost of a service without the need for a training function.

2.3.6 Budget Framework

Student training for health professionals involves the following basic funding sources:
a) Student fees paid to the teaching institution.
b) A subsidy from the national Department of Education paid to teaching institutions.
c) A conditional grant (HPTDG) paid to provincial departments of health for incremental costs associated with on-site training.
d) Transfers paid by Provincial Departments of Health to teaching institutions to fund joint posts between the health and university establishments.

Out of the above a coherent funding framework needs to be determined, this framework must properly co-ordinate the funding flows to achieve national policy targets.

2.3.7 Mandating National Policy Requirements

Establishing national policy requirements in the absence of mechanisms requiring their implementation will significantly weaken the adherence to national policy.

Consideration should be given to mandating the following as a requirement for receiving national funding for the training of health professionals:

a) **Minimum staff/student and associated input ratios:** imposed on all teaching institutions and provincial governments funding joint posts.

b) **Minimum student enrolment targets:** imposed on both provincial governments and teaching institutions.

c) **Minimum graduation targets:** imposed on teaching institutions receiving funds from National Government.

The above should be published in a government gazette each year, with all targets expressed as conditions for funding. To ensure compliance, provision can be made for both reporting on the targets and intrusive inspections.

Non-compliance should result in penalties linked to the Public Finance Management Act and performance contracts of accounting officers. For instance, the right to require the return of funds, at least equivalent to the degree of non-compliance, should also be considered.

2.3.8 Supportive Process

The integrity of the overall framework will not be maintained if an explicit supportive framework is not established to deal responsively with each element of the process. The following are potential options that could be taken into account in the establishment of a supportive process equal to the required task:

a) The national Department of Health should consider the establishment of a technical unit at a chief directorate level to co-ordinate the overall process.

b) Consideration should also be given to the establishment of a national standing co-ordinating committee, made up of all relevant role-players.

The national co-ordinating committee would be in a position to make recommendations on the following:

a) Needs analyses

b) Staff target ratios

c) Required enrolment rates by province and institution
d) Standardised policy on joint posts and university contracts with provincial departments
e) Teacher/pupil ratios
f) The establishment of critical norms and standards which need to become government policy or placed in legislation
g) Costing methodologies
h) Costs per student
i) Conditionalities associated with conditional grants
j) Reporting requirements.

Technical work could be allocated to specific role-players or directly carried out or outsourced by the National Department of Health.

Currently, no dedicated support process exists which co-ordinates or manages any of the requirements described above. Fragmentation of the planning process and funding of health professionals may result from the abscence of such support.

2.3.9 Findings and Recommendations

1. **Central finding.** Based on an examination of the alternatives, this review finds that the central failings of the existing HPTDG are a consequence of factors unrelated to the allocation mechanism. Given this, no significant re-structuring of the fund flows affecting the key parties allocating or receiving funds is required. However, the inter-relationships between the various role-players are sub-optimal and materially impact on the outcomes of the grant expenditure. The remedy for this will involve a significant change to the manner in which the grant is implemented annually.
2. **Policy Framework.** Underpinning all decisions relating to the HPTDG is the need for a government-approved, formal, explicit and quantified policy framework. This should not be contingent on the completion of a complete human resource strategy as reasonable decisions on training and teaching requirements are possible in the absence of the full strategy. It is nevertheless essential that a complete human resource strategy be developed in due course.
3. **Organisation.** To ensure both the continuity and the quality of the policy framework and its implementation, the Commission should recommend that the organisational structure of the national Department of Health be adjusted to include a unit of sufficient technical capacity to co-ordinate and manage the HPTDG. It should be further recommended that a standing committee, involving all the central role-players in the teaching and training of health professionals, be established to reach joint decisions on policy targets, input

requirements and fund flows. Final decisions would be made at higher levels of government. Nevertheless, many of the technical questions could be resolved via this structure.

4. **Minimum Norms and Standards.** It is recommended that certain policy targets, expressed as outputs that can easily be monitored and audited, be set as legislated minimum norms and standards for any tier of government and/or institution receiving earmarked funding for the training of health professionals.

   It is recommended that the following targets be gazetted:

   a) Enrolments

   b) Staff/student ratios.

   Consideration should be given to providing a clear indication of the entities to which the norms and standards apply. It is recommended that consideration be given to placing an explicit obligation on both provincial governments and teaching institutions to comply with the targets.

   As existing legislation governing the training of health professionals does exist, consideration could be given to using this legislation for the above purpose. However, it may be better to establish a dedicated act purely to manage this arrangement.

5. **Auditing Norms and Standards.** It is recommended that all institutions receiving funds emanating from national government for the purpose of achieving legislated national norms and standards should be subjected to an annual external audit. These requirements will need to be added to the standard external audit. This audit should indicate that routine reports provided to confirm compliance with the legislated norms and standards are indeed accurate.

6. **Costing of the Approved Policy Framework.** It is recommended that the entire policy framework underpinning the training of health professionals be costed, making explicit the costs to be incurred by provincial governments and training institutions. Once costed, account should be taken of alternative funding sources, such as university fees, which could be used to offset the funding requirements of training institutions. The complete costing framework should be provided and submitted each year to National Treasury in support of the HPTDG and the budget should be submitted to the national Department of Education. This approach should become the basis for a complete overhaul of the existing allocation.

7. **Flow of Funds.** It is recommended that the total allocation for training health professionals be determined centrally and allocated to both the national Department of Health and the national Department of Education. The Department of Health allocation should be budgeted as a conditional grant to

be transferred to each province in accordance with the costed framework. This would replace the existing HPTDG. The allocation to the national Department of Education would form part of the subsidy to tertiary education institutions and be earmarked for the teaching and training of health professionals. The earmarking will be specified in relation to each institution.

8. **Health Professions Training and Development Grant.** It is recommended that the HPTDG be converted to a specific purpose grant with the provincial allocations based on target enrolment levels and associated costs per enrolment by type of health professional. This allocation should include funding for the nursing training colleges and ambulance training colleges. The degree of specificity incorporated into the grant structure would involve earmarking allocations for relevant institutions.
9. **National Health Laboratory Services.** The Commission should recommend that allocations in respect of pathology students making use of the National Health Laboratory Services be incorporated into the HPTDG. The portion for the NHLS should be earmarked and specified in the same manner as all other funding requirements for health professionals. The allocation could be made directly from the National Department of Health and need not flow through provincial government.
10. **National Department of Education.** The Commission should recommend that the allocation provided to teaching institutions via the national Department of Education could be earmarked in accordance with the target-specific costs arising from the costing framework relevant for teaching institutions.
11. **Provincial Equitable Share.** No basis could be found for making any of the funds available for the teaching and training of health professionals through the provincial equitable share formula. No rationale could be found for distributing teaching functions 'equitably' throughout the provinces.
12. **Teaching in Excess of the Norms.** No basis could be found for limiting any institution or provincial government to training in excess of the norms set by national policy. However, funding for this training would have to be raised from sources other than the earmarked allocation for health professionals. Institutions would still have to comply with any specified quality standards required for the training of health professionals.

2.4 Conclusion

This review has concluded that substantial changes need to be made to both the HPTDG and the NTSG. These changes will not significantly affect the flow of funds. Instead, they focus on the extent to which a costed, government approved policy underpins the allocations.

Presently both grants lack any serious policy framework underpinning the funding modality and their conditions. Developing a new policy framework will affect the values of the grants, what they fund and associated conditions. However, to establish the policy framework will require that an organisational structure with the appropriate skills is established to administer and focus the grants over time.

Based on this review, no rationale can be found for shifting any of the relevant functions to the national level. The achievement of minimum national goals and objectives is possible through the conditional grants framework coupled with the use of legislated minimum norms and standards. No structural impediments could be found to the use of these instruments for the achievement of the required national policy goals.

The review also concludes implicitly that operational efficiencies are likely where delivery is undertaken according to minimum norms and standards. It is very likely that operational inefficiencies will result if national government attempts to take over operational responsibility for any function discussed in this report.

National government must, however, take responsibility for the development of all minimum norms and standards and see to their imposition on the relevant Provincial government departments and institutions. The extent to which planned outputs and policy goals are achieved, however, will depend primarily on the quality of the process implemented by the national Department of Health.

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Chapter 3

Assessment of the National Housing Allocation Formula

Denver Kallis and Rathipe Nthite

Abstract

Government is obligated to take legislative and other measures within its available resources to achieve the progressive realisation of the right to housing. However, a range of intergovernmental financing and delivery issues impedes the progressive realisation of this right.

This report addresses the financing and delivery challenges in the housing sector across the three spheres of government and provides some recommendations on how the funding allocation formula for housing can be improved.

The key research findings are that the current housing formula has a number of shortcomings. These can be summarised as follows:

1) *It is negatively biased against rural provinces as it does not include traditional housing in the calculation of provincial backlogs;*
2) *It does not take account of regional peculiarities such as the price of building a house that meets certain minimum requirements;*
3) *The number of homeless people is not an official Stats SA statistic;*
4) *Some of the variables used are very volatile in nature, e.g. in the North West shacks in backyards varied by 233% between 1996 & 2001; tents and caravans varied by -184% in Gauteng; homelessness varied by -785% in the Western Cape;*
5) *2001 population census data is outdated.*

Based on these findings the paper concludes by proposing a review of the allocation formula and how such a review may be undertaken.

Keywords:

Backlogs, framework, Housing, Subsidy Scheme, Grant, Allocation Formula, Rural Housing, Traditional Housing

3.1 Introduction

3.1.1 Background

The Bill of Rights (Chapter 2 of the Constitution of South Africa) recognises basic rights, including the right to adequate housing. The Constitution further states that the right to adequate housing must be progressively realised over time. Government must show that it has worked as effectively as possible to achieve this right.

Section 214 of the Constitution of South Africa provides for the equitable division of revenue raised nationally among the national, provincial, and local spheres of government. This division must take account of the factors listed in subsection 2, which include among others,

1) The obligations of the provinces and municipalities in terms of national legislation.
2) The need to ensure that provinces and municipalities are able to provide basic services and perform the functions allocated to them.
3) The fiscal capacity and efficiency of the provinces and municipalities.

Following its recommendations on housing in the Annual Submission for the Division of Revenue 2006/07, the FFC identified the need for further research on the financing and delivery trends, as well as the design of the formula for allocating housing funds. This report follows the FFC's previous work on the financing and delivery challenges in housing and focuses specifically on the formula for determining allocations. The report begins with an overview of the institutional and funding framework and gives some insight into the delivery and financing trends. The report then focuses on the housing allocation formula. Finally, the report highlights the key findings of the research and a set of proposals are made on how to refine the allocation formula.

The research methodology is based on interviews with government officials in the national, provincial and local departments of housing (refer Appendix B). An analysis of data and budget trends is also presented in analysing the formula.

3.2 Institutional Framework

3.2.1 Constitutional and Legislative Framework

3.2.1.1 White Paper

One of government's central pro-poor programmes is the delivery of low cost housing (National Treasury, 2003). This objective was envisaged in the Reconstruction and Development Programme (RDP) of 1994. The RDP endorses the principle that all South Africans have a right to a secure place in which to live in peace and dignity. The RDP set a goal of 300,000 houses to be built a year with a minimum of one million low-cost houses to be constructed within five years.

With this in mind, government's White Paper on Housing (Department of Housing, 1994) proposed a national housing strategy. It also formulated government's national housing vision in which Government strives for the establishment of viable, socially and economically integrated communities, situated in areas allowing convenient access to economic opportunities and health, educational and social amenities. All South Africans should have access, on a progressive basis, to:

a) A permanent residential structure with secure tenure, ensuring privacy and providing adequate protection against the elements; and
b) Potable water, adequate sanitary facilities (including waste disposal) and domestic electricity supply.

Government's goal in the White Paper was to increase housing's share of the total government budget to five percent and to increase housing delivery on a sustainable basis to a peak level of 338,000 units per annum within a five year period, and to reach the target of 1 million houses in five years (period beginning 1994). The extent to which this is achieved is addressed below.

3.2.1.2 The Constitution and the Right to Adequate Housing

The Constitution (1996) outlines the guiding principles for housing provision. At a most basic level, the Bill of Rights broadly defines the fundamental values, such as equality, human dignity and freedom of movement and residence, to which housing policy must conform.

The Constitution contains two key components of direct relevance to housing. These are:

1. The specific right to have access to adequate housing, as enshrined in section 26 of the Constitution:

(1) Everyone has the right to have access to adequate housing.

(2) The State must take reasonable legislative and other measures, within its available resources, to achieve the progressive realisation of this right.

(3) No one may be evicted from their home, or have their home demolished, without an order of the court made after considering all the relevant circumstances. No legislation may permit arbitrary evictions.

Sections 26(1) and 26(2) impose two positive obligations on the state. These are to move toward the progressive realisation of the right, and to take reasonable legislative and other measures to achieve progressive realisation. Section 26(3) involves the state's obligation to respect and protect the right by not infringing on people's access to housing by interfering or letting third parties interfere.

Section 25 of the Constitution is also important in that it relates to property rights. Specifically, Section 25(5) states that:

The state must take reasonable legislative and other measures within its available resources, to foster conditions which enable citizens to gain access to land on an equitable basis.

Section 28, which relates to children's rights, states that:

(1) Every child has the right:

(c) to basic nutrition, shelter, basic health care services and social services.

2. The Constitution prescribes that the powers of national, provincial and local governments with respect to housing activities are framed by the concept of "concurrent competence" and developmental local government.

   A provincial legislature has concurrent competence with national government with regard to all matters that fall within the functional areas defined in Schedule 4 of the Constitution, which includes housing.

   At the local level, although housing is not listed in Section 156 of the Constitution as a function of municipalities, Section 156 states that:

   (1) A municipality has executive authority in respect of, and has the right to administer –

   (a) the local government matters listed in Part B of Schedule 4 and Part B of Schedule 5; and

   (b) any other matter assigned to it by national or provincial legislation.

   (4) The national government and provincial governments must assign to a municipality, by agreement and subject to any conditions, the

administration of a matter listed in Part A of Schedule 4 of Part A of Schedule 5 which necessarily relates to local government, if –

(a) that matter would most effectively be administered locally; and

(b) the municipality has the capacity to administer it.

In addition, the Grootboom judgment discussed later and the National Housing Act (2000) outlined the responsibilities of municipalities in supporting housing delivery. This includes making land available for housing.

National and provincial governments have the legislative and executive authority to ensure that municipalities carry out their functions effectively. It is their responsibility to support and strengthen the capacity of municipalities to manage their own affairs, to exercise their powers and to perform their functions.

The Grootboom case is a well-documented Constitutional Court case concerning respondents that had constructed an informal settlement on private land earmarked for low-cost housing. Mrs Grootboom was part of a group of 390 adults and 510 children living in appalling circumstances in an informal settlement in the Cape Metropolitan area. The group moved to nearby land, ear-marked for low-cost housing, and illegally occupied the land. They were forcibly evicted, their shacks were bulldozed and burnt and their possessions destroyed. They could not go back to their original settlement. After they were evicted and rendered homeless, they applied to the High Court for an order requiring Government to provide them with temporary basic shelter or housing until permanent accommodation could be obtained. They based their argument on their constitutional right of access to housing and the children's right to shelter.

The question Grootboom sought to answer was whether the state had taken reasonable measures to achieve progressive realisation of the right to housing. The Court declared that the comprehensive housing programme, called for by Section 26(2) of the Constitution, must include measures 'to provide relief for people who have no access to land, no roof over their heads, and who are living in intolerable conditions or crisis situations'. The state housing programme that applied in the area of the Cape Metropolitan Council at the time of the launch of the application fell short of this obligation.

The Grootboom judgement helped clarify the right to housing in the following ways:

a) It provided useful insight into how international law should apply to the right to access to adequate housing;
b) It enumerated some of the requirements needed to make housing “adequate”;
c) It recognised that the provision of housing involves both state and non-state actors;

d) It recognised that the state's obligations may differ across jurisdictions depending on the needs of residents;
e) It emphasised the importance of clearly defining the role of each sphere of government in the provision of access to adequate housing and holding them accountable for their obligations; and
f) It drew a distinction between the right to access to housing in S26 of the Constitution and the right to shelter in S28(1)(c) of the Constitution

According to the Constitutional framework, the right to adequate housing is therefore more than just the right to shelter. Housing is necessary for a sense of privacy, personal space, a social gathering point, protection from the weather, and security. The house itself must be physically adequate, the legal regime must allow for security of tenure and protect people from discrimination, and the housing must be in close proximity to the basic services needed to realise other human rights.

3.2.1.3 Legislation

National government has passed several laws in order to give effect to its Constitutional obligations. The National Housing Act (1997) and the National Housing Code were designed to move toward the progressive realisation of the right to housing and to uphold Section 26(1) of the Constitution. The Extension of Security and Tenure Act 62 of 1997, the Rental Housing Act 50 (1999), and the Prevention of Illegal Evictions Act 19 (1998) were created to provide security of tenure and to uphold Section 26(3) of the Constitution.

The Housing Act is the supreme housing law in South Africa. It replaces all previous housing legislation, and it clarifies the different roles and responsibilities of the three spheres of government in respect of housing. It sets out how the national housing programme is to be financed. It also ensures that all housing activity in South Africa takes place within the framework of the Constitution and establishes various statutory bodies such as the national and provincial housing boards.

The roles of the three spheres of government as prescribed in the Housing Act are briefly described below.

3.2.1.3.1 National Government

National government, through the National Department of Housing, is responsible for developing national housing policy, assisting provinces and municipalities to develop goals for housing delivery and to monitor performance, and assisting municipalities to develop the capacity to manage and perform their obligations for the provision of housing.

The national government must develop a National Housing Code to help accomplish the above obligations, and keep provinces and municipalities updated on any changes to the Code. Section 4(6) of the Housing Act provides that the National Housing Code is to be regarded as legislation and is binding on the provincial and local spheres of government.

The national housing policy outlines the funding framework for housing development, and negotiates and secures an allocation from the government budget for housing. The policy provides for allocations to provincial governments, municipalities and other national housing institutions that implement national housing programmes.

3.2.1.3.2 Provincial Government

Provincial governments, through their respective Departments of Housing, are responsible for developing provincial housing policy within the national framework. They are allowed to legislate on housing matters that fall within their provincial boundaries, as long as the legislation is not in conflict with national legislation. They approve housing subsidies and projects and provide support for housing development to municipalities. They also assess municipalities' applications for accreditation to administer national housing programmes, and monitor the performance of accredited municipalities.

3.2.1.3.3 Local Government

Every municipality, as part of its integrated development plan, must ensure that within the framework of national and provincial legislation and policy, constituents within their jurisdictional regions have access to adequate housing.

The National Housing Act sets out the responsibilities of local government with regard to the provision of housing. According to Section 9(1) of the Act, local government is responsible for:

a) Ensuring that the inhabitants of its area of jurisdiction have access to adequate housing on a progressive basis;
b) Ensuring that conditions not conducive to the health and safety of the inhabitants of its area of jurisdiction are prevented or removed;
c) Ensuring that services in respect of water, sanitation, electricity, roads, storm water drainage, and transport are provided in a manner, which is economical and efficient;
d) Identifying and designating land for housing development;
e) Planning and managing land use and development;

f) Initiating, planning, coordinating, facilitating, promoting, and enabling appropriate housing development in its area of jurisdiction; and
g) Providing bulk engineering services and revenue generating services in so far as such services are not provided by specialist utility suppliers.

Municipalities are able to administer national housing programmes through a process of accreditation. To become accredited, a municipality must apply to the MEC of Housing. After consultation with the relevant provincial housing board, the MEC will allocate funds to the municipality for the Housing Subsidy Scheme or any other national housing programme. Accreditation empowers a municipality to undertake similar functions to provincial governments as it receives, evaluates and approves or denies applications for subsidies. It also prepares a local housing strategy and sets housing delivery goals.

The supply chain management policy governing the housing subsidy system allows for municipalities to act as developers in the housing delivery process. A "developer" initiates, manages and executes housing projects. A developer can be an organisation in the private sector, a public sector institution, or a non-governmental or community-based organisation.

Municipalities wishing to participate in housing development are, as part of their integrated development plan, required to submit business plans for housing development projects. Business plans have to conform to prescribed norms and standards as set out in the Housing Code. Once business plans have been approved, municipalities enter into contracts with a province to undertake a specific development project. Municipalities have to claim expenditure incurred from the provincial housing development board.

Thus, municipalities initiate, plan, facilitate, and coordinate appropriate housing development within their boundaries, either by engaging developers to undertake projects or by playing the role of developer. Municipalities also set aside, plan and manage land for housing development.

Section 9 (2)(b) of the Housing Act states that:

> *"If a municipality has been accredited under Section 10(2) to administer national housing programmes in terms of which a housing development project is being planned and executed, such a municipality may not act as a developer, unless such project has been approved by the relevant provincial housing development board."*

The implication of this clause is that a municipality must decide either to assume the role of a developer or to become accredited (i.e. administer one or more national housing programmes).

3.3 Funding Framework

The Housing Act requires national and provincial government to develop a multi year plan known as the Medium Term Expenditure Framework (MTEF). The MTEF provides a plan for the delivery of houses that takes into account housing demand and potential supply against available funds for a period of three years. In this regard, it is closely linked to the housing delivery goal. The Minister of Housing prepares a multi-year plan on the basis of multi-year plans prepared by the provincial governments.

The National Department of Housing administers two grants, namely the Integrated Housing and Human Settlement Development Grant (IHHSD) (formerly called the Housing Subsidy Grant), and the Human Settlement Redevelopment Grant (HSRD). The IHHSD grant is the bigger of the two grants, with allocations amounting to about 5 billion in 2004/05, and is expected to maintain a high trajectory in the MTEF period, while the HSRD grant is expected to increase from a low baseline of R116 million to about R130 million moving forward.

The Human Settlement Redevelopment Programme is being phased out in 2005/06 and will be amalgamated with the IHHSD grant. Thus the National Department of Housing will be administering one grant. The HSRD grant will be continued by the provinces until the projects are completed under the programme and no funds will be budgeted for this programme in future. The IHHSD grant is the focus of this report, as it is the grant that is allocated according to the funding formula.

3.3.1 Finance and Delivery Trends

When the new housing programme was introduced in 1994, South Africa's housing backlog was estimated at approximately 1.5 million households. This excluded the large number of rural households. Since then, the programme has provided poor people with more than 1.6 million housing opportunities, benefiting some 6 million people.

Funding for the Human Settlement Redevelopment programme was budgeted as follows:

Table 3.1

2001/02 R'000	2002/03 R'000	2003/04 R'000	2004/05 R'000	2005/06 R'000
96 375	106 000	109 000	115 540	24 396

Source: National Department of Housing, March 2006

These amounts exclude rollover funds provided by provinces. For instance the total roll over amount from 2004/05 to 2005/06 was R147,593 million.

Over a seven year period the following amounts were budgeted for the Integrated Housing and Human Settlement Development grant:

Table 3.2

2002/03 R'000	2003/04 R'000	2004/05 R'000	2005/06 R'000	2006/07 R'000	2007/08 R'000	2008/09 R'000
3 800 679	4 246 244	4 473 602	4 843 506	6 349 949	7 937 946	8 721 383

Source: National Department of Housing, March 2006

These amounts are based on the current formula and have been allocated as follows to the nine provinces:

Table 3.3

Province	2005/06 R'000	2006/07 R'000	2007/08 R'000	2008/09 R'000
Eastern Cape	581 218	761 994	952 554	1 046 566
Free State	398 618	522 601	653 293	717 770
Gauteng	1 340 675	1 757 666	2 197 223	2 414 079
KwaZulu-Natal	799 659	1 048 376	1 310 555	1 439 900
Limpopo	397 650	521 331	651 705	716 025
Mpumalanga	321 123	421 002	526 286	578 228
Northern Cape	79 917	104 774	130 976	143 903
North West	467 880	613 405	766 806	842 485
Western Cape	456 740	598 800	748 548	822 426
Total	4 843 480	6 349 949	7 937 946	8 721 382

Source: National Department of Housing, March 2006

The following section provides an analysis of the IHHSD grant with respect to budget and spending performance. The data analyzed is sourced from National Treasury.

The table below presents the budget for the housing subsidy grant over the period 1998 to 2004.

Table 3.4

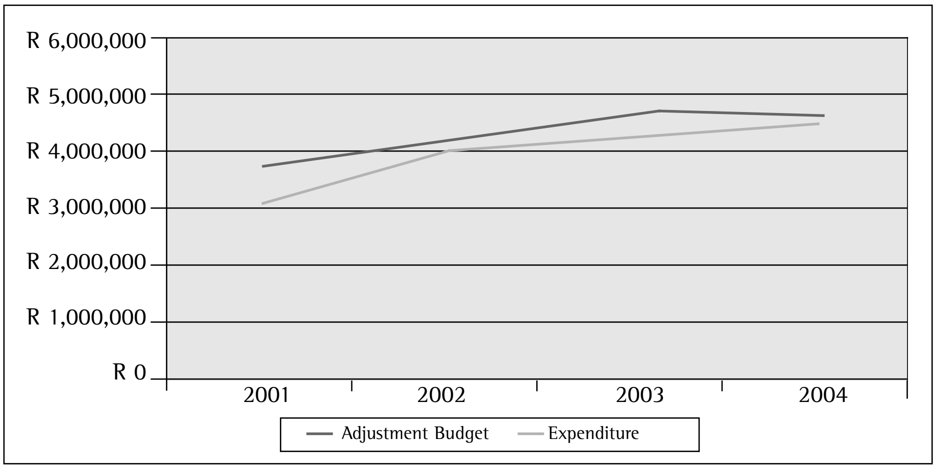
Housing Conditional Grants (R000)	Years						
	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Amount Received	2,748,559	2,570,510	3,063,797	3,528,615	3,800,674	4,246,239	4,473,597
Provincial Rollovers	-	4,163	519,000	285,219	463,500	496,871	374,845
Total Available	2,748,559	2,574,673	3,582,797	3,813,834	4,264,174	4,743,110	4,848,442
Actual Payments	2,748,559	2,570,889	2,945,457	3,157,267	4,075,161	4,343,042	4,440,511

Source Data: National Treasury, February 2006

Since its inception in 1998, government has continued to increase the housing budget over the period to 2005. The total available budget increased from R2,7 billion in 1998/99 to almost R5 billion in 2004/05. This is indicative of government's commitment to reducing the housing backlog. Of particular note is the provincial rollovers, which increased significantly initially and then tended to stabilize and begin to show a decreasing trend in 2004/05.

The graph below illustrates the trend in the adjusted budget and expenditure over the period 2001 to 2004.

Graph 3.1: Adjusted Budget and Expenditure Trend

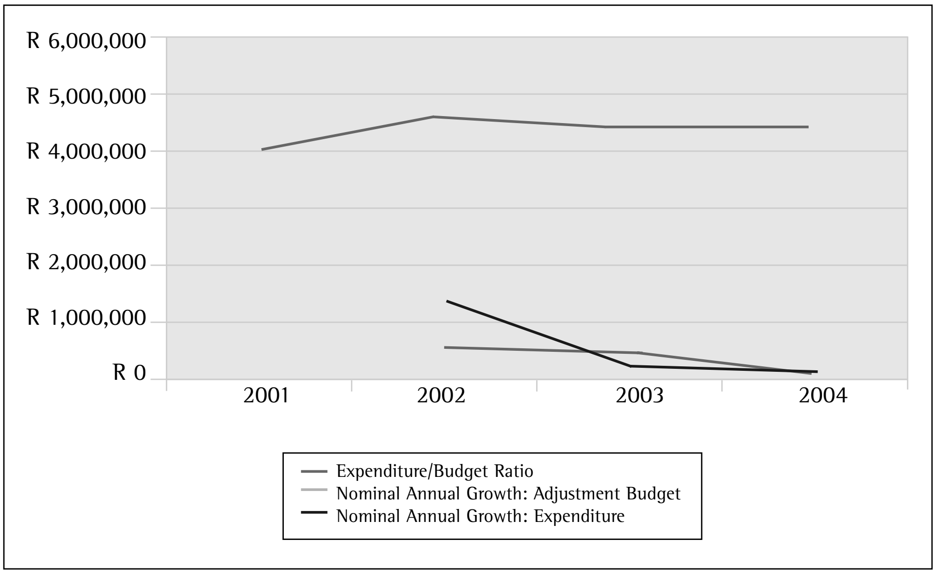


Source data: National Treasury 2006, own calculations

Note that the adjusted budget in the graph is the sum of national allocations received by provinces and provincial rollovers[22]. This should be borne in mind when reading the graph as rollovers tend to inflate annual underspending trends. Between 2001 and 2003, the adjusted budget and expenditure shows a similar increasing trend. From 2003 onward, the increasing trend starts to stabilise. The expenditure line remains below the adjusted budget line. This is indicative of the impact of rollovers. However, underspending does not appear to be significantly high.

The graph below shows the trend in the expenditure/budget ratio as well as nominal annual growth in the adjusted budget and expenditure.

Graph 3.2: Expenditure/Budget Ratio and Growth Trend



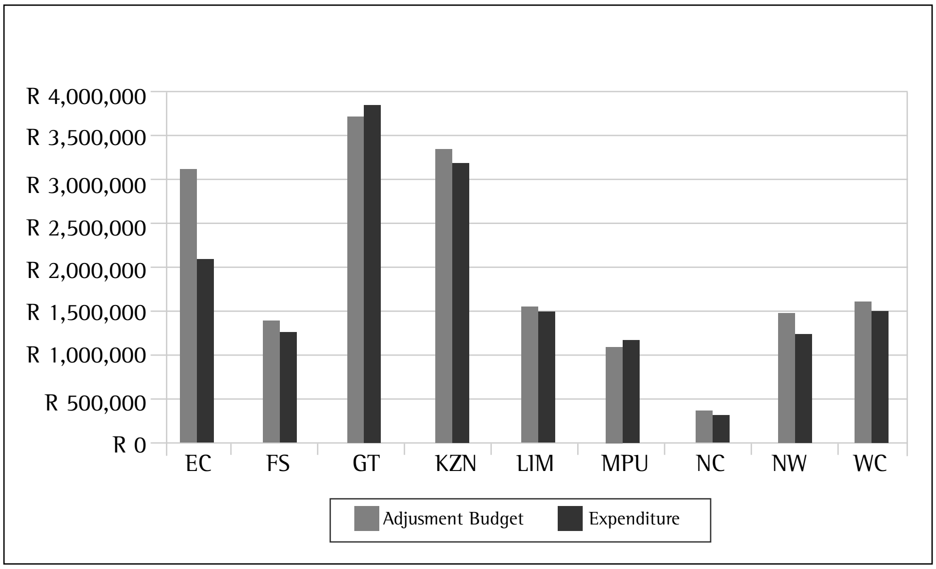
Source data: National Treasury 2006, own calculations

The expenditure/budget ratio increases slightly between 2001 and 2002. Thereafter the trend remains relatively stable, close to 100%. Annual growth in the adjusted budget shows a low and stable trend at first, but shows a decreasing trend from 2003 onward. Annual growth in expenditure shows a decreasing trend initially and stabilizes from 2003 onward.

22. Funds allocated for a financial year that are not spent in that year and carried forward to the next year.

The graph below provides a provincial comparison of total amounts for the period 2001 to 2004.

Graph 3.3: Provincial Comparison



Source data: National Treasury 2006, own calculations

Over the period 2001 to 2004, all provinces except Gauteng and Mpumalanga exhibit a degree of under spending. Bearing in mind that the adjusted budget in the graph is the sum of national allocation received by provinces plus provincial rollovers, the Eastern Cape shows the highest degree of under spending.

In summary, the IHHSD grant is government's primary tool for eradicating the housing backlog in South Africa. Analysis of the grants budget and expenditure shows a favourable trend. The adjusted budget and expenditure shows an increasing trend, with the expenditure/budget ratio relatively high.

Despite the scale of delivery, there has been a growth in the size of informal settlements. Based on the 2001 census, the Department of Housing estimates the current housing backlog to be in the region of 2.4 million households. This is an increase of almost 9% from 1996, when the housing backlog was estimated at 2.2 million households. Karuri *et al* (2002) suggest that the escalating backlog may be attributed to factors such as initial inaccuracies in housing backlog estimates, increasing rates of urbanization, unemployment and population growth.

Another factor is a change in household size (National Treasury, 2004). Between the 1996 and 2001 census, the average population growth rate was 2 per cent per annum, resulting in the population increasing by 4.4 million people. At the same time, there has been a 30 percent increase in the absolute number of households, where only a 10 per cent increase was expected. The reason for this is the drop in average household size from 4.5 people per household to 3.8. This trend would have serious consequences for housing demand and service delivery if it continues unabated.

The table below shows the breakdown of the housing backlog by province for 1996 and 2001. Only two provinces, namely the Eastern Cape and the Northern Cape, have managed to decrease their housing backlogs in the period between 1996 and 2001, while Gauteng's housing backlog increased by almost 20 percent. This is a direct reflection of population trends: Northern Cape's population decreased by 2 percent between 1996 and 2001, the Eastern Cape's increased by only 2 percent, and Gauteng's increased by almost 20 percent (see Census 2001).

Table 3.5: Housing Backlog by Province

Province	1996	2001	1996-2001 % change	2001 % of total backlog
Eastern Cape	223,427	220,524	-1.3	9.2
Free State	204,191	219,191	7.3	9.1
Gauteng	731,780	877,492	19.9	36.5
KwaZulu-Natal	322,415	323,429	0.3	13.4
Limpopo	103,243	112,503	9.0	4.7
Mpumalanga	136,474	144,574	5.9	6.1
North West	215,343	241,523	12.1	1.4
Northern Cape	39,705	33,733	-15.0	10.2
Western Cape	225,941	226,853	0.4	9.2
Total	2,202,519	2,399,822	9.0	100

Source: National Treasury, 2004; C. van der Westhuizen, 2004

As shown in the table below, Census figures indicate that while there was a 7 percent increase in the proportion of households living in formal housing, 36 percent or 4.1 million households were living in informal, traditional, backyard and other dwellings in 2001.

Table 3.6

Distribution by Dwelling Type	Census 2001			Census 1996			
	African	Others[23]	Total	African	Others	Total	Proportion In/decrease
Formal	55%	92%	**64%**	45%	89%	**57%**	7%
Informal	20%	3%	**16%**	21%	2%	**16%**	0%
Traditional	19%	2%	**15%**	25%	1%	**18%**	-16%
Backyard	5%	3%	**5%**	8%	4%	**7%**	-2%
Other[24]	0%	0%	**0%**	2%	3%	**2%**	-2%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	

Source: Censuses 1996 and 2001

The increase in the number of houses built has not been without criticism. Problems related to location, size, lack of access to services, poor thermal performance, and low resistance to dampness have been experienced by people benefiting from Government's housing programme. For this reason government has implemented a policy shift to focus on building quality houses, rather than focusing on the quantity of houses built. The cost implications of this policy shift is outlined below.

3.3.2 The Integrated Housing and Human Settlement Development Grant

The purpose of the IHHSD grant is to:

a) Finance the implementation of National Housing Programmes;

b) Facilitate the establishment of habitable, stable and sustainable human settlements in which all citizens will have access to selected social and economic amenities;

c) Ensure the progressive eradication of informal settlements on a phased basis through formalization of informal settlements by 2014.

The Housing Subsidy Scheme is Government's primary housing delivery programme. The National Department of Housing prescribes criteria for a person to be eligible to apply for a housing subsidy, such as age and household income. Beneficiaries earning in excess of R1500 per month are required to make an upfront contribution of R2479 in order to qualify for a subsidy. In certain cases, such as with the aged or disabled, the requirement is waived. Beneficiaries building their own homes through the peoples housing process projects are also exempt from this requirement.

23. "Others" include Coloured, Indian/Asian, and White population groups.

24. Dwelling category "other" includes tent or caravan and private ship/boat for the 2001 census. For the 1996 census it includes caravan or tent, unit in retirement village none/homeless, and unspecified.

The various housing subsidy types include the following:

a) Project-linked; to assist beneficiaries who are first time buyers to buy fixed residential properties in approved projects;
b) Individual subsidies; to assist beneficiaries who buy fixed residential properties for the first time;
c) Rural subsidies, to enable people who have uncontested informal land rights in respect of state land to access the housing subsidy;
d) People's Housing Process, to provide subsidies to people who want to build their homes themselves;
e) Consolidation subsidies, to enable people who have acquired ownership of a serviced site under a previous subsidy scheme to provide or upgrade a top structure on this site;
f) Institutional subsidies, to provide accommodation through institutions to beneficiaries on the basis of secure tenure such as rental, installment sale and share block;
g) Hostels Redevelopment Programme, to create human living conditions in public sector hostels. Applicants can be families or individuals;
h) Informal settlement upgrading programme;
i) Housing assistance in emergency circumstances;
j) Social housing policy; and
k) Provision of sound and economic amenities.

Up to the end of March 2004, a total number of 3,726 projects had been approved in terms of the various housing subsidy instruments. Of this total, 81% is project-linked subsidy projects, with 7% consolidation and 4.5% institutional housing subsidy projects.

The provision of housing to the poor is a national priority and housing development is viewed as an initiative through which projects and programmes that would enable communities to live in sustainable integrated human settlements are funded. The conditional grant enables the national government to provide for the implementation of housing delivery in provinces and accredited local authorities, and monitor of provinces and accredited local authorities accordingly. Unless government directs otherwise, and taking into account the level of backlogs in housing, it is anticipated that the need for conditional funding will exist for at least the next 20 years

From the National Housing Fund, money is allocated to provinces based on the Housing Allocation formula that was determined by the Housing MinMec[25] and approved by Cabinet in 2001. The formula takes into account:

25. A MinMEC is a political forum where national and provincial departments in the same sector discuss policy issues. It consists of the national Minister and the nine provincial MECs, supported by key departmental officials.

a) The needs of each province as measured by the housing backlog. The backlog is a function of people who are homeless, staying in inadequate housing or under bad conditions.
b) Factors such as homelessness, shack dwelling, caravan dwelling, tents, backrooms, rooms in flats.
c) A poverty indicator measured by households earning less than R3,500 in each province; and
d) A population indicator as measured by each province's share of total population as per the 2001 census.
e) A population share factor as measured by each province's share of total population.

The formula provides for weighting in order of priority of the elements as presented below:

A = HN (50%) + HH (30%) + P (20%)

Where:

A	=	Allocation
HN	=	Housing Need
HH	=	Households earning less than R3500 per month (affordability indicator)
P	=	Population

Housing need in the formula is defined on a weighted formula that takes into account the following:

HN = HL (1,25) + SE (1,2) + SBY (1,0) + TC (1,0) + FR (0,5)

Where:

HN	=	Housing Need
HL	=	Homeless People
SE	=	Shacks Elsewhere
SBY	=	Shacks in Backyards
TC	=	Tents and Caravans
FR	=	Flats or Rooms on shared property

The flow of funds is regulated by the Division of Revenue Act. For 2005/06 and 2006/07 the 2001 Census figures will be applied as funds were allocated over the MTEF period. The MinMec approved and amended formula will be phased in as from the 2007/08 financial year.

3.4 Conclusions and Recommendations

Analysis of the current housing formula highlights a number of shortcomings. The formula is negatively biased against rural provinces as it does not include traditional housing in the calculation of provincial backlogs. Regional peculiarities such as the price of building a house that meets certain minimum requirements are also not considered in the formula. The number of homeless people used in calculating the formula is not a published Statistics South Africa figure. Some of the variables used are very volatile in nature, e.g. in the North West shacks in backyards varied by 233% between 1996 & 2001; tents and caravans varied by -184% in Gauteng; homelessness varied by -785% in the Western Cape. Other data challenges is that the 2001 census population data used currently is outdated.

The following section provides recommendations on how the funding allocation formula for housing may be improved.

The formula is considered by rural provinces as being biased against them and in favour of urban provinces such as Gauteng and Western Cape. The formula does not include traditional housing in the calculation of provincial backlogs. In addition, the formula contains a poverty component that is favourable to provinces experiencing rapid urbanisation with a resultant increase in housing demand.

The housing subsidy formula should, as much as possible, use variables that take account of provincial peculiarities as this will, to a large extent, eliminate bias. Typically, factors like traditional housing, delivery capacity and development potential should be taken into account.

The formula does not take into account regional issues, such as where it is more expensive or cheaper to build a house that meets the minimum requirements, or the more expensive price of land in certain areas.

Therefore the differential costs of meeting the same minimum housing standard across provinces should be recognised.

Although provincial housing departments are expected to contribute towards rural development, the formula does not take into account rural housing need in calculating housing backlogs. Rural provinces are therefore expected to help the housing sector to realise the objective of rural development, but funds are not made available or top-sliced from the pool of housing funds to facilitate the achievement of this objective.

Delivery of housing should not result in communities residing in areas where there is neither supporting infrastructure nor economic or livelihood potential.

> *The demand or need for housing is growing at a faster rate than the ability of government to provide a sufficient number of housing units. The only way that the backlog can be overcome is to substantially increase funding required for housing delivery. However, delivery will still be constrained by the capacity of the construction and building industry. The pressure on government to deliver, coupled with the constraints on the implementation side, negatively affects the requirement of meeting the minimum quality standards.*

Monitoring compliance to minimum quality standards should be enhanced to ensure that rapid delivery of housing does not result in compromised or poor quality housing. Poor quality houses will result in additional costs in the future and result in increasing backlogs.

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Chapter 4

The Demand for Welfare Services: A Review of International Evidence and its Application to South African Intergovernmental Funding

Servaas Van der Berg, Goodwill Ditlhage and
Bongani Khumalo

Abstract

The demand for welfare services is unknown in South Africa. Capturing this demand is also not an easy task. Evidence shows that countries use a variety of proxies to capture such demand. These include demographics, poverty, population density and the volume of services that need to be provided. International practice also reveals that there are conceptual differences as to the definition of welfare services. Furthermore, the experience of other countries indicates an attempt at integrating welfare service with other social services. The experience of other countries also shows that spending on welfare services is dependent on fiscal capacity and that these services tend to receive low political prioritisation. The most prevalent form of funding welfare services is a block grant where sub-national governments enjoy discretion in spending. International evidence again indicates that there is a move towards private provision of welfare services where market forms are mixed with broader forms of social protection. This kind of provision requires a large network of institutions to provide these services. In South Africa, however, institutional capacity is not strong and still needs to be developed further. Having reviewed international practices and the South African situation where expenditure on welfare services only constitutes two percent of total provincial expenditure, this report attempts an estimation of demand in South Africa and suggests factors that may need to be considered in the financing of welfare services.

Keywords:

Allocation, Block Grants, Equalisation, Expenditure, Federalism, Fiscal, Intergovernmental, Transfers, Welfare Services.

4.1 Introduction

This report assesses the demand for welfare services in South Africa. The assessment begins by briefly dealing with some of the conceptual issues related to welfare services. It places South African welfare services in perspective and finally provides a broad overview of the international literature on this topic. The overview is based on the conceptual issues and the South African context, which frame the questions that need to be addressed. The overview is also done in a way that assists with the direction of the overall study. Thereafter, the report proceeds to apply the lessons learnt in the context of South Africa. After attempting to quantify the possible fiscal scope of demand for welfare services, the report concludes with suggestions on possible intergovernmental funding to provinces.

The study assesses the amount of funding required for welfare services in South Africa. This funding has historically been the stepchild of spending within social development departments. The main focus of these departments was funding social security grants. However, with social grants being taken out of provincial jurisdiction and placed with a national agency, it is important to investigate the provincial funding of welfare service provision.

Quantification of welfare service provision is difficult. This is true in countries such as the US, where the wealth of data on the welfare of children is highly developed. For instance, Micklewright (2002: 22) reflects:

> *(w)hen a European looks at what is available in the US in terms of data and analysis of child well-being, it is quite easy to feel sick at times – sick with jealousy.*

However, despite the lack of proper quantification, the perception in South Africa is that the levels of funding of welfare services, as well as the capacity to deliver such services, are so constrained that there is a considerable underfunding. This perception suggest that an assessment of the funding of welfare services is long overdue.

4.2 The Concept Of Demand

The first conceptual issue that needs to be dealt with is the concept of demand, as it relates to the study. Economists usually refer to this concept within a particular framework, where the typical expression is in the form of a demand curve that shows quantities demanded at any given price, *ceteris paribus.* This conventional expression of what the economist means by the demand for welfare services is not what this study is about. Demand for welfare services is not expressed through the price system. One of the reasons is that the demand is by society, not by the individuals to whom these services are offered. Thus, dealing with the rehabilitation of offenders or with family violence, street children or drug addiction is not something which the individuals concerned may seek.

The volume of services offered is affected not so much by the individual demand for them, as by society's demand. What we can usually perceive is the revealed demand, as demonstrated by the political process and expressed in the volume of services offered or the amount of public money spent. That is also highly dependent on the institutional context, relying for instance on what welfare services are being offered, what private efforts are taking place and what institutions exist to deal with many of these issues. Cultural factors also play a role. In some parts of society, the need for care of the aged is not one that arises in the public sphere, because family and the community, rather than society as a whole, are expected to provide the support old people require.

To a large extent, the demand that this study refers to, assesses the implicit demand from society, i.e. the satisfaction of the need for welfare services. This need is also not always revealed. For instance, child abuse is a large problem in many societies but the extent of the problem remains hidden unless society builds institutions that can better identify and address this need. This requires funding and human resources, largely ignored when determining allocations. Yet, in developing countries such as China:

> *Many areas of social services are marked by the scant supply of specialist professionally trained personnel. (Yiyi, 2003, 3)*

In such a context, how can such need for social welfare be determined? To a large extent, it depends on the building of social institutions, such as welfare organisations. At the level of measurement, the demand for welfare services cannot be properly measured and is dependent on the level of development and the time period in which it takes place. In a traditional society, many of these needs may not exist. This may be in part because less value may be attached to certain issues (for instance, violence against women in some societies) or because the community may deal with many of the issues within its fold - such as looking after youth offenders or caring for the old. Moreover, the level of poverty in any country '*also sets a limit to what NGOs can achieve*' (Yiyi 2003: 1). This in turn limits private welfare organisations.

For financial planning purposes, however, measurement within the context of societies with a developed welfare network usually occurs through using a series of proxies. These proxies are used to capture the need for welfare services such as, *for instance*, differences between geographic areas or fiscal jurisdictions. One factor often included in this group is demography – for instance, population size or the population size of a given age cohort. It can hardly be avoided as a factor if the magnitude of the need is to be dealt with. Another factor that is also often included is a set of indicators presumed to be good indicators of need, viz. poverty and poverty-related indicators, such as the rate of unemployment in an area.

Some studies include population density, as it is thought that some problems occur more frequently in cities, but this could perhaps also reflect the fact that urban voters may be more active in demanding services. Alternatively, the costs of service provision may be higher in sparsely populated areas. Further indicators often used in the international context relate to the volume of specific services that are actually offered, such as the number of children in home care (e.g. in homes), the population in care institutions - or welfare caseloads, as they are referred to in the US. In the case studies dealt with later, these proxies and some others for determining ‘demand”, will again receive attention.

4.3 The Concept of Welfare Services

International literature shows complete terminological confusion when dealing with what we in South Africa refer to as welfare services. Firstly, there are the different meanings attached to the term welfare, which is often used as a synonym for well-being, or in the term ‘welfare economics’. Secondly, the term welfare is often attached to the provision of grants or social assistance, particularly in the United States. In that country, the term most often used for what we refer to as welfare services is social welfare services or social services. In some cases these need to be distinguished from some services grouped with Health, so the reference then applies to non-health social services. Other terms used internationally include personal services, social care, care services, personal social services, personal non-health social services or even human services (in Australia).

Unfortunately, it is not only the term which differs across countries. Its coverage also greatly differs among countries and over time. Thus, for instance, some grants included in the funding of such services are not only for care but also for subsidised housing and the subsidisation of energy costs. The latter may be provided to households containing poor children that need care.

Welfare services are also often placed with different departments. Some of them are linked to health, so the placing of these services with Health or with Welfare (including Social Assistance) is not uncommon; but parts of these services are sometimes also offered with Housing, Education or Justice. In some cases, it is even argued that the movement should be towards greater integration with Health. With regard to the European Union, one study notes:

> *Many of the issues affecting healthcare also impact on social services, particularly an ageing society. Yet the work of hospitals and community based care have been organised separately historically. Member States are now looking at coordinating both sets of services more effectively, for example, by shifting towards more home-based and community care coupled with appropriate use of costly hospital services. (Saritas & Keenen 2004: 282-3).*

Also, the concept of developmental welfare that has been accepted within the South African context opens up possibilities. Some of this work could be coupled with that of economic development and therefore placed in other departments, rather than the welfare department. Moreover, the regional level at which services are offered differs, so that in the Scandinavian countries, as in the UK and even US, these services are often regarded as part of Local Services.

Spending is often subsumed in other programmes (especially health and social assistance) but sometimes other spending is added to it (e.g. cost of Medicaid administration in the US):

> *Social services can have multiple meanings and can include, for example, the provision of welfare payments and pensions. Here, the term 'social services' is confined to work rendered by any person or organisation in furtherance of the general welfare of citizens. This includes, but is not limited to, services for:*
>
> - *Children and their families;*
> - *Disabled people of all ages;*
> - *Elderly people (especially those with mental health problems);*
> - *People who misuse drugs and alcohol; and*
> - *Services in relation to HIV/AIDS.*
>
> *Public authorities and voluntary organisations are typically the providers of social services, though the private sector may also play an important role, for example, in the provision of long-term care facilities. (Saritas & Keenen 2004: 292).*

Kramer (1987: 240) defines personal social services as:

> *the social care provided to deprived, neglected or handicapped children or youth, the needy elderly, the mentally ill – in short, all disadvantaged persons with substantial psychosocial problems.*

Given this terminological confusion and institutional fragmentation, it should perhaps not come as too great a surprise that the international literature on the funding of social welfare services is quite thin. There are no summary studies similar to those we find for social security and social assistance in such excellent comparative studies as those of Esping-Andersson (1990), Flora et al (1981) or even, for Latin American countries only, Mesa-Lagos (1978)). This is perhaps to some extent a result of the fact that international comparison is so difficult because of the fragmentation of this sector. It is further exacerbated by the large discrepancies in the way welfare is defined and classified, as well as the institutional and policy heterogeneity that characterises this sector. The literature in this field, admittedly, is strongest when it comes to comparing developed countries, particularly in Europe, but even such literature is absent regarding social welfare services. Almost all studies that could be found on the funding of social welfare services relate to single country case studies only.

The emphasis in studies of the demand for social welfare services usually focuses on one of two factors:

1) The funding of welfare services through formula-based fiscal transfers to lower levels of government.

2) The actual spending levels that differ between different states or local governments, i.e. how demand has been expressed through the political system in the various local or state authorities.

The subsequent discussion will thus largely be based on this distinction.

In all of this literature there is an implicit assumption that need is presently already largely known and expressed, i.e. that the institutions exist for this and that the real requirement is to provide these institutions with adequate and equitably distributed financial resources. This assumption is not valid in a developing country context, where much of the need is unexpressed, because of the lack of institutions. So, for instance, there are no institutions dealing with abuse of women and children in deep rural areas of South Africa; but that does not diminish the need for dealing with this issue. This also means that there are, within one country, different levels of expressed demand, in that in some areas (often cities), institutions may have arisen to deal with many of the social problems faced by the community, whilst that may not be true in other parts of the country. For instance, there is a strong network of welfare institutions dealing with social problems in middle-class urban areas but there is an almost complete absence of such institutions in poor rural areas in South Africa.

4.4 Review of the Studies on the Demand for Welfare Services

We now turn to a discussion of some of the studies on the expressed demand for social welfare services. We shall, in this regard, focus on a few such studies, inter alia those of the United States, United Kingdom, Norway and Finland.

These studies assume a fair degree of fiscal federalism, at least with regard to the funding of social welfare services. Moreover, actual spending levels assume at least some degree of fiscal autonomy, in order for any of these studies to be undertaken. The reason is that these studies all attempt to determine the factors associated with higher levels of spending on such services in different sub-national jurisdictions. To make any sense, this can only be done where the levels of spending reflect, at least partly, local political choices that differ between the jurisdictions. These studies then all try to predict statistically the levels of spending by way of regression analysis, where the regressors are factors such as demographic composition, fiscal capacity and poverty. We shall now investigate a few such studies.

Spending on Social Welfare Programmes in Rich and Poor States (Toikka, Gais, Nikolov & Billen; 2004)

This study deals with spending in 50 US states as well as the federal capital, Washington DC, covering a period of more than 2 decades, from 1977 to 2001. Four welfare spending categories are analysed but only one is pertinent to this paper and equivalent to SA social welfare services. That is the service referred to as 'non-health social (welfare) services', *'...such as child care, child welfare, energy assistance and services to the aged and disabled'* (Toikka *et al.* 2004: Exec Summary p.3), to which is added *'...the costs to the public agencies of administering such programs, cash assistance, and Medicaid'* (Toikka et al. 2004: 27).

The study finds that the states' fiscal capacity affects spending and, out of the four spending categories analysed, spending differentials between poor and rich states are largest for welfare services. Such spending for welfare services rose gradually over the period.

The regression analyses show that the states' mean income and fiscal capacity significantly affected spending by states and their local authorities, but that poverty or unemployment did not. The authors conclude that *'estimating a stable needs function that would predict well state and local spending proved impossible.'* (Toikka et al. 2004: 49). It is rather the case that the fiscal capacity of states determines their spending on social welfare, and that whilst grants by the federal government to states '*...largely increased state and local spending on social welfare, the effects of federal grants were hardly noticeable for the poorest states...'* (Toikka *et al.* 2004: 49).

Also, the study found that:

> *The econometric models were most successful in explaining spending differences among wealthy states and fared less well in accounting for spending in poor states* (Toikka *et al. 2004:* Exec Summary p.3).

Where major cuts were imposed because of fiscal restrictions, this was greatest 'on *non-health social services and administrative expenses, especially staffing'* (Toikka et al. 2004: Exec summary p.4). The authors conclude that the reason for this appeared to be that:

> *...non-health social services were typically of low political salience and administrators were given significant discretion over how to allocate funds across different services... (Toikka et al. 2004: Exec Summary p.4).*

The Cost of Protecting Vulnerable Children: How Child Welfare Funding Fared during the Recession (Scarcella, Bess, Zielewski, Warner & Geen; Urban Institute; 2004)

This paper, interesting though it is and despite the wealth of information it provides, is another example of the difficulty of dealing with welfare services in a non-fragmented way. The paper deals only with child welfare: consequently, its overview of both the legislative changes and child welfare spending, although interesting, conveys only part of a wider picture. That picture is still characterised by the fragmentation of services and institutions within this field.

The paper provides a complete and detailed overview of changes in the realm of legislation and funding arrangements regarding child welfare between 1996 and 2002. The most important aspect in this regard was the introduction of the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA) that led to the replacement of AFDC (Aid for Families with Dependent Children) with TANF (Temporary Assistance for Needy Families). This change is referred to elsewhere in this paper. Here, we shall rather focus on the funding picture in terms of the fiscal magnitudes. The study finds that, despite large-scale objections from the welfare community to the termination of AFDC, funding for child welfare actually increased in the period 1996 to 2002 by 34 percent. Furthermore, all components (federal, state and local) increased in the most recent period, 2000-2002, although the experience differed across states (Scarcella et al. 2004: 30).

Despite this spending increase and large volumes of spending, unmet need still remains substantial. For instance, beyond the initial investigation of claims, only half the children found to be abused or neglected received welfare care services (Scarcella et al. 2004: 32). Of the spending on child welfare, 53 percent comes from the federal government, 35 percent from the states and 12 percent from local government. The most important spending categories of the $22 billion spent by all three of these agencies in 2002 was out of home placements ($10.0 billion) followed by adoptions ($2.6 billion) (Scarcella et al. 2004: 10 & 11, Table 2 & Fig.3).

A Fair Share of Welfare: Public Spending on Children in England (Tom Sefton; Centre for Analysis of Social Exclusion; 2004)

This study deals with spending on children in England. The major component of such spending is education but it also includes spending on personal social services for children, which is what is pertinent from our perspective. Table 1 below summarises the situation with regard to spending on social welfare. The top part of the table shows the spending in 2001/02 by client group, with the largest share going to older people over 65 (40 percent), followed by almost equal spending on other adults and on children (27% each).

Table 4.1: Spending on Social Welfare, England 2001/02

	Total £'m	Total	Children & Families	£ per head of Client Group
By client group:				
Total	**8 273**	**100%**		**228**
Adults aged under 65	3 054	27%		99
Older people	4 493	40%		577
Other groups	726	6%		..
Children & families	3 097	27%	**100%**	275
Breakdown by:				
Commissioning & social work	812		26%	72
Children looked after:	1 422		46%	126
- *Children's homes*	713		23%	63
- *Fostering services*	620		20%	55
Family support services	454		15%	40
Youth justice	117		4%	10
Adoption services	98		3%	9
Other children & family services	194		6%	17

Source: *Based on calculations from Sefton 2004: 43 & 45, Tables 13 & 14.*

Sefton (2004: 63, Table 18) finds that spending on children, his area of focus, increased strongly under the Labour Government. Of more direct relevance to us is that over this period, 1996/7-2001/2, spending on social care increased by 24 percent, with the sub-components of social care for children increasing by 30 percent, social care for working age adults by 26 percent and social care for pensioners by 9 percent. Regarding spending on social care for children, he finds that the value across local governments that was spent on poor children ranged between £370 to £810 in 2001/2, versus £200 to £300 on non-poor children, giving a ratio of 1.22 to 4.10 of spending on the former to spending on the latter (Sefton 2004: 65, Table 19). But worryingly, he reports that the spending per looked-after child varies by a factor of more than 2 between the local authorities spending the most and those spending the least. (Sefton 2004: 67).

Study on a Resource Allocation Formula for Social Services in Finland

This study identifies need indicators, dealing also with endogeneity of need, i.e. that need is partly the result of the services offered. Like many similar studies, some of which are described here, need or demand is determined by investigating actual patterns of spending between different jurisdictions, using regression analysis to explain what factors are associated with differing spending levels. The implicit assumption is that those are the factors that drive demand for services, i.e. that causality flows from the factors that affect demand to actual spending levels. However, once again the political process is the way in which the demand is manifest.

The authors find that political factors are most important in determining allocations for each service, followed by objective need criteria and costs of provision. The present criteria used in the allocation of funds to local governments are population, the age structure, unemployment and what is referred to in Finland as the 'workfactor', which is the share of the workforce in services and industry.

Fiscal and Spending Behaviour of Local Governments: An Empirical Analysis based on Norwegian Data (Aaberge & Langorgen; 1997)

The study employs an intrinsically similar model to determine the factors underlying demand, as expressed through the political and budget allocation process. It does this for eight local government services in Norway and includes also what they refer to as social services and, separately, child care and care for the elderly and disabled. (However, it should be noted that many aspects not considered in SA may be included in some of these other countries, e.g. fiscal grants for housing/food/fuel for some of the poor.) Regressors that were included because they were thought to be potential drivers of spending levels included demographic variables, such as shares of population in various age groups; children in single parent households; the number of mentally retarded in various age categories; unemployment; divorce or separation numbers; the presence of 'foreigners from remote cultures'; average travelling time; municipality size; duration and severity of winter; degree of sewage purification; change in municipal income and exogenous municipal income.

The study finds that spending on social services is income inelastic with respect to the income of local authorities. This applies in particular to services such as education, social services and care for the elderly and disabled, whilst spending on infrastructure is income elastic. This difference they ascribe to the fact that:

> *these service sectors to a greater extent than the remaining sectors are subject to requirements and regulations from the central government. Thus, when these requirements are met the local governments give priority to spending on infrastructure, administration, child care and culture. (Aaberge & Langorgen 1997: 26).*

The authors conclude that spending on child-related welfare services is greater due to the rising need from working single mothers. Also:

> *The higher the education level, the stronger are the local government preferences for child care services and culture services, and the weaker is the aversion against user charges. (Aaberge & Langorgen 1997: 23).*

Whilst referring to Sweden rather than Norway, the information regarding the former is also useful for comparison. Local government spending amounts to 27 percent of GDP and the main components of local government spending are 24 percent for child care, 13 percent for education ('at compulsory levels'), 8 percent for elderly care, leaving 55 percent for other purposes. (Dahlberg & Fredriksson 2001: 7, Table 2)

Redirecting Resources to Community Based Services: A Concept Paper (Fox & Gotestam - World Bank; 2003)

This report starts by defining welfare services quite succinctly:

> *Social care services are services supplied to vulnerable individuals and families to help them out of poverty and exclusion, and live a full and satisfying life. Vulnerable individuals are usually considered to be disabled, frail elderly, people at risk of abuse or deprivation of basic needs, or children deprived of parental care or mistreated in their family.* (Fox & Gotestam 2003: i).

Writing to present some lessons from World Bank experience for the contexts of Eastern Europe, Fox and Gotestam then give an indication of both the scope of welfare services (this time using a more expanded definition) and the complexity in terms of its placement and links to other services:

> *Social care services are services supplied to vulnerable individuals and families to help them out of poverty and exclusion, and live a full and satisfying life. Vulnerable individuals are usually considered to be:*

> 1 *Children (minors) and adults with serious disabilities (temporary or permanent), including the frail elderly,*
>
> 2 *Children (minors) or adults at risk of abuse or deprivation of basic needs, and*
>
> 3 *Children (minors) deprived of parental care (usually because of absence, illness including disabling addiction, or death of parents) or at risk of deprivation of parental care.*
>
> *Social care services are a support for everyday living. They complement support provided by families. They should also be a complement to other social services (health care, education, housing, employment assistance and training, etc.), as well as a support to other public services (justice, etc.). Indeed, encounters with other services often trigger the needs assessment of the client and referral to care services. The objective of social care services may be prevention of the deprivation of human rights or well-being or the correction of the problem. In some cases, social care services replace other social services. This is especially true of residential care. As a general rule, replacement of other services in a specialized institution is more expensive and leads to poorer outcomes in terms of inclusion, functionality, and well-being. (Fox & Gotestam 2003: 3).*

This question of the referral to social welfare services is one that should be carefully kept in mind when addressing the funding needs of such services. Also, in the case of South Africa the referral of cases by the courts creates a large additional need for such services in some jurisdictions which may not be present in others. An example of this would be the placement of child offenders in appropriate institutions or dealing with the placement of foster children in families. Welfare organisations often complain that the caseloads resulting from court referrals drain them of funds and personnel for dealing with other social welfare needs.

4.5 Fiscal Federalism in the Funding of Social Welfare Services: International Experience of Funding Regimes

In the international literature, funding of welfare services where a fiscal federalist principle was applied often includes some form of block grant, linked to a formula based largely on measures that reflect some or all of the following factors: poverty, case loads, the volume of institutional care offered (e.g. children's homes, old age homes) and the fiscal capacity of the lower tier of government. Only in a few cases does one find conditional grants and those are usually for welfare services of limited and specific scope.

This means, in effect, that local jurisdictions have some discretion as to how to spend their resources on welfare services, based on perceived need, relevant service allocation and an ability to shift funds away from or to welfare services.

In the US, the AFDC (Aid for Families with Dependent Children) system of funding was based on unlimited matching state welfare grants by the federal government, with federal oversight to ensure quality control. In contrast, the new TANF (Temporary Assistance for Needy Families) system is based on a fixed block grant (a limited part of which can be redirected to other areas of spending), creating new incentives for states to save on welfare spending. Furthermore, federal oversight has been removed. However, the largest part of the system concerns welfare grants rather than welfare services (Winston et al. 2002: 5).

The termination of the AFDC and its replacement by the TANF took place in accordance with the Personal Responsibility and Work Opportunity Reconciliation Act (PRWORA), that 'changed the nation's welfare system by ending the individual entitlement to cash assistance and giving states considerable flexibility in the assistance programs they operate' (*Scarcella et al. 2004: 2). The system contributes very little to the reduction of spending differentials between different states*:

> *Under pre-1996 welfare programs, expenditures per poor family varied because states' benefit levels, eligibility criteria, and population characteristics differed. Low-income states and southern states generally had lower benefit levels and enrolled smaller shares of their poor families than other states. In 1996, Congress locked in these pre-existing differences in federal funding when it decided to base 98 percent of the federal TANF allocation to each state on the state's historical expenditure on welfare. While 18 states receive grants of less than $2,000 per poor family, 14 states get more than $4,000 per poor family. (Merriman 2004: 2).*

In the UK, welfare services are divided across a number of departments. Many services are provided by Local Government and are funded in part by central government, collectively with a number of other functions, through block grants (for a full description, see Sefton 2004: 74-5). The services covered by the Local Government Finance Settlement are education, personal social services (i.e. welfare services), police, fire services, highways maintenance and environmental, protective and cultural services. Most of this is covered by a formula grant, based on service-specific formulae; however, local governments are free to spend the money on other services. There is also a limited range of conditional ('ring-fenced') grants. The overall level of funding for the different areas of spending is determined by the government's national priorities but the allocation across local governments is by formulae that are supposed to reflect local need. There is a fiscal equalisation part to this formula. Welfare services - called personal social services in the UK -

have separate sub-blocks with their own separate formulae, e.g. for children's services.

There is a similar common structure for each formula, as follows:

1. *A basic amount for each client that is the same for each authority…;*
2. *A Deprivation Top-Up that allows for additional costs of providing services in more deprived areas;*
3. *An Area Cost Top-Up that allows for the variation in wages and business rates across the country;*
4. *Other Top-Ups that address a range of other cost pressures that are relevant for the particular services (e.g. rural sparsity). (Sefton 2004: 74-5).*

The second of these components of the formula determines the extent of pro-poor bias. It depends both on what part of overall spending on the services is allocated on the basis of the poverty/deprivation and also on what indicators are used to proxy for relative need. (Sefton 2004: 75).

To determine what weight to attach to the different factors, regressions are used to explore *'the past relationship between spending on specific services and various need-based indicators'*, in a similar manner as in the demand studies referred to earlier. This, of course, only makes sense as long as there is local discretion in spending across programmes, otherwise the regressions of past patterns would reflect nothing but past allocations by central government. However, because they are also affected by local government decisions, the proxy for the need is expressed through the political process.

For the sub-block of the block grant that refers to children's personal social services, the following indicators are included in determining need:

1. *The proportion of children in families in receipt of Income Support…;*
2. *The proportion of children living in one adult households…;*
3. *The density of population of the area…;*
4. *The proportion of children living in flats…;*
5. *The proportion of children with a limiting long-standing illness… (Sefton 2004: 75).*

Sefton's Annex A is a table that contains these indicators of children's needs for each local government in England.

Essentially, the decision on what to fund, and how much it would take to fund it appropriately, remains a political one. As Fox and Gotestam (2003: IV) comment with regards to the essential care basket:

> *Professional judgments and best practice identify the care package that is likely to give the best outcomes. But making choices among needs is by necessity a political decision. It can be facilitated by needs mapping and good outcome monitoring.*

Fox and Gotestam (2003: ii-iii) distinguish three possible financing frameworks for welfare services (social care, as they call it) across societies. The two extremes are i) no public role and ii) public finance through provision. The middle ground is the purchaser-provider model, which implies that public finance is made available through reimbursement of services provided.

In the case where there is no public role, it usually results in under-provision and consumption of welfare services and care, leading to unmet social needs, because:

> *(a) those most in need would not be able to afford the services, and (b) households and individuals in many cases do not have the information to match services with needs, or they may have a conflict of interest (in the case of a child in need of protection from domestic violence, for example). (Fox and Gotestam 2003: iii)*

To a large degree, the absence of welfare services in many parts of South Africa has resulted in such a situation.

In the case of full public provision of services there are other problems that arise, mainly with regard to the ability of the public sector to be fully sensitive to the needs on the ground, as well as with its ability to deal with quality concerns and with cost inefficiencies:

> *The problem with this (public provision) method is that available resources are allocated not among people in need, but among providers. There is no balancing of supply with need or demand, there is just supply, without choice. The input determines the output and the outcome. There may be an oversupply or undersupply of services relative to demand. Quality problems may also arise since the public sector tends to face problems in sanctioning itself for poor quality, and there are usually limited channels for community and client participation in quality assurance. In its most extreme form, the pure public model substitutes the public sector for the family. (Fox and Gotestam 2003: iii)*

But Blank (2000: C34) notes that '(t)he social services market is characterised by multiple market failures, including informational asymmetries, agency problems, externalities, and distributional concerns.' This is echoed by Winston et al (2002: 20-22), who refer to externalities; incomplete information about the service; agency problems and insufficient competition as economic issues. They further add to that public administration and management perspectives, as well as the political science and legal perspectives.

The purchaser-provider approach, in the view of Fox and Gotestam (2003), 'attempts to duplicate the roles of the consumer and the supplier in the market system, but without the market failures caused by inadequate financing and imperfect information'. Financing remains public, but there is more voice for the consumer and greater competition between providers.

> *The public roles … are divided into two different functions: (a) the purchaser, who finances and purchases care, and (b) the provider, who operates the service delivery units. The job of the purchaser is: (a) to act as gatekeeper or rationer of public funds, determining eligibility, and (b) in the case of more specialized services, to act as the agent for the principal (the vulnerable individual). The purchaser could be any qualified official given responsibility for this task – a teacher, social worker, a child protection officer, a court, etc. Fundamentally, the role of the purchaser is to act as an agent for the financier and the client, to ensure that funds are used to get the best outcome for the client. While the provider could be a public agency, in OECD countries, the provider is more likely to be a private or NGO provider contracted by the public authority, an approach adopted to bring increased client responsiveness and efficiency. In transition countries, public providers are more likely in the initial stages as the private sector is underdeveloped. The private sector will grow over time. (Fox & Gotestam 2003; ii-iii).*

This situation is already quite prevalent in South Africa. In recent years, there has been a growing share of welfare services spending going to the provision of services by the provinces themselves and the payment of their own staff, whilst there has been some cutback in the transfers to welfare organisations who provide these services. This has put greater pressure on such organisations to find private funds, something not addressed in Fox and Gotestam's framework, but which is very prevalent in developed countries, particularly the United States. There, as early as 1980 41 000 voluntary organisations employed 933 000 persons and spent $13.7 billion (Kramer 1987: 240). This combination of voluntary organisations and the state as service provider, with private and public funding co-existing, is most pertinent to South Africa. It is also notable that private and donor funding for welfare organisations has tended to dry up since the political transition. Furthermore, the greater attention given to AIDS in recent years has placed further strain on the adequacy of private funding for the provision of other welfare services.

In the USA, at least, some welfare services are quite commonly performed through private providers. Thus, for instance, although 89 percent of school children attend schools operated and owned by the government, this ratio drops to 17 percent of hospital beds and only 7 percent of slots for child care that are provided by government itself (Blank 2000: C35). In addition, 31 percent of all public spending (including Medicaid) on child welfare services is on contracted-out services (Scarcella et al. 2004: 30). Non-public providers were usually non-profit organisations, with the services most commonly privatised being day care, drug and alcohol treatment, child welfare and adoption, programmes for the elderly and employment training (Winston et al. 2002: 8). Studies quoted by Winston et al. (2002: 16) found that '(t)he empirical evidence on cost savings through contracting out social services tends to be mixed, although overall it suggests the potential for somewhat lower costs.' They also point out that the costing differences do not take into consideration the transaction costs of the contracting.

Smithies (2005: 6) has a different classification system for the activities in personal social services in the United Kingdom. She distinguishes five categories, as defined below. These categories are also used in Table 2 and shows the relative shift over these different types:

i) Pure public: Most spending in this category is Local Authority expenditure on its own provision of care.

ii) Public: User charges: This is fees for Local-Authority Provided services.

iii) Public decision: Contracted out: This is largely composed of Local Authority expenditure which is contracted out to private providers.

iv) Public decision: Contracted out: User charges: This is fees for Local-Authority-Contracted-Out services.

v) Pure private: The bulk of this category's spending comes from self-payers in private care homes.

Table 4.2: Personal Social Services Spending in the UK by Funding Model (%)

	1979/80	1995/96	1999/00
Pure public	71%	43%	42%
Public: User charges	10%	4%	4%
Public decision: Contracted out	11%	35%	32%
Public decision: Contracted out: User charges	1%	5%	8%
Pure private	7%	15%	13%
Total	**100%**	**100%**	**100%**

Note: All columns do not add up to 100% due to rounding.

Source: Smithies 2005: 7, Table 4. For more detail on amounts and the breakdowns between residential care, non-residential care and miscellaneous services within each of these categories, see Smithies 2005: 36-39, Appendix A: 6.

Smithies (2005: 7) notes that, of all the areas of social spending she reviews (Education, Health, Personal Social Services, Housing, Income Maintenance and Social Security), the shifts were most drastic in personal social services, particularly between the early 1980s and the mid-1990s. This entailed a shift away from the first two categories in the table towards the last three, i.e. from direct public provision to more use being made of private providers. But overall spending also increased. In summary, her conclusion for the whole of social spending also holds for welfare services, viz. that *'public financing has not decreased as much as public provision'* in the UK (Smithies 2005: 14).

An overview of the experience of 11 European Union members or applicant states finds an international trend *'to combine the virtues of the market with the advantages of broader forms of social protection'* (Appleton 2005: 251). Looking at family policy, Appleton identifies three organisational types in the delivery of family services through non-profit organisations. In Ireland, the UK, Germany and France, the provision takes place mainly by non-profit organisations, mainly secular ones, working with the state. In the second group of countries (Spain, Italy, Poland and Greece) non-profit organisations also dominate; but in this case the organisations are mainly church-based. In Sweden, Hungary and Estonia, in contrast, the state dominates provision and non-profit organisations play only a limited role (Appleton 2005: 243-4). The different historical influences that have contributed to these different constellations of state, secular and church-based organisations is discussed in more detail in Appleton's paper. From our perspective, the main interest lies in the rising role of purchaser-provider models of welfare service provision in many of these countries, with state funding playing a major role.

Dealing with the demand for welfare services and how these affect the mixture of private, public or voluntary organisation provision, Dollery & Wallis (2002: 18) argue that people who experience 'personal disadvantage':

> *... generally require others, like parents, relatives or guardians, to act on their behalf. But many personally disadvantaged individuals may not have anyone to represent them or available to act in their interests. Given its profit motive, the private sector would seem unsuitable since it would confront strong moral hazards and thus market failure may be expected to exhibit itself. Similarly, public sector delivery agencies are '...likely to receive weak messages from politicians defining their goals and standards' and accordingly 'normal practice will therefore be to leave it to the 'professionals' to act as interpreter and guardian of the personally disadvantaged person' (Billis and Glennerster, 1998, p. 89). Past experience in many developed countries has indicated that under these circumstances government failure in the tragic form of sexual and other abuse often occurs. In comparison, voluntary organisations seem to possess definite advantages...*

Which is the appropriate model of provision? There are some pointers in the literature:

> *If quality is readily observable, the government can regulate private providers to assure standards are met. But when standards are difficult to observe or when the recipient is not the agent who makes the decisions, government ownership may be preferable. (Blank 2000: C34)*

This applies to a large degree in South African welfare services. Although it is not always impossible, it is often difficult to observe standards and very often the decisions about consuming the service are not made by the individual concerned (e.g. addicts, youth offenders, perpetrators of family violence) but rather by social workers or the judicial system. Where the output of the care given cannot be readily observed, there are great dangers that the services provided would be of poor quality or that there would be abuse of the individuals for whom care is to be provided, as both Blank (2000: C42) and Dollery & Wallis (2002: 18) note.

But Kramer (1987: 253) makes the point that the choice of provider model may not be the most important question:

> *...a focus on governmental versus voluntary versus profit-making auspices deflects attention from the major policy question of equity: who should get what services?*

In similar vein, Healy (2002) argues that the trend towards private provision of social services (or human services, as she refers to it in the Australian context) leaves social work professionals out in the cold, as their training is not usually appropriate to deal with this different environment.

In much of the international literature, which is based almost completely on developed countries, the situation is one in which there already exists a large network of welfare institutions, capturing most of the need for welfare provision through its activities. In that developed country scenario, the need has already been revealed through the institutional framework and poor communities do benefit from services and have a civic voice.

This is not the case in developing countries such as South Africa, which implies that the funding problem is not only one of meeting existing expressed demands but also one of needing to in some sense stimulate the demand through the building of institutional capacity in poor communities that are as yet unserved or under-served with welfare services.

Some of the literature touches upon this aspect, e.g. Norman & Hintze (2005: 556) refer to a Tanzanian respondent complaining about 'minimal social work efforts'. and a Sri Lankan who bemoans the lack of recognition for the social work profession.

4.6 Conclusions from the International Literature

The case study reviews has illustrated the complexity of the issue of financing welfare services for the South African context. This complexity derives from lack of clarity on the definition of welfare services themselves, as well as the institutional heterogeneity that is widespread in the organisation and funding of such services internationally. From the perspective of a developing country, much of the foregoing analysis is also somewhat too specific – our issue is as much to develop the institutional capacity so that need can be translated into political demand and eventually fiscal demand.

There are a few useful pointers from the international studies that will be considered and used in the sections below, where these principles are applied to the South African situation. The most important is the fact that a block grant system seems to be the standard funding mechanism for welfare services, leaving discretion at the level of the lower tiers of government on how the money should be spent, as well as allowing for the shifting of resources from or to welfare services through the usual budgetary discretion. The exact content of the formula for the block grant differs, but it seems advisable to think of two main components in the South African context, the one relating to judicially linked services (caring for youth offenders, orphans or victims of abuse) and another for services that reflect need as it arises from society. The latter component is particularly complex, as it is intricately linked to issues of poverty and social pathologies. It is also influenced by institutional capacity constraints. Such constraints may lead to an uneven translation of perceived needs and, consequently, a skewed interpretation of real demand.

4.7 Social Welfare Expenditure in South Africa

International studies show low political attention is given to welfare services. This is also evident in South Africa, as demonstrated by the fact that only R2.4 billion has been budgeted for the social welfare services programme in 2005/06 (or R4.3 billion if all non-grants expenditures of social development departments are taken into account, including approximately 25 percent for administration). This is minute when compared to the R55.4 billion budgeted for social grants and the R213.8 billion in total provincial spending (SA National Treasury Sept 2005, Provincial Budgets and Expenditure Review 2001/02-2007/08, pp. 52 & 148).

Two points arise from the above. Firstly, even though a strong case can be made for greater spending on welfare services, political priorities at provincial level seem to be aligned differently. Secondly, a complex funding model for welfare (in the equitable share and through conditional grants) may not be warranted for such a relatively small expenditure, which has a minor impact on overall provincial allocations (welfare services expenditure is only about 2% of aggregate provincial spending).

In South Africa the funding for welfare services has long been severely constrained, both in the public sector, where it was often squeezed out by strongly rising social grant spending, and also in the private welfare sector, where funds have been drying out for a number of reasons. These include reduced foreign aid, difficulties in raising private funds and constraints on public sector subsidies of private sector organisations, particularly as provincial welfare services have employed increasing numbers of social workers. The sector is a highly fragmented one, with many services provided by a range of organisations. Boundaries between organisations and services are often unclear, and there are often large gaps in provision. Capacity to provide services is quite limited, especially outside the main metropolitan areas. In addition, in recent years the model of provision of welfare services has shifted increasingly away from providing institution-based care, which is expensive and not affordable on a large scale, to providing community-based care. In more affluent parts of the community, a mixture of welfare provision by organisations and own payments is quite common, e.g. for institution-based care for the elderly.

This study now turns to examining the demand for welfare services in South Africa in quantitative terms before concluding with a section on possible funding formulae for welfare services in the intergovernmental funding system.

4.8 Quantifying the Demand for Welfare Services in South Africa

What is the extent of the demand for social welfare services in South Africa? For the reasons referred to earlier, this is an extremely difficult question to answer. Revealed demand is to some extent constrained by the lack of institutional capacity for providing welfare services, whereas the costs of services to some extent reflect a revised provision model. This has shifted from a more expensive model based on privileged institutional care under apartheid to one that is less expensive and places more emphasis on community-based developmental welfare services.

To gauge the possible extent of the demand for welfare services in fiscal terms is extremely difficult. One option would be to base estimates on maximum spending levels in provinces. So, for instance, Table 3 in Appendix C (see also Tables 1 and 2) shows an actual national spend on welfare services, developmental support services and population development of R3.2 billion budgeted for 2005/6 (i.e. non-grant social welfare spending, excluding the expenditure programme administration, yet including the administrative components of spending in these other three programmes). This amounts to per capita spending across the whole South African population of R70.60 (Appendix C, Table 3 and Table 2). In the Northern Cape, the province allocating relatively more to these programmes, spending is R159.47 per member of the population. This would convert to aggregate spending of R7.2 billion if applied to the whole South African population (based on the Northern Cape benchmark). If, instead, the highest provincial spending levels per person on both the developmental support services and population development programmes, as well as on social welfare services sub-programmes, are added together, this amounts to a spending level of R207.03 per person. Applied to the whole South African population, this would come to a total spending of R9.4 billion. This can be taken as a high estimate, given current preferences and institutional capacity, both of which influence political readiness to spend on social welfare.

An alternative set of estimates can be derived from spending levels in apartheid South Africa. Spending levels per capita for non-homeland areas on the different race groups in 1993 (see Appendix C, Table 3) for three social services for which data were available[26] were a multiple of the spending levels presently experienced for similar sub-programmes[27]. If this is further decomposed by race, the following becomes apparent:

1) The 1993 African spending norm outside the homeland areas was only 0.86 times of the current spending per capita in South Africa.

2) The 1993 Indian spending levels were 1.25 times current spending per capita.

3) Coloured levels were 2.51 times current spending per capita.

4) Aggregate 1993 spending outside the homelands was 3.06 times current spending per capita.

5) White spending was a substantial 9.34 times current spending per capita.

Applying these multiples to all social welfare spending in 2005 may be regarded as an indication of the upper range of estimates of possible spending levels. Following this procedure, 1993 white spending norms would require a massive R30.0 billion for social welfare (excluding the administration programme) rather than the present R3.2 billion. Even the average non-homeland spending norm in 1993 implies an increase to R9.8 billion, and the coloured norm a slightly lower R8.0 billion (see Appendix C, Table 3). The white norm can be regarded as a useful upper limit for three reasons:

1) On the one hand, it broadly reflects the demand for welfare services in fiscal terms based on an earlier South African situation, albeit a very special one,

26. Rehabilitation of alcoholics and drug offenders, care of the elderly and care of the disabled.

27. Treatment and prevention of substance abuse, services to older persons and services to persons with disabilities.

where institutional capacity was not a great constraint (welfare services reached well into the white community) and where political support for such spending was strongly developed, given that apartheid placed few constraints on welfare spending for whites.

2) On the other hand, this estimate may tend to be on the high side, as the actual cost of provision is now likely to be lower, given the shift that has taken place to a fiscally more affordable model of provision, i.e. one not predominantly based on expensive institution-based care, as was the case for whites in apartheid South Africa. Also, some of the spending voted for white welfare services in the apartheid era was in fact not spent on whites, despite the apartheid restrictions, as many welfare organisations had used such funds to cross-subsidise services for other people, so that this spending level is an excessively high estimate.

3) In addition, the higher historical spending norm for whites in these three services may perhaps not accurately reflect the differential in other services, so that the estimate may be quite inaccurate.

Table 4.3: Derived spending norms based on 2005 spending by provinces and 1993 apartheid-based patterns (all amounts in 2005 Rand values)

Spending norm	**Per capita spending (for whole population)**	**Implied spending need**
Spending ratio Africans (non-homeland) 1993: SA 2005	R 60.37	R2 744m
Actual 2005	**R70.60**	**R3 209m**
Spending ratio Indians 1993: SA 2005	R 88.29	R4 013m
Highest spending province 2005	R159.47	R7 248m
Highest spending province in each programme/sub-programme	R 207.03	R9 410m
Spending ratio Coloureds 1993: SA 2005	R 176.87	R8 039m
Spending ratio Non-homeland 1993: SA 2005	R 216.02	R9 819m
Spending ratio Whites 1993: SA 2005	R 659.65	R29 983m

Source: Own estimates from:

South Africa, *National Treasury. 2005. Provincial Budgets and Expenditure Review 2001/02-2007/08.* National Treasury: Pretoria. September.

South African Institute Of Race Relations. 1994. *Race Relations Review 1993*. SAIRR: Braamfontein.

Van Der Berg, Servaas. 1996. "Fiscal Implications of the White Paper on Social Welfare." *Social Work* 32(1), March: 8-19.

Thus the white spending norm, or indeed the spending norm for any other group under apartheid, cannot realistically be used to determine the fiscal demand for welfare services in post-apartheid South Africa. What is useful, however, is that it provides some idea of what an expansive norm may amount to, if institutional capacity was not constrained and political support for welfare services was strong.

4.9 Funding Provincial Welfare Services

The fact that provincial social grant spending was recently removed from the equitable share formula and funded through a conditional grant gives rise to a need to reassess the provincial share formula as the Development component is no longer reflected in the formula. Firstly, what would be the most appropriate factors to include in a welfare spending component of the equitable share (and conditional grant) funding formula? Secondly, does the amount at stake warrant a very finely grained and ideal formula that may be quite sensitive to weak data or should an appropriate formula be less robust and less ideal? These issues are addressed in this section.

Based on the notion of developmental welfare that has been incorporated into South African welfare policy, Leila Patel distinguishes three types of services with different funding needs:

1) Rights-based services.

2) Family-centred and community-based services.

3) Poverty reduction and community-oriented social and economic development.

However, because the third of these is difficult to quantify and also not fully separable from the second (as actual provincial expenditure patterns illustrate), an alternative perspective may be more useful. This perspective distinguishes only two types of services to be funded:

1) **Statutory services:** these are services prescribed by law and the courts; dealing with youth offenders would be an example of this. Such services tend to be more common in provinces with more courts, thus imposing additional costs on the affected provincial welfare departments. Ideally this may be funded through conditional grants, based on caseloads and actual spending per case. However, data for such estimates are not easy to obtain and the actual costs may vary widely over provinces and cases, making quantification more difficult.

2) **Other welfare services:** these are perhaps best funded, as the preceding literature review has indicated, by block grants to provinces. This implies that the money would be allocated to provinces, but they would then be free to use these and other funds for social welfare services or other expenditures, depending on the political priority.

What should such a block grant entail? On the one hand, it should be based on need or the manifestation of need. However, as has been argued before, this should be balanced by also considering institutional capacity. Thus, for instance, it is of little use to provide funding to a province based on its need for welfare services, if the institutional capacity is absent to deal with many of the needs. This is particularly a problem in deep rural areas. Funding should encourage capacity building but funding without any capacity would be wasteful and without capacity much of the need would also not manifest itself. (For example, problems of abuse of children or women in households are unlikely to be observed if there is no institutional capacity to encourage reporting of such abuse.)

It would appear that the block grant in an equitable share formula could be based on:

1) **Population and the poor population of provinces, to reflect need.** As welfare need is not a respecter of persons and the need for welfare services is thus not closely linked to poverty. Substance abuse, delinquency, violence against women and children are not necessarily more common amongst the poor. Also, the need for institutionally based care may be greater in some urban than rural settings, as rural populations often take better care of orphans and old people and are indeed encouraged to do so through the social grant system, whilst street children and abandoned old people are more common in urban areas. It is therefore appropriate to give not too great a weight to the poor population compared to the total population.

2) **Institutional capacity, as measured by a weighted average of a number of possible proxy measures.** Discussions with members of the social work profession identified the following possible proxies for the welfare funding shares of different provinces:

   a) **The number of registered social workers and registered auxiliary social workers** (combined or separately).

   b) **The number of registered probation officers** (in combination with the above). Registration of probation officers is only starting to occur, so this may not yet be realistic.

   c) **The number of registered child care workers.** They are at present not yet registered but registration will soon commence, so this is a potential future rather than an actual present measure.

   d) **The number of registered welfare or non-profit organisations (NPOs)**. However, this does not consider the very greatly varying size of these organisations, nor that some of them may be registered nationally and be active in many provinces.

e) **The budget spent by NPOs** (excluding subsidies from provincial welfare departments). NPOs are compelled to report budget spending annually to the relevant government departments.

f) **The provincial budget spent on welfare services.** This reflects both manifest need (in terms of the politically derived demand for welfare services) and institutional capacity. Ideally, these budgets should exclude money spent on statutory welfare services, if these are to be funded from conditional grant.

The main potential data sources are, for registrations, the National Council for Social Service Workers and, for NPO data, the Directorate: Non-Profit Organisations.

Such a funding formula would encourage institution building and also the voting of funds to welfare services by provinces. It would also take account of both unmet need and need as presently manifested. It is also in line with international practice, as using a block grant allows provinces discretion to determine whether they are going to spend money on welfare services or other priorities. Furthermore, it has the advantage of considering population as well as poverty; and, in using actual spending by lower tiers of government as a proxy for the politically expressed demand for services.

The exact formula (i.e. the choice of weights) requires appropriate data and some decisions as to the shift from the past equitable share formula that incorporated social grants spending without explicitly considering social welfare services. That shift would be to one where social grants no longer are incorporated into the block grant and welfare services are explicitly included as a separate, albeit small, share of the equitable grant formula.

However, is such complexity in provincial funding of welfare services warranted? Aggregate welfare spending excluding grants is, as referred to above, only R4.3 billion in 2005/06, which is barely 2 percent of provincial spending. A one percentage point shift in the allocated share for welfare services would thus only bring a change of about R40 million in the allocation of a particular province. Moreover, the conditional grant for statutory services would be relatively small and may not warrant separate treatment.

In its most general format, the welfare services allocation can be written as:

Welfare Services Grant = Conditional Grant (a function of Cost of Statutory Services) + **Equitable Share** (a function of Population, Poverty, Institutional Capacity).

Or, in symbols: **WSG = C. G.** (StatServ) + **E. S.** (Pop, Pov, InstCap).

Some deviations from the general model are possible, if it is judged that the degree of complexity will not be unnecessarily great. Four options are possible:

1) **WSG = C. G. (StatServ) + E. S. (Pop, Pov, InstCap).** This is the general model. Imposing a conditional grant for statutory welfare services, plus applying the proposed formula based on need (population and poor population) and institutional capacity (proxied by a number of possible measures) to the equitable share part of welfare service spending.

2) **WSG = E. S. (StatServ, Pop, Pov, InstCap).** Not imposing the statutory grant and adding to the formula an estimate of the cost of statutory services.

3) **WSG = E. S. (Pop, Pov, InstCap).** Not imposing the statutory grant and also not incorporating the cost of statutory services in the equitable share formula.

4) **WSG = E. S. (Pop, Pov).** Not imposing the statutory grant and using a more simple formula based only on population and the population in poverty, in order to simplify computation and minimise the demand on limited quality data.

Choosing between these different options requires a political decision. The ideal or general model would clearly be most appropriate if good data were readily available and if the fiscal stakes were high in terms of a large amount of funds being at issue. At this stage, however, the quality of the data on institutional capacity is untested. Furthermore, if this route is followed, complex decisions may also still have to be taken on weighting. The other extreme imposes no new data needs and is perhaps most appropriate in view of the fact that the budget amounts at stake are small. Finally, the international literature and local circumstances indicate that the weight given to the poor population relative to the total population should not be too great.

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Chapter 5

Assessment of the 2005/06 Local Government Equitable Share (LES) Formula

Hammed Amusa, Vincent Makinta and Andrew Reschovsky

Abstract

The local government sphere accounts for about a third of total sub-national government expenditures and is pivotal in the provision of essential basic services to South Africa's citizens. To enhance the functioning of local governments, the design and implementation of the formula used in allocating a share of nationally raised revenues to municipalities is of critical importance. In carrying out its constitutional mandate, the Financial and Fiscal Commission is required to provide comments to government on matters relating to any review of the equitable sharing of nationally collected revenue.

This report presents a detailed analysis of the allocations generated by the new local government equitable share (LES) formula taking into account the transitory features of the new equitable share formula. Simulation exercises are run in order to capture the distributional impacts of a fully phased in formula. In addition, to provide a better understanding of the pattern of per capita grant allocation, a separate analysis of the various components of the formula is conducted.

The results of the analysis indicate that in terms of resource distribution, the new LES formula incorporates a fair degree of redistribution as it channels much of the equitable share grants to smaller and poorer municipalities. Although not definitive, the simulation exercise indicates that with a fully phased in formula, a growth in mandated functions of local government sphere will require increased resource allocation if the goal of enhancing service provision by municipalities is to be maintained

5.1 Introduction

A number of reasons have been put forward for justifying fiscal transfers to lower levels or tiers of government. These reasons include the need to (i) equalize vertically i.e. improve revenue adequacy; (ii) achieve horizontal equalization i.e. ensuring interjurisdictional redistribution; (iii) correct for externalities across jurisdictions; and (iv) correct for administrative weaknesses (Schroeder and Smoke, 2003). In the South African context, the need for and, allocation of fiscal transfers to the local sphere of government is captured in Section 214 of the Constitution which requires, amongst other things, that the allocation of transfers to local governments must take into account (i) the ability of municipalities to carry out their constitutionally mandated functions; (ii) the fiscal capacity and efficiencies of municipalities, and (iii) the developmental and other needs of municipalities. The Constitution assigns critical responsibilities to the local government sphere, namely the provision of essential basic services – potable water, electricity and sanitation. While a number of municipal governments, particularly those based in urban areas are able to fulfil their primary legislative mandate via locally raised revenues, many (especially in rural areas) are hindered by their limited capacity to generate substantial local revenues.

As local governments account for about a third of total sub-national government expenditures but fulfil critical social functions, the design and implementation of the formula used in allocating a share of nationally raised revenues to municipalities is thus of critical importance for the delivery of essential services in South Africa. There are a number of reasons for undertaking a review of the LES formula. Firstly, in the 2005/06 financial year, the Government undertook a major revision of the Local Government Equitable Share (LES) formula. In carrying out its mandate, the Financial and Fiscal Commission (FFC) is required to provide recommendations to government on matters relating to the division of revenue and therefore an evaluation of the formula is entirely appropriate. In addition, the evaluation presents an opportunity to analyze the pattern of grant allocations generated by the new formula and compare it to the distribution of grant allocations under previous formulae. Such an analysis should provide the basis for objective evaluation of whether the new formula is achieving its intended objective – that of redistributing more resources to municipalities with the weakest fiscal conditions. Finally, this evaluation forms part of the Commission's on-going research on the different components of the LES formula.

This report evaluates the LES formula in two ways. Firstly it undertakes a qualitative assessment of the formula, tracking the Commission's submission on the formula's evolution and performance with respect to the stated policy objectives outlined by government, taking into account the provisions of Section 214 (2) a-j, and other relevant sections of the Constitution. Secondly, this qualitative assessment of the formula is enhanced by a quantitative assessment of the new LES formula by comparing the pattern of grant allocations under the new formula with those obtained under the previous one. The report therefore addresses the following questions:

1) Has the new formula resulted in an equitable share allocation pattern that is consistent with the goals of the LES?

2) Are the observed changes in the pattern of LES allocations expected, or has the new formula created unanticipated or anomalous outcomes?

3) Does the new formula create particular hardships for individual municipalities or for certain types of municipalities?

The report is divided into five main sections. Section one above outlines the aims of the study. Section two presents a retrospective summary on the LES formula with emphasis on the Commission's review of the formula and Government's responses. Section three presents a detailed descriptive analysis of the distribution of allocations emerging from the new LES formula, while Section four captures the results obtained from changing the cost for delivering basic services. These are followed by a summary of key findings and concluding remarks.

5.2 Rationale for Transfers[28] and a Retrospective View of LES Formula

5.2.1 Rationale for Intergovernmental Transfers

As outlined earlier, the rational for unconditional transfers to local governments is based on the principle of attaining vertical and horizontal equity while ensuring that the transfer system is able to cater for interjurisdictional externalities as well as correcting for administrative weaknesses. In many cases, local authorities either lack access to broad-based tax bases or are unable to generate sufficient own revenues to meet the costs of providing mandated public services. The resulting gap between revenue raising capacity and expenditure needs can be addressed through the process of vertical equalisation. Vertical equalisation can be achieved in two ways – by either transferring resources from higher spheres of government or by increasing the revenue raising powers of local authorities. Differences in endowment resources, demographic composition and geographic location often mean that the quality and quantity of public services provided by local authorities

28. The discussion that follows draws heavily on the paper by Schroeder and Smoke (2003).

varies across jurisdictions. Intergovernmental transfers often serve as a useful mechanism to help in addressing service provision imbalances and the attainment of an adequate equalisation of service differences.

The third rationale for providing intergovernmental transfers to local governments is that certain local government functions such as the provision of basic services (sanitation, water and electricity) sometimes extend beyond the borders of the providing locality generating interjurisdictional spillovers. In cases where local authorities perceive spillovers as being more beneficial to non-residents, this might result in an unwillingness to provide an efficient level of certain essential services. By linking intergovernmental transfers to a commitment by local authorities that additional resources will be spent on services generating spillovers, central/national governments can help ensure that increased essential services are provided. They can also free up other local government resources that may or may not be used on spillover generating services.

Of significant importance to the basic rationale for intergovernmental transfers is a related set of desirable features that the transferring mechanism must possess. The first relates to revenue adequacy and growth. This criterion requires that local governments have sufficient resources to cater for unmet expenditure requirements without placing unnecessary fiscal burdens on local residents. In addition, the system of transfers must over time, ensure that transferred resources grow appropriately alongside legitimate local spending needs. The second set of desirable features – those of predictability, transparency and simplicity are closely linked. A core requirement of budget planning is that a fair degree of certainty should surround the allocation and timing of resources from the national government to sub-national authorities. This will enhance the planning and budgeting process of sub-national governments as well as provide a foundation for designing future plans around service delivery. Knowledge of how their share of the revenue pool was determined helps in the objective evaluation of allocations by different jurisdictions while also reducing the possibility of political gaming in resource allocation.

Thirdly, there is a need that the framework underpinning the design of intergovernmental transfers adheres to the criterion of allocative efficiency. This incorporates two sub-objectives – (i) intergovernmental transfers should be designed in a manner encouraging local authorities to spend their limited resources in the most productive way possible and (ii) efficiency requires local authorities to spend resources on services which are collectively agreed to be of the highest priority. An additional caveat to this second sub-objective is that as local governments are closer to the people, they have a relatively good idea of the priorities and needs of their constituency. As such, unless spillovers exist, intergovernmental transfers should not be allowed to skew the manner in which local governments allocate resources; nor should they influence decisions on how factors of production will best be utilised.

Lastly the transfer system must be designed to promote equity which is directly related to the issue of horizontal equalisation. Although complex, the criterion of equity can best be defined as providing local governments with adequate resources to assure that each municipality is able to provide reasonably comparable levels of public services at reasonably comparable levels of revenues[29]. Fiscal disparities among local governments makes it imperative that the transfer system creates a mechanism that distributes resources across municipalities in a manner that accounts for differences in the needs capacity gap[30] and fiscal capacity. Taking into account the needs capacity of each municipality will ensure that the transfer system provides more resources to municipalities where the unit costs of providing public goods are higher. In addition, the consideration of fiscal capacity will help ensure that fewer resources are channeled to localities with relatively better revenue raising capacities (Schroeder and Smoke, 2003).

5.2.2 The Local Government Equitable Share Formula: A Retrospective View

Since 2000, the Financial and Fiscal Commission (FFC) has conducted a significant amount of research dealing with the structure, composition and fiscal aspects of the local government sphere. This research has culminated in a number of recommendations for consideration by national government. The purpose of this section is not to reiterate all these recommendations but to highlight important recommendations made concerning the local government equitable share allocations. These are presented below.

5.2.2.1 FFC Recommendations 2002

Based on research exploring the conceptual framework of the local government equitable share (LES) formula, the Commission noted that according to section 214 (2) of the Constitution, the division of nationally collected revenue among the three spheres of government in South Africa should be informed by:

1) The need to ensure that provinces and municipalities can provide basic services and perform functions allocated to them [Section 214 (2) (d) of the Constitution].

2) The fiscal capacity and efficiency of provinces and municipalities [Section 214 (2) (e)].

3) The development and other needs of provinces and municipalities [section 214 (2) (f)]; and

29. Where revenues include locally generated tax revenues and transfers from the centre.

30. Reschovsky (2003) defines the needs capacity gap of a municipality as the difference between the municipality's expenditure need and it's revenue raising capacity.

4) The obligation of provinces and municipalities in terms of national legislation [Section 214 (2) (h)].

Based upon these constitutional requirements, the Commission proposed a formula in its Submission for the Division of Revenue 2002/03. The formula, consistent with the Commission's formula for provinces and similar to the local government formula put forward by National Treasury in 1997, was defined as follows:

$$LES = S + B + I + T + m$$

Where the total local government equitable share (LES) allocation is divided among municipalities by means of a formula comprising five major elements:

1) A basic services grant **(S)** to support municipalities in their delivery of basic services
2) A basic component **(B)** to fulfill other Constitutional and legislative responsibilities
3) An Institutional component **(I)** to aid municipalities in financing core administrative functions
4) A tax capacity equalisation grant **(T)** to encourage municipalities to take responsibility for raising own revenue; and
5) A spillover grant **(m)** to provide finance for services with inter-municipal spillover effects.

5.2.2.2 FFC Recommendations 2003

The Commission's 2003 recommendations regarding the LES formula centered on the use of funding windows and nodal allocations within the LES formula. Over the fiscal period 1999/2000 – 2003/04, the Commission observed that national government had been introducing "funding windows" into the equitable share formula, an action that appeared to undermine the transparency and original intention of the formula. While some of these funding windows were intended to be of a transitional nature until staffing and other capacity functions could be transferred to local authorities, the Commission noted some non-temporary funding windows. These included the development node, free basic services (FBS), and free basic electricity allocations (FBE) which had gradually found their way into the LES mechanism. In making its recommendations for the equitable division of revenue, the Commission proposed that:

1) Nodal allocations and other funding windows be excluded from the equitable share allocation. Given that the equitable share was intended to apply uniformly (and equitably) to all municipalities, and issues of national priorities

are best addressed via national grants, the FFC recommended that a better alternative was to convert the funding windows to separate unconditional grants.

2) If government wished to link operational expenditure with existing infrastructure as was the case with free basic services/free basic electricity (FBS/FBE) funding windows, then the move to fund FBS and FBE should be effected through explicit policy instruments rather than through funding windows. This stemmed from the Commission's observation of the duplication between the S component of the LES and the FBE/FBS windows, both of which funded the delivery of basic services to the poor.
3) That government should avoid the use of funding windows in the equitable share formula.

5.2.2.3 FFC Recommendations - 2004

The most comprehensive proposals on the LES to date are contained in the Commission's 2004 recommendations. These proposals examined the components of the LES formula with specific emphasis on the issues and proposed principles related to the S, I and T components. Regarding the B and m components, the Commission stated that:

1) The spillover grant had to some extent been addressed by the existence of regional levies which had traditionally funded spillover grants and
2) It was essential to estimate the service costs of basic municipal services. In order to achieve this, the Commission noted the long term objective of developing a benchmarking framework detailing all the functions municipalities are required to provide.

In summary, the major recommendations around the S, I and T components were as follows:

S (Services) Component

1) That government develop a methodology for measuring the expenditure needs of municipalities. Such an assessment of municipal service costs needed to be informed by the principle that residents in a given locality are entitled to a basic level of service provision. Due to the nature of the technology required, there would be different types of service delivery within the basic level of service provision.
2) That the following principles inform the development of a methodology measuring municipal costs:
    a) Municipalities should not be able to influence the magnitude of their expenditure needs via their fiscal decisions.

b) The methodology adopted should not be too data intensive.

c) Statistical analysis of data and expert opinion be combined to present a realistic approach for measuring costs in South Africa.

d) The calculation of costs for delivering basic services be developed separately for each local government function.

e) The grant formula be as simple as possible.

I (Institutional) Component recommendations were:

1) That Government needs to develop a framework distinguishing between the expenditure needs for *capacity maintenance* and *capacity building*[31]. From the Commission's perspective, capacity maintenance relates to the operational maintenance of the minimum institutional infrastructure required for effective municipal governance and administration. On the other hand, capacity building assumes that the minimum infrastructure is not in place and needs to be established.

2) That expenditure needs related to the maintenance of basic institutional capacity be addressed via the I component of the equitable share while capacity building be funded through the use of conditional grants that will be phased out when basic capacity is built up.

3) That national government needs to develop appropriate administrative and/or institutional instruments that ensure that capacity needs are identified and targeted.

T (Tax Capacity) Component recommendations were:

1) That one overall revenue-raising capacity (RRC) measure be included in the local government equitable share formula, and

2) That the measure of RRC should relate to specific local government revenue sources.

3) That in measuring fiscal capacity, RRC should be assessed by measuring municipal revenue bases where the bases are:

   a) Payroll levy: skills development base

   b) Property rates: municipal property rates base

   c) Electricity: electricity consumption, and

   d) Tariff funded services: disaggregated income or expenditure groups

In addition, the Commission recommended that the measure of RRC be strongly linked to the collection of crucial municipal level data related to regional levies, property rates and electricity consumption data.

31. Capacity maintenance includes expenditure on items such as councillor allowances and administrative overheads while capacity building involves providing administrative buildings and equipment, as well as training municipal officials.

5.2.3 Government's Responses to FFC Recommendations

Proposal on use of funding windows in the LES

The government accepted the Commission's position that the window approach in the equitable share should be avoided where possible. With the comprehensive review of the LES formula in 2004/05, the new formula abolished the use of funding windows within the LES formula, a move that ensured that the formula followed a solely component-based approach.

Proposal on the structure of the LES formula

In determining a new equitable share formula for the local government sphere, National Treasury revisited and reaffirmed the guiding principles underlying the formula as:

1) **Equity:** Intergovernmental transfers should promote the constitutional and governmental goal of ensuring that all South Africans have access to basic services.
2) **Facilitating democracy:** The transfer system should help build the capacity of local authorities as one of the cornerstones of a democratic society
3) **Predictability:** The transfers should facilitate proper budgeting
4) **Accountability,**
5) **Simplicity and Transparency.**

On this basis, and in agreement with the principles espoused by the Commission regarding the long term structure of the LES formula, the government changed the LES formula to an allocation formula based on four main components – basic services, development needs, institutional needs and fiscal capacity. The new LES formula adopted by government is specified as[32].

Total Grant = Basic Services **(BS)** + Development Needs **(D)** + Institutional **(I)** – Revenue Raising Capacity Correction **(RRC)** ± Stabilisation Constraint **(C) (2)**[33]

The stated purpose of the basic services component is to enable municipalities to provide basic services and free basic services to poor households The basic services component has the following characteristics:

1) Supports only poor households earning less than R800 per month;
2) Distinguishes between poor households provided with poor services, and those provided with lesser or no services; and

32. For a detailed discussion of each component of the LES, see Annexure E of the 2005 Budget Review published by South Africa's National Treasury.

33. For a detailed breakdown of the various components of the LES formula, see "Annexure E: Explanatory memorandum to the Division of Revenue" contained in National Treasury's 2005 Budget Review.

3) Recognises water reticulation, refuse removal, sanitation and electricity reticulation as the core services.

For each of the subsidised services, two levels of support are provided: a full subsidy for households that actually receive services from the municipality, and a partial subsidy for unserviced households. The partial subsidy is currently set at a third of the cost of the subsidy to serviced households.

The Institutional component is important for poor municipalities that are often unable to raise sufficient revenue to fund the basic costs of administration and governance. Thus, the institutional component aims to fill the funding gap by supplementing the funding of administration and governance costs that are crucial to the ability of municipalities providing essential basic services. Since its inception in 1998, the LES formula has been characterised by large scale changes. In a bid to ensure some stability in grant allocations, a guarantee mechanism is applied to the indicative three-year budget allocations to the local government sphere. This guarantee mechanism termed the stabilising constraint aims to give, as far as possible, municipalities amounts outlined in previous medium term expenditure framework (MTEF) round of allocations.

It can thus be seen that Government adopted the S, I and T components suggested by the Commission. However, for practical operational reasons, Government did not accept the inclusion of the B and m components suggested by the Commission. With respect to the proposals made on the **S**, **I**, and **T** components (or the **BS**, **I** and **R** components) of the Government's LES formula, the following was noted:

1) Government agrees with the Commission's principle that residents have a right to a basic level of service and municipalities need to be funded for this taking into account their fiscal capacities. However, the Government views the costed norms approach to estimating service costs as having a number of potential weaknesses, especially where a municipality lacks funds or capacity to provide or prioritise such essential basic services. Instead the new formula adopted by Government utilises indicative costs based on its own research. As more census and monitoring information becomes available, the approach suggested by the Commission will be further developed to ensure that the true cost of providing different levels of basic services is reflected in the LES formula.
2) Government supported the Commission's recommendation that a more accurate measure of municipal expenditure should be developed; however, such an approach should only be for purposes of research, modeling and analysis rather than for allocating LES grants to municipalities.
3) Government accepted the Commission's proposal that a revenue raising capacity component be applied to the entire LES formula rather than the I component. The new LES formula gives effect to this recommendation by

incorporating a new component – R – to specifically capture the fiscal capacity of municipalities.

5.2.4 The LES Formula: Design Issues[34]

As mentioned earlier, the LES formula, due to be fully phased in by the 2007/08 fiscal year, consists of five components[35] and the funds are allocated according to key demographic data. The *basic services component* takes into account a poverty measure[36], distinguishes between poor households provided with service and those provided with lesser or no services, and recognises water, electricity and sanitation as core services that municipalities are mandated to provide. The institutional support component (or the I component) supplements the funding of a municipality for administrative and governenance costs[37]. It takes into account administrative capacity and local electoral accountability where these two elements are based on a municipality's population size and the number of councillors.

In simple terms, the formula is an attempt to put municipalities on a broadly comparable footing i.e. using an "equalisation framework". While Section 214(2) requires that fiscal capacity be taken into account (and hence some form of equalisation is necessary), it also requires that the equitable share "must take into account the need to… "provide basic services and perform [constitutionally-assigned] functions". As with the provincial equitable share (PES), conceptually, if equalisation is done on the revenue side, there is no need for expenditure equalisation. However, cost disabilities may be considered to enable equalisation in service standards. Where municipalities lack significant revenue sources, equalising revenues does not serve a meaningful objective and the transfer system should be designed to provide normatively determined standards of public services.

These normative standards thus imply that within the context of individual jurisdictional functions, the cost of providing a given standard of public services must be estimated and aggregated to determine the entitlement of each municipality. Given these standards, an important question is whether or not the LES formula achieves the objective of equity? To enable each municipality to provide a given level of public service, it is imperative that the cost of providing a given level (and standard) of services be estimated. A crucial aspect of the current formula is the subsidy allocated to poor households for various services delivered to them. Based on updates of the 1999 estimates calculated by the Development Bank of Southern Africa (DBSA), the service costs included in the new formula are set at R130 per month for a serviced household and R45 for an unserviced household (National Treasury, 2005).

The estimate of service costs at R130 raises a number of important questions. Given that the estimation of service costs was based on a representative number of

34. Sections 2.4 and 2.5 draw heavily from the work of Reschovsky (2003). The focus of section 2.4 will be on those components – basic services and the institutional components that have been operationsalised in the LES formula. Owing to current long-term deliberations regarding the measure of revenue raising capacity and the nature of the stabilisation constraint, the R and C components are not examined in this section.
35. Following deliberations with the FFC, Government has agreed that the D component be excluded from the current formula as it does not result in an overall increase in the local government equitable share and may create unintended distortions in municipal equitable shares.
36. The basic component supports only households earning less than R800 per month.
37. The I component does not fully fund the entire administration and governance costs of a municipality; this function remains the primary responsibility of each municipality.

households drawn from a sample of municipalities, do the subsidy amounts reflect the true costs of purchasing municipal services? This question is even more important when one considers that disparities in terms of demographics and geography play a huge role in the quality and quantity of service delivered. To address this question, attention needs to be paid to two issues. Firstly, given the constitutional mandate of municipalities and the present framework on the assignment of powers and functions across the different categories of municipalities, is it useful to continue restricting the definition of basic municipal services to water, electricity, refuse and sanitation? Secondly, does a cost estimate based on a sample of municipalities provide an accurate assessment of the costs of providing the basic services?

Previous studies undertaken and submissions made by the Commission have indicated that in all likelihood, there exist gaps between the costs of providing basic services to a municipality's non-poor residents and the amount of revenue these residents are capable of raising at reasonable rates of taxation. As Reschovsky (2003) further notes, such gaps may be quite substantial in heavily urbanised areas where the definition of basic municipal services are much broader[38].

Many urban communities in South Africa contain large populations of near poor households. While these households' income is above the poverty threshold and some might be able to afford the fees levied on the four basic services, overall , their relatively poor financial resources means that the amount of money they pay is not sufficient to cover the full costs of services related to water, electricity, sanitation, and solid waste removal. Outside of the metropolitan areas and district councils, many local governments lack adequate revenue raising capacity. This further hampers their ability to fill the gap between expenditure needs by generating sufficient funds in excess of revenues generated from near poor residents, to cover costs of providing basic services to all. The inability of the S grant to adequately measure the true costs of providing basic services and to take into account near-poor residents means the formula fails to provide municipalities with adequate resources to carry out their primary constitutional mandate of providing all their residents with basic services.

Initially designed as an institutional building grant for newly-created local governments, the Institutional support (I) grant has evolved into one that fills the gap created when mostly poor municipalities are unable to raise sufficient revenues to fund the basic costs of administration. As a result of reforms to the local government sphere, a number of municipalities that initially received the I grant have been merged with larger, more established municipalities. For metropolitan municipalities and mainly urban municipalities, this has meant that the I grant is no longer needed. Given that the institutions of governance and administration in many local governments have gradually improved since 2001, the I grant in its current form will probably need to be revised.

38. In addition to the four basic services, the structure of urban areas will require the provision of essential services such as street lighting and storm water management.

In dealing with institutional capacity needs, it is important that the institutional component distinguish between the expenditure needs of *capacity maintenance* and *capacity building*. As mentioned above *capacity maintenance* refers to the operational maintenance of the minimum infrastructure required for effective municipal governance and administration. It includes items such as councillor allowances and administrative overheads. On the other hand, capacity building assumes that minimum institutional infrastructure such as administrative buildings and the training of municipal officials, is lacking and needs to be established. Past recommendations by the Commission[39] have expressed the view that expenditure needs related to the maintenance of basic institutional capacity are best addressed via the I component of the LES formula[40]. In terms of capacity building, the Commission, while noting Government's objective of establishing minimum capacity within limited time frames, has recommended that capacity building objectives are best financed through the use of conditional grants that will eventually be phased out.

5.2.5 Concluding Remarks

This section has highlighted a number of key issues regarding the local government fiscal transfer system, particularly the LES formula. The conclusions of the section are summarised as follows:

1) An important aspect of the LES formula is that the Constitution requires that the equitable pool be allocated in a manner that ensures that local governments are able to provide basic services. One manner in which the goals of the equitable share can meet its intended objectives is for equitable share transfers to be allocated in proportion to the fiscal conditions in local governments. This will thus require a concise, objective and measurable indicator of fiscal conditions of local governments. This can be achieved via the calculation of needs-capacity (or fiscal) gaps, where the gap is defined as the difference between a municipality's expenditure needs and its revenue-raising capacity[41].

2) Related to the above point are a number of key policy decisions. Firstly, there must be a comprehensive definition of the services that municipalities are mandated to provide. Secondly, the urban – rural divide coupled with the asymmetric assignment of powers and functions will require firm decisions to be made about what levels of mandated services are defined as basic. As Reschovsky (2003) notes, a higher level of services will result in higher expenditure needs, and thus, higher fiscal gaps. To adequately assess the fiscal gaps of local governments, policy makers need to have concise estimates of the revenue-raising capacity of local governments[42].

39. See FFC's Submission for the Division of Revenue 2005/06

40. This recommendation is based on the understanding that the equitable share allocations to local governments are primarily meant to fund (on going) recurrent expenditure.

41. It is important to note that the new LES formula does allocate resources on the basis of fiscal gap, i.e. (BS +IS – RRC). However, the main issue centres on how well the current formula measures the expenditure needs and revenue-raising capacity of local governments.

42. This will include taking a decision about the level of fiscal effort required of individuals and businesses.

3) Given ongoing restructuring of the electricity industry and lack of an encompassing national property valuation roll creates difficulties in approximating revenue-raising capacity consistently across municipality. To over come this, National Treasury uses the relationship between demonstrated fiscal capacity as provided by reporting municipalities, and similar information obtained from Statistics South Africa to proxy revenue-raising capacity for all municipalities.
4) Once these key decisions are made, it becomes necessary to undertake a detailed estimation of the costs of public service delivery (or expenditure needs) and revenue raising capacity of municipalities. Estimation of the costs will need to take into account the fact that delivery of public services entails servicing communities characterised by different types of settlement patterns and different geographical characteristics. Combining information about costs with data on variables such as population density, poverty and settlement types should help assess the minimum amount of money required by a municipality to provide both constitutionally mandated services and any other assigned functions.

5.3 Analysing the LES Allocations

5.3.1 Quantitative Analysis of the Allocation of LES Grants

The new LES formula[43] can be analyzed in two ways. First, even in the absence of any data, one can study the formulas and reach some determination of whether the formula is designed in such a way that it can result in a distribution of grants that satisfy some a priori set of criteria. This has been outlined in Section Two above. Second, one can analyze the actual distribution of resources produced by a formula and assess whether this distribution is consistent with the goals of the formula[44].

While there are many ways in which municipalities could be characterized, this study takes into account the fact that the LES formula allocates resources on the basis of demographic variables. Given the importance that population sizes play in grant distributions and large differences in the size of municipalities, this study follows a conventional approach and conducts the analysis of grant allocations using calculations of per capita amounts i.e. all grant amounts are "normalized" by dividing the grant envelope by the population of the municipality receiving a grant allocation.

43. See Appendix D for a detailed description of the new LES formula.
44. In the case of the LES formula, the Constitution in Section 214 (2) spells out criteria that need to be taken into account in determining the distribution of the nationally-raised revenues through the equitable share.

Second, before proceeding with the calculation of the average LES allocations to groups of municipalities characterized by per capita income and population size, a choice has to be made on whether to base the descriptive analysis on calculations of arithmetic averages of per capita allocations, or population-weighted averages, or both. As the Commission is interested in examining how the new LES formula allocates resources to the average *resident* of a small size local government, or alternatively, to the average *resident* of a relatively high income municipality, it is thus appropriate to base the analysis on calculations of population-weighted averages.

Thirdly, the description of per capita allocations to municipalities requires that local governments be characterized in terms of a continuous variable such as population size or household income. In addition such characterization requires a decision to be made regarding how many categories to use and how to construct the categories using the chosen continuous variable. Following the conventional approach utilised in other studies (see for example Reschovsky 2003; FFC, 2001), municipalities are divided into 7 population size and 6 per capita income categories which are defined in terms of specific population sizes (e.g. "below 10,000", "10,000 to 24,999" etc) and per capita incomes (e.g. "less than R500", "R500 – R799 etc).

5.3.2 Descriptive Analysis of LES Allocations

Analysis of available data on actual LES allocations show that in the 2005/06 fiscal year, total allocations to category A and B municipalities amounted to about R7.9 billion, an amount equal to 84 percent of total LES allocations to the local government sphere (i.e. including category C municipalities and DMAs). In addition, the data indicates that over 90 percent of the country's populace reside in the 237 category A and B municipalities. The analysis of LES allocations to recipient municipalities begins with two descriptive tables of actual per capita LES allocations for the 2005/06 fiscal year. Table 1 divides category A and B municipalities according to population size while Table 2 analyzes the LES allocations using 2006 estimated per capita income as the variable of choice in characterizing municipalities.

Table 1: Per Capita Equitable Share Allocations by Municipal Population Size:2005/06

Population Size of Municipality	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than 10000	4	32,081	0.1%	R 381	0.2%
10,000 – 24,999	22	352,019	0.8%	281	1.3%
25,000 – 49,999	37	1,362,414	3.0%	227	3.9%
50,000 – 99,9999	60	4,173,311	9.3%	203	10.7%
100,000 – 199,999	63	8,918,809	19.9%	164	18.5%
200,000 – 499,999	39	11,577,054	25.9%	184	27.0%
500,000 and more	12	18,320,322	41.0%	165	38.4%
Total	237	44,736,010	100.0%	176	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

Table 2: Per Capita Equitable Share Allocations by Municipal Per Capita Income: 2005/06

Average Municipal Per Capita Income	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than R 500	111	17,292,923	38.7%	R 170	37.2%
500 – 749	58	4,909,194	11.0%	210	13.1%
750 – 999	27	4,741,228	10.6%	227	13.6%
1,000 – 1,499	32	9,387,829	21.0%	186	22.1%
1,500 – 1,999	6	3,181,112	7.1%	98	3.9%
2,000 and more	3	5,223,723	11.7%	151	10.0%
Total	237	44,736,010	100.0%	176	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

Table 1 gives a snapshot of the distribution of population among municipalities in South Africa and shows that the country is highly urbanized with 41 percent of the country's population residing in the largest 12 municipalities[45]. In addition, over half (123) of all category A and B municipalities have populations under 100,000. To assess the amount of redistribution that occurs *relative to an equal per capita distribution of LES*, one can compare the percentage distribution of population across all population size categories (i.e. column 4 in Table 1) with the percentage distribution of total equitable share grants across the same categories (i.e. column 6 in Table 1).

The comparison shows that while local governments with population size less than 100,000 account for 13.2 percent of all residents in the 237 category A and B municipalities, in the 2005/06 fiscal year they received 16 percent of the total equitable share allocations going to category A and B local governments. In contrast, the largest 12 municipalities that account for 41 percent of all residents in the 237 category A and B municipalities are allocated 38.4 percent of total LES allocations. These numbers demonstrate that the LES allocations have a degree of redistribution and from Table 1, it is clear that in terms of general resource allocation, per capita LES allocations are largest in the smallest municipalities and smallest in the largest jurisdictions.

In terms of characterizing municipalities by per capita income, Table 2 shows that about half of the 237 municipalities analysed have per capita incomes averaging less than R500. Table 2 shows that while municipalities with average per capita income of less than R500 account for 38.7 percent of total residents in category A and B municipalities, they also account for a significant share of equitable share allocations, receiving 37.2 percent of total LES allocations to category A and B municipalities. Three municipalities – Johannesburg, Tshwane and Kamiesberg have per capita incomes averaging R2000 or more. These relatively richer municipalities account for 11.7 percent of the total population, and receive 10 percent of total LES allocations going to category A and B municipalities. While the average per capita LES grants to relatively poor 111 municipalities is close to that going to the 3 relatively rich jurisdictions (R170 and R151 respectively), the fact that the share of total allocations are highest in poorest municipalities demonstrates that the equitable share formula has a fair degree of redistribution.

5.3.3 Descriptive Analysis of LES Allocations Using Simulated Changes in Responsibility in Delivering Basic Services

In order to reach any objective conclusions about the underlying LES formula from the actual 2005/06 allocations, it is important to take into account two aspects –

45. These 12 municipalities consists of 6 Category A municipalities (Johannesburg, eThekwini, Cape Town, Ekurhuleni, Tshwane and Nelson Mandela) and 6 Category B municipalities (Buffalo City, Emfuleni, Mangaung, Thulamela, Polokwane and Msunduzi).

the *transitory* features of the formula. The first transitory feature relates to the assignment of responsibility with respect to the delivery of the four basic services – electricity, water reticulation, refuse and sanitation. Presently, while all category A municipalities are responsible for the delivery of basic services, not all category B municipalities have the capacity to deliver these services. In such cases, the functions for delivering basic services and equitable share grants are allocated to an overlapping category C municipality[46]. Table 3 shows that Category C municipalities are responsible for the provision of water and sanitation services on behalf of 105 of the 231 category B municipalities[47]. Only in 5 category B municipalities are overlapping Category C municipalities responsible for the provision of refuse removal services. It is important to note that no category C municipality is responsible for the provision of municipal electricity.

Table 3: Number of Municipalities for Which Selected Basic Services are Provided by Category Cs

Population Size of Municipality[48]	Number of Municipalities	Water and Sanitation	Refuse
Less than 25000	26	5	0
25,000 – 49,999	37	12	1
50,000 – 99,999	60	22	3
100,000 – 199,999	63	44	1
200,000 – 499,999	39	21	0
500,000 and more	12	1	0
Total	237	105	5

46. However, it is important to note that the allocated equitable share amount is a function of the characteristic of the underlying Category B jurisdiction.

47. Of the 237 municipalities analysed, 231 are classified as Category B with most of these having population sizes between 25,000 – 500,000.

48. Note that in this table, we have combined the two smallest population categories.

Noting the assignment of functions above and in order to get a better picture of how the equitable share formula works, the analysis carried it out in Tables 1 and 2 is repeated, but in this instance, allocations that in reality go to Category C municipalities are reassigned to the appropriate underlying category B municipality. To achieve this, we simply conduct simulations in which all category B municipalities are assumed to be have responsibility for the delivery of the four basic services i.e. that the LES formula has been completely phased in. The results are shown in Tables 4 and 5.

Table 4: Per Capita Equitable Share Allocations by Municipal Population Size:2005/06 (with assumption that all Category A and B municipalities provide all 4 basic services)

Population Size of Municipality	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than 10000	4	32,081	0.1%	R 374	0.1%
10,000 – 24,999	22	352,019	0.8%	289	1.3%
25,000 – 49,999	37	1,362,414	3.0%	231	3.9%
50,000 – 99,9999	60	4,173,311	9.3%	205	10.6%
100,000 – 199,999	63	8,918,809	19.9%	179	19.8%
200,000 – 499,999	39	11,577,054	25.9%	194	27.8%
500,000 and more	12	18,320,322	41.0%	161	36.5%
Total	237	44,736,010	100.0%	180	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

Table 5: Per Capita Equitable Share Allocations by Municipal Per Capita Income: 2005/06 (with assumption that all Category A and B municipalities provide all 4 basic services)

Average Municipal Per Capita Income	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than R 500	111	17,292,923	38.7%	R 189	40.6%
500 – 749	58	4,909,194	11.0%	211	12.8%
750 – 999	27	4,741,228	10.6%	213	12.5%
1,000 – 1,499	32	9,387,829	21.0%	176	20.4%
1,500 – 1,999	6	3,181,112	7.1%	98	3.9%
2,000 and more	3	5,223,723	11.7%	151	9.8%
Total	237	44,736,010	100.0%	180	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

In assigning the responsibility for the four basic services, one notes that while the total allocation does not change, the sum of allocations to Category A and B municipalities rises from R7.9billion to R8.1 billon, an increase of 2.4 percent. Tables 4 and 5 indicate that the average per capita allocations (across all municipal categories) rises by 4 Rands i.e. from R176 to R180. Compared to figures in Table 1, those presented in Table 4 show that with the assignment of responsibility for the four basic services to Category B municipalities, the most significant changes in average per capita allocations occur in municipalities with population size between 100,000 – less than 500,000. Across all population categories, increases in per capita allocations average 3 percent[49]. Examining allocations in terms of average municipal per capita income, assigning the four basic services to all category B municipalities skews LES allocations in favour of the poorest municipalities (see Table 5). As a share of total LES allocations to category A and B municipalities, allocations to municipalities with average incomes less than R500 equals 40.6 percent (compared with 37.2 percent in Table 2). This translates to the average per capita equitable share allocations to the 111 rising by 11 percent to R189, an outcome that further demonstrates the redistributive properties of the LES formula.

The second transitory feature is the "correction factor" of the formula. This correction factor is designed to prevent large annual changes in allocations as the allocation mechanism moves to the new formula. While this forms a very rational transition procedure, it would be useful to understand what the impacts of the underlying formula are. To achieve this, we calculate the 2005/06 equitable share allocations without the use of the correction factor. This provides an indication of how the formula should work once it is fully phased in. In addition, in conducting this simulation, we continue with the assumption that all Category B municipalities are responsible for providing the four basic services. The results are presented in Tables 6 and 7.

49. The only exception is with municipalities having population size of 500,000 or more where average per capita allocations decline by 2.4 percent.

Table 6: Per Capita Equitable Share Allocations by Municipal Population Size:2005/06 (Scaled Equitable Share Allocations Without the "Correction Factor")

Population Size of Municipality	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than 10000	4	32,081	0.1%	R 377	0.1%
10,000 – 24,999	22	352,019	0.8%	329	1.3%
25,000 – 49,999	37	1,362,414	3.0%	277	4.1%
50,000 – 99,9999	60	4,173,311	9.3%	247	11.2%
100,000 – 199,999	63	8,918,809	19.9%	217	20.9%
200,000 – 499,999	39	11,577,054	25.9%	229	28.7%
500,000 and more	12	18,320,322	41.0%	170	33.7%
Total	237	44,736,010	100.0%	206	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

Table 7: Per Capita Equitable Share Allocations by Municipal Per Capita Income: 2005/06 (Scaled Equitable Share Allocations without the "Correction Factor")

Average Municipal Per Capita Income	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than R 500	111	17,292,923	38.7%	R 229	42.9%
500 – 749	58	4,909,194	11.0%	254	13.4%
750 – 999	27	4,741,228	10.6%	252	12.9%
1,000 – 1,499	32	9,387,829	21.0%	196	20.0%
1,500 – 1,999	6	3,181,112	7.1%	89	3.0%
2,000 and more	3	5,223,723	11.7%	138	7.8%
Total	237	44,736,010	100.0%	206	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

As stated earlier, the importance of Tables 6 and 7 lies in the fact that they provide the best indication of patterns of LES allocations of a fully phased in formula. Although the sum of correction factors is set at zero, the share of scaled grants i.e. grants less correction factor going to Category A and B municipalities rises from R8.1 billion to R9.2 billion. In terms of both population group sizes and average income categories, the fully phased in formula is certainly more redistributive towards small municipalities than current allocations.

From Table 6, one observes that not only do average per capita allocation decline as population size increases, but all municipalities with population size below 500,000 receive a larger share than they would if there were equal (average) per capita allocations to each local government[49]. Using average income categories (see Table 7), the largest per capita allocations go to the 228 municipalities with (average)per capita income between R500 and R1000, and these municipalities account for 89.2 percent of total LES allocations going to category A and B municipalities. As expected, the richest local governments (those with average per capita incomes equal to R1500 or more) receive the smallest allocations, with their per capita allocations far less than the R206 average amount for all category A and B municipalities.

5.3.3 Analysis of LES Allocations Taking Into Account Revenue-Raising Capacity (RRC) of Municipalities

Although the measure of revenue-raising capacity used in the LES formula is an imperfect measure of the true capacity of municipalities to raise revenue, in view of current absence of comprehensive data on the revenue base of municipalities, the current proxy, arguably represents the best measure of revenue-raising capacity. Tables 8 and 9 provide a description of the distribution of per capita revenue-raising capacity.

Table 8: Per Capita Revenue Raising Capacity by Municipal Population Size:2005/06 (With assumption that all Category A and B municipalities provide all 4 basic services)

Population Size of Municipality	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than 25000	26	384,101	0.9%	R 6.27	0.2%
25,000 – 49,999	37	1,362,414	3.0%	6.86	0.8%
50,000 – 99,9999	60	4,173,311	9.3%	7.26	2.7%
100,000 – 199,999	63	8,918,809	19.9%	4.48	3.5%
200,000 – 499,999	39	11,577,054	25.9%	5.90	6.0%
500,000 and more	12	18,320,322	41.0%	54.05	86.8%
Total	237	44,736,010	100.0%	206	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

49. In this case, the average per capita equitable share amount across all municipalities equals R206.

Table 9: Per Capita Revenue Raising Capacity (RRC) by Average Municipal Per Capita Income: 2005/06 (With assumption that all Category A and B municipalities provide all 4 basic services)

Average Municipal Per Capita Income	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than R 500	111	17,292,923	38.7%	R 1.60	2.4%
500 – 749	58	4,909,194	11.0%	7.72	3.3%
750 – 999	27	4,741,228	10.6%	15.19	6.3%
1,000 – 1,499	32	9,387,829	21.0%	38.14	31.4%
1,500 – 1,999	6	3,181,112	7.1%	68.44	19.1%
2,000 and more	3	5,223,723	11.7%	81.79	37.5%
Total	237	44,736,010	100.0%	25.50	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

The data in Tables 8 and 9 clearly shows that revenue-raising capacity is concentrated in the three largest category A municipalities and a handful of other large municipalities. Per capita revenue-raising capacity is nearly 10 times larger in the nation's 12 largest municipalities than in all other local governments; in addition, the 12 largest municipalities account for 87 percent of the total revenue raising capacity of all category A and B municipalities. This finding is further reinforced by the data presented in Table 8 which indicates that revenue-raising capacity is concentrated in municipalities with the highest levels of monthly per capita income. The country's poorest 170 municipalities (those with average per income of less than R750) have per capita revenue-raising capacity of less than R10. By comparison, the average per capita revenue raising capacity in the nation's wealthiest municipalities exceeds R80.

The equitable share formula includes a scale factor designed to ensure that the sum of allocations to municipalities adds up to the amount of money budgeted by national Government for the local government sphere. The formula is structured so that the scale factor, α, only applies to the basic services (BS) and institutional (I) components and not to the revenue–raising component. Thus, the allocation to a particular municipality *i* is expressed as:

$$\boxed{LES_i = \boldsymbol{\alpha}(BS_i + IS_i) - RRC_i} \qquad (3)$$

where the subscript *i* denotes a particular municipality, LES is the equitable share allocation going to municipality *i*. The terms BS and IS refer to the equitable share, basic services and institutional support components respectively, and RRC to revenue raising capacity. The scale factor α is expressed as:

$$\boldsymbol{\alpha} = \frac{(\text{Total ES} + \sum_i \text{RCC}_i)}{\sum_i (\text{BS}_i + \text{IS}_i)} \tag{4}$$

where TotalES is the share of nationally raised revenues allocated to the local government sphere. It remains unclear as to why the scale factor does not apply to RRC. To assess the impact of not scaling the RRC component, simulations are carried out on equitable share allocations under the assumption that the scaling factor applies to the net fiscal gap, ($BS_i + IS_i – RRC_i$). To accomplish this, we define a new scale factor β, expressed as:

$$\boldsymbol{\beta} = \frac{\text{Total ES}}{\sum_i (\text{BS}_i + \text{IS}_i - \text{RRC}_i)} \tag{5}$$

The results of this stimulation are presented in Tables 10 and 11. The results indicate that in terms of population group sizes and average per capita income categories, the alternative scale factor allocates more resources to smaller municipalities (i.e. those with population sizes less than 200,000) and to relatively poorer municipalities (i.e. those with average per capita incomes less (R1000).

Table 10: Impact on Per Capita LES Grants of An Alternative "Scale" Factor By Municipal Population Size : 2005/06

Population Size of Municipality	Number of Municipalities	Average per Capita LES Grants		Percentage Change Due to Scale Factor
		With NT/ DPLG Scale Factor	With Alternative Scale Factor	
Less than 25,000	26	R 333	R 361	8.4%
25,000 -49,999	37	277	298	7.9%
50,000 – 99,999	60	247	266	7.6%
1000,000 – 199,999	63	217	234	8.2%
200,000 – 499,999	39	229	247	7.8%
500,000 and more	12	170	146	-14.0%
Total	237	206	208	0.5%

Note: Calculations based on allocations to all Category A and B municipalities. Category C and District Management Areas are not included. Calculations are also based on the assumption that all Category B municipalities provide the four basic services and that the "correction factor" is not used.

Table 11: Impact on Per Capita LES Grants of An Alternative "Scale" Factor by Average Municipal Per Capita Income : 2005/06

Population Size of Municipality	Number of Municipalities	Average per Capita LES Grants		Percentage Change Due to Scale Factor
		With NT/ DPLG Scale Factor	With Alternative Scale Factor	
Less than R500	111	R229	R 250	9.2%
500 -749	58	252	271	7.5%
750 – 999	27	252	265	5.3%
1000 – 1,499	32	196	187	-4.8%
1,500 – 1,999	6	89	46	-48.1%
2,000 and more	3	138	91	-34.4%
Total	237	206	208	0.5%

Note: Calculations based on allocations to all Category A and B municipalities. Category C and District Management Areas are not included. Calculations are also based on the assumption that all Category B municipalities provide the four basic services and that the "correction factor" is not used

5.3.4 Descriptive Analysis of the Distribution of Basic Services and Institutional Component Grant Allocations

Tables 12 and 13 examines the allocation of basic services grants under the assumption that the equitable share formula has been fully phased in i.e. that all category B governments are responsible for providing the 4 basic services, and hence receive the LES allocations specified by the formula.

Table 12: Per Capita Basic Service Allocations by Municipal Population Size:2005/06 (With assumption that all Category A and B municipalities provide all 4 basic services)

Population Size of Municipality	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than 10,000	4	32,081	0.1%	R 154	0.1%
10,000 – 24,999	22	352,019	0.8%	160	1.0%
25,000 – 49,999	37	1,362,414	3.0%	148	3.5%
50,000 – 99,9999	60	4,173,311	9.3%	136	9.8%
100,000 – 199,999	63	8,918,809	19.9%	119	18.5%
200,000 – 499,999	39	11,577,054	25.9%	130	26.2%
500,000 and more	12	18,320,322	41.0%	129	40.9%
Total	237	44,736,010	100.0%	129	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

Table 13: Per Capita Basic Allocations by Average Municipal Per Capita Income: 2005/06 (With assumption that all Category A and B municipalities provide all 4 basic services)

Average Municipal Per Capita Income	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than R 500	111	17,292,923	38.7%	R 126	37.9%
500 – 749	58	4,909,194	11.0%	142	11.9%
750 – 999	27	4,741,228	10.6%	149	12.3%
1,000 – 1,499	32	9,387,829	21.0%	132	21.6%
1,500 – 1,999	6	3,181,112	7.1%	88	4.9%
2,000 and more	3	5,223,723	11.7%	127	11.5%
Total	237	44,736,010	100.0%	129	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

Assuming that the LES formula is fully phased in, the total amount allocated for the provision of the four basic services is R5.8 billion. This is equivalent to 99.8 percent of total amount allocated for basic services in the local government sphere. Looking at the distribution of the basic services grant allocations, 95.4 percent of total basic service grant is allocated to municipalities with population size of 50,000 or more with the 12 largest municipalities accounting for the highest share – 41 percent of the R5.8 billion allocated towards providing basic services. These figures provide further evidence of the relative poverty inherent in South Africa's relatively urbanized populace.

Table 12 also shows that the average per capita basic service allocations, across all groups of category A and B municipalities is R129. Most municipalities except those with population sizes between 100,000 – 200,000, and 500,000 and more are allocated per capita basic services grants in excess of the national average. In terms of municipal per capita income categories, one observes that the fully phased in formula exhibits some degree of redistribution (see Table 12). Although over half of the 237 category A and B municipalities (169) record average per capita incomes of less than R750 and contain almost half of the total population, this group of municipalities account for almost half (49.8 percent) of total basic services grant allocated to category A and B municipalities.

With the exception of DMAs, institutional support (I) grants are allocated to all municipalities to assist with the effective administration and functioning of local governments. In the 2005/06 fiscal year, institutional support grants totalled R507.6 million with 79.7 percent of this amount allocated to all category A and B municipalities. The distribution of the I grant across the 237 category A and B municipalities are presented in Tables 14 and 15.

Table 14: Per Capita Institutional Support Grant Allocations by Municipal Population Size:2005/06

Population Size of Municipality	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than 10,000	4	32,081	0.1%	R 73	0.6%
10,000 – 24,999	22	352,019	0.8%	39	3.4%
25,000 – 49,999	37	1,362,414	3.0%	21	7.1%
50,000 – 99,9999	60	4,173,311	9.3%	15	15.9%
100,000 – 199,999	63	8,918,809	19.9%	12	26.6%
200,000 – 499,999	39	11,577,054	25.9%	9	26.9%
500,000 and more	12	18,320,322	41.0%	4	19.4%
Total	237	44,736,010	100.0%	9	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

The average I grant per capita across all 237 category A and B municipalities is equal to R9. Table 14 shows that smaller municipalities i.e. those with less than 200,000 persons are allocated I grants higher than the R9 average. While jurisdictions with population sizes of 200,000 and more receive smallest per capita I grant allocations, these municipalities account for a significant share - 45.3 percent, of total I grant allocations to the 237 category A and B municipalities.

Table 15: Per Capita Institutional Support Grant Allocations by Average Municipal Per Capita Income: 2005/06

Average Municipal Per Capita Income	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than R 500	111	17,292,923	38.7%	R 11	46.8%
500 – 749	58	4,909,194	11.0%	14	16.2%
750 – 999	27	4,741,228	10.6%	10	11.4%
1,000 – 1,499	32	9,387,829	21.0%	7	16.7%
1,500 – 1,999	6	3,181,112	7.1%	5	4.0%
2,000 and more	3	5,223,723	11.7%	4	4.9%
Total	237	44,736,010	100.0%	9	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

Table 15 above shows the distribution of I grants across different municipal per capita income categories. The smallest per capita I grants are allocated to the 9 richest municipalities while the poorest 169 municipalities receive the highest per capita I grant allocations. The redistributive aspect of the formula is further highlighted by the share of I grants to poor municipalities in total institutional support allocations to the 237 category A and B municipalities. Of the R404million allocated to category A and B municipalities for institutional support, the poorest 169 municipalities (i.e. those with average per capita income less than R750) received 63 percent of this amount.

5.3.5 Evaluating the Change in LES Formula Allocations

In this section, we present a brief evaluation of how the new formula allocates equitable share grants relative to the formula used in 2004/05. Owing to the correction factor (and indicative amounts), no big changes are anticipated in the distribution of actual LES allocations between 2004/05 and 2005/06 fiscal years. To provide an idea of the pure impact of the formula change, we compare 2004/05 equitable share allocations with LES allocations (without the correction factor) for the 2005/06 financial year.

Table 16: Change in Per Capita Equitable Share Allocations by Municipal Population Size : 2004/05 – 2005/06

Population Size of Municipality	Number of Municipalities	Average per Capita Grant (05/06)	Increase/ Decrease from 04/05	% Change
Less than 10,000	4	R 377	R-68	-15.2%
10,000 – 24,999	22	284	-15	-5.0%
25,000 – 49,999	37	235	39	19.6%
50,000 – 99,9999	60	208	46	28.8%
100,000 – 199,999	63	154	21	15.9%
200,000 – 499,999	39	184	40	27.7%
500,000 and more	12	167	46	38.2%

Note: Calculations based on actual allocations to all category A and B municipalities. Category C and District Municipal Areas (DMAs) are not included.

The comparison of LES allocation data indicates that across all population groups, per capita LES allocations increased in absolute terms, by R39 (from R111 to R176). Table 16 shows that compared to 2004/05 LES formula, the new formula redistributes equitable share allocations in favour of large municipalities with the greatest percentage change in per capita allocations highest in the 12 largest municipalities. This redistribution in favour of larger municipalities might be a reflection of greater demand for services from residents unable to afford the cost of basic services. Assessing the change in allocations using average municipal per capita income groups, one observes that the 2005/06 LES formula increases the absolute amount of equitable share allocations across all groups with the highest changes in percentage terms, occurring in municipalities with average income less than 1,500 (see Table 17).

Table 17: Change in Per Capita Equitable Share Allocations by Average Municipal Per Capita Income : 2004/05 – 2005/06

Average Municipal Per Capita Income	Number of Municipalities	Average per Capita Grant (05/06)	Increase/ Decrease from 04/05	% Change
Less than R 500	111	R 170	26	18.1%
500 – 749	58	211	54	34.4%
750 – 999	27	227	39	20.7%
1,000 – 1,499	32	186	61	48.8%
1,500 – 1,999	6	98	25	34.2%
2,000 and more	3	151	41	37.3%

Note: Calculations based on actual allocations to all category A and B municipalities. Category C and District Municipal Areas (DMAs) are not included.

5.4 Analyzing the LES Allocations using Simulated Changes to the Cost of Basic Services

The Basic Services component is based on a set of rand amounts representing the average costs per poor household of obtaining four basic municipal services. In the case where all four services—electricity, water, refuse, and sanitation—are provided, the LES formula assumes that the monthly per household cost equals R130. While the DPLG study used to estimate the costs of basic services represents an update on costs estimates developed in 1999 by the Palmer Development group, there certainly remain reasons to question whether this cost estimate is appropriate.

Using data based on a set of detailed case studies carried out by the Palmer Development Group, Reschovsky (2003) estimated the monthly per household costs of providing basic municipal services in a sample of ten category B municipalities located in three provinces –Eastern Cape, Kwazulu-Natal, and Mpumalanga. The ten municipalities sampled were located within a single category C municipality and ranged from a heavily urbanized city with a population size of 750,000 people to a small, largely rural municipality. As accurate measures of costs are difficult to obtain, the cost estimates obtained from Reschovsky's study can be viewed as a preliminary estimate of the true costs of providing mandated basic services. For the four basic services provided by municipalities, Reschovsky (2003) estimated that the monthly per household costs in the municipality with lowest costs range from R110 to R182 while the costs in municipalities with the highest costs range from R185 to R308. Although not definitive, these figures in addition to the FFC's assessment of the costs of constitutionally mandated basic services[51], do suggest that the R130 figure used in estimating basic services grant allocations is low.

This thus raises a crucial question – if indeed the costs of providing basic services are underestimated, how would an increase in the costs of services change the distribution of the LES allocations? To answer this question, it would be most useful to examine an alternative policy scenario in which a *revenue – neutral* simulation exercise is carried out on LES allocations. In this exercise, the monthly household cost of the four basic services is increased from R130 to R175[52], and the consequent LES allocations are calculated without the use of the "correction factor". In addition, the analysis of the allocation is done under the assumption that the LES formula is fully phased in i.e. Category B municipalities are responsible for the provision of the four basic services[53].

The calculation of allocations without the "correction factor" helps to ensure that the sum of LES allocation remains at R9.3 billion i.e. the amount of nationally raised revenues transferred to the local government sphere remains constant. To achieve a total basic services cost of R175, the four basic services were set as follows: water – R45; electricity – R50; sanitation – R40; and refuse – R40[54]. The results of the simulation exercise are presented in Tables 18 and 19. In this kind of simulation, the new parameters are (i.e. summing the costs of basic services to R175) placed in the formula and the basic services component is calculated, and these are obviously larger than actual basic service amounts. However, as this simulation is revenue-neutral, the scale factor is reduced changing individual municipality's allocation from the basic services and institutional support component.

The net result over a revenue-neutral simulation is that the overall LES allocation does not change i.e. remains at R9.3billion. However what changes is the gross amount to which the scale factor is applied[55]. Thus, if the cost factors were increased to R175, then the total gross grant allocations, i.e. the sum of basic services and institutional component before inclusion of revenue-raising capacity and the scale factor is applied, will need to increase by R1.5 billion i.e. from R6.28 billion to R7.78 billion.

51. See the FFC's 2000 recommendation document on the Medium Term Expenditure Framework Cycle: 2001-2004.
52. In 2000, the FFC developed a costed norms approach for calculating the financial resources necessary for the provision of basic social service levels, given constitutional (and nationally) mandated norms and standards. The R175 represents the estimated costs of providing basic services in the sample of municipalities surveyed, and comes close to the average of the estimates calculated in the study by Reschovsky (2003).
53. This exercise is similar to that carried out in constructing Tables 5 and 6 with the additional input being the change in cost of basic services.
54. The costs of these services as used in National Treasury's LES allocation formula are R30, R40, R30 and R30 for water, electricity, sanitation and refuse collection respectively.
55. See Appendix D for a detailed outline of how the local government equitable share is calculated.

Table 18: Per Capita Equitable Share Allocations by Municipal Population Size:2005/06 (Scaled LES Allocations Without the "Correction Factor" and Cost of Basic Services set at R175)

Population Size of Municipality	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than 10000	4	32,081	0.1%	R 369	0.1%
10,000 – 24,999	22	352,019	0.8%	330	1.3%
25,000 – 49,999	37	1,362,414	3.0%	280	4.1%
50,000 – 99,9999	60	4,173,311	9.3%	246	11.1%
100,000 – 199,999	63	8,918,809	19.9%	208	20.0%
200,000 – 499,999	39	11,577,054	25.9%	223	27.9%
500,000 and more	12	18,320,322	41.0%	179	35.5%
Total	237	44,736,010	100.0%	207	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

Table 19: Per Capita Equitable Share Allocations by Municipal Population Size:2005/06 (Scaled LES Allocations Without the "Correction Factor" and Cost of Basic Services set at R175)

Population Size of Municipality	Number of Municipalities	Total Population	Population Share	Average Per Capita Grant	Percentage of Total
Less than R500	111	17,292,923	38.7%	R 218	40.7%
500 – 749	58	4,909,194	11.0%	255	13.3%
750 – 999	27	4,741,228	10.6%	259	13.3%
1,000 – 1,499	32	9,387,829	21.0%	206	20.9%
1,500 – 1,999	6	3,181,112	7.1%	96	3.3%
2,000 and more	3	5,223,723	11.7%	150	8.5%
Total	237	44,736,010	100.0%	207	100.0%

Note: Calculations based on allocations to all Category A & B municipalities. Category C and District Municipal Areas (DMAs) are not included.

5.5 Summary and Conclusions

This study examined the distribution of allocations from the 2005/06 local government equitable share formula. The analysis is conducted by comparing the population–weighted per capita allocations across municipalities grouped by population size and average income. The results obtained are informative. Quantitative evidence shows that 41 percent of the country's population reside in the 12 largest municipalities, and that over 90 percent of the country's people reside in Category A and B municipalities. In terms of the distribution of the equitable share allocations, the analysis shows that in general, the 2005/06 LES formula provides some degree of redistribution, allocating a significant share of resources to small local governments as well as relatively poor municipalities. Thus, it can be noted that overall, the formula does adhere to its primary aim of allocating resources in a manner that enhances the capacity of relatively small and poor municipalities in carrying out their constitutionally mandated functions.

To isolate the distributional impacts of the new formula, we carry out simulations that effectively assume the new formula as completely phased in. Findings suggest that when the formula is completely phased in, more resources especially in terms of basic services grants are allocated towards the relatively small and poorer municipalities, enhancing the primary objective of the formula. The distribution of equitable share allocations is sensitive to the underlying assumptions of the simulation exercises; changes in the responsibility for delivery of basic services has the effect of channelling the bulk of local government allocations to category A and B municipalities. The inference that is derivable from this is that the growth in mandated functions of the local government sphere will require an increase in resource allocation.

A crucial shortcoming of the LES formula relates to the basic services component. This component provides "full funding" of the costs of basic services for those with households income below R800 a month, and not a single Rand for subsidizing the cots of basic services for households with monthly incomes of R801 (and above). In addition, there is evidence, albeit limited, that the costs of providing basic services to household with low incomes is higher than the R130 included in the formula. While the simulation exercise conducted offers no concrete figure on the appropriate costs of public services, it nevertheless offers some informative indications on the distribution of the LES if basic costs increase and the formula is fully phased in. It therefore becomes important that renewed efforts be made to provide careful, up- to- date estimates on the true costs of delivering basic services in a sample of representative municipalities; especially where the selected municipalities reflect different socio-economic and physical/geographical characteristics inherent in the local government sphere.

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Chapter 6

Assessing Provincial Own Revenues in South Africa's Intergovernmental Fiscal Relations System

Bongani Khumalo, Hammed Amusa and
Nomonde Madubula

Abstract

As a follow-up to visits to Provincial Treasuries in 2002, the Financial and Fiscal Commission (FFC) held discussions and interviews with officials of the nine provincial treasuries and their key line departments in the 2005/06 fiscal year. The interviews and discussions were intended to provide the Commission with information on the progress made by provincial treasuries in enhancing and optimising own revenue collection.

The report emanating from the interviews covers (i) provincial revenue strategies; (ii) an assessment of current revenue sources; (iii) an analysis of trends in provincial own revenues and (iv) the identification of risks and other strategic issues in the management of provincial revenues.

The main findings of the report indicate that while the process has been slow, most provinces have finalised detailed own revenue strategies and have set up structures with line departments that will assist in the implementation of those strategies. Provinces have also implemented or are in the process of implementing the recommendations that were made by both the National Treasury and the FFC with regard to tariff policies and the structure of Provincial Treasury with respect to own revenue collection. There is also a general understanding of existing revenue sources. The implementation of the provisions of the Provincial Tax Regulation Process Act is proceeding slowly, with only the Western Cape having made a proposal for a new revenue source.

Keywords:

Provincial own revenue, Provincial Tax Regulation Act, Revenue collection, Revenue management, Revenue optimisation, Revenue sources, Revenue strategies

6.1 Introduction and Background

Section 228 (1) of the South African Constitution empowers provinces to raise revenue by imposing taxes, levies and duties other than income tax, value added tax, rates on property and customs duties. The Constitution requires that the powers of provinces to raise revenue be regulated by an Act of Parliament. The Provincial Tax Regulation Process Act (2001) is the enabling legislation that gives effect to this Constitutional provision. The Act does not prescribe the taxes that provinces may impose. Rather, it lays down the procedures and processes that have to be followed by provinces in order to introduce new taxes.

Section 18 (1) of the Public Finance Management Act (PFMA) requires provincial treasuries to promote and enforce transparency and effective management, including effective management of the revenue of provincial departments and provincial public entities. The core role of the revenue sections within provincial treasuries is to monitor and co-ordinate provincial revenue. Furthermore, Section 38 (1) of the PFMA requires that accounting officers of government departments take effective and appropriate steps to collect all money due to the department. Elsewhere, the PFMA also prescribes how the revenue collected should be managed and how provincial revenue funds should be configured and controlled. It is thus clear that the legislative and constitutional framework gives provincial treasuries a very central and crucial role to play in the collection and management of own revenue. In addition, departmental accounting officers have a legal duty to ensure that all revenue due to the province is collected and audited.

Provincial own revenue constitutes less than 4 percent of total provincial revenue. The main sources of own revenue are road traffic fees, hospital patient fees, horse racing and gambling fees. In some provinces, interest revenue is also a major source of own revenue. Provinces are generally still highly dependent on transfers for their expenditure needs. In its submission for the 2004-07 Medium Term Expenditure Framework (MTEF) cycle, the Financial and Fiscal Commission (FFC) made observations about the lack of flexibility in provincial expenditure patterns that could be explained partly by the low revenue-raising capacity of provinces. Both the National Treasury and the FFC have in the past conducted studies that have identified obstacles to improved revenue collection and have consequently proposed ways that collection could be maximised.

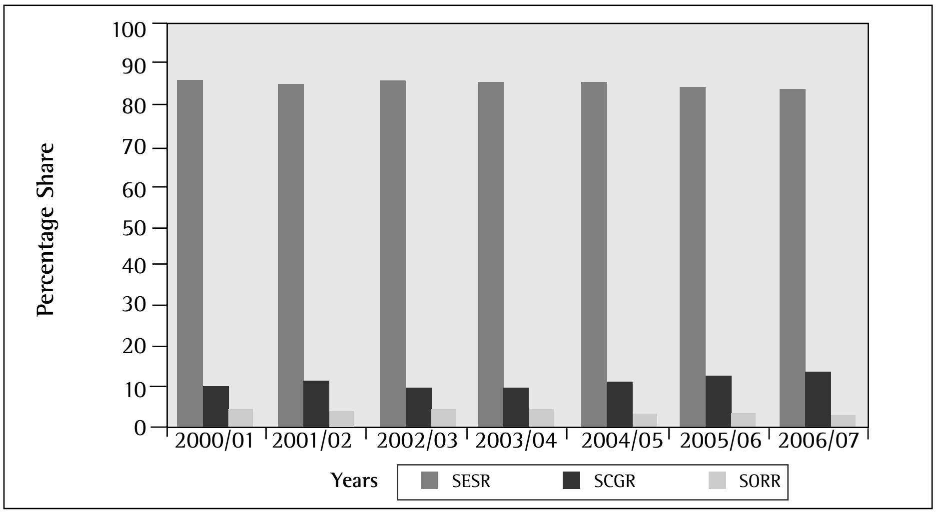
As a follow up on the Financial and Fiscal Commission (FFC) research team's last visit to provincial treasuries in 2002, this report addresses and evaluates provincial progress in addressing some of the issues that have been raised in the past. It also highlights some of the strategies adopted by provinces in order to optimise own revenue collection. The remainder of the report is organised as follows. Section Two briefly discusses observed trends in provincial own revenues over the period under observation. Section Three identifies challenges facing provinces in optimising collections from own revenue bases. Section Four summarises the findings and recommends proposals for addressing some of the problems associated with provincial own revenue collection.

6.2 Trends in Provincial Own Revenue

6.2.1 General Trends

The provincial revenue envelope is made up of two broad components: transfers from nationally raised revenue (equitable share, conditional and other grant transfers) and revenue generated from own sources (tax and non-tax bases constitutionally assigned to provincial governments). Although relatively low, provincial own revenues do contribute to the financing of infrastructure projects to keep pace with economic developments in the provinces. In addition, own revenues are also used to supplement funds received from intergovernmental transfers. Figure 6.1 below illustrates that at an aggregated provincial level, the provincial equitable share accounts for about 85 percent of total provincial revenues over the period under review[56]. Conditional grants and own revenue proportionally accounted for 11 percent and 4 percent, respectively. Measured in terms of growth rates, conditional grants grew at an average of 19 percent over the period, while the equitable share and own revenues recorded average growth rates of 11 and 5 percent respectively[57].

Figure 6.1: Provincial Revenues: 2000/01 – 2006/07



Source: 2004 Intergovernmental Fiscal Relations Database (IGFR). Legend – SESR: share of equitable transfers in total provincial own revenue; SCGR: share of conditional grants in total provincial own revenue, and SORR: share of own revenue sources in total provincial own revenue.

56. The analysis is conducted using revenue data covering the fiscal years 2000/01 – 2006/07

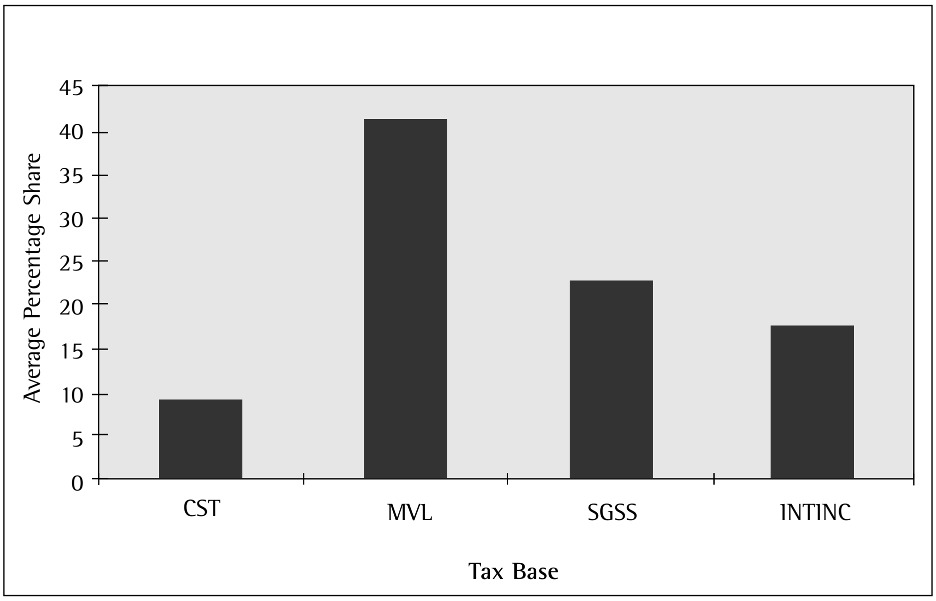
57. It should be emphasised that these figures refer to the aggregate amount, i.e. the sum of revenues collected by the nine provinces. At the individual provincial level, there are significant variations as shown in later sections of the report.

6.2.2 Sources of Provincial Own Revenues

Provincial own revenues can be classified into two main sources: tax and non-tax receipts. Tax receipts are derived mainly from taxes or levies on motor vehicle licences and gambling (casino licences and horseracing fees). On the other hand, non-tax revenues are derived from sales of non-capital goods and services (such as hospital and patient fees), interest income and the levying of a host of fees, penalties and fines.

The four major sources of provincial own revenues are casino licences, motor vehicle licences, sale of non-capital goods and interest income. Together these four tax sources account, on average, for over 90 percent of total own revenue generated by provincial authorities. Motor vehicle licences account for the significant share of provincial own revenues, averaging over 41 percent over the period under review. The shares of income derived from the sale of non-capital goods and services, interest income and casino taxes account for 23 percent, 18 percent and 9 percent of aggregated provincial own revenues respectively, as illustrated in Figure 6.2 below.

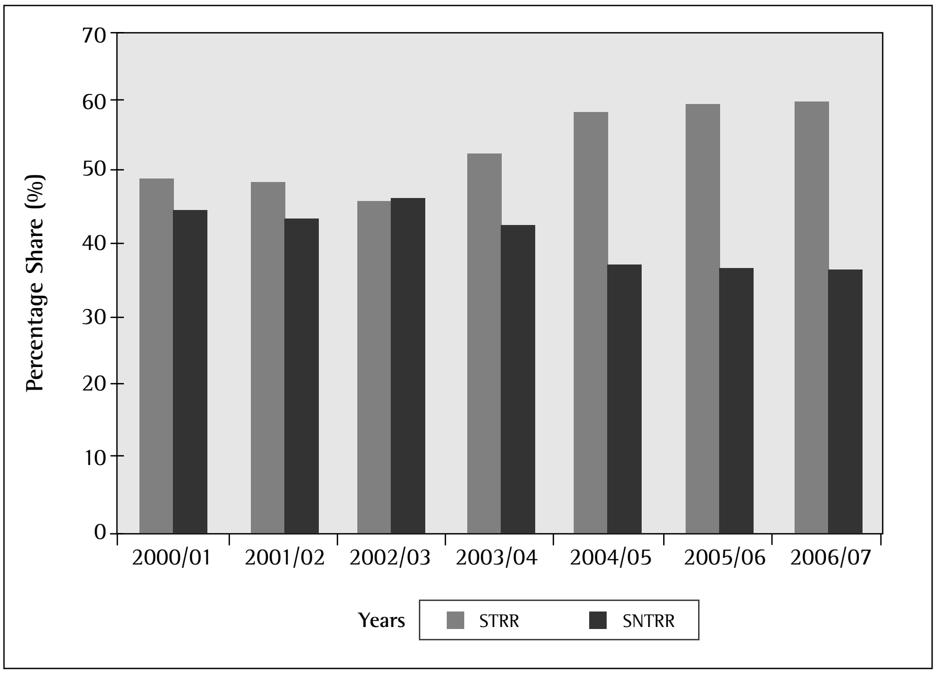
Figure 6.2: Average Share of Tax Sources in Total Provincial Own Revenue



Source: 2004 IGFR database. Legend – CST: share of casino taxes in total provincial own revenue; MVL: share of motor vehicle licences in total provincial own revenue; SGSS – share of sale of non-capital goods and services in total provincial own revenue, and INTINC – share of interest income in total provincial own revenue.

Over the review period, tax revenues have, on average, accounted for about 55 percent of total provincial revenues, compared to 45 percent for non-tax revenues (see Figure 6.3). However, while the share of tax receipts is higher than non-tax receipts, it is interesting to note that over the review period, tax receipts declined by an average rate of about 7 percent, compared to the 3 percent average growth rate recorded by non-tax revenues. This probably reflects recent efforts on the part of provincial treasuries to understand and expand their tax base and improve revenue collection from non-tax sources without resorting to a need to over-exploit available tax sources. Consequently, it may also indicate that less effort has been devoted to increased collection on the traditionally higher yield revenue sources.

Figure 6.3: Share of Tax and Non-Tax Receipts in Total Provincial Revenues: 2000/01 – 2006/07

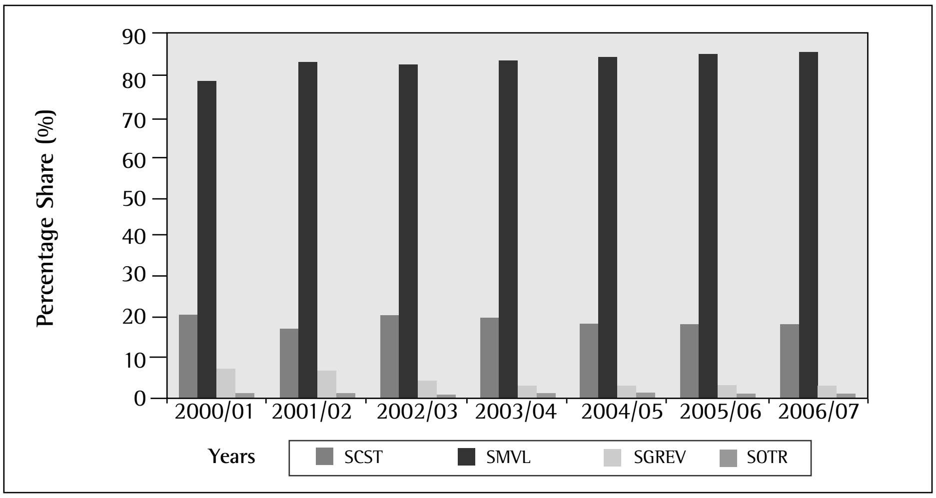


Source: 2004 IGFR Database. Legend – STRR: share of tax revenue in total provincial own revenue receipts; SNTRR – share of non-tax revenue in total provincial own revenue receipts.

Further analysis of tax receipts reveals that motor vehicle licences (Road Traffic Ordinance fees) accounted for around 77 percent of provincial tax receipts. Over the sample period, levies on casino licences and horseracing activities contributed about 18 percent and 4 percent respectively while other tax revenues[58] sources accounted for less than 1 percent of total tax receipts (see Figure 6.4).

58. Using Western Cape's definition, the term 'other taxes' refers specifically to miscellaneous capital receipts, boarding and lodging, refunds from previous years, revenue received from house rent, parking, and totalisator taxes.

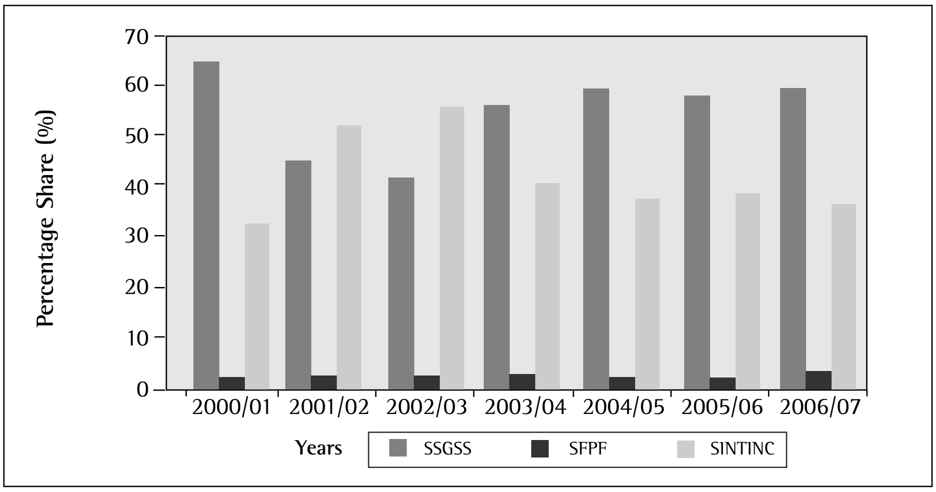
Figure 6.4: Sources of Provincial Tax Revenues: 2000/01 – 2006/07



Source: IGFR 2004 Database. Legend – SCST – share of casino levies in provincial tax revenues; SMVL – share of motor vehicle licence income in provincial tax revenue; SGREV – share of gambling/horse-racing levies in provincial tax revenue, and SOTR – share of other taxes in total provincial tax revenue.

In terms of non-tax revenue, the sale of non-capital goods and services accounts for around 56 percent of non-tax receipts compared to the 2 percent and 42 percent shares recorded by income accruing from fees & penalties and interest income respectively. This is illustrated in Figure 6.5 below.

Figure 6.5: Sources of Total Provincial Non-Tax Revenues: 2000/01 – 2005/06

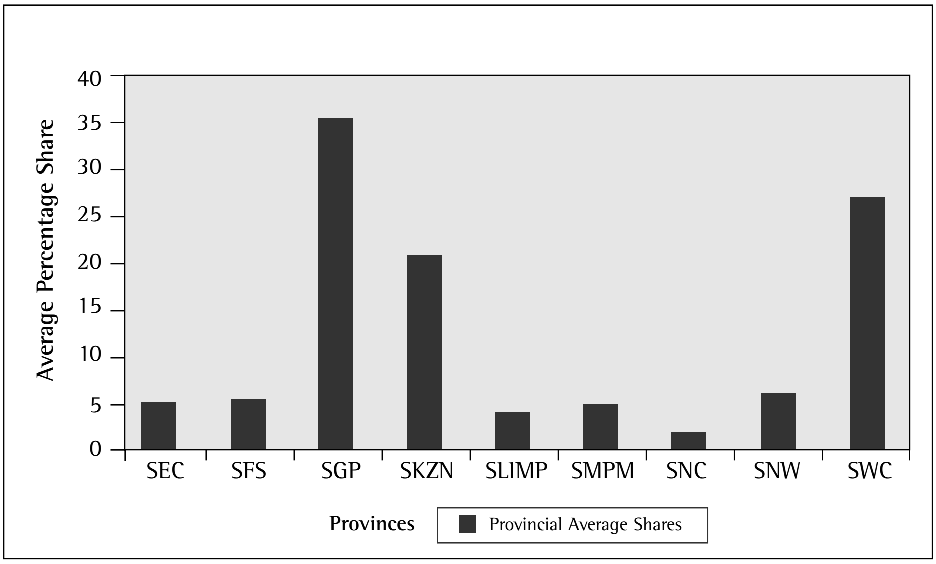


Source: IGFR 2004 Database. Legend – SSGSS– share of non-capital goods and services sales in total non-tax revenue; SFPF – share of fees, fines & penalties income in total non-tax revenues, and SINTINC – share of interest income in total non-tax revenue.

6.2.3 Current Trends in Provincial Revenue by Revenue Source

The next stage in the analysis involves an examination of each province's performance regarding the various own revenue sources. Arithmetic averages, per province, have been computed to ensure that a common basis is used for comparing each province's relative performance. Figure 6.6 below demonstrates the significant concentration of economic activities in the three provinces of Gauteng (GP), Kwazulu-Natal (KZN) and the Western Cape (WC). The large concentration of business activities and economically active population in these three provinces creates relatively viable revenue avenues for the respective governments. This point is further emphasised when one considers that the combined average share of total provincial tax revenues amounts to 83 percent for the three provinces.

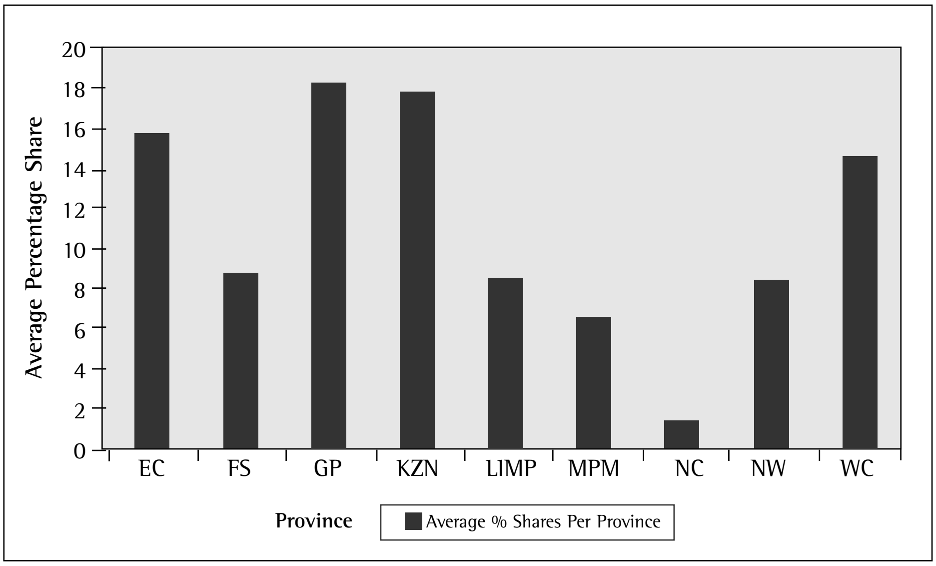
Figure 6.6: Average per Province Share in Total Provincial Tax Revenues



Source: 2004 IGFR Data Base. Legend: S denotes the share that province X contributes to total provincial tax revenue e.g. SEC denotes the average share that Eastern Cape tax receipts contributed to total provincial tax receipts over the period 2000/01 – 2006/07. The terms EC, FS,GP, KZN, LP, MP, NC, NW and WC denote the provinces of the Eastern Cape, Free state, Gauteng, Kwazulu-Natal, Limpopo, Mpumalanga, Northern Cape, North West and Western Cape, respectively.

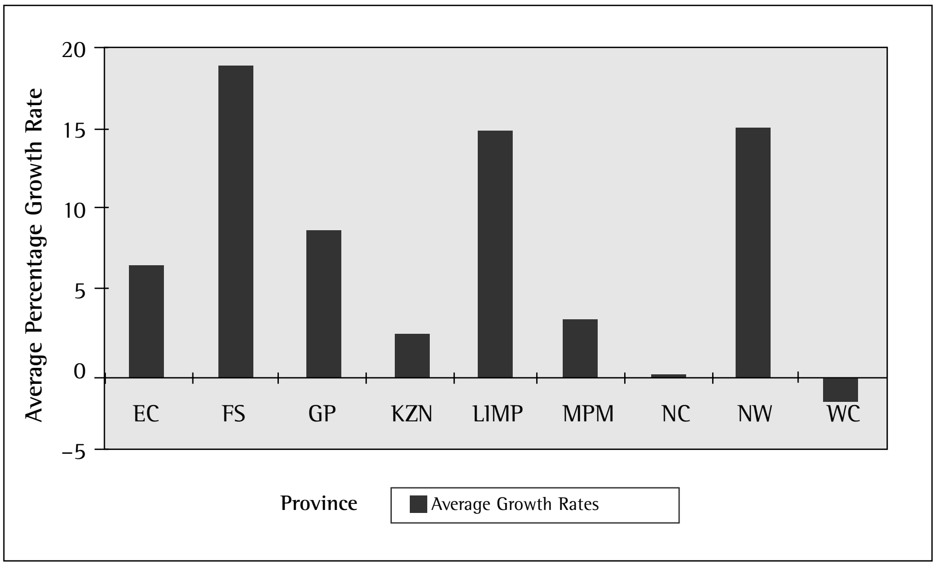
While, on average, the three provinces also account for a significant share of total provincial non-tax receipts, the relatively higher shares for the other six provinces is a useful indication of the importance of non-tax sources, especially the sale of non-capital goods and services, to the fiscus of the provinces of Eastern Cape, Free State, Limpopo, Mpumalanga and North West. This point is further supported by the relatively high growth rates of non-tax receipts in these provinces. Figures 6.7 and 6.8 illustrate this observation.

Figure 6.7: Average per Province Share in Total Provincial Non-Tax Revenue: 2000/01 – 2006/07



Source: 2004 IGFR Database.

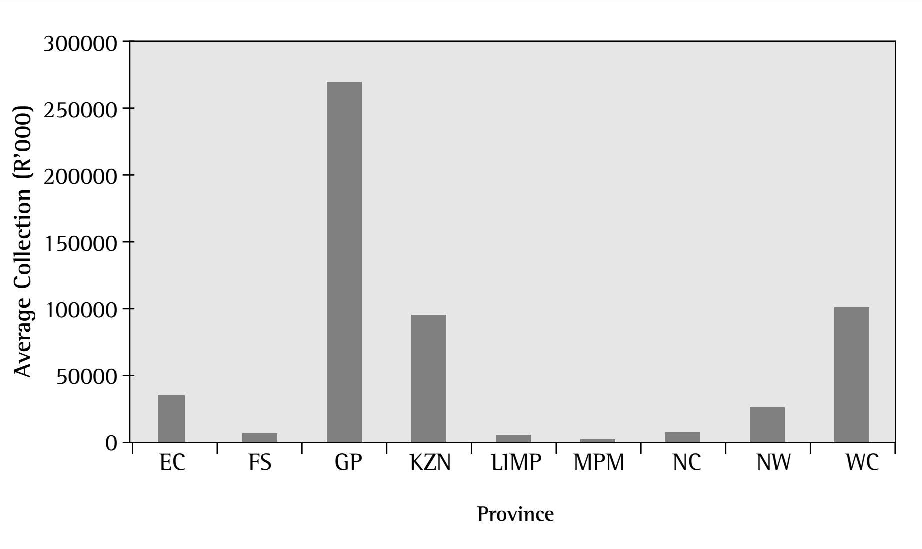
Figure 6.8: Average per Province Non Tax Revenue Growth: 2000/01 – 2006/07



Source: 2004 IGFR Database.

In terms of revenue accruing from levies on casino activities and licences, the provinces of Gauteng, KZN and the Western Cape generate the bulk of total provincial revenues derived from casino taxes. This is illustrated in Figure 6.9 below.

Figure 6.9: Average per Province Collection of Casino Taxes: 2000/01 – 2006/07

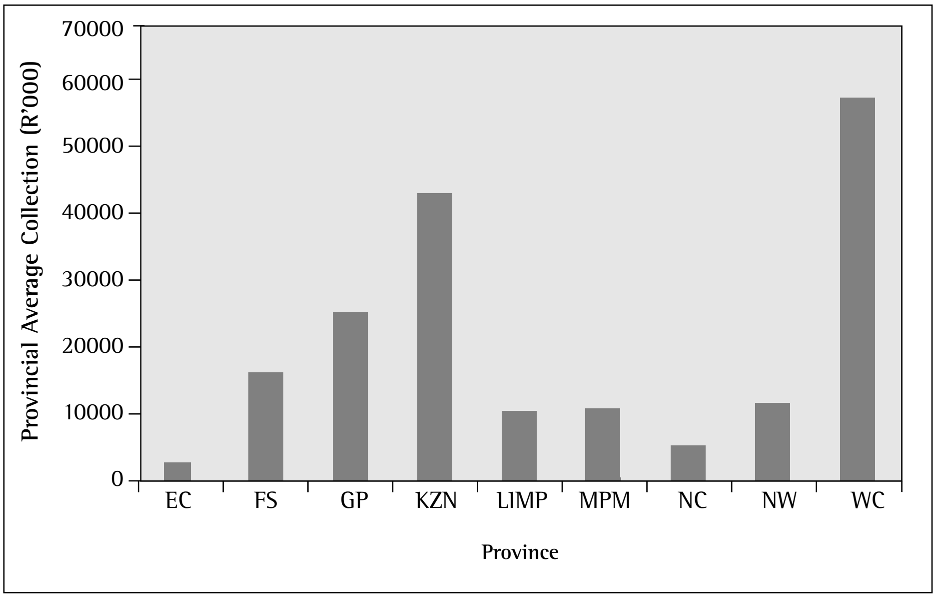


Source: 2004 IGFR Database.

It must, however, be understood that the relatively poor performance of provinces like Limpopo and Mpumalanga is largely due to the late implementation of provincial gambling and racing laws, as well as delayed reforms aimed at aligning these laws to the National Gambling Act (2004). For instance, data analysed over the sample period indicates that only in the fiscal year 2003/04 were revenues for casino fees collected in Mpumalanga province. Discussions with officials from the province's Treasury revealed that provincial authorities are still in the process of implementing reforms. They are also still in the process of developing an encompassing framework for the licensing and regulation of gambling and racing industries within the province.

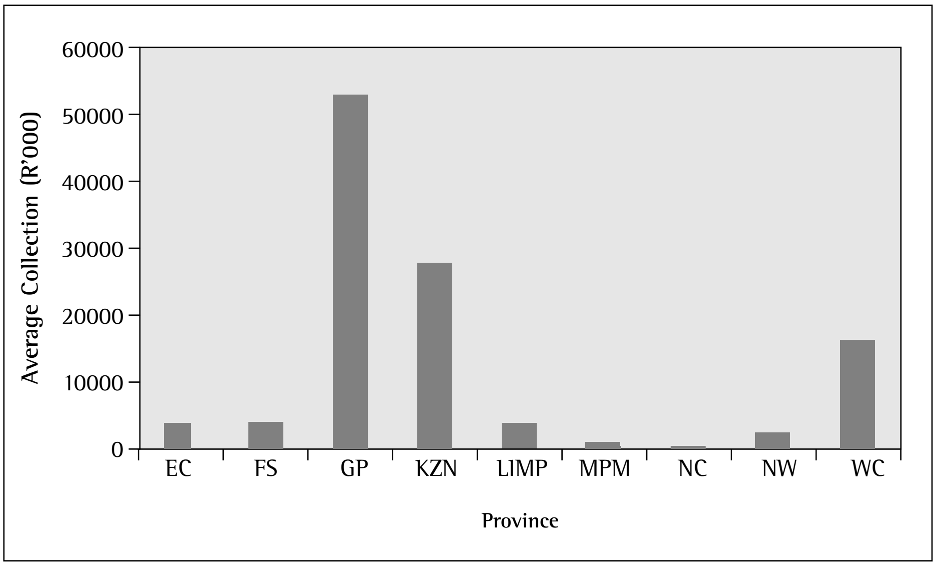
The collection of motor vehicle licences contributes most to provincial own revenues and is highest in the strong economic regions of KZN, the Western Cape and Gauteng. Combined, the three provinces generated an average of R1.3 billion in licence fees over the fiscal years 2000/01 – 2006/07 (see Figure 10). The relatively high average growth rate of revenues (5, 7 and 15 percent for Gauteng, KZN and Western Cape respectively), is indicative of the effective utilisation of the Electronic National Transport Information Systems (eNATIS), to enhance revenue collection in these provinces. A similar trend is also observed when analysing revenues from horse racing fees (see Figure 6.11).

Figure 6.10: Average per Province Collection of Motor Vehicle Licences: 2000/01 – 2006/07



Source: IGFR 2004 database.

Figure 6.11: Average Provincial Collection of Horse racing Fees: 2000/01 – 2006/07

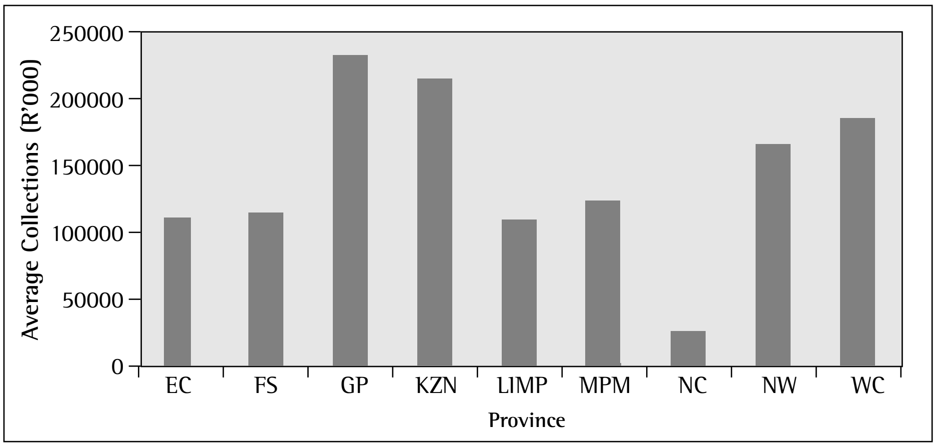


Source: 2004 IGFR Database

6.2.4 Revenues from Sale of Non-Capital Goods and Services

The term 'sale of non-capital goods and services' denotes a variety of non-tax sources across the provinces. Most of the revenues are generated by line departments – health, education, agriculture, public works, housing, social services, cultural affairs and sport. While the structure and revenue activities of departments are not homogenous across provinces, analysis reveals that the departments of health, education, public works and agriculture contribute the bulk of revenue generated from non-capital goods. This can be attributed to these departments charging fees such as hospital and patient fees, boarding fees, rental of public infrastructure and land use levies. Together, these fees contributed over R1.4 billion to provincial revenue coffers, with all provinces (except Northern Cape) recording average collections in excess of R100 million (see Figure 6.12).

Figure 6.12: Average per Province Revenues Derived from Sale of Non-Capital Goods and Services: 2000/01 – 2006/07



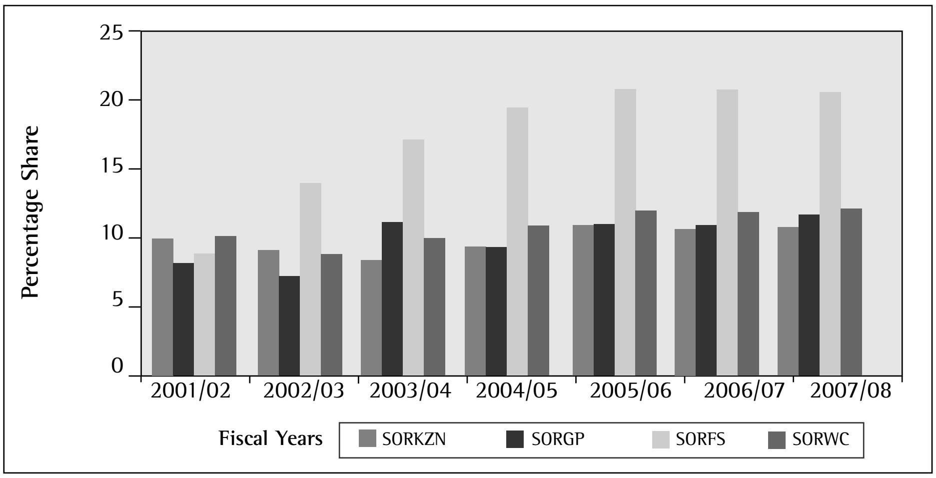
Source: 2004 IGFR database.

Using figures obtained from four provinces, one can observe the growing importance of hospital patient fees in total own revenue of four provinces – KZN, Gauteng, the Free State and the Western Cape - recording hospital fees as contributing an average 12 percent share of total provincial revenues (see Figure 6.13)[59].

The importance of hospital fees is further highlighted when analysed as a proportion of total provincial non-tax revenues. In the case of KZN, Gauteng and the Western Cape, the average shares of hospital fees in non-tax revenues over the fiscal period 2001/02 – 2006/07 were 26 percent, 34 percent and 39 percent respectively (see Figure 6.14).

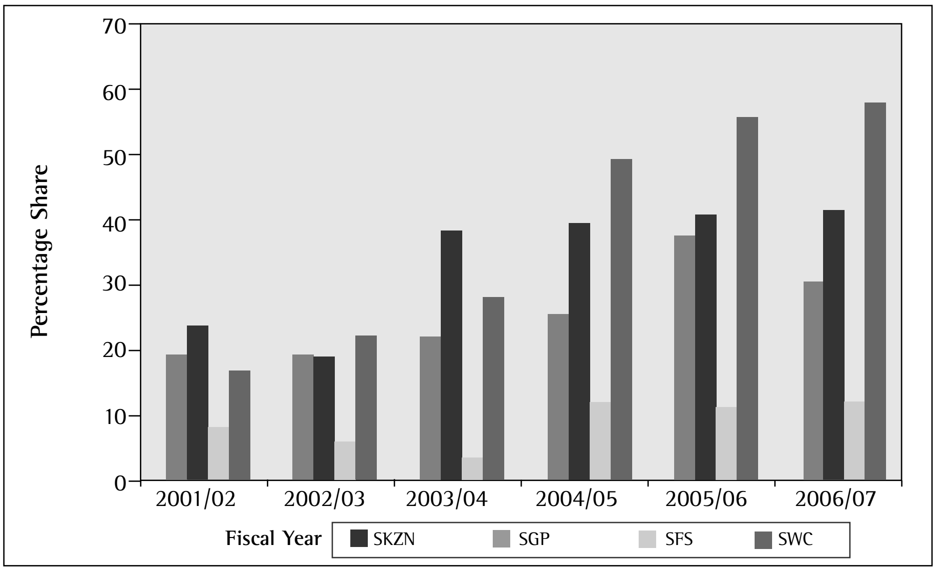
59. Of the nine provinces analysed, only the four included provided detailed time-series data on revenues accruing from hospital patient fees. For the others, incomplete or non-reported data created difficulty for comparison and analysis and were subsequently left out of this section.

Figure 13: Share of Hospital Patient Fees in Provincial Own Revenues (KZN, GP, FS and WC): 2001/02 – 2007/08



Source: IGFR 2004 Database. Legend – SORKZN: hospital patient fees as a percentage of KZN total own revenue; SORGP: hospital patient fees as a percentage of Gauteng total own revenues; SORFS: hospital patient fees as a percentage of the Free State total own revenues; and SORWC: hospital patient fees as a percentage of the Western Cape total own revenue.

Figure 6.14: Share of Hospital Patient Fees in Provincial Non-Tax Revenues (KZN, GP, FS and WC): 2001/02 – 2006/07



Source: National Treasury: *Trends in Intergovernmental Finances*: 2000/01 – 2006/07. Legend: SKZN: hospital patient fees as a percentage of KZN total non-tax revenues; SGP: hospital patient fees as a percentage of Gauteng's total non-tax revenues; SFS: share of hospital patient fees in Free State total non tax revenues; SWC: hospital patient fees as a percentage of the Western Cape's total non-tax revenues.

6.3 Challenges facing Provinces with Respect to Own Revenue Generation

6.3.1 Provincial Revenue Strategies

A number of provinces have conducted, or are in the process of conducting, studies aimed at identifying risks and weaknesses in the collection of provincial own revenue[60]. For those provinces that have conducted the studies, fairly similar patterns are emerging with regard to the design of provincial revenue strategies. In most of the provinces the typical approach is characterised by three processes.

Firstly, the establishment of revenue enhancement teams co-ordinated by the provincial treasury, working together with line departments. These teams are expected to submit departmental revenue enhancement strategies that are ultimately incorporated into the own revenue section of the provincial strategic plans.

Secondly, the delegation of responsibilities to individual officials in departments to ensure that any identified weaknesses in the department's revenue generation and collection environment are rectified.

Thirdly, the establishment of dedicated and well-resourced revenue directorates in the treasuries. These directorates have the authority to interrogate line department assumptions on revenues. They also have to consider whether the methods applied by departments are both technically and politically sound[61].

6.3.2 Challenges to the Optimisation of Own Revenue Generation

The provincial treasuries of the Western Cape, Gauteng, Mpumalanga and Kwazulu-Natal have made good progress in designing own revenue collection strategies. However, there are still significant problems. The assessment has identified several key challenges that the provinces face. These are discussed below.

There is a general lack of commitment to increasing own revenue collection by line departments. Across most provinces, very few line departments have the collection of revenue as a key priority in their strategic plans. They mostly concentrate their efforts on managing expenditure. This situation is amply illustrated in the Northern Cape where the revenue section of the provincial treasury that existed in 1999 was disbanded. The directorate was, however, re-established in June 2005 to develop a provincial revenue strategy and increase provincial revenue collection.

60. The Western Cape has provided a detailed policy document on own revenues to support its proposal for a fuel levy. The provinces of Gauteng, Kwazulu-Natal and Eastern Cape are currently in the process of finalising research on introducing new revenue-generating instruments, as well as assessing the fiscal incidence of these instruments and examining the scope for further exploitation of existing revenue sources.

61. This is already applied in the Western Cape.

The relatively weak exploitation of existing revenue sources is exacerbated by line function departments concerned more with service delivery than with generating additional revenue from the services they deliver. Rather than seeing their role as revenue generators, most line departments view their core function as service delivery agents. Revenue collection from delivered services is seen at best as a secondary function. At worst, it is seen as completely irrelevant.

There is a general lack of provincially accepted policies and procedures in respect of revenue management and controls in the collection of revenue. In addition, many line departments do not build revenue collection into their performance measures. This problem was picked up by provincial treasuries, particularly in the provinces of KwaZulu-Natal, Limpopo and the Eastern Cape.

The problems of information technology (IT) and financial management systems identified by the Commission in its 2002 submission still persist. There are inadequate IT systems to monitor and control outstanding amounts and debts. This problem is further compounded by both a lack of systems procedures and the fact that staff have to conduct some account reconciliations manually. The lack of procedures and adequate staff impact unfavourably on effective own revenue collection.

For the smaller revenue sources, asset registers and databases of revenue-generating assets are either incomplete or inadequate. This situation is further exacerbated by the infrequent review and revision of tariffs.

It must however be added that the latter is becoming less of a problem as most provinces now adjust tariffs more regularly, at least to take account of inflation. In the Free State, for example, the Provincial Treasury sends out reminders annually in December for departments to submit their tariffs and policies for review to ensure timely implementation of new tariffs. The Western Cape has traditionally not hesitated to adjust tariffs. Consequently these tend to be higher than elsewhere in the country. Nevertheless, the Western Cape, in the short to medium term, is not particularly concerned with the potential flight of some bases such as the road traffic ordinance fees. This is because these revenue sources account for a small share of total provincial own revenue.

In the North West, the Provincial Treasury has indicated that Chief Financial Officers (CFOs) should perform quarterly assessments of revenue sources and also, that the management and revision of fees and tariffs should form part of the budget process. This should ensure that tariffs and fees are brought in line with other provinces and trends in the economy.

6.4 Summary and Conclusions

As outlined above, provinces remain heavily reliant on their equitable share of nationally raised revenue for carrying out their constitutional mandate. To enhance own revenue sources, provinces are currently engaged in assessing the potential of their existing revenue sources. Most provinces agree that the enactment of the Provincial Tax Regulation Process Act brings added opportunity for increasing own revenue contributions to the total resource envelope. However, most provinces also submit that there is very little understanding around existing revenue sources. Consequently, only the Western Cape has thus far submitted a formal proposal for increasing provincial own revenues through the introduction of a fuel levy.

The Western Cape's proposal for the introduction of a fuel levy has been submitted to the Minister of Finance, who in turn has received the Financial and Fiscal Commission's recommendations on the proposal, as required by the Provincial Tax Regulation Process Act. Most provincial treasuries, while following closely the developments around the Western Cape's proposal, indicated that they would be adopting a more cautious approach. This approach is one that requires a thorough investigation of the potential for increased revenue from existing revenue sources, identifying the possible weaknesses and putting in place the relevant systems and processes to minimise the identified risks..

Issues around budgeting for provincial revenue - and the credibility thereof - have been identified as a major problem, especially with respect to line departments. Treasuries are, however, beginning to play a significant role in assisting line departments in this respect. Furthermore, provinces are working together with the National Treasury for setting up revenue-forecasting models that may be applied more uniformly across line departments and provinces. The Commission will continue to monitor developments in this area and interact with provinces as and when requested.

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Appendix A: Comprehensive Review of Conditional Grants in the SA IGFR System

Table of Conditional Grants within SA IGFR System

Table A1

Grant	Purpose of the Grant	Responsible Department
Hospital Revitalisation Grant	Infrastructure Development	Health
Comprehensive HIV and AIDS Grant	HIV/AIDS	Health
Implementation of Water Services Projects Grant	Infrastructure Development and Capacity building	DWAF
Water Services Operating Subsidy (via augmentation to the Water Trading Account) & Water Services Operating and Transfer Subsidy	Infrastructure Development and Poverty relief	DWAF
Municipal Infrastructure Grant (MIG)	Poverty relief and Infrastructure Development	DPLG
Local Government Restructuring (LGR) Grant	Capacity building	DPLG
Local Government Financial Management (LGFM)	Capacity building	DPLG
Municipal Systems Improvement Grant	Capacity building	DPLG
National School Nutrition Programme Grant	Poverty relief	Education
HIV and AIDS (Life Skills Education)	Capacity building	Education
Land Care Programme	Poverty relief	Agriculture
Comprehensive Agricultural Support Programme (CASP)	Capacity Building and Poverty relief	Agriculture
Provincial Infrastructure Grant	Infrastructure Development	National Treasury
Alexandra Renewal Project Grant	Capacity Building/ Infrastructure	DPLG
Hospital Management and Quality Improvement Grant	Infrastructure Development	Health

Appendix B: Assessment of the National Housing Allocation Formula

A report on Interviews held with Officials from Departments of Housing[62]

The Integrated Housing and Human Settlement and Development Grant is allocated annually to the nine provinces according to a formula. The allocation formula is consistent with the principles and provisions listed in section 214 (2) (a-j) of the Constitution of South Africa.

Provincial allocations are currently made according to the formula that was approved by the MINMEC (Minister and Provincial Housing MEC's) and is taken up in the Division of Revenue Act (No. 1 of 2005) framework for the conditional grants to provinces. Basically the formula consists of a housing needs factor (50%) as measured by the housing backlog of each province, an affordability indicator based on households earning less than R3500 per month (30%) and a population indicator (20%) as measured by each province's share of the total population based on the 2001 census.

In terms of section 40(4)(b) of the Public Finance Management Act (No. 1 of 1999) the provinces must submit a report on actual expenditure on a monthly basis within 15 days of the end of each month to the National Department of Housing. The Department in turn must submit a consolidated report by the 20th of each month to the National Treasury. Quarterly reports on expenditure are submitted to the MINMEC, Committee of Heads of Departments (HOD Meetings), and Parliamentary Committees.

The main challenge for the National Department is to ensure that overspending and under performance by provinces is limited to the absolute minimum.

Over and above the monthly reporting on expenditure by provinces, they also report on non-financial information such as, housing projects approved, number of subsidies represented by approved housing projects and the number of serviced sites and housing units completed. The financial and non-financial information is monitored on a monthly basis. As projects are completed the progress is recorded on the Housing Subsidy System and the provinces must also submit a non-financial information report on a quarterly basis whereby the deliverables are verified.

The purpose of the grant is to finance the implementation of national housing programmes to establish habitable, stable and sustainable human settlements in which citizens will have access to selected social and economic amenities. There are more than twenty different housing subsidy programmes that the provinces can implement. At the current stage provinces are in the process of submitting provincial

62. Report on interviews with officials in the national provincial and local departments of housing: Marius Hitge, Financial Directorate. National Department of Housing. Seth Maqetuka, Chief Director. Department of Local Government and Housing, Western Cape. Wayne Muller, Director Housing Finance. City of Cape Town. Louis Botha, Director Housing Administration. Gauteng. Ivan Perring, Head Housing Research policy and Planning. Eastern Cape. L. Mpambani, Chief Financial Officer. Department of Housing. KwaZulu Natal. Dave Dunstan, Director. Department of Housing, KwaZulu Natal.

strategic plans for the next three financial years (2006/07 to 2008/09) to be evaluated. These plans must clearly indicate the province's measurable objectives and performance targets as agreed with the National Department of Housing. The provinces are utilizing the grant on housing programmes.

According to the National Department of Housing, the main challenge for the provinces is the lack of capacity to implement the housing programmes. Provinces will simply have to increase capacity to deliver on housing projects. The National Department is currently in the process of increasing capacity that would eventually lead to more frequent visits to provinces to improve monitoring and evaluation.

From the perspective of the provinces the perception is that the housing funding formula contains a poverty component that is negatively biased towards provinces such, as the Western Cape which are experiencing rapid urbanisation with a resultant increase in housing demand. Provincial Officials believe that the formula should also take into account regional issues, such as where it is more expensive or cheaper to build a house that meets the minimum requirements, or expensive land in certain areas. It was felt that the formula should allow for this flexibility so that funds can be cross subsidised and used more efficiently. Municipalities often complain about various hidden costs which they absorb in building houses. These costs are supplemented by municipal revenue for equitable share funding or from rental stock income.

One suggestion made was that the formula needs to be updated regularly according information and statistics used in the calculation. An effort should be made to have the data and information used updated at every Medium Term Expenditure Framework (MTEF) cycle. This will assist in adjusting allocations according to changing migration and demographic patterns.

Officials reported the emergence of a new vision called "Comprehensive Plan for the Creation of Sustainable Human Settlements". The priorities of the plan include amongst others, the eradication of slums, development of rural areas, hostel upgrade etc. Although provincial housing departments are expected to contribute towards rural development, the formula does not take into account rural housing need in calculating housing backlogs.

Officials indicated, that because of the above shortcoming rural provinces are expected to help the housing sector to realise the objective of rural development, but funds are not made available or top sliced from the pool of housing funds to facilitate the achievement of this objective. Departments are concerned that the formula does not cater for presidential priorities. These include among others, creating shelter for the vulnerable groups, e.g. HIV/AIDS homes. The formula should therefore be revamped and include all the elements that the comprehensive plan for the creation of sustainable human settlements seeks to achieve, such as rural development, hostel upgrading and so forth. The formula should also take account of presidential priorities. Through this mechanism resources could be made available to provinces to deliver services and thus realise their set objectives.

Departmental officials reported that the process of accreditation seeks to ensure that service delivery is accelerated and therefore streamlines the bureaucratic administration. It was assumed that if municipalities were capable of delivering housing, accrediting municipalities would then assist the provincial housing department to free-up provincial funds and thus enhance the ability to accelerate delivery of housing. The accreditation process therefore seeks to improve efficiency in housing delivery.

In general the interviews indicated that some provinces are not spending their full allocation every year due mainly to lack of technical capacity and capability to actually deliver on their mandates. The pool of capable housing personnel and the capacity of the construction industry is limited and unable to cope with the pace of public deman and private development. The result will be a backlog in low income housing.

Officials believed that the time lines attached to implementation of the accreditation system are far too optimistic in that a great deal of capacity building will have to done prior to its being a viable alternative to the current system.

The current framework for accreditation stipulates that municipal housing plans must be in place as part of the integrated development planning process and fundamentally that is all that is required as the municipalities themselves do not actually do the physical implementation of housing projects. This is contracted out to the private sector, particularly in the smaller municipalities. Of importance is that accreditation must be accompanied by an equitable allocation of funds, including those funds setting up systems and administration. Another major problem with the accreditation process is that the MEC will in effect lose all his/her ability to drive priorities within the respective provinces. To overcome this problem, the MEC may have to top-slice a portion of the provincial allocation according to his/her priorities and then reapply the national allocation formula to distribute the funds amongst municipalities.

Officials expressed frustration at the continued use of the notion of 'backlog'. The 'demand' is growing at a faster rate than the ability of the state to provide a sufficient number of housing units. The only way that the backlog can be overcome is to substantially increase money required for housing delivery but then delivery will still be constrained by the capacity of the construction and building industry. Failure to eradicate housing backlogs can, in the main, be attributed to, amongst other reasons, disputes around land, slow environmental impact assessment process and the unbundling of households.

Appendix C: The Demand for Welfare Services

Table C1: Social Welfare Spending (excluding grants) by Province, 2005 (in R'000)

Programmes and sub-programmes	E/Cape	F/State	Gauteng
Social welfare services:			
Administration	143 232	6 531	4 508
Treatment and prevention of substance abuse	3 935	7 432	28 233
Services to older persons	42 608	55 827	101 353
Crime prevention and support	26 718	11 461	46 615
Services to persons with disabilities	16 959	14 172	51 615
Services to children, women and families	105 129	113 583	183 254
Total: Social welfare services	**338 581**	**209 006**	**415 578**
-Social welfare services excl. admin	195 349	202 475	411 070
Development and support services	**86 030**	**86 487**	**73 062**
- Admin of above	13 841	4 305	1 467
-Development & support services excl. admin	72 189	82 182	71 595
Population development trends	**1 524**	**1 802**	**2 536**
- Admin of above	729	1 802	2 536
-Population development trends excl. admin	795	0	0
Social welfare services, Development and Support Services plus Population Development Trends	426 135	297 295	491 176
-Non-social assistance excl. admin	**268 333**	**284 657**	**482 665**
Population ('000)	**6 483**	**2 719**	**9 077**

Table C2: Social Welfare Spending (excluding grants) per Person by Province, 2005

Programmes and Sub-programmes	E/Cape	F/State	Gauteng	KZN
Social welfare services:				
Administration	R 22.09	R 2.40	R 0.50	R 19.25
Treatment and prevention of substance abuse	R 0.61	R 2.73	R 3.11	R 1.94
Services to older persons	R 6.57	R 20.53	R 11.17	R 6.94
Crime prevention and support	R 4.12	R 4.22	R 5.14	R 2.02
Services to persons with disabilities	R 2.62	R 5.21	R 5.69	R 4.50
Services to children, women and families	R 16.22	R 41.77	R 20.19	R 20.56
Development and support services	R 13.27	R 31.81	R 8.05	R 14.88
Population development trends	R 0.24	R 0.66	R 0.28	R 0.37
Social welfare services, Development and Support Services plus Population Development Trends	R 65.73	R 109.34	R 54.11	R 70.46

KZN	Limpopo	M/langa	N/Cape	N/West	W/Cape	Total
183 435	100 876	39 119	60 446	50 361	8 095	596 603
18 499	583	7 306	660	2 073	25 157	93 878
66 171	8 884	14 478	7 000	32 138	99 000	427 459
19 269	3 850	6 723	1 820	9 902	92 995	219 353
42 860	4 211	12 261	3 280	16 966	28 915	191 239
195 942	34 106	38 647	26 198	39 154	167 800	903 813
526 176	**152 510**	**118 534**	**99 404**	**150 594**	**421 962**	**2 432 345**
342 741	51 634	79 415	38 958	100 233	413 867	1 835 742
141 855	**117 706**	**61 558**	**27 580**	**93 121**	**64 722**	**752 121**
22 869	31 025	7 725	6 832	19 024	1 924	109 012
118 986	86 681	53 833	20 748	74 097	62 798	643 109
3 525	**4 466**	**3 789**	**3 625**	**0**	**3 239**	**24 506**
2 150	2 966	2 634	3 004	0	509	16 330
1 375	1 500	1 155	621	0	2 730	8 176
671 556	274 682	183 881	130 609	243 715	489 923	3 208 972
463 102	**139 815**	**134 403**	**60 327**	**174 330**	**479 395**	**2 487 027**
9 531	**5 313**	**3 178**	**819**	**3721**	**4612**	**45453**

Limpopo	M/langa	N/Cape	N/West	W/Cape	Total	Ratio maximum: minimum	Maximum
R 18.99	R 12.31	R 73.80	R 13.53	R 1.76	R 13.13	**149**	R 73.80
R 0.11	R 2.30	R 0.81	R 0.56	R 5.45	R 2.07	**50**	R 5.45
R 1.67	R 4.56	R 8.55	R 8.64	R 21.47	R 9.40	**13**	R 21.47
R 0.72	R 2.12	R 2.22	R 2.66	R 20.16	R 4.83	**28**	R 20.16
R 0.79	R 3.86	R 4.00	R 4.56	R 6.27	R 4.21	**8**	R 6.27
R 6.42	R 12.16	R 31.99	R 10.52	R 36.38	R 19.88	**7**	R 41.77
R 22.15	R 19.37	R 33.68	R 25.03	R 14.03	R 16.55	**4**	R 33.68
R 0.84	R 1.19	R 4.43	R 0.00	R 0.70	R 0.54		R 4.43
R 51.70	R 57.86	R 159.47	R 65.50	R 106.23	R 70.60	**3**	R 159.47

Table C3: Welfare Services Spending per Person for Three Sub-programmes by Race (1993) and Province (2005) (in 2005 Rand values)

2005 Provincial spending per person	Treatment and prevention of substance abuse	Services to older persons	Services to persons with disabilities	Total for these three welfare services
Eastern Cape	R 0.61	R 6.57	R 2.62	**R 9.80**
Free State	R 2.73	R 20.53	R 5.21	**R 28.48**
Gauteng	R 3.11	R 11.17	R 5.69	**R 19.96**
Kwazulu-Natal	R 1.94	R 6.94	R 4.50	**R 13.38**
Limpopo	R 0.11	R 1.67	R 0.79	**R 2.57**
Mpumalanga	R 2.30	R 4.56	R 3.86	**R 10.71**
Northern Cape	R 0.81	R 8.55	R 4.00	**R 13.36**
North West	R 0.56	R 8.64	R 4.56	**R 13.75**
Western Cape	R 5.45	R 21.47	R 6.27	**R 33.19**
Total	R 2.07	R 9.40	R 4.21	**R 15.68**
Ratio Max: Min	49.71	12.84	7.91	12.89
Maximum	R 5.45	R 21.47	R 6.27	R 33.19
1993 Non-home-land spending per person (in 2005 Rand)	**Rehabilitation for alcoholics and drug dependants**	**Care of the elderly**	**Care of the disabled**	**Total for these three welfare services**
Whites	R 4.38	R 124.91	R 17.20	R 146.48
Coloureds	R 3.41	R 31.48	R 4.38	R 39.28
Indians	R 6.56	R 4.55	R 8.50	R 19.61
African	R 0.57	R 6.33	R 6.51	R 13.41
Total	R 2.14	R 37.12	R 8.71	R 47.97
Comparing 1993 norm to 2005 norm	**Ratio: 1993 norm to SA 2005 norm**			
White 1993: SA 2005	9.34			
Coloured 1993: SA 2005	2.51			
Indian 1993: SA 2005	1.25			
African (non-home-land) 1993: SA 2005	0.86			
SA (non-home-land) 1993: SA 2005	3.06			

Applying Actual Data to Determine Weights

Only the last three of the funding alternatives mentioned are considered here. At present, three of the proxies initially suggested for institutional capacity do not exist. Probation officers and child care workers are not yet properly registered and the budget spent by non-profit organisations (NPOs) in provinces could not be obtained from the NPO Directorate (although they did provide the numbers of NPOs and indicated that the budgets may be available in the foreseeable future). One major data difficulty consisted of obtaining estimates of the number of court cases and costs involved regarding welfare.

Preliminary work by Conrad Barberton (2006) on the fiscal impact of the National Child Protection Bill was kindly made available. This allowed an estimate of the distribution of the costs to the welfare system of court processes and statutory aftercare orders for children only. This is a very crude proxy (given the poor quality of the data Barberton was able to extract from provinces and the great dependence of the data on assumptions required to derive cost estimates) and is only based on the statutory services rendered to children. Nevertheless, although it provides some indication of the possible inter-provincial skewness in these costs compared to the demand for welfare services that derives from the population itself, it was incorporated into the data set.

The full available provincial shares dataset is set out in Table A below and is also shown in Figure 1. The high correlations in Table B between statutory costs, population and welfare expenditures (of which statutory costs form a part) indicates that little is to be gained from including statutory cost separately, though it remains included in the first proposed allocation formula.

Although the low correlations between provincial NPO shares and other indicators indicate that NPO numbers may be adding some information, it is clear that it is a misleading indicator, as it does not capture what was intended to be measured, i.e. institutional capacity. It is impossible that the Eastern Cape possesses 40% and Mpumalanga another one-quarter of national institutional capacity in welfare services, yet those are their shares of social services non-profit organisations. So this indicator is not used in the further analysis.

What remains as potential measures of institutional capacity are the different levels of social worker availability, as well as actual provincial welfare services expenditure. It probably matters little which of these variables are used, given the high correlation between them. For the sake of completeness and also to reduce dependence on a single indicator, however, it is proposed that two variables should be used in combination to measure institutional capacity, viz. the number of social workers (including auxiliary social workers) registered and the actual expenditure on social welfare services.

Table C4: Provincial Shares using Alternative Variables, 2005

	Population	Poverty	Registered Social Workers	Auxiliary Social Workers	Social Workers plus Auxiliaries	Social Services NPOs	Social Welfare Services Expenditure	Statutory costs
Eastern Cape	14.3%	21.0%	11.4%	9.3%	11.3%	40.2%	13.9%	21.9%
Free State	6.1%	7.1%	4.7%	4.3%	4.6%	2.7%	8.6%	8.3%
Gauteng	19.8%	11.2%	28.3%	29.3%	28.4%	13.8%	17.1%	15.5%
Kwazulu-Natal	20.9%	23.1%	16.3%	9.7%	15.7%	6.4%	21.6%	19.3%
Limpopo	11.8%	17.1%	7.2%	2.3%	6.8%	4.1%	6.3%	8.4%
Mpumalanga	7.0%	6.6%	3.9%	1.8%	3.7%	25.6%	4.9%	4.9%
Northern Cape	1.8%	2.1%	2.9%	11.0%	3.5%	2.0%	4.1%	3.8%
North West	8.2%	8.0%	4.6%	1.2%	4.4%	0.7%	6.2%	2.1%
Western Cape	10.1%	3.8%	20.7%	31.1%	21.6%	4.5%	17.3%	15.8%
Total	100%	100%	100%	100%	100%	100%	100%	100%

Table C5: Correlations between Provincial Share Variables Considered for Inclusion in Formula (Values highlighted in bold exceed 0.60)

	Population	Poverty	Registered Social Workers	Auxiliary Social Workers	Social workers plus auxiliaries	Social Services NPOs	Social welfare services expenditure	Statutory costs
Population	1							
Poverty	0.77	1						
Registered Social Workers	0.77	0.23	1					
Auxiliary Social Workers	0.37	-0.19	0.87	1				
Social workers plus auxiliaries	0.74	0.19	1.00	0.89	1			
Social Services NPOs	0.25	0.39	0.09	-0.03	0.08	1		
Social welfare services expenditure	0.83	0.50	0.84	0.64	0.83	0.13	1	
Statutory costs	0.77	0.66	0.70	0.51	0.69	0.48	0.88	1

Note: Highlighted correlations are those with values exceeding 0.60

There is no obvious weighting for calculating the final allocation indices from the various indicators. Principal component analysis showed no great differences in weighting factors for the first principal component. Thus equal weights were given to all components of each final allocation index. Table C and Figure A below show the resultant shares for the different provinces.

Table C6: Provincial Shares Allocations under Alternative Assumptions

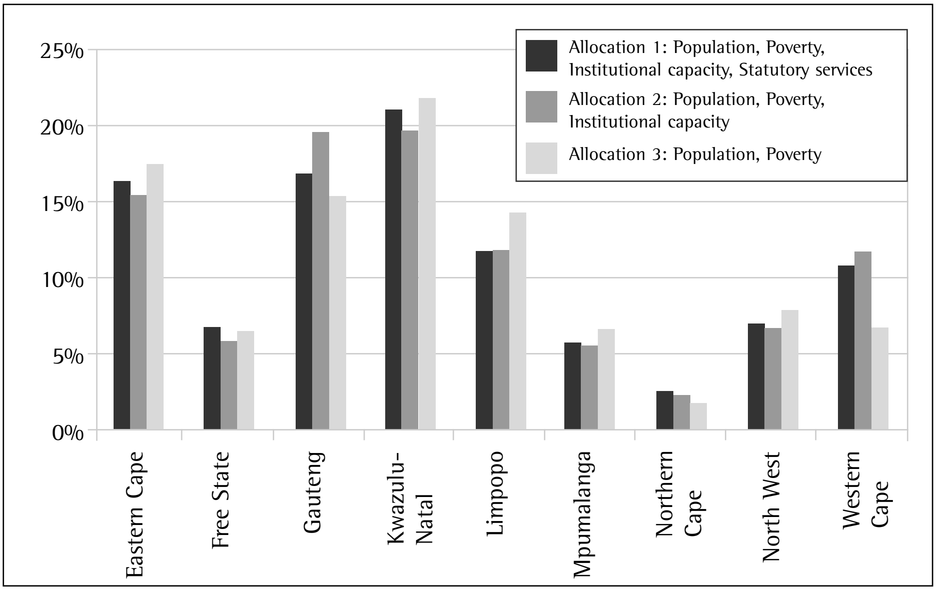
	Population	Poverty	Institutional capacity		Statutory costs	Allocation 1: Population, Poverty, Institutional capacity, Statutory services	Allocation 2: Population, Poverty, Institutional capacity	Allocation 3: Population and Poverty
			Social workers plus auxiliaries	Social welfare services expenditure				
Eastern Cape	14.3%	21.0%	21.0%	11.3%	13.9%	16.3%	15.5%	17.7%
Free State	6.1%	7.1%	7.1%	4.6%	8.6%	6.9%	5.9%	6.6%
Gauteng	19.8%	11.2%	11.2%	28.4%	17.1%	17.0%	19.8%	15.5%
Kwazulu-Natal	20.9%	23.1%	23.1%	15.7%	21.6%	21.3%	19.9%	22.0%
Limpopo	11.8%	17.1%	17.1%	6.8%	6.3%	11.8%	11.9%	14.5%
Mpumalanga	7.0%	6.6%	6.6%	3.7%	4.9%	5.9%	5.8%	6.8%
Northern Cape	1.8%	2.1%	2.1%	3.5%	4.1%	2.7%	2.5%	2.0%
North West	8.2%	8.0%	8.0%	4.4%	6.2%	7.2%	6.9%	8.1%
Western Cape	10.1%	3.8%	3.8%	21.6%	17.3%	11.0%	11.8%	7.0%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Allocation 1: Equal shares for Population, Poverty, Institutional capacity and Statutory services, i.e. weighting is: Population 25%, Poverty 25%, Social workers plus auxiliaries 12.5%, Social welfare spending 12.5% and Statutory services 25%.

Allocation 2: Equal shares for Population, Poverty and Institutional capacity, i.e. weighting is: Population 33.33%, Poverty 33.33%%, Social workers plus auxiliaries 16.67% and Social welfare spending 16.67%.

Allocation 3: Equal shares for Population and Poverty only, i.e. weighting is: Population 50% and Poverty 50%.

Figure C1: Alternative provincial allocations



The differences between Allocations 1 and 2 are relatively minor, and given the extremely weak data on statutory services (which is likely to remain an enduring problem), there appears to be little to be gained from using Allocation formula 1 rather than Allocation formula 2. The remaining issue is then whether Institutional Capacity should also be ignored, thus leading to the simplest formula, Allocation 3 rather than Allocation 2. As is apparent, provinces that stand to lose from retaining Institutional Capacity as criterion rather than only using Population and Poverty as measures would be Limpopo, Eastern Cape and Kwazulu-Natal. However, the cost of a reduction of one percentage point in the welfare allocation between provinces is minor, perhaps only of the order of R40 million. Thus the stakes are relatively small.

Considering the earlier argument that not only should need be considered, but also the capacity to spend resources on meeting the underlying demand for welfare services, it would seem wiser to follow the allocation rule in Allocation 2. Moreover, this formula would encourage provinces to create institutional capacity by increasing spending on social welfare services and thereby also attracting more social workers to the province. This needs to be encouraged, as the major constraint on meeting unmet welfare needs is not finance but the institutional capacity to deal with this need. Consequently, there is a strong case for Allocation formula 2.

Thus it is proposed that the final allocation formula should be based on Population, Poverty and Institutional Capacity, each with a weight of one-third. Population and Poverty act as proxies for need. Institutional Capacity should then be proxied by the share of registered social workers and auxiliary social workers carrying half the weight of this component and by the actual budget for welfare services carrying the other half of the weight.

Appendix D: The New (2005/06) LES Formula

Each municipality i receives a per capita LES allocation of Gi, defined as

$G_i \;=\; ScG_i + CO_i$, (1)

Where ScG_i denotes scaled grant per capita, and CO_i is the correction factor.

$ScG_i \;= \alpha\ (BS_i + IS_i) - RRC_i$, (2)

where BS and IS refer to the basic services and institutional support components, and RRC to revenue-raising capacity, and

$BS_i = \Sigma_j(poor_{serviced,\ ij} *S1_j + poor_{unserviced,\ ij} *S2_j)$, (3)

where

- the subscripts j run over the four basic services, electricity, water, refuse collection and sanitation,
- $poor_{serviced,\ ij}$ is the number of poor households receiving service j in local government i,
- $poor_{unserviced,\ ij}$ is the number of poor households not receiving service j in local government I,
- $S1_j$ is the annual service cost for those poor households receiving public service j and
- $S2_j$ is the annual service cost for poor households not receiving public service j[63]. The monthly service costs used in the 2005/06 formula are listed in Table E.17 of Annexure E of the 2005 *Budget Review*.
- $IS_j = \beta + \gamma*pop_i + \sigma*coun_i$, popi is the population of local government i and $coun_i$ is the number of councillor seats in local government i.

For the 2005/06 LES allocation, the following parameter values are used:

β = R350,000,

γ = R1, and

σ = R36,000.

RRCi = _ * imputed revenue-raising capacity in i. For the current year, _ has been set at 5 percent.

α = scale factor = $(TotES + \Sigma_i RRC_i) / \Sigma_i (BS_i + IS_i)$, (4)

where

TotES is the total local government equitable share as determined by parliament. For the 2005/06 financial year it was set at R 9,343,365,000. For 2005/06 α = 1.681313553.

63. The monthly service costs used in the 2005/06 formula are listed in table E.17 of the 2005 Budget Review

CO_i = a correction factor to prevent large changes in allocations. For each local government, a minimum guarantee amount (MIN_i) has been defined as the indicative amount for this year indicated in the previous MTEF. Local governments for which the scaled grant (ScG_i) is less than MIN_i, receive a **positive correction** or "topup" equal to $MIN_i - ScG_i$. Local governments whose scaled grant is greater than MIN_i are considered to have a "surplus" and receive a **negative correction** equal to that local government's *share* of the total amount of all "top-ups". Municipality *i*'s share is thus equal to its surplus ($ScG_i - MIN_i$) divided to the sum of all surpluses.

Appendix E: High Level Summary of Models Used In the Review of the National Tertiary Service Grant

Overview

The analysis of the National Tertiary Services Grant (NTSG) makes use of two models developed to support this project. The first estimates the acute bed requirement for any catchment population. The second provides the resource requirements (staff and costs) for specific hospital service types (hospital disciplines or sub-disciplines as well as clinical support services). The two models together serve the purpose of estimating the relative need of hospital services for specific catchment populations. Both models are outlined here at a fairly high level.

Estimation of acute bed requirement

Although it is difficult to predict the health needs of individuals, the health needs of large groups can be estimated with a high degree of stability. Many health conditions at a group level are correlated with age and, to a degree, with gender. A relatively recent costing study of prescribed minimum benefits within medical schemes provided extensive underlying data that permitted the determination of these standardised relationships for in-hospital and out-of-hospital services. (Council for Medical Schemes, 2003). These relationships have been used in this analysis to generate the overall acute bed requirement by population.

A further set of relationships are then used to produce the high-level requirement for specific services: level 1, level 2, level 3, maternity, ICU (intensive care units), theatres, outpatients, etc. These are based on existing standard ratios to inpatient services, or to projected demand (births, deaths). **Table 1** provides the final output sheet driven by inputting a designated catchment population by age. The results below indicate the estimated bed requirement for South Africa as a whole.

The model suggests a total requirement for acute beds of 108,353, with 76,234 at level 1, 19,350 at level 2 and 12,769 at level 3. The distribution between levels of care is an interpretation of the hospital-based norms used by the Department of Health until quite recently.[1] There is a need for 7,585 ICU beds. Around 1.3 million operations are required, with a total patient-day equivalent for all services of 48.5 million.

1. These norms described bed/population (per 1,000) ratios based on hospital types. However, hospital services have not been "pure" with regional hospitals providing level 1 services and tertiary hospitals providing extensive level 1 and 2 services. Given this, it was necessary to interpret these norms and to generate a reasonable set of ratios based on levels of care.

Table 1: Output sheet from Catchment Population model

Assessment Sheet: Hospital-based services required for catchment population							
		Beds	Ratio a/b	Admissions	LOS	Occupancy	Bed days
Beds	Total acute	108,353	100.0%	6,327,815	5	80.0%	31,639,073
	Level 1	76,234	70.4%	4,452,057	5	80.0%	22,260,284
	Level 2	19,350	17.9%	1,130,044	5	80.0%	5,650,219
	Level 3	12,769	11.8%	745,714	5	80.0%	3,728,571
	High Care/ICU	7,585	7.0%	738,245	3	80.0%	2,214,735
	Psych: acute	2,167	2.0%	90,397	7	80.0%	632,781
	Psych: chron	17,120	15.8%	16,337	306	80.0%	4,998,974
	Maternity	10,649	9.8%	1,036,510	3	80.0%	3,109,529
	Fem 16-45	12,388,290	The level of care ratios are based on an interpretation of National Norms. The National Norms do not provide an official breakdown by level of care, only by hospital type.				
	Births	1,036,510					
	Deaths	1,036,510	Mortality is assumed as equal to births to ensure surplus capacity				
Theatre	Norm per 100k	3,166	The norm is based on Mexico data for 1995 and is used as a comparative to the norm used in the exercise, which is based on Free State 1999.				
	Comparative	1,484,255					
	Operations	1,265,563	This ratio is based on Free State experience for 1999.				
	Ratio: a/b (FS)	4.0%					
Outpatient services and casualty		Visits	Ratio a/b	% of Tot OPD	% norm/h	% a/h	OPD assump-tions can be modified based on improved data.
	Overall	50,622,517	1.60	100.0%			
	PHC	20,249,007	0.64	40.0%	90.0%	10.0%	
	Gen OPD	15,186,755	0.48	30.0%	90.0%	10.0%	
	Spec OPD	15,186,755	0.48	30.0%			
	Psych OPD	2,847,517	0.09	5.6%			
	Casualty	13,668,079	0.43	27.0%	90.0%	10.0%	
PDE	PDE	48,513,245	OPD/3 + Total Acute Bed days				

Table 1 is then used as an input into the hospital resource model to estimate the resulting resource requirements implied by the outputs.

Hospital resource model

The resourcing of the bed need calculated in **table 1** can vary depending on the following:

1. The staff ratios per bed or hospital unit;
2. The running costs of new technology; and
3. Case-mix (some hospitals may get more complex medical cases than others – increasing the intensity of resource utilization per case).

Of the above the first two issues are taken into account in this model while the third is not dealt with in this analysis. The first two issues are affected by strategic policy decisions made at almost any level of the health system. The staff ratios, or equipment needs can be changed, impacting on the cost per bed. Other factors can influence the cost structure, such as centralized purchasing, as in the case of pharmaceuticals and surgicals, which cause a dramatic price differential between the public and private sectors.

Before the staff and non-staff costs can be inputted, however, the breakdown provided in **table 1** must be further allocated into sub-components of a hospital. This requires information on patient volumes, per age segment of the population, per clinical sub-discipline. In producing this estimate use was made of the Council for Medical Schemes Annual Report (2004), which provides a breakdown of consultations per clinical sub-discipline for medical scheme members. As the catchment population for the private sector is also known, an age-related distribution can be generated, after accounting for the extent to which consultations are hospital- or non-hospital based. **Table 2** provides the resulting breakdown for the South African population as a whole.

The combination of outputs shown in **tables 1** and **2** provide an overall “plan” for a catchment population. The plan is resourced by standard staffing decisions/norms per unit or sub-discipline.

Table 2: Bed allocation to hospital sub-components (RSA Total)

Cost centres	Unit	Total	Beds needed
Patient Care Units	Hospital		
Total Internal Medicine		**40,519**	**100.0%**
Internal Medicine	InpatL1IntMed	36,318	89.6%
Cardiology	InpatL3IntMedCard	1,309	3.2%
Dermatology	InpatL3IntMedDerm	0	0.0%
Endocrinology and Diabetes	InpatL3IntMedEnd	168	0.4%
Gastroentorology	InpatL3IntMedGast	390	1.0%
Haematology	InpatL3IntMedHaem	168	0.4%
Hepatology	InpatL3IntMedHep	168	0.4%
Neurology	InpatL3IntMedNeur	897	2.2%
Oncology	InpatL3IntMedOnc	290	0.7%
Pulmonology	InpatL3IntMedPulm	474	1.2%
Renal Unit	InpatL3IntMedRenal	168	0.4%
Rheumatology	InpatL3IntMedRheum	168	0.4%
Infectious diseases	InpatL2IntMedInf	**167**	**0.4%**
Total Surgery		**25,724**	**100.0%**
Surgery: General	InpatL1Surg	13,551	52.7%
Burns unit	InpatL3SurgBurns	168	0.7%
Cardiothoracic surgery	InpatL3SurgCard	331	1.3%
Ear, Nose and Throat	InpatL3SurgENT	1,985	7.7%
Maxillo Facial surgery	InpatL3SurgMFS	592	2.3%
Neurosurgery	InpatL3SurgNeur	737	2.9%
Opthalmology	InpatL3SurgOpth	2,583	10.0%
Paediatric surgery	InpatL3SurgPaed	168	0.7%
Plastic surgery	InpatL3SurgPlast	280	1.1%
Spinal surgery	InpatL3SurgSpin	168	0.7%
Transplant unit	InpatL3SurgTrans	168	0.7%
Trauma unit	InpatL2SurgTrauma	3,514	13.7%
Urology	InpatL3SurgUrol	1,478	5.7%
Total other		**15,129**	**100.0%**
Paediatrics	InpatL2Paed	3,500	23.1%
Obstetrics and Gynaecology	InpatL2O&G	7,317	48.4%
Orthopaedics	InpatL2Orth	2,325	15.4%
Psychiatry	InpatPsychAcute	1,986	13.1%
ICU total		**7,585**	**100.0%**
Adult	InpatL2ICU	4,334	57.1%
Paediatric	InpatL2ICU	2,167	28.6%
Neonatal	InpatL2ICU	1,084	14.3%
High care	InpatL2HCare	0	0.0%
TOTAL		**89,124**	

The allocation of staff to hospital sub-components involves the development of standard staff establishments at this level. The benchmark ratios for this analysis are based on a number of sources: existing public sector plans, and private sector staffing ratios for mine hospitals. In this report the analysis has been performed on the following catchment populations:

1. Public Sector;
2. Private Sector;
3. Public Sector by Province; and
4. Private Sector by province.

The staffing assumptions are not based on existing practice but rather on a reasonable benchmark, based on health services of reasonable cost and quality in the private sector. However, the modelling framework can accommodate any set of norms decided on.

The staff costs are also affected by the conditions of employment. In this model three options are available:

1. Public sector;
2. Private sector (staff model); and
3. Any proportional adjustment from the public sector to the private sector.

The ratios of non-staff costs per bed are based on standard ratios to salary costs currently observed in the public sector. These are shown in **table 3**.

Table 3: Standard ratios of standard cost items by service level of care

Standard Cost Structures	Salaries	Admin	Supplies	Equip	Buildings
level 1 services	76.4%	1.3%	17.4%	1.9%	3.0%
level 2 services	71.4%	0.6%	23.1%	1.9%	3.0%
level 3 services	67.0%	0.7%	26.3%	3.0%	3.0%

Using this model, and the approach described above, the total cost for a benchmark set of needed hospital services would amount to R49.8 billion. This is around R9 billion more than the current total cost for hospital services in South Africa. This assumes a 50% adjustment toward the conditions of employment found in staff model private hospitals. The costs per level of care are net of administration, management and clinical support services and should not be directly compared to the costs of district, regional and tertiary hospitals in this form.

Table 4: Total cost for a benchmark hospital system in South Africa covering both public and private sector populations (2004 prices)

Cost centres	Total	Salaries	Admin	Stores	Equip	Build
Administration Services	5,714	4,624	462	231	198	198
Hospital Management	2,707	2,190	219	110	94	94
Patient Care: level 1	17,008	12,989	229	2,954	326	510
Patient Care: level 2	12,651	9,032	74	2,921	245	379
Patient Care: level 3	4,917	3,292	37	1,293	147	147
Clinical Support Services	6,805	5,507	551	275	236	236
Total	**49,802**	**37,635**	**1,572**	**7,784**	**1,247**	**1,564**

How the models are used in this analysis

The models are, for convenience, described without differentiation as the "benchmark model". The model has the key strategic assumptions:

1. Staff ratios are based on a combination of sources, but primarily on information on staffing within mine hospitals in South Africa;
2. Conditions of employment costs are assumed at 50% of the full adjustment from prevailing costs in the public sector in 2004/05 and those in staff-model private hospitals (i.e. mining hospitals).

The benchmark resulting from this analysis can therefore be used in the following manner:

1. To indicate the shortfall/excess in service provision against the benchmark, by province and the country as a whole for both the public and private sector populations; and
2. To provide a basis for weighting the relative need by province.