# EQUITY & LOCAL GOVERNMENT EQUITABLE SHARE

**FFC CONFERENCE**

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# INTRODUCTION

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

# THE CONSTITUTION

- 214 (1) “An Act of Parliament must provide for (a) the equitable division of revenue raised nationally …”
- Constitution offers some guidance as to the context within which ‘equitable’ should be understood

1. Broader heading of “General Financial Matters”
2. FFC must be consulted & considered
3. Factors to be considered (clauses a to j) are aligned with the principles of sound fiscal management

# DEFINITION OF EQUITY

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

# ABILITY-TO-PAY

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

# HORIZONTAL EQUITY

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

# EXAMPLE: INEQUALITY

| | Municipality A | Municipality B |
|---|---|---|
| otal Population | 100 | 100 |
| ndigent Population | 20 | 80 |
| ariff Paying Population | 80 | 20 |
| ost of Free Basic Services per person | 10 | 10 |
| otal Cost of Free Basic Services (indigent) | 200 | 800 |
| quitable Share (8 x indigent) | 160 | 640 |
| ost Financed by Cross-subsidisation | 40 | 160 |
| er Capita burden on Tariff Paying population | 0.5 | 8 |
| quitable Share for equal per capita burden | 40 | 760 |

# INEQUITY IN CROSS-SUBSIDISATION

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

# LGES: HOW EQUITABLE?

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

# SUMMARY: IMPACT OF LGES

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

# COMPROMISING HORIZONTAL EQUITY

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

# CONSEQUENCES

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

# SOLUTION

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

# CONCLUSION

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