Financial and Fiscal Commission

Submission
Division of Revenue 2003/04

30 April 2002

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AND FISCAL
COMMISSION

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ABBREVIATIONS

AUSAID	Australian Agency for International Development
CBOs	Community-based Organizations
CHC	Community Health Centre
CHP	Centre for Health Policy
CMBS	Constitutionally Mandated Basic Services
CMIP	Consolidated Municipal Infrastructure Programme
CSSR	Comprehensive Social Security Review
DBSA	Development Bank of Southern Africa
DME	Department of Mineral and Energy Affairs
DoE	Department of Education
DoH	Department of Health
DPLG	Department of Provincial and Local Government
DSD	Department of Social Development
ECD	Early Childhood Development
EDI	Electricity Distribution Industry
EDIRC	Electricity Distribution Industry Restructuring Committee
ERIC	Electricity Restructuring Interdepartmental Committee
FFC	Financial and Fiscal Commission
FMS	Financial Management System
GAMAP	Generally Accepted Municipal Accounting Practice
GGP	Gross Geographic Product

HBC	Home-based Care
HEU	Health Economics Unit
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immune Deficiency Syndrome
HST	Health Systems Trust
IGFR	Intergovernmental Fiscal Relations
INCA	Infrastructure Finance Corporation
KZN	KwaZulu Natal
MEC	Member of Provincial Executive Council
MTEF	Medium Term Expenditure Framework
NDMC	National Disaster Management Center
NaTIS	National Transportation Information Systems
NGOs	Non-Governmental Organizations
NIP	National Integrated Plan (for children infected & affected by HIV/AIDS)
PAYG	Pay-as-you-go
PFMA	Public Finance Management Act
PHC	Primary Health Care
PMTCT	Prevention of Mother-to-Child Transmission
PPP	Public-Private Partnership
RED	Regional Electricity Distributor
RRSP	Registered Retirement Savings Plan
RTS	Representative Tax System
SARS	South African Revenue Services
TB	Tuberculosis
VCT	Voluntary Counselling and Testing

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FOREWORD

A feature of this report is that the Commission addresses issues arising from its submission on the 2001/04 MTEF Cycle (May 2000) and also follows up on some of the proposals made in the submission on the Division of Revenue 2002/03 (June 2001). Also covered in the report are recent developments in the intergovernmental fiscal relations system relating to social security reform and local government.

The structure of the submission emphasises the importance of addressing fiscal issues across all three spheres of Government. It introduces the theme of "cross-cutting issues," which relate to the equitable share and, affect all spheres of government. The issues raised and proposals made in this submission respond to recent policy developments and also seek to address the concerns of key stakeholders.

With respect to the Commission's Submission on the Division of Revenue 2002/03, the FFC notes that Government's response was generally positive. This response is contained in Annexure E of the Division of Revenue Act 2002/03. In it Government concurs with the FFC view for the need to consider a review of the current division of revenue formula. It however took the view – which the Commission shares – that such a review should take place only once the results of Census 2001 are released.

There is also concurrence between Government and the FFC on the need to develop more precise information necessary for the determination of the cost of constitutionally mandated basic services (CMBS). With respect to infrastructure, the Commission will be focusing on developing a proposal of a formula mechanism that can be utilised for the allocation of capital grants on an equitable basis. Indeed the FFC has already begun work on refining its capital grants scheme with a view to enabling more comprehensive coverage of provincial infrastructure needs.

With regard to local government fiscal matters, Government supports the general thrust of the Commission's proposals and indeed finds them substantive and timely given the policy issues currently under discussion.

This submission is the product of considerable collaboration and research. The Commissioners would like to thank the members of all departments, intergovernmental forums, and relevant Ministries who contributed to this document with their information, insights, and criticisms.

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In shaping the contents of this submission, the FFC drew on the knowledge and insights of technical advisors. Their international experience greatly enriched the approach of the Commission to the complex fiscal issues addressed in this Submission. These advisors included Andrew Reschovsky (United States), Ronald Neumann (Canada), Robin Boadway (Canada), Raja Chelliah (India), Diane McIntyre (South Africa), and David Solomon (South Africa).

The Commission would also like to express its gratitude to the Secretariat of the FFC, namely, Myron Peter, Hildegarde Fast, Bongani Khumalo, Conrad van Gass, Patrick Mabuza, Betty Kaseke, and Vincent Makinta. In addition, the logistical support from Antonette Smit, Annaleeze Prosee, Mavuso Vokwana, Cindy Bruce, Kim Biko, Deliswa Schoeman, Annah Mosiane, and Lyn Desai was equally important in making sure that the processes to produce the document were on track.

This submission would not have been completed without the involvement and participation of Commissioners at various project review sessions and Commission meetings. Finally, the Commission would like to express special appreciation to the work of those Commissioners whose term of office has come to an end. Their work and expertise in the various areas of the Commission's work has been invaluable.

As Commissioners and the Executive of the Financial and Fiscal Commission we, the undersigned, are pleased to submit this Annual Submission in accordance with the obligations placed upon us by the Constitution of the Republic of South Africa.

For and on behalf of the Commission

Chairperson:	Murphy Morobe
Deputy Chairperson:	Jaya Josie
Date:	30 April 2002

EXECUTIVE SUMMARY

This report is presented in terms of Sections 214(2), 229(5) and 230(2) of the Constitution of the Republic of South Africa, read in conjunction with Section 9 of the Intergovernmental Fiscal Relations Act of 1997.

Taking into consideration the relevant sections of Chapter 13 of the Constitution, the Financial and Fiscal Commission's (FFC) responsibility is to make recommendations that inform the intergovernmental policy-making process. The FFC has however noted in the past that it remains the role of the three spheres of government and their legislative structures to determine fundamental policy objectives and priorities. The Commission continues to maintain this approach.

With respect to the Submission for the Division of Revenue 2002/03, the Commission notes that Government's response to the proposals was the culmination of substantial consultation with national, provincial, and local government and other stakeholders. Consultative discussions were held during 2001 in national and provincial parliamentary forums, the Budget Council, and the Budget Forum. The Commission also notes the role played by the National Council of Provinces' Select Committee on Finance in facilitating the consultation process with provincial legislatures and local government representatives.

Some of the issues highlighted in this submission require urgent attention. It is important that there exist a consensus on the policy framework for municipal borrowing. Flexibility that allows for easy access to loans is fundamental for increased private sector investment in local infrastructure, which in turn is necessary for improving the delivery of basic services. In this regard, the Commission recognises the lack of uniformity in the local government sphere and hence unequal access to finance markets. The Commission reiterates the need for an asymmetric approach to the municipal borrowing market, with different municipalities being treated differently.

Equally important in this report are proposals on the issue of HIV/AIDS. In its submission for the MTEF 2001/04, the FFC recommended that a variable for HIV/AIDS should not be included in the equitable share formula but that it rather is funded through a national conditional grant. The Commission reiterates this position and calls for greater flexibility to allow for provincial governments to find more innovative ways for dealing with the epidemic. The need for more complete data on the impact of HIV/AIDS cannot be overemphasised.

Another emerging policy development is the Comprehensive Social Security Review (CSSR). It is envisaged that the introduction of the CSS programme may have significant implications for fiscal arrangements in the coming years. It is important that Government's consideration of the proposals is parallelled by an understanding of the changes to current intergovernmental fiscal arrangements that may be required. As a first step, the Commission provides a set of guidelines for the assessment and evaluation of the CSSR Report. The Commission notes that due to the fact that the report is not yet available for FFC consideration, a comprehensive FFC submission will only follow later in the year.

At the close of six years of fiscal reform in South Africa, the Commission believes that it is an opportune moment that a comprehensive review of the intergovernmental fiscal relations system is undertaken. Given the variety of demands in the system, both from a policy and from an institutional point of view, it is important to reflect on the performance of the system in a manner that prepares it for future challenges. This should assist the intergovernmental system to face the developmental needs of the nation in a more effective and efficient manner.

This submission makes proposals across the three spheres of government. It also presents summaries of all submissions that were made to Parliament during the course of the 2001/02 fiscal year. These are submissions made either in terms of relevant legislation or in terms of special requests from different organs of state. The submission also includes follow-up work on proposals that were made in the FFC's Submission for 2002/03.

FFC Submission for the 2003/04 Division of Revenue

The following summary therefore seeks to capture the key points that are dealt with more extensively in the main body of this report.

Local Government

1. With regard to municipal borrowing and municipal finance markets:

The Financial and Fiscal Commission:
- reiterates its proposal that there be a combination of market discipline and the rules-based approach applied to the municipal borrowing market.
- is of the view that there be a differentiated approach to the borrowing market, with classes of municipalities being treated differently according to objective criteria.
- is of the view that those municipalities that are able should continue to issue bonds and access other forms of loan finance.
- advises that municipalities that have no capacity to access debt should be assisted through deliberate policy measures to build their creditworthiness. This objective should be supported through the capital grants system and other appropriate forms of funding and capacity building.

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2. With regard to the Municipal Finance Management Bill, 2001:

The Financial and Fiscal Commission:

- is of the view that clearer lines of accountability and relationships be required between the three spheres of government with respect to municipal borrowing.

3. With regard to the division of powers and functions between district and local municipalities:

The Financial and Fiscal Commission proposes:

- that the following principles inform the division of powers and functions:
  - Existing local government policy should inform the division. Local municipalities should therefore be responsible for the delivery of municipal services, and district municipalities should be responsible for district-wide and support functions; and
  - Issues of redistribution should not determine the division of powers and functions between local and district municipalities, given the primary role that national government should play in funding redistribution.
- that district municipalities be the service authorities for municipal health services, except where efficiency considerations dictate otherwise.
- that district municipalities play no role in the distribution of electricity.
- that local municipalities be the service authorities for water and sanitation services, and district municipalities should be responsible for sanitation promotion (as part of their municipal health function).
- that both district and local municipalities be empowered to operate municipal enterprises such as abattoirs and fresh produce markets. District municipalities should bear responsibility for regulating the public health aspect of these enterprises.

4. With regard to the remuneration of municipal councillors:

The Financial and Fiscal Commission proposes:

- that resources for the remuneration of councillors be channelled through the existing Institutional grant of the local government equitable share.
- that the current Institutional grant be reviewed in light of the most recent legislation and regulations concerning councillor remuneration.

5. With regard to the restructuring of the Electricity Distribution Industry:

The Financial and Fiscal Commission proposes:

- that no stakeholder should experience a deterioration in its circumstances owing to the restructuring process, unless this is an explicit policy decision.
- that tariff support to low-income consumers be financed primarily by a national grant to REDs for the provision of free electricity, and to a lesser extent by a consumer cross-subsidy.

- that capital electrification for low-income consumers be financed by national government, and provision for this should be made in the MTEF Estimates.
- that the local government levy be made available to all municipalities.
  - Municipalities should be allowed to set the levy up to a maximum level.
  - The possibility of allowing a higher cap for distributing municipalities should be investigated, so as to take account of the net loss experienced by some municipalities.
  - The local government levy should not be phased out unless fiscal mechanisms are in place to fully compensate for the loss of revenue.
- that, with respect to the cap of R2.4bn placed on local government revenue:
  - The figure of R2.4bn should be re-examined.
  - Given the increasing loss in receipts to local government implied by the restructuring process, consideration should be given to regular increases to the absolute cap on local government revenue.
- that consideration be given to introducing a “local government levy” for large customers, with the levy being imposed by national government and disbursed through the local government equitable share.
- that the restructuring process focus on compensation to municipalities through the local government levy and not through dividend income.
- that the REDS structure ensure that accountability for efficient service delivery is promoted in a simple and effective way.
- that municipalities be compensated for all losses related to the transfer of electricity distribution to REDs.
- that the advantages and disadvantages of retaining consolidated billing systems with municipalities be carefully weighed, and measures should be implemented to retain the advantages.
- that RED boundaries be co-terminus with municipal boundaries to ensure that residents of a given municipality do not fall within different REDS and hence under different tariff structures.
- that implementation of any proposals be carefully phased in due to the integral role played by electricity provision in the system of local government finance.

Provincial Government

1. With regard to the Provincial Tax Regulation Process Bill:

The Financial and Fiscal Commission proposes that the Bill:
- should specify criteria against which the Minister measures provincial tax proposals.
- should clarify the implications and procedures relating to capacity limitations of SARS in advance.
- should allow provinces maximum flexibility in determining tax rates within tax rate bands.
- should include guidelines with regard to tax room and equalisation measures, where certain taxes have implications for the equitable share revenue pool.
- should specify regulations for dispute resolution, especially where a province may fail to reach an agreement with SARS on certain tax proposals.

- should include a clause for dealing with the impact of a proposed provincial tax or surcharge on local government finances.

2. With regard to Early Childhood Development (ECD):

The Financial and Fiscal Commission proposes:
- that the current conditional grant funding arrangements for ECD continue until ECD can be fully incorporated into the Provincial Equitable Share formula.

3. With regard to HIV/AIDS:

The Financial and Fiscal Commission:
- confirms its previous position that conditional grants remain the most appropriate mechanism for targeting spending on HIV/AIDS.
- proposes that the development of a suitable data and information base on HIV/AIDS be prioritised.

Cross-cutting Equitable Share Issues

1. With regard to social security:

The Financial and Fiscal Commission:
- proposes that its guidelines be used to assist interested stakeholders in reviewing the Comprehensive Social Security Review Report. The guidelines pertain to:
  - The principles and criteria which may be used;
  - The background and context which must be developed;
  - The range of services which might be encompassed; and
  - The financial and administrative frameworks needed for the implementation of social security policy.
- For the interim, re-iterates its proposals that old age and veteran pensions be budgeted and administered by national government.
- In the medium- to long-term, believes that social security should be a national responsibility administered through the establishment of a national social security agency. Among other functions, the core business of the agency would be the payment of old age and child support grants.

1. With regard to the review of the intergovernmental fiscal system:

The Financial and Fiscal Commission:
- In anticipation of the review of the current intergovernmental fiscal mechanisms and processes, wishes Parliament and Government to consider:
  - The possible incorporation of elements and parameters in the intergovernmental transfer formulae that will balance the need to provide constitutionally mandated

obligations with the considerations listed in Section 214(2)(a-j) of the Constitution;
- The need for substantial improvement in data collection to enhance the development of intergovernmental fiscal mechanisms consistent with constitutional requirements; and
- The development of specific intergovernmental fiscal capacity building programmes, both inside and outside of Government.

2. With regard to disaster management funding:

The Financial and Fiscal Commission proposes:
- that central funding mechanisms for disaster management be introduced, so as to ensure that budget frameworks and the delivery of constitutionally mandated basic services are not compromised.
- that local municipalities be primarily responsible for the co-ordination and management of local disasters, unless they lack the necessary capacity.
- that start-up costs for emergency preparedness for local government be funded from a national conditional grant targeted primarily at municipalities with little capacity.
- that on-going institutional costs for emergency preparedness be incorporated into the equitable share.
- that funding for prevention/mitigation projects be provided by national government to provinces and municipalities on a matching-grant basis.
- that a portion of the contingency reserve be used to fund emergency response activities once provinces and municipalities have exceeded a specified financial threshold of disaster response expenditure.
- that national departments, provinces, and municipalities submit requests for reconstruction funding to national government. A budget appropriation, based upon the sum of the approved claims, would be requested.
- that the three relief funds administered by the Department of Social Development be combined and administered centrally. Where budgeted funds are exceeded, the contingency reserve could be drawn upon.

3. With regard to the central contingency reserve:

The Financial and Fiscal Commission proposes:
- that a more defined legal basis be provided for the contingency reserve. This should ensure that the reserve is for emergency purposes.
- that the contingency reserve for a relevant budget year be allocated for two emergency purposes, namely macroeconomic stability and response to natural or human-made disasters.
- that the "new spending priorities" of the outer years of the MTEF be categorised separately as the "policy reserve".
- that the Municipal Finance Management Bill include a provision that empowers municipalities to make appropriations to defray expenditure of an exceptional nature (similar to the provisions of Sections 16 and 25 of the PFMA).
- that provinces and municipalities should exercise their discretion in determining how to build flexibility into their budgets.

LOCAL GOVERNMENT

The Commission proposed a framework for local government finance in its Submission for the Division of Revenue 2002/03. This framework included proposals to introduce a comprehensive fiscal capacity measure in the local government formula, an evaluation of funding arrangements for district and local municipalities, and an assessment of infrastructure funding and financing.

This Submission takes this work forward as follows:
- *Municipal borrowing:* further analysis is provided, and details are added to the proposals for 2002/03. A summary of the FFC's submission on the Municipal Finance Management Bill, which has implications for municipal borrowing, is also included.
- *Funding of district and local municipalities:* in response to changes to the Municipal Structures Act of 1998, the Commission provided an assessment of the division of powers and functions between district and local municipalities. This submission was presented to Parliament and Government in July 2001, a summary of which is provided here.
- *Equitable share:* a brief summary of the FFC's research into fiscal capacity is provided, and five fiscal capacity measures are identified for modeling and further research. The Commission has embarked on a two-year research project on municipal service costs, the results of which will be reported on in the Submission for the Division of Revenue 2005/06.

Two further issues arose in the course of 2001, to which the Commission responded. These are as follows:
- *Electricity restructuring:* Cabinet has approved the restructuring of the electricity distribution industry in South Africa, which will involve the transfer of municipal distribution to Regional Electricity Distributors. As the restructuring process has significant implications for local government finance, the Commission provided its comments to Parliament and Government in March 2002. A summary is provided in this document.
- *Remuneration of councillors:* in response to a proposal that the salaries and allowances of municipal councillors be paid directly by national government, the Commission submitted its comments on the issue in July 2001.

1. Municipal Borrowing and Municipal Finance Markets

1.1 Introduction

In order to realise Government's objective to deliver basic services to all citizens, there is a need to increase investment in infrastructure at municipal level. Constitutionally, municipalities carry responsibility for the provision and management of local services, including electricity, water and sanitation, municipal roads, and waste removal. They are also responsible for community facilities such as recreation amenities and health clinics.

Intergovernmental transfers, such as the Consolidated Municipal Infrastructure Programme (CMIP) and the equitable share, may not be sufficient to deal with existing backlogs, especially in rural municipalities. Municipalities will therefore need to obtain additional funding through loan finance.

In its Submission for 2002/03, the FFC described the trends in municipal borrowing, outlined the key challenges, and made the following proposals:

- Government should create the conditions necessary for the emergence of a local government borrowing market through enhancing debt management capacity and implementing a rules-based approach to complement market discipline.
- Government should give consideration to the extent to which different categories of municipalities may pledge their equitable share revenue to access debt.

Government has indicated that rules-based limits are not appropriate for countries with well-developed capital markets, as in South Africa, and that restricting the use of the equitable share would impede budgetary discretion.

The Commission maintains the position that a rules-based approach is applicable in a context where there is tremendous variation in the fiscal and management capacity of municipalities. This section extends the analysis provided by the FFC for the Division of Revenue 2002/03 and makes further proposals with respect to reforms.

1.2 Recent trends in the municipal debt market

Until 1998, local government access to capital markets was assisted to a significant extent by the system of "Prescribed Asset Requirements". This system required certain financial institutions to invest a specified percentage of their resources in municipalities. This created a large demand for local securities. When Government repealed the system of "Prescribed Assets Requirement", only a few institutions retained their investments in municipal debt.[1]

[1] F. Putman (2001), *"Outline for possible stock issue for Durban Metro,"* Discussion document presented at a workshop on municipal bonds in South Africa, Durban.

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A recent National Treasury study on municipal debt reached the following conclusions:

- The growth in municipal debt over the period 1997-2001 has been below the economic growth rate;
- There is a relative increase in the public sector's contribution to municipal lending due to the activities of the Development Bank of Southern Africa (DBSA);
- Significant changes have occurred with respect to the composition of private sector finance, with insurance and other institutional investors reducing their contribution relative to banks;
- The Infrastructure Finance Corporation (INCA)[2] has increasingly replaced most private sector investment and has become the major source of private finance for municipalities; and
- Long-term lending and securities funding has diminished, while short-term lending in the form of revolving overdrafts has remained fairly stable over the period.[3]

In the first quarter of 2001, total outstanding municipal debt was at R19.3 billion, a three percent nominal increase from 1997. This represents a real decline in the level of outstanding debt over the period. The decline in municipal debt funding levels is attributed to the erosion in the perceived creditworthiness of most municipalities. It was also due to certain changes in the institutional environment and the composition of instruments in the borrowing market.

The municipal debt market has therefore become concentrated among a few lenders. Loans are extended primarily to larger urban municipalities. The trends indicate that certain problems need to be addressed if successful market-driven regulation is to be achieved.

1.3 Government's proposed policy framework for municipal borrowing

Government intends to encourage the emergence of a vibrant and innovative primary and secondary market for short- and long-term municipal debt.[4] It wishes to avoid underwriting municipal debt.

Government would like to promote the development of a securities market where municipalities may issue debt in the form of bonds that may be traded in secondary markets. This is likely to emerge only in the longer term. The framework also aims to promote growth in the market for other forms of debt (including bank lending).

The stated policy of national government is that market discipline is the instrument that will regulate the lending and borrowing activities of market participants. The proposed framework creates an independent institution, the Municipal Financial Emergencies Authority, which will intervene in the activities of those municipalities that may not be able to meet their obligations to creditors.

INCA is a private sector financial ıstitution that offers long-term loans to municipalities. The establishment of INCA resulted in urance companies and pension funds swapping their ıunicipal portfolios INCA bonds. The esult was a decline the share of these stitutional investors in municipal loan funds from 22 ercent to 4 percent over the review period.

National Treasury (2001), *"Trends in municipal debt."* Unpublished cussion document.

National Treasury (2000), *Policy Framework for Iunicipal Borrowing and Financial Emergencies.*

In its Submission for 2002/03, the FFC proposed that a rules-based approach to complement market discipline was more practical in the South African context. While the Commission recognises the merit of market discipline, current realities would call for a more cautious approach, especially given the unequal access to credit by different groups of municipalities.

The merits and demerits of the two approaches are as follows:

- *Market Discipline:* This approach requires the satisfaction of certain conditions. Firstly, markets should be without any regulations, such as reserve or portfolio composition requirements on financial institutions. Second, there must be free and available information on borrowers' outstanding debt and repayment capacity to both lenders and borrowers. Third, there should be no perceptions of potential bailouts in cases of default. Finally, there should be sufficient institutional infrastructure to ensure that borrowers are capable of adequately responding to market signals before they are excluded from any new borrowing.

  For the most part, these conditions do not exist in South Africa. While desirable, market discipline cannot be relied upon as a sole regulatory instrument given the stringent conditions that are unlikely to be met.

- *Rules-based Approach:* The rules-based approach refers to rules specified in the Constitution or other legislation. The rules may set limits on the absolute level of indebtedness, specific purposes for borrowing (typically infrastructure), maximum debt-service ratios, and allowable markets (for example, no foreign borrowing). Many countries in the world tend to limit borrowing to investment projects and require that short-term borrowing be limited to bridging finance and be paid off by the end of the fiscal year.

  The rules-based approach has the advantage of being transparent. There is also the advantage that protracted bargaining between central and subnational jurisdictions can be limited.[5]

  A disadvantage with the rules-based approach is its lack of flexibility. This may foster inefficient behaviour aimed at circumventing the rules. Such behaviour may be in the form of reclassification of expenditure from current to capital. In general, a rules-based approach requires clear and uniform accounting standards, comprehensive definitions of what constitutes debt, and a modernisation of government financial management and information systems.

While sole reliance on market discipline may be appropriate in the longer term, a rules-based approach is a necessary complement in the short- to the medium-term because it takes account of current South African realities.

[5] T. Ter-Minassian (1997), *"Control of Subnational Borrowing," in T. Ter-Minassian & J. Craig (eds.), Fiscal Federalism in Theory and Practice* (Washington: International Monetary Fund).

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1.4 Constraints to the emergence of subnational debt markets

1.4.1 The structure of subnational debt markets

Subnational finance markets are characterised by principal-agent relationships between three types of entities: central government, private investors, and subnational entities (provinces, municipalities, and utilities owned by them). There are certain problems associated with each of these agency relationships:

- ***Hidden action:*** subnational governments as borrowers may have incentives not to repay debt because they perceive that they will be bailed out by national government in case of default. This means that the regulatory framework needs to specify that bailouts will not be resorted to in cases of default (adverse selection).
- ***Hidden information:*** subnational governments may have an incentive not to reveal certain characteristics about themselves to lenders, resulting in adverse selection. The problem can be reduced with clearly defined disclosure requirements (moral hazard).[6]

These agency problems manifest themselves differently. In monopolistic subnational debt markets, where central government provides capital grants and also lends to subnational governments, two sets of agency problems arise:[7]

- ex post conversion risk: subnational governments use conditional grants for purposes other than those intended by central government;
- ex post efficiency risk: inefficiency results from the lack of incentives on the part of subnational governments to deliver best effort in undertaking projects.

In competitive markets, the moral hazard problems associated with a monopolised system are greatly reduced. Here, central government capital grants exist but private financial intermediaries are the principal lenders.

In mixed markets, moral hazard problems relate to the existence of multiple channels for lending. Multiple-principal multiple-agent relationships and implicit or explicit national guarantees increase moral hazard and adverse selection risks. The mixed subnational debt market is characteristic of most developing and transitional economies, South Africa included.

1.4.2 Moral hazard

The way in which interventions are structured and the actual loss imposed on the parties concerned determines the extent of bailouts and the degree to which intervention increases moral hazard.

Limitations on subnational fiscal autonomy breed moral hazard problems. In a system where a large share of local expenditures is mandatory, moral hazard increases

[6] M. Noel (1999), *"Building Sub-national Debt Markets in Developing and Transition Countries,"* (Washington: World Bank Institute).

[7] Noel, *"Building Sub-national Debt Markets"*.

because of expectations that national government will intervene in crisis periods. On the revenue side, limited subnational revenue sources and lack of flexibility on the choice of the tax bases and/or tax rates also increases moral hazard.

Public debt legislation that fails to include guarantees and other contingent liabilities as parts of subnational debt increases moral hazard. Legislation should explicitly state that there would be no bailout of subnational debt. There may be case-by-case exceptions, but the procedures for dealing with such cases must be clarified in legislation.

Lenders may interpret prudential guidelines and/or prior approval of subnational borrowing as an implicit guarantee of debt by national government. This increases expectations of bailouts. While such limits may be necessary in mixed markets as a signal of financial stress, they should be progressively relaxed and eventually phased out as market discipline strengthens.

1.4.3 Lack of market transparency

In many countries, weaknesses in local government budgeting, accounting and auditing reduce the quality and reliability of information. Multi-year budgeting with clear distinctions between capital and recurrent expenditures is a critical element for improving this situation. Currently, the accounting framework appears to lack guidelines for asset-liability management, which complicates decisions on the appropriate interest rate, maturity and structure of borrowings by the jurisdiction.

1.4.4 Weakness of market governance

In many developing and transition countries, investors and financial intermediaries are reluctant to enter the subnational debt market because of a weak regulatory and institutional environment. In such situations, a clear local government bankruptcy framework is a necessary condition to reassure investors. An independent judicial body that is beyond the influence of political pressure and implements the framework is equally important.

1.4.5 Lack of financial management capacity

Municipalities should be provided with the incentives to establish transparent financial management practices and sound budgeting processes.

1.5 Building subnational debt markets in South Africa

The municipal borrowing framework proposed by Government recognises that municipalities are not uniform, yet there is no plan to target this lack of uniformity.

The FFC cautioned against the blanket treatment of municipalities in its Submission for 2002/03. This proposal was made in the context of significant differences in fiscal capacity

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between municipalities and the historical imbalances of the apartheid era, when black local authorities were excluded from participating in the market.

In order to address the differences in fiscal capacity (an important consideration for creditworthiness), an asymmetric approach to the borrowing activities of different municipalities may be more appropriate.

1.6 The transition to a market-regulated municipal borrowing framework

The obstacles identified above form the core policy areas. The goal should be to move over time from a system characterised by various interventions towards the vision of a market-regulated municipal debt market.

The following matrix illustrates the proposed approach for the transition to a market-regulated municipal borrowing framework:[8]

Policy area	Short-term	Medium-term	Long-term
Reduce moral hazard	- Rationalise capital grants - Control fiscal liabilities of municipal entities - Remove soft budget constraints for municipalities	- Stabilise intergovernmental transfers - Establish local government authority over own revenue sources - Establish explicit rules for grant allocations - Monitor conversion of capital grants - Establish provisioning rules for municipal contingent liabilities	- Diversify own revenue bases - Limit capital grants to cover cost of externalities that are difficult to internalise - Progressively relax rules relating to municipal borrowing in line with the opening of market competition
Improve market transparency		- Enforce separate current and capital accounts in municipal budgets - Strengthen local government auditing - Define specific formats for debt disclosure	- Strengthen local government accrual accounting system - Review formats for debt disclosure in line with local government accrual accounting system
Strengthen market governance		Ensure equal treatment of municipal entities in commercial code	Put in place transparent measures to protect the rights of borrowers and lenders
Establish a level playing field in the market	Clearly distinguish between other central government financing schemes and the capital grant system	Phase out government financing schemes	Strengthen state-owned financial institutions
Develop municipal capacity for budget, accounting and financial management			

[8] Adapted from Noel, *"Building Sub-national Debt Markets"*.

1.7 The role of the Development Bank of Southern Africa

The use of parastatal intermediaries to accelerate the emergence of a municipal credit market has been successfully used in a number of countries, notably Colombia and the Czech Republic. In Brazil and India, individual states have set up municipal development funds that have been favoured by multi-lateral development banks as a channel for loans to local authorities.[9]

In the short run, these development intermediaries have to disburse publicly provided credit to local governments and ensure that local investment is efficiently implemented. In the medium- to the long-term, they are supposed to pave the way for a self-sustaining credit system that can access private-market capital.

These intermediaries can be viewed as an instrument to demonstrate that lending to municipalities is good business. The activities of these institutions expose the obstacles faced by municipalities, and the borrowing and lending experience can then be translated into the private sector. If the learning experience were acquired through private sector lending, the potential wave of municipal defaults could turn away private lenders from the municipal market for long periods.

The DBSA's role in this respect could be viewed as part of a continuum in municipal lending, with its success being measured by the number of municipalities that "graduate" to private sector borrowing through having demonstrated creditworthiness under the DBSA. In a dynamic credit system, the best credits will self-select and leave the DBSA to concentrate on the smaller and poorer municipalities.

However, the DBSA should not be viewed as a holder of bad loans. Empirical evidence shows that non-performing loan rates from development parastatals range from 0 percent in the Czech Republic and two percent in Brazil to fifty percent in Honduras, thirty percent in Indonesia, and eighty percent in Kenya. In general, sectoral lending institutions should be set up to clarify credit risks and to help lower risks to reasonable levels through changes in local financial management, intergovernmental financing, and the way in which projects are appraised.[10]

The DBSA can thus be assisted and encouraged to function as an instrument to bring poorer municipalities that have no borrowing history into the mainstream. This is not to suggest that the Bank should provide subsidised loans to poor municipalities, but rather that it may assist such municipalities by providing the necessary capacity through accounting, disclosure and auditing procedures. The graduation of clients to the private market means that the bank can concentrate on higher-risk municipalities and constantly strengthen their creditworthiness.

[9] S. Peterson (2000), *"Building Local Credit Systems,"* Paper published for the Urban Management Program of the World Bank, Washington DC.

[10] Peterson, *"Building Local Credit Systems"*.

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1.8 Conclusions

In order to successfully expand domestic capital markets, it is necessary to:

- Ensure a reasonable match between expenditure responsibilities and revenue sources;
- Strengthen local government institutions, including improved capacity for financial reporting;
- Develop legal, regulatory, and supervisory frameworks consistent with the level of capital market development; and
- Minimise moral hazard.

The current state of the borrowing market in South Africa indicates a concentration of lending among a few institutions. This development does not augur well for the future of municipal capital markets, especially if the long-term vision is that of a market-regulated borrowing environment. This requires that certain conditions be in place, of which competition is very important.

1.9 Proposals

In light of the above discussion, the FFC proposes the following:

- There should be a combination of market discipline and the rules-based approach applied to the municipal borrowing market. This proposal is a reiteration of a previous recommendation made on the same issue.
- There should be a differentiated approach to the borrowing market, with classes of municipalities being treated differently according to objective criteria.
- Municipalities that are able should continue to issue bonds and access other forms of finance.
- Municipalities that have no capacity should be assisted through deliberate policy measures to build their creditworthiness. This objective should be supported through the capital grants system and other appropriate forms of funding and capacity building.

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2. Summary of Submission: Municipal Finance Management Bill, 2001

The Municipal Finance Management Bill of 2001 covers a wide range of issues, including national and provincial supervision, municipal revenue and budgets, municipal debt, budget and treasury processes, council responsibilities, and financial misconduct. The Bill is aimed at securing transparency, accountability and sound management of the revenue, expenditure, assets, and liabilities of municipalities and municipal entities.

The Commission presented its comments on the Bill to Parliament on 13 February 2002, a summary of which is provided below.

2.1 General comments

The Financial and Fiscal Commission believes that the Bill will contribute to the modernisation of budgeting processes in the local sphere of government. The combination of discretion and oversight in a national context is well balanced. Municipalities are given discretion over own budgets and debt, with the proviso that they conform to reasonable requirements on budgeting, debt management, accountability and decision-making. However, there are a number of issues that need to be clarified.

The Commission is concerned that the Bill adopts a uniform approach to municipalities, from the metropolitan municipalities through to small, fiscally weak local municipalities. The Bill should provide for municipalities to be classified according to objective criteria, with different provisions and regulations applying to different categories. The current rules may not be enough for smaller municipalities, while they may also be too rigid for larger municipalities.

The FFC therefore proposes that the Bill should empower the Minister to adjust or relax provisions for municipalities that meet objectively determined criteria. This implies a segmented approach that recognises the significant differences between South African municipalities.

The Bill does not make it clear whether municipalities are accountable in the first instance to the relevant Provincial Treasury or to National Treasury. In many decentralised systems of government, accountability is normally hierarchical, with municipalities accountable to provinces, and provinces to central government. The South African situation is more complex in that national government has oversight of macroeconomic issues. Furthermore, the spherical approach to intergovernmental relations in South Africa makes the lines of accountability difficult to implement.

It is recognised that, in a case of conflict, the oversight role of National Treasury will prevail. However, the role of National Treasury with respect to municipalities seems quite open-ended and not very well defined in the Bill.

The rules for debt are generally reasonable. Municipalities have substantial discretion to issue debt, albeit within prescribed limits. The proscription of national and provincial bailouts or debt guarantees is particularly welcomed by the FFC, since this promotes hard budget constraints for municipalities.

Nevertheless, the Bill should include procedures that would be followed in cases of potential or actual defaults by municipalities. The modalities of intervention in such cases are particularly important, especially with respect to those municipalities that have very little own revenue but are still expected to meet their constitutional mandates.

Any direct intervention by national and/or provincial government may send wrong signals about bailouts to municipalities and creditors, softening the budget constraint. There is also a need to clarify what happens in situations where an outgoing Council incurs non-productive debt that may seem to be immoral for the incoming Council to honour.

2.2 Specific comments

The Commission made a number of specific suggestions for certain sections of the Bill. The details can be found in the full document, which can be obtained from the FFC.

2.3 Conclusion

In general, the Bill goes a long way in addressing past problems associated with the lack of transparency, accountability and sound management of municipal finances. It augurs well for the reform of the management of municipal finances. It is important that careful consideration be given to establishing clear lines of accountability and relationships between the spheres of government. The combination of oversight and discretion in the Bill, while balanced, requires further deliberation in order to ensure that it establishes a firm foundation for strengthening inter-sphere co-operation over time.

3. Summary of Submission: Division of powers and functions between district and local municipalities

3.1 Introduction

In July 2001 the FFC submitted its comments on the division of powers and functions between Category C (district) and Category B (local) municipalities to local government stakeholders.

The submission was made in response to the Municipal Structures Amendment Act (hereafter "the Amendment Act"), which was passed by Parliament in October 2000. There was confusion and controversy regarding the amendments, and the lack of resolution retarded the process of stabilising local government in non-metropolitan areas. The FFC supports the resolution of the Presidential Coordinating Council of December 2001 that this matter be resolved as a matter of urgency.

As the financial consequences became evident to the FFC, the Commission decided in April 2001 to provide an evaluation of the Act. The FFC's submission focuses on the principles that should inform the division of powers and functions. These principles are then applied to water and sanitation services, electricity distribution, municipal health services, and fresh produce markets and abattoirs.

3.1.1 Legal context

The Municipal Structures Act of 1998 (hereafter "the Structures Act") made provision for the division of powers and functions between district and local municipalities. It assigned district-wide functions to district municipalities and most day-to-day service delivery functions to local municipalities. The provincial MECs were empowered to adjust these powers and functions according to the capacity of municipalities to deliver services.

The Structures Act was amended in October 2000, and the main changes were as follows:
- The functions of municipal health, potable water supply, distribution of electricity, and sewage disposal systems were transferred from local to district municipalities.
- The assignment of health, water, electricity, and sewage disposal can be adjusted by the national Minister (that is, s/he can assign a function to a local municipality). The authority to adjust the remaining municipal functions still lies with the provincial MECs.

The transfer of the four major municipal services has significant financial implications for non-metropolitan municipalities. For example, many local municipalities generate surpluses from water supply, and the relevant district municipality would now have jurisdiction over that funding.

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3.2 Principles to guide the assignment of powers and functions

3.2.1 Role of policy

The Local Government White Paper of 1998 states that the primary purpose of district government is to render district-wide functions, including district-wide integrated development planning and infrastructure development. The White Paper did not propose that district municipalities should exercise authority over the delivery of local services, except in cases where there were too few people to justify the establishment of a municipality with a full administration (later termed "District Management Areas" in the Structures Act).

The Structures Act gave effect to the principles outlined in the White Paper. Section 84 of the Act assigned functions to district municipalities which can best be described as "district-wide" functions. Section 85(2) empowered the MEC for local government in a province to adjust the division of functions between a district and a local municipality, but only if the municipality in which the function or powers is vested lacked the necessary capacity.

The Local Government White Paper therefore did not envisage the transfer of local functions to district municipalities on a permanent basis.

The current political systems in the local sphere of government also support this policy. Residents have no direct access to district councillors through ward committees or ward representatives, and they have limited contact with district administrations, which cover vast areas. There are therefore more direct mechanisms of accountability within local municipalities.

Principle 1:
In accordance with local government policy, the general default position should be that local municipalities are responsible for the delivery of municipal services. If a given local municipality does not possess the requisite capacity, a district municipality can provide municipal services directly until local capacity is developed.

3.2.2 General guidelines

The principles that should guide the assignment of powers and functions to district and local municipalities can be found in Section 152 of the Constitution, Section 25 of the Demarcation Act of 1998, the Local Government White Paper of 1998, and Section 83 of the Municipal Structures Act of 1998. Together, these principles point to two broad criteria that should be considered within the context of the division of powers and functions:
- Efficient, effective, and sustainable delivery of services; and
- The need to redistribute financial resources.

Each of these is considered in turn.

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3.2.2.1 Efficient, effective, and sustainable delivery of services

A policy framework for the adjustment of the division of powers and functions was published in July 2000.[11] Based upon the White Paper on Local Government, a number of factors are listed which should influence the division of powers and functions, namely:

a) Equitable, efficient, affordable, economical and sustainable access to basic municipal services by all consumers;
b) The placement of responsibility of providing municipal services as close as possible to the communities the services are meant to serve;
c) Minimising costs of services to consumers or customers;
d) Achieving economies of scale in the delivery of services;
e) Minimising jurisdictional spillovers;
f) Benefiting the greatest number of residents;
g) Causing the least disruptive effect on the delivery of services;
h) Promoting a safe and healthy environment;
i) Promoting efficient, effective and accountable public administration;
j) Promoting co-operative government; and
k) Addressing the historical inequalities of society.

The submission evaluates the nature of each service within the context of these factors (see 3.3.1, 3.3.2, 3.3.3, and 3.3.4 below).

3.2.2.2 The need to share and redistribute financial and administrative resources

The Local Government White Paper makes it clear that local government is expected to play an important role in redistribution. However, it is important to distinguish between mechanisms for redistribution, which may be developed within municipalities, and the sources of redistribution. In its submission on the Division of Revenue 2002/03, the FFC outlined the crucial role of national government in redistribution:

> A principle of public finance is that poverty alleviation should be financed through national tax revenues, because the base of national taxes is much broader than that of local jurisdictions. The tax incidence on any particular region or group is thereby minimised and economic distortions avoided.[12]

If poverty is addressed by the centre, and fiscal capacity fully incorporated into an equitable share formula, then municipalities will be required to indicate how resources are distributed in a jurisdiction, but they will not be required to be the primary source of funds for redistribution. This implies that issues of redistribution should not influence the division of powers and functions between local and district municipalities.

11 *General Notice 2592, 12 July 2000, Government Gazette 21370.*
12 FFC, *Submission: Division of Revenue 2002/03, June 2001, page 38.*

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Principle 2:
Issues of redistribution should not influence the division of powers and functions between local and district municipalities, given the primary role of national government in funding redistribution.

3.2.3 Allocation of funding to service authorities

If a municipality is responsible for a function, it implies that the funding for the function should be allocated to the same municipality. Current legislation makes it clear that only one authority carries final responsibility for ensuring that a function is fulfilled. As the FFC noted in its submission for 2002/03,

> Both the Municipal Systems Act and Water Services Act distinguish between a "service authority" and "service provider": a service authority is responsible for ensuring that a service is provided, but it may authorise another body (which may be a local municipality) to deliver the service. The FFC recommends that funding, including lifeline tariff funding, be directed to the relevant service authority.[13]

This is a key principle, for it means that if a district municipality carries final responsibility for a function, and that function generates revenue from user charges, the district municipality has jurisdiction over that funding source. Some of the specific implications are examined in the evaluation of the separate services in section 3.3 below.

A further implication is that the service authority should have jurisdiction over the capital infrastructure relating to a function and should be responsible for maintaining it.

Principle 3:
All funding for a municipal function should be directed to or should be under the jurisdiction of the relevant service authority.

3.3 Evaluation of municipal services transferred to district municipalities

3.3.1 Municipal health services

The *White Paper for the Transformation of the Health System in South Africa* (1997) recommended that a District Health System be established in order to address issues of equity, fragmentation, efficiency, access to services, and accountability. Health districts were to be established throughout the country, with each health district team being responsible for the planning and management of all local health services for a defined population.

[13] FFC (2001), *ubmission: Division of Revenue 2002/03, page 48.*

In the long term, local government is to be responsible for the health districts, and health districts are to be aligned with district and metropolitan municipal boundaries. However, there is some debate as to the optimal size of health service districts, which may be smaller than the areas encompassed by district municipalities.

Health service delivery is extremely complex as it requires the management of numerous elements. Unlike other municipal services, health service delivery requires a wide range of professionals, direct services, and support services. Furthermore, in order for health services to be effectively delivered at the local level, they must be integrated with other aspects of the health system (such as national health programmes and tertiary hospitals).

Owing to the various types of health services available within a district, significant spillovers can occur if services are not delivered on a district-wide basis. For example, each district will have an optimal number of Community Health Centres (CHC), but there may not be one CHC in each local municipal area.

Generally, the nature of health service delivery would suggest that district municipalities should be the service authorities for health service delivery. The exception to this is where a secondary city dominates the district municipality, as in Mangaung and Buffalo City. In such situations, the local municipality may have a population size that is conducive to economies of scale, and it may have more management capacity than the district municipality. Each secondary city should therefore be evaluated on a case-by-case basis to determine whether it should be designated as a health district.

The FFC supports the transfer of the function of "municipal health" from local to district municipalities for the following reasons:

- It is consistent with the policy of the National Department of Health; and
- It provides the necessary economies of scale and minimises spillovers, except possibly in the case of secondary cities.

3.3.2 Electricity distribution

The Energy White Paper of 1998 recommended that the electricity distribution industry be consolidated into the maximum number of financially viable and independent regional electricity distributors (REDs), and that cost-reflective tariffs and a municipal levy on electricity be introduced. The implication of the Amendment Act is that electricity distribution will first be transferred from local to district municipalities, and then from district municipalities to the REDs.

District municipalities have played no role in the bulk supply of electricity, which is supplied directly by Eskom to (distributing) local municipalities. The question is therefore whether the transfer of electricity distribution from local to district municipalities will serve a purpose. If district municipalities are assigned authority for electricity distribution, it could well be a costly exercise as it will entail two transfers of staff and assets: first from local to district municipalities, and then from district municipalities to Regional Electricity Distributors.

Furthermore, if the transfer of electricity distribution to district municipalities is fully realised, then the municipal levy will in future be channelled to district municipalities. It was estimated in 2000 that municipal levy and shareholding income will together generate approximately R2.4bn annually.

Currently, income from electricity plays a significant role in the finances of distributing municipalities. District municipalities would have access to a new revenue source, but local municipalities which generated surpluses on their electricity account would face significant financial problems.

The FFC therefore does not support the transfer of the function of electricity distribution from local to district municipalities for the following reasons:

- District municipalities are not in a position to play a meaningful service delivery or regulatory role in the distribution of electricity; and
- The channelling of electricity levy income to district municipalities will significantly weaken the service delivery capability of local municipalities.

3.3.3 Potable water supply and sanitation

The definition of "water services" in the Water Services Act of 1997 is "water supply services and sanitation services," which indicates that one service authority is responsible for both services. For example, a district municipality cannot be the service authority for water in a given local municipal area, while the local municipality is the service authority for sanitation in the same area.

However, there is a lack of clarity on the division of responsibility within the water supply and sanitation functions. The Structures Act assigned responsibility for bulk water supply and sewage disposal to districts, leaving the retail distribution to local municipalities. The difficulty is that the distinction between "bulk" and "retail" does not reflect the reality on the ground.

To address this, the Department of Water Affairs has moved away from the term "bulk services" and is considering two broad categorisations:

- Regional water schemes: these schemes currently transcend Category B and/or C boundaries; and
- Dedicated systems: in such systems, "bulk" and "retail" are integrated and provided within one boundary (whether Category C or B).

The key question is what the default position should be in the case of "dedicated systems," namely service delivery by district or local municipalities. The key principle that should guide this decision was outlined in section 3.2.1 above, namely that local municipalities should be responsible for the delivery of municipal services, where capacity exists.

A further reason for allocating this function to local municipalities is the need for integrated billing systems. Credit control can be more easily exercised if the municipal services to which service charges apply are delivered as one basket of services. Furthermore, the delivery of a set of services by one service authority facilitates the application of low-income subsidies. Currently, most local municipalities collect service charges for a number of services (with electricity, water, sanitation, and refuse removal being the most common), and removal of one service will compromise the further development of integrated revenue collection and credit control systems.

With respect to sanitation, there are two aspects to this service: that of waste-water disposal, which requires infrastructure and day-to-day operations, and that of sanitation promotion, which is related to the function of environmental health. Given the recommendation in section 3.3.1 above that district municipalities should be service authorities for municipal health, sanitation promotion should fall under the authority of district municipalities.

The following can be concluded from the discussion above:
- Water and sanitation services should be delivered by the same authority;
- A distinction should be made between sanitation services and sanitation promotion. Sanitation promotion should be the responsibility of district municipalities, given their responsibility for municipal health services;
- The fragmentation of retail service delivery between district and local municipalities will compromise the development of integrated revenue collection and credit control systems; and
- Where possible, the assignment of water and sanitation services to district municipalities should be avoided, except where local municipalities lack the necessary capacity.

3.3.4 Fresh produce markets and abattoirs

There are no policy documents that would suggest where responsibility for these two functions should rest. Both functions as listed in Schedule 5B of the Constitution as local government functions, namely a) licensing and control of undertakings that sell food to the public, and b) municipal abattoirs. The wording of the former indicates the public health aspect of the function, and municipal abattoirs are similarly important in the monitoring of environmental health.

Municipalities initially became involved with abattoirs for public health reasons. If the regulation and monitoring of abattoirs falls within the ambit of environmental health, the public health aspect should be the responsibility of the service authority for health. The same would apply to fresh produce markets, as the “control of undertakings that sell food to the public” (Schedule 5B of the Constitution) implies a public health role. As recommended in section 3.3.1 above, the service authority for municipal health should be district municipalities.

However, this does not imply that the authority that regulates the health aspect of abattoirs or markets has to be the authority responsible for operating the enterprise. Many municipalities operate fresh produce markets (and in some cases abattoirs) to generate income and to promote economic development, since the markets draw potential consumers and producers from a wide area.

In cases where a local municipality has initiated a market, and the market has grown to serve "a major proportion of the municipalities in the district," the local municipality could potentially lose control over a valuable source of income and a generator of economic development.

The FFC therefore proposes the following:
- A distinction should be drawn between the operation of fresh produce markets and abattoirs and the monitoring of their environmental health. Responsibility for operating such enterprises should not be exclusively vested in either Category B or Category C municipalities; and
- Given the public health aspect of both abattoirs and fresh produce markets, the service authority for municipal health services should be responsible for monitoring them.

3.4 Conclusions

The principles that should inform the division of powers and functions are:
- That existing local government policy should inform the division. Local municipalities should therefore be responsible for the delivery of municipal services, and district municipalities should be responsible for district-wide and support functions; and
- That issues of redistribution should not determine the division of powers and functions between local and district municipalities, given the primary role that national government should play in funding redistribution.

The conclusions of the submission are as follows:
- District municipalities should be the service authorities for municipal health services, except in selected large Category B municipalities.
- District municipalities should play no role in the distribution of electricity.
- Local municipalities should be the service authorities for water and sanitation services, and district municipalities should be responsible for sanitation promotion (as part of their municipal health function).
- There is no need to assign service authority over municipal enterprises such as abattoirs and fresh produce markets. District municipalities should bear responsibility for regulating the public health aspect of these enterprises.

4. Summary of Submission: Remuneration of municipal councillors

4.1 Introduction

In the first half of 2001, there were numerous reports regarding a proposal that the salaries and allowances of municipal councillors be paid directly by national government, rather than by municipalities. Since this proposal related to the local government equitable share, and more particularly its institutional component, the Commission submitted proposals on the issue. The FFC's proposals and comments were submitted to Government and Parliament in July 2001.

4.2 Evaluation

4.2.1 Constitutional principles

The Constitution established three spheres of government which are distinctive, interdependent, and interrelated (section 40). The legislative authority of national government is vested in Parliament, while that of provincial and local government is vested in Provincial Legislatures and Municipal Councils respectively (section 43). The resources to enable each sphere of government to fulfil its constitutional obligations are provided through an equitable sharing of nationally-collected revenue, which must take account of fiscal capacity (section 214).

Each sphere is constitutionally obliged to provide transparent and accountable government, which is effected through the election of national, provincial, and local representatives. It can be concluded that the remuneration of these elected representatives should come from each respective sphere of government, since the equitable share is to take account of the need for local government to perform its functions. Currently, the national and provincial spheres of government are responsible for the remuneration of Members of Parliament and Members of the Provincial Legislatures respectively.

Furthermore, elected representatives should be accountable first and foremost to the people who elected them. If elected representatives are remunerated by another sphere of government, the primary accountability would be to the sphere of government providing the remuneration, rather than to the people they serve. This would be contrary to the requirement that municipalities provide democratic government for local communities (section 152). It could also produce adverse effects. For example, if a municipality is experiencing a financial crisis and councillor salaries are paid directly by national government, then councillors would be shielded from the effects of the financial crisis for which they are accountable.

From a constitutional viewpoint, the remuneration of councillors should be provided from local government revenue (which includes own revenue and an equitable share allocation).

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4.2.2 Current mechanisms

The Department of Finance proposed a formula for the distribution of the local government equitable share in 1997, and the formula comprises an Institutional Grant (I) for the support of democratic local government. The I-grant is currently in place and can be used to fund councillor salaries and allowances. The debate should therefore not revolve around the mechanism for remunerating councillors but rather around its sufficiency.

4.2.3 Assessing the sufficiency of local government revenue

The call for the national remuneration of councillor salaries reflects the significant financial pressures faced by municipalities, and may reflect the vertical fiscal imbalance in the system.

Since the initial design of the I-grant, the Department of Provincial and Local Government (DPLG) has determined the upper limits of the salaries, allowances, and benefits of councillors, and new political systems and structures have been introduced in municipalities (for example, some councils now have full-time councillors).

However the current I-grant formula does not reflect the new salary guidelines and political systems. It is therefore necessary to review the I-grant in light of recent legislation and regulations. In this process, it would be important to ensure that the I-grant formula took account of new factors influencing institutional costs. For example, as population increases, the proportion of full-time councillors generally increases. At the same time, political decisions should not result in a municipality being allocated more funding (for example, through appointing more full-time councillors).

Recommendations:

- Resources for the remuneration of councillors should be channelled through the existing Institutional grant of the local government equitable share.
- The current Institutional grant should be reviewed in light of the most recent legislation and regulations concerning councillor remuneration.

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5. Summary of Submission: Restructuring of the Electricity Distribution Industry

5.1 Introduction

Since the early 1990s, there has been much discussion about the restructuring of the electricity distribution industry (EDI). This has been driven by the need to address the substantial fragmentation of the industry. In 1998, Cabinet approved the consolidation of the numerous current distributors into a limited number of Regional Electricity Distributors (REDs). The Department of Minerals and Energy (DME) recommended in January 2001 that six REDs be established based on the results of a series of modeling exercises.

The recommendations have significant implications for the intergovernmental fiscal system and more specifically for local government finances. In March 2002, the Commission submitted its comments on the restructuring proposals to Parliament and Government.

5.1.1 The reform of the electricity distribution industry

Electricity is distributed primarily by Eskom and numerous local municipalities. Municipal distribution differs greatly in terms of customer density, type of customer base, geographic spread, financial base, and effectiveness. The present structure of the electricity distribution industry has led to a wide disparity in cost, tariff and service levels. The quality of supply is poor in many cases. In addition, economies of scale and specialisation are not being captured by many of the small distributors. It has been estimated that if the industry is not restructured, electricity tariffs will rise by 40 percent in real terms in the next ten years.[14]

The Electricity Restructuring Interdepartmental Committee (ERIC) was tasked with developing a government position on the issue. Based upon the report, the Department of Minerals and Energy submitted a memorandum to Cabinet in 1997 that recommended the following:

- The electricity distribution industry should be consolidated into the maximum number of financially viable and independent regional electricity distributors; and
- Cost-reflective tariffs, an electrification levy, and a capped tax for part funding of municipal services should be introduced.

The recommendations were accepted by Cabinet and were subsequently confirmed and elaborated upon in the Energy White Paper of 1998.

To take the process forward, the Department of Minerals and Energy commissioned PricewaterhouseCoopers (PwC) to model the various RED options and to develop the proposals further. The team reported regularly to an Electricity Distribution Industry

14 DME (2001), *EDIRC Blueprint Report, Section 6.8. If the industry is restructured, it is estimated that tariffs will rise 22 percent in real terms over the next ten years.*

Restructuring Committee (EDIRC) and submitted its report to the Department in August 2000. The final recommendations of the EDIRC were submitted in January 2001.

5.1.2 Electricity restructuring and the intergovernmental fiscal system

The re-organisation of the electricity distribution industry has three significant implications for the intergovernmental fiscal system:

- The transfer of electricity redistribution from municipal distributors to REDs has significant implications for the local government finance system, with revenue and credit control being two of the factors affected;
- The final report of January 2001 proposes the introduction of a consumer cross-subsidy; and
- Eskom has financed the extensive electrification programme in recent years. With the conversion of Eskom into a tax- and dividend-paying entity - a situation that will also apply to the REDs - Eskom will not be financing electrification to the same extent, and new funding sources for the programme will have to be identified.

The restructuring of the electricity distribution industry is a complex process, involving aspects such as competitiveness, profitability, and cost structures. Given the legislative mandate of the FFC, the analysis that follows focuses on the implications of the proposals for the intergovernmental fiscal system and the overall system of local government finance.

5.1.3 Principles

Over the years, the FFC has articulated a number of principles that inform its approach to public finance. These are to be found primarily in the Framework Document of 1995, as well as in subsequent submissions to Government. The principles relevant to this submission are provided below.

Principle 1: No stakeholder should experience a deterioration in its circumstances owing to the restructuring process, unless this is an explicit policy decision.

Given the mandate of the FFC to consider the needs of all three spheres of Government, it is incumbent upon the Commission to assess the extent to which there is “collective gain” for the industry, Government, and the country as a whole. It is the aim of the analysis that follows to identify the beneficiaries of the process and those stakeholders who may experience a deterioration in their circumstances.

Principle 2: Redistribution should be funded primarily by national government.

It is important to distinguish between mechanisms for redistribution, such as low-income subsidies, and the sources of redistribution. In its submission on the Division of Revenue 2002/03, the FFC stated that poverty alleviation should be financed through national

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tax revenues, because the base of national taxes is much broader than that of local jurisdictions.[15] This principle has implications for the drawing of boundaries and for consumer cross-subsidies.

5.2 The restructuring proposals

The proposals with intergovernmental fiscal implications are as follows:

(a) Six Regional Electricity Distributors (REDs) should be established.

- The proposed boundaries provide for a balance of customers, for example in terms of type (domestic, industrial) and location (rural/urban/metro).
- The REDs would be owned by distributing municipalities and national government, which would hold ordinary shares. National government would hold Eskom's shares.
- Each RED would have its own set of tariff structures and rates for various customer categories, and there would be no financial transfers between REDs.

(b) Local government should continue to receive the surplus generated by municipalities from electricity supply, with the amount estimated to be R2.4 billion.

- The estimated surplus (of about R2.4bn) would be capped in absolute terms, that is, local government would receive up to that amount on an annual basis.
- The R2.4bn would be raised from: a) a levy on the sale of electricity, and b) dividends on municipal shareholdings in the REDs. As dividends grow, the local government levy declines proportionately.
- Low-income customers should be exempted from paying the levy.
- It would be a Government policy decision as to whether large customers should contribute to local government funding.
- The municipal levy should be in place for the first five years of the REDs, after which it should be reviewed.

(c) REDs will be placed under a regulatory obligation to offer "poverty tariffs" to low-income households according to Government policy.

- There are two broad options for meeting the cost of these tariffs: i) a cross-subsidy from other electricity consumers, which would be shown transparently on customers' bills; ii) a contribution from the local government equitable share allocation.
- The total subsidy required is estimated to be R260 million.
- If the cross-subsidy option is chosen, the levy would range between two percent and eight percent, depending on the RED.

(d) The capital cost of electrification would be the responsibility of national government, and REDs would be responsible for implementation of electrification projects.

- New connections would be funded by general taxation.

15 FFC (2001), *Submission: Division of Revenue 2002/03.*

- Any planned shortfall between the allocation allowance from the fiscus and the expected costs of electrification would be covered as part of the tariff support to the electrified customers.

5.3 Intergovernmental fiscal implications of the proposals

5.3.1 Electricity consumption subsidies

The EDIRC Report proposes that the long run average price to low-income customers should be capped at 30c/kWh. It further suggests that a task team should assess whether this should be funded through a consumer cross-subsidy or the local government equitable share. If funded through a consumer cross-subsidy, the levy has been estimated to be between two percent and eight percent, depending on the RED.

The proposal for a consumer cross-subsidy should be placed in the context of Government's policy to provide low-income residents with a free basic amount of electricity each month. The Commission proposed in its Submission for 2002/03 that the cost of free electricity should be funded nationally and to a lesser extent through consumer cross-subsidies.

If electricity distribution is transferred to REDs and billing systems as well, the national subsidy for free electricity would need to take the form of conditional grants to the REDs (owing to constitutional provisions, the equitable share could not be transferred to REDs). The provision of a national conditional grant would take pressure off the consumer cross-subsidy, allowing electricity prices to be more cost-reflective. This should minimise the intra-RED variations in the cross-subsidy.

Proposal:
- The FFC proposes that tariff support to low-income consumers be financed primarily by a national grant to REDs for the provision of free electricity, and to a lesser extent by a consumer cross-subsidy.

5.3.2 Capital Subsidy

Until recently, the cost of electrification has been borne primarily by Eskom. In January 2000, Eskom became liable for income tax, secondary tax on companies, capital gains tax, value-added tax, and the skills development levy. This new tax-paying status will also apply to REDs in future.

Consequently, Eskom's funding of electrification will fall away. Government has committed itself to funding both grid and non-grid connections to achieve 100 percent electrification by 2010. Some of this funding will be off-set by revenue receipts from Eskom. However, recent budgetary allocations indicate that electrification targets may not be met.

There is a suggestion in the EDIRC Blueprint Report of January 2001 that Government may expect consumers to cover the difference between the Government allocation and required funding. It is unclear whether this implies that the consumer cross-subsidy would include both operating and capital subsidies for low-income consumers. If so, this could significantly increase the price paid for electricity. The FFC does not support the inclusion of the costs of capital electrification for low-income households in the consumer cross-subsidy.

Proposal:

- Capital electrification for low-income consumers should be financed by national government, and provision for this should be made in the MTEF Estimates. If the MTEF allocations do not meet the full costs of capital electrification, the time period for the attainment of one hundred percent electrification should be extended.

5.4 Implications for local government revenue

As a source of revenue, electricity charges made up thirty one percent of income received by municipalities in 1999/2000. Once the costs of provision are accounted for, the surpluses generated from the distribution of electricity comprise between five percent and seven percent of total local government revenue.[16] It should be noted that many municipalities - particularly those in rural areas - do not distribute electricity, and these averaged figures therefore reveal the significance of electricity as a source of revenue for distributing municipalities.

The surpluses generated from electricity provision are generally used to cross-subsidise other municipal services. This can lead to situations where the cost of electricity provision is inflated by the allocation of costs for other municipal services to the electricity account.

Cross-subsidisation between services can serve a useful function, particularly where local conditions influence the costs of service provision (for example, if purchase and distribution of water is expensive). On the other hand, profits from electricity may compensate for the inefficient provision of other services and can obscure financial realities within a municipality.

Electricity departments often supply the operational infrastructure for other aspects of municipal service delivery, whether technical, administrative, or financial. For example, many municipal electricity departments install and maintain street lighting.

5.4.1 EDIRC proposal: Local government levy

The EDIRC Report recommends that local government continue to receive the income from electricity, and that this income should come from dividend income and the

[16] DPLG (2000), *Annual Report on the Equitable Share for Local Government for the 1999/2000 Financial Year;* C. Barberton & J. Keswell (1998), *REDs in South Africa: An Analysis of Governance and Financial Issues,* Applied Fiscal Research Centre.

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local government levy (in other words, it is cash neutral). The Report recommends that the levy should not remain in place indefinitely, and consideration should be given to phasing it out after five years.

It is not clear from the EDIRC Blueprint document of January 2001 whether this levy will be available as a revenue instrument to all municipalities or only to municipalities that distributed electricity prior to the establishment of the REDs. Clarity is needed on whether the local government levy will be available to all municipalities or only to municipalities currently distributing electricity.

5.4.2 Evaluation of the levy

It is likely that all municipalities will be empowered to place a levy on electricity sales. This is consistent with previous policy positions. Furthermore, it would be difficult to distinguish between "distributing" and "non-distributing" municipalities, as many non-distributing municipalities have been amalgamated with distributing municipalities.

If the levy is available to all municipalities as a revenue instrument and the total amount is capped (say at R2.4bn), then distributing municipalities will experience a significant net loss and the non-distributing municipalities will gain access to a new revenue source, at least for a limited (five-year) time period. The possibility of allowing a higher cap for only distributing municipalities should be investigated in order to take account of the net loss experienced by some municipalities.

From a governance point of view, it would be important to introduce a variable levy rather than a fixed one. This would enable municipalities to be held more directly accountable for the raising and expenditure of public funds. As noted in the FFC's recommendations for 2001, the ability to raise their own revenues offers subnational governments a valuable degree of freedom that allows them to implement programmes of their choice and size.[17]

5.4.3 Evaluation of the cap and phasing out of the levy

In terms of the quantum that would be directed to municipalities through the levy, the R2.4bn estimated surplus is based upon a 1993 estimate of aggregate "bottom-line" transfers from municipal electricity departments. However, the amount does not take account of real growth in revenues from 1993 to present, actual inflation figures provided by National Treasury, and the tendency of municipalities to under-report surpluses. The figure of R2.4bn therefore needs to be re-examined.

Furthermore, the compensation to municipalities should be evaluated on the basis of the loss in receipts. This loss (in opportunity cost terms) is likely to increase over time, for municipal receipts from electricity supply would increase in the absence of any restructuring of the electricity distribution industry.

[17] FFC (2000), *Preliminary Recommendations for 2001*. See also FFC (1997), *Local Government in a System of Intergovernmental Fiscal Relations in South Africa.*

The EDIRC Blueprint Report also proposed that the local government levy be phased out over time. If dividend income to municipalities does not increase proportionately to the phasing out of the levy, the local government sphere will experience a net loss of revenue. Indeed, decisions on the distribution of dividends will only partly be in the hands of municipalities. In fact, it may be that no dividends are distributed in some years.

One of the reasons given for phasing out the levy is that a levy on electricity is an inefficient means of raising tax revenue, because it will serve to distort electricity consumption and promote an inefficient allocation of resources in the energy sector. In this respect three comments are germane:

1) The deregulation of the electricity distribution industry in Europe has not led to the disappearance of the taxation of electricity. Indeed, it is common for numerous taxes to be paid on electricity, including company tax, consumption tax, and value added tax. At the same time, price reductions and improved economic performance have been noted in many cases.
2) Taxation of some fuel sources is very high. In the petroleum sector, for example, the fuel levy constitutes 40 percent of the pump price of petrol and diesel, contributing almost 10 percent to national revenue. The Energy White Paper notes that taxation of energy sources needs to be placed on a more rational and consistent basis.
3) The extent to which an energy source should be taxed can be evaluated against three criteria:
    - the necessity to raise revenue for government;
    - allocative efficiency and structural change; and
    - environmental and resource management.

Given that distributing municipalities rely heavily on electricity surpluses, there is a compelling argument to implement and maintain a local government levy in order to raise revenue for the local sphere of government. Furthermore, levy income will be fairly predictable, whereas dividend income will depend upon profitability and shareholder decisions on dividend declarations.

Further concerns with regard to the allocation of shares and payment of dividends are raised in Section 5.5 below, and the conclusion reached by the Commission is that the restructuring process should focus on compensation through the local government levy and not through dividend income.

5.4.4 Evaluation of the proposal to impose the levy on large customers

The EDIRC Blueprint Report introduces the idea of a contribution to local government funding from large customers, and suggests that such a contribution could be phased in over time.

Even a small levy on large customers will produce significant revenues, but differences in the tax capacity of municipalities would be exacerbated. For example, if a large corporation such as Alusaf is located in a municipality, significant revenues will accrue to that municipality while a neighbouring municipality may receive few benefits. Consequently, the introduction of even a very low levy will require the introduction of an equalisation grant.

A more viable alternative would be the imposition of a local government levy on large industrial customers, with the revenue being collected by national government and being disbursed through the local government equitable share.

5.4.5 Proposals

- The local government levy should be made available to all municipalities.
- Municipalities should be allowed to set the levy up to a maximum level.
- The possibility of allowing a higher cap for distributing municipalities should be investigated, so as to take account of the net loss experienced by some municipalities.
- The local government levy should not be phased out unless fiscal mechanisms are in place to compensate fully for the loss of revenue.
- With respect to the cap of R2.4bn placed on local government revenue:
  - The figure of R2.4bn should be re-examined; and
  - Given the increasing loss in receipts to local government implied by the restructuring process, consideration should be given to regular increases to the absolute cap on local government revenue.
- Consideration should be given to introducing a "local government levy" for large customers, with the levy being imposed by national government and disbursed through the local government equitable share.

5.5 Implications for local government shareholding

Equity in the REDs will be apportioned according to the net assets transferred from municipalities to the REDs. Municipalities with net assets will therefore be allocated shares, while municipalities with net liabilities and those that do not supply electricity will not receive any shares.

The proposed allocation of shares and the associated dividend payments would continue the uneven fiscal position of municipalities. The proposals would accentuate inequalities because:

- Dividends that are earned from the entire REDs customer base would be distributed to municipalities that formerly supplied electricity; and
- Residents who purchased electricity directly from Eskom paid tariffs that included a capital repayment component and they contributed to its asset base. It could therefore be claimed that these municipal jurisdictions are entitled to the dividends generated by REDs.

In effect, the current proposal will perpetuate historic patterns of resource allocation.

The FFC is of the view that the shareholding issue is not of primary concern with respect to local government finance. Rather, the emphasis should be on:

- Ensuring that local government as a whole is fully compensated for the loss of electricity surpluses through the assignment of a local government levy (see Section 5.4 above); and
- Ensuring that the REDs are structured in a way that promotes accountability in the efficient delivery of services.

Proposals:
- The restructuring process should focus on compensation to municipalities through the local government levy and not through dividend income.
- The structure of the REDs should ensure that accountability for efficient service delivery is promoted in a simple and effective way.

5.6 Implications of the proposals for the system of local government finance

The consolidation of water, electricity and rates accounts offers considerable advantages to municipalities and customers alike. The removal of the electricity account would mean (a) loss of economies of scale in billing procedures; (b) diminished debt management capability; and (c) reduced scope for customer relationship management.

In addition, the transfer of electricity distribution from municipalities to REDs may well generate new costs for municipalities. There is a need for a detailed study to estimate these costs in order to ensure that municipalities are compensated for such losses.

Local government is still in transition, having to deal with recent boundary determinations. Introducing EDI restructuring in this uncertain environment presents difficulties in assessing the full impact of restructuring. In addition, the demarcation process is imposing short-term administrative costs that are putting pressure on municipal budgets.

RED boundaries should follow the new municipal boundaries. This will ensure that residents of a given municipality do not fall within different REDS and are hence subject to different tariff structures.

Proposals:
- Municipalities should be compensated for all losses related to the transfer of electricity distribution to REDs.
- A detailed study of both the costs and benefits of the transfer should be carried out.
- The advantages and disadvantages of retaining consolidated billing systems with municipalities should be carefully weighed, and measures should be implemented to retain the advantages.
- RED boundaries should be co-terminus with municipal boundaries to ensure that residents of a given municipality do not fall within different REDS and hence under different tariff structures.

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5.7 Conclusions: Electricity restructuring proposals

As noted in section 5.1, it is the aim of this report to consider the effect of the restructuring proposals as a whole and to assess whether there is a “collective gain” for the industry, Government, and the country as a whole. The EDIRC Blueprint Report is silent on the impact of the proposals on cash flows, credit control, and borrowing. Indeed, the proposals pay little attention to the implications of the proposals for the local sphere of government.

On the revenue side, income will be reduced in the long term owing to weakened credit control and decreased cash flow, and it is likely that the overall cash surplus will be reduced for most distributing municipalities. Much of the reliance on electricity as a source of revenue is owing to an intergovernmental fiscal system that places significant responsibility on local government to raise its own revenue.

Municipalities are for the most part in a precarious financial situation. Given the importance of the local government sphere in the delivery of basic services and its current transitional and troubled financial status, the needs of the electricity distribution sector should be balanced against the needs of local government.

The FFC favours approaches that promote equity. The local government levy should be a revenue instrument available to all municipalities, but the negative impact on distributing municipalities should be addressed. The allocation of RED shares only to distributing municipalities should be re-considered, as it would perpetuate historic patterns of resource allocation.

Implementation of the proposals may undermine some aspects of local government capacity in the long term, together with the potential loss of consolidated billing systems and integrated customer management. It is important to note these effects and design measures to address them.

General proposal:
- Implementation of any proposals should be carefully phased in owing to the integral role played by electricity provision in the system of local government finance and the overall precarious financial state and transitional nature of the local government sphere.

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6. Measurement of Revenue-raising Capacity

6.1 Introduction

In its Submission for the Division of Revenue 2002/03, the FFC proposed that the fiscal capacity measure in the equitable share formula should be strengthened. It is important to measure fiscal capacity since the equitable share must ensure that municipalities can fulfil their constitutional functions. If a municipality is unable to generate significant own revenues, regardless of tax effort, then equitable share allocations should take this into account. (see Section 214(2)e of the Constitution).

This section considers the various issues that influence the measurement of revenue-raising capacity and suggests capacity measures that may be considered in the South African context.

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It is important to distinguish between tax capacity and revenue-raising (or fiscal) capacity. Tax capacity refers to income generated from tax base sources, such as property taxes and regional levies. Revenue-raising ((or fiscal) capacity encompasses tax capacity, plus income generated from municipal services delivery, such as utility fees. This section examines revenue-raising capacity because it is important to consider all types of revenue that a municipality can raise.

6.2 Theoretical issues

6.2.1 Data Requirements

Historical data required for measuring fiscal capacity should satisfy the following requirements:

- The data should be disaggregated to local government level;
- Fiscal years should be standardised; and
- There should be common accounting principles and an independent auditing process should ensure that these principles are followed.

Currently, data on local government is collected by various departments and agencies. In addition, the local government fiscal year is standardised (July to June). However, information supplied by municipalities is not reported in standardised format and most municipalities do not yet subscribe to Generally Accepted Municipal Accounting Practice (GAMAP).

The Municipal Finance Management Bill (2001) prescribes the application of GAMAP and require standardised budget reporting formats. However it will take a number of years to fully implement these budget reforms.

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6.2.2 Approaches to Revenue-Raising Capacity Assessment

- *Macro- and micro-economic approaches*

The macroeconomic approach reflects all sectors of the economy. It uses a single aggregate measure of capacity. Alternatively, a combination of more than one macro measure can be used. This may consist of gross domestic product for all taxes that are source-based (such as property taxes and natural resources levies), and gross national product for all taxes that are residence-based (such as personal income tax).

The microeconomic approach focuses on the actual tax system of subnational governments, where separate measures of revenue-raising capacity for each tax are assigned. Therefore, it has the potential for a more accurate assessment of revenue-raising capacity. This approach reflects the Representative Tax System (see section 6.3.5 below).

6.2.3 Criteria for measuring fiscal capacity

A number of issues which relate to good measurement need to be examined:

- *Practicality:* Data requirements should be reasonable, and the data should be available and reasonably accurate.
- *Impact:* The measure should be able to demonstrate sensitivity to different situations.
- *Adequacy:* It is desirable that the targeted taxes and revenue sources yield substantial amounts of revenue.
- *Elasticity:* The revenue sources should respond to the same pressures that affect demand for public expenditure, and the tax base should respond automatically to changes in prices, population, and economic activity.
- *Revenue effort:* The measure should provide municipalities with an incentive to maximise revenue collections.

6.3 Possible measures of revenue-raising capacity

The FFC has identified five methods for measuring fiscal capacity. The first four are based on a macroeconomic approach, in that a single measure or a combination of measures may be used. These are Revenue Collected, Per Capita Income, Gross Geographic Product (GGP), and Total Taxable Resources (TTR). The fifth method is the Representative Tax System (RTS), which is a microeconomic approach. The degree of complexity involved in implementing these methods increases down the list, but the level of accuracy increases.

6.3.1 Revenue Collected

Revenue collections in a given base year can be used as a measure of revenue capacity. However, municipalities that exert low effort at present may benefit in future years if the base year moves forward. In addition, the accuracy of measures of fiscal capacity data are likely to deteriorate over time. Furthermore, the measure does not take into account that the amount of collections is affected by both a municipality's fiscal capacity and fiscal effort. It therefore provides a perverse incentive for municipalities to lower their fiscal effort when used in the allocation of equalising grants.

6.3.2 Per Capita Income

The main advantage of this measure is that per capita personal income is widely available and it is simple, especially if measured accurately. However, this measure fails to account for the ability of subnational governments to tax economic resources or economic rents owned by residents outside their jurisdictions. The measure is currently applied to the I-grant of the local government equitable share.

6.3.3 Gross Geographic Product (GGP)

GGP reflects the total income that can be potentially taxed by the subnational government. This includes income generated within a subnational jurisdiction, irrespective of the location of the residence of the worker or producer. If the data is available, it is easy to implement and the data requirements are reasonable. It is more accurate than the methods above, however it shares their disadvantage of being one-dimensional.

6.3.4 Total Taxable Resources (TTR)

To obtain TTR, national taxes are first deducted from GGP. Second, each subnational government's GGP is augmented with the amount of direct national transfers to firms and individuals, including pensions and unemployment benefits, to arrive at TTR. Thus, TTR provides a more accurate reflection of a subnational jurisdiction's actual fiscal capacity.

6.3.5 Representative Tax System (RTS)

The RTS estimates the amount of revenue that a municipality would collect if it were to exert average fiscal effort. This is done by collecting data on revenue collection and (proxy) tax bases for each of the taxes under consideration. On the basis of information on all tax bases for every municipality and the national average fiscal effort for each of the taxes, the amount of revenue that each municipality would collect under average fiscal effort is estimated. This amount is then considered to quantify accurately the fiscal capacity of the region.

The main benefit of RTS is that computations are made at a disaggregated level and are based on a detailed knowledge of (proxies for) the statutory tax bases.

An alternative solution that maintains much of the accuracy of the RTS while reducing its data requirements is regression analysis. The RTS regression method requires information only on the total amount of the revenues collected for each region, plus data on a series of proxies for the tax bases for each municipality. Thus there is no need to group revenue items into tax components and to specifically match each tax component with a standard tax base.

Alternatively, the RTS regression method can be expanded to include disaggregated information on the main revenue sources, their proxies, and proxies for the remainder of revenues. The RTS method accurately reflects the revenue-raising ability of municipalities, however it is time-consuming and data-intensive.

6.4 Conclusions

Five measures of fiscal capacity have been identified in order of increasing complexity, namely Revenue Collected, Per Capita Income, Gross Geographic Product, Total Taxable Revenue, and Representative Tax System. The level of accuracy increases as the complexity of the measure increases.

Given that the fiscal capacity measure should accurately reflect the revenue-raising ability of municipalities, it desirable that the measure be as accurate as possible. It may well be that a simpler measure is utilised in the short- and medium-term until more accurate data becomes available.

In the coming year, the Commission will conduct further research into the fiscal capacity measures identified above, with a view to identifying the most appropriate measure for South Africa. The research will encompass a more detailed assessment of data availability and accuracy, and will involve exercises that model the impact of the different measures.

PROVINCIAL GOVERNMENT

In June 2001, the FFC submitted a set of recommendations in the context of its May 2000 submission for the 2001/04 MTEF Recommendations. The proposals were:

- Provincial own revenue
  - The Commission reaffirmed its position that broad-based taxes constitute the most feasible form of provincial revenue.
  - Provinces should be allowed the flexibility to determine their own tax rates within the bands determined by the Minister of Finance.
  - Tax room should be created to maintain the tax burden within nationally determined targets.
- Infrastructure provision.
  - The Commission recommended a capital grants model to allocate infrastructure grants.

Government concurred with the Commission's proposals on provincial own revenues, except with respect to the proposal on the Personal Income Tax surcharge. With the Provincial Tax Regulation Process Act of 2001, the FFC will be required to evaluate any taxes proposed by provinces and to submit its recommendations to the Minister.

With respect to the infrastructure-financing model, Government felt the model required more work in order for it to capture the relative needs for infrastructure in the provinces. The Commission is committed to the refinement and extension of the model to include all infrastructure programmes.

The Commission's proposals for 2003/04 on the provincial equitable share cover both the revenue and expenditure aspects of provincial fiscal policy. Section 7 provides an analysis of trends in provincial own revenues, and is in response to a request from the Parliamentary Select Committee on Finance. Section 8 presents the Commission's comments on the Provincial Tax Regulation Process Bill of 2001.

In the recommendations for 2001/04, the FFC indicated that it would seek to incorporate early childhood development into the provincial equitable share formula. Section 9 outlines this on-going work.

With respect to health, the FFC previously excluded any variable from the equitable share formula that takes direct account of the prevalence of HIV/AIDS. Consultations with various stakeholders indicated a need to address the extent of the epidemic and current funding

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arrangements. Section 10 examines the constitutional and equitable share implications of HIV/AIDS for the provision of basic education, health, and welfare services.

There was also a need to revisit the primary health care package. In section 11, the Commission presents some results and indicates areas for further work.

7. Provincial Own Revenue Sources

7.1 Introduction

An important principle of decentralised government is that each government should be assigned effective revenue sources. Recent research of the FFC and National Treasury indicates that the share of provincial own revenue is declining as a proportion of all revenue flows to provinces.

An important reason for these trends is the high administrative costs associated with raising revenue from the narrow-based revenue sources available to provinces. The current sources are, for the most part, user charges and fees. These tend to decline in periods of rising unemployment. Other reasons include poor administration, a lack of appropriate institutional capacity, expenditure-driven budgeting, and a lack of incentives to fully exploit own revenues.

The most effective and sustainable long-term solution is a systems-based solution, namely, the development of a general incentive mechanism via the allocation formula. Unfortunately, this does not seem to be immediately possible because the revenue bases are narrow and vary widely across the provinces.

In order for incentives to be built into a revenue sharing formula, the revenue bases should be significant and provinces need to be able to raise a significant amount of their own revenue. The Provincial Tax Regulation Process Act of 2001 goes some way in addressing this issue.

This section examines recent trends in provincial own revenues and attempts to provide answers to some of the questions around the decline in major sources of provincial own-revenues and to suggest some solutions. It is based on a survey of provinces carried out by the FFC since 1999.

The table below shows trends in provincial own revenues as a share of total provincial revenue, including equitable share transfers.

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Table 7.1: Provincial own revenues as a share of total provincial revenue[18]

Province	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Eastern Cape	1.43%	2.58%	2.19%	2.11%	1.67%	1.72%	1.77%
Free State	4.24%	3.66%	3.72%	3.95%	3.18%	3.11%	3.00%
Gauteng	5.92%	5.74%	6.01%	6.21%	5.12%	5.00%	4.95%
KwaZulu-Natal	3.42%	2.24%	3.03%	3.99%	2.46%	2.49%	2.54%
Mpumalanga	4.69%	3.22%	5.42%	2.08%	2.58%	2.53%	2.34%
Northern Cape	4.59%	3.47%	3.14%	2.55%	2.87%	2.82%	2.82%
Limpopo	1.80%	2.45%	1.92%	2.20%	2.07%	2.05%	2.36%
North West	4.03%	3.80%	3.79%	4.58%	3.74%	3.59%	3.55%
Western Cape	5.55%	4.92%	6.50%	6.50%	5.53%	5.84%	6.23%

Source: National Treasury, Intergovernmental Fiscal Review 2001.

For most provinces, the share of provincial own revenue has been declining as a percentage of total provincial revenue. For the medium term expenditure period, the Western Cape, Eastern Cape, KwaZulu-Natal and the Limpopo estimate relative increases in the share of own revenues. For the rest of the provinces, there are relative declines in the share of own revenues.

18 Note that for all data tables in this section, the periods 1997/98 to 1999/00 show actual revenues, while the periods 2000/01 to 2003/04 show estimated revenues supplied by provinces.

7.2 Trends in provincial own revenues by source

The following section focuses on the three major provincial own revenue sources, namely revenues from road traffic, hospitals, gambling, horse-racing, and betting. These constitute the major part of revenues prescribed by law.

7.2.1 Road Traffic Ordinance

This includes license fees and traffic administration. In aggregate, this revenue source is just under forty three percent for the period 2001/02, rising to an estimated forty five percent in 2003/04. The contribution to total own revenues was just over thirty four percent in 1997/98, making the road traffic fees by far the largest single source of provincial own revenues. The period 1997/98-2003/04 reflects a positive growth in these revenues in general.

Table 7.2: Road traffic revenues by province (R'000)

Province	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Eastern Cape	61,505	52,605	58,927	61,629	41,577	44,487	47,602
Free State	78,693	87,467	103,296	137,329	110,000	114,000	116,280
Gauteng	388,397	413,275	527,596	572,230	516,396	548,665	579,831
KwaZulu-Natal	246,786	274,715	304,656	352,465	329,152	344,212	378,250
Mpumalanga	73,681	55,481	64,691	79,337	74,158	78,607	84,861
Northern Cape	28,077	25,919	36,847	44,335	49,783	53,667	57,470
Limpopo	34,818	39,841	42,867	60,356	49,999	53,998	81,599
North West	59,494	55,499	76,153	92,835	140,645	145,700	160,720
Western Cape	226,495	251,497	299,072	344,127	427,741	491,519	564,839

Source: National Treasury, Intergovernmental Fiscal Review 2001.

For the period 1997/98-1998/99, Mpumalanga, the Eastern Cape, and North West provinces experienced negative growth in road traffic revenues of twenty five percent, fourteen percent and six percent respectively. Limpopo recorded the highest growth rate over this period, with revenues growing at over fourteen percent. Over the period 1998/99-2000/2001, all provinces registered positive growth rates in this revenue source (ranging from five percent in the Eastern Cape to forty one percent in the Limpopo in 1999/00-2000/01).

However, the first estimates for 2001/02 show negative growth for most of the provinces, ranging from seven percent in Mpumalanga to thirty three percent in the Eastern Cape. For the same period only Northern Cape, North West, and the Western Cape show positive growth estimates of twelve percent, fifty two percent, and twenty four percent respectively. For the outer years of the MTEF, all provinces estimate a positive change in this revenue source. The important point to note from these numbers is that they are very unstable over the period under review, although all provinces forecast some stability over the current MTEF period.

Despite the overall annual increases in the Road Traffic Ordinance revenues, discussions with provincial revenue officials suggest that the exploitation of this revenue source still remains below the potential. Although it is not always a bad thing (revenue elasticity is more important), the general lack of standardised fees encourages some degree of price competition between certain provinces. Such differences in fees encourage migration to the lower fee provinces. The Eastern Cape in particular reports that it loses a significant amount of revenue due to this price-induced migration.

Another problem is the failure to consistently adjust license fees to inflation movements. By 1999, the Limpopo had not adjusted its fees since the 1992/93 fiscal year. North West only made this adjustment for the first time in 1999 from 1992 levels.

The Road Traffic Ordinance is managed by the National Transportation Information Systems (NaTIS). This management system is poorly administered in different provinces, and most provinces are grappling with lack of appropriately trained personnel for managing the system. There are also acute shortages of equipment and technical constraints to assist in the collection of these revenues. A further obstacle is a lack of interface between the Financial Management System (FMS), the means for recording revenue, and NaTIS. The lack of a link between the two systems resulted in provinces having to wait for long periods before receipts were consolidated, and this impacted negatively on effective monitoring of revenues.

In most provinces, except the Free State where the Public Works, Roads, and Transport Department is responsible, municipalities collect Road Traffic Ordinance Fees on an agency basis. In some provinces, there is no formal performance contract between the collection agent and the province. The result is that the turning over of revenues from the agencies has not been timeous and in some cases municipalities have even refused to turn over revenues to the province. There have also been disagreements over commission payments and protocols for extracting such commissions. This situation arises primarily because of the absence of contracts. Over and above these agency problems, in some provinces there are also disagreements between the Departments of Transport and Finance, with the latter perceiving that the former are more interested in expenditure rather than increasing revenues.

Corruption has also been cited as a problem. This is difficult to deal with in a situation where more than one department is involved in managing the revenues. Corruption can be in the form of traffic officers accepting bribes for issuing fake drivers' licenses or for not writing out tickets to traffic offenders. There have been significant attempts to deal with corruption and several arrests have been made in provinces like Mpumalanga, North West and KwaZulu-Natal. In the Free State there have been cases where senior officials have been known to be involved. However, these cases have been difficult to investigate due to the fact that the amounts involved at any one point are insignificant, although they do accumulate significantly over time.

7.2.2 Hospital and patient fees

Hospital and patient fees fell from eleven percent in 1997/98 to just eight percent in 1999/00 as a share of total provincial own revenues. They are expected to increase to just over nine percent over the MTEF.

Table 7.3: Hospital and patient revenues by province (R'000)

Province	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Eastern Cape	41,409	23,918	23,324	21,339	22,191	21,410	26,853
Free State	43,317	39,136	30,705	41,447	46,000	46,000	46,920
Gauteng	83,718	75,536	70,924	70,969	78,000	81,000	85,000
KwaZulu-Natal	79,904	84,369	80,179	89,431	110,230	115,120	121,312
Mpumalanga	20,504	15,439	11,425	10,934	33,708	35,730	19,075
Northern Cape	5,485	5,036	5,714	6,825	12,000	11,600	12,300
Limpopo	23,389	23,463	24,465	26,905	28,536	30,819	36,374
North West	10,423	13,030	12,953	13,600	12,528	13,896	14,460
Western Cape	75,312	66,098	61,679	70,451	67,955	71,740	75,736

Source: National Treasury, Intergovernmental Fiscal Review 2001.

There was a general decline for most provinces in 1997/98 to 1998/99. North West and to an extent KwaZulu-Natal experienced significant growth of twenty five percent and six percent respectively, while Limpopo experienced a marginal growth of under half a percent. Eastern Cape and Mpumalanga experienced the highest decline in revenue during this period of forty two percent and twenty five percent respectively.

During 1998/99 to 1999/2000, all provinces except Northern Cape and Limpopo posted negative growth in hospital and patient revenue, with the highest decline in Mpumalanga at twenty six percent and the lowest in North West at just under one percent. Except for Mpumalanga, hospital and patient fees are expected to grow in the medium term for all provinces. Generally, hospitals do not retain any of the collected revenue but pool them into the provincial revenue fund.

There are several reasons for the relative fall in hospital and patient fees. First, there has been significant migration of paying patients to private providers. Due to a general decline in resources to public hospitals, the quality of care has been perceived as declining and this has led to the emergence of the private sector as a preferred service provider by those who can afford the fees.

Second, the national policy of providing free health care for children under the age of six and to pregnant women has reduced the amount of fees available to the public health system. Simultaneously, non-qualifying patients also tend to perceive that they are entitled to free health services. This is further exacerbated by the policy that people may not be refused treatment because they cannot afford to pay. A patient who arrives at a health facility has a right to receive treatment, regardless of whether they have actually paid for the service.

The current system in the public health sector is based upon the classification of patients into income categories. Fees are then applied depending on the classification of the patient. The system therefore depends on individuals providing accurate information to the hospital authorities. There is no practical way of determining the accuracy of information provided by individuals.

There is also a lack of standardisation across provinces in terms of how the fees are applied. In the Western Cape, a person who pays H1 level fees (lowest fee) is classified in the same category as a person in the Eastern Cape who pays H3 level fees (two levels higher). This can and does result in the migration of patients to lower fee provinces due to price differentials.

At the hospital level, the billing systems are highly inefficient. Patient information is solicited via an interview and there is no other way of determining the accuracy of such information. This results in patients providing false information about their income status and sometimes, residential addresses. For hospital authorities, it becomes costly to follow up on collection because the amounts involved are usually small relative to the collection costs. In provinces with international borders, such as Mpumalanga, Free State and Limpopo, illegal immigrants from neighbouring countries such as Swaziland, Mozambique, Lesotho and Zimbabwe take advantage of the system and use hospital facilities, only to cross back to their countries without paying. In most cases, these individuals have South African identity documents that are either genuine or have been illicitly obtained. Hospital administrators have no way of ascertaining the authenticity of such documents.

Because of problems associated with collection of fees, provincial health departments have little incentive to collect fees. In the Eastern Cape there is a perception that the provincial health department is more interested in reducing expenditure than with collecting revenue. This may be due to the fact that revenues are generally not retained by the hospitals or by the departments of health. Gauteng and the Western Cape have only recently granted certain hospitals the right to retain the revenues they raise in order to encourage officials to improve collection.

It is important to note that unless the administrative issues are adequately addressed, hospital and patient fees will always be difficult to collect. The increase in unemployment levels over time will also worsen this trend, because as more people lose jobs, the pool from which such revenues are collected will decline. This is an issue that is particularly worrying for the Free State and Mpumalanga.

7.2.3 Gambling, horse-racing, and betting

The share of gambling, horse racing, and betting revenues has declined as a proportion of provincial own revenues from around eight percent in 1997/98 to around four percent estimated for the outer year of the medium term expenditure period, 2003/04.

Table 7.4: Horse racing, gambling, and betting revenues by province (R'000)

Province	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Eastern Cape	5,548	13,016	3,150	7,141	0	0	0
Free State	10,240	8,970	7,163	7,653	12,000	13,000	13,260
Gauteng	190,998	157,669	85,372	67,367	71,000	76,000	78,000
KwaZulu-Natal	41,816	39,813	29,370	39,186	41,145	43,203	45,362
Mpumalanga	0	0	8,189	8,643	11,236	11,910	12,789
Northern Cape	2,192	538	1,927	2,448	4,700	5,500	6,000
Limpopo	7,148	7,457	5,059	7,163	7,092	7,659	9,682
North West	0	0	65	41	1,145	1,145	1,145
Western Cape	31,806	32,008	29,773	27,733	21,038	19,500	21,000

Source National Treasury: Intergovernmental Fiscal Review 2001.

Over the medium term expenditure period, the Eastern Cape estimates zero revenue from this revenue source. Table 7.4 shows actual revenues and medium term expenditure framework estimates.

Between 1997/98 and 1998/99, revenues from horse-racing, gambling and betting increased by one hundred and thirty five percent in the Eastern Cape, fell by seventy six percent in 1998/99 to 1999/00, and increased again by one hundred and twenty six percent 1999/00 to 2000/01. Another interesting province is Gauteng, where revenues have consistently fallen between 1997/98 and 2000/01 but are estimated to pick up over the medium term expenditure period.

In general, revenues are declining as a share of total own revenues and are expected to be zero for some provinces. The advent of different lotteries that compete directly with gaming activities has resulted in a decline in activities such as horse racing and betting. Consequently, a number of racecourses have been closed and hence the declining trend in revenues from this source.

For provinces with established horse racing and betting industries, such as Gauteng, Western Cape and KwaZulu-Natal, this is a fairly significant source of own revenues, although this revenue is declining. The National Gambling Board was established to promote standardisation of fees and procedures across provinces. Simultaneously, provinces have enacted their own legislation, which has resulted in significant differences across provinces. Current tariffs are considered to be arbitrary and there is general lack of clarity on how they were calculated.

Another problem related to this revenue source is the lack of organised financial reporting systems. It is difficult for provinces to know the exact amounts generated by casinos and so they have to rely on often inaccurate casino reports. Some casinos understate the revenues they generate. Recently, the North West provincial government compared audited casino statements to reported revenues and identified significant discrepancies between the two sets of numbers.

In general, the decline in revenues from gambling may also be attributed to increased competition amongst provinces. This is especially true with respect to the North West province, where competition with Gauteng is significant. It is important to note that over time, as the industry stabilises, there are expectations that the revenues from this source will also stabilise.

7.2.4 Other revenues

There are various other small revenue sources that provinces utilise, which are classified under miscellaneous and/or under moneys not prescribed by law. These are mainly in the form of fees and other charges for services. Among them are included such services as tourism, road transport, agriculture, and forestry. These revenue sources are highly unstable and it is difficult to make inter-provincial comparisons. This is due to the fact that different provinces apply them to different activities.

7.3 Improving provincial own revenues

In this section, the Commission discusses some ways to improve own revenue collection.

7.3.1 Data management systems

A consolidated national database, which stores and continuously updates information on all residents, would go a long way towards addressing the problems faced in collection of hospital fees and traffic fines. Such a database would link national identification details, employment details, and residential addresses. This would enable the hospital system to verify information about the status of patients and thus determine their fee obligations. Ideally, such an institution should be independent of Government.

7.3.2 Financial management

The interest revenue has shown a decline due to increased overdrafts. While it may not be true to suggest that such overdrafts result from lack of efficient financial management, such arguments may to a certain extent be true. The North West province is one example of a province where efficiency in financial management has resulted in consistency in interest revenues.

The North West Treasury has been relatively successful in working together with other departments to ensure that overdrafts are kept to a minimum. This has enabled the province to have reasonable cash flows and to make short-term investments. This is achieved via a close monitoring of the province's bank accounts. The Walker Commitment Control System for monitoring cash flows has been successively used by the North West Treasury.

The implementation of the Public Finance Management Act should also go a long way towards ensuring improved financial management in the provinces.

7.3.3 Appropriate revision of fees, tariffs, and fines

Some fees and tariffs are in specific form, that is, the value of the revenue raised does not automatically increase with inflation (as with ad valorem taxes). If these fees and tariffs are not annually adjusted for inflation, provincial revenues decline in real terms (assuming the same rate of collection). An example given above was motor registration fees, which have not been adjusted for inflation for many years in some provinces.

While it is accepted that inflation adjustments need to be made in order to maintain the value of revenue obtained from these fees, it is also necessary to ensure that increases in revenues are not achieved solely via higher charges but rather via efficiency in collection. Where user fees are less than the actual marginal cost of provision, increases are appropriate. However where such fees approximate costs of provision, the only annual adjustments should be inflation adjustments.

The argument around these adjustments cuts across all the major sources of revenue: gambling and betting, road traffic, and hospital and patient fees. There are obviously political considerations that need to be taken into account when adjusting these charges.

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7.3.4 Incentive structures

Although provincial Treasuries may be adopting revenue-oriented approaches, it does not follow that all provincial departments will do the same. It was mentioned in section 7.2.2 above that in certain provinces, Treasuries believe that departments are more interested in controlling expenditures than in raising revenues. In order to deal with this problem, the Eastern Cape is moving towards allowing the Health Department to retain some of the revenue that it collects. The impact of this is not yet measurable, but there is general enthusiasm on the part of the Health Department for the idea. In other words, allowing departments to retain some or part of the revenues they raise may increase collection incentives.

Such incentives may also be extended to government officials via performance contracts. South African Revenue Services is an example of how performance incentives increase collection. However caution needs to be exercised in the application of such incentives so that they focus on tasks rather than directly on the individual.

7.3.5 Monitoring

The monitoring and co-ordination of provincial own revenues has traditionally been the prerogative of Treasury Departments. In those provinces where the collection is done by agencies such as municipalities or private sector institutions, there will still be problems with monitoring. The best approach would be to specify that contracts for collection are clear and meet all requirements of the PFMA. The current situation shows problems are being experienced between the contracting parties. For example, the Northern Cape and Gauteng are experiencing difficulties in monitoring the proper execution of contractual obligations by agencies. In addition, there is a need for clearly defined rules and procedures on how the system should be coordinated and monitored.

7.4 Conclusions

This section has reviewed the state of provincial own revenues. It has been demonstrated that there are several problems that need to be resolved in the current system. Among the major problems identified is that provincial own-revenues have been declining as a proportion of total provincial own revenues, although they are expected to stabilise over the current MTEF cycle. This has been partly due to management and technical capacity problems at provincial level, although some of these problems have been addressed through on-going reforms by provincial treasuries.

Other obstacles have been the failure to revise charges and fees and the lack of incentives and co-ordination at different levels of the system. Corruption by government officials has also been identified as a problem. Thus, although own revenue sources may be limited, it is possible to collect more revenues if proper reforms and good practices continue to be implemented.

8. Summary of Submission: Provincial Tax Regulation Process Bill (2001)

The Provincial Tax Regulation Process Bill of 2001 seeks to regulate the exercise by provinces of their power in terms of Section 228 of the Constitution to impose taxes, levies, and duties, and flat-rate surcharges on the bases of national taxes, levies and duties.

Section 228(2)(b) of the Constitution provides for the Commission to make recommendations on the regulations governing the exercise of these provincial powers. The FFC Act of 1997 also provides for state organs to solicit the recommendations of the FFC on financial and fiscal matters. The following comments and recommendations were submitted by the FFC in terms of Section 228(2)(b) of the Constitution.

Because national government has the constitutional responsibility for managing the national tax system across spheres of government, it is important that a clear and transparent regulatory framework is developed to enable provincial governments to move forward with exercising their tax powers. In this respect the Bill goes a long way towards addressing this constitutional requirement.

8.1 Comments

Overall, the Bill has moved the intergovernmental fiscal system onto a new plane and should go a long way toward addressing the issue of provincial own revenues, provincial autonomy, and the accountability of provincial governments to their electorate. However, while the Bill is clear and simple to understand, there are certain aspects that need to be addressed.

8.1.1 Costs of implementation

In principle, tax design requires the minimisation of costs in the implementation of taxes. The requirements of Section 3(2) in the proposed Bill have cost implications for provinces. For example, Section 3(2)(e) requires that a province that wishes to propose a tax must conduct detailed studies of the implications of such a tax. The studies should include estimates of revenue to be collected over a three-year fiscal cycle, economic impact on individuals and businesses in the province and outside of the province, and its impact on the province’s economic development. Such estimates are usually not easy to determine at such a detailed level and may result in significant costs to the province.

It is unlikely that most provincial taxes will impact on the ability of the national government to conduct its fiscal and monetary policy or that they might influence inter-provincial trade. It may be more advantageous to shift some of the onus to national government to explain any reservations it has, rather than requiring substantial and costly impact studies to be drafted by provincial departments proposing a tax. Provinces would retain the right to make representations contesting national government’s assertions.

While it is necessary that tax decisions should be based on sound knowledge about the economic and social effects of different taxes, this must be done within a balanced approach that identifies benefits and costs. The Bill does not give equal weight to the benefits of decentralisation (matching programmes with particular needs of citizens) and accountability (bringing tax and expenditure decisions closer to the people). The Bill also does not promote the notion that expenditures are financed by taxes.

To assist provinces, there should be some indication as to what criteria the Minister will utilise in determining whether or not a tax proposal is viable. Since there are no prohibitions on provincial taxes outside the limitations imposed by the Constitution, provinces could well embark on costly studies around taxes that may not be approved by the Minister, and thus resources may be wasted.

8.1.2 Suitability and capacity

While there are criteria suggesting the suitability of certain taxes for provincial and local assignment, most multi-level nations find it necessary or desirable to depart from these criteria. This is in order to establish suitably robust tax bases that can provide the degree of autonomous action and accountability, which in turn yield the benefits of decentralisation.

Narrow-based taxes are unlikely to yield significant amounts of revenue for provinces. If anything, such taxes are likely to result in administrative difficulties and other economic distortions.

For example, a number of provinces currently employ some form of tourist taxes. The experience with these taxes in Australia is that they have significant distortionary effects, and therefore such taxes may have negative effects on the drive to promote tourism.

While the regulations on collection require that agreement be reached with SARS before the imposition of a tax, it is not clear what the capacity limitations of the collection agent are. Therefore, the capacity limitations of SARS may prejudice certain provinces when they wish to impose new taxes. There should be an indication on how disputes or disagreements between SARS and provinces are going to be addressed. For example, is the final decision in a dispute taken by the Minister, the Budget Council, or some such committee where the FFC sits? Moreover, the Bill is silent on the financial implications for provinces using the services of the SARS.

8.1.3 Tax rates and bands

Subsection (7)(b)(ii) of Section 3 requires the Minister to introduce rate bands for the proposed provincial taxes. The FFC supports this principle. However, provinces should be allowed maximum flexibility in determining tax rates. Since provinces can propose any tax that is "allowed" at their convenience, the first province to propose a tax may have greater influence on the definition of the base, the tax rate and band, and even the collection structure.

8.1.4 Inter-jurisdictional impacts

The regulations do not specify what should happen in situations where the proposal of a provincial tax by a single province has significant implications for other provinces and the overall national tax burden. To a certain extent, the literature on public finance and the experience of older federal states like Canada and Australia provide some answers. Fiscal externalities may be dealt with in various ways, such as equalisation processes and the creation of tax room. There is a need for some clarity on the types of measures that could be applied, for example, guidelines for national government creating tax room or defining the limits of fiscal equalisation where tax bases are unevenly distributed across provinces.

Furthermore, the Bill does not refer to the potential impact on municipalities. It is necessary to include a clause that deals with the implications of a provincial tax on the finances of local government, since provinces are entitled in the Constitution to impose flat rate surcharges on any taxes, levies, or duties allowed by national legislation.

8.2 Summary of recommendations

In light of the above discussion, the FFC proposes that the Bill should:

- Specify criteria against which the Minister measures provincial tax proposals.
- Clarify the implications and procedures relating to capacity limitations of SARS in advance.
- Allow provinces maximum flexibility in determining tax rates within tax rate bands.
- Develop guidelines with regard to tax room and equalisation measures, where certain taxes have implications for the equitable share revenue pool.
- Specify regulations for dispute resolution, especially where a province may fail to reach an agreement with SARS on certain tax proposals.
- Include a clause for dealing with the impact of a proposed provincial tax or surcharge on local government finances.

9. Early Childhood Development Funding

9.1 Background

The current equitable share formula for basic education does not include Early Childhood Development (ECD). In its May 2000 recommendations on the MTEF, the Commission indicated that it would be extending the education component of the equitable share formula to include ECD. This is in line with the Commission's recommendation that the equitable share formula should take into consideration the need for provinces to deliver on Constitutionally Mandated Basic Services (CMBS).

This section examines financing mechanisms for Early Childhood Development programmes. Options include the equitable share formula and the conditional grant mechanism.

9.2 The White Paper

In the White Paper for Early Childhood Development, ECD is defined as a comprehensive package of policies and programmes for children's development from birth to nine years of age.

The White Paper on Early Childhood Education (May 2001) outlines the policy objectives of ECD as follows:
- To realise constitutional obligations progressively to provide all learners with ten years of compulsory school education, including one year of early childhood development that is called reception year (Grade R);
- To ensure that all learners entering Grade 1 should have participated in an accredited Reception Year programme;
- To ensure that there is a system of provision that is seventy five percent state subsidised by 2010, rather than the current estimated twenty five percent state subsidization;
- To prioritise the development of a strategic plan for inter-sectoral collaboration, focusing on improving the quality of early learning programmes;
- To prioritise the development of curricula and practitioner career development; and
- To prioritise the subsidisation of early learning programmes for four-to-five year olds from poor rural and poor urban families, and include HIV/AIDS positive or infected children and children with special learning needs.

9.2.1 Implementation issues

Provision of ECD is an activity with significant social returns. Consequently, the Department of Education (DoE) proposed the establishment of a national reception year programme that comprises three types, namely:

- ***Reception year programmes within the public primary school system:*** Primary schools become the sites for the provision of accredited Reception Year programmes and are to be funded through grants-in-aid from provincial departments of education. This grant will be poverty targeted, meaning that children from the poorest 40 percent of families will receive the highest per capita level of grants-in-aid.

- ***Reception year and earlier programmes within community-based sites:*** Although the department does not emphasise the provision of ECD services through community-based sites, these will be used as experimental models in the short term. Under this model, the Department of Education proposes that some sites become, over the short-term, part of the public system for the provision of Reception Year. However, this will apply only in cases where the public primary school option is not available for learners, or not available within a reasonable distance. These community-based sites will be required to fulfil national policy norms and standards on the provision of Reception Year programmes before they qualify.

- ***Independent provision of reception year programmes:*** Pre-primary schools and Reception Year programmes attached to independent schools provide an important service and should continue to do so. These programmes will not receive government subsidies but will, nevertheless, be required to fulfil national policy norms and standards.

9.3 Financing ECD programmes

Government anticipates using two financing mechanisms for Reception Year programmes. These are summarised below.

Conditional grants: These are aimed at encouraging pilot schemes and at providing ECD only in areas where other options are not available.

Direct grants-in-aid: these grants would flow from provincial departments of education to school governing bodies on a per learner basis. The grants would cover only children in the Reception Year and would be poverty targeted. Community-based ECD centres are expected to operate at a lower cost compared to primary school centres. The latter use provincially employed educators, whereas ECD practitioners at community-based centres are employed by communities.

9.3.1 Estimated cost of expanding the provision of the reception year

The resources needed for the expansion of the reception year programme are not expected to put pressure on the education budget. This is mainly because of a declining fertility rate, improvements in efficiency, a declining primary school enrolment rate, and because of the dividends brought about by the changing enrolment patterns at the other levels of the system.

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Table 9.1 shows forecast of actual costs for providing ECD and Ordinary Schooling in billions of Rand.

Table 9.1: Forecasted costs of providing ECD and Ordinary Schooling, 2001 to 2010 (Billions of Rand)

Year	ECD	Primary-& secondary	Both	ECD as a % of Total Education Cost
2001	0.3	36.4	36.6	0.8%
2002	0.4	36.0	36.5	1.2%
2003	0.6	35.7	36.3	1.6%
2004	0.7	35.4	36.1	2.0%
2005	0.9	35.1	35.9	2.4%
2006	1.0	35.7	35.7	2.9%
2007	1.2	34.7	35.5	3.3%
2008	1.3	34.3	34.4	3.8%
2009	1.5	34.0	34.1	4.4%
2010	1.7	32.6	34.0	5.0%

Source: Department of Education, White Paper No. 5 on Early Childhood Education (2001).

The total costs for providing ECD are estimated to be 0.3 billion Rand in 2001. This is just less than one percent of the total cost of providing education in the 2001 fiscal year. This rises to five percent in 2010.

9.4 Current practice in ECD provision

The Department of Education audit of early childhood development sites revealed that access and equity is the main problem of ECD provisioning in South Africa.[20] The audit also shows that approximately seventy five percent of ECD provision is fee-based, unlike primary education where fees play a relatively small role. This supports the argument that the financial burden for ECD provision falls heavily on the poor, especially the rural poor. Only forty percent of government ECD sites are located in rural settings.

9.5 Provincial spending on ECD

Table 9.2 shows actual provincial ECD spending on public ordinary schools from 1997/98 to 1999/00, estimated spending from 2000/01, and MTEF forecasts from 2001/02

[20] Department of Education (2001), *White Paper No 5 on Early Childhood Education.*

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Table 9.2: Provincial spending on ECD

Year	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
Province	Actual R'000	Actual R'000	Actual R'000	MTE Estimate R'000	MTE Estimate R'000	MTE Estimate R'000	MTE Estimate R'000
Eastern Cape							
Free State	11,202	8,770	8,488	8,951	9,445	10,789	11,318
Gauteng	49,123	49,412	4,1701	38,340	37,090	39,730	42,114
KwaZulu-Natal	16,998	16,797	17,058	17,776	17,737	20,485	21,061
Mpumalanga	28,574	23,968	24,872	28,889	32,544	35,344	36,545
Northern Cape	1,263	2,305	1,433	1,647	2,505	4,000	4,800
Limpopo	3,683	531	6,445	1,514	4,435	15,249	17,702
North West	104,204	119,547	93,385	104,385	123,180	125,160	127,540
Western Cape	10,577	4,018	3,502	4,691	4,972	5,271	5,587
National	225,624	225,348	196,884	206,193	231,908	256,028	266,667

Source: National Treasury, unpublished document, 2001.
Note: empty cells mean data not available.

From the table it is shown that general expenditure on ECD is increasing and is expected to increase up to 2003/2004.

9.6 Expanding provision and building inter-sectoral programmes

The Department of Education is aware that providing ECD for children younger than five years requires a combination of programmes that draw in numerous departments, non-governmental organisations, community-based organisations, families, parents and children. Currently the main role players in ECD service delivery of the Pre-Reception year are the Departments of Social Development, Health and Local Government.

9.7. Funding mechanisms for ECD programmes

There are arguments for inclusion of ECD both in the equitable share formula and through conditional grants. The White Paper on ECD states that community-based ECD sites are expected to cost less than public primary school ECD sites. If ECD programmes were to be financed through the equitable share formula, these cost differentials may result in provincial education departments favouring higher-cost public school ECD programmes in order to increase their equitable allocations.

Including ECD financing in the equitable share may also lead to under-spending on ECD programmes by provincial education departments relative to the level desired by the nation as a whole. For example, the inclusion of ECD programme financing in the equitable share may result in provinces shifting resources away from ECD programmes in favour of other pressing needs.

9.8 Conclusions

It is proposed that a simple approach be developed to allocate funds for ECD. The formula should not discriminate between community-based, public school, and independent school sites. The formula should be developed along the following lines:

- It should be based on a poverty-weighted count of eligible children in each province.
- Children can be characterised as coming from poor or non-poor families. Alternatively, children can be divided into more than two household income categories.
- On the basis of studies, it would be possible to assign a "poverty weight" to each poor child (as opposed to a middle class child). This weight would provide an estimate of the additional costs needed to prepare a poor child for primary school.
- The equitable share for ECD for each province would then be determined by multiplying the weighted number of eligible children with a figure representing the national average ECD programme cost per child.[21]
- As the White Paper states that the goal of providing all children with ECD programmes should be achieved by 2010, it will also be important to include a phase-in parameter. This parameter would be increased in each year and would have a value of one in the year the ECD programme is fully phased in.

Whilst the White Paper defines ECD as covering 0-9 year olds, direct funding is directed only at the 5-6 year olds. It is stated in the White Paper that the 0-4 group will be addressed through interdepartmental activities, NGOs, CBOs, and parents. There is an apparent inconsistency between what is stated in policy and what exists in practice. It is important to clarify this position, especially as it relates to the progressive realisation of basic education for all children. It will also be important to investigate the resource implications of extending funding to cover all children entitled to ECD.

It was noted earlier that Government intends phasing out conditional grants for ECD. These will be phased-in into the provincial equitable share. The problem is that if conditional grants are totally phased out, community-based ECD providers will suffer the most. These sites provide a useful service, especially where public schools are not easily accessible to young children.

9.9 Proposal

The status quo of the ECD programme should remain until a funding formula is developed. The FFC intends undertaking this task as part of the comprehensive review of the provincial equitable share formula.

21 Note that the count of eligible ıildren includes all age-appropriate ldren independent of their family income or ıdependent school attendance. There would be no requirement that provinces provide any funding for lependent schools. ɔreover, the use of ı poverty-weighted count of eligible ıdents would result ı lower allocations ɔ richer provinces, ʼhere, presumably, ıdependent school endance would be higher.

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10. Implications of HIV/AIDS for the Health, Welfare, and Education sectors

10.1. Background

HIV/AIDS continues to impose a heavy human and financial toll in South Africa and other developing nations. HIV/AIDS will greatly increase the demand for social services such as health care and poverty relief.

In its recommendations for the 2001/04 MTEF cycle, the FFC proposed a formula for financing Primary Health Care (PHC). For its own purposes, the commission defined basic health care as primary health services. Consultations with stakeholders indicated the need for such a formula to include a variable for HIV/AIDS. The Commission felt that it would not be appropriate to include such a variable in an intergovernmental grants formula because of the nature of HIV/AIDS and also because there was little knowledge of the impact of HIV/AIDS on different sectors of the economy. The Commission recommended that HIV/AIDS be dealt with at a national level through conditional grants.

This section is in response to stakeholder requests and also aims to consolidate the Commission's position regarding its recommendation that HIV/AIDS is better dealt with via conditional grants.

10.2 The Impact of HIV/AIDS on the social sector[22]

The three tables below provide a summary of the impact studies of HIV/AIDS on the social sectors (health, social development, and education). The tables are a useful summary of factors and impacts from several disparate studies undertaken in South Africa. The findings in these studies are based on available data and statistics. If these studies can be validated, they will provide significant parameters for assessing the impact of HIV/AIDS on the equitable share formula.

Table 10.1: Impact on the public health sector[23]

FACTOR	IMPACT	
Demand for and utilisation of health care services	Child admission	• 35% of children admitted at Baragwanath hospital in Johannesburg and Red Cross hospital in Cape Town are HIV positive.
	Adult admission	• 20-25% of adult admissions in Gauteng are HIV-related • Demand for adult hospital beds in Gauteng will increase from 2,000 to over 10,000 between 1998 and 2010 (500% increase)
	Demand for PHC services	• Demand for PHC services will increase as a result of HIV/AIDS

22 This assessment assumes that there will be no breakthrough in the development of a vaccine or cure for HIV/AIDS.

23 This table is based upon the following sources: G. Adler and O. Qulo (1999), *"HIV/AIDS & STDs," in Health Systems Trust, South African Health Review 1999; Steinberg et al (2000), "HIV/AIDS – facts, figures, and the future," in Health Systems Trust, South African Health Review 2000;* A. Hamoudi (2000), *"HIV/AIDS and the changing burden of disease in Southern Africa," Harvard University; Department of Health budget submission (2001), An Enhanced Response to HIV/AIDS and TB in the Public Health Sector – Key Components and Funding Requirements, 2002/03-2004/05;* L. Bollinger & J. Strover (1999), *"The Economic Impact of AIDS in South Africa," Futures Group International; Love Life (2000), "Impending Catastrophe Revisited: An update on the HIV/AIDS epidemic in South Africa.*

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FACTOR	IMPACT	
	Demand for hospital services	• Rural KZN showed an 81% rise in hospital attendance at Hlabisa hospital between 1991 and 1998. Much of this rise was attributable to an increased incidence of TB. TB admissions were up 400% over that period. • 628,000 admissions to public hospitals were associated with HIV/AIDS, which amounts to 24% of all public hospital admissions. • As the illness progresses, the primary care level is less able to treat patients.
	Incidence of HIV/AIDS related diseases rising	• At least 50% of all TB cases are attributed to HIV infection.
HIV/AIDS-related expenditure	Acute health care costs	• Expenditure is expected to more than double in the public sector, but the impact on the private sector will be delayed.
	Spending on public hospitals versus ambulatory care	• If 1995 levels of care were maintained, spending on public sector hospitals (in-patient care) would have to increased by 2.3 times by 2010. The impact on ambulatory care in both public (approx. 60%) and private sectors is likely to be significantly less.
	Cost of hospitalisation	• The cost of hospitalising AIDS patients in public facilities will be at least R3.6 billion in 2001, or 12.5% of the total public health budget.
Non-HIV/AIDS spending in public hospitals	Projected to remain a constant share of total absorption, but in the worst-case scenario to decline due to demographic changes.	• Early on in the epidemic, a decrease in the number of women of reproductive age leads to a decrease in pregnancy and birth-related expenditures. • Later in the epidemic (around 2025), the projections suggest that non-HIV costs will decrease as a result of the smaller proportion of persons entering old age.
Human resources, capacity, and quality of service delivery	Staffing gaps	• Staffing gaps will be created through deaths and absenteeism. Additional staff will have to be trained.
	Ability to provide effective care	• The ability to provide effective care will also be compromised through health workers who are infected or have to care for a family member who has AIDS.
	Staff morale	• Combined with increased work pressure, staff morale is likely to be low.

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Table 10.2: Impact on the welfare sector[24]

FACTOR	IMPACT
Foster care	• Number of children under 15 who will have lost a mother to AIDS will rise from 150,000 in 2000 to about 2.5million by 2010. • Rising expenditure as number of orphans and take-up rates increase
Child support	• Number of poor families increases due to illness and death of provider, thereby increasing take-up rate. • In the long-term, lower birth rates will decrease take-up rates as fewer children are born. • Rising expenditure as number of orphans and take-up rates increase
Old age pension	• In the long term, the take-up rate might decline as fewer people reach old age. • This grant is important in dealing with the effects of AIDS on families.
Disability	Take-up rates unlikely to be significant.
War veterans	No direct impact
Care dependency	No significant impact
Grant-in-Aid	Take-up rates unlikely to be significant
Social services and social relief	• Difficult to project impacts as services are targeted towards specific groups for which data is not available. • The financial impact on the family is as much as 30% more than deaths from other causes, as it strikes mainly adults between the ages of 25 and 45. • Disruption to communities will result in increased demand for institutional care and services. • Poverty and inequality are likely to increase. • Emergency social relief grants may grow significantly, depending on application and processing time of grant.

Table 10.3: Impact on the education sector[25]

FACTOR	IMPACT	
Demand for education	Decline	• Children infected at birth do not live to enroll in school, and some of the children enrolled drop out to care for the ill. • Fewer children will enroll in school because of financial constraints and lower birth rates. • Declining primary-age children over the decade will translate into a reduction at high school and tertiary levels during the following decade.
Changing demand	Increasing demand for second chance	• Demand for second chances will increase as learners return into the system after an absence • There will be increased demand amongst sick parents for ECD and an increase in pre-school intake

24 This table is based upon *Love Life (2000), "Impending Catastrophe Revisited: An update on the HIV/AIDS epidemic in South Africa".*

25 This table is based upon the following sources: *Love Life (2000), "Impending Catastrophe Revisited: An update on the HIV/AIDS epidemic in South Africa"*; C. Carol (2000), *"Keeping the Education System Healthy,"* Paper commissioned by UN Economic Commission for Africa; B.W. Peter, *"The Impact of HIV/AIDS on Education in KwaZulu-Natal,"* Kwa-Zulu-Natal Provincial Education Development Unit & Health Economics and AIDS Research Division; S. Sheldon (1994), *"The Impact of HIV/AIDS on Education: A Review of Literature and Experience,"* UNESCO.

FACTOR	IMPACT	
Supply of personnel	Declining standards (quality)	• The total number of educators expected to leave the system in KZN is estimated to increase due to HIV/AIDS. • At the level of managers and planners: illness, absenteeism, death, and the resulting turnover of personnel will reduce human capital in the system.
Availability of resources	Decrease for the education sector	• Resources may decline due to trade-offs with more directly affected services. • Sick and inactive teacher's salaries would have a significant impact on the available resources. • Salaries of temporary teachers will impact significantly on the available resources. • There will be increased pressure to direct more resources to teacher training.

10.3 Government action in response to HIV/AIDS

10.3.1 National HIV/AIDS Plan

The primary goals of the HIV/AIDS and Sexually Transmitted Diseases strategic plan (2000-2005) are to reduce the number of infections (especially among youth) and to reduce the impact of HIV/AIDS on individuals, families and communities. The Plan centres on the following four areas:

- Prevention;
- Treatment care and support;
- Human and legal rights; and
- Monitoring, research and surveillance.

10.3.2 Financial Implications of the National AIDS Plan

The Department of Health identified four focus areas: prevention; treatment, care and support; tuberculosis control; and programme management. Interventions in each of the four focus areas were then grouped into three categories:

- *Group A - Core interventions:* interventions of proven effectiveness and cost-effectiveness, which can be adopted or expanded with confidence (such as improved availability of drugs and home-based-care).
- *Group B - Lower cost/higher certainty interventions:* interventions for which there is less evidence than for the "core" package, but which show promise pending current research results. An example is the future roll out of the prevention of mother to child transmission pilot programme.
- *Group C - Higher cost/ lower certainty interventions:* interventions which both have significant cost implications and which require substantial further research prior to adoption, but for which policy-relevant answers will be required in the medium-term.

The table below shows the funding requirements of implementing the core intervention package.

Table 10.4: Core intervention package

(R million)	Baseline 2001/02	Total funding requirement (2001 Rand)		
		2002/03	2003/04	2004/05
A. Prevention	201	273	303	329
B. Treatment, care & support	3,971	4,587	5,141	5,691
C. Programme management	48	64	61	59
Sub-total	**4,221**	**4,925**	**5,505**	**6,078**
Tuberculosis	224	282	319	357
Total funding requirement	**4,445**	**5,207**	**5,824**	**6,435**

Source: Department of Health (2001), "An Enhanced Response to HIV/AIDS and TB in the Public Health Sector – Key Components and Funding Requirements, 2002/03-2004/05."

The total estimate for the lower cost/higher certainty interventions for 2002/03 is R46.8 million, while that for the higher cost/lower certainty interventions is R12.8 million. It appears that not all of the interventions mentioned in the National AIDS Plan have been costed, but further work is in progress on modeling the likely costs of the National AIDS Plan.

10.4 Current government funding

The table below summarises Government's funding channels for HIV/AIDS. It is important that the funding system should be flexible enough to deal with the various impacts and to allow for innovation.

Table 10.5: Government funding channels for HIV/AIDS programmes

Channel	Purpose	Estimated expenditure 2001/02
Provincial health budgets	Spending on Aids-related illnesses, including drugs essential for opportunistic infections	R4bn
Government Aids Action Plan	Mostly prevention	R190m
Integrated strategy (education, health & welfare)	Flows mostly as conditional grants to provinces	R125m
Allocations from provincial equitable share	Prevention and information	Unknown
Individual government departments	Provide information to employees & to support them	Unknown

Source: National Treasury, Intergovernmental Fiscal Review 2001.

10.4.1 Provincial Health Budgets

At the delivery level, provinces are experiencing increased demand for services. The expenditure is mostly unplanned, and provinces finance these services mostly from their equitable share allocation. The 2001/02 budget estimate for AIDS-related health care was R4bn. This represents about fourteen percent of total provincial health expenditure.

However, the magnitude of what could be termed "hidden costs" is unknown. These refer to actual visits by AIDS patients to hospitals for treatment of a whole range of opportunistic infections. These costs need to be documented more accurately and in more detail so that there is a basis for assessing whether or not adequate funding is sufficient to provide for constitutionally mandated basic services.

Budget 2002 introduced new funding for HIV/AIDS through the equitable share. In the 2002/03 Budget, R400 million is allocated to provinces as part of the equitable share increase to deal with the additional costs arising from HIV/AIDS. This amount increases to R900 million in 2004/05. The extra funding would cover a range of interventions, including improved care of sexually-transmitted infections and tuberculosis, medication for prevention of tuberculosis and pneumonia in infected persons, and costs arising from hospitalisation and treatment of opportunistic diseases.[26] However, the problem of using the equitable share mechanism is that there is no guarantee that this funding will be used specifically on HIV/AIDS.

The FFC recommended against including HIV/AIDS specifically in the equitable share formula. The FFC believes that public health needs and priorities change continuously as new problems are identified, for example the increase in tuberculosis. Including specific disease factors in the formula tends to lock in patterns of aid distribution, making it more difficult to respond to changing needs. Instead, the FFC suggests that HIV/AIDS epidemic be dealt with as a multi-sectoral priority across the education, health, and welfare functions, and not as one to be addressed separately by the various provincial departments of health.[27]

The equitable share mechanism is not the most appropriate mechanism for making provincial allocations for HIV/AIDS for the following reasons:

- Building components into the formula for which there is no data could undermine the equitable share formula. AIDS manifests itself in many opportunistic diseases that also attack uninfected people. It is therefore difficult to separate diseases that are caused by HIV and those that are not. However, it is important to collect all the necessary data.

26 National Treasury, *Budget Review 2002.*

27 FFC (2000), *Recommendations: 2001-2004 MTEF Cycle.*

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- Including an HIV/AIDS component in the formula is not a guarantee that such funding will be used for HIV/AIDS. The choice of funding mechanism depends largely on the objective that Government wants to achieve. If it is important to track funding and ensure it is used for the purposes for which it is intended, then the best mechanism would be through the use of conditional grants.
- A key principle in the choice of a funding mechanism is that issues of national priority are best dealt with through conditional grants. The reason for treating HIV/AIDS differently from other diseases such as cancer is because it is a national priority.
- Policy on HIV/AIDS is changing rapidly. A requirement for the use of a formula is that it has to be stable and should not change each time there are policy changes.

10.4.2 Government Action Aids Plan

The funding for the Government Action Aids Plan is derived from and managed by the national Department of Health and amounts to about R190 million per year. Direct national-level expenditure is used for a broad range of activities, including condom procurement, campaigns, and research funding.[28]

10.4.3 National Integrated Plan (NIP) for Children Infected and Affected by HIV/AIDS

The NIP aims to complement the Strategic Plan for 2000/05 and represents one of the largest direct flows that are specifically targeted to HIV/AIDS. This programme is meant to assist provinces in providing for the rollout of life-skills training to primary and secondary schools, the expansion of capacity to provide voluntary counselling and testing (VCT) at health clinics, and piloting of home-based care (HBC). The Department of Health plays a major role in implementing this plan. The responsibility for VCT lies with the Department of Health. HBC is split between the Departments of Social Development and Health, and life-skills lies with the Department of Health and Education. In the 2002 Budget, the interventions have been expanded to include prevention of mother to child transmission (PMTCT), step-down care, and provincial management.

28 Department of Health (2001), *An Enhanced Response to HIV/AIDS and TB in the Public Health Sector – Key Components and Funding Requirements, 2002/03-2004/05.*

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Table 10.6: Main dedicated funding streams for HIV/AIDS and TB (R'000)

	2000/01	2001/02 (revised)	2002/03	2003/04	2004/05
Health conditional grant to provinces	16,819	54,398	157,209	266,576	380,480
• Life-skills	27,000	63,500	142,000	117,400	124,924
• VCT	8,629	22,000	49,000	54,829	58,219
• Provincial Management	0	0	6,709	8,386	8,386
• HBC	8,190	12,100	46,502	64,236	68,185
• Step-down Care	0	0	30,000	60,000	90,000
Education conditional grant to provinces	27,000	63,500	142,000	117,400	124,924
Dept of Social Development conditional grant	6,000	12,500	46,500	64,235	68,185
National Dept of Health	164,329	212,464	250,996	277,457	309,023
• NGOs	19,013	34,572	53,000	45,850	73,050
• Core DOH (condoms, media, TB)	145,316	142,892	157,996	186,607	215,973
• Love Life programme	0	25,000	25,000	25,000	0
• SA National AIDS Council	0	10,000	10,000	15,000	15,000
• SA AIDS Vaccine initiative	0	0	5,000	5,000	5,000
Targeted increase in provincial equitable share			400,000	600,000	900,000
Total	214,148	342,862	996,705	1,325,668	1,782,612

Source: National Treasury, Budget Review 2002.

Over this MTEF period, emphasis will be placed not only on prevention but also on care, as evidenced by the introduction of an allocation through the equitable share mechanism.

10.4.4 Allocation criteria

Programme allocations are determined by policy objectives. For the first three years, prevention is a priority, thus allocations to life-skills account for more than fifty percent of the total conditional grant. Thereafter, the focus shifts towards treatment and strengthening home-based care, and the proportion for life-skills declines while that for

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HBC increases. From 2003/04, the share to life-skills and voluntary counseling and testing declines gradually while that to home-based care, mother-to-child transmission, and step-down care increases.

For the first two years, the provincial allocations for the social development grant took into account the capacity of provinces and NGOs to spend the funds effectively. The allocation is made on the basis of the results of the 1999 audit of the readiness of the health and NGO sectors to deliver home-based care and support.[29]

In Budget 2002, the following criteria were used as guiding principles:

- Priority should be given to provinces with high prevalence rates.
- Allocations should reflect resources available in the provinces and the extent to which there are linkages with other programmes and strategies, such as the urban renewal and rural development strategy and the integrated nutrition programme.[30]

The health allocation was based on the national survey conducted in 1999 on the status and availability of voluntary counseling and testing in all provinces and on business plans submitted by the provinces. Lastly, the education portion of the grant was and still is allocated on the basis of the education component of the equitable share formula.

Table 10.7: Provincial HIV/AIDS allocation (Revised estimate, 2001/02 budget) (R'000)

Province	Education	Health	Social Development
Eastern Cape	11,747	6,281	1,500
Free State	4,001	4,716	1,500
Gauteng	7.810	5,630	1,000
KwaZulu-Natal	14,033	13,924	1,500
Mpumalanga	4,636	4,659	1,500
Northern Cape	1,207	4,665	1,500
Limpopo	9,969	5,555	1,500
North West	5,080	4,640	1,500
Western Cape	5,017	4,328	1,000
National	63,500	54,398	12,500

Source: Division of Revenue Bill, 2002.

The allocations as shown in Table 11.7 not show much inter-provincial variation, especially for social development. Since this conditional grant is specific to HIV/AIDS, prevalence rates are an important indicator in the allocation mechanism. The consequence of not using a criterion that measures relative need is a mismatch between infection rates and provincial allocations.[31]

29 National Treasury, Budget Review 2001.0
30 Division of Revenue Bill of 2002.
31 IDASA (2001), Budget Brief 62.

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In the 2001/02 budget, the mismatch in the Department of Social Development (DSD) allocation was very marked. KwaZulu-Natal, with a national infected population share of thirty percent, was allocated twenty two percent of the funding, while Northern Cape, with an infected population of one percent, received twelve percent of the total funding. However, the mismatch between allocation and incidence may be due to factors such as population density, focus on prevention, and capacity to deliver.

From 2002/03 to 2004/05, the allocation criteria for some of the programmes take into account prevalence rates or some appropriate measure of need. The DSD and DoH (home-based care) components take into account the 2000 antenatal survey prevalence results; the DoH voluntary testing and counselling component uses the health equitable share weighting; the mother-to-child transmission component is split according to the estimated share of HIV births; Step-down care uses some HIV/AIDS statistics; and finally the allocation for provincial management is a fixed amount per province.[32]

10.4.5 Underspending

The major problem with the National Integrated Plan is the failure by provinces to spend the funds allocated to them. Of the R15 million transferred to Health, only R10 million was spent; Social Development spent R2 million out of a transfer of R5 million; and Education spent R6 million out of a transfer of R26 million in 2000/01.[33]

Some of the factors identified as causes for under-spending include lack of human and infrastructure capacity, financial planning, and synergy between programme managers and financial managers.[34] However, provinces have projected that spending will improve as capacity improves and other problems are addressed.

10.5 Conclusion and proposals

It is clear that HIV/AIDS is taking an enormous toll on South Africa. The debate about an appropriate mechanism is important in ensuring that funding is targeted towards mitigating the effects of this tragedy.

The Commission's proposals are as follows:

- The FFC confirms its previous position that conditional grants remain the most appropriate mechanism for targeting spending, given the national priority of combating the spread of HIV/AIDS.
- The development of a suitable data and information base that includes long-term projections should be prioritised.

32 Department of Health,

33 National Treasury, *Intergovernmental Fiscal Review 2001.*

34 Department of Health, *"Budget Split and Quarterly Transfers to Provinces for VCT and CHBS 2002/03,"* Unpublished document.

11. The Primary Health Care Package[35]

11.1 Background

Previously, the FFC defined basic service delivery in health as primary health care. At that stage there was no clear definition of what services constituted primary health care (PHC). This section discusses the main components of primary health care as defined by the Department of Health.

In an effort to define a minimum basket of PHC services, the Department of Health (DoH) developed a comprehensive primary health care package in 1998. After a series of consultations with stakeholders, a final version of the PHC package was launched in September 2001.

The vehicle of delivery for this package is the district health system and covers services rendered at community level, clinics (mobile and fixed), and community health centres (CHCs). However, not all districts will be able to provide all these services immediately, and services are to be phased in over a five-year period.

The phase-in time is indicated in the package. This reflects which services should be rendered now, which within three years, and which within five years. The package proposes the type of organisation within a district that will deliver the service. In addition, the package sets out an indicative calculation of resource implications (financial and human).

The Package sets out the following priority areas for primary health care:

- Child health, and in particular infectious diseases;
- AIDS, sexually transmitted diseases, and tuberculosis;
- Reproductive health: Antenatal, family planning and maternity;
- Chronic diseases (e.g. diabetes, asthma);
- Trauma and injuries; and
- Disabilities and mental health.

The table on the following page summarises the type of service and service delivery level.

35 Extracted from Department of Health (2001), *"A Comprehensive PHC service package for SA."*

11.2 Levels of Service

Table 11.1 Service type and delivery level

Level of Service Delivery	Type of Service	
Community Services	District management functions	District management will co-ordinate between various levels of services - Ensure proper referral system - Ensure smooth drug supply - Ensure and monitor activities taking place outside facilities (outreach programmes, visits by CHCs)
	Non-personal services	District-wide services: environmental health, health promotion, school health services, and services to other institutions. Equitable distribution of such services will need to be co-coordinated by district management.
	Personal services: home-based	For equitable provision, these services need to be planned at a district management level.
Clinics and Mobile Services	Defined by the level of skills of staff - in this case, services that can be delivered by a professional nurse. Additional services could be delivered by regular visits from doctors, and other professionals. Three service points are proposed: children, adults, and fast-queue/repeat.	
Community Health Centres	Where no CHCs currently exist, some services would be rendered at hospitals in the short-term. A CHC has three components: • A clinic for the local population • A referral section with specialists • A 24-hour unit with maternity and casualty. In addition, the CHC referral section staff will also visit clinics to hold clinical sessions and training/audit/staff support sessions. Where CHCs do not exist, local hospitals could take over this function.	

11.3 The package

The package is divided into three sections: community services (non-personal services and community-based personal services), clinics (including mobile clinics), and community health centres.

For each level of service, the document explains the criteria used for allocation of services in one level or the other (infrastructure and equipment; type of staff; space requirements; and components of services). Following this is a list of the services and components of each level of services of the Comprehensive PHC package. Time frames for the implementation of the package as well as suggestions for referral mechanisms are indicated. Full implementation of the comprehensive package should be reached within five years.

11.3.1 District-based services

District or community-based services include district level services such as marketing messages, health promotion, institution-based health services (such as those based in schools, prisons, etc), and environmental/occupational health services. The type of staff required ranges from a professional nurse, psychologist, environmental health specialist to oral health professionals and social workers.

11.3.2 Mobile/Fixed Clinic Services

The mobile/fixed clinic services are broken down into services provided at mobile/fixed clinics, clinic/mobile (service point: adults) and clinic (fast queue/repeats). It is up to the local clinics to choose different types of organisation that reflect local conditions.

11.3.3 Community Health Centres

Components of services at a community health centre include antenatal care, reproductive health, chronic diseases, tuberculosis, HIV/AIDS, other curative, mental health, oral health, rehabilitation and disability services, environmental health, occupational health, casualty and maternity.

The district hospital also plays a role in supporting primary health care and being a gateway to more specialist care. District hospitals provide level 1 (generalist services) to in-patients and out-patients (ideally on referral from a CHC or clinic). The hospital has between 30 and 200 beds, a 24-hour emergency service, and an operating theatre. In some cases, PHC services are rendered at district hospitals where there is no alternative source for this care within reasonable distance.

11.4 Costing of the PHC Package[36]

The Centre for Health Policy Unit (CHP) estimated the cost of a PHC package in 1997. This study was based on the "Need Norms" work that CHP had developed in previous years. However, this work had the following shortcomings:

- The CHP costing presented only a model of projected package costs, and made no reference to the "actual" costs of delivering PHC services.
- The CHP costing data was drawn from urban locations, suggesting that further work was needed to adapt them to rural settings.
- The CHP model was based on an explicit set of provision norms developed within the "need norms" framework. However, the DoH's package and its norms and standards are based less explicitly on quantified provision norms.

A primary data collection exercise was then carried out to provide actual data on

36 V. Brijlal and M. Hensher (Department of Health) (2001), *"Estimating the Costs of Implementing the Primary Health Care Package"*.

current PHC costs. The exercise was undertaken in an attempt to estimate the additional resources necessary to comply with the criteria requirements of the DoH package. This exercise was conducted in Hlanganani District of the Free State and in the Eastern Cape. The table below shows the results of the exercise.

Table 11.3 Summary of PHC package cost results

Total Population	Per capita cost	Package Cost
Estimated current	102.79	3,986,075,527
Hlanganani 2.8 visits per person per year	124.78	5,386,197,451
Hlanganani 3.5 visits per person per year	139.71	6,140,757,896
Updated CHP	166.00	6,733,783,883
Eastern Cape 3.1 visits per person per year	175.95	7,580,885,103

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Updated CHP	166.00	6,733,783,883
Eastern Cape 3.1 visits per person per year	175.95	7,580,885,103

The above tables indicate that the different cost estimates and assumptions produce significantly different estimates of the cost of implementing the package.

The Hlanganani study approaches the package in a qualitative manner, and hence compliance with the package appears to be somewhat more affordable. However, this study does not include Community Health Centres, which are an important aspect under Draft 5 of the Department of Health's PHC document. Hence it is cheaper because it avoids a major CHC development programme.

Both the CHP and Eastern Cape approaches are more expensive because they interpret the package more in terms of quantitative provision norms (for example, in terms of staff and facility to population ratios, and prescribed staff time inputs per patient contact). They also put greater emphasis on the role of the CHC. The Hlanganani model attempts to take current practice and expand both quality and access, but using current productivity levels in terms of time per patient. However this does not account for the possibility that current consultation times are too short to provide quality care. Both the Hlanganani and Eastern Cape estimates appear to offer better value for money than the CHP approach in terms of the increased activity they both offer.

11.5 Issues for further investigation

A number of issues require further examination. Firstly, the absence of reliable data specifically on PHC spending at provincial and national level is a problem. Current financial reporting systems do not disaggregate spending on PHC services (clinics and CHCs) from spending on district hospitals. All are reported together under "District Health Services". Only a few district studies attempt this disaggregation. However, the development of National Health Accounts for the Department of Health will provide much firmer estimates of disaggregated expenditure.

Second, the role of the private sector and how its resources can be harnessed in primary health care provision is not clear.

Third, there is a commitment to decentralise district health services to local government. Even though this is a long-term objective, it is necessary to base this process on evidence and analysis of the current situation. The Health Systems Trust (HST), with the assistance of the Health Economics Unit (HEU), UCT, and the Centre for Health Policy Research have undertaken to develop a research and monitoring strategy to evaluate and inform the process of decentralisation and devolution of health services.

Fourthly, there is a need to establish the convergence or divergence between the provision of primary health care services and the provision of constitutionally mandated basic health care services. The FFC will undertake further work on this issue.

Cross-cutting Equitable Share Issues

12. Towards a Review of the Intergovernmental Fiscal System

12.1 Introduction

In 1995/96, the FFC contributed to the development of the current provincial equitable share formula. There was an explicit requirement that this formula be reviewed periodically. The Ministry of Finance and National Treasury have acknowledged the need for such a review to take place, as noted in Annexure E of the Budget Reviews of 2001 and 2002.

Last year, the FFC embarked on a process of reviewing the formula and the intergovernmental allocation mechanisms more generally. In this submission, the FFC further develops its principles for a framework for the equitable sharing of national revenue.

In developing these principles, the FFC believes the following should be considered:
(1) the need to conduct an overall audit of the current intergovernmental fiscal systems and mechanisms as part of a review of the equitable share formula;
(2) the need to consider the incorporation of the constitutional requirement for meeting constitutionally mandated basic services (CMBS) through progressive realisation;
(3) the need to develop a mechanism for the equitable allocation of capital grants for infrastructure development; and
(4) the need to develop more explicit budget processes and mechanisms that incorporate Government's requirement to take account of Sections 214 (2) (a) to (j) of the Constitution.

The FFC made a number of proposals with respect to the equitable sharing of national revenue in its Submission for the Division of Revenue 2002/2003. The Commission proposed a study project involving relevant role-players with the aim of providing definitions of constitutionally mandated basic services and other constitutional obligations. This project would take account of the need to realise these constitutional obligations through a process of progressive realisation.

With specific respect to equitable share formulae, the Commission proposed that a review of the Provincial Equitable Share formula take account of pending legislation relating to provincial taxes and the introduction of the capital grants scheme. Second, the Commission proposed that the Local Equitable Share formula take account of basic municipal service responsibilities and fiscal capacity. Components of the formulae can be operationalised as data become available.

12.2 Expenditure analysis framework

The first chapter of the Commission's Submission for 2002/03 presented the constitutional context and legislative provisions relating to an equitable sharing of national revenue. The submission further formulated a framework for the equitable sharing of national revenue. The following points were noted:

- Total National Revenue (TNR) available for equitable sharing is funded through tax, other revenue, and deficit financing, but, in accordance with subsections 214(2)(b) and (j), is net of debt servicing costs and contingency reserves.
- TNR is available for division as equitable shares for each of national, provincial and local government spheres.
- Litigation and court judgments over the recent past reflect growing concerns that the equitable shares do not adequately address the obligation on all spheres of government to deliver constitutionally mandated basic services. Hence a review of the equitable share mechanism should be reviewed in order to:
  a) Distinguish between CMBS and other constitutional obligations and functions;
  b) Provide the legislatures, judiciary, and other organs of state with a means of assessing whether constitutional mandates are being fulfilled;
  c) Provide a point of departure for determining allocations by rationally considering the financing of CMBS and other obligations;
  d) Serve as a tool for all three spheres to prioritise policy objectives and targets, efficiently allocate resources, and identify fiscal resource gaps; and
  e) Take into account the progressive realisation of basic rights.

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The following matrices summarise the basic framework for the allocation of equitable shares and revenue sources:

Table 12.1 Matrix enabling expenditure/revenue analysis of the equitable sharing of nationally raised revenue

Expenditure Policy Objectives & Targets				
	National Sphere (current / capital)	**Provincial Sphere (current / capital)**	**Local Sphere (current / capital)**	**Total (current / capital)**
Equitable Share	NES +	PES +	LES =	ES
S-Element (CMBS Obligations)				
I-Element (Institutional & Administrative)				
B-Element (Other Constitutional Functions)				
Conditional Grants	-PCG - LCG	+PCG	+LCG	CG = PCG + LCG
Total	(NES – PCG -LCG)+	(PES + PCG) +	(LES + LCG) =	TNR

Revenue Policy Objectives & Targets				
	National Sphere	**Provincial Sphere**	**Local Sphere**	**Total**
Taxes				
User Charges				
Borrowing				

TNR = (NES-PCG-LCG)+(PES+PCG)+(LES+LCG)

Where:
TNR = Total national revenue available for equitable division
NES = National government equitable share
PES = Provincial government equitable share
LES = Local government equitable share
PCG = Provincial government conditional grants
LCG = Local government conditional grants

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12.3 FFC's previous proposals on the review of intergovernmental fiscal mechanisms

Part 1 of Annexure E of the 2002 Division of Revenue Act outlines Government's response to the Commission's Submission on the Division of Revenue 2002/2003.

Government agreed with the FFC that provinces and municipalities must prioritise constitutionally mandated basic service obligations, but viewed the translation of constitutional provisions into a formula-based approach for the division of revenue as impractical. This was owing to:

- The lack of concise definitions of CMBS obligations;
- The absence of objectively determined norms and standards for CMBS and other functions; and
- The lack of data that would enable such an approach.

Nevertheless, Government agreed that the process of regularly reviewing and adapting the formula should be maintained. Furthermore, Government concurs with the need to develop more precise information to determine the cost of constitutionally mandated basic services.

Government will undertake a comprehensive assessment of the equitable share formulae once the 2001 Census results are released. This will enable a review of the structure, components, and data requirements of the formulae in order that it becomes more policy-based for the 2005 MTEF. Government also agrees with the need to review the formula in the light of changes to the fiscal capacity of provinces and municipalities. In terms of the Constitution and legislation, the FFC will be required to make proposals and recommendations for the review of the mechanisms for intergovernmental fiscal relations.

The following contributions are submitted in the spirit of Chapter 3 of the Constitution.

12.4 Conducting an intergovernmental fiscal arrangements audit

The first step in reviewing current intergovernmental fiscal mechanisms would be to conduct an audit of recent arrangements. This section proposes a method for the examination of intergovernmental fiscal mechanisms and processes.

In order to assist the audit process, a template has been developed which has mechanisms or processes along one axis and a range of functions that must be performed in a well-functioning system along the other axis. An example of the template is provided below.

The audit works best if a number of individuals who are knowledgeable about intergovernmental processes undertake the audit individually and then bring their individual rankings and comments together. There are no right or wrong answers. However, the ensuing discussion should assist the participants to draw conclusions on the areas in which the system might need strengthening and the structures and processes that might be used to ensure that the intergovernmental system is satisfactory.

This method has been applied to Canadian intergovernmental fiscal relations processes. The audit was carried out by Ron Neumann, technical advisor to the FFC and senior intergovernmental relations official in the Manitoba provincial government in Canada. The audit can be requested from the FFC.

12.4.1 Audit of the South African intergovernmental system

South Africa rates highly with respect to its institutions and arrangements for managing intergovernmental fiscal issues. This is quite remarkable given the fact that the implementation of democratic government and the creation of the nine provinces is less than a decade old.

However, it is appropriate to take stock of the intergovernmental fiscal system in order to address perceived weaknesses and review the current mechanisms. The FFC believes that the method described above can be adapted for reviewing the current South African intergovernmental fiscal mechanisms.

The application of the proposed audit template will work best if it is used to review each of the following elements of the policy making process to:

- Analyse the current situation;
- Assess how policy objectives were and are being determined;
- Evaluate how policy targets are set, taking into account norms, standards and progressive realisation of objectives;
- Assess the appropriateness of the legal, administrative and institutional policy instruments;
- Examine the adequacy and/or efficient use of the budget allocations in delivering on the objectives; and
- Assess the adequacy and appropriateness of the current information, monitoring and performance mechanisms.

The elements underlined above are discussed in greater detail in the next section.

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Intergovernmental fiscal arrangements processes template

	Constitution	Legislation	Agreements	Forums	Gov't Agents	NGOs	Political	Judicial	Other	Ratin
Identification of issues										
Information										
Policy options										
Consensus building										
Policy adoption & implementation										
Administration & Co-ordinat'n										
Monitoring, Evaluation, & Accountability										
Issue Resolution										
SUMMARY										

Ratings: A - Excellent fulfilment of function in a relatively effective manner
B - Function generally performed well
C - Significant gaps or inefficiencies
D - Inefficient or ineffective performance of the function; significant lack of cohesion
E – Performance of the function often leads to more conflict than resolution of issues

12.5 Addressing Constitutionally mandated basic services through intergovernmental fiscal mechanisms

12.5.1 Budget reform project

The Presidency is leading a project to improve planning and budgeting across Government. In January 2002, the Cabinet Lekgotla adopted the Medium-Term Strategic Framework.

The FFC supports this budget reform project as an essential tool of public accountability and management. It will assist in creating a dataset that is consistent, comprehensive, relevant, understandable, analysable, and verifiable. As such, this is an integral part of a review of intergovernmental fiscal mechanisms and processes.

The iterative development of strategic and budget planning over the medium-term will make it possible to engage in a study project on the definition of constitutionally mandated basic services and other constitutional obligations and functions.

Further, the data set generated can provide an explicit and objective basis on which to prioritise policy objectives, define and evaluate efficiency, establish sustainable targets, and identify resource gaps.

12.5.2 FFC approach

Given the Constitutional obligations set out in the Bill of Rights, the FFC identified, in its Recommendations for the 2001/04 MTEF Cycle, a broad framework within which Government and the Legislatures determine their budget expenditures. This section briefly elaborates on these issues as a contribution towards a review of the IGFR mechanisms and Government's proposed budget reform initiative.

(1) Analysis of the current situation

As part of the assessment of any expenditure vote or budget programme's performance, an analysis and review of recent achievements, failures, gaps and future directions should be undertaken. This may be achieved through the intergovernmental fiscal relations audit.

(2) Political determination of fundamental policy objectives

On the basis of the analysis of the current situation, Government and the Legislatures should debate and agree on the fundamental policy objective of a budget vote and programme. The fundamental policy objective should, in the first instance, be consistent with Government's obligations to provide the CMBS enshrined in the Bill of Rights (for example, "Government will provide basic education to all its citizens").

Policy objectives can be quantified in terms of indicators. These can take the form of service delivery indicators, which measure the outputs of recurrent and capital spending. Examples from the education function might be learner:educator and classroom ratios. Indirect developmental outcomes can also be measured, such as literacy and numeracy rates and matric pass rates.

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(3) Setting policy targets

To attain fundamental policy objectives, policy targets ought to be set. The Bill of Rights states that these may be achieved through a process of "progressive realisation" within available resources and through legislative and other policy measures. This principle is further underlined in Section 214(2)(a)-(j) of the Constitution.

Three types of targets can be identified:

1. Primary targets, for example free education from Grades 0 to 12. These relate to recurrent spending.
2. Secondary targets, such as the number of classrooms required to attain the primary target. These may relate to capital or components of current expenditure.
3. Intermediate targets, such as the number of educators to be trained annually to support the primary target.

Ultimately, these targets should be negotiated between a demand for government services and the capacity and the resources required to provide such. These trade-offs should inform the political determination of norms and standards.

(4) Policy instruments for implementation

Once targets have been set, the Constitution requires that reasonable policy instruments be put in place. These policy instruments may be legislative, administrative, and/or institutional.

(5) Determining budget requirements

The next step in the process is for Government to determine the budget required to finance the cost of achieving the set policy targets and objectives. Funds can be channelled through the Equitable Share, conditional grants, other inter-governmental transfers, own revenue, and donor funding.

(6) Monitoring and evaluation mechanisms

Performance outputs and indicators should be analysed on a regular basis, and the results fed back into the design of the system and the monitoring of governmental performance.

12.6 Incorporation of a Capital Grant element in the intergovernmental grant system

In its two previous submissions, the FFC highlighted the need for Government to consider developing a capital grant scheme for provinces. To this end, the FFC proposed a capital grants model. In Annexure E of the Budget Review 2002, Government responded positively to this proposal:

> "Given that infrastructure is an important part of the health, education, and rural infrastructure variables of the backlog component, infrastructure needs are part of the relevant conditional grants, and the equitable share grant as well. Accordingly, the potential practical contributions of the FFC proposed capital grants model should be considered as part of a comprehensive assessment of the equitable share formula's structure and data, and its relationship to infrastructure needs funded outside the equitable share formula."

As part of its contribution to the review of intergovernmental fiscal mechanisms and taking into account Government's concerns with the FFC capital grant scheme proposal, the Commission will expand its capital grant research project to include:

(1) The refinement, extension, and development of the current model to encompass other basic infrastructure services being provided by provinces and municipalities.

(2) The construction and development of the required data sets from information gathered from provinces and municipalities.

(3) The computer programming and simulations of the model to generate results that should test the appropriateness of allocations.

This project is being supported by the Australian development agency, AUSAID. A reference group including stakeholders will monitor the progress of the project.

12.7 Proposed considerations for a review of current intergovernmental fiscal relations

In anticipation of the review of the current intergovernmental fiscal mechanisms and processes, the FFC wishes Parliament and Government to consider:

(1) The possible incorporation of elements and parameters in the intergovernmental transfer formulae that will balance the need to provide constitutionally mandated obligations with the considerations listed in Section 214(2)(a-j) of the Constitution.

(2) The need for substantial improvement in data collection to enhance the development of intergovernmental fiscal mechanisms consistent with constitutional requirements.

(3) The development of specific intergovernmental fiscal capacity-building programmes for personnel, both inside and outside of Government.

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13. Framework for a Comprehensive Social Security Programme in South Africa

13.1 FFC guidelines for assessing the report on the Comprehensive Social Security Review

Cabinet mandated a Committee with the task of conducting a Comprehensive Social Security Review (CSSR), which is due this year. The FFC has been consulted by the Committee and will be required to comment when the Report is made public. In anticipation, this submission proposes some guidelines for the assessment of the report and its recommendations.

As stated in the June 2001 FFC Submission on the Division of Revenue 2002/03, the FFC:
- Respects the constitutional status of each sphere of government;
- Adheres to constitutional principles;
- Is mindful of the fact that the Constitution's Bill of Rights mandates the provision of basic services;
- Considers other principles of good intergovernmental relations;
- Undertakes extensive research to inform the basis of its recommendations; and
- Considers stated government programme objectives and priorities.

The FFC review of the recommendations emanating from the Comprehensive Social Security Review will follow these criteria.

13.1.1 First principles for social security programmes

- *Equity and the solidarity of the nation:* The importance of South African social programmes cannot be overstated. They are the expression of the solidarity of the people across the nation. They encompass the plans of the nation for the care of its elderly and its children, for the sick and the disabled, and for those who have been marginalised by the economic system. They embody the spirit of fairness and equitable treatment for all citizens.

- *The expression of our rights and our values:* Entire nations, such as France and the Scandinavian nations in the Twentieth Century, have been defined by their commitment to social programmes. Through our commitment to social justice, we establish a profile, both within the nation and to the world, of the standards to which we strive. Social programmes are a means through which we can achieve the progressive realisation of basic human rights.

- *Social and economic progress:* Social and economic progress are not competitors. They go hand-in-hand. The economy provides the resources for health, education, social security, and other programmes. Social programmes ensure that the nation's people are able and have the incentive to take advantage of economic opportunities, because the rewards will be shared by the many, not the few. However, if the solidarity of the nation is threatened, economic progress is also at risk.

Developed countries around the world have shown that economic growth and social progress are both strongest when they are growing together. Similarly, many developing countries with rapid economic growth have achieved the virtual elimination of hunger and homelessness, reduced poverty, and improved health care. In some countries, the distribution of wealth has become more even, in others less even, but almost everywhere the large majority have benefited from economic progress.

- *Comprehensive and integrated reform:* Government should be commended for undertaking a comprehensive - rather than piecemeal - review of social security. The terms of reference for the review indicate that the various components are integrated and complementary. Each sphere of government plays a role and will be affected by reform.

- *Long-term sustainability:* The many-faceted programmes and integrated nature of the comprehensive social security system, the direct linkage to economic growth and affordability, and the fact that the three spheres of government are involved create a situation that is prone to the development of unfunded mandates. The FFC advocates the use of an efficient approach to the development of the financing arrangements for social programmes. Such an approach should be able to establish clear and realisable goals and standards together with the costs and financing arrangements necessary to achieve those goals. Thus the equitable financing arrangements will be able to achieve, effectively and efficiently, the progressive realisation of the proposed reforms. The financing arrangements of social security programmes must be augmented by actuarial analysis in order for them to meet the considerations stipulated in Section 214(2)(a-j) of the Constitution.

- *National goals and standards:* The Report emanating from the Comprehensive Social Security Review will contain a vision for the social security system in South Africa and for the manner in which it should address and balance equity for all South Africans. It is not the role of the Commission to present an alternative view of the basic parameters of the proposals.

  Section 146(2)(b) of the Constitution establishes that the minimum levels of these services are to be determined nationally. The role of the FFC is to reflect carefully and analytically on the national goals, standards, and programmes recommended in light of the Comprehensive Social Security Review Report and the FFC's own research, and then to advise on how the plans may best be financed in an equitable and efficacious manner. This may entail commentary on the feasibility of the plan of action in achieving the goals and standards advocated, within the constraints placed on the system.

- *Progressive realisation of basic rights:* The Constitution provides a Bill of Rights which requires that certain basic services be provided to all citizens, among which are health and welfare services (Sections 27 and 28). These are the essential ingredients of the social security system in South Africa. Progressive realisation of basic rights is explicitly endorsed in the Constitution (Section 27(2)). It is incumbent on the FFC to provide commentary on the plans with respect to the provision of basic human rights and the progressive realisation of them.

- *Other Constitutional Provisions:* The FFC is also required to take into consideration the criteria outlined in Section 214(2)(a-j) of the Constitution, such as the need to ensure that all spheres of government are able to provide basic services and perform the functions allocated to them.

13.1.2 Information requirements

The FFC approach is based on having adequate information in order that the Commission and others may make informed decisions. Some of the required information pertains to the parameters of the particular programmes and services. Other information is required to understand the context in which the programmes must operate. Some important features of this context are outlined in this section.

13.1.2.1 Demographics

In order to effectively analyse any proposals for comprehensive social security reform, good demographic data is necessary. This includes:
- Current, medium- and long-term projections of population;
- Population by province and municipality;
- Gender-specific information;
- Age cohorts (pre-school children, school age, young adult, workforce, retired and aged); and
- Socio-economic status (educational attainment, employment status; income; health status, etc.)

13.1.2.2 Economic and fiscal projections

Medium- to long-term projections of real economic growth and inflation under alternative scenarios are required. Resulting base-line growth of revenue under Government's chosen fiscal stance must be projected. Assumptions concerning the modification of the base-line projections through policy initiatives or other effects should be documented.

While it has been the approach of the FFC to accept the economic and fiscal policy framework of Government, the analysis of the implications of social policy proposals may indicate impacts on economic and fiscal projections. These may be reviewed by the FFC.

13.1.2.3 Actuarial approach

The economic and fiscal projections, together with the demographic data and programme parameters, are basic inputs into actuarial calculations that will establish the funding necessary over the long term.

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13.1.2.4 HIV/AIDS and other major factors

HIV/AIDS will have a major impact on the demand for and the capability to deliver social security programmes. Though the precise dimensions of the effects are uncertain, they are without doubt of major concern. HIV/AIDS may have major impacts on the demographics of the nation and on the economy, as well as have major implications for the demand, delivery capability, and affordability of programmes. The potential impact of HIV/AIDS is discussed in depth in Section 10 of this submission.

While HIV/AIDS is clearly the major issue impacting on social security programmes, other considerations may arise. Immigration policy, environmental change, and growing unemployment and poverty-related diseases may be factors in the future. Globalisation and other world events may constitute risks or opportunities with respect to the policy paths chosen. These cannot all be anticipated, but, should risks be apparent, they must be considered in the plans.

13.1.3 Range of Social Services

The potential range of programmes to be encompassed within the Report of the CSSR is expected to be wide.

13.1.3.1 Income support programmes

Existing income support programmes include:
- Old age pensions;
- Disability pensions; and
- Child maintenance grants.

The FFC believes that programmes for providing free basic services, such as housing, water, and electricity, including cross-subsidisation of rates for these basic services, should be linked to the discussion of income support programmes.

The Comprehensive Social Security Review may discuss the merits of a universal basic income grant. The FFC would review such a proposal and its implications. These could be assessed with respect to the ability of a basic income grant to replace in whole or in part existing income support programmes, given any set of constraints on cost, and its potential effect on economic and fiscal trends.

13.1.3.2 Health programmes

Recommendations with respect to health care are likely to place an emphasis on the review of a primary health care package and HIV/AIDS issues. Other aspects of the health care system that may be affected include:

- Preventive measures;
- Secondary and tertiary hospitals;
- Pharmaceuticals; and
- Home-based care.

13.1.3.3 Workers' programmes

These include:
- Injured workers' programmes;
- Unemployment insurance;
- Labour force adjustment programmes; and
- Wage subsidies.

13.1.4 The Financial Framework

13.1.4.1 Models for public sector involvement in social security

There are several models, used in many nations, for public sector involvement in social security programmes. These include:
- *Public funding (national revenue):* This simply involves the state financing social programmes from general tax revenue, in the same manner it would for other public programmes.
- *Public funding (targeted revenue funds):* This model provides a "Social Security Fund" from designated revenue - often taxes paid by workers and employers. The USA Social Security programme draws on this model.
- *Mandatory private insurance:* In this model, the funds do not enter the public sphere. Rather, the legislation requires mandatory contributions to a private fund, with benefits to be paid from that fund. Perhaps the most frequently cited use of this model is the Chilean pension system introduced in the 1980s. In this plan, workers and employers are required to contribute to pension funds that are administered by competing private fund managers.
- *Tax-supported self-insurance:* In this model, contributions to social security funds are tax-exempt, providing a degree of subsidisation to the growth of the funds. Benefits are usually taxable. However, when coupled with a progressive tax system, benefits earned by pensioners are usually taxed at a lower rate than the rate at which the tax exemption occurred. This model for retirement savings plans is the norm in North America.

13.1.4.2 Possible criteria for choosing a particular financial model

While there are no generally accepted rules for choosing one model over another, a "three pillars" framework has been proposed in Canada and elsewhere. Essentially, the proposal is that different purposes for social programmes should be addressed through different models of funding, as follows:
- Essential safety net programmes: Minimum pension or income payments and essential health care programmes should be funded from general tax revenue or a combination of general

and targeted tax revenue.

- Lifestyle maintenance: Additional pensions, to provide a retirement lifestyle more closely related to the working lifestyle or to provide unemployment insurance, could be financed from targeted revenue or from mandatory private plans.
- Incentives for self-insurance: Whether for additional health care, disability or pension insurance, mandatory contributions to private plans, potentially with preferential tax treatment, could be considered.

It should be noted that public support for lifestyle maintenance and self-insurance are justified on the basis that they prevent individuals from falling into the publicly funded system. Also the incentives create a greater pool of savings and investment, which are a spur to stronger economic growth.

Some nations use a mix of the three approaches. For example, in Canada, universal old age pensions and guaranteed income supplements for the poor elderly are paid from general revenue. There are compulsory contributions from employers and employees to the Canada and Quebec Pension Plans, which provide additional defined benefits in the case of retirement, disability or death. Canadians with income, together with their employers, may also contribute to individual Registered Retirement Savings Plans (RRSP's), which are privately managed. RRSP contributions are exempt from taxation, though benefits paid are taxed at regular rates.

13.1.5 Funding Patterns

There are also several funding patterns that may be considered. Actuarial calculations are important in the determination of the appropriate funding pattern:

- ***Pay-as-you-go (PAYG):*** In this model, current benefits are paid out of current contributions. Contribution rates are set at a level just sufficient to pay benefits being earned, though a small fund might be maintained. Most social security programmes in Canada and Europe began on the pay-as-you-go model. It is particularly appropriate if the labour force, real economic growth, and salaries are increasing more quickly than the payment of benefits. However, should any of these conditions not be projected in the longer term, questions of affordability and of inter-generational transfers arise, and alternative partial- or fully-funded options should be considered.
- ***Funded and partially funded programmes:*** Contributions may be set at rates higher than necessary to pay for current benefits. A fund is established and the investment earnings of the fund contribute to keeping rates lower in the longer term. As demographic and economic projections change, actuarial calculations may be used to project contribution rates under pay-as-you-go and funded plans. Many pension funds in North America and Europe are increasingly using funded plans because these calculations show a growing affordability problem in the future. It

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should be noted that funded plans can still be structured so as to provide progressivity in contribution rates and a transfer from the more to the less affluent, as occurs when general revenue is used to fund the benefits.
- ***Subsidised funded programmes:*** Some nations have found it desirable or necessary to combine funded models with general revenue financing. In this case, either the government may make contributions to the fund or it may top up benefits as they are paid.

13.1.6 The Administrative Framework

13.1.6.1 Sphere of government

- *National:* In South Africa, the national government, in consultation with the other spheres of government, is responsible for setting standards and providing legislation and regulations for social security programmes.
- *Provincial:* Provincial governments are the primary delivery agents for the programmes. They also play a role in the establishment of standards, in that competing programme standards are balanced in the context of local conditions and priorities. Provinces also pass legislation and regulations.
- *Local:* Municipalities act as delivery agents for some programmes (for example, primary health programmes in some cities and districts).

13.1.6.2 Accountability

Mechanisms for accountability must be established:
- To governments
- To beneficiaries
- To tax/rate payers

Frequently this is done through the mechanism of boards for facilities or funds. For example, pension funds may have boards, which administer benefits and/or invest funds, and are responsible primarily to beneficiaries or to contributors to the plans. Hospitals may have boards that are responsible to governments.

13.1.7 Summary of the guidelines for the review of the CSSR Report

The later release of the Comprehensive Social Security Review Report means that the FFC will not have the time to assess the fiscal implications of recommendations emanating from the CSSR before the FFC reports to Parliament, the Legislatures, and local government in May 2002. However, the FFC is cognisant of the fact that the Report is likely to contain recommendations with significant fiscal implications.

The FFC proposes the above guidelines to assist in the review of the CSSR Report when it becomes available. The guidelines pertain to the principles and criteria which may be used, the background and context which must be developed, the range of services which might be encompassed in the Report and the manner in which they are linked into a comprehensive package, and the financial and administrative frameworks for the implementation of policy with respect to social security. The FFC is making these guidelines available to others who may have an interest in reviewing the CSSR Report.

13.2 Proposals to shift the social security function to national government and to establish a Social Security Agency

The Department of Social Development (DSD) has formally requested that the FFC comment on its proposals with respect to the location of the social security function. In addition, the DSD has presented a case for the development of an agency model for the national social security system. The DSD is considering the transfer of the social security function to the national sphere.

13.2.1 Past positions of the FFC

The FFC has commented in the past on the division of funding and delivery responsibilities for social assistance, as follows:

- Distinction between delegated and decentralised functions: Delegated functions are functions that are carried out by subnational governments on behalf of the national government. Subnational government has no control over policy- or decision-making, and neither the extent nor manner of service provision is discretionary. With delegated functions, the national Department of Social Development should fund full costs.

  Decentralised or devolved functions, on the other hand, are functions where substantial decision-making authority resides at the subnational level. This allows subnational government choice over the extent of service provision, the priority of the service, and the manner of delivery.

- The FFC's Recommendations for the 1997/98 Financial Year
  - Where national norms and standards are set, funds must follow from national departments to cover the expenditure requirements of the provinces.
  - It is recommended that in resolving the assignment of responsibilities for social security, financial and managerial responsibilities be located together.
  - The implication of welfare being a delegated function is that national government should be obliged to fund full costs.
  - Two options exist. One is to treat social security function as national; and the second is to allow greater choice at the provincial level. Both options require the impact of nationally established norms and standards to be assessed relative to the overall budget constraint.

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- FFC Preliminary Recommendations for 2001: Consultation Document, Feb 2000:
  - o Old age and veterans' pensions should be budgeted for and administered by national government.
  - o Pensions provide an income transfer to impoverished individuals and constitute a safety net.
  - o In most countries, social security for the elderly is a national function.
  - o Old age pensions play an important role in nation-building by helping to link all citizens in a common economic endeavour. Access to these transfers should not be a function of the particular economic circumstances of individual provinces.
  - o Equity of access can be achieved if fiscal and administrative responsibility lies with national government.
  - o Estimates of number and income levels of eligible persons are likely to be more accurate because data on inter-provincial migration is difficult to obtain. This will reduce the extent to which provinces allow cash entitlements to crowd out non-cash services.
  - o In the case of foster care, child support grants, and social services, there are specific characteristics of provinces and local areas that are relevant in determining access to welfare grants. Trade-offs and adjustments in the bundle of services are best made provincially, taking into account differences in population and administrative capacity.

13.2.2 Further review of the DSD consideration to transfer the social security function to the national sphere

There is some lack of clarity around the bundle of social security services that the DSD proposes to be transferred to the national sphere. Disability grants and other forms of payment appear to fit into the proposals put forward by the DSD. In the past, the FFC has stated that they should remain with provinces in order that local preferences and the integration of non-cash service delivery and cash payments could be co-coordinated to meet the needs of the clients. Non-cash services and services such as foster care do not appear to fit into the "Business Case for an Agency Model" put forward by the DSD. It is not clear whether these should remain functional responsibilities of the provinces or be transferred to national and be provided by the proposed agency or by the DSD directly.

As an initial response, the FFC notes that further clarification is required from the Committee and from the DSD concerning their considerations for a Social Service Agency reporting to a Board.

13.2.3 DSD considerations to establish a Social Service Agency

The DSD is in the process of considering alternative models of service delivery. These may include:

- National social security with responsibility for policy and delivery within the DSD
- Public-private partnership (PPP)
- Social Security Agency responsible to the Minister of Social Development

A number of advantages are cited for the use of an agency model, including:

- More equal access to social security
- Economies of scale and increased efficiency and effectiveness
- Greater capacity to compete for human resources
- Improved collaboration with the private sector
- Improved management through a flatter organisation, more government executive control, more focus on policy development and implementation

In particular, there is a focus on the imperative that a person's access to social security should not be dependent on the economic conditions of his/her place of residence. The DSD's mission for the administration of social security is "to pay the right person, the right amount, at the right time".

There may be other advantages. These include:

- Provincial priorities will not be used to "thwart" the implementation of national norms and standards;
- Capacity will be consolidated at the national level; and
- An agency could improve citizen service and responsiveness to complaints.

The DSD considerations for the location of the social security function in the national sphere under the auspices of an agency mirror the considerations presented in the FFC 1997/98 and 2000 proposals. Whether the social security function is operated directly by national government or through an agency, the FFC believes that formal subnational government representation on the appropriate governing structures would provide an effective means to facilitate accountability, monitoring, participation in policy development, and evaluation of service delivery.

The rationale for these proposals lies primarily in their potential ability to:

- Provide greater equity and efficiency in the delivery of cash payments;
- Limit the possibility of subnational governments taking responsibility for unfunded mandates; and
- Reduce the extent to which provinces allow cash entitlements to crowd out the provision of other constitutionally mandated basic services (CMBS).

13.2.4 Proposals

In the current context and in the absence of a Commission evaluation of the CSSR Report, the FFC proposes that:

- For the interim, the FFC re-iterates its proposals that old age and veteran pensions should be budgeted and administered by national government.
- In the medium- to long-term, the Commission believes that social security should be a national responsibility administered through the establishment of a national social security agency. Among other functions, the core business of the agency would be the payment of old age and child support grants.

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14. Summary of Submission: Disaster Management Bill, 2001

14.1 Introduction

14.1.1 Process

In October 2001, the Minister of Provincial and Local Government asked the FFC to provide an assessment of the financial implications of the Disaster Management Bill. This request was made in accordance with Section 9(4) of the Municipal Systems Act of 2000, which requires the Cabinet member initiating the assignment of a function to municipalities to request that the FFC assess the financial implications of the assignment. The FFC submitted its assessment to the Minister in February 2002, a summary of which is provided here.

Given the interwoven nature of intergovernmental relations, the financing mechanisms for disaster management will necessarily touch on the mechanisms relating to the provincial and national spheres. The FFC therefore assessed municipal disaster management funding in the context of the intergovernmental system as a whole.

There are some funding provisions in the Disaster Management Bill (hereafter "the Bill"), and the Bill makes it clear that further details on funding arrangements will be included in the National Disaster Management Framework. The principles and proposals outlined in the Commission's assessment could apply equally to the Bill or to the future Framework.

14.1.2 Framework

Disaster management consists of various components, namely:
- Emergency preparedness
- Prevention/mitigation
- Emergency response
- Post-disaster recovery and rehabilitation

This categorisation is consistent with the definition of "disaster management" in the Bill (Chapter 1), and with international practice. Details on the activities included in each component are provided in section 14.6 below.

14.2 International trends in disaster management

It is widely agreed in the disaster management community that mitigation is the key to effective emergency management. There is usually no way to escape damage altogether, though with adequate preparation attempts can be made to continue operations with minimal disruption.

A significant feature of disastrous events is that they occur more frequently and result in greater financial and human cost where vulnerability is greatest, namely in emerging economies.

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Factors that play a role in causing and exacerbating disasters are the inappropriate location and high density of settlements, weak infrastructure, and the lack of emergency response facilities. As these features characterise many of South Africa's settlements, there is a great need for appropriate settlement planning and preventive measures.

14.3 Disaster management in South Africa

14.3.1 Current funding arrangements

Disaster management falls under the administration of the Department of Provincial and Local Government (DPLG). The current funding regime is based upon the assumption that local disaster management activities are funded through the local government equitable share,[37] although there is some debate around this (see Section 14.5.2 below).

In the matrix below, each category of disaster management is summarised in terms of current dedicated funding mechanisms for national, provincial, and local government:

Category	Dedicated funding mechanism
Emergency Preparedness	None
Prevention / Mitigation	None
Emergency Response	Limited - co-ordination provided by the National Disaster Management Centre at DPLG - provinces and municipalities can apply for financial assistance
Post-disaster Recovery	Yes: - provinces can apply to Contingency Reserve for infrastructure funds - relief funds administered by Dept of Social Development

14.3.2 The White Paper on Disaster Management

In line with international practice, the White Paper on Disaster Management advocates an approach that focuses on reducing risks, whether loss of life, property damage, or economic loss.

The White Paper recommends the development of a disaster management strategy and the establishment of a National Disaster Management Centre (NDMC). The White

37 DPLG (2001), *"Draft Discussion cument: Funding of Disasters"*..

Paper puts forward two guiding principles for the NDMC, namely that disaster management should be based on existing capacity, and that duplication of disaster management functions should be avoided. The NDMC has already been established within the DPLG.

14.3.3 The Disaster Management Bill

The Disaster Management Bill carries forward the principles in the White Paper. The Bill introduces incentives for engaging in mitigation efforts, such as the provision that financial assistance will take account of the extent to which a jurisdiction instituted prevention and mitigation measures (Section 56). It mandates the establishment of the NDMC, as well as Provincial and Local Disaster Management Centres.

The Bill states that a national Disaster Management Framework must be drawn up (Section 6). This must guide the funding of disaster management, including grants for post-disaster recovery and rehabilitation. Section 57 allows provinces and municipalities to request that national government financially contribute to post-disaster recovery and rehabilitation. Their request will be assessed against whether or not available resources at local or provincial level have been exhausted (the definition of "exhausted" is explored in section 14.4.2 below).

14.4 Funding principles

14.4.1 The case for centralised funding

The Commission proposes that disaster management funding should be funded centrally (the possible mechanisms are discussed in Section 14.6 below). The reasons are as follows:

- *Subnational jurisdictions may not have the resources to respond to a disastrous event.* This is underlined by the definition of "disaster" in the Bill. The Bill defines a disaster as an event "of a magnitude that exceeds the ability of those affected by the disaster to cope with its effects using only their resources."
- *The co-operation of national, provincial, and local government should be facilitated by funding arrangements.* Unless the funding framework for disaster management is very clear, intergovernmental co-operation could be jeopardised. For example, a province may be unwilling to dedicate significant resources to a local disaster if it does not have the assurance that some of its expenses will be reimbursed.
- *The ability of national departments and subnational jurisdictions to deliver constitutionally mandated basic services could be compromised.* Section 214 of the Constitution specifies that the equitable shares should be sufficient to ensure the delivery of basic services, and the Bill of Rights identifies the basic services to which every South African should have access. If provinces or municipalities then divert significant resources away from the delivery of these services, the intention of Section 214 is undermined.
- *The integrity of budget frameworks and performance-based budgeting would be undermined.* With respect to national and provincial departments, the PFMA restricts the extent to which funds can be transferred within budget votes. Furthermore, there is a concerted effort within

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Government to move toward a performance-based system. Directives to release significant resources and personnel could result in unauthorised expenditure and prevent the achievement of performance objectives.

14.4.2 Role of subnational government funding

An issue raised in section 14.3.3 above was how to determine when provincial and local funds are "exhausted".

Australia has a well-established reputation for emergency management and has developed detailed formulae for financial support for states and territories. The Commonwealth (national government) guarantees that a proportion of expenditure incurred by states and territories will be reimbursed, and this applies to measures such as relief to individuals and rehabilitation of public infrastructure. The framework is as follows:

- The central government provides disaster funding where a state's "financial threshold" is exceeded. This is assessed at an amount equivalent to 0.225 percent of the State's total revenue for the prior two years.
- Once a state's expenditure on disaster relief has exceeded its base amount, central funding is provided on a dollar for dollar basis. After a State spends 1.75 times its base amount, central government increases its matching amount.[38]

This approach could be adapted to South Africa. The "financial threshold" would need to be assessed differently for provinces and municipalities, since provincial own revenue is less than 4 percent and municipal own revenue exceeds 90 percent of budget on average. The approach could be as follows:

- In the case of provinces, central funding is provided where disaster management expenditure exceeds a given percentage of budgeted expenditure.
- In the case of municipalities, central funding is provided where disaster management expenditure exceeds a given percentage of own revenue.

In setting the threshold, international examples should be noted:

- In the province of Manitoba in Canada, local authorities and provinces are expected to fund disaster relief activities fully up to $1 per capita, after which they receive matching funding on a sliding scale. The $1 threshold represents 0.1 percent of the budget of its largest city, Winnipeg.
- In the Philippines, the Local Government Code of 1991 requires municipalities to set aside approximately 1 percent of their "Internal Revenue" for disaster relief.
- In the United States and India, funding for disaster relief is provided on a federal: state matching basis of 75:25, with no thresholds applicable.

Provinces and municipalities could be required to match central funding after an initial threshold is reached, as this would strengthen the incentives for preventive action.

38 Department of Welfare & Department of Constitutional Development (1998), *"Emergency Management: The Australian Experience," Report of a study visit.*

However it would be important to retain the principle that once a jurisdiction's resources are exhausted - that is, a "final threshold" has been reached - all emergency response activities would be centrally funded.

It is suggested that the application of a "financial threshold" be applied to the category of "emergency response." Approaches to funding the other three categories are outlined below.

14.5 Local government and disaster management

The role of local government in disaster management is stressed in both the Bill and the White Paper. Section 23 of the Bill, which covers the declaration of disasters, states that until a disaster is classified by the NDMC, the disaster must be regarded as a local disaster. This places a particular onus on the response of local government.

14.5.1 District and local municipalities

The Bill states that within the local government sphere, metropolitan and district municipalities carry primary responsibility for the co-ordination and management of disasters (see Chapter 5).

There are difficulties with this approach. The nature of disastrous events suggests that the immediate response should be provided at the most localised level possible, namely at local rather than district level. Some district municipal offices are located hundreds of kilometers away from local municipalities within their jurisdiction. Equipment to deal with the disaster is not on hand, and co-ordination from a centre other than where the disaster is located is fraught with difficulty.

On the other hand, some local municipalities - particularly in rural areas - lack the resources and expertise to respond immediately and effectively to disastrous events. Furthermore, there are advantages to centralising some disaster management functions, such as vulnerability assessments.

In view of the complexities of the respective roles of district and local municipalities, there is a need for a detailed assessment of (a) the current capacity on the ground; and (b) the ideal division of responsibilities. The Bill and/or the National Disaster Management Framework should facilitate the transition between the current and ideal situations.

Chapter 5 of the Bill should therefore be carefully reviewed in order to divide responsibilities appropriately between district and local municipalities. In deciding on this division, these principles should be followed:
- Local municipalities should be the first to respond to local disasters and be primarily responsible for the co-ordination and management of local disasters, with support being provided by the district municipality.
- Where local municipalities lack the necessary capacity, primary responsibility for disaster management should be located with the district.

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14.5.2 Assignment of functions to local government

There is some debate among legal experts as to whether the responsibilities assigned to local government in the Disaster Management Bill represent a new constitutional responsibility that requires additional funds. If disaster management is categorised as an entirely new responsibility, then additional funds will have to be identified, particularly for emergency preparedness.

The FFC is not in a position to offer legal opinion on this issue. The various funding needs and mechanisms for national, provincial, and local government are identified below, and meeting the financial needs of municipalities will require an evaluation of the legal aspects of the assignment.

Finally, it should be noted that regardless of whether disaster management is deemed to be a new assignment to local government, the Bill does impose additional obligations on municipalities. This issue is addressed under the category of emergency preparedness (Section 14.6.1 below).

14.6 Funding mechanisms

14.6.1 Local government: Emergency preparedness

The Bill states that each metropolitan and district municipality is required to carry out various tasks, such as implementing disaster management frameworks and administering disaster management centres. The extensive list of activities carries financial implications. For example, Section 58 proposes the establishment of units of volunteers, and these people must be recruited, trained, and mobilised. There are hidden costs involved, such as insurance cover for volunteers.

There are two types of institutional costs:

- Start-up costs for the development of disaster management capacity. Because some municipalities have existing capacity, the funding of start-up costs would be done on a case-by-case basis. The Commission proposes that this be funded through a conditional grant from national government; and
- On-going institutional costs. If disaster management is deemed to be a new function assignment to local government, the quantum of the equitable share should increase.

14.6.2 Prevention/Mitigation

There is a strong argument for central funding of some mitigation activities. If a municipality conducts a risk assessment and discovers a potential disaster that poses a significant risk (for example, an unstable slimes dam), it may be unable to address the risk if it lacks the resources to do so and cannot compel those responsible for the risk to address it.

Section 57 of the Bill indicates that local and provincial requests will be assessed against the extent to which the disaster could have been avoided. However, it is not possible to address all disaster risks immediately, and one would not wish to penalise a municipality for failing to address a certain risk when it has been investing considerably in other mitigation projects. For this reason, it is important for the NDMC to co-ordinate a process whereby mitigation projects are identified and prioritised nationally.

Provinces and municipalities can utilise existing funding streams to address potential disasters. For example, CMIP and housing funds can be used to relocate people from flood-prone areas.

However, there are instances where such funds are not available (as with the slimes dam noted above). In such cases, the Commission proposes the use of central funding. The NDMC would, together with provinces and municipalities, identify priority mitigation projects and would request MTEF budget appropriations for the estimated costs. Funding for approved projects could be provided on a matching-grant basis, with the matching amount for municipalities related to their revenue-raising capacity.

14.6.3 Emergency Response

The objectives of emergency response are to save lives, prevent escalation of the event, and relieve suffering by meeting basic needs such as shelter, water, food, and medical care. Emergency response also includes the immediate repair or replacement of critical infrastructure (such as a temporary bridge). The cost of emergency response services can be very high, and frequently exceeds the resources of the subnational jurisdiction(s) affected.

If a disaster occurs and local and provincial funds appear to be insufficient, provinces and municipalities can approach the Minister of Finance for funds. However, there are no criteria in place to guide the Minister’s decision.

There is a compelling reason for funding emergency response from the Contingency Reserve, as swift response is needed in the case of disasters. The Commission therefore proposes that immediate response to emergencies should be funded from the Contingency Reserve once the funds of an organ of state have been exhausted.

- Funding to national departments would be based upon expenditure incurred. Departments that are frequently involved in emergency response activities would estimate the required amount based upon past expenditure and would budget for these amounts. Once this amount was exceeded, an emergency appropriation could be requested.
- Funding to provinces would be provided once the province has spent more than the financial threshold (specified proportion of budget) on accumulated disasters in that financial year.
- Funding to municipalities would be provided once the municipality has spent more than the financial threshold (specified proportion of own revenue) on accumulated disasters in that financial year.

14.6.4 Recovery and rehabilitation

14.6.4.1 Infrastructure rehabilitation

Section 56 of the Bill states that the cost of repairing or replacing public sector infrastructure should be borne by the organ of state responsible for the maintenance of such infrastructure. This poses significant problems. If a flood destroys a bridge, the cost of replacing the infrastructure in the longer term could be prohibitive. Currently, the Contingency Reserve funds rehabilitation of infrastructure damaged by natural disasters. As with funds for emergency response, there are no criteria in place to guide the Minister's decision.

A key question is whether infrastructure rehabilitation should be funded from the contingency reserve or through the regular budget process. Generally, infrastructure projects require long lead times. Such projects may be incorporated into capital budgets as part of annual budget planning. However, there may be cases where permanent infrastructure is urgently needed and can be fast-tracked. In such cases the contingency reserve should be drawn upon.

With disasters of a great magnitude, there can be significant damage to infrastructure. In such instances, the central fiscus may not have the funds available to restore the entire damaged infrastructure to its previous condition. With such disasters, infrastructure projects will need to be prioritised according to their contribution to the delivery of constitutionally mandated basic services and to economic activity.

The Commission therefore proposes that national departments, provinces, and municipalities should submit requests for reconstruction funding. These requests would be verified. A budget appropriation, based upon the sum of the approved claims, would then be authorised.

- In circumstances where infrastructure funds can be spent within the current financial year, funds could be drawn from the Contingency Reserve.
- Consideration should be given to evaluating the requests according to whether they constitute essential infrastructure that is necessary for economic activity and the delivery of constitutionally mandated basic services.

14.6.4.2 Relief to individuals

A crucial aspect of disaster management is the assistance provided to individuals who do not have the resources to cope with the effects of a disaster. Currently the Department of Social Development administers disaster relief. The DSD operates the Disaster Relief Fund, Social Relief Fund, and State President's Fund for this purpose.

The White Paper notes that different boards operate the three funds, resulting in considerable delays in the payment of grants. It recommends that they be merged, and that funds be made available from the contingency reserve.

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The Commission supports the proposals to combine the three relief funds and to administer them centrally. The funds should be part of the annual budget allocations. When additional funds are required, the contingency reserve may be used.

14.7 Recommendations

- Central funding mechanisms for disaster management should be introduced, so as to ensure that budget frameworks and the delivery of constitutionally mandated basic services are not compromised.

- Chapter 5 of the Bill should be carefully reviewed in order to divide responsibilities appropriately between district and local municipalities. In deciding on this division, these principles should be followed:
  - o Local municipalities should be the first to respond to local disasters and be primarily responsible for the co-ordination and management of local disasters, with support being provided by the district municipality.
  - o Where local municipalities lack the necessary capacity, primary responsibility for disaster management should be located with the district.

Table 14.1 Summary of proposed mechanisms for disaster management

Type	Funding mechanism	Funding source
Emergency Preparedness	National and provincial government: already incorporated into equitable share	N/A
	Municipalities: - Start-up costs: conditional grant to municipalities with little capacity - On-going costs: increase in equitable share (if legally applicable; see Section 14.3.3.2 above)	National budget Equitable Share
Prevention / mitigation	Conditional grants on a matching basis to provinces and municipalities for projects meeting criteria	National budget
Emergency response	National departments: reimbursement for expenditure incurred, or from budget of departments frequently involved in disaster assistance	Contingency reserve, national budget
	Provinces: own funding up to financial threshold (proportion of budget), thereafter central funding	Contingency reserve, once financial thresholds exceeded
	Municipalities: own funding up to financial threshold (proportion of own revenue), thereafter central funding	Contingency Reserve, once financial thresholds exceeded
Post-disaster recovery & rehabilitation	Infrastructure rehabilitation: conditional grants to national departments, provinces, and municipalities	National budget, contingency reserve in exceptional circumstances
	Relief to individuals: funding to provinces, municipalities, NGOs / CBOs	National fund (current funds combined), Contingency Reserve if fund exhausted

15. The Contingency Reserve

In its Submission on the Division of Revenue 2002/03, the Commission noted that the top-slicing of the contingency reserve reduces the revenue available for equitable shares. The Commission accordingly proposed the development of objective criteria for the use of contingency reserves. This section examines the contingency reserve in greater detail and proposes some improvements to the current system.

The contingency reserve is deducted from nationally collected revenues before the equitable shares are allocated, that is, it is "top-sliced". This means that the reserve is not allocated to one sphere of government, but is available for specified contingencies. Because it is administered nationally, it is often called the "national contingency reserve". This is misleading as it implies that the reserve is allocated to the national sphere. For this reason, the top-sliced contingency reserve is referred to in this submission as the "central contingency reserve".

15.1 The contingency reserve in South Africa

The MTEF estimates in the Budget Review 2002 indicate that the central contingency reserve is set at R3.3bn for 2002/03, R5bn in 2003/04, and R9bn in 2004/05. As the table below illustrates, the amount allocated to the contingency reserve for the budget year has increased from R1.1bn in 1999 to R3.3bn in 2002.

Table 15.1 Contingency reserve: comparison of budgeted allocations, 1999 - 2002

R Billion	1999 Budget	2000 Budget	2001 Budget	2002 Budget
1999/00	1.1	n/a	n/a	n/a
2000/01	3.5	2.0	n/a	n/a
2001/02	8.0	4.0	2.0	n/a
2002/03	n/a	8.0	4.0	3.3
2003/04	n/a	n/a	8.0	5.0
2004/05	n/a	n/a	n/a	9.0

Source: Budget Reviews 1999, 2000, 2001, & 2002.

The purpose of the reserve was outlined in the Budget Review 2002:

> In the first year the contingency reserve makes provision for unforeseen and unavoidable expenditure. It also cushions the fiscus against changes in the macroeconomic environment and from adverse natural and climatic events. In preparing future budgets, part of the contingency reserve is drawn down to accommodate new spending pressures and priorities.

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This broadly reflects provisions in the Constitution. In its Submission for 2002/03, the FFC noted that the establishment of contingency reserves may have been contemplated in subsections 214(2)(i) and (j) of the Constitution, which reads as follows:

> 214. The [Division of Revenue] Act… must take into account (i) the desirability of stable and predictable allocations of revenue shares; and (j) the need for flexibility in responding to emergencies or other temporary needs, and other factors based on similar objective criteria.

The FFC noted further that the purposes of these reserves should parallel those described in Section 214.[39]

Use of the central contingency reserve needs to be read together with the PFMA requirement for national government, provinces, and municipalities to table adjustments budgets (see sections 30 and 31 of the PFMA and section 20 of the Municipal Finance Management Bill). Adjustments budgets are used to take account of the following:

- Unforeseeable and unavoidable expenditure;
- Charges against the contingency reserve;
- Changes in revenue targets;
- Underspending within a budget vote; and
- The shifting of funds between and within budget votes.

If funds from the central contingency reserve are unspent, these can be re-allocated through the adjustments process.

In practice, the contingency reserve is handled in the following way:

- A central contingency reserve is set aside, and it is used to address disasters and macroeconomic events. All three spheres of government have access to this reserve, according to the broad guidelines outlined above;
- About 9-10 months into the financial year, national government tables an adjustments budget, which provides for new expenditure and over- or under-collection of revenue. Any unspent funds from the contingency reserve are added to the revenue pool and allocated to national, provincial, and local government through a consultative process;
- Any change in revenues allocated to provinces or municipalities through the national adjustments process would then be dealt with through provincial and municipal adjustments budgets.

The contingency reserve is therefore fully allocated by the end of the financial year.

After the amount remaining in the contingency reserve is allocated to the three spheres, there may be concern that funds are not available for disaster response in the 1-2 months remaining in the financial year. However, any additional funds allocated to provinces and municipalities are in reality only spent in the year that

39 FFC (2001), *Submission: Division of Revenue 2002-2003.*

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follows and are accounted for later in adjustments budgets. If a disastrous event occurs later in the financial year, then, funds are available to address the situation.

15.2 Evaluation of the current system

The approach taken by National Treasury is a practical one. The consultation amongst the three spheres regarding the division of any amount remaining in the reserve is important, since the reserve is top-sliced and reduces the amount available for equitable shares. Nevertheless, as explained below, there is room for improvement in the current system.

15.2.1 Contingency and policy reserves

There may be merit in distinguishing between the two general purposes for the Contingency Reserve and adopting different approaches to them:

a) ***Natural or human-made disasters and macroeconomic stability (contingency reserve).*** The role of the central contingency reserve is to provide insurance against significant events, whether natural or human-caused.[40] While the expenses of disasters are specifically unforeseen, it can reasonably be expected that they will generally occur every year. For this reason, there should be a contingency reserve for the budget year.

There is also an argument for making provision for macroeconomic stability within the budget year allocation of the contingency reserve, since Government must be equipped to respond to unforeseen global events, which result in significant economic and fiscal shocks.

The earmarking of the reserve for emergency purposes would ensure that when significant budgetary pressures are experienced, the reserve is protected for disaster management and macroeconomic stability.

b) ***New spending priorities (policy reserve).*** It is difficult in multi-year budgeting systems to project and plan accurately for expenditure in the outer years. If macroeconomic conditions worsen and this places downward pressure on the budget, the contingency reserve cushions the effects on the budget framework since a certain proportion of the budget was unallocated. If, on the other hand, there is macroeconomic stability, the reserve allows Government to allocate the funds to new priorities. Such a policy reserve for new spending priorities is therefore not needed for the budget year, since it is intended to allow for flexibility in the outer years of the MTEF.

[40] While the Budget eview 2002 states at the contingency serve is for natural climatic events (as ainst human-made ies), this should be xtended to include human-made disasters, since nany human-made lisasters cannot be predicted and can have devastating financial consequences.

15.2.2 Legal framework

There is currently no legal basis for the contingency reserve. The appropriation of funds for emergency purposes is authorised in Section 16 of the Public Finance Management Act (PFMA) of 1999. However there is no direct link between these emergency appropriations and the contingency reserve.

This means that the reserve could be used for any purpose in future, since the only guideline is Government's stated policy on the reserve. This can change from one year to the next. For example, the Budget Review 2002 stated that the contingency reserve should cushion the fiscus against adverse economic and natural events, but that it should also make provision for unforeseen and unavoidable expenditure more broadly. Previous budget reviews restricted the use of the reserve to unforeseen economic and natural events.

It is therefore important to put the contingency reserve on a legal footing, which could be achieved through a legal instrument such as PFMA regulations. The use of the reserve should be specified. While Section 16 of the PFMA does not mention the reserve, the rationale for the emergency appropriation of funds is the same:

(1) The Minister may authorise the use of funds from the National Revenue Fund to defray expenditure of an exceptional nature which is currently not provided for and which cannot, without serious prejudice to the public interest, be postponed to a future parliamentary appropriation of funds.

With regard to the emergency appropriation of funds, the PFMA authorises national and provincial government to use funds from the national and provincial revenue funds respectively. The Municipal Finance Management Bill of 2001 does not have a similar provision, but the reasons for enabling national and provincial government to draw directly from their revenue funds apply equally to municipalities. The FFC therefore proposes a similar provision in the Municipal Finance Management Bill.

15.2.3 The contingency reserve versus budgeted expenditure

A key conceptual issue is the appropriate balance between budgeting for adverse events (whether natural or economic) and making provision for such occurrences in the contingency reserve.

It should be possible to anticipate some of the expenses arising from natural and human-made disasters, based upon the estimated costs of disaster response in previous years. This principle is advocated in the Commission's submission on the Disaster Management Bill. If some of the costs are estimated in the budget and the relevant organ of state has immediate access to these funds, rapid response to disasters is facilitated.

15.2.4 Provincial and municipal contingency reserves

If there is a central contingency reserve for adverse economic and natural disasters, the question arises whether provinces and municipalities should similarly budget for contingencies. At present, most provinces do not make contingency appropriations, but rather build flexibility into their budgets in other ways (such as budgeting for a surplus). Municipalities similarly adopt different approaches to emergency funding.

Provinces and municipalities adopt strategies appropriate to their circumstances, and there should be no prescriptions as to whether or how their budgets take account of unforeseen emergencies.

15.3 Proposals

The Commission supports Government's overall approach to the contingency reserve and proposes the following:

- A more defined legal basis should be provided for the central contingency reserve. This framework should ensure that the reserve is for emergency purposes.
- The contingency reserve for a relevant budget year should be allocated for two emergency purposes, namely macroeconomic stability and response to natural or human-made disasters.
  - o The proportions for disaster response and macroeconomic stability should not be specified, since the purpose of the contingency reserve is to provide flexibility when Government responds to emergencies.
- The "new spending priorities" should be categorised separately as the "policy reserve". The current MTEF allocations to the contingency reserve would then be distinguished as follows:

R Billions	MTEF Allocations: 2002 Budget	FFC Proposal	
		Contingency Reserve	Policy Reserve
2002/03	3.3	3.3	0
2003/04	5.0	3.3*	1.7
2004/05	9.0	3.3*	5.7

Source: National Treasury, Budget Review 2002.
**Note: it is assumed that the budget year allocation will increase with inflation. This calculation is not included here.*

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- The Municipal Finance Management Bill should include a provision that empowers municipalities to make appropriations to defray expenditure of an exceptional nature (similar to the provisions of Sections 16 and 25 of the PFMA).
- Provinces and municipalities should exercise their discretion in determining how to build flexibility into their budgets.

GLOSSARY

Constitutionally mandated basic services (CMBS)	Minimum standards of service as mandated by the Constitution and legislation
Basic education	Ordinary primary, secondary, and special school education
Basic health care	Primary health services as defined in the primary health care package
Budget Council	The consultative body consisting of the national Minister of Finance and the nine provincial MECs for Finance
Budget Forum	The consultative body consisting of the members of the Budget Council and representatives of organised local government
Capital expenditure	Spending on new or existing durable goods with a normal life span of more than one year, to be used for (socially/economically) productive purposes
Conditional grants	Transfers from one sphere of government to another, conditional on certain services being delivered or in compliance with specific requirements
Contingency reserve	An amount of nationally collected revenue that is not allocated for a specific purpose in advance in order to accommodate adverse and unforeseen macroeconomic or natural events
Division of revenue	The allocation of funds vertically between the three spheres of government or horizontally amongst provinces or municipalities, as required by the Constitution

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Early childhood development (ECD)	Education for children from birth to nine years of age
Economies of scale	The technological relationship in which per-unit costs of producing a good or service fall as the scale of production increases
Elasticity (of revenue)	The automatic response of revenues to changes in economic activity
Equity	The application of principles of justice to the recognition of rights or division of resources: (1) among individuals or among governments in the same sphere (horizontal equity); (2) between classes of people or different government spheres (vertical equity).
Equitable share	The allocation of revenue to the national, provincial, and local spheres of government in a manner that ensures equity, as required by the Constitution
Ex-post conversion risk	The use of conditional grants by subnational governments for purposes other than those intended by central government
Ex-post efficiency risk	Inefficiency associated with lack of incentives to deliver best effort in undertaking projects
Fiscal capacity	A measure of the ability of a jurisdiction to finance government services
Fiscal dependence	The extent to which one sphere of government relies on another for revenues to fulfil its functions
Fiscal equity	The ability of various governments in the same sphere to provide comparable level of services to their citizens with similar levels of taxation
Funded social security programmes	A social security system in which benefits are paid out of a fund built up from contributions by, or on behalf of members in a retirement system
Horizontal division	The division of revenue among provinces or among municipalities
Inflation	The rate of increase in the general price level

Institutional element — The element in the equitable share formulae designed to fund the operation of provincial and local government institutions

Levies — Compulsory payment made in exchange for non-direct benefits received, e.g. fuel levies

Lifeline tariff — Refers to a subsidised, below-cost charge for a basic service (such as water & electricity)

Moral hazard — A situation when economic behaviour adjusts to incentives in a manner that increases the likelihood that an event insured against will actually take place

National revenue — State income from taxes, levies, and other charges

Pay-as-you-go (PAYG) — A social security system that finances benefits for retired workers in a given year entirely through contributions or taxes paid by currently employed workers

Service authority — The organ of state accountable for ensuring that services are delivered

Service provider — The institution authorised by the service authority to deliver a service

Social costs — The impact of the non-delivery of public services on society

Social security — Non-contributory financial assistance or direct income support to the poor who qualify for such assistance as prescribed by the Constitution or legislation

Soft budget constraint — Exists when subnational governments perceive that national government will intervene in cases of financial crises

Specific tax — A levy of a fixed amount per unit of a good or service exchanged in a market

Tax base — The item or economic activity upon which a tax is levied

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Tax incentives Specific provisions in the tax code that provide favorable tax treatment to economic agents, designed to encourage specific behaviour, e.g. to encourage increased investment

Top slicing The practice of governments by which, prior to allocating revenue, an amount is set aside for special purposes such as national debt payments or contingencies

Unfunded mandates The allocation of expenditure responsibilities by one sphere to another without the commensurate allocation of resources to fund the responsibilities

User charges Prices for the use of public services determined by political rather than market interaction

Vertical division The division of revenue between the three spheres of government

Vertical fiscal imbalance The mismatch between expenditure responsibilities and the necessary revenue sources