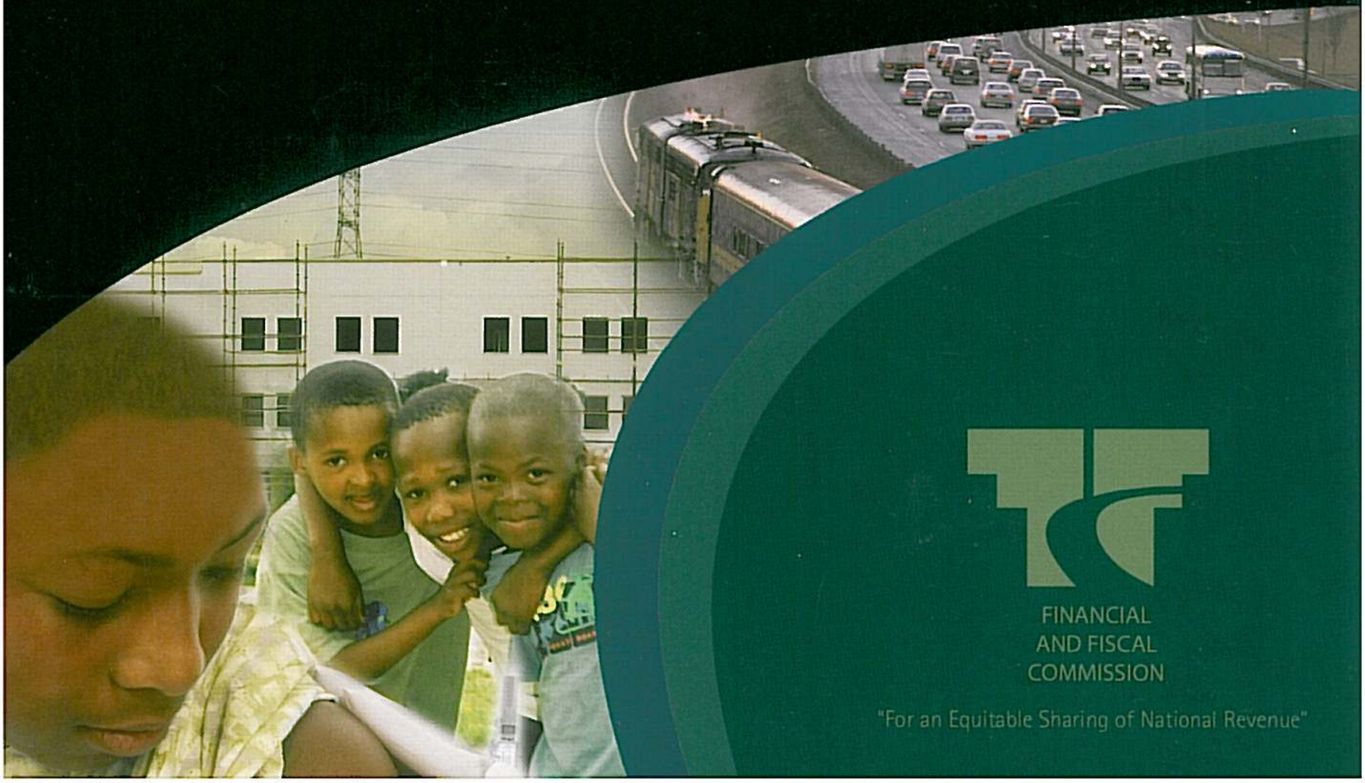
FINANCIAL AND FISCAL COMMISSION

Submission for the Division of Revenue 2007/08

Recommendations from the FFC Review of the Transfers in the Intergovernmental Fiscal Relations System in South Africa

MAY 2006



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"For an Equitable Sharing of National Revenue"

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"For an Equitable Sharing of National Revenue"

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Table of Contents

Back to contents

"For an Equitable Sharing of National Revenue"

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Abbreviations

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

Foreword

The 2005/06 fiscal year was a key milestone in the work of the Financial and Fiscal Commission (FFC). Its May 2005 recommendations concerning the equitable sharing of revenues among the three spheres of government were largely accepted by National Government and supported by the relevant parliamentary committees. Government's response to the Commission's 2005 submission is fully discussed in Annexure E of the Division of Revenue Act (April 2006). In Annexure E Government also highlighted some areas of future work for the Commission.

In its response to the Commission's 2004 recommendations, Government indicated the need for a comprehensive review of the conditional grant system in South Africa. The recommendations and proposals in this submission for the 2007/08 Division of Revenue focus essentially on a comprehensive review and analysis of conditional and specific purpose grants in the intergovernmental fiscal system in South Africa.

Since the inception of South Africa's intergovernmental system, the conditional and specific purpose grants have been the subject of much debate amongst the three spheres of Government and their respective legislatures. The discussion has focused on the rationale for such grants, as well as their conditionality and their implications for sub-regional budget autonomy. There was also debate about balancing autonomy and accountability with regard to the effective and efficient delivery of nationally determined policy objectives.

This 2006 submission of the Commission discusses these issues in the context of a comprehensive review of conditional grants in South Africa. In particular, the review extends its analysis of the National Tertiary Services Grant (NTSG) and the Health Professions Training and Development Grant (HPTDG) presented in the Commission's 2005 submission.

Despite the protracted period (1998-2005) and the huge amounts allocated for these grants (R6.2 billion in total in 2005/06), no significant review of the grants has occurred. Evidence has been emerging over time that both grants have drifted from their original purpose and lack the specificity to achieve their goals effectively. This submission of the Commission presents the findings of a detailed technical analysis and provides a comprehensive set of recommendations to address some of the concerns and issues raised.

Allocations for two other services are also reviewed in this submission. The first is a review of the National Housing Allocation Formula (NHAF) and the second is a review of welfare services financing through the Provincial Equitable Share (PES) formula.

The specific review of the NHAF follows the Commission's previous work on the financing and delivery challenges in the provision of public housing in South Africa. The review of the formula identifies several shortcomings and makes recommendations for addressing these problems.

In its submission for the 2006/07 Division of Revenue the Commission recommended that social welfare services be funded through the Provincial Equitable Share (PES). The Commission then undertook to estimate the level of provincial demand for welfare services in order to develop a more sustainable welfare financing mechanism. This was because social security grants are now paid through a national agency. The current submission summarises the findings of the review of provincial welfare services funding and makes recommendations on how the Provincial Equitable Share (PES) formula may be revised to accommodate the funding of welfare services.

The rest of this submission presents a review of the Local Government Equitable Share (LES) allocations to municipalities and provincial own revenue trends.

The annexures in this document are submissions of recommendations and comments that the Commission made in the course of the 2005/06 fiscal year. These recommendations and comments were made at the request of the Minister of Finance. These submissions have been edited for publication.

The Commission's research and reviews drew on the knowledge and insights of many government and parliamentary stakeholders and independent technical advisors. The commission is grateful to all Ministries, government departments, members of intergovernmental fora and parliamentary committees for their valuable comments. The Commission also acknowledges the significant contributions of technical advisors Alex van der Heever, Prof. Servaas van der Berg, Andrew Reschovsky, Willem Cronje, Ramos Mabugu and Marius van Blerck.

Part-time and full time commissioners play a vital role in providing supervision, direction and peer review as members of research project task teams and participants at seminar reviews of the research as it is developed, completed and finalised for submission to Parliament. This 2006 submission reflects only the summarised background, findings and recommendations for the 2007/08 Division of Revenue. At the request of many government and parliamentary stakeholders, and in the interests of stimulating debate, the Commission will publish in a seperate volume, the technical research reports on which these recommendations are based.

In conclusion, the Commission would like to express its gratitude to the Programme Managers and Researchers of the Recommendations Research Programme (RRP) and the Executive and Administrative staff of the Secretariat for their commitment, dedication and efficiency in producing this submission.

As Commissioners and the Executive of the Financial and Fiscal Commission we, the undersigned, having considered the proposals at a meeting of the Commission held on 23rd March 2006, hereby submit these Annual recommendations to Parliament in accordance with the obligations placed upon us by the Intergovernmental Fiscal Relations Act (1997) and the Constitution of the Republic of South Africa.

Back to contents

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Commissioner	Kamalasen Chetty
Commissioner	Tania Ajam
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For and on behalf of the Commission

Chairperson	Dr. Bethuel Setai
Deputy Chairperson	Jaya Josie

Executive Summary

Section 220 of the Constitution establishes the Financial and Fiscal Commission (FFC) as an independent and impartial statutory body. The Constitution mandates the Commission to make recommendations on the vertical division of nationally raised revenue among the three spheres of government; the horizontal division of revenue among provinces and among municipalities. Furthermore, the Commission is required to make recommendations under legislation pertaining to the issuing of loan guarantees by the three spheres of government; provincial tax legislation; municipal fiscal powers and functions; and provincial and municipal borrowing powers (Sections 214, 218, 228-230).

Following Sections 214 and 222 of the Constitution, Section 9 of the Intergovernmental Fiscal Relations Act (1997) provides for the Commission to make annual recommendations to Parliament and the Provincial Legislatures on the vertical and horizontal division of revenue; Section 10 requires that Government considers the Commission's recommendations. In performing its functions, the Commission takes into account the factors listed in Section 214 (2) [a-j] of the Constitution and the provisions in the Bill of Rights in Chapter 2 of the Constitution.

Part A: Recommendations from the Review of the Conditional Grants in South Africa's Intergovernmental Fiscal Relations System

This section of the Submission presents recommendations for the Division of Revenue 2007/08 and the relevant Medium Term Expenditure Framework (MTEF) Cycle. The recommendations are informed by the research and studies that have been considered by the Commission over the last 12 to 18 months. In making the recommendations, the Commission has taken into consideration the responses from Government as detailed in Annexure E of the Budget Review 2005 and Annexure E of the Budget Review 2006.

As indicated in its submission to Parliament on the Annual Division of Revenue 2006 and the subsequent Division of Revenue Bill in 2006, the Commission's submission carries a comprehensive review of conditional grants in the fiscal system and makes recommendations on the major conditional grants. In particular, there are detailed recommendations focusing on the two major health grants, namely the National Tertiary Services Grant and the Health Professions Training and Development Grant. There is also a review of the Integrated Housing and Resettlement Grant and the National Housing Allocation formula.

These instruments are singled out firstly because of their size and secondly because the Commission is of the view that these grants fall under the scope of the principles that the Commision has recommended in the past. Those principles were drawn up to guide decisions as to whether or not programmes should be financed by conditional grants. They refer to and include spillovers, fiscal externalities (horizontal and vertical) and the need to address national priorities.

Chapter 1: Comprehensive Review of Conditional Grants in the South African Intergovernmental Fiscal Relations System

General recommendations:

The Commission reiterates the following previous general recommendations:

- Conditional grants should only be used to address the problems of spillover benefits and to deal with the funding of programmes identified as matters of national priority that still need to be institutionalised in provincial or municipal budgets. In the latter case, such conditional grants should be phased into the equitable share once the programmes have been institutionalised by provinces and municipalities.
- National government departments should clearly define minimum norms and standards for delivery in areas of concurrent responsibility. They should also monitor the performance of provinces in complying with these to ensure that the minimum requirement for the use of conditional grants is met.

Specific recommendations:

Taking into account its review of conditional grants, the Commission recommends that:

1. The **HIV/AIDS Grant** administered by the Department of Health should remain for the following reasons:
   - This will ensure that sufficient focus and resources continue to be channeled to deal with the pandemic.
   - The grant is in line with the previous FFC recommendation that the funding for all HIV/AIDS programmes should be done through the conditional grant mechanism.

2. The **Hospital Revitalisation Grant** should be incorporated into the Provincial Infrastructure Grant.
   - There is a strong convergence of purpose between the two infrastructure conditional grants.
   - Due to stricter conditions attached to the Hospital Revitalisation grant, provincial preference is given to spending the Provincial Infrastructure Grant which, as a Schedule 4 grant, has less stringent conditions. This results in under-spending on the revitalisation grant.

3. The **Land Care Grant and Comprehensive Agricultural Support Programme Grant** should be merged into one Schedule 4 grant.
   - These two grants have overlapping objectives.
   - The administrative burden on provinces will be minimised by the creation of only one Agriculture Grant.
   - Provinces in which agriculture is the main commercial activity will be able to creatively spend the new less stringent Schedule 4 grant in accordance with their particular circumstances.

4. With regards to the **National School Nutrition Grant**, the conditions that relate to the development and approval of business plans must be refined to take into account the following:
   - Minimal time is spent on the process of developing and approving plans.
   - The delays in the submission of plans and the excessive non-compliance by provinces.
   - The previous FFC recommendation that proposed 'relaxing some stringent conditions, especially for those grants that seek to ensure adherence to national norms and standards, can allow provinces some level of decision space, innovation and creativity in spending the grant'.

5. With respect to the **HIV/AIDS Life Skills Education Programme Grant** the Commission recommends that the grant should continue to be conditional with a clear focus on enrollment as opposed to the current allocation mechanism that uses the education component of the provincial equitable share formula.

6. With respect to the **Local Government Grants**, the Commission recommends that the Municipal Infrastructure grant should go beyond funding the B (Basic residential infrastructure), P (Public municipal service) and E (Social institutions and micro-enterprises) components in the formula. The formula should also include operational and maintenance costs.

Chapter 2: Review of Health Conditional Grants

For the health conditional grants, the Commission makes recommendations as follows:

1. **With respect to the National Tertiary Services Grant (NTSG), that:**
   - An allocation framework based on approved policy norms and standards be introduced, underpinned by an explicit service plan.
   - Consideration be given to the following in specifying norms and standards:
     - Acute beds by level of care and /or discipline
     - High care and ICU beds
     - Acute psychiatric
     - Chronic psychiatric beds
     - Maternity beds
     - Theatres
     - Support services e.g. radiology, pharmacy pathology
     - Casualty
     - Outpatients
     - Staff ratios and requirements per health care service
     - Non-staff costs and requirements per healthcare service.
   - For service planning government develops a national service plan for hospital services that includes level 1 services as a matter of urgency.

- The National Department of Health establish a Chief Directorate (or unit) dedicated to the provision of on-going technical assistance to support the framework for administering the NTSG.
- The redistribution of services be achieved through separate capital allocations, either conditional or appropriated at a provincial level.
- The NTSG be retained as a conditional grant to ensure that incentives are not generated within provincial governments to downgrade referral services required as part of a package of public sector services unilaterally.

2. **With respect to the Health Professions Training and Development Grant (HPTDG), that:**
   - The organisational structure of the National Department of Health be adjusted to include a unit of sufficient technical capacity to coordinate and manage the Grant. Furthermore, a standing committee involving all central role players in the teaching and training of health professionals and the professional bodies be established to reach joint decisions on policy targets, input requirements and the flow of funding.
   - Measurable policy targets be set as gazetted minimum norms and standards for any sphere of government and/or institution receiving earmarked funding for the training of health professionals.
   - All institutions receiving funding from this grant should be subjected to an annual external audit.
   - The entire policy framework underpinning the training of health professionals be determined nationally and that the allocation to the Department of Health be made as a conditional grant and that for the Department of Education forming an earmarked subsidy to tertiary education institutions.
   - The grant be converted to a specific purpose grant with the allocations by province based on target enrolment by type of health professional.
   - The allocations in respect of pathology students making use of the National Health Laboratory Services be incorporated into the HPTDG.

Chapter 3: Review of the National Housing Allocation Formula

With respect to the National Housing Allocation formula, the Commission recommends the following:

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

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

2. **Recognising variation in regional costs.** Differential costs of meeting the same minimum housing standard across provinces should be recognised.

   Currently the formula does not take into account regional issues, such as building and land cost variations in different provinces. Such variations change the cost of constructing a house to a given standard in different locations.

3. **Improving rural development funding.** Delivery of housing should not result in communities being forced to live in areas where there is neither supporting infrastructure nor economic or livelihood potential.

   While provincial housing departments are expected to contribute towards rural development, the formula does not take into account rural housing need in calculating housing backlogs. Although rural provinces are expected to help the housing sector to realise the objective of rural development, funds are not made available from the pool of housing funds to facilitate the attainment of this objective.

4. **Minimum quality standards.** Monitoring compliance to minimum quality standards should be enhanced to ensure that rapid delivery of housing targets does not result in compromised or poor quality housing. Poor quality housing will result in additional costs in the future, with negative implications for eradicating backlogs.

   The demand and need for housing is growing at a faster rate than the ability of government to provide a sufficient number of housing units. The only way that the backlog can be overcome is to increase funding for housing delivery substantially.

   However, delivery will be constrained by the limited capacity of the construction and building industry. The pressure on government to deliver, coupled with the constraints on the implementation side, may impact negatively on the requirement for minimum quality standards to be met.

PART B: Recommendations on the Review of the Equitable Sharing of Nationally-raised Revenue

The submission also contains recommendations on the financing of welfare services as was indicated in the Submission for the 2006 Division of Revenue. The Submission further includes an analysis of the Local Government Equitable Share (LES) formula, together with a report on the implementation of the Provincial Tax Regulation Process Act (2001) and the associated trends in provincial own revenue collection.

Chapter 1: Review of Welfare Services Financing through the Provincial Equitable Share

The Commission recommends the following with respect to financing welfare services:

1. **Incorporating a Social Development Component in the PES formula.** The PES formula should

include a component for Social Development based on population, the population in poverty and institutional capacity. There is no need to impose a separate element to deal with the statutory services as these are already a competence of the provinces. This recommendation is made for the following reasons:

- Simplicity and the need to ensure provinces have discretion in the delivery of a basket of social welfare services.
- To ensure the collection of data on provincial institutional capacity for the proper financing and delivery of social welfare services in the future.

2. **Maximising the reach of welfare delivery.** The funding for Social Welfare Services should take into account the need to maximise the spread of both welfare delivery institutions and human resources. This recommendation is made for the following reason:
   - Empirical evidence reveals that there is an urban concentration of established NGO and professional personnel (social workers) and therefore a consequent bias in the delivery of and access to welfare services.

Chapter 2: A Review of the Local Government Equitable Share (LES) Formula

From its review of the LES, the Commission recommends the following:

1. **Revising the current estimated cost of basic services.** Government should revise the current estimated cost of basic services (R130) to reflect current realities. It is not sufficiently close to the true cost of providing basic services across a range of municipalities facing different socio-economic and geographical disparities and disabilities.
2. **Raising the estimated cost from R130 to R175.** Government should consider raising the current basic services cost to R175. This would ensure that grant allocations are directed towards strengthening the ability of poorer municipalities to carry out their constitutional mandate. Within a revenue neutral scenario, the R175 estimate allocates more basic services grants to Category A and B municipalities, while increasing total LES allocations to municipalities by only R22 million.
3. **Increasing the effectiveness of the LES formula.** In the longer term, the efficiency of the LES formula in addressing its stated principles and objectives will be enhanced if a comprehensive review and assessment of the costs of providing basic public services is undertaken as a matter of urgency. An extensive exercise of this nature must take into account the crucial differences in the demographic disabilities and composition, as well as the regional and geographic disparities, that impact on the quality and quantity of service delivery.

Chapter 3: Review of Provincial Own Revenue Trends

With respect to developments in provincial own revenue, the Commission notes:

1. The general progress that has been made by provinces in the implementation of the Provincial Tax Regulation Process Act (2001).

2. The general progress in the implementation of both National Treasury's and the Commission's own revenue collection recommendations made in 2003.

The Annexures:

The submission also contains annexures representing various submissions that were made by the Commission during the 2005/06 work cycle. These are:

- The Commission's comments on the Western Cape Proposal for a Fuel levy.
- A comment on the proposed replacement of Regional Services Council (RSC) and Joint Services Board (JSB) levies as proposed by the National Treasury.
- A submission on the Development Component of the Local Government Equitable Share formula.

Back to contents

Review of the Conditional Grants in South Africa's Intergovernmental Fiscal Relations System

| Part A |

Chapter 1 Comprehensive Review of Conditional Grants in the South African Intergovernmental Fiscal Relations System

1.1 Background and general framework

Conditional grants are provided by national government to provinces and municipalities in order to achieve specific objectives. The decentralisation of fiscal responsibilities entails various spillover effects that are sometimes referred to by economists as fiscal externalities.[1] These spillover costs appear in three forms.

Firstly, there are the inefficiencies and inequities that result from differences in revenue and expenditure capacities among provinces and municipalities. These differences affect the ability of provinces and municipalities to provide public services at comparable tax rates.

Secondly, horizontal fiscal spillover costs arise from tax and expenditure competition, as well as the export of the burden of the fiscal policy decisions by one province or municipality to another. This simply means a province's or municipality's fiscal decisions serve partly to achieve its objectives at the expense of other jurisdictions.

Thirdly, there are the vertical fiscal spillover costs that arise as a result of one sphere of government exporting its tax or expenditure burden to another. An example would be a decision by national

1. Costs and benefits that spillover on other jurisdictions besides the beneficiaries or providers of a service are often called externalities, or external costs and benefits. The provider is not compensated by the external beneficiary of the service.

government to raise the standard of service delivery on a service that is a provincial competence, without the concomitant increase in financial resources. The higher standard may require an increase in the amount of revenue required by the province and if no new revenue is made available, there will be a negative impact on the province.

Conditional grant transfers in South Africa relate to the additional costs of expenditure spillovers. The cost effects of certain expenditure programmes sometimes spill over across provinces. For example, expenditure on some roads may benefit users from neighbouring regions; higher education and specialised health facilities may be used by non-residents; further education and training may be provided to workers who change provinces. These spillovers or fiscal externalities justify the use of certain categories of grants.

The problems outlined above provide the rationale for additional policy instruments to offset these adverse effects of decentralisation. Fiscal arrangements such as transfers and conditional grants are designed to compensate for these adverse effects.

It is inevitable that as decentralisation deepens, there will be a stronger need to correct for these spillover costs. In many countries there has been a tendency to push for tighter national management of the intergovernmental fiscal relations. In deciding on the trade-offs between sub-regional autonomy and national government obligations, an important point to understand is the role of national government in meeting the objective of redistributive equity.

1.2. Principles in the use of conditional grants

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

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

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

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

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

The advantage of bloc grants is that they can serve a much broader purpose. For instance, they can be used as vehicles through which provincial expenditure programmes could be induced to pursue national policies and priorities.

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

In principle, the use of conditional grants is an exercise of national government's spending authority. In the South African context, where the intergovernmental fiscal relations system is based on an equitable sharing of nationally raised revenue among the three spheres of government, the use of conditional grants may involve some trade-offs in the amounts available for the vertical allocation. An increasing use of conditional grants may therefore result in a reduced amount of transfers flowing through the discretionary equitable share and therefore impact on the flexibility of sub-national governments to implement programmes in compliance with their constitutional and legislative mandates.

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

In this respect the Financial and Fiscal Commission (FFC) has in the past recommended that the use of conditional grants should be used only when it is not possible to finance the relevant programmes through the equitable share. Indeed, in its submission to the Select Committee on Finance made in February 2002, the FFC proposed that where conditional grants are used, there should either be strong reasons to suggest the existence of spillover benefits or they should be used to deal with programmes of national priority. In the latter event, such use of conditional grants should be for sub-national governments to institutionalise the programmes so that they may gradually be phased into the equitable share.

1.3. Issues in the design of conditional grants

1.3.1 Conditionalities of grants

Once a case has been made for the use of conditional grants, the next question which has to be addressed is the conditions that should accompany the grant. Overly strict conditions may prevent sub-national governments from achieving the goals of the conditions in more efficient ways.

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

In most developing countries, some conditionality on grants seems desirable, particularly when national services such as education and healthcare are provided by sub-national governments. Money is fungible. Thus, transfers based solely on need may not ensure that the recipient government in fact uses the funds as central government may wish, unless the receipt is conditioned on performance and compliance is adequately monitored.

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

1.3.2 Minimum norms and standards

One of the issues worth considering in designing effective conditional transfer systems is the setting of norms and standards. It could be argued that where the national government wishes to ensure 'minimum standards' in areas that broadly fall within the constitutional responsibility of sub-national governments, it is often the case that conditional transfers are preferred. Such conditional grants need not be matching, so that recipient governments, especially poorer ones, are not overwhelmed with matching requirements. Transfers designed to finance particular types of services such as road maintenance or education are often linked to measures of need, for instance, length of roads or number of students. Using this approach requires some level of caution. Given inadequate attention, the approach may give rise to measures that may reflect past political decisions on inputs rather than current needs and desired outputs.

1.3.3 Infrastructure grants

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

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

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

1.3.4 Administrative challenges

It should be mentioned that conditional grant transfers often impose administrative costs on both national and sub-national governments. The manner in which the grants are designed can either reduce or increase the probability of administrative burdens. These issues therefore need to be taken into account and an appropriate balance struck.

National government also needs to have adequate monitoring capacity. This capacity is required to ensure that compliance with the conditions and purposes of the grants is assessed on an ongoing basis. Such capacity would also assist in ensuring that the grants have been utilised in the stipulated manner and that the grants did not merely substitute for resources that might have been allocated by the sub-national government. The latter requirement is particularly difficult to monitor.

1.4 The use of conditional grants in South Africa

Over the past several years, detailed attention has been given to the review of the unconditional transfers flowing to provinces and municipalities - the Provincial Equitable Share (PES) and the Local Government Equitable Share (LES). To date, an equally comprehensive review on the design and use of conditional transfers to provinces and municipalities has not been carried out. Even where it has been conducted, it has mainly been done on an ad hoc basis.

The 2004/05 FFC Submission highlighted a number of problems associated with the use of conditional grants in the transfer system. Subsequently, the 2005/06 FFC Division of Revenue Submission focused on two health conditional grants, namely the National Tertiary Services Grant (NTSG) and the Health Professions Training and Development Grant (HPT&DG). Problems around the design and implementation of conditional grant programmes are also evident in other sectors, especially those dealing with infrastructure and poverty alleviation projects, especially where the problems also cut across all three spheres of government.

A comprehensive review of all conditional grants in the system is vital. For example, the review of the LES resulted in a proposed Development Component being kept temporarily at zero, pending some further work. Similarly, work is currently underway on the review of the PES with regard to the Poverty Element, following the removal of the social security grants component from the PES. As most conditional grants do have certain measures of poverty alleviation and development built into them, the FFC decided on a comprehensive review of all the conditional grant transfers. This was done to ensure that there are no transfers in the system that duplicate each other.

Conditional grants are managed and administered according to detailed frameworks in Schedules 4, 5, 6 and 7 of the Division of Revenue Act. The following are ten key criteria against which each grant was reviewed:

- Purpose and measurable objectives of the grant
- Conditions of the grant
- Criteria for allocation among provinces (or municipalities)
- Rationale for funding through a conditional grant
- Monitoring mechanism
- Past performance
- The projected lifespan of the grant

- MTEF allocations
- The payment schedule
- The responsibilities of national transferring departments
- Grant review process
- Review of business plans.

This Submission focuses on conditional grants in the following specific sectors; health, education, social development, agriculture, water affairs, and broad local government basic service delivery areas such as water and electricity.

The following two sections present the key observations and recommendations of the FFC. The detailed review, analysis, observations and findings are contained in a technical research report to be published by the FFC in a separate volume.

1.5 Key Observations

The FFC's research highlights the following key observations:

- New conditional grants have been introduced without due regard to their relationship to existing grants. This leads to duplication and unintended negative consequences.
- There are no pre-implementation plans and assessments that identify potential risks that may impede implementation, nor are there guidelines to mitigate against such risks.
- Challenges related to the administrative requirements of the conditional grants are not identified and resolved before implementation. This is done on an ad hoc basis during implementation.
- There has been a proliferation of short-term conditional grants phased out without any indication as to whether they achieved their stated objectives. This may indicate an inappropriate use of conditional grants or an ad hoc approach to funding certain programmes.
- For some grants, the expected lifespan is generally not related to the objectives of the grant and in some cases it is indeterminate, e.g. the lifespan of a grant listed in a plan as being 'for the duration of the allocations'.
- Allocation mechanisms used in some conditional grants are not supportive of the purpose of the grant, e.g. the possible support of the education component of the equitable share for the School Nutrition Grant Programme.
- There are several uncoordinated grants serving the same purpose. For example there are several poverty alleviation grants in different line departments that are implemented in an unco-ordinated manner.

In introducing new conditional grants the following should be taken into account:

- Risk identification and a management plan should be the central condition in motivating for the establishment of any new conditional grant.

- A conditional grant must not be introduced for a purpose already served by another grant. The extension and expansion of existing grants should rather be investigated and encouraged.
- Emphasis should be placed on ensuring that allocation mechanisms are consistent with and supportive of the objectives of the grant.
- Requirements for the administration of the grant should be established and any related issues dealt with as part of the pre-implementation planning.
- Outputs for the grants need to be as measurable as possible. The conditions and the lifespan of the conditional grant have to be clearly specified.
- Grants targeting complementary and/or similar purposes for different spheres of government should be linked and coordinated. A typical example would be the relationship between the Provincial Infrastructure Grant and the Municipal Infrastructure Grant.

1.6 General recommendations on principles for the use of conditional grants

The FFC reiterates its previous recommendations on the principles for instituting conditional grants in the intergovernmental fiscal relations system as follows:

- Conditional grants to provinces and municipalities should only be used to address the problems of spillover benefits and to deal with the funding of programmes identified as matters of national priority. Such conditional grants should be phased into the equitable share once the programmes have been institutionalised by provinces and municipalities.
- National government departments should clearly define minimum norms and standards for delivery in areas of concurrent responsibility and monitor the performance and compliance of provinces.

1.7 Specific recommendations on conditional grants in the South African intergovernmental fiscal relations system

The FFC makes the following specific recommendations:

1. The **HIV/AIDS Grant** administered by the Department of Health should remain for the following reasons:
    - This will ensure that sufficient focus and resources continue to be channeled to deal with the pandemic.
    - The grant is in line with the previous FFC recommendation that the funding for all HIV/AIDS programmes should be done through the conditional grant mechanism.

2. The **Hospital Revitalisation Grant** should be incorporated into the Provincial Infrastructure Grant.
   - There is a strong convergence of purpose between the two infrastructure conditional grants.
   - Due to stricter conditions attached to the Hospital Revitalisation Grant, provincial preference is given to spending the Provincial Infrastructure Grant which, as a Schedule 4 grant, has less stringent conditions. This results in under-spending on the revitalisation grant.

3. The **Land Care Grant and Comprehensive Agricultural Support Programme Grant** should be merged into one Schedule 4 grant.
   - These two grants have overlapping objectives.
   - The administrative burden on provinces will be minimised by the creation of only one Agriculture Grant.
   - Provinces in which agriculture is the main commercial activity will be able to spend the new less stringent Schedule 4 grant creatively in accordance with their particular circumstances.

4. With regards to the **National School Nutrition Grant**, the conditions that relate to the development and approval of business plans must be refined to take into account the following:
   - Minimal time is spent on the process of developing and approving plans.
   - The delays in the submission of plans and the excessive non-compliance by provinces.
   - The previous FFC recommendation that proposed 'relaxing some stringent conditions, especially for those grants that seek to ensure adherence to national norms and standards, can allow provinces some level of decision space, innovation and creativity in spending the grant'.

5. The **HIV/AIDS Life Skills Education Programme Grant** should continue to be conditional with a clear focus on enrollment.

6. With respect to the **Local Government Grants**, the FFC recommends that:
   - The Municipal Infrastructure grant should go beyond funding the B (Basic residential infrastructure), P (Public municipal service) and E (Social institutions and micro-entreprise) components in the formula. The formula should also include operational and maintenance costs.

Back to contents

Chapter 2

Review of Health Conditional Grants

2.1 Introduction and Overview

This review is a culmination of the work of the Commission on the two important conditional grants in use by the National Department of Health, namely the National Tertiary Services Grant (NTSG) and the Health Professions Training and Development Grant (HPTDG). In its submission for the 2006 Division of Revenue, the Commission made proposals on the use of the two grants but further indicated that it would be carrying out additional work on the grants. In the response to the FFC proposals (See Annexure E of the Division of Revenue Act, 2006), government indicated that there was a need to undertake a more comprehensive review of the conditional grants system. This submission presents the findings and recommendations from the extensive research that the Commission has undertaken in the past year.

The two conditional grants have been in existence in one form or another since 1998/99. The NTSG (valued at R4.7 billion in 2005/06) is designed to:

- compensate provinces for the supra-provincial nature of tertiary services provision and externality or spillover effects.

Back to contents

- provide strategic funding to enable provinces to plan, modernise, rationalise and transform the tertiary hospital service delivery platform in line with national health policy objectives, with a particular focus on improving access and equity.

On the other hand, the purpose of the HPTDG (valued at R1.5 billion in 2005/06) is to:

- support provinces to fund costs associated with the training of health professionals.
- develop and recruit medical specialists in under-serviced provinces.
- support and strengthen undergraduate and postgraduate teaching and training processes in health facilities.
- enable the shifting of teaching activities from central to regional and district hospitals.

Despite the protracted period over which both conditional grants have been in existence, no significant review has occurred. However, evidence has been emerging over time that both grants have drifted from their original purpose and lack the specificity to achieve their goals effectively.

Both grants are formally defined as 'conditional bloc grants', which implies an allocation for a province only in fairly broad terms, with arguably loose conditions. These types of grants generally supplement provincial budgets rather than being specific to the programmes that they fund. In other words, they are meant to compensate provinces for the extra cost incurred in the delivery of the services.

The disadvantage, however, is that this lack of specificity has led to grant leakage, i.e. the funds are not necessarily allocated in line with their intended purpose. For instance, questionable linkages are made between the costs of the grant and functions they are meant to be funding, leading to a potential decline in the services and associated outputs which the grant is meant to protect.

This submission provides the findings of a detailed technical analysis and a comprehensive set of recommendations to address the issues raised by the research.

2.2 The National Tertiary Services Grant (NTSG)

2.2.1 Background

The NTSG has gone through a number of changes since 1998/99. These changes, however, have been restricted to the objectives rather than the value of the grant or its specific purpose. The NTSG evolved from what was originally called the 'Central Hospital Grant', the purpose of which was to support those hospitals and services most affected by structural inter-provincial patient referrals. These services are not distributed equitably on a regional basis and face medium- to long-term structural constraints in the achievement of such equity.

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

i. General specialist services (level 2).

ii. Highly specialised services (level 3).

The above objective was achieved by providing funding for a substantial portion of the overall budget of specific hospitals. However, these hospitals did not necessarily contain all the level 2 and 3 services provided in a province. This situation effectively persisted throughout the period from 1995/96 to 2002/03. When the conditional grant funded so-called 'central hospital services', it referred initially to 10 central hospitals, growing subsequently to 11.

From 2003/04 onwards the grant was de-linked from specific hospitals and aimed to fund the entire cost of 'tertiary services'. From this point onwards, the grant specifically excludes level 2 services, at least by definition, and should fund only level 3 services. In practice, however, the grant actually funds the spillover (the inter-provincial patient referrals) for both level 2 and 3 services, rather than the full cost of level 3 services alone.

The following reflects a consolidation of all the views expressed by stakeholders (government departments and health institutions) on the purpose of the grant.

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

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

2.2.2 Modernisation of Tertiary Services

From 2002/03 the Department of Health initiated a review of the requirements for planning for highly specialised services called the 'Modernisation of Tertiary Services' process (MTS). The MTS process was first and foremost a service prioritisation exercise which, once complete, would provide clarity on the required resource allocations over time. Decisions on the nature and structure of the NTSG would be contingent on the outcomes of this process.

The MTS process operated from the valid assumption that the level of absolute service need had to be identified as a basis for any modification of the funding framework. A further element of the plan involved engineering a convergence of the service mix of regional and tertiary hospitals into a number of standard types. This would theoretically reduce the complications resulting from the extreme variations in service mix between hospitals. Currently a regional hospital bed in the Western Cape cannot be compared to a regional hospital bed in Mpumalanga. The same applies to tertiary hospitals. If the proposals of the National Department of Health were implemented, acute beds by hospital type would be comparable.

2.2.3 Findings

1. The Department of Health, through an MTS task group, has provided a plan for the improvement of specialised and highly specialised hospital services. This has involved a fairly detailed review of existing services, as well as the assessment of what is needed and an agreement on a path forward to eliminate the gap. This plan does not yet have official status, and is consequently not accommodated in the Medium-term Expenditure Framework (MTEF). The Commission supports the approach taken by the MTS process in attempting to formulate a national policy framework for specialised and highly specialised services that enables the development of a comprehensive funding framework.

2. The framework recommended through the MTS will result in the NTSG initially expanding to improve funding for both level 2 and 3 services. The service plan, however, makes provision for the creation of pure level 2 and 3 hospitals. Ultimately this will allow the NTSG to be modified to fund tertiary hospitals fully (and not just the spillover), with regional hospitals funded from the PES. Currently, the NTSG funds the value of the 'spillover' of both level 2 and 3 services without fully funding the services. The funding of level 2 services currently occurring is by default. It should be noted that in its response to the FFC's 2005 recommendations, government emphasised that in principle the NTSG funds only spillovers associated with level 3 services and that inter-provincial billing should cater for any spillovers associated with level 2 services. An indicative costing of the required structural change in the budget framework is provided in the MTS (Department of Health, 2004).

3. Although the MTS, if implemented, would address many of the concerns raised in the 2005 FFC Submission document, a number of issues still need to be addressed, given the fact that the MTS plan is largely still on the drawing board. These issues include the following:
   - Further work is required on resource requirements and the norms underpinning these requirements.
   - More detailed clarification relating to the funding framework is required.
   - There is a need to clarify the process to be used to institutionalise the implementation and maintenance of the required structural changes to the public hospital system.

4. Notable is the fact that even after implementation of the full MTS plan, full inter-provincial equity will not exist, particularly in tertiary services. It is for this reason that the Department of Health motivates for the retention of a conditional grant funding approach for tertiary services. However, level 2 services will potentially be far closer to inter-provincial equity, making it feasible for them to be incorporated in the PES.

5. The overall MTS framework falls short of what is required to move forward as it lacks sufficient technical completion for the implementation of a funding framework equal to the requirements of the indicated service plan. These requirements are:
   - The service plan developed by the MTS must still be converted into a framework of norms and standards.
   - The norms and standards must become official government policy.

- Where a significant portion of the norms and standards would have to be funded via the PES, the norms and standards should be legislated (including any phasing-in process).
- The health component of the PES may need to be adjusted to take into account the norms and standards for any service that is underpinned by legislation.

6. In deciding on the resource allocation requirements of each province for hospital services, it is essential that consideration be given to both the relative and absolute need for a policy-determined minimum essential package of hospital services.

7. There is currently a significant difference between the actual services provided today and reasonable benchmarks of what should be provided. The under-provision of hospital services in the public sector is estimated as follows:
   - Under-provision of acute beds: 10.4%
   - Under-resourcing of public hospitals: 52.1%.

8. Provinces assumed to be over-resourced such as Gauteng and Western Cape are potentially under-resourced when a benchmark analysis is performed. This assessment corroborates the MTS findings.

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

2.2.4 Recommendations

1. **Allocation criteria for the NTSG.** In the medium- to long-term the Commission recommends that an allocation framework based on approved policy norms and standards, underpinned by an explicit service plan, be introduced. The criteria currently in use cannot fulfil the required purpose of the grant in the medium- to long-term. Specific norms and standards can provide a temporary mechanism for ensuring that specialised and highly specialised services are not unduly undermined.

2. **Norms and standards.** The Commission recommends that consideration be given to the following in specifying norms and standards:
   - Health care services in relation to the population:
     - Acute beds by level of care and/or discipline
     - High Care and ICU beds
     - Acute Psychiatric beds
     - Chronic Psychiatric beds
     - Maternity beds
     - Theatres

    - Support services, e.g. Radiology, Pathology, Pharmacy
    - Casualty
    - Outpatients.
- Resource requirements per healthcare service:
    - Staff ratios and requirements
    - Non-staff costs and requirements.

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

The Commission further recommends that these norms and standards be gazetted.

3. **Service planning.** The Commission recommends that the development of a national service plan for hospital services, including level 1 services, be completed as soon as possible and incorporated into Government policy.

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

4. **Supporting framework for administering the NTSG.** To enhance greater policy content of the allocation mechanism, the Commission recommends that the National Department of Health establish a Chief Directorate (or unit) dedicated to the provision of ongoing technical support in this area. It is likely that all the shortcomings identified in the design and application of this grant result from this specific weakness. From the review it is evident that insufficient capacity exists within the National Department of Health to support the conditional grant allocation mechanism effectively. Due to this state of affairs, the achievements of the grant are low.

5. **Achievement of equity.** The Commission recommends that the redistribution of services be achieved through separate capital allocations, either conditional or appropriated at a provincial level. Once these new services have been established, the NTSG can be appropriately directed or redirected. Such an approach requires a degree of planning integration that currently does not occur even under the current MTS process.

6. **Spillover effect.** The Commission recommends that the conditional grant mechanism be retained to ensure that incentives are not generated within provincial governments to downgrade referral services required as part of a package of public sector services unilaterally. For the foreseeable

future there will continue to be inter-provincial referrals for specialised and highly specialised services.

7. **Nature of the grant.** The Commission recommends that the NTSG be retained as a conditional bloc grant, given that it will not fund specific projects or budgets. The value of the allocation should be determined in relation to the set norms and standards.

2.3 The Health Professions Training and Development Grant (HPTDG)

2.3.1 Background

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

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

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

From its inception in 1997 the grant has had no relationship to the actual cost of any service or function related to teaching and training. However, as the grant was created through *carving out* a chosen value[2] from the relevant provincial budgets, it had no significant impact in respect of the budget process, apart from preserving the status quo in terms of hospital funding.

As the Commission indicated in its Submission for the Division of Revenue (2006), no attempt has ever been made to significantly improve the grant's specificity in relation to the stated objectives from its inception to the present. A potential consequence of this has been the fragmentation of decision-making and funding of training for health professionals, resulting in unplanned shortfalls in the required numbers of such professionals.

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

2.3.2 Findings

1. **Central finding.** Based on an examination of the alternatives, this review finds that the central failings of the existing HPTDG are a consequence of factors unrelated to the allocation mechanism. Given this, no significant re-structuring of the fund flows affecting the key parties allocating or receiving funds is required. However, the inter-relationships between the various role-players are sub-optimal and materially impact on the outcomes of the grant expenditure. The remedy for this will involve a significant change to the manner in which the grant is implemented annually.

2. **Policy Framework.** Underpinning all decisions relating to the HPTDG is the need for a government-approved, formal, explicit and quantified policy framework. This should not be contingent on the completion of a complete human resource strategy as reasonable decisions on training and teaching requirements are possible in the absence of the full strategy. It is nevertheless essential that a complete human resource strategy be developed in due course.

2.3.3 Recommendations

1. **Organisation.** To ensure both the continuity and the quality of the policy framework and its implementation, the Commission recommends that the organisational structure of the National Department of Health be adjusted to include a unit of sufficient technical capacity to co-ordinate and manage the HPTDG. It is further recommended that a standing committee, involving all the central role-players in the teaching and training of health professionals, be established to reach joint decisions on policy targets, input requirements and fund flows. Final decisions would be made at higher levels of government. Nevertheless, many of the technical questions could be resolved via this structure.

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

   The Commission recommends that consideration be given to gazetting the following targets:

   - Enrolments
   - Staff/student ratios.

   Consideration should be given to providing a clear indication of the entities to which the norms and standards apply.

   The Commission recommends that consideration be given to placing an explicit requirement on both provincial governments and teaching institutions to meet with the targets.

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

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

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

5. **Flow of Funds.** The Commission recommends that the total allocation for training health professionals be determined centrally and allocated to both the National Department of Health and the National Department of Education. The Department of Health allocation should be budgeted as a conditional grant to be transferred to each province in accordance with the costed framework. This would replace the existing HPTDG. The allocation to the National Department of Education would form part of the subsidy to tertiary education institutions and be earmarked for the teaching and training of health professionals. The earmarking will be specified in relation to each institution.

6. **Health Professions Training and Development Grant.** The Commission recommends that the HPTDG be converted to a specific purpose grant with the allocations by province based on target enrolment levels and associated costs per enrolment by type of health professional. This allocation should include funding for the nursing training colleges and ambulance training colleges. The degree of specificity incorporated into the grant structure would involve earmarking allocations for relevant institutions.

7. **National Health Laboratory Services.** The Commission recommends that allocations in respect of pathology students making use of the National Health Laboratory Services be incorporated into the HPTDG. The portion for the NHLS should be earmarked and specified in the same manner as all other funding requirements for health professionals. The allocation could be made directly from the National Department of Health and need not flow through provincial government.

8. **National Department of Education.** The Commission recommends that the allocation provided to teaching institutions via the National Department of Education should be earmarked in accordance with the target-specific costs arising from the costing framework relevant for health teaching institutions.

2.3.4 Observations

1. **Provincial Equitable Share.** No basis could be found for making any of the funds available for the teaching and training of health professionals through the Provincial Equitable Share formula. No rationale could be found for distributing teaching functions 'equitably' throughout the provinces.

2. **Teaching in Excess of the Norms.** No basis could be found for limiting any institution or provincial government to the target norms set by national policy. However, funding for students in excess of the norm would have to be raised from sources other than the earmarked allocation for health professionals. Institutions would still have to comply with any specified quality standards required for the training of health professionals.

2.4 Conclusion

The FFC review has concluded that substantial changes need to be made to both the HPTDG and the NTSG. These changes do not significantly affect the fund flows. Instead they focus on the extent to which a government approved policy framework underpins the allocations.

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

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

The review also concludes implicitly that operational efficiencies are likely where the obligation to deliver according to minimum norms and standards is squarely faced by provincial government. It is very likely that operational inefficiencies will result if national government attempts to take operational responsibility for any function discussed in this report.

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

Chapter 3

Review of the National Housing Allocation Formula

3.1 Introduction and Background

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

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

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

3.2 Review of the Formula for funding Housing Development

The provision of housing to the poor is a national priority. Furthermore, housing development is seen as an initiative through which projects and programmes would enable communities to live in sustainable integrated human settlements.

The housing conditional grants enable the national government to provide for the implementation of housing delivery in provinces and accredited municipalities. Housing delivery is therefore not funded through the equitable share. Unless government directs otherwise, and taking into account the level of backlogs in housing, it is expected that the housing need will continue to be funded nationally for at least the next 20 years.

From the National Housing Fund, money is allocated to provinces based on the housing allocation formula that was determined by the Housing MinMec (National Minister and Provincial MEC's) and approved by Cabinet in 2001 and subsequently reviewed in 2005. The formula takes into account:

- The needs of each province determined by measuring the housing backlog. Backlog is a function of people who are homeless, living in inadequate housing or inhabitable circumstances.
- Factors such as homelessness, shack dwelling, caravan dwelling, tents, backrooms and rooms in flats.
- A poverty indicator measured by households earning less than R3500 per month in each province.
- A population indicator as measured by each province's share of total population as per the 2001 census.
- A population share factor as measured by each province's share of total population.

The National Department of Housing administers two grants, namely the Integrated Housing and Human Settlement Development Grant (IHHSD) (formerly called the Housing Subsidy Grant) and the Human Settlement Redevelopment Grant (HSRD). The Human Settlement Redevelopment Programme is being phased out as of 2005/06 and will be amalgamated with the IHHSD grant. Thus the National Department of Housing will be administering one grant.

The HSRD grant will be continued by the provinces until the current projects are completed under the programme and no funds will be budgeted for this programme in future. The IHHSD grant is the focus of this FFC review, as it is allocated according to the funding formula.

The purpose of the IHHSD grant is:

- To finance the implementation of National Housing Programmes.
- To facilitate the establishment of habitable, stable and sustainable human settlements in which all citizens will have access to selected social and economic amenities.
- The progressive eradication of informal settlements on a phased basis by 2014.

The formula provides for weighting (in order of priority) of the elements defined below:

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

Where:

- A = Allocation
- HN = Housing Need
- HH = Households earning less than R3 500 per month (affordability indicator)
- P = Population.

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

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

Where:

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

The flow of funds is regulated by the Division of Revenue Act. For 2005/06 and 2006/07 the 2001 Census will be applied as funds were allocated over the Medium Term Expenditure Framework (MTEF) period and are already committed. MinMec approved and amended the formula: it will be phased in as from the 2007/08 financial year.

3.3 Key findings

The FFC research found that the current housing formula has a number of shortcomings:

i. It is negatively biased against rural provinces as it does not include traditional housing in the calculation of provincial backlogs.

ii. It does not take account of regional peculiarities, disparities and disabilities such as the differences in the cost of building a house to meet certain minimum standards.

iii. The number of homeless people is not an officially published statistic.

iv. Some of the variables used are very volatile in nature, e.g. in the North West SBY varied by 233% between 1996 and 2001; TC varied by -184% in Gauteng; HL varied by -785% in the Western Cape.

v. The use of the 2001 census presents a risk of underestimation as these data are outdated.

3.4 Recommendations

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

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

2. **Variation in regional costs.** Differential costs of meeting the same minimum housing standard across different provinces should be recognised.

   Currently the formula does not take into account regional issues, such as building and land cost differences in different provinces. This affects the cost of constructing a house to a given standard.

3. **Lack of rural development funding.** Delivery of housing should not result in communities being forced to live in areas where there is neither supporting infrastructure nor economic or livelihood potential.

   While provincial housing departments are expected to contribute towards rural development, the formula does not take into account rural housing need in calculating housing backlogs. Although rural provinces are expected to help the housing sector to realise the objective of rural development, funds are not made available from the pool of housing funds to facilitate the attainment of this objective.

4. **Minimum quality standards.** Monitoring compliance to minimum quality standards should be enhanced to ensure that rapid delivery of housing targets does not result in compromised or poor quality housing. Poor quality housing will result in additional costs in the future, with negative implications for eradicating backlogs.

   The demand and need for housing is growing at a faster rate than the ability of government to provide a sufficient number of housing units. The only way that the backlog can be overcome is to increase funding for housing delivery substantially.

   However, delivery will be constrained by the limited capacity of the construction and building industry. The pressure on government to deliver, coupled with the constraints on the implementation side, may impact negatively on the requirement for minimum quality standards to be met.

Back to contents

Review of the Equitable Sharing of Nationally Raised Revenue

| Part B |

Back to contents

Chapter 1 Review of Welfare Services Financing through the Provincial Equitable Share

1.1 Introduction and Background

1. In its submission for the 2006/07 Division of Revenue, the Financial and Fiscal Commission (FFC) recommended that:
   - Specific consideration be given to allocating funds to social welfare services in the provincial equitable share.
   - Government works faster to set norms and standards for the delivery of a defined minimum basket of social welfare services for all provinces.

Government responded positively to these recommendations in the 2006 Division of Revenue Act and is now involved in a process of defining the basket of services. It is also developing appropriate norms and standards for the delivery of these services by provinces. The FFC also indicated that, as a follow up to those recommendations, it would carry out further research to estimate the level of demand for social welfare services. This would enable the Commission to propose a more sustainable financing mechanism for welfare services given that social security grants are now a national responsibility. The following sections summarise the findings of the research that was carried out by the Commission and presents the Commission's recommendations.

1.2 The Demand for Welfare Services

The demand for welfare services is not expressed through the price system. The volume of services offered to deal with street children or child abuse is effected by society's demand. That demand is reflected in the political process, in terms of services offered or money spent. This in turn depends on institutions being available to deliver such services.

The international literature on funding welfare services is quite thin and there are no summary studies such as those analysing social security. The emphasis in studies of the demand for welfare services falls on either funding through formula-based fiscal transfers to lower tiers of government or on patterns of actual spending among different states or local governments, i.e. how demand is expressed through the political system. All of this literature implicitly assumes that the need is presently already largely known and expressed. This assumption is invalid in a developing country context.

The complexity in financing welfare services in a developing country derives from the lack of clarity on the definition of welfare services themselves. From this perspective the issue is as much to develop institutional capacity so that need can be translated into political demand and eventually fiscal demand. A block grant system is the most common way in which welfare services are funded under such conditions. Discretion on how to allocate funds across functions is thus left to lower tiers of government.

1.3 Social Welfare Expenditure in South Africa

There is some evidence of low political prioritisation of welfare services provision in South Africa - as opposed to simple social assistance transfer, e.g. grants. For example only R2.4 billion was budgeted for the social welfare services programme in 2005/06, compared to R55.4 billion for social assistance grants and R213.8 billion for total provincial spending.

Even though a strong case can be made for greater spending, government's priorities have generally not reflected this thus far. Part of the reason lies in the fact that social assistance transfers are more visible and claims on them are easily justiciable.

Generally a complex funding model for welfare may not be warranted for such relatively small expenditures (welfare services expenditure is only about 2% of aggregate provincial spending).

Both public and private funding for welfare services has long been severely constrained. The sector is highly fragmented, with unclear boundaries between organisations and services and large gaps in provision. Capacity is quite limited, especially outside highly urbanised and metropolitan areas. In recent years, the model of provision has shifted away from providing institution-based care, which is expensive and not affordable on a large scale, to community-based care.

1.4 Funding Provincial Welfare Services

Two questions need to be answered in order to deal with the funding of provincial welfare services. Firstly, what would be the most appropriate factors to consider in a welfare spending component of the equitable share (and conditional grant) funding? Secondly, does the amount at stake warrant a very finely graded and ideal formula that may be quite sensitive to weak data? Or would an appropriate formula be one that is simpler, more robust and less ideal?

Three distinct types of services with different funding needs have been identified, namely; rights-based services, family-centred services and community-based services. These statutory and non-statutory perspectives are not mutually exclusive. These must be coupled with the additional need for overall poverty reduction and community-oriented social and economic development.

An alternative perspective distinguishes only two types. Firstly, there are the statutory services, or those services prescribed by law and the courts, e.g. caring for youth offenders. Such services are more concentrated in provinces with more courts, thus imposing additional costs (or horizontal spillover effects) that may ideally be funded through conditional grants. Secondly, there are other services not necessarily covered in statutes. These are best funded through block grants.

A block grant should be based on need or the manifestation of need, balanced by institutional capacity. Funding should encourage capacity building, but without any capacity such funding would be wasteful, and much of the need would remain hidden (e.g. child abuse is unlikely to be observed where institutional capacity is lacking to encourage reporting of such abuse).

The block grant in an equitable share formula could be based on:

- *Population* and, in particular, the *poor population* of provinces, to reflect need; but as need for welfare services is not closely linked to poverty (e.g. substance abuse, delinquency, violence against women and children), the weight given to poverty should not be too large.
- *Institutional capacity*, as measured by a weighted average of a number of possible proxy measures: the number of registered social workers and registered auxiliary social workers, probation officers, child care workers, welfare or non-profit organisations (NPOs), the budget spent by NPOs and the provincial budget spent on welfare services.

But is such complexity in funding welfare services warranted, given the small amounts at issue? Also, the conditional grant for statutory services may be too small to warrant separate treatment.

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

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

or, in symbols, **WSG = CG(StatServ) + ES(Pop, Pov, InstCap)**

From the above general format, four options are possible:

- **WSG = CG(StatServ) + ES(Pop, Pov, InstCap).** This is the general model. It imposes a conditional grant for statutory welfare services, and applies the proposed formula based on need (population and poor population) and institutional capacity (proxied by a number of measures) to the equitable share part of welfare service spending.
- **WSG = ES(Pop, Pov, InstCap, StatServ).** Here the statutory grant is not imposed, but the cost of statutory services is specifically accounted for in the equitable share formula component for social development.
- **WSG = ES(Pop, Pov, InstCap).** Here the statutory grant is not specified, and the cost of statutory services is not directly accounted for in the equitable share formula.
- **WSG = ES(Pop, Pov).** Here the statutory grant is not imposed and the equitable share formula is simplified to only a simple formula based solely on population and the population in poverty.

Choosing between these different options is a matter of preference. The first, ideal or general model would clearly be most appropriate if good data were readily available and fiscal capacity allowed. However, the quality of the data on institutional capacity is untested and decisions would still have to be taken on weighting. Option 3 imposes no new data needs and is most appropriate (if one goes for the easiest and simplest option), in view of the fact that the amounts at stake are relatively small in the context of provincial funding. The weakness, however, is that it is heavily population-driven and adds no value to the current equitable share formula.

1.5 Recommendations

The FFC recommends:

1. **Incorporating a Social Development Component into the PES formula.** The PES formula should include a component for Social Development based on total population, the proportional population in poverty and institutional capacity, i.e. Option 3 above. There is no need to impose a separate element to deal with the statutory services element as these are already a competence of the provinces. This recommendation is made for the following reasons:
   - Simplicity and the need to ensure provinces have discretion in the delivery of a basket of social welfare services.
   - To ensure the collection of data on institutional capacity for the proper financing and delivery of social welfare services in the future.

2. **Maximising the reach of welfare delivery.** The funding for Social Welfare Services should take into account the need to maximise the spread of both welfare delivery institutions and human resources. This recommendation is made for the following reason:
   - Empirical evidence reveals that there is an urban concentration of established NGO and professional personnel (social workers) and, therefore, a consequent bias in the delivery of, and access to, welfare services.

Chapter 2 A Review of the Local Government Equitable Share (LES) Formula

2.1. Introduction and Background

The purpose of this review is threefold. Firstly, it presents an analysis of the effectiveness of the new Local Equitable Share (LES) formula as a mechanism for funding to municipalities. Secondly, the review assesses all the components of the formula. Thirdly, the review evaluates whether the new formula is achieving its stated objective of allocating more resources to poorer municipalities.

In the South African context, the need for fiscal transfers to the local sphere of government is captured in section 214 of the Constitution. This requires, amongst others, that the allocation of transfers to local governments must take into account the following:

- the ability of municipalities to carry out their constitutionally mandated functions.
- the fiscal capacity and efficiencies of municipalities.
- the developmental and other needs of municipalities.

The Constitution assigns critical responsibilities to local government, such as the provision of essential basic services: potable water, electricity and sanitation. While a number of municipal governments, particularly those based in urban areas, are able to fulfil their primary legislative mandate via locally raised revenues, many – especially those in rural areas – are hindered by their limited capacity to generate substantial local revenues.

As local governments account for about a third of total sub-national government expenditures but fulfil critical social functions, the design and implementation of the formula used in allocating a share of nationally raised revenues to municipalities is of pivotal importance.

There are a number of reasons for undertaking a review of the LES formula. Firstly, in the 2005/06 financial year, the Government undertook a major revision of the Local Government Equitable Share (LES) formula. In carrying out its mandate, the FFC is required to provide comments to government on matters relating to any review of the equitable sharing of nationally collected revenue.

Secondly, the evaluation presents an opportunity to analyse the pattern of grant allocations generated by the new formula and compare it to the distribution of grant allocations under previous formulas. Such an analysis should provide the basis for objective evaluation of whether the new formula is achieving its intended objective – that of redistributing more resources to poorer municipalities.

Finally, this evaluation forms part of the FFC's on-going research into the different components of the LES formula.

2.2 Discussion

The FFC has noted that the basic services component in the formula is premised on a set of rand amounts representing the average costs per poverty household for obtaining four basic municipal services. In the case where all four services – electricity, water, refuse and sanitation - are provided, the LES formula assumes that the monthly per household cost equals R130. While the Department of Provincial and Local Government (DPLG) estimated costs of basic services represents an update on costs estimates developed in the 1999 study by the Palmer Development Group, questions certainly remain as to whether the R130 figure is appropriate. Other research utilised some of the 1999 cost estimates developed by the Palmer Development Group to estimate the monthly per household costs. In the municipality with the lowest costs, they range from R110 to R182. However, in municipalities with the highest costs, the figures range from R185 to R308.

While not definitive, these figures, in addition to the FFC's assessment of the costs of constitutionally mandated basic services (CMBS), do suggest that the R130 figure used in estimating basic services grant allocations is low. The current LES formula is based on the assumption that households in poverty are unable to pay anything towards the cost of basic municipal services, while households with monthly incomes a rand higher than the poverty threshold can afford to pay the entire cost of the same municipal services.

An alternative and better Basic Services component would take account of the distribution of household income above the poverty threshold. One alternative would be for the LES formula to provide a smaller subsidy for households with incomes somewhere above the poverty threshold.

Updating estimates of basic services costs to the current year suggests that the parameters used in the LES formula may underestimate the cost of services by a substantial amount. It would thus be useful to analyse the impact of choosing alternative cost parameters for use in the Basic Services component.

In the FFC *revenue neutral* simulation exercise, the monthly household cost of the four basic services is increased from R130 to R175. While such an increase changes the distribution of per capita allocations in favour of municipalities with higher concentrations of poor households, the simulation, being revenue-neutral, only increases the monthly per household cost for basic services to R175, but lowers the 'scale' parameter so that the sum of LES allocation would remain at its current R9.3 billion level. To achieve a total basic services cost of R175, the four basic services were set as follows: water – R45; electricity – R50; sanitation – R40; and refuse – R40.[1]

The FFC review addressed the following three questions:

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

ii) Are the observed changes in the pattern of LES allocations expected or has the new formula created unanticipated or anomalous outcomes? Does the new formula create particular hardships for individual municipalities or for certain types of municipalities?

iii) How does changing the costs of constitutionally mandated basic services affect the LES allocations?

2.3. Findings of the Review

The main findings of the review are as follows:

- No significant divergence is found between unweighted and weighted per capita equitable share allocations. Neither was there any divergance in allocations between basic services and institutional components.

In terms of total equitable share allocations, the following is noted:

- Average per capita equitable share allocations are highest in municipalities with population sizes of 100,000 or less.[2]
- However, using global equitable share amounts, average equitable share grants are highest in local governments with population sizes of 200,000 persons or more.[3]
- Using municipal per capita income as the basis of analysis, per capita equitable share allocations are highest in municipalities where average per capita income ranges from R500 – R1500.
- However, the highest average equitable share allocations (an amount of R263 million) go to three municipalities which have average incomes of R2000 or more. This probably reflects the

1. The costs of these services, as used in National Treasury's LES allocation formula, are R30, R40, R30 and R30 for water, electricity, sanitation and refuse collection respectively.
2. Of the 237 Category A and B municipalities, 123 of these have average population sizes of 100,000 persons or less.
3. 51 municipalities out of the 237 category A and B municipalities examined have average population sizes of 200,000 or more.

fact that while the three (Tshwane, Johannesburg and Cape Town) have relatively high per capita incomes, they also house a significantly high number of poor households located within their localities, hence the need for greater resources to provide constitutionally mandated basic services to these households.

In terms of the *basic services* components of the equitable share, the following points are noted:

- The average cost of providing the four basic services is estimated at R130. Relative to this amount, it is observed that municipalities with population sizes of less than 25,000 receive per capita basic services grants higher than the R130.
- However, in terms of average basic services grant allocations, municipalities with average population sizes of 100,000 or more receive basic services grant allocations of R7 million or more.

In terms of the *institutional capacity* grant allocations, the results of the descriptive analysis indicates that:

- On a per capita basis, relatively small municipalities receive higher grant allocations.
- While the per capita grant allocations on an unweighted basis are evenly spread across all income groups, the use of weighted averages shows that relatively poorer municipalities (those earning less than R1000) receive the bulk of institutional capacity grants.

2.4. Recommendations

Based on its research findings and observations the Commission recommends the following:

1. Government should revise the current estimated cost of basic services (R130) to reflect current realities. It is not sufficiently close to the true cost of providing basic services across a range of municipalities facing different socio-economic and geographical disabilities and disparities.
2. Government should consider raising the current basic services cost to R175. This would enhance the LES stated objectives of ensuring that grant allocations are directed towards enhancing the ability of poorer municipalities to carry out their constitutional mandate. Within a revenue neutral scenario, this estimate allocates more basic services grants to Category A and B municipalities, while increasing total LES allocations to municipalities by only R22 million.
3. In the longer term, the efficiency of the LES formula in addressing its stated principles and objectives will be enhanced if a comprehensive review and assessment of the costs of providing basic public services is urgently undertaken. An extensive exercise of this nature must take into account the crucial differences in the demographic composition, as well as the regional and geographic disparities, that impact on the quality and quantity of service delivery.

Chapter 3

A Review of Provincial Own Revenue in South Africa's Intergovernmental Fiscal Relations System: An Assessment of Trends and Challenges

3.1. Introduction and Background

The purpose of this review is twofold. Firstly, it is a follow-up on the progress that has been made by the provinces in setting up adequate policy frameworks aimed at optimising own revenues and implementing the Provincial Tax Regulation Process Act (2001). Secondly, the review assesses provincial revenue strategies and current revenue sources, as well as offering an analysis of trends in provincial own revenue. In addition, the review highlights risks and other strategic issues in the management of provincial own revenues.

The Financial and Fiscal Commission (FFC) has noted the current situation in South Africa where provinces raise an insignificant amount of revenue compared to their expenditure needs. While expenditure assignment is highly decentralised, current revenue assignment is highly centralised as national government controls the revenue sources with broad bases, while provinces only have access to narrow-based taxes and a few user fees.

As a follow up on provincial visits undertaken by the FFC during the 2002 fiscal year, the FFC conducted interviews with relevant officials from provincial treasuries and pertinent line departments regarding the collection and policy framework around own revenues raised by provinces. This submission summarises the outcome of deliberations with provincial treasuries.

3.2. Discussion

Provincial own revenue constitutes less than 4 percent of total provincial revenue. The main sources of own revenue are the road traffic fees, hospital patient fees, horse racing and gambling fees and, in some provinces, interest earned. Provinces are therefore still highly dependent on transfers for their expenditure needs. The FFC in its submission for the 2005-07 MTEF cycle made observations about the lack of flexibility in provincial expenditure patterns that could be explained partly by the low revenue raising capacity of provinces. Both the National Treasury and the FFC have in the past carried out studies that have identified bottlenecks and obstacles to improved revenue collection. The FFC and National Treasury proposed ways that may be explored in order to achieve efficiency in revenue collection.

The FFC has previously noted that encouraging provinces to raise more of their own revenues and matching funds for some conditional grants could result in provinces being more able to adjust spending in line with their local circumstances. However, assigning more revenue raising powers in itself does not necessarily ensure that that they raise more revenue. It is therefore important to consider various ways for the transfer system and tax framework to include appropriate incentives for provinces to raise more of their own revenues.

Thus previous FFC submissions have proposed that Government introduce greater policy incentives for provinces to raise revenues from sources assigned to them by the Constitution and legislation. In addition, the FFC supports the view that such incentives should encourage provincial expenditure accountability, responsibility and efficiency and should direct expenditure towards sustainable economic growth and development.

3.3. Findings of the Review

The FFC's regular review of provincial own revenue trends identified the following issues:

- **Lack of line department commitment.** A general lack of commitment by line departments to optimising own revenue collection. Across most provinces, very few line departments have the collection of revenue as a key component in their strategic plans. However Treasuries in all provinces have established dedicated Directorates to address this problem with line departments. In some provinces, it is a requirement that line departments who collect revenue incorporate revenue collection improvement as part of the strategic plan.
- **Lack of revenue management policy.** A lack of accepted policies and procedures in respect of revenue management and controls in the collection of own revenue. However, it must be noted

that the majority of provinces have made significant progress in ensuring that this problem is addressed through the revenue directorates, together with regular interaction between the revenue directorates in the treasuries and relevant units in the line departments.

- **IT and financial management inadequacies.** The problems of information technology (IT) and financial management systems identified by the FFC in its 1999 submission still persist, although in most provinces this has been addressed. There are still inadequate IT systems to monitor and control outstanding amounts and debts. Coupled with a lack of procedures, this problem is aggravated by the fact that some reconciliations have to be done manually in a number of provinces. Without procedures and adequate staff, the own revenue outcomes are negative.
- **Incomplete revenue generation records and reviews.** For the smaller revenue sources, there are problems with asset registers and databases of revenue-generating provincial assets. This situation is further exacerbated by the infrequent review and revision of tariffs. However, it must be noted that the latter problem is gradually declining as provinces now require regular tariff adjustments to cater for the effects of inflation.
- **Limited own revenue generation.** Total provincial revenues are generated from the following sources – the Provincial Equitable Share (PES), conditional grants and own revenue. On the aggregate and respectively, these sources account for 85, 11 and 4 percent of provincial revenues.
- **Tax and non-tax revenues.** Provincial own revenues are divided into two main categories – tax revenues and non-tax revenue. Across the nine provinces, tax revenues have on average, accounted for around 55 percent of provincial own revenues compared to the 45 percent generated from non-tax sources.
- **The main sources of provincial own revenue.** The four major sources of provincial own revenues are casino licences, motor vehicle licences, sale of non-capital goods and interest income. Together, these sources account, on average, for over 90 percent of total own revenues generated by provincial governments.
- **Tax and non-tax revenue trends.** Over the sample period under review, tax receipts recorded a negative average growth rate of about 7 percent while non-tax revenues grew by an average of 3 percent. This probably reflects recent efforts on the part of provincial treasuries to expand their revenue bases and improve revenue collection from non-tax sources without needing to overburden available tax sources.

3.4. Conclusion

The Commission notes the progress with the implementation of the Provincial Tax Regulation Act in some provinces. Furthermore, the Commission notes that its previous recommendations with respect to the structures and systems relating to the collection of provincial own revenues are being implemented.

Back to contents

ANNEXURES

Annexure A

Financial and Fiscal Commission (FFC) Submission on the Western Cape Province Proposal for a Fuel Levy (Edited Version)

A1. Introduction

In 2005 the FFC received the Western Cape government's proposal for a fuel levy tax for the province. In brief, the Western Cape government proposed the introduction of a fuel levy[1] of 10-50 cents (c) per litre of fuel – with some exceptions for marine bunker fuels used for shipping, fishing and aviation fuel.

This submission constitutes the FFC's comments on the proposal as required by the Provincial Tax Regulation Process Act 2001 and Section 228 of the Constitution of the Republic of South Africa. The comments cover the macro-economic modelling exercises, the impact analysis, the incidence analysis and the public participation process carried out by the Western Cape government. Finally, the submission presents the Commission's recommendations.

1. 'Levy' is the official term used. In this submission, the words 'tax' and 'levy' are used interchangeably.

A2. Background

The FFC has in the past made recommendations on the need for provinces to implement the provisions of Section 228 (2) of the Constitution, which allow them to impose certain taxes to raise revenue. In its Annual Submission in 1997, the FFC highlighted the surcharge on personal income tax (PIT) as the most significant revenue source for provinces followed by the fuel levy. Furthermore, the FFC Submission for the 2004-07 Medium Term Expenditure Framework (MTEF) indicated that the enactment of the Provincial Tax Regulation Process Act (2001) presented opportunities for provinces to augment their own revenues by implementing new taxes that provide significant tax revenues. Among the taxes identified were the fuel taxes.

The preceding paragraph indicates that the Western Cape proposal is not an entirely new input into the Intergovernmental Fiscal Relations System. What is important is that it comes at a time when the enabling legislation for the implementation of provincial revenue-raising powers is in place. In addition, the capacity for provinces to manage their fiscal affairs has improved significantly.

It is important to reflect on the FFC's proposal with regard to the need for sub-national governments to raise significant amounts of their own revenue. In its submission of 1995, the FFC's Framework Document for the intergovernmental system, the Commission stated that while the collection of taxes was most efficiently collected at the national level, in a fiscally decentralised system of government, it is desirable that the efficiency is balanced against accountability. In this respect, sub-national taxes are necessary, although they may not be sufficient to ensure that governments are accountable for their exercise of fiscal powers.

The FFC's comment on the Western Cape proposals and the recommendations thereof are made against this background.

A3. Issues arising from the Objectives of the Proposed Fuel Levy

A natural starting point is to get a full understanding of the objectives that the proposed fuel levy seeks to attain. In introducing a new form of tax/levy of this nature, it is imperative that the objectives are clearly articulated so as to avoid any confusion. Based on the technical reports received by the Commission, it can be discerned that the fuel levy proposal has three main objectives:

i. Revenue raising (p40, para A3.1).

ii. Rehabilitation and/or upgrade of the provincial road infrastructure in order to stimulate job creation.

iii. Environmental impact (addressing costs associated with fuel use).

Assessment and clarification of these objectives forms part of the FFC's response and recommendations.

A3.1. Revenue raising

Fuel levy/taxation has been widely used for the purposes of revenue raising in many other countries. For instance, taxes on vehicular fuels constitute up to 10 percent of the revenue base for many OECD countries according to data from the International Energy Agency. Revenue from fuel is typically derived from broad-based consumption taxes, levies, sales taxes or specific excises. Many countries recognise that fuel is an important input into economic activity. As a result they have rebates for some taxes for certain industrial uses.

It is noteworthy that while there is international precedent for the use of the fuel levy as a revenue-raising instrument, this objective must be considered against the broader issues relating to the relative efficiency of a fuel levy as a source of revenue. Implicit in this argument is the assumption that there may be other forms of tax instruments that can raise revenue more efficiently than a fuel levy. Indeed, Section 228 of the Constitution points to a number of taxes that provinces may impose, while also indicating the prohibited taxes.

There are therefore multiple tax (and expenditure) instrument options that, individually or in combination, may be used to meet the revenue objective. These options are not discussed in any significant detail in the Western Cape proposal. The proposal does not provide any comparative analysis to justify the argument for recommending the fuel levy as the best available tax. Such comparison is important in objectively choosing the most appropriate revenue-raising instrument, given the costs and benefits associated with various other taxes. It is always important to assess the greatest efficiency gains that may be derived from the introduction of a fuel levy as compared to other interventions. The Commission considers this an important omission in the Western Cape proposal.

More importantly, with respect to design issues, there are, broadly speaking, two design features of a revenue-raising instrument that public finance emphasises for the purpose of minimising the negative impacts on resource allocation. These features are (i) tax neutrality and (ii) the treatment of business inputs.

Tax neutrality, in the case of the proposed fuel levy, means that the resulting structure of overall fuel taxation should not unduly influence fuel use choices made by private consumers as well as businesses. The first round impact of the fuel levy is that it has the effect of making diesel and petrol relatively more expensive compared to other fuels. These distortionary effects can be avoided by making the levy apply to *all* fuels. While this may not be an issue in the short to medium term, it may become increasingly so with movement towards environmentally cleaner energy sources.

Revenue-raising fuel measures should ideally exclude producers and only affect final consumers. Theoretically it has been argued that, when producers pay fuel taxes, there are uneven impacts on effective tax rates, resulting in distortions on relative prices of goods and services. Thus the once-off levy becomes an input cost, and most input costs are ultimately borne by the end consumer. In the Western Cape proposal, the levy applies to all sales of petrol and diesel by fuel wholesalers to both fuel retailers and the public. However, fuel sales to harbour bunkers used for shipping and fishing, as well as aviation fuel, are exempted. Rebates on the levy are also proposed for wholesale fuel retailers in border towns.

Consequently, the Commission notes, the proposed system of fuel levy rebates some, but not all, intermediate uses of fuel by business and, hence, is very partial. Production efficiency would require that all producers face the same input prices. This principle is violated if some businesses have their fuel input taxed and others are not taxed. To avoid this pitfall, the Western Cape approach excludes all possibilities for exemptions on the tax side, except for the absolutely necessary economic activities. Rather, the expenditure side of the budget will be used to compensate losers. This approach will address the high administrative costs associated with the competitive bidding for exemptions and exclusions.

A3.2. Earmarking the fuel levy for the rehabilitation and/or upgrading of the provincial road infrastructure

The issue of earmarking a tax for a specific purpose is an important one in the discussion of general principles of taxation. In its current form, the proposal for the fuel tax implies that it is a benefit tax when it is linked to roads. In other words, it is imposed on fuel users because they benefit from using the roads but also damage those roads with their vehicles. The benefit principle suggests that those that benefit the most from the service must pay the highest taxes. The fuel tax, however, is not necessarily paid by motor vehicle owners only. Public transportation utilised by the poor will ultimately bear the tax burden as operators will shift the tax forward in the form of higher fares. Poor commuters have very few choices for cheap public sector modes of transport. Thus, the link between the fuel levy and the damage caused to roads is not necessarily direct. Issues of horizontal and vertical equity as a principle in tax design may be violated unintentionally.

Internationally, there are some countries that indeed use fuel taxes for a specific purpose such as road construction. For instance, in the USA, the entire federal fuel excise revenue is spent on highway construction while in many states fuel taxes are indeed dedicated to varying degrees to road construction. The same is true for Japan where vast proportions of fuel taxation are spent on road construction.

However the use of the provincial fuel levy for this purpose does raise important design issues in South Africa.

Road maintenance costs are largely determined by mass and axle loads of vehicles, distances travelled and the quality of the road pavement. The basic argument for using a fuel levy is that road damage varies with distance travelled, and this is reflected in fuel consumption. It is the Commission's view that this argument is not valid in South Africa. For instance, two different vehicles of different mass using the same amount and type of fuel impose substantially different costs on the road depending on the *type* of vehicle. A five tonne truck will inflict greater damage than a family sedan on the road. Thus, there is the risk of undercharging heavier vehicles.

Thus, the Commission does not regard the design of the fuel levy in the proposal as being adequate because it does not reflect differences in vehicle mass and road type. Instruments that are more responsive to the mass and distance travelled by individual vehicles have to be investigated before such proposals are made. The international literature and experience indeed suggest that there are more effective instruments for raising revenues for the costs of road maintenance and infrastructure. These include road user charges that vary with the mass of the vehicle and distance travelled. The fuel levy could therefore be supplemented by such user charges and a provincial levy on high axle loads.

A final argument against using the fuel tax as a means to address road backlogs specifically, as distinct from using it as an instrument for augmenting generic infrastructure revenues, is the following: if the province limits its objective to road infrastructure, this unnecessarily reduces flexibility and discretion in allocating expenditures and legislatively ties the province to road infrastructure expenditures alone. However, when road backlogs cease to be an issue, the revenues may be used to deal with new priorities. Earmarking the tax for a specific purpose will limit this possibility.

A3.3. Environmental issues

While the proposal points out that the objective of fuel taxation is 'addressing costs associated with fuel use (for example, environmental costs)', it is clear that the proposed fuel levy is not an environmental tax as it is not earmarked for spending on environmental activities. The most important characteristic of an environmental tax is that it should be dedicated to compensating for the negative effects of environmental costs. As a result, the proposal remains open to criticism by environmental lobby groups on the grounds that it is not an environmental tax in the strict sense.

The issues that are being raised in this comment suggest that the objectives for the proposed levy are not really explicit. Explicit arguments and definitions are an important consideration in determining responsibility before a tax is allowed. Other considerations include public confidence and the public's ability to understand the proposed fuel levy. With the passage of time, the public may become disenchanted by a provincial fuel tax that is unclear and proposes arbitrary distinctions. The Commission therefore recommends that the objectives of the tax be clearly defined and that the arguments in the proposal be more explicitly stated and justified.

A4. Impact on the Economy

To assess the cost implications and impacts of the levy on consumers and businesses, the Western Cape Treasury authorities used Bureau of Economic Research (BER) models that included a detailed treatment of fuel taxation and the transport industry. The levy and rebate changes in the proposal are very small compared to overall economic activity. It is not surprising therefore that the impacts measured by gross domestic product and inflation are very small. Furthermore, the distributional effects and poverty incidence are found to be very small. This is not to say that there are no negative effects. As always with modelling, it must be pointed out that the results are inherently associated with margins of error and so should be cautiously interpreted.

Nonetheless, the modelling exercise suggests that there are no significant macro-economic impacts likely to result from the proposed changes by the Western Cape. This is so even if all provinces took similar measures simultaneously. Based on literature assessments of the South African economy, the Commission is inclined to agree with the model results that indicate minor to zero macro-economic impacts[2]. Furthermore, because the net costs to both business and consumers are negative or very low, there is unlikely to be significant negative distributional effects. However, given that poor people are heavily reliant on minibus taxis and public transport, these small negative impacts may result in social unrest.

Finally, the proposed levy will have some implications for the tax burden. If all provinces were to implement the levy at the upper end of 50c per litre, the tax burden will, according to the technical analysis, rise marginally. In terms of its effect, the extra tax burden imposed on the economy will be about R9 billion, raising the tax/GDP ratio to 27.0655. Therefore decisions will have to be made as to whether 'tax room' will have to be created to accommodate all or part of this increase, especially given government's stated objective of targeting the tax burden at 25%. The Commission would also like to note that the introduction of any new taxes must be considered within the broader tax regime environment such as the envisaged tax reforms to the Regional Services Council (RSC) levies.

A5. Implementation and Administration Issues

According to the proposal, the fuel levy will be administered along the lines of the existing Road Accident Fund (RAF) levy. As a result, it is envisaged that there will be minor administrative problems associated with the proposed levy.

The Commission finds that the proposed administration of the levy has merit of its own and other provinces are likely to find this experience and knowledge useful in determining similar own revenue proposals. However, the Commission is of the view that there may be additional administrative costs if the proposal is implemented piecemeal. Consideration should be given to simplifying the process by adopting national legislation to provide the framework for the levy for all provinces. This should give provinces the ability to pass their own legislation to deal with rates, rebates and administrative issues within national rules and regulations.

A6. The Political Dimension

The introduction of a province-specific fuel levy may be politically very unpopular with certain influential groups (e.g. workers, commuters, taxi associations, environmental groups). Indeed, the public consultation process in the Western Cape found that in general the proposal was resented by most residents consulted. The FFC views this as one of the key considerations that ought to be carefully taken into account, if the proposal is implemented. Unless the likely political ramifications

2. The conclusion that the macro-economic effects are minor or small is a subjective one and depends on interpretation. There are at least two ways of viewing the macro-economic effects. If the revenue generated by the additional levy is expressed as a fraction of overall GDP, then the numbers are small, constituting less than 1% of GDP. However, if one looks at the amount involved, then the resultant R9 billion additional tax burden, if all provinces adopted the levy at the maximum rate, is by no means small. Here the former interpretation is used.

are fully anticipated and appropriate prevention measures are put in place, it is possible for the proposal to meet with resistance from many constituencies.

Furthermore, the proposed levy will be seen as an addition to an already highly levied tax base. This on its own may cause further resentment towards the levy. As the public consultation process revealed, the people of the Western Cape already hold the perception that they are heavily taxed and such a tax may prove to be the last straw.

A related issue is that of *timing*. The current environment is characterised by high volatility in oil prices largely driven by forces outside of South Africa's control. Indeed fuel prices have risen dramatically in the recent past and continue to rise. While a purely mathematical-economic interpretation would suggest that the ratio of the tax to price falls with higher fuel prices, the general public will read the imposition of the levy as an additional tax. Imposing a fuel levy in such an environment might just prove to be a trigger leading to social unrest. This suggests that should the proposal be granted, there should be flexibility, especially in how and when the tax is introduced. For instance, the fuel tax may be first introduced in an atmosphere in which world oil prices are falling rather than in the current environment of rising oil prices.

An important and related matter is that the proposal is predicated on the relatively lower coastal price of fuel. While it may be acceptable that consumers in the Western Cape pay a relatively lower price for fuel relative to inland consumers, there is nothing to stop inland provinces from applying the levy once it is granted to the Western Cape. The political dynamics may then be different in the latter scenario and could easily degenerate into 'fiscal wars' detrimental to the economy. This will disturb state financing, allocation of resources and harmony in the three spheres of government. The international literature does provide some evidence that this may be an important issue. In Brazil, the ongoing 'fiscal war' being waged by various states as they manipulate the tax rates and grant special incentives is a case in point. However, since the proposed levy is not a mobile tax, the above observations may not necessarily detract from the merit of the proposal.

A7. Consultation Issues

A look at the impressive list of those consulted reveals large and well-established players, as well as consultations with taxi associations. Consultations were comprehensive and very informative. In this regard, there are two main points that the FFC would wish to raise as regards the consultation process:

i. While appreciating that considerable effort has already been made to obtain feedback from the taxi industry, this has been unsuccessful, and further efforts should be made to solicit the views of this crucial industry. Furthermore, the formal public transport sector, especially the bus industry, should also be approached.

ii. If this proposal is implemented at national level with provincial legislation dealing with certain provincial parameters such as the rate of the levy, other provinces should also be approached and consulted on this issue.

Back to contents

A8. Constitutional Issues

There is an elaborate discussion in the document on the constitutionality of the proposed levy and the conclusion is reached that the provincial government can impose a fuel levy to provide funds for construction and maintenance of roads or, for that matter, for any other purpose. The Provincial Tax Regulation Process Act 2001 also allows for this kind of tax for provinces. The FFC concurs with this assessment and is of the view that the Western Cape's approach to the implementation of the Provincial Tax Regulation Process Act is a step in the right direction as far as augmenting provincial revenues is concerned. This would go a long way towards introducing flexibility in provincial budgets and expenditure patterns.

A9. Recommendations

1. **The merit of the proposal.** The FFC generally considers that the proposal has merit. The methods that have been used in the economic feasibility studies are appropriate and the findings are sensible. The process that has already been undertaken by the Provincial Treasury, namely to engage with people at public meetings, is commendable.
2. **The objectives of the levy.** As they stand in the proposal, the list of objectives for the proposed fuel tax is not very solid and may be open to many criticisms in their current form. The FFC proposes that the objectives should be reviewed and some of the more obvious anomalies, such as those associated with the environmental objective, should be eliminated. Furthermore, to avoid having to make constant recourse to legislation change every time new and justifiable development expenditure needs arise, the Commission recommends that the proposal be justified as a measure to augment infrastructure revenue in general and not be tied solely to road infrastructure.

   Whilst the Commission fully understands the positive approach of aligning the fuel tax regime to road developmental expenditures, it is not clear that a sound and convincing case has been presented indicating clearly that the fuel levy is the most efficient option amongst all potential tax handles at the authorities' disposal.
3. **The levy band.** The proposal requests a band for the fuel levy between 10c and 50c. The justification for this wide band is to allow maximum flexibility over a period of time and to avoid having to change legislation whenever an adjustment is required. It was also felt that a c/litre flat rate would reduce revenue uncertainty in an era of fuel price volatility. Depending on national government's views on the appropriate tax burden, this proposal may call for 'tax room' to be created for a provincial fuel levy in order to avoid raising the tax burden on individuals.
4. **The infrastructure funding alternatives.** The Commission is generally concerned with how the proposal relates to existing provincial infrastructure grants and impending moves by the government to relax the existing constraints on provincial borrowing for infrastructure funding. With constraints on provincial borrowing falling away in the near future, borrowing may be

Back to contents

another way of financing infrastructural developments. The Commission is aware that while borrowing is a valid fiscal tool, it is not necessarily an alternative to taxation. However, the Commission is of the view that the choice is ultimately a political one that the Western Cape Province would have to make after weighing up all the relevant variables. It should also be noted that this proposal should be considered within the context of other reforms to the overall tax regime in the country. In particular any new tax proposal must take into account impending reforms related to Regional Services Council levies[3].

5. **The administration of the levy.** On the administration of the proposed fuel levy, there are certain 'for' and 'against' factors associated with whether the proposed fuel levy is implemented piecemeal or as a national project. One approach would be for the levy to be enabled by national legislation, with provincial legislation dealing with certain provincial parameters, notably the rate and the method (if any) of granting and administering rebate payments, from the provincial treasury. The main attraction of this approach is that potential political problems associated with the tax are negated and administration costs of the levy are further reduced or lowered. An alternative approach is the one proposed by the Western Cape, where the levy is administered purely as a provincial levy. As an initiative of a particular province, a new tax leaves the other provinces open to experimenting with their own proposals, further enriching knowledge and experience on the efficacy of different proposals. The FFC is of the view that the Western Cape proposal will benefit other provinces wishing to introduce similar taxes. This advantage may be lost if national government should take charge of the process of introducing provincial fuel levies.
6. **The need for continued consultation.** The issues raised with respect to public consultation suggest the need for further consultation, especially with the taxi associations and the public transport sector. Efforts to date in this respect have proved unsuccessful. It is critical that the community accepts the tax.
7. **The potential for resistance to province-specific taxes.** Finally, province-specific taxes may be resisted politically. Indeed, the public consultation process in the Western Cape found that in general the proposal was resented by most of the residents consulted. The FFC views this as one of the key considerations that ought to be carefully taken into account *prior* to the introduction of such a sensitive intervention.

3. The impact on the tax system as a whole of reforms to the RSC levy is likely to affect the tax/GDP ratio (and the overall tax burden on taxpayers) if other taxes are envisaged as replacements for the RSC levy. These reforms are likely to result in short terms pressures on the fiscus if transitional grants are envisaged to compensate municipalities who suffer revenue losses due to the abolition of the RSC levy. Thus government will of necessity need to ensure that revenue is available (at the margins) to meet these pressures.

Annexure B

Financial and Fiscal Commission (FFC) Comments on National Treasury's Proposals for the Replacement of the Regional Services Council (RSC) and Joint Services Board (JSB) Levies (Edited Version)

B1. Introduction

The purpose of this submission is to present the Financial and Fiscal Commission's comments on National Treasury's proposed options for the replacement of the Municipal Regional Services Councils (RSC) and Joint Service Board (JSB) (RSC/JSB) levies. The comment is submitted in terms of the Financial and Fiscal Commission Act, 1997, and Section 229 of the Constitution.

B2. Background

When presenting the budget statement for the 2005 fiscal year, the Minister of Finance indicated that the RSC/JSB levies would be abolished effective from the start of the municipal financial year of 2006. In the interim period, National Treasury began a process of investigating alternative revenue instruments for the replacement of these levies, given that the RSC/JSB levies constitute a significant revenue source for municipalities in general and metropolitan and district municipalities (Categories A and C) in particular.

In 2002 the FFC made wide-ranging proposals with respect to the financing of municipalities and how the RSC/JSB levies could be reformed. These recommendations were reaffirmed in the FFC's Submission for the 2005 division of revenue. Several shortcomings, identified through independent research by the FFC, the DPLG's Fiscal Reform Project and the National Treasury, have necessitated a rethink on the utilisation of these levies as tax instruments. Among the shortcomings identified were the following:

- The system more closely resembled a 'donation' to municipalities rather than a tax. This is because the tax base is self-declared by companies and municipalities may not inspect the books of companies, although they may request information from SARS to verify assessments.
- Research identified significant efficiency, equity and administrative problems with the levies as a tax instrument. In particular, enforcement was a problem. Certain municipalities resorted to using 'bounty hunters' to collect outstanding revenues owed to the councils. Generally, this led to higher administration costs.
- Research also indicated the potential for constitutional challenges relating to the definition of the turnover component of the tax on the grounds that it may be a violation of Section 229 of the Constitution.

These problems were presented by National Treasury as sufficient and necessary reasons for deciding to abolish the RSC/JSB levy instruments, despite these being important sources of tax revenue for municipalities. In place of the RSC/JSB levy instrument, National Treasury proposes the following five alternative instruments:

i. A local business tax which may be complemented by a business licence fee for companies falling outside the local business tax system.

ii. Tax sharing or transfers among or between municipalities with an existing national revenue base. Two national tax instruments are highlighted in this context: transfer duties and the general fuel levy.

iii. The VAT zero rating of property taxes.

iv. A surcharge on user charges for municipal services, including a municipal electricity surcharge.

v. Allocations of grants to compensate municipalities for loss of revenues resulting from the removal of the RSC/JSB levies.

The FFC's response to the proposed alternatives is in two related parts. Firstly, the FFC response to the current proposals by National Treasury is based on their merits and demerits with respect to addressing the need to put in place an alternative to the RSC/JSB levies by the end of the municipal financial year. Secondly, in the interests of putting in place a more sustainable long-term system of municipal tax instruments, the Commission proposes to undertake, in its forthcoming recommendations research cycle, a broader assessment of the local government fiscal system, as well as all other potentially viable revenue sources for local government.

The following sections discuss the proposals from National Treasury.

B3. A Local Business Tax (Coupled with a Business Licence Fee)

The National Treasury's 'Local Business Tax' proposal acts much like a nationally imposed production-based business tax. It is payable by all factors of production. A local business licence fee for companies falling outside the local business tax system complements it. The proposed base of the tax is net 'value added' at a rate of 0.38%.

The primary benefits of using a local business tax are that it would be:

- Relatively buoyant,
- Easy to collect using SARS facilities and infrastructure and,
- A potentially large revenue source.

The first observation is that this proposal is similar to a 'business value tax' levied on productive output. Internationally, it is one of a number of alternatives to conventional forms of local business tax. Its main advantage is that it avoids some of the distortionary effects of conventional forms of business taxation, which may discriminate against particular forms of investment. Furthermore, it is sensitive to the effects of the business cycle.

Municipalities currently do not impose local business taxes and there is no existing mechanism to collect the tax. These issues persuaded the National Treasury to propose that the tax effectively be administered by SARS.

While the FFC does not necessarily doubt the administrative convenience of this arrangement, it is not clear whether this proposal serves the interest of enhancing the fiscal capacity of local government. It is important for municipalities to have some real power and control over their operations and destiny. A related issue is that if tax collection is a national responsibility, why should the tax be introduced in the first place as a local business tax? The choice between central and local collection impacts on whether or not the tax is a purely local tax or just a central tax disguised as a local tax.

The National Treasury proposal does not clarify explicitly whether municipalities will generally have some leeway in the setting of local business tax rates. For example, will municipalities freely set these rates or will central government set them? It is important for any replacement to serve the vested interest of local government, as well as businesses that will be required to pay the local taxes. It is important to ensure that local government is accountable to taxpayers, individuals and companies as well.

The National Treasury proposal implies centralisation and the rationale for the proposal follows international experience which suggests that decentralisation of taxes is not essential to achieving local political accountability. The FFC is of the view that there is a need for deeper discussion of this rationalisation. Furthermore, the Commission has been able to find evidence from countries where the setting of local business tax rates is done freely by municipalities. Examples include Germany, Ireland and Luxembourg. In other countries, municipalities can set the rates subject to thresholds and ceilings that are set by national government. Thus, the international experience is replete with many other viable options that have not been explored in the current proposals and may have provided more information on these proposals.

Finally, it is important to explore in greater detail the extent of the burden of introducing such business taxes. There are potential problems associated, for instance, with the mobility of the corporate tax base and resulting impacts on employment. These issues are not discussed. These problems include issues of tax incidence, i.e. the possibilities for shifting the tax burden. While the legal incidence of the tax falls on businesses, research may show that consumers may ultimately bear the economic incidence (final burden) of the tax.

B4. Tax Sharing

The second proposal made by the National Treasury is for tax-sharing arrangements among municipalities with an existing national revenue, or transfer base. Analysis is done for two national tax instruments, namely transfer duties and the general fuel levy.

Local governments may lack the proper financial incentives to mobilise their own revenues under this proposal. This may well be the most critical and fundamental shortcoming of tax sharing as proposed by the National Treasury. The point is straightforward. Revenues generated by local government taxes and charges are often factored directly into the calculation of any 'fiscal gap'. Setting of sharing rates for national taxes, therefore, offers local governments no net financial benefit for mobilising their own revenues.

In the FFC's view there is at least one way of overcoming this difficulty. Authorities could start off by examining all national taxes that are currently performing well and that have long-term potential. They then use such taxes as the basis for designing a revenue-sharing arrangement. Such a system should be designed in such a way that it (i) rewards local governments that utilise the tax revenues to enhance efficiency and delivery of mandated services while penalising underperforming municipalities, and (ii) ensures that tax revenues are allocated to localities with the most pressing needs. This, in principle, should address the incentive bias problem.

However, the two tax bases suggested in the proposal are theoretically suitable for tax sharing, provided central government makes room for the taxes, that is, the arrangement should not impose an additional tax burden on tax payers. A problem that the FFC notes is the absence of a clear and detailed rationale for selecting these particular bases from many others. It is left unclear as to why the tax-sharing alternatives are limited to only these two options.

The FFC is also of the view that, while the technicalities of revenue sharing from the proposed tax bases are straightforward, the tax-sharing measures are likely to encourage fiscal gaming, lobbying and drawn-out bargaining negotiations. The base and rates for these shared taxes are in all cases determined by the central government. Municipalities have very few formal channels or opportunities for increasing official budget revenues under this proposal. The main channel, if current arrangements persist, would be to send representatives of local governments to lobby long and hard for a more generous allocation as part of the annual budget cycle.

B5. The VAT Zero Rating of Municipal Property Taxes

The National Treasury proposes the zero rating of property rates. According to the National Treasury, the zero rating of property taxes minimises administrative costs (by simplifying the compliance and auditing of VAT at a municipal level) and enhances revenue collected by allowing municipalities to deduct input tax that would otherwise remain part of the property rates pool. The National Treasury anticipates that this measure will avail almost R1 billion in additional revenue to municipalities.

The FFC notes the advantages listed by National Treasury and further notes that if the national fiscus is willing to sacrifice some tax revenue to accommodate this measure, this proposal will help to streamline municipal property taxes within the VAT system.

B6. Surcharge on User Fees for Municipal Services

A surcharge on all municipal user fees is proposed by National Treasury as a partial replacement of RSC levies and also as a tool that makes more explicit the hidden tax already included in the municipal pricing schedule. A surcharge arguably needs less administration, than the user fee to which it is applied. However, a balance will have to be struck with regards to how much more consumers pay for utilities, against rising complaints about service delivery. It is a fact that any surcharges will have to be borne by consumers and there are implications on the distribution of the tax burden or incidence, depending on the possibilities for shifting that burden. Imposing another surcharge may especially exacerbate the suffering of those with low incomes.

B7. Grants

The National Treasury proposes to use grants to fund Category C municipalities and District Councils from the national fiscus and/or to enter into funding arrangements with category B municipalities. The FFC supports these *transitional* arrangements for the replacement of the RSC/JSB levies since they are temporary and are meant to ensure that municipalities are not negatively affected by the abolition of the RSC/JSB levies.

As already noted, the FFC has in the past made proposals with respect to the reform of RSC/JSB levies that also inform this submission. Firstly, the principles that guided the FFC's recommendations, were that the revenue currently accruing to municipalities through levies should be retained in local government, regardless of the choice of instrument to replace the levies. Secondly, it was proposed that the revenue instrument chosen be subject to local control, such that municipalities are allowed to vary the rate and thereby ensure accountability to the taxpayers for the rates and the subsequent use of the revenue generated. Thirdly, that alternatives or reforms should follow a decentralised approach. Finally, the FFC indicated that it would assess any proposals by government against these principles.

B8. Recommendations

1. **Grant as RSC/JSB transitional levy replacement.** The FFC supports the proposal to use a grant as a replacement for the RSC/JSB levy. As a transitional measure this proposal addresses the FFC's original recommendation, namely, municipalities that were benefiting from the RSC levy should not be prejudiced as a result of the RSC/JSB levy system being reformed or abolished. The Commission further notes that this principle has been adopted and the instruments in the Division of Revenue for 2006 are indeed the grant and the impending VAT zero rating of property rates. The Commission also emphasises that the long-term objective should be to clearly define what purpose a new revenue source for local government is expected to serve and accordingly proceed with the investigation of the most appropriate revenue sources for achieving the chosen objectives.
2. **Long-term revenue instrument replacement proposals.** The FFC proposes that any long-term replacement revenue instrument for RSC levies should take the following into account.
   - Proposals should be viewed as part of the broader exercise of assigning revenue sources to local government. Hence the proposals to replace RSC/JSB levies should be understood in a broader context, where replacement options are not just limited to already constitutionally assigned revenue sources but are also opened up to other completely new sources.
   - It is clear that the levies were no longer serving the original objective for which they were designed, given the fact that for some districts they constituted the only own revenue source (outside of the equitable share). Is the purpose, therefore geared towards addressing inequality or simply administrative problems? It is important to define the objectives that the replacement is supposed to meet.
   - The need for wider discussion about the overall objectives of local government revenue and expenditure assignments and how these are expected to be aligned with the new proposals. Such an approach will ensure that the choice between decentralising or centralising revenue sources is an informed one, guided by the clear assignment of expenditure responsibility and the degree to which South Africa wishes to entrench the fiscal autonomy of sub-national governments. In effect, this means that the replacement of RSC/JSB levies should be viewed as an opportunity for aligning the local government fiscal framework with the assignment of powers and functions.

Annexure C

Review of the Development Component of the Local Government Equitable Share (Edited Version)

C1. Introduction

As part of the review of the local government equitable share (LES) formula for the allocation of funds to municipalities the Commission was requested by National Treasury (NT) to comment specifically on the inclusion of an explicit development component in the LES formula. Section 214 (2) of the Constitution states that in determining the equitable sharing of nationally-raised revenues, Government should take into account a list of ten factors (a – j) listed in that section. Of primary concern to the Financial and Fiscal Commission (FFC) has been sub-section (d), which states that local governments must be ‘able to provide basic services and perform the functions allocated to them.’ The current Local Government Equitable Share (LES) formula contains a basic services and an institutional component. Although serious questions can be raised about whether the basic services component accurately measures the costs of providing constitutionally mandated basic services, it can nevertheless be argued that these two components of the formula are intended to account for the sub-section 214(2) (d) as a Constitutional mandate.

With the addition of a revenue-raising component to the LES formula, it can be argued that with the exception of sub-section (f), the current LES formula does ‘take into account’ all the factors articulated under section 214(2) of the Constitution. Sub-section (f), however, requires that account be taken of the 'developmental and other needs' of local government.

The 2005-06 LES allocation formula includes for the first time an explicit development component. Given the uncertainly about how the component should be defined, it has been set at a value of zero for the 2005 Medium Term Expenditure Framework (MTEF). The FFC has been asked by National Treasury to make recommendations concerning the appropriate way in which this component may be operationalised to take account of the development and other needs of local government.

The comment is divided into two sections. Section C2 provides a detailed preliminary discussion on defining development, while section C3 outlines the recommendations of the Commission.

C2. Defining the Development Component

There are two major questions: first, what are the 'developmental needs' of local government, and second, how can these needs be most effectively captured in the LES formula? Providing an answer to the first question is difficult and inevitably controversial because the term 'developmental needs' is so general that it is hard to get broad agreement as to its meaning. This report suggests several broad principles that may help narrow the focus of any discussion about the meaning of 'developmental needs'.

The FFC is of the view that the discussion should focus on the needs and responsibilities of *local government*. This means that 'developmental needs' should *not* be defined to include things that are the primary responsibility of individuals, or of provincial or national government. One frequently discussed element of development is poverty alleviation. To the extent that poverty alleviation involves the provision of cash or in-kind transfers to poor families and individuals, this should clearly be seen as a national, rather than local government function. Another example is primary and secondary education. There is widespread agreement, at least among economists, that the provision of high-quality education is a very important key to economic growth and development. As the provision of such education is the responsibility of provincial governments, this aspect of development should also be excluded from any discussion of the developmental needs of local government.

Although the term 'development' is very broad, for the purpose of defining the development component of the LES, the FFC is of the view that the focus should be primarily on the *economic* development of local communities. Within the South African context, economic development can be defined to imply the creation of fixed investment (by both the public and private sectors) in local economies. Such fixed investment should be directed towards generating and/or stimulating local economic growth and the concomitant multiplier effects that, in turn, create employment opportunities and generate income and wealth within a community.

The question of the appropriate role for local government in the creation of jobs and economic activity is both controversial and subject to great debate throughout the world. For example, in many countries, it is easy to identify many local government economic development projects that have been expensive failures. That being said, there may be relatively broad support among development 'experts' that an important pre-condition for economic development within a local community is the provision of a set of public services that are essential for human development for its own sake and for attracting private sector direct investment in a community.

The list of local government services that are a pre-condition for sustained economic development obviously depends on the socio-economic profile and comparative advantage of the community, as well as the type of private sector investment that may be potentially attracted to the community. Any list of public services however, must start with the constitutionally mandated basic services such as the provision of housing, potable water, electricity, public transport, sanitation and refuse removal. Additional public services needed to attract private investment would probably include roads that are passable in all weather conditions, locally accessible child and health care facilities, recreational and tourism facilities, availability of business information and data, efficient and effective municipal administration, street lighting, security, telecommunications, emergency services and storm water control. Almost all of these services are currently accommodated either within the LES or through specific purpose grant transfers from national or provincial government.

Before defining a development component for the LES, it is important to keep in mind that adding a development component does nothing to increase the aggregate local government allocation. Thus, the simple algebra of the LES allocation formula implies that any equitable share allocations devoted to development, will of necessity, subtract from the resources available to local governments to finance basic services. Governance and administrative functions of local governments are currently funded through the institutional component of the LES formula. While the LES formula is developed according to the components listed above, the allocations are used at the discretion of the municipalities.

It would add little or no value to define and operationalise a development component of the LES unless such a component results in a different distribution of the LES than prior to its inclusion. This implies, at least in relative terms, some reconfiguration of the LES allocation that will see some local governments gaining more LES funds, while other local governments lose funds. From a national perspective, this reallocation of funds may be viewed as inequitable unless it results in the creation of new economic activity in communities receiving more LES resources, without impacting negatively on economic growth in communities that lose LES funds.

No matter what definition of development is used, the argument above raises more questions than answers. Who will assess the economic development potential of a particular municipality? Is it not conceivable that almost every municipality in South Africa can make a case for economic development in its community? Once the LES is allocated, who will ensure that the development goals are monitored and met, since no conditions are attached to the LES? There is no objective way to identify and categorise communities without infringing on their democratic rights. How can criteria be determined to objectively categorise communities?

The inclusion of a development component in the formula will not add any real financial value and, in fact, will only serve to complicate the formula further. This would suggest that the most effective way of spurring economic development would be to develop an economic infrastructure grant programme designed explicitly to finance infrastructure investment in communities wishing to attract direct investment. Although this type of grant programme would be explicitly designed to address the developmental needs of local governments, as a spatially targeted grant to finance infrastructure investments, it would be preferable to allocate funding for this grant programme outside the LES. Perhaps including such policy objectives should be considered when redesigning the existing consolidated municipal development and infrastructure grants.

The Commission is of the view that the starting point for addressing this issue should be the principles that the FFC has recommended in the past, namely that development needs should be defined in terms of responsibilities that lie with local governments. The focus should be on economic growth and job creation. Furthermore the design of a funding policy instrument must be defined so that it measures as accurately as possible a characteristic or pre-condition for economic development. This pre-condition must not be confused with the already existing components of the LES formula, nor with the existing design of the Municipal Infrastructure Grant (MIG) and other specific purpose conditional grants.

The above argument implies that the best way for the LES allocations to contribute to the developmental needs of local governments would be to ensure that the LES formula as a whole results in an allocation of nationally-raised revenues that enables all local governments in South Africa to have at their disposal sufficient resources to provide their communities with a set of basic public services. The LES allocations need to be sufficient to allow local governments to provide these public services without having to impose an undue burden (in terms of local taxes or tariffs) on their residents and potential investors. To fully achieve this goal requires that the equitable share formula accurately accounts for both the expenditure needs and the revenue-raising capacity of local governments.

The FFC has yet to complete a full analysis of the basic services component of the new LES formula. From the way the basic services component has been defined, it is clear that, at best, it only provides a partial reflection of the expenditure needs of local governments in South Africa. Firstly, the basic service component only accounts for four basic services, namely water, sanitation, refuse removal and electricity. Secondly, the basic services component is designed to support these four public services only for households with a monthly income of less than R800 per month. This definition of the basic services component implies that all households with monthly incomes of R800 or above can afford to pay in full for their consumption of these four public services, either through tariffs, rates or other taxes. It is implicitly assumed that the required payment for these four public services does not impose an unreasonable fiscal burden on these households or on the local government. Thirdly, there are some indications that the real per household out-of-pocket costs for the four basic services exceeds the R130 per month that is the basis for the calculation of the basic services component in the 2005/06 LES formula.

It can be argued that the developmental needs of local governments may be accounted for in the LES formula by designing a formula that more fully accounts for the expenditure needs of local

Back to contents

government. This is particularly important now that the LES formula includes a revenue-raising capacity component.

The basic argument is that to spur economic development, local governments must not only provide residents and investors with the four designated 'basic services', but they must also provide for a wider array of public services such as all-weather roads, street lights and environmental health care, amongst others. Once the process of 'costing out' a full array of local government public services has been completed, it should be possible to ensure that the basic services and the development component of the LES formula together account for the full expenditure needs of local government. In addition municipalities will also have access to a consolidated Municipal Infrastructure Grant (MIG) or other grants.

C3. Observations

Based on the discussion outlined in section C3 above, the Commission notes the following:

- At present, the current LES formula does not expand the envelope of funds available for the (horizontal) local government equitable share.
- Government has previously shown reluctance in making funding available for nodal areas and free basic services outside of its own vertically determined amount.[1]
- These two points have largely influenced previous FFC recommendations against the incorporation and proliferation of ad hoc funding windows such as free basic services and nodal allocations into the LES formula, as these developments were having no impact on the vertically determined pool for local government.
- In making considerations about inclusion of a development component and its impact on LES allocations, it is important to take into account the revenue-raising capacity of municipalities and balance such considerations against the criteria specified in section 214 (2) a-j of the Constitution.

C4. Recommendations

1. **Development component allocation.** Acknowledging that the development component will not result in an overall increase in the LES, it will be impractical to incorporate it into the LES formula as the result will be a mere realignment of relative shares within the same envelope. Such an outcome could result in decreased allocations being made to local governments that raise relatively higher revenues. The Commission thus recommends that a development component should not be added to the current LES formula.
2. **Requirements for meeting developmental needs.** The developmental needs of local governments should be better accounted for in the LES formula by designing a formula that more fully accounts for the full expenditure needs of local government. This will require:
   - Recognition that in order for municipalities to fully engage in stimulating local economic

1. This point is especially important when it is noted that the basket of basic services and previously funded nodal areas are not determined by the local government sphere but by national government, together with policy objectives emanating from presidential proclamations.

development, they need to provide not only the four basic services, but additional services covering a wider array of public services such as all-weather roads, street lights, environmental health care, public transport and housing.

- A process that 'costs out' a full array of local services to ensure that the basic services and the development needs of municipalities are taken into account in the LES formula and together cover the full expenditure needs of local government.