PROVINCIAL AND LOCAL GOVERNMENT EQUITABLE SHARE FORMULAE

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Public Sector Economist Forum

6th Annual Congress, Western Cape Province

For an Equitable Sharing of National Revenue

Presentation Outline

- About the Financial and Fiscal Commission (FFC)
- Legislative and economic principles underpinning Local Government Equitable Share LES and Provincial Equitable Share (PES)
- Vertical and horizontal division of revenue processes and mechanics
- PES: structure, reforms and challenges
- LES formula: results of recent review

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CONSTITUTIONAL AND LEGISLATIVE MANDATE

- Financial and Fiscal Commission (FFC)
  - Permanent statutory body established in terms of Section 220 of Constitution
  - Independent and subject only to Constitution and the law
  - Must function in terms of an act of Parliament
- Mandate of FFC
  - Makes recommendations, envisaged in Chapter 13 of the Constitution or in national legislation to Parliament, Provincial Legislatures, and any other organs of state determined by national legislation

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General Principles

- FFC is concerned with IGFR
  - Legislative provisions or executive decisions that affect either provincial or local government from a financial and/or fiscal perspective
  - Includes regulations associated with legislation that may amend or extend such legislation
  - Commission must be consulted in terms of the FFC Act
- Important stakeholders for consultation in IGFR
  - Ministry of Finance, The Presidency, Organised Local Government, Ministry of Cooperative Governance and Traditional Affairs, Parliament, Provinces, National Planning Commission

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LEGISLATIVE AND ECONOMIC PRINCIPLES UNDERPINNING PES & LES TRANSFERS

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BACKGROUND PES & LES TRANSFERS

- PES and LES are transfer mechanism to <u>distribute funds horizontally</u>
- Enable provinces & LG to provide basic services
- Each Provincial Legislature or Municipal Council decides where to allocate resources
- PES and LES formulae both introduced in 1998
  - PES and LES Transfers were determined by functions committee prior to 1998
- Both formulae are component & population based
  - Been subjected to numerous review since inception

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CONSTITUTIONAL IMPERATIVE

- S 217 of the Constitution entitles provinces and municipalities to a share of nationally raised revenue
  - Address imbalance in narrow tax base & spending responsibilities
- The Constitution does not prescribe methodology for determining subnational transfers
  - Only list factors to be considered S 214 (2) (a-j)

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Constitutional principles underlying LES and PES

- National interest
- National Debt
- Subnational government obligations
- Developmental needs
- Fiscal Capacity
- Economic disparities

- These factors are considered in the vertical and horizontal division of revenue process

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Public Finance Principles for Transfer Design

- Clear objectives
- Equity (vertical and horizontal fiscal balance)
- Autonomy
- Adequacy
- Predictability
- Simplicity
- Flexibility & Responsive

It is difficult for the formula to satisfy each principle

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Economic Rationale for PES & LES Transfers

- Enable provinces and municipalities to deliver basic services
- Correct for disparities in regional fiscal capacity
  - Minimise horizontal fiscal gap
- Fiscal harmonisation
  - Citizens receive same fiscal benefit irrespective of location
- Address intergovernmental spillovers

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VERTICAL AND HORIZONTAL DIVISION OF REVENUE – PROCESS AND MECHANICS

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Division of Revenue – Vertical Process

- This is a consultative political process
- Informed by changing political priorities
- Gradual decline in national share since 2005

	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
National	53%	51%	50%	50%	50%	48%	47%	47%
Provinces	42%	43%	42%	42%	42%	44%	45%	44%
PES	37%	36%	35%	35%	34%	36%	36%	36%
CG	5%	7%	7%	8%	8%	8%	9%	9%
Local	5%	6%	8%	8%	7%	8%	8%	9%
LES	3%	4%	4%	4%	3%	4%	4%	4%
CG	2%	2%	3%	3%	3%	3%	3%	3%

Horizontal Revenue Sharing

- Numerous methods of allocating transfers are available
  - Ad hoc based
  - Origin of collection
  - Cost reimbursement
  - Performance based
  - Formula based

Used in SA between 1994 and 1998

Preferred method in SA used in both general and specific purpose grant

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Horizontal Revenue Sharing – Origins of Transfer Formulae

- The FFC recommended a formula based approach to horizontal division of revenue in its 1996 submission
  - Formula is less susceptible to manipulation
  - Transparent
  - Objective
  - In line with international best practices

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PROVINCIAL EQUITABLE SHARE: STRUCTURE, REFORMS AND CHALLENGES

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Provincial equitable share – History and Practice

- The provincial equitable share formula was introduced in 1998
- At inception the formula comprised of seven components
- Each component is assigned a weights and use certain (population) variables as need indicator
  - Initial weights were determined by expenditure patterns rather expenditure needs
- PES is an important source of provincial revenue
  - Makes 95% of total revenue on average

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STRUCTURE OF THE PES – THEN AND NOW

1998		2014	
Component	**Weight**	**Component**	**Weight**
Education	40%	E = Education	48%
Health	18%	H = Health	27%
Basic	9%	B = Basic	16%
Institutional	5%	I = Institutional	5%
Backlogs	3%	P= Poverty	3%
Economic activity	8%	E = Economic activity	1%
Social security	17%		

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Current structure of PES and Need Indicators

- $P_a = \sum E_i^{48} + H_i^{27} + B_i^{16} + P_i^{3} + E_i^{1} + I_i^{5}$

Component	Need indicators	Data
Education	School age population School enrolment	Census, 2011 Dept of education, School realities
Health	Risk adjusted index Primary health care visits Hospital workload	Risk Equalisation Fund District Health Information System
Basic	Share of population	Census, 2011 GHS
Economic activity	Contribution to GDP	Census,
Poverty	Share of poor population	Income & Expenditure survey 2011
Institutional	None - shared equally	

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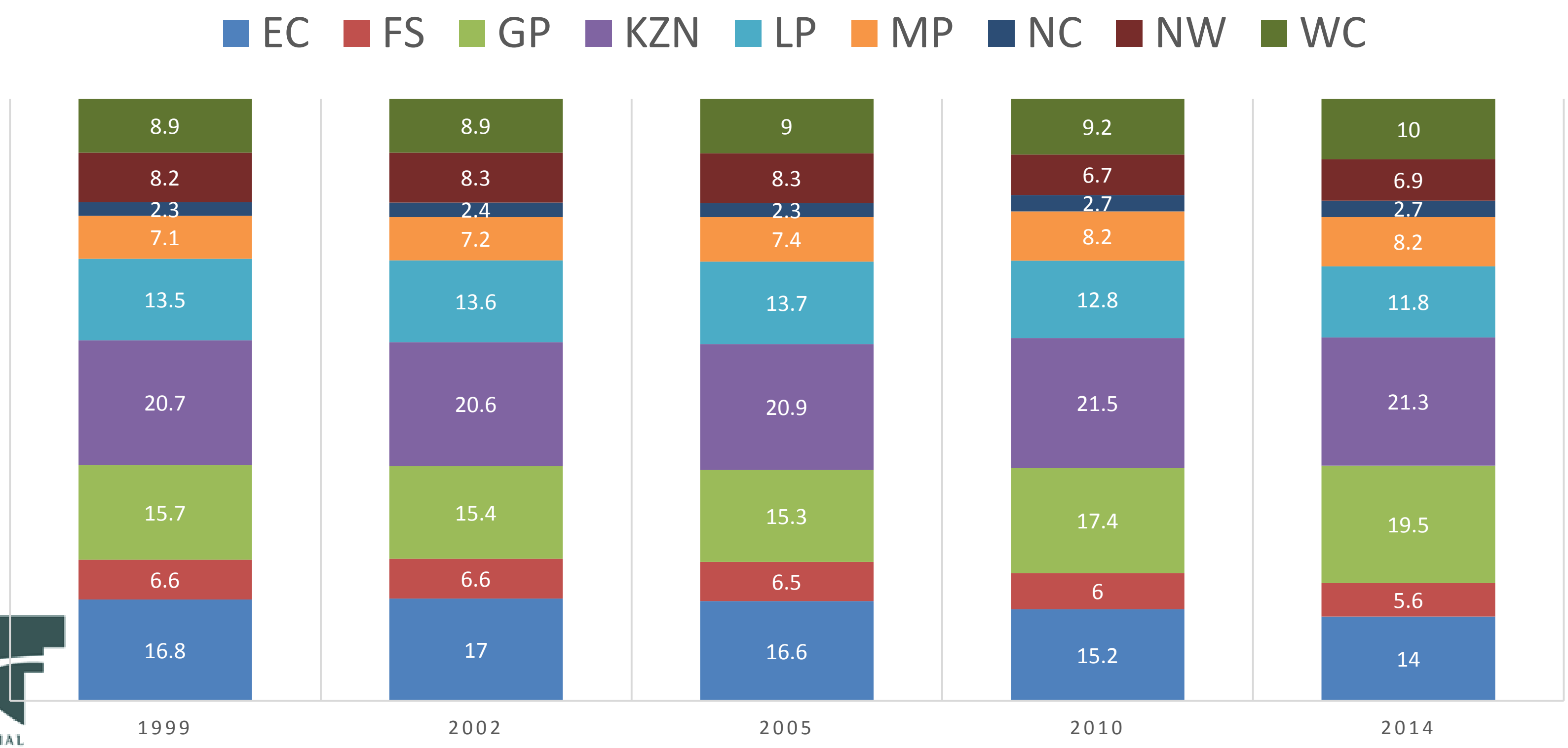
PROVINCIAL DISTRIBUTION OF PES – 2014/15

- Three provinces accounts for 50% of PES
- Allocations correlate with population



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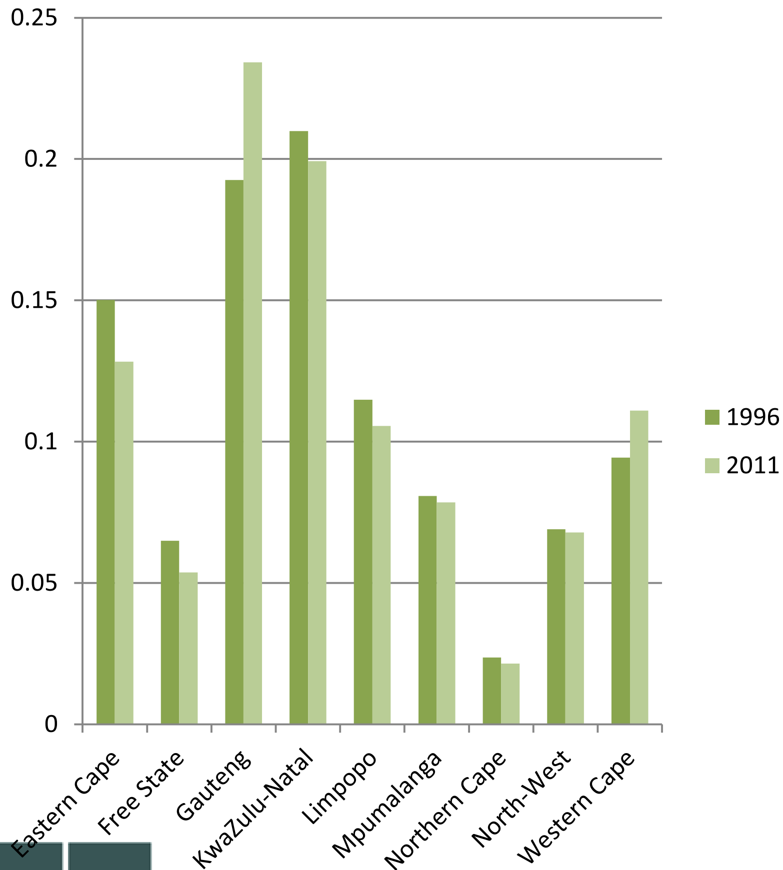
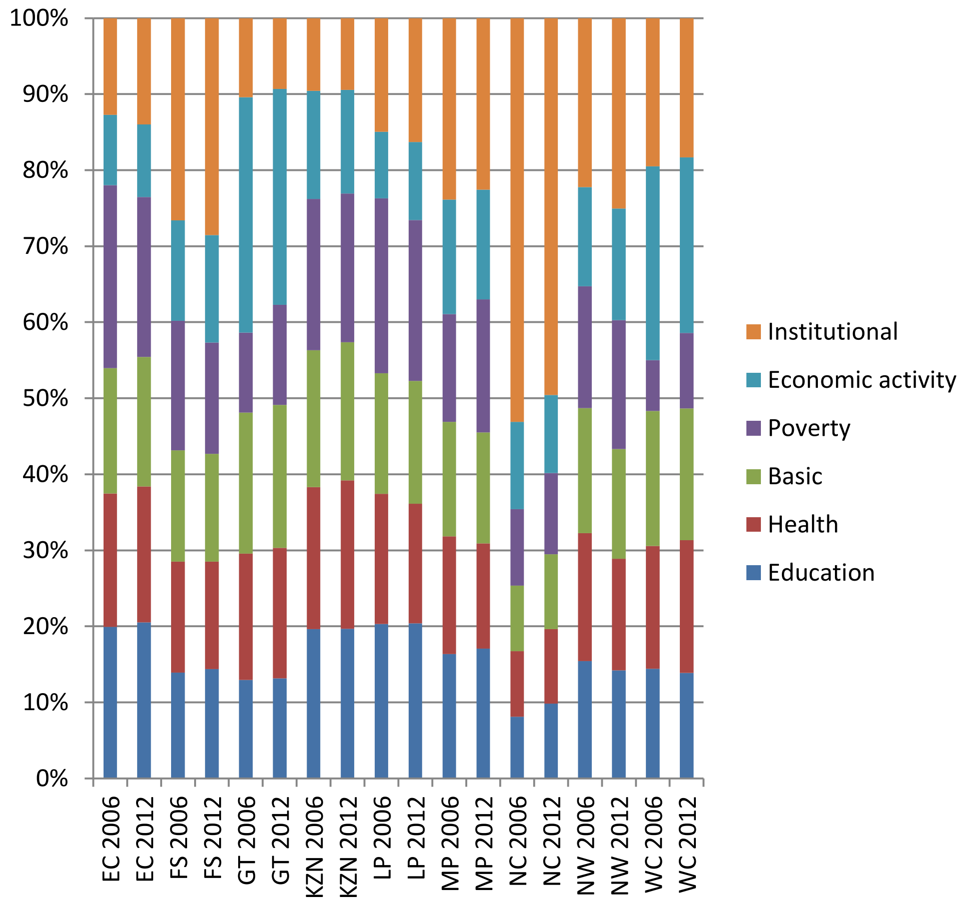
Impact of Changes in Population Distribution





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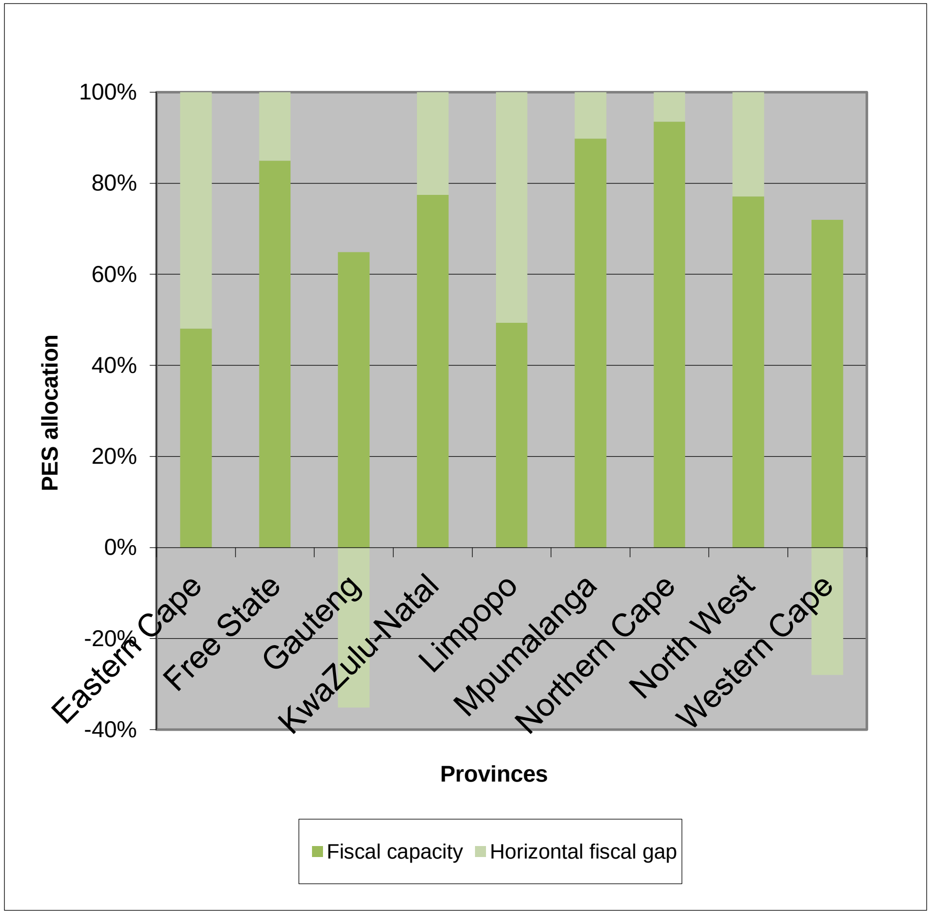
How Equitable is the PES?

- The PES is horizontally redistributive
- Only two provinces are able to meet their current PES funding levels – apply a standard tax rate on GDP-R
- EC and LP require~~s~~ the largest equalisation



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MAJOR PES REVIEWS SINCE 1998

- Formula has undergone several reviews since 1998
  - Removal of the backlogs component in 2001 followed by introduction of infrastructure CG
  - Removal of social security component in 2004 and introduction of poverty component
  - Demarcation induced population updates in 2006
    - North West province adversely affected
  - Review of health component indicators in 2011
  - Updating population data with census results

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FFC-PES Reform Proposals

- Costed norms approach in 2000
  - Derives provincial allocations based on minimum input costs and norms
  - Proposal was rejected on grounds of data shortages
- In 2009 proposed:
  - Deriving expenditure needs in all provincial expenditure needs
  - the Education and Health component of the PES be converted into a block grant
  - Introduction of an equalisation grant

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Ongoing PES Challenges

- Inappropriate Component and rigid weightings
  - Absence of social development component
- Appropriateness of variables to derive provincial shares
  - Population biased
  - Need indicators
- Perpetuates historical imbalance
- Undermine provincial expenditure discretion
  - Misalignment between policies and budgets
- Absence of funding and expenditure NORMS & STANDARDS
  - Variation in levels of services and funding
  - N&S not enforced
- Overloading the transfer system with too many objectives

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LOCAL GOVERNMENT EQUITABLE SHARE FORMULA: RECENT REVIEW

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Background

- The LES underwent review in 2012
- Review sought to:
  - Find a better way of redistributing resources
  - Find objective measurement of revenue capacity
  - Make provision for additional services
  - Adjust costs and demographic data
- The review did not examine the size of Local Government Vertical share

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The Formula Review Process

Stage 1:
Principles and objectives agreed

- Agreed by LGES Steering Committee
- Discussion papers circulated for comments
- Workshops held with municipalities

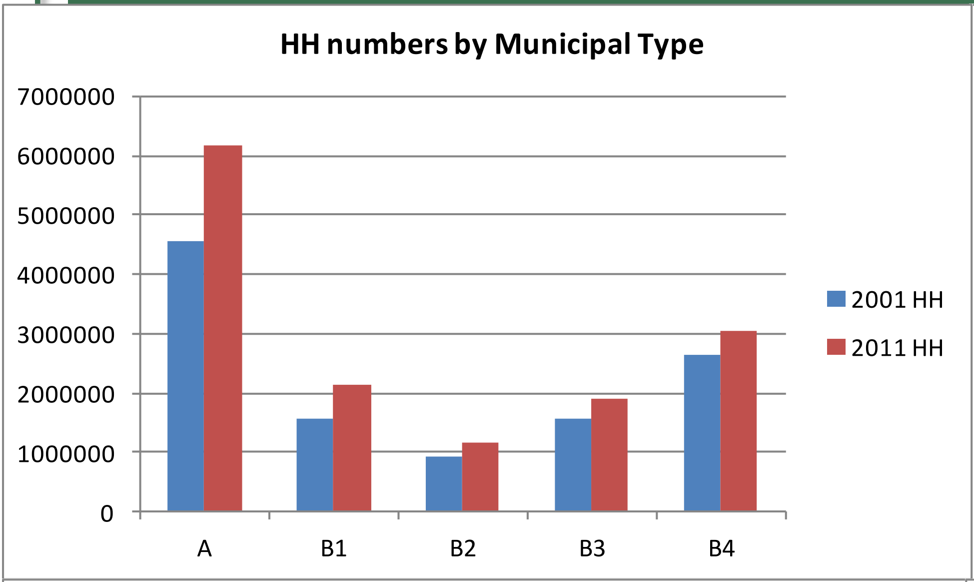
Stage 2:
New formula structure agreed

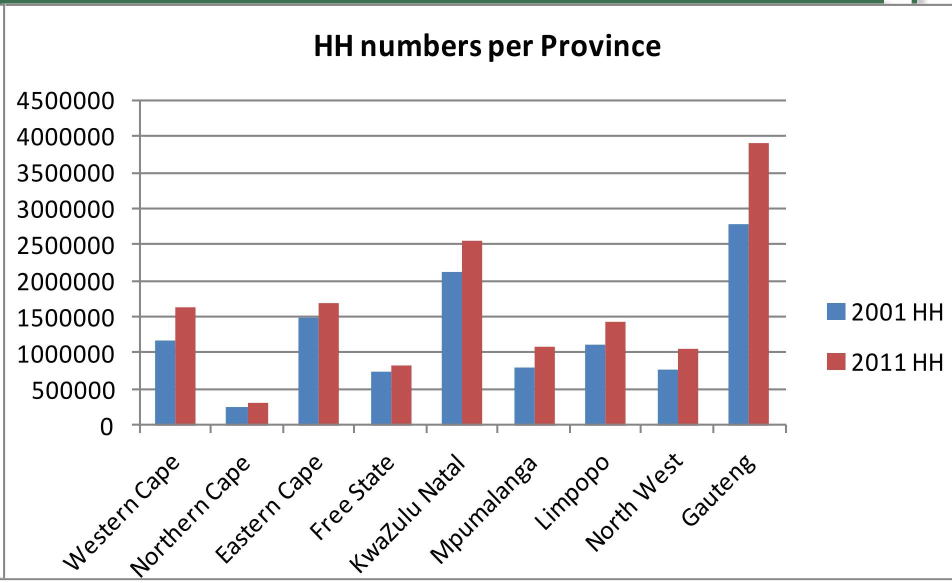
- Agreed by LGES Steering Committee
- Discussion paper circulated for comments
- Workshop held with municipalities
- Endorsed By Budget Forum

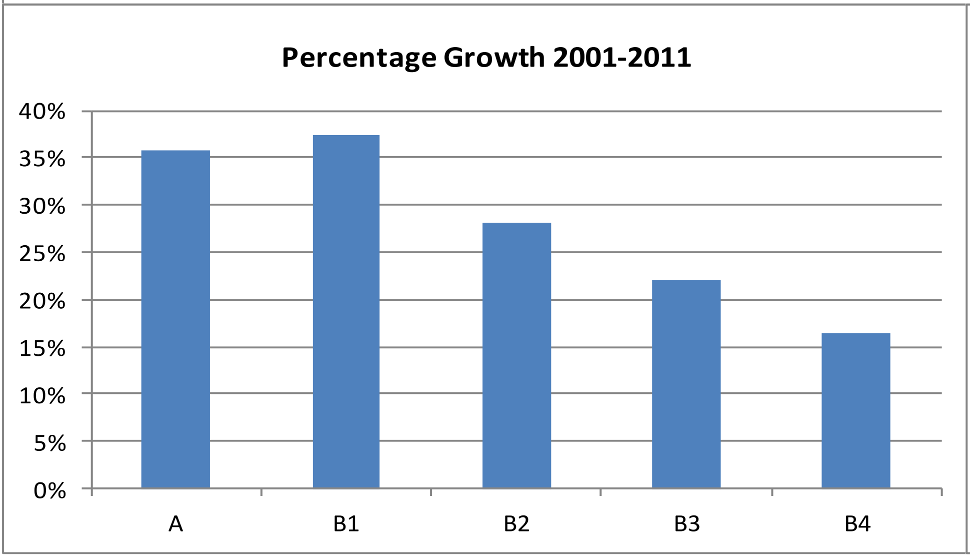
Stage 3:
New allocations determined

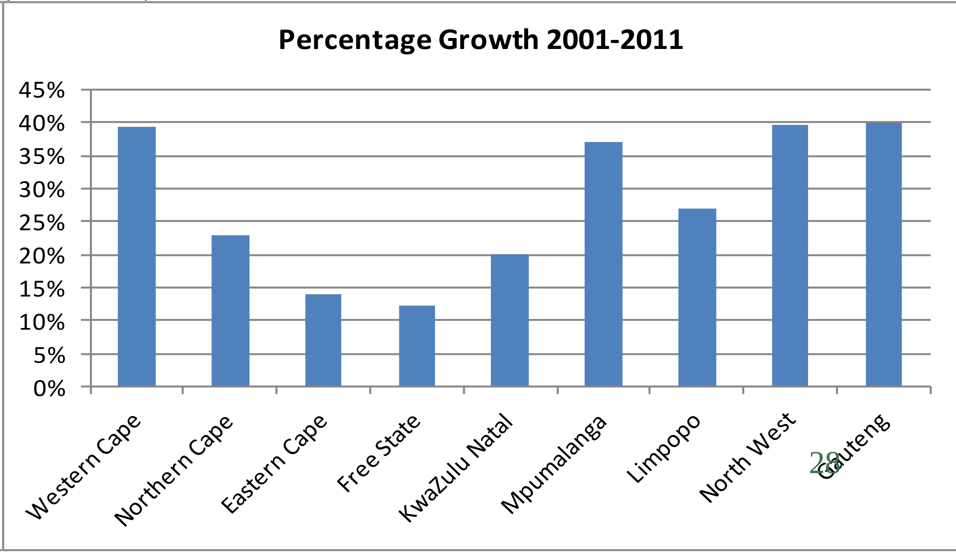
- Approved by LGES Steering Committee
- Approved by:
  - Minister of Finance
  - Budget Forum (7 February 2013)
  - Cabinet (13 February 2013)

Context of the new formula: large growth in households between 2001 and 2011



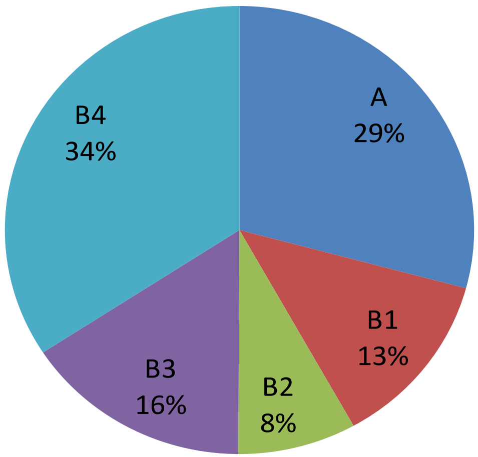


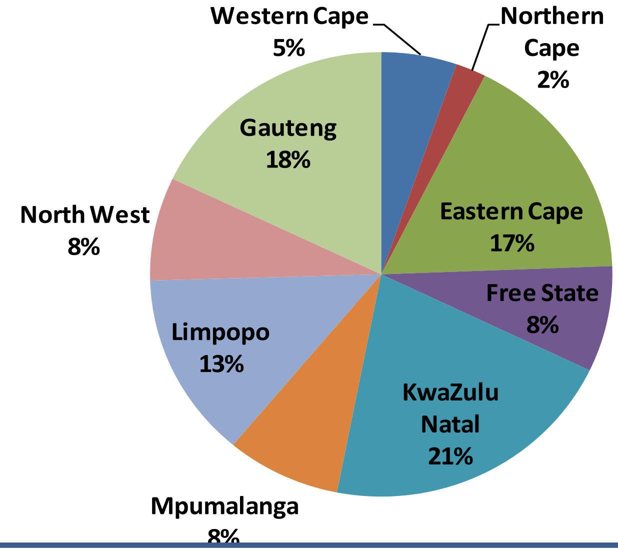




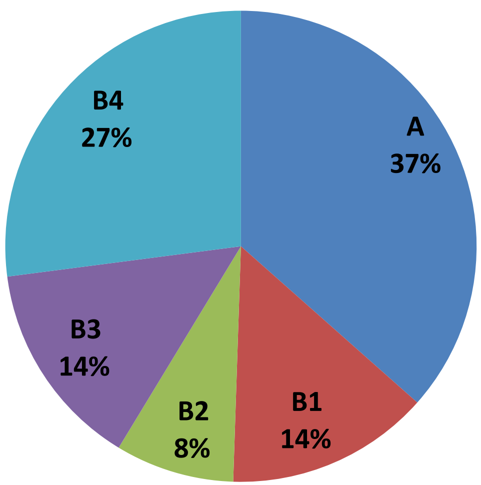
CONTEXT OF THE NEW FORMULA : A CHANGED DISTRIBUTION OF POVERTY

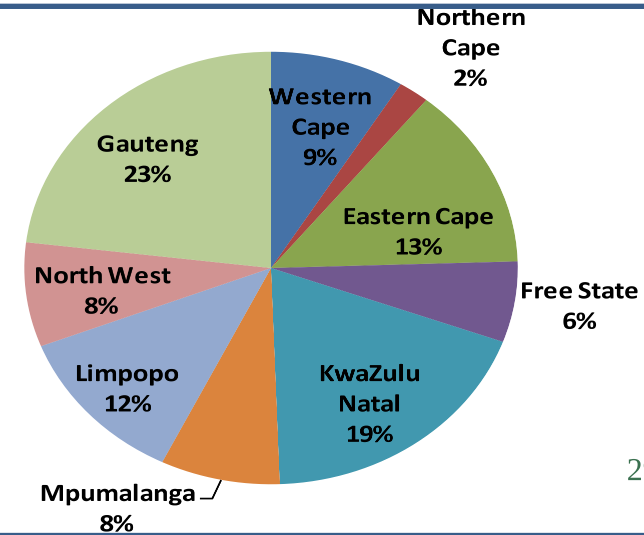
2001 Data: R800 affordability threshold used in formula





2011 Data: R2300 affordabilit y threshold used in formula





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COMPARISON OF THE OLD & NEW FORMULA

Old	New
Grant = BS + D + I – R ± C *Where:* ***BS** is the Basic Services* ***D** is the Development component* ***I** is the institutional component* ***R** is the Revenue Raising capacity correction* ***C** is the correction and stabilisation factor*	***LGES = BS + (I + CS)**x **RA ± C*** *Where:* **LGES** is the local government equitable share **BS** is the basic services component **I** is the institutional component **CS** is the community services component **RA** is the revenue adjustment factor **C** is the correction and stabilisation factor

- Both have basic services, institutional and correction components
- The development component is removed and a new community services (CS) included
- Old formula subtracts a revenue-raising capacity correction from the whole formula. Proposed new formula applies a revenue adjustment factor to the I and CS components only

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Simplified summary of the proposed LGES formula structure

Formula

1 **Basic Services** + 2 **Institutional and Community Services** ± 3 **Correct-ion & Stability**

How it works

1 – Basic Services: **Allocation for every poor household in the country to enable municipalities to fund the cost of free basic services** (including maintenance costs)

2 – Institutional and Community Services: Made up of three parts:

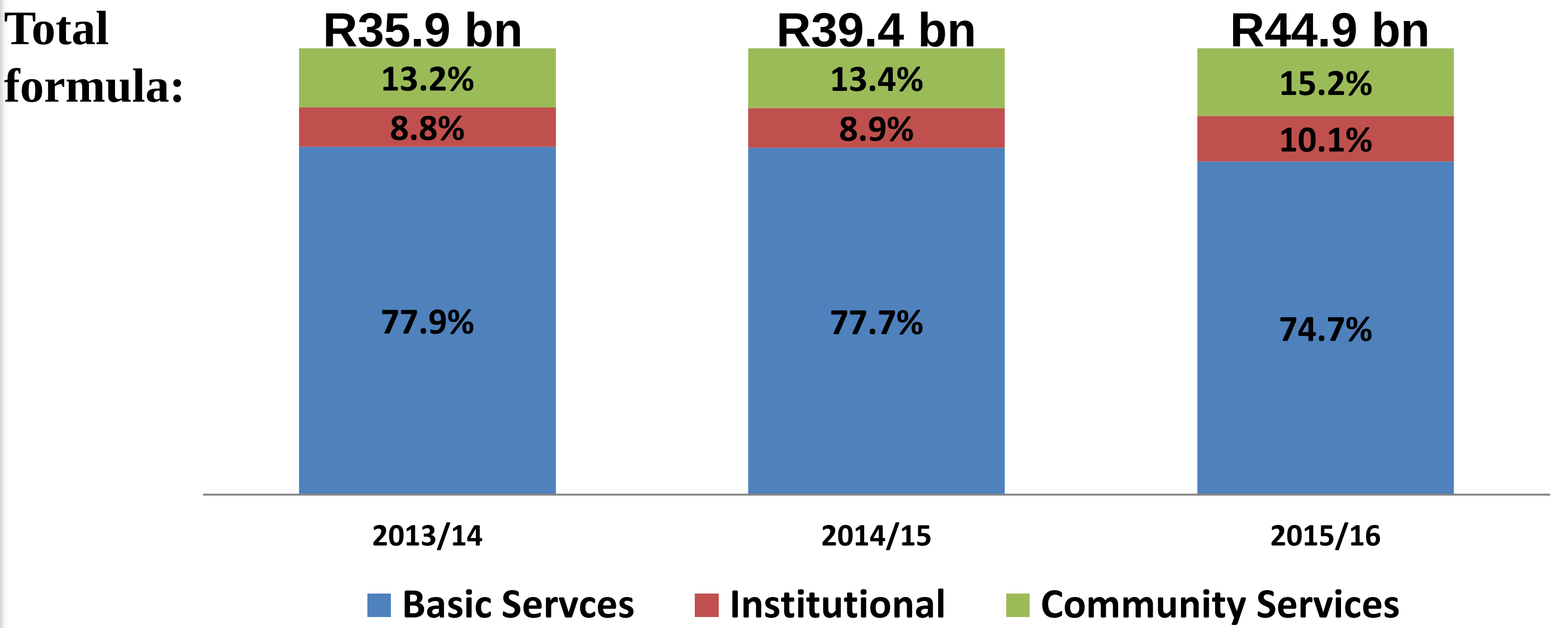
- **Institutional funding** + **Funding for Community Services**
- **Revenue Adjustment factor**: Ensures more funds go to the municipalities with less own revenue capacity (Factor of between 0% and 100% applied)

3 – Correction & Stability: Ensures guarantees are met and smoothes changes in allocations

LGES Allocation

LES Components in Detail

SIZES OF THE DIFFERENT COMPONENTS



- Shares of the institutional and community services components grow as more funds are added to the formula over the MTEF
- R5.4 billion is added to the LGES formula over the 2013 MTEF

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Basic Services component (1 of 2)

Subsidy of R275.17 per month for a package of free basic services

 Water: R86.45

 Sanitation: R72.04

 Energy: R56.29

 Refuse removal: R60.39

Includes 10% for maintenance

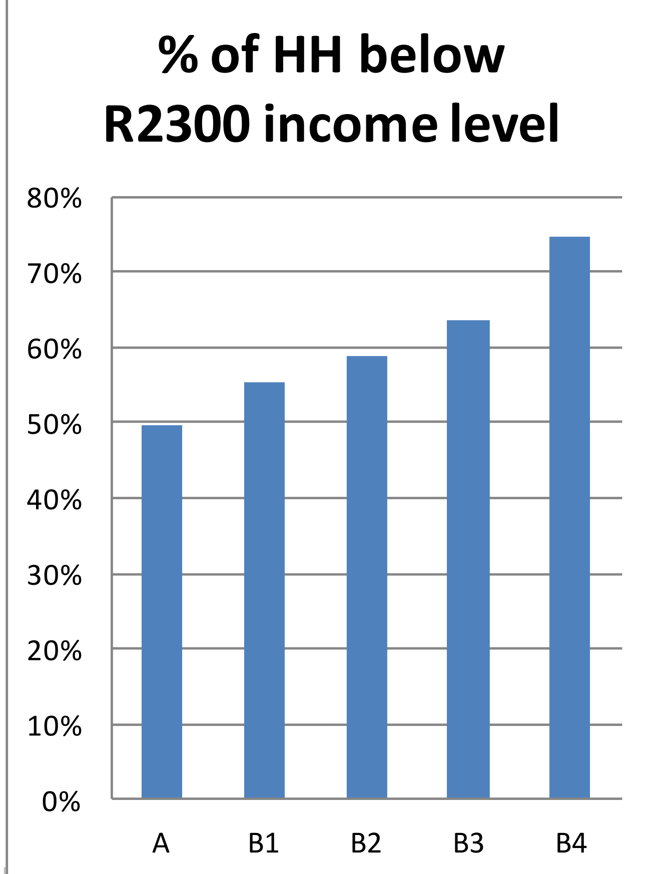
Provided for every household below the affordability threshold

Amounts are updated annually to reflect rising costs

BASIC SERVICES COMPONENT (2 OF 2)

- The **affordability threshold** used in the formula is R2300 household income per month in 2011
  - Based on value of 2 state Old Age Pensions as favoured by municipalities during the consultation process
- **59%** of all households in SA fall below this threshold
- Must not be seen to be an "official poverty line"

Number of households will be updated annually using average growth between 2001 and 2011 per municipality (adjusted to balance with estimated national population growth)



Lowest proportion =44%
Highest proportion = 81%

Institutional Component

- Provides funds for administration costs necessary to run a municipality
- Allocated as follows:

Base allocation of R5 million for every municipality

Additional funds based on council size (recognises that bigger municipalities face more admin costs)

Revenue adjustment factor is applied

Average Institutional component allocation for selected types of municipalities (2013/14)	
Large towns	R6.8 million
Small towns	R6.3 million
Rural municipalities	R23.1 million

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Community Services Component

- New component that funds services outside the basic services
- Allocations for Municipal Health and Fire Services go to District Municipalities
- Allocations for all other services go to Local Municipalities
  - allocated based on number of households in the municipality

Average Community Services component allocation for selected types of municipalities (2013/14)	
Large towns	R13.4 million
Small towns	R7.8 million
Rural municipalities	R38.5 million

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Revenue Adjustment Factor (1 of 3)

- Some municipalities are able to fund the costs of their administration and the provision of community services from own revenues (e.g. property rates and surcharges)
- The LGES therefore applies a revenue adjustment factor to ensure funds from the Institutional and Community Services components only go to municipalities with limited own revenue

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Revenue Adjustment Factor (2 of 3)

- A regression was used to identify how good each of the following variables from the Census was at predicting the past ability to collect property rates:
  - Total income of all individuals/households residing in a municipality
  - Reported property values
  - Number of households on traditional land
  - Unemployment rate
  - Proportion of poor households as percentage of total number of households in the municipality
- These weights were then used to construct an index to rank municipalities from greatest to lowest per capita revenue raising potential – only this measure of *relative* own-revenue raising ability is used in the formula

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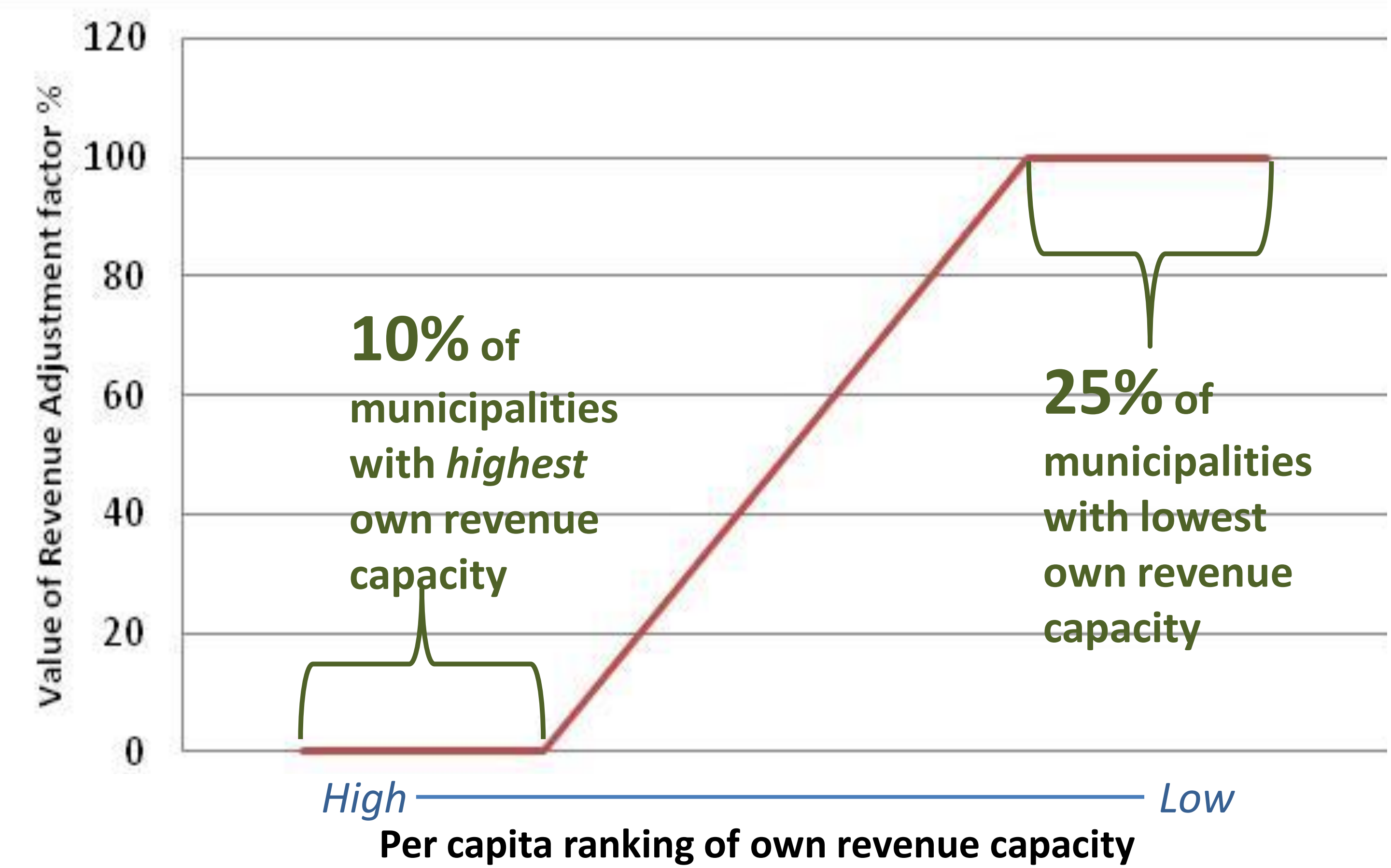
REVENUE ADJUSTMENT FACTOR (3 OF 3)

Diagrammatic representation of how the revenue adjustment factor will be applied to different municipalities



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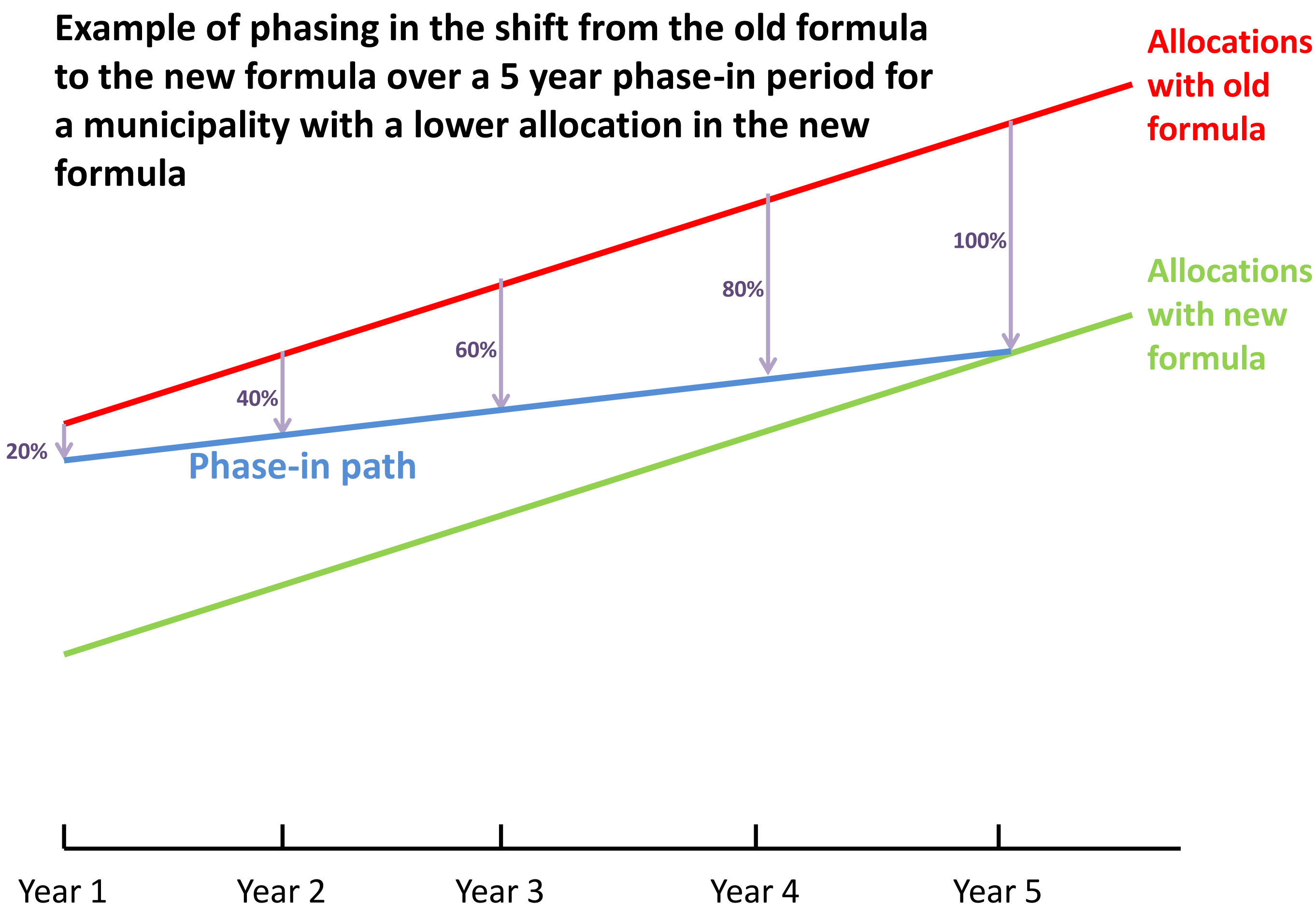
Correction and Stabilisation Factor

- Need to provide stability in allocations (principle 6)
- All municipalities guaranteed to receive at least 90% of 2013/14 allocation gazetted in terms of the 2012 Division of Revenue Act
- In addition it was agreed the new formula be phased-in over 5 years
- Phase in will measure the gap between allocations through the old and new formula
- For municipalities with smaller allocations in the new formula the phase-in mechanism will close the gap between the old formula and the new formula by 20% each year
- Funds for this will be subtracted proportionately from “gaining” municipalities – giving them more time to adjust to their larger allocations

EXAMPLE OF PHASING-IN



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IMPACT OF THE NEW FORMULA

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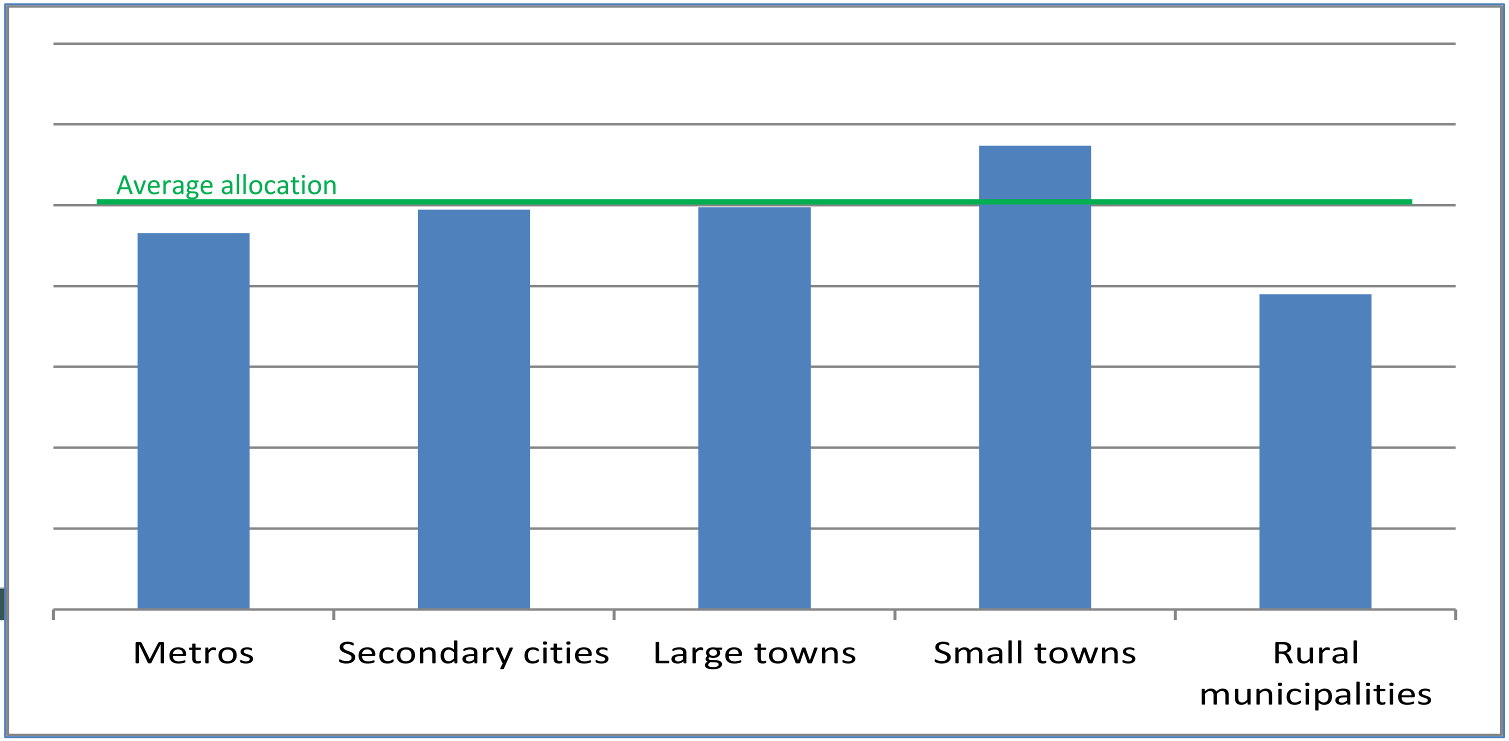
DISTRIBUTIONAL IMPACTS OF THE NEW FORMULA…1

- The old formula allocated less (on a per poor household basis) to those municipalities with the least ability to raise own revenues

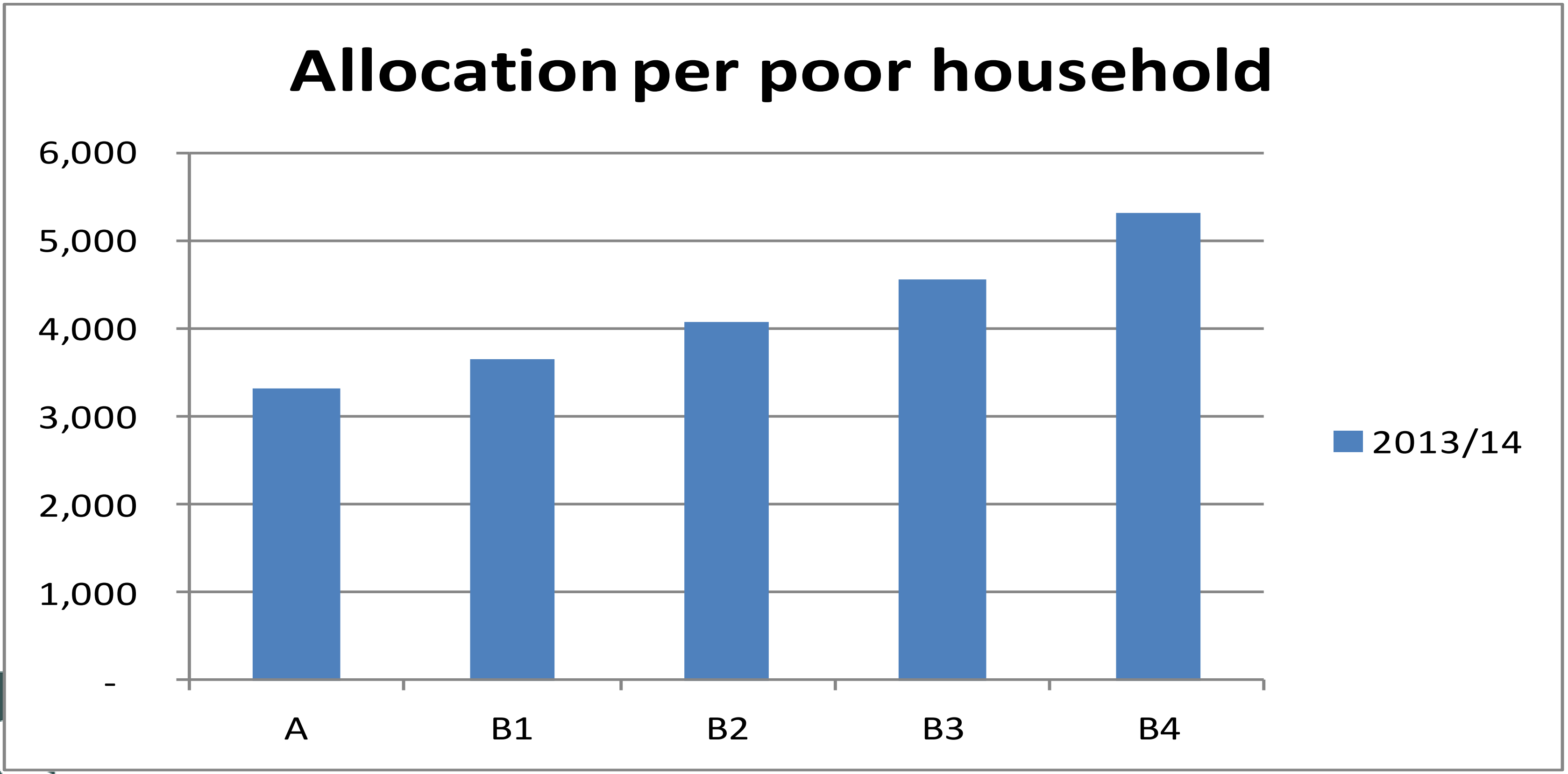
Allocations per poor household in old current formula (2012/13)



Note: allocations for district and local municipalities have been added together in this data

Distributional impacts of the new Formula…2

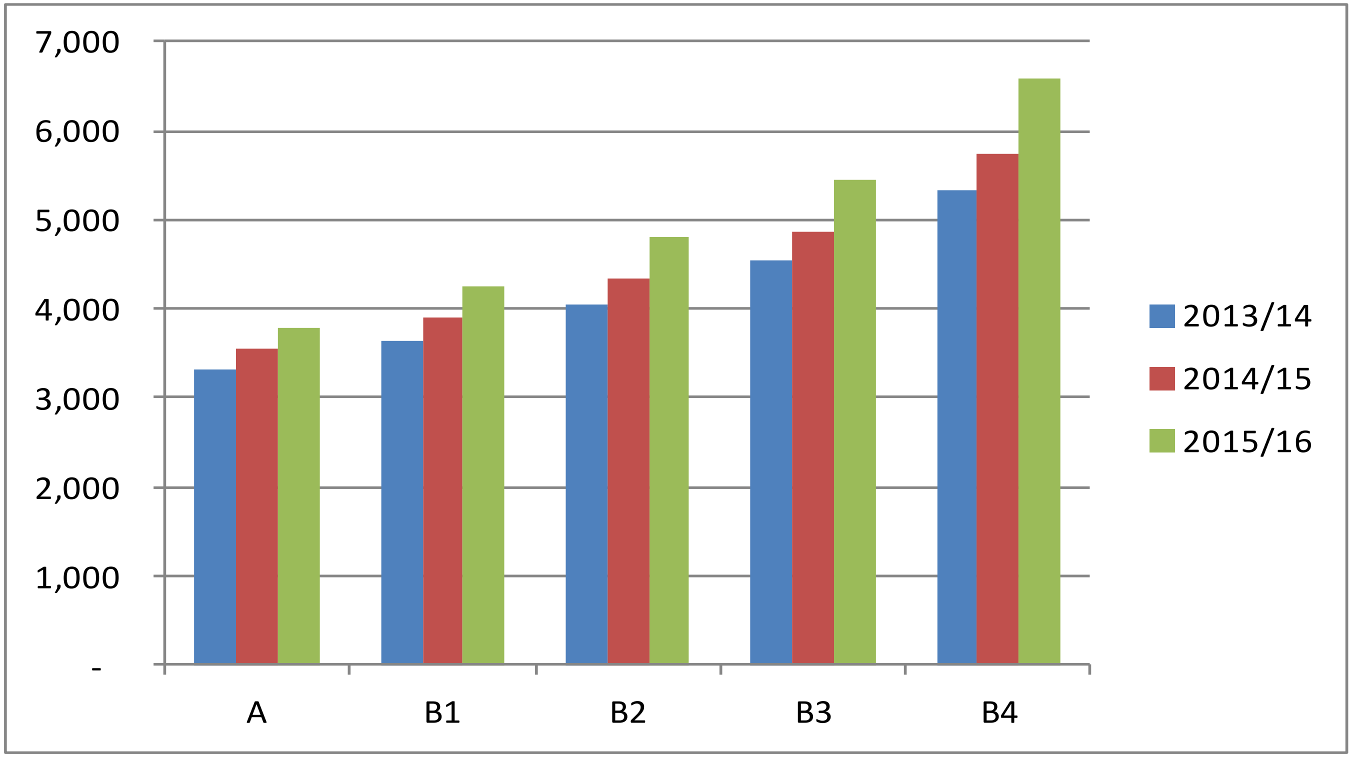
- The new formula ensures that municipalities with the least ability to raise own revenues get larger allocations (per poor household)



Note: allocations for district and local municipalities have been added together in this data

Distributional impacts of the new Formula…3

- This pattern becomes even more pronounced as more funds are added over the MTEF



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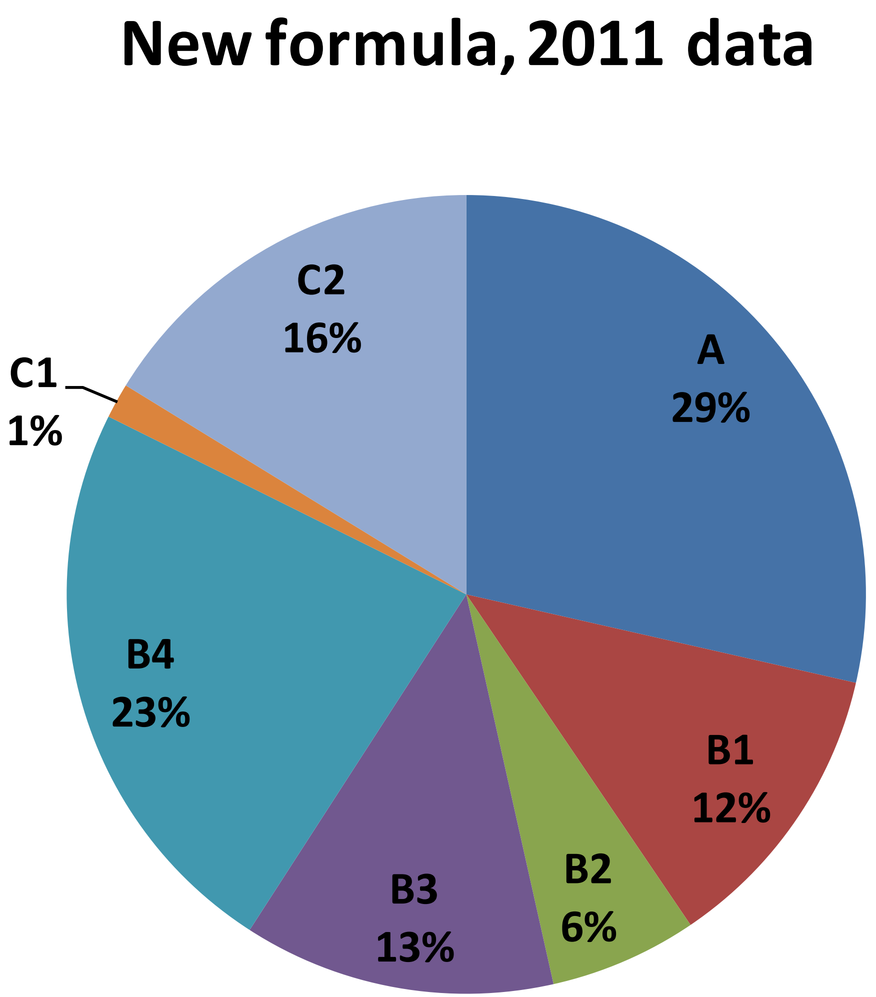
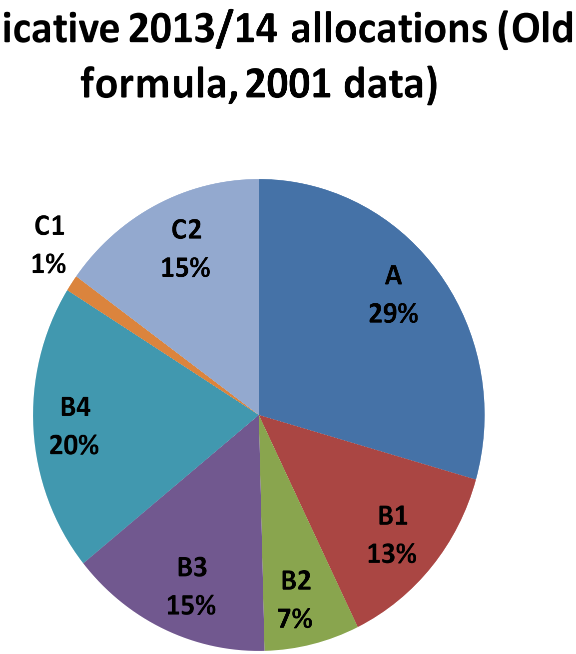
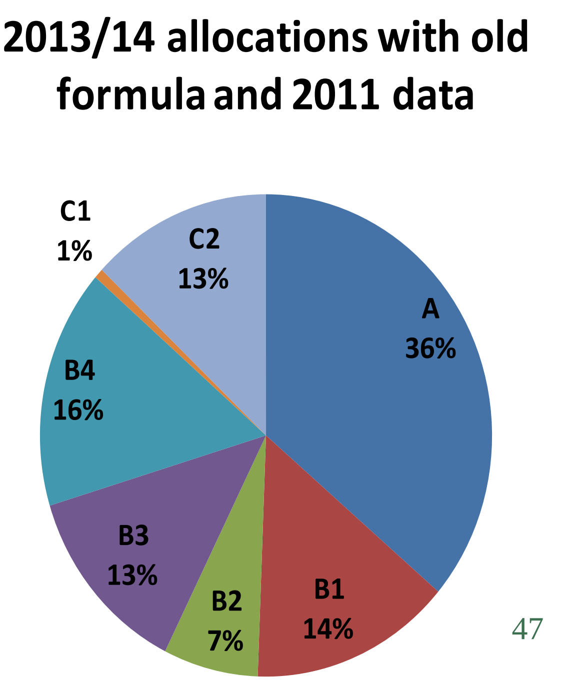
ALLOCATIONS BY TYPE OF MUNICIPALITY

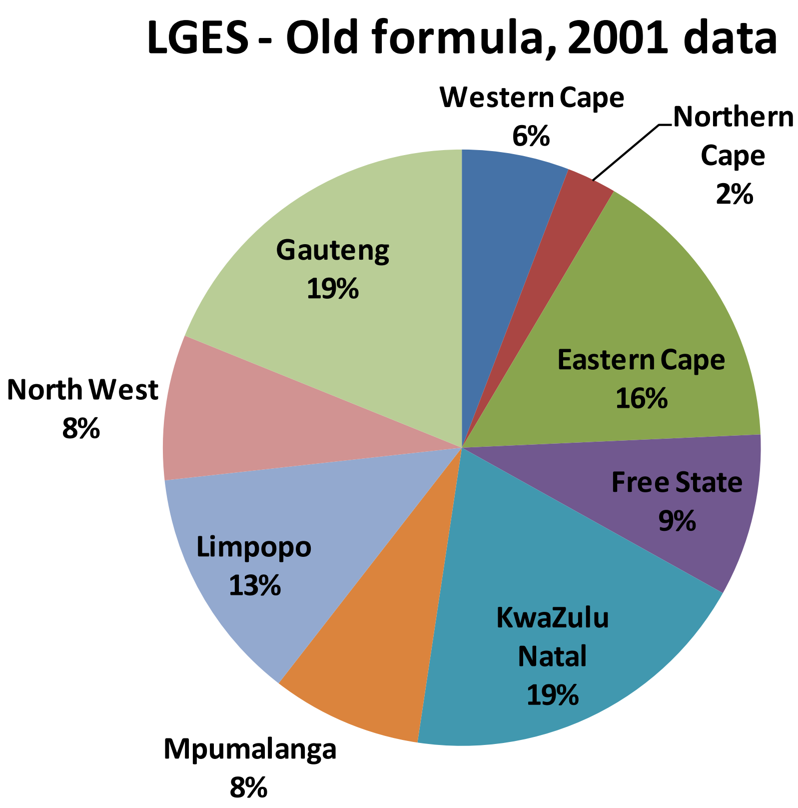


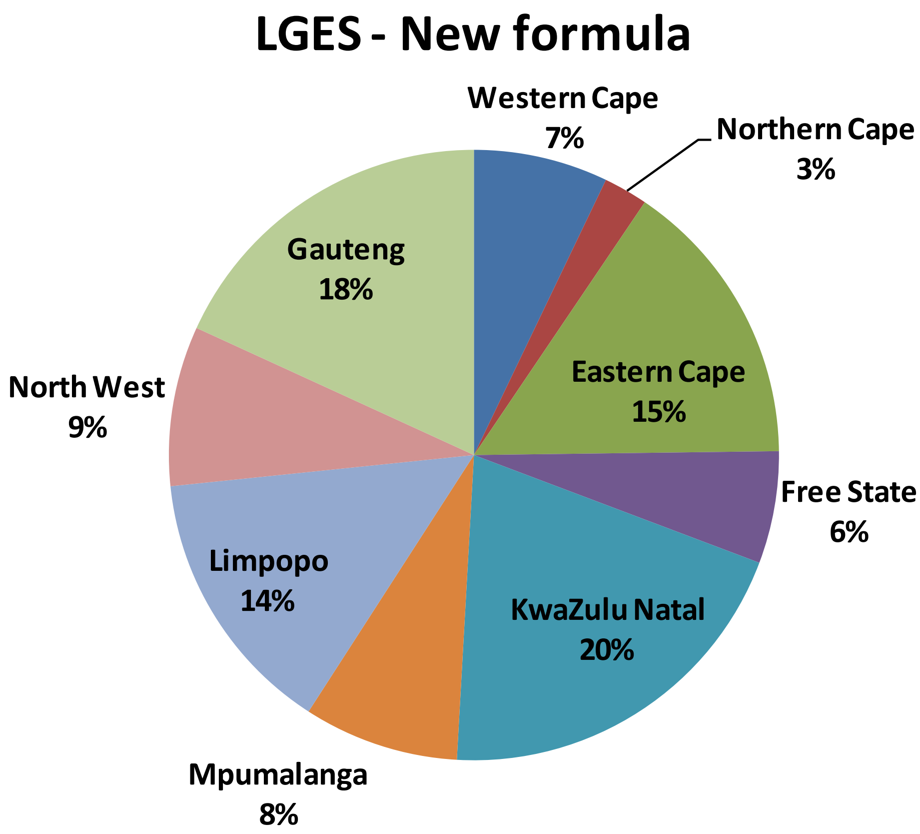
Old formula





PROVINCIAL COMPARISON





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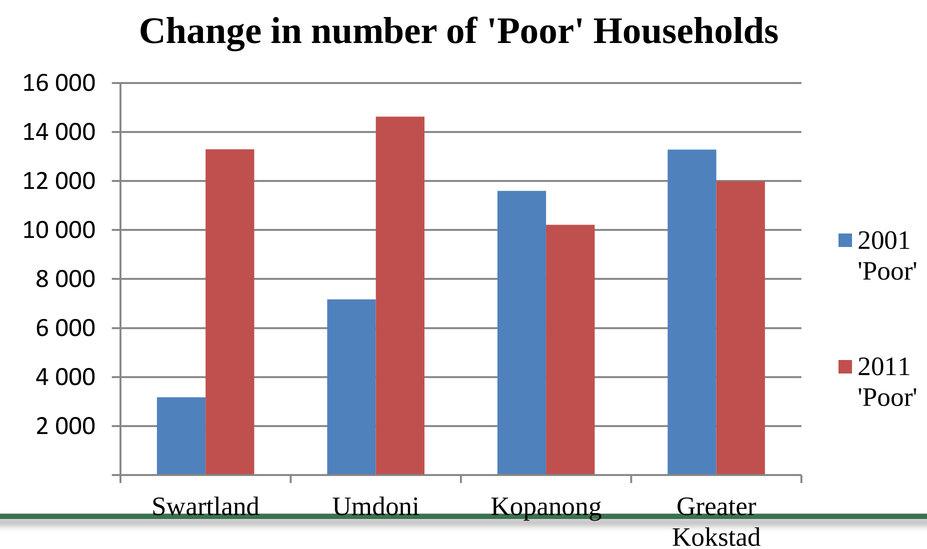
IMPACT WITHOUT PHASE-IN– SOME EXAMPLES

- If no phase-in was applied to cushion the impact of the new formula:
  - Some municipalities experience dramatic increases
    e.g. Swartland (83%) and Umdoni (73%)
  - Others experience significant decreases
    e.g. Kopanong (-49%) and Greater Kokstad (-41%)
  - These large changes are primarily the result of changes in population, and the number of poor households per municipality:



*The 2001 Census data uses the R800 affordability threshold, the 2011 Census data uses the R2300 threshold

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ADVANTAGES OF THE NEW LGES FORMULA

- Simpler formula structure and easier to understand
- Higher affordability threshold
- More realistic cost estimates for basic services though still inadequate
- Capability to update data
  - Can reflect different cost pressures for each service (e.g. electricity)
  - Incorporates estimates of population growth
- More realistic level of institutional funding for those municipalities that need transfers to sustain their administration
- Includes funding for key non-trading services
- More redistributive formula structure

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Unfinished Business

- Formula input data
  - Additional variables and quality
- Service delivered at minimum feasible cost
- Role of executive in setting delivery standards that fit within the budget constraint
  - Pareto optimal budget
- Balancing national control against subnational autonomy
- Optimal equalisation framework

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