

A critical view of the allocation of revenue to provincial governments

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Abstract

This article investigates the principles used in the allocation of revenue resources to the nine provincial governments based on the recommendations of the Financial and Fiscal Commission. The article identifies the aspects that are taken into account in the allocation process.

Problems with the current formula used for the allocation of revenue are highlighted. New legislation regarding the budgetary process is examined to determine if it addresses the problems experienced at the moment.

Key words

Allocation of income

Basic grant

Census data

Financial and Fiscal Commission

Fiscal capacity equalization grants

Institutional grant

Intergovernmental Fiscal Relations Act

National standards grant

Spillover grant

1 Introduction

During 1994 South Africa saw a number of changes including the first democratic election. This resulted in a change in the structure of government. For the first time there was a national government and nine provincial governments. The Constitution allocates certain functions to each of these governments, for which it needs resources. These resources can be obtained from two sources, namely the levying of tax or allocations made from national government. Due to the fact that provincial governments currently do not have the infrastructure to levy tax their main source of income is allocations from national government.

The problems experienced with the allocation of income to the provinces was highlighted in January 1998 when the national treasury had to advance the

Eastern Cape R801-million to pay 564 000 pensioners their pension until the end of the financial year. This article will discuss the methods used to allocate income from national government to provincial governments. The problems with the current system will be identified and changes to the system of allocation of income will be discussed (Business Report: 1998-01-19).

2 Current allocation of resources to provinces

2.1 Background

The introduction of nine provinces was a new concept in South Africa and therefore there was no basis which could be used for allocation of income. The Interim Constitution (Act 200 of 1993) made provision in section 198 for the establishment of the Financial and Fiscal Commission. The Financial and Fiscal Commission has a mandate to play a leading role regarding the development and maintenance of intergovernmental financial and fiscal relations in South Africa.

The Financial and Fiscal Commission is an independent body that should advise Parliament and provincial legislatures on a variety of issues including amongst other:

- financial and fiscal policies;
- criteria for the allocation of financial resources;
- equitable allocations to national, provincial and local governments from revenue collected at the national level;
- taxing powers of the provinces;
- and borrowing by sub-national governments. (Department of Finance 1995:3).

The role of the Financial and Fiscal Commission was entrenched in the new Constitution in section 220:

- (1) There is a Financial and Fiscal Commission for the Republic which makes recommendations envisaged in this Chapter (chapter 13 - Finance), or in national legislation, to Parliament, provincial legislatures and any other authorities determined by nation legislation.
- (2) The Commission is independent and only subject to the constitution and the law, and must be impartial.
- (3) The Commission must function in terms of an Act of Parliament and, in performing its functions, must consider all relevant factors including those listed in section 214(2).

2.2 Factors to consider in allocation of resources to provincial governments

The interim constitution in sections 115 provided that: Provinces are entitled to an equitable share of revenue collected nationally. Section 214(1) of the constitution states that the revenue allocated to provinces consists of two parts:

- percentages of certain national taxes (personal income tax, VAT, and the fuel levy);
- other conditional or unconditional allocations.

In addition to transfers from national revenues a province may raise loans for capital or current expenditure in accordance with reasonable conditions determined by national government (Department of Finance 1997: 4.4). Section 230(1) of the Constitution (Act 108 of 1996) provides further that loans for current expenditure may only be raised when necessary for bridging purposes during a fiscal year and must be repaid within twelve months.

The Constitution (Act 108 of 1996) states that the following factors are to be taken in to account in allocation of income to provinces-

- the national interest;
- any provision that must be made in respect of the national debt and other national obligations;
- the needs and interest of the national government;
- the need to ensure that the provinces and municipalities are able to provide basic services and perform the functions allocated to them;
- the fiscal capacity and efficiency of the provinces, local government and municipalities;
- development and other needs of the provinces, local government and municipalities;
- economic disparities within and among the provinces;
- obligations of the provinces and municipalities in terms of national legislation;
- the desirability of stable and predictable allocations of revenue shares; and
- the need for flexibility in responding to emergencies or other temporary needs, and other factors based on similar objective criteria (section 14(2)).

Using these factors an allocation was made between the national and provincial

governments. The Financial and Fiscal Commission developed a formula for the allocation of the provincial revenue between the provinces.

2.3 Allocation of income between national and provincial governments (vertical division)

The vertical division of the total available resources between the national and provincial governments is based on the constitutional allocation of functions, according to which the delivery of the major services to the public, such as education and health-care, is the responsibility of provincial governments. It should however be taken into account that both levels of government have existing commitments which must be honoured in the short term (Constitution 1996: Section 227(1)).

As the services of only a limited number of national departments are related to the increase in the population, the Financial and Fiscal Commission recommends that allocations to the national government grow more slowly than those to the provincial governments over this period. (Department of Finance 1998a: 4.9)

For the 1998/9 budget the allocation of resources between the different spheres of government is as follows:

	R million	%
National departments	67 131	42.6
Provinces	90 443	57.4

National departments exclude estimated provincial share of improvements in conditions of service.

Provinces include conditional grants and estimated improvements in conditions of service (Department of Finance 1998a: 4.6)

2.4 Allocation of income between provinces (horizontal division)

The Financial and Fiscal Commission recommended that the total provincial allocation (P) be divided among the provinces by means of a provincial grants formula.

The provincial grants formula can be expressed in the form of an equation, namely: $P = S + m + T + I + B$

The elements in the formula are explained as follows:

- S = a minimum national standards grant to enable the provinces specifically to provide primary and secondary education and primary and district health-care to their residents;
- m = a spillover grant to provide for the financing of those services which have inter-provincial spillover effects;
- T = a fiscal capacity equalization grant to ensure that provincial functions are financed from an equitable provincial taxing capacity and to encourage accountability and democratic institutions associated with the establishment of provincial legislatures;
- I = an institutional grant to provide funds for each province to finance the core of its legislature as required by the Constitution; and
- B = a basic grant to enable provinces to establish and maintain the institutions necessary for the fulfillment of their constitutional obligations according to their own priorities.

In calculating each of the abovementioned components a number of factors are taken into consideration:

- the national standards grant (S)

The education component is determined by calculating the cost of providing an acceptable level of education to the residents of a province, between 5 and 17 years of age, using the norm of one teacher for every thirty-eight pupils.

The value of the health-care component is determined by calculating the costs, firstly, of providing within ten years an average of 3.5 visits per year to a primary health-care clinic by people who do not have access to medical aid schemes, and 0.5 visits by those who do have access to such schemes; and secondly, of providing services by district hospitals.

the spillover grant (m)

An amount is provided to provinces with academic hospitals to compensate them for the costs of medical training and the provision of unique health services such as heart transplants.

institutional grant (I)

This grant is established by calculating the cost of running a basic administration in terms of the Constitution and is provided to each province as a "bottom slice" before the rest of the Financial and Fiscal Commission formula is applied.

fiscal capacity equalization grants (T)

A zero-sum system of fiscal capacity equalization grants (which can be either positive or negative for a given province) has been proposed to compensate partially for horizontal fiscal disparities, as reflected in differences in the taxable capacity of the provinces. This grant is not, however, dependent on the provincial tax rate actually chosen (or on other grants it receives). Thus, by levying a tax at a higher or lower rate, a particular province can have a higher or lower level of public services.

basic grant (B)

This grant is determined on the basis of the weighted population figures for each province. A weight of 25 per cent is given to the number of rural people in each province, because "ruralness" is well suited as a proxy for differences in wealth and is a good indicator of deprivation and presents relatively few data-related problems.

The result of the application of this formula is that the resources for the 1998/9 fiscal year are divided as follows (all amounts exclude improvements in condition of service, other conditional grants and payments for services rendered to national government):

Province	R million	%
Eastern Cape	15 106	17.0
Free State	6 003	6.8
Gauteng	14 095	16.0
KwaZulu-Natal	17 628	20.0
Mpumalanga	5 507	6.3
Northern Cape	2 064	2.4
Northern Province	11 066	12.6
North West	7 216	8.2
Western Cape	9 429	10.7

R53 million of resources are not allocated to a specific province (Department of Finance 1998b: 4.7).

3 Problems and constraints of the financial and fiscal commission formula as experienced by provincial governments

3.1 Introduction

On 21 August 1997 a debate on Intergovernmental Fiscal Relations took place in the National Council of Provinces. The Minister of Finance, Trevor Manuel, as well as the Members of the Executive Committees (MEC) for Finance of the nine provinces participated in the debate. Although the debate took place in a constructive spirit MEC's also got the opportunity to air problems regarding the formula used by the Financial and Fiscal Commission in the allocation of national revenue amongst the nine provincial governments.

3.2 Education

The education component of the Financial and Fiscal Commission formula is calculated on the distribution of the population between the ages of 5 and 19 and the distribution of full time education enrolment.

Eastern Cape MEC for Finance and Provincial Expenditure, Prof. Shepard Mayatula, pointed out that according to a report by the Schools and Colleges

Register of Needs Survey 1996, 18.3% of schools in KwaZulu-Natal and 17.8% of schools in the Eastern Cape rely on dams and rivers for their water which poses a health risk. The main concern is however, that 47.98% of schools in the Northern Province and 33.57% of his province's school have no access to water at all (1997:1464).

Other problems related to education in the Eastern Cape include the following:

- 77.1% of schools in the Eastern Cape are without power supply;
- only 18.6% of schools in this province have telephones;
- a current educator-classroom ratio of 1,4.

The formula therefore does not take the shortage of 15 538 classrooms in the Eastern Cape compared with the shortage of only 207 classrooms in the Northern Cape into account. Prof. Mayatula states that this leaves the Eastern Cape as a less endowed province with two rather irrational choices; it can either use it's budget to build classrooms without teachers or it can employ teachers to teach under the trees. (Mayatula 1997:1465)

Currently the educational backlogs faced by some provinces are not taken into account by the formula used by the Financial and Fiscal Commission. To ensure that adequate infrastructure is created in all the provinces the formula could be changed to make specific allocations for this purpose.

3.3 Health services

The health component uses the weighted "qualifying population" estimated by the Financial and Fiscal Commission. The formula weighs more favourably the estimated population without medical assurance cover and a composite of the distribution of the population aged over 60 (weighted 0.33), the total number of women (weighted 0.33) and children under 5 (weighted 0.33). This extension of the Financial and Fiscal Commission proposal takes account of the higher primary health service usage rates of women, infants and elderly. This grant is assuming that there are clinics, hospitals etc. in provinces like the Eastern Cape and the Northern Province, which is definitely not the case.

The allocations made for health services raises a number of concerns. The first area of concern is the availability of accurate and up to date population information. Another concern is that the formula should also make funds available to create the facilities to deliver the health care as required.

3.4 Backlogs of the past

In KwaZulu-Natal 90% or more of the budget is consumed by expenditure on social services, such as education, health and social welfare (Ngubane 1997: 1475). It is important to note that the said expenditure in many instances does not address backlogs on the ground and such expenditure is not geared to improving the economy of the province so that there is less dependency on the national government for social services.

The formula doesn't address the fact that many provinces have still not been fully reimbursed for accumulated overdrafts of the homeland Governments that had to be redeemed. Provinces without this burden had a definite advantage over others (Mufamadi 1997:1468).

3.5 Illegal immigrants

In provinces like Mpumalanga, Northwest and the Free State budgets are being seriously threatened by illegal immigration. In these provinces vast amounts of budgets for health care, social security, welfare pensions and education is spent on citizens of neighbouring countries. These immigrants lead to unbearable pressure on provincial systems and processes of control. As these people are not included in census-data they have a grave influence on budget allocations. This results in reduced levels of service through budgetary shortfalls (Modipane 1997: 1470).

3.6 Demographic cost of delivering services

The fundamental principle on which the formula is based is that provinces should be given equal per capita allowances. Whilst the conditional grants and tax shares are not explicitly demographically based, the overwhelming majority of the allocation (over 80%) is contained in the social grants and the "equitable share" which are based on population measures. This suggests an implicit assumption that the unit costs of service delivery are the same across all provinces. This is clearly debatable for two reasons:

- Some provinces are more efficient than others; and
- Some provinces have inherently higher or lower costs due to their geographical and demographical past.

While it is clear that funding should not be based upon inefficiency, the second

factor should be taken into account. The Northern Cape in particular has almost a third of the land of South Africa and yet only 2% of the population. This inevitably results in higher costs of service delivery. The unit cost of delivering services in a vast area to pockets of people is certainly much higher than to a concentrated group (Akharwaray 1997: 1455).

3.7 Population estimates

The Eastern Cape MEC, pointed out that the data from the 1996 census wiped out one million people from the province. This has a devastating effect on the budget of the province seeing that the formula is population-based (Mayatula 1997: 1466).

Another province that is hard hit by the Financial and Fiscal Commission formula is the Western Cape. In terms of the formula the Western Cape's slice of the cake is supposed to decrease from 10.66% in the 1997 financial year, to only 8.91% by the year 2002. This is based on the census information that indicated that only 9% of the population live in the Western Cape. The latest figures produced by the Household Survey show that 10.9% of the population lives in the Western Cape. The problem with the population-based formula is that accurate information on the population is required (Meiring 1997: 1485).

Procedures should be formulated to ensure that the most recent data is used and that the information be made available timeously.

3.8 Tax room

The Financial and Fiscal Commission argued that the provinces should generate "own" revenue using a 7% "tax room" based on the grounds of promoting democratic and fiscally accountable government in the provinces. The problem with the argument is that the poorer provinces, whether they use this "tax room" or not, are sure to lose. This is due to the fact that they do not have the same tax base as the other provinces to levy the tax on. If one takes into account the already skewed formula, this becomes a double blow to the poorer provinces (Mayatula 1997:1466).

In a report released by the Commission of inquiry into certain aspect of the South African tax structure the commission also opposed the introduction of a surcharge on tax.

3.9 Administrative problems

The MEC for Finance and Economic Affairs of the Free State, Zingile Dingani stated that all three spheres of government should be involved in the determination of equitable share. At this stage it should be recognized that the third level of government, local government, has not yet been taken aboard this process.

The current budgetary process does not take into account the developmental needs of provinces, the economic disparities within and among provinces and obligations of provinces in terms of national legislation. An example of this is the decision by the Department of Welfare and Population Development to introduce a new child support benefit. This will initially cost the Free State R81 million for the 1997/8 financial year, yet no provision has been made by the national department to address this new policy.

The medium term expenditure framework is also imposing an additional administrative burden on senior personnel and there are calls for additional capacity building and training for personnel involved with the budgetary processes not only in treasury but also in line departments (Dingane 1997: 1438).

A lack of consultation between national departments and departments at provincial level have a tendency to create unmanageable expectations and demands on provincial departments to implement these policies (Ngubane 1997: 1460).

4 New developments

4.1 Intergovernmental Fiscal Relations Act

The Intergovernmental Fiscal Relations Act (Act 97 of 1997), which took effect on 1 January 1998, establishes a formal process for considering intergovernmental budget issues. The Act is designed to facilitate and regulate a process of consultation to promote a budget-making process that is fair.

The Act gives effect to section 214 of the Constitution by setting out the process to arrive at the equitable share of revenue raised nationally for the

national, provincial and local spheres of government. This includes the equitable division of the provincial share of that revenue among the provinces and any other allocation that may be made to provinces and local government (Intergovernmental Fiscal Relations Act 1997: section 8).

The budgetary process begins with the Financial and Fiscal Commission making recommendations on the allocation of revenue between the national and provincial governments and between the provincial governments. These recommendations must be submitted to both houses of parliament and the nine provincial legislatures 10 months before the start of the financial year (Section 9(1)).

The Act establishes the Budget Council consisting of the Minister of Finance and the MEC for finance of each province. The Budget Council is established to facilitate consultation with provinces and local government on a wide range of fiscal, budgetary, legislative and financial matters (Section 3).

The Minister of Finance is required to consult with the provinces, local government and the Financial and Fiscal Commission on the proposed allocation of revenue, which can be done in the Budget Council or in another way. Section 10 of the Intergovernmental Relations Act requires the Minister to table the Division of Revenue Bill each year at the time of the Budget, specifying the allocations to each sphere and the conditions that may apply to any of these allocations. In addition, the Division of Revenue Bill is to be accompanied by a memorandum that explains any assumptions and formulae used in arriving at the allocations as well as how they incorporate constitutional requirements and the Financial and Fiscal Commission's recommendations.

The 1999 Budget will be the first budget guided fully by the requirements of the intergovernmental Fiscal Relations Act. Preparation of the 1998 Budget which began in April 1997, followed a slightly different process from the one outlined in the Act, as the Act was only passed in November 1997 (Department of Finance 1998c: 4).

4.2 Report of the Katz commission of inquiry on the tax structure of South Africa

While the Government accepts that expenditure accountability should in principle be matched by taxation powers, it is aware of the potentially disruptive effect sub-national taxation powers may have on national macroeconomic policies. Following a decision of the Budget Council, the commission of inquiry into certain aspects of the tax structure of South Africa (Katz Commission) is preparing a report on the tax powers of provinces in order that legislation regarding provincial taxation powers, as required by the Constitution, can be formulated (Department of finance 1998c: 12).

5 Conclusion

The Financial and Fiscal Commission formulated a basis on which national resources are allocated to provincial governments. The provincial governments use this money to fund the activities delegated to them in the constitution.

During 1998 a number of provinces experienced financial difficulties, especially in respect of health care and pensions. The shortages were partly due to inadequacies in the formula used and partly due to insufficient financial controls in the provinces.

The following major problems with the formula for allocation of revenue have been identified:

- the formula assumes that the infrastructure for the delivery of services exist, even though in some provinces no infrastructure exists;
- the population figures used in calculating some elements of the formula are not up to date which result in inadequate allocation to some provinces;
- the formula does not make provision for the fact that to deliver services in some provinces are more costly than in other provinces due to the geographical distribution of people;

Certain backlogs and debt inherited from the previous dispensation have a negative effect on the administration of some provinces. The formula does not make any allocations to relieve this burden inherited by some provinces.

The establishment of the Budget Council gives provincial governments an

opportunity to become part of the process of allocation of revenue to provinces. These measures can help to prevent a recurrence of the situation in January 1998 in the Eastern Cape. The functions of the Budget Council are set out in legislation. The only aspect that is not included in the Act is the deadlock-breaking mechanism. Should there be a discord between the recommendations of the Financial and Fiscal Commission and the attitude of the Department of Finance in a particular matter the mechanisms to be followed are not clear. The introduction of the Council can, however, be seen as a step in the right direction.

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