Grants, Equitable Share and Intergovernmental Fiscal Transfers – Lessons and Challenges

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1.Decentralisation

- *The transfer of powers, functions and resources from national government to subnational governments*
- Most countries have at least two levels of government
- Decentralised systems have existed in the first world for centuries
- Became fashionable in developing countries in the 70’s and 80’s

2.Types of Decentralisation

- Administrative
- Political
- Fiscal
  - Authority of subnational governments to raise own revenue
  - Authority of subnational governments to make spending decisions (i.e. budgeting authority)
  - Reasonable expectation of subnational governments to receive financial support from national government

3.Rationale

- Governments introduce intergovernmental transfers for one of four good reasons, and for a number of not-so-good reasons.
- The good reasons are:
  - Equalisation
  - Externalities
  - Administrative justifications
  - Address Fiscal Imbalance

4.Fiscal Imbalance

- Revenues derived from local sources are often seriously inadequate to finance their responsibilities.
- Fiscal imbalance arises when the sources of locally raised revenue are exceeded by the expenditure of local governments.
- Unbalanced systems prevail almost everywhere, both in developing and developed countries.
- It is an almost inevitable concomitant of decentralisation.

5.Fiscal Imbalance

- The solution might involve some or all of the following:
  - reduce subnational government functions and responsibilities
  - give subnational governments more revenue raising powers, or
  - provide revenue transfers from the central government to subnational governments
- Usually, transfers play the most important role in addressing the situation

6. The Importance of Design

- Intergovernmental transfers can be vulnerable to political manipulation and poorly designed allocation.
- Given the reliance placed on them as a source of income for sub-national governments, their design is a critical factor in the success of decentralisation.

7. The Importance of Design

- The World Bank – transfers should be
  - determined as openly, transparently and objectively as possible;
  - kept stable from year to year, to enable local governments to plan their budgets; and
  - distributed according to simple, predetermined rules.

8. Elements of Design: Vertical and Horizontal Division of Revenue

- Vertical division of revenues:
  - involves the division of revenues raised by national government between each of the levels of government (national, regional and local);
  - shifts the spending power from one government level to another level.

9. Elements of Design: Vertical and Horizontal Division of Revenue

- In the horizontal division of revenue:
  - the global amount transferred to the **regional** level of government pursuant to the vertical division of revenue is split between the various individual regional governments in a horizontal division process, and
  - the global amount transferred to the **local** level of government pursuant to the vertical division of revenue is split between the various individual local governments in a horizontal division process

10. Methods of Vertical Division

- There are three more or less common approaches to vertical division.
- The total amount to be allocated to a particular level may be determined:
  - as a share of some central government revenue source
  - on a basis of cost reimbursement.
  - on an ad-hoc basis

11.Ad Hoc

- Drawbacks to this approach:
  - It is not transparent, and quite subject to political manipulation
  - It leads to great uncertainties on the part of the subnational governments as they don't know what to expect
  - It encourages the central government to think of the subnational government sector as a lower priority item
  - It does not recognise the link between expenditure responsibilities and revenue resources

12. Horizontal Division

- Two approaches :
  - The derivation approach –based on each area's contribution to a tax
  - The formula grant - uses some objective, quantitative criteria to allocate the pool of revenues among subnational government units.

13. Conditional and Unconditional Grants

- Unconditional grants (also called general purpose grants)
  - made without any conditions being imposed by the transferring government on how they should be spent.
  - purpose is usually to assist governments with their day-to-day activities and administration
- Conditional grants
  - specific conditions on the application of the grants are imposed by the transferring government.
  - conditions may vary from detailed prescriptions to broad guidelines on the spending of the grant money.
  - intended to provide incentives for governments to undertake specific programs or activities.
  - mostly, but not always, made for purposes of developing infrastructure

14. Equalisation grant

- Intended to address horizontal imbalances between local authorities, so as to equalise the capacity of local governments to provide a national standard of public goods and services.

15. Fiscal Capacity vs Fiscal Effort

- Fiscal capacity - the potential revenues that can be obtained from the tax bases of a sub-national government.
- Fiscal effort - the extent to which a subnational government uses or exploits the revenue bases available to it.

16. Governance issues

- Grant dependence
- Reckless spending
- Undermines accountability
- Moral hazard
- Convenient to blame service delivery shortfalls on inadequate funding provided by national government.

17. A Brief Comparison of Systems

- Australia
- India
- Morocco
- Japan
- Botswana
- Saudi Arabia

18.Intergovernmental Finance in South Africa

- South African local government has a developmental focus
- Need for an effective intergovernmental finance system is clear.

19.Constitutional Provisions

- sections 214 and 227.
- Section 214:
  - an Act of Parliament must provide for
    - the equitable division of revenue raised nationally among the national, provincial and local spheres of government;
    - the determination of each province's equitable share of the provincial share of that revenue; and
    - any other allocations to provinces, local government or municipalities from the national government's share of that revenue, and any conditions on which those allocations may be made.

20. S 227

- Section 227 sets out the principles relating to intergovernmental transfers to local and provincial governments.
  - local government and each province is entitled to an equitable share of revenue raised nationally to enable it to provide basic services and to perform the functions allocated to it,
  - may receive other allocations from national government, either conditionally or unconditionally.
  - additional revenue raised by provinces or municipalities may not be deducted from their share of revenue raised nationally;
  - there is no obligation on the national government to compensate provinces or municipalities that do not raise revenue commensurate with their fiscal capacity and tax base.
- In short, if a municipality does not use FISCAL EFFORT to exploit its FISCAL CAPACITY to the fullest, national government is not going to step in to help it.

21. IGFR Act

- The Intergovernmental Fiscal Relations Act, 1997
- Prescribes a process for the determination of an equitable sharing and allocation of revenue raised nationally.
- Section 8: the process for the sharing of revenue raised nationally must be effected in accordance with the Act.
- Section 9: FFC must submit, at least 10 months before the start of each financial year, recommendations to both houses of parliament and the provincial legislatures:
  - regarding an equitable division of revenue
  - regarding the determination of each province's equitable share and any other allocations to provinces, local government or municipalities

22. IGFR Act

- Act must take into account:
  - the national interest;
  - any provision that must be made in respect of the national debt and other national obligations;
  - the needs and interests of the national government, determined by objective criteria;
  - 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 and municipalities;
  - developmental and other needs of 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.

23. IGFR Act

- Section 10 : Minister of Finance must introduce a Division of Revenue Bill which specifies:
  - the share of each sphere of government of the revenue raised nationally;
  - each province's share of the provincial share of that revenue; and
  - any other allocations to the provinces, local government or municipalities from the national government's share of that revenue, and any conditions on which those allocations are or must be made.
- Section 10(5): when the Division of Revenue Bill is introduced, it must be accompanied by a memorandum explaining how the allocations are made
- This memorandum is contained in Annexure W1 (https://www.treasury.gov.za/documents/national%20budget/2026/review/Annexure%20W1.pdf
- See also Chapter 6 of Budget Review
- https://www.treasury.gov.za/documents/national%20budget/2026/review/Chapter%206.pdf

24. Vertical Division of Revenue in South Africa

- Vertical division of revenue in South Africa is an ad hoc process
- Reflects government’s deliberations on policy and associated expenditure priorities over the medium-term, taking into account the responsibilities, expenditure demands, capacity and performance of each sphere of government.

25. Horizontal Division of Revenue in South Africa

- The horizontal division is determined on a formula basis.
- Different formulae are used for the provincial and local spheres
- Local government's equitable share is divided among the country's 257 municipalities, according to a formula which uses demographic and other data to determine each municipality's portion of the local government equitable share.
- See Annexure W1 to Budget Review for the formula

26. DORA

- Division of Revenue Bill
- Once it is passed, the Division of Revenue Bill becomes the Division of Revenue Act, or “DORA,” as it is commonly known.

27. Schedule 1- Vertical Division

SCHEDULE 1

EQUITABLE DIVISION OF REVENUE RAISED NATIONALLY AMONG THE THREE SPHERES OF GOVERNMENT

Spheres of Government	Column A	Column B	
	2026/27	Forward Estimates	
		2027/28	2028/29
	R'000	R'000	R'000
National[1,2]	1 602 840 029	1 662 255 195	1 742 618 772
Provincial	670 322 736	698 625 733	720 409 289
Local	110 090 001	114 483 348	118 041 399
TOTAL	**2 383 252 766**	**2 475 364 276**	**2 581 069 460**

1. *National share includes conditional allocations to provincial and local spheres, general fuel levy sharing with metropolitan municipalities, debt-service costs, the contingency reserve and provisional allocations*
2. *The direct charges for the provincial equitable share are netted out*

SCHEDULE 2

DETERMINATION OF EACH PROVINCE'S EQUITABLE SHARE OF THE PROVINCIAL SPHERE'S SHARE OF REVENUE RAISED NATIONALLY
(as a direct charge against the National Revenue Fund)

Province	Column A	Column B	
		Forward Estimates	
	2026/27	2027/28	2028/29
	R'000	R'000	R'000
Eastern Cape	86 598 556	89 812 902	92 198 807
Free State	36 761 457	38 247 209	39 363 882
Gauteng	140 951 906	147 063 095	151 711 122
KwaZulu-Natal	136 378 118	142 177 502	146 678 660
Limpopo	78 951 229	82 363 593	84 978 627
Mpumalanga	56 019 282	58 585 273	60 580 447
Northern Cape	18 242 252	19 096 640	19 764 502
North West	46 867 158	48 522 477	49 860 269
Western Cape	69 552 778	72 757 042	75 272 973
TOTAL	**670 322 736**	**698 625 733**	**720 409 289**

SCHEDULE 3

DETERMINATION OF EACH MUNICIPALITY'S EQUITABLE SHARE OF THE LOCAL GOVERNMENT SPHERE'S SHARE OF REVENUE RAISED NATIONALLY

	Number	Municipality	National Financial Year		
			Column A	Column B	
			2026/27	Forward Estimates	
				2027/28	2028/29
			R'000	R'000	R'000
EASTERN CAPE					
A	BUF	Buffalo City	1 363 341	1 432 070	1 462 480
A	NMA	Nelson Mandela Bay	1 740 504	1 841 721	1 867 588
B	EC101	Dr Beyers Naude	130 306	134 705	139 662
B	EC102	Blue Crane Route	74 969	76 953	80 313
B	EC104	Makana	139 159	143 934	149 155
B	EC105	Ndlambe	146 218	151 062	156 720
B	EC106	Sundays River Valley	126 877	131 509	136 005
B	EC108	Kouga	212 694	222 318	228 081
B	EC109	Kou-Kamma	74 323	76 965	79 656
C	DC10	Sarah Baartman District Municipality	114 938	117 389	123 067
Total: Sarah Baartman Municipalities			**1 019 484**	**1 054 835**	**1 092 659**
B	EC121	Mbhashe	317 595	314 403	337 969
B	EC122	Mnquma	330 798	327 421	352 019

30. Conditional Grants under DORA

- There are four types of local government conditional grants:
  - general grants that supplement various programmes partly funded by municipalities
  - grants that fund specific responsibilities and programmes implemented by municipalities.
  - grants that provide in-kind allocations through which a national department implements projects in municipalities.
  - grants that provide for the swift allocation and transfer of funds to a municipality to help it deal with a disaster or housing emergency.

31. Conditional Grants and Fuel Levy

- Conditional Grants: 54 658 000 000
- Fuel Levy: 17 530 000 000

32. Extract from Report

- *Most of the municipal respondents were sharply critical of the model. Many respondents who were interviewed complained that it was unrealistic and failed to take into account local conditions, including geographical conditions. Thus, for example, dissatisfaction was expressed that no provision was made for the fact that municipalities which covered vast areas would inevitably find it more expensive to administer those areas. Rural municipalities are in a particularly difficult position when it comes to revenue generation. The high levels of poverty and unemployment, and low levels of economic activity affect the ability of rural municipalities to fulfil their service delivery mandates. Urban municipalities are not without their own problems. Respondents from a range of municipalities (mainly the metropolitan municipalities and secondary cities, but also a number of smaller municipalities) complained that the urbanisation phenomenon was placing enormous strains on their resources and making it difficult to plan. Overall, however, respondents complained that there simply wasn't enough money made available to municipalities to carry out their developmental mandates. An underlying theme which ran through most of the comments was that, given that local government was supposed to be at the forefront of the developmental agenda, the share of nationally raised revenue which was made available to local government was woefully inadequate*

33. NT CONDITIONAL GRANT REVIEW Presentation
Select Committee on Appropriations

- Uncoordinated/misaligned conditional grants
- Grant expenditure not associated with improved service delivery
- Capacity constraints (at all spheres)
- No blueprint for optimal design
- Best practice is for only one ministry to be in charge of the payment of any transfers
- NT's solution revolves around rationalistion

https://static.pmg.org.za/251015_National_Treasury_presentation_on_Conditional_Grants_Review_process.pdf

34. Problems with LGES

- LGES grant has not kept pace with escalating costs of employment or increasing bulk services costs.
- Rural municipalities : higher costs of service delivery are not adequately factored into the LGES
- Focus on Free Basic Services rather than other municipal services.
- Does not directly factor in the cost of increases in the administrative compliance burden.

35. Counter-Arguments

- Municipalities often do not exploit their own revenue sources.
- While municipalities do not have control over the salaries and conditions of employment of their staff, they do have control over staff headcount.
- A high degree of inefficiency in municipal spending as well as fraud and corruption are the true reasons for the transfer funding gap.

36.Unnecessary Expenditure

- National Treasury
  - Non-priority expenditure
  - Catering
  - Foreign travel
  - Cars
- FFC – Efficiency of local government spending

37. Conclusion

- Combination of pressure from two directions
  - Economy in dire straits
  - Poor financial management record
- Unlikely that there will be a significant increase in transfers