

W1

Explanatory memorandum to the division of revenue

- Extract from Annexure W1 to the Budget Review and Division of Revenue Bill (available at www.treasury.gov.za)

■ The provincial equitable share

The equitable share is the main source of revenue for meeting provincial expenditure responsibilities. To ensure that allocations are fair, the equitable share is allocated through a formula using objective data on the context and demand for services in each of the nine provinces. The revisions due to function shifts in health and higher education and the change in NHLS funding arrangements reduce the provincial equitable share by R5.3 billion in 2015/16, R6.8 billion in 2016/17 and R3 billion in 2017/18. This brings the equitable share allocations to R382.7 billion, R405.3 billion and R428.9 billion respectively for each year of the 2015 MTEF period. These revisions result in the provincial equitable share increasing by 6.3 per cent between 2014/15 and 2015/16, and growing at an average annual rate of 6 per cent over the MTEF period.

Allocations calculated outside the equitable share formula

The equitable share includes an amount of R2.3 billion in 2015/16 that was previously part of the *devolution of property rate funds grant*. This grant, which funded provinces to pay municipal charges on provincial properties that were previously administered by national government, has been transferred as part of the provincial equitable share since 2013/14. These funds are still allocated to provinces in the same proportions as the former grant, but from 2016/17 they will be allocated using the provincial equitable share formula.

Over the 2015 MTEF period, the amounts taken out of the provincial equitable share to implement the change in the NHLS's funding arrangements will be subtracted from each province's allocation in proportion to their share of the formula's health component.

The equitable share formula

The provincial equitable share formula is reviewed and updated with new data annually. For the 2015 MTEF, the formula has been updated with data from the 2014 mid-year population estimates published by Statistics South Africa; the 2014 preliminary data published by the Department of Basic Education on school enrolment; data from the 2013 General Household Survey for medical aid coverage; and data from the health sector and the Risk Equalisation Fund for the risk-adjusted capitation index. Because the formula is largely population-driven, the allocations capture shifts in population across provinces, which results in changes in the relative demand for public services across these areas. The effect of these updates on the provincial equitable share is phased in over three years (2015/16 to 2017/18).

Full impact of data updates on the provincial equitable share

Table W1.9 shows the full impact of the data updates on the provincial equitable share per province. It compares the target shares for the 2014 and 2015 MTEF periods. The details of how the data updates affect each component of the formula are described in detail in the subsections below.

Table W1.9 Full impact of data updates on the equitable share

	2014 MTEF weighted average	2015 MTEF weighted average	Difference
Eastern Cape	14.0%	14.0%	-0.01%
Free State	5.6%	5.6%	-0.00%
Gauteng	19.5%	19.5%	0.04%
KwaZulu-Natal	21.3%	21.3%	-0.06%
Limpopo	11.8%	11.8%	-0.04%
Mpumalanga	8.2%	8.2%	0.01%
Northern Cape	2.7%	2.7%	-0.00%
North West	6.9%	6.9%	0.00%
Western Cape	10.0%	10.1%	0.06%
Total	100.0%	100.0%	-

Source: National Treasury

Phasing in the formula

To mitigate the effect of annual data updates on provincial equitable shares, the new shares are phased in over the three-year MTEF period. An amended phase-in mechanism was introduced for the 2014 MTEF to ensure that the weighted share of the provincial equitable share allocated to each province over the medium term closely follows the indicative shares for each year published in the previous MTEF.

The equitable share formula data is updated every year and a new target share for each province is calculated, which is shown in Table W1.10. The phase-in mechanism provides a smooth path to achieving these weighted shares by the third year of the MTEF period. It takes the difference between the target weighted share for each province at the end of the MTEF period and the indicative allocation for 2015/16 that was published in the 2014 MTEF, and closes the gap between these shares by a third in each year of the 2015 MTEF period. As a result, one-third of the impact of the data updates is implemented in 2015/16, two-thirds in the indicative allocations for 2016/17, and the updates are fully implemented in the indicative allocations for 2017/18.

**Table W1.10 Implementation of the equitable share weights,
2015/16 – 2017/18**

Percentage	2015/16	2015/16	2016/17	2017/18
	Indicative weighted shares from 2014 MTEF	2015 MTEF weighted shares 3-year phasing		
Eastern Cape	14.2%	14.1%	14.1%	14.0%
Free State	5.7%	5.7%	5.6%	5.6%
Gauteng	19.3%	19.3%	19.4%	19.5%
KwaZulu-Natal	21.4%	21.4%	21.3%	21.3%
Limpopo	11.9%	11.8%	11.8%	11.8%
Mpumalanga	8.2%	8.2%	8.2%	8.2%
Northern Cape	2.7%	2.7%	2.7%	2.7%
North West	6.9%	6.9%	6.9%	6.9%
Western Cape	9.9%	10.0%	10.0%	10.1%
Total	100.0%	100.0%	100.0%	100.0%

Source: National Treasury

Provision for cushioning the impact of 2011 Census data updates and baseline reductions

The provincial equitable share formula was updated with 2011 Census data in 2013/14. The incorporation of new Census data for the first time in a decade resulted in significant changes to certain components of the formula. To give provinces time to adjust to their new allocations, the Census updates were phased in over three years and R4.2 billion was added as a “top-up” for provinces with declining shares over the 2013 MTEF period. This cushioning was due to come to an end in 2015/16, but it has been extended for another year to reduce the impact of the baseline reductions discussed above. The same provinces that required support for the Census reductions will experience the slowest growth in their allocations due to the baseline reductions. To prevent this, provinces agreed that R2.1 billion should be taken out of the equitable share as a whole (from all nine provinces) and allocated as cushioning to the four affected provinces for another year (2016/17). Table W1.11 shows how these funds are allocated to the Eastern Cape, the Free State, KwaZulu-Natal and Limpopo in 2015/16 and 2016/17.

Further work will be undertaken during 2015 to examine the long-term implications of the current approach to updating and phasing in the data used in the equitable share formula for the financial sustainability of provinces. The Technical Committee on Finance and the Budget Council will be consulted as part of this work.

**Table W1.11 Cushioning for 2011 Census impact on provinces
with declining shares in the 2015 MTEF**

	2015/16	2016/17	2017/18
R thousand	Medium-term estimates		
Eastern Cape	685 628	685 628	–
Free State	171 261	171 261	–
Gauteng	–	–	–
KwaZulu-Natal	773 075	773 075	–
Limpopo	487 036	487 036	–
Mpumalanga	–	–	–
Northern Cape	–	–	–
North West	–	–	–
Western Cape	–	–	–
Total	2 117 000	2 117 000	–

Source: National Treasury

Provincial equitable share allocations

The final equitable share allocations per province for the 2015 MTEF are detailed in Table W1.12. These allocations include the full impact of the data updates, phased in over three years, as well as the cushioning and amounts determined outside of the formula, as described above.

Table W1.12 Provincial equitable share, 2015/16 – 2017/18

	2015/16	2016/17	2017/18
R million			
Eastern Cape	54 312	57 368	60 069
Free State	21 757	22 775	23 979
Gauteng	73 413	78 237	83 602
KwaZulu-Natal	82 254	86 885	91 430
Limpopo	45 377	48 121	50 502
Mpumalanga	31 030	32 971	35 113
Northern Cape	10 138	10 730	11 397
North West	26 151	27 676	29 493
Western Cape	38 242	40 501	43 308
Total	382 673	405 265	428 893

Source: National Treasury

Summary of the formula's structure

The formula, shown in Table W1.13 below, consists of six components that capture the relative demand for services between provinces and take into account specific provincial circumstances. The formula's components are neither indicative budgets nor guidelines as to how much should be spent on functions in each province or by provinces collectively. Rather, the education and health components are weighted broadly in line with historical expenditure patterns to indicate relative need. Provincial executive councils have discretion regarding the determination of departmental allocations for each function, taking into account the priorities that underpin the division of revenue.

For the 2015 Budget, the formula components are set out as follows:

- An *education component* (48 per cent), based on the size of the school-age population (ages 5 to 17) and the number of learners (Grades R to 12) enrolled in public ordinary schools.
- A *health component* (27 per cent), based on each province's risk profile and health system case load.
- A *basic component* (16 per cent), derived from each province's share of the national population.
- An *institutional component* (5 per cent), divided equally between the provinces.
- A *poverty component* (3 per cent), based on income data. This component reinforces the redistributive bias of the formula.
- An *economic output component* (1 per cent), based on regional gross domestic product (GDP-R, measured by Statistics South Africa).

Table W1.13 Distributing the equitable shares by province, 2015 MTEF

	Education	Health	Basic share	Poverty	Economic activity	Institutional	Weighted average
	48%	27%	16%	3%	1%	5%	100%
Eastern Cape	15.1%	13.5%	12.6%	16.2%	7.5%	11.1%	14.0%
Free State	5.3%	5.4%	5.2%	5.3%	5.2%	11.1%	5.6%
Gauteng	17.7%	21.4%	23.9%	17.1%	34.7%	11.1%	19.5%
KwaZulu-Natal	22.5%	21.8%	19.8%	22.2%	15.8%	11.1%	21.3%
Limpopo	13.0%	10.4%	10.4%	13.6%	7.1%	11.1%	11.8%
Mpumalanga	8.5%	7.3%	7.8%	9.2%	7.1%	11.1%	8.2%
Northern Cape	2.3%	2.1%	2.2%	2.2%	2.2%	11.1%	2.7%
North West	6.5%	6.7%	6.8%	8.1%	6.4%	11.1%	6.9%
Western Cape	9.0%	11.3%	11.3%	6.1%	14.0%	11.1%	10.1%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%

Source: National Treasury

Education component (48 per cent)

The education component uses the school-age population (5 to 17 years), based on the 2011 Census, and enrolment data drawn from the Department of Basic Education's 2014 School Realities Survey. Each of these elements is assigned a weight of 50 per cent.

Table W1.14 shows the effect of updating the education component with new enrolment data on the education component shares.

Table W1.14 Impact of changes in school enrolment on the education component share

	Age cohort 5 – 17	School enrolment		Changes in enrolment	Weighted average		Difference in weighted average
		2013	2014		2014 MTEF	2015 MTEF	
Eastern Cape	1 856 317	1 927 081	1 916 285	-10 796	15.2%	15.1%	-0.12%
Free State	657 489	663 312	671 139	7 827	5.3%	5.3%	0.01%
Gauteng	2 231 793	2 116 391	2 178 282	61 891	17.5%	17.7%	0.16%
KwaZulu-Natal	2 758 594	2 857 959	2 865 984	8 025	22.6%	22.5%	-0.08%
Limpopo	1 536 294	1 713 696	1 719 134	5 438	13.1%	13.0%	-0.04%
Mpumalanga	1 053 846	1 049 995	1 055 243	5 248	8.5%	8.5%	-0.02%
Northern Cape	288 839	281 500	287 904	6 404	2.3%	2.3%	0.01%
North West	824 724	787 470	798 894	11 424	6.5%	6.5%	0.02%
Western Cape	1 174 625	1 048 883	1 074 161	25 278	9.0%	9.0%	0.06%
Total	12 382 521	12 446 287	12 567 026	120 739	100.0%	100.0%	-

Source: National Treasury

Health component (27 per cent)

The health component uses a risk-adjusted capitation index and output data from public hospitals to estimate each province's share of the health component. These methods work together to balance needs (risk-adjusted capitation) and demands (output component).

The health component is presented in three parts below. Table W1.15 shows the shares of the risk-adjusted component, which accounts for 75 per cent of the health component.

Table W1.15 Risk-adjusted sub-component shares

Thousand	Mid-year population estimates	Insured population	Risk-adjusted index	Weighted population	Risk-adjusted shares		Change
	2014	2013			2014	2015	
Eastern Cape	6 787	10.5%	96.9%	5 883	13.1%	13.4%	0.22%
Free State	2 787	17.1%	103.3%	2 385	5.4%	5.4%	0.06%
Gauteng	12 915	29.3%	105.4%	9 626	21.9%	21.9%	-0.05%
KwaZulu-Natal	10 694	13.3%	98.9%	9 170	20.9%	20.8%	-0.03%
Limpopo	5 631	9.0%	91.6%	4 695	10.7%	10.7%	-0.04%
Mpumalanga	4 229	15.6%	95.7%	3 416	7.8%	7.8%	-0.01%
Northern Cape	1 167	20.2%	100.7%	937	2.2%	2.1%	-0.06%
North West	3 676	15.6%	102.2%	3 172	7.3%	7.2%	-0.06%
Western Cape	6 116	25.7%	104.0%	4 728	10.8%	10.7%	-0.03%
Total	54 002			44 013	100.0%	100.0%	-

Source: National Treasury

The risk-adjusted sub-component estimates a weighted population in each province using the risk-adjusted capitation index, which is calculated using data from the Council for Medical Schemes' Risk Equalisation Fund. The percentage of the population with medical aid insurance, based on the 2013 General Household Survey, is deducted from the 2014 mid-year population estimates to estimate the uninsured population per province. The risk-adjusted index, which is an index of each province's health risk profile, is applied to the uninsured population to estimate the weighted population. Each province's share of this weighted population is used to estimate their share of the risk-adjusted sub-component. Table W1.15 shows the change in this sub-component between 2014 and 2015.

The output sub-component is shown in Table W1.16 below.

Table W1.16 Output sub-component shares

	Primary healthcare visits				Hospital workload patient-day equivalents			
	2012/13	2013/14	Average	Share	2012/13	2013/14	Average	Share
Eastern Cape	17 725	17 379	17 552	13.6%	4 523	4 572	4 548	14.1%
Free State	7 488	6 894	7 191	5.6%	1 824	1 736	1 780	5.5%
Gauteng	23 084	23 647	23 366	18.1%	6 611	6 722	6 667	20.7%
KwaZulu-Natal	31 112	31 885	31 498	24.4%	8 112	7 995	8 054	25.0%
Limpopo	14 330	14 256	14 293	11.1%	2 898	2 922	2 910	9.0%
Mpumalanga	9 056	9 143	9 100	7.1%	1 819	1 931	1 875	5.8%
Northern Cape	3 413	3 398	3 406	2.6%	514	526	520	1.6%
North West	7 890	8 047	7 969	6.2%	1 578	1 674	1 626	5.0%
Western Cape	14 859	14 308	14 584	11.3%	4 196	4 283	4 240	13.2%
Total	128 957	128 957	128 957	100.0%	32 075	32 363	32 219	100.0%

Source: National Treasury

The output sub-component uses patient load data from the District Health Information Services. The average number of visits at primary healthcare clinics in 2012/13 and 2013/14 is calculated to estimate each province's share of this part of the output component, which makes up 5 per cent of the health component. For hospitals, each province's share of the total patient-day equivalents from public hospitals in 2012/13 and 2013/14 is used to estimate their share of this part of the output sub-component, making up 20 per cent of the health component. In total, the output component is 25 per cent of the health component.

Table W1.17 shows the updated health component shares for the 2015 MTEF period.

Table W1.17 Health component weighted shares

Weight	Risk-adjusted	Primary healthcare	Hospital component	Weighted shares		Change
	75.0%	5.0%	20.0%	2014	2015	
Eastern Cape	13.4%	13.6%	14.1%	13.4%	13.5%	0.12%
Free State	5.4%	5.6%	5.5%	5.4%	5.4%	0.01%
Gauteng	21.9%	18.1%	20.7%	21.5%	21.4%	-0.07%
KwaZulu-Natal	20.8%	24.4%	25.0%	22.0%	21.8%	-0.14%
Limpopo	10.7%	11.1%	9.0%	10.4%	10.4%	-0.07%
Mpumalanga	7.8%	7.1%	5.8%	7.3%	7.3%	0.03%
Northern Cape	2.1%	2.6%	1.6%	2.1%	2.1%	-0.01%
North West	7.2%	6.2%	5.0%	6.8%	6.7%	-0.03%
Western Cape	10.7%	11.3%	13.2%	11.1%	11.3%	0.15%
Total	100.0%	100.0%	100.0%	100.0%	100.0%	-

Source: National Treasury

Basic component (16 per cent)

The basic component is derived from the proportion of each province's share of the national population. This component constitutes 16 per cent of the total equitable share. For the 2015 MTEF, population data is drawn from the 2014 Mid-Year Population Estimates produced by Statistics South Africa. Table W1.18 shows the impact on the basic component's revised weighted shares.

Table W1.18 Impact of the changes in population on the basic component shares

	Mid-year population estimates	Mid-year population estimates	Population change	% population change	Basic component shares		Change
	2013	2014			2014 MTEF	2015 MTEF	
Eastern Cape	6 620 100	6 786 900	166 800	2.5%	12.5%	12.6%	0.07%
Free State	2 753 200	2 786 800	33 600	1.2%	5.2%	5.2%	-0.04%
Gauteng	12 728 400	12 914 800	186 400	1.5%	24.0%	23.9%	-0.11%
KwaZulu-Natal	10 456 900	10 694 400	237 500	2.3%	19.7%	19.8%	0.07%
Limpopo	5 518 000	5 630 500	112 500	2.0%	10.4%	10.4%	0.01%
Mpumalanga	4 128 000	4 229 300	101 300	2.5%	7.8%	7.8%	0.04%
Northern Cape	1 162 900	1 166 700	3 800	0.3%	2.2%	2.2%	-0.03%
North West	3 597 600	3 676 300	78 700	2.2%	6.8%	6.8%	0.02%
Western Cape	6 016 900	6 116 300	99 400	1.7%	11.4%	11.3%	-0.03%
Total	52 982 000	54 002 000	1 020 000	1.9%	100.0%	100.0%	-

Source: National Treasury

Institutional component (5 per cent)

The institutional component recognises that some costs associated with running a provincial government and providing services are not directly related to the size of a province's population or the other factors included in other components. It is therefore distributed equally between provinces, constituting 5 per cent of the total equitable share, of which each province receives 11.1 per cent. This component benefits provinces with smaller populations, especially the Northern Cape, the Free State and the North West, because the allocation per person for these provinces is much higher in this component.

Poverty component (3 per cent)

The poverty component introduces a redistributive element to the formula and is assigned a weight of 3 per cent. The poor population includes people who fall in the lowest 40 per cent of household incomes in the 2010/11 Income and Expenditure Survey. The estimated size of the poor population in each province is

calculated by multiplying the proportion in that province that fall into the poorest 40 per cent of South African households by the province's population figure from the 2014 Mid-Year Population Estimates. Table W1.19 shows the proportion of the poor in each province from the Income and Expenditure Survey, the 2014 Mid-Year Population Estimates and the weighted share of the poverty component per province.

Table W1.19 Comparison of current and new poverty component weighted shares

Thousand	Income and Expenditure Survey 2010/11	Current (2014 MTEF)			New (2015 MTEF)			Difference in weighted shares
		Mid-year population estimates 2013	Poor population	Weighted shares	Mid-year population estimates 2014	Poor population	Weighted shares	
Eastern Cape	52.0%	6 620	3 445	16.1%	6 787	3 531	16.2%	0.08%
Free State	41.4%	2 753	1 140	5.3%	2 787	1 154	5.3%	-0.04%
Gauteng	28.9%	12 728	3 675	17.2%	12 915	3 728	17.1%	-0.09%
KwaZulu-Natal	45.3%	10 457	4 738	22.2%	10 694	4 845	22.2%	0.06%
Limpopo	52.9%	5 518	2 917	13.6%	5 631	2 976	13.6%	0.00%
Mpumalanga	47.3%	4 128	1 951	9.1%	4 229	1 998	9.2%	0.04%
Northern Cape	40.8%	1 163	474	2.2%	1 167	476	2.2%	-0.04%
North West	47.9%	3 598	1 723	8.1%	3 676	1 761	8.1%	0.01%
Western Cape	21.9%	6 017	1 316	6.2%	6 116	1 337	6.1%	-0.02%
Total		52 982	21 377	100.0%	54 002	21 807	100.0%	-

Source: National Treasury

Economic activity component (1 per cent)

The economic activity component is a proxy for provincial tax capacity and expenditure assignments. Given that these assignments are a relatively small proportion of provincial budgets, the component is assigned a weight of 1 per cent. For the 2015 MTEF, 2013 GDP-R data is used. Table W1.20 shows the weighted shares of the economic activity component.

Table W1.20 Current and new economic activity component weighted shares

	Current (2014 MTEF)		New (2015 MTEF)		Difference in weighted shares
	GDP-R, 2011 (R million)	Weighted shares	GDP-R, 2012 (R million)	Weighted shares	
Eastern Cape	219 170	7.5%	234 536	7.5%	-0.04%
Free State	153 284	5.3%	162 601	5.2%	-0.07%
Gauteng	1 005 795	34.5%	1 089 535	34.7%	0.24%
KwaZulu-Natal	458 841	15.7%	496 431	15.8%	0.09%
Limpopo	207 308	7.1%	223 090	7.1%	0.00%
Mpumalanga	205 600	7.0%	222 149	7.1%	0.03%
Northern Cape	65 259	2.2%	70 203	2.2%	-0.00%
North West	189 047	6.5%	201 736	6.4%	-0.05%
Western Cape	413 235	14.2%	438 700	14.0%	-0.19%
Total	2 917 539	100.0%	3 138 981	100.0%	-

Source: National Treasury

Local government equitable share

In terms of section 227 of the Constitution, local government is entitled to an equitable share of nationally raised revenue to enable it to provide basic services and perform its allocated functions. The local government equitable share is an unconditional transfer that supplements the revenue that municipalities can raise themselves (including property rates and service charges). The equitable share provides funding for municipalities to deliver free basic services to poor households and subsidises the cost of

administration and other core services for those municipalities that have the least potential to cover these costs from their own revenues.

Over the 2015 MTEF period, the local government equitable share, including the *RSC/JSB levies replacement grant* and *special support for councillor remuneration and ward committees*, amounts to R158.6 billion – R50.2 billion in 2015/16, R52.9 billion in 2016/17, and R55.5 billion in 2017/18.

Formula for allocating the local government equitable share

The share of national revenue allocated to local government through the equitable share is determined in the national budget process and endorsed by Cabinet (the vertical division). Local government's equitable share is divided among the country's 278 municipalities using a formula (the horizontal division) to ensure objectivity.

A new formula for the local government equitable share was introduced in 2013/14, following a review of the previous formula by the National Treasury, the Department of Cooperative Governance and SALGA, in partnership with the FFC and Statistics South Africa. The new formula is based on data from the 2011 Census, which resulted in major changes to some allocations. As a result, new allocations are being phased in over a five-year period, ending in 2017/18. The local government equitable share formula's principles and objectives were set out in detail in the Explanatory Memorandum to the 2013 Division of Revenue.

Structure of the local government equitable share formula

The formula uses demographics and other data to determine each municipality's share of the local government equitable share. It has three parts, made up of five components:

- The first part of the formula consists of the *basic services* component, which provides for the cost of free basic services for poor households.
- The second part enables municipalities with limited resources to afford basic administrative and governance capacity, and perform core municipal functions. It does this through three components:
 - The *institutional component* provides a subsidy for basic municipal administrative costs.
 - The *community services component* provides funds for other core municipal services not included under basic services.
 - The *revenue adjustment factor* ensures that funds from this part of the formula are only provided to municipalities with limited potential to raise their own revenue. Municipalities that are least able to fund these costs from their own revenues should receive the most funding.
- The third part of the formula provides predictability and stability through the *correction and stabilisation factor*, which ensures that all of the formula's guarantees can be met.

Each of these components is described in detail in the subsections that follow. The formula's structure is summarised in the box.

Structure of the local government equitable share formula

$$LGES = BS + (I + CS) \times RA \pm C$$

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

The basic services component

This component helps municipalities provide free basic water, sanitation, electricity and refuse removal services to households that fall below an affordability threshold. Following municipal consultation, the formula's affordability measure (used to determine how many households need free basic services) is based on the level of two state old age pensions. When the 2011 Census was conducted, the state old age pension was worth R1 140 per month, which means that two old age pensions were worth R2 280 per month. A monthly household income of R2 300 per month (in 2011) has therefore been used to define the formula's affordability threshold. Statistics South Africa has calculated that 59 per cent of all households in South Africa fall below this income threshold. The threshold is not an official poverty line or a required level to be used by municipalities in their own indigence policies – if municipalities choose to provide fewer households with free basic services than they are funded for through the local government equitable share, then their budget documentation should clearly set out why they have made this choice and how they have consulted with their community during the budget process.

The number of households per municipality, and the number below the poverty threshold, is updated annually based on the growth experienced in the period between the 2001 and 2011 Censuses. Provincial growth rates are then rebalanced to match the average annual provincial growth reported between 2002 and 2013 in the annual General Household Survey. Statistics South Africa has advised the National Treasury that, in the absence of official municipal household estimates, this is a credible method of estimating the household numbers per municipality needed for the formula. Statistics South Africa is researching methods for producing municipal-level data estimates, which may be used to inform equitable share allocations in future.

The basic services component provides a subsidy of R313.76 per month in 2015/16 for the cost of providing basic services to each of these households. The subsidy includes funding for the provision of free basic water (6 kilolitres per poor household per month), energy (50 kilowatt-hours per month) and sanitation and refuse (based on service levels defined by national policy). The monthly amount provided for each service is detailed in Table W1.27 and includes an allocation of 10 per cent for service maintenance costs.

Table W1.27 Amounts per basic service allocated through the local government equitable share

	Allocation per household below affordability threshold (Rands per month)			Total allocation per service (R millions)
	Operations	Maintenance	Total	
Energy	59.57	6.62	66.19	7 122
Water	89.77	9.97	99.75	10 732
Sanitation	72.37	8.04	80.41	8 651
Refuse	60.67	6.74	67.41	7 252
Total basic services	282.38	31.38	313.76	33 757

Source: National Treasury

The formula uses the fairest estimates of the average costs of providing each service that could be derived from available information. More details of how the costs were estimated can be found in the discussion paper on the proposed structure of the new local government equitable share formula (available at: http://mfma.treasury.gov.za/Media_Releases/LGESDiscussions/Pages/default.aspx).

The per household allocation for each of the basic services in Table W1.27 is updated annually based on the following:

- The electricity cost estimate is made up of bulk and other costs. Bulk costs are updated based on the multi-year price determination approved by the National Energy Regulator of South Africa (NERSA). In October 2014, NERSA granted Eskom a 12.69 per cent increase in electricity prices in 2015/16, which has been factored into the equitable share's cost estimate. Bulk electricity prices for 2016/17 and 2017/18 are based on NERSA's approved multi-year price determination increase of 8 per cent per

year. If NERSA approves further increases, the revised amounts will be taken into account in future formula updates. Other electricity costs are updated based on the National Treasury's inflation projections in the 2014 *Medium Term Budget Policy Statement*.

- The water cost estimate is also made up of bulk and other costs. Bulk costs are updated based on the weighted average increase in bulk tariffs charged by water boards (although not all municipalities purchase bulk water from water boards, their price increases serve as a proxy for the cost increases for all municipalities). The approved weighted average tariff increase for bulk water from water boards in 2014/15 was 8.3 per cent. Other costs are updated based on the National Treasury's inflation projections in the 2014 *Medium Term Budget Policy Statement*.
- The costs for sanitation and refuse are updated based on the National Treasury's inflation projections in the 2014 *Medium Term Budget Policy Statement*.

The basic services component allocation to each municipality is calculated by multiplying the monthly subsidy per household by the updated number of households below the affordability threshold in each municipal area.

The basic services component

$$BS = \text{basic services subsidy} \times \text{number of poor households}$$

Funding for each basic service is allocated to the municipality (metro, district or local) that is authorised to provide that service. If another municipality provides a service on behalf of the authorised municipality, it must transfer funds to the provider in terms of section 29 of the Division of Revenue Act. The basic services component is worth R33.8 billion in 2015/16 and accounts for 74.9 per cent of the value of the local government equitable share.

The institutional component

To provide basic services to households, municipalities need to be able to run a basic administration. Most municipalities should be able to fund the majority of their administration costs with their own revenue. But, because poor households are not able to contribute in full, the equitable share includes an institutional support component to help meet some of these costs. To ensure that this component supports municipalities with limited own-revenue-raising abilities, a revenue adjustment factor is applied so that a larger proportion of the allocation is received by municipalities with less potential to raise their own revenue. The revenue adjustment factor is described in more detail later in this annexure.

This component consists of a base allocation of R5.6 million, which goes to every municipality, and an additional amount that is based on the number of council seats in each municipality. This reflects the relative size of a municipality's administration and is not intended to fund the costs of councillors only (the number of seats recognised for the formula is determined by the Minister of Cooperative Governance and Traditional Affairs). The base component acknowledges that there are some fixed costs that all municipalities face.

The institutional component

$$I = \text{base allocation} + [\text{allocation per councillor} \times \text{number of council seats}]$$

The institutional component accounts for 10 per cent of the equitable share formula and is worth R4.5 billion in 2015/16. This component is also complemented by special support for councillor remuneration in poor municipalities, which is not part of the equitable share formula (described in more detail later).

The community services component

This component funds services that benefit communities rather than individual households (which are provided for in the basic services component). It includes funding for municipal health services, fire services, municipal roads, cemeteries, planning, storm water management, street lighting and parks. To ensure this component assists municipalities with limited own-revenue-raising abilities, a revenue adjustment factor is applied so that these municipalities receive a larger proportion of the allocation.

The allocation for this component is split between district and local municipalities, because both provide community services. In 2015/16, the allocation to district and metropolitan municipalities for municipal health and related services is R7.81 per household per month. The component's remaining funds are allocated to local and metropolitan municipalities based on the number of households in each municipality.

The community services component

$$CS = [\text{municipal health and related services allocation} \times \text{number of households}] + [\text{other services allocation} \times \text{number of households}]$$

The community services component accounts for 15 per cent of the equitable share formula and is worth R6.8 billion in 2015/16.

The revenue adjustment factor

The Constitution gives local government substantial own-revenue-raising powers (particularly through property rates and surcharges on services). Municipalities are expected to fund most of their own administrative costs and cross-subsidise some services for indigent residents. Given the varied levels of poverty across South Africa, the formula does not expect all municipalities to be able to generate similar amounts of own revenue. A revenue adjustment factor is applied to the institutional and community services components of the formula to ensure that these funds assist municipalities that are least likely to be able to fund these functions from their own revenues.

To account for the varying fiscal capacities of municipalities, this component is based on a per capita index using the following factors from the 2011 Census:

- Total income of all individuals/households in a municipality (as a measure of economic activity and earning)
- Reported property values
- Number of households on traditional land
- Unemployment rate
- Proportion of poor households as a percentage of the total number of households in the municipality.

Based on this index, municipalities were ranked according to their per capita revenue-raising potential. The top 10 per cent of municipalities have a revenue adjustment factor of zero, which means that they do not receive an allocation from the institutional and community services components. The 25 per cent of municipalities with the lowest scores have a revenue adjustment factor of 100 per cent, which means that they receive their full allocation from the institutional and community services components. Municipalities between the bottom 25 per cent and top 10 per cent have a revenue adjustment factor applied on a sliding scale, so that those with higher per capita revenue-raising potential receive a lower revenue adjustment factor and those with less potential receive a larger revenue adjustment factor.

The revenue adjustment factor is not based on the actual revenues municipalities collect. This component therefore does not create any perverse incentive for municipalities to under-collect potential own revenues to receive a higher equitable share.

Because district municipalities do not collect own revenues from property rates, the revenue adjustment factor applied to these municipalities is based on the *RSC/JSB levies replacement grant* allocations. This

grant replaces a source of own revenue previously collected by district municipalities and it is still treated as an own-revenue source in many respects. Similar to the revenue adjustment factor for local and metropolitan municipalities, the factor applied to district municipalities is based on their per capita *RSC/JSB levies replacement grant* allocations. District municipalities are given revenue adjustment factors on a sliding scale – those with a higher per capita *RSC/JSB levies replacement grant* allocation receive a lower revenue adjustment factor, while those with lower allocations receive a larger revenue adjustment factor.

Correction and stabilisation factor

Providing municipalities with predictable and stable equitable allocations is one of the principles of the equitable share formula. Indicative allocations are published for the second and third years of the MTEF period to ensure predictability. To provide stability for municipal planning, while giving national government flexibility to account for overall budget constraints and amend the formula, municipalities are guaranteed to receive at least 90 per cent of the indicative allocation for the middle year of the MTEF period.

A new equitable share formula was introduced in 2013/14 using updated 2011 Census data. As a result, some municipalities will experience large changes in their equitable share allocations. To smooth the impact of these changes and give municipalities time to adjust (both for municipalities with increasing and decreasing allocations), the new allocations are being phased in over five years, from 2013/14 to 2017/18. For municipalities with smaller allocations under the new formula, the phase-in mechanism measures the difference between the municipality's old and new allocations and closes this gap by 20 per cent each year. This means that in the first year a municipality only experienced a change equivalent to 20 per cent of the gap between their allocations under the old and new formulas, in the second year they completed 40 per cent of the change, in the third year (2015/16) they will complete 60 per cent, in 2016/17 they will complete 80 per cent, and in 2017/18 – the final year of the 2015 MTEF period – their allocation will be determined entirely through the new formula.

To provide for this phase-in approach, while staying within the limits of the equitable share, municipalities with larger allocations will also have their increases phased in over five years. The total top-up amount needed to fund the phasing in for municipalities with declining allocations is calculated and deducted from those that do not require a top-up in proportion to their "surplus". This means that municipalities with larger allocations will have some of those gains delayed over the phase-in period.

Ensuring the formula balances

The formula is structured so that all of the available funds are allocated. The basic services component is determined by the number of poor households per municipality and the estimated cost of free basic services, so it cannot be manipulated. This means that the balancing of the formula to the available resources must take place in the second part of the formula, which includes the institutional and community services components. The formula automatically determines the value of the allocation per council seat in the institutional component and the allocation per household for other services in the community services component to ensure that it balances. Significant increases in the cost of basic service provision – due to escalating bulk electricity prices for example – is fully funded by the formula, but this will result in slower growth in the institutional and community services allocations.

Potential future refinements to the formula

Although the local government equitable share formula has been through extensive consultations and technical work, national government continues to work with stakeholders to improve the formula. Areas of work include:

- Exploring the introduction of factors to account for costs related to the size of the land area served and settlement types in municipalities.

- Developing differentiated costing variables to take account of the different costs of services in various circumstances. SALGA and the FFC have completed the first phase of a project that could provide the basis for calculating such variables in future. This work will continue in 2015/16.
- Exploring the creation of separate sub-components for fire services and municipal health services within the community services component. This would enhance transparency in allocations, although funds for the fire services function would need to be allocated to the municipality (district or local) authorised for this function within a specific area. The process can only be completed after the National Disaster Management Centre has completed its consideration of policy and legislative changes for fire services.

Government is committed to considering all proposed refinements to the formula, but another full review is not envisaged until the current formula has been fully phased in and municipalities have had time to adjust to the new allocations.

Details of new allocations

In addition to the three-year formula allocations published in the Division of Revenue Bill, a copy of the formula, including the data used for each municipality and each component, is published online (http://mfma.treasury.gov.za/Media_Releases/LGESDiscussions/Pages/default.aspx).