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LOCAL GOVERNMENT EQUITABLE SHARE FORMULA REVIEW

Overview of the review process

The local government equitable share (LGES) formula is being reviewed during 2012, with the aim of introducing a revised formula for use in the 2013 Budget. The review process is being undertaken by a working group comprised of representatives of the National Treasury, the Department of Cooperative Governance and the South African Local Government Association and in partnership with the Financial and Fiscal Commission and Statistics South Africa. The process to review the formula is intended to include as much input from stakeholders as possible to enrich the review with the ideas and insight from municipalities as well as other interested parties. The two discussion papers being circulated with this covering note are part of the first stage in the review process. During this stage of the review stakeholders will be consulted on their views on the current LGES formula as well as what the principles and objectives of the revised LGES formula should be. Based on the outcomes of this consultation process, the LGES formula review working group will compile proposals for a revised formula structure and these will be circulated for consultation by the end of August 2012. These proposals will then be revised based on inputs received, and a set of proposals will be presented to the Budget Forum in October 2012.

Context

The LGES formula review forms part of the review of the local government functional and fiscal framework (LGFFF) being undertaken jointly by the Department of Cooperative Governance and the National Treasury. The LGFFF review has a much broader scope to review the different aspects of the functional and fiscal arrangements of the local government system. Many of the issues not dealt with in this review (due to its limited scope of only examining the LGES formula) will be addressed as part of the broader LGFFF review.

Scope of the review

This review has the scope to propose the introduction of a new LGES formula and is not limited to only recommending adjustments to the structure of the current formula. However, the review is subject to the following limitations:

- This is a review of the local government equitable share *formula* used to allocate funds among municipalities and will not examine the vertical division of revenue between the local, provincial and national spheres of government. The vertical division of revenue is decided on as part of the national budget process which takes account of the different priorities for additional expenditure by the three spheres. Examining the total size of local government's share of nationally raised revenue is a separate question that is beyond the scope of this review. Keeping these questions separate is necessary to ensure the formula itself is evaluated thoroughly and that this process does not get diverted by a debate over the size of transfers to local government.

- While the review may result in recommendations to strengthen existing systems and processes, it should not require establishing new national capacity in order to implement the revised formula.

- This review will not include a review of the RSC/JSB levies replacement grant.

- The LGES formula review will work within the existing system of functional assignments of municipalities (e.g. the division of powers and functions between local and district municipalities and between municipalities and provinces).

Overview of proposed principles and objectives for the LGES formula

The attached discussion paper on the principles and objectives of the LGES formula outlines the constitutional requirements for the local government equitable share and the principles and objectives for the equitable share set out in the White Paper on Local Government. The document then examines the principles and objectives that previous iterations of the LGES formula were based on and concludes that while none of them are invalid, some are no longer as relevant or as central to the purpose of the formula as they were when the original LGES formula was introduced in 1998.

The discussion paper then proposes the following set of **principles** for the design of the LGES formula:

The LGES Formula must:
1. Be objective and fair
2. Be dynamic and able to respond to changes
3. Recognise diversity among municipalities
4. Only use high quality, verifiable and credible data
5. Be transparent and simple
6. Provide for predictability and stability

The discussion paper also proposes the following three **objectives** for the revised LGES formula:

1. Enable municipalities to provide basic services to poor households
2. Enable municipalities with limited own resources to afford basic administrative and governance capacity and perform core municipal functions
3. Create incentives that promote efficient service delivery

The discussion paper provides details on what each of the principles and objectives mean and a discussion of the reasons these specific principles and objectives are being proposed.

Overview of the analysis of the current LGES formula

The attached discussion document on the analysis of the current LGES formula is intended to provide stakeholders with an information base to engage with the structure and functioning of the LGES formula. The document outlines the history of the LGES formula, describing the original formula introduced in 1998 and the subsequent changes to that formula and the complications and problems that led to it being reviewed and the subsequent introduction of the current LGES formula in 2005. The way the components of the current formula work are described in detail and the allocations these components determine for different groups of municipalities are described.

An analysis of the LGES allocations over the last decade is provided, showing that the value of the LGES is four times larger in 2012 than it was in 2002 in real terms (i.e. inflation adjusted). The level of allocations to different groups of municipalities is analysed, showing the impact changes to the formula have had on the relative shares of the LGES going to different municipalities. The decision to authorise district municipalities in rural areas for the water and sanitation functions resulted in a shift of LGES funds from rural local to district municipalities in 2003. The updating of population data in 2004 led to an increase in metro allocations as a result of urbanisation. This was followed by a further increase in metro allocations when the new formula was introduced in 2005, but changes to the formula in 2009 and 2011 reduced the growth in metro allocations and resulted in larger allocations to rural municipalities.

Throughout the discussion document questions are highlighted on the appropriateness of the way the current formula is designed and the implications of this for a revised formula (a list of these questions is attached to this overview as annexure A). Stakeholders may want to use these questions as a starting point for making comments towards the LGES formula review process. The discussion paper also provides a summary of the main strengths and weaknesses of the current LGES formula.

Way forward

The LGES formula review is a consultative process and the two discussion documents circulated here are intended to stimulate discussion, debate and proposals from stakeholders. Stakeholders are therefore invited to make written comments on these documents as part of the LGES formula review. All written inputs must be sent to LGESreview@treasury.gov.za by **15 June 2012**. Due to the tight deadlines of the review process no late submissions will be considered.

In addition to the opportunity to provide written comments, groups of municipalities representing all types of municipalities will be invited to participate in focus groups on the LGES formula review. This process will take place in parallel with the opportunity to make written inputs to the review. After considering all of the inputs received, draft proposals on the structure of the revised formula will be circulated for further consultation by the end of August 2012.

Annexure A

QUESTIONS FOR DISCUSSION

Questions stemming from the original LGES formula

1. Was the practice in the original LGES formula that municipalities with sufficient revenue raising ability not receive any funding for institutional costs correct and should it be considered for the new LGES formula?
2. Should services be funded individually through the LGES or should there be a generic allocation for a basket of municipal services?
3. If individual services are to be funded, what services should be included in a revised LGES formula?
4. Is there a difference between the provision of basic services and free basic services that requires separate funding streams as was the case in the original LGES formula?

Basic services

5. Is the measure of poverty used in the basic services component appropriate?
6. Have the ‘basic services’ funded through this component been correctly identified?
7. Should services beyond basic services be funded?
8. How can the accuracy of costing for basic services be improved?
9. Should the same cost assumptions be applied to all municipalities? If not, what are the factors that cause service delivery costs to be higher or lower in different areas?
10. How can changes in the factors that drive basic services allocations (population, poverty, access to services etc.) be taken into account in the formula?

Institutional costs

11. Are the factors used in determining institutional component allocations (size of municipality, poverty and a basic allocation to all municipalities) the ones that determine the need for equitable share funding to cover institutional costs?
12. Is the institutional component the right size?
13. Should municipalities with substantial own revenues have their institutional costs subsidised through the LGES?

Revenue raising capacity

14. Should the new LGES formula include a development component?
15. If so, what objective should a development component aim to achieve?

Development

16. Should the new LGES formula take account of the differing abilities of municipalities to raise their own revenue?
17. If the LGES should account for revenue raising capacity, what is the most appropriate mechanism to use to do this?

Stabilisation

18. Is it important to have a guarantee mechanism in the formula and is the current stabilisation mechanism an appropriate way to structure this mechanism?