EXECUTIVE SUMMARY

Economic Context

Through much of the 1990s until 2007, South Africa witnessed a steady growth of economic activity and increased government revenue, which were instrumental in increasing the volume of financing for sub-national government. The growing government spending did not cause fiscal problems, thanks in part to the thorough overhaul of tax administration and collection in the second half of the 1990s and to sustained positive economic growth from 1994 until 2008. Rapid growth in tax revenues in the late 1990s enabled the government to steadily expand spending while reducing budget deficits and the public debt burden, and thereafter keep them at manageable levels.

The recent global economic and financial crisis has dramatically changed the fiscal situation in the country. The sharp slowdown in economic activity has led to reduced national government tax revenue. Yet government expenditures (boosted by countercyclical outlays and the capitalisation of Eskom, among others) have increased. As a result, the national government's budget balance has deteriorated sharply, from a surplus of 0.9 per cent of gross domestic product (GDP) in 2007/08 to a deficit of 6.9 per cent in 2009/10.[1] Today the economy remains vulnerable to slow global recovery (slowdown in China's economic growth and decreased demand for South African exports by the European Union, South Africa's largest trading partner) and to domestic factors such as the recent labour unrest.

Economic growth (in real terms) decreased from 2.8 per cent in 2010 to 2.5 per cent in 2012. Although the economy is growing and expected to recover slowly in the medium term, economic forecasts fall below the 5.4 per cent growth rate cited by Government as necessary to achieve its job-creation and poverty-reduction goals by 2030. Against this backdrop of slower than anticipated economic growth, a subsequent decline in revenue collection and a widening of the deficit, Government tabled a total national budget of R1.2 trillion, to be spent between the three spheres in 2013, growing to R1.3-trillion in 2015/2016.

Thematic Focus

Five years have passed since the onset of the 2008/09 global crisis. Although some believe that another global economic recession may be coming soon, attention has shifted from talking about the crisis to looking at ways to prevent or manage a recurrence. Despite Government's substantial efforts to reduce poverty and inequality, inequality has risen and poverty has fallen only marginally since 2000. Indeed, South Africa's Gini coefficient[2] currently hovers around 0.70[3], one of the highest in the world, having risen from 0.66 in 1993 . Moreover, child poverty may be on the decline but is still at very high levels – and much higher than poverty among adults and the general population. Disappointment at the increasing inequality amidst positive economic growth, heightened by the 2008/09 global crisis, has led to renewed interest in the relationship between macro (growth) and micro (poverty and distribution) issues. Government economic programmes and policies are emphasising more strongly than before the dual objective of accelerating economic growth and fighting poverty and unequal access to opportunities. Government adopted the National Development Plan (NDP), whose principal objective is to eliminate poverty and reduce inequality by 2030. Given the high poverty incidence and depth for various groups, this Submission seeks to contribute to ongoing efforts to implement the NDP Vision 2030.

[1] Government budget is an itemised accounting of the payments received by government (taxes and other fees) and the payments made by government (purchases and transfer payments). A budget deficit occurs when the government spends more money than it receives.

[2] The Gini coefficient is a number between zero and one that is a measure of income inequality.

[3] National Planning Commission (2011), Diagnostic Review, Presidency, Pretoria.

[4] SALDRU data

The Submission addresses one of the critical issues that deserve urgent attention in South Africa today: the role that the intergovernmental fiscal relations (IGFR) system can play by putting inequality reduction and poverty eradication at the heart of the 2014/15 Division of Revenue. South Africa's national development agenda could in effect be held up by the existing system of decentralised finance. The Commission introduces perspectives on the role of IGFR in helping the country meet its social and economic challenges. The overriding theme of the Submission is

"Fiscal Levers for National Development"

The Submission identifies a set of fiscal levers that can be used to spur economic and social development over the next two decades. All spheres of government are empowered with fiscal levers and play important roles in economic development. As powers are increasingly devolved to the sub-national governments, some central questions remain:

To what extent do the IGFR systems support poverty eradication?
What can public and private interests do about the marginalisation of the poor?
Can innovative investments, scaled-up successful projects and new institutions be designed to ensure inclusion and help manage the negative consequences of disparity and deprivation?

The carefully coordinated role of the different spheres of government will be vital for attaining the NDP objective to eliminate poverty by 2030. However, achieving the NDP goals will not be possible without a greater understanding of the impact on the poor of emerging trends in intergovernmental relations and Government's fiscal policy stance in an increasingly uncertain global economic environment.

In order to illustrate the kind of finance-related issues and problems that may exist at national and sectoral level, Part 1: *National Levers for Inclusive Growth in a Post-Crisis Fiscal Response* examines the issues of fiscal consolidation, social welfare, higher education expenditures and conditional grants proliferation. Chapter 1 looks at growth-friendly fiscal consolidation. In the short to medium term, fiscal consolidation[5] has become unavoidable for South Africa. High budget deficits will add large (and potentially unsustainable) amounts to the public debt, put upward pressure on interest rates and discourage private investment – especially in the context of the large infrastructure investment programmes that various public corporations will be undertaking in the next few years.[6] Furthermore, increased interest payments resulting from a rapidly growing debt burden could crowd out public spending on priority functions.

Economic recovery in South Africa has been slow and exacerbated by the inability of the economy to create jobs, as well as recent labour unrest and credit downgrades. The risk is that longer-term fiscal imperatives could be used as reasons to limit the necessary future growth in social services spending, in particular child-support grants. Chapter 2 tackles this issue and addresses how high poverty levels among children can be resolved, or at least managed in the prevailing fiscally constrained environment. Still on the subject of children, perhaps one of the most important issues facing families today is education. With drastically high unemployment and economic instability, South Africa's school leavers are about to enter a world that is racked with uncertainty and fragility; a world where they will need every opportunity to get ahead. For this, further and higher education is crucial. It gives young people a chance to continue their studies at tertiary level and opens the door to all kinds of jobs and opportunities, gaining the skills and knowledge that many employers want. Therefore, Chapters 3 and 4 focus on further education and training, and research funding in higher education.

[5] According to the European Commission (2007), a definition of successful consolidation should incorporate the following elements:

- A measure of fiscal consolidation (i.e. reduction in public debt, reduction in the (cyclically adjusted) budget balance, reduction in government expenditure and/or an increase in taxes);
- A reference period over which a given size of consolidation is implemented; and
- A criterion discriminating between success and failure.

[6] The public sector is expected to spend a total of R846 billion on infrastructure projects during the fiscal years 2011, 2012 and 2013 (National Treasury, 2010. National Budget 2010. Available online www.treasury.gov.za, page 66).

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Chapter 5 relooks at the challenge of managing the conditional grant system, an issue that the Commission had raised as far back as 2001. The Commission has previously made recommendations on principles for the use of conditional grants (which Government accepted) but is concerned by the continued poor design, planning, monitoring and evaluation of conditional grants, as well as their recent proliferation.

Part 2 of the Submission is on *Provincial Fiscal Levers: State Capability and Performance*. It covers issues pertaining to the fiscal performance of provinces, personnel budgets, transport devolution, and monitoring and evaluation. The Provincial Equitable Share is a key lever to promote economic growth and development. Given the prevailing economic environment, a significant injection of funds is unlikely, and so provinces should focus on strategic interventions that will enhance performance and have multiplier effects on the economy. Chapter 6 develops a new index, which provides early warning signals of fiscal sustainability problems for provinces in South Africa. A major component of government consumption is compensation to employees. Government employment is an important aspect of fiscal policy and a sizable element of the labour market. Given its relevance, it seems plausible that part of the transmission mechanism of fiscal policy occurs through the labour market. The relevance of the level of employment and wages in the public sector is not just because of their weight in the economy or in the government budget, but also because they play an important role over the business cycle. However, spending on current items, such as public sector wages, can put at risk the roll-out of the government's infrastructure programme. Chapter 7 addresses issues of sustainability, productivity and affordability of the public sector wage bill.

Claims of a supposed "economic efficiency dividend", associated with the decentralisation of authority and resources, has in part fuelled the recent trend of devolving the transport function to municipalities. Devolution is supposed to deliver greater economic efficiency by giving administrations autonomous powers to tailor policies to local preferences, to be innovative in providing public services, and to encourage greater participation and accountability. However, little is known about how to devolve such functions optimally to ensure that the growth dividend is reaped. Chapter 8 investigates feasible options for improving transport service delivery through devolving transport functions to municipalities. Chapter 9 addresses a number of trends and developments in public sector governance and discusses implications for efforts to strengthen South African intergovernmental planning and budgeting for better outcomes. The major deficiency identified is the dual responsibility of national government and provinces for concurrent functions, which creates multiple points at which executive and legislative decisions can be taken over the same mandate. The chapter argues that introduction of an outcomes-oriented M&E in a decentralised government system requires numerous practical considerations relating to rules, leadership, accountability and design. A clear accountability framework for outcomes between administrators and politicians needs to be developed aligned to existing country-specific circumstances.

Part 3 of the Submission brings in the local sphere and is entitled *Local Government Fiscal Levers: Collaborative Governance for Effective and Sustainable Municipalities*. Similar to Chapter 6 that addresses the issue of fiscal stress at provincial level, Chapter 10 seeks to identify indicators of fiscal stress at municipal level. Chapter 11 shifts the focus to evaluating the case for introducing incentives in the transfer system, as an additional measure to enhance the performance of the local government sector. Chapter 12 assesses whether municipalities spend adequately on municipal infrastructure asset-care activities, in particular water and electricity distribution and reticulation-related infrastructure. It proposes some incentives that Government can employ to encourage greater investment in maintaining and renewing municipal infrastructure. Chapter 13 unpacks the dynamics of the general tax base of rural municipalities. Contrary to anecdotal evidence, the driving factor of poor revenue effort in rural municipalities is not capacity constraints and confusion over land tenure in traditional land. Hindering revenue effort in these areas are social dynamics associated with income inequality. The chapter suggests methods and strategies by which rural municipalities can stimulate their local tax bases.

Recommendations

Overall, this year's Submission indicates some potentially potent fiscal levers for national economic development. Based on the above, the Commission makes the recommendations summarised below.

Table 1. Recommendations for 2014/15 Division of Revenue

Directly related	Indirectly related	Unrelated
With respect to fiscal consolidation, the Commission recommends that:		
› Government continues its efforts to moderate the growth in expenditure components such as the public sector wage bill (which constitutes some 60% of government expenditure), as decreases in government expenditure increase the probability of a successful fiscal consolidation in South Africa. More effort must be made to improve the effectiveness of public finances, through greater and more rigorous oversight to ensure the elimination of fruitless, wasteful, and unauthorised expenditure, and corrupt practices in managing public finances. › Government explicitly considers economic growth as an important factor for fiscal consolidation in South Africa. The most obvious manner in which South Africa could improve its fiscal situation is if the economy grew faster. This would help generate higher growth in tax revenue and thus budget deficits could decline a lot faster, and public debt would begin to reduce accordingly.		
With respect to the social protection sector in terms of social and economic value, the Commission recommends that:		
› Government makes more resources available through the transfer system to enable progressive realisation of an ideal child-support system. An ideal child-support system is a system that relaxes the existing means test and moves towards faster universalisation of the Child Support Grant (CSG). This should happen even under fiscal consolidation because of the social and economic benefits.	› Government puts in place a system to ensure coverage is extended to children currently excluded from accessing the CSG for administrative reasons. › Government moves faster towards consolidating the various social protection instruments (CSG, Foster Child Grant, UIF, social wage, etc.), as part of the longstanding reform of the social security system because of the significant effects on reducing child poverty. › National Treasury provides advice to departments and agencies working with children on developing major cross-portfolio initiatives aimed at eliminating child poverty. To date, a range of child poverty measures have been accommodated and scattered across many agencies, but these should be nested within a new unified outcomes framework of related agencies because of synergies with related programmes.	

Table 1. Recommendations for 2014/15 Division of Revenue

Directly related	Indirectly related	Unrelated
With respect to funding further education training colleges, the Commission recommends that:		
› The funding model for the FET sector after the function shift ensures that: • Baseline funding does not perpetuate past underfunding of the function in certain provinces • Additional allocations are used to achieve a more equitable funding regime across the provinces. • Ongoing infrastructure development and maintenance are provided for. › The transfer of the FET function to the Department of Higher Education and Training (DHET) should include the development of sound systems and uniform templates for financial reporting, designed in a manner that ensures the DHET can proactively monitor the financial health of FET colleges. This should be complemented by holistic interventions to improve fiscal governance in FET colleges including recruitment of appropriate skills, ongoing training, and credible financial systems and processes		
With respect to financing research in higher education, the Commission recommends a review of the current funding framework for higher education and that the DHET:		
		› Redesigns and allocates specific funds in the MTEF budget to the research development plan. › Reassesses the appropriateness of targets and, if necessary, adopts different targets for each university/university of technology. › Revises the formula used to calculate research outputs to take into consideration the profile (rank and qualification) of academic staff at the universities.
With respect to conditional grants, the Commission recommends that:		
› The section in the Division of Revenue Act dealing with preparation for the next financial year is reviewed to make consultation with the Commission mandatory when planning for conditional grants for the forthcoming year. This would assist departments with grant design, especially in the case of new grants, phased-out grants, and material redesign of existing grants. › The efficacy of conditional grants is reviewed, specifically in relation to the necessity and purpose of some of the grants, criteria for allocations, targeting, reporting on non-financial data, performance, and value for money. › National Treasury builds the capacity of transferring national departments for effective grant design, monitoring and evaluation to ensure that guidelines are adhered to.		

Table 1. Recommendations for 2014/15 Division of Revenue

Directly related	Indirectly related	Unrelated
With respect to improving provincial fiscal performance, the Commission recommends that:		
	› National and provincial treasuries put in place an agreed-upon measurement and assessment framework for fiscal performance against which provinces are evaluated. The assessment framework must: • Take into account various factors that capture fiscal performance holistically, including services burden, expenditure efficiency, funding and delivery norms; • Incorporate information from internal audit reports and serve as an early warning system to complement section 32 reports and National Treasury benchmarking exercises; • Provide for monitoring and disclosure of key fiscal performance indicators of provincial departments, particularly when deviation (as defined by the PFMA) from a healthy fiscal trajectory is prolonged; • Provide for monitoring of expenditure benchmarks against which key provincial expenditure items are regularly evaluated and reported by provincial Accounting Officers. › Government considers reducing or replacing the maximum allowed threshold for over and under-expenditure with relative inflation-adjusted figures, to avoid "budget creeping" – a situation where the budget's annual rate of growth makes large amounts of over and under-expenditure acceptable because they are below threshold. › National and provincial Accounting Officers rigorously enforce section 86 of the PFMA, which provides for the initiation of criminal and disciplinary proceedings for persistent contravention, especially for wasteful and unauthorised expenditure. Where individuals are found guilty, consistent sanctions should be applied commensurate with the seriousness of the offence. › Provincial treasuries must carry out mandatory expenditure reviews (overseen by National Treasury and the Department of Performance Monitoring and Evaluation in the Presidency) after every Medium Term Expenditure Framework (MTEF) cycle, specifically focusing on composition, efficiency, economy and effectiveness of expenditure, as well as access to services and realignment of spending with programme objectives and delivery targets.	

Table 1. Recommendations for 2014/15 Division of Revenue

Directly related	Indirectly related	Unrelated
With respect to the provincial public sector wage bill, the Commission recommends that:		
› A transition over the medium to long term is required, towards a more appropriate balance between the wage and non-wage components of provincial budgets for social spending (starting with education and health). This should be in the form of national sector departments setting a norm or ratio of frontline versus administrative staff to total expenditure per sector and/or by specific occupational categories, and developing accurate and up-to-date management information systems to monitor employee compensation expenditure against those norms	› When human resources functions have been delegated to them, accounting officers are required to adhere to agreed staff establishment norms when filling posts. This requirement must be enforced through existing regulations and performance agreements. Furthermore, each accounting officer must be held accountable for establishing effective personnel spending controls, ensuring up-to-date and credible personnel information to act as an early warning, and for taking prompt corrective action when necessary. › The capability of human resource functions within provincial line departments – to cost and budget for staff establishments, establish the necessary control systems, respond to Auditor-General queries, and manage financial and non-financial information – is enhanced. Provincial treasuries and Offices of the Premier should enhance their capacity to monitor, support and supervise management of employee compensation. › Methods to improve productivity of health and education sectors are considered, such as computerisation of certain processes, reorganising and streamlining workflow, and organisational design. The non-wage components of provincial budgets should include adequate provision for health technologies and technologies for e-education (ICT) and supporting organisational innovations in order to enhance productivity in the social sector.	
With respect to the devolution of public transport function, the Commission recommends that:		
	› The national Department of Transport (DoT) selects the eThekwini and Cape Town metropolitan municipalities to pilot the devolution of transport functions in the form recommended by the investigation. The DoT should reach the necessary agreements with all the concerned stakeholders to provide sufficient support and required resources to allow for the pilots to be successfully implemented. › The baseline funding for transport functions is thoroughly understood by the recipient municipalities, beginning with eThekwini and Cape Town metropolitan municipalities.	

Table 1. Recommendations for 2014/15 Division of Revenue

Directly related	Indirectly related	Unrelated
With respect to effective intergovernmental planning and budgeting for better outcomes, the Commission recommends that:		
	› National Treasury and the Department of Performance Monitoring and Evaluation (DPME) introduce budget process reforms necessary for reconciling the collective responsibility for delivery agreement outcomes and the individual department-focused budget-bidding process by: • Realigning the budget process along service delivery agreements such that MTEC hearings are conducted at an outcome level, where applicable, rather than the current sectoral, individual institutional approach. • Directly linking resource allocation to realistic, measurable and few performance targets per outcome. Programme expenditure reviews must be undertaken at the end of each targeting period › In order to incentivise collaboration, Government consolidates and reorients existing conditional grant incentives to reward successful achievement of delivery targets/ outcomes rather than specific, individual, department-specific programme objectives. › Delivery partners, who are party to service delivery agreements, are evaluated on the basis of their contributions and participation in implementing delivery agreements, where aspects such as required budgetary contributions, and meeting agreed-to targets and timelines are constantly monitored. › Service delivery agreements are fully compliant with the requirements of the M&E guideline document before being accepted or signed into a binding document.	
With respect to detecting and managing fiscal distress within local government, the Commission recommends that:		
	› Government develops and institutionalises an early warning system, which would identify municipalities that are heading towards fiscal distress. › Government uses the early warning system as a tool to monitor and assist municipalities heading towards fiscal distress and those already in fiscal distress.	

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Table 1. Recommendations for 2014/15 Division of Revenue

Directly related	Indirectly related	Unrelated
With respect to the impending review the Local Government conditional grants, the Commission recommends that:		
	› Performance-based grants are based on principles and guidelines. The following principles should guide the design of performance-based grants; • Incentives should have sufficient monetary value to motivate desired behaviours by municipalities. • Incentive and performance indicators should be periodically revised and renegotiated between national government and municipalities. • Performance measures should capture performance unambiguously and be within the control and influence of the municipalities. • Performance incentives and associated performance measures should be evaluated at regular and scheduled intervals, and allow time for learning from each cycle. • Incentives should be achievable and evaluated within the specified timeframe. • The transferring officials and the municipality should be sufficiently capacitated to understand the purpose and impact of incentives. • Incentives should be tailor-made to suit specific situations. › The National Treasury and Department of Cooperative Government (CoGTA) ensure that there is sufficient awareness on the nature of performance-based grants, the value of incentives, relevant indicators, assessment criteria and potential benefits thereof, and how potential implementation risks could be managed.	
With respect to maintaining and rehabilitating water and electricity distribution infrastructure, the Commission recommends that:		
	› National Treasury, in collaboration with relevant stakeholders such as CoGTA and the South African Local Government Association (SALGA) develops local government-specific infrastructure asset management legislation, similar to the Government Immoveable Asset Management Act at national and provincial level. The proposed legislation should: • Cover decision-making, planning and control over the acquisition, use, safeguarding, and disposal of local government assets, to maximise their service delivery potential and benefits and to minimise their related risks and costs over their entire life. • Define asset management practices appropriate to the different categories of municipality, given the nature, extent and complexity of infrastructure, the financial and administrative capacity of the municipality, and other relevant factors.	

Table 1. Recommendations for 2014/15 Division of Revenue

Directly related	Indirectly related	Unrelated
	› National Treasury devises local government infrastructure asset management guidelines. These guidelines should be positioned within the broader system of capacity development and performance oversight. Technical assistance should be provided to municipalities to prepare and implement credible infrastructure asset management plans. › Provincial and national authorities must increase scrutiny of the operating implications of capital funding so as to ensure that municipalities are able to adequately maintain and renew infrastructure.	
With respect to developing rural revenue capacity the Commission recommends that		
	In the short term: › National and provincial governments support weaker rural municipalities to ensure improved revenue and expenditure outcomes. This should be done through: • Improved assistance in formulating and implementing budgets, IDPs, LED, debtor management and credit control policies. • More effective capacity-building initiatives, which deal holistically with governance, systems and business processes, as well as recruitment, retention and the development of requisite skills. › National and provincial governments ensure that grant funding to rural municipalities is linked to capacity-building initiatives and structured assistance, so that systems are built to improve the municipality's ability to collect revenues due and increase the quality of spending. › Municipalities ensure that revenue-enhancement strategies are sensitive to broader constraints, such as inequality, unemployment, local politics and land tenure issues so that revenue effort is maximised **In the long term** › Given the skills and resource shortages in rural areas, municipalities explore greater collaboration with the district municipality, neighbouring local municipalities and provinces to pool resources in order to ensure greater regional planning and investments. Where rural municipalities are adjacent to better performing municipalities, best practice methods should be shared through peer learning arrangements among municipalities.	

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