FINANCIAL AND FISCAL COMMISSION

BRIEFING ON THE SUBMISSION FOR THE 2016/17 DIVISION OF REVENUE

November 2015

For an Equitable Sharing of National Revenue

BACKGROUND TO THE SUBMISSION

- Submission made in terms of:
  - Section 214(1) of the Constitution (1996)
  - Section 9 of the Intergovernmental Fiscal Relations Act (1998)
  - Section 4(4c) of the Money Bills Amendment Procedure and Related Matters Act (Act 9 of 2009)
- Point of departure for 2016/17 Submission
  - Current infrastructure is both inadequate and inefficient to meet National Development Plan (NDP) goals of growth, poverty and inequality
  - There is a pressing need to harness the power of public infrastructure given its importance for national development and regional performance
  - Submission contains analysis showing high returns that can result when resources are transformed into assets that support growth and development

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OUTLINE: SUBMISSION FOR THE DIVISION OF REVENUE 2016/2017

I. Macro-Micro and Fiscal Aspects of Public Investment Management

1. Responding to South Africa Infrastructure Challenges: Macro-Micro Dimensions
2. Economic Growth Effects of Municipal Capital Spending

II. Indirect Grants Proliferation, Design and Accountability in Public Infrastructure Management

3. A Review of Direct and Indirect Conditional Grants – Selected Conditional Grants
4. Accountability in Infrastructure Delivery – Case of Local Government Sphere

III. Improving State Capacity through Education and Productivity Innovations

5. Fiscal Arrangements for Financing Early Childhood Development Infrastructure
6. Public Sector Productivity – The Case of Secondary Education
7. Improving Government Operations Through Information and Communication Technologies

1. RESPONDING TO SOUTH AFRICA'S INFRASTRUCTURE CHALLENGES

- Rapid urbanisation is testing Government's capacity to meet growing demand for services.
  - Government already spends significant amounts of money on public investment, but the outcomes fall short of expectations.
  - Infrastructure is ageing and often badly maintained, while the capacity to implement new infrastructure projects is questionable.
  - Municipalities and SOEs failing to meet service delivery targets or spend budgets.
- Increased infrastructure spending is seen as the solution to unlocking economic growth and reducing poverty and unemployment
  - It is central to NDP and the cornerstone of government's economic policy.
  - Infrastructure investments have large multiplier effects and impact productivity
  - However, although public infrastructure investment can indeed be a powerful lever, certain fiscal and structural challenges are impeding the effectiveness of this lever.
- This chapter outlines and addresses these problems

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Economic and Fiscal Outlook: Implications for Infrastructure

- Over the past five years:
  - Low international interest rates kept borrowing costs down
  - Moderate domestic inflation limited budget cost pressures
  - Rising commodity prices supported government revenues
- Over the period ahead, South Africa confronts a new set of circumstances:
  - Rising global interest rates have pushed up the cost of servicing government debt
  - Weaker commodity prices has contributed to lower tax buoyancy
  - Rand depreciation has led to rising cost pressures
  - Number of scenarios possible dependent on outcomes of electricity forecasts
- Pressures will continue to lead to less money available for infrastructure
  - Real year-on-year infrastructure and allocated spending is forecast to decline
  - This downward trend forecast to continue for at least the next three years
- In light of tight fiscal conditions, urgent need to get infrastructure right, by
  - providing the best value for money
  - prioritising investments that will have the greatest impact on growth, and
  - managing infrastructure projects more efficiently

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KEY FINDINGS

- Research identified following obstacles:
  - Insufficient financial resources (to finance and implement municipal investment plans)
  - Large infrastructure projects require specific skills in engineering, productivity improvements, life cycle asset management and complex procurement management that are lacking
  - Infrastructure projects are multi-year commitments, which are difficult when the budget system has insufficient capacity to spend effectively
- Research found that:
  - Increased capital spending on electricity and water and sanitation can spur growth
  - Extending useful life of infrastructure also benefits long-term economic growth
- What is needed to close the country's "infrastructure gap" is:
  - Good coordination among spheres of government and improved capacities
  - Establishment of the Presidential Infrastructure Coordinating Committee (PICC) is a step in right direction towards an integrated approach to delivery of infrastructure
  - PICC projects should ideally dovetail with infrastructure plans at subnational level
  - Much will depend on the capacities and skills available (or can be developed) at subnational level.

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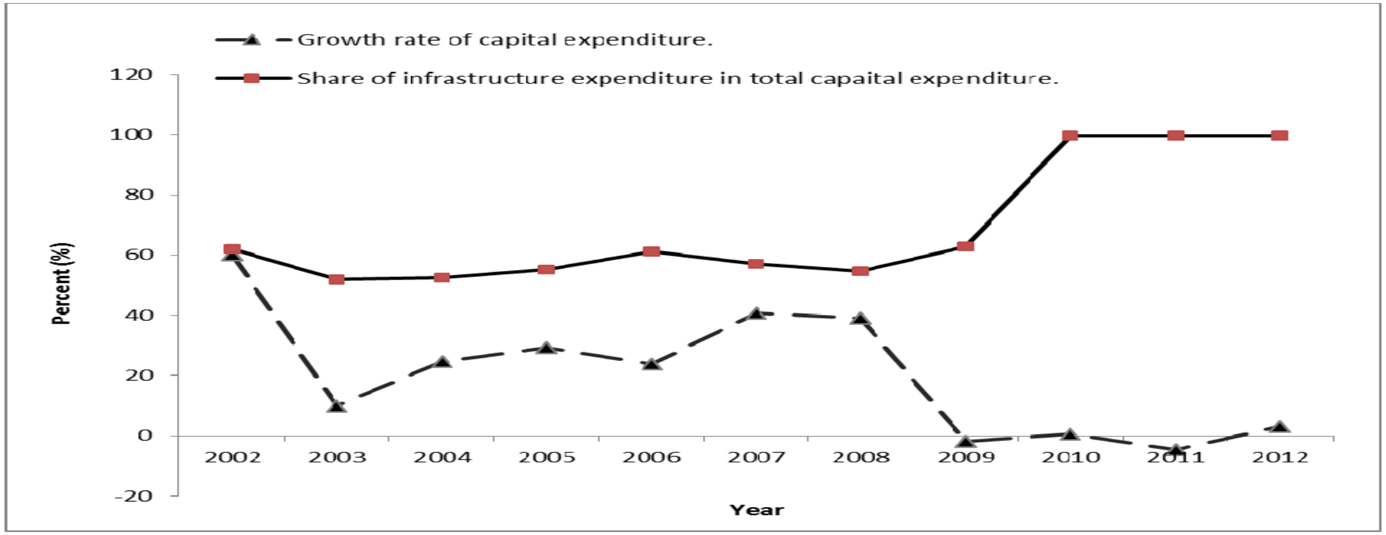
RECOMMENDATIONS

- ***With respect to creating conditions for the future prosperity of all South Africans from infrastructure-led growth, the Commission recommends that Government:***
  - Redesigns capital conditional grants by allowing (a) funds for feasibility and pre-procurement studies, and (b) conditions related to the critical skills required for complex project management (c) grant pledgeability where an authority has a well founded long term capital plan and (d) extending existing incentive support for planning for provinces and municipalities.
  - Develops the National Infrastructure Plan's funding strategy. This has to be done in a sustainable and affordable way.
  - Raise public debt, aggressively using available borrowing space, to help finance deserving and rigorously appraised infrastructure plans (e.g. based on performance and governance profiles) with due regard for prudential benchmarks and ratios
  - Improve acceptability of the user charge principle for higher levels of infrastructure services by (a) using equitable sharing to demonstrate better efforts being made to balance consumer's affordability to pay increased service charges, (b) undertaking transparent and robust WTP, (c) developing costing models for various services
  - Ensures infrastructure procurement planning, contract award and management work in tandem at the highest strategic level with other elements of infrastructure management to raise efficiency

2. Economic Growth Effects of Municipal Capital Spending

- Infrastructure related spending by municipalities a significant component of total local government expenditures, averaging almost 60% since 2006



- In light of service delivery problems facing municipalities, questions remain about effectiveness of capital spending by municipalities
- This chapter examines the growth and productivity effects of mandated municipal capital spending on core socio-economic infrastructure

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KEY FINDINGS

- The specific function that municipal capital is expended on matters for regional/municipal growth
- Capital spending on electricity plus water and sanitation infrastructure contributes positively to municipal economic growth
- Capital outlays on housing and roads infrastructure have a negative effect on growth in municipal gross value added
- Efforts to maintain current infrastructure important as spending dedicated to repairs and maintenance positively impacts on economic growth

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RECOMMENDATIONS

- ***With respect to improving the economic growth effects of municipal capital expenditures, the Commission recommends that***:
  - Grant allocations for infrastructure investment reflect the prioritisation (or weighting) of growth-enhancing infrastructure programmes, to enable municipalities to play their (envisaged critical) role in promoting economic development and growth.
  - Government establishes either an incentive grant or a reserve fund, which can be used to assist or reward municipalities. Funds would be for maintaining and renewing infrastructure, to ensure the long-term sustainability of critical socio-economic infrastructure and enhance local economic growth.
  - Government establishes a transitional capacity-building grant to fund technical assistance for building necessary capacity that will enable municipalities to prepare and implement credible infrastructure asset management plans.

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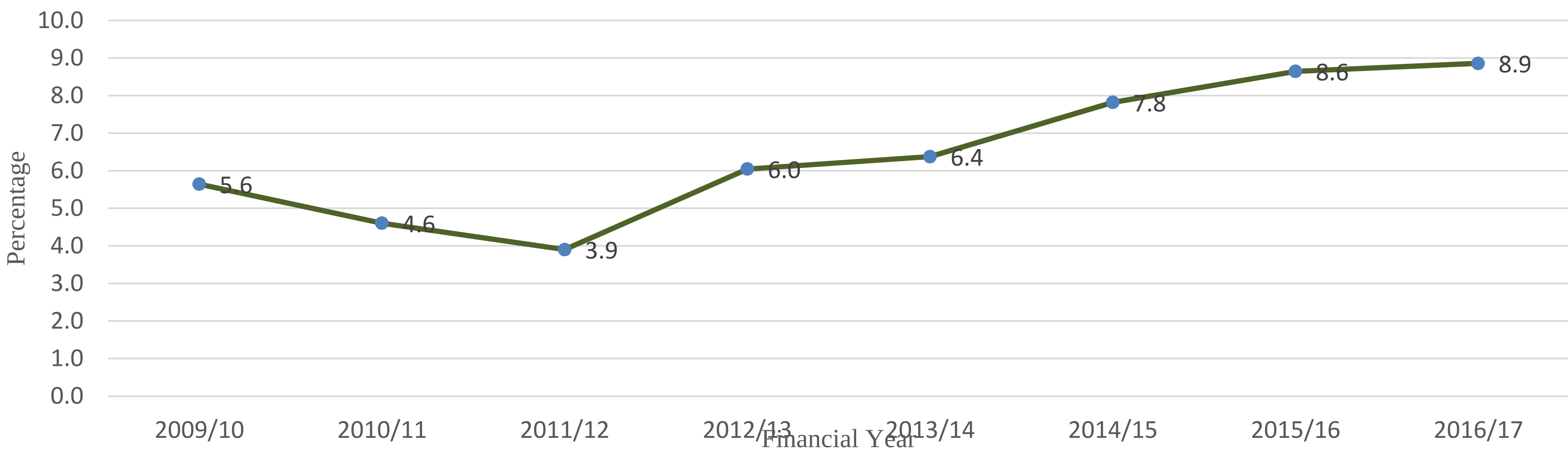
3. Review of Direct and Indirect Grants: Context

- The share of indirect to direct grants is increasing at a phenomenal rate from 3.9% in 2011/12 to 6.4% in 2013/14, and is projected to reach 8.9% in 2016/17



- There has not been any evidence showing that indirect grants perform better than direct grants
- This chapter reviews trends and developments in the use of direct and indirect conditional grants, by assessing the funding and performance of education, health, sanitation and electricity-related conditional grants

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METHODOLOGY

- A quantitative analysis of the performance of grants in the water, energy, education and health sectors have been used
  - Using a direct measure of service delivery approach: This approach takes into account a share of households provided with a service (infrastructure delivered in this case), uses access to a service and a discrepancy between annual service delivery targets and the actual delivery over a period of time as indicators
  - An expenditure approach: entails undertaking expenditure analysis of funds allocated for a function, using underspending as an indicator
- All four chosen sectors have grants comprising of both direct and indirect components, have huge infrastructure backlog and remain part of key infrastructure priority areas for the government

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FINDINGS

- Provinces and municipalities appear better at ensuring grant funding is spent compared to national government

Sector	Category	Financial	Non-financial	Recent developments
Education	Direct	Good	Cannot be directly determined	Average spending was above 100% over three years (2011–2013)
	Indirect	Poor	Poor	Reduced in 2015 MTEF. Poor spending Over three years (2011–2013), spending at 49%
Health	Direct	Good	Non-alignment of targets and delivery	In 2013/14, the direct component was divided into: health infrastructure, hospital revitalisation, and nursing colleges and schools grants Spending was 88% for health infrastructure and 83% for hospital revitalisation
	Indirect	Poor	Non-alignment of targets and delivery	In 2013/14 spending was at 41.5% R167-million was converted into direct grants (KZN & NC) In 2014/15, an allocation of R262-million was shifted to the direct grant

SUMMARY OF FINDINGS [CONT.]

Sector	Category	Financial	Non-financial	Recent developments
Electrification	Direct	Good	Good	Over the period 2006/7–2013/14), spending of the indirect component outperformed the direct component Indirect grants: Most years exceeded its target for households connected Direct grants: averaged over 83%
	Indirect	Good	Good	
Sanitation	Direct	Cannot be determined (2013/14)	Cannot be determined (2013/14)	RHIG was an indirect grant since its inception in 2010/11 and did not perform well until 2013/14 when the direct component was introduced
	Indirect	Poor (improving)	Poor (but improving)	

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RECOMMENDATIONS

- ***With respect to managing direct and indirect conditional grants, the Commission recommends that:***
  - National Treasury and line departments consider the use of indirect grants as a measure of last resort while continuing to build capacity in provinces and municipalities.
  - Clear criteria are developed to guide the scheduling and rescheduling of conditional grants, taking into account:
    - Historical financial performance
    - Non-financial performance
    - Time period before converting a direct grant to an indirect grant. The responsible government sphere should be given sufficient time (at least three years) to administer and implement a direct grant before considering conversion to an indirect grant. Such conversion must be implemented through a differentiated approach
  - Comprehensive capacity-building plans are developed, with clearly determined targets and time-frames, in cases where indirect grants are considered as a result of poor capacity within a province or municipality.

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4. Accountability in Infrastructure Delivery: Case of the Local Government Sphere

- Decentralised delivery of infrastructure recognises the key role of local government as sphere closest to people
- To deliver infrastructure, municipalities rely heavily on indirect and direct conditional grants
- National or provincial departments are responsible for the performance of indirect grants, which are characterised by widespread under-spending
- These grants drive infrastructure provision and are proliferating, but have high levels of under-spending

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CONTEXT

Chapter considers:

- Accountability for conditional grants performance: Where should it lie? With the grant provider or municipality or both?
- Given the levels of under-spending on infrastructure grants, are councils failing to hold the executives accountable?
- If accountability lies with the council, how effective are municipal accountability mechanisms, such as the Municipal Public Accounts Committees (MPAC) and Audit Committees
- Accountability in this context is about giving an account of one's actions, as well as explaining and justifying one's decisions or actions
- **Methodology:** Included both desktop research and fieldwork (i.e. nine municipalities were identified through a stratified random sampling technique)

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KEY FINDINGS

- The proliferation of indirect grants distorts effective accountability within the transfer system
- There is very little accountability between municipalities and their communities due to local government’s heavy reliance on conditional grants and municipalities using little (if any) own revenues for infrastructure funding
- Spending responsibilities on indirect conditional infrastructure grants lie with national departments, and municipalities are not responsible for under-spending on indirect grants
- As indirect grants are not municipal own revenues, municipalities do not always pay attention to their performance

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KEY FINDINGS [CONT.]

- Although national departments responsible for these grants have to account to Parliament, and Parliament in turn accounts to the electorate, this long accountability loop is often ineffective and results in the wrong parties being held responsible for spending inefficiencies
- Majority of municipal accountability committees lack capacity to scrutinise, interpret and analyse information on fiscal and financial matters – information that can be used to hold executives to account
- Despite high value placed on societal accountability for infrastructure delivery, it is limited in many municipalities because of inadequate financial and human resources

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RECOMMENDATIONS

- ***With respect to improving accountability on local government infrastructure delivery, the Commission recommends that:***
  - National Treasury and the Department of Cooperative Governance develop a framework to guide accountability for indirect infrastructure grants. The framework should identify accountability lines, mechanisms, and enforcement, and spell out the consequences for undermining the accountability arrangements.
  - Accountability structures and infrastructure within the local government are strengthened, and incentives are provided within the existing transfer streams for research and technical support. Committees should be provided with adequate technical and research support, and sufficient resources to engage with and account to the communities. Smaller and adjacent municipalities should endeavour to pull together such support to aid the work of accountability committees.
  - That social accountability is institutionalised (established as a convention or norm in the local government sector) and an accountability framework is developed by SALGA, to guide communities on how to hold local governments accountable. This framework should also contain indicators for rating municipality performance on social accountability in general and infrastructure development in particular.

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5. FISCAL ARRANGEMENTS FOR FINANCING ECD INFRASTRUCTURE

- Delivery of ECD facilities is a classical public infrastructure function
- Sector is greatly under-resourced and has long history of underinvestment
  - Many children cared for in unsafe and undercapitalised facilities
- Intergovernmental arrangements for delivery of ECD infrastructure are not always clear
- Chapter evaluates the benefits and funding mechanisms for ECD infrastructure

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METHODOLOGY

- Chapter uses a meta analysis and case study approach
- Meta analysis
  - Used to determine the benefits of ECD infrastructure
- Case study
  - Used to review ECD financing approaches of two provinces and two metropolitan municipalities:
    - Western Cape and KwaZulu-Natal province
    - Cape Town and City of Tshwane

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Key Findings

- Country has no systematic program to finance ECD infrastructure
  - The current subsidy – does not provide for infrastructure although compliance with infrastructure norms and standards is prerequisite for accessing the subsidy.
  - Government – No implied obligation to provide ECD infrastructure
- Fragmented and ad-hoc budget allocations
  - Provincial departments, COGTA, NDA, DLRD and Municipalities
- Contradictory government policy responses
- Several funding approaches available to government to minimise the funding gap

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RECOMMENDATIONS

- ***With respect to fiscal arrangements for financing ECD the Commission recommends that:***
  - Government provides a full or partial capital subsidy for constructing and/or upgrading community-and NPO-based ECD facilities, through the municipal infrastructure conditional grant. The funding will facilitate compliance with the required infrastructure norms and standards, ensure that capital expenditure for ECD is carried out through municipalities and minimise inequities in quality standards and service levels.
  - The Department of Social Development introduces a temporary funding programme from within its allocated budget through which self-identified private ECD facilities in poor areas can apply for capital subsidy assistance, on condition that they agree to meet pre-specified deliverables such as enrolment targets, operational sustainability, educational activities and financial accountability.
  - The national and provincial departments of social development develop an ECD infrastructure sector plan, indicating areas that requires urgent intervention, to inform the allocations and investment in ECD infrastructure by the different government spheres and departments.
  - The provincial departments of social development lobby for the ECD infrastructure plan to be incorporated in municipal IDPs.
  - Government makes available technical intermediary services to ECD facilities that are able to build or upgrade facilities on their own.

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6. Can Public Sector Productivity be Improved? The Case of Secondary Education

- This chapter evaluates the extent to which productivity in secondary education can be improved in order to foster an improved service delivery environment
- With the economy growing slowly and tax revenues under pressure, public service productivity receiving more attention
- Calls for greater accountability from public sectors that consume a large share of government funds, such as education
  - E.g. while real per pupil expenditures have increased over time, evidence suggests educational performance is still unsatisfactory – suggests resources are not being optimally utilized
- Unproductive spending that leads to poor educational outcomes could weaken the successful implementation of the national infrastructure plan

Recommendations

- ***With respect to measures to improve public sector productivity, the Commission recommends that:***
  - A framework on measuring public productivity is developed as a first step to benchmark improvements in the public sector over time.
    - Officials should be trained on the concept of public productivity, and productivity measures should be piloted in certain cluster organisations before rolling them out en masse.
  - The Division of Revenue Act implements the finalised framework on measuring productivity.
    - This may require the implementing agent of a conditional grant to report on the attainment of both quantitative and qualitative indicators of an output, including productivity indicators that track improvements of the service over time.
  - Socio-economic programmes of government which improve living standards and income for households are continued, especially those that lead to improved educational outcomes.
    - Such programmes include the school nutrition programme, no-fee school policy, scholar transport, social security grants and public employment programmes. Research shows higher human capital results in improved labour productivity.
  - Government investigates funding and non-funding mechanisms to improve productivity in public ordinary schools.
    - Such mechanisms should involve enhancing governance and accountability in schools through the appropriate appointment of school principals and enforcing norms and standards that principals must adhere to. Teachers should be supported through training, and the performance management system for teachers should be linked to overall school outcomes. e-Education should be explored as a learning platform to provide both teachers and learners with access to new knowledge.

7. Improving Government Operations through the Use of ICTs

- National Development Plan's (NDP) long-term goal regarding ICT: by 2030 government should be making extensive use of ICT to engage with and provide services to citizens
  - Over the medium term, the NDP commits government to achieving 100% broadband penetration by 2020, with all schools, health facilities and similar social institutions being connected
- Significant resources allocated in respect of ICT across three spheres of government - R17.5 billion spent as at 2011/12
  - Location of spending not taking us in direction of what NDP envisages
  - Spending not happening in coordinated fashion
- Objective of chapter is to identify the factors that hamper investment in ICTs as a lever for improving service delivery
  - Focus is on policy framework underpinning ICT sector
    - Rationale for approach is that what is needed is first an understanding of who is responsible for what before moving on to issues of financing

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FINDINGS

Finding	Explanation
1. Simplification of the policy environment required	Various initiatives underway resulting in areas of overlap and lack of clarity on responsibility
2. Require closer linkages between policy process and implementation	A fully fledge eGovernment approach to service delivery requires broadband. Broadband policy exists but what about fully costed implementation plan
3. eGovernment policy needs to be finalised with haste along with fully costed implementation plan	eGovernment policy has been in draft form since 2001– needs to be finalised and provide direction to other departments/municipalities
4. Performance of regulatory bodies	SITA and ICASA have faced challenges in exercising regulatory oversight and have struggled with a lack of capacity to fulfil their mandates effectively. For these bodies to provide sound oversight within the sector, it is imperative that they are beyond reproach.
5. Demand for eservices must be stimulated	For shift to eGovernment to be successful it must improve ease of access to services – people need to make use of the services

RECOMMENDATIONS

- ***With respect to improving government operations through the use of ICT, the Commission recommends that:***
  - The policy and regulatory framework underpinning the ICT sector is simplified, and roles and responsibilities are clearly delineated, particularly for the roll-out of broadband and eGovernment.
  - The department responsible for devising and finalising the eGovernment policy is identified. Finalisation of the policy along with a fully costed implementation plan should be expedited if the NDP goals around eGovernment are to be met within the required time-frame.
  - A fully costed implementation plan is published and made publicly available, to ensure that the NDP goals for rolling out broadband are attained and that sufficient funding is prioritised.
  - eGovernment services are made more attractive to citizens, by offering a wide range of services and ease of access.

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