For an Equitable Sharing of National Revenue

FINANCIAL AND FISCAL COMMISSION

RESPONSE TO THE SUBMISSION FOR THE DIVISION OF REVENUE

2011/12

FINANCIAL AND FISCAL COMMISSION

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Submission on the 2010 Division of Revenue Bill

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1. Introduction

This submission on the Division of Revenue Bill (DoRB) 2010/11 is made in terms of Chapter 13 Section 214 (2) and Section 9 of the Intergovernmental Fiscal Relations Act (1997).

The submission takes into account consultations that have taken place with the Minister of Finance (and the National Treasury) during the course of the 2009/10 fiscal year. It also takes into consideration consultations through the Budget Council and the Budget Forum. Responses to the Financial and Fiscal Commission's recommendations that were submitted by the various Government departments via the Parliament are also taken into account.

The submission is divided into three parts as follows:

- The first part contains the Commission's response to the various clauses contained in the Bill
- The second part contains the Commission's comments on the fiscal framework, and
- The third part details the Commission's views on the Government's response to the recommendations on the 2010 Division of Revenue that it tabled in May 2009.

2. The Commission's Overall Response To The Bill

The Commission is of the view that the DoRB represents a strategic document capable of linking priorities with outcomes. In its 2009 Submission on the DoRB, the Commission noted that the Division of Revenue Act (DoRA) was becoming increasingly complex, voluminous and too wide-ranging in terms of the issues it covers. The potential danger of the Act becoming a "hold-all" document, and thus losing strategic focus and transparency, was identified. The Commission recommended a review of the Bill with a view to streamlining and reducing its volume. The Commission also notes that the DoRA (first introduced in 1998) preceded other pieces of legislation relating to the management of public finances such as the Public Finance Management Act of 1999, Municipal Finance Management Act of 2003 and the Intergovernmental Relations Framework Act of 2005. Certain issues that have since been addressed in this legislation may still be finding their way into DoRA, which could be addressed through the proposed review. For example, an important issue that this review will need to consider is whether the annual DoRA is simply meant to address the technical elements of the division of revenue and not with any elements of responsibility or accountability for the use of funds. In this case the current “objects” section needs no review. However, if the legislation is interpreted to include responsibility and accountability for use of the funds transferred there is a need to review and probably expand the objects section of the legislation). The Commission is of the latter view.

The Commission welcomes the fact that the 2010 Bill is significantly streamlined, without having lost strategic coherence. In the current Bill for example, a number of specific clauses that deal with allocations are now appropriately dealt within the relevant grant frameworks.

Following consultations with the Ministry of Finance, it has been agreed that the Commission will lead a process for a comprehensive review of the Division of Revenue Bill in preparation for the 2011 division of revenue. It has been further agreed that the work should be completed by June 2010.

3. Commission Comments on the 2010 Fiscal Framework

Five key priorities underlie government policy over the Medium Term Expenditure Framework (MTEF) all of which have been mapped to section 214 (a) to (j) of the constitution namely:

- Improvement in education and skills development
- Enhancing the quality of health care
- Fight against crime and corruption
- Employment creation and
- Rolling out a comprehensive rural development strategy

The Commission notes the priority areas guiding government's allocation decisions over the 2010 MTEF. A concern from the Commission is the apparent lack of intergovernmental structures such as MinMecs and Clusters for coordination of the employment creation and rural development priority areas. These two priority areas are both very important and cut across the three spheres of government. As such they require very strong intergovernmental structures to coordinate the various strategies from the different sectors and spheres of government.

More broadly, the view of the Commission is that the impact and aftermath of the global recession just witnessed has added further challenges to attainment of government's priority objectives. As part of its work for the 2011 division of revenue, the Commission is investigating measures that could assist in the cushioning of the impact of similar recessions while at the same time preparing the country for future growth through the division of revenue process.

Another key aspect in ensuring progress in the attainment of these objectives is in the area of actual service delivery. As part of its work, the Commission has developed a budget analysis tool that allows it to assess performance amongst the three spheres of government.

Finally, improved health care and the fight against HIV and AIDS require that personnel, utilities and infrastructure in the area health are able to cope with the demands placed upon them. The anticipated introduction of the National Health Insurance scheme has the potential to be a key input in this. However, it should be noted that the details of the system have not been made available to the Commission. The Commission can only comment once the formal proposal has been forwarded to it by government.

What follows now are the Commission's comments regarding the fiscal framework as it applies to the national, provincial and local government spheres of government.

For the 2010 budget, an additional R112 billion has been added to the fiscus to finance the priorities. Of this, R33.3 billion (or 38.3 per cent) goes to national government, R 45.5 billion (or 52.3 per cent) to provinces and R7.8 billion (or 8.9 per cent) to municipalities. The Commission's reaction to this division of revenue amongst the three spheres is that:

- Whilst the local government sphere receives the smallest share of total revenue relative to the other two spheres, it exhibits the fastest growth
- With respect to provinces, conditional grant allocations grow faster than allocations made via the provincial equitable share
- Allocations to national departments are expected to show an annual average growth rate of 4.7%.

The Commission notes that there is an increase in the debt service cost compared to other items of the budget. In this respect it is also important to note the rapid increase in the public sector wage bill. This scenario might imply that significant amounts of the debt service costs increases are driven by personnel expenditure. If this is indeed the case, it would be important that this development is reversed as soon as possible. Large amounts of debt that are driven by current consumption as opposed to the financing of capital assets are known to ultimately compromise future economic growth and destabilise the domestic financial system. The Commission's submission for the 2010 division of revenue emphasised the need to, where possible, restrict long term borrowing to the financing of infrastructure investment in order to secure a better life for future generations.

3.1 Comments on the National Allocations

The additional R33.3 billion to the national sphere is mainly to deal with the new defence force remuneration system, the Occupation Specific Dispensation (OSD) for Correctional Services and additional policing personnel under the area of Justice, Crime Prevention and Policing. An additional R3.7 billion is added to drive nationally managed employment creation initiatives that include the textile sector, an automotive production incentive and bio-security.

3.2. Comments on the Provincial Allocations

The provincial total expenditure, including conditional grants made by provinces, for 2010/11 amounts to R322 billion. This represents an upward revision of oR45.5 billion in transfers to provinces. Of this, R33.9 billion is allocated using the equitable share. This is largely intended for improvements to staff conditions of service. In turn this is intended to attract and retain skills in the health, education and social development sectors, and improve the quality of service delivery. Part of this adjustment is meant to assist provinces in accommodating the higher than anticipated OSD wage settlements.

R1 billion over the MTEF is made to accommodate the shifting of the Further Education Training (FET) function from provinces to national government. Government indicated that as part of the preparatory stage to shifting the function, an amount spent by every province on this grant was ring fenced to create the base line for the new national grant. Because all provinces are guaranteed to receive back the amount ring fenced out of their equitable share there should be no direct impact on the spending to this area, except that the change equates to conditionalizing part of the equitable share. It is the Commission's view that the constitutionality of such an exercise can be challenged. Government argues that this is done in order to prepare for the shift in this function from the provincial to the national sphere of government (as FET moves to Higher Education). Further, it is recognised that this skills training through FET has become a national priority and would benefit the other schemes like the SETAs and related industrial training. This would mean the grant will most likely enjoy increased funding as the purpose and scope will widen beyond that which would be the case if it were to remain located at a provincial level.

With respect to the distribution of the equitable share between provinces the Commission notes and agrees with the updating of the relevant information used in the allocation formula. These include accounting for the re-incorporation of Merafong into Gauteng from the North West. The Commission has always held the view that the data used in the revenue sharing formulae should be the most recent available and in this regard, the revisions to the PES formula have been consistent with the Commission's recommendations.

However, the Commission cautions government against the risk of increasing demand for bail-out money when demarcation related decisions are taken. In its recommendations after the 2005 demarcation process, the Commission indicated that such processes tend to have vertical fiscal externalities since the decision is taken from the centre in an environment where norms and standards are not consistent across provinces or municipalities. In this respect the Commission recommended the use of conditional and performance-based transitional transfers to assist negatively affected provinces or municipalities adjust to their new boundaries. In order to avoid unrealistic expectations it would make more sense to build in incentives for sub-national governments to make necessary expenditure adjustments. This could be done through better structured transitional transfers, wherein a province would need to use funding to take the right decisions how ever hard they may seem in terms of their budgets.

3.3. Comment on the Local Government Allocations

The 2010 MTEF will see an additional R10.3 billion allocated to the local government sphere. The bulk of this increase (R6.7 billion) is in respect of the local government equitable share. The Commission commends the increase to the local government equitable share baseline and government's acknowledgment of the need to both ensure continued expansion of access to basic services and to assist municipalities in dealing with increases in the cost of purchasing bulk electricity. The remainder of the R10.3 billion will be allocated to infrastructure grants.

With respect to the local government equitable share formula, the Commission would like to raise two areas of concern. The first relates to the data underpinning the formula, whilst the second relates to the potential unconstitutionality of the revenue raising component of the formula.

- Data underpinning the Local Government Equitable Share (LES): In the 2008 MTBPS and the 2009 DORA, government stated that it would explore updating the LES with the 2007 Community Survey. However, after several statistical tests and analysis, the degree of error on the survey is deemed too large to be used to allocate funds for the LES. Although such a decision should be supported as only the most accurate of data can be used for a fiscal function of such magnitude, it raises the question of the current design of the formula. Given the dynamic demographics situation faced by municipalities, it is pivotal that the data are updated as frequently as possible in order to fund municipalities accurately and efficiently and prevent large shocks in allocations that an update in data every decade will have. The current design of the formula only allows for an update in the data every 10 years with a census. Government needs to urgently explore technical changes to the formula and the data required so as to ensure a constant as possible update to the formula using international best practice.

- Revenue Raising Component (RRC) is potentially unconstitutional: The RRC serves as a correction mechanism to account for a municipality's own revenue potential in the allocation of funds via the LES formula. Once a municipality's allocation through the Basic Services (BS) and Institutional (I) components is calculated, the RRC mechanism would subtract funds from this initial allocation to calculate a municipality's final allocations through the LES formula. Section 227(2) of the Constitution states that "Additional revenue raised by provinces or municipalities may not be deducted from their share of revenue raised nationally, or from other allocations made to them out of national government revenue. Equally, there is no obligation on the national government to compensate provinces or municipalities that do not raise revenue commensurate with their fiscal capacity and tax base" (RSA, 1996). According to this section, an individual municipality's own revenue ability or other allocations from national government to municipalities should not be deducted from its equitable share allocations. However, in the current LES formula, a municipality's ability to generate its own revenues is taken into account through the RRC Component, which clearly contradicts the Constitutional requirement in Section 227(2).

3.4. Revisions to Conditional grants

3.4.1 Provincial Grants

This year sees the introduction of at least 4 new conditional grants to provinces, despite previous recommendations of the Commission's highlighting the need to reduce the number of conditional grants. Two of these new grants are in the education sector. Other new grants are the Expanded Public Works Programme for the Social Sector (a once off allocation of R57 million in 2010/11), the Secondary School Recapitalisation Grant and Dinaledi Schools Grant for the purchasing of mathematics and science teaching material, and the grant (discussed previously) to facilitate the transfer of FET colleges to national government.

The Commission welcomes funding of the *EPWP Incentive Grant for the Social Sector.* However, it must emphasize that caution needs to be exercised to avoid asymmetry in the expenditure patterns within the grant framework. There will be a need to standardise the employment framework for the sector including conditions, wages and progression across provinces and municipalities. The Commission is also concerned with the difficulties still being experienced with the transfer of the *Expanded Public Works Programme Incentive Grant to Local and Provincial Governments*. In the 2009/10 certain provinces (e.g. Western Cape) raised a concern that they received transfers outside the ambit of the Division of Revenue and can't spend the money because it is not properly appropriated through various legislatures.

The general challenge with this grant is that provinces and municipalities still find it difficult to integrate it through their infrastructure programmes. Labour intensive infrastructure projects must be planned, costed and scheduled properly. It should be noted that not all projects will yield the same labour intensity, so targets must be set by project type and category. Some projects will better lend themselves to labour intensive methods than others. This must be factored into the budget allocations and monitoring of the grant.

The Commission welcomes the certainty in funding shown by firm allocations for *Public Transport Improvement & Systems Grant* over the MTEF. However, the Commission is still concerned about the vague allocation criteria for this grant. In the past the Select Committee has raised its reservations about the performance of this grant, especially with regard to deliverables such as bus stations, pavements, pedestrian and bicycle ways constructed, for which there has been inadequate reporting on non-financial performance. Of importance is that funding for the transport sector needs to be urgently reviewed. There are pockets of funding for transport in the fiscal framework (Equitable Shares, Infrastructure Grant to Provinces, Municipal Infrastructure Grant, Rural Transport Services and Infrastructure Grant and the PTIS), yet no coherent fiscal strategy for the long term sustainability of public transport services is in place.

The Commission is currently reviewing the whole system of conditional grants and will be making recommendations in the submission for the 2011 Division of Revenue.

3.4.2 Revisions to the Local government conditional grants allocations

Key developments with respect to local government conditional grants include the discontinuation of three grants and the introduction of one new grant. Each is considered in turn:

The Backlogs in Water and Sanitation at Schools and Clinics: This grant was implemented during the 2007/08 financial year as a three-year grant with the intention of providing funding for the eradication of water supply and sanitation backlogs at all clinics and schools. More specifically, it was envisaged that, by 2008/09, 465 clinics would be supplied with basic sanitation facilities and 719 clinics would be supplied with water supply. With respect to schools, 170 were targeted for supply with safe water and sanitation facilities. A total of R665 million was made available over the 2007 MTEF cycle to ensure that all identified clinics and schools would be granted access. The Commission notes that it is not clear whether all outputs associated with this grant have been reached.

The Backlogs in the Electrification of Clinics and Schools Grant: Similar to the Backlogs in Water and Sanitation at Schools and Clinics Grant, this particular grant was introduced into the system in 2007/08. It was an in-kind allocation that aimed to implement the Integrated National Electrification Programme through the provision of capital subsidies to Eskom in order to address the electrification backlog of schools and clinics. R285 million was made available to fund this intervention that was meant to connect 6928 schools and 411 clinics with electricity by 2009/10. The Commission again notes that it is not clear whether all outputs associated with this grant have been reached.

The Electricity Demand Side Management Grant: This grant was introduced as recently as 2008/09. The intention was that the programme would run until the 2014/15 financial year. The purpose of the grant was to implement an energy efficiency demand side management (EEDSM) programme by providing capital subsidies to licensed distributors to address EEDSM in residential dwelling, community and commercial buildings in order to mitigate the risk of load shedding and supply interruptions. It is now intended that as of 2012/13, it will be discontinued. When this grant was first introduced, the Commission cautioned against the introduction of any financial instrument to encourage energy efficiency in the absence of first identifying areas causing high energy intensities and waste. At that point the Commission noted that it seemed that the magnitude of the problem was not yet identified and quantified. The Commission re-iterates the sentiment expressed last year that investment decisions should be based on a thorough interrogation of costs and benefits before spending decisions are taken. This will aid the achievement of greater value for tax-payers' money.

Over the 2010 MTEF period, one new conditional grant is introduced, namely the Rural Households Infrastructure Grant. This grant will be funded through savings that were realized from the lower than anticipated electricity tariff increase. The intended purpose of the grant is to facilitate the provision of rural sanitation and rural water in villages and homesteads to existing households through the use of on-site solutions. Allocations to this grant over the 2010 MTEF amount to R1.2 billion – R100 million in 2010/11, R350 million in 2011/12 and R750 million in 2012/13. The grant will be located within the Human Settlements Department. The Commission is concerned with the institutional location of the grant and its link to the interventions of, for example, the Department of Rural Development and Land Reform and infrastructure-related grants such as the Municipal Infrastructure Grant (MIG). MIG also has a focus on the provision of capital finance for basic municipal infrastructure for poor households, some of which can be on-site technologies. In addition, it is not yet clear that sufficient rigour has gone into the design of this programme, given that its creation was a function of savings from lower than anticipated electricity price increases.

In general, with respect to conditional grant allocations the Commission recommends that as a matter of standard and ongoing practice:

- Independent exit reviews of discontinued grants be conducted in order to evaluate their performance relative to objectives, and provide lessons for the ongoing improvement to other conditional grant programmes
- A design and implementation planning review be conducted for new grants (in this instance the Rural Households Infrastructure Grant), and
- There be independent mid-term grant performance reviews for all grants in the system.

As raised in the Commission's response to the Division of Revenue for 2010, concern exists around continued delays in the implementation of policy in key service delivery sectors and the impact that this has on the intergovernmental system. This is raised specifically in the context of the restructuring of the electricity distribution industry (EDI) and the proposed establishment of Regional Electricity Distributors (REDS). In addition to the political, economic and social changes that have transpired since the reform process was initiated, and which bring into question the current assumptions underpinning the restructuring process, the current hiatus with respect to the implementation of the REDs continues to generate new costs. The Commission continued to believe that this requires a total re-evaluation of the costs and benefits of the restructuring, relative to what were anticipated at the conception of the idea.

5. Comments on Government's response to the Commission's recommendations

In 2009 the Financial and Fiscal Commission made recommendations in 8 areas of government spending as follows;

- The review of the provincial equitable share
- Funding for public infrastructure
- Funding for social security
- Performance of public hospitals
- Funding for rental housing
- Financing and management of roads infrastructure
- Assessment of universal access to water and sanitation services and,
- Assessment of institutional and fiscal capacity support mechanism for local government.

The Commission's reaction to Government's response that is contained in annexure W1 can be summarised as follows:

- The Commission welcomes the fact that Government has accepted almost all of its recommendations.
- Furthermore the Commission is committed to ensuring ongoing improvements with respect to the relevance and quality of its recommendations
- In this spirit, the Commission proposes further consultation with National Treasury (and relevant government departments) following the tabling of the national budget

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