# Submission on the 2017 Division of Revenue Bill

*For an Equitable Sharing of National Revenue*

10 March 2017

Financial and Fiscal Commission
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## LIST OF ACRONYMS

| | |
|---|---|
| DM | District Municipality |
| DoR | Division of Revenue |
| DoRB | Division of Revenue Bill |
| EU | European Union |
| FFC | Financial and Fiscal Commission |
| GDP | Gross Domestic Product |
| HFRG | Health Facility Revitalisation Grant |
| HSDG | Human Settlement Development Grant |
| IGFR | Intergovernmental Fiscal Relations |
| LES | Local Government Equitable Share |
| MIG | Municipal Infrastructure Grant |
| MTBPS | Medium Term Budget Policy Statement |
| MTEF | Medium Term Expenditure Framework |
| NHI | National Health Insurance |
| PES | Provincial Equitable Share |
| PTOG | Public Transport Network Grant |
| SCoA | Select Committee on Appropriations |
| UK | United Kingdom |
| US | United States |
| USDG | Urban Settlement Development Program |

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## 1. Background

1.1. This Submission on the 2017 Division of Revenue Bill (DoRB) is made in terms of Section 214 (1) of the Constitution of the Republic of South Africa (1996) and Section 35 of the Intergovernmental Fiscal Relations (IGFR) Act (1998).

1.2. Section 9 of the IGFR Act require the Financial and Fiscal Commission (FFC or the Commission hereafter) to make recommendations on (a) an equitable division of nationally raised revenue among the national, provincial and local spheres of government, (b) the determination of each province's equitable share in the provincial share of that revenue and (c) any other allocations to provinces or municipalities from the national government's share of that revenue, and any conditions on which those allocations should be made. The Commission's recommendations were tabled in May 2016 and ran under the theme 'Fiscal instruments for rural development'.

1.3. The submission consists of seven sections which cover the following areas:

- Section 2: General economic outlook and 2017 Division of Revenue
- Section 3: Overview and general assessment of the Division of Revenue Bill
- Section 4: Major changes and additions to the 2017 Division of Revenue
- Section 5: Conditional grant budget analysis
- Section 6: Government responses to Commission and Select Committee on Appropriations (SCoA) recommendations
- Section 7: Concluding Remarks

## 2. General Economic Outlook and 2017 Division of Revenue Bill

2.1. The 2017 Fiscal Framework is enacted in an environment in which South Africa needs to balance the prospects of moderate pickup in economic activity with potential adverse effects stemming from downside risks. The 2016 Medium Term Budget Policy Statement (MTBPS) lowered the growth projections for 2016 and 2017 from 0.9 percent to 0.5 percent and from 1.7 percent to 1.3 percent respectively. The 2017 Budget forecasts have largely maintained the MTBPS projections. Higher than expected global growth, stabilising commodity prices, greater reliability of the electricity network, more favourable weather conditions, recovering business and

consumer confidence, and improved labour relations are expected to combine to boost growth in 2017 and mark and end to recent trend of declining growth.

2.2. Government's 2016 MTBPS economic growth forecasts, of 0.5 percent in 2016, 1.3 percent in 2017, 2.0 percent in 2018 and 2.2 percent in 2019, were retained for the main 2017 Budget. This enabled Government to stick quite closely to the deficit reduction programme set out in successive budgets over the past few years. The fiscal deficit for the current 2016/17 fiscal year was retained at -3.4 percent of gross domestic product (GDP). For the coming 2017/18 fiscal year, the budget deficit contained in the MTBPS was retained at -3.1 percent of GDP. For 2018/19 there was a marginal increase in the budget deficit, to -2.8 percent of GDP from the -2.7 percent figure contained in the MTBPS. Similarly, the deficit for 2019/20 was revised upwards marginally from -2.5 percent to -2.6 percent of GDP. The 2017 Budget proposals will return the public finances to a sustainable path. The Budget sets out tax increases and spending reductions to narrow the fiscal deficit and stabilise growth of public debt, while protecting core social and economic programmes. What all these deficits in turn imply is that the rise in the public debt is likely to be marginal over the next three years, before it begins declining in the first half of the 2020s. The current public debt to GDP ratio is set to increase from 45.5 percent in the current 2016/17 fiscal year, to 47.0 percent in 2017/2018 and edge upwards to 47.6 percent in 2018/19 and 48.1 percent in 2019/20. Under such circumstances, the ratings agencies are unlikely to quibble with the government's commitment to fiscal consolidation, which constitutes one of the important prerequisites for not to downgrade in the country's credit rating to sub-investment grade.

2.3. With a commitment to such a path for public debt, the risk of a default on such debt is low. Yet fiscal measures alone are not enough. To expand the social wage in a sustainable manner, create jobs and reduce poverty, South Africa needs much faster rates of inclusive economic growth. Despite deterioration of economic growth in the first three quarters of 2016 that was largely due to a contraction in manufacturing output, there remains expectations of a moderate recovery based on stronger than expected pickup in economic activity within advanced countries. With the United States (US) expected to pursue a more expansionary fiscal policy and adopt less gradual normalization of monetary policy to combat inflationary pressures stemming from future increases in aggregate demand, coupled with increased infrastructure investment in the Chinese economy, both the demand and prices of base metals has strengthened relative

to pre-2016 levels. Along with global economic growth projected at 3.4 percent and 3.6 percent in 2017 and 2018, respectively, rebound in economic activity across advanced economies in Europe, Asia and the US could provide impetus to Government's objective of enhancing terms of trade and reducing the current account deficit via increased export volumes.

2.4. Despite optimism about the global economic outlook for 2017, potential downside risks remain for the current account deficit and the potential for exports to provide impetus for economic recovery. In the main, these risks relate to events in the US, China, United Kingdom (UK) and the European Union (EU) which collectively account for over 40 percent of South Africa's exports.

a. Following the recent US presidential elections, significant uncertainty remains around the sustainability of strong recovery in the US economy. Any ramping up of protectionist measures by the new administration could adversely affect global trade and undermine growth within emerging and developing market economies.

b. Uncertainty also persists regarding the prospects for the UK economy following the decision of its citizens to vote in favour of leaving the European Union. The impact on mutual trade and financial flows of the UK's exit decision will only be clear once the process of the UK's exit from the Eurozone is finalized. With the exit process likely to require intense round of negotiations and take several years to complete, significant uncertainty remains around the long-term economic prospects of EU nations as well as the UK in the post-Brexit era. While the latter half of 2016 has recovery in the Eurozone boosted by stronger-than expected performance in Germany, Spain and Italy, rising sentiment against cross-border economic integration in other EU states could intensify calls for implementation of populist, inward-looking policies that pose a risk to continued slow growth recovery across the EU.

c. In addition to risks discussed above, underlying vulnerabilities remain in the Chinese economy where capacity reductions and rising demand for commodities have caused producer price inflation to rise for the first time since 2012. The 2017 growth forecast for the Chinese economy has been revised upwards (from 6.2 to 6.5 percent). While upward revisions are a welcome development, especially for commodity exporting countries, it is mainly driven by expectations of continued implementation of policy stimulus measures.

However, rapid credit-driven nature of China's recent growth coupled with slow progress in stabilizing the debt and budgets of state-owned enterprises raises the risk of an unsustainable credit bubble which may require adjustments that create financial sector vulnerabilities, and undermine the growth trajectory of the Chinese economy.

2.5. On the domestic front, the contribution to growth in expenditure on GDP show that while investment, in the form of gross fixed capital formation, has previously been the major driver of economic growth on the demand side, household consumption has now become the main driver of economic growth. Data from Statistics South Africa indicate that the contribution of gross fixed capital formation to GDP increased from 2.5 percent in the first quarter of 2013 to reach a peak of 9.9 percent in the third quarter of 2013. The acceleration significantly slowed down thereafter, decelerating to -0.1 percent in the fourth quarter of 2014 and further declining to -6.1 percent in the third quarter of 2016. The data also show that investment contributed negatively to economic growth whereas relative to its levels in the first quarter of 2013, household consumption reached its highest level in the third quarter of 2016. The weakening of the rand has resulted in a significant decline in growth of imports 3.3 percent year-on-year in the first three quarters of 2016. This decline - the first consecutive three-quarter decline since the global financial crisis, reflects structural transformation on the demand side of the economy as imports are being replaced by domestic consumption. Further supporting this structural shift has been the deprecation of the exchange rate which has fuelled a private consumption led growth trajectory for much of 2016.

2.6. The sharp decline in investment as expressed by the declining contribution of gross fixed capital to GDP by -1.2 percent in the first quarter of 2016 is concerning. On the upside, accelerated investment supported by a weak but more stable rand, improved electricity capacity and less fractious labour relations could lift exports and stimulate growth. However, if investment remains weak, growth prospects could be severely undermined, heightening the possibility of a rating downgrade, and triggering a vicious circle of low growth–low investment. In this regard, a predictable business environment through greater policy certainty remains a crucial prerequisite for accelerated investment.

2.7. Investment is also crucial in job creation. The labour market conditions in South Africa remain very challenging. The Statistics South Africa Quarterly Labour Force Survey for the fourth quarter of 2016 show that in the first two quarters of 2016 the number of

people employed decreased by 473 000. In the last two quarters of 2016, the number of people employed increased by 523 000, translating into only 50 000 net increase in the number of people employed in 2016. The number of unemployed people increased by 530 000 and 239 000 in the first and third quarters of 2016 respectively and it decreased by 90 000 and 92 000 people in the second and fourth quarters respectively. This translates into 587 000 net increase of the number of people unemployed in 2016. These figures corroborate the fact that subdued growth and low investments is holding back the economy from making meaningful improvement in both the employment and unemployment figures.

2.8. While electricity shortages and disruptions to production emanating from labour relations that curtailed growth in the past have subsided, domestic politics is now weighing heavily on investor confidence constraining crucial investments that are prerequisite to structural reforms. Domestic politics and policy uncertainty are now constituting major internal risk to economic growth and outlook. While the strength of South Africa's institutions is indisputable, perceptions of heightened uncertainty on policy direction are now linked with low investment and consumer confidence. Mining investment, for instance, is hugely depended on the final content and passing of the Mineral and Petroleum Resources Development Act, as well as a new Mining Charter; agricultural investment will also largely be determined by the nature and details of land reform and the settlement of restitution claims on land.

## 3. OVERVIEW AND GENERAL ASSESSMENT OF THE 2017 DIVISION OF REVENUE BILL

### A. Technical Changes to the 2017 Division of Revenue Bill

3.1. **Conversion of allocations:** Clauses 21(1), (2) and (4) have been revised to relax the requirements for in-year conversion of indirect allocations to direct allocations, tighten the conditions for in-year conversion of direct allocations to indirect allocations, and to clarify the requirements for utilisation of the converted allocations from direct to indirect. The new clause 21(1), allows the National Treasury (at the request of the transferring officer and after consulting with the receiving officer) to convert any portion of indirect allocations to direct allocations without certifying that the conversion will prevent under-expenditure or improve the level of service. The amended clause 21(2) requires the National Treasury to convert direct allocations to

indirect allocations on the condition that the conversion will prevent under-spending or improve service delivery, and is on the basis of historical poor performance and lack of capacity. Clause 21(4) has been revised to clearly specify that the converted portion of an allocation from direct to indirect must be utilised for the same province/municipality. It further encourages the involved parties to ensure that the converted funds are used for the projects that they were intended for. In cases where the allocations cannot be utilised for the projects that were planned for had the allocation not been converted, the clause states that the receiving officer must sign an agreement that defines the new project to be funded before the implementation takes place. Furthermore, it is stated that with regards to School Infrastructure Backlogs Grant (SIBG), the converted funds can only be used for the same province to which the funds were originally allocated and the projects that were planned if the funds had not been converted.

3.2. The Commission notes these alterations as they are meant to reduce inefficiencies in managing conditional grants. These revisions coincide with the recommendations previously made by the Commission, discouraging the utilisation of indirect grants as they appear to be performing poorly. However, the Commission remains concerned about the unclear definition of thresholds for conditions under which direct grants are converted to indirect grants. Clearly defined extents of these conditions would help minimise subjectivity, and ensure that a decision to convert a grant is impartial.

3.3. **Delegations and assignments:** in replacement of the sub-paragraph removed from Clause 27(2) (d), new clauses (clause 35(5) and (6)) were added into clause 35 to allow transferring officers to in writing, delegate any power entrusted to, and assign any duty imposed on them in terms of the division of revenue act, to officials in their respective department. Clause 35(6) further specify that the delegation and assignment in terms of clause 35(5) will be subject to the constraints specified in clauses 35(2) and 35(3). The Commission welcomes the changes in clauses 27(2) (d) and 35 as they will prevent inconsistencies and accountability problems that could arise as a result of delegations and assignments of powers.

3.4. **Payment requirements:** Clause 23(2) (b) has been added to specify that under-payments to municipalities must be corrected within ten days after it comes to the attention of the national department responsible for local government. The Commission welcomes this addition as underpayments may interrupt service delivery, especially if a municipality has to wait for the next quarter to have the error corrected.

## 4. Major Changes and Additions to the 2017 Division of Revenue

### A. Changes and Additions to the National Fiscal Framework

4.1. Over the period 2017/18 to 2019/20, government is expected to spend R5.055 trillion relative to a revenue envelope of R4.618 trillion. The bulk of the resources are allocated in respect of non-interest allocations in the form of equitable share and conditional grant funding. In terms of real annual average growth over the 2017 MTEF period, non-interest allocations are projected to grow by 1.3% per annum.

4.2. Table 1 outlines the division of nationally raised revenue over the 2017 MTEF period. In nominal terms, annual average growth in allocations to all three spheres is well above inflation, particularly in respect of the provincial and local equitable share allocations. As the following paragraphs highlight, when inflation is factored in, the growth in the allocations leaves little room for expansion of services to new eligible recipients. Local government shows the highest real annual average growth amounting to 2.5% compared with the 0.9% and 1.4% growth level projected for national government and provinces respectively.

4.3. In the case of local government, growth over the 2017 MTEF period is driven by significantly stronger growth in the local equitable share allocation (amounting to a real annual average 4.4%) relative to local government conditional grants which are projected to grow marginally by a real annual average of 0.9% over the 2017 MTEF period. Given the significant service delivery responsibilities of municipalities, the Commission welcomes the relative priority given to resources allocated to local government. The Local Government Equitable Share (LES) is intended to supplement municipal resources aimed at funding the delivery of basic services to indigent households. As a result, the increases in resources to municipalities, if spent effectively should realise significant gains in terms of redistribution and access to services for the poorest of the poor.

4.4. The reverse is true for provinces where provincial conditional grants are projected to grow by a real annual average of 2.5% over the 2017 MTEF period relative to a 1.2% real annual average growth projected for the provincial equitable share (PES) allocation. This trend is influenced by the introduction of three grants in 2017/18 namely: a new early childhood development grant, a grant to fund the education of

learners with intellectual disabilities and a social development grant aimed at funding the employment of additional social workers.

**Table 1: Division of Nationally Raised Revenue, 2013/14 to 2019/20**

| | 2013/14 | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 | **Real Annual Average Growth over 2017 MTEF** |
|---|---|---|---|---|---|---|---|---|
| R billion | | **Outcome** | | **Revised estimate** | | **Medium-term estimates** | | |
| **National departments** | **453.4** | **490.0** | **546.1** | **557.5** | **590.2** | **631.4** | **681.6** | **0.9%** |
| **Provinces** | **410.6** | **439.5** | **471.4** | **500.4** | **538.2** | **578.6** | **621.0** | **1.4%** |
| Equitable share | 336.5 | 359.9 | 386.5 | 410.7 | 441.3 | 471.5 | 506.1 | 1.2% |
| Conditional grants | 74.1 | 79.6 | 84.9 | 89.7 | 96.8 | 107.1 | 114.9 | 2.5% |
| **Local government** | **82.6** | **87.6** | **98.3** | **103.3** | **112.5** | **121.5** | **132.3** | **2.5%** |
| Equitable share | 39.0 | 41.6 | 49.4 | 51.2 | 57.0 | 62.7 | 69.3 | 4.4% |
| Conditional grants | 34.0 | 35.8 | 38.3 | 40.9 | 43.7 | 46.3 | 49.8 | 0.9% |
| General fuel levy sharing with metros | 9.6 | 10.2 | 10.7 | 11.2 | 11.8 | 12.5 | 13.2 | -0.4% |
| **Non-interest allocations** | **946.6** | **1,017.1** | **1,115.8** | **1,161.1** | **1,240.9** | **1,331.5** | **1,434.9** | **1.3%** |
| ***Real Year on Year Increases*** | | **2013/14-2014/15** | **2014/15-2015/16** | **2015/16-2016/17** | **2016/17-2017/18** | **2017/18-2018/19** | **2018/19-2019/20** | |
| **National departments** | | **2.4%** | **6.5%** | **-4.0%** | **-0.2%** | **1.0%** | **2.0%** | |
| **Provinces** | | **1.4%** | **2.5%** | **-0.2%** | **1.4%** | **1.5%** | **1.4%** | |
| Equitable share | | 1.3% | 2.7% | -0.1% | 1.3% | 0.9% | 1.5% | |
| Conditional grants | | 1.8% | 2.0% | -0.7% | 1.8% | 4.4% | 1.4% | |
| **Local government** | | **0.4%** | **7.4%** | **-1.3%** | **2.7%** | **1.9%** | **2.9%** | |
| Equitable share | | 1.1% | 13.5% | -2.6% | 5.0% | 3.9% | 4.4% | |
| Conditional grants | | -0.3% | 2.3% | 0.2% | 0.9% | -0.1% | 1.8% | |
| General fuel levy sharing with metros | | 0.4% | 0.0% | -1.0% | -1.0% | -0.1% | -0.2% | |
| **Non-interest allocations** | | **1.8%** | **4.9%** | **-2.2%** | **0.7%** | **1.3%** | **1.9%** | |

Source: Commission compilations based on Budget Review 2016 and 2017.

4.5. Table 2 provides detail regarding the extent of indirect transfers by the national sphere to provinces and local government. Indirect transfers to municipalities are generally twice as large as those to provinces. By the end of the medium term indirect transfers to provinces are projected to decline to R1.9 billion – reflecting a significant real annual average decline of 17.1% per annum. In contrast, indirect transfers to municipalities are set to decline marginally by a real annual average of 4.7% per annum. By the end of the 2017 MTEF period indirect transfers are projected to amount to R8 billion. The Commission welcomes the declining trend in indirect conditional allocations along with provision made in the bill to streamline and tighten requirements for conversion of direct grants into indirect grants.

**Table 2: National Government Indirect Transfers to provinces and Local Government, 2014/15 to 2019/20**

| | 2013/14 | 2014/15 | 2015/16 | 2016/17 | 2017/18 | 2018/19 | 2019/20 | Real Annual Average Growth over the 2017 MTEF |
|---|---|---|---|---|---|---|---|---|
| R billion | Outcome | | | Revised estimate | Medium-term estimates | | | |
| **National departments** | **453.4** | **490.0** | **546.1** | **557.5** | **590.2** | **631.4** | **681.6** | **0.9%** |
| ***of which:*** | | | | | | | | |
| Indirect transfers to provinces | 2.7 | 5.8 | 3.5 | 3.7 | 4.3 | 1.8 | 1.9 | -17.1% |
| Indirect transfers to local government | 5.9 | 8.3 | 10.4 | 7.8 | 7.3 | 7.6 | 8.0 | -4.7% |

*Source: Commission compilations based on Budget Review 2016 and 2017.*

B. Sector Specific Allocations

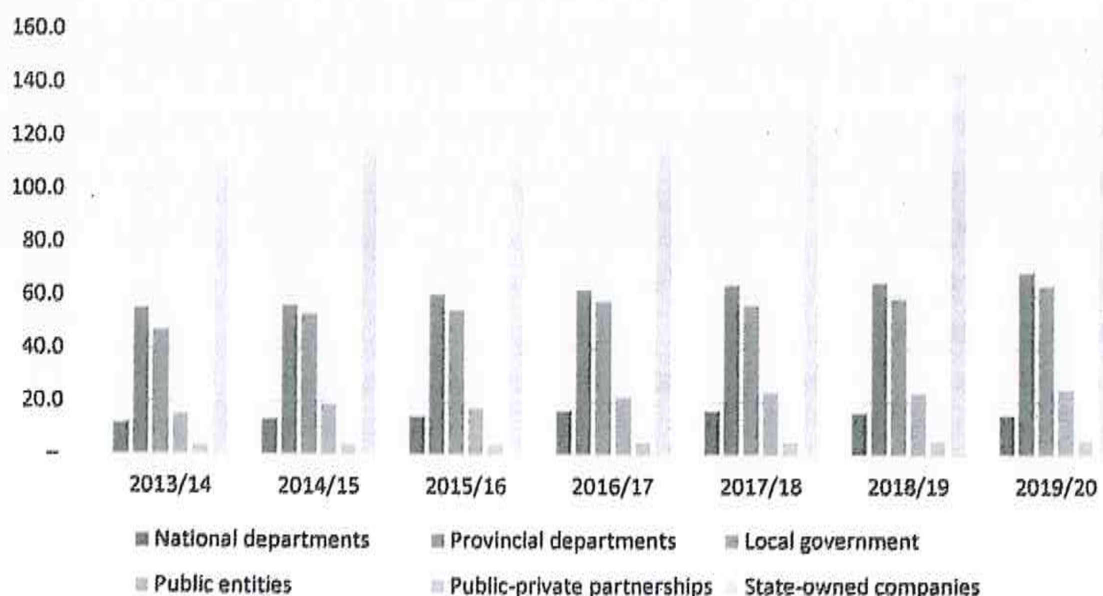
4.6. **HIGHER EDUCATION AND TRAINING:** Government has announced that, in addition to the increases of R32 billion that government made in the higher education allocations in last year's Budget and the 2016 MTBPS, a substantial additional allocation to higher education of R5 billion in the outer year of the MTEF is proposed. Government pronounced that the increase in the university fees for 2017, only applies to students from households with incomes greater than R600,000, consequently, all National

Student Financial Aid Scheme (NSFAS) qualifying students, as well as "missing middle[1]" will experience no fee increase. Furthermore, government introduced the pilot project/ trial period for the introduction of a mixed funding scheme for the "missing middle" student income group in 2017. The Commission submits that as part of the feasibility study of the model which is said to run in parallel to the pilot project, government should proactively determine the long term financial implications of such financial aid. This may have "huge consequences" for allocations towards higher education funding and also on the fiscus. The Commission emphasizes that quality education is key as it will enhance the country's global competitiveness. Furthermore, the Commission acknowledges, governments' commitment to finding a lasting solution to funding higher education. The government has demonstrated this commitment through, among others the formation of the Presidential Commission of inquiry into higher education and training funding, Inter-Ministerial Committee on Higher Education and the established Ministerial Task Team on funding support for the poor and "missing middle. The Commission has been invited to make a presentation to the Commission of Inquiry into Higher Education and Training ("the Fees Commission") scheduled for March 2017. The central question posed is whether fee-free Higher Education and Training is feasible in the South African context.

4.7. INFRASTRUCTURE AND ECONOMIC DEVELOPMENT: Infrastructure has been identified as a key binding constraint to economic growth and the Commission welcomes the sustained government program of infrastructure spending. Over the 2017 MTEF government infrastructure spending amount to R950 billion. State owned enterprises account for the biggest share (45 percent) followed by provinces and municipalities (see Figure 1). Infrastructure budget allocations alone cannot drive economic growth. Complementary planning and proper execution are equally useful. In this regard the commission welcomes the new infrastructure budgeting facility being introduced to address budgeting, planning and execution challenges in large infrastructure projects. This facility should be extended to infrastructure projects undertaken by municipality and further align with existing sub-national planning and coordination processes.

[1] Students whose families earn above the NSFAS threshold but who are unable to support their children to access higher education.

**Figure 1: Public Infrastructure spending by sector/sphere**




*Source: Adapted from Budget Review, 2017.*

C. Changes and additions to the provincial fiscal framework

4.8. Table 3 shows the 2016/17 provincial fiscal framework inclusive of conditional grants. Unlike previous years, government has made no total baseline adjustments to the provincial fiscal framework over the MTEF period. The Commission welcomes this decision as it brings stability to the finances and planning decisions of provincial governments. By keeping provincial baselines unchanged, government may be signalling that reducing the provincial fiscal framework further to fund reprioritisation may have reached its threshold and any further reductions could have an adverse impact on service delivery at provincial level, especially in health and education services.

4.9. Compared to the 2016 Division of Revenue Bill, the provincial allocations as reported in the 2017 Division of Revenue Bill have in fact increased by R4 billion in 2017/18 and 2018/19 respectively. The increase, however, had been factored into the 2016 MTBPS and therefore there is no direct impact on the 2017 Division of Revenue Bill (DORB).

**Table 3: Changes to the Provincial Fiscal Framework – 2016/17 – 2019/20**

| R' million | 2016/17 | 2017/18 | 2018/19 | 2019/20 |
|---|---|---|---|---|
| Changes from 2016 DORB to 2016 MTBPS | -1 | 4 | 4 | |
| Changes from 2016 DORB to 2017 DORB | -1 | 4 | 4 | |
| Changes from 2016 MTBPS to 2017 DORB | 0.1 | 0 | 0 | 0 |

*Source: Division of Revenue Bill (2016, 2017), MTBPS (2016); Commission Calculations*

4.10. A key fiscal risk to the provincial framework is the ongoing escalation of the public-sector wage bill. While a three-year wage settlement deal signed in 2015 has brought much needed stability to the economy, the fiscal impact these increases have on limited state resources and expanding social priorities should be seriously considered. The Commission therefore welcomes the stabilising of the provincial wage bill as mentioned in the 2017 budget. Headcounts in provinces have declined by 2.8% since the beginning of 2016/17 and the proportion of budgets spent on personnel has declined from 60.4% in 2015/16 to 59.8% in 2016/17. Government should carefully monitor that personnel reductions should be limited to non-core areas of provincial services only and that core staff in education and health services should be protected. The Commission has previously noted the lack of any linkage between wage increases and productivity in the public sector and would like to reiterate the recommendation made in the submission for 2016/17 division of revenue that a framework for measuring public sector productivity be finalised as a matter of priority.

4.11. The provincial equitable share is expected to increase on average by 1.23 % per annum in real terms over the 2017 MTEF period while conditional grants grow at 2.53% per annum over the same period (see table 4). In an environment of tight fiscal constraints, the average real increase in the provincial equitable share over the 2017 MTEF period is welcomed and provinces should deliver a marginally expanded basket of constitutionally mandated services. Nevertheless, the Commission would like to emphasize the need for provinces to evaluate each aspect of their spending plans to ensure any inefficiencies in provincial service delivery systems are eliminated. National departments should also carefully monitor and support provinces in this regard,

especially around planning for service delivery in big spending areas such as health and education, so that spending programmes are effectively implemented.

4.12. The PES includes an amount of R2 billion in 2017/18 which previously funded adult basic education and training. This function was shifted from national to provincial government at the start of the 2015 MTEF period and is still allocated to provinces in the same proportions prior to the function shift. From 2018/19 onwards, these funds will be allocated via the PES. To support improvements in health and education, R3 billion is added to the equitable share in 2018/19 and R4.3 billion in 2019/20.

**Table 4: 2017 MTEF Growth Rates of Provincial Transfers**

| R'million | 2016/17 | 2017/18 | 2018/19 | 2019/20 | Annual Average Real Growth Rate |
|---|---|---|---|---|---|
| **PES** | 410.7 | 441.3 | 471.5 | 506.1 | |
| **Conditional grants** | 89.7 | 96.8 | 107.1 | 114.3 | |
| ***Real Annual Growth Rate*** | | | | | |
| **PES** | | 1.3% | 0.9% | 1.5% | 1.23% |
| **Conditional grants** | | 1.8% | 4.4% | 1.4% | 2.53% |

*Source: Commission calculations based on Division of Revenue Bill (2017) and MTBPS (2016)*

4.13. There are no changes to the weights assigned to the six components of the PES formula. Since the formula is largely population driven, allocations capture shifts in population across provinces.

4.14. The formula has been updated with new data and this is being phased-in over a three year period. The Commission agrees with the principle that any effects on updates to the PES is phased in over a three-year period as this provides for stability of the IGFR system and smoothing of expenditure over time.

4.15. Government has announced a review of the provincial equitable share formula. The review is expected to cover the funding burden of poorer schools, the cost of service provision and assessment of data reliability. The Commission welcomes this review.

## D. Changes and additions to the local fiscal framework

4.16. The local government sphere is set to receive R389.3 billion worth of transfers over the 2017 MTEF, with R366.3 billion transferred in the form of direct grants, and R23 billion transferred as indirect grants. In total the sector will receive about 9.1% of government non-interest expenditures. Over the MTEF, the sphere is allocated R187.2 billion through the Local Government Equitable share, R37.4 billion through the general fuel levy, and another R139.8 billion in conditional grants.

4.17. The Local Government Equitable share (LES) continues to be a critical revenue stream for the local government. As the main funding instrument for free basic services, the LES allocations continues to experience positive real growth (2.5 percent) into the MTEF. This unconditional supplementary revenue stream accounts for about 44 percent of transfers to the local government. Over the 2017 MTEF, additions to the LES amount to R3.3 billion, excluding R1.5 billion that was added in the current year and the R3 billion that would be added in 2018/19 from the 2016 MTEF. The Commission welcomes the addition of resources to the LES to offset the ever-increasing costs of basic services and enable the sector to provide basic services to the poor households. The Commission is of the view that municipalities can be realistically compensated for the rising costs of basic services only if the true cost of municipal operating and maintenance services are used. To assist determine the true costs of basic services FFC and South African Local Government Association (SALGA) developed (and still being refined) a model that accounts for different cost influencing factors. The Commission will continue to investigate further own-revenue alternatives for municipalities and contribute to on-going efforts to refine the LES formula and general mechanisms of allocating funds in municipalities to ensure that there is efficiency in the system.

4.18. The Commission welcomes the realisation of the discrepancies in the funding of district municipalities. A number of District Municipalities (DMs) have been receiving very low allocations from the Regional Services Council (RSC) levy replacement grant, a development that has impacted negatively on their ability to deliver services and support local municipalities. The Commission welcomes the interim measures taken by government to relieve the funding bottleneck faced by some 13 DMs that have been receiving less than R40 million per-annum as their LES allocation. However, the Commission strongly feels that these measures should be regarded as temporary, and a

long term sustainable funding model for DMs should be found. Such a model should be based on a clear identification of the powers and functions of DMs.

4.19. The Commission also welcomes the updating of the LES with the 2016 Community Survey data as this will ensure that the formula is responsive to new household changes. The Commission also welcomes the three-year phase-in period as this will minimise shocks in the Local Government Fiscal Framework (LGFF) that may accompany the introduction of new data.

## 5. Conditional Grants Budget Analysis

### A. Provincial Conditional Grants

Human Settlements and Transport

5.1. Human Settlements Development Grant (HSDG) aimed at establishing habitable, stable and sustainable human settlements in which all citizens have access to social and economic amenities has been performing well over the last 8 years with an average expenditure of 96.1%. Despite its performance, the grant has been experiencing reductions in its baseline over the recent years. In 2016 Division of Revenue, baseline was reduced by R1.6 billion and the Commission raised its concern as baseline reduction could invariable compound the rate of decline in the number of housing units delivered. The baseline for HSDG will be reduced again in 2017 MTEF by R871 million. Although this reduction is lower than the last financial year's one, the Commission is of the view that any reduction in the baseline of HSDG is likely to negatively affect the performance of the sector in terms of the number of housing units delivered contributing to the downwards trends in housing delivery and widening the gap between housing needs and delivery in the affordable housing market.

5.2. In 2015/16, a once-off allocation of R180 million was made available to accelerate the upgrading of informal settlements in mining towns and in 2016/17 allocation for the same purpose was increased to R3.6 billion. Over the 2017 MTEF period, a total of R3.6 billion is ring-fenced for upgrading of informal settlements in mining towns. The Commission reiterates its recommendations made in its 2016 Submission to the Division of Revenue that the government should consider rental tenure option (for low and medium income households) or a balanced mix given that locations around mining

areas comprise predominantly of migrant labour who may prefer rental over ownership. Furthermore, the government should find a way of entering into partnering with the mining sector in its attempt of addressing housing needs in mining towns. This could accelerate the program of upgrading informal settlements with less burden on the fiscus.

5.3. Public Transport Operations Grant (PTOG) aimed to support provinces to ensure that contractual obligations are met and services are efficiently provided. Currently, the public transport contracting and regulatory function resides in provinces hence funding is disbursed from the National Department of Transport to provinces. However, in 2017/18 the function may be devolved to certain metros. Devolution of functions to local government/municipalities where capacity to undertake functions exist is what the Commission has been recommending over the years. The Commission therefore supports the intention to devolve the function to those metros with capacity during 2017 and that the funding would be transferred directly to those metros as per the principle of funding following a function. The Commission however recommends that careful consideration has to be made with respect to baseline to ensure that metros are not disadvantaged. Furthermore, a decision to devolve the function should be taken and communicated to affected metros without delays as this affects planning and contracting and its delay creates uncertainty.

Health

5.4. A review of health conditional grants shown in Table 1 shows that most of the grants on average have been spending well with the exception of National Health Insurance (NHI) and the (Health Facility Revitalisation Grant) HFRG. The 2017 budget shows reduction in baseline to the HFRG by R115.4 million in 2017/18 and R248.2 million over the 2017 MTEF. In the 2016 budget, it was the same case where reductions to this grant were at R200 million 2016/17 and R365 million over the 2016 MTEF. The Commission is concerned about the base line reduction to this grant given its importance towards the construction and maintenance of health infrastructure in line with NHI reforms underway. On the Comprehensive HIV/Aids and TB grant there are also reductions on the baseline by R327.3 million over the 2017 MTEF and in the 2016 budget it was noted that this grant was reduced by R176 million in 2016/17 respectively. The Commission is also concerned about baseline reductions to this grant, given that this grant is already under pressure due to increased uptake of people on ARV's every

year including the extension of the scope of the grant (in 2016) which included tuberculosis (TB).

5.5. The Commission also notes the closure of the direct component of the national health insurance grant and the continuation of the indirect component (allocated R3 billion over the 2017 MTEF) to be overseen and managed by the National department of health in preparation for launch of NHI fund. The direct NHI grant has been beleaguered by poor spending performance problems (and downward revision to the allocations) caused by among other things: poor supply chain management systems, weak human resource capacity and the lack of delegation powers at district level. This points to the need for far reaching reforms to be undertaken before NHI is fully rolled out – because allocations alone cannot address pre-existing operational and institutional challenges at provincial level. The national department of health should use the current indirect grant to build capacity of the health district offices as they are central to the implantation of NHI. Further the Commission welcomes the preparations made through the indirect NHI grant transfer the responsibility for rolling out the human papillomavirus (HPV) vaccine to provinces from 2018/18 financial year. The Commission fully support this approach.

5.6. The 2017 budget further indicates that government plans to introduce the NHI fund, funded through the reduction of medical tax credit, as a step towards full implementation of national health insurance. The Commission welcomes the intentions to move beyond the NHI piloting phase but at the same time advice government to clarify the current ambiguities with regard to the role of NHI fund and to implement the reforms in a sequential manner. Introducing an NHI fund over a fragmented health system and problematic health governance and accountability system will inevitably lead to undesired results and loss of public confidence in NHI. Recently held NHI colloquiums by the Commission highlighted among other things the need for sequenced interventions starting with stewardship and governance, pooling, purchasing and benefits design. While the Commission acknowledge that the preparatory interventions, under the indirect NHI grant, covers such important things as contracting with private sector general practitioners and strengthen central hospitals patient information system, this processes remain visibly un-sequenced. In order to minimise uncertainties about the role of the envisaged NHI fund government should speedily finalise the White Paper on NHI so that process can be streamlined and of the NHI fund can be designed in accordance with the policy goals.

Education

5.7. Spending performance shows that education conditional allocations over the years have an average good spending performance except the maths, science and technology grant. The Commission welcomes the baseline increase on the National School Nutrition Programme (NSNP) by R390 million over the 2017 MTEF which would among other things takes account of inflation and expand access of nutrition to poor learners in public schools. This is in line with international literature that nutrition programmes offered at schools improve attendance and concentration of learners. Further, the FFC in its recommendation on the annual division of revenue (2007/08), recommended for among other things for increased budget allocation on this programme so as to expand access to all learners that meet the criteria.

5.8. The Commission notes the reduction to the baseline of the maths, science and technology grant[2] by R63 million over the 2017 MTEF and is concerned about its underperformance given the vital role it plays on increasing learner uptake numbers on these subjects towards the improvement of educational outcomes. The Commission caution the reduction of baseline to this grant due to issues of poor performance-reiterating on its previous stance on the need to address underlying issues of poor performance to the grants as merging is not necessarily a solution.

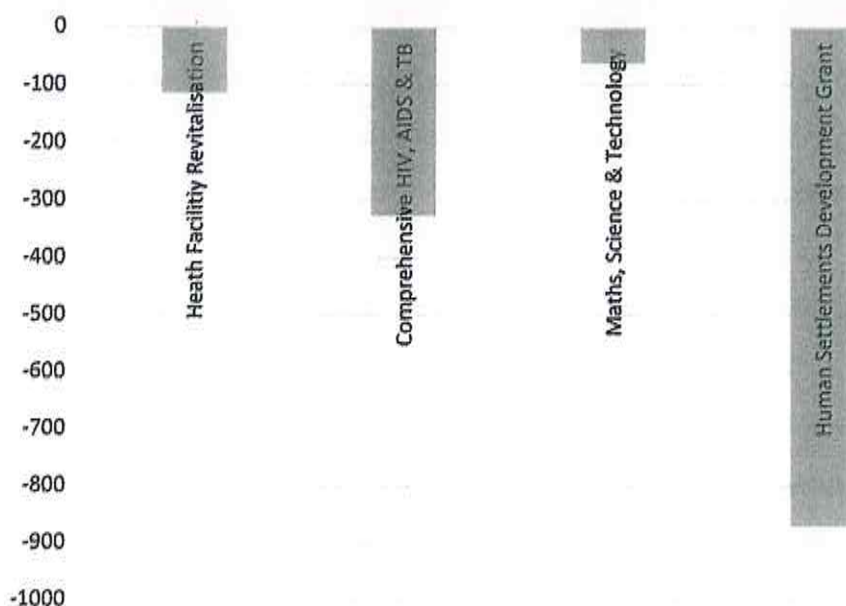
5.9. Further the Commission welcomes the introduction of the new grant 'learners with profound intellectual disabilities' over the 2017 MTEF period so as to expand access to education for learners with intellectual disabilities in line with meeting international and local obligations of inclusive society of all persons. The grant on learners with profound intellectual disabilities grant is allocated R72 million in 2017/18, R185.5 million in 2018/19 and R220.8 million in 2019/20. The Commission would like to highlight the need for this grant to fund and address among other things issues of accessibility to public transport within those schools, the physical condition of the schools as well as professional capacity in those schools. In the past the Commission has recommended that government must, through input and output norms and standards, take reasonable measures to give effect to the inclusive education of intellectually disabled children. These norms should indicate human, physical,

[2] Merger of the Dinaledi and the Technical Schools Grant.

administrative and regulatory resources provided by government dedicated to achieving targets for inclusive education.

5.10. The Commission welcomes the allocation of R1.3 billion to Early Childhood Development (ECD) over the MTEF as it is in line with its previous recommendations on financing of ECD facilities. Figure 2 gives a summary of baseline reductions to the above mentioned provincial conditional grants.

**Figure 2: Total Baseline Reductions to key Provincial Conditional Grants 2017/18 (R-Millions)**




*Source: National Treasury*

Social Development

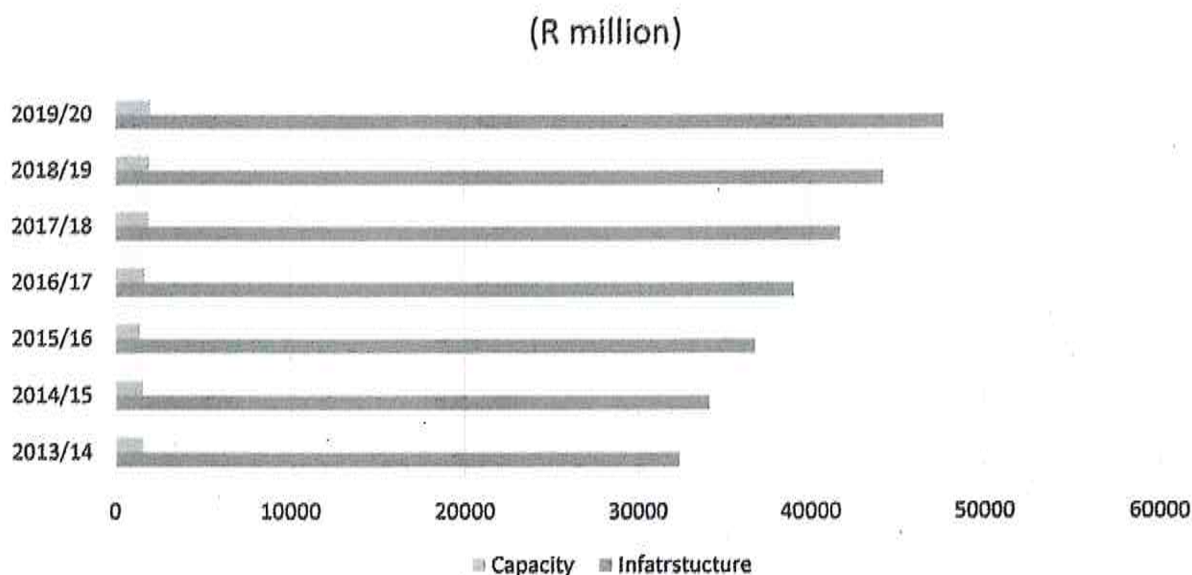
5.11. Government has introduced a new social worker employment grant amounting to R591.3 million over the 2017 MTEF period. The grant is intended to reduce the backlog in the number of social worker graduates that remain unemployed. The grant is funded from reprioritised funds that the Department of Social Development previously utilised to subsidize the scholarship program. The Commission is of the view government should discourage departments from designing scholarship programs linked to any guaranteed employment as this could lead to financial mismanagement, especially if these new graduates were not budgeted for as part of the compensation budget by the department. Government should clarify if provinces can utilise this grant to fund Non-

Governmental Organisations that are in need of social workers as the conditional grant framework does not clearly pronounce on this.

### B. Local Conditional Grants

5.12. Conditional grants account for 39% of local government transfers and grow from R43.7 billion in the 2017/18 financial year to almost R50 billion in 2019/20. Conditional grants are divided into capacity and infrastructure grants. National government will transfer R156.4 billion (both direct and indirect) to local government for infrastructure development and R7.2 billion for local government capacity building initiatives during the 2017 MTEF. Figure 3 shows the trajectory of direct conditional infrastructure and capacity grants. Direct conditional grants continue to increase while capacity grants have largely remained stagnant.

**Figure 3: Local Government Infrastructure Direct Conditional Grants**

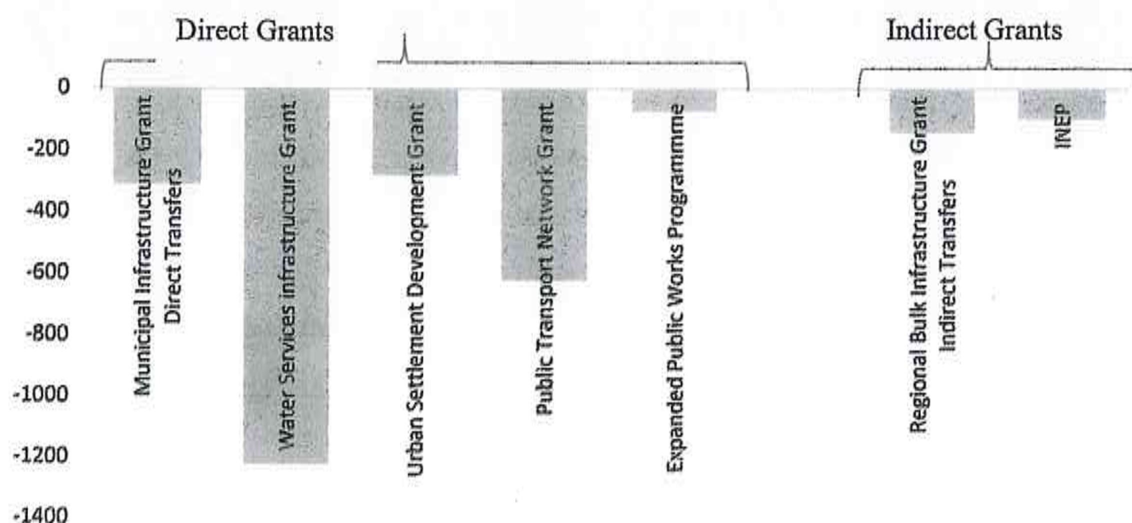



*Source: National Treasury data base.*

5.13. Many local government grants will see their baselines reduced over the 2017 MTEF. While R4.3 billion will be added to the baselines of local government grants (mainly on the LES and Integrated National Electrification Program (INEP) grants), R2.8 billion will be deducted from a number of grant baselines. Figure 4 shows the spread in the reductions to both direct and indirect grant baselines. The worst affected grants (in

terms of reductions) are the Municipal Infrastructure Grants (MIG), Water Services Infrastructure grant, USDG and the PTOG. Although the addition of resources to the sector is commendable as it will go a long way in supporting the 'Back to Basics' plan and the National Development Plan (NDP), the Commission wishes to reiterate its long-standing position that reductions should prioritise underperforming grants.

**Figure 4: Total Baseline Reductions to Local Government Grants over 2017 MTEF (R-Millions)**




*Source: National Treasury*

5.14. Table 5 below on the performance of the 4 affected grants (using spending patterns as a proxy) shows that the cuts affected even the best performing grants e.g. the MIG and USDG are among the best performing grants. The Commission is also concerned that these reductions affect key municipal deliverables: infrastructure, water, human settlements and transport services. Furthermore, the Commission is concerned that cuts to baseline disproportionately affect direct grants. Two years ago, the Commission noted that direct grants generally outperform indirect grants. Thus, the Commission would expect more reductions to be incident on indirect grants. With respect to the Water Services Infrastructure grant, the Commission is further concerned that this grant is affected more than any other grant despite the fact that its scope has been increased to include sanitation. In its 2017/18 Annual Submission, the Commission noted that sanitation backlog remain high particularly in rural areas and a government set target of achieving universal access to sanitation by 2014 has remained elusive.

**Table 5: Conditional grants Spending**

| | 2013/14 | 2014/15 | 2015/16 |
|---|---|---|---|
| Municipal Infrastructure Grant | 96% | 92% | 93% |
| Urban Settlement Development Grant | 94% | 95% | 96% |
| Public Transport Network Operations Grant | 62% | 78% | 84% |
| Water Services infrastructure grant* | 66% | 81% | 85% |

*Source: National Treasury.*

5.15. The 2017 budget was also presented against a backdrop of a restructured local government. Through mergers, the number of municipalities were reduced from 278 to 257 in August 2016. The 2016 amalgamations were partly motivated by the desire to improve municipal financial viability and functionality. Although the Commission has reservations on the notion that amalgamation can correct for municipal financial viability and functionality, it nonetheless supports the continued allocation of funds through the Municipal Demarcation Transition grant to support this process. In 2017/18 amalgamated municipalities, will be allocated a total of R112 million through this grant to defray costs associated with amalgamations.

5.16. The Commission also welcomes four areas that the government will focus on to turnaround the local government. The four areas are:

a. The Select Committee on Appropriations (SCOA) to improve municipal information and better financial management

b. Supply Chain improvements to minimise irregular expenditure or outright corruption

c. Proposed guidelines to set tariffs. This will minimise disparities in costs of services and tariffs, especially electricity

d. Improved assets management and asset maintenance

5.17. These four areas will ensure that municipalities will manage scarce financial resources efficiently, maintain decaying infrastructure, and set tariffs that will not compromise their financial viability. The Commission will add to the list (although it can be located within (a)), the issue of the ever-escalating consumer debt and municipal debt. The increase in consumer debt has continued to affect the fiscal viability and financial health of municipalities. Similarly, the operations of public entities owed large sums by municipalities have been adversely affected. Municipalities currently owe Eskom over

R10 billion and at the same time they are owed R113 billion (as of June 2016) by national and provincial spheres, businesses and households (i.e. 5.4% by national and provincial governments; 23% by business and 65% by households). The Commission wishes to implore the task team examining the intergovernmental debt to speedily resolve the issue and government to put similar pressure on municipalities and government to honour their debts.

## 6. Government Responses to the Commission and Standing Committee on Appropriations Recommendations

### A. Response to Commission Recommendations

6.1 The Commission tabled its Submission for the Division of Revenue (DoR) 2017/18 to Parliament in May 2016. As required by the IGFR Act, Government published its response to the recommendations made by the Commission for the 2017/18 DoR when the Minister of Finance tabled the annual DoR Bill with the annual budget in the National Assembly.

6.2 The 2017/18 submission comprises of 11 chapters with a total of 37 recommendations. Government has responded to recommendations in 9 of the chapters within the submission, these recommendations have a direct impact on the Division of Revenue. Overall the Commission welcomes the extensive consultative process and the manner in which Government has responded to the recommendations and further invite parliament to exercise oversight in the implementation of the accepted recommendations.

6.3 Government agrees with most of the recommendations made by the Commission and in some cases, has indicated processes currently government practice to address some of these recommendations.

### B. Responses to Standing Committee on Appropriations Recommendations

6.4 Various committees of the National Assembly produce reports on the budget review, the fiscal framework and division of revenue with recommendation that are addressed to Government. Section 7 of the Money Bills and Amended Procedures and Related

Matters Act requires the Minister of Finance to table the budget with details of how such recommendations have been taken into account. The 2017/18 budget review lists 51 such recommendations that Government has responded to. The recommendations cover a wide array of issues mainly targeted at Government's investment in infrastructure. This section responds to the request from the Standing Committee on Appropriations (hereinafter the Committee) over the years to assess the Committee recommendations and Government responses. The Commission agrees with most of the Committee recommendations and government responses.

6.5 The recommendation made on outreach programmes on the use of reporting systems. The Commission support this recommendation though government need to ensure departments readiness (availability of resources) to absorb such educational outreach.

6.6 The committee recommended rollout of basic social infrastructure to the poor. The Commission agrees and further suggest that government departments and municipalities build in-house capacity to enable them to rollout basic social infrastructure to the poor.

6.7 With respect to measures to reduce lease costs, the Commission agrees with the recommendation and further suggest that government should, interrogate the cost of ownership versus leasing of office accommodation.

## 7. Concluding Remarks

7.1 The Commission is in agreement with the general thrust of the 2017 Division of Revenue Bill as it resonates with the spirit of its previous submissions. The tight macroeconomic and fiscal environment requires bold decisions to bring the trajectory of public spending trends in line with available revenue. Previously, the Commission has reiterated the need for government to maintain fiscal consolidation as a means to achieve sustainability and most importantly to ensure productive spending and social spending that benefits poor people is not cut. Coupled with tax changes to generate more revenues, Government has proposed spending reductions on non-essential items while major poverty reduction and social programmes have been protected.

7.2 As done in previous years, Government in consultation with the Commission has classified the Commission's recommendations into: recommendations that apply directly or indirectly to the division of revenue and recommendations that do not relate to the division of revenue. Responses in the explanatory memorandum accompanying the Division of Revenue Bill are provided for those directly and indirectly related to the division of revenue. Recommendations that do not apply to the division of revenue are being considered and responded to by the appropriate national departments. Parliament is invited to follow through on the responses and commitments made by the departments to implement the recommendations.

7.3 Given the tight fiscal framework, the Commission commends efforts by Government to protect social spending, Provincial Equitable Share and Local Equitable Share which are fundamental in maintaining and improving service delivery to communities.

7.3.1 The PES and LES formulae have been updated with new data and this is being phased-in over a number of years. The Commission agrees with the principle that any effects on updates to the PES and LES is phased in over period of time as this provides for stability of the IGFR system and smoothing of expenditure over time.

7.3.2 Government has announced a review of the provincial equitable share formula. The review is expected to cover the funding burden of poorer schools, the cost of service provision and assessment of data reliability. The Commission welcomes this review.

7.4 Given the tight fiscal framework, the Commission commends efforts by Government to protect various conditional grants, which are fundamental in maintaining and improving service delivery to communities. The Commission supports the proposed conditional grant

changes, addressing identified weaknesses it has raised in the past and will continue engaging with government and other stakeholders in the exercise.

7.4.1 The Commission is also supportive of the proposed new conditional grants, subject to matters raised in this submission.

7.5 The Commission welcomes the realisation of the disparities in the funding of District Municipalities. A number of District Municipalities have been receiving very low allocations from the RSC levy replacement grant, a development that has impacted negatively on their ability to deliver services and support local municipalities. Although the Commission welcomes the interim measures taken by government to relieve the funding bottleneck it is of the view that a long term sustainable funding model for District Municipalities should be found and such a model should be based on a clear identification of their powers and functions.

7.6 Expenditure in respect of social protection provides an important buffer for the poor, making the upward revision a welcome development, especially at the time of exerted fiscal pressure on most spending programmes. There are positive socio-economic impacts on poor households such as increased likelihood of job search, education provision and food security among others from such expenditures and Government should continue to maintain increased access provision to the needy and deserving.

7.7 Improvement in economic growth prospects as a means of generating additional tax revenue to bring down the budget deficits and public debt should be a pre-requisite. South Africa should continue to focus its strategy for reigniting growth on improving education expenditure outcomes in particular, increasing skills bases, maintaining strong growth on social safety net spending and increasing productivity of public infrastructure.

For and on behalf of the Financial and Fiscal Commission

Mr. Velile Mbethe

Acting CEO