BRIEFING TO THE STANDING COMMITTEE ON THE APPROPRIATION BILL [B1-2013]

"For an Equitable Sharing of National Revenue"

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List of Acronyms

CPI	Consumer Price Index
CWP	Community Works Program
DoHS	Department of Human Settlements
DWA	Department of Water Affairs
EPWP	Expanded Public Works Program
FFC	Financial and Fiscal Commission
GDP	Gross Domestic Product
HSDG	Human Settlements Development Grant
LES	Local Equitable Share
MFMA	Municipal Finance Management Act
MISA	Municipal Infrastructure Support Agency
MTBPS	Medium Term Budget Policy Statement
MTEF	Medium Term Expenditure Framework
NDP	National Development Plan
NGP	New Growth Path
PICC	Presidential Infrastructure Coordinating Commission
RHIG	Rural Household Infrastructure Grant
SCM	Supply Chain Management
SIP	Strategic Integrated Project
USDG	Urban Settlements Development Grant
VAT	Value Added Tax

1. THE CONTEXT: BRIEFING TO PARLIAMENT'S POWERS TO AMEND MONEY BILLS

1.1 As already mentioned by the Financial and Fiscal Commission (the Commission) when it made its submission to Parliament on the 2013 Division of Revenue Bill and Fiscal Frameworks and Revenue Proposals, a major achievement by the South African Government has been the development and adoption of a national development plan (NDP) as the key driver for policy-making.

1.2 The NDP identifies two clear, time-bound targets for increasing sustainable economic development in South Africa:

(a) To attain a growth rate of gross domestic product (GDP) of 5.4% per annum until 2030

(b) To eliminate poverty defined using the income based measure by 2030

1.3 The motivation for fiscal reforms contained in the 2013 Budget begins to create a fiscal framework which will give the country greater ability to increase sustainable economic development. This submission presents an assessment on certain key interventions to meet objectives relevant for Government's priority areas. The submission is made in terms of Section 4 (4) (2) of the Money Bills Amendment Procedure and Related Matters Act (Act 9 of 2009) which requires Parliamentary Committees to consider any recommendations of the Commission when processing the Appropriations Bill[1]. It is also made in terms of Section 3 of the FFC Act (1997), as amended, which requires the Commission to respond to any requests for recommendations by any organ of state on any financial and fiscal matter.

2. MACROECONOMIC AND FISCAL OUTLOOK

2.1 The views of macroeconomists towards fiscal policy have undergone substantial change over the last several decades. Prior to the Great Depression (1929-33), the idea of *balanced budgets* (government should offset deficits incurred during war with surpluses during peacetime) prevailed. Following the Great Depression when it became clear that economies would not self correct in the absence of stumuli, Keynesian ideas

[1] The Appropriation Bill is a piece of legislation that serves to appropriate money from the National Revenue Fund for the requirements of national government in order to provide for subordinate matters incidental thereto.

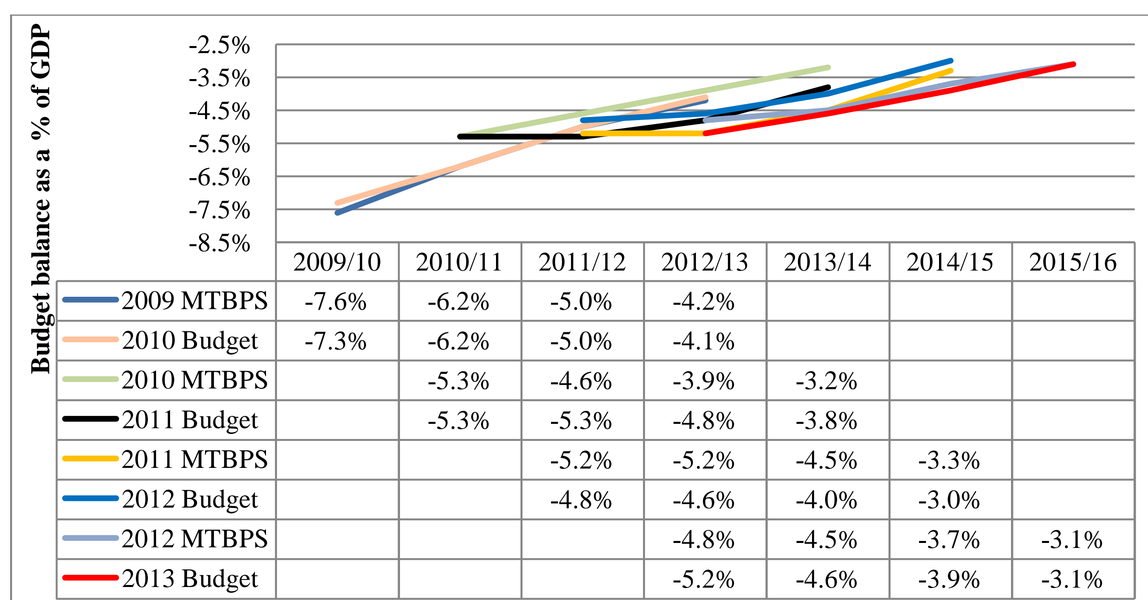
characterized by activist fiscal (and monetary) policy seen as a requirement to manage aggregate demand and ensure full employment dominated. Through the 1980s and 1990s, these ideas waned and fiscal policy was largely driven by concerns over macroeconomic imbalances (inflation, balance of payments, deficits and debt). Recently, issues of sustainability have come to the forefront. This is the idea that changes to the fiscal framework should show the cost effectiveness of the funding mechanism and at the same time ensure sustainability of spending levels both in the short and long-term. There are three critical elements to be considered in relation to sustainability: (i) macroeconomic stability, (ii) budgetary stability, and (iii) affordability.

2.2 The South African economy remains vulnerable to slow global recovery (slowdown in China's economic growth and decreased demand for South African exports by the European Union which is South Africa's largest trading partner) as well as to domestic factors such as the recent violent labour conflicts. Economic growth (in real terms) has decreased from 2.8% in 2010 to 2.5% in 2012. Against the backdrop of slower than anticipated economic growth, a subsequent decline in revenue collection and a widening of the deficit, Government tabled a total national budget of R1.2-trillion to be spent across the three spheres for 2013 financial year, growing to R1.3-trillion in 2015/2016. A significant portion of this allocation is spent at national (47.6%) and provincial level (43.5%), while the local government sphere receives 8.9% of this allocation. The 2013/14 baseline is revised upwards by R10 billion. This raises the total allocated expenditure for the three spheres to R951 billion. National government receives the largest share of revisions to baseline (R 6.2 billion) while provinces and local government receives R3 billion and R800 million respectively. The total 2013/14 baseline revisions are made up of a combination of reprioritized funds and savings amounting to R7.2 billion and new additions amounting to R2.8 billion.

2.3 South African budgetary stability should no longer be taken for granted. To illustrate this point, prevailing economic conditions have meant that Government's approach to moderated expenditure thus far has not seen a significant improvement in the budget balance. Figure 1 shows the results of a comparison of the budget deficit forecasts from 2010, 2011, 2012 and 2013 Medium Term Budget Policy Statement (MTBPS) reports and budgets. Compared to the 2010 Budget (light orange line) which indicated a fast pace to closing the budget deficit, Budgets 2011 (black line) and 2012 (blue line) indicated gradual declines in the first year of the Medium Term Expenditure

Framework (MTEF) followed by a more aggressive approach in the outer years of the medium term. Budget 2013 (dark orange line), indicates a reversal of the 2011 and 2012 trends. From an aggressive approach in the first two years of the MTEF, we see a slow down by year 3. In its response to the 2012 MTBPS, the Commission noted that the slowing down of fiscal consolidation since 2009 meant that South Africa would be unlikely to achieve -3% budget balance as a percentage of GDP over the medium term. Whether the planned moderation of growth in government expenditure as outlined in Budget 2013 would counteract the lower than expected revenue collection to result in the medium-term budget balance breaching the 3% to GDP level by 2015/16 remains to be seen.

Figure 1: Medium-Term Budget Deficit Projections



	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
2009 MTBPS	-7.6%	-6.2%	-5.0%	-4.2%			
2010 Budget	-7.3%	-6.2%	-5.0%	-4.1%			
2010 MTBPS		-5.3%	-4.6%	-3.9%	-3.2%		
2011 Budget		-5.3%	-5.3%	-4.8%	-3.8%		
2011 MTBPS			-5.2%	-5.2%	-4.5%	-3.3%	
2012 Budget			-4.8%	-4.6%	-4.0%	-3.0%	
2012 MTBPS				-4.8%	-4.5%	-3.7%	-3.1%
2013 Budget				-5.2%	-4.6%	-3.9%	-3.1%

Source: MTBPS (2009, 2010, 2011, 2012); Budget Review (2010, 2011, 2012, 2013).

2.4 The most obvious manner in which South Africa could improve its fiscal situation is if the economy could grow faster. This would help generate higher growth in tax revenue and in this way, budget deficits could decline a lot faster and public debt begin to reduce accordingly. Indeed, to some extent the National Treasury has incorporated such a scenario into its three-year MTEF. Gross Domestic Product (GDP) growth is projected to accelerate from a forecast level of 2.7% for this year, to over 3% for 2014 and over 4% for 2015. In this way, the Government has managed to budget for a reduction in the budget deficit as a percent of GDP from 5.2% in 2012/13, to just 3.1% in 2015/16. This enables the public debt to GDP ratio to top out at around 45% in

2016/2017. There are two obvious challenges in this regard. The first, is whether the economy will actually accelerate its growth in such a way so as to enable these optimistic projections to be achieved. In this regard, the Government is dependent not only on addressing domestic structural impediments to economic growth, but also on the performance of the international economy, given the high correlation between the growth of South Africa's economy and that of the world. Should the world's leading countries not be able to extricate themselves from the low growth environment of the past year driven by the need to observe fiscal austerity in the face of huge public debt levels, South Africa's own economic growth will suffer. The hoped-for reduction in budget deficits and public debt will then be harder to achieve. Secondly, incorporated into these forecasts is the budgeted assumption that growth in the public sector wage bill, which was 8.3% per annum in the last three years, will decline to just 1.3% per annum over the next three years. In this regard, the Government rests its assumption on the fact that it has a three year public sector wage agreement with public sector unions in place, to grant increases of 1% above the consumer price index (CPI) inflation rate plus a further 0.3% per annum for notch increases.

2.5 The next macroeconomic issue concerns *sustainability*. Conventional assessments of fiscal sustainability *project* the implications of current fiscal/ monetary policies for deficits, real rates of interest and growth. A set of policies would be fiscally unsustainable if it would result in government being unable to pay its debts, i.e. if it resulted in insolvency. Fiscal sustainability analysis provides a judgment on whether a particular mix of fiscal/ monetary policies could be sustained. From the 2013 Budget, it is important for this discussion to map public expenditure as it is a key channel for fiscal impact on growth. Notice that much of the fiscal sustainability discussion focuses on the deficit or primary surplus and ignores the composition of expenditure. Even though there is concern for the long term budget constraint, it is confined to the way the deficit and its financing affect the economy. A central question is of course whether it would matter for growth if for the same deficit, a government spent on consumption or investment? It should, but most fiscal policy discussion ignores the key channel for fiscal policy to influence growth, i.e. the effect of the composition of expenditure (and taxation). Not surprisingly, fiscal adjustment has often been achieved in ways that would have undermined long term growth. It is difficult to assess the growth consequences of South Africa's fiscal stance. In one respect, if GDP growth does not meet the Government's own forecasts and hence tax revenues fall short of budget, this

in itself will cause the fiscal situation to deteriorate, necessitating further fiscal austerity, leading to lower economic growth. On the other hand, a better outcome for GDP growth would make it that much easier to meet the Government's deficit reduction programme. In this regard, to the extent that the deficit reduction programme is premised on reducing growth in the public sector wage bill, this in itself removes one of the pillars driving rapid growth in consumer spending between 2010 and 2012. With the planned substantial reduction in real growth of remuneration of public sector employees, growth in consumer spending is bound to slow, not only because of the planned effective erosion in disposable income of public sector employees, but also because the growth of unsecured lending to the public services is likely to diminish if Government refrains from employing more persons in the service. However, hopes still exist that in terms of the overall GDP growth rate, the slowdown in the growth of consumer spending will be counterbalanced by increased infrastructural investment spending and an improvement in exports and the trade balance on the back of the real depreciation of the Rand over the past year. Accordingly, it is still reasonable to project economic growth in 2013 of between 2.5% and 3.0% and of slightly more than 3.0% in 2014. As will be elaborated on later in this submission, these insights are corroborated for South Africa by recent simulations by the Commission that focused on the intertemporal impact of increased current and investment spending[2].

2.6 Based on this analysis of the macroeconomic aspects of the 2013 Budget, it is clear that a solid understanding of the macroeconomics (and microeconomics) of the budget is essential for good oversight/review of the 2013 Budget. There is a need to engage Governments with a well developed view of how fiscal policy and public spending impact the growth and development process. While the analysis outlined above represent a credible scenario for the next few years, it is appropriate to outline the risks to the analysis. The majority of risks to the outlook appear to be on the downside. The main identifiable risks include:

- A steeper or more prolonged downturn in our main trading partners
- The possibility that global financial market problems persist for longer than expected
- Further exchange rate depreciation, particularly against the Euro;

[2] This is based on work reported in Mabugu, R., Robichaud, V., Maisonnave, H., and Chitiga, M., (2013) "Impact of Fiscal Policy in an Intertemporal CGE Model for South Africa", *Economic Modelling*, **31**: 775-782, Elsevier B.V. Publishers.

- Further out, there is the possibility that structural unemployment may persist, thus limiting the ability of the economy to achieve growth above trend.

2.7 The main upside potential stems from the possibility that the various stimulus packages being put in place around the globe have a more rapid and more beneficial impact on world demand than is currently assumed.

3. General Assessment: Giving Effect to Government's Priorities

3.1 The South African Government has adopted four overarching priorities under the banner of the 2013 Division of Revenue Bill. These four priorities are:

- Promoting economic support and development
- Investment in infrastructure
- Job creation; and
- Enhancing local government capacity

3.2 Promoting Economic Support and Development

(a) Under the **current framework**, Government has in place most of the key elements of supply-side economic policy, including education, skills and infrastructure, which are believed to be important determinants of competitiveness and long-term economic growth. In addition to education and infrastructure policies, other important economic policy levers with a bearing on economic growth rate include: (a) energy policy, (b) competition policy, (c) trade policy, (d) economic regulation of utilities (e.g. telecommunications, broadcasting and energy), (e) financial services and regulation of financial markets, (f) consumer protection and product and trading standards; and (g) policies affecting the labour market, including employment law and immigration. These are significant responsibilities which have a considerable bearing on the performance and the growth potential of the economy. Decisions in these areas by Government can also have important consequences for fiscal policy, at both a national level and in provinces and municipalities. For example, decisions on labour market policy, and particularly on immigration, can have an important influence on demand for public services and the size of the tax base. The challenge across the board is in the implementation of the policies in order to achieve the relevant objectives and address priorities of government.

(b) Table 1 reports changes to the 2013/14 financial year, comparing MTBPS 2012 and Budget 2013. Welcome developments include significant upward revisions of science and technology by 12.4%. South Africa needs to improve the pipeline for developing infrastructure skills. Despite limited fiscal space, it is noteworthy that annual average growth of health and social protection and employment and social security all show increases. Expenditure in this area, especially for social security, provides an important buffer during cyclical downturns.

Table 1: Expenditure Component Revisions (Functional Classification)

	2013/14 Figures		
R'billions	**2012 MTBPS**	**Budget 2013**	**% Change**
General public services	56.0	56.7	1.3%
Defence, public order and safety and state security	151.7	153.7	1.3%
Transport, energy and communication	91.5	88.6	-3.2%
Economic services	48.1	48.0	-0.3%
Local government, housing and community amenities	132.5	132.1	-0.3%
Health and social protection	267.8	268.5	0.3%
Education and related functions	234.0	232.5	-0.6%
Employment and social security	48.6	49.2	1.2%
Science and technology	14.5	16.3	12.4%

Source: MTBPS (2012); Budget Review (2013); Commission Calculations

(c) Overall the Commission is of the view that, given the prevailing economic climate, growth and employment in South Africa can only be achieved through a combination of fiscal consolidation and investment in future growth. Already a number of policies have been put in place such as the Special Economic Zones, Manufacturing Bonus Scheme and the cushioning of social services. However, while Provincial Governments have significant levers to shape spending programmes, for example, on education and skills, there is a need to enhance their abilities to shape the establishment of clusters and key sectors, levers that are seen as vital to sustainable economic development (a provincial function). Ensuring an improvement in the quality of provincial spending is equally important. Were the country to succeed in implementing the NDP (which has been officially endorsed by Government and the African National Congress), there is reason to believe that the country's sustainable

growth rate would rise sufficiently in a manner that enables the country's public debt to GDP ratio eventually to decline on the back of enhanced tax revenues. Included in the NDP as strategies to improve sustainable economic growth are an increase in the focus on education and skills development, a less adversarial relationship between business and organised labour, more focus on improving small business development of entrepreneurship, increased infrastructural investment, greater cooperation between public and private sectors, improved capacity of the public sector to implement projects and strategies to reduce corruption.

(d) For Provinces and Local Government, establishment of clusters and key sectors is vital to sustainable economic growth. The Nobel laureate Paul Krugman, in his theory of New Economic Geography[3], has stressed the importance of the growth and development of clusters and key sectors in developing networks, enhancing economies of scale, creating spillovers and ultimately boosting economic growth. Government policy has an important role to play in ensuring that provinces and economic regions are well placed to take advantage of such opportunities.

(e) In the main, national departments have not established precise and costable norms and standards for concurrent functions for provinces to implement. This implies that accurately costing a standard basket of social/economic services across provinces is currently not possible. The access to and quality of services enjoyed by beneficiaries from different provinces is therefore uneven. A further consequence of inadequately specified, financed and implemented norms and standards is the possible disproportionate economic growth of provinces along different development trajectories.

(f) In accordance with Section 153 of the Constitution, municipalities promote and provide economic support and development through the delivery of basic services such as water, sanitation, electricity and refuse removal. The provision of these services are funded via two sources, the local government equitable share (LES)[4] allocation and municipal own[5] revenue. For the 2013/14 financial year just over

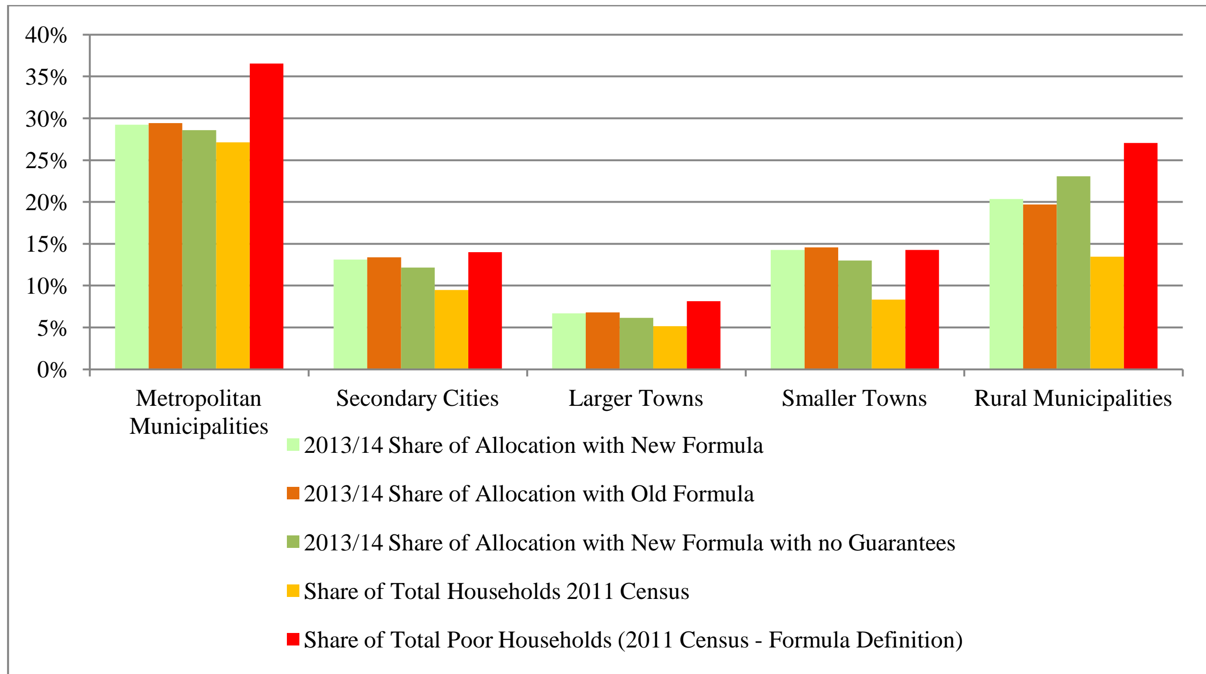
[3] Krugman P., 1991, "Increasing Returns and Economic Geography", *Journal of Political Economy*, Vol. 99, pp. 483 – 499.

[4] The LES is an unconditional transfer to municipalities via the annual Division of Revenue process

[5] This refers to revenue that a municipality raises and has discretion over. Revenue derived from property rates represents an example of own revenue.

R40 billion is allocated in respect of this discretionary funding to municipalities. Notable revisions have been made to the LES funding mechanism that will ensure greater funding support to poorer and more rural municipalities (see Figure 2).

Figure 2: Comparative Assessment of Old and New Formula[6]



(g) The Commission fully supports the changes made to the LES mechanism[7]. As the revised formula is phased in over the next five years, the Commission recommends that Government closely monitor the ability of poorer, rural municipalities to absorb and effectively spend additional funding. To this end Section 154, which describes the support that provincial and national governments need to provide to municipalities, is important if municipalities are to successfully promote economic support and development.

3.3 INVESTMENT IN INFRASTRUCTURE

[6] Notes: Figure excludes allocations to district municipalities, but includes allocations with the new formula without the phasing-in provisions for comparative purposes. Poor households are defined as households earning less than R2300 per month in 2011

[7] For further information on the Commission's views on the LES and other local government fiscal framework issues, please consult the Commission report titled: *"Sustaining Local Government Finances: Final Report on the Financial and Fiscal Commission's Public Hearings on the Review of the Local Government Fiscal Framework"*. The full report can be accessed on the Commission's website - http://www.ffc.co.za/

(h) For provinces, savings of R1.7 billion to the baseline of conditional grants have been identified and R8.2 billion has been added to the baseline. The increase in conditional grants to provinces is largely to fund infrastructure in health and education. Increased health and education infrastructure spending is meant to stimulate job creation and create social capital that will boost social and economic development. Provinces have historically underspent on infrastructure budgets. A concern for the Commission was the poor planning and critical skills shortages in provincial infrastructure delivery. The revised design of the provincial infrastructure grant will incentivize good performance and reallocate resources to where such resources are being spent. Close scrutiny on spending of these grants will be important to ensure policy priorities are adequately provided for. The Auditor General's recent performance report on health and education infrastructure in provinces highlighted an accountability deficit, especially in relation to supply chain management. Consolidation efforts must be accompanied by interventions to address underlying drivers of poor performance and improvement in accountability framework.

(i) Much of the investment in infrastructure takes place within municipalities and is channeled to the local sphere through conditional grant funding. There is particular emphasis on water (through the newly created Municipal Water Infrastructure Grant) and electricity (through the Integrated National Electrification Programme (INEP)). In terms of additions to the baseline for 2013/14, water and electricity receive R312 million and R511 million respectively. The Commission is pleased to note that a proportion of the baseline addition to the INEP is in respect of piloting an approach to asset management[8], an aspect that is sorely lacking across the local government sphere. The introduction of the new Municipal Water Infrastructure Grant is noted. The Commission would advise Government to guard against creating overlaps across different grants with a similar purpose. In this case, both the Municipal Infrastructure Grant (MIG) and the newly created grant, aim at increasing access to water to poor/rural households. This type of arrangement has the potential to

[8] The pilot will fund implementation of the Approach to Distribution Asset Management (referred to as ADAM). Asset management practice incorporates the practice of decision-making, planning and control over the acquisition, use, safeguarding and disposal of assets to maximise their service delivery potential and benefits and to minimise their related risks and costs over their entire life

undermine the original role of the MIG as the tool to deal holistically with municipal infrastructure.

(j) Historically, municipalities have not been able to spend infrastructure budgets effectively. Performance has been characterized by delays, poor planning, lack of project management capacity and poor oversight on the part of provincial and national government. If planned investment is to foster stronger economic growth, these challenges will need to be overcome. Existing capacity building initiatives such as the Infrastructure Skills Development Grant and the recently established Municipal Infrastructure Support Agency (MISA) reflect attempts to address these long-standing issues. Given that these two interventions are relatively new, it would be premature to judge their performance.

(k) The Commission would like to emphasise that alongside investment in new infrastructure, there is a pressing need to maintain and renew existing infrastructure adequately. Research conducted as part of the Commission's Submission for the 2014/15 Division of Revenue indicates that municipalities underfund and underspend on maintenance and renewals, thus putting at risk the potential benefits that could be reaped as a result of Government's large investment in infrastructure.

3.4 Job Creation

(a) While post-apartheid South Africa has witnessed many positive developments, unemployment and poverty remain serious challenges. Unemployment has been consistently very high in the last two decades. Unemployment increased from 1995, and from 1996 rates remained stubbornly above the 20% threshold. Persistently high unemployment has many negative repercussions on individuals, families, government and broader society. Not only does it place psychological and financial strains on those unable to find work and their families especially given the high dependency ratios in South Africa, it also places budgetary pressures on the national government and on provincial and local governments, as tax revenues decline and expenditures increase. In the long term, unemployment erodes skills thereby reducing future national productivity and income.

(a) Government has maintained focus on job creation as a key priority over the MTEF. As Table 2 shows, job creation and social security expenditure increased from R41.7 billion in 2012/13 to R61 billion in 2015/16 financial year. In

2013/14, job creation has been allocated an amount of R33.6 billion. Of this amount, about 68.3% is allocated for social security funds. The total social security funds include unemployment insurance fund, compensation funds and road accident fund.

(b) The 2013/14 budget also makes provision for other job creation initiatives such as expanded works programme (EPWP) and community work programme (CWP). Through its coordination of the EPWP, the Department of Public Works aims to create 3.7 million work opportunities by the end of 2016. In addition, it also makes provision to support the work of the Commission for Conciliation, Mediation and Arbitration in preparation for amendments to labour legislation. The EPWP Integrated Grant (R355.9 million) and the Social Sector EPWP incentive grant (R257.6 million) for provinces are the main job creation funding streams identified in the Appropriation Bill for provinces. Both grants steadily increase over the MTEF and are solely for job creation projects. Several other grants also have a job creation component, but there are also other objectives these grants have to achieve. For example, the grants under the Provincial Departments of Agricultural all aim to create jobs, but also include objectives such as training, and capacity development, technical advice, disaster relief and support.

Table 2: Employment and Social Security Expenditure, 2009/10-2015/16

R million	2012/13	2013/14	2014/15	2015/16
National departments	11 332	13 181	15 134	15 497
Provinces	1 265	1 671	1 677	1 720
Social security funds	28 476	33 633	39 579	42 893
Public entities	604	746	849	905
Total	**41 677**	**49 232**	**57 239**	**61 015**
Of which:				
Expanded public works programme	*1 729*	*1 948*	*2 076*	*2 156*
Community work programme	*1 348*	*1 675*	*2 390*	*2 505*
Commission for Conciliation, Mediation and Arbitration	*479*	*594*	*687*	*734*

Source: Adapted From National Treasury Budget Review, 2013

(c) At the local sphere, CWP grant provides work opportunities for historically marginalized communities and is projected to grow by 23% over the MTEF

period. The EPWP Integrated Grant for Municipalities is a conditional grant aimed at promoting greater use of labour intensive methods in delivering municipal services. R610 million is allocated in respect of this grant for the 2013/14 financial year. On their own, the initiatives are unlikely to make a significant dent on unemployment. Part of the problem lies in the inability of municipalities to effectively spend allocated resources. For example in 2011/12, only 54% of the total available for this grant was allocated to eligible municipalities[9].

(d) As can be deduced from the discussions above, the main pillars of government economic policy, the New Growth Path (NGP), the Industrial Policy Action Plan and the NDP for 2030 are anchored in a significant ramping up of capital expenditure by the state which they expect will contribute significantly to meeting the government job-creation target of 5-million jobs in 2020 (NGP) or 11 million jobs by 2030 (NPD). So much is riding on this state infrastructure spending as the solution to reducing poverty, inequality and unemployment and generating economic growth. The Commission has examined these broad arrays of policy approaches designed to reduce unemployment[10]. The main finding involves the negligible impact on employment growth of interventions such as an expansive infrastructure strategy or expanded public expenditures. The analysis shows clearly that fiscal policy (infrastructure and current expenditures) alone is not going to solve job-creation problems unless complemented by these other interventions.

(e) At the very least, the finding suggests government interventions that emphasise infrastructure alone are unlikely to make an impression on employment. While infrastructure development is a critical fiscal lever for expanding employment, if we want to see the type of growth in jobs envisaged by the NGP and NDP this is not enough. Rather than replacing ageing infrastructure, policy should therefore target public investments that serve as a catalyst to shifts towards jobs and knowledge-intensive production and

[9] Eligible municipalities refer to those municipalities that actually made greater use of labour intensive methods in the delivery of services. The grant allocation is based on past performance – thereby creating the incentive effect.

[10] For further information, please refer to chapter 1(titled: Perspectives and Prospects for Job Creation and the Intergovernmental Fiscal Relations System) of the Commission's 2013/14 Submission for the Division of Revenue.

provision of government services (including maintenance of existing infrastructure). We need to look at shifting the skills mix, other regulatory constraints and possibly even the informal and SMME sector to create jobs in the short term. Similarly, the 'prisoner's dilemma' scenario[11], which is currently preventing realization of a coordinated social compact among the role players who can influence employment, requires urgent redress.

3.5 Enhancing Local Government Capacity

a) Limited capacity is often cited as a hindrance to good performance at the local level. A number of initiatives aim to address this challenge. Section 155(6) of the Constitution requires that the provincial government must provide for the monitoring and support of local government in the province, and the promotion of local government capacity. Section 105(1)(a-c) of the Municipal Systems Act (Act 32 of 2000) places the responsibility on the provincial department of co-operative governance to monitor the development of local government capacity in the province and assess the support needed by municipalities to strengthen their capacity to manage own affairs, exercise their powers and perform assigned functions. The Appropriation Bill does not contain any specific funding that is channeled to provinces for local government capacity building. Funds for these initiatives are usually allocated through the provincial appropriations process.

b) The 2013 Appropriation Bill allocates R763.6 million in respect of capacity building at the local level. This includes the Municipal Systems Improvement Grant (R240.3 million), the Infrastructure Skills Development Grant (R98.5 million) and the Local Government Financial Management Grant (R424.7 million). The impact and outcomes attached to these initiatives (in terms of producing a more skilled and efficient civil service) are critical if the public sector is to achieve more within the constraints of limited resources. The ability of the civil service to do more with fewer resources is particularly important if South Africa's economic growth remains subdued. Going forward it will be important to ensure that municipalities are able to absorb and utilize the funding available through these conditional grants, particularly

[11] 'Prisoner's dilemma' refers casually to situations where role players (unions, government and business) could gain important benefits from cooperating but suffer from the failure to do so, finding it merely difficult or expensive, (but not necessarily impossible) to coordinate their activities to achieve cooperation.

the Infrastructure Skills Development Grant which is projected to increase by 56% between 2013/14 and 2014/15 (see Table 3).

Table 3: Key Local Government Capacity Interventions

R'million	**2013/14**	**2014/15**	**2015/16**
Municipal Systems Improvement Grant	240	252	261
Local Government Financial Management Grant	425	449	470
Infrastructure Skills Development Grant	99	154	179
TOTAL	**764**	**855**	**910**
Annual Growth			
Municipal Systems Improvement Grant		5%	4%
Local Government Financial Management Grant		6%	5%
Infrastructure Skills Development Grant		56%	16%
TOTAL		**12%**	**6%**

Source: Adapted from Appropriations Bill, 2013

c) The Commission would like to reiterate two capacity related recommendations made in its Submission for the Division of Revenue 2013/14[12]:

- The first regards the need to strictly enforce the minimum competencies as entrenched in the Municipal Finance Management Act (MFMA) so as to ensure that appropriate technical skills are in place. This is critical in light of the Auditor-General pointing out that one of the root causes for poor audit outcomes is the fact that officials in key positions at over 70% of municipal auditees do not have the minimum competencies and skills to perform their jobs[13].
- The second is the need for the conditions attached to capacity grants to commit municipalities to specific, independently verifiable capacity and

[12] For further details, see Chapter 9 of the FFC's 2013/14 Submission for the Division of Revenue.
[13] See foreword contained in the Consolidated Report on the Audit Outcomes of Local Government, 2010/11.

performance improvements. This can assist in attaining the desired outcome of a more skilled and professional local government work force.

4. Assessment of Infrastructure Investment in National Government

4.1 Presidential Infrastructure Coordinating Commission

a) As in previous years and alluded to above, investment in infrastructure represents Government's focus for growing the economy. In the 2013/14 budget, Government continues to focus on financing infrastructure investment. An amount of R827 billion has been budgeted and approved for infrastructure investment over the MTEF. Of this amount, about R430 billion is allocated from the fiscus.

b) In 2011, the Presidential Infrastructure Coordinating Commission (PICC) was established. The PICC is composed of ministers, premiers and metropolitan municipality mayors. Its main function is to identify, prioritize and coordinate infrastructure development. Thus far it has prioritized 18 strategic infrastructure projects (referred to as Strategic Integrated Projects (SIPs)). Most of these projects focus specifically on infrastructure falling within the ambit of local government. This includes plans to:

- Expand the electricity distribution network and provide access to electricity
- Develop national capacity to assist the 23 least resourced districts in addressing their maintenance backlogs and upgrading water, electricity and sanitation bulk infrastructure
- Coordinate planning and implementation of public transport, human settlement, economic and social infrastructure so as to create sustainable urban settlements[14]

4.2 National Infrastructure Plan

c) Table 4 gives the national investment plan over the MTEF. Over the MTEF period, an amount of R397 billion is allocated to state-owned companies. Of this amount, a significant portion is allocated mainly to Eskom (R205 billion) and Transnet (R124

[14] For further details, see the PICC Report for 2012.

billion). This money will be used to fund ongoing building of power stations and the rolling out of new electricity transmission, new rail, ports, pipelines and water transfer scheme.

d) The majority of public infrastructure expenditure will be by state owned companies (with Eskom and Transnet accounting for the largest proportion), followed by provincial departments and then local government. The national departments are responsible for a smaller share of public infrastructure investment equivalent to 4.8 percent over the 2013 MTEF. When state owned companies and other extra budgetary institutions are included, the national government's share of public infrastructure investment increases to 60.9 percent leaving provinces and municipalities with a respective share of 17.9 percent and 18.2 percent respectively over the 2013 MTEF period.

Table 4: Public Sector Infrastructure Expenditure by Area of Responsibility, 2011/12-2015/16

	2011/12	2012/13	2013/14	2014/15	2015/16	MTEF Total
R million	**Outcome**	**Budget**	**Medium-term estimates**			
National departments	6 599	10 802	11 225	14 046	14 329	39 600
Provincial departments	43 449	43 762	46 202	49 385	52 098	147 685
Local government	33 239	38 489	46 940	50 506	53 161	150 607
Extra-budgetary institutions	15 418	15 697	21 493	21 909	23 176	66 578
of which:						
SANRAL non-toll building programme	*8 296*	*9 667*	*10 206*	*10 433*	*10 960*	*31 599*
Public-private partnerships	10 710	17 955	7 145	4 504	13 713	25 362
General government	**109 415**	**126 705**	**133 005**	**140 350**	**156 477**	**429 832**
Eskom investment programme	58 815	76 141	72 107	68 016	64 934	205 057
Transnet investment programme	21 821	31 183	37 320	38 815	48 026	124 161
SANRAL	5 683	2 012	1 785	1 620	2 669	6 074
Central Energy Fund	1 209	5 226	3 719	2 061	398	6 178
Trans-Caledon Tunnel Authority	1 191	1 659	1 230	3 068	1 871	6 169
Rand Water	1 514	1 352	2 108	1 966	1 820	5 894
Other state-owned companies	8 638	11 627	11 537	15 184	16 992	43 713
State-owned companies	**98 871**	**129 200**	**129 806**	**130 730**	**136 710**	**397 246**
Total	**208 286**	**255 905**	**262 811**	**271 080**	**293 187**	**827 078**

Source: Adapted From National Treasury Budget Review, 2013

4.3 Assessing Credibility of National Infrastructure Plan

a) A vital component of Government policy is hence increased spending on public infrastructure, in particular accelerated investment in social and economic infrastructure. This raises a number of critical questions, including how the money

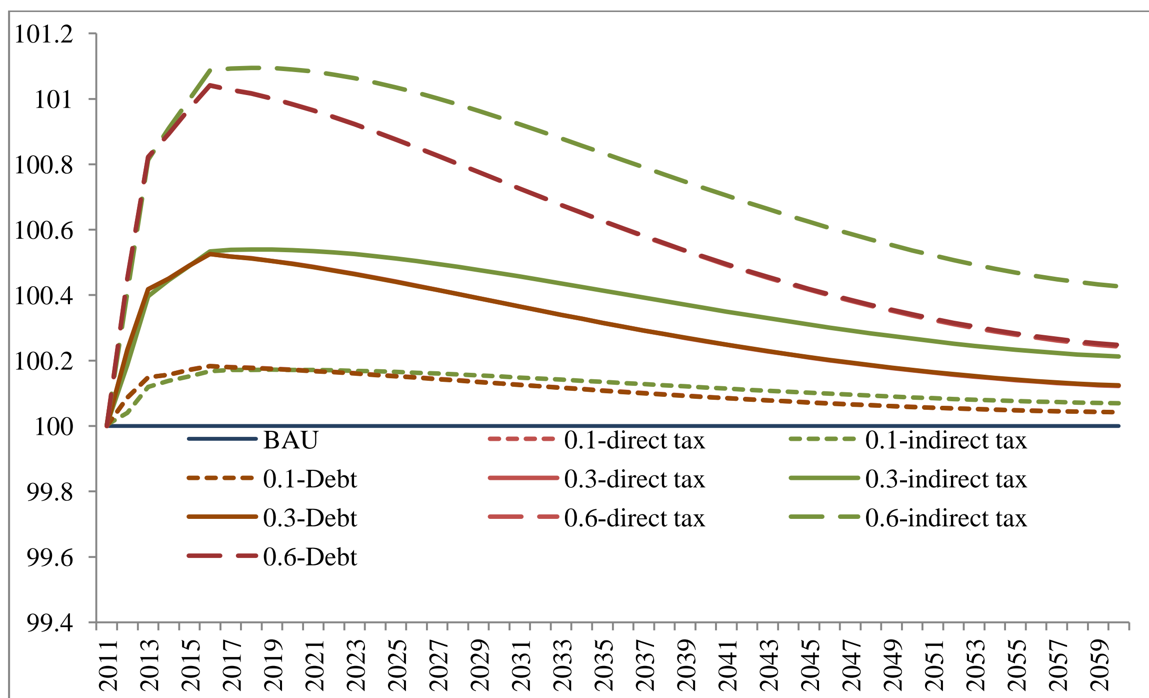
should be spent and how the expanded spending should be financed. A recent study[15] by the Commission oriented towards constraints the government faces in financing its infrastructure expenditures (including SIPs) provides answers to these questions. The findings are that in the short term, real GDP stays about the same as before the increase in expenditure, but investment decreases, which affects the long-term value of GDP. The impact on investment is greater when the additional spending is financed by increasing either income tax or the deficit. Increasing indirect taxes to finance additional spending affects investment less in the short term, but in the longer term leads to a similar decrease in real GDP.

b) To ascertain the sustainability of increasing public spending in this manner, the debt-to-GDP and deficit-to-GDP ratios were calculated over the next 60 years. The impact of the three financing methods on these ratios was found to be different (whereas they have a similar effect on macroeconomic variables). In the short term, modelling suggests that the impact on real GDP is negligible if government increases its investment spending. However, in the medium and longer term, GDP grows because spending on investment leads to increased infrastructure and economic output. Under a rigid deficit, taxes would eventually go down as a result of greater production in the economy. As the GDP grows over time, a constant deficit translates into an improvement of both ratios. More surprisingly, the greatest improvement happens in the debt-financed scenario. If tax rates are kept the same throughout the period (2011–2059), government revenues will increase in the longer term and thus allow for a smaller deficit in the future.

c) To test the robustness of these findings, the Commission performed various sensitivity tests to see how increased public investment affects GDP under the three financing methods, using different values of 0.1, 0.3 and 0.6 (for the impact such expenditures have on total factor productivity in South Africa). Figure 3 presents the impact on real GDP. Whatever the financing method used, the results are similar for all three values (within a range of less than 1%).

[15] For more details, the interested reader is referred to Mabugu, R., Robichaud, V., Maisonnave, H., and Chitiga, M., (2013) "Impact of Fiscal Policy in an Intertemporal CGE Model for South Africa", *Economic Modelling*, **31**: 775-782, Elsevier B.V. Publishers.

Figure 3: Impact of increased public investment on GDP



d) The lessons learnt are extremely valuable for South Africa where considerable attention is being given to the use of expansive fiscal policy for economic growth and the creation of jobs. These conclusions are driven by the positive impact infrastructure has on total factor productivity. Without this feature, increased public investment would have almost no impact on the South African economy.

5. Measures to Stimulate Cost Efficiencies

5.1 Defining and Measuring Cost Efficiencies

(a) Cost-effectiveness that the Appropriations Committee requested briefing on is clearly a desirable attribute. This is because using a cost-effective instrument involves allocating the smallest amount of resources to reaching a priority, conditional on a given target being achieved. It has the minimum opportunity cost. Hence, the use of cost-effective instruments is a prerequisite for achieving an economically efficient allocation of resources. Three policy issues emerge as important in inter-governmental relations from this. One is how to balance the need to provide constitutionally mandated basic services (CMBS) with macroeconomic constraints that limit the available resources. Another is how to

objectively determine the equitable sharing of available revenue amongst the national, provincial and local spheres of governments. The final one is what resources need to be allocated to capital spending in a way that is consistent with the answers to the first two questions. Despite the centrality of cost efficiencies to this and considerable amounts of work and interest that have been devoted to it, providing a comprehensive and directly available measurement of public sector costs, for a large number of countries and time periods, remains an incredibly difficult challenge.

(b) There are at least two conceptual approaches to deriving the cost of providing provincial, local government and national government services. One approach, the so-called costed norms method proposed by the Commission in 2001, is to estimate the average cost of providing a particular service. This estimate is usually based on historical estimates of capital, labour and variable inputs costs, per unit of service provided. The next step is to devise output standards that are to be achieved for each service. Using the estimates of average cost it is then possible to deduce the total cost of providing a service at some specified standard. If one then sums across all services, it is possible to obtain an estimate of the total costs to be met by each province and the national government based on the derived average costs and chosen output standards. A second approach is to estimate a 'cost function' for each nationally, provincially and local government provided service. Cost functions are widely used in economic analysis and for given costs of inputs define the minimum cost of producing various levels of output. For given values of the input prices and poverty/inequality disabilities, the cost function yields the minimum cost of providing a given service in a particular province/local government. Cost measurement approaches suffer from severe limitations and can be only partial in terms of cost factors coverage and data availability. Indirect approaches based on fiscal and financial volumes and/or prices by definition provide less information about the priorities policymakers should target in order to meet a certain target.

5.2 THE COST CHAIN

(a) Looking back at the various cost components enumerated in previous sections, several dimensions of costs can be identified that recur along the whole fiscal chain. These can be interpreted as "underlying" or "primary" sources of costs.

Identifying the major underlying sources of costs can help prioritise the policy reforms meant to reduce these costs and enhance the efficiency of the IGFR system. The first primary factor identified relates to issues of (un)certainty, (un)predictability and (un)reliability in delivery, transport delays and/or payments, which are largely related to indirect cost components. These concerns are commonly mentioned as one of the main hindering factors of trade flows in business surveys, and are often a central and explicit motive of international and regional trade agreements. Yet, uncertainty may rise at many different points all along the supply chain. Risks of corruption and bribery at the borders, insecurity, roadblocks and checkpoints on transit routes, terms-of-trade and exchange rates volatility, non-transparent legislations and trade regimes, political risks, etc., are as many sources of variation and uncertainty about what shipping a good from the producer to its final user will actually cost.

(b) The second major underlying factor relates to the discrepancy between costs and prices that households and firms have to incur, due to numerous windows of opportunity for intermediaries to extract rent all along the trade chain. Rent extraction represents in many regards a direct cost for trade operators. Whether rent extraction is due to uncompetitive regulations, to monopolistic powers in the transport, customs brokerage, telecommunication, or financial services sectors, to corrupt customs officials or to informal smugglers, it often adds a significant burden on both exporters and importers. As already suggested, rent extraction strongly complicates the design of remedial policies because they have to ensure that when reducing/removing rent at some point of the chain they do not generate new rent seeking behaviours at other points.

(c) The third underlying source of trade costs and of difficulties in addressing them is related to the political economy of business policy. Despite the fact that the benefits of participation to international trade on income levels and growth are widely acknowledged, policymakers may opt for policies that depart from a presumably optimal free trade regime in order to serve political economy considerations under the pressure of vested interests. These policies may tend to favour certain groups by transferring resources (through subsidies and taxes, market access restrictions, protectionist regulations), display partisan preferences, or promote re-election.

(d) They may also interact with policy preferences of various types of private interest groups like lobbies, political parties, unions, consumers' associations, etc. As Rodrik (1995) reminds us, business policy instruments are far from being distribution-neutral, and plenty of trade models have exposed how organised groups or individual voters can influence the income-distribution consequences of trade flows. In order to internalise political-economy considerations in the design of policies meant to facilitate trade, the reciprocal causation between trade flows, trade costs and business policy need to be kept in mind.

5.3 A Diagnostic Tool To Assist Identifying Cost Efficiencies

(a) The aim of this section is not to tell legislators *what* they should target as a priority, but rather *how they* should think of the fiscal system chain and what questions they should ponder in order to build the appropriate policy/oversight agenda and, ultimately, reduce costs in a cost-effective manner. The necessity to adopt a comprehensive view on all costs along the fiscal system chain does not however mean that all issues/components should be addressed evenly and at the same time. With respect to many dimensions, costs as well as the marginal benefits associated with their reduction vary according to a jurisdiction's per capita income level, stage of development, institutions, geopolitical and business climate. In addition, jurisdictions differ in financial, institutional and political implementation capacities. Therefore such variation rather calls for a pragmatic case-by-case policy approach, instead of mechanically replicating "best-practices" or "benchmarks" that tend to overlook the idea that costs may be generated by all sorts of different reasons. Appropriate policies are almost always context specific; the prioritisation and sequencing of reforms should be designed in order to accommodate each jurisdiction's specificities. The prime determinants of fiscal costs matter, and a diagnostics framework could help legislators identify them in the specific circumstances of their oversight work.

(b) The conceptual advantage of a diagnostics approach is that it gives priority to identifying the most *binding* constraints, or, more precisely, the ones binding disproportionately, the ones whose relaxation will bring the biggest returns. At their core is the identification of what we called the "primary" or "underlying" causes of costs.

(c) The "costs diagnostics" approach can be summarised in the following sequential quest*ions:*

- *What* is the underlying source of costs?
- *Where* it is *primarily* and most heavily located in the fiscal system chain?
- *What* is the implementation cost of relaxing the constraint, given national capacities?
- *What* is the impact of remedial policies at this given point on downstream/upstream links?
- *How* much is the cost factor dependent on other policies?

(d) This diagnostics approach proposes a pragmatic tool that the Committee can use to identify the most binding barriers to service deliv*ery and* prioritise policy reforms meant to reduce costs. Such prioritisation needs to account for the inter-dependences between all cost factors and between jurisdictions policies in a context of fragmented supply chains, and should be revised according to jurisdiction resources, institutions and implementation capacities.

6. Other Related Matters

6.1 Provincial Budget Overview

(a) The Commission is pleased to note provincial expenditure on personnel budget is within the spending limits for 2012/13 as at March 2013 (see Table 5). This suggests provinces are exercising stricter controls on the provincial wage bill. This is reassuring as resources allocated to other important government priorities are protected from potential over-expenditure on personnel expenditure budget. The Commission is concerned though over the high under expenditure on capital assets (7.2%). The opportunity cost of such under spending is high given that significant backlogs in critical infrastructure still persist.

Table 5: Total Provincial Aggregated Budgets and Expenditure as at 31 March 2013

R thousand	Adjusted Budget	Actual spending as at 31 March 2013	Actual spending as % of adjusted budget	(Over)	Under	Net	% (Over)/ under of adj. budget	% To E
Eastern Cape	57 396 592	55 927 852	*97.4%*		1 468 740		*2.6%*	
Free State	25 905 974	25 617 591	*98.9%*		288 383		*1.1%*	
Gauteng	74 687 207	73 760 446	*98.8%*		926 762		*1.2%*	
KwaZulu-Natal	86 182 525	85 728 762	*99.5%*		453 763		*0.5%*	
Limpopo	47 954 552	45 868 946	*95.7%*		2 085 606		*4.3%*	
Mpumalanga	31 553 299	31 346 263	*99.3%*		207 036		*0.7%*	
Northern Cape	11 795 270	11 235 152	*95.3%*		560 118		*4.7%*	
North West	26 909 556	25 587 997	*95.1%*		1 321 559		*4.9%*	
Western Cape	40 256 115	39 937 322	*99.2%*		318 793		*0.8%*	
Total	**402 641 090**	**395 010 331**	***98.1%***		**7 630 759**	**7 630 759**	***1.9%***	
Per key Departments								
Education	168 214 763	166 073 346	*98.7%*		2 141 417		*1.3%*	
Health	123 508 959	122 608 686	*99.3%*		900 273		*0.7%*	
Social Development	12 277 992	12 091 056	*98.5%*		186 936		*1.5%*	
Total	**304 001 714**	**300 773 087**	***98.9%***		**3 228 627**	**3 228 627**	***1.1%***	
Per key economic classification								
Personnel	236 011 883	234 013 781	*99.2%*		1 998 102		*0.8%*	
Goods and Services	77 502 083	75 280 134	*97.1%*		2 221 950		*2.9%*	
Payment for Capital	30 762 220	28 357 667	*92.2%*		2 404 553		*7.8%*	
Transfers and Subsidies	58 340 100	57 230 056	*98.1%*		1 110 044		*1.9%*	
Payment for Financial	10 903	88 501	*811.7%*	-77 598			-7.1171453	
Total	**402 627 189**	**394 970 139**	***98.1%***	**(77 598)**	**7 734 649**	**7 657 050**		
Per Revenue Source								
Provincial Equitable Share	313 015 798	313 015 798	*100.0%*				0%	
Conditional Grants	75 708 089	75 342 639	*99.5%*		365 450		*0.5%*	
Own Revenue	11 885 337	13 250 616	*111.5%*	-1 365 280			*-1.8%*	
Total	**400 609 224**	**401 609 053**	***100.2%***	**(1 365 280)**	**365 450**	**(999 830)**	***-0.3%***	

Source: National Treasury S32 Reports (2013)

6.2 WATER AFFAIRS

(a) As shown in Table 6, the Department of Water Affairs (DWA) consists of six programmes, with *Water Infrastructure Management* (25%) and *Regional Implementation and Support* (59%) comprising 84% of the total budget in 2013/14. The departmental allocation is R1.43 billion more in 2013/14 compared to expenditure in 2012/13. Departmental estimates over the baseline are expected

to increase by 15.9 % per annum in real terms compared to 5.6% per annum growth in expenditure between 2009/10 and 2012/13. Significant increases over the baseline period are expected in *Water Infrastructure Management* (16.3% per annum) and *Regional Implementation and Support* (18.8% per annum) Programmes[16].

Table 6: Overview of the Department Budget

Programme expenditure & estimates (Rands in millio	2009/10 (million)	2010/'11 (million)	2011/'12 (million)	2012/'13 (million)	2013/'14 (million)	2014/'15 (million)	2015/16 (million)	2009/10 - 12/13 Real Avge Growth P.A	2013/14 - 15/16 Real Avge Growth PA
Administration	865	827	782	865	979	1 068	1 126	-4.2%	4.1%
Water Sector Management	444	424	512	454	516	598	619	-2.8%	5.9%
Water Infrastructure Management	2 108	2 132	2 384	2 138	2 565	2 945	3 813	-3.6%	16.3%
Regional Implementation and Support	3 063	3 499	4 376	5 154	5 983	7 685	9 772	14.5%	18.8%
Water Sector Regulation	73	126	91	110	119	122	126	17.2%	-0.6%
International Water Cooperation	11	16	21	29	25	32	33	31.2%	0.4%
DEPARTMENT OF WATER AFFAIRS	**6 564**	**7 024**	**8 165**	**8 749**	**10 187**	**12 449**	**15 488**	5.6%	15.9%

(b) Approximately 41% (R 4.2 billion) of the total funds appropriated for DWA in 2013/14 are conditional grants compared to 59% (R5.985 billion) direct allocation. Over two thirds of conditional grants (R 3 billion) are for regional bulk infrastructure projects in district municipalities. An important consideration here is the need to provide adequate support to these district municipalities to spend the funds efficiently and also to have proper processes in place for the timely transfer of funds.

(c) The department's spending performance has worsened from 2010/11 (96% of total budget spent) to 2011/12 (90% of total budget spent). Pre-audited figures for the 2012/13 financial year suggest that the department had spent 96% of its total budget. In-year spending trends indicate a 'hockey-stick effect', with nearly half of the total budget in 2011/12 and 2012/13 being spent in the last quarter of the year. A disaggregated analysis suggests most of the funds spent in the last quarter are on transfers and subsidies and payments for capital assets. This suggests the department may not have adequate in-year budget monitoring processes in place to monitor spending plans. It also suggests a broader problem of inadequate financial management systems in place. The Auditor-General has also highlighted

[16] 92% of all funds in the Water Infrastructure Management Programme is transferred to the Water Trading Entity.

this concern in his 2011/12 audit report. Despite proactive steps taken by the department, such as establishing a budget committee, it does not seem the department has made sufficient progress to avoid the 'fiscal dumping' that is evident in the in-year spending trends.

(d) At the end of 2011/12, the department reported a total of R1.085 billion in irregular expenditure. Most of the irregular expenditure accrued as a result of poor Supply Chain Management (SCM) practises and internal controls. In 2011/12 the department investigated several cases of SCM irregularities to ascertain possible impropriety in instances where irregular expenditure were reported. In 2011/12, the department also incurred R18.8 million of fruitless and wasteful expenditure. This was largely due to overpayments, value added tax (VAT) paid to non-VAT vendors and VAT incorrectly calculated.

(e) In its 2011/12, the department received a qualified opinion as a result of pre-payments made to implementing agents, inadequate systems, insufficient audit evidence for certain entries, no supporting documents for a contingent liability of R60.7 million and loan amounts between financial statements with no valid explanation provided. The Auditor General also found that the department had not completely met 92% of its planned targets. Further, 91% performance of indicators in programmes 1 and 4 were not verifiable and lacked key controls in terms of collection, collation, verification and storage of indicator data. This suggests that although 90% of the budget was spent in 2011/12, the funds at the disposal of the department may not have been spent effectively. The department would therefore need to strengthen its internal controls to ensure the 11% real increase in funding for 2013/14 is spent towards achieving its targets and that funds spent are properly accounted for.

(f) **New Grant:** A new municipal water infrastructure grant administered by the DWA is being introduced for 2013/14. An amount of R4.3 billion is allocated over the MTEF period[17]. The grant provides funding to municipalities to construct new water infrastructure and refurbishment and extension of existing water schemes. A key concern here is whether the funds will be adequately spent given the prevailing challenges at local government level. The Commission welcomes the grant as it could address some of the backlog problems at local

[17] R602 million in 2013/14, R1.05 billion in 2014/15 and R2.67 billion in 2015/16.

government level but cautions that without proper technical, management and financial support, municipalities the funds may not be fully absorbed by municipalities. Similarly there is need to avoid duplication of what the Municipal Infrastructure Grant intends to do with this grant.

(g) **Economic Support and Development:** The Commission commends the Water for Growth and Development framework the DWA has developed that intends to support the broad national economic and social development goals whilst also maintaining the sustainability of water resources. The DWA is also providing a subsidy of R5.5 million in the 2013/14 Appropriations Bill for emerging farmers to equip them with rainwater harvesting tanks, meant to improve access to water for food production. A concern for the Commission is the reported double-digit increases in municipal charges for water supply. There is a need for better coordination to deal with inflation pressures and a possible rise in the costs of production that may negatively impact on economic development.

(h) **Infrastructure Investment:** The DWA is allocated R4.3 billion over the MTEF for municipal water infrastructure grant to provide water supply to rural households in 23 district municipalities prioritized by Cabinet. An amount of R3.7 billion over the medium term is set aside for regional bulk infrastructure grant for upgrades and refurbishment of 6 existing plants and bulk water infrastructure projects and R1.5 billion is being allocated for upgrading of a pipeline and construction of a new pipeline. The DWA is therefore investing heavily in water infrastructure to meet future water demand from a growing economy and expanding population. Despite increased levels of infrastructure investment, scarce skills such as infrastructure planning, project management and coordination and maintenance spending remain a concern. The Commission commends DWA for developing the Infrastructure Investment Framework that is meant to inform future water sector funding requirements, which is needed to take a longer term view of an important national resource.

(i) **Job Creation:** DWA's flagship *Working for Water Project* created 28 400 jobs in 2011/12. A further 4505 jobs was created through the regional bulk infrastructure programme in 2011/12. DWA also developed 50 graduate trainees and placed them in candidate positions. These job creation initiatives are funded through the Regional Implementation and Support Programme. Funds for these job creation initiatives are subsumed in sub-programme budgets and as a result specific funds

set aside for these projects cannot be identified either from the Appropriations Bill or the 2013 Budget Statements for the Department.

(j) **Enhancing Local Government Capacity:** The Commission welcomes the signing of the Enhanced Local Government Support Concept Paper by the Minister in 2011, which provides a framework for a more structured approach to local government support. The Department has established a number of initiatives to assist local government with provision of water supply, consistent with one of its strategic objectives which is to 'ensure provision of local government support'. The Commission also commends the establishment of the rapid response unit to address local government emergencies such as floods, pollution of water, draughts etc. Of concern are the ongoing delays in the transfer of funds from national to local municipalities. In 2011/12 and 2012/13, 50% and 46% of transfers and subsidies from DWA were disbursed in the final quarter of the financial year respectively, which includes transfers to municipalities. The funds transferred are typically not absorbed by municipalities because there is insufficient time to spend the funds. The problem is also hampered by challenges at local government level, such as delays in supply chain procedures, problems between contractors and municipalities, lack of capacity, etc. Transfer funds that are unspent at local government level exacerbate the backlog in water reticulation and infrastructure and waste-water treatment is being further delayed impacting on an important lever to support economic growth and local development. Only 22 out of 52 municipal schemes were refurbished in 2011/12 because of these delays. The Department seems to be following a strategy of extending the footprint of water boards so that they are able to support municipalities and provide service delivery on behalf of poorly capacitated municipalities, especially in rural areas. The Commission views this approach as a short-term measure that should be supplemented with intensive initiatives to improve capacity of poor performing municipalities to ensure proper accountability and service delivery to communities are sustained.

6.3 HUMAN SETTLEMENTS

(a) The main aim of the Department of Human Settlements (DoHS) is to facilitate the creation of sustainable human settlements and to improve the quality of the lives of households. This aim is implemented through the use of conditional grants

(Human Settlements Development Grant (HSDG), Rural Household Infrastructure Grant (RHIG) and Urban Settlements Development Grant (USDG)) among other things.

(b) HSDG is a key conditional grant in the delivery of housing and is transferred to all provinces using a formula that takes into account housing needs, migration patterns and development potential. A large number of municipalities are dependent on this grant for housing delivery since they lack capacity to raise own revenue. Two new grants within the human settlements sector include RHIG and USDG. RHIG was introduced in 2010 to assist with achievement of universal access to water and sanitation by 2014. This grant was established as a result of high levels of backlogs in water and sanitation in most rural municipalities and the fact that some settlement patterns are so dispersed that it would require excessive funds to build the necessary infrastructure and to connect households. USDG grant was introduced in the 2011 MTEF for metros to improve the efficiency and coordination of investments in the built environment. The performance for the past three years and allocation over 2013 MTEF is shown in Table 7 below.

Table 7: Overview of performance of DoHS Grants

R'000		2009/10 Audited	2010/11 Audited	2011/12 Audited	2012/13 Adjusted	2013/14	2014/15 MTEF	2015/16
HSDG	Allocation	10 819	13 032	15 121	15 725	16 983	17 918	19 667
	% spent	99%	98%	98%				
RHIG	Allocation		100	258	340 (138)	106	113	118
	% spent		67.7% (Mar 2011)	72.8% (Mar 2012)	17.9% (Jan 2013)			
USDG	Allocation			6 266	7 392	9 076	10 334	10 699
	% spent			44%	45% (Jan 2013)			

Source: Commission's calculations based on National Treasury's 2013 Estimates of National

(c) Generally, overall spending on the HSDG has been good over the period. Spending stood at 99% in 2009/10, 97% in 2010/11 and 98% in 2011/12.

Average growth over the 2013 MTEF is about 7.7%. The Commission views this growth as reasonable response given the past good performance of this grant.

(d) RHIG performance has been poor since introduction. In the 2012/13 financial year, allocation was R479 million. The allocation was reduced by R138 million following a request by DoHS. The allocation has since remained at R340 million. Although reducing the allocation retards the pace towards achievement of universal access to sanitation especially in rural areas, the reprioritisation of funds carried was essential given the consistent poor performance of the grant. The allocation for the 2013 MTEF decreases by (-57%) from base allocation with a further reduction of about 68% in 2013/14 and slight growth in the two outer years. The lower grant base will provide both the DoHS and municipalities an opportunity to resolve current challenges affecting performance of this grant. In 2013/14 financial year, RHIG has been changed from Schedule 6B (indirect conditional grant to municipalities) to Schedule 5B (direct grant to municipalities).

(e) The USDG has not been performing well since inception in 2011/12 with an expenditure of 44% of total allocated funds. By January 2012/13 expenditure stood at 45%. Average annual growth over the 2013 MTEF is about 13% which is relatively high in relation to the poor past performance of the grant in its first year.

(f) Clearly these three programs contribute to achieving the country's human settlements priorities in one way or another. Improving the leverage of DoHS programmes is key towards fulfilling national development goals on human settlements and optimise equity. Given their significance, it is essential not only that baselines to programmes are increased but importantly that these amounts are spent in the intended areas. Revisions to the baseline of housing delivery grant must take into consideration both spending performance and impact on service delivery. In this regard, over the 2013 MTEF the RHIG allocation grows by a nominal growth rate of 10 percent while HSDG and USDG grow by 15 percent and 17 percent respectively. While the revisions upwards in baseline for HSDG are merited on the basis of past performance, there are serious questions about RHIG and USDG baseline that need redress. In this respect, the Commission recommendations that:

- RHIG should remain a schedule 6B grant. Should there be a need to review RHIG, this should be done as part of the broader review of all infrastructure grants
- Government should review the design of RHIG with a view to make it flexible (where necessary and cost effective, repair and maintenance should be considered a priority).
- The USDG should also be reviewed as part of the broader review of all infrastructure grants.
- Finally, in its 2012/13 submission, the Commission recommended the use of alternative modes of delivery where appropriate to circumvent inherent delivery bottlenecks within government institutions.

7. CONCLUSION

As a way of concluding, the Commission commends the Government for a well-crafted Appropriations Bill. There are three pertinent points:

7.1 Through much of the 1990s and up to 2007, South Africa has established a good fiscal track record. Even during the recent periods of rapidly rising and relatively high government debt, the country has avoided fiscal crises of the type witnessed in many developing countries and industrial countries during, and in the aftermath of, the international financial crisis of 2007-2009. This allowed a period of sustained economic growth which provided for a more ambitious and expansive fiscal policy not seen for many years.

7.2 The current economic deficit represents the single biggest strategic fiscal risk facing South Africa. This fiscal downturn means that a prolonged period of consolidation in public expenditure will lead to difficult choices. In trying to balance the competing needs of fiscal sustainability and promoting growth, it is critical that fiscal consolidation be done in such a way that (a) short run growth is least compromised, (b) the potential for long run growth is increased and that (c) gains in the progressive realisation of socio-economic rights are not rolled back but are in fact extended, (d) the impact of existing public spending is raised and (e) institutional capability, accountability and performance orientation is built. Taken together, these measures will be instrumental in maintaining a positive economic growth rate and prudent

financial management and importantly move the country towards attaining the identified priorities of (a) promoting economic support and development, (b) investment in infrastructure, (c) job creation and (d) enhancing local government capacity.

7.3 The message from the analysis in this year's submission of the proposed appropriations by Government is that while resources are generally efficiently allocated to priority areas, the need remains for Government to improve spending impact in order to positively contribute to the lives of all South Africans. Within the confines of lower growth in expenditure, strategies included in the NDP to improve sustainable economic growth, a less adversarial relationship between business and organised labour, more focus on improving small business development of entrepreneurship, increased infrastructural investment, improved capacity of the public sector to implement projects and strategies to reduce corruption must be supported.

For and on behalf of the Financial and Fiscal Commission

Mr. Bongani Khumalo

Acting Chairperson/CE