



# Financial and Fiscal Commission: Submission on the 2011 Medium Term Budget Policy Statement

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*For an Equitable Sharing of National Revenue*

31 October 2011

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## List of Acronyms

|         |   |
|---------|---|
| AIDS    | Acquired Immune Deficiency Virus                        |
| ART     | Anti-retroviral treatment                               |
| ARV     | Anti-retroviral   |
| BAU     | Business as usual scenario                              |
| CPI     | Consumer Price Index                                    |
| DHET    | Departments of Higher Education and Training            |
| DOH     | Department of Health                                    |
| DORB    | Division of Revenue Bill                                |
| DPW     | Department of Public Works                              |
| DSD     | Department of Social Development                        |
| ECD     | Early Childhood Development                             |
| EDI     | Electricity Distribution Industry                       |
| EPWP    | Expanded Public Works Programme                         |
| FFC     | Financial and Fiscal Commission                         |
| GDP     | Gross Domestic Product                                  |
| HIV     | Human Immunodeficiency Virus                            |
| HPTDG   | Health Professional Training and Development Grant      |
| ICS     | Improvement in Conditions of Service                    |
| IDIP    | Infrastructure Delivery Improvement Programme           |
| IGFR    | Intergovernmental Fiscal Relations                      |
| INEP    | Integrated National Electrification Programme           |
| LES     | Local Government Equitable Share                        |
| MBAPRMA | Money Bills Amendment Procedure and Related Matters Act |
| MDG     | Millennium Development Goal                             |
| MFMA    | Municipal Finance Management Act                        |
| MISA    | Municipal Infrastructure Support Agency                 |

|       |  |
|-------|--|
| MTBPS | Medium Term Budget Policy Statement        |
| MTEF  | Medium Term Expenditure Framework          |
| NGO   | Non-governmental Organisation              |
| NGP   | New Growth Path                            |
| NPO   | Non Profit Organisation                    |
| NHI   | National Health Insurance                  |
| NTSG  | National Tertiary Service Grant            |
| OSD   | Occupation Specific Dispensation           |
| PES   | Provincial Equitable Share                 |
| PFMA  | Provincial Finance Management Act          |
| PHC   | Primary Health Care                        |
| PPP   | Public Private Partnerships                |
| RED   | Regional Electricity Distribution          |
| RSC   | Regional Services Council                  |
| SALGA | South African Local Government Association |
| TB    | Tuberculosis                               |
| SARB  | South African Reserve Bank                 |
| USDG  | Urban Settlements Development Grant        |
| VCT   | Voluntary HIV counselling and testing      |
| WHO   | World Health Organisation                  |

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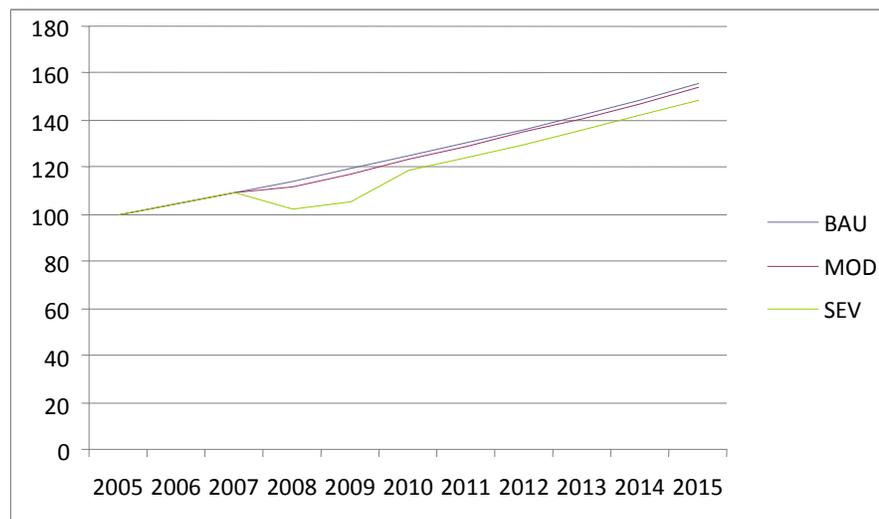
## 1. Background

- 1.1. This submission is made in terms of Part 1 (3) {1} of the Financial and Fiscal Commission (FFC) Act (2003) as amended, which provides for the FFC to act as a consultative body for and to make recommendations to organs of state in the national, provincial and local spheres of government on financial and fiscal matters. The Submission is also made in terms of Section 4 (4c) of the Money Bills Amendment Procedure and Related Matters Act (MBAPRMA)(2009), which requires Committees of Parliament to consider the FFC's recommendations when dealing with money bills and related matters.
- 1.2. In view of the above legislative mandate and government outlined priority areas, the Standing Committees on Finance and Appropriations requested the Commission to comment on the Medium Term Budget Policy Statement (MTBPS) that was tabled by the Minister of Finance on 25 October 2011.
- 1.3. This Submission, over and above making general observations on the highlights of the MTBPS also addresses in more specific terms the following areas: *the macro-economic and fiscal policy position of the country and the macro-economic projections as reflected in the 2011 MTBPS, spending priorities of government; the proposed division of revenue among the spheres of government and among arms of government within a sphere; the proposed substantial adjustments to conditional grants allocations to provinces and local government if any; and a review of actual spending by each national department and each provincial government between 1 April and 30 September of the current financial year in line with the request of the Committee.*
- 1.4. A hallmark of the new government administration has been a distinct thrust towards outcomes-based policy formulation and this would be expected to be the main driver of change in government's economic policy. The key priority areas that government outlined for the next 5 years are: *creation of decent work and sustainable livelihoods; education; health; rural development, food security and land reform; and the fight against crime and corruption.*

## 2. Macroeconomic Outlook and Fiscal Frameworks

- 2.1. The Commission's economic outlook reported in the 2010 Annual Submission for the Division of Revenue projected that Gross Domestic Product (GDP) would fall in 2008 and 2009 and then increase again from 2010 although it does not return to its business as usual (BAU) value even by 2015.
- 2.2. What is relevant to note here is that even though the crisis is in effect only in 2008 and 2009 and economic recovery started in 2010, impacts on investment remain in the long run. Indeed, under both scenarios projected by the Commission one still observes lower investment in 2015 than under the BAU. The world economic crisis produced a huge drop in GDP (Figure 1). For both scenarios, GDP falls in 2008 and 2009 and then increases again, but it does not return to its BAU value even by 2015. In other words, without positive shocks or deliberate and successful interventions that stimulate the economy and counteract the negative impact of the world economic crisis, GDP will not recover to what it would have been in the absence of the crisis, that is, the BAU scenario (see Figure 1). As was expected, the 2011 MTBPS announced a downward revision of GDP growth in the current year from about 4% to 3.1% of GDP. The medium-term growth forecast outlined in the 2011 budget was considered too ambitious by the Government given the uncertain economic climate and crises in the global economy.

Figure 1: Evolution of Real GDP in BAU, Moderate and Severe Scenarios



Source: *Financial and Fiscal Commission*

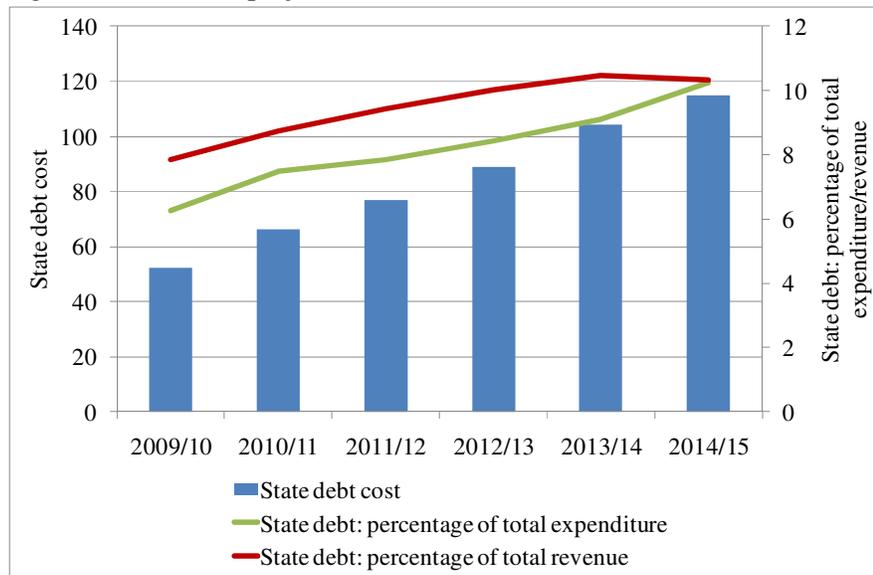
- 2.3. Little has changed in terms of the vulnerability of the South African economy to interruptions in global recovery since the Commission's submission on the 2010 MTBPS – major trading partners' slow recovery may still impact the sectoral composition of economic growth. The major contributors to the latest economic

growth figures (i.e. the average real GDP growth for the first two quarters of 2011) are reported to be (a) finance, real estate and business services (0.8%), (b) manufacturing (0.6%), and (c) wholesale, retail, motor trade and accommodation (as well general government services; both at 0.5%). These are the likely sectors to suffer in the case of disruptions to the global recovery process, particularly because these are important exporting sectors in South Africa and also because manufacturing sector together with the agricultural and mining sectors is shrinking.

- 2.4. Given the revision in the economic growth figure for this year as well as the estimates for economic growth over the medium term, it is apparent that South Africa will need a much higher economic growth than the 7% set out in the New Growth Path (NGP) document. This is further borne out by the current slow, positive growth rates not producing significant job increases. If National Treasury's estimates for 2012/13-2014/15 materialise, the country will need an average growth rate of 8-9% in the period 2015/16-2020/21 (Commission's estimates). This figure is highly unlikely considering that emerging market economies are expected to grow at some 5-6% over the same period. The Commission also notes that the forecasts in the 2011 MTBPS document are based on some very restrictive assumptions, namely: orderly resolution of the European debt crisis, the avoidance of a US recession and a continued strong growth in the emerging market economies (particularly China and possibly capitalising on economic opportunities in Africa profitably). Given that the current economic climate is very uncertain, it is likely that more pessimistic economic growth figures might be realised in the medium term that are likely to put even more pressure on the job-creation goals of the government (what the Commission referred to as the "severe" scenario in 2009).
- 2.5. The Commission would like to reiterate the importance of fiscal consolidation in the South African context. Given the uncertainty surrounding global recovery, government should exercise caution by conserving fiscal space which can then be used to deal with future shocks (this strategy was very successful in averting more serious effects of 2009 crisis). A particular risk from the Commission's view that requires cautious management is the sharp projected increase in government debt which is set to rise to 40% of GDP by 2015 after which it is expected to stabilise and decline. Even though South Africa's government debt to GDP ratio is relatively low compared with that of advanced economies, it is projected to increase by a lot more than the corresponding public debt ratios of other developing countries, most notably India, Brazil, Mexico, Chile, Thailand and Poland. In addition, given that debt service costs are the fastest rising component of general government expenditure, adverse domestic and global conditions can make debt repayment very difficult. Hence, although this debt increase is not posing an immediate threat to fiscal sustainability, it could turn out to be a significant constraint on the fiscal space in the event of shocks. Supplementing these concerns is scepticism relating to the ability of the government to hold down the growth in public sector remuneration to a maximum of 6.5% over the coming year, as assumed in the MTBPS.

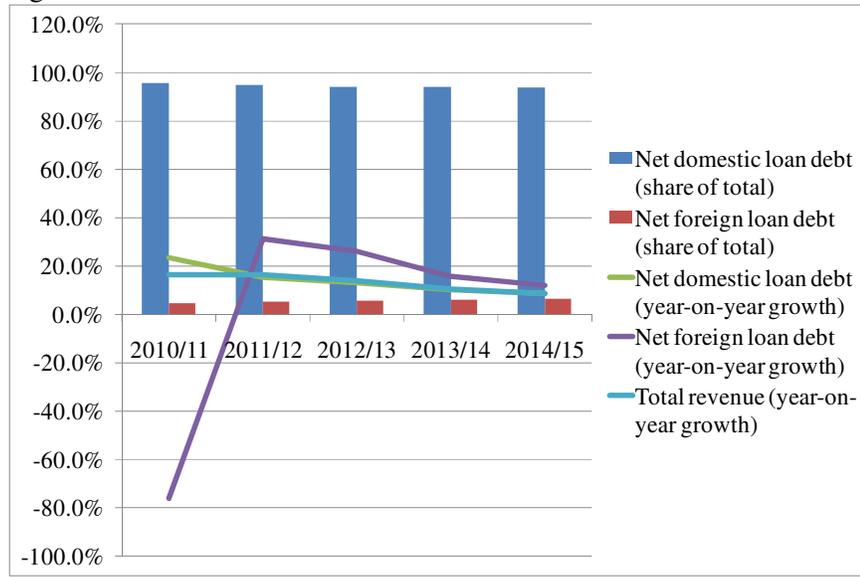
2.6. Similar to the Commission's submission on the 2010 MTBPS, state debt (adjusted for inflation) in South Africa is increasing no matter how one looks at it (see Figure 2 below)– that is, in absolute terms, as a percentage of total expenditure, or as a percentage of total revenue. State debt as a percentage of total revenue can loosely be interpreted as the debt service ratio, which is increasing steadily (pointing towards an increase in the state debt burden) and then levelling off towards the end of the Medium Term Expenditure Framework (MTEF). This implies that expenditure increases are increasingly being financed by debt. Figure 3 illustrates the source of funds used to finance the deficit (also adjusted for inflation). The revenue components as well as the net domestic loan debt growth rates level off, whereas the net foreign debt growth rate increases sharply and then levels off towards the end of the sample. It is true that the share of net foreign debt to total debt remains constant at approximately 5-6%, but there still is cause for concern around the sharp increase in foreign indebtedness especially given potential exchange rate volatility in the wake of increased uncertainty should the assumptions listed in 2.3 not materialise.

Figure 2: State debt projections



Source: 2011 MTBPS, Commission's calculations.

Figure 3: Loan debt and revenue



Source: 2011 MTBPS, Commission's calculations.

### 3. Medium Term Spending Priorities

3.1. Table 1 provides analysis of average real annual growth rates of government expenditure components. Even though over the medium term there seems to be a declining trend in the annual growth rates of the expenditure components, the shares are still quite high in nominal terms – particularly considering that the government is concerned about keeping public expenditure at moderate levels. In line with Commission's previous recommendation, successful fiscal consolidation in South Africa necessitates a tighter fiscal stance, particularly when it comes to expenditure. With the exception of few categories (such as 'General public services' and 'Fuel and energy'; figures not in bold in the last column of Table 1), on average, all of the categories seem to be growing over the estimated 3% real annual growth rate required to achieve a balanced budget by 2015/16 (Commission's calculations). The 2010/2011 Budget – which provides for a phased reduction in the budget deficit of the national government to 4.8 percent of GDP in fiscal year 2013 based on a combination of revenue growth and strict expenditure discipline – represented the first step of required consolidation effort. The Budget provided for a 1 percentage point reduction in the expenditure-to-GDP ratio from fiscal year 2011 to fiscal year 2013 despite an expected increase in the debt costs component of 0.6 percentage points of GDP.<sup>1</sup>

<sup>1</sup> As discussed below, the expenditure implications of this deficit-reduction strategy pose particular challenges to the provinces, whose current spending increased rapidly in 2008 and 2009 as a result of employment growth, significant general salary increases and the implementation of occupation-specific salary dispensations (mainly in education and health).

3.2. From Table 2 above it can be seen that shares of expenditure components in total expenditure are expected to stay fairly constant over the medium term. However, revised 2011/12 figures indicate significant increases in expenditure on 'Recreation and culture' as well as 'Education' (Table 3). Downward revisions for 'General public services', 'Fuel and energy', 'Housing and community amenities', 'Defence' as well as 'Public order and safety' were also recorded.

Table 1: Average Real Annual Growth of Expenditure Components (Functional Classification)

|   | 2011/12 | 2012/13 | 2013/14 | 2014/15 | Average annual growth (2011/12-2014/15) |
|---|---------|---------|---------|---------|---|
| General public services                           | 4.6%    | -1.8%   | 2.0%    | 6.6%    | 2.9%                                    |
| Defence   | 7.3%    | 3.8%    | 1.0%    | 2.3%    | <b>3.6%</b>                             |
| Public order and safety                           | 3.9%    | 3.7%    | 1.9%    | 2.3%    | 2.9%                                    |
| Police  | 4.5%    | 1.9%    | 2.1%    | 2.3%    | 2.7%                                    |
| Law courts  | 2.1%    | 8.5%    | 2.8%    | 1.7%    | <b>3.8%</b>                             |
| Prisons   | 3.1%    | 6.7%    | 0.3%    | 2.2%    | <b>3.1%</b>                             |
| Economic infrastructure                           | 3.8%    | 5.0%    | 2.2%    | 6.5%    | <b>4.4%</b>                             |
| Communication                                     | 7.1%    | 15.1%   | -2.1%   | -3.4%   | <b>4.2%</b>                             |
| Fuel and energy                                   | 2.1%    | -7.6%   | -17.8%  | 3.9%    | -4.9%                                   |
| Transport   | 3.9%    | 5.9%    | 4.0%    | 7.2%    | <b>5.3%</b>                             |
| Economic services and environmental protection    | 9.0%    | 2.2%    | 1.6%    | 0.5%    | <b>3.3%</b>                             |
| Local government, housing and community amenities | 15.4%   | 0.5%    | 3.9%    | 0.5%    | <b>5.1%</b>                             |
| Housing development                               | 15.9%   | 5.3%    | 5.5%    | 3.2%    | <b>7.5%</b>                             |
| Local government and community development        | 12.4%   | 3.2%    | 4.0%    | -3.1%   | <b>4.1%</b>                             |
| Water supply                                      | 20.1%   | -6.8%   | 2.7%    | 4.2%    | <b>5.0%</b>                             |
| Health  | 7.6%    | 2.1%    | 2.2%    | 3.6%    | <b>3.9%</b>                             |
| Recreation and culture                            | -12.6%  | -5.0%   | -9.3%   | 1.9%    | -6.3%                                   |
| Education   | 8.2%    | 1.0%    | 2.4%    | 2.6%    | <b>3.5%</b>                             |
| Social protection                                 | 7.1%    | 2.8%    | 2.6%    | 2.0%    | <b>3.7%</b>                             |
| Science and technology                            | -15.0%  | 5.4%    | 7.7%    | 0.8%    | -0.3%                                   |

Source: MTBPS (2011), Commission's calculations

Table 2: Selected Expenditure Components (Functional Classification) Share in Total Expenditure

| Category                               | 2010/11 | 2011/12 | 2012/13 | 2013/14 | 2014/15 |
|--|---------|---------|---------|---------|---------|
| <b>General public services</b>         | 5.45%   | 5.41%   | 5.15%   | 5.07%   | 5.20%   |
| <b>Defence</b>                         | 3.84%   | 3.91%   | 3.93%   | 3.84%   | 3.77%   |
| <b>Public order and safety</b>         | 9.39%   | 9.26%   | 9.30%   | 9.15%   | 8.99%   |
| <b>Fuel and energy</b>                 | 0.81%   | 0.79%   | 0.71%   | 0.57%   | 0.57%   |
| <b>Housing and community amenities</b> | 12.43%  | 12.41%  | 12.09%  | 12.14%  | 11.72%  |
| <b>Health</b>                          | 11.31%  | 11.57%  | 11.44%  | 11.28%  | 11.23%  |
| <b>Recreation and culture</b>          | 1.17%   | 1.06%   | 0.90%   | 0.79%   | 0.78%   |
| <b>Education</b>                       | 18.94%  | 19.49%  | 19.07%  | 18.85%  | 18.58%  |
| <b>Social protection</b>               | 14.83%  | 15.10%  | 15.04%  | 14.91%  | 14.62%  |

Source: MTBPS (2011), Commission's calculations

Table 3: Revisions of the Selected Expenditure Components (Functional Classification)

| Category                                   | 2011/12 figure<br>(Budget Review) | Revised 2011/12 figure<br>(MTBPS) | Percentage<br>change |
|--|-----------------------------------|-----------------------------------|----------------------|
| <b>General public services</b>             | 55.4                              | 53.0                              | -4.3%                |
| <b>Defence</b>                             | 38.4                              | 38.3                              | -0.3%                |
| <b>Public order and safety</b>             | 90.9                              | 90.6                              | -0.3%                |
| <b>Fuel and energy</b>                     | 7.9                               | 7.7                               | -2.5%                |
| <b>Housing and<br/>community amenities</b> | 121.9                             | 121.5                             | -0.3%                |
| <b>Health</b>                              | 112.6                             | 113.2                             | 0.5%                 |
| <b>Recreation and culture</b>              | 6.4                               | 9.6                               | 50.0%                |
| <b>Education</b>                           | 172.7                             | 190.8                             | 10.5%                |
| <b>Social protection</b>                   | 146.9                             | 147.8                             | 0.6%                 |

Source: Budget Review (2011), MTBPS (2011), Commission's calculations

- 3.3. Comparing the revised estimates for 2011/12 with what was projected in this year's budget, the following categories were revised upwards: Health, Recreation and Culture, Education, and Social protection. On the other hand, the following categories were revised downwards: General public services, Defence, Public order and safety, Fuel and energy, and Housing and community amenities.
- 3.4. The concern for the Commission is the downward revision of housing which can contribute to economic growth. It could also compromise Government's outcome on human settlement in the face of growing backlogs. While government has indicated that continuing on a subsidy trajectory is not sustainable, any reform may require a budgetary injection. Another concern is the downward revision of public order and safety which is one of the broader priority areas of government.

3.5. **Job Creation:** Much of the MTBPS this year has been about emphasising the need to shift priorities in government spending away from consumption towards infrastructure investment as a critical vehicle through which to generate more jobs. The Commission welcomes these proposed shifts in the composition of public expenditure. As proposed in FFC's 2011 Annual Submission, government should actively and specifically continue pursuing the implementation of significant capital investment in public infrastructure that has a positive impact on total factor productivity and employment in the context of NGP. Government's capacity to influence economic outcomes through fiscal policy has been severely constrained by capacity constraints that have prevented the relatively expansionary fiscal policy to stimulate economic growth and job creation. Part of the reason for the failure has been that funds earmarked for capital projects have remained unspent and the funds used for purposes of increasing remuneration of the public service over and above what was budgeted. Specifically, with regard to investment in infrastructure, reasons for under spending (and under-delivery) on local government level are often attributed to capacity problems. The question that needs to be raised is whether or not capacity-building initiatives (such as Infrastructure and Delivery Improvement Programme (IDIP), as well as government's plans to increase the number of technical staff and data capturers to work with provinces and municipalities) are sufficient to improve delivery given the increases in funding for infrastructure over the medium term, or is sub national government in a sense set to fail on a grander scale? Adequate capacity is a critical concern for municipalities and provincial governments. The availability of appropriately skilled human capital, capable of ensuring solid financial management practices and strategic planning, is an asset for any government entity. Lack of capacity in this regard has a definite impact on the performance of a municipality. Constant growth in capacity building grants should, as noted in the Commission's Submission for the Division of Revenue for 2010/11, take into consideration current weaknesses in the framework underpinning capacity building initiatives. The concern is that interventions are fragmented, uncoordinated and largely unresponsive to the nature and underlying causes of the challenges experienced. Thus allocating additional funding within this context would not be fiscally prudent and would certainly not adequately address current capacity challenges. In its response to the 2010 MTBPS, the Commission further called for a greater focus on institutionalisation of project management, external auditing of budget expenditure, greater involvement of the private sector through PPPs (public private partnerships), establishment of budgeting norms and standards as well as institutionalising life-cycle project management as interventions towards dealing with capacity issues. These suggestions remain relevant. Government should be applauded for recently putting in place initiatives that require departments to submit projects upfront and also for National Treasury to visit entities in the compilation of the Estimated National Expenditures.

3.6. **Health and Millennium Development Goals:** In South Africa, progress in achieving the health-related Millennium Development Goals (MDGs) has been slow. Based on

current trends, the country will not reach the MDGs for child mortality (Goal 4), maternal mortality (Goal 5), and HIV/AIDS, malaria and tuberculosis (Goal 6). A recent study<sup>2</sup> by the Commission takes a detailed look at the economic impact of different options for creating and using fiscal space to attain outstanding MDGs. The former refers to mobilizing resources and the latter to their possible uses. Prioritisation of health MDGs proposed in this year's MTBPS is in line with the recommendations and findings of the Commission. Government has responded in the MTBPS by proposing earlier treatment for AIDS through widening of cd4 350 threshold. In the area of Primary Health Care (PHC), government is proposing sustaining rising PHC visits through increased allocations. The continued emphasis by government on the need to achieve greater efficiencies and cost-savings for reprioritisation is also in line with FFC recommendations in the 2011 Annual Submission. With regard to National Health Insurance (NHI), government describes a largely coherent framework of reforms, designed to help deliver on the objective of a health service aimed at providing universal coverage while ensuring that everyone has access to quality, needed health services in the recently released NHI Green Paper. Government promises that steps will be taken over the medium-term expenditure framework (MTEF) period ahead to improve public health administration, accelerate the hospital revitalisation programme and pilot district-based primary health services as part of the preparation for national health insurance. There is a need for government to come up with an interim financing mechanism for these activities that is credible. There are two issues for discussion here. The first pertains to interim financing arrangements of NHI, in particular the proposed pilots. One option is to simply transfer these allocations (which are already far below the stated gap) via the Provincial Equitable Share (PES) formula. Another option is to set up a new conditional grant as an interim financing strategy as mentioned in the Green Paper. The Commission's view is that the proposal to create a conditional grant is worth pursuing as funding mechanism in the interim but in the context of reforms to resolve more structural issues in the sector. These issues include guaranteeing an effective support/supervision mechanism for these 'frontline' workers, ensuring integrated planning of the services that they are supposed to be rendered by Health Departments and NGOs (non-governmental organisations) involved. The Commission is of the view that the interim funding arrangements should go with some conditions: a) transformation of funding strategies in provinces to allow for integrated services across all the sectors mentioned, with a strong focus on prevention; and b) a viable monitoring system be established to track quality of services provided by government and the NGOs involved. Key shortcomings will start to be addressed in the pilots but further action is needed along these lines and laying out a clear business case for the proposed pilots. The second issue pertains to important fiscal challenges that lie ahead with NHI and implications for taxation. The NHI Green Paper suggests that this

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<sup>2</sup> Mabugu, R, Robichaud, V, Maisonnave, H, and Chitiga, M. 2011. Realising Millennium Development Goals Through Intergovernmental Transfers, Chapter 4 in Financial and Fiscal Commission (2011). *2012/13 Submission for the Division of Revenue Technical Report*, Midrand, South Africa.

would entail costs rising from R121bn in 2012, to R255bn in 2025 in real terms. This figure entails a funding gap of R120bn. This latter figure is more feasible than the earlier announcement in September 2010 that entailed costs rising from R127bn in 2012, to R376bn in 2025 in real terms but it amounts to little more than the assumption of normal increases one would have anticipated in the budget allocated to health care over the next 15 years. Irrespective of the exact figure, envisaged changes to health systems will have implications for public finances. The Commission looks forward to an in-depth consultation process by Government during 2012 promised in the MTBPS.

- 3.7. **Social Security:** With respect to *Social Development*, the main proposal in the 2011 MTBPS is to reprioritise funds already in the baselines towards strengthening selected child welfare programmes. The two main programmes proposed to be supported in the MTBPS are access to early childhood development services and home and community based child care and protection. The Commission's view is that this proposal is worth pursuing but in the context of reforms to resolve more structural issues in the sector. These issues include guaranteeing an effective support/supervision mechanism, ensuring integrated planning of the services rendered by DSD (Department of Social Development) and NPOs (non-profit organisations) involved. The Commission proposes that funding the priorities should go with some conditions: a) transformation of funding strategies in provinces to allow for integrated services across all the sectors mentioned, with a strong focus on prevention; and b) a viable monitoring system be established to track the quality of services provided. The overriding issue however is the urgent need to move towards a universal provision approach. Giving more money to the sector should therefore be guided by the need for a serious policy review about the role of the state and the effectiveness of delivery models. The current approach is quite patchy and not consistent with international good practice for a service that has very strong positive externalities. The public good and poverty reduction elements in ECD (early childhood development) necessitate a government-supported integrated programme that: a) provides a core package of services outside the centre/facility<sup>3</sup>; and b) strengthens the facility based approach by government taking care of salaries, and establishing a strong compliance monitoring system to ensure quality provision and avoid leakage of resources.

#### 4. Division of Revenue and Provincial Policy Issues

- 4.1. Table 4 below sets out the division of revenue among the three spheres of government. After a net adjustment of R2.9 billion in 2011/12, the total expenditure envelope grows from a revised R811.1 billion in 2011/12 to R1 trillion by 2014/15.

<sup>3</sup> . Options for such a service delivery approach have already been tried in parts of the country. In addition, funding should ensure the scaling up of the best of these or elements of these.

Using the base year 2011 consumer price inflation (CPI) of 5%, this represents an average real growth in expenditure of about 2.3%. Compared to the 2010 MTBPS growth rate of 2%, the provincial allocations are growing at a slower rate. As a result the share in allocations for national and local government is projected to grow, while that for provinces declines, though marginally from 44.9% to 44.7% over the MTEF.

- 4.2. The share of national allocations remains stable over the 2012 MTEF at average 46.8%, increasing slightly from the initial 46.7% in 2012/2013 to 46.8% in spite of the economic downturn. In addition, the local government fiscal framework remains buoyant, growing at a real rate of 3.4% in 2012/13 and 3.6% in 2014/15. Provincial baselines grow by only 1.1% while local government baselines grow by a healthy 4% in real terms over the medium term. The Commission agrees with government that the latter is important to assist municipalities in the provision of free basic services to the poor and cover administrative costs where cost increases are a result of exogenous factors such as increased administrative prices and while the emphasis continues to be placed on elimination of waste, corruptions and inefficiency.

Table 2: Division of Revenue 2011/12-2014/15

|                            | 2011/12      | 2012/13               | 2013/14     | 2014/15       | 2012          | Average annual growth |
|----------------------------|--------------|-----------------------|-------------|---------------|---------------|-----------------------|
| R billion                  | Revised      | Medium-term estimates |             |               | MTEF Totals   | 2010/11 – 2013/14     |
| <b>National</b>            | 377.8        | 410.3                 | 445         | <b>474.7</b>  | 1329.7        | 7.9%                  |
| <b>Provincial</b>          | 363.2        | 384.5                 | 411         | <b>437.8</b>  | 1233.3        | 6.4%                  |
| <b>Equitable share</b>     | 291.7        | 308.5                 | 328         | <b>348.8</b>  | 985.7         | 6.1%                  |
| <b>Conditional grants</b>  | 71.5         | 76                    | 83          | <b>89</b>     | 247.6         | 7.6%                  |
| <b>Local</b>               | 70.1         | 77                    | 84          | <b>90.8</b>   | 251.6         | 9.0%                  |
| <b>Total</b>               | <b>811.1</b> | <b>871.8</b>          | <b>940</b>  | <b>1003.3</b> | <b>2814.6</b> | <b>7.3%</b>           |
| <b>Percentage share</b>    |              |                       |             |               |               |                       |
| <b>National</b>            | 48.2%        | 46.7%                 | 46.8%       | <b>46.7%</b>  | 46.8%         |                       |
| <b>Provincial</b>          | 43.9%        | 44.9%                 | 44.6%       | <b>44.6%</b>  | 44.7%         |                       |
| <b>Local</b>               | 7.9%         | 8.4%                  | 8.6%        | <b>8.6%</b>   | 8.6%          |                       |
| <b>Changes to baseline</b> |              |                       |             |               |               |                       |
| <b>National</b>            | -2.3         | 1.9                   | 6           | <b>15.1</b>   | 22.8          |                       |
| <b>Provincial</b>          | 5.2          | 4.1                   | 7           | <b>9.4</b>    | 20.2          |                       |
| <b>Equitable share</b>     | 3.2          | 2.8                   | 5           | <b>5.8</b>    | 13.35         |                       |
| <b>Conditional grants</b>  | 2            | 1.3                   | 2           | <b>3.6</b>    | 6.9           |                       |
| <b>Local</b>               | 0            | 0                     | 2           | <b>3.5</b>    | 5             |                       |
| <b>Total</b>               | <b>2.9</b>   | <b>6.0</b>            | <b>14.0</b> | <b>28.0</b>   | <b>48.0</b>   |                       |

Source: National Treasury, 2011

- 4.3. **Education** remains the largest priority in government spending, accounting for over 20% of non-interest allocations. Increasing public spending in education should not

only be about increasing teachers' salaries. Expenditure should be directed towards the hiring of quality teachers, increasing teaching contact time, increased on-the-job mentoring of teachers to increase subject expertise, subsidies for transport, supplies for teaching aids, building of new and safer schools, and prioritisation of learners with special needs. Such increase in government spending will have an impact on the rest of the economy as well as on the realisation of millennium development goals (MDGs).

- 4.4. **Health spending** is set to increase by 7.4% a year, from R113 billion this year to R140 billion in three years' time. This includes the NHI pilot projects in ten districts focused on comprehensive primary health care discussed above. The focus on primary health care is in line with the Commission's recommendation that there should be re-examination of the distribution of resources between the different levels of care without weakening the role played by tertiary hospitals, but also strengthening the role played by primary health care in the health system of the country and patient responsiveness and accountability.
- 4.5. In line with a national need for fiscal tightening policy, provincial governments are, on average, decelerating expenditure growth (see Table 5). This is reflected in a projected under-spend to budget of -3.11% half way through 2011-12. This is compared to an under-spend of -2.75% last financial year. North West and Western Cape are projected to under-spend by more than 8% this year. Gauteng, Kwazulu Natal and Mpumalanga contribute disproportionately to fiscal discipline. Limpopo is the only province to project over-expenditure. Limpopo barely posted an under-spend last year and recorded the highest provincial deficit. Northern Cape, Kwazulu Natal and Free State recorded increases in spending of over 10% between financial year 2010 and 2011.

TABLE 5: Provincial total spending to budget performance - FY 2010 and 2011

| ALL DEPARTMENTS      | 2010-11                                   |   | 2011-12   | 2010-11 to 2011-12         |
|----------------------|---|---|---|----------------------------|
|                      | % (under-) / over-spending to main budget | % (under-) / over-spending to adjusted budget | projected % (under-) / over-spending to main budget | nominal annual growth rate |
| <b>ALL PROVINCES</b> | <b>0.27%</b>                              | <b>-2.75%</b>                                 | <b>-3.11%</b>                                       | <b>7.09%</b>               |
| Eastern Cape         | -0.37%                                    | -3.39%  | -0.42%  | 9.12%                      |
| Free State           | -1.90%                                    | -3.79%  | -0.35%  | 10.17%                     |
| Gauteng              | 1.01%                                     | -2.37%  | -3.90%  | 5.76%                      |
| Kwazulu Natal        | -2.00%                                    | -4.82%  | -3.40%  | 10.30%                     |
| Limpopo              | 3.56%                                     | -0.32%  | 1.14%   | 8.21%                      |
| Mpumalanga           | 0.43%                                     | -2.13%  | -3.60%  | 7.38%                      |
| Northern Cape        | 1.19%                                     | -3.58%  | -0.38%  | 10.51%                     |
| North West           | -1.00%                                    | -2.40%  | -8.83%  | 1.88%                      |
| Western Cape         | 2.50%                                     | -0.99%  | -8.27%  | -0.82%                     |

Source: National Treasury; Medium-Term Budget Policy Statement 2011

- 4.6. Despite higher than average growth of provincial education spending (at 12.43%), education departments are projected to over-spend their budgets slightly (0.83%) in financial year 2011 (Table 6). This contrasted with an overall under-spend in financial year 2010 of -1.6%. Under-spending against budget is most marked for North West, Western Cape and Northern Cape. By contrast, Kwazulu Natal, Limpopo, Mpumalanga and Eastern Cape are projected to over-spend their education budgets this year. Last year, only Limpopo over-spent its budget and contributed to the deficit burdens of the national government. Above average growth of education budgets was recorded for Kwazulu Natal, Gauteng and Mpumalanga.

TABLE 6: Provincial education spending to budget performance - FY 2010 and 2011

| EDUCATION            | 2010-11                                   |   | 2011-12   | 2010-11 to 2011-12         |
|----------------------|---|---|---|----------------------------|
|                      | % (under-) / over-spending to main budget | % (under-) / over-spending to adjusted budget | projected % (under-) / over-spending to main budget | nominal annual growth rate |
| <b>ALL PROVINCES</b> | <b>0.61%</b>                              | <b>-1.60%</b>                                 | <b>0.83%</b>  | <b>12.43%</b>              |
| Eastern Cape         | -0.45%                                    | -2.61%  | 2.13%   | 11.43%                     |
| Free State           | -0.92%                                    | -3.10%  | -0.99%  | 11.13%                     |
| Gauteng              | -0.98%                                    | -2.53%  | 0.02%   | 16.65%                     |
| Kwazulu Natal        | -0.94%                                    | -2.74%  | 4.05%   | 18.01%                     |
| Limpopo              | 6.58%                                     | 2.56%   | 3.25%   | 7.40%                      |
| Mpumalanga           | 0.59%                                     | -3.04%  | 2.99%   | 15.01%                     |
| Northern Cape        | 1.38%                                     | -0.11%  | -4.43%  | 10.74%                     |
| North West           | 0.57%                                     | -0.81%  | -6.83%  | 5.04%                      |
| Western Cape         | 0.93%                                     | -0.35%  | -4.93%  | 6.01%                      |

Source: National Treasury; Medium-Term Budget Policy Statement 2011

- 4.7. The evidence of provincial government fiscal consolidation is noted against health departments budgets (Table 7). Halfway through 2011-12, an under-spend of -2.5% is projected, continuing the trends from last year when an under-spend against budget of -2.57% was recorded. Nevertheless the sector increased its spending by a rate of 9.3% per annum. Mpumalanga, Western Cape, Free State and North West are projected to under-spend by more than 5% this year. Current spending rates in the Eastern Cape and Limpopo health departments will lead to over-spend if not curbed. No province over-spent its health budgets last year. Kwazulu Natal, Eastern Cape, Limpopo and Gauteng record higher than average annual growth rates in excess of 10%. Real declines were experienced in Eastern Cape and Mpumalanga.

TABLE 7: Provincial health spending to budget performance - FY 2010 and 2011

| HEALTH        | 2010-11                                   |   | 2011-12   | 2010-11 to 2011-12         |
|---------------|---|---|---|----------------------------|
|               | % (under-) / over-spending to main budget | % (under-) / over-spending to adjusted budget | projected % (under-) / over-spending to main budget | nominal annual growth rate |
| ALL PROVINCES | -0.31%                                    | -2.57%  | -2.51%  | 9.34%                      |
| Eastern Cape  | -0.51%                                    | -4.11%  | 5.15%   | 12.79%                     |
| Free State    | -2.15%                                    | -4.57%  | -5.59%  | 6.98%                      |
| Gauteng       | 1.97%                                     | 0.39%   | -0.95%  | 10.53%                     |
| Kwazulu Natal | -4.52%                                    | -6.52%  | -4.20%  | 13.43%                     |
| Limpopo       | -0.28%                                    | -1.30%  | 1.74%   | 12.22%                     |
| Mpumalanga    | 1.68%                                     | -0.95%  | -10.63%   | 0.83%                      |
| Northern Cape | -4.38%                                    | -4.31%  | -4.19%  | 11.11%                     |
| North West    | 2.40%                                     | 0.21%   | -4.91%  | 5.15%                      |
| Western Cape  | 3.19%                                     | -0.51%  | -6.40%  | 1.56%                      |

Source: National Treasury; Medium-Term Budget Policy Statement 2011

- 4.8. **Social development** spending constitutes only 3.2% of the provincial total and includes welfare services to children, women and the disabled. Halfway through 2011-12, an under-spend of -6.5% is projected, continuing the trends from last year when an under-spend of the same rate was projected (Table 8). Nevertheless, the sector increased its spending by an above average rate of 10.7 % per annum. Kwazulu Natal, Western Cape and Gauteng are expected to under-spend by more than 10% this year. Last year, Kwazulu Natal, Gauteng and Limpopo under-spent their budgets by more than 10%. As with the other provincial social sector departments, the Limpopo Department of Social Development is the only one in the country projected to over-spend, and significantly by 13.3%. Several provinces have grown their spending on social development in excess of ten per cent per annum. From highest to lowest, these are Limpopo, North West, Gauteng, Kwazulu Natal and Mpumalanga. By contrast, the Western Cape's spending on social development has been cut in nominal terms by -6.5%, and in real terms by approximately -12%.

TABLE 8: Provincial social development spending to budget performance - FY 2010 and 2011

| SOCIAL DEVELOPMENT | 2010-11                                   |   | 2011-12   | 2010-11 to 2011-12         |
|--------------------|---|---|---|----------------------------|
|                    | % (under-) / over-spending to main budget | % (under-) / over-spending to adjusted budget | projected % (under-) / over-spending to main budget | nominal annual growth rate |
| ALL PROVINCES      | -3.08%                                    | -6.51%  | -6.47%  | 10.69%                     |
| Eastern Cape       | 0.24%                                     | -0.14%  | -4.93%  | 4.02%                      |
| Free State         | -1.27%                                    | -0.32%  | -5.41%  | 6.44%                      |
| Gauteng            | -11.64%                                   | -12.29%                                       | -9.51%  | 14.68%                     |
| Kwazulu Natal      | -13.79%                                   | -13.79%                                       | -16.04%   | 14.02%                     |
| Limpopo            | 24.60%                                    | -12.34%                                       | 13.30%  | 30.83%                     |
| Mpumalanga         | -3.79%                                    | -3.79%  | -2.35%  | 10.09%                     |
| Northern Cape      | 3.02%                                     | -0.23%  | -1.21%  | 7.49%                      |
| North West         | -1.31%                                    | -0.03%  | -2.45%  | 16.28%                     |
| Western Cape       | 0.24%                                     | -0.94%  | -14.40%   | -6.74%                     |

Source: National Treasury; Medium-Term Budget Policy Statement 2011

4.9. On revisions to **Provincial Equitable Share (PES)** formula, the 2011 MTBPS indicates that there are slight changes made to the health component of the formula to make it more transparent and simpler since its introduction last year. While the Commission will provide a fuller submission on the formula at the time of the tabling of the Division of Revenue Bill (DORB) in February 2012, there are a few key principles worth highlighting at this stage.

1. While the revision to individual components of the formula have merit, they under-serve the greater purpose of having a full revision which should simultaneously be supported by substantial injection of resources to achieve the intended impact. The piece meal approach to reviewing the formula therefore results in much reduced impact unless the overall formula can be changed. The incremental revision carried out by government so far gives an impression to the Commission that the formula remains generally inequitable despite “tinkering at the margins”. The main challenge remains that of ensuring that grant allocations translate into quality outputs (provincial) and outcomes (improved pass rates) that ensure an equitable, progressive realisation of the socio-economic right to education.
2. At the level of an equitable outcome, there is a need to ensure that provinces spend efficiently and that allocated budgets are not overspent on personnel or under-spent on capital and maintenance budgets, or learner teaching aids. On the outcome side, provinces need to ensure that budgets yield value for money

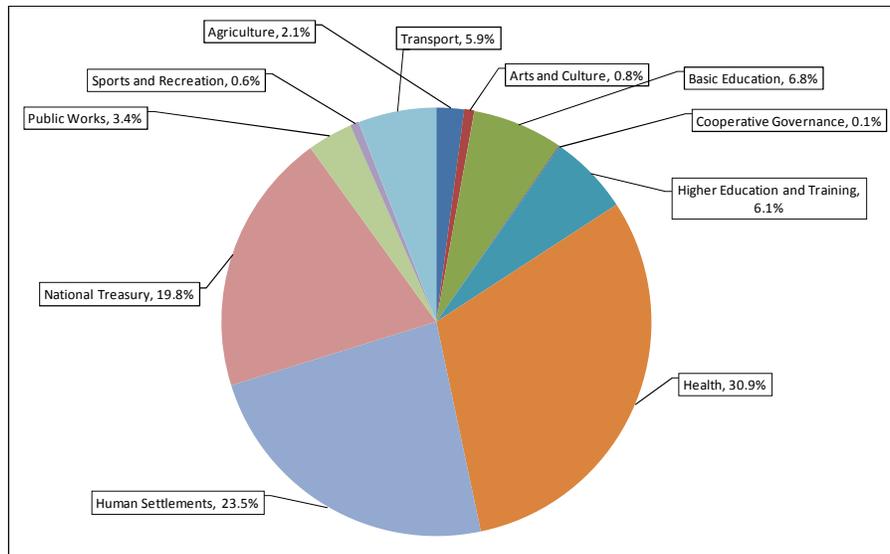
in terms of improved and better pass rates especially in key subjects like mathematics and sciences. Outcome 1 details government's approach to doing this.

3. In reviewing the formula, a clear balance should be struck between the formula and decisions taken during the normal budget process. For instance, adjustment budget should not compromise equity by rewarding provinces that overspent on personnel, without prior agreement at national level and compliance with virement restrictions. This also creates perverse incentives, undermines Parliament's original intentions reflected in initial grant framework and promotes increased government dissaving.
4. The Commission would also like to reiterate its 2009/10 recommendation that some IGFR (intergovernmental fiscal relations) issues may be better dealt with at a level of vertical division outside of the PES, for instance underfunding of the provincial functions. With the exception for roll-overs in conditional grants and accruals from the previous financial year the biggest challenge is that such pressures come from the area of personnel. Given its nature and if allowed to grow out of control, personnel could be difficult to contain due to the nature of carry through and mandatory cost associated with it. As a result, it's not uncommon that provinces redirect funds away from "non core" areas towards education and health within which the main cost driver is personnel. The consequence of this is that service delivery can be expected to slow down in preference to wage agreements. Funding of provincial functions can only be understood in the context of accurate costings based on minimum norms and standards, expenditure needs and revenue raising abilities.

## **5. Proposed Adjustments to Conditional Grants**

- 5.1. Conditional grant allocations are divided and arranged into Schedules in the Division of Revenue Act. Schedule 4 grants supplement the equitable share given to provinces. Schedule 5 grants contain allocations to provinces for designated special programmes (National Treasury, 2008). In terms of provincial conditional grant budget allocations from 2010/11 to 2013/14 totalling R294.5 billion), health conditional grants account for the biggest share (R91 billion or 30.9%) of conditional grants to provinces followed by human settlements grants (R69.3 billion or 23.9%), National Treasury administered grant (R58.4 billion or 19.8%) basic and higher education grants (R38 billion or 12.9%) and transport grants (R17.4 billion or 5.9%) (See Figure 4).

Figure 4: Provincial Conditional Grants – 2010/11 to 2013/14



Source: National Treasury, 2011

- 5.2. **Health Professional Training and Development Grant (HPTDG):** This grant is intended to compensate provinces for externalities associated with additional service costs associated with training health professionals and carrying out research. An example of such externality is time taken by a specialist to supervise trainees or breakages to equipment associated with trainees. Training of specialists and sub specialists takes place in public sector academic hospitals and primary centres. Challenges with this grant is that it is difficult to track how the grant is budgeted and utilised by provinces, especially in the absence of integrated national and provincial blueprint for human resource development.. In 2010, the Department of health estimated that 1687 registrars post were unfilled. The Commission is aware that the grant is under review for integration with the Department of Higher Education. The review must address framework defining the responsibilities for health sciences student training between the Departments of Higher Education and Training (DHET) and Health, training standards, infrastructure, financing and operational requirements.
- 5.3. **National Tertiary Service Grant (NTSG):** Currently 26 hospitals and complexes of hospitals receive funding from this grant. Western Cape and Gauteng receive the largest proportion of the grant as these provinces provide the highest proportion of tertiary services In the past, the Commission raised an issue that the lack of norms and standards for public hospitals makes it difficult to make an objective assessment of funding allocations from an equity point of view. Another issue is the lack of data on and the impact inter-provincial migration or referral makes on funding pressures of tertiary facilities, that is, accounting for the additional costs associated with spill over effects. The Commission still reiterates its position that it is important therefore for the Department of Health (DOH) finalise norms and standards for different levels of public hospitals coupled with credible monitoring and evaluation instruments which can lay, among other things, the foundations for tracking DRGs (diagnostic related

groups as mooted in NHI proposals). Data of on inter-provincial migration for medical assistance at tertiary hospitals needs to be collected to inform resource allocations based on utilisation of tertiary health services.

- 5.4. **Comprehensive HIV / AIDS Grant:** This is a Schedule 5 grant which is a specific purpose allocation to provinces. In 2011, government decided to expand the HIV/AIDS treatment programme in line with the World Health Organisation (WHO) guidelines. All HIV positive infants, regardless of their CD4 count, are now provided with anti-retroviral drugs (ARVs). Pregnant HIV positive women and HIV and TB co-infected patients are now eligible to begin anti-retroviral treatment (ART) at a CD4 count of 350, rather than 200. Provinces face a challenge of increasing higher numbers of patients on anti-retroviral therapy than the original forecast due to continuing enrolments during the year. Any shortfall in the funding for ART needs to be funded from the equitable share allocation, thus putting added pressure on provincial budgets. There is a need, therefore, to improve provincial targeting, budget forecasting and increasing the quantum of funds to cater for an expanded programme on the Prevention of Mother to Child Transmission and voluntary HIV Counselling and Testing (VCT).
- 5.5. **Education and Health Infrastructure Grants:** The Commission notes that in the adjusted budget for 2011/12, almost R200 million is allocated for improving health facilities. Currently, both the departments of education and health manage the education infrastructure, health infrastructure and health revitalisation grants. These grants are fraught with poor expenditure. There still appears to be challenges in delivery models across provinces where there is little alignment between the budget cycle and the infrastructure delivery cycle. Infrastructure projects are experiencing delays in planning and implementation, and significant variation orders. The poor performance of contractors impacted negatively on both the quality and timely completion of projects as well as poor supply chain management practices by the Departments themselves.
- 5.6. It is also critical that both the health infrastructure grant and the **health revitalisation grant** are aligned to cut the administrative cost of managing them by provinces. They are all meant for the delivery and maintenance of infrastructure. Both national education and health departments need to enhance their capacity and provincial departments' capacity for planning, infrastructure project management monitoring and evaluation. An alternative approach will be for the departments to manage grants while the implementing agent is made responsible for infrastructure delivery. A service level agreement will be needed to manage the roll-out of various national interventions aimed at improving the quality and efficacy of infrastructure delivery at provincial and project level. **Extended Public Works Conditional Grant:** This is a program of the national public works department and is disbursed to provincial and municipal departments that adopt labour-intensive methods of employment on infrastructure projects. The Commission is in agreement that the grant can play a critical role towards attaining a target of 3.4 million job opportunities over the next

three years through investments in labour intensive infrastructure projects. It is designed as an incentive to employment on projects financed through the Infrastructure Grant to Provinces, the Municipal Infrastructure Grant, as well as the various agricultural conditional grants to provinces. In terms of the grant framework, provinces and municipalities must spend their budgets on Expanded Public Works Program (EPWP) projects and after that the grant will be paid by Department of Public Works (DPW) quarterly as an incentive (after employment has been created). The programme and its component incentive grants to the infrastructure and social sectors have been under-spent against budget since their inception. Projected under-spend in financial year 2011 is -28.4%. Last year, the actual under-spend was -38.4%. Despite this, the annual growth of this budget was a very much higher than average rate of 23.9%. Expenditure reports on the grant performance at local government are inaccessible. DPW should explain how transfers are reconciled with actual expenditure. The grant should be streamlined to the Division of Revenue Act (DORA) requirements in terms of allocation and disbursements of funds. Punitive and incentive elements of the grant should be made transparent to all the stakeholders.

- 5.7. **Human Settlements conditional grants:** One of the new positive developments in the 2011/12 Division of Revenue on human settlements sector is the merging of the Integrated Housing and Human Settlements conditional grants with part of the infrastructure grant for metros to form the Urban Settlements Development grant. The Commission has welcomed this development as a step in the right direction. However, the Commission believes that there are a number of other infrastructure related grants that need to be aligned and these include regional bulk infrastructure grant, electrification grant and neighbourhood development grant.
- 5.8. The other development relates to the **upgrading of Informal Settlements Programme** which is an initiative aimed at elimination of informal settlements. This is also a positive development and government has indicated that funding for this programme will increase to upgrade informal settlements in 45 cities and towns. Key to the process of identifying informal settlements to be upgraded through this programme is a clear criterion that is followed to identify which informal settlements are to be prioritized and expanding the role of municipalities in the process. In most cases informal settlements are denser and well located (in areas close to the where individuals work), this implying less commuting and spending on public transport. Upgrading of informal settlements especially in situ is therefore in line with the Commission's recommendation on promoting compact cities made earlier this year for the 2012/13 Division of Revenue.
  1. The Commission also notes the slow **pace of municipal accreditation (the number of accredited municipalities remains at 18 at the beginning of this year.** Addressing challenges on the funding of the built environment is unlikely to yield positive results without accreditation of municipalities with the overall administration and control over the housing function.

2. Government's commitment to extend community development programmes, including the human settlements development and urban settlements development infrastructure grants are welcomed by the Commission as this will likely contribute to up scaling of housing delivery and reduction of housing backlog. However, further attention needs to be given on the design of the human settlements grants. Apart from the need to align infrastructure related grants noted under sub-section 5.7, there is a need to review these grants including the human settlements grant to ensure that they can be used as incentives for the promotion of efficient land use especially in urban areas where land is a scarce resource. Such a review is in line with the Commission's recommendation for the 2012/13 Division of Revenue on creating fiscal incentives to promote compact cities. In its current form the housing grant has resulted in new settlements often being located on the periphery of urban areas due to a number of factors including funding gap (funding provided only for a top structure and not for land). Furthermore, conditional grants within the built environment are not integrated at the project level and are characterised by lack of proper sequencing of actions between infrastructure provisioning and building of top structures. The other weakness of the current conditional grants is that m they cannot be used as innovative instruments to leverage co-funding and to attract private sector investment for infrastructure and property development especially in relation to incremental in situ upgrade and may create distortions in the affordable housing market.
- 5.9. With respect to **transport**, the Commission supports the provisions of the National Land Transport Act (No.5 of 2009) that cities need to take a greater responsibility for the operational cost of integrated public transport networks including roads and rail routes. However, issues relating to the following should be addressed before the proposed devolution of public transport function:
1. The National Department of Transport should ensure that cities and affected municipalities have capacity to fully undertake this function;
  2. Where cities/municipalities lack such capacity, the National Department of Transport should capacitate affected cities/municipalities;
  3. The National Department of Transport should take all the necessary steps to ensure that cities fully understand what would be expected of them and all resources implications;
  4. The establishment of the dedicated Municipal Land Transport Fund and sources of funding streams to ensure adequate, predictable and sustainable funding should be finalized. This should be done before the actual public transport function shift to avoid this becoming an unfunded mandate.
  5. A requirement for provinces to adopt road asset management systems for the provincial roads maintenance grant is welcomed by the Commission and this

should be enforced by the National Department of Transport and used as a checklist to release funding.

- 5.10. **Disaster Conditional Grant:** The Commission is currently undertaking a study on alternative financing mechanism for disaster management. The Commission notes that Schedule 9 of the 2011 Division of Revenue Act (Act No. 6 of 2011) makes provision to specifically cater for immediate release of funds to provinces and municipalities for disaster response. This process does not have to wait for the adjustment period before funds can be dispersed to provinces and municipalities. The FFC welcomes this approach. This will assist in reducing the lead time between the occurrence of natural disasters and the release of funds. This can be through a sectoral grant or an augmented grant. This process however does not resolve challenges engulfing the financing and management of disasters in the intergovernmental relations system. The process and institutions in declaring an area a disaster area need to be clarified. All spheres have a responsibility in this regard, however, municipalities, especially district municipalities, are experiencing difficulties to implement provisions of the Disaster Management Act (No 57 of 2002) and the guidelines provided in the National Disaster Management Framework (2005). One of the main reasons given for this situation is inadequate funding for planning and prevention. There is no fiscal space in provincial and municipal budgets for this purpose. Conditional grants for natural disasters are ex post allocations. With the recurrence of natural disasters, it is unlikely that public finance will cope with the demands for reconstruction. In the long-term, therefore, a variety of measures must be considered and applied to possibly reduce the physical destruction caused by natural disasters. These measures include land-use planning and building standards aimed at ensuring some level of robustness against natural disasters including climate change risk reduction, response and mitigation. The development and regulation of domestic insurance markets including the introduction of innovative market based financing of disaster relief and recovery such as risk pooling, reinsurance, derivatives, micro-insurance and catastrophe bonds should be explored.
- 5.11. **Solid Waste Management Grant:** The Commission welcomes the additional funding for waste management through a conditional grant proposed by Government. Waste management is one of the major constraints to the roll out of basic services especially in rural and low income areas. Proper waste management has public health benefits, potential to create jobs and is a revenue source for municipalities. The other condition linked to the grant is that there must be uniform tariff structures across municipalities for this function. There is a challenge that some municipalities treat solid waste management as free basic services whilst other do not. This grant will serve as an incentive to municipalities to adequately budget for waste management and innovation for environmental conservation and climate change issues.

## 6. Local Government Fiscal Framework

- 6.1. As far as baseline increases are concerned, the total local government allocation is set to increase by R5 billion over the MTEF period. Increases to the baseline are phased in the beginning of 2013/14 financial year.
1. Of the R5 billion increases R2.2 billion is in respect of the equitable share allocation to municipalities, whilst local government conditional grants are set to increase by R2.8 billion.
  2. The Commission notes with concern that there will be no increases to the 2012/13 baseline allocation for the LES. While noting the tight fiscal environment and the prioritisation of government expenditures, the importance of providing adequate basic services on a sustainable basis to local communities should not be underestimated. The ability of municipalities to deliver on their service delivery mandates has been negatively impacted by the recent domestic recession. The economic slowdown has had negative impacts on municipalities' tax bases while simultaneously increasing their expenditure responsibilities to protect communities against the social impacts of the recession. The impacts of such have been further exacerbated by the country's sluggish recovery from the recession. In addition, the increasing costs of providing basic and Free Basic Services is a concern, particularly in light of the large increases in the bulk price of electricity and water. Such price shocks, if not appropriately factored into the LES, will likely take a toll on municipal expenditures and revenues. The outer year adjustments are welcomed. The Commission further reiterates its earlier recommendations that proper costing of services in the local government sphere is necessary so that expenditure allocations are informed by correct underlying costs of providing a service.
- 6.2. In a tight fiscal environment, expenditure prioritisation and austerity measures are paramount in ensuring that the resources available to government are used efficiently and effectively. It is in this regard that the Commission strongly supports the emphasis on efficient expenditure in improving outcomes and service delivery to communities alluded to in the MTBPS. Recent Commission research<sup>4</sup> on municipal expenditure efficiency indicates that municipalities are spending approximately 60% of their resources inefficiently.
- 6.3. Underlying problems in the LES have been consistently raised by the Commission in various forums and the Commission is aware of the review being conducted by National Treasury. Specific issues to highlight in this regard include:

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<sup>4</sup> Mahabir, J. 2011. Measuring the Efficiency of Local Government Expenditure: an FDH Analysis of South African Municipalities, Chapter 8 in Financial and Commission (2011). *2012/13 Submission for the Division of Revenue Technical Report*, Midrand, South Africa.

1. The Commission supports Government's proposal to align the development of a new LES formula to the release of the 2011 census. This will allow the formula to be updated and its review to take into account new variables that will emerge from the Census.
2. Updating the data of the LES formula will continue to be a problem following the 2011 census. One of the fundamental obstacles in the review and subsequent reform of the funding formulae is the lack of frequently updated data, which results in secondary issues such as accounting for migration, changes in household sizes and cost of municipal services, that is often affected by uncoordinated changes of the formula parameters. Such tinkering further complicates and distorts the fundamental objects of these funding mechanisms and can only be solved with accurate and frequent data. Section 7(2)(a) of the Statistics Act 06 of 1999 makes provision for a census to be undertaken every 5 years, unless determined otherwise by the Minister of Finance on advice from the Statistician General. Government needs to urgently take a stance over the use of alternative local government data. If comprehensive data for municipalities is only available every 10 years with a census, then such information should be officially communicated so that the formulae used to disburse funds can be appropriately configured to minimise the effects of such a constraint. For example, the data gap created by 10 year censuses can be filled by use of a Community Survey. In terms of the latter, Government needs to ensure that the quality of such surveys are improved substantially compared to the 2007 initiative.
3. In addition to the point above, Government needs to take the lead to ensure that the projections and assumptions underpinning planning and budgeting of individual municipalities are consistent at provincial and government-wide levels. This will ensure that municipal budgets are based on sound economic, demographic and social assumptions and are credible in terms of the intended outcomes of such revenues and expenditures. This highlights the importance of the municipal benchmarking exercises undertaken by National and provincial treasuries.
4. The Commission supports greater funding being afforded to municipalities to support their institutional and administrative costs. Such an initiative is in line with the Commission's recommendation for greater funding being targeted to poor municipalities via the Institutional Component of the LES formula. These poorer municipalities are resource constrained and thus find it difficult to fund their administrative expenses and attract the appropriate skills from their revenue base. Such an initiative will assist in ensuring that resources earmarked for service delivery is not compromised to fund institutional and administrative requirements.
5. Although the Commission acknowledges the difficulties in measuring municipal capacity within the LES formula, the continued use of the Revenue

Raising Component as measured in its current form can be legally challenged. The Commission reiterates its concerns over the continued use of this component in its current form as a challenge to the equity and overall integrity of the allocations generated by the formula remain.

- 6.4. The R2.8 billion increase in local government conditional grant funding over the MTEF period is driven by increases in the Urban Settlements Development Grant (USDG), and the Integrated National Electrification Programme (INEP) Grant. The Commission commends government's attempts to entrench the principles of differentiation which is particularly evident with respect to the principles underlying the allocation of local government conditional grant funding (examples include the Urban Settlements Development Grant and the Rural Transport Services and Infrastructure Grant). The Commission would like to highlight two aspects with respect to local government conditional grants, namely
  1. Its support for the stance taken by National Treasury of tightening the systems and processes around unspent conditional grant funding and returns to the National Revenue Fund (National Treasury, 2011). The risk of having the equitable share allocation offset against unspent conditional grant funding, will surely have an effect in terms of motivating municipalities to use conditional grants appropriately and for the purpose they were designed for.
  2. Given the number of existing conditional grants at the local level, the fact that certain grants will be discontinued at the end of 2011/12 (most notably, the Electricity Demand Side Management Grant) and the possibility of new allocations in respect of waste management in rural municipalities, the Commission would like to reiterate as per its 2011/12 recommendations, the need for government to ensure independent evaluations of grant performance at entry, midterm and end of the grant life cycle.
- 6.5. As in previous years, the Commission raises concern around lack of realistic budgeting and spending on capital and repairs and maintenance.
  1. Generally municipalities rely on intergovernmental transfers to fund capital spending. On average, intergovernmental transfers comprise 40% of total capital revenue in 2008/09. For certain categories of municipalities, particularly rural municipalities and medium to smaller towns, this component is in excess of 50% of total capital revenue. Municipalities find themselves in a difficult position where, due to poor credit worthiness they are unable to access external loans. When one looks at budgeted versus actual capital expenditure, Commission's analysis indicates that during 2008/09 municipalities spent, on average, 87% of what had been budgeted for. This performance is largely influenced by relatively good spending by metropolitan municipalities. All other municipal categories were barely able to spend 70% of what had initially been budgeted for capital. This hints then at the severity of unrealistic budgeting.

2. Unless poor municipal planning and spending on capital is addressed, Government's plans to invest in economic and social infrastructure as a means of promoting economic growth will remain unattainable.
  3. With respect to repairs and maintenance, Commission's analysis indicates that poor performance cuts across municipalities regardless of their size and capacity, with an overwhelming majority of municipalities either over budgeting or under spending on this component. As indicated in the Commission's 2012/13 Submission, the pervasiveness of these points to two things. The first is that even well-capacitated municipalities are displaying this challenge, suggesting that the root cause may well be poor financial management. The second is that municipal tariffs have a long history of not being cost reflective (despite the requirements of Section 74(2) of the Municipal Systems Act which tariffs charged for a service to factor in repairs and maintenance costs). This again highlights the need to adequately cost municipal services.
  4. In addition, the need for stronger adherence to basic financial management principles on the part of municipalities, and stricter enforcement on the part of spheres tasked with oversight responsibilities, is essential if this aspect of municipal performance is to be improved.
- 6.6. The Commission notes that climate change is increasingly becoming a formidable threat to infrastructure in general and that of the local government in particular as mitigation and adaption mechanisms are weak. The Commission welcomes government's commitment to the climate change agenda. Efforts by government to improve energy efficiency are particularly welcome. To further strengthen such efforts, the Commission reiterates its recent recommendation of a performance-based conditional grant which will reward or incentivise actions that are environmentally efficient and responsive to adaptation and mitigation challenges of climate change.
- 6.7. Skilled human capital is the engine of municipal service delivery. Whereas MTBPS 2011 is not explicit around recent developments in the areas of municipal capacity, the Commission commends government for recognising and attaching priority to the challenge of capacity through the establishment of the Municipal Infrastructure Support Agency (MISA).
1. The Commission sees this as a positive step in accordance with the spirit of Section 154(1) of the Constitution and Section 34 of the Municipal Finance Management Act (MFMA) both of which envisage national and provincial government taking a proactive stance on the issue of municipal capacity building.
  2. The Commission submitted a review of the Siyenza Manje capacity building initiative to Parliament. The highlights of this review are that the programme was not well coordinated and fragmented. The Commission is hopeful that the newly established agency, which has already seen significant resources being

allocated to it, will spearhead a more coordinated and innovative approach to addressing the municipal capacity challenge and that the risk of institutional fragmentation will be guarded against.

3. To ensure value for taxpayer's money and in accordance with its 2010/11 recommendations and the parliamentary submission on Siyenza Manje, the Commission strongly recommends drawing on the Siyenza Manje experience to ensure that the same obstacles to effective capacity building, are guarded against. In this regard, strong oversight and strategic guidance from the parent department is emphasised.
- 6.8. Following the scrapping of the regional electricity distribution (REDs) proposal, government has been silent on this issue. The Commission is of the view that following the expenditure of significant amounts of public resources and the still existing need for reform, government should, in the spirit of accountability and transparency, provide clarity on the way forward. The Commission had anticipated that the MTBPS would reflect government's position on this outstanding policy issue but the MTBPS is silent on this aspect.
  - 6.9. The Commission highlights the importance of municipalities being appropriately resourced to fulfil their constitutional mandates. In this regard, the Commission notes the increasing expenditure pressures placed on the sphere in terms of extending and sustaining quality services to households, investing in new and existing infrastructure and supporting local economic and community development. The fiscal strains across municipalities are apparent and have been exacerbated by increasing electricity and water tariffs.
  - 6.10. Previous research undertaken by the Commission highlighted several principles that underpin a good local tax. This includes taxes that enhances the fiscal autonomy and discretion of local governments; strengthens the accountability of local government regarding the administration and use of the proposed tax base; yields an adequate and buoyant revenue stream for municipalities in the face of cyclical instability and maintains macroeconomic balance. In other words, such principles require municipalities to have control over the base, rate and administration of the tax. It is important that these principles underpin any proposals submitted in terms of Section 5 of the Municipal Fiscal Powers and Functions Act as a mechanism in extending local taxation sources.
  - 6.11. The success and appropriate design of a funding framework for local government can only be successful in an environment where the expenditure responsibilities of the sphere are clear and well defined. In this sense, the Commission reiterates its concern on the stalled policy implications of the review of the powers and functions of local government as envisaged in the review of the Local Government White Paper process. The concern is in terms of the funding of district municipalities. The Commission is of the view that this is an important issue that needs to be addressed.

## **7. Review of Actual Spending by National Departments and Provincial Government – 1 April to 30 September 2011/12**

- 7.1. Expenditure smoothing would imply government spending that is evenly distributed through the four quarters of the financial year. If such smoothing were to take place, it would be expected that total expenditure up to September would be at 50% of the main budget. This would differ depending on whether a government program that the department is dealing with is recurrent or capital expenditure driven.
- 7.2. Such expenditure smoothing would most likely lead to improved quality of spending and reduced level of unauthorised spending.
- 7.3. Table 9 shows aggregate spending and deviation from this norm.
- 7.4. Total government spending as at September 2011 is below the assumed norm of 50% by 1.7% at R429 billion against a total of R888 billion. A total of all votes at national level have also spent 2.1% (or R239 billion of the main budget) below the 50% norm. The figure increases when looked at as a total direct charge against national revenue fund to 0.8% (R189 billion of the main budget) below the 50% norm.
- 7.5. Using key selected government programs that drive government recent priorities (such as Education, Health, Justice and Policing, and key Built Environment programmes such as Energy, Human Settlements and Rural Development), government is above the norm by 1% at R103 billion. This bodes well for the achievement of the agreed priorities within the stipulated time frames as budgeted.
- 7.6. With respect to the equitable share, Provinces have spent 48.4% of the main vote. This represents an in year under spending of about 1.6% below the norm. The expenditure can be expected to rise significantly quicker with the advent of the implementation of the agreed to wage settlement.

Table 9: Aggregate Spending and Deviation from the Norm

| <b>R'000</b>                                       | <b>Main Budget</b> | <b>Spending as at September 2011</b> | <b>% expenditure</b> |
|--|--------------------|--------------------------------------|----------------------|
| <b>Total Expenditure</b>                           | <b>385,312</b>     | <b>189,755</b>                       | <b>49.2%</b>         |
| <b>Appropriation by Vote</b>                       | 499,481            | 239,457                              | 47.9%                |
| <b>Direct charges against Revenue Fund</b>         | 888,923            | 429,211                              | 48.3%                |
| <b>Fuel levy</b>                                   | 8,573              | 2,858                                | <b>33.3%</b>         |
| <b>State debt cost</b>                             | 76,579             | 37,399                               | 48.8%                |
| <b>Other charges against national Revenue fund</b> | 11,667             | 5,251                                | 45.0%                |
| <b>PES Transfers from National</b>                 | <b>260,974</b>     | <b>130,487</b>                       | <b>50.0%</b>         |
| <b>Selected Key budget Votes</b>                   | <b>203,789</b>     | <b>103,439</b>                       | <b>50.8%</b>         |
| <b>6. Public Works</b>                             | 7,819              | 3,187                                | 40.8%                |
| <b>14. Basic education</b>                         | 13,868             | 6,426                                | 46.3%                |
| <b>15. Health</b>                                  | 25,732             | 13,024                               | 50.6%                |
| <b>16. Higher Education and Training</b>           | 28,229             | 20,877                               | 74.0%                |
| <b>20. Correctional Services</b>                   | 16,559             | 7,348                                | 44.4%                |
| <b>23. Justice and Constitutional Development</b>  | 11,413             | 5,832                                | 51.1%                |
| <b>24. Police</b>                                  | 58,062             | 27,503                               | 47.4%                |
| <b>25. Agriculture, Forestry and Fisheries</b>     | 4,720              | 2,119                                | 44.9%                |
| <b>27. Economic Development</b>                    | 595                | 266                                  | 44.7%                |
| <b>28. Energy</b>                                  | 6,090              | 2,888                                | 47.4%                |
| <b>30. Human Settlements</b>                       | 22,578             | 10,594                               | 46.9%                |
| <b>32. Rural Development and Land Reform</b>       | 8,124              | 3,375                                | 41.5%                |
| <b>PES Expenditure at provincial level</b>         | <b>365,496</b>     | <b>177,067</b>                       | <b>48.4%</b>         |
| <b>Education</b>                                   | 154,181            | 77,732                               | 50.4%                |
| <b>Health</b>                                      | 109,997            | 53,615                               | 48.7%                |
| <b>Social Development</b>                          | 11,740             | 5,490                                | 46.8%                |
| <b>other</b>                                       | 89,578             | 40,230                               | 44.9%                |

Source: National Treasury (2011), Commission's own calculations

## 8. Concluding Remarks

- 8.1. A main theme running through the 2011 Medium-Term Budget Policy Statement (MTBPS) is that economic growth has come in slower than expected and as a consequence revenue growth will be lower and the forecast budget deficits slightly higher than budgeted for in February 2011.
- 8.2. Much of the MTBPS this year has been about emphasising the need to shift priorities in government spending away from consumption towards infrastructural investment

as a critical vehicle through which to generate more jobs and to increase the productivity of public spending as well as quality of services delivered.

- 8.3. This submission on the MTBPS by the Commission details and highlights the key issues emerging from the 2010 MTBPS and tries to link the issues with the Commission's recommendations that were tabled in May 2011. This approach is taken partly to enable the Commission to understand the extent to which its recommendations find resonance with Government's own direction and also to enable Parliament to be able to process the MTBPS and take on board the Commission's recommendations in accordance with the legislation.
- 8.4. Government's goal of achieving the 5 million job creation goal by 2020 seems unlikely given the negative effects that the global economy has had on South African growth prospects. Considering the global downturn as well as domestic obstacles to economic growth and job creation, the country should not rely on its global counterparts but should be doing more domestically to find solutions to the country's employment problems. In this regard, Commission welcomes shifts in the composition of public expenditure towards investment and economic development and calls upon it to actively continue investing significantly in public infrastructure, which has a positive impact on productivity and employment. Government should weigh up carefully the impact of increasing spending against the risk associated with increasing taxation rates, spending levels and re-allocating expenditure from capital expenditure. Capacity-building initiatives (such as Infrastructure and Delivery Improvement Programme (IDIP), as well as government's plans to increase the number of technical staff and data capturers to work with provinces and municipalities) should be assessed with a view at ascertaining whether they are sufficient to improve delivery given the increases in funding of infrastructure over the medium term. Particularly considering that the review of the IDIP (for example) has identified some problems with norms and standards, linking budgets and infrastructure plans as well as with unclear priorities when it comes to infrastructure investment and maintenance. The Commission calls for a greater focus on institutionalisation of project management, external auditing of budget expenditure, greater involvement of the private sector through PPP's (public private partnerships), establishment of budgeting norms and standards as well as institutionalising life-cycle project management as interventions towards dealing with capacity issues.
- 8.5. Reaching all the health MDGs (child and mother-related health goals) within four years seems unlikely, even impossible. National, provincial and local government should further reprioritise expenditures in respect of Equitable Share and Conditional Grants for 2012/13 to move towards attaining the MDGs. In this respect, Government should continue prioritising MDG 6 (HIV indicators) in the interim as its attainment will have positive impacts on other MDGs (positive spillovers) while the time-frame for attaining all outstanding MDGs simultaneously should be extended beyond 2015 to make the task feasible. Government, and in particular the departments of health, should ensure that the Health 10 Point Plan is implemented and weigh up carefully the

impact of increasing spending against the risk associated with increasing taxation rates, spending levels and deficit finance.

- 8.6. National government and municipalities should put systems in place that allow poorer performing municipalities to learn from their better performing counterparts. More efficient municipalities may already have solutions to the problems faced by less efficient municipalities. However, one drawback of the research is that it compares only municipalities in South Africa. While the ‘best practice’ municipalities are efficient compared to the other municipalities in South Africa, they may not be efficient in comparison to municipalities in other countries.
- 8.7. Government should encourage cities to become more compact and dense both for fiscal and environmental considerations. Policy options which include transport and housing subsidies and infrastructure grants can promote densification, while local taxes and charges can discourage underutilisation of land, and land-use regulations can smooth the progress of densification. Government should prioritise use of grants; integrating environmental concerns in procurement policies; and the development of appropriate municipal specific adaptation and mitigation policies to climate change.
- 8.8. The Commission appreciates this opportunity to interact with Parliament in relation to the MTBPS and the fiscal framework, and looks forward to future engagement in relation to the Division of Revenue.

**For and on behalf of the Financial and Fiscal Commission**

Mr Bongani Khumalo

Acting Chairperson/CE