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FOREWORD

This Submission for the 2012 Division of Revenue is made in terms of Section 214(1) of the Constitution of the Republic of South Africa (1996), Section 9 of the Intergovernmental Fiscal Relations Act (1998) and Section 4(4c) of the Money Bills Amendment Procedure and Related Matters Act (Act 9 of 2009).

In the wake of the aftermath of the globally induced recession, government responded to high levels of unemployment by means of the New Growth Path and other job-creation measures, and to persistent poverty and growing inequality by consolidating social assistance and other social wage programmes within a highly restrictive fiscal environment. This Submission explores further instruments that government can use to tackle these pressing socioeconomic issues. The Financial and Fiscal Commission (the Commission) is of the view that the intergovernmental fiscal relations system is a crucial instrument in funding public sector delivery across the three spheres of government. It is in this context that the Commission offers its recommendations, in pursuit of its overarching vision to enhance the developmental impact of public resources through the financial and fiscal system.

A key issue addressed in this Submission relates to the appropriate consolidation of public deficits and debt reduction following increased expenditures as an aftermath of the 2008/2009 global financial and economic recession. A further related issue is the appropriateness of countercyclical stabilisation policy, increased intergovernmental grants and other transfers to generate high employment, and reduced inequality and poverty (all key tenets of fiscal policy goals) in the depressed environment. Increased public expenditures could have a positive impact on social objectives. The system of intergovernmental transfers plays an integral part in realising these social objectives. However, increased spending, if unchecked, may translate into higher levels of debt, which may not be sustainable in the long run, thereby undoing gains made on the social objectives front.

At least two other fundamental issues are raised in the Submission. Firstly, it is clear that national economic success is to a significant degree dependent on urban success, although this should not be at the expense of contributions to rural development in the form of roads, support to rural municipalities, housing and agriculture. The urban environment provides the foundation for long-term economic and social development, and it is clear that cities need to focus on the long-term strategies as much as they focus on short-term planning issues. Given the rapid inward migration into cities, urban areas are required to fulfil the twin roles of, on the one hand, creating favourable conditions for economic development and, on the other, ensuring continued expansion of access to basic services and infrastructure (roads, water, sanitation, electricity). Access to land is an important prerequisite for successful urban development with the potential to reduce poverty and inequality. Climate change similarly poses a real threat to the local government sector, further aggravating the costs of inefficient land use. Municipalities also face challenges of managing budgets and collecting revenue efficiently and productively. Addressing these challenges can benefit society by improving expenditure efficiency and reducing municipal debt, which enhances government's capacity to initiate and maintain development programmes.

Secondly, it is clear that in the face of fiscal consolidation, government needs to focus more closely on fiscal responsibility and improving the quality of services, and also to pay attention to the issue of unfunded mandates. With regard to the composition of public expenditures, government will need to assess not only the appropriateness of spending programmes but also planned non-discretionary and discretionary non-priority spending, taking into account distributional and growth considerations in each area and placing due emphasis on spending programmes that are beneficial for vulnerable groups.

A theme running through this Submission is the urgent need for a directed, effective and efficient intergovernmental system for allocations, budget and spending performance. The issues raised cut across all three spheres of government, although an attempt has been made to divide them according to their commonalities. In this regard, the Submission is divided into three parts, six chapters and two annexures all addressing the theme. The Submission presents well-documented evidence that sustainable economic growth and development rests on the three pillars of (i) macroeconomic stability, (ii) progressive realisation and (iii) sustainable development. When taken together, the chapters in this Submission suggest that interventions must not only be financed in a sustainable, non-inflationary manner at national, provincial and local government levels, but attention needs to be paid to the allocative and technical efficiencies of public expenditures as well as to their environmental aspects.

This Submission (and its accompanying technical report) has benefited from collaborative input from various partnerships. Rigorous consultations have been held with the Commission's primary stakeholders from the provincial and national legislatures, expressed primarily through the Finance Committees; government, primarily through the Budget Council; and organised local government through the Budget Forum and the South African Local Government Association. The technical reports that support the recommendations rely on collaborative research with our technical advisors, partners and members of the Commission's Sub-Committee on Research and the Secretariat of the Commission.

The Financial and Fiscal Commission expresses its sincere gratitude to its former Chairperson Dr Bethuel Setai, whose term came to an end during the course of the year.

We, the undersigned, hereby submit the Financial and Fiscal Commission's recommendations for the 2012 Division of Revenue in accordance with the obligations placed upon us by the Constitution of the Republic of South Africa.

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For and on behalf of the Commission



Mr Bongani Khumalo
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Date: 25 May 2011

* Term expired in September 2010

EXECUTIVE SUMMARY

Although South Africa is recovering from the recession induced by the 2008/2009 global economic crisis, unemployment, poverty, inequality and low growth persist. Poverty is still high among African and female-headed households, despite an unprecedented extension of government social grants that have helped to reduce absolute poverty. Poor educational and health outcomes are similarly skewed against the poor. Distorted settlement patterns, which mean that the poor often locate at the peripheral urban and remote rural areas, further exacerbate the problems. By international standards South African cities are inefficient, as measured by low-density development, high travel costs and long distances to and from places of work, and high carbon footprints. The vulnerability of cities implies that a large proportion of South Africa's population and the bulk of economic activity residing there are exposed to climate change-related hazards. While all income groups are worse off financially because of an inefficient urban form, low-income households are most adversely affected by the urban sprawl, having to pay significantly more for transport. There are therefore enormous challenges to upgrade human capital skills and well-being while addressing spatial distortions that are reinforcing the social ills. These challenges are made more urgent by the realisation that the dates for attaining the Millennium Development Goals – many of which are directly linked to issues that provinces have a constitutionally assigned mandate to deliver on – are a mere four years away. While some targets have already been achieved, some gaps remain, particularly in child and maternal mortality and the environment.

A direct impact that the 2008/2009 recession has had on the availability of revenue for division among the three spheres of government is that the growth in sub-national government baselines can be expected to slow down considerably. Because sub-national governments have their own strategic goals to deal with within their mandates over the short to medium term, these goals may now need to be adjusted or delayed for later implementation, or (where funds are locked in the provision of basic services) the funds will now buy fewer basic services than before, especially for the poor. As the cost of services increases (e.g. for electricity, water and food) austerity can be expected to lead to reduced growth in budgets, with the result that fewer services will be provided, or the quality of the existing ones will be reduced. It therefore becomes important to develop strategies that emphasise a need to protect programmes such as those for combating HIV/AIDS from being under-funded or re-prioritised downwards.

At the national level, ever larger social reforms are being proposed to address the problems of poverty, growth and inequality. The National Health Insurance promises to be the largest reform yet undertaken in the health sector since the end of apartheid. Cabinet also approved the New Growth Path for South Africa, launched in October 2010, which aims to accelerate the creation of decent jobs and reduction of inequality and poverty. There is, by definition, a tension between fiscal restraint and finding resources for all the expenditure needs of all three spheres of the government, including these big social programmes. The Commission's perspective is that staying the course and delivering on the constitutional imperatives is critical to sustaining the current growth momentum. The bedrock of sustainable growth is macroeconomic stability. Maintaining macroeconomic stability, as characterised by low inflation, stable interest rates and a sustainable balance of payments position, is critically dependent on redressing fiscal imbalances, re-prioritising and getting full value for money spent. On the matter of the way forward to fiscal responsibility and attaining constitutional imperatives, two important qualifications are in order. First, fiscal correction is needed not just at the national government level but also in the provinces and municipalities. Second, for sustaining and accelerating growth, macroeconomic stability is necessary but not sufficient. Attention needs to be paid not only to achieving the targets in quantitative terms but also to the quality of adjustment, which means in particular improving both the allocative and technical efficiencies of public expenditures. This Submission explores alternative approaches to tackling these pressing issues from an intergovernmental fiscal relations perspective.

Below is a summary of the key areas addressed in this Submission and its constituent chapters, followed by the recommendations made.

Chapters 1 and 2 cover the *Macroeconomic and Fiscal Outlook*, setting out the background for the recommendations, reflecting on the economic and fiscal position, discussing options for putting fiscal policy on a sustainable path and analysing the difficult tradeoffs policymakers face when implementing policy changes that affect public spending programmes and inter-governmental fiscal transfers. The 2008/2009 global economic crisis led to a widening gap between government spending and revenues. This gap has remained wide even though the economy has started to grow again and shows signs of returning to normality. The government faces difficult tradeoffs in deciding how quickly to implement policy changes that would reduce future budget deficits. Chapter 1 describes research done by the Commission in 2010/2011, showing that the fiscal deficit

reduction strategy proposed in the 2010 Medium-Term Budget Policy Statement presents an efficient path in terms of output stabilisation and debt sustainability. A reduction in the deficit by between 0.8% and 1.3% a year will close the output gap by the end of 2013 and ensure that debt does not breach 50% of gross domestic product. The Commission therefore supports the current fiscal consolidation process. Macro and fiscal stability by itself, however, does not ensure high rates of economic growth (efficiency), let alone its distribution (equity).

Chapter 2 shows that sustained high rates of economic growth also depend upon key structural measures. Although the country has made some progress in achieving its social objectives, problems still require attention, such as inequality, poor educational attainment and child and maternal mortality. This is especially because the Commission's research in 2009/10 showed that the global economic crisis did worsen the monetary poverty felt most by the poorest children. It also showed that the impact of the recession will last for a longer time than anticipated, with the main problems being in the recovery of employment and investment. The intensified use of expansionary fiscal strategies to address these problems raises a number of critical policy questions, such as the composition of spending and how much it matters whether the expanded spending is financed by reductions in government expenditure, or by increases in government's budget deficit, or by increased taxation. The chapter makes the point that, in general, interventions that improve the distribution of income and assets within society and enhance productive capacity should form essential elements of the interventions aimed at general well-being, meeting the Millennium Development Goals, reducing inequality and increasing the supply of jobs. Such expenditures should therefore continue to be used to lay firm foundations for quality improvement.

Chapters 3, 4 and 5 focus on local government issues, paying specific attention to the role and conduct of municipalities in their unique spatial environments, under the theme of *Vibrant Urban Economies*. Like most other aspects of South African society, municipalities are diverse and operate in unique social, demographic and economic spaces. These unique characteristics have a significant impact on municipal performance and strategies required to ensure a well-functioning local government sphere. Sustainable development is anchored in a well-functioning local government sector and vibrant urban economies in particular. Vibrant urban economies spur robust development in all spheres of the economy, including rural areas. These three chapters, in various ways, carry the message that vibrant urban economies are key to sustainable development. In turn, such vibrancy is based on using scarce resources in an effective, efficient and sustainable manner. Chapter 3 evaluates the mobilisation and use of public resources. It examines the trends and performance of municipal revenues and expenditures and also critically analyses the ability of the local government sphere to support other spheres of government in delivering good quality services to the people. The chapter delivers the message that vibrant urban economies can be promoted if, *inter alia*, budgetary resources are used efficiently and productively. Chapters 4 and 5 focus specifically on issues to do with the urban built environment, in particular some of the less understood problems that local government faces, such as land-use patterns and climate change. The message of these three chapters is that, to fulfil their role as engines of growth and development, local governments need to manage their built environments efficiently, effectively and sustainably.

Chapter 6 (and two accompanying appendices reporting on the Commission's work in progress that is directly relevant here) looks at *Improving Development Outcomes of the Intergovernmental Fiscal Relations System*. An argument is made that the provinces need to exercise increased fiscal responsibility in the context of government's overall fiscal consolidation stance. This implies slower growing medium-term expenditure framework allocations, coupled with cost pressures (e.g. for occupation specific dispensation, OSD) as well as rising demand for services. In this regard, improving the quality and efficiency of services in education, health and rural development are central. Government should protect such services within existing medium-term allocations so as to cushion the effects of the fiscal consolidation on the most vulnerable as well as to assist in building human and social capital critical for future growth development. Ensuring intergovernmental fiscal institutional arrangements that can robustly and flexibly support these goals would include effectively using equitable and conditional grant allocations as well as management arrangements of other division of revenue-related issues such as OSD. Appendix 1 reports on ongoing work in rural development and Appendix 2 tackles the issue of unfunded mandates. The financial (legal) impact with respect to housing, health and library services and ways to improve the assignment of powers or functions becomes critical in such service delivery and human capital development efforts.

The recommendations of the Commission for the 2012/13 Division of Revenue now follow.

With respect to South Africa's transition to a consolidated budget and fiscal guidelines, it is recommended that:

- Over the medium term, government should continue with a gradual programme of fiscal consolidation that entails reducing moderately but consistently the budget deficit. Such efforts to preserve fiscal sustainability must be sustained in the future, even with the addition of longer-term programmes such as the New Growth Path and proposals for National Health Insurance.
- Recent government proposals on fiscal guidelines in South Africa should be supported. The Commission is of the view that proper implementation of fiscal rules (guidelines) can contribute to and complement existing fiscal policies in South Africa. However, even though international experience with fiscal guidelines has shown that such measures can further strengthen the current countercyclical policy and contribute towards fiscal sustainability, there is no "one size fits all" formula when it comes to the institutional arrangements, design and the implementation of such guidelines. The government should thus focus on these aspects of fiscal guidelines in the short to medium term. The Commission will continue to investigate the implementation implications of introducing fiscal rules in South Africa.

With respect to inclusive growth, development and fiscal policy, it is recommended that:

- National, provincial and local government should further reprioritise expenditures in respect of the Equitable Share and Conditional Grants for 2012/13 to move towards attaining the Millennium Development Goals. In this respect:
 - a. Government should prioritise MDG2 (universal education) and MDG6 (HIV indicators) in the interim as their attainment will have positive impacts on the other MDGs (positive spillovers); and
 - b. The time frame for attaining all outstanding MDGs simultaneously should be extended beyond 2015 to make the task feasible.
- Government should continue strengthening the equity focus of the current system of intergovernmental transfers, in particular in the health and education sectors. The existing transfer system is not the most effective instrument to support government's growth objectives, and this aspect should continue to be strengthened so that it plays a supportive role in this respect.
- 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 the New Growth Path.

With respect to local government revenue and expenditure assessment, it is recommended that:

- National and provincial treasuries' efforts to improve the credibility of municipal budgets through annual benchmarking exercises should continue to be supported, the results of these evaluations be reported to Parliament and provincial legislatures, and placed in the public domain. This may incentivise effective financial management among municipalities.
- National government should specifically enforce the provisions set out in Section 74(2) of the Municipal Systems Act, such that the basis of municipal tariffs accurately reflects the cost of providing the specific service, as well as conforms to the National Treasury expenditure guidelines for repairing and maintaining municipal infrastructure. This will improve planning and funding of repairs and maintenance.
- National and provincial government should require and assist municipalities to identify the primary cause of poor performance in their billing and revenue collection functions and use the information to design appropriate remedial strategies. Subsequently, municipalities should establish municipal service districts to facilitate improved performance
- As an interim measure, government should establish and publish guidelines for municipalities on the management of municipal consumer debt in terms of, but not exclusive to, interest charges, debt impairment and writing off of bad debts.
- Section 64 of the Municipal Finance Management Act (No.56 of 2003) should be amended to require the regular collation and updating of information on the indigent residents of a municipal area, as an integral component of municipal revenue management practices.

- National and provincial government should develop and support peer learning and support programmes that assist poorly performing municipalities to leverage the experience and best practices of well-performing municipalities, particularly in relation to spending performance, efficiency in using resources, proper debt management and the achievement of desired developmental outcomes.
- Data available at local government level should be reviewed so as to ensure appropriate surveys or alternatives are available to account accurately for changes in demographics and other factors at municipal level. This recommendation is a reiteration of previous recommendations on data requirements for the local government fiscal framework made by the Commission.

With respect to sustainable development of the built environment, it is recommended that:

- Government actively and specifically pursue the development of a more spatially compact urban form for South African cities, by developing and adopting appropriate policies and financing instruments. Specific fiscal instruments that can support these objectives include wider use of development charges in financing infrastructure associated with the land development process, public transport subsidies that specifically target high density low-income areas, and fiscal incentives for urban land development projects located within the existing urban form.
- Government should conduct a broad-based review of the efficacy of current housing finance arrangements in meeting housing needs within the context of creating sustainable and more compact human settlements. The Commission acknowledges recent developments in the funding framework, including the introduction of the Urban Settlements Development Grant. It believes that this creates an important opportunity for the realignment of other funding instruments in the built environment, particularly the Integrated Housing and Human Settlements Grant. The Commission intends to review the design of the Urban Settlements Development Grant once further details about this programme are made known.
- Government should review the Commission's analytical work on the fiscal and economic costs of the current urban form of South African cities and guide the Commission as to the further development of these analytical methods.

With respect to environmental sustainability and climatic change in the local government sector, it is recommended that:

- The government should ensure that municipalities develop their own climate change mitigation and adaptation strategies and plans for climate change as part of the Integrated Development Planning process. Government should provide support in this respect to municipalities over the next three years, distinguishing between different types of municipalities by both location and capacity in terms of the mandatory requirements placed on them.
- The government should consider providing municipalities with a performance-based conditional grant, which rewards or incentivises actions that are environmentally efficient and responsive to the adaptation and mitigation challenges of climate change. The design of the proposed grant should pay attention to municipality specific factors, such as the area, topography, coastal/or otherwise, and vulnerability to climate change. Specific focus areas for this grant should include:
 - a. Efficient water management practices, including the minimisation of water losses, effective asset management or rehabilitation programmes, and demand management;
 - b. Efficient energy management practices, including the minimisation of electricity losses (unaccounted for electricity), the elimination of illegal connections and energy savings by both households and industry; and
 - c. The implementation of green procurement principles.

With respect to basic education and health, it is recommended that:

- Government should finalise the implementation of occupation specific dispensation and formalise the performance evaluation system. In dealing with the expansion and implementation for occupational specific dispensation, government should:

- a. Be mindful of the rising public sector wage bill relative to other priorities.
- b. Rethink funding of personnel costs, which are centrally determined but funded by provinces through the equitable share. A full costing of the occupational specific dispensation implementation must be undertaken, and national government must take the responsibility for funding, preferably a specific purpose conditional grant.
- c. Formalise performance evaluation with the aim of boosting performance by emphasising high competence of education and health personnel.
- Increases in education spending should be directed towards investments that will have the biggest impact on quality, and this includes learner and teacher support materials. In this regard, government should improve quality and prioritise epistemological access to education by:
 - a. Developing capacity to evaluate academic performance of learners throughout their academic careers.
 - b. Ensuring that the required amount of time is spent on teaching by relieving teachers of administrative duties through the hiring of administrative assistants.
 - c. Supporting the training and development of teachers and making explicit the amount spent for this purpose through the Division of Revenue.
 - d. Improving schools accountability for learner performance.
- Coordination, financing and provisioning of scholar transport should be improved. The Commission is aware that agreement has been reached between the Departments of Basic Education and Transport that the scholar transport function be transferred from the Department of Basic Education to the Department of Transport. In so doing, it is recommended that:
 - a. All resources associated with delivering a service associated with scholar transport are transferred to the Department of Transport, including current assets and budget and all future resources.
 - b. A thorough assessment of the financial and fiscal implications of this shift is conducted before the shift happens.
- Government must, through input and output norms and standards, take reasonable measures to give effect to the inclusive education of intellectually disabled children. These norms should indicate human, physical, administrative and regulatory resources provided by the government dedicated to achieving targets for inclusive education.
- The government should extend its ongoing efforts to reform health fiscal frameworks by taking into account the burden of disease giving rise to budget pressures, to cover:
 - a. Review of the funding for HIV/AIDS, opportunistic and other infectious diseases through a regular review of usage costs for chronic disease services in HIV/AIDS, TB, maternal and child health to inform resource allocations in the public sector health care system.
 - b. Institutionalisation of a budget process that forces provincial health budgets to be based on estimations of the needs of health care service users and holds provincial governments accountable for underfunding of hospitals and clinics.
 - c. 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.
- Certain functions, such as procurement, human resources and financial management, should be devolved to hospital management to boost efficiencies and better performance.