

# Financial and Fiscal Commission: Submission on the Medium Term Budget Policy Statement 2010

*For an Equitable Sharing of National Revenue*

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## List of Acronyms

AIDS	Acquired Immune Deficiency Virus
CASP	Comprehensive Agriculture Support Programme
CPI	Consumer Price Index
EDI	Electricity Distribution Industry
EPWP	Expanded Public Works Programme
EU	European Union
FFC	Financial and Fiscal Commission
GDP	Gross Domestic Product
HIV	Human Immunodeficiency Virus
ICT	Information and Communications Technology
IMF	International Monetary Fund
LES	Local Government Equitable Share
LGTAS	Local Government Turnaround Strategy
MAFISA	Micro-Agricultural Finance Initiative of South Africa
MBAPRMA	Money Bills Amendment Procedure and Related Matters Act
MDG	Millennium Development Goal
MFMA	Municipal Finance Management Act
MTBPS	Medium Term Budget Policy Statement
MTEF	Medium Term Expenditure Framework
NDPW	National Department of Public Works
NHI	National Health Insurance
NLTA	National Land Transport Act
PFMA	Provincial Finance Management Act
PPP	Public Private Partnerships
PSC	Public Service Commission
RRC	Revenue Raising Correction

SARB	South African Reserve Bank
STATSSA	Statistics South Africa
UN	United Nations
VAT	Value Added Tax

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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 Appropriations Committees of Parliament formally requested the FFC on 28 October 2010 to comment on the MTBPS that was tabled by the Minister of Finance on 27 October 2010.
- 1.3. This Submission, over and above making general observations on the highlights of the MTBPS against the Commission's recommendations for the 2011 Division of Revenue also addresses in more specific terms the following areas: *the spending priorities of government for the next three years; the proposed division of revenue among the spheres of government and among arms of government within a sphere for the next three years; 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 development 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*. Such priorities find expression in the MTBPS. Over and above these are seven other key outcomes that government has identified that should also inform the way government conducts its business and utilises its resources.

## 2. Overall Fiscal Framework and Fiscal Consolidation

### 2.1. Global Economy and Potential Risks for South African Economy

- 2.1.1. Since mid-2008, the Government has utilised the fiscal and monetary space gained through previous prudent macroeconomic policy to support economic recovery following the global economic crisis of 2007. The repo rate has steadily decreased from 12% in 2008 to a current level of 6%, while the budget deficit has increased from a small surplus of 0.9% to a projected deficit of 7.3% of gross domestic product (GDP) during the same period. Latest economic growth figures are positive (3.2% during the second quarter of 2010) indicating that South African economy is indeed in the recovery phase. Economic forecasts by institutions such as the International Monetary Fund (IMF) and the South African Reserve Bank (SARB) also forecast positive economic growth of around 3% for 2010 overall, with the output gap closing around 2014 in line with the “moderate recession impact scenario” projections the Financial and Fiscal Commission (FFC) carried out in its recommendations for the 2011 Division of Revenue.
- 2.1.2. The following factors may pose a threat to the recovery pace/path of South African economy:
- a. Interruptions in global recovery may affect the South African economy – specifically, major trading partners’ slow recovery may impact the sectoral composition of economic growth. The major contributors to the latest economic growth figures are reported to be (a) manufacturing, (b) wholesale, retail, motor trade and accommodation, and (c) finance, real estate and business services. These are the likely sectors to suffer in the case of disruptions to the global recovery process<sup>1</sup>.
  - b. Exchange rate volatility (which has been increasing over the last couple of years) might potentially harm the demand for South African exports.
  - c. Though South Africa is quite diversified in terms of the sectoral contributions to economic growth, human resource needs and labour markets (characterised by a substantial skills mismatch) remain serious constraints across the different sectors of the economy as observed also in a recent United Nations (UN) report on Africa.
  - d. Access to budget deficit financing might be constrained by the international demand on capital markets driven, in particular, by economies that were relatively more severely affected by the sovereign debt crisis, although South Africa has of late benefitted from short term financial liquidity inflows that

<sup>1</sup> It should be noted that (a) – (c) are the largest industries in the second quarter of 2010 (STATSSA, 2010), with the first two being especially important South African exports to the European Union (EU).

could be managed properly to partially finance the deficit. These inflows are, however, quite volatile and cannot be sustained over the longer term.

- 2.1.3. Projections show a persistent budget deficit over the medium term. As noted in FFC's Submission on the 2009 MTBPS, the main drivers of the budget deficit remain continued increases in infrastructure investment, expansion of the social safety net and wage bill costs (larger than anticipated). While investment in infrastructure is not particularly problematic, the rest of the drivers do pose sustainability problems in the long term.

## **2.2. Summary of the Fiscal Austerity (Consolidation) Measures and Job Creation**

- 2.2.1. Given the evidence that fiscal austerity (fiscal consolidation) may be harmful to economic growth (especially in the short run<sup>2</sup>), there is a need for a credible austerity (consolidation) package that will be able to stimulate demand (through consumer and business confidence<sup>3</sup>) and produce a positive net effect on economic growth.
- 2.2.2. In South Africa, the floating exchange rate regime as well as an accommodative monetary policy will need to facilitate the process of fiscal consolidation. When talking about "fiscal consolidation", we must look beyond deficit reduction. Given that economic recovery is gaining momentum in South Africa, the government should actively be looking for ways to increase productivity in a bid to support long-term, sustainable economic growth. A possible way to do this is through innovation as well as diffusion of Information and Communications Technology (ICT). While the South African government does emphasise the need to create a "knowledge based economy", it is lagging behind the rest of the world in terms of innovation as well as the pace of ICT development. The recently established Technology Innovation Agency is a step in the right direction in this respect. Hence, consistent policies and implementation strategies (including resources) need to be put in place to address this issue.
- 2.2.3. Taking into account the macroeconomic factors, as well as the different aspects of fiscal policy, the Commission modelling exercises find that a gradual fiscal consolidation is the best policy option for South Africa over the medium term. "Best" policy option refers to a policy that would bring the output back to its potential level (over the medium term) as well as one that will result in the least possible amount of output volatility.
- 2.2.4. In addition, the role of debt management in the budget consolidation process must not be underestimated. Though the South African government has reduced its debt

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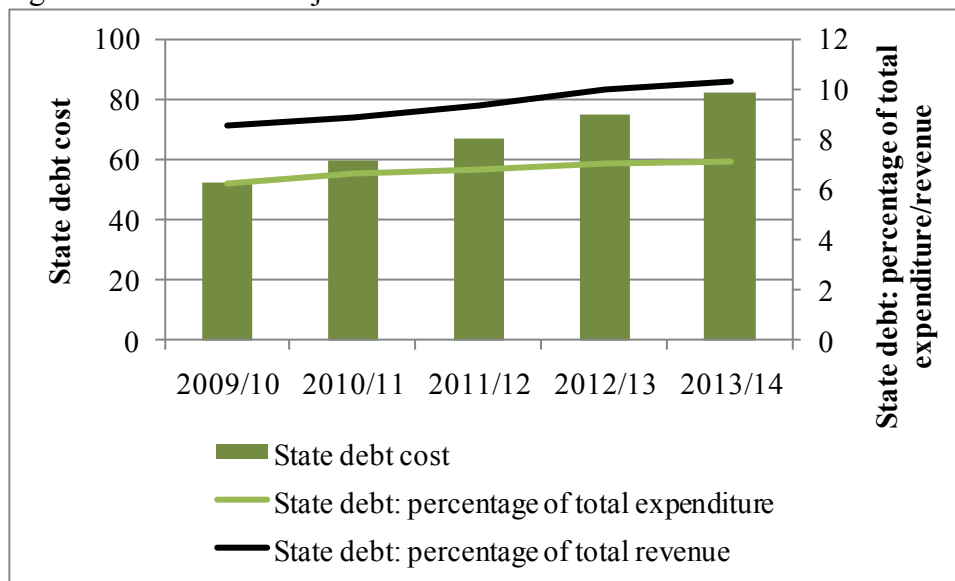
<sup>2</sup> IMF (2010), Chapter 3.

<sup>3</sup> Alesina and Ardagna (2009).

obligations prior to the recession, there is a need to ensure that rising debt costs do not penalise future expenditure and economic growth<sup>4</sup>.

- 2.2.5. Figure 1 below shows that state debt increases no matter how one looks at it – 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. This implies that expenditure increases are increasingly being financed by debt.

Figure 1: State Debt Projections



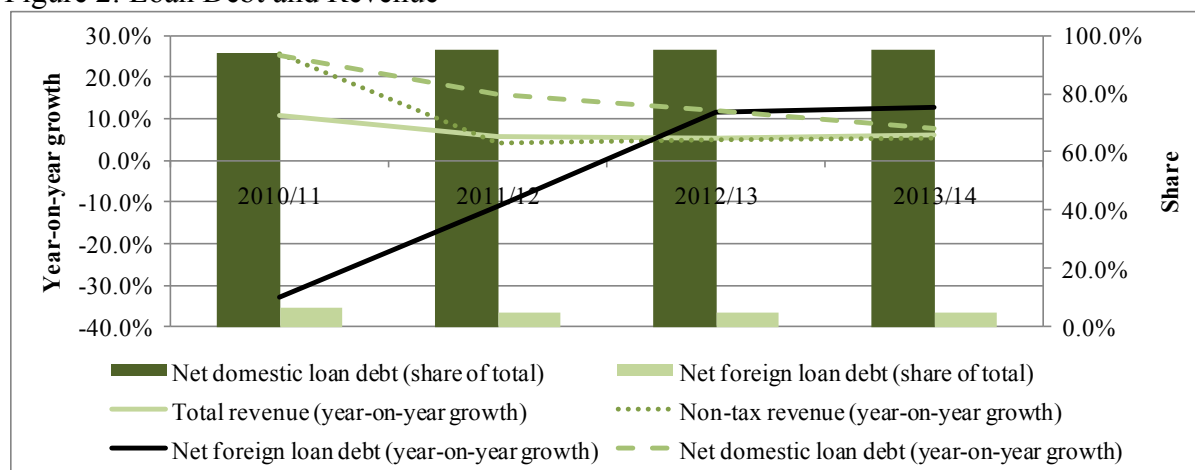
Source: National Treasury (2010), Commission's own calculations.

- 2.2.6. Figure 2 illustrates the source of funds used to finance the deficit. Non-tax revenue includes mineral and petroleum royalties, mining leases and departmental revenue. The revenue components as well as the net domestic loan debt growth rates level off, whereas the net foreign debt growth rate increases sharply. It is true that the share of net foreign debt to total debt remains constant at approximately 5%, but there still is cause for concern around the sharp increase in foreign indebtedness.

<sup>4</sup> It should be noted that debt service costs are also a “first” charge on the division of revenue pool, effectively increasing the national slice and squeezing out subnational expenditure. Furthermore, the non-discretionary nature of debt service costs also introduces fiscal rigidities while decreasing discretionary fiscal policy space i.e. to accommodate ambitious new spending initiatives.



Figure 2: Loan Debt and Revenue



Source: National Treasury (2010), Commission's own calculations.

## 2.3. Economic Growth, Social Services and Infrastructure

### 2.3.1. Economic Growth:

- a. There is a general consensus that what the country needs at this stage is a faster and more inclusive economic growth. The recent launch of the *New Growth Path* aimed at alleviating poverty and creating employment by Government is welcome in this respect. In particular, it is the Commission view that the commitment in the MTBPS to improve education and skills development, to concentrate government spending on infrastructure (and specifically labour intensive infrastructure), as well as to root out corruption by means of new systems to regulate the management of the rollout of government tenders would enhance economic growth if implemented tenaciously.
- b. From a public finance perspective, the main concern is that although South Africa has very high spending on social services (South Africa spends as much as a first world country), their productivity, impact and social returns remain below expectation.
- c. As noted in the FFC's 2011 Division of Revenue recommendations, distribution of social expenditure needs to be rethought. While social grant expenditure has been well targeted and reduced poverty, increases in access in the other areas of the social assistance package remain suboptimal and need to be accompanied by massive improvements in service delivery efficiency, effectiveness and quality.

### 2.3.2. Investment in infrastructure:

- a. Investment in bulk infrastructure has been identified as a key ingredient for job creation. There are funding versus capacity issues here that need urgent redress<sup>5</sup>.

<sup>5</sup> We should not only look at increase in the stock of new infrastructure but also the rehabilitation and upgrade of existing infrastructure.

Capacity issues are pertinently illustrated by rollovers in conditional grants especially for local government. Interventions could focus on institutionalisation of project management (Contract Management and Project Implementation Department) with proper tenders/bidding and follow-ups, greater involvement of the private sector through public private partnerships (or PPP's which currently constitute approximately 5% of total public sector infrastructure expenditure), revaluation (external auditing) of budgeted expenditure and further developing and institutionalising life-cycle project management. With regard to all this, there is a need to realise that funding might not be as much of a problem as capacity is.

- b. Government would need to accelerate the speed of undertaking already approved infrastructural investment projects, as well as increase maintenance and rehabilitation spending. There is a need to establish and enforce expenditure norms in the budgets of government if the country is to arrest the deterioration of new and existing infrastructure and the accumulation of backlogs.

## **2.4. Financing of New Imperatives: MDGs and Health**

- 2.4.1. In its Submission on the 2011 Division of Revenue, the FFC cautioned against implementing large and expensive new government programmes in the face of fiscal consolidation. However, there are two major developments in terms of government priorities that cannot be ignored going into 2011 and the MTEF period, namely a push toward attainment of Millennium Development Goals (MDGs) and the National Health Insurance (NHI) scheme that has come to the fore of the policy discourse and is being investigated by Government. With regard to the MDG's a particular point to note is that these speak quite closely to gaps in the health sector (child and maternal mortality, HIV/AIDS and also on job creation and income distribution). While issues of job creation and income distribution are partly linked to the *New Growth Path* there is still a need to boldly address the specifics of how government intends to proceed with these programs quite quickly in order to limit the potentially unwelcome uncertainty regarding its ability to address or implement such large programmes in the face of fiscal consolidation efforts.
  - 2.4.2. From the Commission's perspective, the first step should be to establish exactly how much is required to finance these mega programmes against an array of possible delivery models. The second step would then be to agree on ways of raising the required financing in as least costly a manner as possible to the economy. The third and final step would then be to formalise the effective delivery models and to assess how these will impact on the current intergovernmental fiscal arrangements and
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where there is a need, the powers and functions of the different spheres of government.

- 2.4.3. The Commission is of the view that government could at one extreme rely entirely on reprioritisation and spending cuts or at the other on tax increases. Ongoing work by the Commission on expenditure cuts and consolidation tentatively suggests that irrespective of the outcome of the spending cuts and prioritisation exercise, fiscal consolidation will still require tax increases even though they may be unwelcome. The magnitude of the requisite tax increases cannot be immediately ascertained, however. Some of the areas that government could look into in raising these revenues could be (a) higher income taxes, (b) higher value-added tax (VAT), (c) new carbon tax, (d) Tobin tax<sup>6</sup> and (e) windfall tax.
- 2.4.4. It is clear that the implementation of such large and complex interventions affects national, provincial and municipal spheres of government. It would require massive coordination of these various spheres in their approach to the development and implementation to avoid waste, ineffectiveness and duplication which could result in unnecessarily high costs for the tax payer. In this respect the efforts of government directed at deriving value for money in public expenditure should be supported by all South Africans.

### **3. Spending Priorities of National Government for the Next Three Years**

- 3.1. Table 1 below gives detailed analysis over the three years by reporting the average annual growth for the medium term.
- 3.2. In terms of recent FFC research, the expenditure components that contribute to growth are mainly defence and health – interestingly enough, these two are projected to decrease in the medium term. Other productive expenditure components that can contribute positively to growth are also agriculture, education and housing – all of which are also decreasing and can thus negatively affect the growth trajectory over the medium term.

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<sup>6</sup> This is a small tax (0.1 - 0.5%) on cross-border currency transactions designed to stabilize currency markets. It can be enacted by national legislature, followed by multilateral cooperation for effective enforcement.

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

Category	2009/10	2010/11	2011/12	2012/13
<b>General public services</b>	8.1%	2.8%	2.1%	8.0%
<b>Defence</b>	-1.9%	13.7%	7.4%	6.0%
<b>Public order and safety</b>	11.4%	8.5%	7.9%	6.5%
<b>Agriculture</b>	10.5%	7.1%	6.1%	5.8%
<b>Fuel and energy</b>	6.0%	5.7%	2.2%	6.3%
<b>Housing and community amenities</b>	17.5%	13.0%	9.0%	6.5%
<b>Health</b>	11.5%	9.3%	6.8%	6.8%
<b>Recreation and culture</b>	-13.5%	-6.3%	6.7%	4.7%
<b>Education</b>	11.0%	10.1%	5.8%	7.0%
<b>Social protection</b>	9.2%	10.6%	9.0%	7.7%

Source: National Treasury (2010), Commission's own calculations.

3.3. Table 2 below shows that the shares of expenditure components in total expenditure are not expected to vary so much over the medium term (the most notable finding here is that the share for housing is expected to increase by about 1% over the medium term, which according to the Commission's modelling work on the impact of spending is a welcome development as housing expenditure contributes positively to growth).

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

Category	2009/10	2010/11	2011/12	2012/13	2013/14
<b>General public services</b>	5.2%	5.2%	4.9%	4.6%	4.6%
<b>Defence</b>	4.4%	3.9%	4.2%	4.1%	4.0%
<b>Public order and safety</b>	9.4%	9.6%	9.6%	9.6%	9.4%
<b>Agriculture</b>	1.8%	1.9%	1.8%	1.8%	1.8%
<b>Fuel and energy</b>	1.0%	1.0%	1.0%	0.9%	0.9%
<b>Housing and community amenities</b>	10.0%	10.8%	11.3%	11.3%	11.1%
<b>Health</b>	11.0%	11.3%	11.4%	11.2%	11.0%
<b>Recreation and culture</b>	0.9%	0.7%	0.6%	0.6%	0.6%
<b>Education</b>	18.8%	19.2%	19.5%	19.0%	18.7%
<b>Social protection</b>	14.8%	14.8%	15.2%	15.3%	15.1%

Source: National Treasury (2010), Commission's own calculations.

3.4. If we compare the revised estimates for 2010/11 (see Table 3 below) with what was projected in this year's budget, the following categories were revised upwards:

- Defence,
- Public order and safety,
- Housing and community amenities,
- Education, and
- Social protection.

On the other hand, the following categories were revised downwards:

- General public services,

- Agriculture<sup>7</sup>,
- Health,
- Fuel and energy, and
- Recreation and culture.

Of these, the only causes of concern for the Commission are downward revisions of agriculture and health which are found to contribute positively to economic growth (and which also have really high positive elasticities<sup>8</sup> together with education). Furthermore, these are in the broader priority areas of government especially agriculture which is a key component under Rural Development and Food Security.

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

Category	2010/11 figure (Budget Review)	Revised 2010/11 figure (MTBPS)	Percentage change
General public services	52	46.7	-10.2%
Defence	33.8	35.7	5.6%
Public order and safety	85.6	86.8	1.4%
Agriculture	17.1	16.8	-1.8%
Fuel and energy	28.9	8.8	-69.6%
Housing and community amenities	93.2	97.4	4.5%
Health	104.6	101.9	-2.6%
Recreation and culture	5.8	6.4	10.3%
Education	165.1	173.2	4.9%
Social protection	128.4	134.2	4.5%

Source: National Treasury (2009, 2010), Commission's own calculations.

#### 4. Proposed Medium Term Expenditure Framework and the Division of Revenue between the Spheres of Government

- 4.1. Table 4 below sets out the division of revenue among the three spheres of government. As is evident, an increased share of growth in allocations is projected for provinces and local government.
- 4.2. The total expenditure envelope grows from a revised R748 billion in 2010/11 to R914 billion in 2013/14. This represents a growth in expenditure of about 6.9%, with provinces and local government growing at above 7% each. This type of growth is essential, especially as these two spheres are better placed to implement service delivery and protect the poor and vulnerable.

<sup>7</sup> The projections related to agriculture are contrary to those related to government's development goals, namely rural development, food security and land reform.

<sup>8</sup> The elasticities discussed here measure the impact of an increase in an expenditure component on growth – i.e. a positive elasticity implies that increase in a particular expenditure component contributes towards economic growth. In addition, the higher the estimated elasticity, the bigger the contribution of that particular expenditure component towards growth.

- 4.3. The national share of allocation continues to decline over the MTEF from 48.2% in 2010/2011 to 46.7% in 2013/14. Over this same period, the provincial and local government share of the division of revenue grows from 43.9 and 7.9% to 44.6% and 8.6%, respectively.
- 4.4. Provincial baselines are expected to grow by only 7.5% over the 2011/12 medium term. With an assumed CPI of 3.2%, the real growth of the provincial resource envelope is therefore only 4.3%.
- 4.5. Local Government baselines grow by a healthy 10% over the MTEF with significant growth in the conditional grants framework. Such an addition is to be expected given the fact that local government has come under the spotlight in the service delivery arena.

Table 4: Division of Revenue, 2010/11-2013/14

	2010/11	2011/12	2012/13	2013/14	2011	Average annual growth
<b>R billion</b>	<b>Revised</b>	<b>Medium-term estimates</b>		<b>MTEF</b>		<b>2010/11 – 2013/14</b>
<b>National</b>	<b>360.6</b>	<b>374.5</b>	<b>401.0</b>	<b>427.3</b>		<b>5.8%</b>
<b>Provincial</b>	<b>328.1</b>	<b>359.5</b>	<b>382.3</b>	<b>407.7</b>		<b>7.5%</b>
Equitable share	265.1	289.0	305.7	323.3		6.8%
Conditional grants	63.0	70.5	76.6	84.4		10.2%
<b>Local</b>	<b>59.3</b>	<b>67.2</b>	<b>74.0</b>	<b>79.0</b>		<b>10.0%</b>
Equitable share	30.6	34.1	37.6	40.0		9.4%
Conditional grants	21.2	24.5	27.4	29.5		11.6%
<b>General fuel levy sharing with metropolitan municipalities</b>	<b>7.5</b>	<b>8.6</b>	<b>9.0</b>	<b>9.6</b>		<b>8.4%</b>
<b>Total</b>	<b>748.1</b>	<b>801.2</b>	<b>857.3</b>	<b>914.1</b>		<b>6.9%</b>
<b>Percentage share</b>						
<i>National</i>	48.2%	46.7%	46.8%	46.7%		
<i>Provincial</i>	43.9%	44.9%	44.6%	44.6%		
<i>Local</i>	7.9%	8.4%	8.6%	8.6%		
<b>Changes to baseline</b>						
<b>National</b>	<b>1.5</b>	<b>4.0</b>	<b>7.3</b>	<b>12.5</b>	<b>23.8</b>	
<b>Provincial</b>	<b>5.3</b>	<b>9.0</b>	<b>13.0</b>	<b>18.2</b>	<b>40.1</b>	
Equitable share	4.2	8.3	10.3	11.2	29.8	
Conditional grants	1.1	0.7	2.7	7.0	10.3	
<b>Local</b>	<b>0.5</b>	<b>0.5</b>	<b>1.0</b>	<b>1.6</b>	<b>3.1</b>	
Equitable share	0.4	0.2	0.3	0.7	1.2	
Conditional grants	0.1	0.3	0.6	0.8	1.7	
<b>General fuel levy sharing with metropolitan municipalities</b>	<b>–</b>	<b>0.0</b>	<b>0.1</b>	<b>0.2</b>	<b>0.3</b>	
<b>Total</b>	<b>7.3</b>	<b>13.5</b>	<b>21.3</b>	<b>32.3</b>	<b>67.0</b>	

Source: National Treasury (2010), Commission's own calculations.

## 5. Local Government Fiscal Framework

- 5.1. Over the 2011 MTEF period, there is a welcome R3.1 billion increase in transfers to local government. Of this, R1.2 billion is in respect of increases to the baseline of the local government equitable share (LES) and R1.7 billion is for conditional grants. In addition, R300 million will go to metropolitan municipalities from the sharing of the general fuel levy.
- 5.2. The increase in the LES is a positive development as pressure for basic services from communities, coupled with increased input costs in providing services, have been mounting. Government should ensure that increases to local government are informed by a thorough understanding and costing of municipal expenditure pressures.
- 5.3. The Commission notes the planned changes to the LES formula and the longer term review thereof. However the Commission would like to emphasis two important issues:
  - 5.3.1. In its Annual Submission for the 2011/12 Division of Revenue, the FFC undertook a comprehensive review of the LES formula and pointed out several technical and legal flaws. One of the most pertinent issues was the unconstitutional aspect of the Revenue Raising Correction (RRC) component of the formula that required immediate change. The Commission will be raising this matter again in consultations with the government towards the finalisation of the budget.
  - 5.3.2. Government's proposed approach to target funding to poorly resourced municipalities through amendments to the LES formula is a positive step and resonates well with the FFC's recommendation to restructure the Institutional (I) component to fund poor municipalities. In the 2010 MTBPS, Government states that increased funding to poorer municipalities will not be to the detriment of metropolitan municipalities. Given the zero-sum allocation nature (formula is applied on a pre-determined pool based on priorities) of the formula, the Commission would like to caution against detrimental effects for middle-income municipalities.
- 5.4. Over the MTEF period, the largest increase to the local sphere is via conditional grant allocations. Poor performance with respect to conditional grant spending is emphasised by the R1.8 billion in rollovers from the previous financial year. Past spending performance and access to adequate human capital capacity and technical capacity of municipalities should be considered when determining allocations, particularly in the case of municipalities that perennially under spend on their budgets. The potential benefits of increased funding to municipalities could be lost should ineffective and/or underspending, as a result of inadequate capacity, persist. To this end, the FFC views continued allocation of funds in respect of local government capacity building initiatives without concomitant improvement in

outcomes as an inefficient use of public resources. In addition, existing capacity challenges could seriously endanger the achievement of the objectives of the Local Government Turnaround Strategy (LGTAS).

- 5.5. Past resolutions regarding a number of critical issues continue to be delayed. In addition to the issue of accreditation discussed in more detail below, the restructuring of the electricity distribution industry (EDI), a replacement for the RSC levy for district municipalities and the need for greater certainty around the roles and responsibilities of local and district municipalities are still not finalised. Continued delays on these issues create substantial uncertainty within the local government sphere. The Commission recommends that government adopt firm policy positions on these issues that will bring finality and remove the uncertainty.
- 5.6. Municipal consumer debt severely constrains the extent of own revenue that municipalities have at their disposal. However, it is anticipated that the baseline increases in respect of the devolution of the property rates grant to provinces will bring some relief. The Commission notes that the extent to which potential benefits of the devolution process will be realised will depend on the efficacy with which provinces transfer funds/pay municipalities.

## **6. Proposed substantial adjustments to Conditional Grants Allocations to Provinces and Local Government**

- 6.1. Before dealing specifically with adjustments to conditional grants, it is important to look at changes to the equitable shares (see Table 5). These adjustments are made up of R1.5 billion to the national sphere, R5.4 billion to provinces and R 500 million to local government.
- 6.2. Table 5 shows aggregate budget and expenditure of provinces as at March 2010 and spending up to September 2010 on the current 2010/11 MTEF. What is clearly visible is the reduction in the number of provinces that have overspent their budgets compared to previous years. This is clearly a result of conscious decisions taken to ensure that provinces engage in cost savings through reprioritization on goods and services. Such measures are to be applauded.



Table 5: Provincial Expenditure as at 31 March 2010 and PES Versus Adjusted Budgets

R thousand	Adjusted budget	Pre-audited outcome as at 31 March 2010	Pre-audited outcome as % of adjusted budget	(Over)	Under	% (Over)/ under of adjusted budget
Eastern Cape	44,565,434	45,234,576	101.5%	-669,142	–	-1.5%
Free State	19,351,054	18,783,121	97.1%	–	567,933	2.9%
Gauteng	58,546,671	59,695,097	102.0%	-1,148,426	–	-2.0%
KwaZulu-Natal	61,906,779	63,811,448	103.1%	-1,904,669	–	-3.1%
Limpopo	35,954,875	35,596,564	99.0%	–	358,311	1.0%
Mpumalanga	23,856,044	23,683,918	99.3%	–	172,126	0.7%
Northern Cape	8,390,707	8,178,513	97.5%	–	212,194	2.5%
North West	20,670,779	20,365,345	98.5%	–	305,434	1.5%
Western Cape	30,672,104	30,113,167	98.2%	–	558,937	1.8%
<b>Total</b>	<b>303,914,447</b>	<b>305,461,749</b>	<b>100.5%</b>	<b>-3,722,237</b>	<b>2,174,935</b>	<b>-0.5%</b>
				<b>Net</b>	<b>-1,547,302</b>	

R thousand	Adjusted budget	Pre-audited outcome as at 31 March 2010	Equitable share per province	Share of Adjusted Budget	Share of Expenditure Outcome	% Deviation from Equity
Eastern Cape	44,565,434	45,234,576	15.2%	14.7%	14.8%	-0.4%
Free State	19,351,054	18,783,121	6.0%	6.4%	6.1%	0.1%
Gauteng	58,546,671	59,695,097	17.4%	19.3%	19.5%	2.1%
KwaZulu-Natal	61,906,779	63,811,448	22.0%	20.4%	20.9%	-1.1%
Limpopo	35,954,875	35,596,564	12.6%	11.8%	11.7%	-0.9%
Mpumalanga	23,856,044	23,683,918	8.1%	7.8%	7.8%	-0.4%
Northern Cape	8,390,707	8,178,513	2.7%	2.8%	2.7%	0.0%
North West	20,670,779	20,365,345	6.7%	6.8%	6.7%	0.0%
Western Cape	30,672,104	30,113,167	9.2%	10.1%	9.9%	0.6%
<b>Total</b>	<b>303,914,447</b>	<b>305,461,749</b>	<b>100.0%</b>	<b>100.0%</b>	<b>100.0%</b>	

Source: National Treasury (2010).

- 6.3. It should be noted that the pressures experienced by provinces are in the main personnel-related, bringing projected overspend to R4.7 billion for all the nine provinces.
- 6.4. There are certain important changes to the conditional grants fiscal framework. During FFC's consultations with National Treasury, indications were made that conditional grants would be reviewed for the MTEF period and that some grants could be merged and/or rationalised, whilst others would be consolidated into the equitable share. The Commission will await the details of these changes and make detailed recommendations at the appropriate time. Table 6 below shows proposed revisions to conditional grants for provinces followed by a discussion.

Table 6. Proposed Revisions to Provincial Conditional Grant Allocations, 2011/12-2013/14

R million	2011/12	2012/13	2013/14	Total
<b>Technical revisions</b>				
<b>Health</b>	–	-620	-1,154	-1,774
Forensic Pathology Services Grant	–	-620	-654	-1,274
Hospital Revitalisation Grant	–	–	-500	-500
<b>Public Works</b>				
Expanded Public Works Programme Incentive for the Infrastructure Sector	-244	-241	-201	-686
Social Sector EPWP Incentive Grant for Provinces	244	241	201	686
<b>Addition to baselines</b>				
<b>Agriculture, Forestry and Fisheries</b>	<b>50</b>	<b>120</b>	<b>230</b>	<b>400</b>
Comprehensive Agricultural Support Programme	50	120	230	400
<b>Higher Education and Training</b>	<b>104</b>	<b>536</b>	<b>864</b>	<b>1,504</b>
Further education and training colleges	104	536	864	1,504
<b>Health</b>	<b>60</b>	<b>60</b>	<b>1,360</b>	<b>1,480</b>
Comprehensive HIV and Aids	60	60	1,360	1,480
<b>National Treasury</b>	<b>100</b>	<b>1,415</b>	<b>3,689</b>	<b>5,204</b>
Infrastructure Grant to Provinces	100	1,415	3,689	5,204
<b>Public Works</b>	<b>338</b>	<b>528</b>	<b>752</b>	<b>1,618</b>
Devolution of Property Rate Funds	338	527	695	1,560
<b>Social Sector EPWP Incentive Grant for Provinces</b>	<b>–</b>	<b>1</b>	<b>57</b>	<b>58</b>
<b>Total Additions to baselines</b>	<b>652</b>	<b>2,659</b>	<b>6,895</b>	<b>10,206</b>

Source: National Treasury (2010).

- 6.5. *Dinaledi Schools initiative to boost maths and science pass rates:* Although government has identified mathematics and science as key school focus subjects to reach its education development goals, continuing low pass rates do not augur well for the future. There are currently more than 500 Dinaledi schools in South Africa. In 2009, the national Matric pass rate stood at 60.7%, representing a 2% decrease from the 62.5% pass rate achieved in 2008. Overall, pass rates in science, maths, mathematical literacy and accounting dropped. In 2008, the Dinaledi schools accounted for over 50 000 of matriculates writing maths and science exams. According to its 2008 performance report, 54 of the Dinaledi schools had fewer than 20 maths passes and science passes fell below 2008 targets. However, the Commission is of the view that targeting and funding should also be made available to strengthen numeracy and literacy at primary school level. In this regard, the Foundations for Learning Campaign, which focuses on improving reading, writing and numeracy abilities to ensure that all learners are able to demonstrate age-appropriate levels of literacy and numeracy should be supported.
- 6.6. *Comprehensive HIV/AIDS Conditional Grant:* The proportion of the global burden of disease borne by South Africa, with a population of only 48 million, is

disproportionately high. The combination of acute and chronic diseases spanning all age-groups and socioeconomic strata imposes a massive burden on an already weak and underdeveloped public health-care delivery system. Moreover, the rise in HIV-related mortality has contributed to average life expectancy at birth to be 50 years for men and 54 years for women. More than half a million people are now on antiretroviral treatment in the country and the target, which is unprecedented worldwide, is 1.5 million by 2010. The effect on the health budgets of providing for such an uptake would be quite high and government would have to closely monitor this.

- 6.7. *Modernisation of hospitals and primary health care facilities:* The Commission notes that the role of the *National Tertiary Services grant* is important in contributing to the operation of modernized tertiary hospital services. The grant is necessary to ensure that the significant cross boundary flows to access tertiary services are funded. However, it should be noted that health expenditure is dominated by tertiary-level hospitals; 30% of total public health expenditure is spent on super tertiary hospitals based in Johannesburg, Pretoria, Cape Town, and Durban. Not disregarding the important role played by tertiary hospitals in terms of regional referral and educational roles, investment in primary health care is equally important if not a prerequisite, for effective health systems. It is important that increased effort be directed towards primary health care facilities over the medium term. The rapid rise in demand for chronic care for HIV and tuberculosis and non-communicable diseases emphasises the need for strong and modernised primary and community health care system. There is a need therefore to re-examine 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 this country. In addition, this should be coupled with improvements in the quality of primary health care service delivery. Previous FFC research (2008) indicates that whilst access to clinics and other primary health care facilities is good, utilisation is low due to poor quality and other service delivery issues (perceived and/or actual).
- 6.8. *Eradication of Backlogs in Education and Health Infrastructure:* The Commission raised a concern about the termination of two conditional grants in the 2009/10 financial year that were aimed at addressing backlogs in the provision of electricity, water and sanitation in schools and clinics. A considerable number of schools and clinics, especially in the rural areas remain without electricity, water and sanitation. The Commission is of the view that the decision on these grants should be reviewed against the objectives for which they were introduced and that there should be greater focus on the relevant departments to deliver.
- 6.9. *Agriculture Conditional Grants:* Agricultural expenditure by economic classification shows that almost 47% of the budget is spent on personnel and an average of 12% is spent on transfers and subsidies. There are three main conditional grants focussing on agricultural development, namely, the Comprehensive Agriculture Support Programme (CASP), Ilima/Letsema grant, and the Land Care Grant. The Micro-

Agricultural Finance Initiative of South Africa (MAFISA), which is managed by the Land Bank is aimed at providing micro and retail agricultural financial services and facilitate access to public sector programmes to enable market efficiency. On average, CASP accounts for 74% of the total agriculture conditional grant allocations. Letsema accounts for 16% and the Land Care grant accounts for 5%. Generally, these budget allocations (equitable share and conditional grants) are quite small in relation to the amounts required to revive rural economies and ensure food security. Rural provinces should be incentivised to spend more on agriculture and this is where the rationalisation of agricultural fiscal frameworks, which includes both the equitable share and conditional grants, is required. The Commission recommended in 2006 that these grants should be merged and still subscribes to the same view.

- 6.10. Expanded Public Works Programme (EPWP) Incentive Grant for Infrastructure: The Commission notes the low expenditure reported against this grant in the Provincial Finance Management (PFMA) Section 32 reports. This grant is also not reported in the Municipal Finance Management Act (MFMA) Section 71 reports due to its “*after the event performance nature*”. The way the grant is administered is that provinces and municipalities only get budget allocations once they have achieved targets set by national Department of Public Works (NDPW). For the current financial year (as at 31 August 2010), the grant was only transferred to four provinces (Eastern Cape, Gauteng, Kwa-Zulu Natal and Mpumalanga) which achieved target as set out by NDPW. Other provinces cannot reflect expenditure as the grant is not yet transferred to them (see Table 7).

Table 7: Provincial Expenditure: EPWP Incentive Grant for Infrastructure

Province	Dec-09	Feb-10	Aug-10
Eastern Cape	-	-	7.4%
Free State	-	-	-
Gauteng	-	-	3.0%
KwaZulu-Natal	-	-	2.5%
Limpopo	9.2%	9.2%	-
Mpumalanga	89.6%	89.6%	0.5%
Northern Cape	-	-	-
North West	42.4%	21.1%	-
Western Cape	15.0%	65.0%	-
<b>Total</b>	<b>5.1%</b>	<b>4.9%</b>	<b>3.0%</b>
<b>Benchmark Performance</b>	<b>75%</b>	<b>91.67%</b>	<b>41.67%</b>

Source: National Treasury (2009).

- 6.11. At the EPWP Summit held in Durban on 14 October 2010, the NDPW indicated that it will meet with the Mayors and MECs for public works in nine provinces to ascertain the next step in their respective EPWP programmes. The department reported that work opportunities were being created but not properly reported by provinces and municipalities. It reported that effective reporting of EPWP projects

allows municipalities to access incentives grants, which is something KwaZulu-Natal, the Eastern Cape and Gauteng have managed to do efficiently. As a way forward, municipalities will receive technical support across all EPWP sectors to optimise the implementation of EPWP and will be provided support in the form of monitoring and evaluation, training and enterprise development for all municipal projects. The Commission concurs with this approach and is of the view that it was long overdue.

6.12. The Commission recommends the following with respect to transport and human settlements.

6.13.1. As required by the National Land Transport Act (No. 5 of 2009), the government must accelerate:

- the devolution of the public transport function to cities,
- the establishment of the dedicated Municipal Land Transport Fund.

6.13.2. While alignment of housing plans and funding streams is crucial, the following challenges needs to be addressed:

- slow pace of accreditation,
- general poor quality and peripheral location of low-cost housing projects.

## **7. Review of Actual Spending by National and Provincial Government between 1 April and 30 September 2010**

7.1. If aggregate government spending were to be evenly distributed through the four quarters of the year, it would be expected that total expenditure up to September would be at 50% of the main budget. This would differ depending on whether the 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. Departmental spending benchmark would be about 50% at end of September were this smoothing in spending to be realised. Table 8 below shows aggregate spending and deviation from this norm.

7.4. Total government spending as at September 2010 is below the norm by 1.8% at R394 billion against a total of R818 billion. A total of all votes at national level have also spent 1.6% (or R223 billion of the main budget) below the 50% norm, and the figure increases when looked at as a total direct charge against national revenue fund to 1.2% (R170 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, Housing and Rural Development), government is on the

optimal 50% point expenditure norm as assumed above. 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, although 50% of the equitable share due to provinces in this financial year has been transferred, provinces reported R590 million more expenditure on their budget table in February (this includes provincial own revenue and conditional grants). Provinces have spent 46.4% of the main vote. This represents an under spending of about 3.7% 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 8: Aggregate Spending and Deviation from the Norm

R 1,000	Main Budget	Spending as at September 2010	% expenditure
<b>Total Expenditure</b>	<b>350,625</b>	<b>170,975</b>	<b>48.8%</b>
<b>Appropriation by Vote</b>	461,518	223,460	48.4%
<b>Direct charges against Revenue Fund</b>	818,143	394,436	48.2%
<b>Fuel levy</b>	7,542	2,514	33.3%
<b>State debt cost</b>	71,358	32,988	46.2%
<b>Other charges against national Revenue fund</b>	10,751	4,986	46.4%
<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>168,348</b>	<b>84,118</b>	<b>50.0%</b>
<b>6. Public Works</b>	6,446	2,780	43.1%
<b>14. Basic education</b>	6,166	2,834	46.0%
<b>15. Health</b>	21,497	10,599	49.3%
<b>16. Higher Education and Training</b>	23,721	17,292	72.9%
<b>20. Correctional Services</b>	15,129	6,504	43.0%
<b>23. Justice and Constitutional Development</b>	10,250	4,632	45.2%
<b>24. Police</b>	52,556	24,752	47.1%
<b>25. Agriculture, Forestry and Fisheries</b>	3,658	1,894	51.8%
<b>27. Economic Development</b>	419	171	40.8%
<b>28. Energy</b>	5,535	2,089	37.7%
<b>30. Human Settlements</b>	16,201	7,798	48.1%
<b>32. Rural Development and Land Reform</b>	6,770	2,773	41.0%
<b>PES Expenditure at provincial level</b>	<b>329,810</b>	<b>152,612</b>	<b>46.3%</b>
<b>Education</b>	137,439	65,487	47.6%
<b>Health</b>	98,381	46,315	47.1%
<b>Social Development</b>	10,236	4,332	42.3%
<b>other</b>	83,755	36,479	43.6%

Source: National Treasury(2010), Commission's own calculations.

- 7.7. Two important points to be noted with respect to this section include:



- 7.7.1. Over the 2010/11 period of adjustment, the Commission has become aware of the fact that expenditure adjustments are and can be unduly influenced by a provincial own decision. For instance, some provinces can decide to unilaterally spend on personnel beyond agreed norms or expand on the number of people employed without an approved budget. Over-expenditure creates perverse incentives since it rewards weak budget constraints and penalises provinces which have maintained fiscal discipline and taken hard decisions in the interests of fiscal consolidation. Furthermore, any inherent equity in division of revenue may be negated by inequity following such adjustments and this compromises the original intent of the Division of Revenue Bill. It is therefore proposed that government should define more tightly what should constitute unforeseen and unavoidable expenditure in this respect. The Division of Revenue Amendment Bill is a positive step in this direction and assists Cabinet to monitor the extent to which the proposed adjustments can justifiably be regarded as unforeseen and unavoidable. The Bill will also allow members to ensure that there is equity in the inclusion or exclusion of requests that should be treated as unforeseen and unavoidable.
- 7.7.2. Given an environment of fiscal consolidation, issues of operational efficiency are very paramount. These issues include but are not limited to the reduction of fruitless and wasteful expenditure and outright corruption. For instance the recent Public Service Commission (PSC) Report indicated that in the 2008/09 fiscal year, about R100 million was siphoned out of the system through fraud and financial misconduct of civil servants, fruitless and wasteful expenditures, of which only about 10% was recovered. It is therefore important that Government has prioritized improvements in public sector management going forward. The move towards tightening the disincentives to engage in this area should be welcome, for example dismissals as opposed to paid suspensions that can take as long as eighteen months to resolve. In general, Government in the 2010 MTBPS has recognised the need for vigorous anti-corruption efforts and the need to entrench ethical values in the stewardship of public resources, and the Commission strongly supports these initiatives.

## **8. Concluding Remarks**

- 8.1. The MTBPS is a key first milestone in a conversation about the budget process that will culminate in the tabling of the Budget in 2011. This Statement needs to provide more detail on the economic policy direction of government which frames the fiscal environment in which the intergovernmental fiscal relations system must operate.
- 8.2. In particular issues around the proposed NHI and the new growth path constitute an important development in the system that would require detail, especially in relation

to the implications for the three spheres of Government. Such detail will enable the Commission to more effectively engage with processes at a fairly early stage as opposed to an environment where it is consulted at the tail-end of the process as happened with the Constitution, 17<sup>th</sup> Amendment Bill in 2009 where the Commission had to write to the relevant Ministers upon observing that it had not been formally consulted on such an important matter falling in the ambit of its mandate.

- 8.3. This second 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 2010. 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. The Commission, through its evidence based research and impartial policy advice, will be engaging further with Government through the consultative processes prescribed in legislation, in particular the Intergovernmental Fiscal Relations Act (1997) and the Financial and Fiscal Commission Act (2003) on the range of implementation issues that have been tabled in the MTBPS and going forward to the finalization of the budget process for 2011. Issues that the Commission will follow up with include but not limited to reforms of the provincial and local equitable share, review of the local government fiscal framework including the approaches to cities, review of conditional grants and frameworks. The Commission will also be closely following the unfolding discourse around the NHI and the implementation of the EPWP incentive programme as a job creation vehicle.

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

Mr Bongani Khumalo

Acting Chairperson/CE



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