Responding to South Africa's Infrastructure Challenge

POLICY BRIEF

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EXECUTIVE SUMMARY

Meeting the government's social and economic goals requires faster economic growth, which is affected by long-standing structural weaknesses in the economy. The cornerstone of the government's economic policy is the significant ramping up of public capital expenditure, and much is riding on state infrastructure spending being the solution. However, the country faces many challenges associated with public infrastructure management, including: the complex requirements of large infrastructure projects funded over many years, weak intergovernmental coordination processes, weak management and accountability systems (that create the conditions for corruption), and a lack of capacity at subnational level. Public investment efficiency needs to be maximised, through better economic growth and investment spending. Public infrastructure investment through debt was found to have a strong effect on economic growth, but ultimately accelerated economic growth is needed in order to bridge the capital finance gap. To create conditions for the future prosperity of all South Africans from infrastructure-led growth, the Financial and Fiscal Commission recommends developing and fully funding the National Infrastructure Plan, redesigning capital conditional grants (to allow for payment e.g. of feasibility and pre-procurement studies and for more support to provinces and municipalities), aggressively raising public debt to help finance deserving and rigorously appraised infrastructure plans, encouraging the user-pays principle, and integrating infrastructure procurement planning, contract award and management with other elements of infrastructure management to raise efficiency.

Increased infrastructure investment is an essential part of government's economic policy.

BACKGROUND

Since 1994, South Africa's fiscal choices have resulted in positive growth rates, improved welfare and standards of living, and expanded access to bulk economic infrastructure for a majority of the population. Despite remarkable progress in reducing poverty and inequality, the country still faces tremendous shortfalls in economic and social infrastructure. In response, the government has adopted a raft of measures including the National Development Plan (NDP), which sets ambitious goals for social reforms to eliminate poverty and reduce inequality by 2030. However, to provide the necessary revenue to meet these goals, the economy needs to grow faster, by 5.4% per annum. Growth is affected by the longstanding structural weaknesses in the economy, as a result of long-term planning and financing challenges, and the lack of a strategic vision. Through the NDP and the Infrastructure Development Act, which sets the framework for the Presidential Infrastructure Coordinating Commission (PICC), the country has a clear vision and policy basis from which to work.

A significant ramping up of current and capital expenditure by the state is the cornerstone of the main pillars of government economic policy: the New Growth Path (NGP), the Industrial Policy Action Plan and the Strategic Infrastructure Projects (SIPs). In the 2014 Budget, government allocated a total of R847.3-billion to public infrastructure investment, in particular the transport and electricity sectors. This was revised downwards by R34.2-billion, to R813.1-billion, in the 2015 Budget because of lower-than-anticipated economic growth and the need to contain expenditure.

Much is riding on state infrastructure spending being the solution to reducing poverty, inequality and unemployment and generating economic growth.1 The argument for public investment rests on the belief that resources allocated to public capital investment lowers the cost of production (or distribution), which benefits the private sector and improves overall growth. However, South Africa faces a triple infrastructure challenge:

- To provide infrastructure that stimulates economic growth and job creation.
- To maintain existing infrastructure.
- To provide infrastructure and services to the poor in order to eradicate poverty.

Given these challenges and the importance of public infrastructure for national development and regional performance, there is a pressing need to get public infrastructure right. Therefore, the Financial and Fiscal Commission (the Commission) investigated the intergovernmental fiscal relations (IGFR) problems associated with public infrastructure management.

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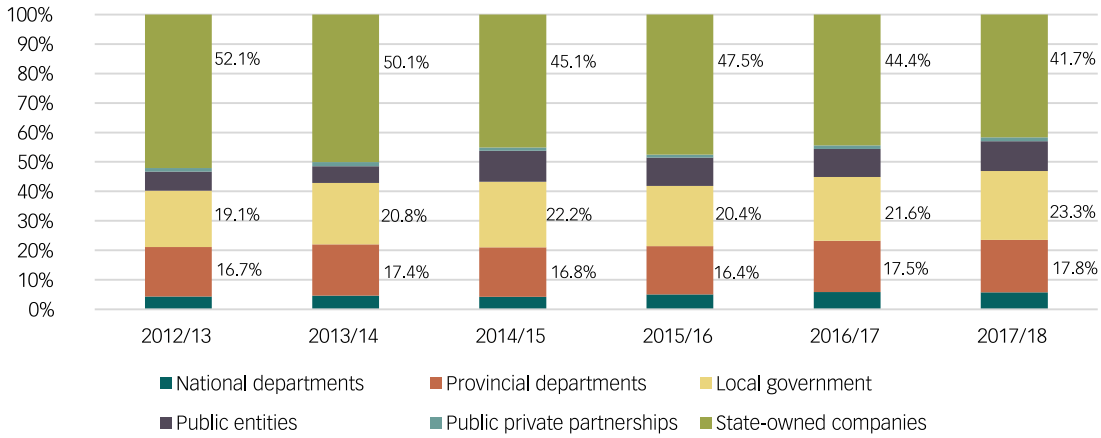
1. In its drive to raise employment levels, the South African government has put in place a number of other policies and programmes, such as the Expanded Public Works Programme and the Community Works Programme, that also affect location and investment.

FINDINGS

The responsibility for investing in new and existing infrastructure is a concurrent function that lies with all three spheres of government, as well as state-owned entities (SOEs). Over the 2015 Medium Term Expenditure Framework (MTEF) period, SOEs and local government account for just under 70% of all public investment in infrastructure (Figure 1).

Figure 1: Responsibility for public infrastructure spending



Source: Author's calculations based on National Treasury Budget Review 2014

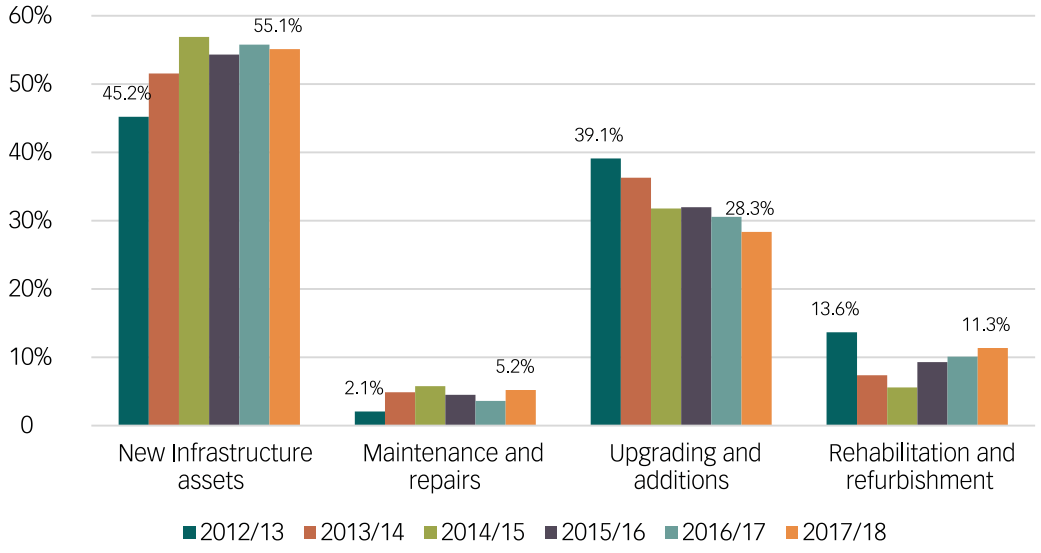
At subnational level, insufficient financial resources to finance and implement municipal investment plans are seen as a major obstacle. At the same time, the ability of municipalities (and SOEs) to drive South Africa's infrastructure-led growth is questionable because of poor financial management performance and unmet service delivery targets. Other challenges include:

- The requirements of large infrastructure projects (including productivity improvements, life cycle asset management and complex procurement challenges) that can result in significant delays and cost escalation.
- Weak intergovernmental coordination processes, which can lead to delays in both project evaluation and project oversight and implementation.
- Projects that allocate resources over many years are a problem if budgets are not spent effectively and institutional mechanisms to ensure accountability in infrastructure delivery are lacking.
- Complex projects coupled with weak management and accountability systems can create the conditions for corruption.
- The lack of capacity available at the subnational level, especially for developing urban infrastructure, including transport, sewerage, water and sanitation.

In the 2014 Budget, government allocated a total of R847.3-billion to public infrastructure investment, in particular the transport and electricity sectors.

The study found that maintaining and efficiently using existing infrastructure may be more important than building new infrastructure but is often assigned not prioritised. As Figure 2 shows, by the end of the 2015 MTEF period, 55% of resources allocated to infrastructure investment will be for new infrastructure, with the balance for repairing, rehabilitating and upgrading existing infrastructure.

Figure 8: Share of infrastructure spending by type



Source: Author's calculations based on National Treasury Budget Review 2014.

While the three spheres of government rush to identify new infrastructure investment projects, existing public capital stock is degrading rapidly. Closing the 'infrastructure gap' entails more than simply increasing new public investment. The failure to address this 'recurrent cost', or deficient operations and maintenance expenditure problem will have powerful macroeconomic consequences, especially for the sustainability of growth and jobs.

<< [4] The full study contains a detailed discussion on the potential blockages for each of the grant components.

Government's extensive infrastructure programme is aimed at rectifying inadequate and inefficient infrastructure, and improving and increasing the country's infrastructure network. To provide some guidance on how to finance the required infrastructure scale-up, the impact of scenarios on investment rates, growth and employment was modelled. While some scope exists for government to expand its own financing of capital expenditure through improved operating performance, private funding will be required. A strong relationship was found between economic growth and public infrastructure investment financed through debt. Ultimately, however, bridging the capital finance gap will require accelerated economic growth: infrastructure that supports accelerated growth initiatives will lead to government spheres receiving higher taxation revenue returns, which will enable higher service provision.

Maintaining and efficiently using existing infrastructure may be more important than building new infrastructure

There are few simple answers to South Africa's weak economic growth rate and associated unemployment and poverty rates. More rapid and sustained growth is required which means more savings and investment, more productive use of capital by better skilled workers, and moderation in unit labour costs. The issue of productivity is crucial, but growing productivity requires wide-ranging changes to policies and incentives, including better management and skills development.

CONCLUSION

Public infrastructure investment is important for national development and regional performance. With uncertain future economic prospects and tight fiscal conditions, this infrastructure must be better managed, to achieve the highest value for money and the greatest growth impact from spending public money. Public investment efficiency needs to be maximised through better economic growth and investment spending. South Africa faces many challenges, including corruption in public procurement and investment, but also has assets that can be mobilised to its advantage. These include a resilient people, a world-class Constitution and a NDP that sets the broad direction for infrastructure development. South Africa can build on these strengths and, at the same time, must address the inadequate institutional structures that have deterred long-term investment. intergovernmental fiscal relations are likely to work best when the central government actively strengthens institutional frameworks at the subnational level, by supervising programme implementation and holding subnational bureaucracies accountable. In order to create conditions for the future prosperity of all South Africans from infrastructure-led growth, the Commission recommends:

- The National Infrastructure Plan's funding strategy is developed and fully funded, so projects are delivered on time and in accordance with the plan.
- Capital conditional grants are redesigned to allow for the payment of (e.g. a special fund for feasibility and pre-procurement studies) and extending existing incentive/support for provinces and municipalities
- Public debt is raised aggressively, to help finance deserving and rigorously appraised infrastructure plans. The increase in debt levels should not trigger a review of the country's credit rating because well-planned and well-executed infrastructure ultimately pays its way through higher economic growth.
- The user-charge principle is accepted for higher levels of infrastructure services, while balancing the consumer's affordability to pay increased service charges and encouraging willingness to pay. Costing models should be developed to demonstrate how service charges could/should be calculated (and appropriate level of service).
- Infrastructure procurement planning, contract award and management are integrated with other elements of infrastructure management to raise efficiency (e.g. conditional capital grants should not only give money but also ensure that the requisite procurement and engineering skills are in place).

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