FINANCIAL AND FISCAL COMMISSION

BRIEFING ON THE SUBMISSION FOR THE 2015/16 DIVISION OF REVENUE

September 2014

For an Equitable Sharing of National Revenue

BACKGROUND TO THE SUBMISSION

- Submission made in terms of:
  - Section 214(1) of the Constitution (1996)
  - Section 9 of the Intergovernmental Fiscal Relations Act (1998)
  - Section 4(4c) of the Money Bills Amendment Procedure and Related Matters Act (Act 9 of 2009)
- Overarching theme underpinning Submission: ***"Balancing fiscal sustainability with socio-economic impact "***

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Balancing Fiscal Sustainability with Socio-Economic Impact

I. Macroeconomic and Fiscal Frameworks for Inclusive Growth

1. Macroeconomic Perspectives and Fiscal Frameworks
2. Public Debt Challenges
3. Social Programmes and the Need for Reform

II. Improving Investments in Education and Health

4. Equitable Resourcing of Schools
5. Adequacy and Efficiency in Primary Health Care Financing
6. Impact of Fiscal Expenditure on Food Security

III. Investment in Infrastructure

7. Improving Financing of Municipal Capital
8. Improving Public Transport
9. Impact of Electricity Prices on Municipalities
10. Better Human Settlements through Improved Panning and Funding

IV. Demarcations and Beyond

11. Impact of Demarcations on Municipal Finance

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Part I: Macroeconomic and Fiscal Frameworks for Inclusive Growth

1. Public Debt Challenges and the Need for Fiscal Reforms

- SA's economic growth has been insufficient to generate convergence towards income levels envisaged by National Development Plan (NDP)
- Chapter discusses evolution of public debt and its impact on the economy
  - Argument = if debt must not explode over time, policy makers have to respond to changing conditions in their tax base (economic growth) and to the cost of finance (interest rates)
- Simulations were run to assess potential impact of different public debt reduction scenarios on the SA economy
  - The impact of fiscal consolidation on investment and real GDP was found to be quite small but show that government would ↑ its domestic borrowing, which would hamper private investment, leading to a ↓ in GDP in the long run.
  - The economic growth scenario is quite interesting, as debt would ↓ in the long run and real GDP would ↓ slightly. This suggests that it is feasible to decrease public debt without slowing down GDP and therefore future growth

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RECOMMENDATIONS

1. Government should avoid setting targets for size of public debt. Borrowing is a valid and appropriate option available to government to help finance ongoing infrastructure and developmental requirements consistent with realising aspirations of the NDP. This presumes that debt management continues to have the objective of raising the required funding at the lowest possible cost within a given risk tolerance
2. Government should not simply cut costs. The need to restrain spending should be an opportunity to reform programmes and service delivery. Simple cost-cutting may be effective in achieving deficit reduction targets but does not encourage longer-run fiscal stability or allow for reforms that will generate more value for money spent
3. Government should avoid across-the-board cuts or expenditure ceilings. Such tools treat valuable, efficiently run programmes and outdated and poorly managed programmes in the same way. Spending should be aligned with government priorities to ensure adequate funding of high-priority initiatives and elimination or substantial reduction of lower-priority programmes

2. Social Programmes and the Need for Fiscal Reforms

- As SA seeks to boost economic growth, pressures on socio-economic outcomes may intensify, jeopardizing the sustainability of that growth and well-being of the population
- The social security system plays a central role to alleviate and ↓ poverty, vulnerability, social exclusion and inequality. The social protection system as defined within the fiscal framework has two separate but interrelated entities, one that deals with social assistance and another with social insurance
- Results show direct differences between beneficiaries and non-beneficiaries of the programme in terms of their observed outcomes. The main hypothesis that the findings confirm is that social grants have significant and important indirect effects through labour market participation and households' total consumption patterns, consumption budget shares and saving-investment behaviour
  - This becomes important as the size of the programme continues to ↑
  - While fiscal prudence and consolidation are pursued in the medium term, analysis shows that social security spending contributes to faster economic growth and to ↓inequality. This warrants targeted demand *stimulus* today, not contraction, which is now holding back growth

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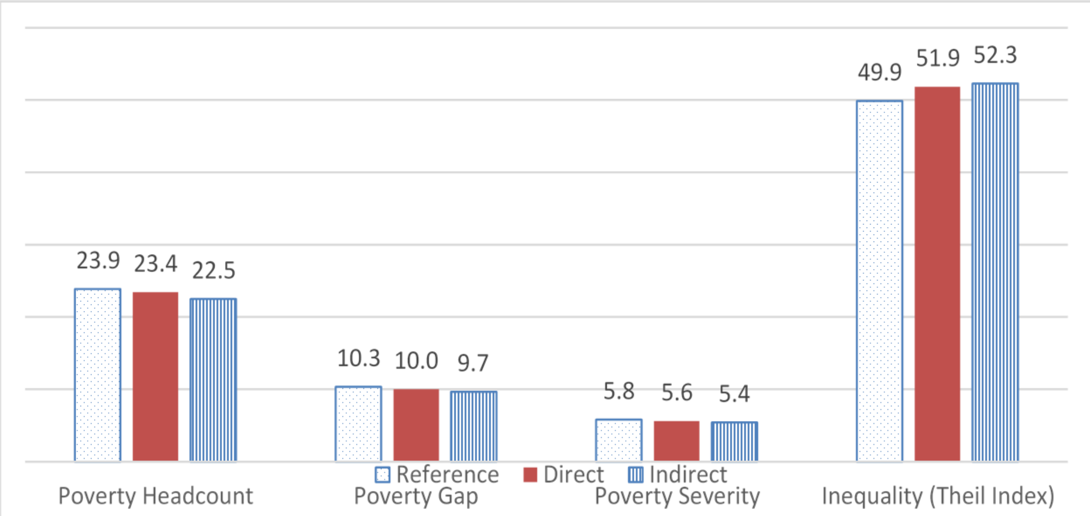
2. Social Programmes and the Need for Fiscal Reforms [cont.]

Poverty and inequality indexes



Source: Authors, from the simulation results

Changes in macro variables (%)

	GDP	Public Final Consumption	Private Final Consumption	Fixed Capital Formation	Change in Inventories	Exports	Imports
Share	100.0	19.5	64.6	16.8	1.2	24.5	26.4
Change	-0.9	0.0	5.6	-26.1	0.0	-3.3	-3.4

Source: Authors, from the simulation results

- In the s/term, results show little evidence that an alternative use of resources invested in social grants will ↓ poverty head count, poverty gap and poverty severity
- SA GDP level is 0.9% lower in the absence of the social grant programme driven by households that are spending 5.6% more (private final consumption) and not investing (fixed capital formation -26.1%)

RECOMMENDATIONS

1. Government should move aggressively towards a fully integrated benefits system that simplifies client access, improves client outcomes and improves fiscal sustainability through greater programme effectiveness, reduced fraud and corruption and reduced administrative costs
2. Government should implement a fully integrated benefits system that seeks efficiencies by, at a minimum, centralising income testing and payment delivery, automating the processing of applications, eligibility and payments, automating income verification, consolidating programme delivery and standardising eligibility criteria
3. Government should collect the information necessary to delivery and evaluate a fully integrated benefits system. In so doing, personal information and privacy should continue to be respected and protected

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PART II: IMPROVING INVESTMENTS IN EDUCATION AND HEALTH

3. Equitable Resourcing of Schools for Better Outcomes

- The chapter evaluates the process of resource distribution to schools and the effect such resources have on outcomes in light of growing emphasis on performance and quality outcomes
- Key findings include:
  - Variation and disparities in the allocation of resources to and performance of schools
  - General perception of inadequate funding to fulfil curriculum requirements
  - Dissociation between resources and outcomes particularly in poor schools

RECOMMENDATIONS

1. The national Department of Basic Education aligns learner subsidy allocations with national policy requirements and priorities. The current baselines do not cater for the significant increase in funding to cover the curriculum requirements. The alignment must be carried out in conjunction with strengthening oversight of provincial education departments (PEDs) to ensure adherence to national policy priorities
2. The allocation framework to schools takes into account the full package of minimum education inputs when deriving the minimum adequate benchmark funding per learner, in order to address the skewed distribution of resources between schools and districts. These inputs must be linked to both the process norms and output standards
3. The allocation framework for education infrastructure conditional grants sets out clear expenditure targets for quintile 1 to 3 schools and timelines for addressing priority infrastructure backlogs in each quintile and the general thrust of the School Infrastructure Backlogs Grant make provision for transitional asset handover process to School Governing Boards and PEDS on newly built schools. This would address alignment between funding for non-physical inputs and physical inputs as well as curb decaying of newly constructed infrastructure

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RECOMMENDATIONS

4. School funding norms and standards explicitly indicate the responsibilities of schools and PEDs for maintaining and upgrading school infrastructure, so that the division of expenditure responsibilities is clear, in order to avoid prolonged neglect of infrastructure upgrades and to ensure consistent budget allocation to maintenance and its monitoring thereof
5. School expenditure and performance are monitored at national and provincial level and accompanied by inspectorate visits. The Department of Basic Education and National Treasury must monitor provincial learner subsidy allocations and intervene where national targets are not met or allocations not transferred to schools timeously. This can be done by means of a portal similar to EMIS where individual no-fee schools can report payment delays and other problems

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RECOMMENDATIONS [CONT.]

6. The national Department of Education integrates existing outcomes improvements programmes, such as the integrated national strategy to improve numeracy and literacy, and targets them to poor performing districts, to improve translation of inputs into outcomes. Schools should be placed under the programme for a set period during which necessary infrastructure upgrades are carried out, skilled teachers are attracted and existing teachers trained, learner-specific interventions are carried out and, more importantly, SGBs are trained

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4. Adequacy and Efficiency in Primary Health Care Financing

- Chapter assesses adequacy of public health care funding and how health care budgets are allocated across provinces (through their programmes) as well as ascertain the efficiency and spending pressures of the sector
- Despite ↑ growth in health spending the sector is beleaguered by challenges such as suboptimal quality of care, inefficiencies in the system, heavy burden of disease, input cost pressures, growing number of an uninsured population, inequitable distribution of resources and the widely held perception that health care is underfunded
- If left unchecked these challenges will continue to undermine performance and delivery of the health care system and negatively impact progress towards implementation of National Health Insurance (NHI) and its roll out

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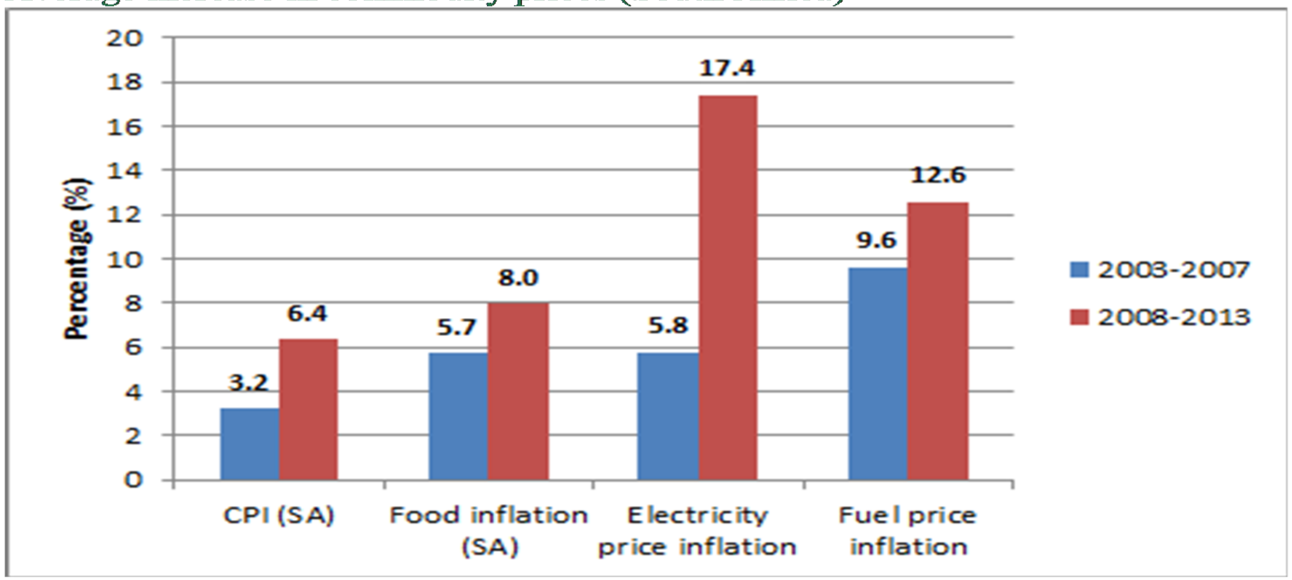
RECOMMENDATIONS

1. Provincial Governments must increase their allocation levels of PHC funding, to be in line with the minimum norms and standards for PHC package set by the National Departments of Health, in particular on clinic services such as integrated management of childhood diseases, reproductive health and HIV/AIDS
2. Inefficiencies (wasteful/irregular expenditure) in the health sector should be minimised so as to be in line with international experience. Wasteful expenditure needs to be identified, categorised and addressed:
   - *Clinical waste* through measures such as clinical performance measures that promote efficient use of resources (cost effectiveness, research and information dissemination)
   - *Operational waste* through measures such as standardisation of system processes and procedures
   - *Behavioural Waste* through measures such as preventative services advocacy so as to avoid unnecessary complications or illnesses

5. Impact of Fiscal Expenditure on Food Security

- This chapter investigates the impact of public spending on the level of household food security in SA and assesses effectiveness of the intergovernmental functional arrangement in implementing the existing policy framework. Economic crisis in 2007 may have led to a possible ↓ in household purchasing power due to the sudden increase in electricity, fuel prices and food inflation rising faster than inflation
- Coordination problems exist, partly contributing towards underperformance of the agriculture conditional grants

Average increase in commodity prices (South Africa)



Source: StatsSA (2003–2013).

RECOMMENDATIONS

1. DAFF strengthens its ability to enforce the conditions in the grant framework to ensure better oversight of provinces, so that spending and performance of the agricultural conditional grants can be improved. The Commission suggests that norms and standards be developed to assess the performance of provinces and five-year evaluations of conditional grants be institutionalised
2. Special focus is put on improving the operations of different food security programmes, especially Agriculture, EPWP and the School Nutrition Programme, which accelerate reduction in household food security without necessarily increasing programme expenditure. Areas that can yield improved results include better joint planning (such creating a value chain between smallholders receiving grant support and the NSNP) and streamlining procurement processes with the assistance of the Chief Procurement Office. The ability to use available resources optimally for the food security programmes have declined overtime

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RECOMMENDATIONS [CONT.]

3. Government clarifies the legislative mandate and responsibility of municipalities in relation to food security. In this regard, DAFF should develop a policy on urban food security with concrete proposals on how such a mandate will be funded. Currently, food security is not seen as a competence of municipalities and therefore cannot be funded
4. The terms of reference for the committee to review the agricultural conditional grants are finalised without unnecessary delays. The review should be comprehensive in scope and should include assessing the value chain of conditional grants and unlocking operational constraints, especially in relation to planning, procurement, comprehensive smallholder support, cash flow and monitoring and evaluation among others. Stakeholders such as the DRDLR should be invited to be part of the committee, and ways to streamline the funding overlap between the Illima /Letsema grant and the recapitalisation and development programme should be examined

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PART III: INVESTMENT IN INFRASTRUCTURE

6. Improving the Financing of Municipal Capital Investments

- The Commission hearings on the Local Government Fiscal Framework (LGFF) confirmed a vertical (and likely horizontal) capital funding gap
- The current infrastructure grants are not sufficient to cover capital expenditure needs given current funding sources
- Given constraints on own revenue capital funding sources the chapter identifies factors that are impacting on the own revenue contribution to municipal capital financing and quantifies the magnitude of this contribution
  - It also reviews the grant framework of local government that supports financing of municipal infrastructure to assess its adequacy, performance and targeting of infrastructure-related conditional grants and makes recommendations on additional funding streams to support municipal capital expenditures

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RECOMMENDATIONS

1. The monitoring and evaluation of municipal capital planning and spending needs to be improved. National and provincial treasuries should improve this assessment during municipal benchmarking exercises by:
   - Ensuring that capital budgets are realistic and financed, based on capacity to deliver and revenue assumptions
   - Placing a greater emphasis on refurbishing and renewing existing infrastructure stock as determined by the municipality's asset register
   - Ensuring that tariffs are appropriately designed so that the depreciations costs of existing infrastructure and the funding of new infrastructure are recovered from the tariff. The design of such tariffs should explicitly consider the customer affordability and protection of the poor
2. Government explores a new funding and infrastructure delivery model for poorly resourced and rural municipalities. There is potentially a greater role for state-owned companies and other state agents to deliver infrastructure on behalf of these municipalities

7. Improving Public Transport for Better Mobility

- This chapter evaluates the South African public transport system with the aim of recommending an appropriate transport framework that will align the transport operations and subsidies with the policy provisions
- Household travel surveys consistently show that large proportions of households have no access to any form of public transport or are dissatisfied with the quality of the available public transport
- Public transport is managed as isolated modes of transport and is becoming more fragmented as new modes of transport are added to the network
- Experiences elsewhere show that addressing such backlogs requires focused interventions and appropriate consolidation of functions

RECOMMENDATIONS

1. All municipal integrated transport plans must clearly indicate how the municipalities intend to exercise control over network, including the required resources. This should be one of the minimum requirements for preparing integrated transport plans and should be gazetted accordingly
2. The Department of Transport (the custodians of national transport policy) formulates and implements a transport subsidy framework, which explicitly incorporates social welfare, service productivity and environmental management, which are the three aspects endorsed by national transport policy

RECOMMENDATIONS [CONT.]

3. Given the ever increasing complexity of modern transport networks, municipalities should be guided on the minimum skill set required to be able to manage modern transport systems should be formulated. This is one of the critical interventions to unlock service delivery constraints. This should be carried out jointly by the Department of Transport and the South African Local Government Association
4. A comprehensive review of municipal integrated transport plans is carried out, with a view to identifying gaps that need to be addressed. This should be carried out jointly by the Department of Transport and the South African Local Government Association

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8. Impact of Electricity Prices Increases on Municipalities

- Chapter evaluates the effect of electricity price ↑ on municipal expenditure and revenue
  - Municipalities are constitutionally mandated to deliver basic services, including distribution of electricity
- Studies on the impact of electricity price increases tend to focus on poor households or the economy as a whole, but not municipalities – this despite the pivotal role that municipalities play in facilitating social and economic development
- Key findings indicate that ↑ in electricity prices negatively affect municipal expenditure and revenue
  - This finding needs to be considered in light of priority attached to environmental sustainability and how this will impact electricity prices

Recommendations

1. Government put in place a plan to manage the risks to municipalities associated with increases in the price of bulk electricity purchases. Such a plan should consider the implications of increases in the price of bulk electricity purchases on municipal expenditure (to the extent that increases may crowd out expenditure on other items) and revenue (to the extent that revenue to fund maintenance, asset renewal or cross-subsidisation may be eroded)
   - Such a plan should be explicit in terms of the differential impact that increases in the price of bulk electricity purchases will have on different categories of municipalities
   - The crafting of this plan is particularly important given developments aimed at prioritising environmental sustainability such as for example the pending implementation of the Carbon Tax and the implications that this will have for the cost of bulk electricity purchases

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9. Better Human Settlements through Improved Planning and Funding

- Chapter evaluates housing demand with a view to better understand the housing demand ladder
- The chapter identifies key constraints and levers for self-build housing and considers what well-located land in spatial terms entails in relation to empirical demands of population movement and settlement in the subsidy income band

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Recommendations

1. Municipalities especially metros should invest in forward looking processes and systems that will enable such municipalities to accurately understand and disaggregate housing demand
2. Metros focus on planning for rental flats and creating new (or transform existing) neighbourhoods in intermediate suburbs, which have lower densities than in the inner city
3. Government's housing subsidy prioritises the most vulnerable groups, which include poor female-headed households with children below the age of 20 years and households containing adults who are permanently out of the labour market
   - Targets and indicators should be put in place and closely monitored annually
   - The national Department of Human Settlements should report on households benefitting from government housing programmes based on gender and by age group on a yearly basis

RECOMMENDATIONS [CONT.]

4. Municipalities should prioritise land ownership registration processes where informal settlements are located in the developable areas
5. Government prioritises the provision of infrastructure in areas with the potential for self-build housing

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PART IV: DEMARCATIONS AND BEYOND

10. Impact of Demarcating Municipal Boundaries on Their Financial Viability

- The Municipal Demarcation Board is mandated to determine municipal boundaries and to delimit wards
  - The process of demarcation has seen 1262 LG structures reduced to 843, 284, 283 and now 278
  - Proposals with MDB indicate municipalities will ↓ further by 2016
- As municipal boundaries are *being* changed the questions that arise include: (a) What is the impact of these demarcations on municipal financial performance? (b) What is the impact of demarcations on tax bases, revenues, expenditures, asset bases, liabilities and other fiscal variables of municipalities? and (c) Have these demarcations promoted fiscally sustainable municipalities?
- Chapter 11 evaluates whether municipal boundary changes promote fiscally viable municipalities and rrecommends reforms necessary to create a demarcation process that promotes a fiscally/financially viable system of local government

RECOMMENDATIONS

1. The financial and fiscal implications of boundary re-determinations are prioritised and established before any demarcation decision is pronounced. A funding stream for the demarcation process should be identified before the process takes effect. In order to avoid negative effects of demarcations on municipalities and their populations, economic considerations (i.e. both fiscal and financial) should be at the core of any demarcation decision, both in theory and in practice. The current criteria are clear that economic considerations should be part of the criteria, but this does not appear to be the case in practice

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RECOMMENDATIONS [CONT.]

2. For every vertically decided demarcation process, government bears the transitional costs of the restructuring. A transitional demarcation grant should be awarded to the amalgamated municipality. This grant should be temporary and be awarded over at least three years (at least a year before, the year of and the year after demarcation takes place). The purpose of the grant will be to facilitate the restructuring process. This includes the following:
   a. Planning and preparing an amalgamated municipality's delivery model, e.g. combining the delivery models of individual municipalities
   b. Rationalisation and harmonisation policy regimes, IDPs and bylaws of different municipalities
   c. Rationalisation of tariffs
   d. Rationalisation of employment policies and other human resources systems (grading of workers and job evaluation processes)
   e. Rationalisation and harmonising evaluation rolls and assert registers
   f. Building capacity to deal with change management
   g. Facilitating communication about demarcation

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Thank You!