

2012/13

SUBMISSION FOR THE DIVISION OF REVENUE

FINANCIAL AND FISCAL COMMISSION



For an Equitable Sharing of National Revenue

FINANCIAL AND FISCAL COMMISSION

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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
Acting Chairperson/Chief Executive
Financial and Fiscal Commission

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.

PART 1: MACROECONOMIC AND FISCAL OUTLOOK

Chapter 1

SOUTH AFRICA'S TRANSITION TO A CONSOLIDATED BUDGET AND FISCAL GUIDELINES

1.1 Introduction

South Africa, along with most of the world, faces tough decisions regarding the size of the budget deficit and how to reduce it. This chapter examines some of the issues related to the current fiscal policy context in South Africa. In Section 1.2, fiscal policy is decomposed into relevant components to see which of them can help achieve the three key objectives of fiscal consolidation¹: closing the output gap,² reducing output volatility³ and managing government debt. The analysis presented in Section 1.2 shows that extreme views such as leaving the fiscal deficit unchanged or decreasing it rapidly should be ignored and that a gradual (consistent) response is the optimal response to fiscal consolidation in South Africa. In addition, Section 1.3 of this chapter argues that proper implementation of fiscal guidelines/rules⁴ could contribute to and complement the existing fiscal policies. This would not only ensure that fiscal policy remains sustainable, but also allow for proper counter-cyclical fiscal policy that has maximum spending impact during recessions and contributes to savings during expansions (which 'crowds in' or encourages investment). Given that the South African Government is intent on continuing its policy of fiscal stability and consolidation (as well as possibly implementing fiscal guidelines to strengthen its fiscal frameworks in the future) any expenditure and taxation decisions need to be carefully balanced in order to achieve its social objectives. Section 1.4 presents evidence of linkages between fiscal policy and economic growth in South Africa from a national, provincial and municipal perspective. Lastly, Section 1.5 outlines the recommendations derived from this chapter.

1.2 Fiscal Consolidation in South Africa

The 2008/09 global financial crisis put pressure on the fiscal balances of most economies. The limited scope (ability) of monetary policy to stimulate economies in recession meant that fiscal deficits (and hence public debt) had to increase. South Africa's small budget surplus in 2008/09 was used to prevent the contagion effects of the financial crisis. Gross domestic product (GDP) growth became negative in the final quarter of 2008 and peaked in the second quarter of 2009 at -7.43% (SARB, 2010). However, positive growth was registered in the latter half of 2009 and peaked at 4.56% in 2010Q1 (SARB, 2010). Even when considering the uncertainty around economic recovery, policymakers' focus shifted to fiscal sustainability. In South Africa, debt is projected to reach a maximum of 44% in 2015/16 according to the Budget Review (National Treasury, 2010a,b). Given the sovereign debt crisis in the euro area peripheries, it comes as no surprise that austerity measures are called for, which implies immediate changes in the budget in the form of (for example) cuts in expenditure and/or widening of the tax base. For this purpose, it is important to distinguish between transitory and permanent influences on the budget, as incorrect diagnoses can lead to fiscal over- or under-adjustment. In addition to the composition of fiscal consolidation, timing considerations are also important – for example, a premature and untimely fiscal exit⁵ may harm growth and ultimately lessen fiscal effectiveness.

1 Fiscal consolidation refers to government policies aimed at reducing government deficits and debt accumulation.

2 Output gap is defined as the difference between actual and potential output (GDP). Essentially, output gap measures actual output against what it should be if the economy were using its resources efficiently.

3 Output volatility refers to the pace at which output (GDP) moves higher and lower. A number of studies have shown that output volatility impedes economic growth and welfare and increases poverty (cf. Ramey and Ramey, 1994).

4 For the purposes of this chapter, the terms "fiscal rule" and "fiscal guideline" are synonymous and are used interchangeably.

5 The term "fiscal exit" refers to the shift in the role of fiscal policy from supporting demand (by, for example, increasing expenditure) to reducing the budget deficit.

1.2.1 Background

Fiscal consolidation is generally defined in terms of policies aimed at reducing government deficits and debt accumulation. Siebrits and Calitz (2004), Ajam and Aron (2007) and Du Plessis and Boshoff (2007) note that there are sound reforms behind fiscal consolidation in South Africa, one of the main being the Public Finance Management Act (PFMA) of 1999, which calls for sound expenditure controls and a system of supervision, among other things. They further refer to discretionary fiscal policy in South Africa post-1997 as “transparency-based discretion”, which amounts to fiscal authorities reporting cyclical, structural and off-the-line budget items. Other fiscal reforms contributing to fiscal consolidation in South Africa are related to the budget procedure, as well as tax reform and revenue collection.

South Africa has a good track of fiscal prudence (OECD, 2010). Since the 2008/09 economic recession, the budget framework has balanced the need for short-term stimulus with the long-term goal of fiscal sustainability (National Treasury, 2010a). Public debt has increased significantly to ensure that spending on social services does not decline despite a decline in tax revenue brought on by the recession. In addition, the government has made a commitment to reducing the deficit in order to bring the budget back into a sustainable position. However, the latest budget has posted bigger deficits over the next three years than previously expected, largely in a bid to support the job-creation efforts set out in the New Growth Path (NGP) (National Treasury, 2011). Despite this, the government is adamant about staying on course with its policy of fiscal stability and consolidation, which is also borne out by recent efforts to create stronger fiscal institutions to aid government policies by implementing fiscal guidelines. The following section examines the effects of various paths of fiscal consolidation on debt sustainability and output in South Africa.

1.2.2 Paths (Strategies) for South Africa

Figure 1 shows the possible scenarios for different fiscal consolidation strategies for South Africa. The top left panel of the figure shows the possible fiscal consolidation paths, which can be defined as follows:

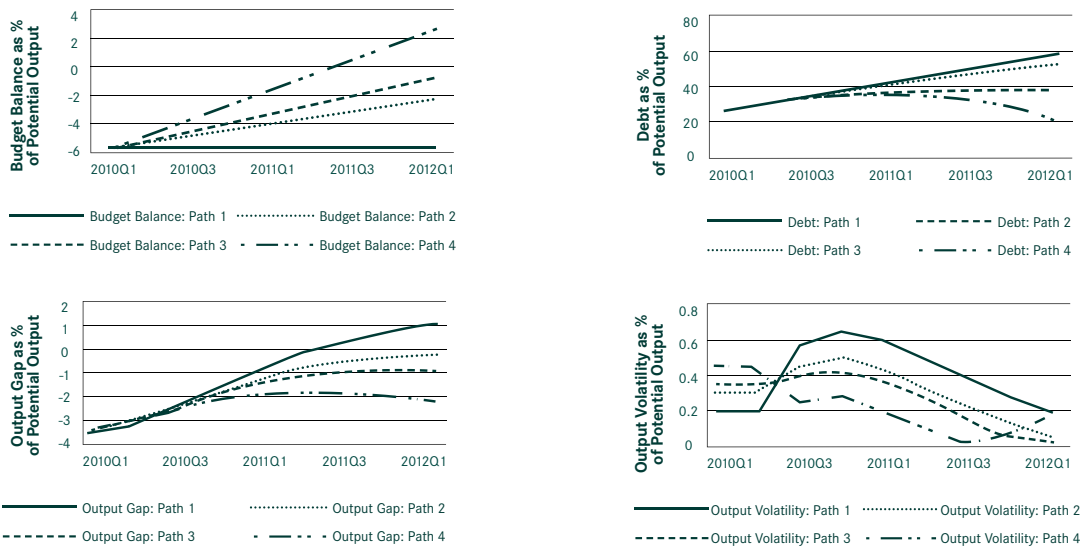
- Path 1 (solid line): the ratio of budget balance to potential output remains unchanged over the medium term (i.e. 2010Q1–2012Q1 Medium-Term Expenditure Framework, MTEF).
- Path 2 (dotted line): the ratio of budget balance to potential output decreases by 0.4 percentage points every quarter over the medium term.
- Path 3 (dashed line): the ratio of budget balance to potential output decreases by 0.6 percentage points every quarter over the medium term.
- Path 4 (dot-dashed line): the ratio of budget balance to potential output decreases by one percentage point every quarter over the medium term.

The top right and two bottom panels show how different macroeconomic variables (i.e. public debt, output gap and output volatility) respond to the different consolidation paths as set out in the four points above. The patterns used in these graphs correspond to the patterns that are assigned to the four consolidation paths above. Thus, for example, the dashed line in the bottom left panel illustrates the output gap trajectory over the medium term that is associated with consolidation strategy under Path 3 (i.e. when the ratio of budget balance to potential output decreases by 0.6 percentage points every quarter).

In this analysis, fiscal shocks (i.e. decreases in the ratio of budget balance to potential output) are treated as exogenous (i.e. in control of fiscal authorities) and take various paths that are plausible. As mentioned above, Path 1 keeps the budget deficit at a constant level through the MTEF. From the bottom left panel, it can be seen that the output gap associated with Path 1 (solid line) closes very quickly (i.e. moves quickly towards 0). However, the shape of the output gap is curved, implying that keeping the budget deficit relatively high might result in a lower output in the future. This is most likely due to the feedback effects of debt, interest rates and inflation on economic growth. The top right panel shows that debt associated with Path 1 increases in a linear fashion above 50% in 2011, which poses a potential risk for future fiscal policy in South Africa. Taking the other extreme of reducing the deficit very quickly (Path 4, and to some extent Path 3) does not ensure a closing output gap even though debt levels decline to very low levels over the medium term (dashed and dot-dashed lines in the four panels of Figure 1). This implies that fiscal multipliers are negligible and ineffective in addressing poverty issues or averting a recession.

Choosing a fiscal deficit reduction in the fashion of Path 2 (dotted line) seems to be a plausible policy option. Under this scenario the output gap closes towards the beginning of 2012, and debt levels stabilise around the same period, which means that the deficit should be reduced in line with output gap movements. Under the Path 2 scenario the concerns of public finances are balanced in terms of social outcomes as well as in terms of output volatility (which decreases at a reasonable rate throughout the forecasting period: see the dotted line in the bottom right panel of Figure 1).

Figure 1. The effects of different fiscal consolidation paths on public debt, output gap and output volatility



Along with most of the world, South Africa faces tough decisions regarding the size of the deficit and how to reduce it. This analysis shows that extreme views, such as leaving the fiscal deficit unchanged (Path 1) or decreasing it rapidly (Path 4), should be ignored. A negative output gap will persist even when closing the deficit at a faster rate (i.e. faster than the rate at which the output gap closes), as it limits the impact of fiscal multipliers (which will result in a slower closing of the output gap). Conversely, if the deficit is kept at the current level, or decreased at a very slow rate, the result will be higher debt levels and hence higher debt service costs. Over the long run, its contribution to the output gap also becomes negative. These findings therefore suggest that a gradual response is the optimal response to fiscal consolidation in South Africa.

With the above in mind, proper implementation of fiscal guidelines/rules can only contribute to and complement the existing fiscal policies. This would not only ensure that fiscal policy remains sustainable, but also allow for proper counter-cyclical fiscal policy that has maximum spending impact during recessions and contributes to savings during expansions (which 'crowds in' investment). However, the difficulty of implementing such rules lies not in the rules themselves but in the numerical targets set out by these rules. Section 1.3 below looks at the issues around fiscal guidelines, with a particular focus on the South African context.

1.3 Usefulness of Fiscal Rules (Guidelines) for South African Fiscal Policy

Over the last few years, internationally, public finance has been characterised by rising deficits and public debt. In a bid to achieve the goal of sustainable public finances (as well as the reduction of debt to sustainable levels), many countries have adopted some form (or combination) of fiscal rules/guidelines. Generally, a government with a strong reputation for fiscal prudence does not need to be constrained by rules, but when this is not the case, international evidence shows that fiscal rules can provide a useful framework for fiscal policy and ultimately contribute to macroeconomic stability and economic growth.

Furthermore, in order to enhance their effectiveness, the rules need to be well-designed at both the national and sub-national levels, which has implications for intergovernmental fiscal relations (IGFR). For South Africa (as well as for many other countries emerging from the crisis), the question becomes whether or not the government has been fiscally prudent (and pursued stable public finances) and if the answer is in the negative, what type of fiscal rules should be followed to entrench the current efforts of fiscal consolidation. In addition, the question of whether or not South African

government is expected to have stable and sustainable public finances is also important.⁶ Simply put, the choice is between the following two broad strategies:

- Fiscal discipline based on fiscal frameworks that are focused on credible and transparent strategies (i.e. the focus is on proper/effective fiscal institutions)⁷, or
- The adoption of a fiscal rule to entrench fiscal prudence.

In response to a request from Parliament, the National Treasury prepared a draft of fiscal guidelines for discussion (National Treasury, 2011). These guidelines propose the adoption of an annual target for the budget balance, among other things, and are based on the principles of countercyclicality,⁸ long-term debt sustainability and intergenerational equity. As is the case with most other countries, South Africa needs to take account of potential long-term structural developments and risks. There are *fiscal* dimensions to many of these risks and problems for which there are fundamental uncertainties that need to be dealt with. In this case, a multi-pronged approach is necessary to deal with issues of a long-run nature, involving strengthened policy analysis, reforms of the budget process, sustained fiscal consolidation and sectoral policy reforms. In this section, the focus is on exploring the potential to strengthen South African fiscal rules by assessing the need for stronger national fiscal frameworks and independent fiscal institutions.

1.3.1 What are Fiscal Rules?

Fiscal rules are defined as permanent constraints on fiscal policy through simple numerical limits on budgetary aggregates (IMF, 2009). In order for fiscal rules to guide fiscal policy, a fiscal indicator (instrument) is needed to create a rule that is relatively simple and can be easily monitored and communicated to the public. Fiscal rules are generally adopted with the aim of achieving fiscal (debt) sustainability, yet these rules can have different roles, such as stabilising the economy and limiting (or expanding) government size.⁹ The different rules can be summarised as (Kopits, 2001; Kennedy and Robbins, 2001; IMF, 2009):¹⁰

- Budget balance rules, which can be based on the overall balance, structural balance or cyclically adjusted balance (CAB).¹¹
- Debt rules, which generally target a certain level of debt-to-GDP ratio and are most effective in achieving the goal of debt convergence.¹²
- Expenditure rules, which, for example, permanently limit total, primary or current spending (i.e. spending of the ordinary state budget plus spending of the public investment budget) in relation to GDP.
- Revenue rules, which aim to boost revenue and/or prevent tax burden (by, for example, restricting the debt-to-GDP ratio).

6 It is reported, for example, that the USA public debt-to-GDP is expected to double by 2018, whereas the UK is facing many years of budget deficits and a rising debt burden.

7 Countries like Australia, New Zealand and Canada have all reduced their debt to GDP ratios without strictly enforced fiscal rules. Generally, countries are more likely to reduce their debt burdens during times of strong economic growth (e.g. Spain and the UK).

8 As defined in Swanepoel and Schoeman (2003:803), countercyclical fiscal policy requires government deficit and debt to increase during recessions and decrease during booms.

9 Fiscal rules also need to be growth oriented.

10 Fiscal rules have a long history. An increasing number of countries have adopted fiscal rules since the 1990s (to eliminate deficits and ensure the stability of public finances), with the sharpest increases being those of emerging and low-income countries. Another recent trend in fiscal rules is that countries have moved away from a single rule to a combination of rules that focuses on debt sustainability. Generally, this has resulted in a number of countries adopting a budget balance rule combined with a debt rule (expenditure rules have been used to curtail the size of government). In addition, custom-made rules are sometimes also deemed necessary because of differences in institutional capacity and exposure to external shocks. Finally, rules based on the CAB have become more popular in recent years. For a more detailed report on recent trends in international fiscal rules please refer to IMF (2009).

11 It should be noted that the CAB is linked mainly to the debt sustainability goal (IMF, 2009). Generally, during a recession/slowdown phase of the economic cycle, government finances worsen due to tax revenues slowing down and social payments rising. The CAB seeks to make an adjustment for the effects of the economic cycle and thus provide a more accurate representation of the budget. It is thus a measure of the balance that takes out the effect of economic swings that are above or below the natural rate of economic growth. In essence, the CAB is the balance that is in accordance with the long-run natural economic growth rate of the country. A CAB rule generally requires that its numerical target is constant, and movements in the CAB can be seen discretionary fiscal expansion. For South Africa, the CAB was introduced in the 2007 Medium-Term Budget Policy Statement (MTBPS) and currently the CAB is reported regularly together with the estimates of the structural revenue and structural expenditure. See for example Chapter 4, Figure 4.8, in the Budget Review (National Treasury, 2010a).

12 Debt convergence refers to the ratio of debt to GDP converging to a certain level (or a steady state) through the actions of fiscal authorities (i.e. the implication is that government is keeping public debt under control and that public debt is not exploding).

In addition to the above, a distinction must be made between hard rules and broader rules (Emmerson *et al.*, 2004). Hard rules can result in an accumulation of tax reserves as safety margins, which can reduce welfare. Broader rules, on the other hand, specify a central target with an acceptable range. A summary of the trade-offs involved in fiscal rules is provided by Kilpatrick (2001):

- Transparency vs rigidity: the higher the transparency the less need for a rule to be rigid. The assumption here is that if fiscal authorities behave in a transparent, credible manner, a fiscal rule can allow for some cyclical variation in spending and give some flexibility in the budget planning process.
- Rigidity vs. tax/revenue smoothing: the more rigid the rule, the less able is the government to smooth tax/revenue. A rigid rule implies a lower possibility for fiscal policy to adapt to changing economic conditions.

Flexibility of fiscal policy is an important economic mechanism that can counter an expected or an unexpected shock through changes in public deficits, which are in turn managed through smoothing of tax/revenue. The need for tax/revenue smoothing is created by shocks in the benefits of public spending created by events such as the 2008/09 economic crisis. Some rules may be more suitable for national levels while others are more suitable for the sub-national levels (Kennedy and Robbins, 2001). In fact, some studies argue that fiscal rules are more suited to sub-national than national governments (Bayoumi and Eichengreen, 1995; Corsetti and Roubini, 1996; Alesina and Bayoumi, 1996).¹³ Section 1.3.4 contains a more comprehensive discussion on sub-national fiscal rules.

The purpose of fiscal rules is to bind government to responsible behaviour, which may not always be in its short-term interests.¹⁴ In addition, fiscal rules can address the problem of time inconsistency (cf. Gutiérrez and Revilla, 2010), where the government's favoured choice (action) changes over time (i.e. fiscal rules increase the political cost of breaking past commitments and foster credibility because the government would adopt rules, set targets and adhere to them). Fiscal rules can be part of a broader legal framework (statutory requirement), making them more difficult to reverse. Policy rules (guidelines) that are not legislated do not impose binding constraints on government (Kennedy and Robbins, 2001). In South Africa, fiscal responsibility laws are outlined in the PFMA and Municipal Finance Management Act (MFMA) as well as in various sections of the Constitution (see Section 1.3.4 below).¹⁵ The general advantage of such legislation is that it limits the government's ability to focus selectively on policy that would reflect it favourably. However, more stringent frameworks for accountability, monitoring and enforcement need to be put in place, together with clear penalties for non-compliance (such as administrative sanctions, financial penalties and/or loss of reputation).

1.3.2 Reasons for Implementation of Fiscal Rules

One of the main problems with completely discretionary fiscal policy is that the government's record of fiscal policy cannot really be assessed without firm guidelines (Emmerson *et al.*, 2004). In addition, a fair number of factors lie outside the government's control, such as the position in the economic cycle, shocks to the international economy and levels of debt and deficit from previous years. As mentioned in the previous section, generally the motivation for fiscal rules is that they create a depoliticised policy framework (i.e. they correct the government's short-sightedness resulting from electoral prospects). In addition, fiscal rules have been known to contain the size of government and promote intergenerational equity. Although fiscal rules have been associated with improved fiscal performance (for example in EU countries), it is difficult to isolate the direction of causality and the effect – i.e. the introduction of rules might make government more responsible, but responsible governments are also more likely to make rules. When it comes to fiscal rules fostering consolidation efforts, international evidence has been favourable (see for example IMF, 2010). A major disadvantage of fiscal rules is that they constrain discretion when discretion is needed and may force fiscal policy to be procyclical when it needs to be countercyclical (Kennedy and Robbins, 2001; IMF, 2009).¹⁶ In addition, fiscal rules, and expenditure rules in particular, may result in capital spending cuts, which could harm long-term economic growth. Kennedy and Robbins (2001) cite the following reasons for adopting fiscal rules:

13 For example, Alesina and Bayoumi (1996) find that the stringency of a national fiscal rule does not affect output variability, which implies that the state's role in stabilising output is not important. They conclude that if this is the case, balanced budget rules may not be suitable for national government and are thus more suitable for sub-national government instead.

14 Kennedy and Robbins (2001) argue that what underlies fiscal rules is a sense that present (or future) governments may not be able to implement optimal fiscal policy measures without external pressure.

15 It should be noted that New Zealand was the forerunner in the fiscal responsibility legislation with the introduction of the Fiscal Responsibility Act in 1994 (Emmerson *et al.*, 2004).

16 In the South African context, there is a general opinion that fiscal policy needs to be more countercyclical so as to maintain low future capital costs and inflation, support a more competitive exchange rate, reduce debt service costs and provide fiscal space (Loewald, 2010).

- Fiscal rules ensure macroeconomic stability through the promotion of countercyclical fiscal policy.
- Fiscal rules enhance the credibility of governments' fiscal policy and aid in deficit elimination.
- Fiscal rules ensure the long-term sustainability of fiscal policy.

The timing of the implementation of fiscal rules is a major consideration, as it is vital to implement rules at the correct time.

1.3.3 Fiscal Rules: Further Considerations

(a) What are some of the preconditions that need to be in place for fiscal rules to be effective?

First of all, adequate public finance management systems need to be in place. Adequate data also need to be available, which generally is the case for South Africa. In addition, the government needs to have a good track record in technical forecasting capacity because budgetary aggregates need to be predictable with a certain degree of accuracy to avoid the risk of large fluctuations from the announced fiscal policy stance, which would undermine a rule's credibility (cf. Emmerson et al. 2004; Favero and Massimiliano, 2005).¹⁷ Budget reporting systems need to be extensive, and fiscal data should be publicly released, which is the case for South Africa at the national level. However, this could prove problematic at provincial and particularly municipal levels, if fiscal rules are to be introduced to sub-national governments in South Africa. Political commitment is also key because without this fiscal rules are unlikely to be sustained and may even harm the credibility of fiscal policy.

Furthermore, the following are needed for a fiscal rule to operate optimally (IMF, 2010):

- An unambiguous and stable link between the numerical target and the ultimate goal. Fiscal rule methods, linkages and outcomes must be clearly announced in advance. In addition, a clear reaction function must be formulated – one that explains how government will respond to failures to meet the rules.
- Sufficient flexibility to be able to respond to shocks. Specifying a clear reaction function does not mean that government must always follow the rule. However, when it does not, the government must have a good reason and provide a clear explanation why.
- A clear institutional mechanism to map deviations from numerical targets and take corrective action. In addition, a decision must be made as to how the rule will be judged (i.e. retrospectively or prospectively).

(b) Design, timing and implementation of fiscal rules

Implementation of fiscal rules would necessitate that government publishes in advance three key pieces of information: how the rules will be met, what happens if the rules are not met or are not on course to be met (i.e. corrective action and penalties), and the time frames for when the targets will be reached (Emmerson et al., 2004).

In terms of the design of fiscal rules, two requirements need to be satisfied:

- First, the rule must deliver the required adjustment and put debt on a sustainable path.
- Second, the rule has to have a certain degree of flexibility built into it in order to deal with shocks.

A fiscal framework should have the following main features (Kopits, 2001):

¹⁷ National Treasuries should publish (or provide an indication) of past forecast errors for fiscal aggregates (Emmerson et al., 2004). The idea is to publish data series of forecasting errors (i.e. comparing the initial forecast with the final outcome, preferably adjusted for subsequent policy changes), as this information will indicate the degree of uncertainty surrounding current forecasts (and also indicate the probability distribution within which these forecasts should be based). Variables that can be considered include public sector net borrowing, public sector net debt, current budget balance, current receipts, current spending and public sector net investment (Favero and Massimiliano, 2005). Regular summaries of the size and variability of the forecasting errors could be summarised and the National Treasury could use this information to indicate and quantify the uncertainty surrounding the current set of fiscal forecasts (graphical representation can take the form of fan charts). This will also make communication to the public easier in the sense that government will be able to determine and communicate the probability of breaking the rule and plan accordingly. Furthermore, fan chart representation (for example) can make the public more aware that outcomes do not necessarily lie in line with the forecasts (Emmerson et al., 2004).

- A numerical policy rule.
- A set of “procedural” rules.
- Monitoring by an independent, authoritative body.
- Full and clear public accounts (including future costs).

Other issues to consider include:

- Coverage of rules.
- Whether or not the rules should respond to past deviations.
- Effective monitoring and evaluation.

In addition, considerations when choosing the fiscal instrument include (cf. IMF, 2009):

- The instrument must be closely linked to the ultimate objective of fiscal policy.
- The instrument must be controllable.
- The instrument must be transparent and easy to monitor – commentators must be able to audit fiscal policy, and so the fiscal authorities need to publish as much data and information as possible.¹⁸

The budget balance to GDP ratio generally fulfils the above requirements and thus makes a good instrument. Constraining the debt ratio, on the other hand, is more difficult because of the lags that are involved before any budgetary slippages can be detected and also because debt is more volatile. Generally, if debt is targeted, it is targeted together with a budget balance. In addition, targeting revenue is also tricky because it is not linked directly to debt ratio unless the expenditure side is considered. A growth-based balance rule (an augmented one) performs well in a low-growth environment (however, the price is the reduced countercyclicality).

In terms of the implementation, the following are important points (Anderson and Minarik, 2006; IMF, 2009):

- Before a rule is introduced, countries need to make an effort at fiscal consolidation and macroeconomic stability, which is likely to make the rule more credible.
- Speed of adjustment is also an issue, as the rule might require an excessive speed of adjustment, or it might not mandate as much adjustment as is needed/feasible/optimal.
- Fiscal rules should not be introduced in a markedly uncertain macroeconomic environment.

The main points to keep in mind are that the cost of breaking the rule needs to be higher than the benefit of doing so, and while fiscal rules can anchor medium-term expectations, they are not ideal when dealing with extreme shocks.

1.3.4 Sub-national Fiscal Rules

Generally, since fiscal discipline is greater at the national level, fiscal rules at this level are found to be more effective than those implemented at the local government level (IMF, 2009). Other reasons for inefficiency of fiscal rules at the sub-national level are: limited authority and dependence on central government transfers, which creates situations of moral hazard; spillovers from higher spending jurisdictions; and differences in the timing and size of economic cycles across sub-national government that may spur procyclical behaviour. It should be noted that countercyclical fiscal policy is desirable as it aids

¹⁸ Although it is understandable that governments would want/need to withhold some information to manage expectations. In South Africa, fiscal authorities publish budget documentation that is consistent with the IMF’s “Revised Code of Good Practices on Fiscal Transparency” and is currently considered one of the most transparent fiscal authorities in the world (out of a sample of 94 countries considered). It publishes information on forthcoming policies as well as policies under consideration, provides consistent data and presents estimates of the budgetary aggregates over the medium term.

the government by acting as a stabiliser – i.e. spending during downturns and saving during upturns in the business cycle. However, if sub-national fiscal rules are introduced, it is optimal for these rules to be simultaneously introduced at all levels of government. However, this is rarely the case: internationally, fiscal rules have either been first introduced at the national level and then at the sub-national level (e.g. Argentina) or the other way around (e.g. Canada).

What are some of the elements that need to be in place before a sub-national fiscal rule is introduced? Firstly, fiscal legislation needs to be imposed at corresponding government level(s) to provide a means for accountability for policymakers (Kopits, 2001). In South Africa, this aspect is covered by the PFMA of 1999 and MFMA of 2003 legislations. Secondly, the underlying vertical (regional) imbalances need to be offset by a sufficient mechanism of intergovernmental compensation transfers (cf. Kopits, 2001), such as the equitable share mechanism in South Africa. While the national government raises the bulk of aggregate revenues, its expenditure responsibilities are much lower, which means a mismatch between revenues raised and expenditure responsibilities. A converse mismatch exists at the provincial and local government level. This vertical mismatch is known as a vertical fiscal imbalance (pre-transfer fiscal deficit).

There are also horizontal imbalances since the revenue-raising capacity of sub-national governments varies and because different regions may face different cost and demand pressures as they attempt to meet their assigned expenditure responsibilities. The gap between revenue and spending in sub-national jurisdictions is met through intergovernmental transfers (grants and revenue sharing), borrowing by governments in deficit, or a combination of the two. While the equitable share transfers may appear to be free of rules, it is important to note that many institutional and legal arrangements are in place for the use of these transfers. In terms of the Intergovernmental Fiscal Relations Act (IGFRA) of 1997, the Minister of Finance has a legal obligation to convene the Budget Council twice a year and the Budget Forum once a year. The Council and the Forum may be convened in order to solve any disputes, in line with the scheme provided for in the IGRFA of 2005.

The PFMA and MFMA also govern reporting requirements as well as the Appropriation Act, which regulates the conditional allocation of national revenue directly. Local governments in South Africa are required to enact balanced budgets. Therefore, strictly speaking, the equitable share is supposed to be used by recipient sectors to deliver on constitutional mandates. Where a province (or a municipality) fails to deliver on these mandates, the national government (or a province) can intervene through Sections 100 and 139 of the Constitution. It is the responsibility of national departments to implement “emergency” Section 100 (of the Constitution) measures to bring provincial spending and revenue into balance. Such intervention has happened before and is currently in place in the Eastern Cape education department.

It goes without saying that budget and/or debt rules should be viewed as complementary rather than substitutes for the equitable share mechanism. There are two general approaches to fiscal responsibility at the sub-national level: sub-national autonomy and a coordinated approach (Shah, 1994; Kopits, 2001). In the autonomous approach, the sub-national government seeks to gain credibility for its own fiscal policy, while in the coordinated approach all sub-national governments are subject to uniform rules in order to establish credibility for overall macroeconomic policy.

In the latter case, a free rider problem could arise, so penalties for non-compliance need to be introduced at the sub-national level as well. Flexibility is also an important consideration at the sub-national level. For example, mechanisms must be put in place to correct unanticipated deviations from target (unless these stem from cyclical fluctuations). In addition, revenue shortfalls and over-expenditure need to be met with automatic measures.

1.3.5 International Experience and Lessons for South Africa

In addressing fiscal challenges, South Africa can draw on experience from other countries. Internationally, combining budget balance and expenditure rules has been particularly effective, and even more so when the countries had wide coverage and strong monitoring.

The following are some examples of international experience with fiscal rules.

UK and Australia: Neither framework has legislated numerical targets. Instead, emphasis is placed on requiring government to set out its fiscal strategy and targets clearly. Australia’s reduction in debt is mainly due to privatisation proceeds, and the current objective is to balance the budget over the economic cycle by running short-term surpluses and aiming to improve its net worth as a supplementary objective.

Japan: This country has had some or other form of fiscal rules since 1947. However, since 1997 it has had rules to address the deficit as well as ensuring that the sum of national and local government debt does not exceed 3% of GDP. In addition, deficit financing bonds need to be reduced every year and numerical limits are set on expenditures.

New Zealand: Here the Fiscal Responsibility Act places more emphasis on transparency than on numerical targets. The government did set some targets for fiscally prudent levels of debt. Temporary departures are allowed as long as the government specifies reasons for doing so (and also when it plans to return to the principles). In general, improved fiscal performance in New Zealand can be attributed to fiscal rules plus improved reporting requirements, better economic conditions and political commitment.

Canada: This country set limits on programme spending (overspending is permitted in one year if offset in the following two years, and unspent amounts can be allocated to the subsequent fiscal year). The government has also introduced a number of non-legislated rules that have contributed to better federal finances (two-year rolling deficit targets with an ultimate goal of a balanced budget and credible short-term fiscal targets combined with commitment).

Chile: Often cited as a success story in the implementation of fiscal rules, the country introduced a new fiscal framework in 2001 (codified in the Fiscal Responsibility Law). The target is a structural fiscal surplus, and the cyclical stance is determined by an expert committee. Between 2004 and 2008 the country had a cumulative surplus of 28.5% of GDP. In 2009, there was 14.5% real growth in public spending despite a 28.5% fall in fiscal revenue (implying a fiscal deficit of 4%).

South Africa has come a long way in operating some sort of fiscal rules that are implemented through constitutional amendments, statutory provisions or policy guidelines. A variety of enforcement mechanisms exist to enforce these. When rules are violated, sub-central governments may be subject to administrative sanctions, financial penalties, or a loss of prestige and reputation. For instance, "peer pressure", in the form of recommendations by the Commission to restore fiscal discipline when sub-national governments fail to adhere to such rules, is available.

There have been instances where local level authorities have been removed from office for violating fiscal rules. Furthermore, a constitutional provision allowing Parliament to adjust the budget proposed by government has proven to act as if allocations are indeed rules. The government's medium-term horizon for fiscal policy, which has given fiscal policy some discipline without making it rules-based, has also proved useful because markets could easily detect any deviation from medium-term targets. The entrenched recognition and clear demonstration of fiscal prudence by South African authorities permeates through to sub-national government. A key issue that arises in the context of South Africa is whether and how to strengthen fiscal rules.

Thus, the first aspect should be to recognise the existence of some sort of fiscal rules that by and large are working reasonably well. The second aspect is that the National Treasury is certainly conflicted, as it acts as both judge and jury on its performance. This calls for a separation of function and, in this regard, the Swedish model of an independent fiscal policy council is a good guide and needs to be considered.

On the basis of these considerations, a possible option for fiscal rules would be to target a balanced budget or surplus over the cycle, without any limits, which would allow for the operation of automatic stabilisers and also for discretionary countercyclical action. In addition, limits need to be imposed on the government wage bill. Generally, if an expenditure rule is to be proposed, then limiting capital expenditure (which is thought to contribute to long-term growth) is not an option. However, transparent, unambiguous and operationally sensible definitions of capital expenditure are needed (so that the focus is on productive capital expenditure).

1.4 Link between Fiscal Variables and Economic Growth in South Africa

The question of whether or not fiscal policy stimulates growth has obvious important implications for the South African economy. Given that the South African Government is intent on continuing its policy of fiscal stability and consolidation (as well as possibly implementing fiscal guidelines to strengthen its fiscal frameworks in the future), any expenditure and taxation decisions need to be carefully balanced in order to achieve its social objectives. Unfortunately, the question of whether or not fiscal variables have a positive effect on economic growth has no simple answer. One viewpoint holds that government involvement in economic activity is fundamental for achieving economic growth; another argues that government operations are inherently bureaucratic and inefficient and hence suppress rather than promote economic growth. In an attempt to shed some light on this issue, this section presents various evidence of linkages between fiscal policy and economic growth in South Africa from national, provincial and municipal perspectives.

1.4.1 National Level

There is a considerable quantity of literature on the influence of fiscal variables (expenditure on government programmes and taxes) on economic growth, most of which are reported in the form of tax and/or revenue elasticities.

Though difficult to obtain, and while strictly speaking these elasticities are meant for closed economies, they offer a useful indication of the effect of fiscal policy on economic growth. Simply defined, elasticities are measures of responsiveness of a variable to a change in another variable.

For South Africa, a number of studies have estimated tax elasticities (albeit using different methods and sample periods). In addition, the Commission has estimated revenue elasticities for different components of public expenditure. Tables 1 and 2 provide summaries of these estimated elasticities.

Table 1. Summary of tax elasticities for South Africa

Study Tax ↓	Swanepoel and Schoeman (2002)	IMF (2006)	Du Plessis and Boshoff (2007)	Jooste (2009)
Personal income tax	-	1.43	-	0.84
Corporate income tax	-	2.52	-	1.79
Value added tax	-	0.99	1.14	1.01
Income and profit	1.04	-	1.05	-
Goods and services	1.24	-	-	-

Source: Jooste and Naraidoo (2010)

Table 1 shows the responses of taxes to the economic cycle, which has important implications for calculating the CAB. Most countries assume that taxes respond in a one-to-one relationship with the cycle. However, recent studies such as Wolswijk (2007) and Jooste and Naraidoo (2010) show that taxes respond asymmetrically to the economic cycle. Thus, significantly different CAB outcomes may be obtained, depending on the elasticity.

There is an obvious trade-off between technical sophistication and a communicable method of calculating the CAB. While technical rigour might provide a more “exact” outcome of the CAB, it is not as transparent as a communicable method and may be subject to manipulation. And whereas a communicable method is transparent, it can sometimes be off the mark.

Table 2. Summary of revenue elasticities for South Africa

Expenditure Category	Elasticity estimate
Agriculture, forestry and fishing	2.41
Defence	0.22
Education	1.51
Fuel and energy	0.61
Health	1.87
Housing and community amenities	0.37
Mining, manufacturing and construction	-1.86
Public order and safety	-1.38
Recreation, culture and religion	-0.25
Social protection	0.39

Source: FFC calculations

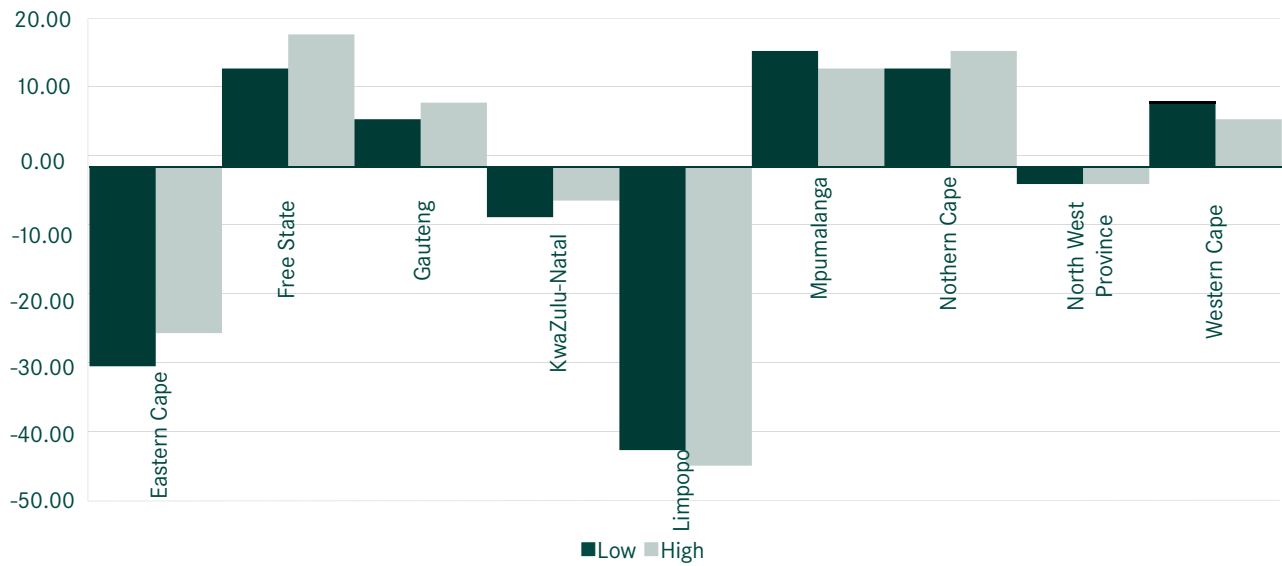
Table 2 shows the responses of economic growth to changes in public expenditure components. Positive elasticities larger than 1 are considered conducive to economic growth (i.e. a 1% increase in government spending leads to more than a 1% increase in economic growth, all other things being constant), making agriculture, education and health the key contributors to economic growth in South Africa. Negative elasticities can indicate a reverse causality, i.e. from growth to expenditure.

1.4.2 Sub-national Level

Empirical evidence at the provincial level for South Africa is scant, mainly because of data deficiencies (for example in the case of interregional mobility and expenditure profiles). Furthermore, many complex responses arise from the interaction of the different sectors of government and to capture these effectively is difficult. Using a multiple provincial/regional computable general equilibrium (CGE) model, a recent study by the Commission provides a picture of how South Africa’s efficiency and equity goals are affected by altering existing fiscal rules. Fiscal rules here are loosely embodied in the conditions and restrictions associated with intergovernmental fiscal transfers discussed earlier. A reduction of intergovernmental transfers with tax compensation is therefore interpreted as a loosening of fiscal rules. This loosening is found to have heterogeneous effects on households’ well-being, which is measured by changes in the equivalent variation of initial con-

sumption expenses.¹⁹ The nation-wide welfare does not change significantly (0.6% in both scenarios), but its distributional effect among provinces is important (see Figure 2).

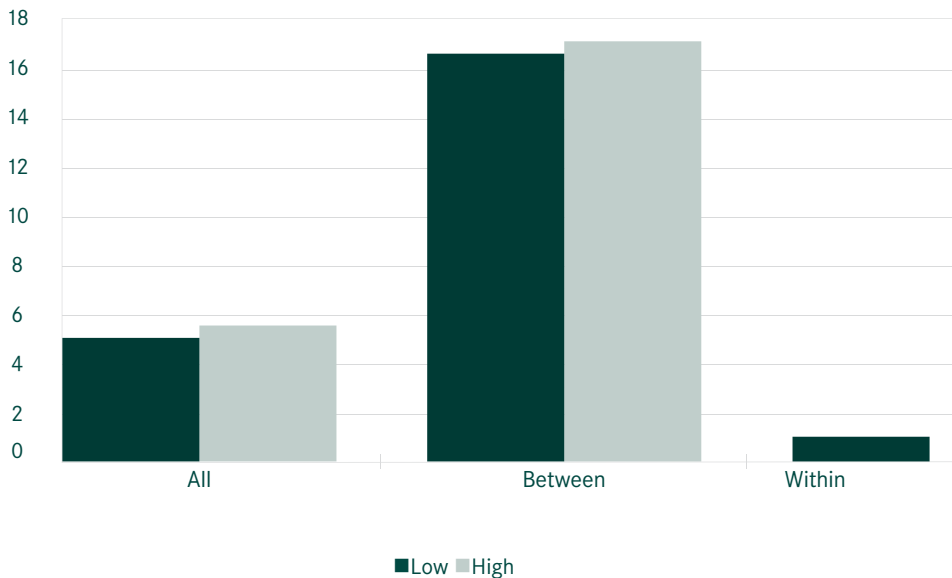
Figure 2. Equivalent variation of initial consumption expenses (%)



Source: Own calculations

Theil indices are used in the study to measure regional disparities, in particular within and between regions.²⁰ The overall regional disparity increases by 5 to 6% (Figure 3 is essentially imputed to the increase in disparities between regions).

Figure 3. Variation in Theil indices (%)



Source: FFC calculations

These results are varied but pertinent for the use of fiscal rules. The first general point is that sub-national governments play a key role in successful fiscal consolidation. This provides support for the argument that understanding sub-national govern-

19 This is the change in consumer income that results in a change in well-being that is equivalent to a change in well-being resulting from a price change. It can be positive or negative.

20 The Theil index is part of a larger family of measures referred to as the General Entropy class and is a statistic used to measure economic inequality. While less commonly used than the Gini coefficient, an appealing feature of the Theil index compared with the Gini coefficient is that it is additive across different sub-groups or regions in the country, which explains why it is used here.

ment behaviour is important for overall macroeconomic stabilisation. Grant allocations provide a mechanism whereby the national government retains considerable effective control over aggregate sub-national government expenditures.²¹

The second general point is that cuts in grants can play an important role in fiscal consolidation. However, the results demonstrate that there are significant interregional equity effects although the overall impact is less important. Such concerns about intragenerational equity appear to be well justified if deficit reduction is implemented through cuts in social assistance or a reduction in regressive taxes. Not least from a South African welfare state perspective, a programme of fiscal consolidation could easily conflict with ambitious (re)distributive objectives. The third general point is that cuts in grants can be offset by increases in compensatory taxation. However, the increase in sub-national taxation following an episodic cut in grants is that households' gross incomes fall and income disparity widens.

1.5 Recommendations

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.

21 In the context of the South African local government grant process, Amusa et al. (2008) offer empirical evidence on the concept of fiscal illusion, using the flypaper effect hypothesis. The flypaper effect refers to the observed tendency of local government authorities to spend intergovernmental grant transfers rather than pass them on to constituents through, for example, tax cuts. The empirical framework used in this study has its foundations in the median voter model developed in the article by Wyckoff (1991) and adapted by Heyndels and Smolders (1994). Amusa et al results suggest the absence of a flypaper effect on municipal expenditures from intergovernmental transfers. In other words, fiscal rules implemented through conditions on various grants have not had unduly discernible negative effects on local government. Two major implications of these findings for fiscal rules would be the need to (i) improve the overall administrative, institutional and financial capacity of municipalities (in particular making them more innovative and effective in spending their grant allocations) and (ii) further understand the effects that current reform proposals could have on the fiscal autonomy and revenue-raising capacity of municipalities.

Chapter 2

INCLUSIVE GROWTH, DEVELOPMENT AND FISCAL POLICY

2.1 Introduction

South Africa experienced a long period of economic decline in the last decades of apartheid (1985–1994). In the immediate post-apartheid period (1995–2003) economic growth rates improved and then picked up substantially from 2004 to 2007. However, in 2008 the global economic crisis resulted in a slowdown in economic growth. As shown in Chapter 1, economic recovery and ensuing fiscal consolidation has evolved better than expected. This good performance, however, masks a more complex reality, that of a tepid economic recovery associated with unemployment, poverty and inequality. Poverty remains high, especially 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. These social realities, together with the realisation that dates for attaining the Millennium Development Goals (MDGs) are a mere four years away, have galvanised government to seek alternative ways of using public expenditures to grow the economy in order to address poverty and inequality.

Further ambitious social reforms are being proposed to tackle poverty, growth and inequality problems. The National Health Insurance (NHI) promises to be the largest reform undertaken in the health sector since the end of apartheid. Government has adopted the New Growth Path (NGP) for South Africa, which aims to accelerate the creation of decent jobs and reduce inequality and poverty. There are many dilemmas to be resolved and balances to be struck: between stabilisation, interconnectedness and broad-based development, and short-term growth; between economic inclusion/equity and productivity/efficiency; and between social transformation and stability/confidence.

As government identifies options for public expenditure, the need for reliable assessments of the probable impact of such expenditure becomes critical. To evaluate the impact of large social programmes, linked intertemporal models are used. Firms and households have a forward-looking behaviour and thus take into account all future prices in their investment and consumption decisions. The models suggested in this chapter take into account not only intertemporal dynamics but also a richer production disaggregation. They are a subset of economic models of South Africa built by the Commission that capture complex interactions between government decisions, economy-wide variables, and individual, household, national and provincial economies both within and across time periods.

2.2 Development and Fiscal Policy

Government's key priorities to achieve a more inclusive and equitable growth path are designed to achieve the 12 outcomes of the Medium-Term Strategic Framework. In the 2011 Division of Revenue Bill, government identified the following top policy priorities for the 2011/12 financial year:

- Improving the quality of basic education and skills development,
- Improving the quality of health care and infrastructure,
- Investing in new infrastructure and proper maintenance of social and economic infrastructure networks, and
- Accelerating job creation.

Furthermore, the government adopted the United Nations Millennium Declaration alongside other countries, as an unprecedented declaration of solidarity to rid the world of poverty. Some of the indicators expressed by the MDGs are closely related to the socio-economic rights mentioned in the South African Constitution and to the government's policy priorities. The government's outcomes and the MDGs indicate the results that the country wants to achieve, based on certain inputs (resources), outputs (the goods and services actually delivered) and impact (the change brought about by, or the effect of, an intervention). Updated targets for each

MDG taken from the South African Country Report (UNDP, 2010) show that MDG7 and MDG8 (environmental sustainability and global partnership for development) have already been achieved, while MDG2 and MDG6 (primary education and HIV/AIDS, malaria and other diseases) are likely to be achieved. However, the country has fared badly in terms of MDG4 and MDG5, which pertain to child and maternal mortality, largely because of the HIV/AIDS and TB pandemics. A series of policies, delivery agreements and budgets give expression to the government's commitment. In particular, the intergovernmental fiscal system is a key instrument for funding public sector delivery across the three spheres of government. In this respect, the country has followed four major development strategies since 1994 (see Box 2.1).

Box 2.1: Brief history of development strategies in South Africa

The four major development strategies since 1994 are:

1. The Reconstruction and Development Programme (RDP), which was launched in 1994. Its primary objective was to remove racial biases in a bid to address poverty and socioeconomic inequalities inherited from the previous regime.
2. The Growth, Employment and Redistribution (GEAR) strategy, introduced in 1996, was a macroeconomic policy framework that aimed to achieve sustained annual real gross domestic product (GDP) growth of 6% or more by the year 2000 and create 400,000 new jobs annually.
3. The Accelerated and Shared Growth Initiative for South Africa (AsgiSA), embarked on in 2006, was a coordinating framework to enable the achievement of new government goals of halving unemployment and poverty between 2004 and 2014. It aimed to accelerate economic growth to an average of at least 4.5% between 2005 and 2009 and further to a sustainable 6% average annual rate between 2010 and 2014.
4. The New Growth Path (NGP) was launched in 2010/11 and gives top priority to boosting employment and tackling poverty and inequality.

The main policies to be used to achieve the NGP targets fall within three broad areas: (1) macroeconomic policies, (2) microeconomic measures and (3) stakeholder commitments, which are envisaged to lead the economy to higher growth. As Box 2.2 shows, this growth will then translate into more jobs through five job drivers: (a) infrastructure (including housing, public works, input manufacture and improved competitiveness); (b) the main economic sectors (including the agriculture value chain, the mining value chain, manufacturing, tourism and high-level services); (c) seizing the potential of new economies (including the green economy and the knowledge economy); (d) investing in social capital (including cooperatives, the social investment community, social initiatives and the public sector); and (e) spatial development (including rural development and African regional development).

Box 2.2: The New Growth Path and job drivers

The Minister of Finance announced several complementary measures to the NGP in the 2011 Budget (National Treasury, 2011). These are:

- Education and skills development remain top priorities in government expenditure
- Investment in infrastructure of over R800 billion over the next three years
- Phased implementation of social security and National Health Insurance reform
- Additional R94.1 billion in government expenditure plans over the next three years.

The NGP targets five million jobs over ten years, distributed as follows:

- Infrastructure development and housing: 250,000 jobs a year to 2015

- Agriculture and agro processing: 500,000 jobs by 2020
- Mining: 140,000 by 2020
- Manufacturing: 350,000 jobs by 2020
- Tourism: 225,000 jobs by 2015
- Green, knowledge and social economies: 660,000 jobs by 2020
- Health, education and policing: 100,000 jobs by 2020
- Regional integration: 150,000 jobs by 2020.

Other far-reaching social security reforms will also be introduced in the period ahead. Government has promised to table proposals on the alignment of social security arrangements and retirement savings in 2011. The 2011 Budget also showed government's intent to introduce an NHI system (see Box 2.3), which is expected to be phased in over 14 years.

Box 2.3: National Health Insurance in South Africa

According to Amnesty International, National Health Insurance (NHI), which is sometimes called statutory health insurance, insures a national population for the costs of health care. It is usually instituted as a programme of health care reform, is enforced by law, and may be administered by the public sector or the private, or by a combination of both. On 11 September 2009, the South African Minister of Health signed a notice establishing the National Health Insurance Advisory Committee (Government Notice No. 903 in Government Gazette No. 32564, dated 11 September 2009). According to the 2011 Budget Review, the NHI will be phased in over 14 years. The 2011 Budget sets aside allocations for specific health service interventions, which are meant to lay the foundation for NHI as part of the Department of Health's Ten-Point Plan for restructuring public health. The full NHI will require more funding than what is currently allocated to public health. Proposals under review for raising money to finance the NHI include:

- Payroll tax
- Higher VAT
- Surcharge on taxable income
- Core payments or user charges.

Government has promised to announce specific funding instruments in the 2012 Budget.

To finance government priorities, expenditure in the 2011 fiscal framework rose by a total of R94.1-billion relative to the baseline of the Medium-Term Expenditure Framework. The respective policy levers and budget set out the means to realise these proposals. The proposed intensified use of expansionary fiscal strategies raises a number of critical policy questions, such as the composition of spending and whether the expanded spending is financed by reductions in government expenditure, by increases in government's budget deficit or by increased taxation. As Mountford and Uhlig (2009) note, these questions are critical for the science of economics and the practice of fiscal policy alike. Hence it is an opportune time to reflect on the current state and likely future of South African fiscal policy. The rest of this chapter provides such reflection, focusing specifically on the impact that the composition of government spending and alternative financing arrangements will have on the economy, for both short and longer term development and on the allocation of resources.

2.3 Comparative Analysis of Scenarios and Results

Increased public expenditures can have a positive impact on the economy. However, assuming all else is held constant, increased spending will translate into a greater debt, which may not be sustainable in the long run. Indeed, increasing spending may mean that the government will either need to reduce spending in the future or increase taxes, in order to get back to its original debt-to-GDP ratio. To evaluate the impact of such policies, the Commission carried out a dynamic analysis of the major policy initiatives. Three simulations were carried out, representing three different financing option scenarios, corresponding to:

- The NGP,
- The MDGs, and
- Reform of the intergovernmental transfer system.

The specifications and the results of these simulations are discussed in the following sections in terms of their current and future effects relative to a “business as usual” (BAU) scenario.²²

2.3.1 New Growth Path

Two simulations representing the NGP were run, both increasing government expenditures by the same percentage up to 2020: Stimulation 1 increases current expenditures, while Stimulation 2 increases investment expenditure. Both simulations assume that government expenditures will go back to their BAU values thereafter. Three different financing mechanisms are envisaged. The first assumption is that government cannot run a greater deficit and therefore taxes would have to be increased in order to compensate for this new spending. Two different types of taxes are alternatively set as endogenous to keep the deficit constant: tax rate on households’ income and taxes on commodities. As a third experiment, all taxes are kept constant and government is allowed to increase its deficit. In other words, the public administration finances its additional expenditures through increased debt.

Table 3 shows the impact of increased current public spending under these three financing mechanisms for three years (2011, 2015 and 2025). It shows that, in order to finance its additional expenditures, government would need to raise actual income tax by 2.65 percentage points in the short run, but this increase would be temporary as income tax rates would slowly go back to their original levels, as public expenditures revert to their BAU values. If government chooses to finance new spending through indirect taxation, an additional tax of 1% on all commodities will be necessary to keep the deficit constant.

As in the direct taxation scenario, this new tax would no longer be necessary in the longer run, for the same reasons. Under all these financing mechanisms, the impacts on macroeconomic variables are rather small. In the short run, real GDP stays about the same as in the BAU, but impacts on investment are bigger, thus affecting the long-run value of GDP. This impact on investment is greater under the income tax and the debt financing mechanisms because of the greater effect on savings from households and public deficit respectively. Although an indirect tax affects investment less in the short run, its impact is more even across periods, thus leading to a similar decrease in real GDP in the longer run.

Table 3. Simulation 1 – Impact of increased current public expenditures on macroeconomic variables (deviation from BAU in %)

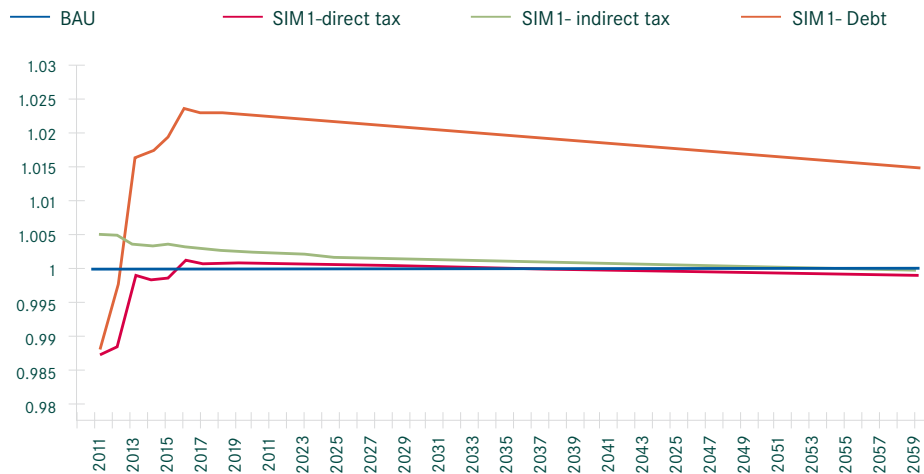
	Direct tax financing			Indirect tax financing			Debt financing		
	2011	2015	2025	2011	2015	2025	2011	2015	2025
GDP	1.18%	0.07%	-0.10%	-0.54%	-0.42%	-0.23%	1.14%	0.04%	-0.12%
GDP deflator	1.19%	0.38%	0.11%	-0.56%	0.15%	0.16%	1.15%	0.35%	0.10%
Real GDP	-0.01%	-0.31%	-0.20%	0.02%	-0.57%	-0.39%	-0.01%	-0.32%	-0.21%
Real consumption	-1.07%	-0.71%	-0.24%	-1.65%	-0.81%	-0.40%	-1.09%	-0.74%	-0.27%
Real investment	-5.56%	-0.77%	-0.05%	-2.54%	-1.27%	-0.28%	-5.69%	-0.81%	-0.07%
Debt	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	1.97%	2.08%
Gov. expenditures	5.92%	1.22%	0.03%	6.23%	1.36%	0.07%	5.91%	1.43%	0.25%
Increase in tax rate	2.65%	0.63%	0.06%	1.01%	0.26%	0.04%	n.a.	n.a.	n.a.

Source: FFC calculations

²² “Business as usual” in macroeconomic terms is taken here to mean the natural trend of the economy and economic policy. In other words, this is the trajectory the economy would have followed without the positive shocks or deliberate interventions that are simulated.

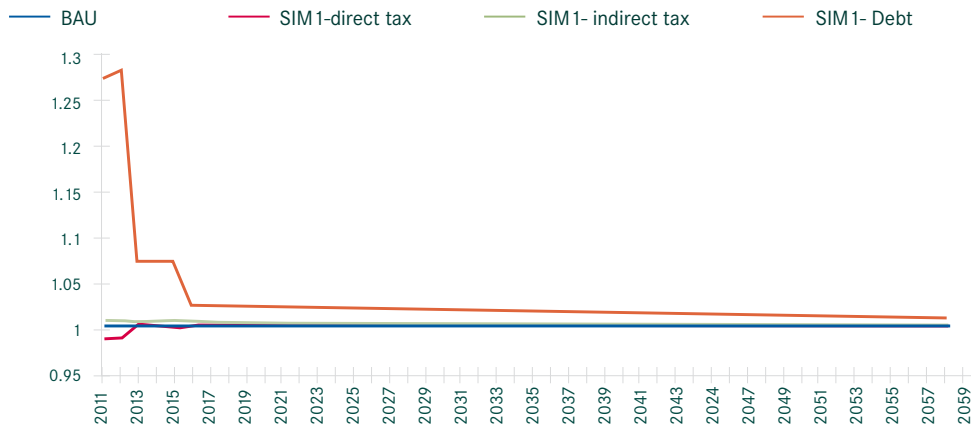
Figures 4 and 5 show the debt-to-GDP ratio and the deficit-to-GDP ratio respectively, over the next 60 years for Simulation 1. Although the impacts of the three financing mechanisms are about the same for the macroeconomic variables, these two ratios do vary quite differently. Indeed, in all cases the ratios would be greater than they would have been without the increased current spending. However, the impact is very much more important if the government chooses to finance its extra spending through increased debt. In the very long run, the debt-to-GDP ratio is 1.5% greater than it would have been and close to 1% for the deficit-to-GDP ratio. In other words, increased government spending for a short period of time will have a long-lasting impact on these two indicators.

Figure 4. Simulation 1 – Impact of increased public current expenditure on debt-to-GDP ratio (BAU = 1)



Source: FFC calculations

Figure 5. Simulation 1 – Impact of increased public current expenditure on deficit-to-GDP ratio (BAU = 1)



Source: FFC calculations

It is worth mentioning that increased public spending in education and health would probably have a positive impact on the productivity of the factors of production. A more educated and healthy work force is likely to be more productive. However, in its current version, the model does not attempt to capture this impact. Further econometric work on how public spending affects productivity would be required in order to take this aspect into account. In other words, the results presented here could be considered the worst case scenario, as any positive impact on productivity would generate a positive impact on GDP and other economic variables. Furthermore, assuming all else is held constant, a positive impact on GDP would translate into smaller debt-to-GDP and deficit-to-GDP ratios. In Simulation 2, the government increases its investment spending (see Table 4). Although the amplitude of the shock is the same as in Simulation 1, current expenditures represent a greater part of public expenditures. It is thus not surprising to see that the required rise in taxes (direct or indirect) is much less than the one presented in Table 3. Similarly, impacts on real GDP in the short run are negligible. However, as these expenditures finance investment, thus increasing total infrastructure and output, the GDP is positively affected in the medium and longer run. In fact, under a rigid deficit, taxes would eventually go down in the future as a result of greater production in the economy.

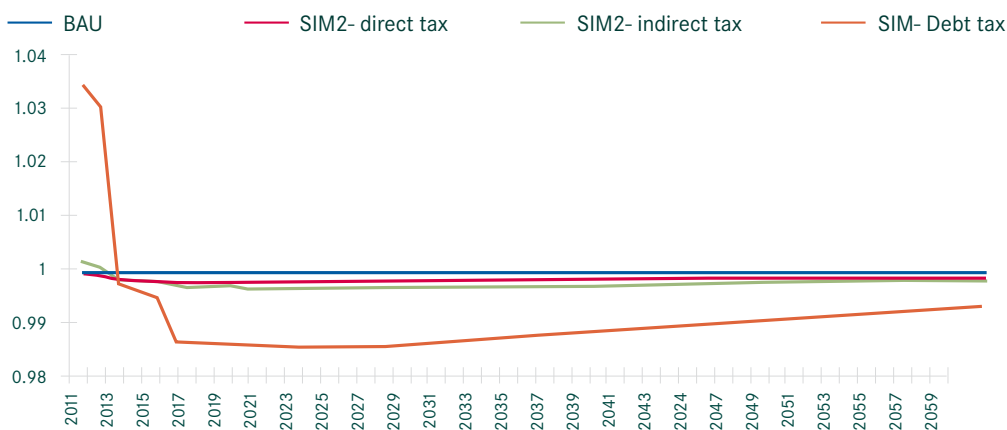
Table 4. Simulation 2: Impact of increased public investment (2011–2015) on macroeconomic variables (deviation from BAU in %)

	Direct tax financing			Indirect tax financing			Debt financing		
	2011	2015	2025	2011	2015	2025	2011	2015	2025
GDP	0.02%	0.15%	0.17%	-0.22%	0.16%	0.26%	0.02%	0.15%	0.17%
GDP deflator	0.02%	-0.34%	-0.27%	-0.22%	-0.33%	-0.25%	0.02%	-0.34%	-0.27%
Real GDP	0.00%	0.49%	0.44%	0.00%	0.49%	0.51%	0.00%	0.49%	0.44%
Real consumption	0.07%	0.30%	0.37%	-0.09%	0.23%	0.37%	0.07%	0.30%	0.38%
Real investment	-0.21%	0.89%	0.51%	0.46%	1.12%	0.79%	-0.25%	0.88%	0.51%
Debt	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.17%	-0.15%
Gov. expenditures	0.73%	0.07%	-0.07%	0.76%	0.06%	-0.10%	0.73%	0.08%	-0.08%
Increase in tax rate	0.34%	-0.03%	-0.11%	0.13%	-0.01%	-0.04%	n.a.	n.a.	n.a.

Source: FFC calculations.

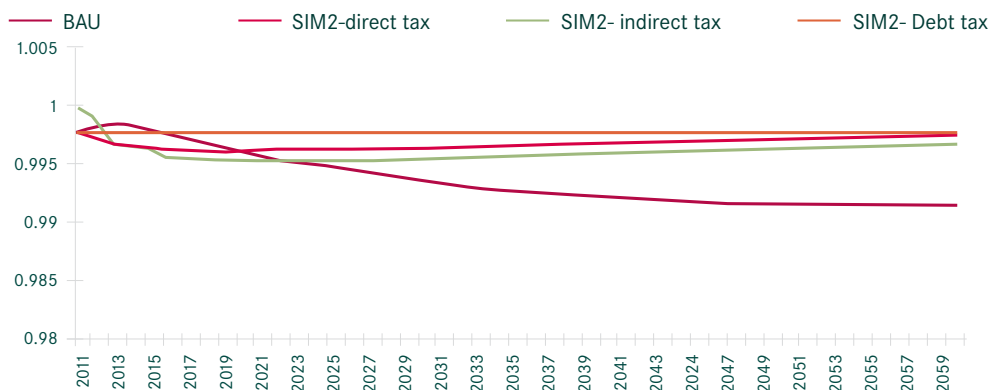
Figures 6 and 7 display different trends for the debt-to-GDP and deficit-to-GDP ratios to those seen in Simulation 1. In fact, as the GDP grows over time, a constant deficit translates into an improvement of both ratios over time. More surprisingly, this improvement is the greatest under the debt-financed scenario. In fact, keeping the same tax rates throughout the model horizon (2011–2059) would increase government revenues in the longer run and thus allow for a smaller deficit in the future.

Figure 6. Simulation 2 – Impact of increased public investment on debt-to-GDP ratio (BAU = 1)



Source: FFC calculations

Figure 7. Simulation 2 – Impact of increased public investment on deficit-to-GDP ratio (BAU = 1)

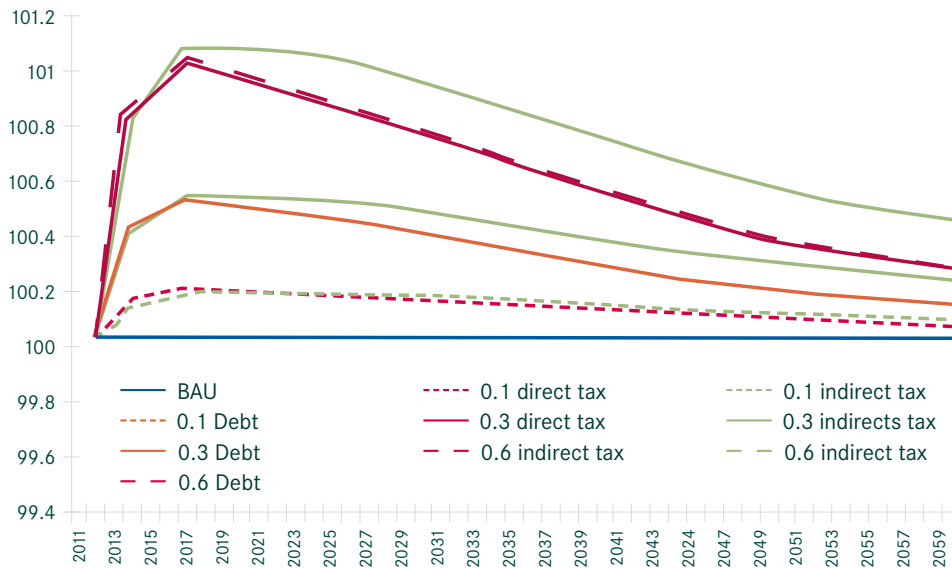


Source: FFC calculations

To test the robustness of the model to the elasticity values, Simulation 2 was run under the three different financing mechanisms using the lowest (0.1) and the highest (0.6) values of elasticities obtained from the South African econometric literature (Abedian and Van Seventer, 1995; Ayogu, 2005; Bogetic and Fedderke, 2005). Figures 8 and 9 present

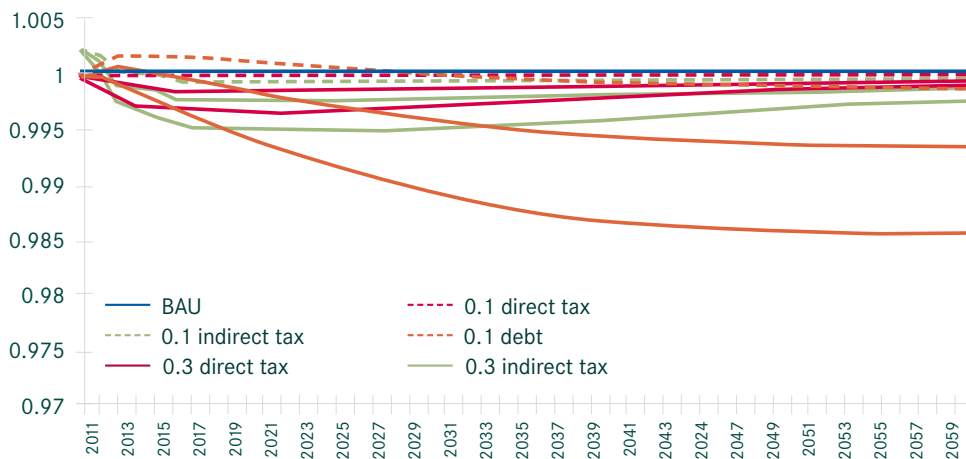
the impact of increased public investment on real GDP and debt-to-GDP ratio respectively. The results are qualitatively similar, whatever the value of the elasticity of the total factor productivity to infrastructure. In fact, the conclusions discussed above still hold when comparing the different financing schemes. As might be expected, the magnitude is somewhat different, but the impacts differ in a range of less than 1% and thus are not significant.

Figure 8. Simulation 2 – Impact of increased public investment on GDP (BAU = 100)



Source: FFC calculations

Figure 9. Simulation 2 – Impact of increased public investment on debt-to-GDP ratio (BAU = 1)



Source: FFC calculations

2.3.2 Attaining the Millennium Development Goals

A key question that needs answering is whether South Africa can achieve the MDGs, considering that 2015 is just a few years away. As discussed earlier, some of the MDGs have already been attained, but for the health-related ones (MDGs 4 and 5) attainment seems unlikely, even infeasible (UNDP, 2007, 60). Therefore, this section looks at how much additional public spending is needed to reach some of the goals. Moreover, some MDGs have a feedback effect on other MDGs. For instance, the HIV/AIDS MDG (MDG6), which will probably be reached, directly affects MDG4 and MDG5 (National Treasury, 2011). Indeed, more mothers who are HIV positive die giving birth than HIV negative ones. The same is true for under-five mortality (UNDP, 2007). Thus, investing in this particular MDG will also have positive effects on the other MDGs. The purpose is not to impose any hierarchical structure of importance or

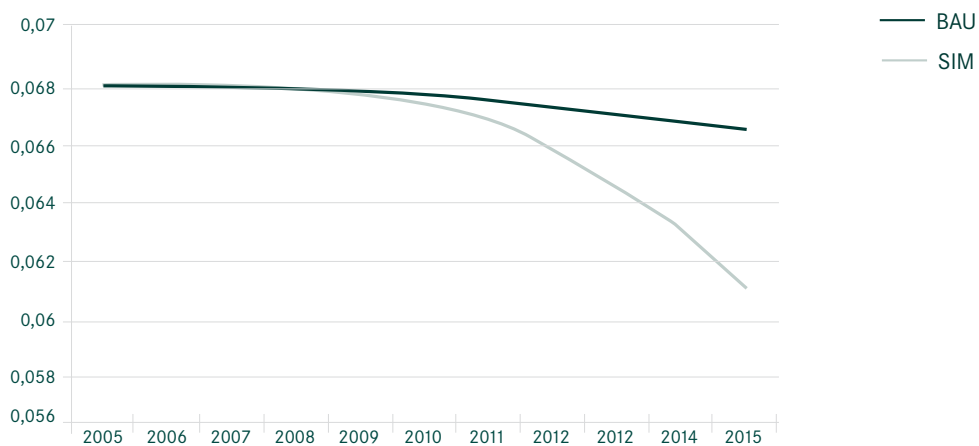
preference on the MDGs, but to try to simulate an improvement in the general situation within the time constraints. Simulations were run for the following three scenarios:

- Scenario 1: How much would it take to reach MDG2 (universal education) by 2015?
- Scenario 2: How much would it take to reach MDG6 (HIV indicators) by 2015?
- Scenario 3: Can MDG6 be reached through indirect tax financing by 2015?

(a) Scenario 1. How much would it take to reach MDG2 (universal education) by 2015?

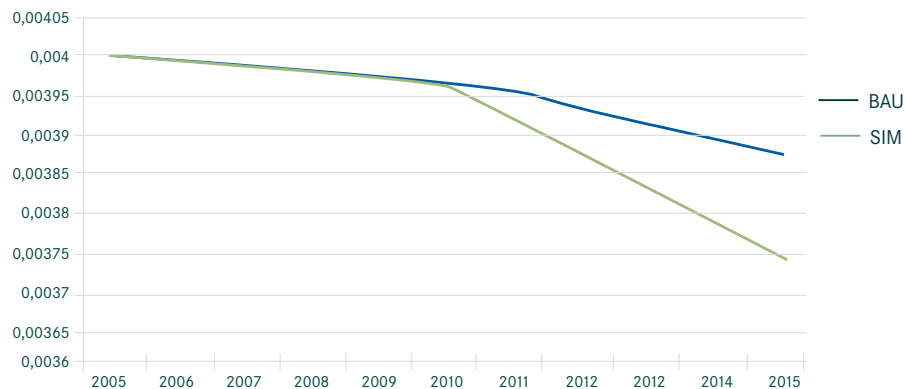
This scenario consists of reaching MDG2 (universal education) and seeing the cost in terms of primary education public spending. As explained earlier, improving the skills level of the population will have positive spillovers for other MDGs, by creating more skilled people for the economy in the long run. However, the assumption is that government borrows from domestic agents, and no corresponding tax or expenditure adjustment is available elsewhere to finance the policy. Increasing public spending in education for the primary education sector is not only about increasing teachers' salary. Increasing the education budget in fact means that government hires more teachers, gives subsidies to children for transport, supplies teaching aids, builds new safer schools, and so on. This increase in government's spending will have an impact on the rest of the economy as well as on the other MDGs. Figures 10, 11 and 12 below show the positive impact the policy has on the other MDGs.

Figure 10. Impact on MDG4 (deviation from BAU in %)



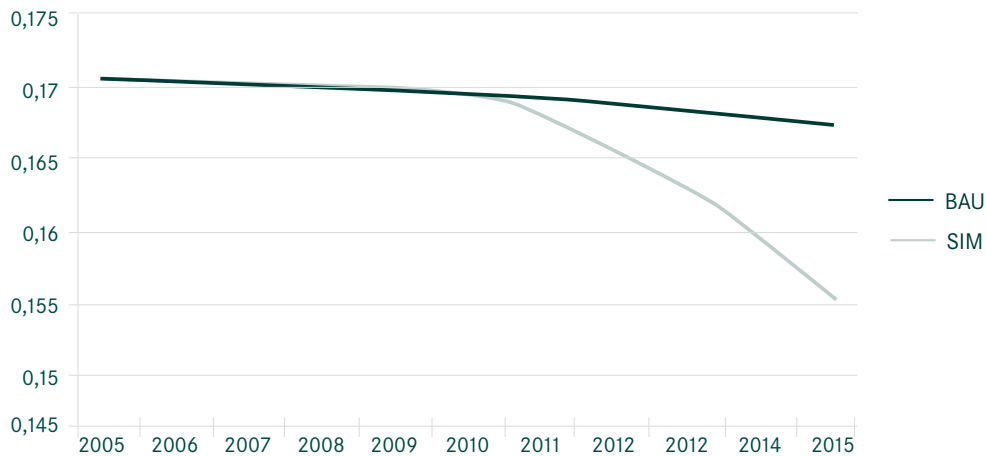
Source: FFC calculations

Figure 11. Impact on MDG5 (deviation from BAU in %)



Source: FFC calculations

Figure 12. Impact on MDG6 (deviation from BAU in %)



Source: FFC calculations

As mentioned previously, increased public spending also has an impact on the whole economy. As government hires more people (to teach, to build new schools, etc.), the effect on labour demand, and therefore on unemployment rates, is positive. A general equilibrium effect occurs, which means that government carries the other sectors of the economy through backward and forward linkages. The categories that really benefit from the policy are highly skilled and semi-skilled labour, but the effect is negligible for the low-skilled workers. The impact on households' income is also positive, as their spending on consumption also increases, by 1.14%, as do direct taxes (1.17%).

Government's income increases, notably due to the increase in households' direct taxes and in indirect taxes (as households consume more commodities). However, not surprisingly government savings decrease due to the absence of fiscal reform to compensate for the policy. The corresponding value is small, which explains the huge variation. Increased government borrowing, notably from domestic firms, has an impact on domestic investment, as firms are normally the main contributors to total investment, which declines. It is a typical crowding-out effect. GDP increases slightly in this scenario.

Summing up this simulation, the increase in public expenditures on education has a very positive short-term effect on employment because of the strong increase in the labour demand of the education sectors. The impact on student behaviour is also positive, with the number of drop-outs falling. This policy also has long-term beneficial impacts, notably on the education sector and through improved skilled labour endowment of households. However, over a longer timeframe, the education policy results in an increase in the unemployment rate of skilled workers.

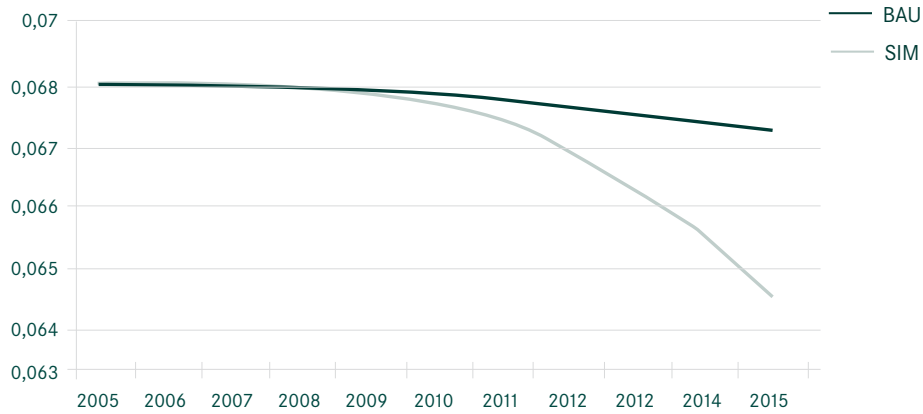
Moreover, the policy is expensive for some sectors, causing them to hire fewer people and reduce their production, whereas one would have hoped that the policy could generate enough qualified people who could find a job and pay taxes. Government could decide to increase households' both direct and indirect taxes to finance this policy. Such tax simulations indicate that similar positive effects would be felt in the education system, but the tax's introduction is quite bad for the economy. In the long run, unemployment and production of all sectors would decrease due to the tax increase.

(b) Scenario 2. How much would it take to reach MDG6 (HIV indicators) by 2015?

This scenario assumes that MDG6 (HIV indicator) is reached in 2015. According to the South African MDG Report, this objective is attainable (UNDP, 2007, 75). In order to reach the target, government increases its consumption for health services. In other words, it builds extra hospitals where necessary, improves the transport system to enable people to reach their health centres, allowing more people to access free treatments and so on, and implements the Department of Health's Ten-Point Plan effectively.

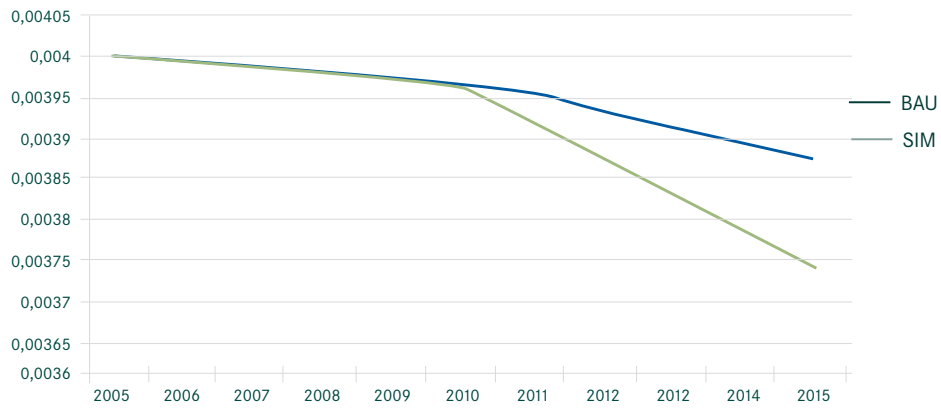
As previously mentioned, targeting MDG6 has positive knock-on effects for other MDGs, especially MDG4 and MDG5. Figures 13 and 14 show these effects.

Figure 13. Impact on MDG4



Source: FFC calculations

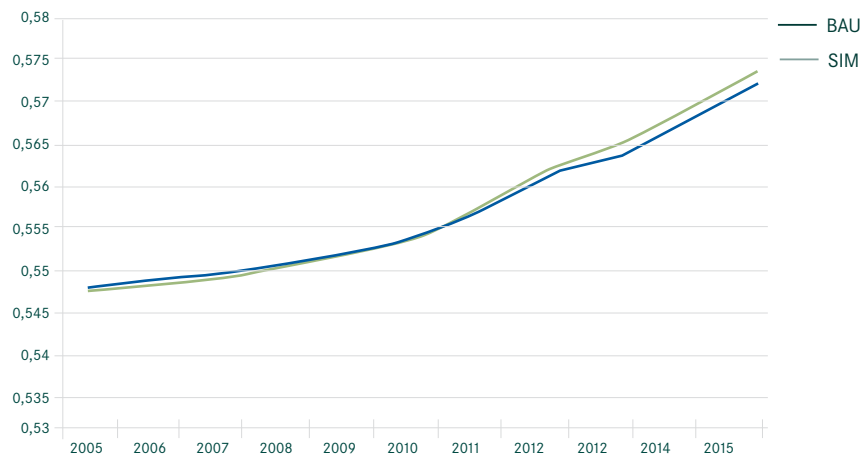
Figure 14. Impact on MDG5



Source: FFC calculations

The general improvement in health also affects the education indicator (MDG2), as children who are not sick can go to school and follow a normal school life. However, as Figure 15 shows, the impact is not as strong as for the previous indicators.

Figure 15. Impact on MDG2

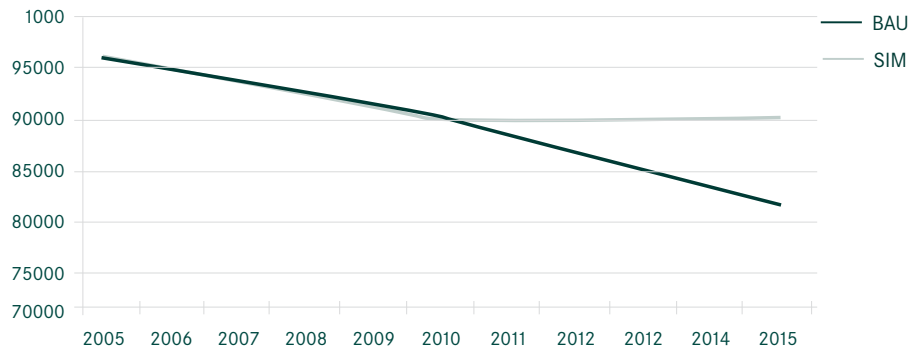


Source: FFC calculations

The implementation of the policy has positive effects on the entire economy. Indeed, government needs to hire people in order to build new care centres, as well as new doctors and nurses, which has a positive impact on the level of employment. The results clearly show that unemployment decreases for each type of worker and especially for skilled and highly skilled workers.

The impact on households is also positive, as their income increases by 0.63% in 2015, and as a result they start saving. The level of direct taxes collected by government also increases, which leads to an increase in government's income in 2015. Again in this scenario, government savings decrease by 2015, as in order to finance its policy the government borrows from the domestic market. Figure 16 clearly shows that from 2011 government increases its borrowing.

Figure 16. Impact on domestic borrowing (deviation from BAU in %)



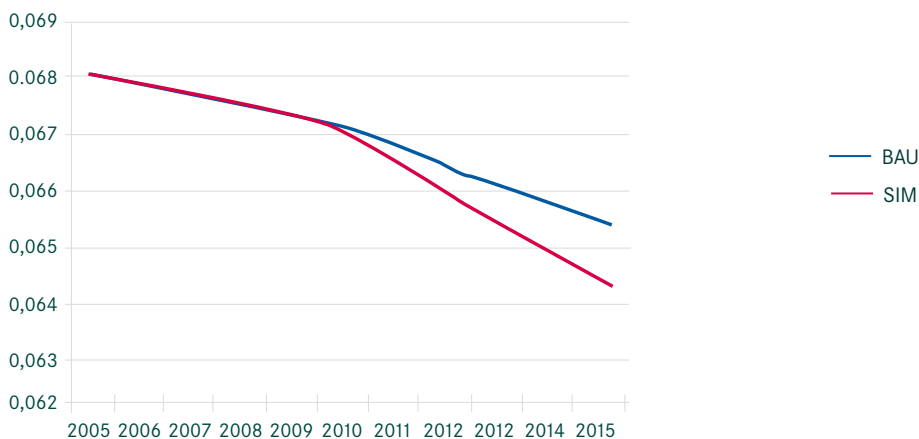
Source: FFC calculations

This increase in public borrowing, mainly from the domestic firms, has an impact on total investment. As in the previous scenario, increased public expenditure has a crowding-out effect. In order to avoid this crowding-out effect, and the bad consequences of a negative impact on total investment in the long run, the same stimulation was run. This time a fiscal reform was added, so that government will not have to borrow from the domestic economy.

(c) Scenario 3. Can MDG6 be reached through indirect tax financing by 2015?

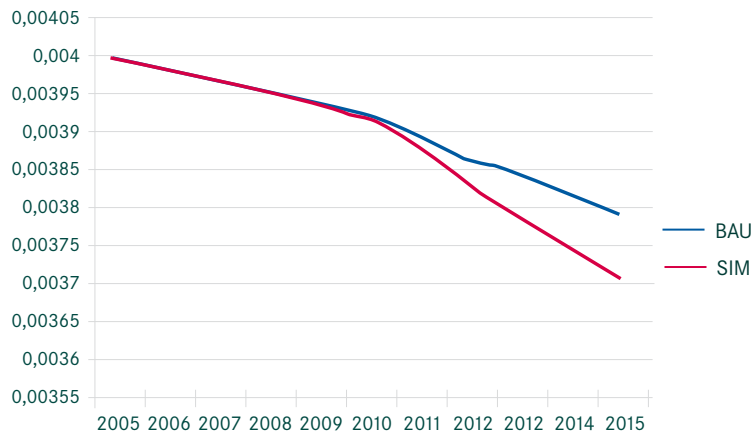
The scenario consists of reaching MDG6 by increasing government's consumption in health services, but adding a uniform tax on commodities to keep government's deficit constant. As in the previous scenario, the health-related MDGs (4 and 5) improve and child and maternal mortality decrease (Figures 17 and 18). However, a slight decrease is observed in MDG6 (Figure 19), as this indicator depends on the graduation rate, which relies on several proxies. Among them, households' per capita consumption decreases sharply, due to the tax financing option adopted. However, the decrease is almost undetectable, dropping from 0.588 to 0.584.

Figure 17. Impact on MDG4 (deviation from BAU in %)



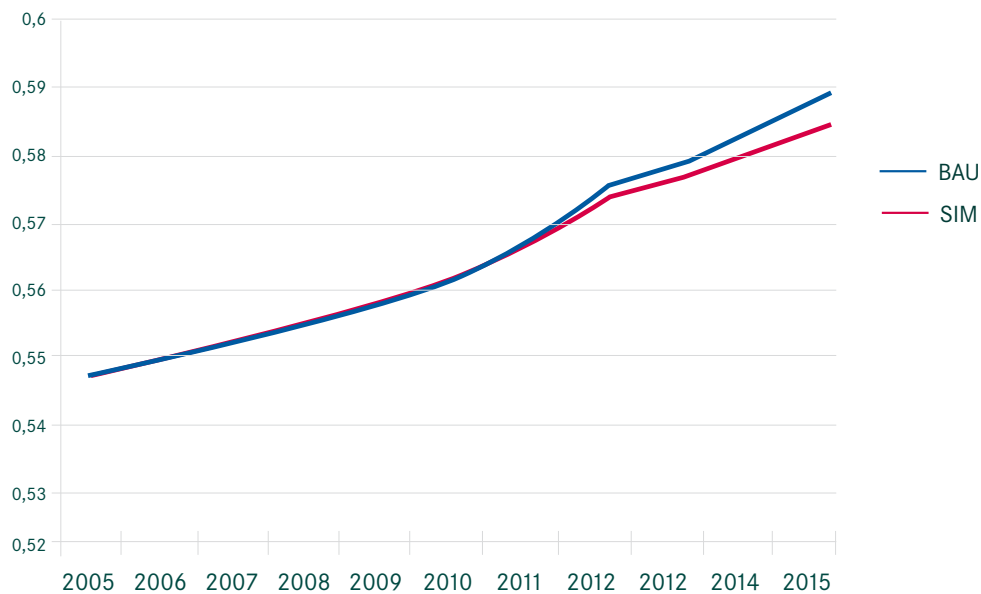
Source: FFC calculations

Figure 18. Impact on MDG5 (deviation from BAU in %)



Source: FFC calculations

Figure 19. Impact on MDG6 (deviation from BAU in %)



Source: FFC calculations

As in the previous simulation, government's increased consumption in health services stimulates activity in the whole economy and leads to an increase in labour demand, which results in an increase in households' income. However, due to the indirect tax, real consumption per capita decreases by 0.4% in 2015. The impact on government's income is positive, as it finances the policy by setting an indirect tax. The drop in households' consumption has a negative impact on total production, which decreases. The wage rate and the rate of return of capital consequently decrease. The decrease in the rate of return affects firms' incomes, and consequently the transfers²³ they make and their savings. Here investment is affected by the decrease in firms' savings, whereas in the previous simulations, it was affected by the decrease in government's savings. The impact on GDP (at basic prices) is hardly noticeable.

23 This explains why households' transfer and government's transfer incomes decrease.

2.3.4 Reforming the intergovernmental fiscal transfer system

To analyse the effectiveness of reforms to the intergovernmental fiscal transfer system, a simulation was run that reduced these transfers across the board assuming a low and high interprovincial factor mobility rate. This has heterogeneous effects on the well-being of households, as measured by changes in the equivalent variation of initial consumption expenses. Although, nation-wide, welfare does not change significantly (0.6% in both scenarios), its distributional effect among provinces is important. Changes in welfare are negative in four provinces: Limpopo, the Eastern Cape, KwaZulu-Natal and the North West, but positive in the other five: Mpumalanga, the Northern Cape, the Free State, Gauteng and the Western Cape.

A negative change in welfare is expected in Limpopo and the Eastern Cape, as these two provinces are initial net receivers of the intergovernmental revenue transfers and so experience a loss of revenues. KwaZulu-Natal and the North West Province also experience a reduction in welfare, as they lose transferred revenues. Positive changes in welfare in Mpumalanga, the Northern Cape, the Free State, Gauteng and the Western Cape are due to the additional revenue spending in these provinces because of the partial cancelling of revenues initially transferred to other regions.

When regional disparities are measured (using Theil indices), in particular within and between provinces, the overall regional disparity increases by 5–6%. Although the within-province disparities remain unchanged, the results vary from one province to another. In general, the effects are more pronounced among the bottom income groups of households (Table 5). Income disparities between the top and bottom income categories increase in Limpopo and the Eastern Cape, provinces that initially receive net positive intergovernmental revenue transfers. The reduction of revenue transferred to other provinces – and consequently an increase in national government spending in the province – has more benefit for the bottom income groups in the Northern Cape, Mpumalanga and the Free State. A similar trend is observed for the two scenarios.

Table 5. Impact of change in intergovernmental transfer arrangements on equivalent variation (% change of initial consumption expenses)

Household category	Eastern Cape	Free State	Gauteng	KwaZulu Natal	Limpopo	Mpumalanga	Northern Cape	North West Province	Western Cape
P1	-27.2	9.8	5.9	-3.4	-39.8	14.4	10.8	-2.3	6.3
P2	-26.0	9.8	5.6	-3.8	-36.6	12.5	8.7	-2.5	6.0
P3	-26.6	9.9	5.2	-3.7	-37.3	12.9	8.4	-2.2	6.3
P4	-26.3	9.9	4.8	-3.6	-37.8	13.1	9.3	-2.2	6.6
P5	-26.5	9.8	5.1	-3.7	-36.8	12.9	9.0	-2.3	6.4
P6	-26.7	10.0	4.8	-3.6	-38.2	13.4	9.9	-2.2	6.3
P7	-27.8	10.0	5.3	-3.4	-39.4	12.7	10.9	-2.3	6.2
P8	-27.9	10.1	4.8	-3.5	-40.0	13.1	16.2	-2.3	6.5
P9	-28.1	10.4	4.4	-3.4	-41.6	14.2	15.1	-1.9	6.9
P10	-35.4	11.6	4.5	-3.7	-51.7	17.9	13.8	-1.8	7.0
P11	-41.9	12.4	6.9	-3.9	-49.8	17.3	18.5	-2.5	7.2
P12	-31.5	13.9	5.2	-3.7	-42.2	15.4	54.8	-1.9	7.4
ALL	-30.4	11.3	5.1	-3.7	-41.7	14.8	14.3	-2.1	7.0

Source: FFC calculations

Decreasing intergovernmental fiscal transfers would therefore lead to an increase in regional disparities. Provinces like Limpopo and the Eastern Cape witness significant welfare losses compared to other provinces. Similarly, low-income households are heavily hit compared to the middle- and high-income households in these provinces. Provinces that were initially transferring revenue witness welfare gains and falling income disparities.

These findings suggest that decreases in grants play an important role in attaining the equity objective. Thus, the current intergovernmental transfer system is effective and contributes to realising the national government equity goal, and indeed achieving social cohesion. However, if fiscal restraint is widely perceived to be associated with not only a higher net tax burden on current generations, but also a more unequal distribution of their after-tax incomes, it would seem difficult to agree on painful measures to keep the interregional budgets balanced. Such concerns about intragenerational equity appear to be well justified if deficit reduction is implemented through cuts in social assistance or less regressive taxes. Not least from a South African welfare state perspective, a programme of fiscal consolidation could easily conflict with ambitious (re)distributive objectives.

The overall GDP effect is small; indeed, in this scenario, GDP falls by 0.1%. Higher provincial integration lowers the adverse effect of reducing intergovernmental transfers, but provincial disparities are more important. The group of provinces receiving revenues within the system witnesses a fall in GDP, which is particularly significant in Limpopo and the Eastern Cape. GDP falls slightly in KwaZulu-Natal and the North West Province. Regions transferring revenues (the Northern Cape, Mpumalanga, the Free State, Gauteng and the Western Cape) see their GDPs increase.

2.4 Recommendations

The New Growth Path is an accelerated investment programme in social and economic infrastructure and general government spending. South Africa has made some progress in achieving its MDGs. There are, however, some gaps that need attending to: inequality, poor educational attainment, child mortality and maternal mortality. The intensified use of expansionary fiscal strategies in this way raises a number of critical policy questions, such as the composition of spending and whether it matters that the expanded spending is financed by reductions in government expenditure, or by increases in government's budget deficit, or by increased taxation? To attempt to answer these questions, the Commission used intertemporal economy-wide models with elaborated government features.

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.

PART 2: VIBRANT URBAN ECONOMIES

Chapter 3

ANALYSIS OF LOCAL GOVERNMENT REVENUE AND EXPENDITURE

3.1 Introduction

Like most aspects of South African society, municipalities are diverse and operate in unique social, demographic and economic spaces. These characteristics have a significant impact on municipal performance and the subsequent strategies required to ensure a well-functioning local government sphere. Chapter 3 analyses the trends and performance of municipal revenues and expenditures against the unique spatial, social and economic characteristics of the various municipalities. To this end, municipalities were grouped according to their spatial characteristics, as depicted in Table 6, which appropriately distinguishes between the economically vibrant urban centres and the sparsely populated rural areas of the country.

Table 6. Categorisation of municipalities used in analysis

Category	Number	Description
Metropolitan Municipalities	6	As per the constitutional definition of category A municipalities. Large metropolitan cities
Secondary Cities	21	Local municipalities with the highest operating budgets and a large urban spatial pattern
Large Towns	29	Local municipalities that consists of a large town
Medium to smaller Towns	111	Local municipalities that consists of several smaller urban settlements
Rural Municipalities	70	Local municipalities that are largely rural with large sprawling settlements
District municipalities without major powers	25	Category C municipalities without the water and sanitation service powers and functions
District municipalities with major powers	21	Category C municipalities with the water and sanitation service powers and functions
Total	283	Local government sector

Source: *Local Government Turnaround Strategy (2009)*

The two sides of the budget – revenue and expenditure – play equally important roles in the country's economy and social well-being. Therefore, this chapter carefully examines the revenue and expenditure performance of municipalities between 2003/04 and 2008/09. Data was sourced from a wide range of sources – in particular National Treasury's Local Government Database for 2009/10. With respect to revenue, special emphasis is placed on revenue performance and the challenge of municipal consumer debt. On the expenditure side, the drivers of municipal expenditure are assessed alongside the efficiency with which local authorities are spending limited resources.

3.2 Overview of Municipal Revenue Trends

To fund constitutionally mandated expenditure responsibilities,²⁴ municipalities rely on two main sources of revenue: own revenue and intergovernmental fiscal transfers. With respect to own revenue sources, municipalities are constitutionally accorded an array of fiscal instruments. These revenue instruments include property rates, user charges for municipal services rendered and other local taxes.²⁵ Local government in South Africa is generally self-financing, deriving

²⁴ As detailed in Part B of Schedules 4 and 5 of the Constitution.

²⁵ In addition, it should be noted that under Section 230 of the Constitution, municipalities are also assigned borrowing powers, which are an important source of revenue particularly for infrastructure.

an average of 73.4% of total real operating revenues from own revenue collection over the period 2003/04 to 2008/09. Due to economic inequalities across the country, certain municipalities have less own revenue resources. Therefore, intergovernmental transfers play an important role in bridging these inequalities to ensure that all municipalities are well funded to fulfil their service delivery mandates. Over the period under review, intergovernmental fiscal transfers contributed on average 26.6% to total municipal revenue.

As Table 7 shows, total municipal revenue grew by a real annual average rate of 13.2% between 2003/04 and 2008/09. This growth was driven largely by strong increases in intergovernmental transfers to enable, among other things, greater access to basic services, the replacement of the Regional Service Council (RSC) levy²⁶ and preparations for the 2010 FIFA World Cup™.

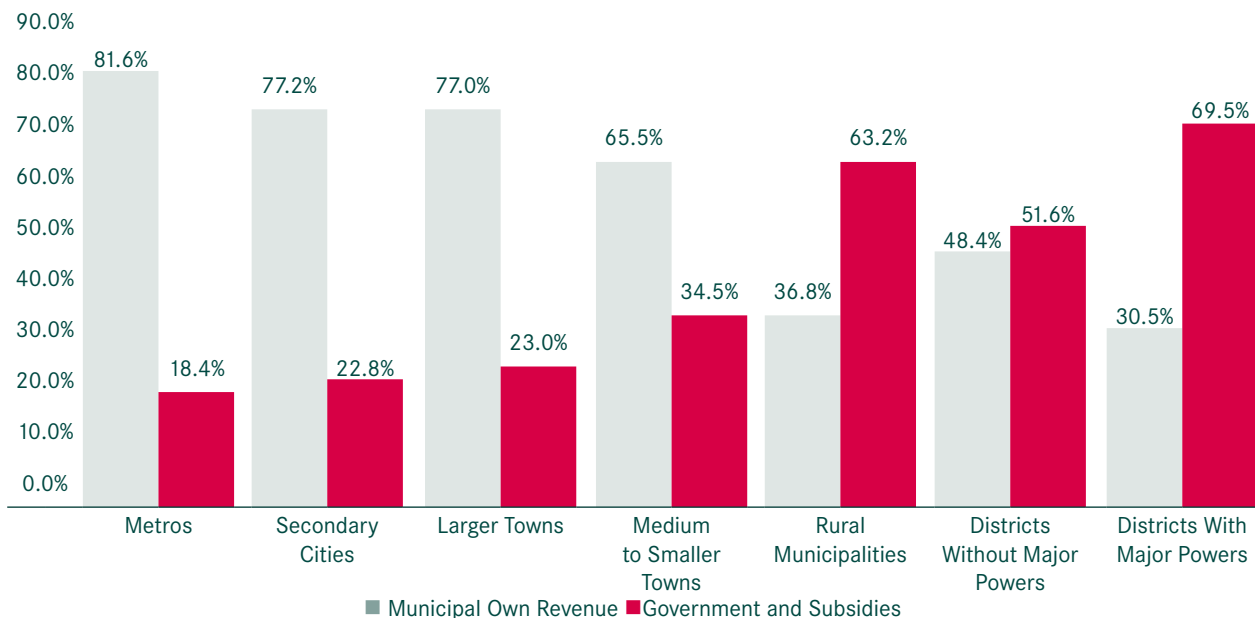
Table 7. Performance of municipal revenue over the period 2003/04 to 2008/09

	Outcome (R'million)						Real Annual Average Growth
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2003/04-2008/09
Total Municipal Own	66,426	70,037	86,780	84,830	89,486	94,921	7.4%
Total Government	13,492	18,900	25,106	35,200	44,638	53,882	31.9%
Total Municipal	79,919	88,937	111,887	120,031	134,125	148,803	13.2%

Source: FFC calculations based on National Treasury Local Government Database, 2010/11

Figure 20 illustrates the real average contribution of own revenue versus intergovernmental transfers to total municipal revenue per municipal category. On average the revenue bases of metros, secondary cities, larger towns and medium to smaller towns are dominated by own revenue (derived mainly from property rates and user charges), whereas rural municipalities and districts tend to rely heavily on intergovernmental transfers.

Figure 20. Real average contribution of main revenue sources to total municipal revenue over the period 2003/04 to 2008/09



Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

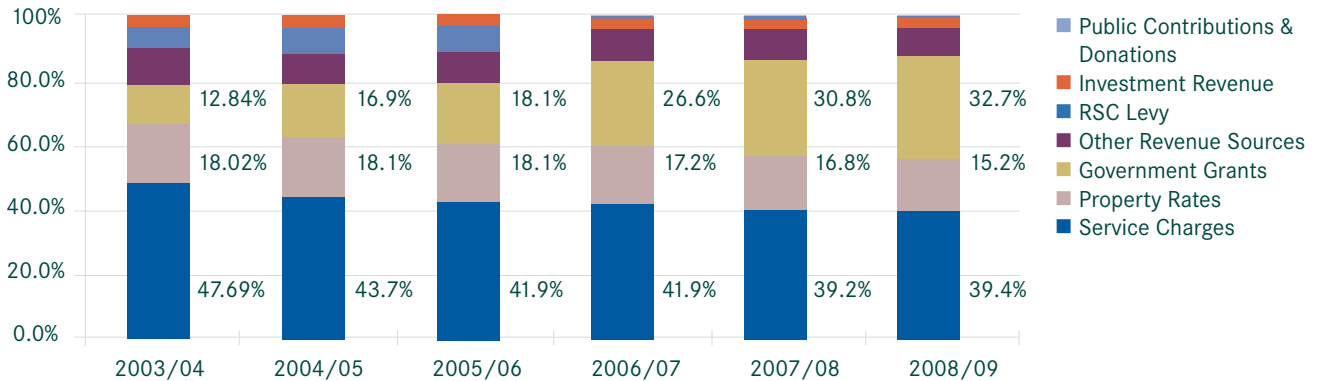
26 The RSC levy was a local government tax afforded to category A and C municipalities and was abolished from the 2006/07 financial year. It was replaced by an interim grant up until 2009/10; whereupon Category A municipalities were given a share of the general fuel levy (also supplemented by the VAT zero-rating of municipal property rates), and the grant continues for Category C municipalities.

Total municipal revenue can be subdivided into two broad categories, operating and capital revenue.

3.2.1 Municipal Operating Revenue

As at 2008/09, total municipal operating revenue recorded real annual growth of 7.7%, which is slower growth relative to the 8.3% of the previous year. Municipal operating revenue is comprised of several components: service charges, government grants and subsidies, property rates, other revenue sources, RSC levies, investment revenue and contributions and donations from the public. Figure 21 illustrates the contribution of these various items to total operating revenue.

Figure 21. Contribution of main revenue sources to total municipal operating revenue over the period 2003/04 to 2008/09



Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

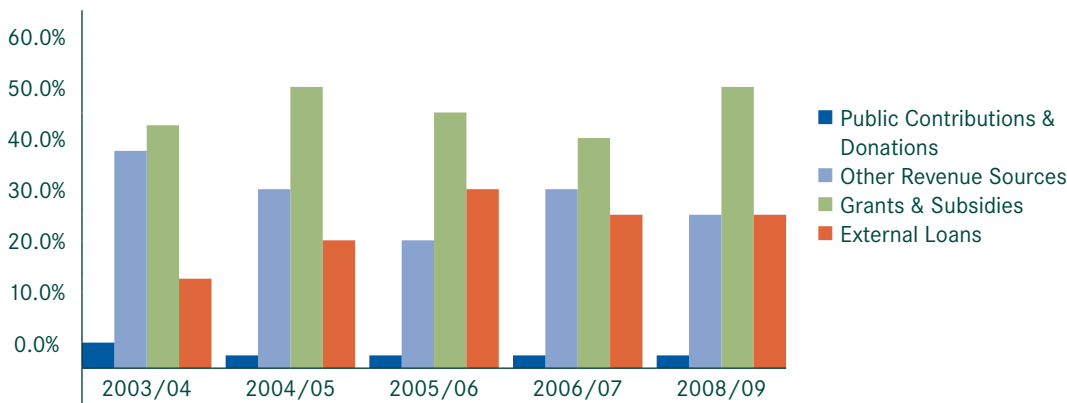
Revenue derived from services charges made up the largest component of operating revenue, particularly for metros, secondary cities, larger towns and medium to smaller towns. In 2003/04, service charges generated over half the total operating revenue within these four municipal categories. As at 2008/09, the proportion contributed by service charges had declined, alongside strong increases in intergovernmental transfers. As explained in Section 3.2.3 below, non-payment for municipal services, particularly water, may be one cause for the decline in service charges. The decline in own revenue generation can also be partially explained by the financial crisis of 2008. On the other hand (and as noted in Section 3.2 above), increases in intergovernmental transfers is largely the result of government's drive to ensure greater access to basic services, the replacement of the RSC levy and preparations for the 2010 FIFA World Cup™. In the case of rural and district municipalities, government grants, specifically the local government equitable share (LES) allocation, are the dominant operating revenue source. District municipalities have limited services to levy, and thus national transfers are the main source of operating revenue.

Metros and local municipalities (secondary cities, larger towns and medium to smaller towns) are allowed to levy property rates. This item contributed, on average, 17.2% to total municipal operating revenue over the period under review. During 2008/09, the contribution of property rates to total operating revenue declined slightly. This can partially be explained by the financial crisis of 2008, when the property market took a knock from the crisis, and alludes to the vulnerability of municipal property revenues to economic shocks. Other revenue sources also made a significant contribution to total municipal operating revenue. For the sake of transparency, municipalities need to be specific about what exactly comprises "other revenue".

3.2.2 Municipal Capital Revenue

In aggregate terms, funding for capital increased by a real annual average of 26% between 2003/04 and 2008/09. One of the primary reasons for this strong real growth was increased funding to municipalities in preparation for the hosting of the 2010 FIFA World Cup™. Capital revenues are derived from four main sources: government grants and subsidies; other own revenues; external loans; and public contributions and donations. Figure 22 illustrates the contribution of these various revenue sources to aggregate municipal capital revenue.

Figure 22. Real composition of total municipal capital revenue



Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

The contribution of grants and subsidies to capital revenue is significant across all municipal categories but is most pronounced for districts with major powers, rural and medium to smaller municipalities. For example, in 2008/09 government grants and subsidies contributed 86.0%, 70.2% and 57.7% respectively to total capital revenue in these municipal categories. On the other hand, metros are increasingly making use of the borrowing powers at their disposal.²⁷ Over the period under review, external loans contributed on average 33% to total capital revenue in metros. The “other” component constitutes own income of municipalities and contributes a significant portion to total municipal capital revenues across all municipal categories. As with municipal own revenue, municipalities need to be more transparent as to what the term “other” entails.

3.2.3 Performance of Revenue Collection and the Challenge of Municipal Consumer Debt

Municipal consumer debt refers to non-payment of property rates, fees/charges for services provided by municipalities (for example water, sanitation, electricity and refuse removal) and various other financial obligations to municipalities (including, for example, traffic fines and rental housing payments). Non-payment emanates mainly from households, businesses and government. A fourth group is categorised as “other”, and its contents varies from municipality to municipality; an example of what might be listed in this category is debt from insolvent estates. It should be noted that the practice of using “other” is contrary to the reporting format prescribed by National Treasury, one of the aims of which is to improve clarity and accessibility of information. Essentially poor consumer debt collection constrains municipal own revenue and, specifically, the operating component of own revenue.

As noted in Section 3.2.1, municipal contributions to total operating revenues have shown evidence of slower growth. In addition, the contribution of key municipal revenue drivers to total operating revenue – service charges and property rates – have both declined significantly over the review period. Part of this decline can be explained by non-payment.²⁸ (The decline in the share of property rates can partially be explained by the financial crisis of 2008, as the property market was particularly affected by the crisis). The Commission’s analysis of consumer debt is based on a six-year database (2004/05 to 2009/10).²⁹ For each of the six years covered in this database, the number of municipalities reporting was different and consistently increasing.³⁰ To account for the year-on-year improvements in reporting, and to get a sense of whether actual consumer debt was increasing over and above the increases in the number of municipalities reporting, the reporting variances were controlled for by averaging out the debt figures by municipal category.

The Commission’s analysis of municipal consumer debt over the review period reveals that municipalities are making in-roads with respect to this challenge. The key message in Table 8 is that consumer debt is generally declining across

27 As provided for in Section 230 of the Constitution.

28 Non-payment and its causes have received significant coverage in the literature: see for example, Booysen (2001), Botes and Pelsler (2001), Burger (2001) and Fjeldstad (2004).

29 Please note that the analysis on municipal consumer debt is based on a slightly different review period – it covers six years starting from 2004/05, up until 2009/10 – as opposed to the revenue and expenditure analysis, which runs from 2003/04 up until 2008/09.

30 Differences in the number of municipalities reporting in each year should not be viewed unfavourably, as the important point is that there have been consistent increases in reporting since 2004.

the majority of municipal categories. Secondary cities and districts with major powers recorded real increases between 2008/09 and 2009/10; however, growth was significantly slower in 2009/10 in districts with major powers.

Table 8. Real average municipal consumer debt per municipal category, 2004/05 to 2009/10

Municipal Category	R'million					
	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Metropolitan Municipalities	4,423	3,431	4,187	3,772	3,826	3,715
Secondary Cities	286	499	287	306	352	404
Larger Towns	56	1,368	106	124	127	111
Medium to Smaller Towns		173	38	39	51	42
Rural Municipalities	10	116	49	21	27	25
Districts Without Major Powers	7	37	7	5	17	4
Districts With Major Powers	11	41	63	43	61	70
Real Year on Year Growth (%)						
Metropolitan Municipalities		-22.4%	22.0%	-9.9%	1.4%	-2.9%
Secondary Cities		74.5%	-42.5%	6.6%	15.0%	14.8%
Larger Towns		2342.9%	-92.3%	17.0%	2.4%	-12.6%
Medium to Smaller Towns			-78.0%	2.6%	30.8%	-17.6%
Rural Municipalities		1060.0%	-57.8%	-57.1%	28.6%	-7.4%
Districts Without Major Powers		428.6%	-81.1%	-28.6%	240.0%	-76.5%
Districts With Major Powers		272.7%	53.7%	-31.7%	41.9%	14.8%

Source: FFC calculations based on National Treasury data, 2009 and 2010/11.

Table 9 assesses consumer debt relative to municipal operating revenue and confirms that the picture is indeed improving. The key point is that consumer debt, as a proportion of municipal operating revenue, is on a downward trend. Districts with major powers show marginal increases from 2007/08 onwards.

This issue may be something to monitor, as districts with major powers are one of the two categories that exhibit real increases in municipal consumer debt. Between 2006/07 and 2009/10, the proportion of consumer debt to operating revenue has remained generally constant. Again, as consumer debt in secondary cities has shown real increases, in the region of 15% in two consecutive years (2007/08–2008/09 and 2008/09–2009/10), this is definitely a municipal category that should be monitored to ensure that consumer debt does not start to affect the financial health of these municipalities.

Table 9. Real average municipal consumer debt as a proportion of real average operating revenue, 2004/05 to 2009/10

Municipal Category	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
Metropolitan Municipalities	10.9%	26.6%	7.5%	6.1%	5.9%	4.7%
Secondary Cities	4.1%	8.1%	1.9%	1.9%	2.0%	1.9%
Larger Towns	15.9%	283.3%	2.4%	2.6%	2.0%	1.4%
Medium to Smaller Towns		6.0%	1.1%	0.7%	0.6%	0.5%
Rural Municipalities	12.2%	3.8%	5.5%	1.1%	0.8%	0.6%
Districts Without Major Powers	3.5%	5.6%	0.7%	0.3%	0.7%	0.2%
Districts With Major Powers	5.7%	40.2%	3.0%	1.1%	1.3%	1.6%

Source: FFC calculations based on National Treasury data, 2009 and 2010/11.

Despite progress made, consumer debt remains a challenge. For example, metros are still faced with, on average, just under R4 billion worth of consumer debt. However, this analysis indicates that the severity of this challenge is weakening. Policy-makers therefore need to reflect accurately on the consumer debt challenge and acknowledge the progress that has been made.

The Commission also considered reasons for non-payment from households, businesses and government.³¹ Across all three groups, the inadequacy of municipal billing systems (largely with respect to inaccuracy) was emphasised. Other factors were: for households, poor metering systems and recipients being unable to afford to pay for services; and for businesses, unhappiness with services and high tariffs. Concerns persist around affordability and poor municipal billing systems, which indicate that despite decreases in the severity of the consumer debt challenge, the root causes of non-payment are not being effectively addressed. Based on these reasons, the following aspects that require improvement are highlighted:

(a) Management of debtors

The accounting treatment of debtors varies across municipalities. The issues range from the recognition of revenue,³² to the inadequate writing off of irrecoverable debt (thereby artificially inflating the amounts outstanding) and making inadequate provision for bad debt. There is also little uniformity with respect to the level of interest charged on outstanding amounts.³³ While these aspects are at the discretion of municipalities and their councils and should be location-specific, formal debt management guidelines for different categories of municipalities could assist government in getting a handle on this challenge. This could be done in terms of Section 168 of the Municipal Finance Management Act (MFMA), which allows for the Minister to establish national regulations or guidelines applicable to municipalities.

(b) Accurate accounting for indigents

Due to unemployment and poverty, there are households/citizens that are unable to access or pay for basic services – this grouping is referred to as indigent (DPLG, 2005). According to the Free Basic Service (FBS) Policy of South Africa, indigents are exempt from having to pay for basic services below a certain threshold.³⁴ The roll-out of FBS within municipalities is funded through the LES allocation and municipal own revenue. As a result, the issue of indigents is intricately related to non-payment, as non-payment reduces the amount of own revenue at a municipality's disposal, which affects its ability to extend access and deliver FBS to the poorest of the poor.

Municipalities target indigents in a variety of ways. In the case of water, which is the service where most non-payment accrues, the majority of municipalities use what is referred to as the targeted approach.³⁵ The indigent register is an important management tool³⁶ that is used to keep track of indigent households. The problem is that municipalities do not regularly update this information and so indigents may be included among those that have been listed as (illegal) defaulters, thus inflating the extent of consumer debt. Accurate information on those eligible for FBS (versus those who should pay for services) is essential to devise credible revenue and expenditure estimates. It is therefore suggested that regular updating/maintenance of indigent information be recognised as an integral component of revenue management and be included as part of Section 64 of the MFMA. More weight should be attached to the quality and accuracy of data and information on indigents, as this type of information is valuable for addressing a range of challenges, from better targeting the poorest of the poor, to assisting to quantify consumer debt better, and contributing to more credible revenue and expenditure estimates.

(c) Affordability of basic services

Related to the issue of indigents is the need to monitor the affordability of basic services (water, electricity, sanitation, refuse removal). Although a national benchmark establishes [income] baselines for those households eligible for FBS,

31 Reasons driving non-payment emanating from households, businesses and government were arrived at as follows: for households, the main area of non-payment is water. The key reasons for this type of non-payment were derived from annual General Household Surveys which contain questions on the non-payment of water. For businesses, Business Unity South Africa (BUSA), the umbrella body for business in South Africa, provided information while reasons for non-payment on the part of government departments, were sourced from provincial treasuries, particularly treasuries in provinces where the metros are located.

32 This refers to some municipalities adhering to Generally Recognized Accounting Practice (GRAP) 9 versus others that comply with International Accounting Standards (IAS) 36 and IAS 39. With GRAP 9 the rendering of a service to an indigent does not increase debtors. The opposite is true for those municipalities who adhere to IAS 36 and IAS 39 – these municipalities recognise services delivered to indigents and these are then reflected as debtors and provision for bad debts need to be made (see Salga Input to Budget Forum, 2010 for more information).

33 In some municipalities, interest is pegged to the prevailing prime rate, whereas in others the rate charged is at the discretion of the chief financial officer.

34 For example, in the case of electricity, the FBS threshold is 50 kilowatt hours per household per month. For water, the FBS amount is 6,000 litres per formal connection per month.

35 The targeted approach refers to cases where the municipality identifies which households are indigent (according to a determined income threshold) and then supplies these households with FBS.

36 See Non-Financial Census, 2008/09

municipalities are at liberty to increase this threshold.³⁷ During economic recession or periods of higher than average tariff escalations, municipalities should be sensitive to the impact on households that fall below the threshold or are close to the margins.³⁸ Affordability indicators need not be complicated.

For example, to monitor affordability, municipal policy-makers can use consumption-related indicators (such as percentage of total household expenditure devoted to a commodity or per capital consumption/expenditure on a commodity), price-related indicators (for example unit prices paid for a commodity), or payment-related indicators (such as the use of arrears statistics, use of alternative payment schemes and disconnections owing to debt) (Milne, 2004, 5). Such indicators can assist municipalities to be more sensitive to potential increases in consumer debt and/or the need to adjust municipal indigent thresholds.

(d) Billing and collection

As recent reports indicating public discontent with the poor billing practices of, for example, the City of Johannesburg proves, poor billing/collection is specific not only to smaller, less resourced municipalities.³⁹ Improvements in billing and collection have the potential to bring about immediate enhancements to the revenue bases of municipalities. Instead, as households, business and government confirm, issues around incorrect billing continue to affect negatively the integrity of local authorities. Poor performance can result in paying customers being categorised as defaulters and can, in certain instances, exacerbate unwillingness to pay.⁴⁰ Achieving and maintaining accurate and efficient billing and collection processes are based on a number of factors. These include accurate customer databases, effective and regular metering of service consumption, adequate staff capacity and convenient facilities for customer payments (World Bank, 2008). Of the reasons driving household non-payment, poor/irregular metering systems were particularly emphasised (StatsSA, 2005, 2006, 2007, 2008). In this instance, wider use of prepaid meters may be a possible solution.⁴¹

Some municipalities successfully implement creative measures to improve billing and collection. eThekweni Municipality, for example, has developed a geographic information system to facilitate enhanced management of water and sanitation services. The system uses aerial photographic surveys carried out annually to produce maps that indicate, for example, recently constructed properties and can show the precise location of all connected and unconnected properties (World Bank, 2008). This municipality also employs dedicated staff to recover debt from government and the largest debtors. The City of Cape Town employs a similar strategy, establishing a dedicated section to focus on the top 1,000 debtors in the City. Theewaterskloof municipality places particular emphasis on the use of customer profiling and regular updating of its indigent register.

In addressing the billing and collection problem, municipalities need to determine the root cause of poor performance. In instances where municipalities do not have the financial and human capital resources to upgrade and employ more sophisticated administrative and billing systems, consideration should be given to either outsourcing the function (this is permissible in terms of Section 76(b) of the Municipal Systems Act) or establishing an internal municipal service district to facilitate improved performance (permissible in terms of Section 85 of the Municipal Systems Act). In less severe cases, municipalities should leverage the experience of their counterparts who are capably managing their billing and collection functions. Finally specific key performance indicators could be included in the performance contracts of municipal managers, to attach appropriate weight to the role of sound and efficient billing and collection processes in municipalities. These should include, for example, reducing the average time between meter reading and invoicing, increasing metered consumption (if metering is chosen over the use of prepaid systems) and improving the average time between complaints being lodged and (partially or fully) addressed.

37 According to the 2005 "Guidelines for the Implementation of the National Indigent Policy", R1,600 is cited as the monthly household income threshold for determining indigent status.

38 For example, according to Eskom's multi-year price determination for the period 2010/11 to 2012/12, the cost of electricity is to increase by just under 26% annually. Municipalities often have little choice but to pass these increases on to consumers.

39 The City of Johannesburg recently spent R580 million on Project Phakama, an upgraded system described on the municipality's website as a system that will "ensure greater functionality in the areas of metered services, billing, collections, customers' service options and payment process" (Mungoshi, 2010).

40 Political interference that prevents officials from collecting arrears or applying pressure to defaulters is another factor that can entrench a culture of non-payment (See Lubbe and Rossouw, 2010).

41 The use of prepaid meters carries with it certain disadvantages, most notably a false sense of progress with respect to access to basic services as a result of self-disconnection. However, if indigent thresholds are sensitive to changes in affordability and are appropriately adjusted, the advantages of using prepaid meters may outweigh the negatives.

(e) Municipal power to recover unpaid amounts

In instances of good debt management, the government can consider extending more punitive recovery measures, by taking a differentiated approach to expand the powers of municipalities. This differentiated approach should not be based merely on municipal category, but rather on individual municipal performance with respect to consumer debt. To this end, a range of factors – from general management of debt to regular updates of indigent information – should be considered.

Relative to 2004/05, municipalities are showing progress with respect to this challenge. However this does not imply that municipalities should not try and further contain consumer debt. Municipalities can choose from an array of revenue instruments to finance their constitutional mandate and related service delivery responsibilities. However, they need to spend these scarce resources effectively and efficiently so as to ensure that outcomes are achieved and services to communities are maximised and sustained. In this regard, the next section analyses the expenditure decisions, outcomes and performance of municipalities in South Africa.

3.3 Overview of Municipal Expenditure and Outcomes

Municipal expenditures can be divided into two categories: operating expenditures and capital expenditures. Table 10 provides an aggregate picture of these two types of expenditure across the local government sphere. As a proportion of the total, operating expenditure far exceeds capital expenditure, but capital spending was the fastest growing component. This trend is probably the result of government’s drive to eradicate service backlogs and substantial investment in infrastructure related to the 2010 FIFA World Cup™.

Table 10. Total municipal expenditure, 2003/04 to 2008/09

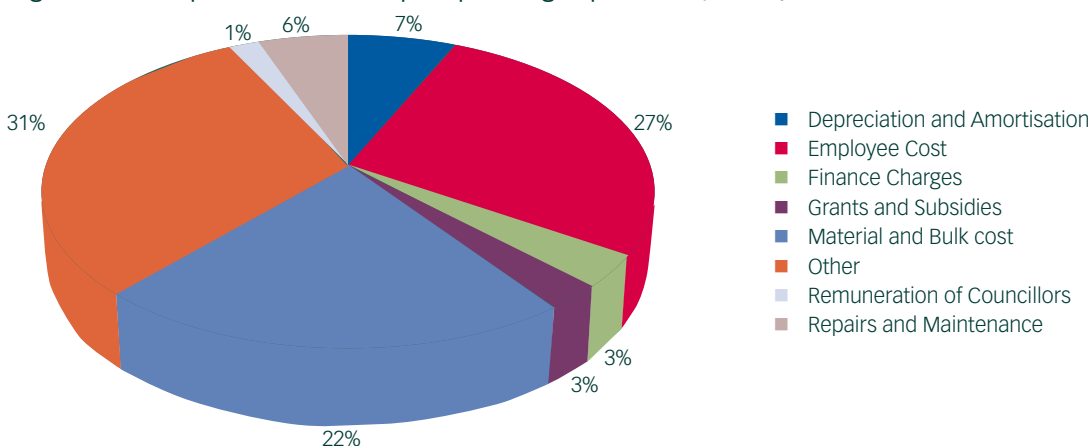
R Millions	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Municipal Operating Expenditure	79 548	85 615	86 237	91 261	96 764	107 399
Municipal Capital Expenditure	11 311	13 952	16 933	19 472	25 395	31 312
Total Municipal Expenditure	90 859	99 567	103 170	110 734	122 159	138 711
Real Year on Year Growth		2004/05	2005/06	2006/07	2007/08	2008/09
Municipal Operating Expenditure		7.6%	0.7%	5.8%	6.0%	11.0%
Municipal Capital Expenditure		23.3%	21.4%	15.0%	30.4%	23.3%
Total Municipal Expenditure		9.6%	3.6%	7.3%	10.3%	13.5%

Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

3.3.1 Municipal Operating Expenditure

Municipal operating expenditure represents the recurrent costs that a municipality incurs in providing constitutionally mandated basic services to its communities. Figure 23 below looks at the composition of total municipal operating expenditure for the 2008/09 financial year.

Figure 23. Composition of municipal operating expenditure, 2008/09



Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

As Figure 23 shows, total municipal operating expenditure is driven by seven components. Two of the components – employee costs and repairs and maintenance – warrant further analysis.

(a) Employee/personnel costs

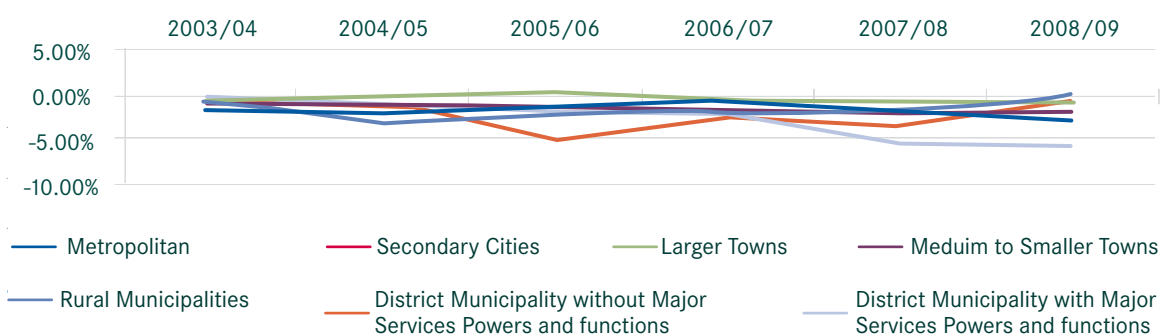
Expenditure on salaries is driven by the need for labour, as an input to provide services and run the municipal administration efficiently and effectively. A disaggregated analysis of personnel expenditures by municipal category reveals that spending on personnel tends to be larger in municipalities with fewer service-level responsibilities. As a result, rural and district municipalities have the largest shares of personnel expenditure to total operating expenditure, and relatively larger real growth rates for personnel expenditure.⁴² Various hypotheses can be driving this trend: (1) these municipalities are perhaps simply paying excessive salaries to their staff; (2) service delivery processes of these municipalities are possibly more labour intensive. While these two hypotheses would explain the above trends, most of the municipalities in question have no or limited major service powers and functions, relative to metros. (3) Building from the first hypothesis, it could be possible that these municipalities, which are largely located in poorer, rural parts of the country, have to pay excessive salaries in order to attract appropriate skills.

In the case of the first and third hypotheses, a possible conclusion is that these municipalities and their communities are in dire straits, as resources required for the delivery of services appear to be diverted to pay large salaries. Service delivery is perhaps being compromised in these areas. Therefore, extensive research is required to understand the fundamentals and drivers of municipal personnel expenditure in the South Africa, particularly in more rural municipalities.

(b) Repairs and maintenance

Adequate maintenance of new and existing municipal infrastructure is pivotal for ensuring sustained delivery of quality services and preventing service delivery failures due to poor maintenance. Although National Treasury recommends that 8–10% of municipal operating budgets be geared towards this expenditure item, ideally expenditure on repairs and maintenance should be planned and executed relative to the existing municipal asset base. As illustrated in Figure 24, spending performance on repairs and maintenance is extremely poor, regardless of the size, capacity or characteristics of municipalities. In fact, over the period under review, all municipalities failed to spend fully their budgeted amounts for repairs and maintenance (except for larger towns in 2005/06).

Figure 24. Actual expenditure on repairs and maintenance relative to budgeted amounts per municipal Category, 2003/04 to 2008/09



Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

As poor spending on repairs and maintenance cuts across all municipal categories, it is likely that the reasons underlying such trends go beyond general capacity issues and are more the result of poor management and performance. One possible reason for such poor expenditure performance could be because municipal services are not cost reflective. In essence, repairs and maintenance of infrastructure should be funded via the tariff charged for a service, which is a requirement legislated in Section 74(2) of the Municipal Systems Act (South Africa, 2000). However, municipal tariffs have

42 For example, expenditure on personnel increased on average by 16% in districts with major powers, compared to just 3% and 4% in metros and secondary cities respectively. In rural municipalities, real personnel expenditure increased, on average, by 16% over the period under review.

a long history of not being cost reflective. To correct this, the government is planning to undertake a review of municipal tariff structures.

Based on the discussion above, poor expenditure on repairs and maintenance can be equated to poor planning by municipalities in terms of their spending performance and tariff determination. Although a precedent should not be created where national government will bail out poor municipal performance, it is important to distinguish between social and economic infrastructure when considering the funding of repairs and maintenance. Whereas a tariff can be charged to consumers for the use of economic infrastructure, social infrastructure⁴³ is the infrastructure required to deliver a basic service to a household, specifically poor households, and no return on this investment is likely. In South Africa, municipalities receive the Municipal Infrastructure Grant (MIG), which is a conditional grant that primarily funds infrastructure to households not connected to services. Although municipalities use own revenues to invest in infrastructure, in most cases the MIG accounts for large amounts of the capital budgets. Since MIG-related infrastructure serves poor households, who in turn receive free basic services, a return on these investments is unlikely. This creates an expenditure item that is not readily funded or needs to be funded from other sources. While certain municipalities have the ability to cross-subsidise such expenditures, municipalities containing large proportions of poor households are unlikely to be able to fund repairs and maintenance. Such issues should be considered as part of the review of the local government fiscal framework.

(c) Factors influencing operational expenditure

Municipal expenditures are informed by implicit and explicit factors. Implicit factors can include municipal expenditure efficiency, planning and budgeting decisions, all of which are within the control of municipalities. Explicit factors that impact on the size and nature of municipal operating expenditures tend to be subject to the unique social, economic, demographic and spatial nature of the municipalities and are thus beyond their control. To identify and quantify these factors, a fully specified cross-sectional model is used.⁴⁴ Knowledge of these factors is expected to aid internal planning and expenditure processes and assist in the design of intergovernmental transfers, to ensure that the expenditure needs of municipalities are captured and appropriately subsidised through the various grant mechanisms. However, severe data constraints limit the scope of this analysis and, as a result, important variables are excluded, which impacts on the overall fit of the model. Such variables include mostly supply-side factors, such as wage rates across municipalities and geographic and topographical variables, which are extremely difficult to obtain per municipality in South Africa. Despite these constraints, the exercise yielded interesting results. Some of the factors⁴⁵ that were found to have a significant and positive effect on municipal expenditures are:

- *Access to basic services.* The more households connected to services, the higher the expenditures required to serve these households
- *Greater economic activity.* This captures the demand for services from business, which results in positive impacts on expenditures,
- *Institutional arrangements.* Municipalities with powers and functions for services spend more due to these greater service responsibilities,
- *Population density.* General theory suggests that the denser the settlements, the lower the service costs. However, the population density variable has positive effects on operating expenditures, which is possibly explained by the additional costs associated with denser settlements, such as increased crime prevention efforts and the need for additional infrastructure.
- *Household income.* Higher disposable income of households results in greater purchasing power, which likely results in a greater demand for quality services,
- *Poverty rates.* The social role that municipalities play in offering support to poor households in the form of FBS is apparent: the more poor households in a municipality, the higher the operating expenditures.

43 In this context, social infrastructure refers to infrastructure required to provide basic services to communities, particularly poor households and would include, for example, water and electricity.

44 The cross-sectional model was estimated for the 2007/08 financial year for all 283 municipalities, using mainly 2007 Community Survey data. Municipal operating expenditure was analysed in per capita terms.

45 Please make reference to the technical report for a detailed list of variables and how they were measured.

An assessment of the share of total population across the different types of municipalities between 1996 and 2009 highlights the extent of urbanisation in the country, especially migration between the largely rural municipalities and the six metros. A similar trend is also apparent between secondary cities and smaller towns. This suggests that urban municipalities face an annual increase in demand for services from new households being established within their jurisdictions. The impact of migration on municipal operating expenditures was tested in the model. The migration variable comes out as significant in explaining the variation in operating expenditures but has a negative effect on such expenditures. This suggests that municipalities are finding it difficult to cope with the increased pressures of migration and the quality of service provision is negatively affected.

In terms of the design of intergovernmental transfers, the LES is the primary operating grant for municipalities. This grant adopts a formula-driven equalisation framework. Therefore, the formula needs to estimate accurately the expenditure need of municipalities relative to their fiscal capacity to determine allocations. Based on the analysis and results described above, several factors clearly have an impact on municipal operating expenditures. Therefore, the assumptions that inform the expenditure estimations in the model must reflect the different factors that can have an impact on the costs of providing services. Furthermore, the current LES formula is based on 2001 census data, and so migration patterns, population movements and service-related dynamics over the past ten years are not accounted for in the formula. Thus, it is possible that funds from this grant are not being appropriately distributed relative to the demand for services and concentration of poor within local government. Such considerations should be factored into the review of the LES formula, which the government is currently undertaking.

(d) Performance of municipal operating expenditure

One way of assessing the performance of local government operating expenditures is to calculate the efficiency⁴⁶ with which municipalities use their resources to generate appropriate service delivery outputs. This was estimated, using the Free Disposable Hull (FDH) approach,⁴⁷ for a sample of 129 municipalities that are authorised to and provide all basic services. The efficiency scores should be interpreted as the use of resources (input) to generate services (outputs).⁴⁸ Municipalities with a score of 100% are fully efficient in using their given resources relative to the sample, whereas a municipality with a score of 0.85 uses 15% less resources to produce the same amount of services. This exercise is significant because it is a relatively new method that can be used to identify and benchmark best practice in local government in South Africa.

Over the period, four municipalities remain constantly efficient: Thembisile in Mpumalanga, Polokwane in the Limpopo province, Mangaung in the Free State and eThekweni in Kwazulu-Natal. The average efficiency score ranges from 0.30 in 2005/06 and peaked at 0.39 in 2007/08 and decline to 0.35 in 2008/09. This suggests that, on average, municipalities in the sample can obtain the same level of services with at least 60% to 70% less resources. In the 2005/06 financial year, a total of 11 municipalities were computed as efficient, decreasing to just seven in the 2008/09 financial year. Then, in order to further gauge the factors that have an impact on municipal efficiency, an estimation was undertaken against a range of factors that could theoretically affect efficiency.⁴⁹ The key results are described below:

The more fiscally capacitated a municipality, the more inefficient the use of resources.

- The financial capacity⁵⁰ and experience of municipal managers has a positive impact on efficiency. This finding confirms the importance for municipalities to adhere to the minimum skills requirements for employing senior officials, such as the Municipal Manager and Chief Financial Officer, as stipulated in the Municipal Regulations on Minimum Competency Levels.⁵¹
- Outsourcing refuse removal services improves efficiency, while outsourcing water and electricity does not result in any significant impacts on efficiency.

46 The technical efficiency of municipalities was assessed in this exercise. Technical efficiency is defined as the optimum use of given resources to produce a certain level of services. In other words, inputs are minimised and outputs maximised.

47 The Free Disposable Hull approach is a technique that identifies "benchmark" municipalities that use resources efficiently within the sample and thereafter computes efficiency scores for the remaining municipalities as a percentage relative to the efficient municipality.

48 Inputs were measured as total operating expenditure per capita to capture the costs of labour, capital and materials to provide municipal services. Outputs were captured by computing service indices of all major services provided by municipalities, which were averaged into one output index.

49 A cross-sectional tobit estimation, based on the FDH efficiency scores generated for the 2008/09 financial year was undertaken - the analysis was done for the 129 sampled municipalities.

50 In terms of the modelling, financial capacity was indicated by skills and experience of the Chief Financial Officer and audit outcomes, among others, as considered in the financial classification system of the MFMA.

51 For more detail, see Government Gazette Volume 504, No. 29967.

- Of the several policy methods used to implement FBS in South Africa, the most common are the technical,⁵² broad-based⁵³ and self-targeting⁵⁴ approaches. When assessed against the efficiency scores generated, municipalities that used the technical approach were the most efficient in providing free basic electricity. The targeted approach was identified as the most efficient in terms of providing water and sanitation.

3.3.2 Performance of Municipal Capital Expenditure

Municipal capital expenditure constitutes a municipality's investments in (social and economic) infrastructure projects. As such, this type of expenditure plays an important role in the social development of communities and the economic growth of the country. Local government capital expenditure is dominated by three items: water and sanitation, roads and storm water and 'other'.⁵⁵

Performance of capital expenditure is defined here as deviations in planned from actual capital expenditure.⁵⁶ As is evident in Table 11, municipalities experience severe challenges aligning the budgeted and actual capital expenditure. Over the entire period reviewed, actual capital expenditure is less than what was planned. When the aggregate picture is decomposed according to the various municipal categories, all categories of municipalities (except for metros) are experiencing problems with capital spending. Apart from metros, every other category show deviations in excess of the 20% benchmark/acceptable variance set by the Department of Cooperative Governance. One of the reasons for this variation is that budgeting and spending for capital projects differ from operational activities. In many cases, municipalities simply divide the projected cost of a capital project by the estimated number of years to completion and budget on this basis. The reality is that most capital projects are multi-year undertakings with increases or spikes in spending towards the end of the project life cycle. This calls for sound project and financial management on the part of municipalities to ensure that under/overspending does not occur.

Table 11. Budgeted vs. Actual capital expenditure by municipal category, 2003/04 to 2008/09

Municipal Category	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
Metros	55.4%	64.8%	70.8%	85.1%	96.9%	110.5%
Secondary Cities	70.0%	78.2%	66.1%	65.4%	69.3%	72.1%
Larger Towns	48.6%	54.7%	78.8%	69.3%	72.3%	65.7%
Medium to Smaller Towns	57.0%	72.8%	56.1%	64.7%	59.1%	66.4%
Rural Municipalities	52.6%	63.1%	48.6%	51.1%	75.9%	67.2%
Districts without Major Powers	63.7%	104.4%	43.0%	24.2%	58.7%	43.1%
Districts with Major Powers	35.7%	51.0%	66.5%	68.2%	47.3%	55.1%
TOTAL	55.1%	66.3%	66.6%	72.7%	78.7%	87.0%

Source: FFC calculations based on National Treasury Local Government Database, 2010/11.

The Commission has consistently raised the issue of poor capital grant spending at local government level. With the tabling of the 2010 Medium-Term Budget Policy Statement (MTBPS), the poor conditional grant spending was highlighted 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 grant allocations. The potential benefits of increased funding to municipalities could be lost should ineffective spending and/or under-spending persist due to inadequate capacity.

3.3.3 Outcomes Related to Municipal Expenditure

Ultimately, the core responsibility of municipalities is to ensure that their communities receive a sustained and high

52 The technical approach to free basic electricity includes the use of prepaid meters, where a portion of the service is provided free of charge and thereafter the household has to pay for any extra usage.

53 With the broad-based approach, all households receive a portion of electricity free, with households that use more than the stipulated free amount paying more to cross-subsidise poorer households.

54 In terms of the targeted approach, the municipality needs to identify a household as indigent and then supply this household with a portion of electricity free.

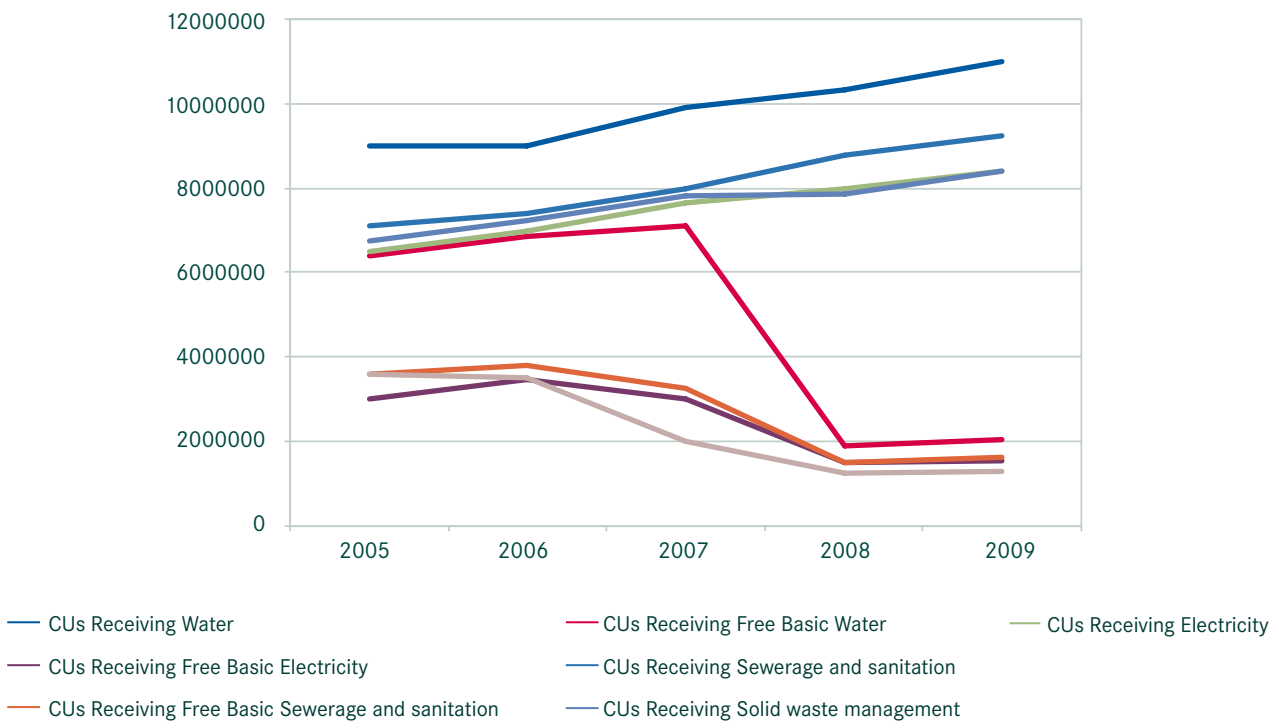
55 In this case 'other' refers to expenditures on land, buildings, vehicle fleets, etc.

56 As opposed to operating expenditure, the technical efficiency of capital expenditure was not assessed due to the dynamic nature of this type of expenditure.

quality of service. Municipalities are also required to provide sufficient social support to indigent households and to promote economic development within their jurisdictions. In terms of the former, municipalities are responsible for the provision of FBS, a government policy that affords households deemed as indigent, a portion of basic services free of charge.

Figure 25 illustrates growth in the average number of consumer units (CUs)⁵⁷ receiving basic services and FBS in South Africa. It clearly shows a gradual increase in the number of CUs receiving services, which correlates well with the increases in operating expenditure over this period. In 2005, just over six million CUs were receiving the electricity, sanitation and refuse services, while almost nine million CUs were receiving the water service. In 2009, this increased to well over eight million for all services, with over ten million CUs receiving the water service. It is clear that the increasing demand for services from consumers is being accommodated by municipalities, and that there is a certain degree of achievement in terms of rolling out services.

Figure 25. Growth in number of consumer units receiving basic services and free basic services (FBS), 2005 to 2009



Source: StatsSA, 2005 to 2009.

Turning to capital expenditure and basic services backlogs, Table 12 illustrates the proportion of households with access to the four basic municipal services. These trends constitute substantial progress in extending services to previously disadvantaged and poor households by government in 13 years of democracy. However, backlogs in access to sanitation and, especially, refuse removal are considerably high. These figures are a concern, as the Millennium Development Goals dates approach.

Table 12. Basic services backlogs

Basic Service	1996	2001	2007
Percentage of households where there is refuse removal by a local authority at least once a week	51.2%	55.4%	60.1%
Percentage of households with access to a flush toilet connected to a sewerage disposal	Not available	49.1%	55.1%
Percentage of households using electricity as the main source of lighting	57.6%	69.7%	80.0%
Percentage of households with access to piped water	Not available	84.5%	88.6%

Source: StatsSA, 2007.

57 A consumer unit is defined as the point at which a service is charged i.e. the entity that receives a municipal bill. This would therefore include households and business.

3.4 Recommendations

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.

Chapter 4

SUSTAINABLE DEVELOPMENT OF SOUTH AFRICA'S BUILT ENVIRONMENT

4.1 Introduction

A vibrant urban economy is the key to unlocking the full potential of the economy at large.⁵⁸ The absence of vibrant urban economies retards development and growth in many sectors, as urban areas provide the necessary impetus and platform for growth. Only when the full potential of such economic hubs are harnessed can economic development and growth be realised. The vibrancy and potential of urban economies in South Africa is threatened by, *inter alia*, inefficient land-use patterns. Land is a critical factor of production that is at the centre of any city's development, and land-use planning influences how land is used and determines how cities grow or develop.

Basically, cities can either develop up or outwards, and each form of development has its own costs and benefits, which are felt differentially by different groups. In South Africa, urban growth form has been influenced by a number of factors, including apartheid spatial regulations which resulted in significant social costs being borne mainly by the poor. While land-use planning influences developmental sustainability, its impact on financial sustainability of cities is seldom analysed. This chapter presents one of the first systematic evaluations of the institutional, financial and fiscal costs of poor land-use management in the South African local government sector. The specific objectives of this chapter are:

- To quantify the financial and fiscal implications of the current urban land-use patterns with respect to the transport, infrastructure, land and housing sectors,
- To examine the current institutional and funding arrangements pertaining to urban public transport and human settlements, and
- To make policy recommendations on the fiscal policy alternatives required to restructure patterns of urban land-use patterns.

This chapter is underpinned by both quantitative and qualitative research. On the quantitative side, the chapter employs a spreadsheet-based city efficiency costing model (CECM), developed specifically to quantify the capital and operating costs of housing, land, transport services and infrastructure for a hypothetical South African city. This hypothetical city has all the key attributes of a South African metropolitan. On the qualitative side, the chapter uses secondary information to evaluate the impact of funding, institutional and legal arrangements on land use in the urban areas.⁵⁹ The next section of the chapter provides a summary of the main findings of the study.

58 This is not to discount the importance of the rural economy and rural municipalities.

59 A detailed discussion of the methodological issues is presented in the Financial and Fiscal Commission, Technical Report: Submission for the Division of Revenue 2012/13.

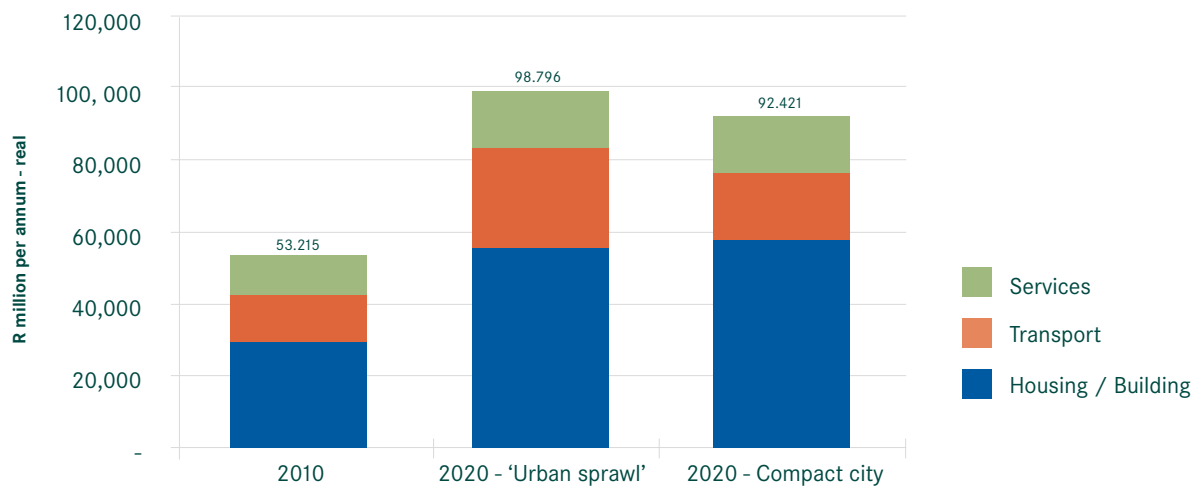
4.2 The Costs of Inappropriate Land-use Patterns in the South African Local Government Sector

This section summarises the main findings on the costs of inappropriate land-use, which are divided into recurrent, capital and environmental.

4.2.1 Recurrent Costs

The findings suggest that the current costs of low-density urban development in South African cities are approximately R6.4 billion more per annum than those of a compact urban form, an operating cost difference of about 7% between the two growth scenarios. If this is extrapolated to only the six metros, the difference between the urban sprawl scenario and the compact city scenario amounts to approximately 1.4% of gross domestic product (GDP) by year ten. The overall results of the CECM indicate that, based on 2010 data, the recurrent costs for the hypothetical city would be R53 billion per annum. By 2020 the recurrent costs (in real 2010 rands) increase to R99 billion and R92 billion for an 'urban sprawl' and 'compact city', respectively. This is illustrated in Figure 26 below.

Figure 26. Recurrent cost by sector (R million per annum real)

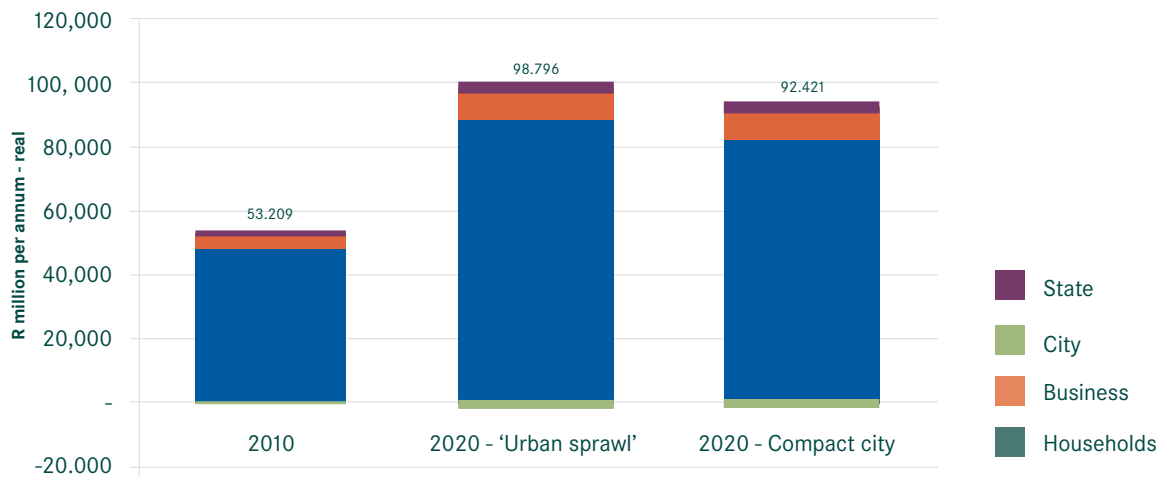


Source: FFC calculations

What is important to note from Figure 26 is that housing is the largest expenditure item across the scenarios, and this trend will continue to 2020. The biggest difference between the two scenarios by 2020 is the transport costs, which is mainly because the model assumes less commuting in the compact city than in an urban sprawl scenario.

The model also shows that households incur the largest financial burden in both scenarios, as illustrated in the Figure 27. However, the burden is larger in the urban sprawl scenario than in a compact city scenario.

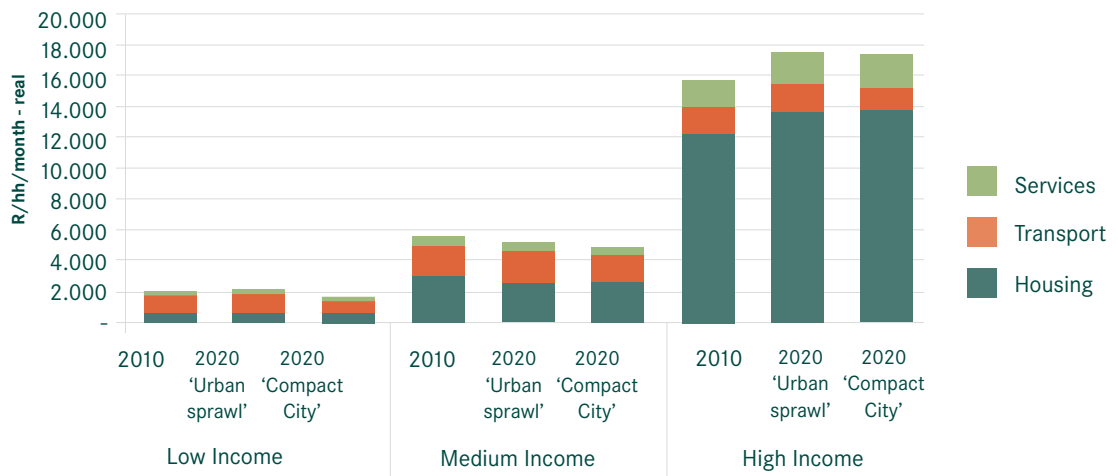
Figure 27. Recurrent cost by financial actor (R million per annum real)



Source: FFC calculations

A further analysis of expenditure on transport, services and housing shows that low-income households spend, per household per month, 14% more in the urban sprawl scenario and 10% less in the compact city scenario than in the base year (see Figure 28).

Figure 28. Average recurrent household expenditure (R/hh/month real)



Source: FFC calculations

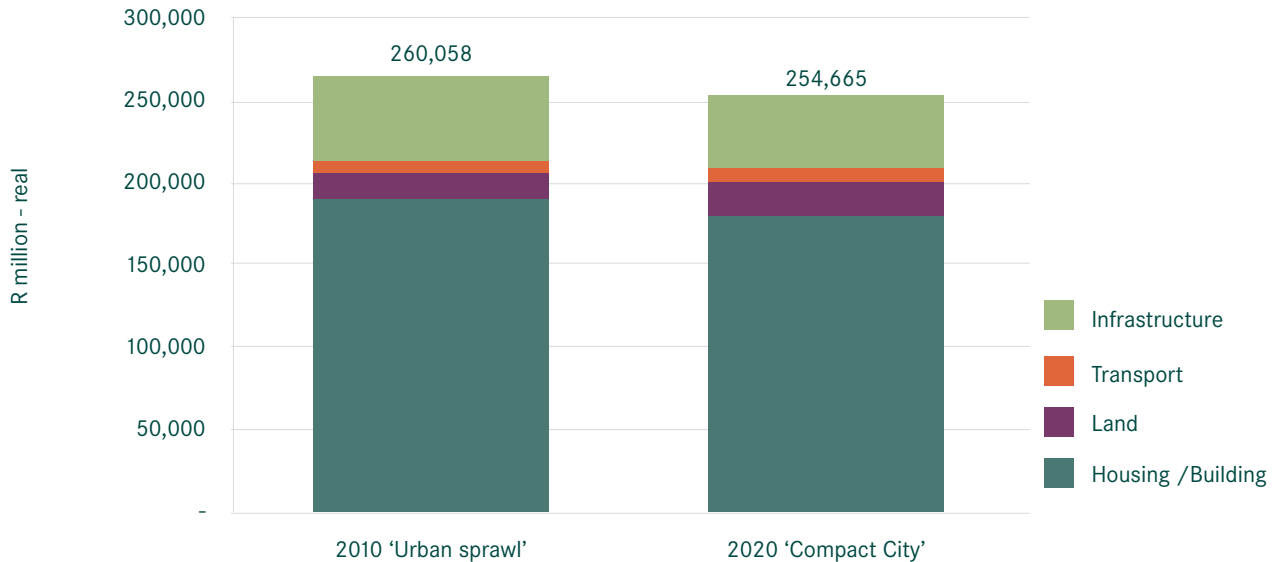
The major difference is in transport costs. Middle-income households spend 8% less in the urban sprawl scenario and 13% less in the compact city scenario on transport. In the urban sprawl scenario, high-income households spend more every month on transport (12% increase) than in the compact city scenario (10% increase). Low-income spending is dominated by transport costs, while high-income spending is dominated by housing expenditure. Thus, all households benefit in the compact city scenario, especially the low- and the middle-income groups, while in the urban sprawl scenario, low-income households are most negatively affected.

4.2.2 Capital Costs and Subsidies

Calculating total capital investment over ten years produces the surprising result that the capital costs are very similar for both scenarios: the urban sprawl scenario is only 2.1% more expensive than the compact city scenario (see Figure 29). Overall infrastructure and transport costs for the two scenarios are almost identical. However, while the same capital is required for transport, public transport usage is lower in the urban sprawl scenario, which mean a higher investment per passenger. The main difference is in land and housing costs. In the urban sprawl scenario, housing/building costs are greater because of the

assumed values of high-income units. For example, the average value of a high-income, single residential property is less than that of an average high-income flat. Thus, with increased density, the total capital required is less. Although the relationship is reversed for low-income households, the high-income trend dominates because low-income housing has a much lower value than high-income housing.

Figure 29. Total capital investment over ten years by sector (R million real)



Source: FFC calculations

The study also found that, in the compact city scenario, increased land costs account entirely for the difference in capital costs for businesses. Investment by the city and the state is roughly equal in both scenarios, with government paying more for housing and land, but less for transport and infrastructure.

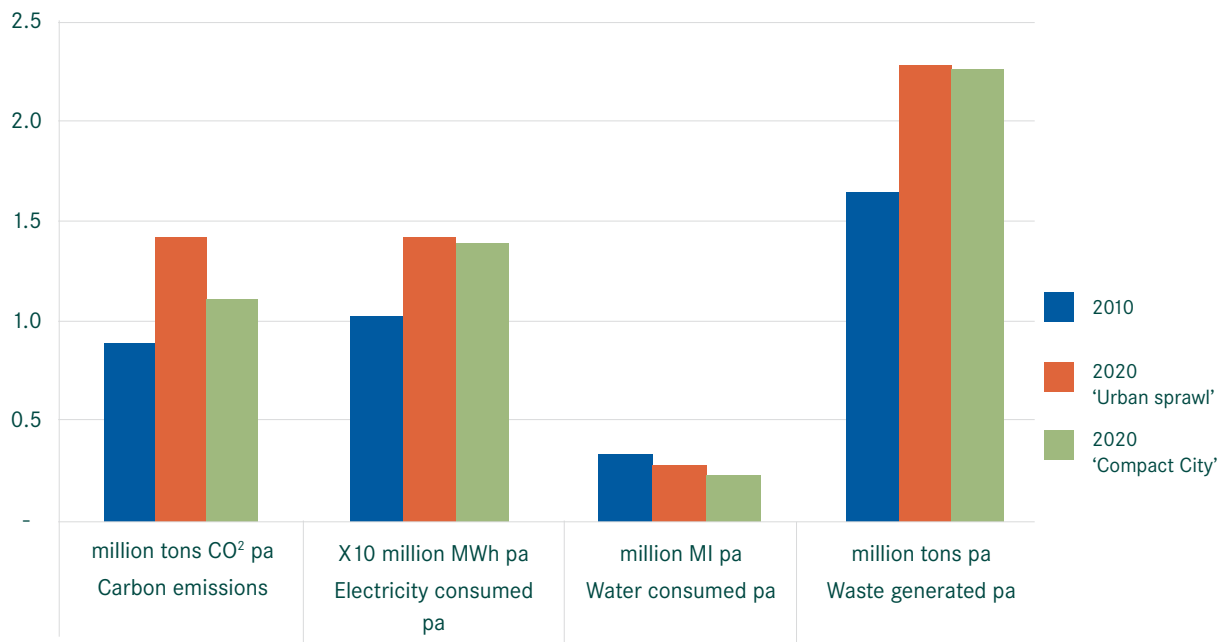
The model reveals that over the next ten years, the urban sprawl scenario will require more housing subsidy (a state housing subsidy of about R5.6 billion topped up with R322 million from the city). The compact city scenario will require a higher state housing subsidy of R6.5 billion, topped up with R1.6 billion from the city over the next ten years. Transport capital subsidies are assumed to cover only rail and BRT systems. In total, for the urban sprawl scenario, the state's contribution will be R6 billion over ten years, versus the city's contribution of R1.7 billion. The compact city scenario will require 4% less subsidy, but for fewer passengers. The total subsidy will amount to R7.7 billion (over ten years), or R897 per passenger per year in the urban sprawl scenario, and R7.4 billion, or R677 per passenger per year in the compact city scenario.

Assuming no change in the subsidy policy, under the compact city scenario public transport operating subsidies will reduce by 33% because of shorter aggregate travel distances on currently subsidised modes: rail and bus. This is a substantial saving and is also indicative of the overall improved efficiency of passenger transport in the compact city.

4.2.3 Environmental Costs

The environmental cost analysis shows that the resource use and waste generation rates are unchanged between the two growth scenarios. As Figure 30 illustrates, the most significant result is a 22% difference in the carbon tons emitted by all transport modes, which implies that compact city models are critical for a sustainable and vibrant city landscapes. In other words, inappropriate land-use patterns in urban spaces are a real threat to the environment.

Figure 30. Environmental impacts of the two growth scenarios



Source: FFC calculations

4.3 Current Challenges in the Built Environment

In this section, the challenges facing the built environment in South Africa are discussed together with the institutional, legal and funding arrangements.

4.3.1 Spatial Form of South African Cities and the Institutional and Legal Arrangements

South African cities are characterised by low-density settlement patterns that were shaped largely by a past system of racial segregation. During the apartheid era, the government introduced pieces of legislation that preserved white supremacy. For example, the 'Group Area Acts' (1950 and 1966) directed population groups into specific urban spaces, separated by buffer zones of open land, with whites allocated to large central areas and blacks displaced to distant urban periphery townships. The apartheid system did not just segregate races, but entrenched inequality, of housing form, geographical location, environmental landscape and distribution of facilities (Spinks, 2001).

In general, South African cities have comparatively low settlement densities⁶⁰, when measured by the number of people per hectare. For example, the densest city in South Africa is the City of Johannesburg, which has a population density of 20.9 people per hectare, followed by eThekweni with 15 people per hectare. These levels of density are relatively low when compared to other cities in the developing world, such as Addis Ababa, Bangalore, Ahmedabad and Curitiba that have density levels of 560.8, 134, 207 and 57 people per hectare, respectively.

Low density has, *inter alia*, two disadvantages. The first one relates to the high consumption of land, which increases the per capita cost of land infrastructure and services and, to some extent, limits social interaction. The second disadvantage is that the high demand for movement across the city, and long trips undertaken by people to access important amenities, results in the loss of time and higher spending on public transport, especially for the poor. In South Africa densification has tended to drift towards peripheral areas of the urban core and has taken place without factoring in public transport (Settlement Planning and Dlodla Development cc, 2008).

A densification strategy should be aligned with public transport plans. The city of Curitiba, for example, encourages higher densification and mixed-use developments along its famous bus rapid transit (BRT) routes (Magalhães, 2009). Similarly, the Government of India is making considerable investments in transport infrastructure, under its National

60 Density can be measured in a variety of ways including population density (number of people per hectare), dwelling unit density (number of dwelling units per hectare) and building density (ratio of total floor area of building to the corresponding site) among others.

Urban Transport Policy in 2006 that aims to “ensure safe, affordable, quick, comfortable, reliable and sustainable access” to urban residents to employment and other services.

In South Africa, various pieces of legislation emphasise proper land-use planning and densification, for example: the Development Facilitation Act of 1995 (DFA), the Spatial Planning and Land Use Management Bill of 2011 (SPLUMB), the “Moving South Africa” (MSA) policy document of 1998 and a White Paper on Spatial Planning and Land Use Management (2001). While the DFA attempted to accelerate land development by introducing principles of equity and efficiency in spatial management, a key problem is the spatial planning system, which consists of an overlay of inherited provincial legislation from the 1980s and national legislation governing less formal township establishment from the early 1990s. The problem is further compounded by the fact that some provinces and municipalities did not adopt the mechanisms available under the DFA and continue to develop without an adequate land development framework, which essentially implies that adherence to common national norms and standards is nonexistent. The LUMB (2008)⁶¹ seeks to close this gap, but its enactment has been delayed, which further exacerbates the inappropriate land use. However, the Commission notes and supports a recent development on land-use management with the Department of Rural and Land Reform’s publication of a draft Spatial Planning and Land Use Management Bill for comments (in May 2011). This bill is intended to replace all pre-1994 pieces of legislation on land-use management and development, including the DFA.

The coordination between the spheres of government responsible for different modes of public transport is one of the public transport institutional issues that need to be addressed. This has given rise to possibilities of inefficient use of space as well as resources. For example, due to the lack of coordination, some BRT routes (managed by the cities) directly compete with passenger rail routes managed by Passenger Rail Agency of South Africa (PRASA), as these routes are parallel to each other (FFC, 2010). This challenge is associated with uncoordinated investment decisions within the public transport sector and may have negative implications on the long-term sustainability of modes of transport, especially as densities are relatively low to sustain public transport in South African major cities. If not addressed, this low density may be costly and could further lead to underutilisation of services in the bus and rail modes.

According to the Constitution, housing is clearly a concurrent function of the national and provincial governments. The Constitution also provides for the national and provincial governments, through agreements, to assign administration functions to municipalities when:

- a. The function would be administered more effectively at the municipality level; and
- b. The municipality has the capacity to administer such a function.

In addition, the Housing Act No. 107 of 1997 also makes provision for municipalities with adequate capacity to be accredited⁶² with the housing function.

The outcome of all these pieces of legislation is that the housing delivery and development function rests with the higher spheres of government, while the actual delivery of housing and other complementary services such as water and sanitation are municipal responsibilities. Furthermore, municipalities are responsible for the overall Integrated Development Plan (IDP). However, government policy has started to recognise the centrality of municipalities in the provision and management of housing. New developments in this regard include accrediting cities to manage the overall planning and delivery of public human settlements. Such accreditation will result in a more integrated system of housing delivery. On the transport sector, recent developments include devolving public transport function to the cities as provided for by the National Land Transport Act (2009) (NLTA).

Although devolving some functions to the cities is desirable for better coordination and planning, some risks are involved, such as simply transferring existing problems at a sectoral level or within a particular sphere of government to the cities. For example, accrediting cities to undertake the overall human settlements function will not result in much

61 Roles and functions of different spheres of government are covered in the bill. The national is mainly responsible for establishing norms and standards, enforce compliance and capacitate other spheres. Provincial sphere through the provincial land-use tribunals must consider and decide on all applications and appeals lodged and redirected to it in accordance with this bill. Municipalities through municipal land-use committees must consider and decide on all applications lodged or redirected to it in terms of this bill.

62 Accreditation of a municipality, especially level 3, is advantageous as it allows a municipality to administer any national housing programme within its jurisdiction, including receiving, evaluating and approving/disapproving applications for subsidies. Furthermore, a municipality accredited at level 3 would be able to receive its transfer directly from the national government, effectively removing the provincial sphere from the equation. This improves planning as well as implementation and eliminates delays in the disbursement of funding.

improvement if the present funding and capacity challenges within the current framework and land-issue problems are not first resolved. This implies that various issues need to be resolved within the entire and fiscal intergovernmental relations in order to improve the human settlements delivery system.

The challenge of transforming the spatial form of South African cities is greater than institutional coordination failure and legislative gap and is complicated by an urgent need to address housing and other basic services backlogs. A focus on eradicating backlogs has to some extent entrenched the apartheid city form and reflects path dependency, as the government with limited resources could choose either to channel funding to address historical backlogs or to attempt to change the spatial city form.

4.3.2 Funding

Two key challenges are highlighted in this section: the housing subsidy design and the overall funding of the built environment.

(a) The design of housing subsidy

One of the major problems is the current public housing subsidy system, which focuses on direct state provision of housing. In so doing, the system fails to leverage private finance and end-user contributions for housing delivery. The focus on the mass provision of fully-subsidised housing units has also constrained consumers' choice and often leads to sub-optimal output. Furthermore, there has been a lack of focus on key issues such as resolving administrative problems associated with land release and tenure security. In most cases the trade-off has been between the larger stands in distant location, where land is cheaper, and smaller lots, which are normally of poor quality and relatively more expensive, but located closer to economic opportunities.

The location of human settlements and important amenities determines transport costs and expenditure incurred by households. The fact that poor households choose to live in informal settlements, slums and backyard dwellings is an indication that they are prepared to accept poor quality housing closer to economic opportunities. Therefore, if given a choice, they would choose for their houses to be built closer to the jobs.

However, the current system does not allow such choice. The only remedy to the distortion in city shape caused by large subsidised housing programmes is to make subsidies "portable" and to let low income households make their own trade-offs between land-use standards, transport costs and location. An example of a portable subsidy is creating a "housing account" at an existing bank institution, to which qualifying households can also contribute, based on income level. The account would be interest-bearing and tax-free and offer the consumer a choice of when and where to use the subsidy.

The current funding for human settlements has also contributed to the peripheral location of low-cost housing and does not promote densification. The funding grant does not incentivise infill and brownfield developments,⁶³ but is designed to provide a complete housing product on cheaper peripheral locations. It fails to recognise that the biggest challenge is access to well-located land and providing subsidy amounts sufficient to build settlements with optimum densities that will eventually offset higher land costs. Other cities have achieved higher densification through infill and brownfield developments using incentives/disincentives that the South African system lacks.

(b) Funding for the built environment

A number of sectoral grants within the built environment are currently administered by different spheres of government and departments and are subjected to different conditions and reporting frameworks (see box 4.1).

63 Infill development generally refers to the development that prioritises the development of parcels of vacant, underdeveloped or underutilised sites within an urban area, rather than allowing development of undeveloped land outside the city. Brownfield development refers to development that takes place within an area or on land that was used previously but subsequently become vacant or derelict.

Box 4.1: Conditional Grants in the Built Environment*Integrated housing and human settlements development grant.*

Administered by the Department of Human Settlements, its purpose is to provide funding for creating sustainable human settlements, while the urban settlements development grant (USDG) is allocated to metropolitan municipalities to supplement their capital budgets. It is intended to fund the provision of basic municipal services to new housing projects.

Municipal infrastructure grant (MIG cities/urban development grant).

Administered by the Department of Cooperative Governance, its purpose is to provide specific capital finance to address basic municipal infrastructure backlogs for poor households, micro enterprises and social institutions serving poor communities.

Integrated national electrification grant.

Administered by the Department of Energy, it is aimed at the provision of electrification of residential dwellings, the installation of bulk infrastructure, rehabilitation and refurbishment of electricity infrastructure in order to improve the quality of supply.

Regional bulk infrastructure grant.

This grant is for the development of regional bulk infrastructure for water supply under the Department of Water Affairs.

Public transport infrastructure and systems grant.

Administered by the National Department of Transport, it is intended for accelerated planning, construction and improvement of public and non-motorised transport networks.

Neighbourhood development partnership grant.

Administered by the National Treasury, its purpose is to support neighbourhood development projects that provide community infrastructure and create the platform for other public and private partnerships.

The common purpose of these grants is to provide sustainable human settlements with the necessary basic infrastructure. For example, sustainable human settlements should have water and sanitation services, and roads and electricity among other things. The challenge lies not in the funding itself (as shown by the variety of grants) but in the lack of coordination.

Some recent positive developments within the funding framework include the introduction of an urban settlements development grant (USDG)⁶⁴, which supplements metropolitan municipalities' capital budgets for the development of sustainable human settlements, and the shifting of the sanitation function to the Department of Human Settlements (DoHS, 2010). These developments are positive for alignment of grants and improved coordination in the delivery of human settlements. However, it is only the beginning of the process, as a number of grants still need to be aligned. Currently, there is a lack of strategic or operational relationship between infrastructure transfers, housing subsidies and other grants/subsidies including the one for public transport investment, which is an issue that the Commission highlighted in 2005 (see Box 4.2).

64 The USDG is the result of merging the MIG cities grant and the internal infrastructure portion of the provincial human settlements development grant.

Box 4.2: Lack of Coordination and Alignment in the Funding for the Built Environment

The lack of coordination is not a new issue, as it was raised by the Commission in 2005. Subsequently a recommendation was made that linking new housing subsidies with MIG (among other things) should be considered. Government accepted the recommendation, but also noted that MIG does not only target new housing. Nevertheless, the Commission remains of the view that this should be done at least for new human settlements developments.

This lack of relationship is reflected in the continued fragmentation of infrastructure-related transfers across different sectors, which leads to delays in infrastructure provision. One practical example of the effect of this lack of coordination is the delay in the provision of human settlements due to unavailability of bulk infrastructure (Sexwale, 2010).

4.4 Recommendations

The current land-use patterns in South African cities result in high economic, fiscal and financial costs. In the current form of city development, households, especially the poor, incur the largest costs, mostly in the form of transport costs. The CECM used in the study to quantify the costs of the current land-use patterns revealed that moving toward a compact city model results in savings within ten years. The main benefit is in the form of reduced spending on transport, as households will be closer to their areas of work and mass public transport (higher density levels are necessary for efficient public transport). Other benefits include reduced fiscal burden on public transport subsidies, as fewer households will be commuting, and lower carbon emissions due to decreased travel distances and use of private cars. Other key challenges within the built environment in South Africa relate to the institutional arrangements, fragmentation in planning, lack of coordination in the funding, lack of incentives to promote densification as well as some legislative shortcomings noted elsewhere in this chapter.

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 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.

Chapter 5:

ENVIRONMENTAL SUSTAINABILITY AND CLIMATE CHANGE IN THE LOCAL GOVERNMENT SECTOR

5.1 Introduction

The impact of climate change on world economies is fast taking centre stage in global and political debates and policies. The severity and frequency of associated natural disasters have made climatic change one of the major threats to global economies in the 21st century. The hazards of climate change have manifested themselves in, *inter alia*, wide temperature variations, changes in rainfall patterns, rises in sea levels, unprecedented levels of air pollution, frequent floods and droughts, and increased water- and vector-borne diseases (World Bank, 2010). Although every economy is vulnerable to climatic change, their vulnerability is unequal and disproportionately distributed across continents and regions. The developed world generates most of the negative externalities associated with climate change, while the poorest global populations bear the greatest risks. This is because developing countries have weak and inadequate adaptation and mitigation infrastructure and limited resources to withstand the hazards of climate change. While disproportionate impacts of climate change are seen in urban areas across the globe, the same urban areas are also the biggest contributors to the problem. As highlighted in Chapter 4, as principal drivers of economic growth, development and innovation, these cities and towns need to recognise the challenges posed by climate change.

In the South African government's 12 agreed Medium Term Strategic Framework, the issue of environmental sustainability is prioritised in outcome ten, which deals with the protection and enhancement of environmental assets and natural resources. The government has also recognised that climate change is one of the critical factors influencing the environmental sustainability and vibrancy of cities, and that appropriate responses to climate change have fiscal implications. The structure of intergovernmental fiscal relations (e.g. grants) can create incentives or disincentives for proactive climate change responses by municipalities.

The Commission is concerned with the impact of climate change because of its potential to strain public finances and so undermine any gains in intergovernmental fiscal relations that the Commission is constitutionally mandated to promote. The Commission is also concerned by the potential of climate change to undermine development and economic growth, imposing costs on society and government through expenditure related to the amelioration of climatic effects.

This chapter highlights the results of empirical work in the local government sphere on the impact of climate change. It also recommends possible, appropriate fiscal and economic policies and instruments that will enable municipalities to respond timeously to the threats and opportunities that accompany climate change. The focus is on how climate change will affect water and energy security, as these two sectors play a central role in the development and growth of local governments.

5.2 Climate Change Impacts in the Local Government Sector

The section reports on the findings of research into the implications of climate change for water and energy (electricity) security in the local government sphere. The research found that increased rainfall variability (a proxy for climate change) is significantly associated with increases in municipality's water and electricity expenditures, which can be interpreted as rainfall variability increases municipal water and energy demand.⁶⁵ This result suggests that climate change leads to greater spending on water and electricity-related infrastructure. Thus, climate change will mean higher

⁶⁵ It should be pointed out that these measures can be applied to other sectors and services as well.

(and more often than not) unplanned expenditures for municipalities, which will have to forego the provision of some essential services, as budgets are stretched to cater for the consequences of climate change.

South African municipalities already face a number of persistent problems with respect to water and electricity provision. These include water and electricity losses due to ageing infrastructure, illegal connections, inappropriate pricing and poor water quality. Climate change adds another volatile variable to this mix of challenges facing municipalities. As central drivers of local government growth and development, it is critical that water and energy resources are used efficiently.

Water is a scarce resource that must be used efficiently by eliminating water losses. Table 13 shows the water distribution in the different categories of municipalities and shows that South Africa loses a significant amount of water (about 30%). With the added burden of climate change, it is imperative that local authorities manage water resources capably and in particular minimise water losses. Water losses of this magnitude may be a result of ageing infrastructure. Yet, in many municipalities repair and maintenance of infrastructure is not prioritised, and budgets for repair and maintenance are remarkably low. Therefore, mechanisms and adequate budgets need to be put in place to minimise incidences of poor maintenance, especially for water-related infrastructure.

Table 13. Distribution of water

(Ml pa)	A	B1	LW	DW	Total
Water sold	1,299,702	498,567	342,738	499,999	2,641,004
Residential customers	907,989	386,523	299,392	440,156	2,034,060
Non-residential customers	391,713	112,044	43,346	59,842	606,945
Unaccounted for water	557,015	213,671	146,888	214,285	1,131,859
Bulk water requirement	1,856,716	712,238	489,625	714,284	3,772,863

Source: Palmer Development Group, 2010

Municipalities need to become champions of energy-efficient ⁶⁶ initiatives and to promote the development of energy-efficient sectors, such as renewable (wind, geothermal, and solar) energy and bio-fuels. They should encourage energy efficiency in building and construction, agriculture and forestry, as well as alternative energy-efficient transportation, recycling and proper waste management, (The Thirteenth Finance Commission, 2009).

Municipalities need to deal proactively with the consequences of climate change, which can be tackled through a number of instruments, including the budget, by mainstreaming clean environmental objectives into the budget (what has become to be known as “greening” budgets). The intergovernmental fiscal relations framework can be used to “incentivise more innovative approaches to environmental management and to reward good environmental performance” (The Thirteenth Finance Commission, 2009). For example, local authorities can use taxes and subsidies to influence sustainable energy production and consumption.

5.2.1 Environment-friendly instruments

Below are some of the instruments that could be used to promote environment-friendly forms of water and energy consumption and production. ⁶⁷

(a) Subsidies

Subsidies are an important mechanism for achieving environmental goals. Subsidies can be used to encourage the production of eco-friendly goods and services or discourage the production of goods that harm the environment. In the case of South Africa, green initiatives could be encouraged through subsidising, researching and developing eco-friendly technologies. The cost of such subsidies can even be recouped through taxing competing technologies that are not environment-friendly.

(b) Transfers

Grants are also a potent mechanism for driving the eco-friendly agenda. Lessons from the Thirteenth Finance Commis-

⁶⁶ Energy efficiency means minimising energy wastage, using less energy to perform the same activities and shifting to cleaner energy sources.

⁶⁷ It should be pointed out that these measures can be applied to other sectors and services as well.

sion (2009) are useful for the South African local government sector. In India grants have been used to reward good environmental performance and environmentally sound programmes. In South Africa, the government should consider establishing a separate special purpose conditional environmental grant that would seek to achieve the following:

- Reward and incentivise environment friendly actions and performances in the local government sphere.
- Provide for repair and maintenance, and rehabilitation of water and energy infrastructure.
- Build capacity to address climate change management in local governments,
- Provide minimum environmental protection services
- Fund research into best adaptation and mitigation practices and new environment-friendly technologies (especially water and energy-efficient technologies), waste management, green building, etc.

When establishing a separate special purpose environmental grant, special attention should be paid to its design, as the grant should be sensitive to factors such as the municipality's size, topography, vulnerability and riskiness to climate-related hazards.

(c) Green public procurement

Another effective avenue for achieving environmental goals is through "Green Public Procurement". As municipalities are the main buyers of goods and services in their areas, mainstreaming environmental concerns in their procurement policies can go a long way in promoting a clean environment. In green procurement (also known as sustainable procurement or green tendering), public authorities deliberately and strategically procure eco-friendly goods and services from a selection of environmentally conscious suppliers or contractors. Public officials can also set environmental requirements in procurement contracts. Cities can be turned into "green" zones through easing the development of, and sustaining, environmentally sensitive markets.

(d) Adaptation and mitigation

The burden imposed by climate change means that municipalities need to minimise the impact, by putting in place appropriate adaptation and mitigation plans and mechanisms. Some municipalities already have functional climate change adaptation and mitigation strategies in place, for example Cape Town and eThekweni (McKenzie, 2011). In developing adaptation and mitigation mechanisms, municipalities need to take into account the following.

- *Sound analysis of climate change at municipality level.* Rigorous municipality level analysis of the climate change impacts is required. Municipalities should endeavor to come up with their own municipal level risk analysis, which includes identifying primary and secondary hazards, assessing relative exposure and vulnerability of the population, and analysing institutional capacities. This analysis will then support their adaptation and mitigation plans and strategies. An understanding of the individual impacts is important for crafting municipal level adaptation and mitigation strategies.
- *Adequate financing of adaptation and mitigation.* Successful and sustainable adaptation and mitigation depend on sustainable financing. Elsewhere in the world, "Climate Change" grants have been used to fund adaptation and mitigation strategies and programmes. Climate or environmental grants can also be considered in the case of the South African local government sector. In addition, municipalities themselves need to seriously consider budgeting for adaptation and mitigation programmes, as the climate change disasters are becoming more frequent and intensive. Collective financing could be considered in cases of budgetary or capacity constraint.⁶⁸
- *Timely and adequate information, communication and awareness.* Successful adaptation and mitigation also depends on timely and adequate information, communication and awareness about the vulnerability and impacts of climate change. The short- and long-term impacts of climate change must be understood and communicated to

⁶⁸ This simply means pooling resources to finance a common activity.

individuals and organisations that are likely to be affected by climate change. Adequate information will minimise uncertainties that often surround climate change issues.

- *Community involvement.* Local communities should be involved in mitigation and adaptation programmes and projects, so that the sustenance of the projects and programmes will be guaranteed.

5.3 Recommendations

Climate change is a real threat to municipalities in South Africa, especially to water and energy security at the local government level. Therefore, local governments need to be proactively involved in local, national and global efforts to adapt to and mitigate climate change impacts. Individual municipalities need to understand and establish their specific climate change impact assessments that take into account their specific conditions and circumstances. This will give rise to the crafting and implementation of effective, efficient and well targeted policy measures and programmes.

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.

PART 3: IMPROVING DEVELOPMENT OUTCOMES OF THE INTERGOVERNMENTAL FISCAL RELATIONS SYSTEM

Chapter 6

BUDGET ANALYSIS AND EXPLORATION OF ISSUES TO INCREASE PERFORMANCE IN BASIC EDUCATION AND HEALTH

6.1 Introduction

South Africa spends a large amount of its budget on health and education, mainly through provincial governments, which accounts for almost 70% of consolidated provincial government expenditure. This chapter reviews the role of public expenditures in promoting development outcomes in education and health programmes. Coming at a time when fiscal policy is tightening, this chapter explores how well public expenditure works to deliver basic education and health policy objectives and millennium development goals (MDGs) – specifically universal primary education and a reduction in the under-five child mortality rate – and how government might best support publicly funded programmes to achieve MDG outcomes. Education and health outcomes are a function of the complex interaction of factors such as socioeconomic status, poverty, cultural, geographical, and environmental, as well as other determinants and conditions which have a bearing on the quality of life.

The chapter focuses on the return on investment in education and health, to ascertain whether South Africans obtain good value for the large amount of money that the government spends on education and health. The differences in the provision of education and health in terms of efficiencies, quality and performance are wide within and between provinces. Many township and rural schools perform badly, and low standards of quality education and efficiency are prevalent and persistent in these areas and among poor households. In a nutshell, the basic education system in South Africa faces access to formal and epistemological (transfer of knowledge) problems, which will form the core of this chapter.

Maternal and child mortality rates are increasing, life expectancy is worsening, and the public sector health care system remains under severe pressure. The burden from communicable and non-communicable diseases, injury and trauma continues to be a barrier to faster development. Substantial increases in mortality and morbidity threatens to overwhelm the health system, with HIV/AIDS and tuberculosis (TB) posing the greatest challenges. This state of affairs is the principal cause for concern about prospects for South Africa achieving effectively both education and health MDG goals and targets.

Efficiencies and quality improvements cannot be corrected by higher levels of expenditure without service delivery reforms, proper resource planning and management, and a commitment to tackle inherited problems in education and health sectors irrespective of what happens to access. Reforms in these sectors need to go hand-in-hand with the broader intergovernmental fiscal reforms of government. The ability of provincial governments to determine actual budget allocations and to drive expenditures within these sectors is limited and inequitable at times. The intergovernmental fiscal relations system is undergoing reforms especially in the area of concurrent functions, which are necessary to target and allocate resources more efficiently in order to facilitate the proper financing of education and health services.

Other spheres of government have an important role to play in improving the social determinants of education and health, such as proper shelter, water, sanitation, transport, and social assistance. Government is also crucial in order to channel fixed capital investments in the education and health sectors across the country, especially in rural areas.

6.2 Public Expenditure and Performance Outcomes of Basic Education, and Health and Rural Development in South Africa

6.2.1 Governance and Institutional Frameworks for Education and Health Services

Schedule 4 (part A and B) of the South Africa Constitution (Act No. 108 of 1996), as amended, lists education and health (including municipal health services) as functional areas of concurrent national and provincial legislative competence. In terms of the National Health Act (No. 61 of 2003) provinces are given bulk responsibilities for primary health care, while municipal health services are defined narrowly to include environmental health services and are a function of metro and district municipalities. As defined in the Municipal Structures Act (No.117 of 1998), local municipalities have historically provided municipal health services, with minimal services outside the cities and main towns (Centre, 2011). This institutional arrangement potentially gives rise to an unfunded mandate for health services at local government level. Public expenditure for basic education and health in South Africa has been rapidly increasing since 1994. The aim has been to equalise service and improve access to services for the previously disadvantaged members of the population.

6.2.2 Resource Allocations and Funding of Education and Health Services

As mentioned earlier, spending in education and health constitutes roughly 70% of consolidated provincial budgets. These two priorities are funded mainly through the provincial equitable share (PES), which is an unconditional fiscal transfer system. However, other national education and health priorities are funded through conditional fiscal transfers or conditional grants. For example, (i) *Education*: Dinaledi schools, HIV/AIDS, life skills education, national school nutrition programme, technical secondary schools recapitalisation; (ii) *Health*: health revitalisation programme, comprehensive HIV/AIDS programme, forensic pathology services, health professions training and development programme, and national tertiary services.

Unconditional fiscal transfers allow operational and financial decision-making to be decentralised to the provinces and municipalities with national departments only retaining responsibility for policy-making and determining norms and standards (Okorafor *et al.*, 2005). Depending on provincial priorities and pressures, Provincial Executive Councils (PECs) and Legislatures determine the amount of money that goes to each function based on national priorities, the influence of provincial treasuries and the capacity of each provincial department to motivate for funding. In essence, fiscal decentralisation, or the intergovernmental relations system in South Africa, limits the role of national government to determine actual resource allocations within provinces, except for conditional grants. This makes the challenge of planning, funding and coordinating policy objectives more complex in a multi-sphere system of government. Adequate fiscal transfers are critical in order to address the problems of equitable access to the education, health care and rural development programmes. In the Annual Submission for the Division of Revenue for 2010/11, the Commission made recommendations for reviewing the provincial equitable share (PES) formula, and highlighted the formula's design problems associated with attempts to achieve too many objectives using one instrument. Other intergovernmental fiscal relations (IGFR) challenges are that provinces do not always adequately fund education and health, and that they use the PES to also fund other provincial priorities that may not necessarily converge with agreed national priorities. This is to be expected as the formula is used to allocate a predetermined pool of funds horizontally. The 2011 Division of Revenue Bill reflects the changes (especially in the health component) to the PES formula for the 2011 Medium-Term Expenditure Framework (MTEF).

The weight allocated to the education component was reduced (from 51% to 48%), and the reformed health component was revised upwards (from 26% to 27%). The basic component of the formula was revised upwards (from 14% to 16%), while the other components in the formula remain the same. The reformed health component is commended as it now considers utilisation rates⁶⁹ and hospital case-mix.⁷⁰ However, the risk for the health component is reliable data, and data is barely collected for health treatment in the public health care system. The change in the education weight was based on historic expenditure, which is problematic as it only reflects provincial school enrolments. The PES review focused only on the formula, and not on the other pillars of the IGFR system, and so did not deal with vertical division and fiscal needs at a horizontal level. Generally, if the pool does not grow (given that other IGFR/vertical division issues

69 Health care utilisation rates are a measure of why people use health care services. People use health care services for many reasons: to cure illnesses and health conditions, to prevent or delay future health care problems, to reduce pain and increase quality of life, and sometimes merely to obtain information about their health status and prognosis (Schoen *et al.*, 2000).

70 Case-mix provides the health care industry with a consistent method of classifying types of patients, their treatment and associated costs. It includes developing and implementing health care classifications, tools and services (Schoen *et al.*, 2000).

are not dealt with), the review does not add much to ensuring that provincial functions are adequately funded. Still not clear is the balance on resource allocations between the spheres of government responsible for rural development. It thus remains to be seen whether these revisions to the PES formula will lead to increased equity, achieve quality, move towards better provincial education and health expenditure and less waste.

Despite real increases in education and health, correspondingly large improvements in outputs, outcomes or quality are difficult to identify. Government expenditure analysts in South Africa, which include the Commission, have raised concerns that most provincial budgets are informed by historical allocations and are simply adjusted for inflation. This practice perpetuates previous policies of depriving former homelands and poor rural areas of necessary education and health services (Chetty, 2007). Despite high vacancy rates in public hospitals, the majority of provinces are overspending on their personnel costs, mainly because of the implementation of the occupational specific dispensation (OSD). Budget, drug and staff shortages are becoming the norm in several provincial hospitals. The challenge regarding education and health performance is not about adequate funding per se but rather the system of transfers, from national to provinces and from the provinces to actual delivery centres (e.g. districts, schools, hospitals and clinics), which is not functioning efficiently.

Failures in intergovernmental policy-making, coordination and budgeting manifest themselves in resource allocations. Several studies on fiscal and health decentralisation are beginning to point to increasing spending inequalities among sub-national government, which translate into widening spatial inequalities in access to quality services. There are spending and service-level inequities between rural and urban areas. In rural areas, people still travel long distances for education and health services. Provincial inadequate budgeting and habitual over-expenditure on education and health leads to a shortfall of appropriate schools, learner support material, quality teachers, community health centres with access to full-time doctors, radiology and laboratory services, and obstetric services on a 24-hour basis. The overall performance of education and health systems needs to be strengthened and the fiscal responsibility and accountability of provincial governments improved.

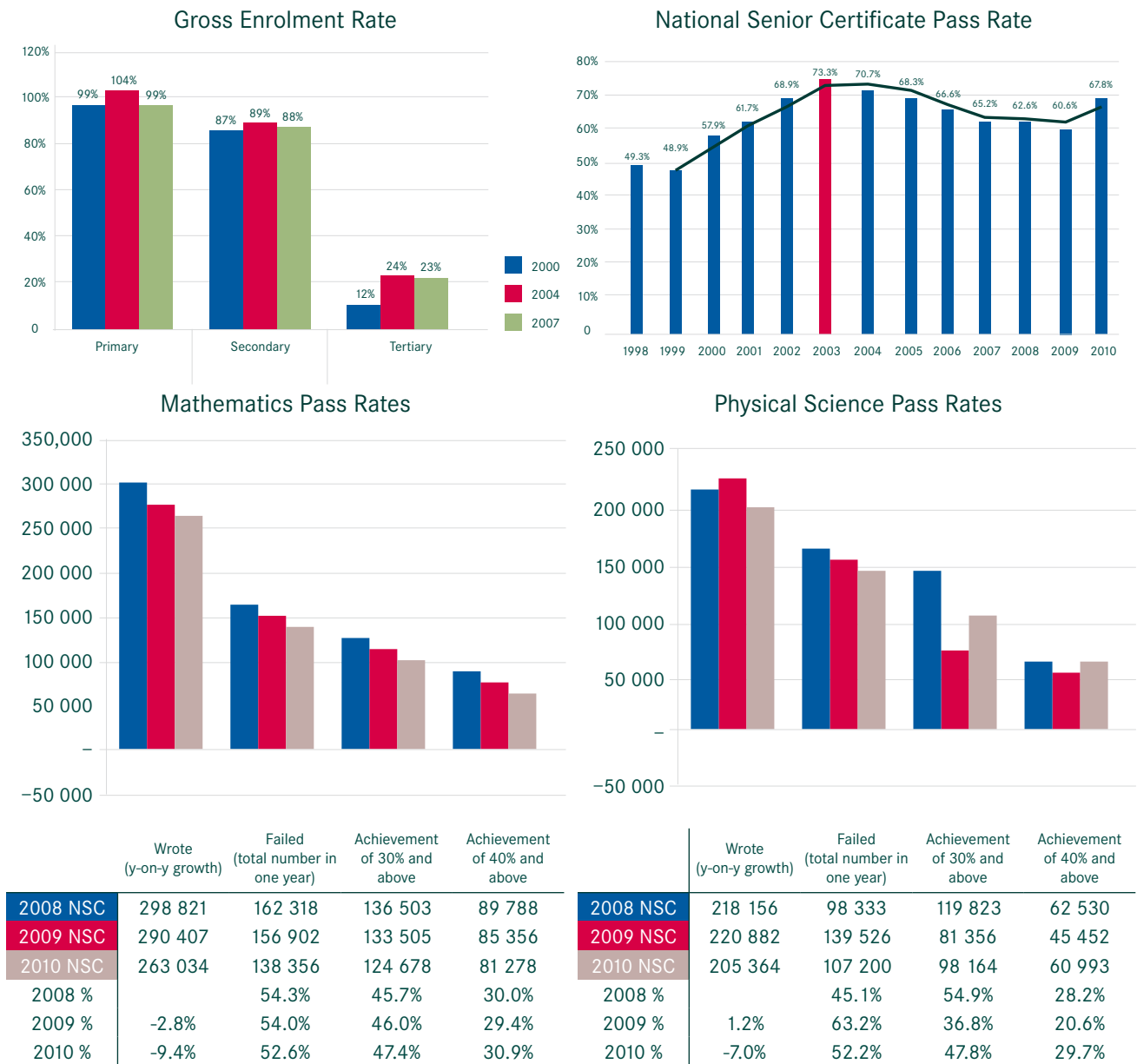
6.2.3 Performance of Education, Health and Rural Development Programmes in South Africa

In South African schools, gross enrolment rates are quite high at primary levels of education, which shows that the country has expanded access (not necessarily quality) to basic education and is on track to meeting the MDG2 of achieving universal primary education (Jansen, 2008). The challenge facing basic education in South Africa is that completion rates are low at secondary level, where drop-out rates increase each year, reaching about 20% by Grade 9 (Gustafsson and Morduchowicz, 2008). Analysts support this point, noting that over 1.3 million learners began Grade 1 in 1999, but less than half of them reached Grade 12 and became the “2010 matriculants” (Bowie, 2011). This is due to various reasons including, but not limited to, high drop-out rates and high grade repetition levels. There is thus a critical and urgent need for attention by the developmental state.

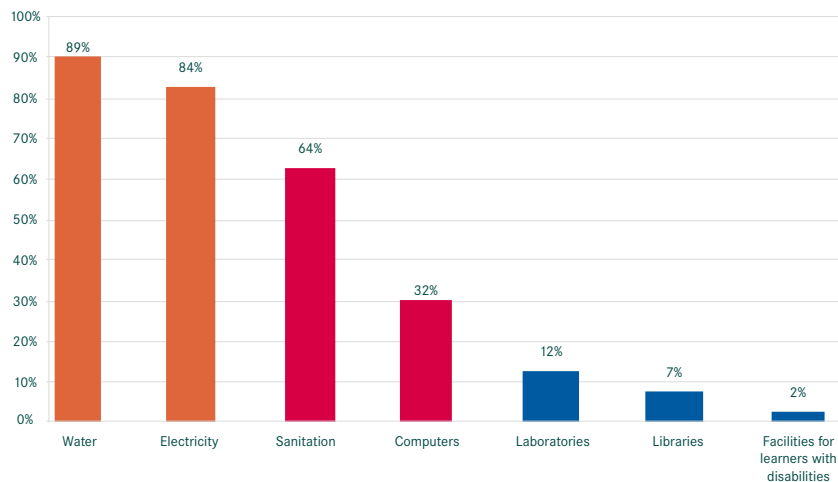
The annual average pass rate in the national senior certificate (NSC) between 1998 and 2010 was 63.2% and the pass rate in mathematics and physical science remained below 50% (see Figure 31). Furthermore, the number of NSC candidates writing the mathematics examination since 2008 has been declining. The overall pass rate in 2010 was 10% higher than that of 1955 but lower than the peak pass years of the 1960s and early 1970s. The 2008 university entrance pass rate (13.4%) was significantly lower than that of the 1950s, 1960s, and 1970s (Cronje, 2010). Quintile 1 schools, which are the poorest schools, perform badly in the NSC with some few outliers: of the 3341 learners who wrote the NSC in 2009 in Quintile 1 schools, only 265 or 7.6% passed. Bushbuckridge in Mpumalanga was South Africa’s worst-performing region in terms of 2009 NSC. There was no improvement in the NSC failure rate in Quintile 1 schools in 2010: of the 1096 learners who wrote NSC in Quintile 1 schools in 2010, only 71 or 6.5% passed.

Generally, continuing low pass rates do not augur well for the future and are a cause for considerable concern, as mathematics and physical science have been identified as key subjects for providing the skills needed for growth in South Africa.

Figure 31. Snapshot of school realities in South Africa



Schools Infrastructure



Source: Department of Basic Education: Education Statistics, 2009 - 2011

The effect of poor performance in public education system is the migration of students to independent schools, even by learners from townships. The 2009 School Realities data by the Department of Education shows that 386,098 learners attended 1,174 independent schools in 2009. These trends are interesting to note for basic education policy in South Africa, as they show substantial growth in private schooling in South Africa accompanied by socioeconomic and demographic diversification. African learners currently constitute more than 70% of all learners in independent schools, mainly in schools with low to average fees (du Toit, 2004). This is partly due to the perceived better quality education in independent schools. However, private or independent schooling is based on the willingness and ability to pay, and such schools are not easily accessible for the rural population. The government in partnership with civil society has a responsibility to fix challenges of quality education in public schools in South Africa, as migration to independent schools cannot be a solution.

Quality education and learner performance are also affected by formal access issues to education, mainly scholar transport, learner support materials, libraries, laboratories and inclusive education (i.e. catering for learners with special needs). Learner transport, especially in rural areas, remains a problem and, as the Commission has noted in its 2007 Submission, substantial institutional fragmentation is associated with the learner transport provision in provinces. This problem is particularly acute in rural areas where a significant number of learners travel long distances, use unsafe modes transport and are exposed to weather and other related dangers (Rogan, 2006). The Department of Basic Education's access norms and standards require that learners should be within a three kilometre distance of a school, but the average walking distance in rural areas is five kilometres (Rogan, 2006), beyond which transport should be provided. According to the 2009 General Household Survey by Statistics South Africa, nearly three-quarters (73.6%) of individuals attending an educational institution walk to get there. A further 8% travel by private car and 8% use buses and taxis. As a response to this challenge, the school funding norms make a provision for learners to be provided with transport or hostel facilities if they live more than one and half hours' walking distance from the nearest available school. However, inconsistencies are found across provinces with regards to the funding, procurement provision and coverage of scholar transport.

With regards to inclusive education, the 2001 Education White Paper 6 on Special Needs Education envisages that within a 20 year period, the Department of Basic Education would have expanded access and improved the quality of special schools. However, as Jansen argues, "a blind child, or a child in a wheelchair, or a child with diabetes, struggles much more to gain access to schools than children without special needs. Able-bodied children have easier access to the education system relative to children with disabilities of various kinds" (Jansen, 2008). Various analysts on special needs education agree that knowledge, skills and training for effective implementation of inclusive education is lacking in South Africa. The school environment is unprepared and unequipped for this policy imperative (Cook, 2001). For inclusive education to gain momentum, government would require investments in infrastructure, learner material, capacity and teacher support, as well as a change of attitude from both teachers and learners.

In health, the rapidly rising cost of health care and the impact on the equity and efficiency of the public sector health care system are of concern. This concern is found throughout the world. However, besides a few technocrats and policy-makers, there has been little debate about the tensions that arise between the principles of equitable financing of health and equal opportunity of access for equal health needs. It is important to note the fact that, in practice, these goals are difficult to reconcile. The concern about equity was one of the main motivating forces behind the creation of universal, equal health coverage for all in Australia, Canada, Great Britain, New Zealand, and the USA (Schoen *et al.*, 2000). Health is essential to well-being and to overcoming other effects of social disadvantage. In this regard, the Commission welcomes the fact that government intends to reform the health delivery system in South Africa through the introduction of the NHI but also notes the challenges that will need to be addressed before that objective is finally realised. Reliance on the private health market, based on private insurance and patient out-of-pocket costs results in social costs and raises access barriers for those with the greatest health care needs and divides communities around reform policies (Chetty, 2007). Equity, while it will not eradicate health problems on its own, is still the most important step toward eliminating health care disparities and should support the right to the highest attainable standard of health as indicated by the health status of the most socially advantaged groups.

According to the World Health Organisation (WHO, 2008), total health expenditure in South Africa in 2007 was equivalent to 8.6% of gross domestic product (GDP), as Table 14 shows. This expenditure was at similar levels with that of Australia (8.9%), the UK (8.4%), Brazil (8.4%), and above that of China (4.3%), India (4.1%) and Russia (5.4%). However, Russia spends more than South Africa in per capita terms. National Treasury notes that total health care expenditure in South Africa in 2007 was slightly more than R115 billion but less than half was public spending.

The private sector accounted for about 56%, the public sector for 41% and 2% was the contribution by non-governmental organisations (National Treasury, 2009). McIntyre and Thiede (2007) argue that private health expenditure has continued to increase on an annual basis since the 1980s, at rates far exceeding the inflation rate. As a result membership of medical schemes is unaffordable for most South Africans, and a relatively small proportion (16.9%) of individuals had medical aid coverage in 2009 (Health Systems Trust, 2010). Coupled to this, an estimated 21% of the population with no medical coverage prefers to use private doctors and pharmacies on an out-of-pocket basis (Gilson *et al.*, 2007).

Table 14. Health care expenditure and health status indicators
Comparison of healthcare expenditure and health status indicators in developed and developing countries

Country	Health care expenditure as % GDP, 2007	Per capita govt expenditure on health (PPP int.\$)	Life expectancy at birth, 2008	Infant mortality rate per 1000 live births, 2008 (MDG 4)
South Africa	8.6	340	53	48
High income countries				
Australia	8.9	2266	74	4
Canada	10.1	2730	73	5
United Kingdom	8.4	2446	72	5
USA	15.7	3317	70	7
BRIC member states				
Brazil	8.4	348	64	18
China	4.3	104	66	18
India	4.1	29	56	52
Russia	5.4	512	60	9
Middle income countries				
Chile	6.2	507	70	7
Cuba	10.4	875	69	5
Egypt	6.3	118	60	20
Malaysia	4.4	268	64	6
Thailand	3.7	209	62	13
AVERAGE	7.49	1005	65	16

Source: World Health Organisation estimates for country Health Accounts, 2010

Medical personnel and hospital facilities utilisation rates in developed and developing countries, 2008

Countries	Physicians		Nursing and midwifery personnel		Dentistry personnel		Pharmaceutical personnel		Hospital Beds
	Number	Density (per 10 000 population)	Number	Density (per 10 000 population)	Number	Density (per 10 000 population)	Number	Density (per 10 000 population)	(per 10 000 population)
South Africa	34 829	8	184 459	41	5 995	1	12 521	3	28
High income countries									
Australia	19 612	10	222 133	109	29 624	15	15 339	8	39
Canada	62 307	19	327 224	100	38 310	12	27 078	8	34
United Kingdom	126 126	21	37 200	6	25 914	4			39
USA	793 648	27	2 927 000	98	463 663	16	249 642	9	31
BRIC member states									
Brazil	320 013	17	549 423	29	217 217	12	104 098	6	24
China	1 862 630	14	1 259 240	10	136 520	1	351 620	3	30
India	643 520	6	1 372 059	13	55 344	1	592 577	6	9
Russia	614 183	43	1 214 292	85	45 628	3	11 521	1	97
Middle income countries									
Chile	17 250	11	10 000	6	6 750	4			23
Cuba	72 416	64	97 800	86	20 158	18	7 047	6	60
Egypt	179 900	24	248 010	34	25 170	3	92 540	12	21
Malaysia	17 020	7	43 380	18	2 160	1	2 880	1	18
Thailand	18 987	3	84 683	14	4 471	1	7 350	1	22
AVERAGE	341 603	20	612 636	46	76 923	7	122 851	5	34

Source: World Health Organisation estimates for country Health Accounts, 2010

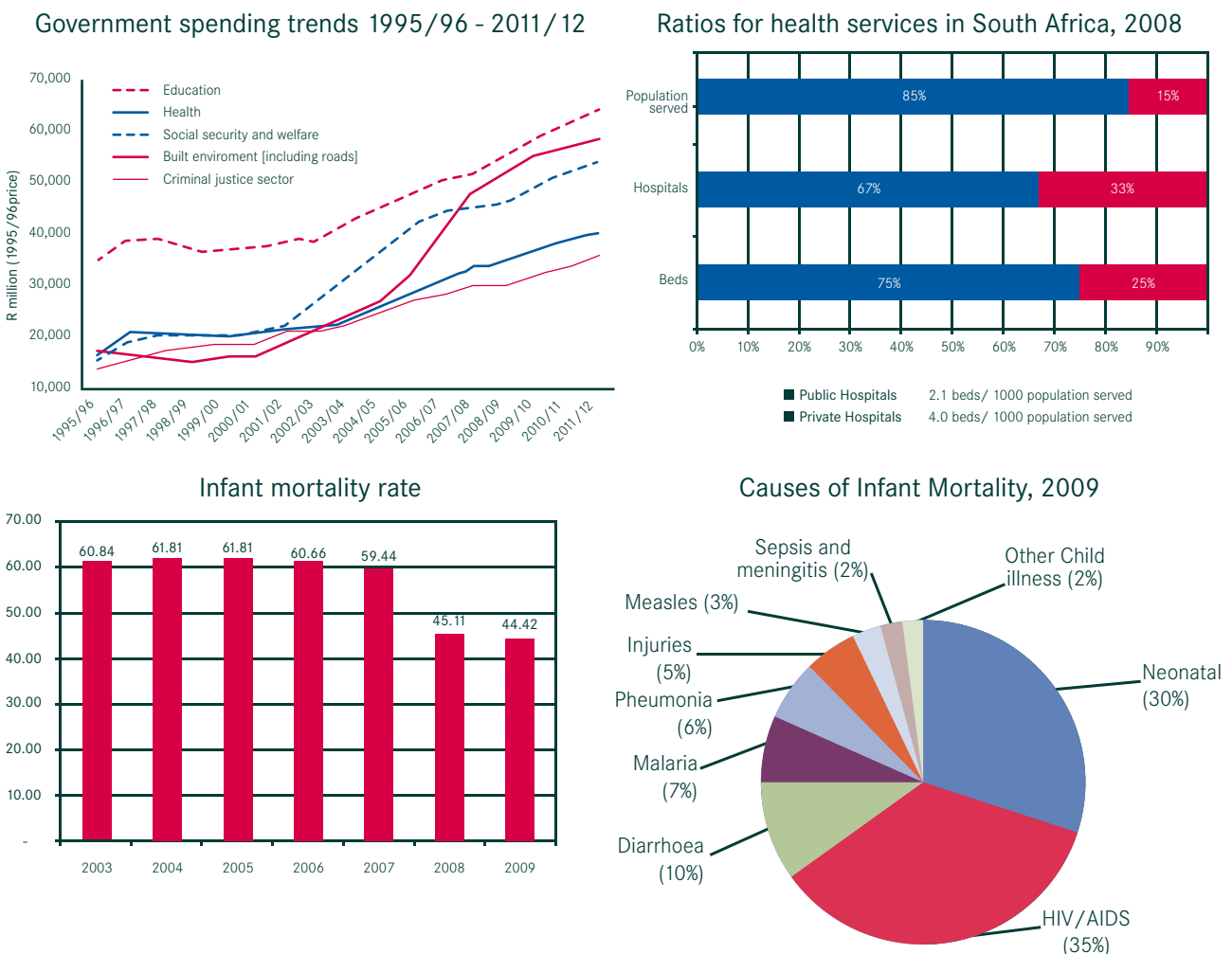
Within the public health sector system, about 88% of government health expenditure is allocated to provinces. Spending trends on the government's policy priorities show that the health sector's share of total government expenditure has been increasing since 2004/05, but from a lower base compared to education, social security and the built environment allocations. Health budget allocations are mostly growing in the area of HIV/AIDS, especially the costs of providing anti-retroviral treatment due to an increasing uptake by patients. Other health cost drivers are the hospitals and health facilities management revitalisation programme, and the provision of OSD for health professionals (National Treasury, 2010). Against the backdrop of global health of people that has improved more than in the whole span of human history (WHO, 2008), South Africa faces the challenges of declining life expectancy and high infant mortality rates. Average life expectancy in South Africa is 53 years (52 for males and 55 for females), and the under-five infant mortality rate per 1000 lives (i.e. the probability of dying by age 1 per 1000 live births) is 48 per 1000 live births.

Many health analysts and official health reports cite HIV/AIDS as the main reason for South Africans dying younger and in greater numbers. Deaths in the neonatal period contribute substantially to under-five deaths; outside the neonatal period, HIV/AIDS and childhood infections (mostly diarrhoea and respiratory infections) are the major causes of deaths (Norman *et al.*, 2006). In trying to understand variations in international health expenditures and South Africa's relatively poor health outcomes, most health analysts agree that poor maternal and child health, infectious diseases and malnutrition are associated with poverty.

Health analysts argue that there is a strong linkage between poverty, morbidity and mortality in South Africa (Woolard, 2002). The poor have particular difficulties in accessing health care services mainly because of economic reasons and social standing. Other studies also reveal complex patterns of mortality, morbidity, risk factors and unhealthy lifestyles among the poor in South Africa (Bradshaw and Steyn, 2001). The poor suffer from substantial premature mortality due to chronic disease including HIV/AIDS, strokes, asthma, epilepsy and cervical cancer. In order to finance their health needs, many poor families end up using all their resources, indebt themselves and mortgage assets to fund health care in catastrophic situations (Bradshaw and Steyn, 2001).

This state of affairs is also blamed on the country's health care system's inequities, which are exacerbated by the fact that, of the 37 million people who make use of the country's health services, the private health system caters for a population of just seven million people; the remaining 30.2 million people are treated in the public-health sector. The allocation of resources is inequitable between the private and public sectors as well as within the public sector itself (among provinces and different levels of health care). With the over-resourcing of private health insurance and under-resourcing of the public sector, health care practitioners have been attracted to the more lucrative private health system (McIntyre and Thiede, 2007). The majority of the population depends on the public sector for all their conventional health care services amid an exodus of doctors and other health professionals from the public to the private sector. Government alone cannot afford and assure all the health of the population. It is on this basis that this Submission provides recommendations towards improvements in the South African health system.

Figure 32. Snapshot of the performance of health care system in South Africa



Source: Department of Health, Health Systems Trust, National Treasury: Budget Reviews, Medical Research Council, World Health Organisation

6.3 Recommendations

This chapter sought to analyse particular challenges facing implementation of education, health and rural development policies in South Africa. Even though the government has massively increased its expenditure on education and health, the returns have been sub-optimal. Education and health in South Africa are fraught with many supply and demand side challenges, which are related not only to funding, but also to the quality services, role of teachers and health professionals, parents, state of facilities, learner performance and the recipients' status. Even though the PES has been reformed to cater for the use and demand for education and health services, provincial health budgets are not based on an estimation of the needs of health service users. Health budgets do not adequately account for the magnitude of the HIV epidemic and South Africa's other growing health challenges. Worryingly, provinces habitually overspend their education and health budgets and accrue large debt that is not adequately covered by annual budget allocations. Provincial budgets account insufficiently for the OSDs for teachers, nurses and doctors. It is worrying that OSD is being extended to other sectors and professionals, when the implementation challenges with regard to teachers, nurses and doctors still persist.

All these factors require robust intervention by the government, and the responsibility for ensuring proper financial management should rest with the National and Provincial Treasuries. If these interventions are not made promptly, the public education and health systems will be a constraint on South Africa's economic development and economic growth prospects.

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 through 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.

Appendix 1

IMPLEMENTATION OF THE RURAL DEVELOPMENT PROGRAMME AND ITS IMPLICATIONS FOR THE INTERGOVERNMENTAL FISCAL RELATIONS SYSTEM IN SOUTH AFRICA

A1.1 Introduction

In this Appendix, the challenges pertaining to the implementation of rural development programmes in South Africa are analysed. The South African government acknowledges that rural areas face significant poverty and development challenges. The pervasive poor delivery of basic services in rural areas continues to constrain development efforts in South Africa. As such, rural development is one of the five policy priorities for the current government's elective term and included in the Medium-Term Strategic Framework 2009-2014; it is also Outcome 7 in the government's delivery agreement between the President and Ministry of Rural Development and Land Reform. This priority is part of the government's redistributive agenda and involves some form of social justice and rebalancing, since the heart of economic fragmentation is felt most in rural areas.

A number of social and economic surveys and research studies confirm the extent to which South African poverty is concentrated in the rural areas. Most of the underclass of workerless households is located in the former "Bantustans" where average income per head and service delivery are marginally lower than in towns and cities (Makgetla, 2010). Illiteracy and low education levels are more prevalent in rural areas than in urban areas. The concentration and persistence of the most extreme forms of poverty, and rising inequality in the distribution of the national resources and incomes remain vexing outcomes of efforts at combating rural development challenges often through uncoordinated and ineffective initiatives.

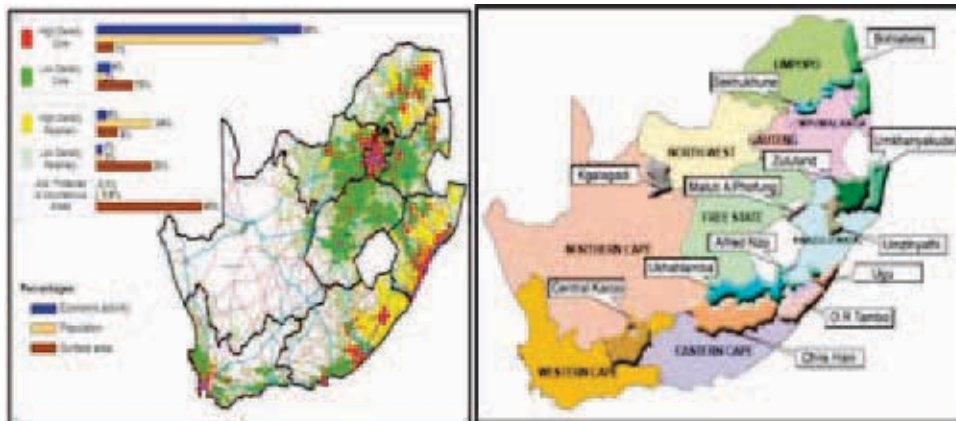
The other challenge is that rural development, both as a concept and a government programme, continues to be characterised by ambiguity, conflicting policy prescriptions and lack of coherence across the activities and incentives in all spheres of government and departments (Parnell, 2008). There is no government-wide definition of what are rural and remote rural areas. The dividing lines between city, large town, small town, urban, peri-urban, farm and deep rural areas are very blurred. From an intergovernmental-relations perspective, there is still a lack of consensus about what constitutes a successful rural development programme in relation to policy objectives, planning, programming and budgeting and institutional arrangements. These widespread challenges call upon alternative approaches, which may have greater chances of reducing rural poverty and inequalities, to be explored.

From a fiscal policy and budgeting perspective, the multi-dimensional nature and complementarity of the rural development programme and outcomes are not well understood. For instance, the interrelations between the quality of services in rural areas – roads, electricity, water sanitation and telecommunications – and the willingness and encouragement of doctors, nurses and teachers to live and provide services in rural areas. Further, improved water and sanitation services will play an important role in reducing child mortality, which will also socially benefit the rural populace at large (Woolard, 2002). Clarity is needed on the role of all spheres of government in rural development. Once this is agreed upon, it will be less difficult to design fiscal frameworks for this important policy objective. An accelerated rural development programme is the key to promoting shared and broad-based economic growth. Improving conditions in rural areas is not only a goal in itself for a better quality of life, but also its positive impact on the economic development is far-reaching.

A1.2 The Contextualisation of Rural Poverty in South Africa

The aim of rural development is to improve access, to constitutionally mandated services and the development of economic opportunities, for the ten million rural poor who reside in 15 Presidential Poverty Nodes, described as the “spatial manifestation of the second economy” (The Presidency, 2008). Rural areas are sparsely populated and characterised by communal land tenure in which people depend on migratory labour system, remittances and subsistence farming for survival (Hemson *et al.*, 2004). Figure 33 also illustrates the concentrated nature of the South African space economy and indicates the distribution and location of people living in poverty (as calculated by using the number of people living under the minimum living level, MLL) and economic activity (using gross value added (GVA) as an indicator).

Figure 33. High concentration of people living below the MLL compared to economic accessibility



Source: The Presidency, 2008

Both the red and the green indicate areas that are highly accessible to large numbers of the population. The yellow indicates areas that are also relatively densely populated but much less accessible. The bulk of the poor live in the rural areas of the Eastern Cape (Alfred Nzo, Chris Hani, O.R. Tambo and Ukhahlamba), followed by KwaZulu Natal (Ugu, Umkhanyakude, Umzinyathi and Zululand) and Limpopo (Maruleng and Sekhukhune). Thabo Mofutsanyane in the Free State, Bushbuckridge in Mpumalanga, Kgalagadi in Northern Cape and North West, and Central Karoo in Western Cape are also rural nodes. Social security grants as a source of income are more prevalent than salaries in rural nodes. Remittances as a source of income played an important role in most provinces, especially in Limpopo, the Eastern Cape and Mpumalanga. Various studies show that the rapid urbanisation in South Africa is mainly as a result of urban migration by the rural populace for better economic opportunities and living conditions in towns and cities (Parnell, 2008). This suggests that are challenges related to access to constitutionally mandated basic services and economic opportunities in rural areas. Consequently, unemployed, poor and uneducated parents in rural areas are not in a good position to look after the education and health needs of their children. Similarly, the linkages of education and health to poverty eradication and long-term economic growth are weak. Further, food security is a major challenge for poor families in rural areas even though studies do show that this is also increasingly becoming a challenge in urban areas as well. The right to access sufficient food and water is stipulated in Section 27, subsection 1(b) of the Constitution. High food prices pose a threat to this right, which is acknowledged by the Department of Rural Development and Land Reform in its delivery agreement with the President on “Output 7: vibrant, equitable and sustainable rural communities and food security for all”.

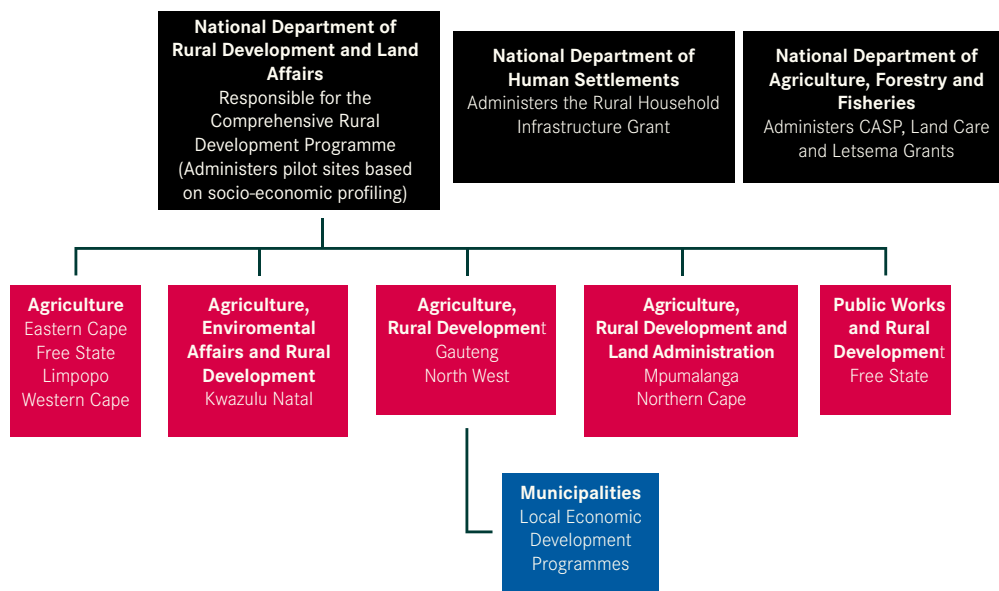
This output intends to accelerate the land reform programmes to “ensure sustained productivity by new landowners, contribute to their income, food security and local economic development”. This is conceived with the view that most people in rural communities are involved in agriculture and farming. However, agricultural employment growth in South Africa has fallen by almost 45% since 1995. In 2009 alone, 149,000 people lost their jobs in the agriculture sector and employment growth declined by 19.5% (National Treasury, 2010). As compared to other developed countries, agriculture peasantry in South Africa is not significant. “Income generated and food consumed from agriculture is a minor component of household resources (4% of the income)” (Hemson *et al.*, 2004). What is emerging is that people in rural areas are engaged in farming for their own consumption instead of commercial purposes. So food security should be at the centre of rural development in South Africa rather than commercial farming *per se*.

A1.3 Institutional and Fiscal Arrangements for Rural Development in South Africa

In an attempt to accelerate the programme as part of the 2009–14 Medium-Term Strategic Framework, national departments

with responsibilities for agriculture, land reform and rural development were reformed. The responsibility for these functions is now shared by: the Department of Rural Development and Land Reform, which is responsible for the overall coordination of rural development, land and agrarian reforms; the Department of Agriculture, Forestry and Fisheries, which is responsible for agricultural development and administers the Comprehensive Agriculture Support Programme Grant, Land Care and Ilima/Letsema Grants (see Figure 34); and the Department of Human Settlements, which administers the Rural Household Infrastructure Grant. The Rural Household Infrastructure grant is a new grant that was introduced in the 2011 Medium-Term Expenditure Framework and addresses the access issue of water supply and sanitation in rural areas.

Figure 34. Institutional arrangements for agriculture and rural development in South Africa



Source: FFC analysis, 2010

Immediately after the 2009 national elections, these departmental institutional arrangements were also replicated in some provinces. However, (as at December 2010), the Eastern Cape, Limpopo and the Western Cape did not have departments named rural development. Only Mpumalanga and Northern Cape have departments for land administration. Municipalities do not have stand-alone institutional arrangements or programmes for rural development, but incorporate these programmes within their integrated development programmes and local economic development programmes. The spread of rural development functions across provincial departments makes planning, budgeting and delivery of difficult to implement.

In South Africa there are no official standard definition(s) or indicators for 'rural areas', which makes fiscal analysis of rural development programmes difficult to measure and quantify. It also makes budget analysis in terms of allocative efficiency not easy because budget programmes and economic classification for rural development are not as yet standardised in the provincial budgets. A differentiated approach is needed in policy and fiscal frameworks to deal with urban and rural nodes. This does not necessarily presuppose additional money into the fiscus but there is a need to strengthen the weak link between spending and outcomes. There must be a government-wide agreement on quality and quantitative indicators that can be used as proxies for rural development programmes and targets.

Rural-to-urban migration has resulted in some relocation of poverty to town, which probably indicates that the underclass is now found in urban as well as rural areas (Bhorat and Kanbur, 2006). The rapid migration of people, both within a country (internal migration) and across borders (cross-border migration) must, of necessity, inform the government's future urban and rural development policies. Furthermore, agriculture and rural development programmes should not be top down and divorced from local communities' circumstances, but should incorporate traditional knowledge, indigenous knowledge systems expertise, skills and practices related to rural people and their areas, agricultural production, food security and diversity.

A1.4 Observations

This Submission sought to assess the particular challenges facing rural areas in South Africa. The historical challenge to deliver government services to the rural populace has made rural development one of the top five priorities for the current

government. However, from the intergovernmental relations perspective, the concept of rural development is still nebulous and needs a proper conceptualisation.

The role of all spheres of government in rural development needs to be clarified. Once this is agreed upon, it will be easier to design fiscal frameworks for this function. Furthermore, rural development cannot just be limited to agrarian and land reforms, but requires a rethink on the nature of government programmes dealing with rural poverty. Challenges facing the rural poor are more than agriculture and agrarian reforms. They concern education, health care, social and economic infrastructure, the creation of employment opportunities, as well as changing the economic geography of rural areas. For this to happen, intergovernmental fiscal reforms are needed to enhance rural development.

The following advisories are made:

- The governance and institutional arrangements for rural development across the three spheres of government need to be clarified urgently. This is important for planning, budgeting and implementation of rural development programmes. The Commission recommends that a functional mapping of all rural development activities be undertaken, with specific responsibilities assigned to each sphere of government.
- The fiscal framework (both the equitable share and conditional grant allocations) for rural and agricultural development must be reviewed. In particular, government should merge current conditional grants into a comprehensive agriculture and rural development finance programme, preferably administered by one department. This will improve the focus, targeting and impact, and reduce transaction costs in the administration of conditional grants.

Appendix 2:

THE IMPACT OF UNFUNDED MANDATES IN SOUTH AFRICAN INTERGOVERNMENTAL RELATIONS

A2.1 Introduction

This Appendix reports on the progress of the first phase of the work, which the Commission began during the second half of 2010, into the impact of unfunded/underfunded mandates on provincial and local government. This phase focused primarily on the six metropolitan areas. Since their inception, some municipalities have raised the issue that they are compelled to perform functions, which are not allocated to them in terms of the Constitution and legislation on powers and functions. Some provinces have also pointed out that they face unfunded or underfunded mandates as a result of policy decisions made at a national level. These decisions have financial implications, but come without the necessary funding for their implementation. To deal with unfunded mandates and the constraints they place on other spheres of government, the government has put in place several initiatives. The most notable are the 2003 amendments to the Municipal System Act of 2000, specifically to Sections 9 and 10, which aim to prevent unfunded mandates flowing from legislative assignments; and the 2003 amendments to the Financial and Fiscal Commission Act of 1997, which requires organs of state to assess the financial and fiscal implications (and obtain the Commission's recommendations) before functions that are assigned to other organs of state in another sphere of government become law. In evaluating the impact of unfunded mandates on service delivery at provincial and local government level, this Appendix focuses on housing, health care services, roadworks, libraries and museums, as these are the commonly cited services when unfunded mandates are discussed.

Section A2.2 discusses the legislative framework for assigning or shifting powers and functions, which is followed by a discussion of unfunded mandates in Section A2.3. In section A2.4 the results of a questionnaire administered to assess the prevalence and impact of unfunded mandates in South Africa are discussed and interpreted. The Appendix concludes by highlighting the key findings and providing advisories.

A2.2 Framework for transferring powers and functions

The starting point is that unfunded mandates can be understood in the context of the constitutional and legislative framework for the allocation and transfer of powers and functions.

A2.2.1 Constitutional framework

The Constitution defines the functions and relationships of the spheres of government in South Africa. Provinces have concurrent powers in functional areas listed in Schedule 4 (shared with the national government) and exclusive powers with regard to Schedule 5 matters. Municipalities have powers in respect of the functional areas listed in Schedules 4B and 5B. All residual matters fall under the national government's jurisdiction. Table 15 provides a summary of each sphere of government's role in providing specific functions in the areas reviewed and highlights sector-specific legislation for the assignment of these functions.

Table 15. The role of each sphere of government and legislation for the assignment of functions

Functions in constitution			Sector specific legislation for the assignment of specific functions	
Function	Relationship to schedule 4B and 5B	Provinces	Municipalities	Legislation
Health care services	A municipal health service is listed as a Schedule 4B function in the Constitution.	Undertakes a function of Primary Health Care services.	Provide Primary Health Care Services as a delegation from provinces.	The National Health Act, 2003 (Act No 61 of 2003) provides for the primary health care functions to be assigned to local government.
		Co-ordination of municipal health services.	Undertakes a function of municipal health services.	
Housing	Housing appears as a competency in Schedule 4A. 'Housing' as a competency has not been defined in any statute or court judgment.	Facilitates and promotes the provision of adequate housing with the province and within the framework of national policy.	Implement the process of integrated development planning within the framework of national and provincial housing legislation and policy.	The Housing Act 107 of 1998 provides for 'accreditation' of municipalities to undertake housing activities.
Libraries	"Libraries other than national libraries" are a Schedule 5A function that falls within the exclusive legislative competence of a province.	Provincial libraries and archives.	Provide libraries although this is not a municipal function.	There is no legislation. The function is provided without formal delegations from provinces.
Museums	"Museums other than national museums" are a Schedule 5A functional area that falls within the exclusive legislative competency of a province.	Provincial museums.	Provide museums although this is not a municipal function.	There is no legislation. The function is provided without formal delegations from provinces.

This division of powers is not watertight, as there are great difficulties in defining the cut-off points between the schedules and the two parts of the schedules. Provinces and municipalities may exercise their powers in the listed functional areas at their discretion. However, the Bill of Rights does impose duties on the government as a whole to perform functions in the areas covered by the listed socioeconomic rights⁷¹. In addition, municipalities are also constitutionally bound to provide basic municipal services.⁷²

The Constitution draws a link between the functions of sub-national governments and the funding to perform that mandate. Section 227(1)(a) provides that: "Local government and each province is entitled to an equitable share of revenue raised nationally to enable it to provide basic services and perform functions allocated to it". The entitlement to an equitable share is thus linked to basic services to be provided.

Equitable share transfers are complementary rather than the sole source of revenue for such functions. Therefore, when determining the equitable share allocation, the fiscal capacity and efficiency of provinces and municipalities must be taken into account.

A2.2.2 Legislative framework

The relevant legislation includes the Municipal Systems Act (32 of 2000), the Intergovernmental Fiscal Relations Act (97 of 1997), the Financial and Fiscal Commission Act (99 of 1997), the Division of Revenue Act (DORA) and the Public Finance Management Act (PFMA).

71 Ss 26 and 27 Constitution.

72 Joseph v City of Johannesburg 2010 (3) BCLR 212 (CC).

The Municipal Systems Act (32 of 2000). In terms of section 9 and 10 of the Municipal Systems Act there are procedural and substantive requirements that must be complied with during the assignment process. A national minister initiating the assignment of a function to municipalities in general (or to any category of municipalities) by means of an Act of Parliament must go through a procedure of consultation with the various stakeholders within a reasonable time before the Bill is introduced in Parliament.

The Intergovernmental Fiscal Relations Act (97 of 1997). The Act provides for consultation with the Financial and Fiscal Commission (the Commission) when any sphere of government intends to shift or delegate a function to another sphere of government.

The Financial and Fiscal Commission Amendment Act (99 of 1997). Section 3 of the Act provides for consultation with the Commission on the financial and fiscal implications before an organ of state in one sphere of government assigns the power or function to an organ of state in another sphere of government.

Division of Revenue Act (DoRA). When a function is shifted, the resources employed to render the function shift with the function. This principle arises from section 27(2) of the Annual Division of Revenue Act and requires that the equitable share allocations for the financing of particular functions and conditional grants (both operating and capital) must be paid to the organ of state that will become responsible for the function following an assignment.

The Public Finance Management Act (PFMA) provides for the calculation of the financial implications for the transfer of function. In terms of Section 35, draft national legislation that assigns an additional function or power to, or imposes any other obligation on, a provincial government, must, in a memorandum that must be introduced in Parliament with that legislation, give a projection of the financial implications of that function, power or obligation to the province.

A2.3 Definition of unfunded mandates

The concept of unfunded mandate is used loosely in the South African intergovernmental relations context. Unfunded mandates can be viewed broadly as (Khumala and Mokate, 2007:271):

Unfunded mandates refer to situations in which sub-national governments are legally mandated in terms of the Constitution or by policy pronouncement to undertake specific functions but do not receive funds from nationally raised revenues in order to fulfil these functions. This scenario is highlighted in cases where the framework underlying the provision of particular services require provincial or local governments to implement nationally determined minimum-service standards. However, the funding for the delivery of such services fails to reflect the cost of the service standards, forcing sub-national authorities to divert scarce own-revenue funds to meet the standard set.

A more narrow definition confines unfunded mandates to the transfer of new functions (not constitutionally assigned) to provinces and municipalities. The South African Cities Network defines an unfunded mandate as when “cities perform the functions of other spheres of government and bear significant costs out of their own revenue sources” (South African Cities Network, 2007:78).

The focus here will be on the narrow definition of unfunded mandates because the functional areas of housing, libraries, museums and primary health care are all matters that appear to fall outside Schedules 4B and 5B.

A2.3.1 International case studies on eliminating unfunded mandates

This section provides comparative case studies in order to gain insight into respective countries’ experiences with addressing problems associated with unfunded mandates. The concern about unfunded mandates is widespread in federal and decentralised systems and appears under various names. It is referred to as service responsibility downloading in Canada (McMillan, 2006) and cost shifting in Australia (Sansom, 2009).

During the late 1970s–early 1980s and again in the early 1990s, 15 states in the United States amended their constitutions to curb unfunded mandates. The methods used were the following (Zimmermann 1995: 88):

- (a) Prohibiting the imposition of some or all types of state mandates;
- (b) Requiring reimbursements of all or part of the costs associated with the mandates;
- (c) Authorising local governments to ignore an unfunded mandate;
- (d) Requiring a two-thirds vote of each house of the state legislature for imposing a mandate;
- (e) Authorising the governor of a state to suspend a mandate; or

- (f) Providing for the implementation date of a mandate to be delayed.

Following state initiatives that sought to curb states from imposing unfunded mandates on municipalities, the US Congress passed the Unfunded Mandates Reform Act of 1995 (UMRA). The object of the UMRA was not to place a ban on unfunded mandates, but to promote decision-making by compelling the Congress and federal agencies to consider the cost of imposing mandates on states, local and tribal governments and the private sector.

Unfunded federal mandates on local government also featured in the recent reform agenda of German federalism. In the major reform initiative of 2006, the *Länder*⁷³ asserted their constitutional dominance over local governments to the exclusion of the federal government. Articles 84(1) and 85(1) were thus amended by adding the following sentence to each: "Federal laws may not entrust municipalities and associations of municipalities with any tasks". Thus, transfers of tasks would come only from *Länder* (Gunlicks, 2007:120). Lander constitutions have also contained some provisions to limit unfunded mandates.

A2.4 The existence of unfunded mandates

A2.4.1 Health service (primary health care)

Municipalities also often cite primary health care as an unfunded mandate⁷⁴. In 2005 the National Health Council resolved that primary health care would be a provincial responsibility, and municipal health services (comprising selected components of the environmental health package of services) would remain a municipal responsibility. In terms of the 2005 resolution, municipal clinics were to be transferred under the provincial health structures, in a process known as "provincialisation". This policy will be reviewed in 2015 and may be amended or reversed if a single public service has been established by then.

Following this resolution, the provincialisation process started, with provinces making different levels of progress. However, in October 2007 the South African Local Government Association (SALGA) advised municipalities to halt all further transfers of primary health care to the provincial government until clarity had been reached on what constitutes primary health care, and research has been done on whether municipalities are best placed to provide effectively and efficiently primary health care services. According to Versteeg et al. (2009), since then no primary health care services have been provincialised from any metropolitan municipality in the country.

(a) Relation to Schedules 4B and 5B

The Constitution lists "Municipal health services" as a Schedule 4B function. The National Health Care Act 61 of 2003 defines municipal health services as water quality monitoring, food control, waste management, health surveillance of premises, surveillance and prevention of communicable diseases excluding immunisations, vector control, environmental pollution control, disposal of the dead and chemical safety.

Municipalities that provide primary health services must adhere to national standards, which deal with, among other things, the free provision of health services. In addition, municipalities are under considerable situational pressure to perform the service or to maintain quality standards. Thus these municipalities feel compelled to provide the service and to uphold a legally prescribed standard in doing so – which comes at a cost. Municipalities that perform primary health services do so in terms of agency agreements, which reportedly provide for inadequate funding arrangements.

A2.4.2 Libraries

(a) Relationship to Schedules 4B and 5B

"Libraries other than national libraries" are a Schedule 5A functional area that falls within the exclusive legislative competence of a province. Municipalities have no comparable competence. As an exclusive provincial competence, provinces are active in this functional area but to a limited degree. For example, in the Western Cape, the core functions of the provincial library service are the selection, ordering, professional preparation and processing of library materials, the provision of an information service, the promotion of the use of libraries and library materials, and the maintenance of a computerised library information system. Municipalities perform the bulk of the function, i.e. employing staff, managing the operations of libraries and maintaining library buildings.

Furthermore, municipal libraries also perform a strong supplementary role in primary and secondary education (a Schedule 4A function). They are a reference source for school projects, particularly in light of the poor quality of many school libraries. Many libraries also provide study space for learners.

(b) Duty or discretion?

There has been no legislative or executive assignment by the provinces of the library function to municipalities. However, until the 1996 Constitution came into operation, libraries were a local government matter, and so most public libraries are currently still administered and funded by municipalities.

In the Western Cape, for example, there are 148 library sites in non-metropolitan areas (130 public libraries, three multi-purpose community centres, five mobile libraries and ten satellite libraries) and 105 in the City of Cape Town (98 public libraries, three mobile libraries and four others). The Province administers libraries in only three municipalities, which was apparently due to the refusal of the municipalities to continue with the library function in 2000, and the province was willing to take them over. The question is then why do municipalities continue to perform a function that is not legally theirs. The answer is situational: it is socially and politically unacceptable for municipalities to close their libraries knowing that the provincial governments may not take over or provide adequate compensation for this function.

A2.4.3 Museums**(a) Relation to Schedule 4B and 5B**

“Museums other than national museums” are a Schedule 5A functional area that falls within the exclusive legislative competence of a province. Provinces have been active in exercising their constitutional powers by administering or supporting museums. Although “museums” are not listed in local government’s constitutional functional areas in Schedules 4B or 5B, municipalities are conducting similar activities (a practice that, like libraries, predates the Constitution), ostensibly as part of their local tourism function (a Schedule 4B functional area).

(b) Duty or discretion?

There has been no legislative or executive assignment by the provinces of the museum function to municipalities. As museums were a local government matter until the 1996 Constitution came into operation, most museums are currently still administered and funded by municipalities.

Museums are not a basic service, and no obligation is imposed on municipalities to either establish or support them. Should the province assign the legislative function to municipalities, it would merely be extending a discretionary competence. Thus, there can be no compulsion to establish, run or support a museum. However, should a municipality decide to venture into this functional area, the province could set minimum standards for managing museum collections, visitor services and facilities.

(c) Costs

As suggested above, since the functional area of museums is discretionary power, any costs incurred would be for the account of the municipality concerned.

A2.4.4 Housing

Although the precise content of the housing competency in Schedule 4A is not defined in any statute, it broadly refers to the regulation, planning, funding and execution of government-subsidised housing schemes. The location of housing in Schedule 4A means that both national and provincial government may adopt and administer housing legislation. However, without assignment, municipalities may not make legislation with regard to housing or administer the housing subsidy.

There are two important legal qualifiers. First, municipalities may be accredited to assume a greater role in housing, and the process of accreditation does not result in an unfunded mandate as defined in this Appendix. Second, the Constitution instructs the State, including municipalities, to realise the right of access to housing. Municipalities have been allocated, by statute and by court judgment, responsibilities to realise the right of access to housing. For example, the Prevention of Illegal Evictions from and Unlawful Occupation of Land (PIE) Act instructs municipalities to submit information to the eviction court about alternative accommodation, and courts have instructed municipalities to make alternative land available to evictees whose eviction will result in homelessness. Municipalities have argued that, in practice, these obligations are no longer a small component, but go to the heart of the housing function.

First, the imposition of the abovementioned obligations emanates not only from PIE but mostly from the Bill of Rights, which removes the issue from the definition of unfunded mandates adopted here. Duties, arising from the Bill of Rights and imposed on municipalities through court orders, should not be considered unfunded mandates.

Second, while the provision of subsidised housing falls outside of the municipality's constitutional mandate, the same cannot be said of the provision of serviced sites or the facilitation of access to unoccupied buildings.

A responsibility would qualify as an unfunded mandate, as defined in this Appendix, to the extent that government has transferred responsibility to local government to submit reports to eviction courts. It is a responsibility, imposed by national government through legislation that falls outside Schedule 4B and 5B, and is not accompanied by a dedicated funding stream from national government. The Act predates the assignment framework of the Municipal Systems Act and the FFC Act. However, the courts appear to attenuate this duty by requiring municipalities to act "reasonably". Municipalities may therefore limit their involvement to evictions of the desperately poor that will result in homelessness. This involvement is based on the municipality's duty to implement the right of access to housing. Evictions that do not result in homelessness do not fall within that category.

The duty of local government to respect, protect, promote and fulfil the right of access to housing is not an unfunded mandate as defined in this Appendix. It forms part of the responsibilities allocated to the municipality by the Constitution and must be catered for in the equitable share. However, it may very well be an underfunded mandate in that the equitable share is not designed to incorporate a municipality's constitutional responsibilities concerning the right of access to housing in the context of evictions.

A2.5 The impact of unfunded mandates between spheres of government

This section provides an analysis of the financial impact of unfunded mandates as they relate to local government and provinces. First, it looks at the financial impact of unfunded mandates on metropolitan municipalities i.e., eThekweni, City of Johannesburg, Nelson Mandela Bay, Ekurhuleni, Tshwane and City of Cape Town. A questionnaire was administered to the six metros to assess the financial impact of unfunded mandates. The focus is only on metropolitan municipalities and KwaZulu-Natal, Eastern Cape and Gauteng provinces, and is part of the Commission's first attempt to assess the impact of unfunded mandates in South African intergovernmental relations. The Commission plans to undertake further research into the impact of unfunded mandates on local municipalities, district municipalities and other provinces in 2011.

A2.5.1 The financial impact of unfunded mandates in practice

(a) Metropolitan municipalities

What emerged from the questionnaire was that municipalities perform functions on behalf of provinces. These functions include Health Care Services, Libraries, Housing Services, Museums and Roadworks.

Table 16. Unfunded mandates by metropolitan municipality (nominal terms)

Type of unfunded mandate	eThekweni		City of JHB		Nelson Mandela		Ekurhuleni		Tshwane		City of Cape Town	
	08/09	09/10	08/09	09/10	08/09	09/10	08/09	09/10	08/09	09/10	08/09	09/10
R million/year												
Health Care Services	115.3	112.4	308.2	330.8	42.4	45.3	90.2	274.8	215.2	277.4	88.9	120.3
Library Services	131.4	155.6	121.1	139.9	45.1	42.7	15.3	45.6	54.2	60.1	203.0	274.0
Museums	29.6	35.5	44.4	54.6	8.5	16.8	0.0	0.0	13.1	14.2		
Housing: New Develop.	578.6	492.8	446.7	547.4	0.0	0.0	432.7	519.2	318.9	53.5		
Formal Housing	89.8	120.6	205.8	130.6	18.7	-53.9	0.0	0.0	197.6	379.0		
Roadworks subsidies	0.0	0.0	0.0	0.0	4.0	5.0	0.0	0.0	0.0	0.0		
Total	944.7	916.9	1126.2	1203.3	118.7	55.9	538.2	839.6	799.0	784.2	291.9	394.3
Total 2008/09	3818.7											
Total 2009/10	4194.2											

Source: Metropolitan Municipalities: eThekweni, City of Johannesburg, Nelson Mandela Bay, Ekurhuleni, Tshwane and City of Cape Town

73 German state

74 Metropolitan municipalities provide primary health care services in terms of agency agreements with their provincial departments.

Table 16 summarises the cost of unfunded mandates by metropolitan Municipality. It reflects that, in addition to the total amount received from provinces and other sources, the six metros have used/spent from their own budget on existing unfunded mandates. They spent an additional amount of R3,819 billion in 2008/09 and R4,194 billion in 2009/10. The City of Johannesburg spent more on unfunded mandates than other metros did for the 2008/09 and 2009/10 financial years, allocating R1,126 billion and R1,203 billion respectively. The eThekweni municipality spent about R945 million in 2008/09 and R917 million in 2009/10.

Based on the figures above, municipalities clearly perform functions on behalf of provinces without assigning full expenditure to the functions. This has implications for the equitable sharing of nationally collected revenue and the delivery of services. The findings of the research also highlighted the following challenges related to the delivery of these services as a result of unfunded mandates:

Health Care Services	Libraries
<ul style="list-style-type: none"> • Infrastructure is inadequate and does not address the needs of the patients and the health care services. Extensions, upgrading and maintenance of the health facilities is for the account of the local government. • There is a critical shortage of personnel to render the promotive and preventative health care. • In some instances nongovernmental organisations are used to fund staff and implement certain programmes in primary health care facilities. Once the service is provided, the funding of the non-governmental organisations is stopped or limited, and the staff has to continue rendering services, which creates an even higher workload for the remaining staff. • Financial constraints are experienced as stock, equipment and records required for primary health care (e.g. needles, syringes, dressings) have to be funded by the local government budget. 	<ul style="list-style-type: none"> • The Library Grant published in the Gazette is inadequate to fund the expenses of the Library service. • The Library service has been curtailed in its functionality to save on costs. • There is a shortage of staff. • Existing buildings need maintenance. • There is lack of funding for programmes and projects. • Municipal operational and capital budgets allocated internally are not sufficient to maintain/improve/expand services, resources and facilities. The standard of library services and facilities is declining slowly, instead of growing to satisfy the ever-changing and increasing needs of communities.
Housing	Museums
<ul style="list-style-type: none"> • The rental collection rates are poor. • There is scarcity of suitable land for development. • Inherited aging stock leads to high maintenance costs. • The subsidy quantum does not relate to the cost of delivery. • Additional facilities are needed. 	<ul style="list-style-type: none"> • There is shortage of education and support staff. • Most museums have inadequate infrastructure for storage and exhibitions. • The space for visiting schools and practical workshops is limited.

Other issues related to the exercise of powers and functions among the three spheres of government include:

- In some instances, the Service Level Agreements for the last three years have not been signed by Provincial Departments.
- Provincial Departments do not adhere to the principles of these agreements with regard to the provision of all resources.
- Some allocations from the province are not transferred on time according to the agreed payment schedule.
- Some services are devolved to municipalities without consultation and additional funding.

(b) Provinces

In addition to a questionnaire devised for metropolitan municipalities, the existence of unfunded mandates between national and provincial government (where metropolitan municipalities are funded through the respective provincial treasuries) was investigated. The findings of the investigation are summarised below. KwaZulu-Natal Provincial Treasury indicated that unfunded mandates do exist between national and the province. These arise because of policy decisions made at a national level, which have financial implications but come without the necessary funding to the province for implementation. The Treasury further argued that these unfunded mandated place pressure on the provincial fiscus. The total cost of unfunded mandates in the province amounts to R310,888 million, with the bulk emanating from the Departments of Education (R130,000 million) and Agriculture, Environmental Affairs and Development (R85,070 million).

Table 17. Unfunded mandates by Province and Department – 2011/12

Department (R'000)	KwaZulu-Natal	Eastern Cape
Provincial legislature	11,445	
Agriculture, Environmental Affairs and Rural Development	85,070	
Rural Development and Agrarian Reforms		1,040,040
Economic Development and Tourism	4,000	1,239,669
Education	130,000	2,514,233
Health		1,242,500
Social Development		38,900
Human Settlements		131,922
Public Works	47,114	155,339
Arts and Culture	33,259	
Total	310,888	6,362,603

Source: KwaZulu-Natal Provincial Treasury and Eastern Cape Provincial Treasury

The Eastern Cape Provincial Treasury also highlighted that unfunded mandates exist between national and the province. It indicated that, in the current financial year, the total cost of unfunded mandates amounts to R6,363 billion. Similar to KwaZulu-Natal the bulk emanates from the Department of Education, followed by the Departments of Health, Economic Development and Rural Development and Agrarian Reforms with estimated costs of R2,514 billion, R1,243 billion, R1,240 billion and R1,040 billion respectively.

According to the above, Section 35 of the Public Finance Management Act (PFMA) is contravened, as it requires the financial implications for the transfer of a function to be calculated, which is not the case. It also states that draft national legislation that assigns an additional function or power to (or imposes any other obligation on) a provincial government, must, in a memorandum that must be introduced in Parliament with that legislation, give a projection of the financial implications to the province of that function, power or obligation.

In the case of Gauteng, the Provincial Treasury's understanding is that an unfunded mandate is a statute or regulation that requires a provincial government or local government to perform certain functions, yet provides no money for fulfilling the requirement. Thus, in the strictest sense of this definition, the province does not have unfunded mandates. However, over the years the province has suffered from the misalignment between policy and the manner in which funds are allocated to the province, which has resulted in partial funding. The Provincial Treasury highlighted that:

There is a gap in the manner in which the province has been compensated for occupation specific dispensation (OSD). This gap will remain in the system for the years to come.

In the last two years, Human Settlement Departments are now expected to register the houses built with the National Home Builders Registration Council. However, the conditional grant does not make provide for this and the cost of other related professional fees.

Through a conditional grant called Public Transport Operations, the province has been mandated to provide a bus subsidy on behalf of the National Department of Transport. Being aware that such a grant will not be sufficient to cover everything, national government has classified this grant as Schedule 4, which creates problems for the province at implementation stage.

A2.6 Observations

The Commission is of the view that unfunded mandates do possibly exist between the spheres of government, as municipalities do perform provincial functions without the necessary funding. For instance, what emerged from the metropolitan municipalities questioned was that in total the six metros have spent an additional amount of R3,819 billion in 2008/09 and R4,194 billion in 2009/10 in the provision of existing unfunded mandates. In this case, it was the responsibility of the metros to use/spend their own budget for these functions.

There are examples of unfunded mandates in the fields of libraries, museums, health and, to some extent, housing. However, numerous claims by municipalities may not be sustained based on the narrow definition of unfunded mandates. It is suggested that they must therefore be addressed through the equitable share.

However, determining whether a mandate falls outside Schedules 4B and 5B is not always easy, as the cut off points between functional areas are not readily ascertained, which becomes apparent in the area of health services.

Essential legal procedures clearly need to be followed when assigning and delegating additional functions or powers to other spheres of government. However, in some instances metros are allocated functions without the Service Level Agreements governing such delegations. Where agreements exist, allocations from the provinces are not always transferred on time according to agreed payment schedule.

There are also problems with a shortage of staff to render the services. This raises serious concerns, as section 27(2) of the Annual Division of Revenue Act (DORA) requires that the resources employed to render a function are shifted with the function. It requires equitable share allocations for the financing of particular functions and conditional grants (both operating and capital) to be paid to the organ of state that will become responsible for that function following an assignment.

The assignment framework that binds national and provincial governments and seeks to prevent unfunded mandates is not effective. Despite the overlapping of the various pieces of legislation dealing with assignments (and which sometimes makes the framework difficult to apply), it is clear that section 9 and 10 of the Systems Act are honoured in their breach rather than in their application. This is even more pertinent to section 3(2D) of the Financial and Fiscal Commission Act. Local government's ability to discharge its mandate effectively is damaged when the lack of compliance results in an unfunded mandate.

In a number of functional areas, there is no legal basis for local government's activities. The clearest example is libraries. A further troublesome example is primary health services. While it is permissible for "municipal health services" to be defined in national legislation (subject of course to judicial scrutiny), the (informal) administrative reallocation of tasks to metros has no secure legal basis and tends to disadvantage municipalities.

Lastly, prior consultation with the Commission, before assignment legislation is introduced in a legislature, can be regarded as a formal validity requirement of such legislation. It may be argued that the provisions of the Systems Act and the FFC Act do not necessarily "overrule" provisions contained in other statutes. However, the "manner and form" provisions of the Systems Act and the FFC Act apply before the new legislation becomes a reality. They regulate the actions of the executive in preparing assignment legislation or making assignment decisions. With regard to assignments done by executive act, section 3(2A) (b) of the FFC Act is clear. It provides that an assignment "has no force" unless the Commission's recommendation has been considered.⁷⁵

In response to the problems identified above, the following advisories are made by the Commission:

- Government should undertake a review of the extent of compliance with legal procedures for the assignment and delegation of functions, as set out in the Intergovernmental Fiscal Relations Act, the Financial and Fiscal Commission Act, the Division of Revenue Act and the Local Government Municipal Systems Act. In particular, it is recommended that compliance with the following legal requirements are assessed:
 - a. The financial and fiscal implications of a function shift on the sphere of government or organ of state. The organ of state initiating a general assignment must provide these implications to the Commission for its recommendations to the Minister of Finance in line with Section 3 of the FFC Act 2003 as Amended and the Minister of Finance. The Commission tabled a compliance check list for this specific purpose in 2007.
 - b. All resources associated with delivering a service associated with a function to be shifted are transferred. These should include current assets, budgets and all future resources. There must be evidence of a decision taken by the Executing Authority of the assigning or delegating department or organ of state that this is acknowledged and pledged.
- Government should take steps to ensure that all mandates have a legal basis. The functions performed by each sphere of government must have a secure legal footing. Performing functions falling outside their mandate impinges upon the lawfulness of their budgets (although their expenditure is not necessarily illegal).
- Government should develop a time-bound programme to regularise the functional assignment of libraries and museums.

⁷⁵ A consultation requirement in the Constitution with regard to legislation dealing with local government's taxing powers (s 229(5) Constitution), was successfully challenged in court. See *Robertson v City of Cape Town* 2004 (9) BCLR 950 (C). The invalidity of the contested Act was not upheld by the Constitutional Court on a different ground. See *Steytler & De Visser* 2007, para 1.2.1.

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ACRONYMS

AIDS.....	Acquired Immune Deficiency Syndrome
AsgiSA.....	Accelerated and Shared Growth Initiative for South Africa
BAU	Business As Usual
BRT	Bus Rapid Transit
CAB	Cyclically Adjusted (Budget) Balance
CGE.....	Computable General Equilibrium
CU.....	Consumer Unit
DFA	Development Facilitation Act
DCoGTA	Department of Cooperative Governance and Traditional Affairs
DoHS	Department of Human Settlements
DORA.....	Division of Revenue Act
DPLG.....	Department of Provincial and Local Government
EU	European Union
FBS	Free Basic Services
FDH.....	Free Disposable Hull
FFC	Financial and Fiscal Commission
GDP	Gross Domestic Product
GEAR	Growth Employment and Redistribution
HIV	Human Immunodeficiency Virus
IDP	Integrated Development Plan
IGFR	Intergovernmental Fiscal Relations
IGFRA.....	Intergovernmental Fiscal Relations Act
IMF	International Monetary Fund
JHB.....	Johannesburg
LES.....	Local Equitable Share
LUMB.....	Land Use Management Bill
MDG	Millennium Development Goals
MFMA.....	Municipal Finance Management Act
MIG.....	Municipal Infrastructure Grant
MSA.....	Moving South Africa
MTBPS.....	Medium Term Budget Policy Statement
MTEF	Medium Term Expenditure Framework
NGP	New Growth Path
NHI.....	National Health Insurance
NLTA	National Land Transport Act
NMBM	Nelson Mandela Bay Municipality
OECD.....	Organisation for Economic Cooperation and Development

OSD	Occupation Specific Dispensation
PBER	Provincial Budgets and Expenditure Review
PEC	Provincial Executive Council
PES	Provincial Equitable Share
PFMA	Public Finance Management Act
PIE	Prevention of Illegal Evictions
PRASA	Passenger Rail Agency of South Africa
RDP	Reconstruction and Development Programme
RSC	Regional Services Council
SALGA	South Africa Local Government Association
SARB	South African Reserve Bank
StatsSA	Statistics South Africa
TB	Tuberculosis
UK	United Kingdom
UMRA	Unfunded Mandates Reform Act
UNDP	United Nations Development Programme
USA	United States of America
USDG	Urban Settlements Development Grant
WHO	World Health Organisation

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