BRIEFING TO THE PORTFOLIO COMMITTEE ON PUBLIC ACCOUNTS AND FINANCE (FREE STATE LEGISLATURE) ON THE DIVISION OF REVENUE AMENDMENT BILL

Financial and Fiscal Commission

16 July 2020

For an Equitable Sharing of National Revenue

INTRODUCTION

- The Commission makes this submission on the 2020 Division of Revenue Amendment Bill (B9-2020) to the Portfolio Committee on Public Accounts and Finance in terms of Section 214 (1) of the Constitution and Section 35 of the Intergovernmental Fiscal Relations Act (1998) as well as the FFC Act.
- This submission is made in the context of then Coronavirus pandemic which has caused an unprecedented shock to the economy and people's livelihoods. It has amplified and compounded existing structural fragilities in the economy and pushed the already weakened fiscal metrics downward faster than anything ever seen since the financial crisis a decade ago. It has intensified the existing inequalities and condemned many people into poverty and unemployment.
- The pandemic has made it necessary to revisit the Division of Revenue presented in February as many aspects of it were no longer attainable. Government has responded through a special adjustments budget.
- This adjustment budget is a technical adjustment tool to take into account Covid-19 induced changes in the economy; government's response to the health crisis caused by Covid-19 as well as the economic impact. It is not a policy statement. The policy statement is expected in October (i.e. MTBPS).
- This presentation will provide some highlights on some changes in the macroeconomy that have direct implications on the Division of Revenue and then look at changes in the Division of Revenue Amendment Bill

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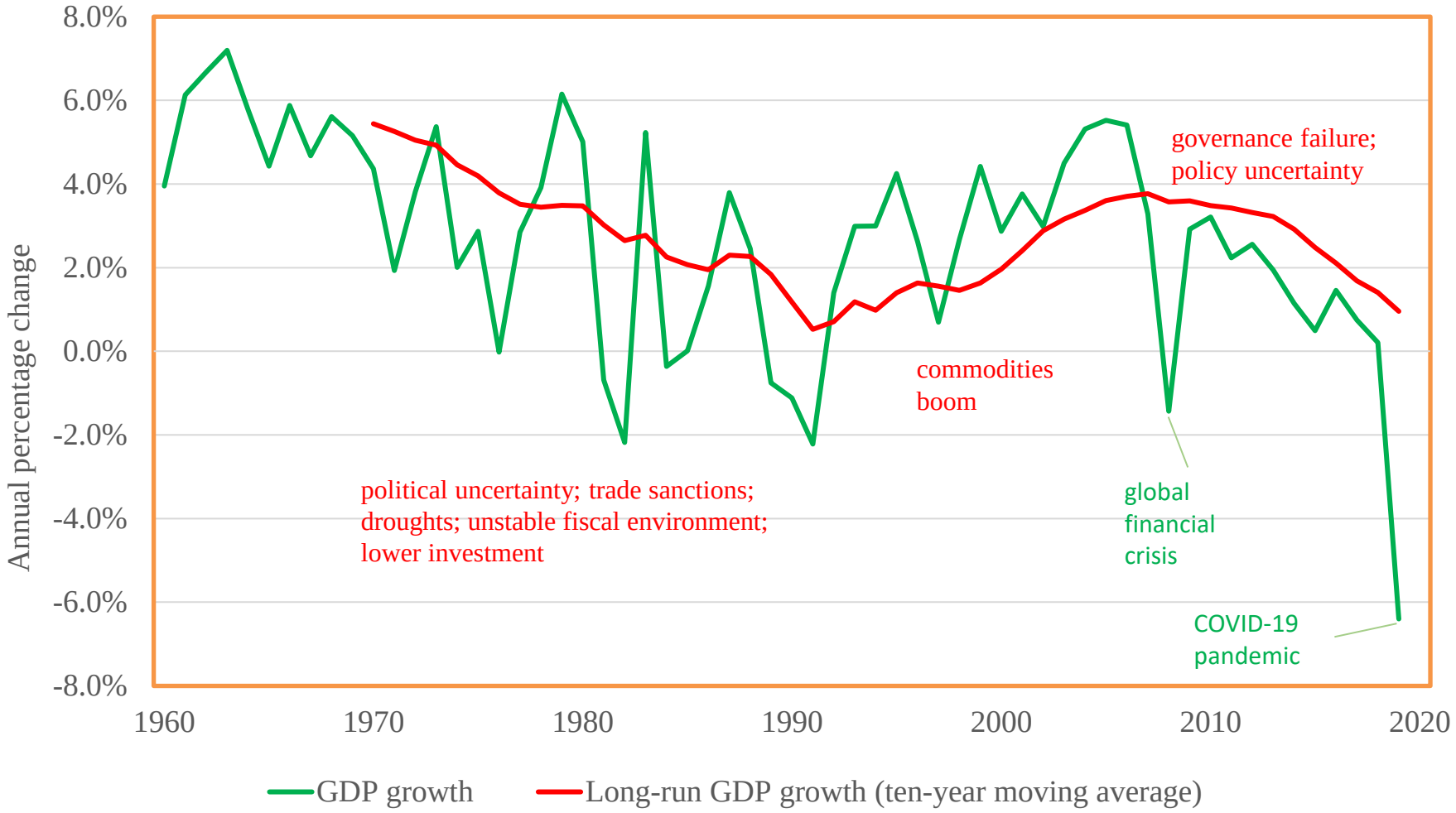
The Performance of the Economy and implications to the Division of Revenue

South Africa's economic performance (1960-2020)

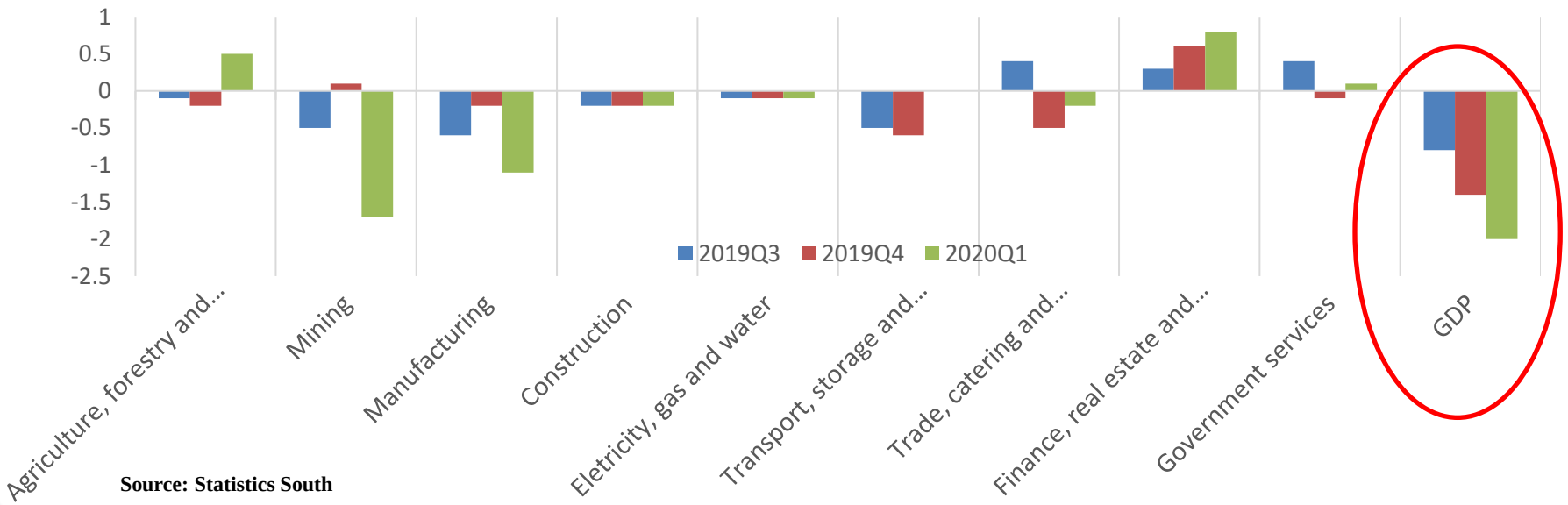


Source: South African Reserve Bank (2020), Commission's compilation

DOMESTIC ECONOMY IN DEEP RECESSION

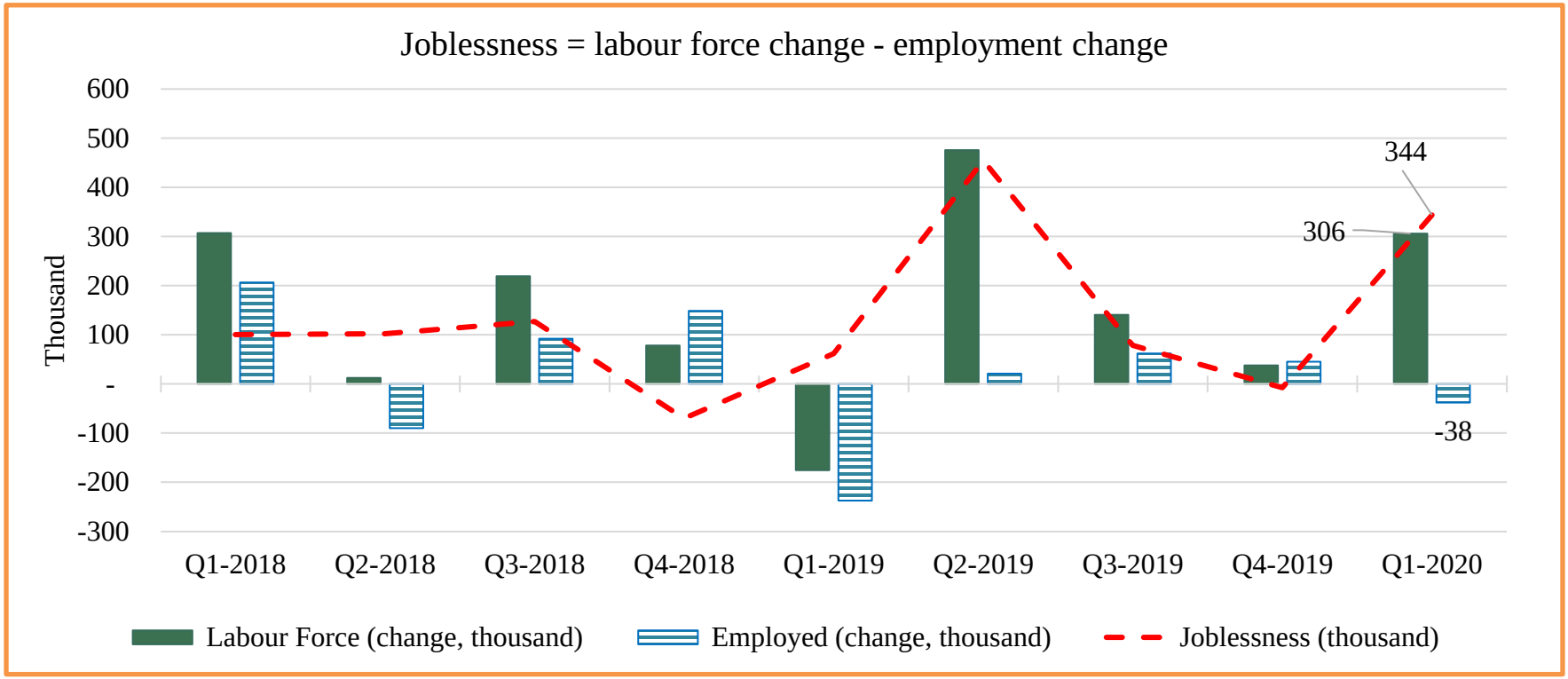
- The economy has entered into a deeper recession after GDP growth contracted by 2% in 2020Q1, a 3rd consecutive quarter of negative growth. Real GDP growth is projected to contract by 7.2% in 2020, primarily due to the Covid-19 impact.
- SA's growth challenges are structural but the policy dilemma is that financing of the required reforms to boost growth are hamstrung by the constrained fiscal and debt situation, which itself primarily results from SA's prolonged slow growth.
- Slow growth has translated into tax revenue growth contraction which together with increasing spending has resulted in a ballooning budget deficit, triggering fears of an unsustainable public debt spiral.

Contributions to growth in GDP, 2019Q3-2020Q1



Source: Statistics South Africa, 2020

COVID-19 IMPACT: CHANGES IN EMPLOYMENT AND JOBLESSNESS, Q4 2019 – Q1 2020



- 38 000 jobs were lost in Q1 2020, with the addition of 306 000 entrants in the same quarter unable to find jobs in the labour market.
- Hence, the total estimated unemployment increased by 344 000 resulting in 7.07 million unemployed individuals in South Africa.

Source: Statistics South Africa, Quarterly Labour Force Survey (Q1 2020) and own calculations

Fiscal outlook and Implications for Division of Revenue

- Consolidated budget deficit will more than double from 6.8% to 15.7% of GDP for 2020/21. Government debt will increase from 81.8% GDP in 2020/21 to 86% in 2022/23 in the active scenario. Debt service costs will increase to 22% of government revenues in 2020/21 from 15% in 2019/20.
- The historical budget deficits emanated from increased financial support for SOEs. Some SOEs (Eskom in particular) continue to face financial difficulties that may require further government support, representing contingency liability risk.
- Furthermore, debt accumulation has largely financed wage and interest bill increases, as opposed to growth-enhancing investments. The rising wage and interest bill will crowd out other social and investment spending priorities, worsening longer-term economic growth prospects.
- The fiscal space has been depleted by high debt levels, contingent liabilities, and an increasing interest bill. Revenue shortfall is estimated to be close to R300 billion in 2020.
- Thus the Division of Revenue should be understood in the context of these diminishing revenues and that responding to any economic shock will require larger adjustments than would otherwise be desirable in the context of subdued growth.

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CHANGES TO THE DIVISION OF REVENUE

Adjustments to Division of Revenue Framework

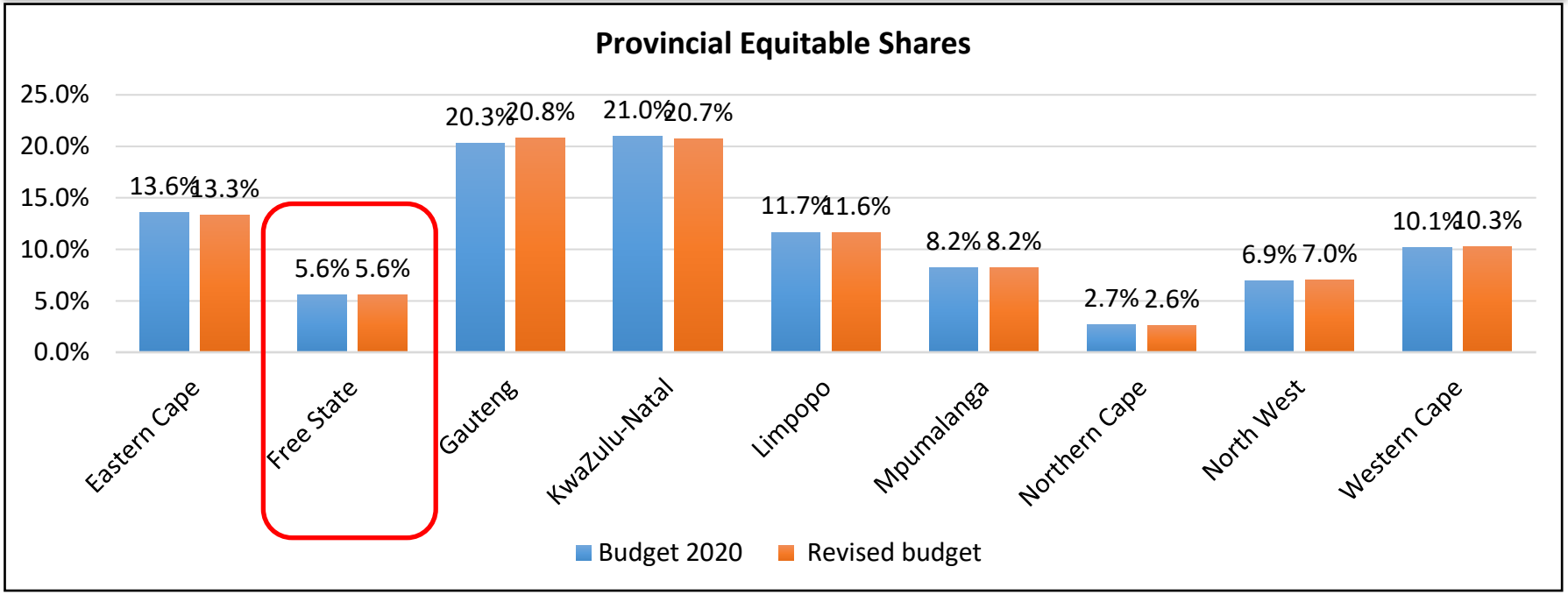
	2020/21		
R billion	**Main**	**Adjustment**	**% change**
National departments	757,7	790,3	4,3%
Provinces	**649,3**	**645,3**	**-0,6%**
Equitable share	538,5	538,5	–
Conditional grants	110,8	106,8	-3,6%
Local government	**132,5**	**139,9**	**5,6%**
Equitable share	74,7	85,7	14,7%
Conditional grants	43,8	40,2	-8,2%
Percentage shares			
National departments	49,2%	50,1%	
Provinces	42,2%	41,0%	
Local government	8,6%	8,9%	

- The national share for 2020/21 increases from 49.2% to 50.1%, the provincial share decreases from 42.2% to 41%, and the local government share increases from 8.6% to 8.9%.
- The Commission supports the division of revenue as it addresses the government response to health, social and economic implications of COVID-19. Local government is at the coalface of service delivery and this is reflected in the increases local equitable share.
- The provincial equitable share has not been affected. The decrease (from 42% to 41%) on provinces share is driven by changes in conditional grants.
- Provincial Conditional grant decreases from R110.8 billion to R106.8 billion (-3.6%) in the adjustment budget.

Key Provincial Functions and Challenges

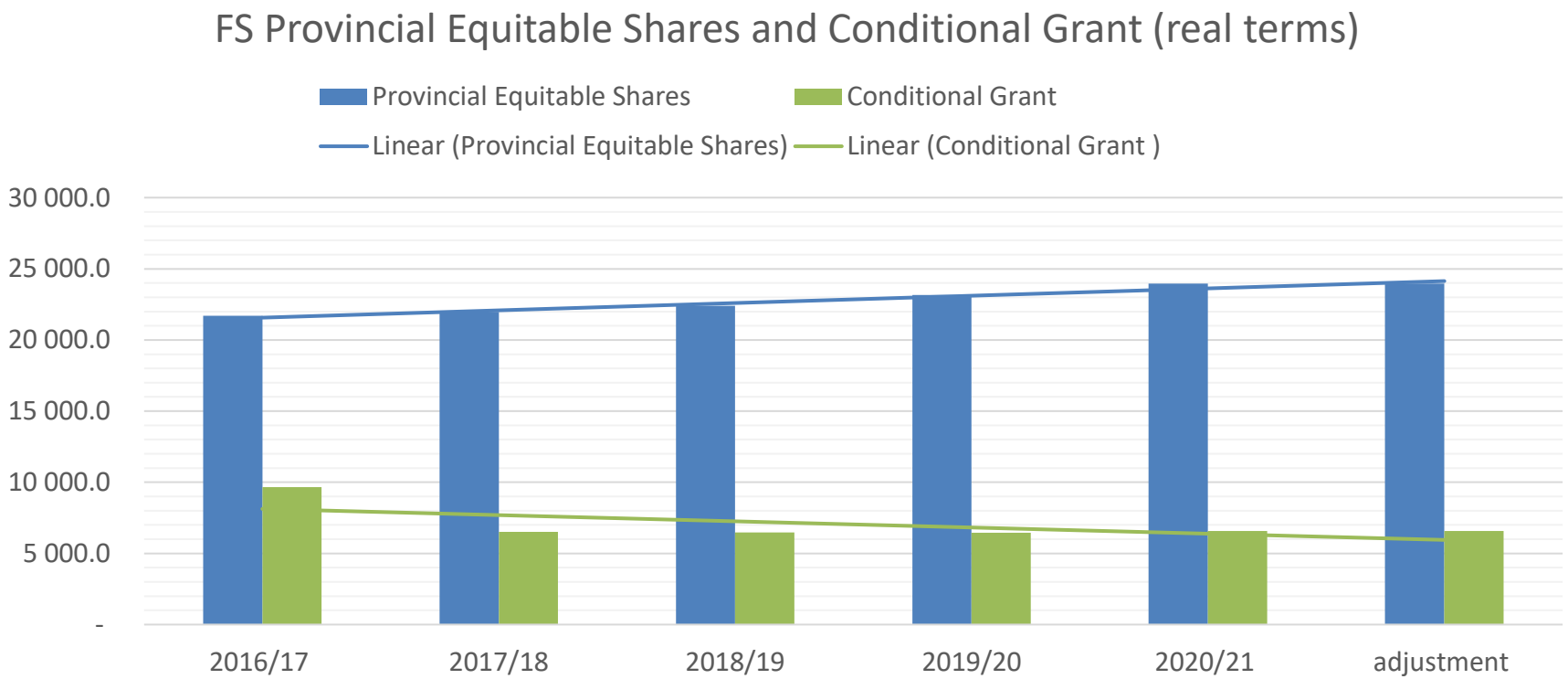
- Provinces are responsible for social services which include education, health and social development and economic services like agriculture and roads and transport
- Prior to the outbreak of Covid-19 pandemic these provincial functional areas were facing a number of challenges:
  - ✓ **Education**: In basic education, there are still inequalities with respect to access to quality education for all, whereas enrolment rates are high, and learners from poorer schools continue to be disproportionately affected by a poor quality education and education environment
  - ✓ **Health**: Structural issues, funding and inequality challenges and increasing number of people living with HIV, hence a plan to rollout the NHI and increasing the number of people receiving ARVs
  - ✓ **Agriculture**: Lack of adequate government support to facilitate production and market access – this affects especially small and emerging farmers' ability to sustain their farming activities. Drought affected many provinces including the Free State.
  - ✓ **Roads and Transport**: Road implementation and maintenance backlogs: increased roads use, low investment, and poor maintenance have led to higher transportation cost and transport bottlenecks
- Covid-19 has amplified these challenges and has the potential of delaying efforts aimed at addressing the existing inequalities especially with respect to access to quality education and healthcare as well as the implementation of reforms such as NHI and infrastructure projects

Percentage of Provincial equitable shares on national raised revenue



- The proportion of the provincial equitable shares allocate to the Free State province and Mpumalanga province remain unchanged at 5.6% and 8.2% respectively.
- The proportion allocated to Gauteng province increases from 20.3% to 20.8%, North West province increase from 6.9% to 7% and Western Cape from 10.1% to 10.3%.
- Commission supports these adjustments – Provincial governments are responsible for most of the public health system that provides care for COVID-19 patients and thus important in supporting government response to COVID-19.

Free State Provincial equitable Shares & Conditional Grants in real over time



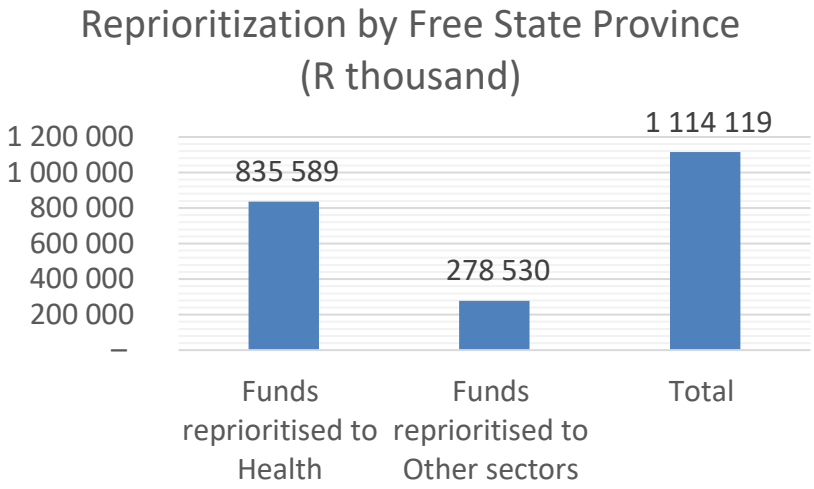
- The Free State Province provincial equitable share has been growing in real terms. In 2016/17 financial year, the provincial equitable share was at R 21.6 billion in real terms and in the adjustment budget it's at R 23.9 billion in real terms.
- In contrast the Free State Province's conditional grant allocation has decreased from R9.6 billion in real terms in 2016/17 to R 6.5 billion in real terms in the adjustment budget.

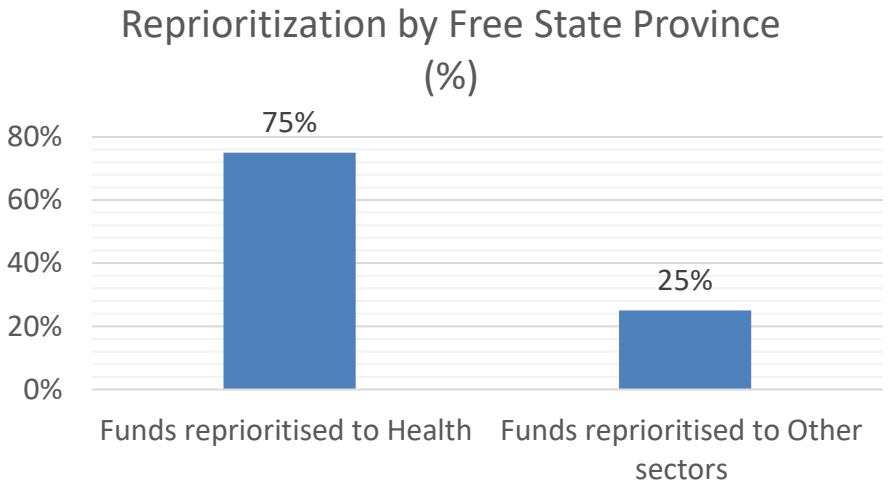
PROVINCIAL CONTRIBUTION TO REPRIORITISATION BY PROVINCES

R thousand	Funds reprioritised to:		Total
	Health	Other sectors	
Eastern Cape	1 988 374	662 791	2 651 165
Free State	835 589	278 530	1 114 119
Gauteng	3 126 485	1 042 162	4 168 647
KwaZulu-Natal	3 105 174	1 035 058	4 140 231
Limpopo	1 735 434	578 478	2 313 913
Mpumalanga	1 228 288	409 429	1 637 718
Northern Cape	396 847	132 282	529 130
North West	1 045 383	348 461	1 393 844
Western Cape	1 538 426	512 809	2 051 234
Total	**15 000 000**	**5 000 000**	**20 000 000**

- According to National Treasury, a consistent pattern of reprioritizing 75% to health and 25% to other sectors is applied across provinces.
- The Commission notes the (75% health and 25% other sectors) approach that is geared towards saving lives whilst focusing on reviving the economy. However it is important to recognize the disparities in health and the pressures which COVID-19 may place on different provinces when determining a criteria. It is also not clear whether this consistent reprioritization is consistent with the disease burden/health sector needs across the provinces.

Free State Reprioritization of Provincial equitable shares



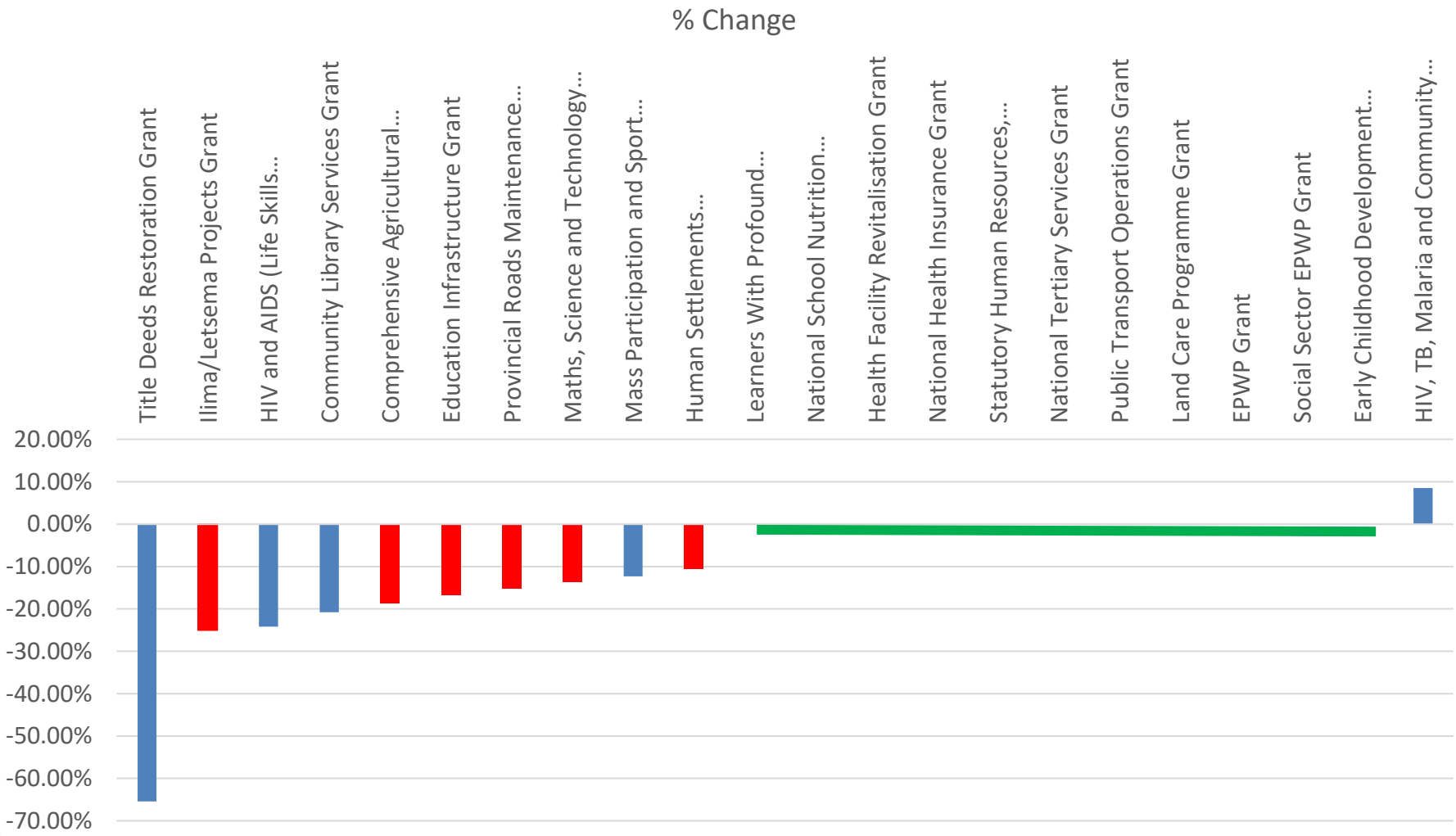


- The allocations of provincial equitable share remains unchanged. The Free State province reprioritize a total of R1.1 billion (R835 million to health and R278 million to other sectors.
- Although the Commission supports these adjustments as pprovincial governments are responsible for most of the public health system that provides care for COVID-19 patients and thus play an important role in responding to the COVID-19 pandemic, the Commission is concerned that provinces were expected to do their own reprioritisation without any guiding framework to ensure a common approach to the process.
- The criteria for reprioritising the R20 billion in general (or R1.1 billion in the Free State) is not clearly determined and this may result in unevenness in the services delivered by provinces. In the absence of a uniform criteria it is important for the legislature to exercise oversight of these shifts.

February Budget vs Adjustment budget: Conditional Grants Free State Province

Free State	2020/21			
R'000	Main	Adjusted	Diff	% Change
Equitable Share	**30 017**	**30 017**	0	
Direct Conditional Grants	**8 239**	**8 240**	1	0.0%
Education Infrastructure Grant	840	700	-140	-16.7%
HIV and AIDS (Life Skills Education) Grant	12	9	-3	-24.2%
Learners With Profound Intellectual Disabilities Grant	27	27	0	0.0%
Math's, Science and Technology Grant	37	32	-5	-13.6%
National School Nutrition Programme Grant	432	432	0	0.0%
HIV, TB, Malaria and Community Outreach Grant	1 472	1 598	125	8.5%
Health Facility Revitalisation Grant	587	587	0	0.0%
National Health Insurance Grant	22	22	0	0.0%
Statutory Human Resources, Training and Development Grant	237	237	0	0.0%
National Tertiary Services Grant	1 210	1 210	0	0.0%
Provincial Roads Maintenance Grant	1 447	1 228	-219	-15.1%
Public Transport Operations Grant	297	297	0	0.0%
Comprehensive Agricultural Support Programme Grant	176	143	-33	-18.6%
Ilima/Letsema Projects Grant	68	51	-17	-25.0%
Land Care Programme Grant	8	8	0	0.0%
Human Settlements Development Grant	951	850	-101	-10.6%
Informal Settlements Upgrading Partnership Grant	-	-	-	-
Title Deeds Restoration Grant	34	12	-22	-65.4%
EPWP Grant	24	24	0	0.0%
Social Sector EPWP Grant	40	40	0	0.0%
Early Childhood Development Grant	56	56	0	0.0%
Community Library Services Grant	167	132	-35	-20.8%
Mass Participation and Sport Development Grant	94	83	-12	-12.3%

February Budget vs Adjustment budget: Conditional Grants Free State Province



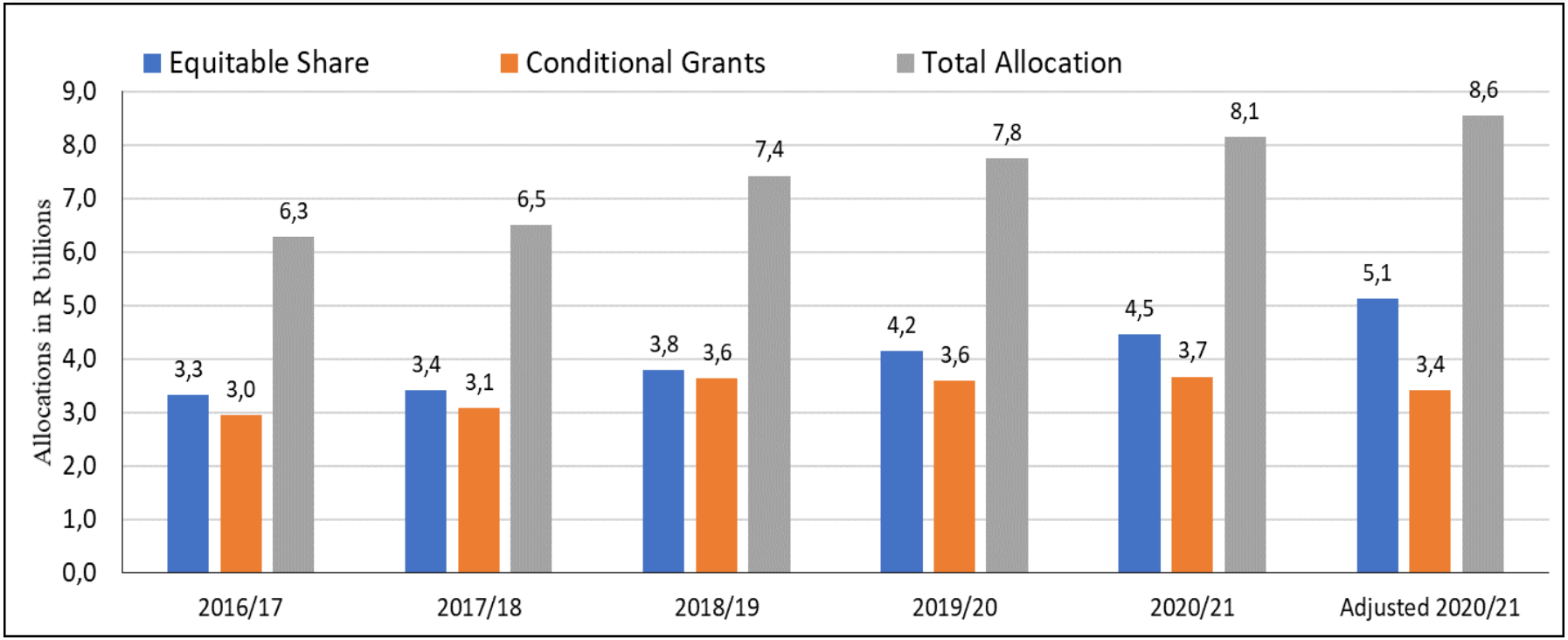
FEBRUARY BUDGET VS ADJUSTMENT BUDGET: CONDITIONAL GRANTS FREE STATE PROVINCE

- The Provincial Road Maintenance Grant sees a decrease of R219 million from R1.4 billion to R1.2 billion. This constitutes a decrease of about 15.1% s
  - ➢The Commission is concerned about the reduction in this grant as this is important for road maintenance in the province. The condition of roads requires constant maintenance
- The Human Settlement Development Grant sees a decrease of R 101 million or 10.6% from what was estimated in the 2020 budget.
  - ➢ The Commission is concerned about the reduction of this grant as the provision of human settlement remains an important objective for the government. It is also important during this pandemic where containment of the virus requires social distancing.
- The Comprehensive Agricultural Support Programme Grant and Ilima/Letsema Project Grant decrease with 18.6% and 25% respectively.
  - ➢ The Commission is concerned these decreases since agriculture is important for food security especially because the Free province is experiencing a drought
- The Maths, Science and Technology Grant: Key towards moving towards innovation, digital, knowledge economy. Reductions may affect this departure in the long run
- Education Infrastructure Grant: It is key with respect to reconstruction, maintenance and refurbishment of education and schools.
- Title Deeds Restoration Grant; The Commission would support this change provided this grant has accomplished its objectives. It is also key that when a grant is discontinued, a thorough evaluation of its impact should be undertaken.

CHALLENGES IN THE LOCAL GOVERNMENT

- Before the outbreak of COVID-19 , the South African local government was crippled by a number of challenges, and generally failing to effectively and efficiently fulfil its constitutional mandate. The challenges include:
  - Underspending on capital budgets, lack of institutional capacity, declining own revenue collection, lack of accountability, poor financial management , poor governance and unfunded budgets among others
- Free State(FS) municipalities are no different, as they are battling with the same challenges
- In the 2018/19 Audit Report, AGSA painted a grim picture of the performance of FS municipalities, citing issues of poor financial discipline and non-compliance
  - Increase in money owed to creditors such as Eskom and water boards (from R2,5 billion in 2017/18 to R3,1 billion in 2018/19), consumer debt increasing due to poor collection by municipalities, increasing irregular expenditure (R1,4billion), overspending on operational budgets (58%), deteriorating audit outcomes and poor infrastructure maintenance
- The poor performance in the local government sector is compounded by lack of effective oversight by national and provincial governments
  - Some municipalities are placed under section 139 intervention repeatedly, but show no signs of improvement after intervention
- The Commission is of the view that these challenges should not be overlooked when dealing with COVID-19 as they could hamper the success of the COVID-19 interventions

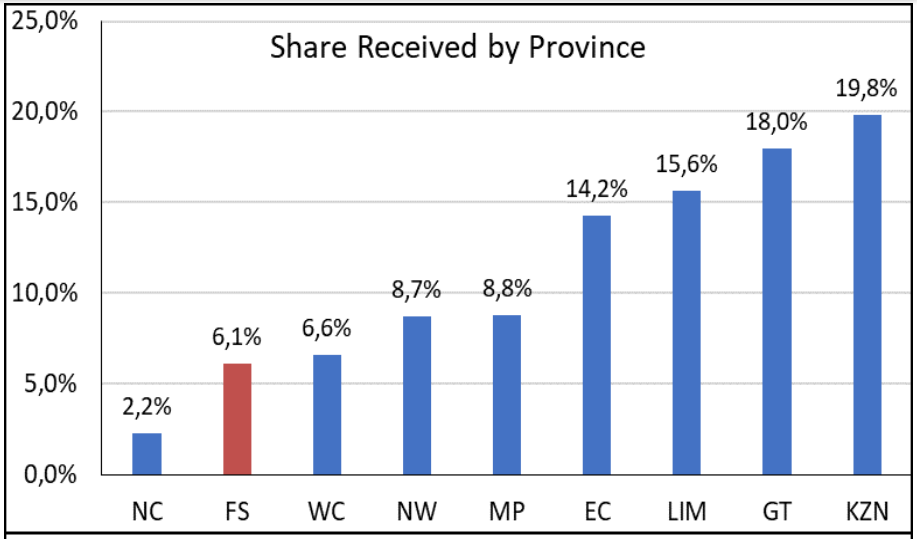
LOCAL GOVERNMENT ALLOCATION:2020 FEBRUARY BUDGET VS ADJUSTED BUDGET

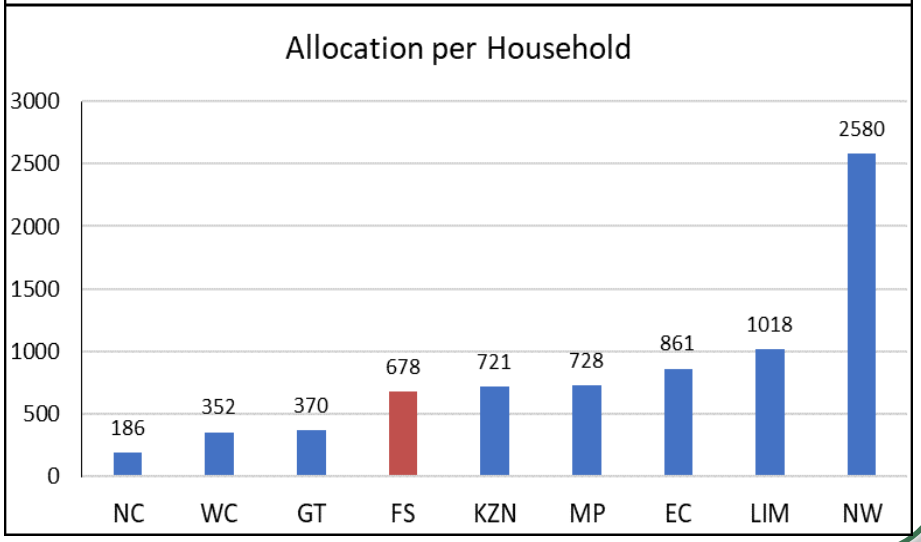


- FS municipalities account for 6,1% of the total allocation to the local government
- The total allocation to FS municipalities increased over the years from R6,3 billion in 2016/17 to R8,6 billion in the adjustment budget
- In the 2020/21 Adjusted Budget, the allocation grew by 15%
- Local government equitable share allocation increased in the adjusted budget, while conditional grants declined

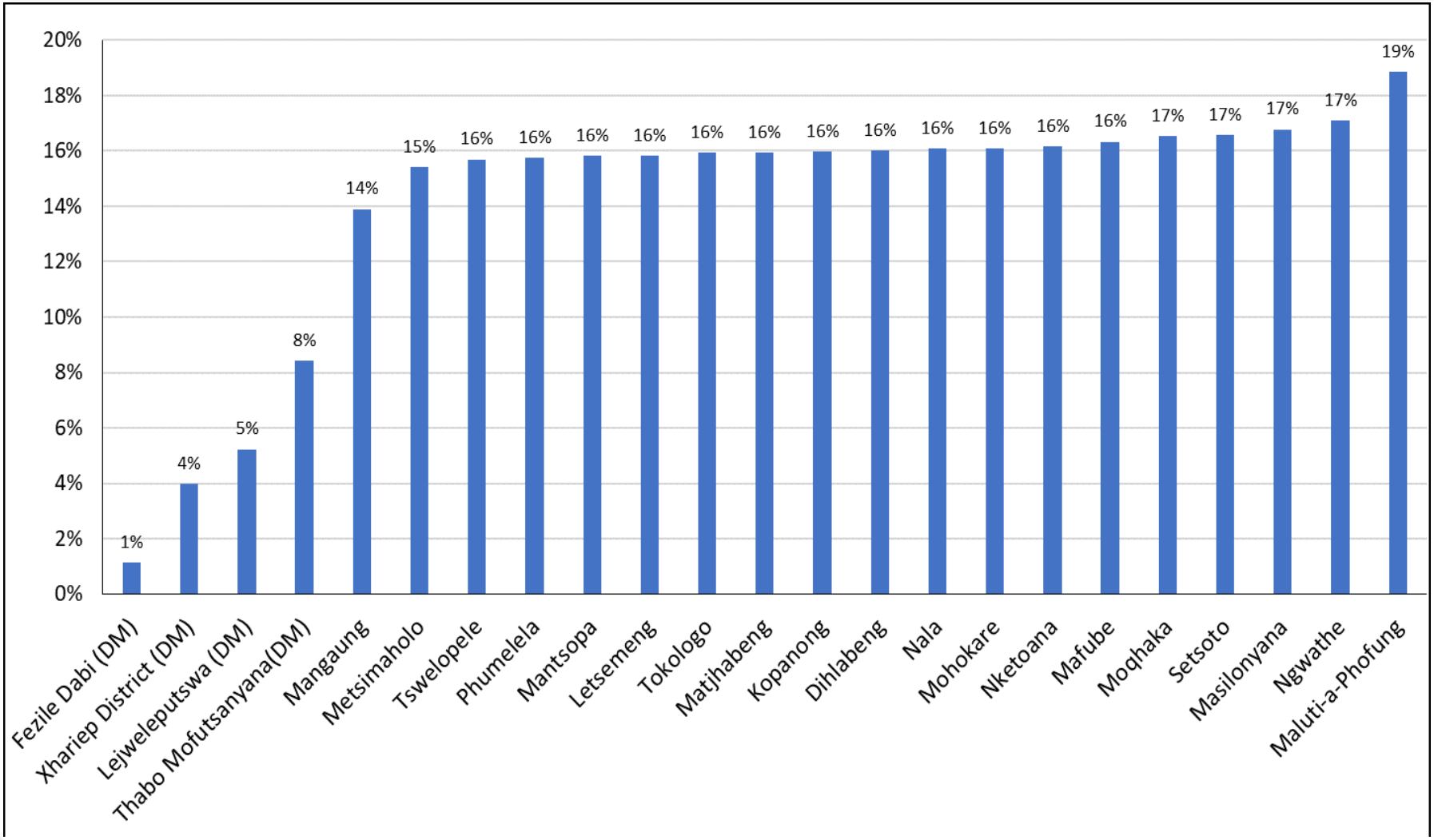
Local Government Equitable Share :February 2020 budget vs Adjusted budget

- The 2020/21 Adjusted Budget, provides for an additional allocation R11 billion to the all municipalities
  - The additional funds are distributed across 257 municipalities, through the LGES
- Free State municipalities received 6.1% (R668,2 million) of the total additional funds
  - With in the province, the largest share is received by Mangaung (16,7%) Maluti-a-Phofung (18,2%) and Matjhabeng(13.0%), which are metros and secondary cities, respectively
  - Allocation to FS municipalities grew by an average of 15% from the 2020 budget allocation, which is the second highest to Limpopo municipalities(17%)
- FS municipalities received an average per household allocation of R678





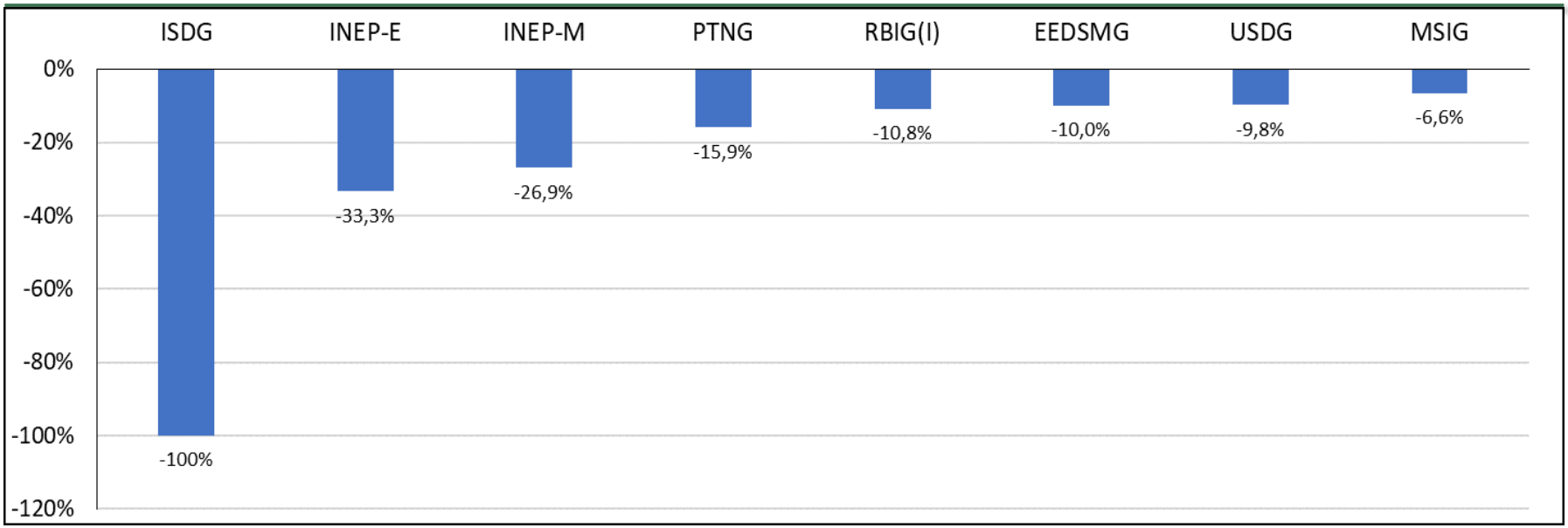
Local Government Equitable Share :February 2020 budget vs Adjusted budget (Growth Rates)



Local Government Equitable Share :2020 February Budget vs Adjusted Budget cont.

- The Commission notes the R11 billion added to LG through the LGES. The Commission is of the view that as the rationale for this injection is to compensate municipalities for the loss of revenue due to Covid-19, allocating this money through the LGES formula may not adequately compensate those municipalities experiencing the deepest revenue shortfalls (in this case metros). In reality, rural municipalities realise less revenue loses since their own revenue base is very limited. Metros have experienced a disproportionate effect of Covid-19 in terms of revenue loses (as they rely predominately on own revenues); and in terms of Covid induced expenditure needs (emergency shelter, water, health facilities), and as engines for economic growth.
- The Commission is of the view that this allocation should rather have been allocated through a conditional grant that would balance rural-urban needs in the context of the pandemic, and also so that the R11 billion acts a stimulus for cities as engines of growth.
- In addition, there is a need to attach conditions to this allocation, in order to ensure that the funds are not used for salaries.

Conditional Grants: February 2020 budget vs Adjusted budget

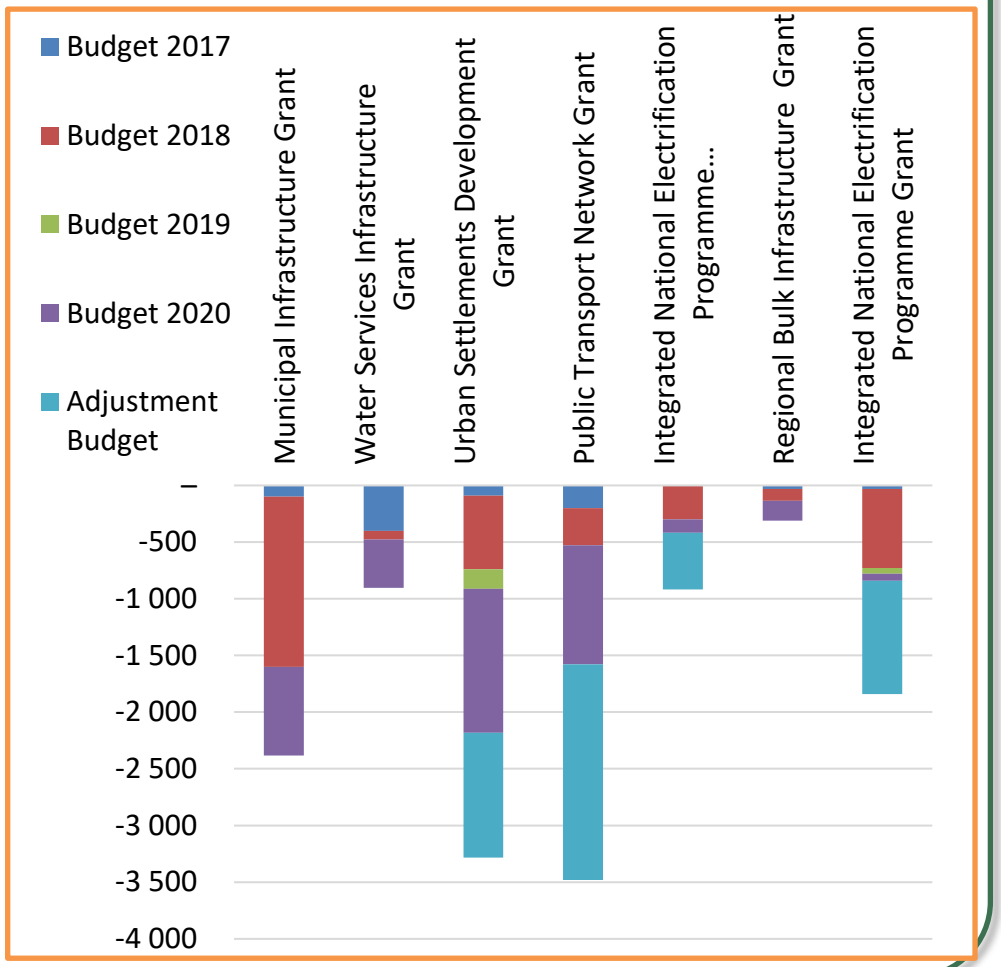


- Allocation through conditional grants increased from R3,0billion in 2016/17 to R3,7 billion in 2020/21
- In the 2020/21 adjusted budget total allocation through conditional grants declined to R3,4 billion
- The decline is due to reductions in allocation through conditional grants, with ISDG reduced by 100%, followed by INEP-E (33.3%), INEP-M (26,9%) and PTNG(15,9%)
- The Commission acknowledges the need to make funds available for Covid-19 interventions, but is of the view that the cuts should be targeted at under-performing grants to minimise the effect on services delivery

ADDITIONAL NOTE ON THE DoR

- The Commission notes that some grants have been affected repeatedly by reprioritisations and baseline cuts over time
- Cuts compound uncertainties on governments in terms of planning; affect infrastructure investment and asset care
- In the long run they will affect service delivery and ultimately derail the achievement of NDP goals
- There is therefore a need for a thorough assessment of the implications of the repeated reprioritisation and budget cuts on some grants.

Baseline Cuts (2017-2020 budgets) and Net Suspensions (2020 Adjustment Budget)



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CONCLUDING REMARKS

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- The Adjustment Budget should not be viewed as a policy statement, but rather technical adjustments to take into account changes, forced by the Covid-19 pandemic. The havoc caused by Covid-19, on an already fragile economy warrants an Adjustment Budget. The deepening recession has resulted in unprecedented revenue shortfall.
- Revenues available for sharing are diminishing at a faster pace. This is making it difficult to finance reforms that will boost growth and improve the fiscal metrics. A bold reform agenda is required in future budgets, anchored on fighting corruption, strengthening the capacity of state to coordinate and monitor, restoring the integrity of key state institutions, and improving policy implementation
- While the Covid-19 pandemic has amplified some of the challenges to the fiscus, challenges facing local government and SOEs which continue to pose a serious risk to the fiscus should not be overlooked. Measures to turnaround local government and reform SOEs should be accompanied by clear reform plans, with clear timeframes, monitorable deliverables and strengthening of the center's ability to monitor reforms.
- Given the diminishing traditional revenue sources and tax revenue, there is need for all the spheres of government to enhance revenue mobilisation and appraise parliament on measures they undertake to enhance their revenues. There is a need to enhance transparency and leverage the capacity (of elected officials and citizens) for oversight and abilities to monitor spending particularly in the local government sector. An increase in resources in an environment fraught with challenges of irregular and wasteful spending can have unintended perverse effects.

CONCLUDING REMARKS

- The reprioritization of conditional grants has implications on the ability of the provincial and local governments to meet its service delivery needs. The reprioritization process should be not hinder service delivery in the long run. A balance between responding to the ongoing health crisis and service delivery is important during this time.
- Aggressive reprioritization on conditional grants such as provincial road maintenance and human settlement development grant can have negative implications on service delivery.
- On infrastructure budgets that have experienced reprioritisation/reductions, especially rehabilitation and maintenance budgets, it is important that outer years of the 2020 MTEF see these prioritised, and that government should provide clear funding and delivery plan for delayed 2020/21 infrastructure projects, and infrastructure maintenance.
- The criteria for reprioritising the R20 billion and (R1 billion in FS) in provinces is not clearly determined and this may result in unevenness in the services delivered to households in different provinces. In the absence of a uniform criteria it is important for provinces to report to Parliament on the reprioritisation criteria used by each province.
- The additional R11 billion to municipalities should compensate those municipalities carrying a disproportionate burden of revenue shortfalls from the pandemic, and such resources should ideally be allocated through a conditional transfer mechanism that also balances the needs of both rural and urban municipalities, and catalyses economic growth. Allocating this money through the LES carries the additional risk of funds being diverted to salaries.

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LIST OF ACRONYMS

USDG	Urban Settlements Development
PTNG	Public transport network
NDPG	Neighbourhood development partnership
INEP-M	Integrated national electrification programme (M)
EEDSMG	Energy efficiency and demand-side management
ISDG	Infrastructure skills development
INEP-E	Integrated national electrification programme (Eskom)
MSIG	Municipal systems improvement
LGES	Local Government Equitable Share