



Financial and Fiscal Commission: Submission on the 2013 Medium Term Budget Policy Statement

For an Equitable Sharing of National Revenue

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List of Acronyms

ADAM	Approach to Distribution Asset Management
BAU	Business as usual
CASP	Comprehensive Agriculture Support Programme
CWP	Community Works Programme
DoR	Division of Revenue
EPWP	Expanded Public Works Programme
FET	Further Education and Training
GDP	Gross domestic product
GFIP	Gauteng Freeway Improvement Project
HSDG	Human Settlements Development Grant
ICOR	Incremental Capital Output Ratio
ICS	Improvements to Conditions of Service
IPAP	Industrial Policy Action Plan
LES	Local Equitable Share
MDG	Millennium Development Goal
MISA	Municipal Infrastructure Support Agency
MTBPS	Medium Term Budget Policy Statement
MTEF	Medium Term Expenditure Framework
NDoHS	National Department of Human Settlements
NDP	National Development Plan
NGP	New Growth Path
NHI	National Health Insurance
OSD	Occupation Specific Dispensation
PES	Provincial Equitable Share
PFMA	Public Finance Management Act
PICC	President's Infrastructure Coordinating Committee
PPP	Public Private Partnership
RBIG	Regional Bulk Infrastructure Grant
RHIG	Rural Household Infrastructure Grant
SANRAL	South African National Roads Agency Limited
SARB	South African Reserve Bank
SASSA	South African Social Security Agency
SIU	Special Investigating Unit
SOC	State Owned Companies
SMME	Small Medium and Micro Enterprises
USDG	Urban Settlements Development Grant

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1. Background

- 1.1. This Submission on the 2013 Medium Term Budget Policy Statement (MTBPS) is made in terms of Section 4 (4c) of the Money Bills Amendment Procedure and Related Matters Act of 2009, which requires Committees of Parliament to consider recommendations by the Financial and Fiscal Commission (the Commission) when dealing with money bills and related matters. The Submission is also made in terms of Part 1 (3) {1} of the Financial and Fiscal Commission Act of 2003 as amended, which provides for the Commission to act as a consultative body for, and to make recommendations to, organs of state in the national, provincial and local spheres of government on financial and fiscal matters.
- 1.2. The 2013 MTBPS is divided into four chapters which cover the following areas:
 - Chapter 1: Securing Inclusive Growth
 - Chapter 2: Economic Outlook
 - Chapter 3: Fiscal Policy and Trends
 - Chapter 4: Medium Term Expenditure Framework and Division of Revenue
- 1.3. The Commission assesses the 2013 MTBPS against the need for medium term fiscal responses to the long term development goals as envisaged by the National Development Plan (NDP). It is also important for the country's fiscal policy to be sustainable while simultaneously stimulating the economy in the short and long term. With this in mind, the Commission's submission addresses: (i) the medium to long term fiscal challenges that need to be considered towards attaining the 2030 vision (ii) the economic outlook and current fiscal strategy (iii) the current risks to the fiscal strategy (iv) the medium term fiscal strategy designed to meet long term goals (v) the fiscal frameworks and the proposed division of revenue (vi) the medium term spending priorities and (vii) a review of the of actual spending and adjustment estimates.
- 1.4. Overall, Government has done a commendable job in signalling through the MTBPS its intent and commitment to implement the National Development Plan (NDP). Given that the country is rapidly urbanising and that the level of poverty, inequality and shortfalls in Millennium Development Goal (MDG) realization in health remain large, an ambitious policy strategy for growth is a pre-requisite if the country is to move further on its transition to attaining the 2030 Vision. Such a strategy must be predicated on a scaling up of the rate of investment, high efficiency in the use of investment resources, and a focus on the key areas of infrastructure that are necessary to meet the economic growth, employment, poverty and inequality reduction targets as established. The government is looking towards infrastructural investment (forming a substantial part of gross fixed capital formation) as the principal driver of whatever upturn in economic growth is anticipated. Infrastructural investment programmes form part of the NDP which should go some way towards overcoming the dearth of investment by the private sector. The corollary to the relatively high growth in gross fixed capital formation

forecast by the government is that the current account deficit is forecast to remain at levels above 6% of Gross Domestic Product (GDP). The Commission hopes that the work of the Presidency and National Treasury on the medium term strategic framework, which will culminate in the tabling of the 2014/15 budget, will provide greater detail on what the next three years will contribute in terms of progress towards the 2030 Vision. At the very least a list of NDP milestones that will be achieved by the end of 2016/17 would be useful in order to gauge progress towards attaining the NDP and hence enhancing alignment of the intergovernmental budgeting system with the NDP.

2. Macroeconomic and Fiscal Outlook Underpinning 2013 MTBPS

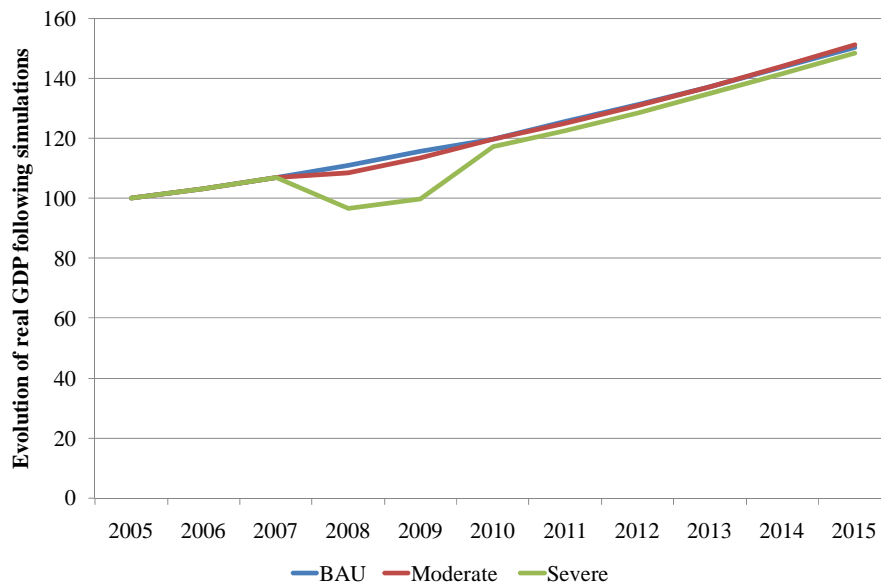
- 2.1. **General economic outlook.** The 2013 MTBPS is formulated against the backdrop of an economy that remains vulnerable to slow global recovery and to domestic factors such as the recent labour unrest. GDP growth has been revised downwards to 2.1% for this year from 2.7% as at the time of the February 2013 Budget, to 3.0% for next year from 3.5% at the time of the Budget and as much as 4.2% at the time of last year's (2012) Budget. Downward revisions do not end here. The budgeted growth for 2015 is now forecasted to be just 3.2%, from 3.8% in the February Budget and 4.1% at the time of last year's 2012 MTBPS. Finally, for the first time a forecast has been included in the rolling medium term expenditure framework (MTEF) for 2016, at 3.5%.
- 2.2. These downward projections on the economic outlook confirm the Commission's projections undertaken in 2009. The Commission had simulated the impact of the global financial crisis on the domestic economy under three scenarios: business as usual (BAU)¹, moderate² and severe³(see Figure 1).The Commission had noted that South Africa's GDP would not recover to the BAU levels without positive shocks (such as increased factor productivity or favourable world commodity prices) and deliberate interventions (such as expansionary fiscal and monetary policies) to counteract the protracted negative impacts of the world economic crisis. This pessimistic scenario is unfortunately being confirmed by such growth projections, which is being exacerbated by domestic and international pressures.

¹In the context of this submission, business as usual, in macroeconomic terms, is the natural trend of the economy and economic policy.

²The moderate scenario is consistent with the view that growth begins to pick up, albeit moderately, from the end of 2009 onwards.

³A severe scenario reflects a protracted slow global growth era and implies tight public budgets for some time to come.

Figure 1: Evolution of real GDP in BAU, moderate and severe scenarios



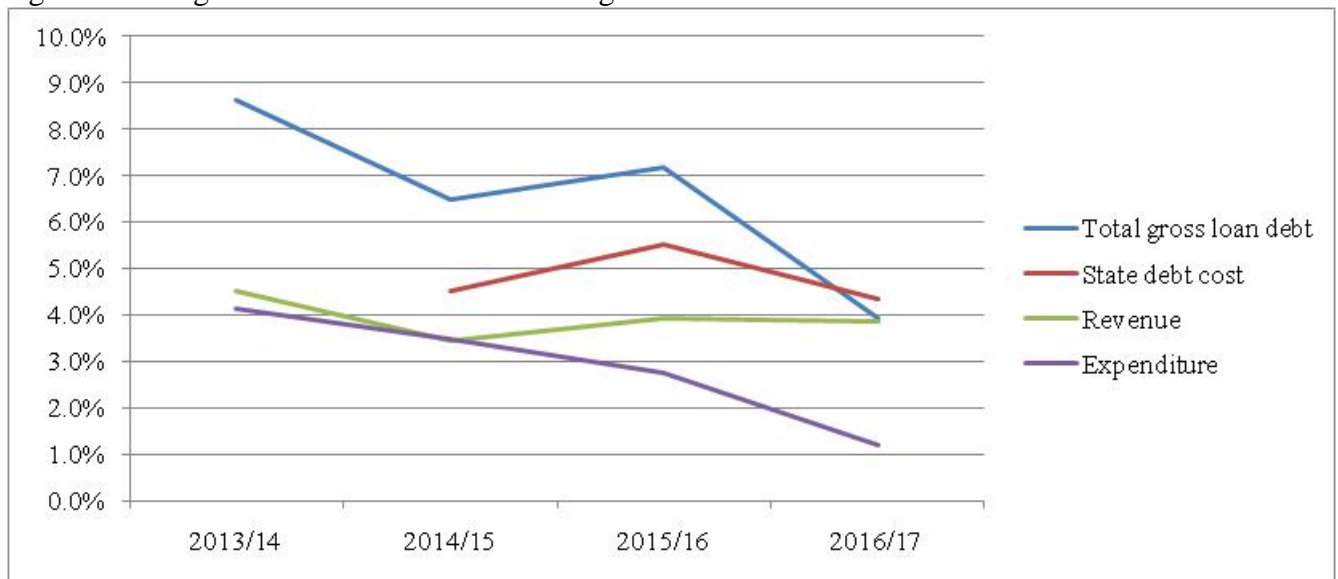
Source: Commission's calculations.

- 2.3. These downward revisions imply that by 2015/16, GDP is now forecast to be -2.8% lower than had been projected at the time of the February 2013 Budget. Since GDP is the denominator in key economic indicators such as the budget deficit or public debt to GDP ratios, the lower GDP statistically tends to push up the relevant ratios, usually in a way that can be interpreted negatively without recognition that part of the increase is simply a function of dividing by a smaller base.
- 2.4. **Fiscal consolidation.** The Government's position on fiscal consolidation is in line with the Commission's submission for 2014/15 Division of Revenue (DoR) which emphasised the need for South Africa to continue on a path of gradual fiscal consolidation. Renewed decelerating global economic growth presents substantial uncertainties and downside risks to the South African economy. In light of the downward revisions to growth forecasts and the associated revenue growth forecasts it is somewhat surprising that the associated budget deficits were not raised particularly dramatically. Indeed, the budget deficit for the 2013/14 fiscal year was left unchanged, at -4.2% of GDP. However, even the increased budget deficits for 2014/15, of -4.1% of GDP, up from -3.9% of GDP in the February Budget and for 2015/16, of -3.8% of GDP, compared with just -3.1% of GDP in the February Budget, represented smaller increases than might otherwise have been anticipated. To the extent that the deficits might not be quite as high as many might have feared, this should be seen as a positive indicator working against the possibility of further credit rating downgrades.
- 2.5. Figure 2 shows the real growth rates of the consolidated budget⁴ over the medium term. From the figure, it is apparent that government expects tax revenues to increase.

⁴ The consolidated budget refers to all revenues and spending commitments of all levels of government, including social security funds and selected public entities including transfers to municipalities businesses or other entities.

Government is relying on strict expenditure restraint decisions to support the decrease in the fiscal deficit. It is important to balance the financing needs to implement the NDP with the goal of budget consolidation. In this regard, real non-interest expenditure is budgeted to grow by just 2.2% per annum over the next three years. This is a decrease relative to the comparable 2.3% figure used in the 2013 Budget and a 2.9% growth figure assumed in last year's 2012 Budget. The fact that the real increase in government expenditure (2.2%) is greater than GDP growth (2.1%) indicates a degree of fiscal support in stimulating the economy. The primary budget deficit decreases to –R41 billion in 2014/15 from –R37.9 billion projected in 2013/14.

Figure 2: Real growth rate in consolidated budget over the medium term



Source: MTBPS 2013, Commission's calculations.

- 2.6. The thrust of fiscal discipline is centred on a significant reduction in the growth of compensation of public sector employees. Such growth is set at 6.5%, 6.8% and 6.9% in each of the next three fiscal years, following a 10.0% projected increase in the current 2013/14 fiscal year. The fact that the public sector remuneration bill is set to decline in this way is reflected in the decline in the growth of government employment over the past year, which in turn has been one of the important contributors towards lower growth in unsecured lending that has impacted negatively on growth of consumer spending.
- 2.7. The largest area of expenditure growth is unemployment and social security, at 13.8%. Social grants are anticipated to rise in line with inflation as well as numbers of beneficiaries. The Commission supports the growth in social security expenditures, which is in line with the Commission's recommendations for the 2014/15 DoR. The Commission found that increased social assistance has a significant impact in eradicating poverty while indirectly supporting long term economic growth. It is also possible that the proposed employment incentive scheme for first-time jobseekers forms part of the high growth envisaged in such expenditure. On the whole, growth in expenditure is

forecast to accelerate slightly over the three-year period 2013/14 to 2016/17, to 8.7% per annum, from the 8.1% figure forecast in the February Budget. It will also be observed that growth in economic infrastructure, at 7.9% per annum and in housing and social amenities, of 8.4%, are the other areas of growth in expenditure that exceed the average. This supports the view that government intends to focus on infrastructural investment.

2.8. Debt sustainability. The imperative on the government to restrict the growth in its public debt is gleaned from the fact that the interest bill on public debt is set to be the second-largest growth area of expenditure over the next three years, at 10.4% per annum. It can be observed that the ratio of public debt to GDP is set to rise to 47.7% by 2016/17, up from 42.5% in the 2012/13 fiscal year. There can be no doubt that the upward revision of budget deficits from 2014/15 onwards represents one of the reasons why the budgeted public debt to GDP ratio for 2015/16, for example, is now set at 47.3%, compared with 44.6% at the time of the February Budget. Such figures are still below the peak public debt to GDP ratio of more than 48% seen in 1998/99, but might be seen as an uncomfortably high level of public indebtedness. Fortunately, only a minor portion (falling from 8.5% of gross loan debt in 2013/14 to 7.5% in 2014/15 and 7.1% in 2015/16) of this is designated as foreign debt. As a result, any depreciation in the Rand's exchange rate would not increase the Rand value of government debt enormously. This is a point of stability in the fiscal structure of the South African economy. Nonetheless, it does leave the domestic economy exposed to a turnaround in international sentiment towards emerging markets that might see capital inflows into domestic bonds slowing at some stage. The Rand would risk depreciating substantially in such an eventuality, with a resumption of significant increases in interest rates which in turn stand to harm economic activity in the longer term. Generally, the Commission is of the view that current levels of debt remain sustainable. The Commission also supports Government's intention of not incurring additional debt financing.

2.9. Risks to economic and fiscal outlook

1. *Public Sector Wage Bill Pressures:* Government has taken steps to ensure that expenditure is contained over the medium term to support its efforts for fiscal consolidation. One of the avenues to contain expenditure growth without compromising growth is the public sector wage bill. Public sector wages continue to grow above inflation over the medium term, albeit at a slower rate. In general, the Commission welcomes these developments and also the firmer stance taken by government in enforcing discipline in the hiring of new employees and to maintain staff levels over the medium term as they are in line with the Commission's recommendations for the 2014/15 DoR. However, it remains important that government productivity and service delivery remains the core of its recruitment policy such that frontline staff core to service delivery are prioritised over general administrative positions. The size and sustainability of the public sector wage bill would continue to be a concern if core service delivery employment were not prioritised during this period.

2. *Persistent under spending:* As mentioned, government's move towards fiscal consolidation is balanced with a mildly expansionary fiscal policy stance. However, for government expenditure to play a stimulatory role in the short run while ensuring that the long term goals, as envisaged in the NDP, are realised, government is required to spend effectively and efficiently. However, all three spheres of government are expected to generate unspent balances amounting R3.14 billion in 2012/13. Continued under spending can jeopardise the attainment of short and long term priorities especially since under spending tends to relate to capital spending which undermines an infrastructure-led growth strategy.
3. *The Negative Current Account Balance:* South African remains a net importer of goods and services. The current account deficit is projected at 6.5% of GDP in 2013, 6.4% in 2014, 6.2% in 2015 and 6.1% in 2016. In this regard, the Commission supports the increased diversification of South Africa's trading partners, with more focus on emerging economies such as China and India through the BRICS initiatives. However, it is important to maintain South Africa's traditional trading partners in the form of the European Union, particularly with the improved economic performance of industrialised nations, while the diversification of exports remains important to ensure the economy is less susceptible to changes in commodity prices.
4. *Robustness of global growth and domestic responses:* The country's capacity for mobilizing the fiscal resources required to implement its public investment program (and equally the prospect for the private sector to also achieve the targeted growth in its investment share) will be strongly influenced by the pace and structure of global growth. Given the dependence on these external resources, a slower global growth would probably be reflected in slower South African growth, lower fiscal revenues and the need for a smaller budgetary envelope. The state of the global economy is thus an important determining factor on the local fiscal position. One of the major challenges facing South Africa is the concern around the relationship between government, labour and the private sector. The crux of the 2013 MTBPS and the success in maintaining the fiscal position going forward rests on the strength of the continued cohesion between these parties. In this regard, government should continue to play an active facilitative role in supporting interaction between all sectors of society and ensuring that the expectations of all parties are realistic and well informed. The breakdown of this relationship remains a serious potential risk to South Africa's fiscal position

3. Assessment of How 2013 MTBPS responds to Medium to Long Run Challenges

- 3.1. South Africa's NDP Vision for 2030 clearly articulates that fiscal policy would be expected to play a central role in influencing the pace at which the economy will grow and its capacity to deal with the key challenges that will arise over the next several decades. Domestic policy challenges include poor education and health outcomes, challenges of coping with rapid urbanization, infrastructure capacity weaknesses coupled with inadequate investment levels and household and spatial inequalities. External challenges include immigration and an uncertain global economic environment. All these uncertainties raise the question of whether fiscal policy, to be robust under alternative scenarios, should be more conservatively managed, particularly with respect to the level of non-concessional borrowing⁵ that would be appropriate in financing the investment program (or more pointedly, in the level of any fiscal debt anchor that might be considered in managing fiscal policy). They also raise questions as to the core investment programme which would appear appropriate, given the uncertainty as to which scenario might eventuate.
- 3.2. Fiscal policy will not only affect macroeconomic stability, but also whether the country can transition to a higher economic growth path, reduce its high poverty rate, and address its substantial income, asset, and regional inequalities. This is the link to MTBPS and NDP in ensuring that the medium term fiscal strategy is conducive in supporting the country's long term strategy as envisaged in the NDP. Given the need to balance medium term challenges with long term development, fiscal policy has an important role to play in managing the demand side of the economy while ensuring sustained government investment in the supply side, particular on human and economic capacity. However, there are several domestic challenges that need to be considered that is likely to effect the attainment of these goals.

3.3. Domestic Challenges

1. *Infrastructure.* Government plays a pivotal role in investing in economic infrastructure necessary to foster private investment and increase and sustain the long term growth capacity of the economy. However, the inadequacy of existing infrastructure, particularly with respect to port facilities, roads, rail, energy, water and sanitation acts hampers the country's long run growth potential. As discussed below, the 2013 MTBPS highlights an important role for government and State Owned Companies in supplying such economic infrastructure. In addition, the fiscal policy stance proposes greater capital investment in the economy. As per South Africa's intergovernmental fiscal system, investment in new and existing infrastructure lies with all three spheres of government. However, poor

⁵ Non-concessional borrowing refers to a market-rate loan whereas concessional borrowing refers to a loan that is extended on more generous terms (for example, lower interest rates).

performance in infrastructure development and asset care is a challenge that cuts across all three spheres of government and can compromise the long run growth potential of the economy. In this regard, government should explore alternative approaches in investing in new and existing infrastructure, including the use of Public Private Partnerships (PPPs). Ultimately, however the Commission is of the view that the President's Infrastructure Coordinating Committee (PICC) which was established in order to fast-track infrastructure development should assume the leadership in determining the appropriate implementation mechanisms to ensure rapid roll out of infrastructure. The enabling legislation for PICC should be fast tracked so that it becomes fully operational.

2. *Mobilizing finances.* Building from the point above, the 2013 MTBPS highlights the tight fiscal framework in which government needs to draw sufficient revenues to finance its infrastructure needs. Government is required to ensure its long run fiscal sustainability while simultaneously supporting the economy in the short term. The buoyancy of tax revenues continues to be an issue of concern, particularly in the currently depressed economic environment. In addition, Table 1 confirms that the tax buoyancy⁶ is becoming a concern. The table shows the tax revenues to GDP ratio and indicates a progressive decline in the buoyancy ratio. A ratio above 1 indicates a greater than 1% increase in tax revenues for a 1% increase in GDP. From the 1990s onwards, this ratio decreased to below 1, indicating that revenue generation is less sensitive to economic growth. This is a concern in that increased economic growth will not lead to a concomitant increase in government revenues. It is clear that generating the required financing for a higher level of investment will be a further challenge. A sound fiscal policy will constrain how much can directly be provided from the budget, leading to the acknowledged need to rely on the private sector, domestic and external, for the remaining financing. Therefore, it is also important that government continues to create an environment that attracts and fosters greater investment from the private sector. The Commission is aware of the Tax Review Committee that Government has set up and looks forward to continue engaging Government through this Committee on the issues noted here.

⁶ Tax buoyancy is a measure of how rapidly the actual revenue from a tax rises as the tax base rises.

Table 1. Tax revenues to GDP ratio (1971 – 2011)

Fiscal Years	Average Ratio
1971/72 - 1980/81	1.2
1981/82 - 1990/91	1.36
1991/92 - 2000/01	0.99
2001/02 - 2010/11	0.97

Source: 2012 Tax Statistics

- Human capacity.* Structural unemployment, skills constraints and a workforce impacted by poor health standards continue to be a serious problem in the country. The performance of South Africa's educational system is a long standing source of concern in relation to long term growth potential. The extent of the challenge is emphasised by statistics on very high youth unemployment⁷. Weaknesses in the health system are reflected by high infant and maternal mortality rates⁸, both of which pose a heavy burden on the system. Coupled with this, the AIDS epidemic has cost South Africa significant losses. Many countries' success in realizing high growth rates has been derived from the ability to productively employ the rising share of the working-age population. According to the 2013/14 Global Competitiveness Report⁹, the health of South Africa's workforce is ranked 133rd out of a total of 148 economies included in the report. This poor ranking is directly attributed to the high level of communicable diseases but also the generally poor state of South Africa's health indicators. The ranking of South Africa's educational system fares worse – 146th out of the 148 total countries assessed. Therefore, strengthening the quality and exploiting the productive use of South Africa's human capital, must remain a high policy priority. The 2013 MTBPS, as has been the priority since the democracy, has prioritised expenditure on education and health. This supports the view that government intends to focus on human capital development in line with the objectives of the NDP. It is important that such resources are used effectively and efficiently to ensure that education and health outcomes are improved. The achievement of improved education and health outcomes, whilst national priority areas, are implemented at the provincial level. As such the ability of provinces to improve effectiveness of service delivery in accordance with NDP goals is critical.

⁷ According to Statssa data, the median unemployment rate is 42% for people aged between 15 and 34 years old. However, the youth unemployment is higher than 50% in some areas.

⁸ UNAIDS data indicates that South Africa has a maternal mortality ratio of 310 deaths per 100 000 live births and an under-five mortality rate of 56 deaths per 1 000 live births - 50% of maternal deaths and 40% of under-five deaths are as a result of HIV infection.

⁹ World Economic Forum. 2013. The Global Competitiveness Report, 2013-14.

4. *Governance Issues.* This issue of governance remains an obstacle to South Africa fully exploiting its growth potential¹⁰. Effectively implementing government policy requires sound institutions underpinned by a competent civil service. Unfortunately, along with a poor rating in the Global Competitiveness Report, South Africa also fares poorly relative to numerous other countries on the issue of corruption¹¹ and general inefficient or unproductive government expenditures. The Commission is aware of progress that might assist in the detection of corruption, for example the recent establishment of the Chief Procurement Officer, and the Public Administration Management Bill, which will effectively criminalise the non-disclosure of interests by civil servants (previously non-disclosure was merely seen as misconduct). Table 2 highlights the concern of potentially rising inefficiency and unproductive expenditure levels by illustrating the growth of fruitless and wasteful expenditure detected by the Auditor-General across all three spheres of government between the 2008/09 and 2011/12 financial years. Over the period, over R5 billion of expenditure by the three spheres of government was considered fruitless and wasteful. This gives a slight indication of the level of inefficiencies currently inherent in the public sector. Given that audits are undertaken on a sample basis, the amount cited above is probably an understatement of actual unproductive expenditures. Based on the aforementioned, the attempts by Government (as noted in the 2013 MTBPS) to increase its credibility through a wide ranging set of measures aimed at limiting excessive expenditure by officials within government, is welcomed. Although the amount of money set to be saved through such measures may be relatively small compared with the overall expenditure, it does nonetheless send a very strong message of commitment to fiscal discipline and has to be greatly welcomed. It should be noted that whilst national government has put in place a variety of measures to improve governance and limit scope for corruption, the responsibility and accountability for ensuring adherence to these frameworks lies with provincial treasuries and accounting officers of departments and municipalities. To this end, the Commission notes the persisting need to strengthen accountability and create consequences for wilful looting of public resources.

¹⁰ According to the 2013 Ibrahim Index, which conducts annual assessments of governance in African countries, South Africa is ranked fifth which reflects a decline since the data was first collected in 2000.

¹¹ South Africa ranks 69th in Transparency International's Corruption Perception Index, 2012 (see www.transparency.org).

Table 2. Fruitless and wasteful expenditure by sphere of government

Financial Year	Fruitless and Wasteful Expenditure				
	R'000	Local Government	Provincial Departments	National Departments	Total
2008/09		128000	262000	90500	480500
2009/10		209000	189000	143600	541600
2010/11		248000	850000	593000	1691000
2011/12		568000	986150	806850	2361000
Total		1153000	2287150	1633950	5074100

Source: Auditor General and Commission Calculations.

5. *Poverty and Inequality.* Despite the progress made in reducing poverty incidence and disparity, South Africa still faces high income and asset inequality as well as significant regional inequality in incomes and assets. Such social issues compromise the long term economic growth potential of the country and it is thus pivotal that such social problems are aggressively engaged. While rapid growth over the next two decades would do much to reduce absolute poverty levels, the number of absolute poor¹² will still remain substantial. Together with continued high inequality, this would constitute a significant drag, in political economy terms, on South Africa's ability to obtain popular support for an ambitious resource mobilization and savings effort. Certainly, unless addressed, income inequality will constrain growth in the country, dampen the scope for poverty reduction and create an environment for social and political unrest. The 2013 MTBPS highlights the need to maintain roll out of social assistance to qualifying individuals and households to continue the poverty eradication strategy and reduce income inequality. Government's Free Basic Services Policy, which entitles indigent households to a minimum level of basic services (water, sanitation, electricity) is an important component to the poverty eradication strategy. Government is making progress in rolling out access to basic services. However, the quality and sustainability of these services, in the light of poorly maintained infrastructure, is cause for concern and can hinder attempts at eradicating poverty.

3.4. Domestic Challenges Going Forward

¹² Add a footnote: Absolute poverty is a level of poverty as defined in terms of the minimal requirements necessary to afford minimal standards of food, clothing, health care and shelter. The intuition behind an absolute measure is that mere survival takes essentially the same amount of resources across the world and that everybody should be subject to the same standards if meaningful comparisons of policies and progress are to be made. Measuring poverty by an absolute threshold has the advantage of applying the same standard across different locations and time periods: it makes comparisons easier. On the other hand, it suffers from the disadvantage that any absolute poverty threshold is to some extent arbitrary; the amount of wealth required for survival is not the same in all places and time periods.

1. *The rapid rate of urbanization:* The rapid rate of urbanization means municipalities and provinces will have to invest in urban infrastructure (e.g., housing, water, sewage, transport, schools and health facilities) to accommodate a virtual doubling of their populations. Such urban infrastructure investments are likely to have diminishing marginal productivity gains as most of it would be social infrastructure eradicating growing backlogs, further constraining the prospects for achieving the high efficiency level required to realize a 5.4% annual growth rate up to 2030. The challenges with respect to implementation of infrastructure and asset care, particularly at the local level, have been alluded to above. Should the current spending levels and lack of adequate maintenance and rehabilitation practices continue, within the next five years, the bulk of water and electricity infrastructure will deteriorate to a level that will compromise sustained service delivery. The Commission notes government's efforts in the 2013 MTBPS aimed at promoting better land use and establishment of more compact cities, in alignment with the NDP. The urban settlements development grant and the integrated cities development grant are evidence of this. The Commission notes, particularly with respect to the urban settlements grant, that explicit outputs are difficult to ascertain. As per the Division of Revenue Act of 2013, metropolitan municipalities report on this grant against their entire capital budgets and subsequent infrastructure development that can obscure actual outcomes of the grant. Given the magnitude of the grant and its strategic importance, this is a cause for concern.
2. *The pressures for job creation:* The NDP target around job creation is 5 million jobs within the next decade and an additional 11 million jobs created by 2030. Whilst the Commission acknowledges that the public sector cannot be solely responsible for employment, government expenditure policies will need to be sensitive to the job creation possibilities associated with the realization of the government's expenditure programme. Government has maintained focus on job creation as a key priority in the 2013 MTBPS. The largest area of expenditure growth is unemployment and social security, at 13.8%. The employment incentive scheme for first-time jobseekers is a likely part of the high growth envisaged in such expenditure. The Commission welcomes the proposals to introduce employment tax incentives to improve employment in the medium term while acknowledging that need for continued investment and improved outcomes in the education. Its success however will depend ultimately on the ability and willingness to substitute labour for capital in the production process as well as the amounts dedicated to the subsidy. Government also makes provision for other job creation initiatives such as expanded works programme (EPWP) and community work programme (CWP). Through its coordination of the EPWP, the Department of Public Works aims to create 3.7 million work opportunities by the end of 2016. In addition, it also makes provision to support the work of the Commission for Conciliation, Mediation and Arbitration in preparation for amendments to labour legislation.

3. *Technological advancement:* Technological advancements have large impacts on local productivity levels and can potentially have larger impacts on economic growth. In recent years, Government has continued its investment in local research and innovation with such policies crystallised in the Industrial Policy Action Plan II (IPAP2) and the New Growth Path (NGP). Although local innovation remains pivotal for long term economic growth, the importation of ideas and new technologies is also an avenue for technological advancement to ensure South Africa remains dynamically efficient going forward. The Commission is pleased to note the R374 million allocation in respect of broadband connectivity in public schools. This resonates with recommendations around the need for improved financing of e-education as motivated for in the FFC's Submission on the 2013/14 DoR. It should be noted however, that one of the key challenges for South Africa is balancing the need for economic growth that is labour intensive (job creating growth) with technological advancement.
4. *The looming costs of climate change:* The coastal provinces and municipalities will need an alleviation plan. There are also drought threats for inland areas. Addressing the potential deleterious effects on agricultural productivity will require a combination of intensified investment in water-control systems that promote enhanced efficiency in the use of water resources; a further shift in the role of non-agricultural outputs and new R&D efforts at promoting agricultural techniques robust to drought and uncertain precipitation conditions.

4. State Owned Companies

- 4.1. *State Owned Companies.* The 2013 MTBPS acknowledges that one of the risks to South Africa's fiscal path is the balance sheets of state owned companies (SOCs). SOCs are expected to borrow on the strength of their balance sheet, rather than being funded from the fiscus. Besides risks in terms of contingent liabilities, increasingly there are risks in terms of greater use of user fees as shown in the run up to implementing e-toll fees for the Gauteng Freeway Improvement Project¹³. However, the Commission notes with concern that government has continued to issue guarantees to SOCs that are expected to support the rollout of government infrastructure through investment in infrastructure that is capable of supporting long-term growth.
 1. Government granted South African Airways (SAA) a R5 billion guarantee for a period of two years, starting from September 1, 2012. SAA had requested recapitalisation at an estimated cost of between R4 billion and R6 billion. This would enable the airline to strengthen its balance sheet and order new planes. In

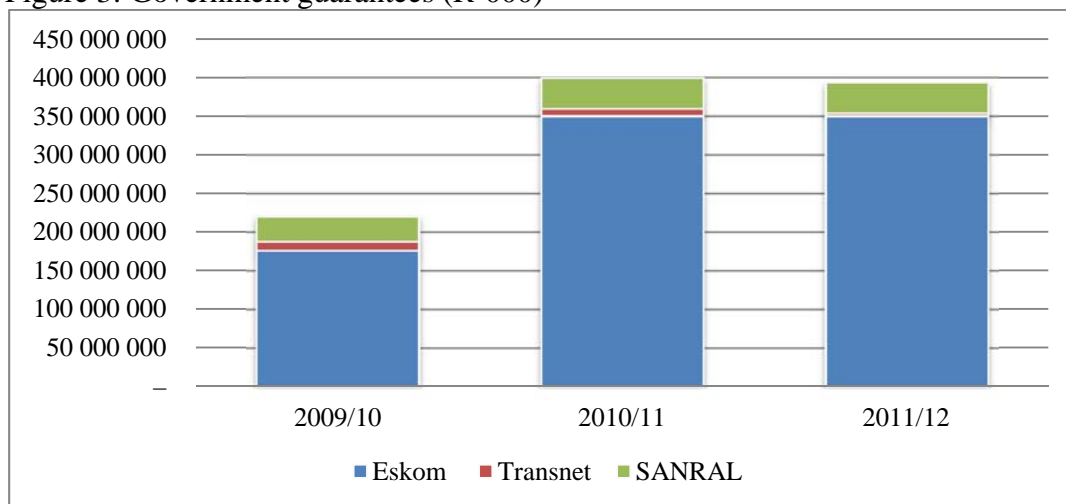
¹³ The Commission has made recommendations around the GFIP as part of its Briefing on the Additional Appropriations Bill for 2012. This report is available at:

<http://www.ffc.co.za/index.php/submissions/commission-submissions>

2004, a hedging loss of R6 billion wiped out the company's capital base, and in 2008, soaring oil prices led to another R1 billion hedging loss. In November 2009, Government approved the South African Broadcasting Corporation (SABC) application for a Government Guarantee for R1.473 billion for the corporation after the broadcaster reported cash flow problems. The SABC paid off its R1 billion government guaranteed loan to Nedbank earlier than expected, saving interest payments.

2. Figure 3 indicates that between 2009/10 and 2011/12, Government continued to issue guarantees to Eskom, Transnet and the South African National Roads Agency Limited (SANRAL). It shows that government issued guarantees totalling R220 billion in 2009/10, R399 billion in 2010/11 and R393 in 2011/12. Most guarantees were issued to Eskom (R176 billion in 2009/10, R350 billion in 2010/11 and 2011/12 respectively), followed by SANRAL (R32.9 billion in 2009/10, R39.9 billion in 2010/11 and 2011/12 respectively).

Figure 3: Government guarantees (R'000)



Source: National Treasury, 2013.

3. For Eskom, the R350 billion includes the R176 billion worth of guarantee announced by government in February 2009. The guarantees are also in addition to the R60 billion subordinated loan from government which was approved in July 2008. The guarantee was issued to enable Eskom to continue the capacity expansion programme it has committed to over the next seven years, including the Kusile, Medupi and Ingula power stations as well as the associated transmission infrastructure. For SANRAL, the guarantees were issued to attract private finance for funding the expansion and upgrade of the GFIP and the NI/N2 Winelands projects over the medium term. In its 2012 response to the MTBPS, the Commission noted that government guarantees represents a contingent liability to

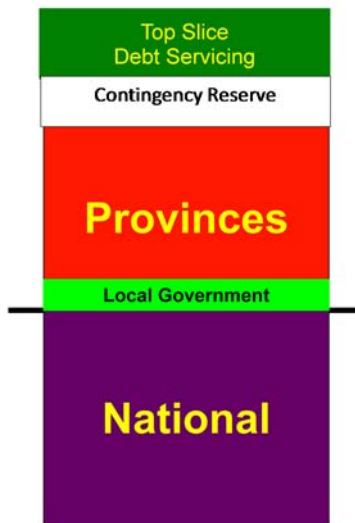
the state that should be monitored closely. It emphasised that such guarantees should not become frequent practice.

4. The Commission also notes with concern that even though these companies have been receiving guarantees from government, their performance continues to be less than optimal. For instance some of the SOCs are making losses. The Commission welcomes Government's approach towards operational restructuring of SOCs to become financially sustainable and to better fulfil their mandates. Government should also commit more extensively to the use Private Public Partnerships (PPPs) and other innovative financing methodologies to encourage investment in infrastructure projects where appropriate. When effectively implemented, the use of PPPs has the potential to lure capital from private sector and increase the efficient use of public resources.

5. Fiscal Framework and Proposed Division of Revenue in 2013 MTBPS

- 5.1. The total appropriated expenditure for a given financial year comprises all government revenues, including revenues generated from taxation and debt incurred. This revenue supports all government expenditure and ultimately informs the division of revenue among the three spheres of government. However, prior to the division of revenue process, funds are "top sliced" from total government revenues to pay for the costs of government debt and to support a contingency reserve. The contingency reserve aims to protect the country in instances of unforeseen or unavoidable expenditures that may arise during the financial year as well as to support pivotal Government policy decisions that may also arise. Once these two expenditure items are accounted for, the remaining funds are available to inform the division of revenue process.

Figure 4 Vertical division of revenue



Source: Commission.

- 5.2. Table 3 below illustrates the division of revenue amongst the three spheres of government over the 2014 MTEF. The table also makes reference to allocations for the 2013/14 financial year. Two figures are noted for 2013, one from Budget 2013 and the second is a revised figure as per the 2013 MTBPS. The latest estimate for the 2013 division of revenue has been revised upwards by R1.7 billion. This is mainly driven by revisions to the provincial allocation, specifically a R1.3 billion injection to the provincial equitable share (PES) allocation to address inflation-related salary adjustments and upgrades in the salary level of public sector clerks.
- 5.3. Within the confines of fiscal consolidation and the maintenance of the expenditure ceiling determined in Budget 2013, the 2014 MTEF is characterised by moderate growth increases – real annual average growth of 1.02% is projected. Government is expected to spend R3.3 trillion over the 2014 MTEF period, with the national sphere making up 47% of total allocations followed by provincial government at 43%. Local allocations remain the lowest at R300 billion, but are expected to grow faster than the other spheres at 2.09% in real terms per annum over the MTEF period.
- 5.4. To cater for increased spending pressures over the 2014 MTEF period, Government has adopted a two-pronged approach, namely reducing the contingency reserve allocation and reprioritising funding away from underperforming items with a specific focus on conditional grants.

Table 3. Medium term expenditure framework division of revenue (R billion)

Division of Revenue	2013 Budget	2013 MTBPS	2013 MTBPS			Real Annual Average Growth Rate (2014/15-2016/17)
	2013 M/Term Estimate	2013/14 Revised	2014/15	2015/16	2016/17	
National Allocations	452.5	452.5	487.9	520.4	550.1	0.60%
Provincial Allocation	414.2	415.8	444.7	478.2	507.8	1.25%
<i>Equitable Share</i>	337.6	338.9	362.5	388.0	412.0	1.01%
<i>Conditional Grants</i>	76.6	76.9	82.3	90.2	95.8	2.22%
Local Allocations	84.7	84.8	91.9	101.4	106.7	2.09%
TOTAL	951.4	953.1	1 024.5	1 100.0	1 164.6	1.02%

Source: 2013 MTBPS, Commission's calculations.

- 5.5. Over the 2014 MTEF period a total of R1.4 trillion is allocated to provinces. This represents a net increase of R11.2 billion to provincial baseline allocations. Increases in the provincial allocation are mainly to fund high wage costs. Real annual average growth of 1.25% is projected for the provincial allocation over the 2014 MTEF period. This growth is driven by relatively faster growth in provincial conditional grant allocations mainly due to the provision of funding for flood damage caused during the first half of 2013 and the establishment of a new, two year grant aimed at funding the implementation of occupation specific dispensation (OSD) for therapists in the education sector.
- 5.6. Over the 2014 MTEF, the local government sphere is allocated 9% of the total division of revenue allocation. This translates to a R300 billion allocation over the 2014 MTEF (R91.9 in 2014/15, 101.4 in 2015/16 and 106.7 in 2016/17). Increases to discretionary funding to municipalities are aimed at funding delivery of basic services to poor households whilst funds to incentivise improved spatial planning particularly within metropolitan municipalities is being funded via conditional grants.

6. Medium Term Spending Priorities in MTBPS

- 6.1. Table 4 reports the real growth of expenditure components. The real growth of expenditure components is relatively modest and less than the forecasted 3% average annual growth rate over the MTEF. The exceptions are: (i) employment and social security, (ii) local government, housing and community amenities, (iii) water and (iv) science and technology, which record average real growth rates of above 3%. This is in line with government's priority of expanding job creation and investing in infrastructure to boost economic growth. With the increased risk of water scarcity from factors such as climate change, the 8.67% average annual growth in water supply budget over the MTEF period is a positive development. Government's approach of reallocating resources

within a constrained fiscal environment has meant making important trade-offs which is reflected in the negative growth of economic services and general public services over the MTEF period.

Table 4. Real growth of expenditure components by functional classification

	2013/14	2014/15	2015/16	2016/17	Average
Defence, public order and safety	3.13%	-0.01%	-0.14%	1.07%	1.02%
Defence and state security	2.82%	-0.11%	0.41%	0.65%	0.94%
Law courts	6.02%	1.20%	-0.18%	2.15%	2.30%
Police services	3.07%	-0.37%	-0.33%	1.10%	0.87%
Prisons	1.04%	0.59%	-0.12%	0.55%	0.51%
Economic infrastructure	1.35%	5.73%	3.44%	-2.68%	1.96%
Communication	21.02%	-18.02%	4.64%	3.67%	2.83%
Fuel and energy	-5.90%	6.76%	2.17%	1.59%	1.15%
Transport	1.14%	6.84%	3.53%	-3.36%	2.04%
Economic services	2.34%	-2.94%	-0.77%	-1.20%	-0.64%
Education and related functions	2.20%	1.21%	1.33%	1.28%	1.51%
Employment and social security	23.84%	12.68%	5.47%	6.14%	12.03%
General public services	1.35%	-0.75%	0.58%	-3.39%	-0.55%
Health	-0.11%	2.28%	1.03%	0.99%	1.05%
Social protection	2.07%	3.37%	0.92%	0.51%	1.72%
Local government, housing and community amenities	5.30%	4.33%	3.22%	0.41%	3.31%
Housing development	5.84%	3.97%	1.84%	-0.31%	2.84%
Local government and community development	1.90%	2.31%	3.17%	-0.39%	1.75%
Water supply	15.67%	10.23%	5.41%	3.36%	8.67%
Science and technology and environmental affairs	16.73%	1.84%	2.03%	-5.70%	3.73%

Source: MTBPS (2013), Commission's Calculations.

6.2. Table 5 reflects the relative prioritization of expenditure categories for the period 2011/12 to 2015/16. Three categories with increased shares are: (i) employment and social security (ii) local government, housing and community amenities and (ii) science and technology and environmental affairs. The social sector (i.e. Health, Education and Social Security), which comprise nearly half the total budget allocation (47.9% in 2013/14); all reflect declining shares, even though by marginal amounts. Although boosting investment spending in areas that will stimulate job creation is critical, the Commission calls for social sector spending programmes to be protected in any reprioritization of Government spending programmes.

Table 5. Main expenditure categories as a share of total non-interest expenditure

	2012/13	2013/14	2014/15	2015/16	2016/17
Defence, public order and safety	14.8%	14.8%	14.5%	14.2%	14.3%
Economic infrastructure	8.2%	8.1%	8.3%	8.5%	8.2%
Economic services	4.6%	4.5%	4.3%	4.2%	4.1%
Education and related functions	22.6%	22.4%	22.1%	22.1%	22.3%
Employment and social security	4.1%	4.9%	5.3%	5.5%	5.8%
General public services	6.1%	6.0%	5.8%	5.7%	5.5%
Health	13.2%	12.8%	12.8%	12.7%	12.8%
Social protection	12.9%	12.7%	12.8%	12.8%	12.8%
Local government, housing and community amenities	12.1%	12.3%	12.5%	12.7%	12.7%
Science and technology and environmental affairs	1.4%	1.6%	1.6%	1.6%	1.5%

Source: MTBPS (2013), Commission's Calculations.

- 6.3. **Job Creation.** Similar to the 2012 MTBPS, job creation initiatives, especially among the 19 – 29 age group, remains an important priority for Government. As discussed earlier, government has adopted a multi-pronged strategy involving both short-term job creation initiatives such as the EPWP, CWP, job fund and creating special economic zones and long-term structural reforms such as improving educational outcomes and boosting productivity of its workforce and enhancing competitiveness of the local industry¹⁴. The job fund receives a total allocation of R3.4 billion for 64 projects and is expected to create 90 000 new jobs and 100 000 training opportunities over the MTEF period. A forecasted growth of 5.4% is needed in order to meet job creation and poverty targets of the NDP.
- 6.4. **Education.** The funding for Education increases by R234 billion in 2013/14 to R287 billion in 2016/17, representing an increase of R34 billion. The additional funds are mainly for salary requirements. Education employs 38% of the total public sector workforce and is the largest budget function. The Commission agrees with the sentiment expressed in the MTBPS that educational outcomes need to improve. According to the NDP, improved education, will lead to higher employment and earnings. The Commission is of the view where schools under-perform; emphasis should continue to be placed on the professional development of teachers, improving school management as well as greater accountability of school principals.
- 6.5. **Health.** The allocation for health increases from R133 billion in 2013/14 to R164 billion in 2016/17, which represents a R31 billion increase over the period. The additional funds are mainly to accommodate additional salary requirements, anti-retrovirals, a new

¹⁴ The recent Global Competitiveness Report, which evaluates competitiveness environment of 148 countries, ranked South Africa 53rd, in 2013, down from 45th place in 2008/9.

vaccine for cervical cancer and the building of a forensic chemistry laboratory. Again the Commission agrees with the sentiment that health outcomes need to improve. The Commission awaits the funding arrangements for NHI and associated long term fiscal report. It also notes the existing challenges with the rollout of NHI pilot studies.

- 6.6. **Social Protection.** Funds allocated to social protection rises from R133 billion in 2013/14 to R164 billion in 2016/17, representing an increase of R31 billion over the period. Social grant spending increases to accommodate the rise in social grant beneficiaries and inflation adjustments to the value of grants. This is aligned with the recommendation made by the Commission for the 2014/15 division of revenue. The Commission is pleased with efforts by Government to improve spending efficiency by eliminating erroneous or fraudulent grant claims. It is noted that funds from Health have been reprioritized to establish shelters for victims of gender-based violence and substance abuse. The Commission would like to emphasise its concern around the huge disparities in the funding of child welfare services, which was a key issue emanating from its recent report on “The Provision and Funding of Child Welfare Services in South Africa”¹⁵. The Commission calls on Government to actively engage with the recommendations of the study, especially in light of the financial crisis that many NPOs are currently experiencing. These recommendations offer a way forward for the sector and places child welfare services on a more sustainable path.
- 6.7. **Section 100 interventions.** The Commission pointed out in its submission on Section 100 interventions, that there is a regulation vacuum in which interventions are carried out. In this regard, the Commission would like to reiterate that there is a need for a refined framework for intervention with clear parameters setting out triggers for intervention, clarifying roles, responsibilities and lines of accountability during intervention as well as timelines for interventions for all stakeholders, including legislatures. In its 2014/15 submission on the Division of Revenue, the Commission developed measures of fiscal stress for provincial and local government that is intended serve as early warning signals and to pre-empt possible S100 and S139 interventions. Legislatures and organized local government are encouraged to use these tools as part of their oversight instruments to monitor the financial health of provincial and local government.

7. Proposed Adjustments to Conditional Grants

- 7.1. For the 2014/15 financial year the provincial conditional grants baseline is adjusted upwards by R1 billion after taking into account reduction on underperforming grants. This represents a 0.6% increase from the baseline projected in the 2013 budget. The human settlement development grant (HSDG) receives the highest addition to baseline to fast-track the upgrading of informal settlements in mining towns. This is followed by

¹⁵ This report is available at <http://www.ffc.co.za/index.php/media-a-events-interactive/public-hearings/child-welfare-services>

the further education and training (FET) colleges grant and the public transport operations grant which increases by R160 million and R150 million over the MTEF, respectively.

- 7.2. The Commission notes with concern the proposed reductions to the allocations of underperforming grants. Reductions for the 2014 MTEF period are made as follows: R200 million from the comprehensive agricultural support programme (CASP) grant and the land care grant, R1.5 billion from the education infrastructure grant and the school infrastructure backlogs grant (an indirect grant), R46 million from the National Health Insurance (NHI) grant (an indirect grant) and R80 million from the EPWP, an incentive grants to provinces. While the principle of reducing allocations to underperforming grants in the short term is sound, it is of concern to the Commission that reductions are carried out without making an assessment of what effect they have on the attainment of grant objectives and broader national goals as articulated in the NDP as well as the underlying causes of under-performance. Both the education infrastructure and school infrastructure backlog grants are critical in addressing inputs required to improve educational outcomes and ensure the progressive realisation of education norms and standards. Reductions in the allocations to the NHI grant may in all likelihood undermine later successful implementation of the NHI pilots and the resultant experimental lessons required to implement the NHI fully. The EPWP grant is an important source of work opportunities for the unskilled and the unemployed. As a result, reductions in the allocations to this grant will undermine the country's national goals of reducing unemployment to 14% by 2020 and 6% by 2030. In all these cases in addition to short term reallocation measures, grant transferring and receiving accounting officers should be held accountable for building the expenditure absorption capacity to implement these grant objectives and mitigate the risk of serial underspending and under-delivery. The Commission also reiterates its recommendations on the need to improve grant design *ex ante* to improve grant performance *ex post*¹⁶.
- 7.3. It is especially concerning to the Commission that under spending on indirect grants¹⁷ is significantly higher relative to direct grants. This reflects the inability of national departments to coordinate their spending and delivery plans with those of provinces. Where the requisite capacity exists, the School Infrastructure Backlog grant and the NHI grant should be transferred directly to provinces in order to allow for greater expenditure control and alignment of accountability with delivery outcomes. The Commission emphasises that shifting the organisational location of a grant from sphere to sphere or department to department will not necessarily improve grant performance. Instead,

¹⁶ The Commission has a long history of evaluating the use of conditional fiscal transfers – it carried out comprehensive work on conditional grants in 1995, conducted a ten year review of conditional grants in 2005 and again in 2010, the performance of fiscal transfers was evaluated. In its Submission for the 2014/15 DoR, the Commission reiterates its previous conditional grant recommendations and calls for a review of the efficacy of conditional grants particularly with respect to the necessity and purpose of some of the grants.

¹⁷ Indirect grants refer to grant that are spent by national departments on behalf of a sub-national government.

national sector departments need to build capacity so as to adequately perform their oversight and improve sub-national capacity building initiatives.

- 7.4. The Commission welcomes the addition to the HSDG, as this highlights the importance placed by government in addressing housing needs and backlogs. Additions to baseline allocations should however be accompanied by efforts to reduce the escalating rate of decline in the number of housing units delivered per annum. This is especially important given that the HSDG is one of the grants which has consistently shown good expenditure performance (of 98%) since 2009/10 up until more recently, in 2012/13. It is however of concern to the National Department of Human Settlements (NDoHS) that both the Eastern Cape and Limpopo provinces continue to under-spend on their HSDG allocations despite the growing backlog. The Eastern Cape and Limpopo provinces under-spent their allocation by 13% and 10% respectively in 2011/12 and 8% and 7% respectively in 2012/13. The Commission is therefore of the view that the NDoHS needs to ascertain underlying challenges affecting performance of these two provinces and develop plans to assist them to improve performance. Furthermore, in anticipation of the housing function being shifted to the six metros by 2014, the Commission recommends that the NDoHS set aside additional resources for supporting and monitoring these municipalities. The Commission welcomes the use of 2011 census data to determine allocations. However, in the long term the Commission is of the view that despite supply-side improvements, the system is unlikely to be financially sustainable or meet the scale, pace and quality of housing demand. The Commission therefore reiterates the findings arising from its report on titled “Exploring Alternative Finance and Policy Options for Effective and Sustainable Delivery of Housing in South Africa”¹⁸.
- 7.5. The Urban Settlements Development grant (USDG) was introduced in 2011/12. The Commission appreciated this development as a step in the right direction but noted a need for other municipal infrastructure-related grants to be aligned with the USDG. To date, there has not been any progress in aligning other municipal infrastructure-related grants to the USDG. In terms of performance, the USDG under-performed during the year under observation with a reported spending of 44% by March 2012. Spending has since improved in 2012/13 with a reported spending of 96% of allocated funding, with a number of metros spending close to 100%. Only Buffalo City and Mangaung spent below 90% (with spending at 73% and 80% respectively).
- 7.6. Additional funds to cover the costs of salaries in FET colleges are also a welcome development. The Commission notes the process of shifting the FET function from provinces to national government and reiterates that the baseline funding requirement be established before completion of the transfer and that national government addresses any fiscal gap that may arise. In applying the principle of funds follow function, caution should be exercised not to reduce the equitable share by an amount bigger than what provinces have determined as optimal to spend on the function.

¹⁸ This report is available at <http://www.ffc.co.za/index.php/media-a-events-interactive/public-hearings/housing-finance>

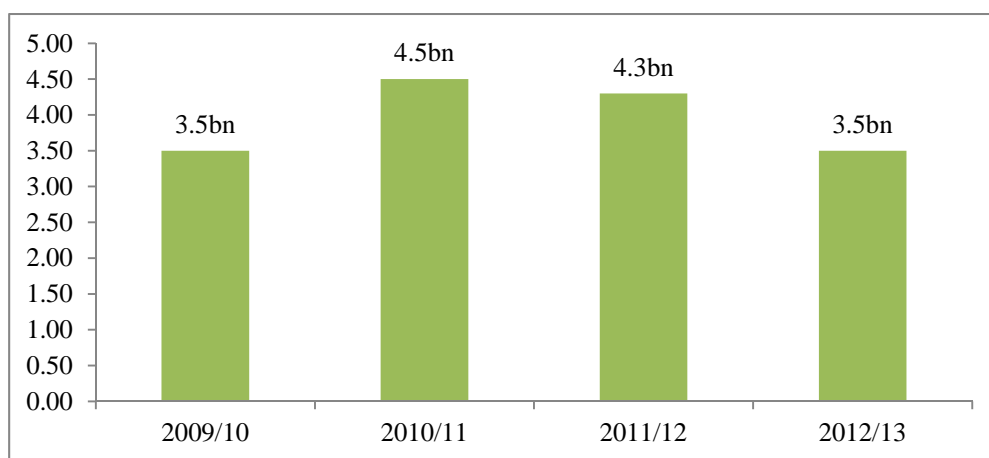
- 7.7. The rural household infrastructure grant (RHIG), introduced in 2010, to improve the provision of sanitation, continues to underperform. From an adjusted budget of R340.6 million, in 2012/13 only R205 million (60%) was spent. Some of the reasons for under-spending relate to delays in the appointment of service providers and finishing of work behind schedule. The Commission has previously made recommendations on RHIG. The recommendations include the need to strengthen the monitoring and evaluation role of the NDoHS as well as municipal capacity development (given that a number of recipient municipalities are poor, rural ones).
1. When RHIG was introduced in 2010/11, and up until 2012/13, it was a Schedule 6B grant administered, managed and implemented by the DoHS for onsite sanitation and water facilities. As of the 2013/14 financial year, this grant was changed from a Schedule 6B to a Schedule 5B grant. The effect of this shift is that the DoHS is no longer involved in implementation as the grant now flows directly to municipalities. The Commission has made a submission to the Portfolio Committee on Human Settlements on this issue. The Commission's view is that changing this grant from a schedule 6B to a schedule 5B (direct grant to municipalities) is unlikely to improve performance of this grant. The Commission reiterates this point and would urge Government to investigate the real cause of underperformance as opposed to moving the challenge from one sphere to another. This is particularly important given the capacity deficit that exists at the local level.
- 7.8. In 2011 the provincial disaster relief grant was introduced as a schedule 9 grant but later changed to a schedule 7 grant. This change was mainly to cater for immediate release of funds to provinces in the case of disasters. Over the 2011 MTEF period, R675 million was set aside for this grant, divided into R305 million for 2011/12, R180 million for 2012/2013 and R190 million for 2013/14. Of the R180 million allocated in respect of the provincial disaster relief grant in 2012/13, only R850 thousand was approved for disaster response in Limpopo province. In 2013/14, R103 million has been allocated to five provinces and five provincial sector conditional grants through the adjustment budget. For the 2014/15 MTEF, disaster allocations amount to R997 million. The Commission, in its response to the 2011 MTBPS, supported the introduction of this grant due to the fact that the recipients did not have to wait for the adjustment period before funds could be disbursed to provinces. However, it appears that the process for immediate release of funds and declaration of disasters remains unresolved as evident in the recent allocation of disaster relief fund through the adjustment budget.

8. Local Government Financing Issues

- 8.1. The Commission welcomes the proposed increase of 9.2% to the local government equitable share (LES) allocation. Municipalities are facing increased demand for services from local communities and increasing costs in providing such services and it is important that the LES continues to play an effective role in supporting service delivery

1. The Commission notes the progressive implementation of the new LES formula and welcomes the greater distribution of funds to more poorly resourced municipalities, as per the design of the new LES formula.
 2. Whereas the Commission supports greater funds being allocated via the LES to poorly resourced municipalities, the Commission re-emphasises the point made in its Response to the 2013 DoR Bill regarding the importance of the spending capacity of these municipalities. In the absence of the ability of recipient municipalities to absorb and effectively spend, the targeting of additional funds through the LES may contribute to an increase in unproductive and inefficient expenditure and poor service delivery outcomes. Government should improve efforts over the medium term to ensure that such municipalities are able to deliver on their service delivery mandates.
- 8.2. Conditional grant funding to the local sphere is projected to increase from R34.6 billion in 2013/14 to R42.6 billion in 2016/17, or by 23% over the MTEF period. Whereas conditional grants provide an important revenue stream for funding infrastructure development at the local level, the Commission cautions against increasing resources that may ultimately remain un/underspent (see Figure 5 below).

Figure 5. Aggregate conditional grant under spending (R'Billion)



Source: Section 71 Reports, Commission's calculations.

- 8.3. Within the context of slower GDP growth and the need to do more with less, the Commission notes the deliberate reprioritisation of funding away from a number of underperforming local government conditional grants, namely: the municipal infrastructure grant (MIG), the USDG, the EPWP integrated grant for municipalities, the infrastructure skills development grant and the energy efficiency demand side management grant. The reduction in the aforementioned grants will fund increases to the integrated city development grant and the regional bulk infrastructure grant (RBIG). Importantly, the Commission notes that funds from direct grants to municipalities are being diverted to an indirect grant, which effectively shifts spending of these funds from

the local to national sphere. If this is a measure aimed at improving delivery performance it will remain to be seen whether national government will be successful in overcoming the implementation challenges incurred by municipalities or, whether poor performance will continue, thus alluding to grant design issues.

- 8.4. The additional R356 million over the MTEF, to the integrated city development grant is welcomed, as this grant is designed to encourage the development of compact and efficient cities as articulated in the NDP. This is aligned to the recommendation the FFC made in its Annual Submission on the 2013/14 DoR around the need for more efficient land use. Equally important is the additional R934 million to the RBIG to support bulk water project. The Commission notes that whilst the shifting of funds from some grants may be redirecting unspent funds to areas of need, this does not solve the challenge of poor grant performance, especially if the underlying causes of poor performance are not dealt with in the first place. As a result, the Commission does not see reprioritisation of funds as a long term, sustainable solution and would rather advise Government to address systemic issues giving rise to non performance as well as closer scrutiny of the design of conditional grants.
- 8.5. The Commission raises a serious concern over the potentially severe underinvestment in social and economic infrastructure at the local government sphere due to a combination of structural financing problems and municipal inefficiencies. In terms of the latter, the persistent under spending of infrastructure grants by local government threatens the local need for economic infrastructure to support economic growth and the social infrastructure required to eradicate service backlogs. It is pivotal that the use of existing resources is improved to ensure capital investment requirements are attained. In addition, one of the main findings coming out of the Commission's comprehensive review of the local government fiscal framework¹⁹ is the potential under funding of capital. It is impossible to address this capital funding gap if existing resources cannot be spent. Local government capital expenditures remain a significant concern.
- 8.6. With that being said, the Commission is also acutely aware of the challenges around asset care (specifically maintenance and rehabilitation) at the local level. The Commission therefore stresses the importance of an integrated approach to unblocking this challenge. Capacity building grants need to be linked to interventions being undertaken by the Municipal Infrastructure Support Agency (MISA) as well as sector-specific interventions such as the Approach to Distribution Asset Management (ADAM) underway in the electricity sector. In addition, as recommended by the Commission in its Submission for the 2014/15 DoR, the limited regulatory framework guiding asset care at the local level needs to be addressed through the establishment of formal legislation to guide municipalities with respect to maintaining and renewing their infrastructure.

¹⁹ The full report if available at <http://www.ffc.co.za/index.php/media-a-events-interactive/public-hearings/local-government>

- 8.7. Finally, with respect to conditional grants, the Commission is a member of the task team established to review local government infrastructure grants and will therefore continue to engage Government on the issues noted here.
- 8.8. The Commission advises that existing uncertainties around the powers and functions of district municipalities receives urgent attention as it creates ambiguities around the expenditure assignment and appropriate financing instruments of this category of municipalities. The financial sustainability of these municipalities continues to be a concern if such expenditure assignments are not finalised. The Commission advises that a lasting solution to this long-standing issue be implemented.
- 8.9. The Commission notes Government's efforts to contain wasteful, irregular and inefficient spending within the public sector, and local government in particular. To this end, it is important that efforts are undertaken to professionalise local government. In achieving this, the improved enforcement of competency standards as prescribed in the Municipal Systems Act will go a long way in ensuring that posts are held by individuals with the appropriate skills mix. Municipal councils are responsible for filling key and strategic posts (i.e. municipal manager and Section 57 managers) within a municipality. The Commission thus sees the role of municipal councils as integral to achieving greater professionalisation within the local government sphere.
- 8.10. Since its inception, the Commission has been very critical of the sharing of the General Fuel Levy instrument with metros. One of the concerns raised was around the buoyancy of the revenue instrument. The projected revenue from the general fuel levy is revised downwards for the 2013/14 and 2014/15 financial years relative to projected amounts in the 2013 Budget. As the metros receive a fixed share of around 23% of the general fuel levy, the overall envelope afforded to these municipalities is likely to decrease. This is likely to put financial pressure on these municipalities and reiterates the concerns around the buoyancy of this revenue source, amongst other administrative issues (such as its method for distribution). In this regard, the Commission welcomes the review of the general fuel levy sharing along with all the own revenue funding sources of local government.

9. Review of Actual Spending by National Departments and Provincial Government – 01 April to 30 September 2013/14

- 9.1. Expenditure smoothing implies government spending that is evenly distributed through the four quarters of the financial year. If such smoothing were to occur, it would be expected that total expenditure up to September would be at 50% of the main budget. This would of course differ depending on whether a government program that the department is dealing with is recurrent or capital-expenditure driven. Expenditure smoothing would most likely lead to improved quality of spending and reduced level of unauthorised spending.

9.2. Table 6 shows aggregate spending and percentage spent six months into the 2013/14 financial year.

1. Total government spending as at September 2013 is below the assumed norm of 50% by 2% at R506.9 billion. Spending by all votes is 3% below the norm (R278.8 billion of the main budget). Noteworthy is the 4% above the norm that have been spent on other charges against the National Revenue Fund, even though the absolute amount spent is small relative to the total budget (R6.7 billion of the main budget)
2. Using selected key national government programmes that drive government priorities (such as education, health, justice and policing), and key built environment programmes such as energy, human settlements and rural development), government has spent on par with the norm (49.9%). Uneven spending patterns are nevertheless noticeable, with Higher Education and Training spending 70% of their budget compared to only 38.8% by Rural Development and Land Reform.

9.3. With respect to the PES, 50% of the total amount has been transferred to departments.

Table 6. Aggregate spending and deviation from the norm (March-September 2013)

R'000	Spending as		
	Main Budget	at September 2013	% Expenditure
Total	1 056 005	506 959	48.0%
Appropriation by Vote	588 682	278 831	47%
Direct charges against National Revenue Fund	462 363	228 128	49.3%
Fuel levy	9 613	3 204	33%
State debt cost	99 741	49 186	49.3%
Other charges against National Revenue Fund	15 435	6 952	45%
PES Transfers from National	337 572	168 786	50.0%
Selected Key budget Votes	240 707	117 821	49%
7. Public Works	6 170	2 662	43.1%
15. Basic education	17 592	8 549	49%
16. Health	30 707	14 867	48.4%
17. Higher Education and Training	34 322	24 236	71%
21. Correctional Services	18 748	8 830	47.1%
24. Justice and Constitutional Development	14 134	6 358	45%
25. Police	67 917	32 058	47.2%
25. Agriculture, Forestry and Fisheries	6 178	2 902	47%
28. Economic Development	771	376	48.8%
29. Energy	6 598	2 838	43%
31. Human Settlements	28 110	9 053	32.2%

33. Rural Development and Land Reform	9 460	5 092	54%
Provincial level	418 499	168 786	40.3%
Education	173456	87640	50.53%
Health	129162	64446	49.90%
Social Development	13984	6352	45.42%
Other	101897	44393	43.57%

Source: MTBPS (2013), Commission's Calculations.

- 9.4. Education and Health have spent their budgets in line with the budget norm, although Social Development is 5.5% below the norm as a result of underspending on goods and services (44%) and transfers to NPOs (40%). If the underspending to NPOs is as a result of delayed transfers, this is a concern as NPOs rely on the prompt and regular disbursement of these grant allocations to fund crucial mandatory welfare services delivered on behalf of government. Education and Health are typically labour-intensive functions and therefore the bulk of their resources are allocated to funding personnel costs. For Social Development, an amount of R1.5 billion, (R1.3 billion in declared unspent funds) is transferred out of the Child Support Grant in the adjusted estimates. Commission findings show the child support grant help fund important consumption expenditure by poor households, hence efforts to cover qualifying beneficiaries that do not yet receive the grant should be undertaken if any unspent funds are realized.
- 9.5. Table 7 reflects historical growth in selected key national departments and provincial social sectors. Public Works, Basic Education, Economic Development, Energy and Human Settlements all grew above 10% in real terms on average per annum and are in line with the priorities identified in the Medium Term Expenditure Framework (MTSF). The Commission notes all other votes grew at a positive annual average growth rate although Correctional Services (2.8%) and Rural Development and Land Reform (2.8%) registered the lowest growth figures.
- 9.6. The provincial social sector departments also grew at a steady pace, with health increasing on average per annum by 7.8%, representing the largest increase among the social sectors.

Table 7. Real growth rates of key national and provincial votes, 2009/10-2012/13

	2009/10	2010/11	2011/12	2012/13	Real Annual Average Growth
Selected Key National Votes					
7. Public Works	25.1%	15.4%	2.0%	3.9%	11.6%
15. Basic Education	16.3%	6.4%	44.0%	10.9%	19.4%
16. Health	10.0%	13.4%	9.5%	3.1%	9.0%
17. Higher Education and Training	3.5%	10.7%	14.4%	6.0%	8.7%

19. Social Development	5.4%	6.1%	5.0%	2.5%	4.7%
21. Correctional Services	0.0%	3.3%	6.0%	2.0%	2.8%
24. Justice and Constitutional Development	9.3%	6.6%	3.6%	7.0%	6.6%
25. Police	7.8%	8.2%	3.5%	3.8%	5.8%
26. Agriculture, Forestry and Fisheries	4.4%	-6.9%	23.3%	10.6%	7.9%
28. Economic Development	36.1%	23.2%	39.5%	6.9%	26.4%
29. Energy	17.9%	45.1%	7.4%	3.5%	18.5%
31. Human Settlements	16.9%	11.2%	14.8%	4.5%	11.9%
33. Rural Development and Land Reform	-18.8%	17.4%	7.6%	6.6%	3.2%
Provincial Departments					
Education	10.7%	5.4%	8.6%	0.6%	6.3%
Health	11.4%	6.7%	9.3%	3.9%	7.8%
Social Development	1.8%	5.5%	12.3%	-1.4%	4.6%

Source: *ENE (2008-13), Provincial AFS (2008-13)*.

10. Adjustment Estimates 2013/14

- 10.1. Annually government makes adjustments to the main, approved budget passed in February. These are expenditures that cannot be planned for in the beginning of the financial year. These adjustments are meant to cater for unforeseen and unavoidable expenditure. Generally expenditure requirements may be the result of an in-year rise in inflation, reimbursements to sub-national governments for the shortfalls in the agreed to salary adjustments for public servants or for refunding sub-nationals that experienced nationally declared natural disasters.
- 10.2. Ordinarily, government makes provision for these expenses in the annually budgeted contingency reserve. This year, however, government has shown its seriousness with respect to consolidation by funding these unavoidable pressures through the release of savings amounting to R344 million as reflected in the 2013 Adjustment Appropriation Bill (published with the 2013 MTBPS). This allows government to move allocations between spheres and programmes in order to fund areas that are under genuine pressures during the year.
- 10.3. The biggest nett reductions were from national departments' transfers and subsidies budget which amounted to R4.4 billion. The following departments have cut back their spending on transfers and subsidies: Department of Social Development (R2 billion), Department of Health (R359 million), National Treasuries (R323 million), Department of Environmental Affairs (R168 million), Department of Trade and Industry (R109 million) and Department of Energy (R89 million). This frees up government spending of R3 billion from goods and services and R1.5 billion from compensation of employees. The following departments' compensation of employees budget were reduced: Labour (R100 million), Correctional Services (R95 million), Statistics South Africa (R56 million), Agriculture, Forestry and Fisheries (R52 million), National Treasury (R51

million) and Trade and Industry (R35 million), Sports and Recreation (12 million) and Social Development (R11.5 million). The following departments increased their COE budgets significantly: Department of Defence and Military Veterans (R508 million), Police (R873 million), International Relations, Justice and Constitutional Development (R170 million) and International Relations and Cooperation (R115.5 million).

1. **Communications.** The Department of Communication shifts an amount of R374 million from transfers and subsidies to fund the Schools Connectivity Project for the provision of internet connectivity for designated schools. This project is funded from a net reduction of R99 million in goods and services. The reprioritization is in line with the Commission's recent recommendation on e-education which emphasized the importance of placing greater focus on the implementation of the e-education policy of Government.
 2. **Cooperative Governance and Traditional Affairs.** The Department of Cooperative Governance and Traditional Affairs shifted R130 million in 2012 and R149 million in 2013 to Transfers and subsidies. The adjustment in 2013/14 also includes additional R33.4 million, which was funded through reductions of R31.7 million in Goods and Services. Reprioritized funding is being used for paying employees, skills development and policy-relevant development. The Commission calls for closer financial management scrutiny after R21 million was incorrectly classified in the 2013 Estimates of National Expenditure.
 3. **Trade and Industry.** The department of Trade and Industry had its budget substantially reduced in 2012 by R740 million compared to R57 million this year. In both years the reductions were made to transfers and subsidies (R911 million in 2012 and R109 million in 2013). These reductions largely due to underspending by manufacturing development incentives programme (R50 million), infrastructure programme (R50 million) and automotive production programme (R15 million) due to delays in implementation, not complying with rules on incentives and delays in incentives. The Commission is concerned that adequate planning of these incentive programmes may not be taking place.
 4. **Rural Development and Land Reform.** Transfers and subsidies receive an additional R1.57 billion which is funded from goods and services (R1.26 billion) and compensation of employees (R288 million). An amount of R971 million from goods and services is reallocated from the comprehensive rural development plan, which may be due to underspending. The Commission would like to reiterate that Government should put in place adequate measures to ensure funds are spent adequately as this is an important programme for rural development.
- 10.4. For provinces, the freed-up allocations make provisions for an additional R563 million available to deal with increases in improvement to conditions of service (ICS). This include proposed adjustment of R369 million for upgrading of clerks, plus an adjustment of R11.5 million inflation adjustment for FET colleges.

10.5. A total of R103 million is reallocated for disasters in provinces. Other adjustment proposals include those for conversions of indirect provincial conditional grants to direct grants in health for facility revitalisation in KwaZulu Natal and in the Northern Cape.

10.6. A proposed R109 million is allocated through the PES for funding the devolution of property rates fund grant and reimbursements for the Marikana tragedy. Two amounts in the conditional grants framework have been approved for Limpopo province in respect of the technical secondary schools recapitalisation grant and the Dinaledi schools grant. Reallocations amounting to R8.7 billion have been made between provinces in respect of the provincial roads maintenance grant. Another adjustment is made to host cities for the 2014 African Nations Championship: health and medical services grant.

10.7. An amount of R118 million is allocated to at least 10 municipalities for disaster recovery, the majority of which are in the Eastern Cape province. A total of R73 million is allocated in respect of rollovers

10.8. Rollovers

Table 8. Rollovers of selected national votes, 2010/11-2013/14

R million	2010	2011	2012	2013	TOTAL
	MTBPS	MTBPS	MTBPS	MTBPS	
Total	3737	1789	1506	894	7 926.0
Selected Key budget Votes					
Cooperative Governance	430.8	5.6	139.5	72	647.9
Public Works	120	0	87.1	0	207.1
Basic Education	1	29.9	104.7	14.7	150.3
Health	49.8	231.3	87.2	22.2	390.5
Agriculture, Forestry and Fisheries	15.6	37.5	68.2	0	121.3
Communication	19.8	112.2	0	0	132.0
Energy	61	88.2	25.8	28.1	203.1
Human Settlements	82.7	64.6	13.5	120.5	281.3
Rural Development and Land Reform	495.7	0	96	0	591.7
Water Affairs	79	145.8	416.6	188	829.4

Source: *Adjusted Estimates of National Expenditure (2010 – 2013)*.

1. The Commission welcomes the decline in rollovers from R3.73 billion in 2010/11 to R894 million in 2013/14. The decline in rollovers suggests Government is exercising stricter controls with respect to monitoring expenditure and rollover requests.
2. Consistently large rollover requests approved over the four year period are observed for DCOG (R647.9 million), Health (R390.5 million), Human Settlements (R.281.3 million) and Water Affairs (R829.4 million). Rural Development and Land Affairs also had significant rollover requests approved in 2010/11 and 2012/13. The approvals for requests of unspent grant funding have

declined and approval granted only where existing commitments are still outstanding.

3. Grant funding rolled over for Water Affairs are typically infrastructure-related projects, which suggests possible implementation and project management weaknesses. The Commission would like to re-emphasize that institutions such as MISA should be called upon to assist municipalities with the implementation of these bulk water infrastructure projects.

11. Concluding Remarks

- 11.1. Government should be commended on its fiscal stance highlighted in the 2013 MTBPS. The fiscal position recognises the need for fiscal consolidation in order to ensure government spending and debt levels are sustainable going forward while also being relatively expansionary in supporting a flat economy. The Commission recognises that striking such an appropriate balance is difficult but Government has made significant strides in this regard.
- 11.2. From an aggregate fiscal policy perspective, the Commission is of the view that Government has done enough to stave off downgrades from rating agencies. There is much work however on improving the value-for-money and impact of public spending. These micro fiscal goals lie in the domain of individual portfolios and accounting officers of departments, not directly within the domain of the National Treasury which is the custodian of aggregates. The capability of provincial treasuries and Offices of the Premier to drive improvements in financial management practice within provincial departments and municipalities is crucial.
- 11.3. In addition to the above, there are also many areas of the economy that need attention, namely weak educational and labour market outcomes, which are inimical to higher sustainable growth and greater employment intensity, as well as research and innovation. The Commission believes that the 2013 MTBPS could have addressed these issues in more detail. A major macroeconomic (rather than purely fiscal risk) relates to the tightening financial and capacity constraints which threaten a public infrastructure-led growth strategy and the poor investment climate that has subdued both internal and foreign investment. In this regard a better understanding of the obstacles causing the delays in the rollout of the infrastructure strategy is critical and the Commission views this as central to the work of the PICC.
- 11.4. The Commission emphasises that shifting the organisational location of a grant from sphere to sphere or department to department will not necessarily improve grant performance. Instead, national sector departments need to build capacity so as to adequately perform their oversight and improve sub-national capacity building initiatives.

- 11.5. The 2013 MTBPS begins to address the key challenges facing South Africa and lays the foundation to implementing the NDP Vision 2030. The Commission would like, however, in the 2014 budget and departmental strategic plans to see greater detail on what the next three years will contribute in terms of progress towards the 2030 Vision. This should be in the form of specific output and outcomes milestones that will be achieved by the end of 2016/17 which will help to gauge progress towards attaining the NDP Vision.
- 11.6. Finally, the Commission views the 2013 MTBPS as a rallying call to strengthen government policy credibility by clearly demonstrating what the implementation issues around the NDP are and calling on the private sector to play its part. In that respect the Commission sees a close link to what the main thrust of its Annual Submission on the 2014/15 Division of Revenue was about and what comes out in the 2013 MTBPS.

For and on behalf of the Financial and Fiscal Commission



Bongani Khumalo (Mr.)
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