RESPONSE TO THE 2013 DIVISION OF REVENUE BILL

For an Equitable Sharing of National Revenue

06 March 2013

Financial and Fiscal Commission
Montrose Place (2nd Floor), Bekker Street,
Waterfall Park, Vorna Valley, Midrand,
Private Bag X69, Halfway House 1685
www.ffc.co.za
Tel: +27 11 207 2300
Fax: +27 86 589 1038

Table of Contents

List of Acronyms

CPO	Chief Procurement Officer
DCoG	Department of Cooperative Governance
DoR	Division of Revenue
DHS	Department of Human Settlements
ECD	Early Childhood Development
FBS	Free Basic Services
FET	Further Education and Training
FFC	Financial and Fiscal Commission
IGFR	Intergovernmental Fiscal Relations
LES	Local Equitable Share
LGFF	Local Government Fiscal Framework
MIG	Municipal Infrastructure Grant
MTEF	Medium Term Expenditure Framework
NHI	National Health Insurance
NPOs	Non Profit Organisations
PES	Provincial Equitable Share
RHIG	Rural Household Infrastructure Grant
SALGA	South African Local Government Association
STATSSA	Statistics South Africa

List of Tables

List of Figures

1. BACKGROUND

1.1. This Submission on the 2013 Division of Revenue Bill is made in terms of Section 214 (1) of the Constitution of the Republic of South Africa (1996) and Section 35 of the Intergovernmental Fiscal Relations (IGFR) Act (1998).

1.2. The Commission in general supports the Bill and is in agreement with the broad principles espoused in it. Furthermore, proposals to introduce a new local government equitable share (LES) formula as well as conditional grant reforms as most of these were part of extensive consultations between government and a number of stakeholders, of which the Commission was a part.

2. GENERAL COMMENTS ON THE 2013 DIVISION OF REVENUE BILL

2.1. **Provincial conditional grant reforms and incentives:** Government is proposing far reaching measures aimed at institutionalising planning with respect to the spending of provincial infrastructure conditional grants. The Commission welcomes the addition of clauses which address reforms in provincial infrastructure conditional grants necessitated by consistent under spending on the part of Provincial Governments. The new approach provides for a two year lead planning and competitive funding approval for infrastructure projects to minimise the level of under-spending, requests for rollovers and increase budget credibility. The new approach further provides for incentive to provinces with good spending records by affording then an opportunity to bid for additional funds which may have not been successfully secured by other provinces.

1. The Commission welcomes in principle efforts to improve planning prior to approval of conditional grants.

2. The rewarding for performance is only supported in cases where performance exceeds minimum standards set. Provinces should not be rewarded for carrying out their constitutional duties at the minimum. There must be a clear framework detailing circumstances under which performance incentives are granted including sanctions for below minimum performance. The Commission will make recommendations in its 2014/15 submission on the design of incentive based transfers drawing lessons on how past attempts at incentivising performance have fared.

2.2. **Reforms to Health Infrastructure Grants and NHI Grant**: **T**he 2013 Division of Revenue Bill proposes amendments that will enable the shift of the National Health Grant (indirect grant) to the Health Facility Revitalisation Grant (direct grant) and/or NHI grant (direct grant) to provinces with proven capacity. The Bill also proposes to amend the provincial budgets for the 2013 medium term expenditure framework (MTEF) to include the revised Health Facility Revitalisation Grant (direct grant) and/or NHI grant (direct grant) allocations for the 2013 MTEF.

1. The Commission welcomes in principle efforts to consolidate and reduce the number of conditional grants. The proposal moves towards consolidation of grants rather than proliferation which has always been a concern to the Commission.

2. With respect to consolidation of Health Infrastructure Grants and NHI Grants, the Commission welcomes efforts to consolidate and reduce the number of conditional grants in light of its past recommendations against grant proliferation. The proposal moves towards the creation of a block grant to protect health expenditure allocations. The resulting health conditional block grant will give provinces flexibility to allocate resources according to their specific health infrastructure needs as opposed to individual conditional grants requirements. The Commission, however, notes with concern that only 14% of the R150 million allocated to NHI pilots in 2012 had been spent at the end of February 2013 compared to the National Treasury benchmark of 83%. The Commission therefore supports the decision by government to reduce the grant over the MTEF period by R25.7 million. This action will hopefully allow the department time to improve its readiness. The revised allocation to provinces for the existing NHI grant is now R192 million over the 2013 MTEF period.

2.3. **Assignment of function to administer national housing programmes to Metros:** Clauses have been added to prepare for the intended executive assignment of the function to administer national housing programmes to six metropolitan municipalities, namely, Ekurhuleni, Tshwane, City of Johannesburg, eThekwini, Nelson Mandela Bay and the City of Cape Town. The function to be assigned is the administration of all national housing programmes (with the exception of individual and relocation subsidy mechanisms that remain the responsibility of the provincial department responsible for human settlements). The administration of national housing programmes from provinces to the metros will be undertaken in terms of Section 126 of the Constitution and will be concluded in terms of Executive Assignment Agreements between the relevant Members of Executive Committees (MECs) and metros and then through proclamation by the Premier. The Commission welcomes Government's pro-activeness in inserting Section 16 in the Bill to make provision for smooth transfer of funds from provinces to municipalities which are earmarked or eligible for the assignment of human settlement and public transport functions. This assignment instrument allows for a differentiated approach dependent on municipal capacity and accountability and satisfies a desirable principle of situating the function closest to the area of need. However, such assignment has financial and fiscal implications that need to be identified (e.g., to capital grant allocations, operational funding requirements, transfer of immoveable and moveable assets and transfer of staff and other contractual obligations). The Commission is currently reviewing the proposal as required in terms of Section 9 and 10 of the Municipal Systems Act (2000) and the Financial and Fiscal Commission Act (1997) and will make its review available to the Minister of Human Settlement, Human Settlements MEC's and Parliament on 31 March 2013.

2.4. **Provision for funding of natural disasters:** Section 19 4(a) provides for utilisation of unspent infrastructure conditional allocations to address damages to infrastructure caused by disasters within an affected province or municipality. The Commission supports this proposal as a step in the right direction towards addressing recommendations made in its 2012/13 Submission on financing of natural disasters. However, there is still a need to address comprehensively the challenges related to financing of disaster including whether approval to use unspent conditional allocations should be preceded by formal declaration of a state of disaster as required in terms of the Disaster Management Act and how to deal with cross boarder disasters which straddle provinces or municipalities.

2.5. **Payment schedule with respect to schedule 6 grants (indirect grants):** The 2013 Bill extends the process for approval of and compliance with payment schedules with respect to indirect grants or grants implemented by national government on behalf of provinces or municipalities. It is the view of the Commission that any reform that is aimed at improving transparency and certainty should be supported. Provinces and municipalities need to be fully aware of funding commitments undertaken by National Government within their jurisdiction especially if such expenditure involves carry through costs of maintenance. From the Commission's perspective, it is also important that infrastructure related indirect transfers to provinces are subjected to similar planning and approval process as those envisaged in the new provincial conditional infrastructure allocation framework to avoid inconsistencies.

2.6. **Section 27**: The Commission welcomes the insertion of section 27 to facilitate commencement of expenditure before the Bill comes into effect or when the effective implementation date passes beyond the 1st of April as a result of delays emanating from mandatory money bills parliamentary participatory processes. The transitional clause will enable Government to commence with expenditure and implementation of delivery programs while the Bill undergoes final parliamentary processes before enactment thus ensuring continuity and certainty.

2.7. **Local Government Equitable Share Formula Review:** The review of the local government equitable share (LES) formula was completed in the past year by a technical team led by the National Treasury, the Department of Cooperative Governance (DCoG) and the South African Local Government Association (SALGA) with technical advice from the Commission and Statistics South Africa (STATSSA). The process was highly transparent with all municipalities invited to make inputs through a rigorous consultation process. The review process culminated in a new LES formula to be applied only on the horizontal division of revenue. The Commission is of the view that all its recommendations that have been made in the last six years in respect of the formula were taken into account and thus welcomes and supports the principles that informed the formula as well as agreeing that indeed the outcome is an appropriate formula for present day South Africa. The formula manages to recognise the vast differences in South Africa's municipalities in terms of socio-economic profiles and their associated own revenue potential. It succeeds in targeting the most vulnerable municipalities without unduly punishing the relatively well off municipalities.

1. Most (78%) of the money distributed through the LES formula will be through the Basic Services component. This is mainly due to the fact that the majority of poor households in the country are in the metropolitan and rural municipalities. These municipalities receive the largest share of allocations in the new formula accounting for 52% of LES allocations (Metros get 29% while rural municipalities receive 23%).

2. As part of ensuring that allocations yield desirable outcomes, it is important that greater capacity support is provided and oversight exercised in poorer municipalities that may be

facing severe financial governance challenges as indicated by the Auditor General findings and slow spending performance. In addition, because the LES formula is designed to provide each municipality with at least enough money to provide free basic services to each poor resident household, it would be useful to ensure that this is actually reflected in the municipalities' budgets through the benchmarking exercises that National and Provincial Treasuries have started conducting.

3. It must be noted that the recently completed review of the equitable share formula is only a part of the process of reviewing the local government functional and fiscal framework that government has committed to embark on. The Commission is currently finalising and will shortly be submitting its final report on the local government fiscal framework (LGFF) that it conducted through a set of public hearings and is of the view that the report should be used as an input into the broader government review.

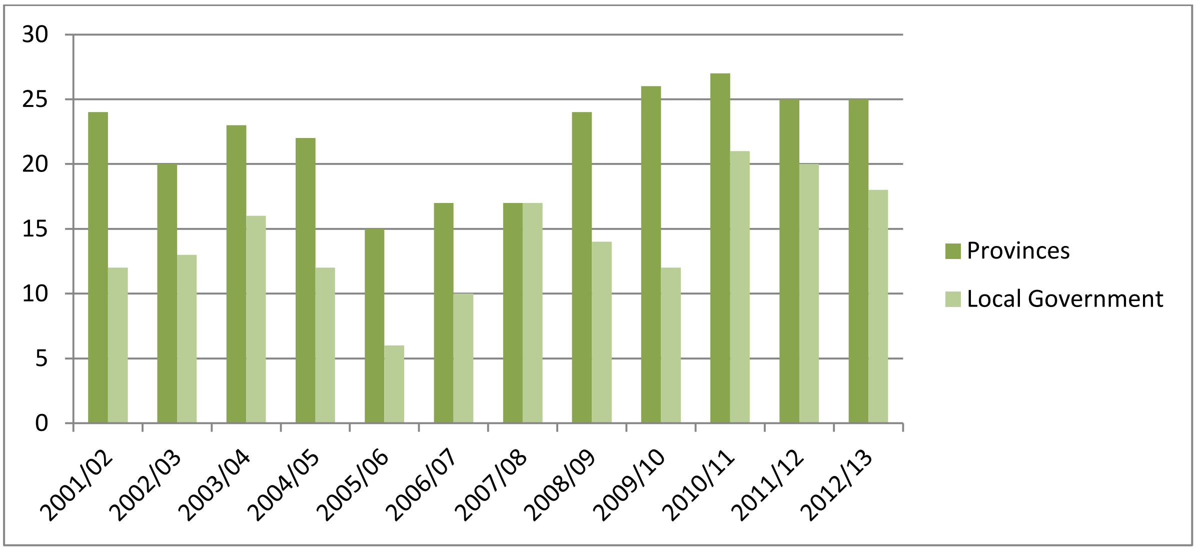
4. As part of ongoing work on the LES, there are a number of issues that the Commission will be taking forward in its 2013/14 work cycle as part of the overall local government fiscal and functional framework review. These issues are all associated with costing of basic services.

2.8. **Grant proliferation**: An important issue regarding the Bill relates to the continued growth in the number of grants which constitutes a strong feature of this year's Bill across urban and rural municipalities and provinces. The issue of grant proliferation has been raised as a major concern in the past and continues unresolved this year. The Bill proposes a total of 4 new conditional grants to local government as well as the restructuring and shifting of grants from national government to provincial government and municipalities. For provinces and municipalities, grant proliferation is a problem primarily because it often leads to a confusing array of overlapping programmes with variously competing or duplicated objectives and conditions, and complex implementation and reporting requirements. Proliferation often reflects framework and programme design weaknesses in transferring departments, which increases the risk of under spending and other suboptimal outcomes such as compliance cost for municipalities which already suffer from capacity constraints. The Commission has made recommendations on the introduction and termination of conditional grants with a view towards entrenching good principles in designing and implementing such grants since 2005.

1. While the Commission acknowledges the evolving nature of the intergovernmental fiscal system, the current approach to introduction, termination and reviewing of conditional grants destabilises the composition and predictability of transfers. Figure 1 shows changes in the number of conditional grants per province and local government per annum. Over the 12 year period from 2001/2002 to 2012/2013, there have been significant movements in the number of conditional grants available to provinces and municipalities per annum. Analysis of grant life span patterns (when grants are introduced or terminated) shows similar volatility. Such volatility is likely to make the task of planning for and administration of grants extremely difficult and subsequently affect grant expenditure performance. This issue of proliferation arose during consultations between the Minister and the Commission and it was agreed that the

Commission will pick up this matter with more substantive recommendations in the Annual Submission for the 2014/15 Division of Revenue.

Figure 1: Number of provincial and local conditional grants per annum



Source: Compiled from National Treasury, Division of Revenue Act

2. NATIONAL FISCAL FRAMEWORK

2.1. Table 1 presents the MTEF estimates for the 2013 budget. Due to external economic conditions exacerbated by internal strife in the labour markets that resulted in a downward revision of revenues, this year sees the least addition to the national fiscal framework compared the previous years. A total of R72.69 billion is added to the baselines over the MTEF. The total allocations increase from R878.6 billion in the 2012 budget to R951.3 billion in the 2013 budget. Government is expected to spend R3.1 trillion over the next three years in all spheres. With these revisions, the national sphere receives 47.6% of total expenditure, provinces receive 43.5%, while the remaining 8.8% goes to local government. Despite the smaller allocations to the local government sphere, allocations are expected to grow faster than the other spheres at 5% in real terms per annum over the MTEF period.

Table 1: Division of Revenue 2013/14 – 2015/16

R billion	2012/13	2013/14	2014/15	2015/16
National allocations	413.1	452.5	489.5	521.7
Provincial allocations	388.5	414.2	441.7	474.4
Equitable share	*313.0*	*337.6*	*359.9*	*383.7*
Conditional grants	*75.5*	*76.6*	*81.8*	*90.7*
Local government allocations	77.0	84.7	91.6	101.5
Total allocations	**878.6**	**951.3**	**1 022.8**	**1 097.6**
Changes to baseline				
National allocations	0.7	6.3	10.6	24.8
Provincial allocations	4.0	3.1	4.7	17.3
Equitable share	*4.0*	*8.7*	*10.6*	*18.3*
Conditional grants	*0.1*	*-5.6*	*-5.9*	*-1.0*
Local government allocations	–	1.0	1.0	7.0
Total	**4.8**	**10.4**	**16.4**	**49.0**
Percentage shares				
National departments	50%	48%	47%	47%
Provinces	43%	44%	45%	44%
Local government	*8%*	*8%*	*8%*	*9%*

Source: National Treasury, 2013

2.2. Government is supported for exercising fiscal prudence and managing the sustainability of the fiscal framework, despite pressures from higher than anticipated wage bargaining agreements, carry through costs of Occupation Specific Dispensation and constrained resource envelope due to worsening economic conditions. The Commission agrees with Government's planned efforts to restrict real growth in public spending below the rate of gross domestic product (GDP) growth by 2014/15. The Commission emphasizes the need to simultaneously improve the quality and developmental impact of public spending. Furthermore, cuts should be made in such a way that core services as well as repairs and maintenance expenditure are protected and not compromised.

3. Provincial Fiscal Framework and Medium Term Priorities

Provincial Equitable Share

3.1. The 2013/14 provincial fiscal framework inclusive of conditional grants is revised upwards by R25.6 billion over the 2013 MTEF mainly to cater for inflation related improvement of conditions of service amounting to R26.1 billion over the MTEF. The equitable share adjustment is revised slightly upwards compared to the allocations received through a re-prioritisation exercise with an additional R938 million set aside for the absorption of social work graduates. The 2013 division of revenue bill proposes an increase to the provincial equitable share (PES) from the revised R313 billion in 2012/13 to R335.5 billion in 2013/14. This amount excludes the R2.1 billion from the property rates grant which is to be phased into the PES. Inclusive of the property rates grant, the PES will amount to R337.6 billion in 2013/14 reaching R383.7 billion in 2015/16.

3.2. The weight among components of the PES formula remains unchanged. All the data underlying the formula are however updated to take account of the shifts in population reported in the 2011 Census. The effect of the new census sees significant population shifts in favour of Gauteng, the Western Cape, Mpumalanga and the North West province. Provinces that experienced declines in their share and subsequently their allocations over the 2013 MTEF period due to population shifts are KwaZulu Natal (0.89 per cent), Eastern Cape (0.78 per cent), Limpopo (0.57 per cent) and Free State (0.2 per cent). As a result of these shifts there is a reduction of R6.6 billion for KwaZulu-Natal, R5 billion for the Eastern Cape, R3.6 billion for Limpopo and R370 million for Free State. Government provides R4.2 billion cushion over the MTEF to absorb the impact of population changes brought about by new Census data. This move resonates well with the Commission's past view over the importance of cushioning shocks to provinces emanating from external factors through phase-in procedures. There has been renewed interest and pressure from provinces to review the Provincial equitable share formula, especially with respect to, over reliance on population driven variables. The Commission will engage relevant stakeholders on the matter.

Provincial Conditional Grants Adjustments

3.3. For the 2013/14 financial year, revisions to conditional grant baseline amounts to R260 million (of which R48 million is from savings). The R260 million is allocated to the roads maintenance grant and the

Further Education and Training (FET) colleges grant (at R169 million and R91 billion respectively). In total, the provincial conditional grant baseline for 2013/14 is revised downwards from an initial R82.2 billion to R77.9 billion as a result of the FET function shift from provinces to national government and devolution of the property rates grant.

3.4. Despite the downward revision due to policy change, the total provincial conditional grant allocation recovers in the outer years with a proposed addition of R9 billion (or average growth of 7%) over the 2013 MTEF.

PROVINCIAL SECTOR SPECIFIC ALLOCATIONS

3.5. **Education**: The MTEF allocation for education increases from R225 billion in 2013/14 to R258.7 billion in 2015/16. In real terms, annual real growth rises from 1.7% in 2013/14 to 2.7% in 2014/15. The increase in funding is largely to cover the cost of wage settlement but also to improve the delivery of school infrastructure and quality of education for learners from poor backgrounds. An important consideration going forward should be the associated operational costs of school infrastructure such as safeguarding, maintenance and operation of school infrastructure. The Commission supports the benchmark exercises that National Treasury conducts with relevant provincial departments and recommends closer scrutiny during these exercises on the funds allocated and spent by provincial education departments on these spending items[1].

1. The Commission is concerned that children in many rural schools do not have conditions required for effective attainment of learning outcomes such as proper infrastructure, materials, basic services, safe scholar transport and well equipped teachers[2]. The Commission welcomes government's decision to publishing norms and standards for school infrastructure and prioritizing the removal of inappropriate school structures and replacing them with proper facilities. To improve schooling outcomes, especially in under-performing schools, emphasis should continue to be placed on the professional development of teachers, improving school management as well as greater accountability of school principals. Furthermore, a significant proportion of children who suffer from disabilities are not succeeding in accessing education. In its 2012/13 Division of Revenue submission, the Commission recommended that input-output norms be established to give effect to inclusive education for intellectually disabled children.

3.6. **Health**: The allocation for health increases marginally over the MTEF from R137.7 billion in 2013/14 to R156.6 billion 2015/15 representing a 0.34% annual average real increase. Additional allocations for health are intended to strengthen prevention and treatment programmes. An amount of R338 million is

[1] See State of Infrastructure Report Card on the state of school infrastructure by the South African Institute of Civil Engineering (2011)

[2] Although numeracy has improved in the recent 2012 Annual National Assessments, the results show quality of performance worsens as learners move up the grades. For grade 9 learners for example, 2.3% passed numeracy adequately (i.e. by 50% and more). The assessment does not disaggregate the results, thus masking the actual performance of schools in disadvantaged areas.

added over the MTEF to roll out new diagnostic for tuberculosis and R800 million to expand anti-retrovirals to cover 500 000 more people per year. With very little fiscal space to expand expenditure, the Commission welcomes Government's intention to improve value for money spent on health-related activities over the MTEF such as efforts aimed at improving the quality of spending on health infrastructure by revising the application process. The Commission recommends tightening of monitoring and oversight mechanisms on procurement practices in Health Departments to prevent irregular and fruitless and wasteful expenditure from taking place as evidenced in some provinces where the hi-tech health equipment purchased without any service plan. Subsequently, the expensive equipment had to be replaced when it broke down[3]. In this regard, the Commission welcomes the concrete measures taken towards establishment of the Chief Procurement Officer function and the inclusion of new infrastructure procurement regulations in the proposed amendments to the PFMA (1999). The Commission reiterates the recommendation it made in the 2012/13 Division of Revenue submission that human resource, financial management and procurement should be devolved to hospital management to boost efficiencies and performance[4].

1. Prioritisation of health Millennium Development Goals (tuberculosis and HIV and AIDS) proposed in this year's budget is in line with the recommendations and findings of the Commission from 2011 as is the continued emphasis by Government on the need to achieve greater efficiencies and cost-savings for reprioritisation. With regard to NHI, the Commission awaits the results of the pilots that are currently under way and funding arrangements for the new reform. The Commission notes government's intention to phase-in the implementation of the NHI over a 14-year period and that additional revenue will be required to fund the new initiative. The balance between phasing-in the NHI, increasing revenue through possible tax increases and ensuring a more equitable health care system should be carefully considered. The Commission further welcomes Government's announcement in the 2012 Medium Term Budget Policy Statement that the long-term fiscal report will model the impact of the introduction of NHI proposals as part of its work. The number of medical personnel is one of the major cost drivers in the health budget. Although the forecasted numbers are expected to fall, it is the Commission's view that infrastructure upgrades and development of health facilities, including the phased introduction of the NHI, will create a demand for medical personnel. The fiscal impact of a burgeoning medical fraternity must be carefully considered against available resources, especially in the context of slow economic and revenue growth. Emphasis should also be placed on improving the skill set of health care personnel and achieving better outcomes in the health care sector. The Commission has been requested by the Minister of Finance to interrogate whether health is adequately funded. Recommendations to this effect will be made in the 2014/15 Commission submission.

---

3 Shamase, Nelly, 2012. 'Limpopo Hospitals in Dire State', Mail and Guardian, 31 August 2012.

4 A programme conducted by the Lean Institute of Africa in 2010 showed that hospitals could significantly reduce waiting periods and cut overtime by simply reorganizing the flow of work and organizational processes.

3.7. **Social development**: With respect to social development, the main proposal is to reprioritise funds already in the baselines towards strengthening selected child welfare programs, improve the South African Social Security Agency's infrastructure and systems, as well as to employ additional social workers. The budget will also provide for the recruitment of graduates from the social worker scholarship program, support Non-Profit Organizations (NPOs) in social development and for facilitating a more equitable funding model for these organizations. The allocation for social development increases from R171.5 billion in 2013/14 to R200.1 billion in 2015/16, representing an average real increase of 3.3%. The Government has stated that it has identified savings of R450 million per year as a result of the new grants system. It is noted that some of these funds will be used to improve the infrastructure and systems employed at the South African Social Security Agency and to employ the 5000 graduates from the Social Worker Scholarship Program. Whilst administration costs are expected to fall by 5%, grant beneficiaries are expected to increase from 16.1 million to 17.3 million over the next three years.

1. Although the Government has indicated a commitment to give attention to NPOs, the Commission observes with concern how provincial departments of social development, in response to budgetary pressures internally prioritize away from transfers to NPOs to cost of employment and goods and services. The downward adjustment of transfers to NPOs will further push NPOs, who are already struggling to survive financially, into a crisis. Furthermore, NPOs are effectively implementing agents of departments and as such fulfil important legislative obligations of Government. The Commission notes that these cuts appear inconsistent with the context of the new Financial Awards Policy (developed by the Department of Social Development in response to the Free State court judgement) that seeks a fair and equitable way of allocating resources to NPOs. The progressive realization of rights contained in the Bill of Rights for specific vulnerable groups (e.g. Children) may be compromised by these cutbacks. In addition, the implementation of Early Childhood Development (ECD) services may be negatively impacted by the reduction in transfers to NPOs. ECD centres are regarded as one of the important cornerstones of the National Development Plan.

2. The Commission is currently undertaking research on the funding of child welfare services in part to understand the underlying reasons giving rise to closure and non-viability of NPOs. The Commission will be holding public hearings on this subject and subsequently table a report to parliament for consideration during 2013. The South African Human Rights Commission is also working on a related project on "Policy options for addressing poverty traps and social exclusion among children in South Africa". The Commission participates as a Reference Group member on this project and a report on concrete policy recommendations to lift children out of poverty traps and closer to the goal of a more inclusive society will be produced.

4. Local Government Fiscal Framework and Adjustments to Conditional Grants

4.1. In total, the local government sphere receives R277 billion over the 2013 MTEF. Of this, the total local government baseline allocation will increase by a net R.12.1 billion over the MTEF period. Of the

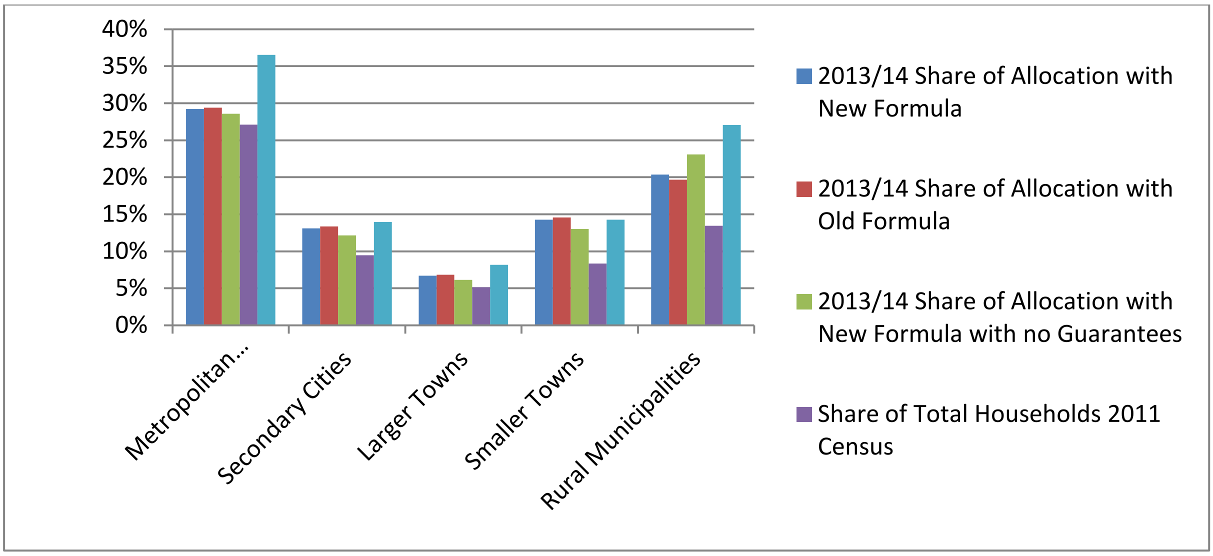
R12.1.billion additions to baseline, R8.2 billion is in respect to direct transfers to municipalities while R3.9 billion will be spent on behalf of local government in the form of indirect transfers.

LOCAL GOVERNMENT EQUITABLE SHARE

4.2. The 2013/14 financial year sees the introduction of a revised LES formula. In its advisory representation in the review process at both a technical and strategic level, the Commission also confirms that the new LES formula explicitly incorporates Commission recommendations that were previously proposed to Government. Some pertinent features of the new LES formula emanates from previous Commission recommendations as follows:

1. In its Submission for the 2011/12 Division of Revenue, the Commission recommended that the design of the LES formula should ensure greater support to poor rural municipalities, given the limited revenue raising ability in these areas. In this regard, the Commission welcomes greater resource distribution to poorly resourced municipalities via the new LES formula in line with the principle of equalisation. In terms of formula design, equalisation grants such as the LES should be targeted to municipalities with limited fiscal capacity and to places where there is greater need for services. The new formula achieves this goal more directly relative to the previous formula. This is confirmed by Figure 2 below that compares the allocations of the old and new formula. Allocations through the new formula have distributed relatively more funds to rural municipalities. The LES also better reflects the underlying demographics in local government. The majority of households and poor households in the country are in the metropolitan and rural municipalities. Consequently, these municipalities receive the largest share of allocations.

Figure 2: Comparison of old to new formula allocations



Source: Census 2011

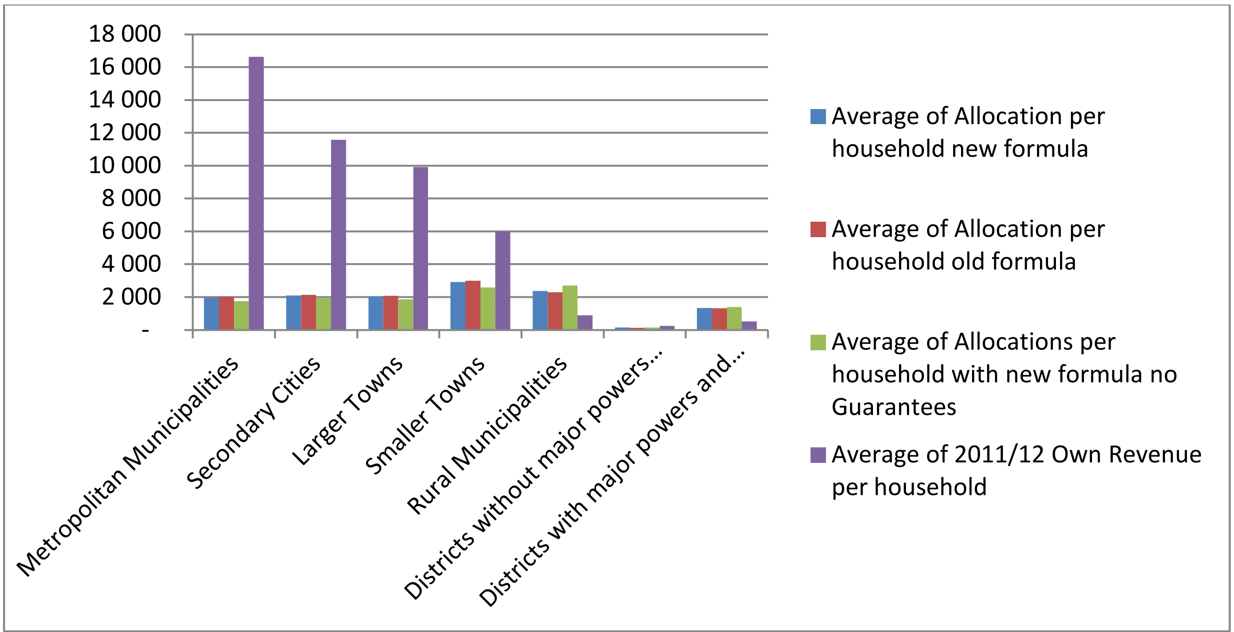
Notes: Figure excludes allocations to district municipalities

The figure includes allocations with the new formula without the phasing-in provisions for comparative purposes

Poor households are defined as households earning less than R2300 per month in 2011

2. Furthermore in its 2011/12 Submission, the Commission recommended that government find a more effective way of accounting for a municipality's fiscal capacity through the revenue adjustment component to ensure that it does not create incentives for municipalities to not collect their own revenues (as in the previous formula). The Commission notes that the revenue adjustment component in the new LES formula is a fair and objective approach to account for the varying revenue raising capabilities across municipalities. Consequently, the new LES formula accounts better for the ability across the different municipalities in funding their expenditure mandates from own revenue sources. Figure 3 compares the average LES allocation per household with its average own revenue generated per household across the various types of municipalities. As the ability to generate own revenues decrease across the types of municipalities, the allocation per household tends to increase to some extent. This confirms that the formula accounts relatively well for the inability of rural municipalities to generate own revenues.

Figure 3: Comparative assessment of old to new formula (Redistributiveness)



Source: Census 2011 Data

Note: Figure excludes allocations to district municipalities

The figure includes allocations with the new formula without the phasing-in provisions for comparative purposes

3. Other prominent features of the new formula emanating from previous Commission recommendations includes the funding of additional services through the formula with the introduction of the community services component (which includes the funding of roads, fire fighting services and storm water drainage), the need to view development as an outcome of municipal service delivery (as opposed to explicitly funding development) and the explicit funding of repairs and maintenance associated with the delivery of basic services.

4.3. The Commission recommends that in the implementation of the new LES formula, the following aspects be monitored:

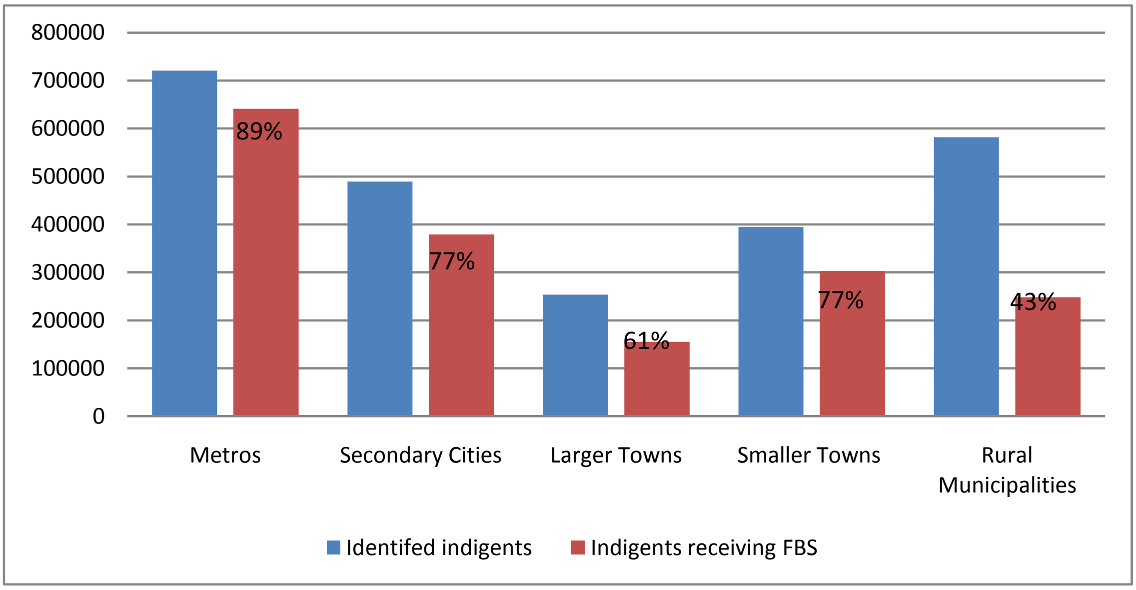
1. Previously, the Basic Services component provided different levels of funding to a municipality based on the number of households connected and not connected to infrastructure networks. The result was that those municipalities that were unable to roll out infrastructure received relatively lower allocations. The revised formula does not include that distinction such that all poor households qualify for a full basic services subsidy. Consequently, the onus in on the recipient municipality to ensure poor households are afforded adequate social assistances through the provision of Free Basic Services (FBS) (via the LES) and that service delivery backlogs are continuously eradicated through improved infrastructure investment. There is a need to ensure that parallel to increases in LES funding, adequate support mechanisms are in place to assist municipalities to absorb these increases and spend funds in accordance with the constitutional mandate attributed to municipalities.

2. In achieving the aim of improved grant outcomes and service delivery, it is important to emphasise that Section 154 of the Constitution requires national and provincial government to support and strengthen the capacity of municipalities to fulfil their constitutional mandates, including the appropriate utilisation of financial resources. Therefore, national and provincial governments are obligated to appropriately monitor the performance of local government and effectively support and build capacity in municipalities where necessary. In addition, the Constitution, through Sections 139 and 216(2), empowers national and provincial government to directly intervene in municipalities where constitutional mandates are not being achieved.

3. Building from the discussion above, emphasise need to be placed around efficiency and effectiveness issues of the recipient LES income. As indicated above, the revised formula will see greater funding being directed to poorer municipalities so as to account for their inability to generate sufficient own revenues. Equally important is the capacity of these municipalities to spend such funds and do so efficiently. Additional funding to municipalities that are unable to spend such resources will contribute to an increase in unproductive and inefficient expenditures. From a financial management perspective, most of the 70 municipalities gaining from the revised formula struggle to get unqualified audit outcomes. For example, in the 2010/11 financial year, 56% of these rural municipalities obtained either a disclaimer, adverse or qualified audit opinion. Only three municipalities received an unqualified audit with no matters of emphasis. Effectively, this places over 20% of LES allocations at risk for potential mismanagement and inefficient spending. More telling is the performance of these municipalities relative to the delivery of FBS to the poor within their borders. This aspect is important given that municipalities have a constitutional mandate to deliver basic services and the LES allocation is specifically aimed at funding the delivery of these services. Figure 4 indicates the delivery of FBS relative to the indigent households indentified by the municipality. It is concerning that the delivery of FBS is not provided to all households that qualify for such services across all types of municipalities, including the metros. Of greater

concern are rural municipalities that only provide FBS to 43% of the households that qualify for such services.

Figure 4: FBS coverage against indigent registers 2010



Source: 2010 Non-financial Census of Municipalities (Statistics South Africa)

Note: Free Basic Services are measured by the total number of indigents receiving at least one of the four basic services free (for illustrative purposes only)

4.4. Given the above discussion and the fact that as a result of the revised LES some municipalities will experience increases/decreases in their respective allocations, the Commission supports the proposed 5-year phasing-in approach as a measure to protect municipalities from large shocks to their allocations. Specifically, this timeframe should allow poorly resourced municipalities to ensure that there is a concomitant increase in their capacity to absorb additional funds.

4.5. The review of the LES formula should be seen as the first step in a greater urgent review of the general LGFF. The Commission supports Government's efforts in addressing this concern by undertaking a comprehensive review of the local government functional and fiscal framework. In this regard, the Commission would like to extend its experience and findings from its public hearings process on the review of the LGFF to assist in this process. It is important that the LES, conditional grants and own revenue sources of local government are well aligned to ensure proper funding and improved outcomes for municipalities. Furthermore, the Commission will continue to undertake research to improve on certain aspects of the formula. This includes research to improve the costing methodology proposed in the new LES formula, particularly in as far as this relates to the Basic Services component.

LOCAL GOVERNMENT CONDITIONAL GRANTS

4.6. The local government sphere will receive four new grants, namely the Municipal Water Infrastructure Grant, Public Transport Network Operations Grant, Integrated Cities Development Grant and the 2014

African Nations' Championships Host Cities Operating Grant. The 2014 African Nations' Championships Host Cities Operating Grant is a once off grant that will assist host cities during the tournament that is scheduled to follow the Africa Cup of Nations. The Rural Households' Infrastructure Grant (RHIG) will become a direct grant having previously been an indirect grant implemented by the National Department of Human Settlements (DHS). Administration of the grant will, however, continue to rest with the DHS.

4.7. Over R2.3 billion has been reduced from Municipal Infrastructure Grant (MIG) over the MTEF towards the new Municipal Water Infrastructure Grant administered by the Department of Water Affairs. The Commissions supports efforts to align funding with functional assignment areas to improve accountability. However, Government should guard against the potential to create unintended overlaps across different grants with similar purpose that can arise. This has potential toundermine the original intentions of MIG to deal holistically with municipal infrastructure through a single grant. With respect to conversion of RHIG into a direct grant to municipalities, the Commission holds the view that interventions on the grant should be accompanied by improvement in collection of non financial performance information and spending capacity. The Commission welcomes government decision to reverse the 2012 division of revenue bill proposal to integrate RHIG into MIG. Further reforms on the grant should address reasons underlying the persistent sub-optimal performance of the grant. The grant receive R338 million over the 2013 MTEF.

4.8. The Commission welcomes Government plans to review the local government conditional grant system extensively. The need for this review is pivotal in improving the spending and outcomes of local government conditional grants. Proliferation of grants and piecemeal fixing of existing grants in an attempt to solve more fundamental problems in the system remains a concern in the local government fiscal framework. Figure 1 discussed earlier illustrates the point of grant proliferation. Over the period, the introduction of local government conditional grants into the system has been inconsistent, with the total number of local government conditional grants increasing sharply from 2010. Increasing the number of conditional grants to local government increases the administrative burden on a sphere characterised by large capacity constraints and may not be the desirable approach to ensuring the achievement of policy priorities and outcomes. In 2002, the Commission recommended a consolidated and coherent local government conditional grant system that would support improved outcomes of conditional grant spending while simultaneously limiting the administrative and monitoring burden placed on municipalities and national government departments respectively. The Commission reiterates this recommendation as a way of improving the monitoring and outcomes of conditional grants in local government.

4.9. The Commission welcomes the more effective monitoring of conditional grant allocations to local government. Direct interventions such as withholding transfers to ensure conditional grant expenditure can be useful especially where underlying problems resulting in under spending of grants have been addressed. Thus, capacity building initiatives must be made sensitive to the core problems contributing to the inability of municipalities to execute expenditure decisions in order to solve the perennial issue of conditional grant under spending.

OTHER ISSUES

4.10. The Commission notes efforts from Government to improve expenditure on rehabilitation and refurbishment, which are capital expenditure items, in order to protect existing municipal infrastructure networks. Such additions to the existing local government conditional grant framework will assist in ensuring funds are earmarked for such expenditures.

4.11. The Commission reiterates its concerns over poor expenditure on repairs and maintenance of existing municipal infrastructure on the operating budgets of municipalities. Current research being undertaken by the Commission indicates that municipalities underfund and under spend on repairs and maintenance. In addition, the current practice of spending on maintenance being benchmarked against percentage of operating budget allocated in respect of maintenance is flawed. Instead maintenance needs should be a function of the nature, extent, service commitments and compliance requirements related to a particular asset. A poorly maintained infrastructure network threatens the sustainability of quality service delivery and is likely to lead to greater financial and social costs in the long term. Whilst there is a mounting maintenance and renewals backlog and the condition of existing municipal infrastructure is deteriorating, additional assets are continually constructed. This effectively increases asset maintenance and renewal funding needs, often without a commensurate increase in municipal revenue. The challenge is that infrastructure and other community facilities are created through the grant system that create an operating and maintenance burden, as well as a future renewals burden, without a commensurate increase in operating revenue. It remains to be seen whether the inclusion of additional resources aimed exclusively at funding repairs and maintenance through the Basic Services component in the revised LES formula, will improve the situation. The Commission however is of the view that at this time no significant gains can be derived from increasing funding for asset care provisions when measures as the planning instruments through which to determine and allocate funding are flawed.

5. GOVERNMENT RESPONSES TO COMMISSION RECOMMENDATIONS

5.1. The Commission tabled its *Submission for the Division of Revenue 2013/14* to Parliament in May 2012. As required by the IGFR Act, Government published its response to the recommendations made by the Commission for the 2013/14 Division of Revenue when the Minister of Finance tabled the Division of Revenue Bill with the annual budget in the National Assembly. The recommendations by the Commission where structured into 10 chapters and set out plans to fundamentally reform three areas, namely (a) supporting inclusive growth – jobs, knowledge and regional development; (b) climate change and environmental sustainability – opportunities and risks for inclusive growth and innovation; and (c) institutional development for inclusive growth and innovation. In this year's explanatory memorandum, Government divided its response to Commission recommendations into three categories as follows: (a) Recommendations that apply directly to the division of revenue, (b) Recommendations that indirectly apply to issues related to the division of revenue and (c) Recommendations that do not relate to the division of revenue Government responded to the recommendations that apply directly to the division of revenue and to those on issues indirectly related to the division of revenue.

5.2. Government has agreed and accepted all of the recommendations made by the Commission. The Commission welcomes the Government's responses. The Commission is of the view Government has provided comprehensive responses to the recommendations and it will be up to oversight organs of state to ensure that the recommendations where they have been accepted are actually implemented by the various departments. The Commission appreciates that for certain recommendations there is an inevitable time lag between when they are accepted and when they are fully incorporated into government operations.

6. CONCLUDING REMARKS

6.1. This Submission has provided commentaries on the 2013 Division of Revenue Bill. Government's plans to intensify efforts to carry out expenditure reviews aimed at increasing efficiency of spending and combating waste should be supported.

6.2. The recommendations by the Commission tabled in May 2012 set out plans to fundamentally reform three areas, namely (a) supporting inclusive growth – jobs, knowledge and regional development; (b) climate change and environmental sustainability – opportunities and risks for inclusive growth and innovation; and (c) institutional development for inclusive growth and innovation. In this year's explanatory memorandum. Government has agreed with the recommendations made by the Commission in this category. The Commission welcomes the Government's responses and looks forward to detailed proposals of institutional arrangements or legislation required to implement the recommendations.

6.3. Government is proposing far reaching reforms to the local government equitable share formula. The Commission endorses the proposed changes and has actively advised and participated in the technical review of the formula. The reform process was clearly constrained by the absence of data about the delivery of public service at the local government level and more work should continue in the coming year estimating the costs of delivering basic municipal services.

6.4. Although the new LES formula distributes additional resources to poorer rural municipalities, the evidence above suggests that the benefit of such funds to poor households may not be realised given the weak institutional and governance structures inherent in such municipalities. National and provincial governments have a role to play in ensuring that the outcomes of these funds are achieved by providing the necessary capacity support and proper monitoring of these poorly performing municipalities. In this regard, the Constitution, the establishment of the Municipal Infrastructure Support Agency (MISA) and other initiatives, such as the Local Government Turnaround Strategy, provide a comprehensive set of existing mechanisms to achieve these aims. Furthermore and where necessary, national and provincial governments can utilise greater punitive powers to intervene appropriately to ensure that the desired outcomes of grants (discretionary or non discretionary) improve. Thus, there is a structured set of mechanisms available to national and provincial government to ensure grant outcomes and effective service delivery occurs in places with weak municipal governments. These mechanisms need to be effectively utilised.

6.5. The Commission welcomes proposals to consolidate the number of provincial conditional grants and efforts to remedy the shortcomings of the old grant configuration by allowing for a two year lead time in planning for grants. Having said that, moves towards incentivising conditional grants require further work and interrogation by the Commission before it gives recommendations on this matter in the forthcoming Submission for the 2014/15 division of revenue. In similar vein, Government proposals to review the current local government conditional grant system in totality is welcome. The Commission will use such forums to contribute to this review.

For and on behalf of the Financial and Fiscal Commission

Mr Bongani Khumalo

Acting Chairperson/CE

6 March 2013