RESPONSE TO THE 2011 DIVISION OF REVENUE BILL

For an Equitable Sharing of National Revenue

24 February 2011

Financial and Fiscal Commission
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Contents

1. Background

1.1. This submission on the 2011 Division of Revenue Bill is made in terms Section 214 (1) of the Constitution of the Republic of South Africa (1996) and Section 9 of the Intergovernmental Fiscal Relations (IGFR) Act (1998).

1.2. The submission is presented in six parts. The first part is the introduction. The second part deals with key strategic issues around the Division of Revenue Bill for the Commission and Government's consideration following on the agreement in February 2010 for a review of the Bill by the Financial and Fiscal Commission (FFC) and the National Treasury. The third part discusses challenges in different sectors in both provincial and local government while the fourth part contains a discussion on the Provincial Equitable Share (PES), Local Equitable Share (LES) and the reviews of the respective allocation formulae. The Commission's comments on the Government's response to the recommendations tabled in the FFC Submission for the 2011 Division of Revenue are discussed in the fifth part while the sixth part concludes the Submission.

1.3. Comments on the fiscal framework, revenue proposals and policy stance will be tabled separately to the Chairpersons of the Finance Committees under the Money Bills Amendment Procedure and Related Matters Act, Act No 9 of 2009.

2. Strategic Principles for the Division of Revenue Bill

The Commission and National Treasury agreed to review the Division of Revenue Bill (hereinafter referred to as the Bill) following the Commission's recommendations made in February 2010. It was agreed that there would be short and long term revisions to the Bill. Of the short term revisions that have taken place, there are some noticeable changes to the 2011 Bill.

2.1. **Focus the Bill on outcomes:** Initial findings from this work are that there is a need to continue re-orienting the Bill in order for it to become distinctly outcomes focused, (i.e. ensuring that its clauses continuously agitate for a need to report on targeted outputs and outcomes, including emphasis on quality). Government has already acknowledged the need to focus not just on budget allocations but on policy outcomes in the Medium Term Strategic Framework and the delivery agreements around the 12 outcomes. This approach should find resonance in the Division of Revenue Act as well. Recent research suggests that factors listed in section 214(2) of the Constitution, collectively and when read together with the Bill of Rights result in the Division of Revenue Bill being viewed as an instrument that can be used to fulfil its minimal Constitutional obligation. In this respect, it is important to note that while the Division of Revenue Act is enacted annually outcomes are achieved only in the medium to long term. This means that the allocations (e.g. conditional grants) over the term of office of a government could be evaluated in terms of its agreed outcomes for a five year period. Making the Bill fully outcomes based is, however, not amenable to reform through short-term revisions to the Division of Revenue Act, and should be investigated further with a view to the long-term reform not only of Division of Revenue Act but of related and supporting sectoral legislation

2.2. **Continue streamlining the Bill:** The 2011 Bill is significantly focused and contains clauses relevant to issues for the year to which it is enacted. This is a welcome development and in line with the preliminary findings of the joint work of the Commission and the Treasury. Some of the key short term findings of the work relate to the relationship between the Bill and other statutes. In this case, while the Bill sets conditions on grants allocated to provinces and municipalities, the Appropriation Bill allocates funds to different national departments. Compared to other statutes, findings are that while both the Division of Revenue Bill and PFMA/MFMA regulate the management of national revenue, the Division of Revenue Bill gives further effect to the framework reporting provisions of the PFMA/MFMA. The findings suggest that there is not so much duplication between the Division of Revenue Bill and the PFMA/MFMA but rather that there is more complementarity.

- It is the Commission's view that these common areas need to be cross referenced. The precise interaction between the Division of Revenue Act and other legislation will need to be fully understood and made as effective as possible.

- The joint technical team will carry out further work to identify the relevant sections that need cross referencing in this regard. Meanwhile, the provisions in the Division of Revenue Act should serve to strengthen those in the PFMA and MFMA.

- For the next phase of the review of the Division of Revenue Bill, it is the view of the Commission for work on the Bill to include;

    - The Money Bills Amendment Procedure and Related Matters Act and its impact on the Bill.

    - The social and economic aspects of the division of revenue, bearing in mind that the Bill is a statute that gives effect to the political decisions guided by the political and economic vision, objectives and or intentions of government.

3. Sectoral Challenges

3.1. **Health:** The recent PFMA section 32 reports on provincial expenditure show that the Provincial health budget is under extreme pressure (see Table 1). Four provinces, the Eastern Cape, Gauteng, North West and the Western Cape overspend their Budgets in aggregate, while the rest of the other provinces made savings to the tune of R1 billion. KwaZulu-Natal and the Western Cape are the only provinces reflecting savings on their personnel budgets while the rest of the provinces mainly cut back their capital expenditure and goods and services. North West province exhibits over expenditure in all categories. In general provinces overspent their budget by a total of R2.9 billion while other provinces made a savings of R1.04 billion, ensuring a net overspend of R 1.8 billion for the total provincial health budget.

Table 1 : Provincial Personnel Expenditure: Health as at 31 December 2010

R thous and	Adjus te d budget	Proje cte d outcome	Actual spe nding as at 31 De ce m be r 2010	*Actua l spending as % of adj usted budget*	(Ove r)	Unde r	*% (Over)/ under of adj usted budget*	*% sha re of Hea lth Per sonnel to tota l personnel expenditure*
Eastern Cape	8,204,792	8,662,892	6,289,860	*76.7%*	-458,100	–	*-5.6%*	*26.2%*
Free State	3,693,486	3,786,859	2,811,549	*76.1%*	-93,373	–	*-2.5%*	*30.2%*
Gauteng	10,893,823	12,001,693	9,031,356	*82.9%*	-1,107,870	–	*-10.2%*	*37.0%*
Kw aZulu-Natal	13,231,196	13,153,297	9,542,832	*72.1%*	–	77,899	*0.6%*	*31.9%*
Limpopo	6,599,370	6,617,370	4,823,961	*73.1%*	-18,000	–	*-0.3%*	*24.7%*
Mpumalanga	3,579,957	3,579,957	2,657,642	*74.2%*	–	–	*0.0%*	*23.1%*
Northern Cape	1,199,991	1,293,944	954,694	*79.6%*	-93,953	–	*-7.8%*	*25.3%*
North West	3,130,487	3,295,316	2,425,603	*77.5%*	-164,829	–	*-5.3%*	*25.8%*
Western Cape	6,937,042	6,925,932	5,021,302	*72.4%*	–	11,110	*0.2%*	*37.7%*
Total	**57,470,144**	**59,317,260**	**43,558,799**	***75.8%***	**-1,936,125**	**89,009**	***-3.2%***	***30.0%***

Source: National Treasury Section 32 report

3.2. Overspending curtails the provinces’ ability to offer healthcare. The reasons given for increased healthcare funding revolve around increasing burden of diseases and personnel costs. However from the Auditor-General’s findings, poor financial management and corruption in the supply chain management permeate almost all provinces. There is thus no certainty that increases in funding will result in any increase in outputs. Provincial departments of health, supported by National and Provincial Treasuries must put together plans of action to improve compliance with the Public Finance Management Act (PFMA) and take steps to further decentralise decision-making and internal accountability to address these internal proximate causes of poor health outcomes.

3.3. An independent external peer assessment of public health facilities level of performance in relation to the standards is long overdue. This will assist in getting an accurate assessment of the state of health services nationally. Currently, one of the difficulties of coming up with an accurate analysis is the lack of definition of all levels of the health service as well as a lack of official norms and standards for each level. The setting up of Family Health Teams is an important milestone in South Africa. Such Family Health Teams include a team of family physicians, registered nurses, social workers, and other health professionals who work together to provide health care in communities. They provide more service and a wide range of health options, especially for families that don’t have a doctor and ensure that people receive the care they need in their communities, as each team is set-up based on local health and community needs. The focus should be on chronic disease management, disease prevention and health promotion, and work with other health care organizations and nongovernmental organisations.

3.4. Regarding the implementation of the National Health Insurance (NHI) in 2012, the Commission does not at this stage have official government policy documents on the health funding system proposed. It is however a fact that the NHI is going to affect the way health services are provided in the country across all three spheres of government and the private sector. In line with Government's Health 10 Point Plan, the Commission agrees that there is generally a need to improve quality in the public healthcare system, in particular addressing the required increase in professional medical personnel such as doctors and nurses as a precondition for successful implementation of the NHI. Further issues that need to be clarified for the implementation of the NHI are the role provinces and municipalities and providers and purchasers of national health services are going to play, funding streams, supply chain management and procurement of services, delivery of services, organisation and management. It is important that the space for official engagement of these issues is opened up before implementation in 2012.

3.5 **Education**: Education similarly exhibits the worrying trend of overspending. The highest over expenditure was reported for the provinces of Limpopo and the Eastern Cape for the same period (Table 2). They both average above 6 per cent of the provincial average. Taken together, provinces reflect a net overspend of R2.8 billion from their total budget with most of this made up by the Eastern Cape and Limpopo. Like the Gauteng Province problem with respect to health, this pressure comes from personnel expenditure with the Eastern Cape at R1.2 billion and Limpopo at R1 billion, respectively. These pressures can be expected to create challenges in the delivery of services unless these provinces adjust their personnel spending to an acceptable level. Depending on how the provincial administration reacts to the challenge, there is a risk of interrupted service delivery as is already the case in the Eastern Cape where there are reported cases of suspended scholar transport, school nutrition programme and the dismissal of temporary teachers. The developments in the Eastern Cape where essential but soft targets for expenditure cuts, namely learner transport, temporary teachers and children feeding schemes subsequently bore the brunt of the fiscal adjustments are unwelcome developments.

Table 2: Provincial Personnel Expenditure: Education as at 31 December 2010

R thousand	Adjusted budget	Projected outcome	Actual spending as at 31 December 2010	*Actual spending as % of adjusted budget*	(Over)	Under	*% (Over)/ under of adjusted budget*
Eastern Cape	18,332,258	19,501,193	14,540,661	*79.3%*	-1,168,935	–	*-6.4%*
Free State	6,822,986	6,822,986	5,088,933	*74.6%*	–	–	*0.0%*
Gauteng	16,869,088	17,243,618	13,038,840	*77.3%*	-374,530	–	*-2.2%*
KwaZulu-Natal	22,769,852	23,505,888	17,533,163	*77.0%*	-736,036	–	*-3.2%*
Limpopo	15,162,567	16,166,419	11,838,544	*78.1%*	-1,003,852	–	*-6.6%*
Mpumalanga	9,246,479	9,246,185	6,976,751	*75.5%*	–	294	*0.0%*
Northern Cape	2,719,157	2,764,425	2,050,952	*75.4%*	-45,268	–	*-1.7%*
North West	6,937,153	6,997,153	5,293,968	*76.3%*	-60,000	–	*-0.9%*
Western Cape	9,330,046	9,326,944	6,823,873	*73.1%*	–	3,102	*0.0%*
Total	**108,189,586**	**111,574,811**	**83,185,685**	***76.9%***	**-3,388,621**	**3,396**	***-3.1%***

Source: National Treasury, section 32 reports

3.5. The improved pass rate in the 2010 National Senior Certificate examinations is broadly welcomed and applauded. However, there are still challenges to be resolved to improve the quality of basic education in the country. According to the Curriculum and Policy Statements, Mathematics and Physical Science have been identified as key subjects for providing the skills needed for growth. The pass rate in both subjects remains below 50%. Another area of major concern is that many learners are falling out of the basic education system before they reach grade 12 and this high dropout rate needs to be addressed.

3.6. With regards to schools infrastructure investments, the Commission welcomes the decision by government to target directly the infrastructure backlogs and set time frames for their elimination which is in line with the Commission's 2002 recommendation. Failure to provide adequate schools infrastructure dispossesses children of the potential to realise their intellectual capabilities. It is for this reason that an alternative delivery method be piloted. From the start of the 2011 MTEF, the Department of Basic Education will administer the school infrastructure backlogs grant and the education infrastructure grant. The school infrastructure backlogs grant is aimed at ensuring that backlogs in inappropriate structures and access to basic services in schools are eradicated during the 2011 MTEF. The grant will cease to exist at the end of the MTEF (by 2013). In light of the challenges to deliver on this mandate by provinces (see for example the Eastern Cape mud schools court case), a public entity created solely for schools infrastructure development to be managed by the Department of Basic Education is proposed as an alternative service delivery model. This arrangement misses a key point that a specific purpose vehicle is created that separates asset creation from maintenance and this disjuncture will likely result in asset stripping over time. Another point is that national and provincial governments have been promising to eliminate "mud schools" by the "end of the year" for several years. Clear performance indicators must be spelt out and providers be held accountable for performance. It must also be clarified whether the new special purpose vehicle would be a permanent feature. Parliament must also increase its oversight over provinces that fail to perform in this regard.

3.7. **Agriculture**: The Commission submits that agricultural conditional grants are too small to be administered separately and to have the large desired impact on agriculture and rural development. There are three conditional grants which are specifically meant for this purpose, namely: *the Comprehensive Agriculture Support Programme (CASP), Ilima/Letsema Grant, and the Land Care Grant. The Micro-Agricultural Finance Initiative of South Africa (MAFISA)*, which is managed by the Land Bank is aimed at providing micro and retail agricultural financial services and facilitate access to public sector programmes to enable market efficiency. Given the low spending capacity history for these grants, the Commission has in the past recommended the merging of these grants into one comprehensive agriculture finance programme. While funding is just but one of the challenges facing agriculture and rural development, the roles of provinces and municipalities, especially the latter in providing irrigation facilities need also to be clarified. It is also not clear how the Department of Agriculture, Forestry and Fisheries intends to interact with these spheres of government and the Department of Rural Development which is also responsible for rural livelihoods (Government's Outcome 7 on vibrant, equitable and sustainable rural communities and food security for all acknowledged this shortcoming in the context of intergovernmental relations and rural development). These intergovernmental relations (use of cooperatives as organisations to develop small scale farmers and other rural communities as well as related initiatives by the department of Trade Industry) need to be resolved as part of the rural development strategy. With regards to extension services, the Commission has not seen major improvements in the effectiveness and efficiency of extension delivery. Norms and standards for extension and advisory services in agriculture were approved in 2005. The Department of Agriculture together with Provincial Departments of Agriculture rolled-out the first year of the implementation of the Extension Recovery Plan in 2008/09. According to the Department of Agriculture, Forestry, and Fisheries, the ratio of extension staff to commercial and subsistence farmers is 1: 21 for commercial farmers, 1: 857 for subsistence farmers and 1: 878 for the combined group. These ratios are not particularly high by global standards. It is important though to point out that it is not just the global numbers of extension staff that is important per se but their capacity to deliver. This factor is a particular challenge to CASP and other agriculture conditional grants, particularly with respect to the provision of extension support to land reform beneficiaries.

3.8. **Vibrant Built Environment**: There are massive opportunities for urban development through cities. However, there is a need to look closely at effective implementation as well as managing certain risks involved.

3.9. ***Roads and public transport***: Metropolitan cities and secondary municipalities are struggling to cope with increased maintenance and rehabilitation of roads and transport infrastructure due largely to the 2010 FIFA world cup investments and the implementation of the Bus Rapid Transport system. Overall urban transport funding models should be reviewed. This includes municipal own revenues, user pay principle and fiscal transfers. Maintenance and rehabilitation of road infrastructure should be a priority over the period ahead, particularly in cities. This should be extended to actively pursuing previously untapped revenue sources to finance these priorities.

1. The issue of devolving the public transport system to cities is one of the recommendations that were made by the Commission in its 2005 Annual Submission. The National Land Transport Act No. 5 of 2009 takes the devolution of public transport function further by providing for the establishment of a Municipal Land Transport Fund (MLTF). The Commission recommends that the sources of funding to contribute to the MLTF be finalised without further delays to ensure consistent and predictable funding of this function by the cities. Furthermore, performance of public transport needs to be monitored by identifying indicators such as reduced costs, reduced travel times, reduced percentages of household income spent on transport, regular renewal of the public transport fleet and access to transport.

2. Whilst noting road maintenance challenges, the Commission submits that the national fiscus alone cannot be a solution to maintenance backlogs (especially those created by coal haulage). Other options such as rail transportation for freight, user-pay principle and road traffic management for overload should be explored and enforced where deemed viable. Pertaining to user pay principle, the seemingly uncoordinated way in which the recent proposal to toll the national roads in Gauteng point to the need for government departments, agencies and spheres of government to work together. Failure to do so leads to unnecessary damage to government credibility as well as potentially compromising predictability in spending and road financing through such innovative approaches as 'user pay'.

3.10. On the investment on rail, the Commission in its 2010/2011 Annual Submission for the Division of Revenue highlighted the fact that there has not been investment on passenger rolling stock since the 1980s. Therefore, allocation to recapitalize passenger rail rolling stock would be commendable. However, such investment should be complimented with improved service conditions in passenger rail including security issues. Furthermore, government should ensure that funding is channelled to the prioritized corridors classified as A or B on the National Rail Plan.

3.11. ***Human settlements and community amenities***: Due to the Constitutional role of the local government, municipalities are responsible for the delivery of a number of services that make human settlement habitable. The Commission notes that from 2011/12, the portion of the *Human Settlements Development Grant* which went to cities for internal infrastructure to houses will be taken out of the grant and added to what was the MIG Cities and is now the *Urban Settlements Development Grant (USDG).* This move will assist to accelerate the alignment of functions as well as funding streams that impact on the built environment and human settlements. Other funding streams that still need to be aligned include the National Housing Subsidy, Municipal Infrastructure Grant (i.e., in other municipalities as those receiving USDG will not get MIG), Bulk Water, Electrification, and Transport Grants.

3.12. One of the important aspects within the delivery of housing that has been consistently debated in South African inter-governmental relations is the accreditation of municipalities where delivery capacity exists. The Commission has made recommendations on municipal accreditation in line with the Housing Act No. 107 of 1997. Some of the positive developments in this area include the establishment of an accreditation panel by the National Department of Human Settlements in 2009. However, this process has 'crawled' towards attaining the desired results as no municipalities, including metros have yet been accredited at level three. The Commission therefore recommends that MECs for human settlements in provinces should prioritise the process taking into account recommendations by the accreditation panel. It should be noted however, that accreditation of municipalities is not the only issue that needs urgent attention in the delivery of human settlements. Other key issues include the role of local government in housing delivery, provision of land, sustainability of the current delivery models, quality and standards compliance and monitoring (in 2010 it has been estimated that 40 000 RDP houses were of poor quality costing about 10% of the human settlements budget) and peripheral location of low-income housing projects).

3.13. The financial health of municipalities is paramount to ensuring sustainable service delivery. In addition to general poor spending performance within the sphere, municipalities are beginning to demonstrate difficulty in maintaining healthy and positive cash balances. A generally accepted norm is that municipalities should have at least three months of average operational expenditure on hand. Figures for 2008/09 indicate that three metros, 13 secondary cities, 66 Category B municipalities and 30 Category C municipalities had less than one month's worth of operational expenditure on hand. This illustrates the precarious financial position that a number of municipalities find themselves in.

3.14. Resolutions regarding a number of critical issues continue to be delayed. In addition to the issue of accreditation, the restructuring of the electricity distribution industry (EDI), a replacement for the Regional Services Council (RSC) levy for district municipalities and the need for greater certainty around the roles and responsibilities of local and district municipalities are still not finalised. Continued delays on these issues create substantial uncertainty within the local government sphere. The Commission recommends that government adopts firm policy positions on these issues that will bring finality and remove the uncertainty. The following key aspects are emphasised:

3.14.1. Specifically, on the issue of EDI restructuring, the Commission notes Government's decision to discontinue the process of creating six Regional Electricity Distributors (REDs). This is in line with the Commission's research and recommendations for the 2011/12 Division of Revenue. The Commission awaits further details on the future of the restructuring of the electricity distribution industry. It should be noted that whilst the original approach might have been dismissed, the restructuring of EDI so as to improve performance and efficiency remains to be resolved. The Commission is of the view that any new reform approach adopted should be well targeted to the challenges besetting EDI in South Africa. To this end a differentiated approach, that recognises existing cases of good performance should be adopted. In light of the continuously growing electricity distribution industry maintenance backlog (estimated at approximately R30 billion in 2010) and the need to roll out universal access to electricity, the need to effectively restructure EDI should be a high priority.

3.14.2. The Commission notes that progress and results with respect to the Department of Cooperative Governance's (DCoG) review of the White Paper has stalled. This is raised specifically in relation to the need to clarify a suitable role for district municipalities. The Commission is of the view that conclusions arising from the review process are necessary and should in fact form the basis for resolving a number of related outstanding issues – the determination of a suitable revenue source for the abolished RSC levy for district municipalities, being a case in point.

4. Provincial and Local Equitable Share

4.1. Following work on the review of the provincial equitable share (PES), the Commission made two recommendations on this in 2009. The first recommendation called *Option 1* was to stay within the confines of the current system but to fine tune the PES with the goal of addressing some of the problems that had been identified so that the PES can improve its performance in a number of important areas. However, these reforms were meant to be more of stopgap nature and not deemed sufficient to address the deep structural problems confronting the PES. The second recommendation called *Option 2*, departed from the realization that addressing problems of the PES required fixing other aspects of the current fiscal decentralization system. Specifically, the reform of the PES would require the reform of current expenditure and revenue assignments between the central and provincial governments. The implementation of Option 2 would require significant changes in the current legislation and amendments to the Constitution. National Treasury subsequently took the lead in work aimed at comprehensively reviewing the provincial equitable share. The 2011 Division of Revenue Bill reflects government's intention to implement substantial changes to the Provincial Equitable Share formula for the 2011 MTEF. The Commission would like to welcome this development as it is in line with its recommendation of 2009/10 on the review of the equitable share formula. Overall, the Commission views the work done by Government on the health component reform as very comprehensive and in the right direction wherein the new approach is trying to balance the needs-based with the demand-based approach. The debate on health sees the implementation of a close proxy of the costed norm when closely looked at especially on the output side. The Commission welcomes this approach to health financing. The other proposals made including education financing and changes to weights will require further work going forward and the Commission will be conducting further investigation.

4.2. In its submission on the 2010 MTBPS, the Commission raised a concern that the PES formula weights are not used when deciding on additional provincial allocations during the Adjustment of Estimates. Since such adjustments are mainly for personnel, the Commission had always indicated that there is a risk of rewarding some provinces for making wrong choices. These choices include making unauthorised personnel appointments and provinces deliberately creating pressures on own budgets while other provinces continue to do the right things and get penalised. Furthermore, any inherent equity in division of revenue may be negated by inequity following such adjustments and this compromises the original intent of the Division of Revenue Bill. In adjusting the formula, government indicates that the new health component will now be the only instrument used for policy adjustment to the health component. This is a welcome development and government needs to be commended for this. This consistent approach is being applied to all the formula components including the education sector.

4.3. The Commission notes the planned changes to the LES formula and the longer term review thereof and will be participating as part of the technical team working on the review.

5. Government's Response to Commission Recommendations

5.1. The Commission welcomes government's response on its recommendations on fiscal consolidation and expenditure reviews. It shares Government's proposals on fiscal consolidation and budget reprioritisation over the medium term. Moreover, the Government's inquiry into the cost effectiveness of beneficiary payments is strongly supported by the Commission. Lastly, Government's strides towards achieving high levels of education and health services, as well as the implementation of GIAMA, are welcomed by the Commission.

5.2. The Commission understands Government's position that instituting a block grant will require constitutional amendments and hence cannot be pursued in the short run. The Commission's view is that this should still be considered as a long term agenda for addressing the financing of concurrent functions and streamlining the revenue allocation processes and mechanisms.

5.3. The Commission welcomes the general response from the Government on social assistance reform. Government's view on piloting is understandable, given problems associated with reversing perceived entitlement programs. Without belabouring the point, the Commission is satisfied at this stage that Government in principle is not opposed to the idea of piloting and has in fact used the approach before to implicitly support a programme to policy approach. The realisation of this distinction is important and welcomed.

5.4 On the review of LES, the Commission welcomes the fact that all of its recommendations have been accepted by government. In particular, it welcomes and supports the proposed changes to the I component to support funding to poorer municipalities, the removal of the stepped taxation structure in the implementation of the RRC component and the discontinuation of using the RSC levy grant to approximate own revenue. These changes will impact positively on the practical mechanics of the formula in the short and long term and will further improve the efficiency and equity of the allocations.

5.5 Section 227 (2) of the Constitution states that no additional revenue raised by municipalities shall be subtracted from its share of nationally raised revenues. However, the current method of factoring a municipality's revenue raising capacity into the formula represents an inflation adjustment on actual own revenues collected by municipalities and not specifically a prediction model of revenue raising capacity. As a result, the current practice runs contrary to the Constitution. With respect to changes to the RRC component, the Commission acknowledges the short term constraints in accurately determining fiscal capacity of municipalities. The Commission has attempted to assist government with developing a prediction model that could ensure a robust, impartial and accurate prediction of municipal fiscal capacity. However, severe data and time constraints hampered any reasonable conclusions to the initiative. Government has now implicitly accepted that there are these several illegalities with this measurement, but such illegalities are outweighed by "the desirability of stable and predictable allocations" which rules out an immediate dropping of the component but rather prioritises it in the on-going review of the formula.

5.6 With this background in mind and also accepting that National Treasury also obtained legal opinion to the contrary of the one the Commission has, the position of the Commission is that in its current form, the RRC may expose Government to unwarranted litigation. The Commission however supports government's decision to prioritise the revision of the component in the broader review process of the LES formula to be completed later this year. The Commission will also be undertaking further research on methods to appropriately define and subsequently predict fiscal capacity of municipalities in its next research cycle to inform the review that government is carrying out and avoid the possible legal challenges in future.

5.7 The Commission notes government's decision to discontinue EDIH and the process of establishing the REDs. It should however be noted that the broader issue of restructuring electricity distribution and in fact the entire electricity value chain, remains unresolved. In addition the Commission's input pertained more broadly to the approach that government should take when restructuring areas of poor service delivery, in particular to the regionalisation of basic services delivery. To this end, government's response is incomplete as it only focuses on a particular aspect of the recommendation and hence does not respond to the full essence of the recommendation. The Commission's recommendation emphasised that reform strategies should be well targeted and that blanket reform strategies that have the potential to affect even cases of good performance, be avoided. Going forward it is suggested that strict accountability measures that will assist in preventing fruitless expenditure, be put in place to avoid a situation where significant resources are spent on reform strategies that are ill suited to the challenges they are meant to overcome.

6 Concluding Remarks and Recommendations

6.4 The Commission generally welcomes the 2011 Division of Revenue Bill and applauds ongoing efforts to make it a truly strategic document.

6.5 Overspending of health and education budgets constitute a major concern. This unwelcome tendency is having strong negative implications. It is not leading to better outputs and is diverting resources away from other priorities. Simply imposing special purpose vehicles to address fundamental problems of public service capacity (in decision-making and administrative capability) is not good practice. While the Commission supports the job creation thrust, there is a need to recognize that these basics of public service administration must be sorted first as a matter of urgency.

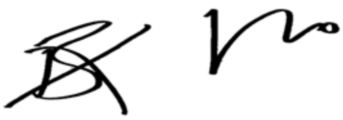
6.6 A vibrant built environment constitutes a massive opportunity for urban development. In particular, focusing on roads, public transport and human settlements. There are important risks (such as unwarranted credibility damage due to poor coordination) and opportunities (especially in road finance, human settlements) that need to be addressed.

6.7 Reforms of the Provincial Equitable Share and Local Equitable Share should be pursued with a view to comprehensively reforming these sharing arrangements and streamlining the revenue allocation processes and mechanisms so that they can respond to the new realities confronting the country (including the fact that government is now structured and running differently compared to the past when the formulae were first developed, initiatives such as NHI etc). There are outstanding issues around the treatment of RRC in the LES formulae that need to be addressed, as well as long term steps towards the funding of concurrent functions in reforming and refining the PES formula. The Commission will continue the work that was started in 2007 in this regard.

6.8 The Commission generally welcomes government's response to its recommendations. Further work will be undertaken by the joint technical team from the National Treasury and the Commission on the review of the Bill.

6.9 The Commission would like to note that for the 2011/12 division of revenue the engagement with the recommendations across the three spheres of government have been very robust and contributed to dialogues on a wide variety of topical issues which have intergovernmental fiscal dimensions. This process was very ably facilitated by the Minister of Finance on the Executive side through the Budget Council and the Budget Forum and the Finance Chairpersons on the side of the legislatures. In this regard it would be useful in future for the Commission to receive reports from the provincial legislatures on the views taken on the recommendations so that it can use such reports as a point of departure for responding to their needs as stakeholders and also as an input to its research agenda.

For and on behalf of the Financial and Fiscal Commission



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