

Commission Response to Division of Revenue Bill

2005/06



**THE FINANCIAL AND FISCAL COMMISSION'S
SUBMISSION TO PARLIAMENT
ON THE
DIVISION OF REVENUE BILL
2005**

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EXECUTIVE SUMMARY

1. Introduction and Methodology

1.1 Mandate and Objectives

This submission is the Financial and Fiscal Commission's annual commentary on the Division of Revenue Bill. The submission is required in terms of the Constitutional and legislative mandate outlined in S 214 (1) of the Constitution and given effect to in Section 35 of the Intergovernmental Fiscal Relations Act (1998). The IGFR act requires that the Minister of Finance must consult the Commission fourteen days prior to the introduction of the Bill.

1.2 Methodology

In preparing its commentary on the Division of Revenue the Commission takes into account the equitable division of revenue amongst the three spheres of government and amongst provincial and municipal governments. First, the division of revenue is evaluated using criteria drawn from section 214(2) of the Constitution. Second, commentary received from Parliament finance committees as well as other stakeholders in government and the public sector is taken into account. Finally, the Commission undertakes its own independent research to inform its response to the Division of Revenue.

Subject to data availability, this document emphasizes a quantitative analysis of trends over the past ten years to provide context and to indicate fiscal and institutional capacity to meet national policy objectives. This is compared, where feasible, with projected trends for the forthcoming medium-term budget and planning cycle. Past trends give an indication of development of fiscal and institutional capacity against which realistic targets can be set.

1.3 Document Structure and Analytical Framework

The document begins with an Executive Summary and Introductory chapter. Chapter 2 reviews the dialogue with Government over the Commission's recommendations and is a direct response to Government's comments contained in Annexure E of the Budget Review documentation. Chapter 3 reviews macroeconomic policy trends and assesses the performance of Government against its economic and fiscal policy objectives relating to economic growth, employment creation and poverty reduction / redistribution. These policies might be viewed as constituting the national interest and include making provision for national debt obligations. Chapter 4 reviews expenditure trends for the three spheres of government over the preceding ten years. Chapters 5 and 6 assess performance in the delivery of those social and infrastructure services constitutionally mandated as basic in the Bill of Rights and generally delivered by provincial and municipal governments.

The Commission uses the budget analytical framework it introduced in its 2001 and 2002 submissions. Herein, trends in real spending growth, coverage of eligible populations and impacts on income, capability, and asset poverty are assessed against national policy objectives expressed as policy targets.

2. Reviewing the Dialogue with Government over the Commission's Recommendations

The Financial and Fiscal Commission is legislatively mandated to make annual recommendations with respect to the forthcoming division of revenue. Government responds to these recommendations in Annexure E of the Budget Review document that accompanies the Division of Revenue Bill. The Commission comments on Government's response in the context of its previous recommendations.

2.1 Vertical Division and Function Shifts

In 2003, Government agreed to shift the function of the administration and disbursement of social assistance grants from the provinces to national government and establish the South African National Social Security Agency. The establishment of the national agency is due to be implemented in FY 2005. The FFC notes that this function shift has necessitated a review of the component weightings in the Provincial Equitable Share formula.

2.2 Provincial Fiscal Framework

In reviewing the fiscal framework for provinces, the Commission reiterated its recommendation that the provinces need to augment provincial revenues through the implementation of Section 228 of the Constitution and take advantage of the provisions of the Provincial Tax Regulation Process Act. Government, while not responding directly to this recommendation reduced the weighting for the economic activity component, (which was meant to be a proxy for tax capacity); a step which may be construed as an indirect incentive for provinces to increase provincially raised revenue.

The Commission review of the formula argued for, and hence, agrees with the removal of the Backlogs component in favour of a conditional Provincial Infrastructure Grant. However, the Commission needs to further interact with government with respect to the relative weights of the economic activity component and the newly introduced poverty component. The Commission views the issue of poverty targeting in a holistic manner and therefore suggests that further work, including a detailed assessment of all transfers in the system, is required in order to determine the appropriate trade-off between poverty and economic activity. This would be in line with the criteria in S 214 (2) a-j of the Constitution.

The Commission also welcomes the expansion of the PES formula to incorporate (ECD) Grade R and the equal weighting of school age population and actual enrolment. While the FFC agrees with Government's concerns

over data constraints with respect to the healthcare component, it also emphasises the need for the Department of Health to prioritise the collection of the relevant data. The FFC also notes that government did not address the issue of welfare services financing in the formula, given that from the social development component, only social security grants and their administration will move to national government. It is important for government to provide clarity on the basket of welfare services that provinces are expected to provide and the appropriate funding mechanism for the delivery of these services.

In respect of capital grants, the Commission proposed that Government utilise the FFC capital grant scheme model for the equitable allocation of infrastructure grants to provinces. Provinces will qualify based on the state of their capital stock for a backlog and a maintenance pool of funds. While the backlogs component is conditional, provinces have the flexibility to choose their priority sectors. The FFC will engage with government in assessing the availability of sector specific data so as to target infrastructure backlogs sectorally.

2.3 Local Fiscal Framework

The Commission welcomes the Government's endorsement of a components-based approach rather than the ad hoc use of funding windows, which has characterised the development of the LES formula.

The Commission also welcomes Government's inclusion of a more direct revenue raising capacity component in the revised LES formula. The Commission has noted the problems associated with the measurement of fiscal capacity and accepts the interim proxy measure introduced by National Treasury. The Commission will continue with its work on the identification of appropriate measures of revenue raising capacity.

The Commission will also continue with its ongoing work of researching the cost of a basket of municipal services. This exercise, the FFC reiterates, will

be enriched if government can define the list of the basic services that all municipalities are expected to deliver.

2.4 Associated Intergovernmental Fiscal System Issues

The Commission is developing an approach of relating performance in spending, delivery and developmental impact to national policy objectives against varying norms, standards and targets as a means of linking policy and planning.

In the recent past, the Commission has argued for Census and survey planning to generate and/or verify the data on norms, coverage rates and on poverty and development at local level

Apart from welcoming consideration of these associated systems issues, Government has not provided specific responses to these proposals.

3. Macro-economic and Fiscal Policy

3.1 Growth, Investment and Savings Policy

Over the past decade, economic growth has averaged 2.75% per annum (pa). Government seeks to shift towards a more investment-led than consumption-led growth path and has set an investment target of 25% of GDP in order to lift the average growth rate to between 5% and 6% pa. The current proportion of investment to GDP is 16%. Public spending on infrastructure increased from 5.3% to 5.5% of GDP between FY 2001 and FY 2004 and is projected to rise to 6.25% over the 2005 medium-term cycle.

Savings constitute the funding source of investment. Government has reduced its dis-savings from 6% to 1% of GDP over the past 10 years and is a signatory to the Financial Services Charter aimed at raising household savings through improving access to banking services.

3.2 Employment and Labour Policy

Over the past decade, the growth of employment has approximated half that of GDP implying labour saving technological progress. Further, the labour force of mainly young adults has been increasing at well above the population or economic growth rates. This poses a challenge for poverty reduction given the close correlation between unemployment and income poverty in South Africa.

More recently, Government has expanded the Public Works program aimed at providing community infrastructure and stimulating the use of more labour-intensive technologies in the construction sector. A target of 1 million people accessing public works employment has been established but, together with current rates of employment growth, this will provide less than half the jobs required to halve unemployment by 2014.

Within the labour force, many jobs are being casualized whilst skills shortages constrain productivity and hence economic growth. A target of 80 000 learnerships have been established by the Sectoral Education and Training Authorities, in part, to address this problem.

3.3 Fiscal and Financial Policy

A norm of 25% of GDP to nationally raised revenue was established in Government's Growth Employment and Redistribution macro-economic policy document. This norm has served as a target for improving national revenue raising capacity. Coupled with controlled spending over the past decade, the general government deficit was reduced to well within the 3% international benchmark, as indicated in the table below. The deficit is projected to average 4% over the 2005 medium-term budget cycle. Between FY 1994 and FY 2004, the Debt- GDP ratio has fallen from 49% to 37%.

Similar norms or targets have not been set for general government (including municipalities, social security funds and extra-budgetary institutions), nor for the public sector (including financial and non-financial public enterprises), suffice it to say that government has sought to manage debt levels by not providing guarantees to public enterprises and has introduced the Provincial Borrowing Act and the Municipal Finance Management Act.

Trends in Fiscal Capacity Ratios (1994 – 2002)

	Expenditure GDP		Revenue GDP		Deficit GDP	
	1994	2002	1994	2002	1994	2002
National Budget	29%	26%	23.5%	25%	5.5%	1%
General Government	35%	32.5%	29%	31.5%	6%	1%
Public Sector	n/k	n/k	n/k	n/k	6.5%	0.5%

The Constitution allows government to use deficit funding to finance capital, but not current spending. Until FY 2002, the value of general government investment was less than the deficit, implying the use of deficit financing for operational purposes. The primary cost-driver in general government's budget has been the take-up of social assistance grants. Nonetheless a decline in debt servicing costs over the past decade has enabled an accelerating real growth of funds available for the division of national revenue.

3.4 Monetary Policy

Over much of the past decade, real interest rates have exceeded both the economic growth rate and global average interest rates. The high interest rate regime may have discouraged fixed investment and encouraged speculative inflows. Between 1999 and 2002, the exchange rate exhibited extreme volatility, but has since stabilized.

Over the past 10 years, the central feature of monetary policy has been development towards continuous inflation targeting: This policy was adopted in 2003 and has been successful in keeping inflation below the maximum 6% limit. Persistence is required in inflation targeting to break the cycle of inflation, interest and exchange rate instability.

As of 2005, Government has adopted an Administered Prices Index to also monitor the public sector's compliance with the inflation target.

4. Trends in the Division of Revenue

4.1 Vertical Division and Balance

Reprioritization of spending towards social assistance grants and household infrastructure services over the past ten years has resulted in a significant shift of expenditure to provinces and municipalities respectively. On the one hand revenue raising by provinces has declined despite the fact that the Constitution accords them revenue raising powers. On the other hand, municipal own revenue raising has increased. The table shows trends in the vertical fiscal imbalance.

Trends in the Vertical Division (1994 – 2002)

Level of Government	% of Spending		% of Revenue Raised	
	FY 1994	FY 2002	FY 1994	FY 2002
National	57%	43%	85%	84%
Provincial	32%	39%	5%	2%
Local	11%	18%	10%	14%

4.2 National Fiscal Framework

Over past 10 years, the composition of nationally raised revenue has shifted from personal income, sales and international trade taxes to corporate

income, payroll and property taxes, making the system more income progressive.

The general trend in national government spending over the past ten years has seen a declining share going to economic and infrastructure services and a rising share to financial and administrative services and the integrated justice sector. More recently, a policy drive to increase the rate of public investment has reversed this trend.

4.3 Provincial Fiscal Framework

Provincially collected revenue as a proportion of provincial government revenue declined from 5% to 3% over the past 10 years. Approximately 15% of intergovernmental grants are conditional and primarily intended for use in infrastructure provision and institutional capacity building. Approximately 85% of provincial revenue is derived through the unconditional Provincial Equitable Share (PES) grant. Until 2005, the PES was designed to provide for the operational and capital costs of providing social assistance grants, basic education and health services as well as the maintenance requirements of provincial road, agricultural and social service infrastructure. The ratio of ES to conditional grants has shifted from two-thirds to one-third.

Over the past ten years, the composition of provincial spending has shifted in favour of social development (+10%) and away from health (-1%), education (-6%) and, until recently, from economic and infrastructure services (-3%) such as transport and agriculture. Whilst capital spending has been growing faster than average over the past five years, spending on maintenance has declined.

Provincial budget allocations and spending patterns have served to reduce horizontal fiscal imbalance over the past decade by redistributing public resources from richer to poorer provinces.

4.4 Municipal Fiscal Framework

The proportion of municipal revenue derived from intergovernmental grants has increased from 12% to 14% over the past decade. Metropolitan authorities derive between 3% and 8% of their revenue from the equitable share, whilst rural municipalities derive between 60% and 90% of their revenues from LES. The composition of grants to municipalities has shifted from 2/3 to 1/3 conditional grants during this period.

Municipal spending patterns illustrate a trend common across all three levels of government, namely, the more rapid growth of operational compared to capital spending and maintenance spending. Municipal government spending patterns have not contributed to the reduction of horizontal fiscal imbalance over the past decade. Whilst nationally raised revenue enables redistribution, sub-nationally raised revenues tend to perpetuate inherited disparities.

5. Provision of Basic Social Services

Until 2005, the Constitutionally mandated basic social services of social assistance and welfare, education, health care and food adequacy have been the functional responsibilities of provincial governments and, with the exception of food programs, have been funded through the unconditional Provincial Equitable Share grant. Social assistance grants are due to be transferred from National Government and administered through a national agency. A conditional grant which is ring-fenced for this function will be used as an interim funding mechanism until the National Social Security Agency is established.

5.1 Social Development

The take-up rate for grants has been accelerating since the introduction of the Child Support Grant in 1997 and averaged 18% pa over this period. At 8% pa the real growth rate of spending has been lower than the take-up rate. Most

take-up has been of the Child Support Grant, which is valued at between one quarter and one fifth of the pension and disability grant, respectively. More recently, the HIV-AIDS pandemic has provided momentum for the rapid take-up of the disability and foster care grants. Since FY 1998, per capita grant values have increased at slightly higher than the Consumer Price Index.

Official statistics indicate an increase in the poverty rate between 1995 and 1999. However, the positive role of social assistance grant take-up in alleviating poverty has not been isolated in this data. Other independent research indicates that social assistance grants have impacted positively on poverty reduction.

5.2 Education

Despite an average growth in the number of school going age children of 1.74% pa between 1996 and 2001, learner enrolment declined by nearly one million learners. This may have been the result of policies to reduce "errors of inclusion" such as over-age learners.

Since 2001, learner enrolment has been increasing at 1.27% pa - still below the growth of the school-going age population. Enrolment targets have been established for all the component programs of basic education namely, Early Childhood Development (ECD), primary and secondary school education, Further Education and Training (FET) and Adult Basic Education and Training (ABET). Real growth rates in spending have also accelerated and are projected to average 2.3% over the 2004 medium-term cycle.

Between 1996 and 2001, adult literacy rates improved (83% to 89%) whilst the proportion of adults with post-secondary education increased from 23% to 29%.

5.3 Health Care

Spending on primary (clinic) and secondary (hospital) health care averaged 2% between FY 1996 and FY 2001 and has accelerated to an average 4% since. Spending on hospitals has lagged that of primary health care provision in clinics. While not a functional assignment of municipalities, local governments have provided almost half the government's primary health care services.

There has been clear improvement in targets set for coverage of antenatal care, immunization and tuberculosis treatments. Mortality rates have been increasing however and this is probably due to HIV-infection. In 2003, HIV incidence was officially estimated at 11.3% of the population.

5.4 Food Adequacy

The Child Nutrition Grant has identified a target population of 4.58 million poor children. Less than 1% of provincial budgets are set aside for food adequacy programs. However, 4% real growth in these programs was projected for the 2004 medium-term budget cycle. The impact of this program on the nutritional status of children has not yet been measured.

6. Performance in the Provision of Basic Infrastructure Services

Household infrastructure services that may be constitutionally mandated as basic include housing, land and water. Sanitation, waste disposal and electricity might be implied through the environmental health mandate. Transport services enable access to other basic services and hence serve a complementary role in the provision of other services. Municipalities are the primary delivery agents of many of these infrastructure services and several cross-municipal public entities are involved. Most capital funding is through special purpose conditional grants or utility fees.

6.1 Education and Health Care

There has generally been a very low rate of expenditure of capital budgets for Education and Health.

6.2 Housing

The delivery rate of housing over the past decade has exceeded the rate of household formation. On average, approximately 161 400 housing opportunities (serviced sites and starter houses) have been delivered annually with a peak in FY 1997 of 296 000. The national housing department has set a delivery goal of 338 000 houses per annum.

The value of the housing capital subsidy did not keep pace with inflation until FY 2001 and the qualifying household income brackets have not changed since 1995. The housing expenditure has decelerated since FY 2001 and is projected to continue declining over the 2004 medium-term. The operational costs of meeting the housing capital expenditure targets are passed onto municipalities

6.3 Water

Between 1996 and 2001, the proportion of households with reticulated access to water increased from 60% to 62%. The current norm is 50 litres per person per day within 200 meters of the dwelling. Full access to water services is targeted for 2008.

Since FY 2001, municipalities have increased their capital spending on water provision but reduced their operational spending. Whilst, the regional Water Boards have reduced their capital spending and increased their operational spending in real terms.

6.4 Sanitation and Waste Disposal

The proportion of households with water-borne sewerage or ventilated improved pit-latrines (VIP) toilets increased from 50% to 55% between 1996 and 2001, whilst the proportion receiving municipal waste disposal services increased from 53% to 57%. Coverage improvement in the metropolitan areas was less substantial. This could be as a result of rapid urban migration of the poor. Full access to adequate sanitation is targeted for 2010.

6.5 Electricity

Coverage rates for connections to the national or municipal grid increased from 57% of households to 70% between 1996 and 2001. Government has targeted full coverage by 2012.

Regional Electricity Distributors are being operationalised from 2005. The distribution of electricity surpluses and the implications of that for municipal billing systems are being addressed.

6.6 Transport

In FY 2003, provincial governments undertook 57%, municipalities 30% and national government 13% of road construction and maintenance spending. Between FY 2000 and FY 2004, provincial spending on roads increased by 11% pa in real terms, whilst spending on bus, taxi and train subsidies increased by 6.5%.

7. Conclusion

This submission will further develop its budget analytic methodology to consider the object of the Division of Revenue Bill to co-ordinate policy planning with budget preparation. Consideration may be given to the process of norm and target setting in relation to current resources capacities.

Indicators may be developed for data availability, stability and institutional capacity. To be comprehensive, the integrated justice system should be evaluated as a constitutionally mandated basic service.

CHAPTER 1 – INTRODUCTION AND METHODOLOGY

1.1. Mandates and Objectives

1.1.1 Mandates

When making its recommendations, the Commission is to take account of the factors listed in Section 214 (a) to (j) of the Constitution.

Sections 218, 229 and 230 require the Commission to be consulted prior to enactment of legislation pertaining to provincial and municipal revenue raising and borrowing powers and national government guarantees thereon.

Since 1998, the Intergovernmental Fiscal Relations Act has governed the process for determining an equitable division of revenue. Sections 10 (3) and (4) of this Act require the Minister of Finance to consult the Commission 14 days prior to the introduction of the annual Division of Revenue Bill. The Bill must be accompanied by a memorandum indicating what account was taken of the Commission's recommendations submitted 10 months prior to the end of each financial year and of the consultation referred to above.

Other legislative mandates follow from the Provincial Tax Regulation and Provincial Borrowing Powers Acts, the Municipal Systems and Finance Management Acts. The recent FFC Amendment Act consolidates the role of the Commission in advising on functional assignment shifts.

1.2. Methodology

1.2.1 Evaluation Criteria

The Commission evaluates the Division of Revenue Bill against the obligations listed in the Bill of Rights, the requirements set out in Section 214 (2) (a-j) of the Constitution, the relevant sections of the Intergovernmental Fiscal Relations Act and other legislation.

1.2.2 Stakeholder Consultation

This submission is presented to the Portfolio Committee of Finance of the National Assembly, the Select Committee of Finance of the National Council of Provinces and the Joint Budget Committee of both houses during the Parliamentary Hearings on the annual Division of Revenue Bill during February / March.

This follows a consultation with the Minister of Finance and the National Treasury 14 days prior to the introduction of the Bill.

1.3 Document Structure and Analytical Framework

1.3.1 Document Structure in Relation to Division of Revenue Bill documentation.

The document consists of 5 chapters. Chapters 2 and 3 are structured in accordance with the Constitutional mandate of S 214 (1) which establishes the context and framework for the Division of Revenue Bill by requiring (a) governments response to the FFC recommendations, (b) the equitable vertical division of revenue between the national, provincial and local government and (c) horizontal division between provinces and municipalities through the Provincial and Local Equitable Share grants and infrastructure, capacity building and other conditional grants to provinces and municipalities.

Chapter 4 concerns itself with Government's macro-economic policy objectives. A review of trends over the past few years is intended to contextualise the projections provided in the Economic and Fiscal Policy sections of the Budget Review.

Chapter 5 considers the provision of basic social services listed in the Bill of Rights (i.e. social assistance, health, education, food adequacy and information), whilst Chapter 6 considers basic household infrastructure services listed in the Bill of Rights (e.g. housing, land, water) or implied (such as sanitation, waste disposal, electricity and transport services). The policy objectives focussed on are income, capability and asset poverty.

1.3.2 The Commission's Emerging Budget Analytical Framework

Chapter 3, 5 and 6 follow from and develop upon a budget analytical framework proposed in the Commission's 2001 Submission for the 2002 MTEF (Section 12.5.2). This approach involves analysing government activities according to (a) contextual history, (b) policy objectives, (c) primary, secondary, intermediary policy targets, norms and standards, (d) policy instruments, (e) budget and spending trends against allocations and (f) performance against these objectives, targets and norms.

The extent of data analysis is constrained by the availability of official data. A 10-year time series of financial input data is readily available for national and provincial governments, but not for municipalities. Many municipalities were being established during the ten-year period and common reporting formats are still to be widely implemented. Service delivery data is also not readily available from Statistics SA. This information is generally collected by government departments though often not collated or made available to the public. Developmental outcome data is generally collected by Statistics South Africa, either through the Census, 5-yearly surveys or annually for most macro-economic data. Save for Census data, these results are not usually available at municipal level.

CHAPTER 2 - REVIEWING THE DIALOGUE WITH GOVERNMENT OVER THE COMMISSION'S RECOMMENDATIONS FOR 2005

2.1. Introduction

In June 2004, the Commission tabled its submission for the Division of Revenue for 2005. As part of the submission, the Commission made Recommendations on its review of the PES and LES formulae emphasising key issues with respect to the different components of the two formulae. The recommendations made in respect of the PES formula assumed that the structure of the formula would not be changed.

Following on previous Commission engagements with stakeholders, in particular, the Finance Committees of the national and provincial legislatures and, following on decisions of government (as detailed in Annexure E of the Division of Revenue Bill for 2004), National Treasury also embarked on a review of both the provincial and local equitable share formulae, and the broader provincial and local government fiscal framework. In conducting this review, National Treasury, through a task team of the Technical Committee on Finance consulted widely with the Commission and other key stakeholders including government departments and organised local government. This submission constitutes the FFC's comments on Government's response to the Commission's recommendations contained in Annexure E to the 2005 Budget Review.

In preparing its comment on Government's response to its recommendations, the Commission would like to emphasise that its recommendations are part of the FFC on-going work on the Intergovernmental fiscal relations system. This FFC work is informed by stakeholder responses to annual submissions and specific requests from the legislatures and the three spheres of government. In addition, at the request of Government, Commission conducts further

research to underpin specific recommendations dealing with matters of principle. In the absence of formal protocols the Commission believes that its current approach is the most practical way for determining the nature and content of its submission within the terms and conditions set out in the Constitution and other legislation.

In developing formal protocols of understanding with government the Commission would like to highlight the need for a comprehensive response to its recommendations by all government departments, organised local government and legislative stakeholders. It may also be useful that the final response from Government indicates, even in broad terms, areas of engagement for the next budget and MTEF cycle. This would undoubtedly ensure that the Commission's next annual submission is informed by the needs of all stakeholders.

2.2. The Provincial Equitable Share

In making its recommendations on the PES formula, the Commission conducted a detailed examination and evaluation of the individual components in order to establish how each component performed against the policy objectives. Among these objectives was the improvement of equity in access to basic services and the efficiency with which resources are utilised. The following section summarises the Commission's recommendations on the equitable sharing of nationally raised revenue.

2.2.1 Provincial Revenue Raising Capacity

The Commission's recommendations highlighted the need to augment provincial own revenues by encouraging provinces to take advantage of the provisions of the Provincial Tax Regulation Process Act (2001) that enable provinces to implement their tax powers as provided for in Section 228 of the Constitution. This recommendation arises from the fact that due to lack of substantive "own" revenue, it has been difficult for provinces to alter

expenditure patterns according to their needs. While the allocation formula aims to respond to the expenditure obligations of provinces, the expenditure patterns do not seem to reflect expenditure need but rather tend to equalise per capita expenditures across provinces.

The Commission recognises that recourse to tax powers by provinces entails many legislative requirements and procedural stages. Government also notes in the Explanatory Memorandum on the Division of Revenue Bill (2005) that despite the passing of the Provincial Tax Regulation Process Act 2001, no province has yet submitted any proposals for new taxes. This means provinces still depend significantly on their equitable share transfers.

Notwithstanding this current situation, the Commission would, nevertheless, appreciate a more direct response to the principles proposed in the FFC submission as some provinces envisage introducing certain provincial taxes in the future.

2.2.2 The Economic Activity Component

A proposal related to provincial own revenue was the possible review of the use of the economic activity component as a proxy for tax capacity. The Commission accepts the argument that in areas where economic activity is high, public infrastructure tends to come under pressure and therefore provinces with higher economic activity should be compensated. However, the Commission also believes that the economic activity component may be effectively applied if it is more precisely defined and an empirically tested method used to determine its relative weight in the formula. In its response to the FFC proposal Government does not advance an empirical reason for reducing the weight of the economic activity component by one percent. This may be viewed as an indirect incentive for provinces to improve on their revenue raising capacity as highlighted in the FFC proposals.

However, the decision to alter the weight for economic activity was accompanied by the introduction of a 3% poverty component weight in the formula. While the Commission understands the need for the formula to be redistributive, the introduction of such a poverty weighting into the current formula is not supported by any explanation and/or empirically tested method on which this decision was made. The Commission believes that before redistributive components are introduced into the formula, it is important to analyse and evaluate the impact of such components on the roles, powers and functions of provinces and, against other requirements listed in Section 214(a-j) of the Constitution.

2.2.3 The Poverty Component and Targeting

The Commission would like Government to note that, in the coming year, it will review all the transfers in the system aimed at addressing poverty. This exercise will be carried out across the spheres of government in order to evaluate the performance and impact of poverty-targeted grants with respect to both beneficiaries and economic development. In the first instance, the Commission intends to make proposals on grant design options that may address unintended duplication and the inefficient use of fiscal resources by the different spheres of government. In the second instance, the Commission has decided to investigate the possible refinement of the IGFR allocation system that will balance government provision of constitutionally mandated basic services taking account of the criteria listed in Section 214 (2) (a-j) of the Constitution and other macroeconomic constraints. In particular, the Commission is concerned with the fiscal consequences of rising unemployment, socio-economic inequality and the resulting poverty. These factors will put increasing pressure on the demand for social security grants, given the obligations on Government provided in the Bill of Rights.

Another important aspect of the Commission's submission related to how different beneficiary groups are treated in the PES formula. Demographic data heavily drives the formula. However, all individuals are treated the same in the formula regardless of socio-economic status. The Commission's submission

highlighted the issue of poverty impacting differently, for example on learners from different socio-economic categories. This observation, however, does not imply that poorer provinces need to be compensated by the formula but rather that provinces with a high number of poor people have a cost disability that needs to be taken into account in the allocation of resources. For example, instead of treating learners as having the same ability, capability and access to education in the education component of the formula, an approach may be adopted that categorises learners into poor-urban, poor rural, etc and different weightings assigned to the different categories. This means direct targeting of beneficiaries in the allocation formula.

While the Commission is cognisant of some of the political imperatives associated with the decision to introduce a poverty component in the formula, it also urges government, in the phasing in period, to undertake a rigorous investigation to determine the factors that drive the different components in the formula in order to avoid ad hoc changes and new components in the transfer system. In its submission the Commission indicated that the long-term structure of the formula should reflect the policy priorities and objectives of the government. Such an approach may require a different structure of the formula altogether.

2.2.4 The Services Components

With respect to specific social sector components of the formula, the response of the Government supports the Commission proposals and addresses most of the past concerns of the Commission in the new formula. While the education component still utilises the school-age population, it will end the double weighting of this against the actual enrolment. The education component will also incorporate ECD with the age cohort expanded to incorporate Grade R.

Government agrees with the Commission proposal for replacing the medical aid non-medical aid population with differential demographic group utilisation rates in the health care component of the PES formula. However, government

also notes that current data are not very credible and thus emphasises the need for the health sector to improve the collection of the data for future use in the formula. For the next period more recent data on the medical and non-medical aid population will be utilised. While the Commission accepts the concerns of Government with respect to data, it also emphasises in its proposals that the relevant departments need to be encouraged to prioritise the collection of credible data for use in the formula.

With respect to the social development component, Government supports the FFC proposal for a transitional financing arrangement for the payment of Social Security grants. Social assistance grants have been classified under schedule 5 in the Division of Revenue Bill 2005.

Government has also implemented the previous FFC proposal that recommended the costing of all grant-types for the calculation of allocations. In the past only the major grants, viz old age pensions, disability and child support grants were calculated this way. This will address the adequacy of allocations to provinces. The calculations will henceforth be based on individual grant types for all social assistance grants per province. Government is also conducting thorough assessments of grant beneficiaries in all provinces to monitor compliance with all means test procedures. This exercise is intended to ensure that only qualifying individuals benefit from the grants.

In recognising this development the FFC notes that Government has not fully addressed the Commission's proposal on the social development component of the formula. In particular, the Commission raised concerns that the shifting of social security to National Government may result in the possible neglect in the funding of welfare services in the provinces. The Commission urges government to expedite the process of defining the basket of welfare services that provinces need to provide in order to avoid compromising the delivery of these services. As part of its on-going research, the Commission noted the discrepancies prevalent in the delivery of welfare services in different provinces.

2.2.5 Removal of the Backlogs Component

A key proposal of the Commission was that the backlogs component of the PES formula should be folded into the basic component and a separate conditional grant for infrastructure backlogs be set up and allocated to provinces through the Commission's capital expenditure model. The response from Government was to accept that the backlogs component had not really served the purpose for which it was designed. The component was duly removed from the formula. The 2005 DoR Bill, however, implies that this component is incorporated in the Provincial Infrastructure Grant, although this grant is not necessarily specific to backlogs.

2.3. Conditional Grants to Provinces

2.3.1 Capital Grants

The principle of a conditional grant for infrastructure backlogs was accepted by government, but it was indicated that the Commission's model could not be implemented at the moment due to inadequate data. Instead, National Treasury put forward an alternative approach to allocating the infrastructure grant. Government believes that the Commission's model does not deal with the issues that the current provincial infrastructure grant aims to address. The Commission however, would like to highlight that its proposed model refers to infrastructure backlogs in a generic sense and is not directly aimed at the existing provincial infrastructure grant.

While the Commission notes Government's comments, it also emphasises that its model, in its current form, uses aggregated capital expenditure data from National Treasury and aggregated provincial capital stock data from the South African Reserve Bank. To provide broad indications of horizontal infrastructure grant allocations to provinces from a policy determined pool of funds, the model does not require any extra data other than the expenditure

data held by National Treasury and the backlogs data held by the SA Reserve Bank. If there is agreement that these data are credible, then the Commission's grant scheme does present government with a very flexible tool for allocating conditional infrastructure grants to address provincial infrastructure backlogs and on going capital expenditure needs. Since the formula allocates a grant for backlogs in terms of a province's overall capital stock rather than sector specific stock, the onus is then upon the province to decide on the priority sectors that require urgent attention. The conditions for utilisation of the grant should target infrastructure backlogs in the delivery of basic services in education, health and socio-economic inequalities.

The Commission also notes that the proposed grant scheme does not ignore on-going capital expenditure needs for provinces with no severe infrastructure backlogs. The model also allocates an equal per capita amount to all provinces irrespective of whether or not a province has been defined as having backlogs or not. Furthermore, the model offers provinces the discretion and option for more effective prioritisation and planning. More importantly, it has a built-in mechanism for Government to monitor whether provinces are progressively eliminating infrastructure backlogs, building new and maintaining old infrastructure in order to provide CMBS and promote provincial growth and development.

Following consultations with National Treasury and other stakeholders in 2004, the Commission introduced weightings into the model to take account of relative cost disabilities and disparities specific to each province. This new version of the model was presented to Government and Parliament in January 2005 as a supplement to the FFC's 2004 annual submission.

The approach adopted by government in addressing infrastructure backlogs was to introduce the Provincial Infrastructure grant as already noted above. The grant as defined by government in page 83 of the Bill is aimed at directing funds towards provinces with large infrastructure backlogs. However, the computation of the allocations is dependent on a "roads" factor as a proxy for all other factors in respect of basic service delivery infrastructure backlogs.

The grant is classified as a Schedule 4 grant which is not a specific purpose grant. This means it is not targeted at backlogs but rather used for dealing with the general financing of provincial infrastructure needs.

While the Commission accepts the concerns about data, it should be noted that such data problems become compounded when allocations are based on sector-specific allocations. To address this problem National Treasury is consulting the Commission on the possibility of the FFC coordinating a research project that will assess the availability of capital stock data in all provinces and for all sectors.

2.3.2 Other Conditional Grants

The FFC has consistently advocated a qualified use of conditional grants in the equitable sharing of national revenue in South Africa. In particular, the Commission supports the use of conditional grants for financing national priorities and policy objectives and, for funding the spill-over effects that arise in the delivery of services across provincial boundaries. In the current review of the conditional grant system, the FFC intends to establish whether or not the existing conditional grants are in line with these principles. The FFC will also investigate the management capacity difficulties and identify the bottlenecks that result because of under-spending of some of the grants.

Currently, conditional grants to provinces are classified as either Schedule 4 (general/national allocated function) or Schedule 5 (specific purpose) grants. The details on how these grants are utilised and the relevant conditions are listed in the DoR Bill p 36-45.

The Commission submitted its preliminary observations on the use of conditional grants and how these grants may be made more effective. Government noted the Commission's observations and generally agrees with the challenges highlighted by the Commission. However, government warned that some of the Commission's observations had the potential for the introduction of inequity in the conditional grant system if pursued aggressively.

It noted rather that a more supportive approach be adopted where there is evidence of lack of capacity in the relevant department administering the grant. This, government argues, would ensure that reduction in allocations would remain only a short-term measure to discourage under-spending.

The Commission will be making specific recommendations on conditional grants in the Submission for the Division of Revenue 2006. The Commission also notes that Government has taken into account its observation that certain provincial departments lack the capacity to spend grants. Henceforth, Government will allow for the reallocation of these funds to areas where spending is optimal.

2.4. The Local Equitable Share

2.4.1 Agreement on a Components Based Approach

In general, government agrees with the Commission's approach to the review of the local government equitable share (LES) formula. Government agrees with Commission, in particular, that the windows approach to LES allocations should be avoided. Government has now adopted the broad component based structure of the formula proposed in 2002 by the Commission. Thus, the revised LES formula specifically incorporates the Commission's principal proposal that the provision of funding for municipalities should take account of the key cost drivers for basic municipal services

2.4.2 Cost Disabilities

The Commission welcomes the decision taken on this principle in guiding the review of the local equitable share formula. Government also agrees with the Commission that different types of delivery methods for basic services should depend on the appropriateness and cost of technology. Geographic and population density considerations do require different technologies for the delivery of similar basic services.

2.4.3 Revenue Raising Capacity and Spill-over Components

The Commission proposal for the need to incorporate a revenue-raising component is supported by government. The new LES formula from National Treasury has a component for the direct measurement of the revenue raising capacity of municipalities. This is in line with the Commission's recommendations.

The Commission submission emphasised that a revenue raising capacity measure will be difficult to directly determine in the short term because of reforms to local government revenue sources, e.g. RSC levies, property rates, and the electricity distribution industry reforms. In the interim, government introduced a proxy revenue raising capacity measure into the formula. The Commission, in principle agrees with the use of the proxy measure and will continue with its current work to identify an appropriate measure for revenue raising capacity.

Government's response indicates that the Commission proposal for a spill over component in the formula does not show how this component should be defined and designed. The Commission notes this observation and will further investigate the criteria that should be used to define this component. However, several areas that require further clarification are discussed below.

2.4.4 Measuring Basic Municipal Service Expenditure Needs

The following paragraphs highlight some areas of the government's response to the FFC's proposal that require further clarification and explanation.

Firstly, Government's new LES formula makes provision for municipalities that offer higher levels of service (e.g. water borne sanitation as opposed to more basic sanitation). It is unclear whether or not the new formula will provide funding for municipal services irrespective of the standard/level of service that a municipality chooses. It would be more appropriate to stress that the LES should ensure funding for basic municipal services and any costs above that

is borne by own revenue sources. In this respect, and as indicated by government, the Commission is continuing with its work on municipal service costs. Progress on this work will be advanced if government provides greater clarity on what constitutes the basket of basic municipal services.

Secondly, while it is in agreement with the Commission that a more accurate measure of expenditure needs for municipalities should be developed, Government suggests that such research should be for purposes of modelling and analysis rather than for allocations. This statement is unclear, as the Commission believes that any research on expenditure requirements is always undertaken to inform its recommendations on allocations.

Thirdly, Government states that it will not amend the MFMA in order to protect the equitable share from being ceded by municipalities as collateral for obtaining loans. The Commission's recommendation in this regard was based on legal opinion. The legal opinion indicated that no procedures and rules exist that regulates the ceding of the LES for municipal borrowing. [In particular, all of the procedures in Section 45 of the MFMA relate to the selling of municipal capital assets needed for delivering basic services]¹. Despite government's position, there is no fundamental disagreement, as Government did not disagree with the other option proposed by the Commission. The Commission welcomes the fact that Government accepts that the provision of constitutionally mandated basic services should not be compromised through the inappropriate borrowing activities of municipalities.

Finally, on the Commission's recommendation proposing that policies on tariff subsidies should be assessed to ensure that all residents have access to a minimum level of basic services, Government states that it cannot prescribe on the use of the equitable share. This assertion seems to misinterpret the Commission's proposal. In this proposal the Commission is pointing to the fact that municipalities are expected to provide free basic services. However, many of them may not be able to do so outside of their equitable share

¹ Legal opinion can be made available on request

allocations since they have negligible or no other source of revenue to enable cross-subsidisation. The Commission is therefore highlighting the need for government to ensure sufficiency of transfers for the provision of free basic services.

2.5. Conclusion

It is widely recognized that, over the past 10 years, the Commission has made and will continue to make significant contributions to the development of South Africa's intergovernmental fiscal relations system. Guided by the precepts of the Constitution and the mandates thereof, the Commission constantly seeks to fulfil its obligations in a manner in which it applies sound financial and fiscal principles of public finance. In addition, it seeks to ensure the relevance of its recommendations to the problems and challenges posed by poverty, unemployment, governance, and the delivery of services, and the imperative to refine the intergovernmental fiscal relations system. Key to this task is the submission of advisories and recommendations to government, annually, based on sound research and national and international best practice.

Thus, the Commission welcomes government's acceptance of most of its recommendations for the Division of Revenue 2005. Acknowledging certain problems raised by government, the recommendations that have been accepted by government will enhance the allocation system and set the foundation for further and on-going constructive engagement in the development of South Africa's intergovernmental fiscal relations system.

CHAPTER 3 – MACRO-ECONOMIC POLICY

3.1 Introduction

A primary goal of macro-economic policy is stable economic growth and movement towards addressing unemployment. Economic growth is necessary, though not sufficient for job creation and for the growth of government revenue required to alleviate poverty and provide basic services. This chapter describes and assesses government's macro-economic policy objectives for the 2005 Division of Revenue. These macro-economic policy objectives have their foundations in the Growth, Employment and Redistribution (GEAR) policy document and, to some extent, the White Paper on the Reconstruction and Development Program (RDP). They have subsequently been elucidated through the agreements of the Growth and Development Summit and through Presidential State of the Nation addresses and Budget Speeches. The 2005 Division of Revenue Bill provides the necessary funds for increasing public sector investment and stimulating growth and development.

3.2 Growth, Investment and Savings Policy

There has been an increase in infrastructure investment aimed at transport, housing and construction and other public utilities. All these sectors are labour intensive and will have significant positive impacts on unemployment and income distribution. On the development side, infrastructure investment will facilitate the delivery of basic services in provinces and municipalities.

3.2.1 Government Instruments for Stimulating Economic Growth

Government makes direct and indirect contributions to growth through its purchases of goods and services, as well managing aggregate demand through monetary and fiscal policy. Thus, an important means of enhancing economic growth is capital expenditure on machinery, equipment and infrastructure (including

residential and non-residential building and other construction / civil engineering works). This expenditure also serves to facilitate other investment in the economy.

One important way in which government contributes to investment is through capital spending by government and public entities. Within the framework of the budget, this is done through the allocation of capital expenditure to the different sphere of government, primarily through conditional grants. Private investment is also directly stimulated through government support for public-private partnerships. In addition, government has given significant mandates to public entities, such as Transnet, Eskom and Telkom to undertake appropriate investments to encourage economic growth and development. The 2005 DOR Bill infrastructure investment programme targets many of these sectors.

Raising productivity is a further intervention for stimulating economic growth. Technological progress raises both capital and labour productivity. In light of this a number of productivity raising initiatives have been undertaken by government, including enhancing the education and skills of the populace, funding research and development, as well as providing incentives to the private sector to invest in the most productive sectors of the economy.

3.2.2 Policy Objectives and Targets

A major objective of the 2005 DOR Bill is to create an enabling policy framework that supports Government's targets of promoting sustainable economic growth (of between 5–6% per annum), and impacts positively on goals of social infrastructural development, and job creation. National government recognises that two factors are crucial to the attainment of sustainable growth, these are an enabling/growth enhancing level of investment or capital formation, and an adequate level of domestic savings.

To this end, government seeks to raise the rate of investment to 25% of GDP. The rate of savings should rise concomitantly with the rate of investment. Government dis-saving is targeted through a deficit reduction program. Household savings may be stimulated over the long-term through mass access to banking services. For

example a target of 1 million new bank accounts within a year of introduction of Mzansi was established in the Financial Services Charter.

3.2.3 Trends and Performance

As previously indicated, government has had a major focus on the raising economic growth rate of the country. Between 1994 and 2004, growth of GDP averaged 2.75%. Over the previous 5 years, growth averaged 2.9%, slightly higher than during the first 5 years of the democratic government's tenure. Over the 2005 MTEF, growth is projected to exceed 3.5% pa. The 4.3% growth projections for 2005 is well within the MTEF framework

The national rate of gross fixed capital formation is approximately 16% of GDP. Over the FY period 2000 to FY 2004, gross fixed capital formation grew faster than the economy at 5.8% pa. Although in general, the rate of investment in the public sector lagged behind that of the private sector. Public sector investment in infrastructure rose from 5.3% to 5.5% of GDP between FY 2001 and FY 2004 and is projected to rise to an average 6.25% pa. over the 2005 MTEF cycle. Finally, the rate of government dis-saving fell from approximately -6% of GDP in 1994 to -1% in FY 2002.

3.3 Employment and Labour Policy

3.3.1 Government Instruments for Generating Employment

Government and other public sector enterprises contribute directly to job creation. Further, government it has an indirect impact on job creation in the private sector through its purchases of goods and services. The community services sector (e.g. health, education and security services) is one of the more labour intensive economic sectors and employs the highest number of public sector employees, indicating the significant role that government plays as an employer.

Apart from direct employment, government has put in place various policies aimed at creating employment. Among these include the implementation of the Extended Public Works program, the encouragement of labour intensive technologies as well as support of the more labour-intensive sectors in the economy such as agriculture, construction and tourism. The Extended Public Works Program not only creates employment but is also aimed at stimulating the construction sector and providing basic infrastructure and incentivises the most labour-based technologies.

One of the challenges that South Africa faces is the enhancement of the skills of its citizens in order to improve labour productivity, and bridge the mismatch between skills and employment opportunities. The economy is currently characterised and held back by a skills mismatch. Skills shortages exist in both professional/managerial and vocational occupations. These challenges are being addressed through initiatives in further and higher education and training and skills development provided by the Sector Education and Training authorities (SETAs). These initiatives are the responsibilities of the national departments of Education and Labour respectively.

3.3.2 Policy Objectives and Targets

Government has set itself a goal of halving unemployment by 2014. This suggests an average of 372 000 people to be employed per annum. One million people are targeted for jobs through the Extended Public Works Programs. Sectoral Education and Training Authorities (SETAs) have set a learnership target of 80 000 learners for skills development in different sectors of the economy. It will be important for government to put in place the necessary legislative, administrative and institutional instruments to enhance efficiency in the implementation of these objectives.

3.3.3 Trends and Performance

Over the past 10 years, the growth rate of employment has been approximately half that of the growth rate of GDP. This is suggestive of economic growth driven by technological progress that has been labour saving. Since 1998, private sector, non-agricultural employment has grown approximately in line with GDP. Most of

these jobs though are unskilled. Employment in commercial agriculture appears to be more cyclical but to have exhibited an overall decline since 1998. Employment in the public sector has declined and the stagnation in employment growth can be attributed to this trend. The trend, however, is being reversed as government creates employment through its Expanded Public Works Program, to date, 76 000 people have been employed.

The casualisation of unskilled jobs increases the number of individuals likely to apply for unemployment benefits. When the broader definition of unemployment is applied, statistics indicate that greater numbers of people are seeking work. In short, the supply of labour is growing faster than the demand for labour.

3.4 Fiscal Policy

The two primary instruments of fiscal policy are government spending and taxation. These are both analysed in this section.

3.4.1 Policy Objectives and Targets

Between 1994 and 1999, government pursued a fiscal policy stance that sought to reduce the government deficit and contribute to economic growth and development. From 1999 onwards the fiscal policy stance has been relaxed. The primary strategic objectives of government spending are (a) accelerating the rate of investment, (b) widening the social security net, alongside (c) investment in community services and human resource development, (d) reducing crime and improving safety and, (e) promoting opportunities for the participation of marginalized communities in economic activity. Some objectives of tax policy include creating incentives for investment and job creation and making the personal and company income tax systems more income progressive, thereby reducing the tax burden on lower-middle income households and small to medium sized enterprises. The 2005 DOR Bill specifically targets these objectives

3.4.2 Norms and Standards

The norm established for the tax to GDP ratio is 25%. Government has not established any norms on the size of the public sector in the economy. Internationally a budget deficit of around 3% of GDP is considered acceptable in developed countries. The 2005 projected budget deficit is not too far off from this standard.

3.4.3 Trends and Performance

Between FY 1994 and FY 2002, government succeeded in restricting the growth of spending resulting in a decline in general government expenditure from 35% to 33% of GDP. During the same period, general government revenues extracted from GDP increased from 29% to 32%. Increases in nationally raised revenue from 23.5% to 25% of GDP constituted half this increase. Between FY 1994 and FY 2002, sub-nationally raised revenue increased from 5.5% to 7% of GDP. With provincially collected revenue falling to negligible proportions over this period, municipalities have collected most of the sub-nationally raised revenue.

3.5 Debt Financing

3.5.1 Policy Objectives and Targets

The advent of the new democratic government in 1994 was accompanied by potential for the government to fall into a debt trap (i.e. debt raised in order to service pre-existing debt). Hence, one of the objectives of fiscal policy after 1994 was to reduce deficit financing. This position was adopted to ensure that public debt was reduced to levels that are sustainable in the longer term. This would help ensure that real interest rates are also kept at levels that are internationally competitive.

3.5.2 Norms and Standards

Government has decided to limit borrowing to the financing of capital expenditure that enhances economic growth and not for current expenditure.

3.5.3 Trends and Performance

3.5.3.1 Quantum and Utilization of Public Sector Borrowing Requirement

Government fiscal policy targets led to a general government deficit decline. The deficit declined from 6% to 1% of GDP between FY 1994 and FY 2002. In FY 2004, the general government deficit was projected to rise to 4.1% of GDP and average 3.9% over the 2005 MTEF. In FY 2002, the main budget deficit stood at 1.1% of GDP whilst surpluses generated by public enterprises, extra budgetary institutions, social insurance funds and provincial governments lowered the global Public Sector Borrowing Requirement (PSBR) to 0.6% of GDP. In 2004, the PSBR stood at 4.1% of GDP, almost all of it constituted by the general government deficit. Over the 2005 Medium-Term cycle, a significant economic infrastructure program involving several public corporations sees the PSBR rising above the national deficit for the first time in a decade and averaging 4.5% of projected GDP.

Government deficits are ideally used for fixed capital formation. For most of the period, FY 1994 to FY 2002, general government investment was less than the government deficit implying the possible use of debt for operational purposes. However, by 2004/05, government investment had increased slightly to 5.5% of GDP, which is higher than the deficit. Nonetheless, the combination of refinancing to shift the maturity profile of the debt portfolio, debt consolidations, buy-backs and the issuance of inflation-linked bonds reduced debt-servicing costs. In 1994, the average maturity of government's debt portfolio was below 10 years, 60% of which required refinancing within five years. By 2003/04, approximately 38% of the debt portfolio was due within 5 years.

The decline of the debt-servicing burden has enabled positive and rising real growth of national revenue available for division and spending on basic services. This averaged 3.2% pa. over the recent past 5 years and a 4.5% average annual growth rate over the 2004 Medium-Term was projected.

3.6 Conclusion

A combination of improved revenue raising capacity and restrictive fiscal policies on spending reduced deficit financing to within the specified government objectives. In addition, declining debt-servicing costs have enabled real growth in spending on social and infrastructure services. Infrastructure spending has required a more targeted approach through the conditional grant mechanism.

CHAPTER 4 - TRENDS IN THE DIVISION OF REVENUE

4.1. Introduction

This chapter considers the 2005 Division of Revenue Bill by reviewing revenue and spending trends at the national, provincial and municipal levels of government over the past 10 years in accordance with the Constitutional mandate of Section 214 (1).

The 2005 DoR is examined in the light of its contribution to the inter-governmental fiscal system and is evaluated in terms of whether the division of revenue between provinces and municipalities has become more equitable given the inherited socio-economic disparities between provinces and municipalities. This is balanced against notions of sub-national fiscal autonomy and sustainability.

4.2. Vertical Division and Balance

South Africa's intergovernmental system is characterized by the existence of a vertical fiscal imbalance. This section reviews the overall trend in the vertical fiscal imbalance over the past ten years. In Fiscal Year (FY) 1994, the national sphere raised 85% of general government revenue. By FY 2003, this had declined to 81%. The provincial share of revenue raised declined from 5% in FY 1994 to 1.7% in FY 2003. The municipal sphere's share of revenue raised increased from 10% to 17% over this period. The Constitution accords provincial governments the right to levy particular taxes. Nonetheless, provinces have not in all instances exercised their rights to levy those taxes, except more recently when the Western Cape put forth a proposal for a fuel levy.

On the other hand, the national sphere's contribution to general government spending fell from 57% in FY 1994 to 40% in FY 2003. Provincial governments increased their contribution to government spending from 32% to 39% between FY

1994 and FY 2002. The contribution of municipalities to government spending increased from 11% to 21% over this period.

Government's expenditure responsibilities have shifted significantly to sub-national governments between FY 1994 and FY 2004. This has been driven by a shift of spending towards provincial social services (notably social assistance grants) and basic municipal infrastructure services. Transfers previously allocated to provinces for transfer onto local government have since been transferred directly to municipalities. The substantial difference between the contribution of provinces to spending and their contribution to revenue raised is the highest in the world as recorded by the World Bank in 2002.

In general, municipalities collect most of their own revenue and the larger municipalities are able to be fiscally autonomous. Rural municipalities receive a greater proportion of their funding from intergovernmental transfers than metropolitan and urban municipalities.

4.3. National Fiscal Framework

4.3.1 Trends in Nationally Raised Revenue

Most revenue collected is from taxes on mobile bases and hence collected nationally. National and provincial governments receive relatively less revenue from personal income taxes (from 40% of nationally raised revenue in FY 1994 to 32% in FY 2004) and relatively more from corporate income taxes (from 13% in FY 1994 to 21% in FY 2004). Most personal income tax cuts have benefited lower-middle income groups. Government is receiving proportionately less from sales taxes, which are income regressive. Between FY 1994 and FY 2004, the contribution of sales taxes declined from 39% to 37.5% of nationally raised revenue. In compliance with international trade agreements, funding from international trade taxes has fallen from 5% to 3% over the same period. Payroll and property taxes have become more significant contributors to nationally raised revenue.

4.3.2 Trends in National Government Spending

Between FY 1996 and FY 2004, the proportion of nationally raised revenue (before debt servicing) transferred to provinces increased from 46% to 57% and to municipalities from 3% to 5%. These proportions are budgeted to rise marginally over the 2005 medium-term budget cycle.

Of the budget left for national government, spending trends between FY 1996 and FY 2002 indicate an increase in the share of national government financial and administrative services (from 11.2% to 13.2%), the integrated justice sector (from 29% to 31.5%) and some social services. On the other hand economic and infrastructure services declined from 26.7% to 20.3% and these trends continue through the 2005 medium-term cycle.

4.4. Provincial Fiscal Framework

4.4.1 Trends in Provincially Raised Revenue

As indicated above, provincial governments have been collecting proportionately less own revenue. Between FY 1996 and FY 2004, the share of provincial budgets collected from own sources declined from 4.6% to 3.1%. Vehicle license and gaming fees have been a significant source of provincial own revenues between FY 1996 and FY 2004. Provincial governments continue to receive the bulk of their revenue through inter-governmental transfers.

Conditional grants constitute an important part of the intergovernmental fiscal system as it has evolved. They have been used to address spill-over effects in service provision, national policy priorities as well as a transitional mechanism for financing certain functions. Between FY1994 and FY2003, the Provincial Equitable Share (PES) constituted an average of 85% of transfers to provinces and conditional grant 15%. During 2005, the creation of a conditional grant to finance the age-extension of the child support grant shifted the ratios to 2/3 PES and 1/3 conditional grant. These ratios are maintained across the 2005 MTEF.

4.4.2 Trends in Provincial Government Spending

4.4.2.1 Trends in Current Spending

Approximately 80% of provincial budgets are spent on education, health and social welfare combined, and the remaining 20% on economic and infrastructure services and administration.

The most significant shift in provincial spending patterns between FY 1996 and FY 2004 has been the increased share of social development spending from 17% to 27%. By 2007, this component is projected to continue rising to 28%. The rate of take-up of social assistance grants is the most significant trend in general government finances. This trend is politically and policy-driven in the case of age extensions of the child support grant (planned to reach 14 year olds by 2006 / 07), and impacted upon by the HIV-AIDS pandemic in respect of disability grants. These grants are government's primary tool for addressing income poverty alleviation in the face of rising unemployment and poverty over the past 10 years.

The 10% increase in the share of the budget going to the social development function has corresponded with declining shares to education (6%) health (1%) and infrastructure and economic services such as agriculture and transport (3%). Over the 2005 medium term, this trend of declining education share continues whilst the decline in the infrastructure share is to be reversed.

All social assistance grants are to be shifted to the national sphere during the forthcoming medium-term budget planning cycle. The establishment of the National Social Security Agency offers medium- to long-term opportunities to minimize fraudulent errors of inclusion and control rapid rates of take-up.

4.4.2.2 Trends in Capital Spending

In most provinces, capital budgets have been increasing as a proportion of total spending over time. Provinces spent approximately 6% of their budgets on capital

spending in FY 2004. The ratio is maintained over the 2005 medium term cycle. Education is allocated the larger portion of the capital budget followed by health.

While capital expenditure on roads has also been growing over time, maintenance budgets as a proportion of total provincial spending have been declining.

4.4.2 Intergovernmental Transfers to Provinces – The Provincial Equitable Share

The Provincial Equitable Share is an unconditional grant, to the nine provincial governments. It is their share from nationally raised revenues and constituted approximately 85% of provincial governments' revenues between FY 1996 and FY 2003. This ratio has subsequently reduced to approximately 66% due to the shifting of social assistance function to national government.

The Provincial Equitable Share is divided between the nine provinces according to an objective formula based primarily on Census population data, and to a lesser extent, on poverty data. The formula was first introduced in 1997 and originally comprised seven components. Four of these components related to actual provincial government functions, namely education, health, social development and the institutional components. There is a loose relationship between the weights attached to these components and the actual proportions of spending on these functions. As of 2005, the PES formula will exclude the social assistance grants component as the function will be performed by a national security agency in future

The remaining 3 components included a backlog component intended to cover the costs of new infrastructure (schools, hospitals and roads), an economic activity component intended to cover maintenance costs of existing infrastructure and a basic component for other services. From 2005, the backlog component is to be dropped (given the existence of the Provincial Infrastructure Grant) and a poverty component introduced.

4.4.4 Conditional Grants to Provinces

Conditional grants are allocated through national department budgets and are primarily used to encourage spending on infrastructure and institutional capacity building. Growth in conditional grant allocations is largely driven by the introduction of new basic service programs, notably those geared towards HIV-AIDS prevention and treatment, and the school nutrition and adult basic education programs. Grants for infrastructure have been lagging but are projected to grow 10% per annum in real terms over the 2005 medium-term. As provincial governments mature, the real value of institutional capacity building grants continues to decline.

4.4.5 Horizontal Fiscal Balance

GDP is a rough proxy for revenue raising capacity and population for expenditure need. Disparities between provinces in GDP per capita indicate the extent of horizontal balance or imbalance. In 1996, GDP per capita in Gauteng (at R 26 500) was 3.96 times that of the poorest province Limpopo (at R 6 700). This gap had narrowed to 2.95 times by 2001 indicating a significant decline in socio-economic disparities due partly to urban migration and partly to the equalizing impact of government transfers.

In FY 1996, provincial government spending per capita in the richest province Gauteng was R 1 778 (78% of the national average) and R 2 760 in North West (122% of the national average). By FY 2002, the spread had narrowed with Gauteng at 80% of the national average and North West at 118% of the national average. Thus, provincial spending clearly reduces the horizontal fiscal imbalance and has become progressively more equalizing over the period FY 1996 to FY 2002. Defining eligible populations in the PES formula on the basis of population in poverty would enable further equalization.

4.5. Municipal Fiscal Framework

4.5.1 Trends in Municipally Raised Revenue

Between FY 1997 and FY 2003, municipalities derived a declining proportion of their revenues from own revenue sources (e.g. property taxes, payroll & turnover levies, utility charges etc.) The proportion dropped from 87.6% to 86.3% of total revenue. On the other hand, intergovernmental transfers increased from 12.3% to 13.7% of municipal revenue.

An increasing tendency toward the utilization of unconditional grants is indicated. In FY 1997, 61% of intergovernmental transfers to municipalities were conditional. By FY 2004, only 42% were conditional. This trend continues over the 2005 medium term. Nearly 4% of municipal revenue was derived from provincial transfers in FY 2002.

4.5.2 Trends in Municipal Government Spending

Between FY 1996 and FY 2003, real spending growth by municipalities has averaged 2.85% per annum. Operational spending has increased by 4% p.a. whilst capital budgets have declined in real terms by 1.22% per annum over this period.

Municipal accounts do not readily enable an analysis of spending by function. Therefore, a proximate indication of municipal spending patterns for the 3 Gauteng Metropolitan Authorities is provided in the Intergovernmental Fiscal Review 2003 as follows:

Function	% of Budget FY 2002 - 03
Water	18.5%
Waste Management	5.2%
Electricity	29.3%
Road Transport	6.9%
Public Safety	6.7%

4.5.3 Intergovernmental Transfers to Municipalities – The Local Equitable Share

In FY 2002, metropolitan municipalities received between 3% and 8% of their revenue from intergovernmental grants. By contrast, rural municipalities were funded from intergovernmental transfers to between 60% and 90% of their revenue.

4.5.4 Conditional Grants to Municipalities

As with the provinces, conditional grants from national departments concentrate on ensuring spending on capital and institutional capacity building. A conditional operating subsidy for water provision is justified on the basis of ensuring a socio-economic right in rural municipalities where own revenue and LES funding is insufficient.

4.5.5 Horizontal Fiscal Balance

In 1996, GDP per capita in the metropolitan municipalities was 5.1 times that of mainly rural municipalities. By 2001, the gap had narrowed marginally to 4.8 times. This may be due to urbanization of the poor.

Municipal spending per capita figures are available from 2003. In that year, metropolitan municipalities spent between R 3 200 and R 3 800 per capita. Rural municipalities spent between R 400 and R 800 per person. The gap is between 4 and 9.5 times indicating that municipal spending contributes little to spatial equalization between urban and rural municipalities.

4.6 Conclusion

Socio-economic disparities between provinces and between municipalities narrowed between 1996 and 2001. This process has been primarily driven by urbanization of the poor. Inter-provincial disparities in per capita spending by

provincial governments are narrower than for per capita GDP and hence contribute to the equalization process between provinces. By contrast, inter-municipal disparities in per capita spending by municipal governments are as wide as for per capita GDP indicating that municipal spend is distribution neutral, rather than equalizing.

Provincial governments raise a small and declining proportion of their own revenue. By contrast, municipalities and especially metropolitan municipalities raise most of their own revenue. Nationally raised revenue enables redistribution and equalization between provinces and municipalities.

The primary tool of income redistribution is social assistance grants. Between 1996 and 2004, the share of social assistance grant spending increased 7% to over 27% of provincial government spending. Education spending has declined relatively and, during some periods, in real terms as well. The vertical division of spending has shifted from the national to the provincial level for these reasons. These trends are due to reverse post 2005 with the establishment of a national agency for social assistance payments.

Operational spending pressures led governments at all three levels to reduce capital spending. Post 2000, policy and conditional grant driven spending on infrastructure have enabled shares of infrastructure capital spending to recapture lost shares. This trend continues over the 2005 medium term.

CHAPTER 5 – THE PROVISION OF BASIC SOCIAL SERVICES

5.1 Introduction

This chapter considers the 2005 Division of Revenue Bill with respect to the performance of government spending, over the period of the Intergovernmental Fiscal Review, and on the basic social services listed in the Bill of Rights. An attempt is made to match national policy objectives to financial input, service delivery output and developmental outcome performance indicators.

Socio-economic inequalities arising from South Africa's past apartheid's policies contributed to significant levels of poverty. There are four dimensions to poverty, income, capability, asset and accessibility poverty. Household income for the poor is generally derived from informal or formal employment and transfer payments from family and government. Income poverty is generally caused by capability poverties such as low educational status, ill health and malnutrition and poor access to household infrastructure services.

The Constitutionally Mandated Basic Social Services listed in the Bill of Rights constitute most components of an income and capability poverty reduction package. Income poverty is primarily addressed through the government's social security and assistance mandate and capability poverty through the education, health and food adequacy mandates. Access to information and the justice system are also indicated in the Bill of Rights. The Constitution especially emphasises the first and second (i.e. socio-economic) generation rights of children.

5.2 Social Development

5.2.1 Policy Objectives Norms and Standards

The objective of social assistance grants is to alleviate income poverty and ensure access to all eligible. Social assistance grants are a clearly defined costed norm.

Between 1998/99 and 2004 /05, the old age and disability pensions have increased from R 490 to R 740, an average annual increase of 6.1%, slightly above average Consumer Price Index (CPI) of 5.5% over the same period. During the same period, the child support grant increased in value from R 100 to R 170, an average annual increase of 7.9%.

5.2.2 Fiscal and Institutional Instruments

Social development, consisting of social assistance grants and social welfare services, is listed in the Constitution as a concurrent function of national and provincial government. It has recently been decided that social assistance grants will be assigned to national government and provided through a national agency. Welfare services will remain a provincial assignment. As a consequence of this decision, funding for social assistance grants will no longer be included within unconditional PES allocations as of FY2005. In the interim, the funding of social grants will be provided through a conditional grant. Funding for social welfare services is included within the unconditional PES allocation.

5.2.3 Spending Trends

Between FY 1996 and FY 2001, real growth of spending on social assistance grants grew by an annual average of 1.12% pa. Since then, the pace has picked up, averaging 18.07% in 2004/05 and projected to grow at 9.96 % over the 2005 medium-term.

5.2.4 Coverage Rates

Between the two Censuses, the average annual growth rate of beneficiaries for all grants was 14.1%, rising to 30.5% between 2001/02 and 2004/05. The difference between real spending rates and take-up rates can be explained by the rapid take-up of the child support grant, which is valued at approximately one quarter of the other social assistance grants. By April 2004, there were 7 941 562 recipients of grants, of which 26% were old age pensioners, 17% disabled and 54 % children. The extent of errors of inclusion is currently being determined.

Eligibility for the social assistance grants can be defined in terms of demographic categories and poverty rates. A comparison of the annual average growth rate of target populations and of social assistance beneficiaries between 1996/97 and 2001/02 is given below:

Table 5.2 Coverage and Spending Rates – Social Assistance (1996-2001)

Grant Type	Target Population	Growth Rate of Target Population	Growth Rate of Beneficiaries	Real Growth Rate of Spending
Child Support And Foster Care	Able children 0-14 yrs old	0.61%	172.81%	n/k
Care Dependency	Disabled children 0-19 yrs old	1.27%	52.35%	n/k
Disability – Permanent	Disabled adults 20 yrs +	2.59%	-1.70%	n/k
Disability – Temporary	HIV infection rates?	13.36%	n/a	n/k
Old Age Pension	Women 60 yrs+ and Men 65 yrs+	2.54%	3.31%	n/k
TOTAL	All above	3.10%	14.11%	1.12%

In all instances, save for the disability grant, the growth of recipients exceeded the growth of the target population indicating progressive realization in breadth of coverage. A strong rate of progressive realization is indicated for all grant types post 2001 with age extensions of the child support grant and temporary disability grants to the HIV-infected in some provinces.

5.2.5 Developmental Outcomes – Income Poverty

Social grants are the primary component of government's income poverty alleviation program. Between 1995 and 1999, official Income and Expenditure Surveys suggest that the proportion of poor households increased from 28% to 33%. Poverty is defined here as household spending of less than R 800 per month

(in 1996 prices). This may be an indication that the provision of social assistance grants during this period was insufficient to counteract increasing poverty.

Given the subsequent acceleration of cash grant provision, there is a clear need to evaluate the impact of state spending on poverty reduction. Non-official surveys of income poverty indicate that social assistance grants had a positive impact on poverty alleviation. Wage income is the primary source of household income. Despite the positive impact of social assistant grants, they can not be solely relied on to relieve households of poverty as they are intended to be supplementary to the wage income.

5.3. Basic Education

5.3.1 Policy Objectives and Targets

Basic education is defined as the following programs: Public Ordinary School Education, Independent School Subsidies, Public Special School Education, Further Education and Training, Adult Basic Education and Training and Early Childhood Development.

The overall goal of the public education system is to provide access to lifelong learning, education and training opportunities to all. All children between 6 and 8 years are to be provided with a school education. The target is that by 2015, all school entrants should have one year of Early Childhood Development (ECD) and 280 000 disabled children should have been enrolled in schools for children with special needs. Annual or medium-term targets are also specified for Adult Basic Education & Training (ABET). Improving the literacy rate of over 15 year olds is a stated objective of ABET though targets have not been set.

5.3.2 Fiscal and Institutional Instruments

Education is constitutionally listed as a concurrent national and provincial function. All components of basic education are delivered through provincial education

departments, while tertiary education is a national function. Funding for education is largely provided through the unconditional PES grant.

5.3.3 Norms and Standards

In FY 2003, spending per learner was R 5 011. This has increased by approximately 3.7% p.a. in real terms between FY 2001 and FY 2004. This increase is due to funding in excess of growth in the number of learners. During the five years prior to FY 2001, per learner spending grew by 1.8% pa., but this may have been as a result of declining learner enrolment. In 2002, the average learner: educator ratio was 32. In 2000, the average learner: classroom ratio was 38. Specific norms have not been set for the learner classroom ratio.

5.3.4 Spending Trends

Between the 2 Census years of 1996 and 2001, real spending on basic education programs declined by 1.28%. Since then, spending has picked up to 3.8% in 2004/05 and is projected to grow at 2.24% p.a. over the 2004 medium-term cycle. The fastest growing components of the basic education system are ECD (10.7% between 2001/02 and 2004/05), FET (7.7%) and ABET (7%).

5.3.5 Coverage Rates

The decline in spending on basic education corresponds to a decline in learner enrolment of 0.95% p.a. between 1996/97 and 2001/02. The number of learners in the system declined from 12 million to 11 million during this period but has subsequently increased again to 12 million learners. Between 2001/02 and 2004/05, the number of learners in the system grew by 1.27% pa.

In assessing coverage however, it is necessary to compare the rate of change in the number of basic education beneficiaries with that of the demographic target groups. In contrast to a decline in enrolment, the number of school-going age children increased by an average of 1.74% pa. between 1996 and 2001. The relative decline in public school enrolment may be explained by: (a) a policy

discouraging inappropriate age learners and, (b) migration to private schools. The impact of the loss of inappropriate age learners and of learners of private schools needs to be measured before an inference can be made about improved access to schooling facilities.

Between 1996 and 2001, gross enrolment ratios for primary schools remained constant at 96%, but increased for secondary schools from 70% to 85%.

Table 5.3 Coverage & Spending Rates – Basic Education (1996-2001)

Education Program	Target Population	Growth Rate of Target Population	Growth Rate of Beneficiaries	Real Growth Rate of Spending
Childcare	Children 0-4 yrs old	-0.22%	n/a	n/a
E.C.D.P. + Primary School	Able children 5-9 yrs old	0.54%	n/k	-1.20%
Secondary School	Able children 10-14 yrs old	1.45%	n/k	-1.03%
F.E.T.	Able children 15-19 yrs old	3.32%	n/k	-1.44%
Ordinary School Education	Able Children 5-19 yrs old	1.74%	-0.95%	-1.23%
Special School	Disabled children 5-19 yrs old	1.74%	n/k	-0.40%
ABET	Unschooling Adults 20 yrs+	1.09%	n/k	-2.22%

5.3.6 Developmental Outcomes – Capability Poverty

Capability poverty alleviation can be assessed against changes in literacy and numeracy rates and the educational status of the adult population (20 yrs +). During this period, the adult literacy rate increased from 83% to 89%. A comparison of educational status between the two Censuses is provided below.

Table 5.4 Educational Outcomes 1996-2001

Highest Level of Education attained	% of adult population - 1996	% of adult population - 2001
None	19.3%	17.9%
Primary	24.2%	22.4%
Some Secondary	33.9%	30.8%
Matric	16.4%	20.4%
Higher	6.2%	8.4%

The results indicate an improvement in education capability with a higher proportion of the adult population attaining Matric or higher and a declining percentage without or with less than a secondary school education.

5.4 Health Care

5.4.1 Policy Objectives and Targets

In respect of access, an objective of the primary health care system is to achieve an increase in health care provision to the World Health Organization standard of 3.5 consultations per person per annum by 2005. In respect of health outcomes, a 30% reduction in infant mortality rates was targeted for 2000.

5.4.2 Fiscal and Institutional Instruments

Healthcare is listed in the Constitution as a concurrent national and provincial function. Primary health care is assigned to provinces, although municipalities have traditionally delivered almost half the country's primary health care services. Secondary and tertiary care services are delivered through hospitals and are a provincial function and national function, respectively.

Primary, secondary and emergency health care is largely funded through the Provincial Equitable Share. Academic hospitals and health professional training are funded through conditional grants.

5.4.3 Norms and Standards

Expenditure per capita (rather than per patient) was R 1 013 in FY 2004. Per capita spending has remained roughly constant in real terms since 1996. Expenditure per capita at primary health care clinics was R 176 in FY 2004 and average cost per visit was R 68.40. Expenditure per capita in hospitals was R613.

5.4.4 Spending Trends

Between FY 1996/97 and FY 2001/02, spending increased by 1.99% p.a. (in real terms) on the clinic and hospital programs. Since then, real growth in spending on these core programs has accelerated to 4.16% per annum. Over the past three years, spending on clinics and hospitals has increased by an average of 4.6% and 1.7% per annum respectively. Anecdotal evidence suggests that HIV-AIDS is placing great strain on both secondary and tertiary hospitals.

5.4.5 Coverage and Utilization Rates

Between 1990 and 1998, the number of visits per capita to a primary health care clinic ranged from between 1.3 and 2.7 per annum. This is below the WHO standard of 3.5 visits. In 2003, immunisation coverage stood at 81%, antenatal coverage at 99% and tuberculosis cure rates at 54%. Between 1996 and 2001, the overall population growth rate has been 2.01% p.a. and is roughly equivalent to the real growth rate of spending on clinic and hospital services.

5.4.6 Developmental Outcomes – Capability Poverty

Basic health provision is a further element of capability poverty alleviation. Official data is patchy on policy outcome measures such as infant / child / adult mortality

rates and morbidity / infection rates. Between 1991 and 1998, the infant mortality rate appears to have increased from 40 to 45 deaths per 1000.

5.5 Food Adequacy

5.5.1 Policy Objectives and Targets

The objective of the school nutrition program is that every child should receive at least one nutritious meal per day.

5.5.2 Fiscal and Institutional Instruments

Food adequacy and security programs are currently being addressed through the provincial departments of agriculture e.g. through starter packs for subsistence farmers, in the education sector through the school nutrition programs and in, Health and Social Development by providing emergency food relief. Funding for these interventions is through conditional grants to provinces.

5.5.3 Spending Trends

In FY 2004, 0.82% of provincial budgets were allocated to food adequacy and security programs. A real growth of 4.1% pa. is projected over the 2004 Medium-Term cycle.

5.5.4 Coverage Rates

In the case of the Child Nutrition Grant, the target population of poor children is estimated at 4.58 million children. Coverage has increased from 89% of targeted learners to 94% between 1994 and 2004. Target populations for food relief are not easy to predict because of the unpredictability of natural disasters. Agricultural starter packs may be aimed at households with capacity for subsistence agriculture.

5.5.5 Developmental Outcomes – Capability Poverty

Statistics SA has published data on the nutritional status of South Africa's population. The impact of government intervention on the population's nutritional status has not been ascertained.

5.6 Information Services

A vital component of any poverty reduction strategy is access to information, by poor people with respect to the availability of and access to public services. This is an important reason for errors of exclusion in the poverty targeting of government services. The target population could be defined as the poor or as the population not currently in receipt of the relevant government services. Means of dissemination of information include, probably most effectively, radio, followed by television, newspapers, pamphlets, community meetings and access to government websites. Government is currently utilising all these media to provide target groups with information.

5.7 Conclusion

Spending on social assistance programs has rapidly increased since 2000. Take-up rates of social assistance grants have also increased rapidly since 2000. In education declining learner enrolment and spending rates characterised the period to 2001, but have since been reversed. Per capita health expenditure has remained roughly constant over the past 10 years. Further data collation is required to assess performance trends in the delivery and maintenance of community facilities such as schools, clinics and hospitals.

Academic surveys suggest that social assistance grant provision is alleviating income poverty. The educational status of the population is improving but infant and adult mortality and morbidity rates appear to be rising. Trends in the nutritional status of children remain to be ascertained. Finally, performance measures for information dissemination remain to be developed.

CHAPTER 6 – THE PROVISION OF INFRASTRUCTURE FOR THE DELIVERY OF BASIC SERVICES

6.1. Introduction

This chapter considers the 2005 Division of Revenue Bill with respect to government spending on the infrastructure required for the delivery of basic services listed or implied in the Bill of Rights. The provision of social and physical infrastructure for the delivery of CMBS directly addresses the problem of inequalities that poor people face. A further developmental outcome of government capital spending on basic infrastructure services is a reduction in household asset poverty. Asset poverty disables economic opportunity by denying the landless and homeless the opportunity to save for investment and access to finance.

Municipal free basic service operating subsidies to households alleviate income and capability poverty by reducing household spending on water, electricity, sanitation and waste disposal and improving environmental health conditions. Furthermore, asset poverty is addressed through the housing and land mandates of the Bill of Rights. Housing can be defined as property once it is registered and connected to the water, sanitation, sewer and road networks of the municipality. Water is an important supplementary service in the provision of assets to poor people both with respect to housing and land, and is explicitly listed as a socio-economic right. An additional dimension is the environmental health mandate, which allows for sanitation, waste disposal and pollution control services to be classified as basic. Access to services is enabled by road and transport systems.

There are generally no norms, standards and targets against which the quality of capital expenditure can be assessed in the various sectors.

For the 2004/05 financial year, about 6.2% of the provincial budget was earmarked for expenditure on capital assets. However, as on the 31 December 2004, capital expenditure constituted only about 4.1% of the total expenditure and only about

24.1% of the capital budget was already expended. With only three months left to the end of the financial year and with 75.9% of capital budget yet to be spent, an inference can be made that there is, in general, still insufficient capacity to spend and project planning and management constraints amongst provinces persist.

6.2 Education

The 2004/05 education capital budget is about 22.7% of the total provincial sector capital budget and as on the 31st December 2001 only 22.7% of the education capital budget had already been spent. Budget for the maintenance of education capital assets for the year was 19.6% and only 18.6% had already been spent by end of December 2004.

In fact, the School Infrastructure Review undertaken by the Department of Education indicates that the degradation of school infrastructure assets is one of the departmental challenges. Another challenge identified is the impact of cost disability factors on the provision of school infrastructure to rural areas. The Review estimates that the classroom need has been reduced from 57 499 in 1996 to 31 254 in 2004.

6.4 Health

About 19.1% of the 2004/05 provincial capital budget was earmarked for the health sector but only 18.1% of that had already been spent by end of December 2004. Approximately twenty seven percent of the health capital budget was meant for maintenance of assets and 17.5% of it had already been spent by end of December 2004. Construction spending is also very low at only 18.9% of the budget.

The Hospital Revitalisation grant is meant to grow by 59.8% from 2003/04 to 2006/07 suggesting a policy intention to accelerate capital spending in the sector. However the spending on the grant was a mere 55.5% as on the 31st December 2004.

6.5 Public Works, Roads and Transport

Thirty four percent of the total provincial sector capital budget for 2004/05 was earmarked for public works, roads and transport. The sector projection of under spending is 56%, which is comparatively better than in other sectors. Maintenance was budgeted to take 52.4% of the budget with only 27% having been spent by end of December 2004.

6.6 Provincial Infrastructure Grant

There is no reporting required for spending on this grant, so monitoring of expenditure is not possible. Of the total amount available for the grant, 75% was transferred to provinces for infrastructure expenditure.

The inability to monitor spending on this grant implies that it is not possible to assess whether the grant is achieving the purpose for which it was intended. However, provinces are also afforded the flexibility to spend in accordance with their priorities and this is not dissimilar to the infrastructure conditional grant that the Financial and Fiscal Commission proposed. The FFC also proposed that the Capital Grants Model it developed be used to equitably allocate that grant.

6.6 Housing

6.6.1 Policy Objectives and Targets

The Government of National Unity (GNU) set itself a target of delivering 1 million houses within 5 years. In addition, the Housing Department aims to increase the sustainable housing delivery rate to 338 000 units per annum.

6.6.2 Fiscal and Institutional Instruments

Housing is listed in Schedule 4 of the Constitution as a concurrent national and provincial function. However, municipalities are important delivery agents. The

housing capital subsidy is intended to provide for a serviced site and dwelling per household. Funding is covered by a conditional grant to provinces.

6.6.3 Norms and Standards

The housing capital subsidy is differentiated by household income. Current amounts for FY 2004 are R25 800 for households earning below R 1 500 per month (pm), R15 700 for households earning between R1 500 and R2 500 pm and R 8 600 for households earnings between R2 500 and R3 500 pm.

The average real growth rate of the subsidy amount since 2001/02 is 6.21%. However, prior to 2001/02 the subsidy amount did not keep pace with inflation. The household income brackets have also not been indexed with inflation and remain unchanged for 10 years.

6.6.4 Spending Trends

Provincial spending on housing and municipal services is covered by the departmental expenditure on Housing, Local Government and Traditional Affairs. Between FY 1996 and FY 2001, the real growth of spending by these departments averaged 0.71% pa. Between FY 2001 and FY 2003, the rate of spending decelerated to –2.20% and is anticipated to slide further to – 3.05% over the 2004 medium-term. This deceleration of the housing expenditure may be related to, amongst other reasons, the declining real value of the housing capital subsidy and the increasing reliance on individual and municipal top-up funding, which restrict both demand and supply. The 2005 DoR has reversed this trend with 10% real increases in housing expenditure.

6.6.5 Delivery and Coverage Rates

Between FY 1994 and FY 1999, 883 385 houses were completed or under construction, just short of the Government of National Unity's (GNU's) target. By FY 2003, 1 614 512 houses were at least under construction. This implies an average

delivery rate of 161 400 houses per annum. This delivery rate has been falling since FY 1997 when a maximum of 295 811 housing opportunities were delivered.

A comparison of the 1996 and 2001 Censuses yields an average annual growth rate of households of 4.34%. By contrast, in the same period, the number of households in formal dwellings increased by an average of 7.17%. This implies that a comparatively larger proportion of households have access to formal dwelling in 2001 than in 1996. This a notable achievement when it is considered that the average household size declined from 4.5 to 3.8 as indicated by census 2001.

6.6.6 Developmental Outcomes – Asset Poverty

Housing and land ownership are perhaps the government's primary objectives for an asset poverty alleviation program. Government does not currently publish consolidated measures of asset poverty, hence the outcome in respect of poverty alleviation cannot be measured.

6.7. Water Services

6.7.1 Policy Objectives & Targets

The current national goal is to ensure that all households have easy access to clean running water by 2008. The initial norm established was 20 litres per person per day within 200m radius of the dwelling. This norm also underscores the free basic water component of municipal water services. This amount has recently been increased to WHO standards of 50 litres per person per day. The water backlog for households is defined here as those households deriving water from any communal source of water including public taps, boreholes/wells, rivers, water-tankers etc.

6.7.2 Fiscal and Institutional Instruments

Water services are a local government function listed as a concurrent national and provincial legislative competency. Water storage and bulk distribution (and rural

reticulation) on the other hand, are functions of Water Boards, which are generally public companies. Municipal water departments undertake urban reticulation. It is intended that rural reticulation should be passed into municipal hands as well.

Water services are generally self-financing, though surpluses may be used to cross-subsidize other municipal services. Increasingly, municipal water distribution is itself being cross-subsidized.

6.7.3 Spending Trends

In FY 2003, the Water Boards and municipalities spent nearly R 10 billion on the provision of water services. Water Boards are spending less on capital and more on operating expenses. By contrast, between FY 2001 and FY 2003 the municipalities sharply increased their capital expenditure and have been reducing their operational expenditure.

6.7.4 Delivery and Coverage Rates

In comparison to the number of households growing at an annual rate of 4.34% between 1996 and 2001, the growth rate of household connections to a reticulated water supply increased by 5.35% pa. This implies that a greater proportion of households have access to water services in 2001 than 1996.

A provincial comparison of households constituting the backlog is indicated in the table below. Across the nation, coverage of access to water services increased from 60.4% of households to 62.3%. Coverage rates are increasing at a lower rate in the metropolitan areas than in non-metropolitan municipalities, probably because access to water was already at a higher level in these areas in 1994. This may also be attributed to rural-to-urban migration stretching the capacity of metropolitan authorities to provide basic water services. Indeed, in the two mainly urbanized provinces of Gauteng and the Western Cape, there are more households without adequate access to water supplies in 2001 than in 1996. Less easy to explain is the increasing water backlog in Northern Cape and Mpumalanga.

Table 6.1 Trends in Water Service Coverage (1996 – 2001)

Province / Type of Municipality	% of households with adequate water services	
	1996	2001
TOTAL – S.A.	60.4	62.3
Eastern Cape	35.0	37.8
Free State	70.1	71.1
Gauteng	84.5	84.0
Kwazulu Natal	48.0	50.8
Limpopo	35.0	40.5
Mpumulanga	62.0	60.1
Northern Cape	82.5	82.1
North West	49.8	54.4
Western Cape	89.0	85.2
Metropolitan Municipalities	80.5	82.2
Non-Metropolitan Municipalities	48.3	51.9

6.7.5 Developmental Outcomes

Two possible developmental outcomes of improved water supply may be declining incidence of water-borne diseases (an impact shared with sanitation services) and improvements to the asset values of poor households. It is difficult to isolate the specific impact of water services in these environmental health and asset poverty outcomes without further research.

6.8. Sanitation and Waste Disposal

Sanitation and waste disposal services are included here under the rubric of environmental health services. Other environmental health services might include pollution control, vector control and food licensing.

6.8.1 Policy Objectives, Instruments and Targets

Waste disposal, cleansing, vector control and food licensing are local government functions with exclusive provincial legislative competence. Sanitation and pollution control have concurrent provincial and national competencies. Three hundred thousand households are due to be provided with basic sanitation services in 2004/05 such that the pace is established to ensure that all households have access to adequate sanitation services by 2010.

6.8.2 Norms and Standards

The sanitation backlog for households is defined here (using Statistics South Africa's definitions for the 1996 and 2001 Censuses) as those households using the bush, buckets or pit latrines for sanitation purposes. The refuse removal backlog for households is defined as those households without a municipal waste disposal service.

6.8.3 Spending Trends

Municipal expenditure on sanitation, waste disposal and related environmental health services has not been compiled. Thus it is impossible to set the spending trends in this regard. This is an area for future research as reliable spending data is obtained.

6.8.4 Delivery and Coverage Rates

In comparison to the number of households growing at an annual rate of 4.34% between 1996 and 2001, the growth rate of household toilet installations increased by 7.2% pa.

Table 6.2 Trends in the Coverage of Household Sanitation Services

Province / Type of Municipality	% of households with adequate sanitation services	
	1996	2001
TOTAL – S.A.	50.3	54.8
Eastern Cape	30.6	35.2
Free State	45.2	48.4
Gauteng	82.8	83.4
Kwazulu Natal	41.8	47.9
Limpopo	13.2	19.3
Mpumulanga	37.8	41.0
Northern Cape	59.6	67.8
North West	32.1	38.0
Western Cape	85.7	86.6
Metropolitan Municipalities	80.5	80.7
Non-Metropolitan Municipalities	33.6	40.0

The rate of growth in access to sanitation services, from the table above, is lower in metropolitan than in non-metropolitan areas probably due to, amongst other reasons, substantial migration into the metropolitan municipalities.

Table 6.3 Trends in the Coverage of Household Waste Disposal Services

Province / Type of Municipality	% of households with adequate waste disposal services	
	1996	2001
TOTAL – S.A.	53.4	57.2
Eastern Cape	35.5	38.7
Free State	64.5	61.6
Gauteng	85.0	85.9
Kwazulu Natal	43.1	50.4
Limpopo	12.0	16.0
Mpumulanga	39.5	41.0
Northern Cape	69.5	71.3
North West	35.9	38.4
Western Cape	84.6	88.6
Metropolitan Municipalities	89.7	84.5
Non-Metropolitan Municipalities	36.2	38.6

Coverage of waste disposal services to households improved between 1996 and 2001 from 53.4% to 57.2% of households. However, the proportion of households connected to municipal waste disposal services declined in metropolitan municipalities. This indicates that the number of households increased at a much faster rate than at which households were provided with access to waste disposal services.

6.9 Electricity Services

6.9.1 Policy Objectives and Targets

The Government of National Unity established a goal of providing 2.5 million households and all schools and clinics with electricity by 2000. Government aims to eliminate household electrification backlog by 2012.

6.9.2 Norms and Standards

Adequate access to electricity is defined here as having access to the municipal grid. This follows from definitions used by Statistics South Africa in the 1996 and 2001 Censuses. Free basic electricity accounts for the first 250 KWh of a household's monthly consumption. Electricity tariffs and tariffing structures vary widely between municipalities.

6.9.3 Fiscal and Institutional Instruments

Electricity distribution is assigned as a local government function, in the Constitution, but with concurrent provincial and national legislative competencies. In practice, electricity is primarily distributed by ESKOM and some by municipalities. Regional Electricity Distributors are being established to take over both parties' roles in the electricity distribution industry.

Electricity services generally generate surpluses, that municipalities often use to cross-subsidize other municipal services and ESKOM uses to meet the household electrification targets. Electrical distribution infrastructure is funded through conditional grants to municipalities. The Integrated National Electrification Programme grant has been incorporated into the Municipal Infrastructure Grant (MIG).

6.9.4 Delivery and Coverage Rates

In comparison to the number of households growing at an annual rate of 4.34% between 1996 and 2001, the growth rate of electrical connections increased by 8.34% pa. indicating progressive realization between 1996 and 2001.

Coverage rate increases are least pronounced in the two urban provinces of Gauteng and Western Cape. Both are destinations significant of urban migration from rural provinces.

Table 6.4 Trends in the Coverage of Household Electricity Services

Province /	% of households with adequate electricity services	
Type of Municipality	1996	2001
TOTAL – S.A.	57.3	70.2
Eastern Cape	31.3	49.7
Free State	56.8	74.8
Gauteng	79.4	81.1
Kwazulu Natal	53.3	62.1
Limpopo	36.2	64.0
Mpumulanga	56.3	68.4
Northern Cape	68.8	76.7
North West	43.8	71.2
Western Cape	84.9	88.1
Metropolitan Municipalities	79.3	82.2
Non-Metropolitan Municipalities	45.2	62.7

Table 6.4 above indicates that the proportion of households with adequate access to electricity increased from 57% in 1996 to 70% in 2001. Of all municipal services, this is the most substantial improvement in access recorded.

6.10 Transport Services

6.10.1 Policy Objectives and Targets

Output targets can be established for number of kilometres of road/railways constructed or maintained, passengers subsidized and coverage of target populations. They can also be established for average distance and time home to work and home to service centre trips.

6.10.2 Norms and Standards

No specific norms have been established for the transport sector, although vehicle and/or passenger utilization rates can be established as norms against different standards of road surface (from concrete, through tar and gravel to graded roads).

6.10.3 Fiscal and Institutional Instruments

Constitutional mandates are assigned to all 3 spheres of government in roads and transport matters. In FY 2003, provinces undertook 57% of government's road construction and maintenance spending, municipalities 30% and national government 13%. Road traffic control is a provincial function. Bus, taxi and rail subsidies are transferred to provinces by the national department of transport.

6.10.4 Spending Trends

Provincial spending on roads has increased in real terms by 11% p.a. between FY 2000 and FY 2004. National and provincial spending on bus, rail and taxi subsidies increased by 6.45% pa. during this period.

6.10.5 Delivery and Coverage Rates

Provincial governments indicate that they have maintained 175 722 km of road and constructed, upgraded or rehabilitated 3 294 km during FY 2003. There are currently 348 527 km of proclaimed provincial roads.

6.10.6 Developmental Outcomes

One possible developmental outcome might be a reduction in average commuting time and distance. Town and regional planning initiatives for urban densification complement transport planning in achievement of this aim.

6.11 Conclusion

Well-defined output targets have been long established in respect of increasing the coverage of households with access to adequate water, sanitation, waste disposal and electricity. Performance can be measured by comparison of the 1996 and 2001 Censuses. In general, delivery rates have exceeded the rate of household formation. Increases in coverage rates are less marked in the metropolitan municipalities and urban provinces where in-migration most likely challenged delivery capacity. Another reason could be that metropolitan areas are starting from a higher level of coverage and hence the required growth rates to meet their targets would be lower. The rate of household electrification has been most noticeable. However, coverage of water services declined in some provinces.

Further data collation is required to measure the coverage and impact on income and capability poverty of free basic municipal services as an operating subsidy to households.

Measures of asset poverty should be enabled through municipal property registrations and valuations. The relative impacts of primary and environmental health care interventions may be difficult to distinguish. Income poverty measures do not normally measure government spending on the poor (i.e. the social wage).

Spending on allocated capital budgets has generally been very low and several reasons can be advanced to explain the trend. Amongst the possible reasons are lack of project planning and management capacity, possible non-reporting of expenditure incurred, and general lack of focus on infrastructure delivery.

ANNEXURE A:

REVIEWING THE DIALOGUE WITH GOVERNMENT OVER THE COMMISSION'S PREVIOUS RECOMMENDATIONS

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1. Introduction

This section reviews the role of the Financial and Fiscal Commission in the development of South Africa's intergovernmental fiscal system by considering its recommendations over the past 10 years and government's response to and dialogue over the Commission's contributions for the improvement and enhancement of the IGFR system.

The Commission is frequently asked how often its recommendations are accepted. Given the long-term nature of much of the Commission's advice, it is often only possible to begin assessing its influence after a number of years.

2. The Commission's Framework Document of 1995

2.1 Content Matter

In interpreting its Constitutional mandate, the Commission's inception report and Framework Document of 1995 emphasized as content matter, the allocation of national revenue among the three spheres of government (vertical division of revenue), the equitable horizontal division across provinces, the design of unconditional and conditional capital grants to sub-national governments, provincial tax raising powers and sub-national borrowing powers.

Further, the document pointed out the importance of related content matter in the field of intergovernmental fiscal relations such as functional assignment shifts, macro-economic stabilization issues, associated institutional arrangements and mechanisms, data requirements, performance monitoring and the integration of budgetary and strategic planning.

2.2 Evaluative Criteria

The Commission's inception document also established criteria for the evaluation of financial and fiscal matters. These criteria were based on its interpretation of the factors listed in Section 214 (2) a-j of the Constitution. The following criteria were identified:

- Horizontal equity in tax and expenditure assignment;
- Fiscal autonomy of sub-national governments;
- Developmental promoting economic growth, human and community development;
- Nation-building especially in respect of norms and standards;
- Administrative efficiency and effectiveness;
- Accountability (to Parliament);
- Transparency; and
- Certainty of revenue and stability through transitional periods.

3. Recommendations on the Provincial Equitable Share and Fiscal Framework– 1996 onwards

The Provincial Equitable Share is an unconditional grant from nationally raised revenue to the 9 provincial governments. The Commission played an important role in the development and implementation of the formula for allocating the PES.

3.1 The Commission's Proposed Formula

The Commission's proposed formula evolved incrementally over the years since 1996. The Commission's formula structure was constituted as follows:

- A (S)ervices component, constituted initially of Education and Health sub-components and supplemented in 1997 with a Social Security sub-component reflecting the 3 major expenditure responsibilities of provincial governments.
- An (I)nstitutional component to cover the provincial governments' overheads such as Provincial Legislatures, Premier's Offices and other administrative functions.

- A (B)asic element to account for all remaining provincial service responsibilities.
- A (T)ax Capacity Equalization component to enable the option of tax devolution to provincial governments by compensating for inequalities in the tax capacities of different provinces. To date, this component has been not been activated because provinces have not implemented own revenue raising powers.
- An (m) or spillovers component has been dropped once it was agreed that the inter-provincial spillovers in the form of tertiary level hospitals and health education should be provided for through conditional grants, rather than the unconditional PES.

3.2 Comparison with the Official Formula

The Commission's proposed structure of the formula corresponds in some respects to that of the official formula adopted by Government in 1997. Both formulae contain the social services components (Education, Health, Social Development-with the latter to be removed this year), and an Institutional component. The official formula does not directly recognize a Tax Capacity Equalization component because, at the time of its adoption, the enabling legislation for provinces to exercise their tax powers was not yet in place. Instead, an economic activity component was introduced as a proxy for fiscal capacity. In addition to a Basic component, the official formula included a Backlogs component to deal with infrastructure backlogs in health and education, which is also earmarked to be removed this year.

The Commission has always maintained the view that infrastructure funding, especially for backlogs should be provided for through a conditional grant on the grounds that operating spending pressures tend to crowd out capital spending.

4. Recommendations on the Local Equitable Share and Fiscal Framework – 1997 onwards

The Local Equitable Share is an unconditional grant from nationally raised revenue to municipalities. Most municipalities however raise a significant amount of revenue

for their expenditure needs from service charges. The Equitable share for local government is therefore a less significant revenue source for municipalities than it is for provincial governments.

The Commission's inception report entitled "Local Government in a System of Intergovernmental Fiscal Relations in South Africa" proposed an approach to the local fiscal framework in 1997. The structural components of the framework included a capital grant to overcome household backlogs in water and sanitation service, an operational grant to provide for minimum household consumption of water. The third component was a Tax Capacity Equalization component to account for inherited inequalities in fiscal capacities between metropolitan and rural municipalities.

4.1 Evolution of the Official LES Formula

The official LES formula was adopted in 1998. Initially, it consisted of a basic municipal services (S) component which allocated an affordable per household amount to cover operating costs of water, sanitation, waste removal and electricity (and) an Institutional component which, like in the PES, allowed for a fixed cost of administering a municipality but added a population-driven component.

A transitional window was introduced to enable the transfer of former R293 Bantustan townships from the provincial to the municipal sphere. This set a precedent for future ad hoc introduction of funding windows to the LES to deal with new local government priorities. For example, in FY 2002, an additional funding window was opened for municipalities in which rural and urban development nodes were allocated. Subsequently in 2003, Free Basic and Free Electricity Services windows were introduced to account for the policy determined free basic services over and above the S grant.

4.2 The Commission's Proposed LES Formula – 2001 onwards

In 2001, the Commission made comprehensive formula proposals for the LES. In particular the Commission proposed that Government should clearly define basic municipal services to be covered by the "S" component of the LES. In its proposal, the Commission indicated that the definition of basic municipal services ought to be guided by the Constitution and relevant legislation. The proposed formula mirrored the PES formula comprising a basic component, a services component, a revenue-raising component, an institutional component and a spillover component.

This basic approach has been retained and further elaborated on in the Commission's submission for 2004. Government's response to these proposals is addressed in Chapter 2 of this Submission.

5. Recommendations on Infrastructure Funding & Financing

5.1 Utilisation of Borrowing Powers

The Commission's Framework Document of 1995 noted the Constitutional rationale of limiting the use of long-term borrowing to capital spending and of short-term borrowing to one-year overdrafts on current spending. It noted further that borrowing was suitable for commercially viable capital projects, implying that the capital component of many basic services was best funded through capital grants, and that these should be conditional to avoid crowding out by current spending pressures.

5.2 Provincial Infrastructure Grants

The Commission's Provincial Capital Grant formula was first introduced in 2000. Through subsequent interaction with government and other stakeholders, the model has since been modified to address certain weaknesses that had been identified. A detailed discussion of the model and government's response to it is covered elsewhere in this submission.

5.3 Municipal Infrastructure Grants

In 2001, the Commission proposed that municipal infrastructure grants should be consolidated into a single grant and be allocated on a formula basis. This proposal was motivated by the fact that, over time, a plethora of conditional grants emerged in the system all aimed at addressing infrastructure needs but without co-ordination and rationalisation. This resulted in duplication of efforts by various departments and role players, and by implication, inefficient use of resources.

The above proposal culminated in a process undertaken by Government whereby all capital grants to local government were consolidated into the Municipal Infrastructure Grant in 2004. The MIG has components for residential, bulk connector, and SME infrastructure plus additional funding for development nodes and a performance bonus. The residential B-component currently prioritizes water and sanitation followed by roads.

6. Recommendations on Sub-National Revenue Raising Capacity

6.1 Provincial Revenue Raising Capacity

Since its Framework Document in 1995, the Commission has highlighted the need for provincial government to increase their revenue raising capacity by implementing the provisions of Section 228 of the Constitution. Section 228 defines the activities upon which the provinces can impose taxes. The Commission recognised that the implementation of this Constitutional provision required the enactment of enabling legislation. Further, its research indicated some of the useful taxes that would benefit provinces in terms of the potential revenue yield, among which, a surcharge on personal income tax (PIT) was preferred. The Provincial Tax Regulation Process Act of 2003 enabled provinces to propose new taxes to supplement their revenues. To date none of the provinces have proposed any taxes for consideration by the Minister as required by the Act. It must be noted that

the role of the Commission according to the Act is not to determine or identify taxes for provinces but rather to provide recommendations to the Minister on the proposals for provincial taxes.

In 1997, Budget Council agreed that there should be a moratorium on the exercise of provincial borrowing powers. This moratorium was agreed upon to enable the system to put measures in place for dealing with certain moral hazard problems that resulted in some provinces getting into financial problems. However, government did not ban borrowing by provinces and thus provinces do have borrowing powers as granted by the Provincial Borrowing Powers Act (1996)

6.2 Local Government Revenue Raising Capacity

Metropolitan municipalities raise approximately 90% of their revenue whilst rural municipalities generate between 20% and 40% of their budgets. Municipalities derive their income from property rates, water and electricity fees, a payroll and turnover levy (i.e. the Regional / District Council Levy) and a range of license fees and fines.

Electricity distribution is one of the few municipal services to consistently generate surpluses with which to cross-subsidize other services. Further, the municipalities' power to disconnect is an essential component of debtor management. In 2002, the Commission expressed concern at the potential for disruption to municipal finances that the proposed restructuring of the electricity distribution industry might induce. Specifically there will be losses of surpluses for those municipalities that currently distribute electricity. The Commission proposed that the revenue currently generated by electricity for local government should not be lost to the sphere and that losers be fully compensated.

In response to a debate on the Constitutionality of the Regional / District Levy as a municipal sales or corporate income tax, the Commission recommended in 2001 that the Regional / District Levy be reformed and retained as a revenue source for local government.

In respect of municipal borrowing powers, the Commission has since 2001 noted that the fiscal and institutional capacity of municipalities to access infrastructure finance is widely different between metropolitan and rural municipalities. The Commission proposed that explicit capacity building measures were required to develop this capacity through a differentiated approach. The Commission also cautioned against the wholesale utilisation of equitable share transfers as collateral for municipal loans.

7. The Costed Norms Debate - 2000

Through 1999 and 2000, the Commission detailed and consolidated its formula proposal for allocating the Provincial Equitable Share. Central to implementing the approach is a clear definition by the relevant Government departments of minimum norms and standards for services that need to be delivered by provinces. This approach was labelled the "costed norms approach". Using its own assumptions in the absence of clearly defined norms and standards, the Commission applied the approach to a definition of basic education, primary health care and social security grants as the most important Constitutionally mandated basic services delivered by provincial governments.

Important features of the approach included (a) the specific targeting of the beneficiary population by age, gender, poverty status and rural location as a cost disability, (b) the use of phase-in or take-up rates as a measure of progressive realization, and (c) incentives against errors of inclusion such as out-of-age learners.

The approach prompted vigorous debate within government. Some of the concerns raised by government included the following:

- The costed norms approach is data-intensive and many of the data requirements were identified as not currently available from official sources, namely Statistics South Africa.

- The approach requires data on numbers of beneficiaries and service delivery costs that are obtained from sources, which might have an incentive to exaggerate demand.
- Moral hazards may arise from specifying service delivery norms and phase-in rates that are not affordable

Government however noted the potential usefulness of the approach as tool for analysing provincial budgets rather than making provincial allocations.

8. Review of the Intergovernmental Fiscal Relations System – 2002 onwards

8.1. Data Availability

The Commission has long recognized the data availability problems but regards the incentive provided to supply the data requirements of the costed norms approach as worth the investment. In 2003, the Commission: (a) proposed that a Census and survey planning group be established to ascertain the data requirements of the intergovernmental fiscal system, (b) noted the lag between collection, release and utilization of Census data, and (c) proposed a role for Statistics South Africa in collecting developmental outcome data and to verify the service delivery data collected by government departments.

8.2 Budgetary and Strategic Planning

In 2003, the Commission elaborated on its view that its costed norms approach provided the link between budgets and delivery program standards, and hence budgetary and strategic planning. Its definition of take-up rates or backlog eradication as progressive realization also establishes criteria for performance monitoring and evaluation. In this respect, the Commission proposed that performance be evaluated in respect of financial inputs (e.g. real growth rates and relative weights), service delivery outputs (e.g. take up rates against different

service delivery norms) and development policy outcomes (e.g. poverty reduction, job creation, growth enhancement and beneficiary satisfaction).

8.3 Poverty Targeting

In 2003 and 2004, the Commission reaffirmed the efficiency and effectiveness of poverty and other forms of categorical targeting and of reducing errors of inclusion in its social assistance, basic education, basic housing and free basic municipal services programs of poverty alleviation.

8.4 Budget Processes – Flexibility for Emergencies

The importance attached by the Commission to prioritising the basic services listed in the Bill of Rights as second-generation or socio-economic rights is reflected in its opinions on the utilization of contingency reserves to be legally defined for emergency use in the event of natural disasters. The value of the reserve can be limited through a comprehensive disaster management system at local and provincial levels based on mitigation and preparedness.

8.5 Budget Processes – Function Shifts

The costed norms approach also has important applications in assessing the budgetary implications of functional assignment shifts. Recent amendments to the Commission Act provide a role for the Commission to advise in this regard. To date, the Commission has consistently suggested or recommended one function shift, namely, that of social assistance grants from the provinces to a national agency. The Commission is also exploring the primary and environmental health care functions and the need for clear distinctions between provincial and municipal health services and the appropriateness of housing as a provincial, rather than a local government function.

9. Conclusion

The Commission has been attempting to establish a common platform for both the Provincial and Local Equitable Share and Infrastructure grants through a shared structure and methodology. Government prefers the costed norms approach as an analytical tool than an approach to allocations because of perceived moral hazard problems.

The Commission has been developing applications of the costed norms approach to budget analysis, linking strategic and budgetary planning and function shifts. This has implications for addressing the limitations imposed by official data sources.

The Commission has consistently expressed concern over the loss of sub-national revenue-raising capacity or powers. This has been viewed as a loss of fiscal autonomy. However, the Commission recognizes the trade-off between fiscal autonomy and equalization.

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