SUBMISSION ON THE 2014 DIVISION OF REVENUE BILL

For an Equitable Sharing of National Revenue

18 March 2014

Financial and Fiscal Commission
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List of Acronyms

BEPP	Built Environment Performance Plan
FFC	Financial and Fiscal Commission
GDP	Gross Domestic Product
HSDG	Human Settlement Development Grant
HPV	Human Papilloma Virus
IGFR	Intergovernmental Fiscal Relations
LES	Local Equitable Share
MIG	Municipal Infrastructure Grant
MISA	Municipal Infrastructure Support Agency
MTBPS	Medium Term Budget Policy Statement
MTEF	Medium Term Expenditure Framework
NDP	National Development Plan
NHI	National Health Insurance
OSD	Occupation Specific Dispensation
PES	Provincial Equitable Share
PPP	Public Private Partnership
USDG	Urban Settlement Development Grant

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1. Background

1.1. This Submission is made in terms of Section 214 (1) of the Constitution of the Republic of South Africa (1996) and Section 9 of the Intergovernmental Fiscal Relations (IGFR) Act (1998).

1.2. The Commission is generally in agreement with the overall thrust of the 2014 Division of Revenue Bill.

1.3. The Submission is presented in eight parts following this background. Section 2 looks at specific and general issues surrounding the 2014 Division of Revenue Bill. Section 3 discusses the national fiscal frameworks. Section 4 looks at provincial fiscal frameworks while Section 5 focuses on local government fiscal frameworks. Section 6 discusses Government response to Commission recommendations made for the 2014/15 division of revenue. Section 7 discusses Government responses to recommendations by the Standing and Select Committees on Appropriations as they relate to the 2014 Division of Revenue Bill and section 8 concludes.

2. General and Specific Comments on the 2014 Division of Revenue Bill

2.1. **Objects of the Bill.** Clause 2 (a) (ii) of the 2014 Division of Revenue Bill stipulate that the object of the bill is to provide for the determination of each province's equitable share in line with section 214 (1) of the Constitution. The Commission proposes that clause 2 also give effect to section 227 (1) of the Constitution which entitles local government to an equitable share of nationally raised revenue to enable it to provide basic services and perform the functions allocated to it.

2.2. **Increase in indirect grants and re-centralisation of functions and spending**. The Commission notes increased frequency with which functions are being moved around between provincial, local and national government as well as the rapid introduction of indirect conditional grants. What is particularly concerning has been the disregard for due processes and inconsistency associated with re-assignment of functions and introduction of the conditional grants. Section 214 (1) of the Constitution and section 2 (a) of the FFC Act requires the Commission to carry out an assessment of the fiscal implication of the division of revenue when functions are assigned. On many occasions the Commission has been bypassed by assigning authorities thereby violating due processes required by legislations and risking integrity of the fiscal system. The increase in indirect grants or grants in kind is a related area of concern, particularly in so far as coordination and capacity support is concerned. Indirect grants are projected to increase by 366 percent (from just over R3 billion in 2010/11 to R14 billion in 2016/17). These grants are mainly allocated funds shifted from underperforming direct grants such as Rural Household Infrastructure Grant, Integrated National Electrification Programme Grant and Municipal Water Infrastructure Grant. While the intended objectives of these shifts are expediting delivery, indirect grants are not always the appropriate instruments for dealing with weaknesses of conditional grants and government delivery systems. Instead direct implementation of projects by national government at the lower spheres could weaken capacity, blur accountability and impose additional carry through costs for unplanned capital expenditure. Much of the weaknesses in conditional grant spending are attributable to poor design and in this regard the Commission has offered to provide assistance to Government when designing new conditional grants. Indirect grants can however be useful when they are coupled with clear phase-out strategies and synchronised capacity building for affected provinces and municipalities.

2.3. **Duties of Transferring Officers.** The2014 Division of Revenue Bill makes important changes to duties of receiving officers aimed at increasing transparency and accountability in grant administration. Receiving officers are now required to include reasons why a grant transfer has been withheld or stopped in their expenditure reports. This is an important milestone. The Commission proposes that grant transfers should not be stopped or withheld without valid reasons and this be extended to include a report on steps for improvements and managing risks of recurring incidents made by national departments after the withholding and stopping of a grant. This ensures that national interventions of this nature bring about positive change in administration of transfers.

2.4. **Unspent Conditional Grants.** Section 22(3) (a) that deal with unspent conditional allocations has been rephrased. Previously in the 2013 Division of Revenue Act the clause stated that receiving officers must ensure that all funds not approved for roll-overs be paid into the National Revenue Fund. The 2014 Division of Revenue Bill has added an element of time to the clause by stating that the funds need to be repaid into the National Revenue Fund by a date determined by National Treasury. The expansion of this clause is welcomed by the Commission as it is consistent with its own past recommendations. If there is under spending and funds have not been approved for rollovers, there is no reason for a lengthy process in returning the funds. This increases the likelihood that unspent funds are put to more productive use elsewhere.

2.5. **Incentives for investments that support more integrated and efficient cities.** A new clause 14and several other provisions have been included in the 2014 Division of Revenue Bill to institutionalise Built Environment Performance Plans (BEPPs) as a tool for changing the spatial development patterns of cities. Metros are now required to submit council approved BEPPs giving strategic summaries of how grants will be used to develop more integrated and efficient cities. Municipalities that are able to meet these requirements are rewarded with an incentive through the Integrated City Development Grant. The Commission views this development positively in light of no new funds for spatial integration and because it is in line with a previous recommendation towards building compact cities that help promote integrated planning and spending consistent with Chapter 8 of the National Development Plan (NDP) that the Commission made in 2010/11. The Commission however emphasises the need for aligning the incentives with the outcomes and not just spending and planning alignment.

2.6. Requirements to submit BEPPs should be extended to cover national and provincial governments with concurrent local functions so that they align spending plans with those of municipalities to foster better integration. Furthermore, small municipalities should be assisted where necessary to maximise the benefit of integrated planning and efficient land use More importantly BEPP requirements must be integrated with other existing local government planning tools, such the Integrated Development Plans, City Spatial Development Frameworks, Service Delivery and Budget Implementation Plans (SDBIP) and the budgets to avoid introducing additional layers of planning bureaucracy. Particular attention must be given to the quality of the BEPP and the underlying planning skills within municipalities to drive better urban settlement patterns.

2.7. **Incentive approach in terms of provincial conditional grants.** In the 2013 Division of Revenue Act the Commission welcomed the addition of clauses requiring provinces to plan infrastructure spending two years in advance as conditions for receiving health and education infrastructure grants. Allocations for 2015/16 with respect to direct health and education infrastructure grants were determined using those conditions. Requirements for the second year of planning towards 2015/16 allocations have been added into the 2014 Division of Revenue Bill. Requiring planning two years in advance is a welcome step towards enhancing grant performance and hence the Commission supports the new clauses. An important intention is not just to achieve greater revenue equity, but also to give priority to other objectives such as furthering all provinces' financial capacity, certainty and accountability and their operational efficiency and service effectiveness. This is notwithstanding conflicts between these service effectiveness goals and the equity objective which has been addressed in the 2014 Division of Revenue Bill by catering for existing provincial commitments in the 2015/16 allocations. Indirect education conditional grants such as the School Infrastructure Backlogs Grant should also be subject to similar planning processes.

3. National Fiscal Framework[1]

3.1. Table 1 shows the division of revenue amongst the three spheres of Government over the 2014 Medium Term Expenditure Framework (MTEF). Government tabled a total national budget of R3.3 trillion over the 2014 MTEF period to be spent amongst the three spheres Government. A significant portion of this allocation is directed at national (47.5 percent) and provincial level (43.5 percent), while the local government receives 9 percent of this allocation. Most municipalities fund the majority of their spending through charges and taxes.

3.2. Similar to the 2013 Medium Term Budget Policy Statement (MTBPS), a total of R1.4 trillion is allocated to provinces over the 2014 MTEF period. This represents a net increase of R12 billion when compared to the 2013 MTEF provincial baseline allocations. Increases in the provincial allocation are mainly to fund carry through costs of higher than projected inflation on the 2012 wage agreements; construction of facilities for substance abuse; new vaccine for papillomavirus; housing acceleration; infrastructure repairs due to floods and the increased cost of provincial bus services. Taking inflation into account, a real annual average growth of 1 percent is projected for the provincial allocation over the 2014 MTEF period.

3.3. The policy funding for local government are earmarked for the acceleration of the provision of bulk water and sanitation, promotion of more integrated and efficient cities

[1] The Commission's Submission on Fiscal Frameworks and Revenue made to the Standing Committee on Finance discusses in greater detail the testing macroeconomic and fiscal outlook as well as the volatile external economic environment that the fiscal framework has had to contend with.

and to build capacity for development of human settlements. Local government receives an allocation of R296 billion over the 2014 MTEF (R91billion in 2014/15, R100 billion in 2015/16 and R105 billion in 2016/17). Increases to discretionary funding to municipalities are aimed at funding delivery of basic services to poor households whilst funds to incentivise improved spatial planning particularly within metropolitan municipalities are being funded through conditional grants.

3.4. On the whole, the 2014 Budget is very much in line with the Commission's expectations expressed when it made submission on the 2013 MTBPS. Government has succeeded in pursuing fiscal discipline even more rapidly than was then anticipated. The 2013/14 fiscal deficit came in slightly lower than budgeted, at 4.0 percent of gross domestic product (GDP), compared with an original budget deficit of 4.2 percent of GDP. The explanation for this is that Government has not revised its forecast for 2014 economic growth down as sharply as anticipated at the time of MTBPS. It now sees 2014 economic growth coming out at 2.7 percent. The Commission's own projections based on a computable general equilibrium model suggest that validity of this assumption could only be realised when prospects of improved medium term growth in the global economy and the increased competitiveness for the productive side of the domestic economy arising from the 30 percent real depreciation in the Rand over the past two years are realised.

Table 1. Medium term expenditure framework division of revenue (R' billion)

Division of Revenue	2014 Budget	2013 MTBPS			Real Annual Average Growth Rate (2014/15-2016/17)
	2013/14 Revised	2014/15	2015/16	2016/17	
National Allocations	449.3	489.4	522.3	553.0	0.7%
Provincial Allocation	414.9	444.4	477.6	508.3	1.3%
Equitable Share	*338.9*	*362.5*	*388.0*	*412.0*	*1.0%*
Conditional Grants	*76.0*	*82.0*	*89.7*	*96.2*	*2.7%*
Local Allocations	83.7	90.8	100.0	105.2	2.0%
TOTAL	**1,362.8**	**1,469.1**	**1,577.6**	**1,674.7**	**1.5%**

Source: 2014Budget Review, Commission's calculations.

3.5. The important question arises as to how so much from a tax point of view could be afforded in the context of relatively low economic growth. The answer is readily discernible from the statement that real growth in expenditure is budgeted to amount to no more than two percent per annum over the next three years. To cater for increased spending pressures over the 2014 MTEF period, Government has reduced the contingency reserve allocation and reprioritised funding away from underperforming items with a specific focus on conditional grants.

3.6. This is a significant cutback on the growth of Government spending which had increased in real terms at a rate of around 9 percent per annum between 2003/04 and 2009/10. The functional classification of expenditure shows that overall growth in Government spending is set to average 7.6 percent per year in nominal terms over the next three years, but interest payments are set to grow by 11.2 percent per year and employment and social security expenditure by 13.1 percent per year. This illustrates the manner in which rising interest payments are crowding out all other forms of expenditure. For example, growth in expenditure on education is set at no more than 6.8 percent per annum, for health at 7.1 percent per annum, for defence at 6.0 percent per annum and for public order and safety at 6.0 percent. The Commission calls on Government to make all effort to stick to the parameters outlined in the budget to prevent further diversion of ever more resources towards paying the interest on public debt that it might accumulate. This is in line with previous Commission recommendations to ensure that that cuts associated with consolidation exert smallest possible negative impact on economic growth and maintain well targeted social spending to protect the vulnerable.

3.7. While the Commission applauds Government for the idea of setting an expenditure ceiling that has proven effective in controlling expenditure and maintaining stability for following periods, going forward Government should give guidelines on scope of the ceilings (e.g., will they apply to all expenditures or will there be exceptions and basis for that), setting of the precise level of the ceiling and assessment of whole of Government's performance against the ceiling and progressive realisation of constitutional mandates. Importantly, while expenditure ceilings have been guided by issuance of circulars and practice notes, the approach will need to be put in legislation such as the PFMA in order to avoid confusion between the output and outcomes based PFMA and the input controlling thrust of expenditure ceilings.

4. Provincial Fiscal Framework and Adjustments to Conditional Grants

Provincial Equitable Share

4.1. The 2014/15 provincial fiscal framework inclusive of conditional grants is revised downwards by R200 million which is reallocated mostly into indirect grants over the 2014 MTEF period. The 2014 Division of Revenue Bill proposes an increase to the provincial equitable share (PES) from the revised R338.9 billion in 2013/14 to R362.5 billion in 2014/15. The increase is earmarked to fund higher wage costs in the main. This could compromise equity in the system if some provinces are less willing to exercise control over their wage bill and end up taking proportionately more from the additional allocations provided. Furthermore, efficiency considerations would suggest that wage increases should be driven by productivity increases as suggested by the NDP to avoid a situation where more resources buy even fewer outputs.

4.2. Growth in conditional grants is projected to rise faster than the provincial equitable share mainly due to the provision of funding for flood damage caused during the first half of 2013 and the establishment of a new, two year grant aimed at funding the implementation of Occupation Specific Dispensation (OSD) for therapists in the education sector.

4.3. The data underlying the PES formula are updated to take account of the shifts in population reported in the 2013 October midyear estimates. The Commission notes the much smaller changes in the provincial weights compared to last year when the provincial equitable share formula was updated with Census 2011 data. The phasing-in of the changes in shares over the 2014 MTEF period is supported as it enhances greater stability of the system without significantly compromising equity considerations amongst provinces. The Eastern Cape Province experiences a 0.5 percent drop in its equitable share over this period. There is need for National Government to provide necessary strategic oversight support in order for the province to transition to its new allocation without disruptions to service delivery implementation.

4.4. The education component of the PES formula was updated with new enrolment figures. Gauteng, North West and Western Cape have increased their enrolment share as a result of higher enrolment numbers. Provinces that have experience a net decline in learner numbers are compensated for by partial phasing in of the data into allocations. The risk-adjusted sub-component for health has also been adjusted with updated data, with Kwazulu-Natal and Western Cape increasing their share of this sub-component by 0.3 percent.

PROVINCIAL CONDITIONAL GRANTS ADJUSTMENTS

4.5. **Human Settlements.** Over the 2014 MTEF, Government has identified priorities which include the 'Bucket Eradication Program' and 'Acceleration of Housing Programme in Mining Towns'. Government has decided to fund those priorities by making reductions to some grants that are underperforming. Accordingly, downward revisions to the Human Settlements Development Grant (HSDG) and Urban Settlements Development Grant (USDG) have been made. The HSDG will be reduced by R900 million over the MTEF despite the grant having performed well with an average spending from 2008/09 to 2012/13 financial years of around 98 percent. Downward adjustment in the grant is likely to negatively affect the delivery of housing in terms of units delivered per annum. The National Department of Human Settlements therefore needs to put in place some mechanisms to ensure that this downward revised allocation does not derail existing projects being carried by provinces. This is especially important in that previous Commission work indicated that the scale, pace and funding for housing provision falls short of existing housing demand and curbing growing backlogs.

4.6. A once-off amount of R180 million has been allocated to accelerate the upgrading of informal settlements in mining towns for 2014/15. This will help reduce informal settlements around mining towns. While these mining areas consist of people who predominantly work in mines together with their families, it should not be taken for granted that these households automatically prefer housing ownership in these mining towns as reality may differ from this assumption. Government should therefore consider rental options or a balanced mix in order to match supply and household preferences on the basis of well identified needs and preferences.

4.7. **Health Grants.** In the 2014 Division of Revenue Bill the Commission notes consolidation of the nursing colleges and schools grant introduced in 2012/13 into the health facility revitalisation grant. The 2012/13 amalgamation had led to three components of this grant which fall way according to the 2014 Division of Revenue

Bill. The Commission supports the rationale for consolidating these grants because they are all related to funding of construction and maintenance of infrastructure.

1. The National Health Insurance (NHI) Grant to fund pilot districts and test readiness of NHI roll out experienced weak spending performance in 2012/13. Only 52 percent of the grant was spent. Underspending on the grant was largely attributable to under preparedness of provinces and the NHI pilots. Furthermore, it is a common occurrence for newly introduced conditional grants to fail to spend allocated budgets fully in the first three years of implementation. This failure can be avoided by carrying out proper planning and needs evaluation analysis before conditional grants are introduced.
2. The NHI grant is complemented by the National Health Grant which is an indirect grant introduced in 2013/14 with 3 components:
    a. The first is the national insurance grant for district piloting. The Commission views this grant as duplication of the NHI grant. The grant also funds piloting of the districts for NHI roll out. There needs to be one grant that funds districts piloting (streamlining of grants which have same purpose) to avoid creating confusion in reporting lines and measuring what has been achieved by each grant. This component of the grant is based on a premise that national government can make pilot districts perform better. If the national government is not going to take over the current pilot districts and given the constitutional dispensation, it is necessary that a well-defined transition plan is laid out for management of districts by provincial governments.
    b. The second is the infrastructure grant intended to fund construction, maintenance, upgrading and rehabilitation of health infrastructure. This grant again has the potential of duplicating the functions of the health facility revitalisation grant as the objectives are the same. Therefore the Commission proposes streamlining all health infrastructure related grants.
    c. The third component is the Human Papilloma Virus (HPV). The Commission welcomes the introduction and the roll out of the HPV vaccine as HPV is the root cause for cervical cancer amongst women. The Commission is concerned, however, that the grant has too many objectives that may hamper effective attainment of intended outcomes. The Division of Revenue Bill indicates that the HPV vaccine would be funded under the National Health Grant for 2014/15 and 2015/16 and thereafter will be incorporated into the

PES. Proper financial planning and infrastructure is needed in relation to the roll out of such a critical vaccine. Funding the vaccine via the conditional grant and then phasing into the PES is unlikely to be sustainable given how expensive this vaccine is. In other countries such as Kenya the vaccine is funded through Public Private Partnerships (PPP). Government is urged to explore funding this vaccine through the PPP vehicle to enhance sustainability.

4.8. **Education Grants.** There is a new grant called ‘occupation specific dispensation’ for education therapists, counsellors and psychologists which funds costs of implementing the OSD agreement. The grant would be allocated for 2014/15 and 2015/16 after which it is phased into the PES. The Commission welcomes the funding of the OSD through the grant and this approach is in line with its 2012/13 recommendation that full cost of OSD implementation must be undertaken, with national government taking full responsibility for funding. Once this grant is phased into the PES, there would be need to ensure that provinces spend efficiently and that allocated budgets are not overspent on personnel at the expense of other priorities.

4.9. **Agriculture Grants.** The 2014 MTEF baseline allocation for the Comprehensive Agriculture Support Programme (CASP) increased by R209 million largely to implement the recently approved Fetsa Tlala strategy. The strategy is aimed at bringing a million hectares of productive land into operation by 2019 with the intention of creating 300 000 jobs. On aggregate though, agriculture grant allocations have declined largely due to under-performance on these grants. The main reasons for underperformance are poor planning, procurement challenges, late submission of business plans and skills deficit in some of the provincial agriculture departments. The view of the Commission is that the sector should explore how it can leverage private sector partnerships, better absorb available funds, improve coordination with other sector departments, quality of spending and remove existing duplication and cross-overs with other departments.

5. Local Government Fiscal Framework and Adjustments to Conditional Grants

Local Equitable Share

5.1. The local government equitable share (LES) allocation amounts to R147.6 billion over the 2014 MTEF. This translates to an average (real) growth rate of 10.4 percent. The Commission supports the increased resources afforded to municipalities in recognition of their service delivery responsibilities. It is also important that such increases are sensitive to the greater cost of delivering basic services whilst also recognising the potential squeeze on local government revenue sources due to volatile economic conditions.

5.2. The Commission supports improvements in the distribution of the LES funds to municipalities with the new formula and continues to engage Government in its capacity as a member of the technical task team that oversees and refines the formula.

5.3. The revised LES is a welcome departure towards revenue equity amongst municipalities. Equally important objectives include building financial capacity, ensuring certainty and accountability and, ultimately effective service delivery. Initiatives aimed at ensuring and strengthening financial capacity of municipalities are ongoing and include the Financial Management Grant, Municipal Systems Improvement Grant and more recently the Infrastructure Skills Development Grant. These all aim to ensure the development of critical mass of skills at the local level. Coherence and synergy between attempts at improving capacity is central and requires attention when one considers the various conditional grants and interventions underway.

5.4. With respect to stability and certainty, adherence to the concept of the MTEF, which enables organs of state to better plan their operations, should prevail. Whilst policy reprioritisations are natural and expected in a society sensitive to the needs of its people, it should be borne in mind that the shifting of focus should aim to be as smooth as possible with little disruptions to areas of existing good performance. In terms of the important aspect of accountability, the Commission is pleased to see a strong focus on eliminating corruption, a process that has already been actively pursued in municipalities such as Buffalo City, eThekwini and others.

5.5. In light of increased pressures on local government revenue sources due to increases in costs associated with higher demands for service delivery, and the manner in which general fuel levy is shared with metros, the Commission welcomes the review of own sources of revenue for metropolitan municipalities that is currently being undertaken. The Commission will continue to engage with Government in its capacity as a member of the task team.

5.6. Although various reviews of local government revenue instruments underway is a welcome development, the overall ability of these reviews to solve fundamental fiscal issues holistically, given that there remains uncertainties over the powers and functions of local government should be questioned. This includes the existence of unfunded mandates faced by local government and the uncertainties around the powers and functions of district municipalities relative to local municipalities. Having adopted the principle of "funding following function", it is difficult to design an appropriate revenue framework when ambiguities around function assignments still persist. The Commission is concerned that little progress has been made on the Department of Cooperative Governance's review of the local government functional and fiscal framework. This review needs to be concluded to ensure appropriate design and functioning of the local government fiscal framework. As part of this review, the Commission also recommends a review of Section 84 and 85 of the Municipal Structures Act which details the division of powers and functions between district and local municipalities and conditions under which adjustments to this division can occur.

Local Government Conditional grant adjustments

5.7. Conditional grants to the local government sphere increased from R34.3 billion in 2013/14 to R36.1 billion in 2014/15. One new conditional grant, the Human Settlements Capacity Grant, has been established in 2014.

5.8. Local government conditional grant funding over the MTEF period includes R131.6 billion in respect of infrastructure-related grants and R12.2 billion for capacity building grants. In terms of infrastructure grant allocations, direct grants to municipalities increase by R104.6 billion while indirect grants by R27 billion over the MTEF.

5.9. As with the 2013 Budget, the 2014 Budget makes downward adjustments to certain grants in order to redirect funding to priority areas (e.g. efforts to eradicate the bucket system). Over the 2014 MTEF period, these downward adjustments will affect grants such as the Municipal Infrastructure Grant (MIG) and the USDG. This is the second time that the MIG will see a downward revision in its allocation as a result of reprioritisation. The 2013 Budget Review indicated a R2.4 billion downward revision to the MIG. As part of the 2014 MTEF reprioritisation process, MIG is projected to decline by a total of R850 million over the two outer years of the MTEF. The USDG is set to decline by a total of R130 million over the 2014 MTEF period (R50 million in 2014/15, R45 million in 2015/16 and R35 million in 2016/17).

5.10. The Commission welcomes the prioritisation of the eradication of the bucket system but cautions that progress in this regard should not come at the expense of developments in other sectors. As a result, the Commission advises that the sector departments responsible for the MIG and USDG grants ensure that existing plans and projects being funded via these grants are not derailed as a result of the reduction in allocations.

5.11. With respect to the Rural Household Infrastructure Grant, a new development for 2014 MTEF is to divide the grant into a direct grant (for those municipalities deemed to have capacity to implement sanitation projects themselves) and indirect grant (for municipalities lacking capacity to implement sanitation projects on their own). While this development may be a good one in acknowledging differences between capacities of municipalities, the Commission is of the view that recipients of this grant are mostly rural municipalities lacking capacity to implement sanitation projects. Therefore the direct grant is unlikely to yield required results unless the department has done a comprehensive capacity assessment. The Commission therefore advises that allocations in respect of the direct component of this grant be based on an assessment of the capacity required within the recipient municipalities to successfully implement the program and fund the maintenance of the alternative sanitation service that replace the bucket system.

5.12. The Commission appreciates Government’s efforts to entrench a differentiated approach to funding municipalities. In this regard the Commission notes grants allocated based on varying levels of capacity. For example the Water Infrastructure Grant now contains both direct and indirect components whereby municipalities with capacity will (through the direct component of the grant), implement the grant themselves. With respect to recognising spatial differences, the Commission notes that the Neighbourhood Development Partnership Grant will, as of 2014, be split into two components focussing on urban areas on the one hand, and towns and rural areas on the other hand. Given how heterogeneous South African municipalities are, this differentiated approach to grant funding and implementation is a positive and welcomed development.

5.13. Capacity constraints still remain a concern that hampers the ability of local government to fulfil its service delivery mandate. The Commission has previously raised the general failure of capacity building grants and capacity building programmes in improving municipal performance. In this regard, government should consider a review of the capacity building grants and programmes in terms of its design, implementation and outcomes. Such a review is important given the numerous capacity-related interventions at the local level including the establishment of the Municipal Infrastructure Support Agency (MISA). The outcomes of such a review could assist in mapping out a more coordinated approach to capacity building and can serve to fine tune the role and subsequent impacts of grants vis a vis national interventions such as MISA. The challenge confronting the local government sphere is to generate greater improvements from the plethora of capacity interventions focussed on municipalities.

5.14. A Human Settlements Capacity Grant will be introduced in 2014. An amount of R900 million will be allocated over the 2014 MTEF period. The purpose of the grant will be to fund capacity related to the development of human settlements in cities. Given the imminent assignment of the human settlements function to certain municipalities, the Commission agrees with the need to build and strengthen capacity to undertake the function. The Commission however emphasises the need for coordination between this intervention and various other capacity-related grants and interventions so as to avoid unnecessary overlap and duplication with respect to capacity building at the local level.

5.15. The Commission welcomes the review of local government infrastructure grants that is currently being undertaken and reiterates its full commitment to working with other stakeholders in this process. This review is important given the greater demand for local infrastructure and the funding constraints faced by local government in rolling out such infrastructure. This is in line with the Commission's research that found a vertical fiscal gap in funding municipal capital expenditures. The Commission research highlighted the poor repairs and maintenance of municipal infrastructure and its potential repercussions for the long-term sustainability of local government. A proper system for ensuring adequate asset care should be central in the review of the conditional grant system. In reviewing these grants, it is important that the broader issues of governance and capacity be considered as this impact on successful implementation of any grant framework.

6. Government Responses to Commission Recommendations

6.1. The Commission tabled its *Submission for the Division of Revenue 2014/15* to Parliament in May 2013. As required by the IGFR Act, Government published its response to these recommendations when the Minister of Finance tabled the Division of Revenue Bill with the annual budget in the National Assembly. The recommendations by the Commission where structured into 13 chapters.

6.2. Chapter 1 and 3 of the Commission recommendations address issues relating to budget consolidation and funding of further education and training. Government agrees with Commission recommendations. In response to Chapter 1, Government further indicates that issues pertaining to consolidation or public sector wage bill moderation are primarily concerned with management of staff and remuneration policies. The Commission's view is that the issue is not only about personnel management but also requires Government to put in place norms and standards for managing personnel.

6.3. Owing to persistent poor design, spending and performance of conditional grants, Chapter 5 recommended that government legislate through the Division of Revenue Act mandatory consultation with the Commission when introducing and planning for conditional grants. Government supports the recommendation but proposes that the requirement to legislate the requirement not be followed as it feels that the IGFR Act and FFC Act appropriately provide for consultation with the Commission. The Commission maintains that requirements for proposing and introducing conditional grants, including consultation with the Commission, as per Section 214 (1) of the Constitution and the FFC Act. . New conditional grants are still introduced at the tail end of the budget process thus inhibiting proper planning and timely spending on the part of implementing spheres. The Commission's analysis indicates that part poor performance of conditional grants is largely attributable to poor grant design, poor preparations and lack of implementation risk management and its recommendations seeks to circumvent such problems.

6.4. The Commission welcomes Government's response to Chapter 7 wherein it supports the recommendation for an appropriate balance between wage and non-wage components. The Commission feels that norms for frontline versus administrative staff to total expenditure per sector and/or by specific occupational categories are of critical importance. The treasuries and sector departments as well as the Department of Public Service and Administration should collaboratively establish mandatory norms and standards relating to the functions of the public service, the organisational structures and establishments of department and other organisational and governance arrangements in the public service as required by Public Service Act (1994).

6.5. The Commission commends Government for taking active steps to reign in the public sector wage bill. Support provided in the form of costing and budgeting guidelines by National Treasury to assist institutions is welcomed. Nevertheless, the Commission notes with concern continued fiscal pressures being placed on provincial budgets by education and health functions largely due to cost pressures emanating from compensation of employees. The Commission would like to re-emphasize recommendations made previously on containing employee costs and the need for Accounting Officers to take responsibility to ensure a balance between frontline and back office staff, maintain affordable organograms and enhance employee productivity. There should be consequences for Accounting Officers who recruit outside of their approved establishment. Personnel information systems should also be improved substantially, especially given the adverse Accountant General human resources related audit findings.

6.6. With respect to Chapter 9 on effective intergovernmental planning and budgeting for better outcomes, Government is in support of the recommendation for explicitly aligning the budget process with the outcomes oriented delivery approach. The Commission welcomes the newly implemented functional budgeting approach to enhance collective planning, delivery and accountability. Going forward, it is important that the functions are aligned to the outcomes as per the respective service delivery agreements and not retrofitted between the outcomes.

6.7. Government support for recommendations of improving performance of municipalities through incentives based grants is welcomed. As discussed earlier, the 2014 Division of Revenue Bill proposes additional incentives for promoting spatial planning and integration through the Integrated Cities Development Grant. These incentives must be carefully institutionalised without being scattered across different grants.

6.8. Following on the agreement reached between the Commission and the Minister of Finance, Government has responded only to recommendations that are deemed directly or indirectly related to the division of revenue. The Commission's recommendations not only address issues pertaining to division of revenue but also other legislation enabling its constitutional mandate including but not limited to the Financial and Fiscal Commission Act and the Money Bills Amendment Procedure and Related Matters Act. The Commission would like to draw Parliament's attention in particular to Chapter 2 on economic and social value of social grants; Chapter 6 and 10 concerning assessing and improving the fiscal performance of provinces and measuring fiscal stress in local government; and Chapter 12 regarding challenges, constraints and best practices in maintaining and rehabilitating water and electricity distribution infrastructure. Recommendations contained in these chapters have an important bearing on fundamental constitutional principles upon which the division of revenue is determined and are necessary to maintain the sustainability of the intergovernmental fiscal system. The Commission invites parliament to note these important recommendations in dealing with the budget process.

7. Government Responses to Standing and Select Committees on Appropriations Recommendations

7.1. Government has tabled responses to recommendations by Standing and Select Committees on Appropriations as they relate to the division of revenue. The Commission has been requested to comment on these responses.

7.2. **Priorities in provincial and municipal budgets**. The Commission agrees with the proposals and Government's responses to ensure that provincial and local government reflect national priorities in their budgets and the weighting attached to the various components of equitable share formulae. Alignment between budgets and priorities must be fostered through established intergovernmental forums and through active and robust consultative processes of setting priorities.

7.3. **Avoiding unnecessary rollovers in health grant.** Government indicates that the shifting of funds between different components of conditional grants is necessary to prevent under-spending and thus address the Committee's concern regarding potential unnecessary roll overs. The real issue for the Commission here is readiness and capacity of grant recipients to spend additional funds, perpetuating service disparities and restricting flexibility. While shifting of funds is necessary to expedite implementation, care should be exercised not to undermine the importance budgetary planning and spending as planned.

7.4. **Addressing sanitation backlogs.** The Committee recommends that shifting of funds away from Municipal Infrastructure Grant should not compromise delivery of sanitation services. Government is of the view that the creation of Municipal Water Infrastructure Grant and the new bucket eradication grant will fast track delivery of sanitation services. The Commission's view is that the grant framework should tighten the conditions to ensure that there is accountability in ensuring that the objectives are met within a predetermined timeframe and an exit strategy is put in place.

7.5. **Monitoring of Free Basic Services.** The Committee's recommendation that National Treasury and other relevant national departments should monitor provision of Free Basic Services (FBS) is welcomed by the Commission. This should be done in conjunction with improvements in the Monitoring and Evaluation systems of municipalities and the Department of Cooperative governance.

7.6. **Grant Design.** With respect to building the capacity of national departments to design and monitor conditional grants, the Commission is of the view that sector departments do not commit to effectively resourcing the design of grants and performance monitoring as Government indicates in its response.

7.7. **Support for municipalities on maintenance.** In response to the Committee's recommendation about budgeting for infrastructure repairs and maintenance, government indicates that a standard norm of eight percent of total operating expenditure for maintenance is enforced. International best practice calls for maintenance spending to be informed by the nature and condition of an asset as well as the risk appetite and asset failure information that a municipality has at its disposal.

7.8. **Provincial expenditure.** The Commission agrees with the Committee recommendations to ensure that provincial treasuries improve their projections and expenditure monitoring. Provincial treasuries mainly require appropriate staffing to carry out the functions described in the PFMA.

8. Conclusion

8.1. The Commission is in agreement with the overall thrust of the 2014 Division of Revenue Bill. Against a background where economic growth forecasts have been downgraded, Government has succeeded in sustaining a deficit reduction programme.

8.2. The thrust of several clauses and provisions that have been included in the 2014 Division of Revenue Bill to institutionalise better planning for infrastructure at provincial level and drive towards compact and integrated cities is supported. The requirements balance appropriately achievement of greater revenue equity and other competing objectives such as furthering financial capacity, certainty and accountability and their operational efficiency and service effectiveness. This is notwithstanding conflicts between these service effectiveness goals and the equity objective which has been addressed by catering for existing provincial commitments in the 2015/16 allocations.

8.3. The Commission notes the increased frequency with which functions are being moved around between provincial, local and national government without consulting the Commission and with poor baselines.

8.4. There is also concern with the presumption that centralizing functions to national will solve problems automatically as shown by the massive increase in indirect grants. It should not be taken for granted that indirect grants would always be the appropriate instruments for dealing with weaknesses of conditional grants and government delivery systems. Often weaknesses in conditional grant spending are due to faulty grant design and the Commission has offered to provide assistance to Government in the design of new conditional grants from conceptualisation phase.

For and on behalf of the Financial and Fiscal Commission

Mr Bongani Khumalo

Acting Chairperson/CE