Report of the Select Committee on Appropriations on the proposed division of Revenue and Conditional Grant Allocations to Provincial and Local Spheres of Government as contained in the 2014 Medium Term Budget Policy Statement, dated 26 November 2014

In compliance with Section 6(10) of the Money Bills Amendment Procedure and Related Matters Act 9 of 2009, the Select Committee on Appropriations, having considered the 2014 Medium Term Budget Policy Statement and having heard comments from stakeholders, reports as follows:

1. Introduction

The Minister of Finance (the Minister) tabled the Medium Term Budget Policy Statement (MTBPS) on 22 October 2014, outlining the budget priorities of government for the medium term estimates. In terms of the Money Bills Amendment Procedure and Related Matters Act No 9 of 2009 (herein referred to as "the Act"), committees on appropriations are required to consider and report on the proposed division of revenue and conditional grant allocations to provincial and local government as contained in the MTBPS. The report of the Select Committee on Appropriations as per Section 6(10) of the Act must contain the following; as referred to it in terms of Section 6(8):

- The spending priorities of national government for the next three years;
- The proposed division of revenue between the different spheres of government and between arms of government within a sphere for the next three years; and
- The proposed substantial adjustments to conditional grants to provinces and local government, if any.

2 Fiscal and Economic Outlook

The proposed division of revenue and conditional grant allocations are made during the need for sustainable public spending due to the current weaker economic environment and poor economic outlook. For this reason, growth projections have been revised downwards in the MTBPS to 1.4 per cent from 2.7 per cent in 2014, to 2.5 per cent from 3.2 per cent in 2015, and to 2.8 per cent from 3.5 per cent in 2016.

The weaker economic environment and outlook is due to both external and internal factors. The external factors include the slowdown in the Eurozone, vulnerability of capital flows and the cooling down of the Chinese economy. The internal factors include among others supply shocks in electricity and water as well as labour-related disturbances such as prolonged labour strikes in the mining and postal services.

The National Treasury empahsisedthat if public debt is to be kept below unsustainable levels, fiscal consolidation can no longer be postponed. For this reason the MTBPS proposes lowering the expenditure ceilings for the first two years of the 2015 MTEF by R10 billion and R15 billion, respectively.

The fiscal policy measures proposed to moderate expenditure growth are coupled with tax reforms that are aimed at increasingrevenue to improve the fiscal position by R22 billion in the 2015/16 and R30 billion in the 2016/17 financial years, respectively.

3. Medium Term spending proposals

Over the next three years, government proposes an expenditure growth of 7.6 per cent which will take the consolidated expenditure from R1. 344 trillion in the 2015/16 financial year to R1. 553trillion in the 2017/18 financial year. Government proposes to place significant resources for the 2017/18 financial year into an unallocated reserve as a buffer against economic and fiscal shocks. This amounts to R45 billion, a portion of which can also be used to fund high-impact programmes.

Considering only the allocated funds, the fastest-growing function is post-school education and training, with average annual growth of 8.5% over the 2015 MTEF. Basic education has a proposed allocation of R640 billion over the 2015 MTEF period. The post-school education and training

proposed allocation is R192 billion. Almost R500 billion will be allocated to health. Government proposes to allocate just under R500 billion to social protection for social grants. The allocation to defence, public order, and safety will reach R193 billion in the 2017/18 financial year. Economic infrastructure and network regulation will be allocated R227 billion over the next three years. Government proposes to shift funds from existing road allocations at provincial and national level to the Moloto Road project. Funding for local development and social infrastructure is expected to total R630 billion over the next three years.

Industrial development, trade and innovation will be allocated R214 billion over the next three years. Expenditure on incentive accounts for onethird of overall spending in this function group. Tax rebates supporting industrial development amount to about R20 billion per year over the MTEFperiod. A sum of R206 billion has been budgeted for employment, labour affairs and social security funds over the next three years. Government has proposed a medium-term allocation of about R35 billion for rural development and land reform. Government is expected to allocate R1.1 billion for the reopening of land claims. Government will spend R30 billion to promote arts, sport, recreation and culture. The baseline allocation for general public services amounts to R208 billion.

The total expenditure by economic classification indicates relatively rapid growth in spending on state debt costs, transfers to households, the acquisition or construction of capital assets, and transfers to provinces and municipalities.

4. The proposed division of revenue

Division of Revenue	2014 MTBPS			Real Annual Average Growth Rate (i.e. Nominal- CPI Inflation) (2015/16-2017/18) %
	2015/16 R billion	**2016/17 R billion**	**2017/18 R billion**	
National allocations	**523.1**	**553.2**	**585.0**	**0.2%**
Provincial allocations	**468.5**	**496.8**	**527.0**	**0.6%**
Equitable share	383.0	405.6	429.3	0.5%
Conditional grants	**85.4**	**91.2**	**97.7**	**1.4%**
Local government allocations	99.2	103.9	110.0	1.0%
Equitable share	50.2	52.9	55.5	2.1%
General fuel levy sharing with metropolitan municipalities	10.7	11.2	11.8	-0.6%
Conditional grants	38.4	39.8	42.7	0.00
Total allocations	**1 090.8**	**1 153.9**	**1 222.0**	**0.5%**

The above table shows that the budget available for sharing between the three spheres was projected to increase from R1.09 trillion in the 2015/16 financial year to R1.2 trillion in the outer year. Over the MTEF period, the division of revenue amongst the three spheres is projected to grow by a real annual average of 0.5 per cent.

5. The proposed provincial government funding and conditional grants

Over the next three years, provinces will be allocated R1.49 billion. Of this amount, 81.6 per cent will take the form of the provincial equitable share and 18.4 per cent will be conditional grants transferred by national departments. The baseline for equitable share transfers to provinces will be reduced by R2.6 billion in the 2015/16 and R4 billion in the 2016/17 financial years, with baseline allocations for direct and indirect conditional grants reduced by R1.8 billion and R2.6 billion in those years. National government has made a commitment to work with provinces to ensure that spending adjustments do not disrupt front-line services.

Government reported that personnel-related expenditure was the largest category of spending in provinces (62 per cent in the 2014/15 financial year) and that tight management of compensation spending will be essential to improve efficiency. Government further highlighted that savings in this line item could be achieved by reducing non-core staff and by ensuring the recruitment and retention of appropriate skills. Further emphasis will be placed on achieving efficiencies in goods and services budgets. Provinces will be encouraged to identify areas where efficiency can be improved from expenditure reviews undertaken by the National and Provincial Treasuries, as well as reforms driven by the Office of the Chief Procurement Officer.

Government is also phasing in an incentive-based funding approach. The approach will promote more efficient delivery of infrastructure for schools and health facilities. The first allocation will be awarded in the 2015/16 financial year, on condition that provinces' performance meet planning requirements. Support is, however, still being provided to those provinces that are not yet meeting the required standards.

6. The proposed local government fundingand conditional grants

Following years of rapid growth in the value of local government transfers, the rate of growth will moderate over the period ahead. Over the MTEF period, transfers to local government will total R313 billion. Of this, 61.4 per cent will be in the form of unconditional allocations such as the equitable share and the sharing of the general fuel levy. The local government equitable share continues to fund the cost of providing free basic services to the approximately 59 per cent of households with incomes below the value of two old-age grants. Greater emphasis will be placed on ensuring that free basic services reach all poor households.

The remaining 38.6 per cent is allocated through conditional grants. The lower expenditure ceiling means that baseline allocations for local government conditional grants will be reduced by R920.6 million and R1.4 billion in the 2015/16 and 2016/17 financial years, respectively. National Treasury is leading a collaborative review of the local government infrastructure grant system, intended to make evidence-based reforms that maximise value for money from existing resources while improving the sustainability of the system and the assets created. The review will continue in 2015, but has already produced proposals for reform in the following areas:

- Rationalising the number of grants, with greater differentiation in the types of grants and accompanying levels of oversight for different types of municipalities;
- Life-cycle asset management to sustain the functionality of existing infrastructure;
- Strengthening administrative oversight to avoid *ad hoc* proliferation of grants; standardising reporting to increase accountability; and improving monitoring and benchmarking of performance.

The details of how these reforms will affect the grant system will be refined in 2015 and implemented over the course of the 2016 MTEF period.

The structure of local government financing continues to follow a differentiated approach in responding to the different capacities and obligations of urban municipalities, which raise up to 80 per cent of their own revenues, and rural municipalities, some of which rely on transfers to fund up to 80 per cent of their budgets.

7. Observations

While considering and deliberating on the 2014 MTBPS and submissions by stakeholders, the Select Committee on Appropriations observed the following:

7.1 Government has reduced the expenditure ceiling and baseline allocations for direct and indirect conditional grants that showed under-spending. The reduction of the expenditure ceiling will however not affect the provision of services. Moderate real growth in spending will enable government to finance most medium term strategic framework priorities.

7.2 Government's expenditure will remain focused on social services with about 42 per cent of allocated spending over the MTEF period going to social services. On the other hand, government adopted a deficit-neutral approach in financing state-owned entities.

7.3 Government proposes to shift funds from existing road allocations at provincial and national levels to the Moloto Road project.

7.4 Over the next three years, the Office of the Chief Procurement Officer will rollout a new national approach to procurement as a cost-cutting measure.

7.5 The National Treasury is leading a collaborative review of the local government infrastructure grant system. It aims to make evidence-based reforms that maximise value for money from existing resources, while improving the sustainability of the system and the assets created.

7.6 The National Treasury has indicated that the North West Province's request for disaster funding for the Matlosana Local Municipality is receiving attention and might be accommodated either within the 2015/16 Budget or the 2015 Division of Revenue Amendment Bill.

8. Recommendations

After considering and deliberating on the 2014 MTBPS and submissions by stakeholders, the Select Committee on Appropriations recommends as follows:

8.1 Reduction of grants and reprioritisation of such funds should be used as an interim measure while efforts are made to improve efficiency in grant spending.

8.2 Efforts to minimise financial support to state-owned entities should avoid unintended consequences such as rewarding under-performing entities while constraining performing ones in their attempt to expand their capacity to fulfil economic and developmental mandates.

8.3 National Treasury should be commended for swiftly responding to the previous Committee recommendation to fund the Moloto Road Project. The Committee further notes that the reprioritisation of the funds and trade-offs made were due to the current financial constraints.

8.4 In addition to Central Procurement of certain services as a cost-cutting measure the National Treasury should explore other cost-cutting avenues such as the use of shared services, better land and property utilisation, reducing printing costs, reducing advertising costs, and using video conferencing instead of travel.

8.5 The National Treasury should expedite its processes so that the request for disaster allocations in the Matlosana Local Municipality can be funded during the 2015/16 Budget.

8.6 Capacity to spend should be a determining factor when grants are designed and introduced to avoid under-spending that might lead to the unnecessary conversion of grants at a later stage or unnecessary roll-overs or poor maintenance of such assets and infrastructure.

8.7 Municipalities should take measures to improve their multi-year planning with regard to the Municipal Infrastructure Grant, as required by the grant framework.

8.8 Having considered the 2014 Medium Term Budget Policy Statement and submissions made by stakeholders, the Committee reports that it has agreed to the proposed division of revenue and conditional grant allocations to provincial and local government, as contained in the 2014 Medium Term Budget Policy Statement.

Report to be considered.