

**Public Hearings on the Draft Money Bills Amendment
Procedure and Related Matters Bill, 2008**

***Submission to the Portfolio Committee on Finance
National Parliament***

Compiled and presented by

Applied Fiscal Research Centre (AFReC) (Pty) Ltd

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1. Introduction

We thank the Chairperson of the Portfolio Committee on Finance for inviting AFReC to make a submission on the Draft Money Bills Amendment Procedure and Related Matters Bill of 2008.

AFReC welcomes this Bill, which gives effect to the Constitutional intent for a role for Parliament not only in overseeing the execution of the budget, approving it and enacting it into law, but also in contributing to budget prioritisation. It is encouraging to note that the legislative arm of government acts on its constitutional oversight and accountability mandate by introducing the above-mentioned Bill. AFReC notes with approval that the Bill accords with the recommendations AFReC made in 2000 to introduce a phased approach to the budget process with parliamentary oversight at each stage (please see Appendix 1).

There are, however, a few general issues which should be borne in mind in the specific phrasing of the Bill, and subsequently in its implementation. These are explored below.

2. General issues

2.1 *Distinguishing between macro-economic forecasts and policy targets*

Distinction should be made between macro-economic forecasts (e.g. in relation to expected growth, current account balance etc) and fiscal policy targets (planned aggregate taxation, expenditure and borrowing). The former is a technical exercise dependent on modelling the relationship and evolution of various economic variables. The latter are policy decision variables, which respond to macroeconomic forecast.

2.2 *Enhancing credibility of macroeconomic forecasts through independent validation*

Macro-economic forecasts should ideally be validated by an independent organisation. This is considered good practice internationally and has already been recommended by the International Panel on Growth (chaired by Ricardo Hausmann) in 2007, by the Financial and Fiscal Commission (FFC, 2007), and by local academics (Du Plessis & Boshoff, 2007). These macro-economic forecasts are technical, not policy related, yet they provide the anchor for fiscal policy related choices relative to aggregate taxes, borrowing and expenditure. Forecasts are by their very nature uncertain. Yet

systematically inaccurate forecasts can create fiscal risk for government (such as potential over or under-spending relative to actual revenue collected).

2.3 Suggestion: fiscal rules framework for considering budgets

The challenge facing the legislature is to balance fiscal responsibility with the need to ensure that budgets are pro-poor, progressively realise the socio-economic rights conferred in the Bill of Rights and respond to other priorities such as HIV/AIDS. Most legislatures define for themselves the parameters within which they will operate on the budget (e.g. that additional expenditure should be matched by increased taxes). This promotes time-consistency and ensures that budget trade-offs are made in the present, rather than burdens systematically been borne by future generations in the form of debt. The Constitution (section 230) itself adopts certain fiscal rules (e.g. the so called “golden rule” which permits borrowing for capital assets but not for current consumption).

AFReC suggests that Parliament defines for itself a framework for considering budgets, which should at least identify fiscal rules, such as running balanced budgets. It has been argued by leading fiscal economists that fiscal rules are desirable when economies are vulnerable to adverse exogenous shocks, and if macroeconomic policy is mostly unable to stabilise the level of economic activity (Calitz & Siebrits, 2002). On the first point, it is widely held that South Africa’s small open economy made it quite susceptible to exogenous shocks, as was witnessed with the international financial crises of 1999 and the oil price shock of 2007/08. The second point could be of a more debatable nature, although government planners would probably concede that our macroeconomic growth patterns of the last five years were largely driven by exogenous international capital and commodity flows, as opposed to the effects of the increased public infrastructure and social welfare expenditure, to name but two prominent government interventions.

It has also been argued that fiscal rules deter overly-activist and populist budget choices that politicians may be incentivised to enter into, with detrimental long term economic effects (Von Hagen, 2002). With clear fiscal rules in place, for example referendum requirements for drastic tax hikes, elected politicians are restricted in their variety of budget choices, which would contribute to fiscal discipline. Numerical fiscal rules is widely in use in Brazil; rules include for example limits to the number and size of proposed individual and collective amendments that can be proposed by politicians (Santiso, 2005). Even though Brazil has a presidential government system, which is not fully comparable with South Africa’s parliamentary system, Brazil is an example of the increasing precedence for developing countries to implement fiscal rules

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Although AFReC does not intend to prescribe any specific fiscal rule, the following criteria should at least be considered when formulating a fiscal rule framework:

- In general, criteria for fiscal rules should address constitutionally mandated outcomes for budgets, notably *efficiency (both allocative and operational), effectiveness, economy, and transparency*.
- Adopting so-called “*golden rules*” of international best practice, for example diligently running balanced budgets, and only borrowing nationally for capital expenditure, not operational expenditure.
- Amendments to departmental budgets should amount to *zero sum gains and losses* for the affected departments and programmes. In other words, increased allocations to a particular department would be accompanied by decreased allocations to other departments or programmes.
- Fiscal rules should be *internally consistent*, i.e. different measures to amend budgets should still be consistent with the desired outcomes such as efficiency, effectiveness, economy, and transparency.
- Fiscal rules should be *time consistent, i.e. original budgetary commitments should not be tinkered with unless there are* compelling economic arguments, or there exist significant alternatives to current programme structures and service delivery methodologies.

Even if Parliament does not elect to implement any particular fiscal rule, good fiscal governance requires that it fully understands and articulates publically, its rationale for changing the executives fiscal framework, the various options open to it, the compelling nature and consequences for the economy flowing from the preferred option (on macro and micro equity and efficiency). These should be extrapolated for the short, medium and long term.

2.4 The importance of broad consultation before proposing amendments

The Bill does not make provision for extensive consultation. The requirement for consultation should be strengthened in order to ensure that any change can indeed be implemented effectively. For instance, any change which requires a variation in the tax rate or base should entail extensive engagement with SARS. Similarly, macro-

prioritisation changes where the budget of one line department is increased and another decreased should entail significant interaction with both organs of state to ensure that the implications of any changes are fully understood, and the attendant risks well managed.

2.5 *Circumspect use of amendment provisions*

Invoking Parliament's ability to amend the budget should be seen as a last resort measure once all other avenues have been exhausted (e.g changes with the MTEF period rather than in the appropriation itself). There should be a compelling rationale for why the anticipated benefits of an amendment (in terms of improved allocative and operational efficiency, fiscal discipline, or fiscal accountability) would outweigh possible disruption emanating from changes introduced at the tail end of an 18 month budget process. Parliament, in motivating any amendment, should consider how risks such as potential absorption capacity by organs of state, potential underspending and rollovers could be avoided. The budget tends to be characterised by fiscal rigidities (due for example to personnel wage structures which are centrally bargained, social grants whose entitlements are set in legislation, multi-year contractual obligations etc). This leaves very little fiscal discretion for changes in the short term (a one year horizon).

3. Specific issues

This section speaks to specific issues relating to the drafting of the Bill itself.

3.1 *Refining the definition of 'fiscal framework'*

The definition of 'fiscal framework' (under Section 1: Definitions) is tautological and unenlightening. AFReC suggests the following more useful definition by the United Nations Development Program:

“‘Medium-term Fiscal Framework’ is a 3-year, rolling forecast of key macro-fiscal aggregates such as tax/GDP ratios, current and capital spending and the fiscal deficit. It draws on the overall ‘Macroeconomic Framework’ which provides forecasts of relevant macroeconomic variables such as growth, inflation, etc.” (UNDP, 2007)

3.2 *Institutionalisation of fiscal coordination*

Consultation with the National Treasury and the FFC should be institutionalised, i.e. the Bill should specifically require that the proposed Committee should consult these institutions. Furthermore, the proposed Committee should also consult the line

departments affected by the changes in budget envelopes in order to establish their respective absorption capacities. Notably, Section 7(4) may have to be changed to broaden the consultation basis.

3.3 Suggested change to Section 5: inclusion of “medium”

Sections 5(1) and 5(2) of the Bill should be rewritten to read “*medium* term statements.” AFReC contends that with this addition (i.e. reference to the best practice of three year rolling forecasts) the medium term nature of these mentioned plans is made explicit and would allow for better oversight and subsequent decision making.

3.4 Suggested change to Section 7(9): inclusions in the Report

The Report required by Section 7(9) of the Bill should also indicate the medium term fiscal impact of the proposed amendment(s) on at least the fiscal framework, division of revenue and departmental allocations. The Report must outline a reconciliation of the proposed amendment(s) to the budget relative to the initial proposals from the Ministry. Section 7(9) should also explicitly note the list of stakeholders who should be consulted when considering the amendments. This point relates to the institutionalisation of fiscal coordination described above and the suggestion to change Section 7(4) to include consultation of all major stakeholders that would be affected by changes in expenditure and revenue allocations.

Important issues to be consulted on may also have to be listed explicitly. These should at least include changes in revenue and expenditure allocations, but also projected national borrowings so as to provide forecasts for deficit funding costs.

3.5 Suggested change to Section 7(14): clarification in terms of PFMA

Section 7(14) of the Bill should be reconsidered and perhaps changed to take into account Section 29 of the Public Finance Management Act (No.1 of 1999) (PFMA), which allows for the withdrawing and spending of money from the National Revenue Fund for the purposes of services of the state before the relevant budget has been passed.

3.6 Establishment of a budget office: need for independence and capacity

The establishment of a dedicated Parliamentary Budget Office is an absolute prerequisite for effective legislative engagement with the budget process. It is in line with international tendencies for legislatures to increasingly exercise oversight over budget processes (Schick 2002). World Bank literature indicates that independent budget offices enhanced the quality, transparency and clarity of public budgeting, thereby enhancing the

credibility of government in general. However, the Parliamentary Budget office's mandate and performance criteria may need to include an explicit focus non-partisanship and objectivity, without which the budget office would not be able to function independently (Johnson & Stapelhurst, 2007). Coupled with the need for independence is the importance for clarity on the roles and responsibilities of Parliament, Ministers/Members of Executive Councils (MeCs), and Accounting Officers (AOs), i.e. in terms of the separation of state powers. This is necessary to relieve the tension between the Parliament's oversight function and its ability to amend budgets, since clear distinctions in roles and responsibilities help to avoid incentives for Parliament to micro-manage the Executive. To this end, AFReC for example noted that a lack of clear separation between legislative and executive powers in municipal councils often problematised the implementation of the Municipal Finance Management Act since 2004.

The Parliamentary Budget Office has to be established with sufficient capacity and resources to engage with the National Treasury and the provincial treasuries, and other executive stakeholders in a technically credible manner. Because these skills are in such short supply, Parliament must be prepared to invest heavily in the relevant human resources and other forms of capacity. Fiscal analysts in the Parliament Budget Office should have both operational public expenditure management experience and the requisite conceptual, analytical and modelling skills.

Furthermore, it should be borne in mind that many of the institutional constraints confronting the executive will also confront legislative budget analysts. For instance, if the executive's monitoring and evaluation systems are weak, then the parliamentary budget office will also be challenged by unreliable and outdated financial information and incomplete and inaccurate information on service delivery outputs and the outcomes and impacts on communities.

4. Summary of recommendations

General:

1. The Bill needs to distinguish clearly between macro-economic forecasts and fiscal policy targets.
2. Macroeconomic forecasts should ideally be validated by an independent organisation or commission.
3. Parliament should adopt a fiscal rules framework for considering budgets, which should include consideration of criteria targeting efficiency, effectiveness, economy, transparency, zero sum gains and losses, internal consistency, time consistency, and broad stakeholder consultation.
4. The requirement for consultation should be strengthened in order to ensure that any change can indeed be implemented effectively in the upcoming fiscal year.
5. Parliament should exhaust all reasonable avenues before amending budgets.

Specific:

6. The Bill's definition of 'fiscal framework' should be refined to include reference to rolling 3-year forecasts of key macro-fiscal aggregates.
7. Sections 5(1) and 5(2) of the Bill should be rewritten to read "*medium term statements.*"
8. The Report outlined in Section 7(9) should include the medium term fiscal impact of the proposed amendments, and an outline of the reconciliation of the proposed amendments relative to the initial proposals from the Ministry. Section 7(9) should also explicitly note

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the list of stakeholders who should be consulted when considering the amendments.

9. The Parliamentary Budget Office needs to be adequately resourced and capacitated.
10. The Parliamentary Budget Office's mandate and performance criteria may need to include an explicit focus non-partisanship and objectivity in order to protect its independence.

5. References

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Appendix 1

Public Hearings on the *Division of Revenue Bill 2000*

Submission to
The Select Committee on Finance

Compiled and presented by

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10 March 2000

AFReC

APPLIED FISCAL RESEARCH CENTRE

1 Introduction

We thank the Chairperson of the Select Committee on Finance for inviting AFReC to make a submission on the *Division of Revenue Bill* and the *Explanatory Memorandum* that accompanies this Bill (Annexure E in the *Budget Review 2000*).

It is a fact that the budget process has become more transparent in recent years. It is therefore encouraging to see that this is being sustained and improved upon. As we noted last year the *Explanatory Memorandum* is well presented and informative. Indeed the Department of Finance needs to be complemented on it. However, in our view there are a number of issues that either still need to be addressed or should be brought to the attention of the honourable members of the Select Committee on Finance. These include:

- The power to amend the *Division of Revenue Bill*;
- The timing of the tabling and parliamentary debate of the *Division of Revenue Bill*;
- The kinds of information that underpin the division of nationally collected revenue;
- Changes to the current division of nationally collected revenue; and
- Formula allocation on the basis of actual costs of service delivery versus the use of proportions;

These issues form the focus of the rest of this submission.

2 The power to amend the *Division of Revenue Bill*

The *Division of Revenue Bill* is a Section 76 Bill. The NCOP and the National Assembly therefore have the power to amend it. It is important to note that because the *Division of Revenue Bill* is **not** a money Bill, the Act of Parliament that is required in terms of Section 77(2) of the Constitution to provide for a procedure to amend money Bills does not have to be in place before Parliament can exercise this power.

In other words, Parliament (and therefore the NCOP) can in principle amend the Division of Revenue Bill that is currently before it in the same way as it would amend any other Section 76 Bill before it.

(Note: the Division of Revenue Bill is not a money Bill as it does not appropriate money or impose any taxes, levies or duties. It simply provides for the division of nationally collected revenues between the different spheres of government where it is appropriated by the relevant legislatures or local councils.)

3 The timing of tabling undermines Parliament's power

In our view the provision in Section 10(1) of the *Intergovernmental Fiscal Relations Act of 1997 (IGFR Act)* which requires the Minister of Finance to introduce the *Division of Revenue Bill* together with the *National Budget*, in fact, undermines Parliament's power to make amendments to the aforementioned *Bill*.

This is because the *Division of Revenue Bill* is the foundation on which the *National Budget* and provincial budgets are built. Therefore for Parliament to make amendments to the *Division of Revenue Bill* at this late stage in the budget process would be disastrous for the overall integrity

and coherence of government budgeting. Literally months of careful planning could be undone, considered expenditure trade-offs could be nullified and preparations to implement certain policies could be undermined. Not least of all, the Government's difficult task of maintaining fiscal discipline while ensuring effective delivery could become infinitely more difficult.

It is against this background that AFReC offers the following analysis of the current budget process and makes proposals as to how the process could be changed so as to allow Parliament to exercise its constitutional powers responsibly and effectively.

1.1 Budgeting in South Africa is currently a three-stage process

In practice, the current intergovernmental budget process can be broken down into three interrelated stages:

- (1) First, there is the division of revenue between the spheres of government. The initial proposals for this division are based on the first draft of the consolidated MTEF, which is considered by the extended Cabinet in about July each year. The indicative division of revenue set down in this meeting informs the next stage of the budgeting process. The actual division of revenue, however, only becomes fixed with the enactment of the *Division of Revenue Bill*;
- (2) The indicative division of revenue determines the resource envelopes available to the national and provincial governments for allocation to departmental clusters and departments. The determination of indicative allocations for each department reaches an advanced stage with the compilation of the respective national and provincial MTEFs, and the submission of the consolidated draft MTEF to the Budget Council in mid-October. The publication of the *Medium Term Budget Policy Statement* outlines the indicative allocations across functions and sets the scene for the final stage in the budgetary process.
- (3) Once the indicative allocations for each department have been set, each department has to adjust its various programme budgets so as to keep within the resource envelope made available to it. This process culminates with the presentation of the various budgets to Parliament and the respective provincial legislatures.

As noted above because the *Division of Revenue Bill* and the *National Budget* are tabled together, Parliament has to consider the outcomes of each of the above stages simultaneously. Consequently, there is little scope for it to propose changes to the outcomes of the first two stages, including making amendments to the *Division of Revenue Bill*. In our view the current procedure in fact reduces the *de facto* role of Parliament with regards to the *Division of Revenue Bill* to that of a rubber stamp. Any changes at this late stage would impinge on the integrity of the Budget.

1.2 A three-stage process for passing the Budget

Given the above mentioned budget process, AFReC proposes that Parliament should approve each stage in the budget process prior to the next stage of budgeting commencing. This would suggest a three-stage process:

- (1) Around July: Parliament could be presented with and approve an indicative division of revenue between the spheres of government and between the provinces/local governments (this would be a precursor of the final *Division of Revenue Bill*);
- (2) Around October: Parliament could be presented with and approve broad indicative allocations for each national department or cluster of departments. Provincial legislatures could be presented with similar allocations for each provincial department.

February: Parliament would be called upon to approve the final *Division of Revenue Bill*, and the *National Budget* which would give details of department's programme expenditures and

(1) service delivery outputs. Provincial legislatures would also be presented with final provincial budgets.

The procedure described above for purposes of illustration would give Parliament the scope to exercise its powers over the division of revenue and over the budget proposals suggested by Government at each stage in the budget process. In other words there would be a step-wise firming up of budget totals. Each time Parliament approves a set of indicative allocations, the next stage of budgeting by Government would have to take place within the prescribed resource envelope. By the same token, Parliament would be bound to maintain previously approved totals when proposing any amendments in subsequent stages. Government may be allowed to present amendments to the previously approved allocations when the final *Division of Revenue Bill* and the *National Budget* are presented to Parliament in February. However, the rationale for such changes would have to be clearly spelt out, and would in all likelihood have to relate to the need to respond to changes in economic circumstances.

AFReC recommends that Parliament should seriously consider amending the *IGFR Act* so as to reorganise the budget process along the lines set out above.

1 Information to be included in the *Explanatory Memorandum*

At last year's public hearings on the *Division of Revenue Bill*, AFReC outlined a number of crucial areas where the Ministry of Finance should give more information in the *Explanatory Memorandum* both in the interests of greater transparency and to foster greater parliamentary and public debate regarding the budget process and the actual budget outcomes. We based our call for further information on Section 10(5) of the *IGFR Act*, which reads as follows:

- 10 (5) When the *Division of Revenue Bill* is introduced it must be accompanied by a memorandum explaining -
- (a) how the bill takes account of each of the matters listed in section 214(2)(a) to (j) of the Constitution;
 - (b) the extent to which account was taken of any recommendations of the [Financial and Fiscal] Commission submitted to the Minister in terms of section 9 or as a result of consultations with the Commission in terms of subsection (3) of this section; and
 - (c) any assumptions and formulae used in arriving at the respective shares mentioned in subsections 2(a) and (b).

In other words the Government is required to explain the logic, methodology, trade-offs, assumptions and formulae used to arrive at the division of national revenue detailed in the *Division of Revenue Bill*.

Much of the information that we requested in our submission last year relates to the determination of the so-called *vertical split* of nationally collected revenues. In response to our request the honourable Minister of Finance noted at the hearings that because the so called *vertical split* reflects the priority of respective services provided by each sphere of government it was essentially a "political decision". We agree, but would add that a "political decision" of this importance should be based on sound information and that such information should be included in the *Explanatory Memorandum* and made public since the Government is committed to the principles of openness and transparency. We therefore outline briefly again what kinds of

information we believe should be presented in the *Explanatory Memorandum* that accompanies the *Division of Revenue Bill*.

We would recommend that Parliament should insist that the *Explanatory Memorandum* should contain all the information necessary to replicate the calculations made to effect both the *vertical* and *horizontal splits*. This is not possible at present.

The following sections give details of the information AFReC believes should be included in the *Explanatory Memorandum*, but which is not.

1.1 Schedules of governments' obligations and responsibilities

Much of the additional information requested relates to the principle that *finance follows function*. As we noted last year it is by no means clear that this principle has been applied in the past or that it underpins in the current division of nationally collected revenue. In the first instance, to ensure that finance does indeed follow function at each sphere of government the *Explanatory Memorandum* should present comprehensive schedules of the functions and obligations of each sphere of government. The purpose of these schedules would be to set out exactly *what* functions and obligations are taken into consideration. They should be sufficiently detailed to show shifts in functions and obligations between the spheres of government from year to year, as well as changes in functions and obligations due to new legislation or the phasing in and out of programmes. It is proposed that the following schedules are required:

- A schedule of national government functions and obligations
- A schedule of provincial functions and obligations
- A schedule of local government functions and obligations

For a detailed discussion of what information these schedules should include please refer to the submission AFReC made last year (a copy can be obtained from Carla: tel. 650 2719). Briefly, however, each schedule should include a list of institutions that each sphere of government has to fund in terms of the Constitution and a list of basic services each sphere of government is expected to provide in terms of the Constitution or in terms of national legislation. The schedules for the provincial and local spheres should also include a list of national legislation that has been delegated or assigned to provincial and local governments to implement.

1.2 The fiscal capacity of each sphere of government

In terms of Section 214(2)(e) of the Constitution the fiscal capacity of provinces and municipalities has to be taken into account in the division of nationally collected revenue. However, fiscal capacity needs to be considered in relation to the functions and obligations of these respective spheres of government. The *Explanatory Memorandum* should therefore give information on:

- Own revenue sources of the provinces and local governments and the amount of funding raised from these sources; and
- On the cost to provinces and local governments:
 - to maintain the institutions of governance as set out in the Constitution;
 - to meet their obligations with regards to basic services for which national minimum norms and standards have been set, and
 - to implement national legislation that has been delegated/assigned to them (This is especially important given section 35 of the Public Finance Management Act of 1999 which calls for national legislation having financial implications for the provinces to be costed).

Ideally this information should be broken down by province and local government. Aggregate information would not be suitable since it would tend to hide the disparities in fiscal capacity and obligations that exist between different provinces and local governments.

This information would provide a benchmark to assess whether the division of nationally collected revenue at both the vertical and horizontal split does indeed take the fiscal capacity (in relation to their obligations) of the respective spheres of government into consideration. It would also set explicit input/output standards or benchmark costs by which to measure the efficiency of service delivery by provinces and local governments.

1.1 The actual formulae used in the division of revenue

AFReC noted last year that while the *Explanatory Memorandum* gives an interesting discussion of the assumptions and formulae used to make the division of nationally collected revenue, the actual formula itself should also be presented. This would make the present discussion of the assumptions underlying the different components, the weightings and the use of data far more real and transparent, especially for members of Parliament, the Legislatures and broader civil society. Intergovernmental resource allocation is by its nature a complex series of interactions, nevertheless the formula could be made more accessible to the non-specialist reader. As noted above, it is crucial that all the information that is required to replicate the calculation underlying the division of nationally collected revenue should be presented in order to foster transparency in the budget process.

1.2 Population data

This year's *Explanatory Memorandum* notes that because new population data are not available from Statistics SA, 1996 census data have been retained throughout. There is no problem with this approach, but for some unknown reason this population information is not presented this year. Even though it was presented in the *Explanatory Memorandum* that accompanied the *Division of Revenue Bill* for 1999 (see table E.7, *Budget Review 1999*, page 264), we believe that key information of this nature should be standard to each year's *Explanatory Memorandum*. It is creating a bad precedent to exclude such information for whatever reason. It also means that researchers who only have access to the current *Explanatory Memorandum* do not have access to this population data.

1.3 Information on conditional grants

In the same vein, information on the allocation of conditional grants between the provinces is not included in this year's *Explanatory Memorandum* whereas it was included last year. This information is available in Table 7.5 of the *Budget Review 2000*, but again AFReC believes that certain types of information should be standard.

We believe Parliament should indicate to the Ministry of Finance what kinds of information it expects to see in the *Explanatory Memorandum* and not leave it to officials to decide what information to they wish to communicate to Parliament.

2 Changes to the way the division of revenue is calculated

This is the first time that a 'normal' *Division of Revenue Bill* has been tabled in Parliament. In previous years the process was still in its embryonic stages. It is therefore important to note some important precedents that are being set.

1.1 Allocation of the increment in nationally collected revenue

The first important point to note is that in the discussion of the division of revenue between the three spheres of government (the *vertical split*) the Ministry of Finance focuses attention on the allocation of the increment in available resources, rather than on the allocation of all nationally collected revenues. Focussing on the increment assumes that the baseline allocations are correct. When the division of revenue was first introduced there was considerable disagreement on this issue. At the time the view was expressed that provinces and local government were being under-funded relative to national government. Emphasising the division of the increment shifts the focus away from this debate. We believe that the baseline allocations underpinning the *vertical split* need to be re-examined.

Secondly, the information given in Table E2 does not indicate what proportion of the increment allocated to provinces and local governments goes to their respective equitable shares and what proportion of the increment is conditional grants from the national share of revenue. This is important to know because it would indicate to what extent national government is directing the use of resources at the margin as opposed to allowing provinces and local governments to decide over the use of such resources. This would of course have implications for the degree of fiscal autonomy of subnational spheres of government.

Table 1: Additional resources to equitable share versus conditional grants

R million	1999 Budget	2000 Budget	Allocation of additional resources	% of additional resources allocated to equitable shares & conditional grants
Total to be shared	176 652	184 963	8 311	
National allocation	70 739	76 095	5 356	100
Provincial allocation	103 433	106 037	2 604	
Equitable share	92 071	94 408	2 337	89.7
Conditional grants	11 362	11 629	267	10.3
Local government allocation	2 480	2 830	350	
Equitable share ¹	1837	1 867	30	8.6
Conditional grants	643	963	320	91.4

1. Calculated using information from Table 7.3 in the *Budget Review 2000*

2. Information from Table 7.3 in the *Budget Review 2000*

The above table indicates that while the additional resources allocated to provinces go to them primarily via their equitable share, over 90% of the additional resources allocated to local government go to them by way of conditional grants from the national share of revenue. The use of these additional resources to local government is therefore determined by national Government according to its priorities, and not by the local councils.

1.2 Lack of consistency in the treatment of conditional grants

There is some inconsistency in the way conditional grants allocated between the different spheres of government are treated. The Department of Finance is very careful to deduct from the national share of revenue conditional grants to provinces and local governments, but is less consistent with regards to conditional grants from the provinces to local government. In Table 7.3 of the *Budget Review 2000* it is clear that grants totalling R 613 million are paid to provinces

for transfer to local government. This creates the impression that these funds form part of the total transfer to provinces, thus inflating the figures. In reality these conditional grants are transfers from the national government's share to local government, with the provinces simply acting as a conduit for the funds.

1.1 Change in weightings of social service components

Since 1998 the weighting of the social service components in the formula used to calculate the horizontal split have increased by 4 percentage points, the basic share and backlogs component combined have decreased by 5 percentage points and the institutional grant has increased by 1 percentage, as shown in the table below.

Table 1: Change in the weightings used in the *horizontal split* formula

Per cent	Education	Health	Social welfare	Basic share	Backlogs	Economic activity	Institutional	Target shares
1998	39	18	16	15		8	4	100
1999	40	18	17	9	3	8	5	100
2000	41	19	17	7	3	8	5	100

The most important point to make is that these weightings have increasingly come to reflect provinces past expenditures on the social services. As far as can be determined, in 1998 and 1999 they were based on some weighted average of province's past expenditures and MTEF projections. This year it is stated explicitly that they "reflect a 3-year average expenditure on these services" (*Explanatory Memorandum*, page 11).

Firstly, the use of expenditures to calculate the weightings is problematic because it amounts to nothing more than a sophisticate form of incremental budgeting. In other words the weightings simply reflect past expenditure patterns. It is well known that the baseline for these expenditure patterns was primarily determined by apartheid spending priorities. While the above mentioned changes in the weightings reflect some reprioritisation, questions remain regarding the base from which these incremental changes are being made. AFReC has consistently called for these weightings to be benchmarked against the real cost of meeting the need for such services measured against minimum standards.

Secondly, the *Explanatory Memorandum* does not show how the changes to the formula impact on the division of the provincial equitable share between the provinces. In other words there is no comparison between what individual provinces would have got if the formula had not been changed and what they get given the changes. The point is that each change to the formula has a real impact on the distribution of resources between provinces, and that currently this is not being made explicit. Link this to the fact that not sufficient information has been given to replicate the calculations, it means that there is no way Parliament can get this information in order to evaluate whether such changes are justified or not, or whether the changes are equitable.

1.2 Lack of updated data and incremental adjustments

It is of some concern that the only updated data available for calculating the *horizontal split* was data on remuneration. The following table sets out the age of the data used for calculating the different components of the *horizontal split* formula, the institutions responsible for the different data and the implications of using old data.

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Table 1: Implications of using old data in <i>horizontal split</i> formula			
Kind of data	Age of data	Responsible institution	Implications of old data
Provincial distribution of total population	1996 (1999 available)	Statistics SA	Affects accuracy of the basic and welfare components. Discriminates against provinces with populations growing faster than the national average.
Age breakdown of population	1996	Statistics SA	Affects accuracy of the education and welfare components. Discriminates against provinces with ageing or more youthful populations.
Rural-urban breakdown of population	1996	Statistics SA	Affects accuracy of the backlog component. Discriminates against provinces whose share of the rural population is growing.
School Enrolment	1998	Dept of Education	Affects accuracy of the education component. Discriminates against provinces with growing youthful populations.
People with medical aid	1995	Statistics SA	Affects accuracy of the health component. Discriminates against provinces with low levels of economic development.
Distribution of income	1995	Statistics SA	Affects accuracy of the welfare component. Discriminates against provinces whose share of poor people is growing.
Weighting of expenditure on social grants	1997	Dept of Welfare	Affects the welfare component. Discriminates against provinces with populations growing faster than the national average, and with populations that are either ageing or becoming more youthful.
Gross Geographic Product (GDP)	1994	Statistics SA	Affects accuracy of the economic component. The fact that this data has not been updated since 1994 has already caused the Department of Finance to use the provincial distribution of remuneration as a proxy.
Remuneration data	1999	Statistics SA	Data is up to date. However this variable is being used as a proxy for GDP
Information on backlogs	1998	Depts of Education & Health	Affects accuracy of the backlog component. Discriminates against provinces where the backlog is being addressed more slowly.

The above table shows that not a single component of the *horizontal split* formula is based on current information, and that in the case of GDP data the information is so old that the Department of Finance has had to substitute it with proxy data. Parliament should place pressure on the institutions responsible for data to keep it current.

Not regularly updating the data underpinning the *horizontal split* formula creates the risk that revenue allocations will diverge progressively from the relative demand for services between the different provinces. As a result when new data becomes available it may not be possible to implement the new resource allocations without disrupting service delivery. This would necessitate yet another "phasing in period" such as that associated with the introduction of the 1996 census data. As noted, this discriminates against those provinces that will have experienced increases in demand for services. Our preliminary assessment is that in nearly all

instances this is to the disadvantage of the poorer provinces. The issue of keeping data current is therefore an important equity issue.

1 Actual costs of service delivery versus proportions

AFReC has consistently argued that for certain services it would make more sense to allocate funds based on the actual cost of such services, rather than the proportional demand for such services as is currently the practice. The most obvious example is social security where it should be possible to estimate the demand for social grants in each province with a high degree of accuracy and therefore to calculate the exact amount of nationally collected revenues each province requires in order to meet this statutory obligation. This approach would obviate the current problem where increases in social grants put pressure on other expenditures especially social welfare services. This approach could be extended to other services as explicit norms and standards for service delivery, and baseline unit costs are established. The use of benchmark norms and standards would place a check on perverse incentives for cost escalation at subnational level.

1 Summary of main points

In summary this submission makes the following points:

1. Parliament has the power to amend the *Division of Revenue Bill* and it does not have to wait for the legislation required by Section 77(2) of the Constitution to exercise this power because the *Division of Revenue Bill* is not a money Bill.
2. The requirement that the *Division of Revenue Bill* be tabled together with the *National Budget* undermines Parliament's power to amend the *Division of Revenue Bill*.
3. To allow Parliament to participate meaningfully in budgeting, it is proposed that a three-stage process for passing the budget be adopted.
4. The *Explanatory Memorandum* needs to present schedules outlining the responsibilities and obligations of the different spheres of governments so that Parliament can evaluate the soundness of the "political decision" regarding the so called *vertical split*.
5. The *Explanatory Memorandum* should give a detailed analysis of the fiscal capacity of different spheres of government in relation to their responsibilities and obligations.
6. The *Explanatory Memorandum* should present the actual formula used to make the *horizontal split*, and all the information required to replicate the calculations.
7. Parliament should indicate to the Ministry of Finance what information it expects to see in the *Explanatory Memorandum*, so as to avoid the current situation where the information presented is left to the discretion of officials and certain key pieces of information are left out.
8. The focus on how the increment in nationally collected revenues is divided between the spheres of government shifts the focus from the how the total revenue pool is divided and whether the baseline for the *vertical split* is fair. We believe that the baseline allocations underpinning the *vertical split* need to be re-examined.
9. The treatment of conditional grants in calculating the total transfers to the different spheres of government needs to be standardised, particularly conditional grants from the national share of revenue to local governments that are channelled via the provinces.
10. The weightings of the social service components of the *horizontal split* formula are based on historical expenditures. AFReC believes they should be benchmarked against the real cost of meeting the need for such services measured against minimum standards.
11. The *Explanatory Memorandum* should compare the impact that changes to the *horizontal split* formula have on the distribution of resources between provinces relative to the what they would have been if the formula had not been changed.
12. Parliament needs to place pressure on the institutions responsible for the data underpinning the *horizontal split* formula to keep it current. Not updating this data regularly appears to discriminate the poorer provinces.
13. It would make more sense to allocate funds for certain services based on the actual cost of such services, rather than the proportional demand for such services as is currently the practice. The most pertinent example is social security.