

*For an Equitable Sharing of National Revenue*



FINANCIAL AND FISCAL COMMISSION

# SUBMISSION FOR THE DIVISION OF REVENUE

2011/12

The background to this year's submission is that South Africa is recovering from the deepest and most serious economic crisis to affect the world since the Great Depression.

FINANCIAL AND FISCAL COMMISSION

SUBMISSION FOR THE DIVISION  
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# FOREWORD

The Financial and Fiscal Commission's submission for the 2011/12 Division of Revenue focuses on the process of adjusting to the recession and global economic crisis from which the South African economy is emerging. The Commission concentrates on the need for cushioning the vulnerable and laying the foundation for future growth and development. This theme runs throughout the submission and focuses on the fiscal adjustments and reprioritisation that will need to be made in order to take the economy back onto the path it was before the recession without compromising access to basic services by the vulnerable groups in our society.

It is important to note that this is the Commission's first submission since the Money Bills Amendment Procedure and Related Matters Act of 2009 was passed. The Act allows Parliament's Finance and Appropriation Committees to amend the macroeconomic and fiscal framework as well as budget allocations in line with Section 77(3) of the Constitution.

The Commission has, since its establishment, submitted recommendations on the Division of Revenue among the three spheres of government. These were made in terms of Section 214(2) and Section 229(5) of the Constitution and in terms of section 9 of the Intergovernmental Fiscal Relations Act of 1999. After the Money Bills Amendment Procedure and Related Matters Act was enacted, the Commission has submitted:

- 1. its recommendations on the Division of Revenue for 2010/11 in May 2009;**
- 2. its first ever comments on the Medium Term Budget Policy Statement in November 2009;**
- 3. its comments on the Division of Revenue Bill in February 2010;**
- 4. its first ever comments on the fiscal framework in March 2010; and**
- 5. its first ever comments on the Appropriations Bill in April 2010.**

As has always been the tradition with the Commission's work, this year's submission relies on collaborative input from various partnerships. There have been rigorous consultations with the Commission's primary stakeholders from the provincial and national legislatures, expressed through the finance committees, to government, primarily through the





Budget Council and Budget Forum, and to local governments, through the South African Local Government Association. The technical reports that support this year's recommendations rely on collaborative research with our technical advisors, partners and members of the Commission Secretariat. Their contributions are greatly appreciated.

We, the undersigned, hereby submit the recommendations for the 2011 Division of Revenue in accordance with the obligations placed upon us by the Constitution of the Republic of South Africa.

Dr. Bethuel P. Setai  
 Mr. Bongani Khumalo  
 Ms. Lucienne Abrahams  
 Ms. Tania Ajam  
 Mr. Krish Kumar  
 Mr. David Savage  
 Ms. Nelisiwe Shezi

For and on behalf of the Commission

Dr Bethuel P Setai  
 Chairperson/CE

Mr. Bongani Khumalo  
 Deputy Chairperson  
 Financial and Fiscal Commission

Date: 17 May 2010

# EXECUTIVE SUMMARY

The Financial and Fiscal Commission makes this submission in terms of Section 9 of the Intergovernmental Fiscal Relations Act of 1999. The background to this year's submission is that South Africa is recovering from the deepest and most serious economic crisis to affect the world since the Great Depression. Strong links to the world economy meant a sharp fall in demand for South African exports and falling prices of key export commodities.

The South African economy contracted by almost 2% during 2009. About a million jobs were lost in 2009 alone. There have also been adverse implications for investment, incomes and poverty.

The government reacted to the crisis in several ways. The broad principles governing government's reaction include:

- 1. avoiding placing the burden of the downturn on the poor and vulnerable unfairly;**
- 2. ensuring that all activities are aimed at increasing the capacity of the economy to grow and create decent jobs during and after the crisis;**
- 3. maintaining the planned high levels of investment in public sector infrastructure; and**
- 4. encouraging the private sector to maintain and improve its levels of fixed direct investment wherever possible.**

On cushioning the vulnerable, government maintained and continues to maintain high levels of spending in the social services sector (health, education and social assistance). With particular reference to the most vulnerable group (children), it is particularly important to ascertain the effectiveness with which the government reduces the effect of the crisis through

the child support grant. The child support grant is a uniquely South African feature. The government has expanded access to the grant in recent years and aims it particularly at children in poor families.

Research that the Commission did shows that introducing social protection programmes in South Africa, especially the child support grant, has paid off in terms of assisting poor families to mitigate the effect of poverty in both ordinary and extraordinary times. It is the Commission's view that the decision by government to continue with these programmes during the crisis, especially expanding the coverage of the child support grant should be supported.

It is the Commission's view that the poor, especially children, the elderly and disabled should not suffer disproportionately because of the economic meltdown and the necessary fiscal realignment that will follow. This submission explores further possibilities and options open to government to address the negative effects of the crisis. These are to lay the foundations for future growth and development on the one hand and cushioning the poor and vulnerable through the division of revenue process on the other.



This annual submission covers four interrelated areas.

Chapter 1 sets the background for the recommendations and reflects on the recent global economic crisis. It establishes the economic and fiscal position before discussing the consequences of the crisis for the economy from the perspective of children. The chapter suggests that the global crisis interrupted the decline of child poverty and hunger and had quite a strong effect on child poverty, especially amongst the very poorest children. The chapter suggests that fiscal reforms and consolidation are essential and the reduced fiscal space will probably limit future growth in spending, particularly on costly new programmes. The chapter ends by making recommendations on what should be done.

Chapter 2 addresses options for reforming social assistance in the face of severe fiscal stress. It reflects specifically on the fiscal sustainability of the system of grants, its effectiveness in combating poverty in the longer-term and its effect on allocating resources before making short-term and long-term recommendations for reforming social assistance.

Chapter 3 asserts that the tighter than usual economic

conditions in which South Africa finds itself make good governance imperative. The tighter economic environment of the current budget cycle has also focussed increased attention on concerns about the institutional and operational efficiencies of several of the fiscal and revenue instruments of the sub-national government spheres in particular. The performance and efficiencies of the instruments of local government, which include intergovernmental transfers and own revenue sources, are pivotal to cushioning the effects of the recession on communities and for providing a solid platform for buoyant and equitable growth and sustained service delivery in the long-term as South Africa emerges from the recession.

The chapter covers the following areas:

- a) improving the performance and effectiveness of conditional grants;
- b) revenue improvement strategies, especially at the level of local government; and
- c) reforms in the Local Government Equitable Share formula.

It is imperative that, as the global recession recedes, government pursues innovative recovery policies that are inclusive and supportive of those below the poverty line and that sustain service delivery, especially within the local government sphere, as well.

Chapter 4 focuses on laying the foundations for growth and development. It addresses inter-governmental fiscal issues in urban public transport. There has been a significant increase in public spending on public transport and related infrastructure in recent years and the inter-governmental fiscal system has been instrumental in much of this expenditure. Key issues discussed include ongoing bus subsidies, the Gautrain, and the new bus rapid transit projects in cities like Johannesburg and Cape Town. All of these are sub-national government projects.

The chapter highlights a number of important strategic financial issues against this background. They include issues of possible approaches to funding public transport in South Africa and some recommendations.

The recommendations of the Commission for the 2011/12 Division of Revenue are:

**With regard to the global economic crisis, fiscal frameworks and coping with vulnerabilities, the Commission recommends that:**

1. In the short-term, government should continue to strive for fiscal consolidation through limiting the growth in entitlement spending to those programmes that have demonstrably worked while refocusing expenditure to ensure better coordination and to deepen access by focusing on improved service quality. In particular, the Commission recommends that the government should:
  - a) Continue to expand the child support and old age pension grants (the best targeted of social spending programmes that also complement anti-poverty interventions while building human capital and meeting other basic needs).
  - b) Maintain high access levels to education and health services that it achieved even during the period of the global economic crisis.
  - c) Reprioritise expenditure towards repair and maintenance by emphasising existing projects and initiating new ones.

2. In the medium- to long-term, the government should:
  - a) Introduce a block grant for education, health and social development to fund clearly defined and costed outcomes in these areas.
  - b) Undertake independent cost effectiveness and quality reviews (in both the public and private sectors) of education, health and the social wage.

**With regard to the options for social assistance reform during a period of fiscal stress, the Commission recommends that the government should:**

3. Protect the overall amount of social-assistance expenditure as far as possible during the fiscal consolidation. These are the targeted social spending programmes and the main cash-transfer component of poverty-focused public spending that complements anti-poverty interventions (which build human capital and meet other basic needs).
4. Not compromise the relative simplicity of the social assistance system especially when contemplating reform options.
5. Pilot conditional cash transfer and workfare programmes on a smaller scale and continue to evaluate them in order to expand successful pilots.
6. Strengthen non-cash complementary social developmental services through emphasising quality improvements within a defined resource envelope.
7. Avoid universal income grants, as these are currently unaffordable and would need to be accompanied by a broader restructuring of the entitlement system.

**With regard to the design and administration of conditional grants, the Commission recommends that:**

8. When introducing and terminating conditional, national departments must:
  - a) Introduce a mandatory, systematic process for designing and planning individual conditional grants that covers

- incentive effects, administrative accountability arrangements and stipulates regular review periods and exit strategies of the grant
- b) Ensure that there is an independent evaluation of the grant performance at entry, midterm and end of the grant
  9. Government should make the criteria for dividing grant allocations transparent. At the moment, they are only explicitly reflected for the whole programme and not for each individual grant.
  10. Government must continue to emphasise the importance of non-financial data reporting. In this regard it should link outer year allocations to independently evaluated performance information and gazette expected deliverables (like schools and kilometers of roads).
  11. To ensure results-based accountability through incentive grants, national departments must make accounting for delivery a prerequisite for most conditional grants. They should encourage designing grants that consider explicitly promoting innovation in sub-national governments and strengthen incentives for optimal service delivery.
  12. The Commission emphasises that the budget allocation process must follow the grant frameworks specifically and that this should be monitored periodically through section 32 of the Public Finance Management Act (PFMA) and section 72 of the Municipal Finance Management Act (MFMA).

**To improve the general performance of municipalities in revenue improvement and collection, the Commission recommends that:**

13. Government should adopt standard indicators or early warning systems to measure and detect fiscal stress in municipalities and reach consensus about them. In addition to the criteria prescribed in section 138 of the Municipal Finance Management Act of 2003 for identifying serious financial problems in municipalities:
  - a) These indicators should be pre-conditions for instigating mandatory provincial intervention in terms of Section 139 of the MFMA and Municipal Financial Recovery Plans in terms of Section 140 of the MFMA.
- b) Section 71 of the MFMA, on monthly budget statements, should be amended to require that accounting officers report on actual revenue per source and on the percentage of collected revenue to the total value of billed revenue.
14. Government legislates, through Section 43 of the Local Government Municipal Systems Act of 2000, revenue collection as one of the key performance areas against which to assess overall municipal performance.
  - a) Municipalities must use at least the following standard indicators to harmonise revenue collection performance assessment across municipalities:
    - o The collection ratio, which is the extent to which services are billed, collected and enforced.
    - o The coverage ratio, which is the extent to which all service users are captured on the tax or rates roll.
15. Excessive levels of municipal debt from residential customers, businesses and government, which undermine the long-term financial viability of the sphere, must be reduced through constant taxpayer education and incentives to improve the provision of good quality services generally.
  - a) Government must provide for, or enable, local government through the Municipal Systems Act of 2000 to issue garnishee orders on defaulting customers.
  - b) The judicial system should have dedicated courts to deal with outstanding municipal accounts until the debt is reduced to acceptable levels.
16. The Revenue Raising Component of the Local Government Equitable Share should be reformed so that it rewards good performance in revenue collection as opposed to the current 'Robin Hood system', or stepped tax bands, which allocates more funds based on low revenue collection.
17. The government should support concerted efforts to estimate the fiscal capacity and fiscal effort of municipalities to dispel the perception that certain municipalities will never be financially viable.

18. Municipalities should have broad revenue improvement programmes. They should not focus only on administrative streamlining but also on revenue-side interventions, expenditure-side interventions and efficiency-based interventions.
  - a) The nature of the interventions must be specific to local economic circumstances so that small rural municipalities, which mainly face structural fiscal stress, develop efficiency-based and expenditure-side revenue improvement interventions. Urban municipalities, which encounter cyclical fiscal stress, can pursue revenue-side interventions.
  - b) Small rural municipalities must develop institutional arrangements or reforms that emphasise revenue assignment that is geared especially to sharing powers and functions between category B and C municipalities.
19. Effective revenue management processes, good financial management and the provision of good quality services should underpin revenue improvement programmes. Municipalities should only conduct them when they have maximised the collection of locally available and outstanding revenue sources.
  - a) Where feasible, bigger municipalities, which already have financial systems, should be encouraged to share their systems and expertise with smaller ones.
20. The performance of revenue improvement programmes should be subjected to empirical tests that cover changes in the effective tax rates, tax burdens for all service users, the total revenue yield, economic efficiency and overall fairness.
21. The institutional component of the Local Government Equitable Share should be used to assist poor municipalities.
22. Related to the above, the Commission believes that the Revenue Raising Component is supposed to correct for those municipalities that are able to raise their own revenues better. The Commission makes the following short-term recommendations for the Revenue Raising Component:
  - a) Government should remove the step structure of the differentiated tax mechanism of the Revenue Raising Component, as this is inefficient. Government should develop a flat gradient structure so that municipalities on the outer ends of bands are not treated unfairly.
  - b) Using actual property rates revenue collected and reported by municipalities raises several inefficiencies in the system. Firstly, the poor fiscal effort of municipalities is used as a measure for additional funding. This also applies to poor reporting by municipalities. Secondly, it can create an incentive for municipalities to under report on collection rates, as this would result in a lower Revenue Raising Component calculation and more revenue from the Local Government Equitable Share. Lastly, the current methodology of using actual property rates and own revenues collected can be seen as a contradiction of section 227(2) of the Constitution. The Commission recommends that this practise is replaced with alternative methods of revenue prediction.
23. General recommendations.
  - a) In the absence of an assessment of the specific performance challenges that the different municipalities face in implementing the functions listed in part B of schedules 4 and 5, the Commission recommends that approving a blanket regionalisation approach, as proposed in the 17th amendment to the Constitution, is not supported. Current legislative provisions allow for alternative and creative service delivery arrangements that do not call for a dilution of local government autonomy.
  - b) Not all electricity distributors suffer from the challenges that the restructuring intends to overcome. As a result, the Electricity Distribution Industry (EDI) restructuring

**Based on the work on regionalising municipal services, the Commission divides its recommendations into two groups:**

**With regard to the reform of the Local Government Equitable Share formula, Commission supports the on-going review of the Local Government Equitable Share formula. It is the Commission's view, however, that as a matter of urgency (in view of the fact that the results of the review may only be ready for the 2012 budget) the institutional component revenue raising component are reformed as follows:**

21. The institutional component of the Local Government Equitable Share should be used to assist poor municipalities.
22. Related to the above, the Commission believes that the Revenue Raising Component is supposed to correct for those municipalities that are able to raise their own revenues better. The Commission makes the following short-term recommendations for the Revenue Raising Component:
  - a) Government should remove the step structure of the differentiated tax mechanism of the Revenue Raising Component, as this is inefficient. Government should develop a flat gradient structure so that municipalities on the outer ends of bands are not treated unfairly.
  - b) Using actual property rates revenue collected and reported by municipalities raises several inefficiencies in the system. Firstly, the poor fiscal effort of municipalities is used as a measure for additional funding. This also applies to poor reporting by municipalities. Secondly, it can create an incentive for municipalities to under report on collection rates, as this would result in a lower Revenue Raising Component calculation and more revenue from the Local Government Equitable Share. Lastly, the current methodology of using actual property rates and own revenues collected can be seen as a contradiction of section 227(2) of the Constitution. The Commission recommends that this practise is replaced with alternative methods of revenue prediction.
23. General recommendations.
  - a) In the absence of an assessment of the specific performance challenges that the different municipalities face in implementing the functions listed in part B of schedules 4 and 5, the Commission recommends that approving a blanket regionalisation approach, as proposed in the 17th amendment to the Constitution, is not supported. Current legislative provisions allow for alternative and creative service delivery arrangements that do not call for a dilution of local government autonomy.
  - b) Not all electricity distributors suffer from the challenges that the restructuring intends to overcome. As a result, the Electricity Distribution Industry (EDI) restructuring

process should consider a differentiated approach that allows for differences in performance.

24. If the EDI restructuring and establishment of Regional Electricity Distributors (REDs) proceeds, the Commission recommends that:

- a) The government revisits the Blue Print assumptions initially made to restructure the EDI. The EDI component was informed by restructuring the electricity industry as a whole, including the electricity supply industry. The government needs to clarify the policy issue of whether it is necessary to change ownership and structure in order to ensure efficiency, economies of scale, robust regulations and to deal with management challenges in the sector.
- b) The government conducts an up-to-date re-evaluation and analysis of the benefits of restructuring the EDI. In addition to the political, economic and social changes that have happened in the last eight years and which raise questions about the current assumptions underpinning the restructuring process, delaying the implementation of the REDs has generated new costs that require a total re-evaluation against the benefits that were perceived at the conception of the idea.
- c) The government finalises the EDI Restructuring Bill and the practical guidelines related to the shifting of municipal/Eskom distribution assets (the Asset Transfer Guide) first before moving towards more advanced stages of restructuring.
- d) The government implements measures to ensure that municipalities are adequately compensated for their loss of assets, particularly in the early stages of implementing REDs, where dividends are expected to be zero or minimal.
- e) The government should ensure the compatibility of operating systems that will underpin the activities of the REDs before establishing them as this can affect smooth service delivery negatively and reduce any savings that could derive from the restructuring significantly.
- f) It is important that the social objective of making access to electricity universal is not lost in the process of restructuring the EDI. The government must make it clear which sphere of government will be responsible for

planning, budgeting for and implementing the electrification programme.

**Finally, with regard to the intergovernmental fiscal issues in urban public transport, the Commission recommends that:**

1. Passenger Rail Agency of South Africa and cities should ensure that investment projects on rail and roads infrastructure are aligned and coordinated. This will ensure that limited resources are used optimally to a targeted area or group of passengers instead of each mode investing independently on its own infrastructure to service the same target group of passengers
2. The government should make a decision without further delays on the funding streams that will contribute to the Municipal Land Transport Fund as delays could negatively affect the financial position of affected municipalities.
3. Passenger Rail Agency of South Africa should ensure that funding that has been made available for investment on the commuter rail sector should prioritize corridors already identified as A and B in the National Rail Plan.
4. A comprehensive review should be conducted by relevant stakeholders including national departments, cities and the Financial and Fiscal Commission into the costs associated with current urban form in a selection of major South African cities in order to improve the efficiency of land use patterns.
5. The current mechanisms and basis for distributing transport subsidies should be reviewed by the Department of Transport, National Treasury and other key stakeholders in order to promote the efficiency of urban transport and land use systems, taking into account equity and distributional effects on households.
6. The potential financial implications resulting from the promulgation of the National Land Transport Act on municipalities should be examined by the Department of Transport and the National Treasury and dedicated funding streams for public transport identified.
7. The Department of Transport should regularly update the South African National Household Travel Survey.

# CHAPTER 1:

## THE GLOBAL ECONOMIC CRISIS, FISCAL FRAMEWORKS AND COPING WITH VULNERABILITIES

### 1. INTRODUCTION

Poverty in South Africa is much higher than one would expect in a country with its level of per capita gross domestic product (GDP). There is a high degree of inequality in South Africa, and it has its origins in the apartheid policies of the past. Child poverty, in turn, is still much higher than poverty amongst adults. This makes it imperative to deal with the phenomenon of child poverty as a specific issue.

This is necessary to prevent large numbers of children growing up in dire circumstances that can prevent them from developing their potential. Economically, childhood poverty also leaves a mark in terms of poor human capital and lower productivity in later life, thus creating the risk of a vicious cycle of poverty. To ensure that upward mobility of those born into poor families is possible, South Africa needs to create conditions that will reduce child poverty. Poverty and inequality are also high on the government's agenda as expressed in the Constitution and the Medium Term Strategic Framework.

Government has made significant progress towards alleviating and reducing poverty and inequality by rapidly increasing its expenditure on grants and other social programmes from the mid-1980s. The thorough overhaul of tax administration and collection in the second half of the 1990s and sustained positive economic growth from 1994 until 2008 were the main

reasons that increased social spending has not caused fiscal problems. The subsequent rapid growth in tax revenues has enabled the government to expand social spending steadily, to reduce budget deficits and the public debt burden during the second half of the 1990s and to keep these aggregates at manageable levels thereafter.

The recent global economic crisis has radically changed the fiscal situation. Government has developed a substantial fiscal stimulus package, supported by a substantial budget deficit, to counter the effects of the crisis. This might have tightened the fiscal space available for social spending and its corresponding fiscal frameworks significantly for the future.

Up to now, prudent management of the public finances during the crisis has left South Africa in a much sounder fiscal position than many other countries. Nevertheless, fiscal consolidation has become unavoidable. There is little room





for introducing costly new social initiatives, especially given that the debt cost of total spending is expected to increase by 0.6 percentage points of GDP. In the longer term, growth in tax revenues will be a key factor in determining the scope for expanding the social expenditure system.

This environment is the one in which the Financial and Fiscal Commission has had to make its recommendations on the 2011/12 Division of Revenue.

This chapter reflects on these developments and deals with the effect of the world economic crisis on the economic and fiscal future. It then traces these effects to the vulnerable sectors of society, using children as an illustration. This it does by linking a macroeconomic model to a microeconomic analysis in order to identify how economic performance may affect child poverty in order to estimate its likely extent.

## 2. THE ECONOMIC CRISIS, MACROECONOMIC OUTLOOK AND FISCAL FRAMEWORK

### 2.1 Macroeconomic outlook

The Commission based its economic analysis on a dynamic computable general equilibrium (CGE) model to evaluate the effects of the international crisis on the South African economy. The scenario analysis allows for the possibility of a moderate and a severe economic outlook.

In both scenarios made about the severity of the crisis, GDP falls in 2008 and 2009 and then increases again. However, it does not return to its business as usual (BAU) value even by 2015<sup>1</sup>. In other words, without positive shocks or deliberate and successful interventions to stimulate the economy and counteract the negative effect of the world crisis, GDP will

<sup>1</sup> Business as usual, in macroeconomic terms, in the context of this submission, is the natural trend of the economy and economic policy.

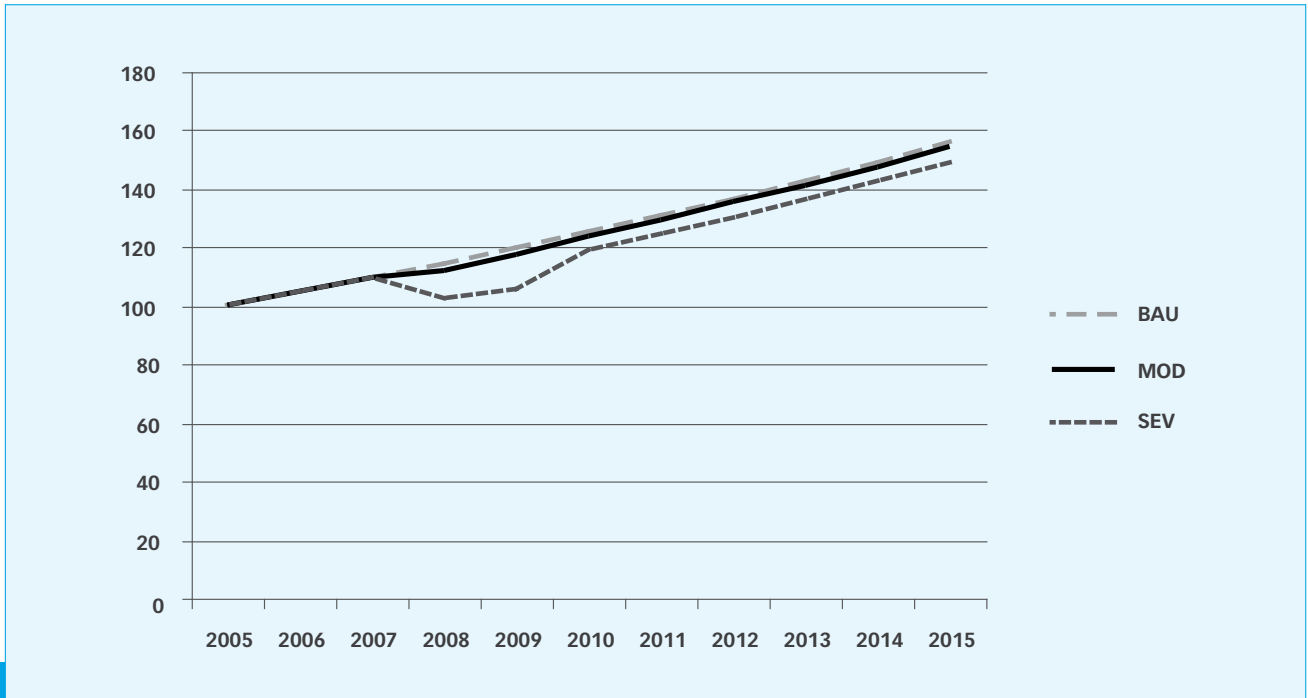


Figure 1: Evolution of Real GDP in BAU, Moderate and Severe scenarios

not recover to what it would have been without the crisis (the BAU scenario). Given all the preceding effects, it is no surprise to observe a huge decrease in total investment. What is relevant here is that, even though the crisis affected only 2008 and 2009 and the recovery started in 2010, the effects on investment remain in the long term. Both scenarios predict lower investment in 2015 than the BAU does.

The decrease in world prices, together with the drop in world demand, led to a fall in production for most sectors. This reduces employment and unemployment rates increase as a result. Households see their income drop. The situation is worse for informal workers who do not have the protection of an effective wage floor that unions provide. They face a huge drop in their wage rate (earnings). Firms also suffer from the crisis as their incomes and savings decrease tremendously. Even if the crisis only lasts for 2008 and 2009, its effects will remain long afterward, particularly because of the permanent effect of the drop in investment<sup>2</sup>.

## 2.2 Public sector consequences and fiscal frameworks

With the recession from which the South African economy is emerging, government revenue is expected to decrease. Indeed, based on the modelling exercise, direct taxes are decreasing (as a share of households and firm income), and taxes on goods and services are also decreasing for most sectors (because of the decreases in imports and production). Half of government income comes from direct taxes and around a third from indirect taxes on products. Thus, one can expect its revenue to decrease. Figure 2 shows the variations of the share of government income in GDP as well as government savings as a percentage of GDP for the BAU and both scenarios.

These developments result in a sharp deterioration in the national government's budget balance (see figure 2). Government savings over GDP would have decreased to reach a small surplus in 2015 had there been no shock. With the crisis, we do not of course observe the same pattern

<sup>2</sup> On the other hand we could argue that, in the long run, the reduction in investment will lead to a reduction in the capital stock because of the continuous depreciation of capital stock. A reduction in the speed that capital is accumulated could eventually lead to a change in the rate of return of capital. This could cause firms and households to increase their savings. The same argument could apply to the behaviour of foreign firms. They could eventually rebuild their capital stock, thereby helping their domestic partners to increase their investments. If this happens, then the permanent effects mentioned here of the crisis could eventually become only temporary if the households and firms try to rebuild their stock of capital at their usual levels.

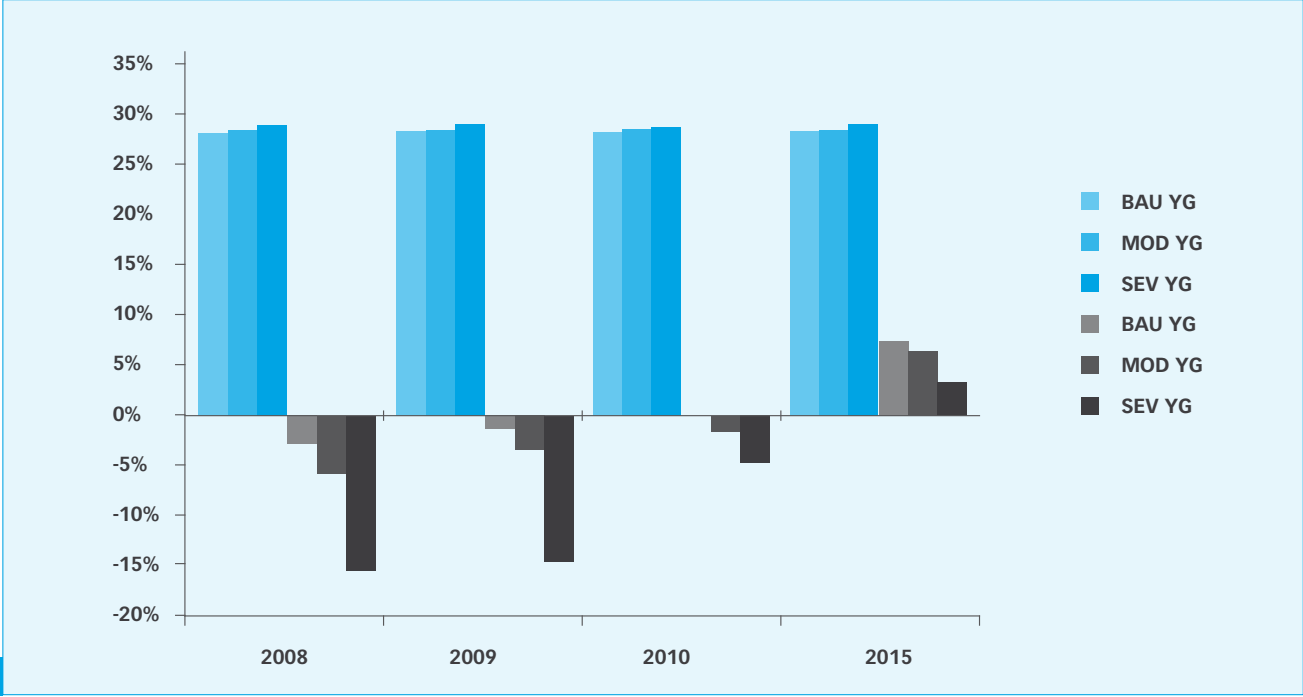


Figure 2: Revenue to GDP and Savings to GDP for government<sup>3</sup>

in the short run. Indeed, the deficit reaches 15% of GDP in 2008 and 2009 in the severe scenario, and around 5% in the moderate scenario. The national government gross loan debt is now projected to reach 43.1% of GDP in the 2013 fiscal year, up from 27.0% in 2009. The situation improves somewhat in the long-term, but remains far below what it would have been had there been no global crisis.

A crucial aspect of the fiscal system from an intergovernmental perspective comes into play as well. This arises from the fact that South Africa has a three-sphere system of government. We have had to adjust the model to incorporate these three spheres by disaggregating fiscal accounts according to the different spheres (we used the Free State as an illustration). The results reported in Table 1 show that provincial governments rely mainly on transfers from national

government for their income.

They also receive a share of capital income, which is decreasing. Provincial governments spend all their incomes (on provincial education, provincial health and other provincial public services) and do not save. Fiscal policy responses to the dilemma of deficit financing include raising tax revenue, reducing or deferring expenditure and improving spending efficiencies. In order to stabilise their fiscal environment, the sub-national governments in South Africa will need to undertake a combination of these three responses over the coming years. The 2010/2011 budget, which provides for a phased reduction in the budget deficit of the national government to 4.8% of GDP in the 2013 fiscal year – based on a combination of revenue growth and strict expenditure discipline – is the first step in such a consolidation effort.

Table 1: income and savings of government

	INCOME		SAVINGS	
	Moderate	Severe	Moderate	Severe
Provincial Governments	-0,03	-0,13		
Local Governments	-0,68	-2,83	-2,93	-12,22

Source: Own projections

<sup>3</sup> We compute government income ÷ gross domestic product (YG÷GDP) and government savings ÷ gross domestic product (SG÷GDP). BAU refers to the situation without a crisis (business as usual), MOD and SEV refer to moderate scenario and severe scenario respectively.

### 3. SOCIAL GRANTS, POVERTY AND DEVELOPMENT IN SOUTH AFRICA

It seems that poverty has been increasing and that this has increased the number of poverty-affected children. The concern is about the extent to which the crisis will undermine the gains made in child well-being in recent years, as well as about the risks to the achievement of child-related targets of the Vision 2014 and the Millennium Development Goals (MDGs). Thus, the crisis will further compound the challenges to meeting the MDGs and realising the rights of children. It will be important to consider how these effects are mediated using mechanisms that may partly protect children from such shocks.

The Commission used the economy-wide effects described above together with a micro-model of the economy to estimate the likely effect of the economic crisis on child poverty in South Africa. This section reports on these findings.

#### 3.1 A profile of child poverty in South Africa

To derive a profile of child poverty, the Commission set a poverty line at the 40th percentile of household per capita income in the 2005 Incomes and Expenditure Survey (IES)<sup>4</sup>. Naturally, there are important issues about the appropriate poverty line and about whether it would make a difference if some adult equivalent scale were used instead of per capita income. However, we have dealt with that in another work (Streak, Yu and Van der Berg, 2009). The Commission concludes that the profile of poverty is not really affected by using any adult equivalent scale and that there is stochastic poverty dominance across most dimensions<sup>5</sup>. In other words, the poverty profile would not change much if an alternative poverty line or an alternative poverty measure to the headcount ratio were used. Therefore, using per capita

income rather than adult equivalent income shows that the research findings, on the insensitivity of the child poverty profile to the choice of adult equivalence scale, support the argument of Woolard and Leibbrandt (2006). This is that one may as well use the simple per capita method of profiling poverty in South Africa and testing its robustness to alternative poverty lines.

Table 2 presents the profile of child poverty. Poor households tend to be larger. Therefore, the poverty headcount for the population as a whole is 52.9%. However, poorer households have a disproportionate number of children: 65.5% of children are amongst the poor (this converts into 11.8 million poor children)<sup>6</sup> as against only 45.2% of the adult population. Moreover, similar differences between adult and child poverty apply for the depth and severity of poverty. In fact, the proportional differentials are larger, indicating that children's share of the poverty headcount rises if lower poverty lines are used because of more severe poverty amongst children compared to adults.

With respect to age, Table 2 illustrates that the poverty headcount and poverty shares based on the headcount are highest amongst the youngest age cohort, followed by children aged between 5 and 14 and between 15 and 17. The profile also confirms the racial dimension of child poverty, which is much higher amongst black children and high amongst coloured children<sup>7</sup>. The poverty depth and severity measures are also far higher for children from these groups. There is little gender difference in child poverty. Child poverty is still more prevalent, deeper and more severe in rural areas – nearly two thirds of children identified as poor live in rural areas. Its rural face is the most prominent feature of child poverty in South Africa, and this especially applies when the

<sup>4</sup> The line is arbitrary, but agrees with what a number of other authors have used, particularly in assessing the effect of the adult equivalence scale.

<sup>5</sup> The exception is the provinces. There is no stochastic poverty dominance across this dimension, thus there are some provinces where the poverty ranking would change if another poverty line or another poverty measure were used.

<sup>6</sup> This level, though somewhat arbitrary considering the equally arbitrary choice of the poverty line, can be seen in the context of findings based on earlier data sets that used similar poverty cut offs. The National Institute for Economic Policy (NIEP) measurement study (1996), which is based on the Project for Statistics on Living Standards and Development (PSLSD) of 1993, and which used the old Organisation for Economic Co-operation and Development (OECD) Adult Equivalent Scale (AES), found the poverty headcount amongst children aged between birth and 4 years of age to be 60%. Woolard (2002), using the October Household Survey (OHS) 1999, a welfare indicator of adult equivalent income and a Cutler and Katz (1992) type AES with the child cost parameter set at 0.6 and economies of scale parameter at 0.9, found it to be 59.2% amongst children aged between birth and 17 and 59.3% amongst children aged between birth and 6. Thus the poverty findings here are not all that different from those in previous studies, whereas there is somewhat less child poverty if the suggested Statistics South Africa (StatsSA) poverty line is used.

<sup>7</sup> Defining households by colour is one of the popular ways used in South Africa. Including the race-based definition is rooted in the apartheid period policies. The 'black' people of South Africa are natives of the country. They include mainly the Zulu, Xhosa, Ndebele, Swazi, Sotho-Tswana, Tsonga and the Venda language groups. 'White' people are mainly descendants of the colonial immigrants of Dutch, German, French Huguenot and British origin. 'Coloureds' are most commonly people of a mixed race or descendants of the Khoi and San. 'Asians' are mainly people of Indian descent (South Africa. Info, 2007).

**Table 2: Poverty profile for children and adults using per capita income as the welfare measure and with the poverty line set at the 40th percentile of households**

	CHILD POVERTY (0-17 YEARS)					ADULT POVERTY		
	Po Poverty headcount rate			P1 Poverty depth measure	P2 Poverty severity measure	Po Poverty	P1 Poverty depth measure	P2 Poverty severity measure
	Rate (%)	Share (%)	Number			Rate (%)		
Age								
0-4	66.1	26.0	3 066 509	0.336	0.213			
5-14	65.7	56.5	6 681 507	0.343	0.202			
15-17	63.8	17.5	2 067 609	0.332	0.203			
0-17 (all children)	65.5	100.0	11 822 544	0.328	0.205			
18+ (all adults)						45.2	0.213	0.126
<b>Racial group</b>								
Black	72.5	93.9	11 100 826	0.375	0.232	54.4	0.261	0.156
Coloured	41.3	5.3	623 412	0.167	0.093	30.1	0.110	0.057
Asian	24.2	0.7	76 137	0.093	0.052	13.7	0.049	0.027
White	2.0	0.2	18 081	0.012	0.008	1.2	0.006	0.004
<b>Gender</b>								
Girls	65.4	49.1	5 819 410	0.336	0.204	39.7	0.238	0.142
Boys	65.6	50.9	5 985 265	0.332	0.206	49.9	0.184	0.109
<b>Urban/Rural location</b>								
Rural	82.8	63.3	7 376 451	0.446	0.280	69.0	0.344	0.209
Urban	48.6	36.7	4 442 491	0.226	0.133	31.7	0.139	0.080
<b>Province</b>								
Western Cape	37.9	5.0	0 587 580	0.153	0.085	25.1	0.094	0.048
Eastern Cape	77.9	20.1	2 378 696	0.415	0.258	59.8	0.292	0.174
Northern Cape	69.1	2.0	0 235 269	0.333	0.195	48.5	0.219	0.126
Free State	63.6	5.9	0 695 166	0.294	0.171	44.2	0.193	0.110
Kwazulu-Natal	75.0	25.2	2 975 734	0.413	0.266	53.8	0.279	0.175
Northwest	66.2	8.1	0 962 355	0.345	0.216	49.3	0.239	0.143
Gauteng	41.3	9.6	1 138 511	0.186	0.110	26.0	0.111	0.065
Mpumalanga	66.4	7.2	0 846 494	0.322	0.187	48.6	0.218	0.123
Limpopo	78.0	16.9	2 002 739	0.400	0.242	65.6	0.313	0.183

Source: Own calculations using income and expenditure of households (IES) 2005 data

depth and severity of poverty are considered: the rural poor are further below this poverty line than the urban poor are, and the share of the rural child poverty headcount thus rises as the poverty line is set lower. There is large variation across provinces in child poverty.

Though the poverty incidence is highest in Limpopo, the poverty share of the more populous provinces is larger. Kwazulu-Natal and the Eastern Cape together have 46% of the poor children. The rankings for the poverty severity measure are slightly different from those on the depth and headcount measures. This indicates that stochastic poverty

dominance does not always hold. Kwazulu-Natal has the most severe poverty, while it has the second highest poverty depth and the third highest poverty headcount. Limpopo ranks third in terms of the severity and depth measures, but first on the poverty headcount measure. Western Cape is the best performer on all three of the Foster-Greer-Thorbecke (FGT) poverty measures – it has the lowest child poverty headcount rate (P0)<sup>8</sup>, the lowest depth of child poverty (also known as the child poverty gap ratio [P1])<sup>9</sup> and the lowest child poverty severity ratio (P2)<sup>10</sup>.

Testing the robustness of the child poverty profile to select

the poverty line found the age, race, gender, and urban-rural dimensions to be robust. In the poverty-relevant range, there is clear first order dominance in each of these cases. This implies that the poverty rankings are invariant to the poverty line chosen and to whether the poverty measure used is P0, P1 or P2. Figure 3 below shows that the results for the provincial rankings are slightly more complex and hence the provincial cumulative density functions or curves (CDFs) or poverty incidence curves. The CDF shows the population arranged from poorest to richest using the selected poverty measure and expresses those below any possible poverty line as a percentage of the total population (Deaton, 1997). In other words, it shows the headcount ratio of poverty at different poverty lines. It is therefore also known as a poverty incidence curve. Regardless of where the poverty

line is drawn, Western Cape and Gauteng have the lowest child poverty headcount rates. However, the Western Cape has the lowest headcount up to an income level of approximately R6 000 per capita, per annum. Thereafter, however, there is a change. Except for the very low poverty lines, three provinces – Kwazulu-Natal, Limpopo and Eastern Cape – have the highest poverty headcounts. There is also a shift in the rankings of the weakest performers when alternative poverty lines are selected.

Where one CDF consistently lies above another, there is first-order stochastic poverty dominance. This implies that the ranking of poverty between two provinces remains unchanged whatever poverty line is used and whichever of the three FGT poverty measures (P0, P1 or P2) is analysed.

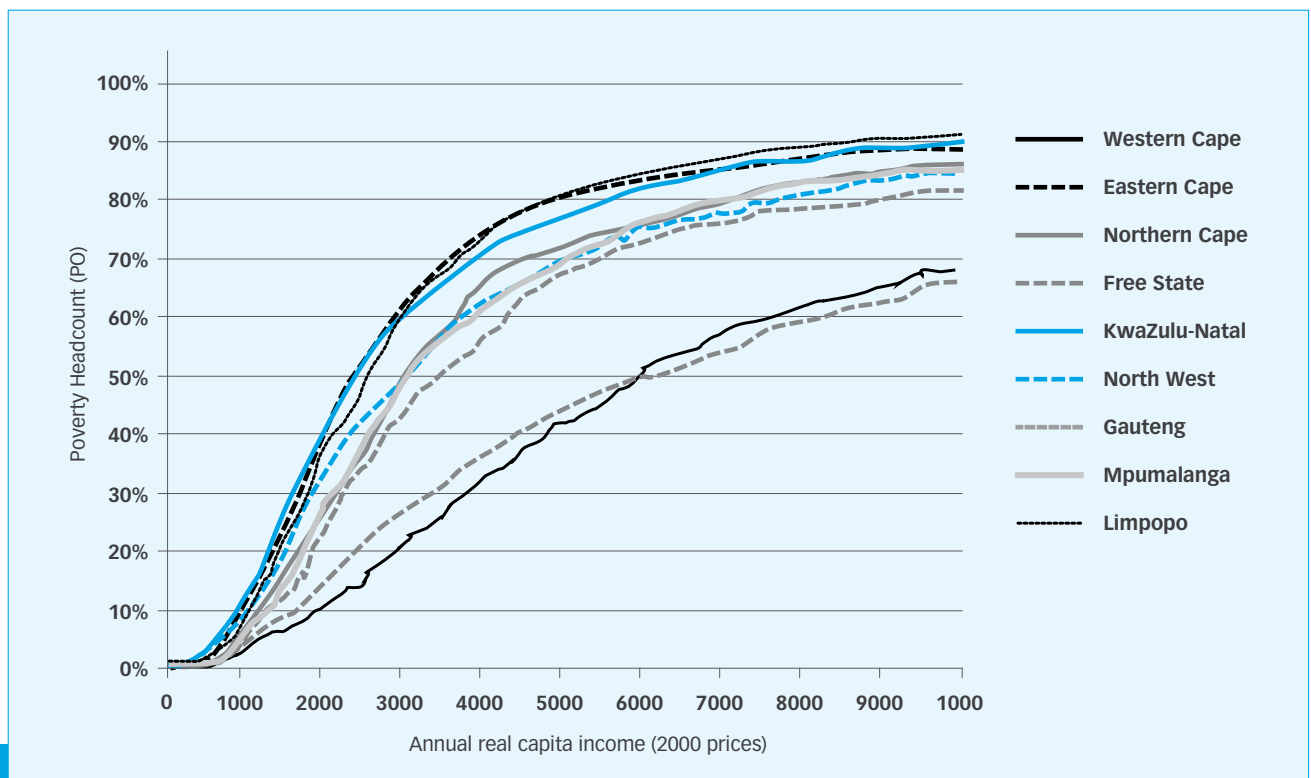


Figure 3: P0 (0-17 years) per province, per capita method

line chosen and whether the poverty measure used is the headcount, depth or severity of child poverty affect the ranking of child poverty. This confirms the results from Table 1. It does matter which measure is used, and this analysis

implies that the choice of the poverty line itself is important for ranking poverty between provinces. At very low poverty lines, the severity of child poverty that Kwazulu-Natal experiences will be reflected even in the headcount index.

<sup>8</sup> The headcount ratio, P0, is the number of poor below the poverty line out of the total population.

<sup>9</sup> The poverty gap is defined as the average poverty gap in a population as a proportion of a poverty line. It accounts for the intensity of poverty, meaning how poor the poor are.

<sup>10</sup> The severity of poverty gives more weight to the lowest incomes.

However, if poverty lines are set high, there is a danger of underestimating Kwazulu-Natal's child poverty share when focusing on the headcount rate only.

The profile of child poverty in South Africa presented here, based on IES 2005, suggests that child poverty (at 65.5%) remains more extensive than poverty amongst the population as a whole (52.9%) and poverty amongst adults (45.2%), if the chosen poverty line includes 40% of poor households. This confirms that children are found more often in poorer households. Moreover, despite the massive injection of transfers to households with poor children through child support grants, poverty amongst children remains substantial.

The child poverty profile sheds new light on the age dimensions of child poverty. The headcount, depth and severity of poverty are all higher amongst children in the youngest age cohort (birth to 4) followed by children aged 5 to 14, followed by those aged 15 to 17. This is surprising because the child support grant did not extend to the oldest group at the time of the survey. One would expect households containing only older children to experience more poverty.

### 3.2 Effect on money metric poverty

The Commission used the economy-wide effects described above, together with a micro model of the economy, to estimate the likely effect of the economic crisis on child poverty in South Africa. This section reports these findings.

Essentially, the major purpose of the micro model was to estimate the effect of the economic changes simulated by the CGE model on households. The Commission modelled three channels:

1. Variations in prices, which were assumed to apply to all households. Differences only arose in their spending habits. Note that adult equivalence scales were also applied to allow for differential spending patterns.
2. Variations in wages in different skill categories.

3. Changes in employment for the three formal labour market categories.

Price and wage variations are relatively small and have little effect on poverty in the model. Changes in employment had easily the greatest effect on poverty. Probit models of the probability of employment for each employed and unemployed worker for jobs in various skills categories were estimated. These models were then used to identify those employed workers in each skill category most likely to lose their jobs when employment declines relative to the labour force. The wages of employed workers were assumed to remain as they had been recorded.

The dataset used for the micro simulations was the 2008 National Income Dynamics Survey (NIDS). The 2008 data was assumed to reflect the situation before the 2007 crisis. The model was then applied to these data to arrive at simulations. Because the micro simulations dealt essentially with a static model, no projections beyond 2011 were attempted. Poverty would almost have returned to its usual level, in terms of both scenarios, by then.

Child poverty in 2007 (before the crisis) was estimated at 52.6% when using the moderately low poverty line of R250 per capita per month in 2000 rand terms, or R377 in January 2008 (when applying the NIDS data)<sup>11</sup>. Without an economic crisis, this headcount rate of child poverty would be declining by a small percentage every year if one linked the macro and the micro simulations. It would have declined to 52.2% in 2008 and to 51.9% in 2009. It would have declined to 51.8% by 2011 according to the business as usual simulations. Thus, business as usual would have meant a slow but continuing decline in child poverty.

Figure 4 shows that the most severe effects of the crisis occurred in 2008 and 2009, while by 2010 the effects on poverty were already being reversed to some extent, even under a severe scenario. Its scale allows for a visual inspection of the different effects, but the range is small. However, it accentuates the stark difference between the

Economically, childhood poverty also leaves a mark in terms of poor human capital and lower productivity in later life, thus creating the risk of a vicious circle of poverty.

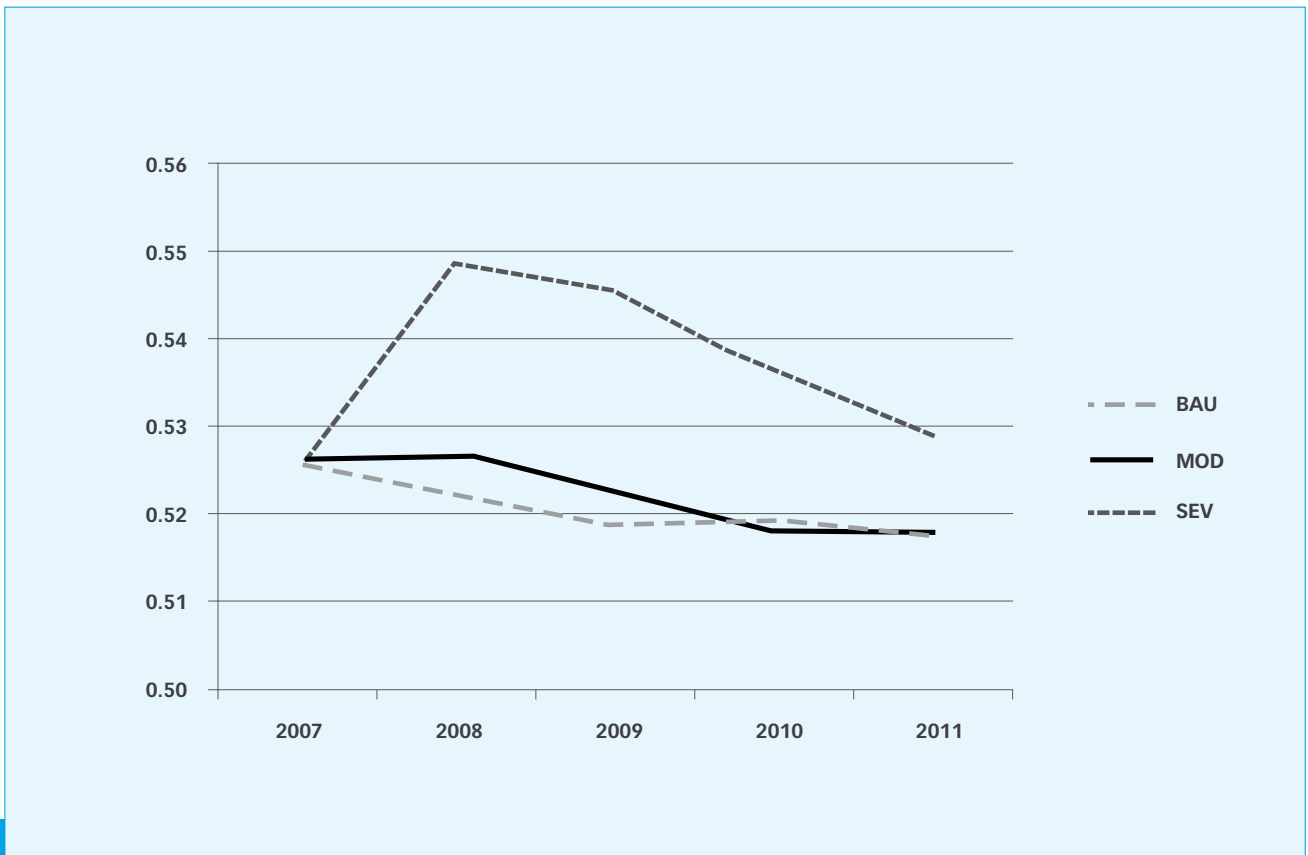
<sup>11</sup> This is a poverty line often quoted in the literature. The 'lower bound' poverty line of Statistics South Africa of R322, quoted by Woolard and Leibbrandt (2006) and derived by Hoogeveen and Ozler (2005), is about 30% higher. The 'upper bound' line of R593 per capita per month in 2000 is about 140% higher.

Table 3: Trends in child poverty under three scenarios, 2007-2011

		BAU	% CHANGE	MODERATE SCENARIO	% CHANGE FROM 2007	SEVERE SCENARIO	% CHANGE FROM 2007
2007	P0	0.526	0.0%				
	P1	0.205	0.0%				
	P2	0.107	0.0%				
2008	P0	0.522	-0.8%	0.527	0.2%	0.549	4.4%
	P1	0.205	0.0%	0.230	12.2%	0.294	43.4%
	P2	0.106	-0.9%	0.137	28.0%	0.208	94.4%
2009	P0	0.519	-1.3%	0.522	-0.8%	0.545	3.6%
	P1	0.204	-0.5%	0.219	6.8%	0.304	48.3%
	P2	0.106	-0.9%	0.125	16.8%	0.215	100.9%
2010	P0	0.519	-1.3%	0.518	-1.5%	0.536	1.9%
	P1	0.203	-1.0%	0.203	-1.0%	0.238	16.1%
	P2	0.105	-1.9%	0.105	-1.9%	0.145	35.5%
2011	P0	0.518	-1.5%	0.518	-1.5%	0.529	0.6%
	P1	0.201	-2.0%	0.202	-1.5%	0.228	11.2%
	P2	0.104	-2.8%	0.104	-2.8%	0.135	26.2%

Source: Own projections Note: % change is shown relative to BAU in 2007

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Figure 4: The poverty headcount ratio (P0) for 2007 to 2011 using three scenarios: business as usual, moderate scenario and severe scenario



severe and moderate scenarios.

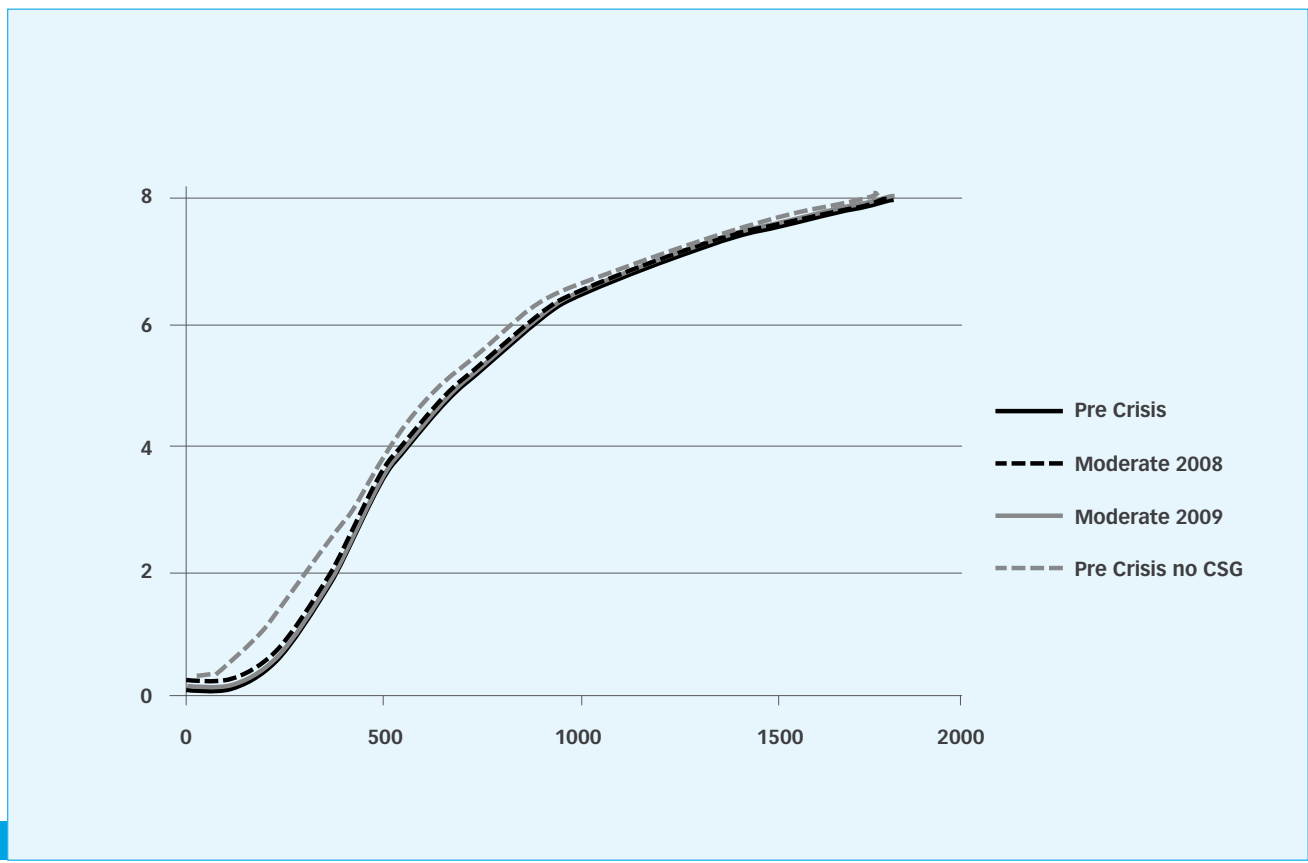
If one focuses on the headcount ratio only, and uses this slightly below conventional poverty line, it is clear that the effect of the moderate scenario on the child poverty headcount was quite small in 2008<sup>12</sup>. The child poverty headcount ratio (P0) hardly increases (by only 0.1 percentage points, or 0.2%). However, there is a 12% increase in the child poverty gap ratio (P1) and a 28% increase in the child poverty severity ratio (P2). This indicates that many of the changes in the economic situation in 2008, in terms of the moderate scenario, occur at lower levels of income (that is, some way below the poverty line). Thus, the poorest are also the most affected. The moderate scenario shows that child poverty actually starts improving in 2009. The headcount ratio drops to 52.2%, only 0.3% above the level of poverty that would have applied in the business as usual scenario and below the initial poverty headcount ratio. Nevertheless, some effect on the poverty gap ratio and on the poverty severity ratio for children remains. This indicates that, although fewer children

were poor than in 2007, the changes at the bottom of the distribution have worsened the situation for the worse off children. If the poverty line had been drawn at a lower level, the poverty headcount also would have risen.

In the case of the more severe economic growth scenario, the child poverty headcount ratio would rise by 4.4% (2.3 percentage points) to 54.9% in 2008 compared to 2007, the poverty gap ratio by 43% and the poverty severity ratio by 94%. This again illustrates the severe consequences for children at the bottom of the income distribution, that is, far below conventionally used poverty lines. Clearly, in the severe economic scenario, very poor children were greatly affected by the crisis in 2008. There was little further change in the poverty figures in 2009 if one used the three conventional measures.

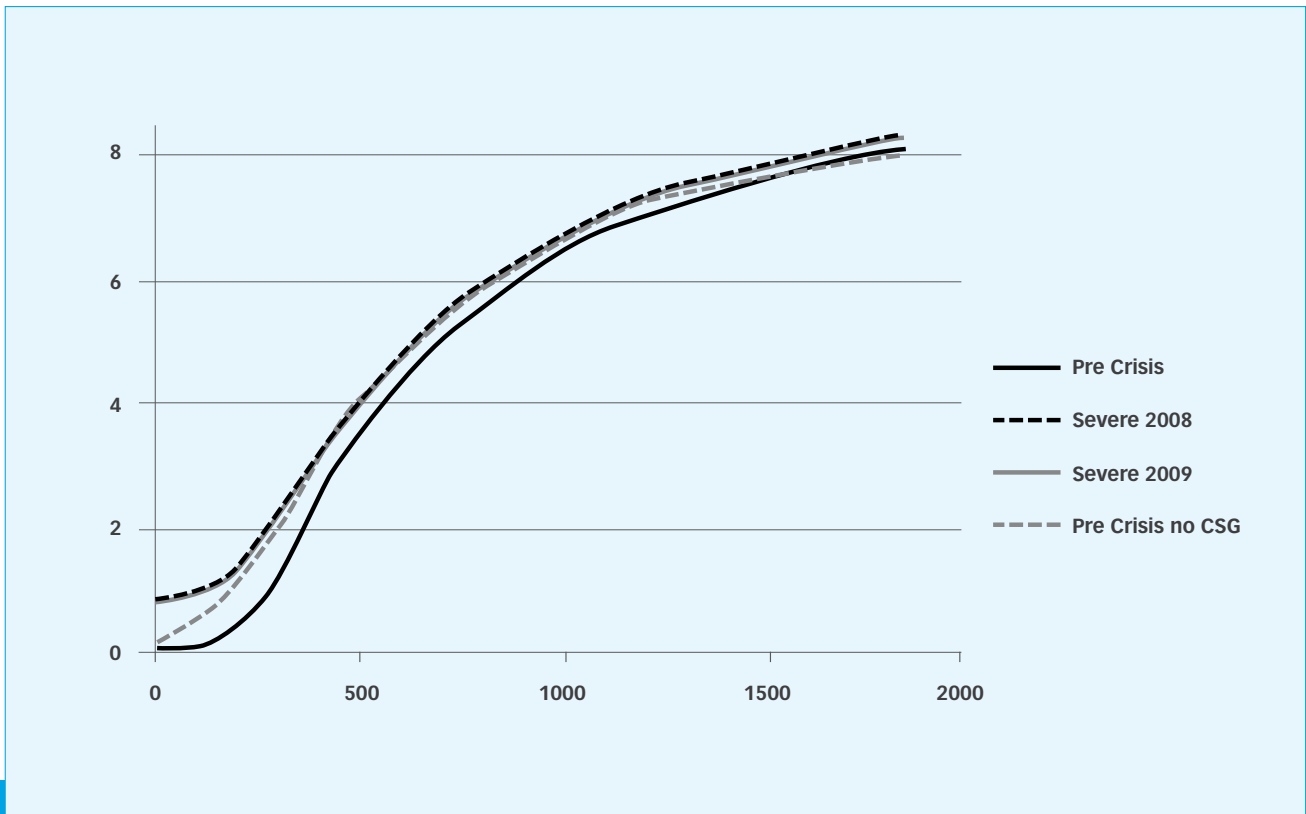
Figure 5 shows the effect of the moderate scenario in 2008 and 2009 against the initial situation in terms of cumulative density functions. If one CDF line lies clearly above poverty,

<sup>12</sup> In practice, poverty lines for this model are derived for each cluster of households in the sample using price levels in their area as reflected by consumption patterns. The per capita lines are those derived directly from the data without considering prices by determining what poverty line would give the same child poverty headcount ratio.



5

**Figure 5: Cumulative density functions (curves) for child poverty in 2007, 2008 and 2009, in the moderate scenario, and a comparison with the beneficial effects of the child support grant**



**Figure 6: Cumulative density functions (curves) for child poverty in 2007, 2008 and 2009, in the severe scenario, and a comparison with the beneficial effects of the child support grant**

using any of the conventional measures and irrespective of the poverty line chosen, we have stochastic poverty dominance. The three lines showing the initial situation and the moderate scenarios in 2008 and 2009 are barely distinguishable, except at the very lowest income levels, where there is clear poverty dominance. These scenarios show relatively small changes that would probably fall within 95% confidence levels of the initial cumulative density function. In comparison, the child poverty situation would have been much worse if there had been no child support grant: the line depicting that situation lies well above all the other three lines. Thus, the moderate scenario for the economic crisis shows an effect that is far too small to undo the beneficial effects for children of the earlier introduction and expansion of the child support grant.

Figure 6 shows the CDFs that compare the 2007 situation with the effect of the severe scenario in 2008 and 2009. Here the effect of the crisis is much clearer and there appears to be complete poverty dominance. Irrespective of the poverty measure or poverty line chosen, except for very high poverty lines, there is a large (and probably statistically significant) effect on poverty. It is even larger among the very poor and

offsets the beneficial effects of the child support grant.

In summary, the cumulative density functions indicate that the effect of the moderate scenario is not that large. In contrast, the effect of the severe scenario is great, particularly at the lower levels. Clearly, we are dealing with poverty effects that affect the poorest most.

Using a lower poverty line confirms what the CDFs and the magnitude of the effects on P1 and P2, relative to P0, have already intimated. This is that the major effect of the crisis is closer to the bottom of the income distribution. At the lower line, the effect of the severe scenario is to increase the poverty headcount ratio more than was the case at the higher line.

Another way of looking at this is to separate the effects on child poverty in urban and rural areas. Poverty amongst children is more severe in rural than in urban areas. In 2007, before the crisis, poverty amongst children in urban areas was 44.9% as against 58.7% in rural areas. The economic crisis appears to have a similar effect in terms of who crosses the poverty line in urban and in rural areas, as the rise in

P0 is quite similar in magnitude. However, the crisis affects already poor children in rural areas much more. P2 rises by 55% in urban areas in 2009 and by 136% in rural areas, using the severe scenario. All poverty measures improve a little in urban areas, while P2 deteriorates by 31% in rural areas if one applies the moderate scenario. Even the price effects, which tend to moderate the difference at lower incomes, cannot overcome the greater effect of labour market events in rural areas. This clearly needs a longer run to determine the positive effect of a return to economic growth.

The greater effect of the crisis at lower income levels and in rural areas may, at first glance, appear strange. However, further investigation shows that, although much of the income loss occurs in urban areas and even among skilled workers, these people are better protected against job losses because they are often members of households that have a variety of other income sources. Apart from social grants, which have a similar effect of diversifying income among the poor, the poor and rural dwellers are, in many cases, quite weakly protected against job loss. It is therefore not surprising that they fall below, or further below, the poverty line when they lose their jobs.

If one separates that part of the effect caused by price changes and job losses, we see that the effect of job losses is by far the greater. Nevertheless, price changes do play an independent role and in some situations serve to moderate the effect of poverty on rural compared to urban areas. This particularly applies to people close to the poverty line<sup>13</sup>.

### 3.3 Non-money metric poverty

Up to now, the analysis has been largely on money metric poverty. Lack of money because of the economic crisis may also spill over into other spheres of life, with possible consequences for other dimensions of child poverty. Three potential areas stand out: education, health, and welfare services.

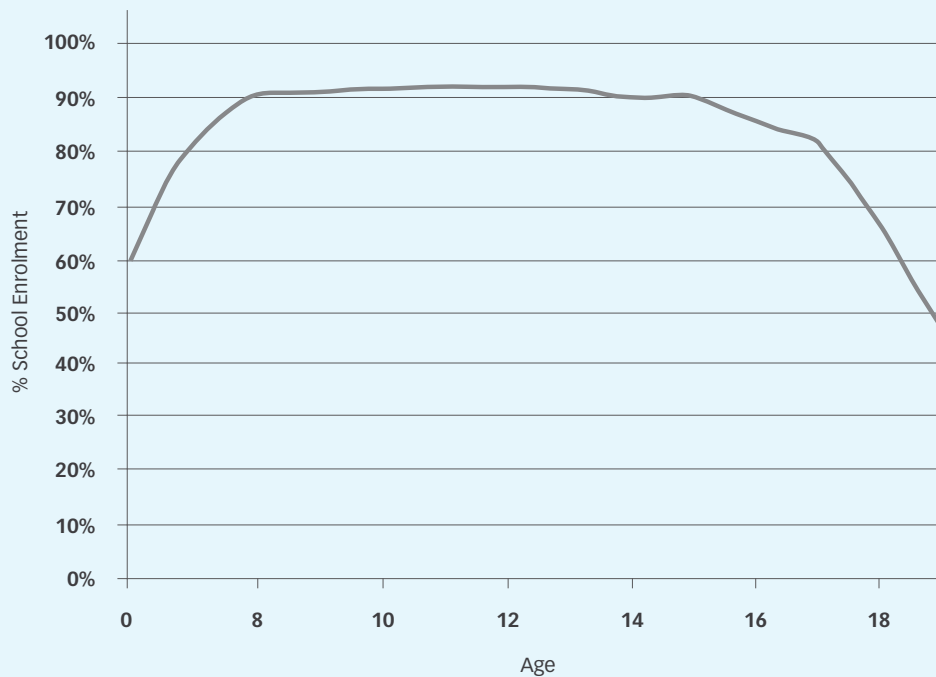
Access to education up to secondary school level is now almost universal. The poor are not excluded from schools, but often obtain a poor quality education. Figure 7 below shows that almost all children between the ages and 7 and 17 are enrolled at schools. However, given universal access to schools and government policies to support access to the poor (like the recent decision to introduce no fee school education

for children in the poorest two quintiles and not the poorest three quintiles of schools), the economic crisis and increased money metric poverty, it has probably had little effect on school enrolment. However, there may have been negative implications for school attendance, a much more pervasive problem. School-related costs (uniforms, some books and, in some cases, school fees and fees for excursions) make it more difficult and sometime embarrassing for some of the poor to attend school, although school feeding programmes may dampen the effect. However, few school-age children in South Africa have realistic options of participating successfully in the labour market or being engaged in subsistence farming, because of the small size of this sector.

Access to health services has improved considerably since the political transition, despite severe quality problems. The issue is, to a large extent, no longer access to health care of some sort but access to quality health care. Most people, even the poor, seek this through visiting private health facilities when their ailment is serious enough or when their financial resources permit. Figure 8 shows that there is little evidence of a problem of getting access to a health worker when ill. The differences between those in poorer income categories and those in richer ones are not significant. The issue is rather access to quality health services, which are often identified with having access to a doctor, mainly private doctors in their consulting rooms. It is quite evident from the figure that this access is largely dependent on economic status. The poor do not suffer from lack of access to health facilities because of their poverty, for most public health services are free or heavily subsidised. The financial aspect only becomes a factor when it comes to the choice of health facility or health worker and it is likely that the crisis may have forced some poor children back to visiting public rather than private health facilities.

Social welfare services in South Africa are inadequate and mainly urban based, as they depend largely on private welfare organisations, some of which partly subsidised by the state. Child abuse is quite common, particularly in some of the poorest communities. Although this phenomenon does not link directly to money metric poverty, one can expect increased economic stress levels to contribute in circumstances where the problem is already common. Thus, the problem may have arisen because of the economic crisis.

<sup>13</sup> This may not seem an appropriate way of modelling the results, and one may wish to revert to a scenario in which only the effect of the labour market is measured. Nevertheless, in this model, poverty lines have been set for each cluster of observations in the initial sample based on the price ratios that appear to apply in those clusters. The methodology is described in the technical report.



Source: Calculated from General Household Survey (GHS) 2008.

Figure 7: School enrolment ratio by age for children aged 6 to 19, 2008

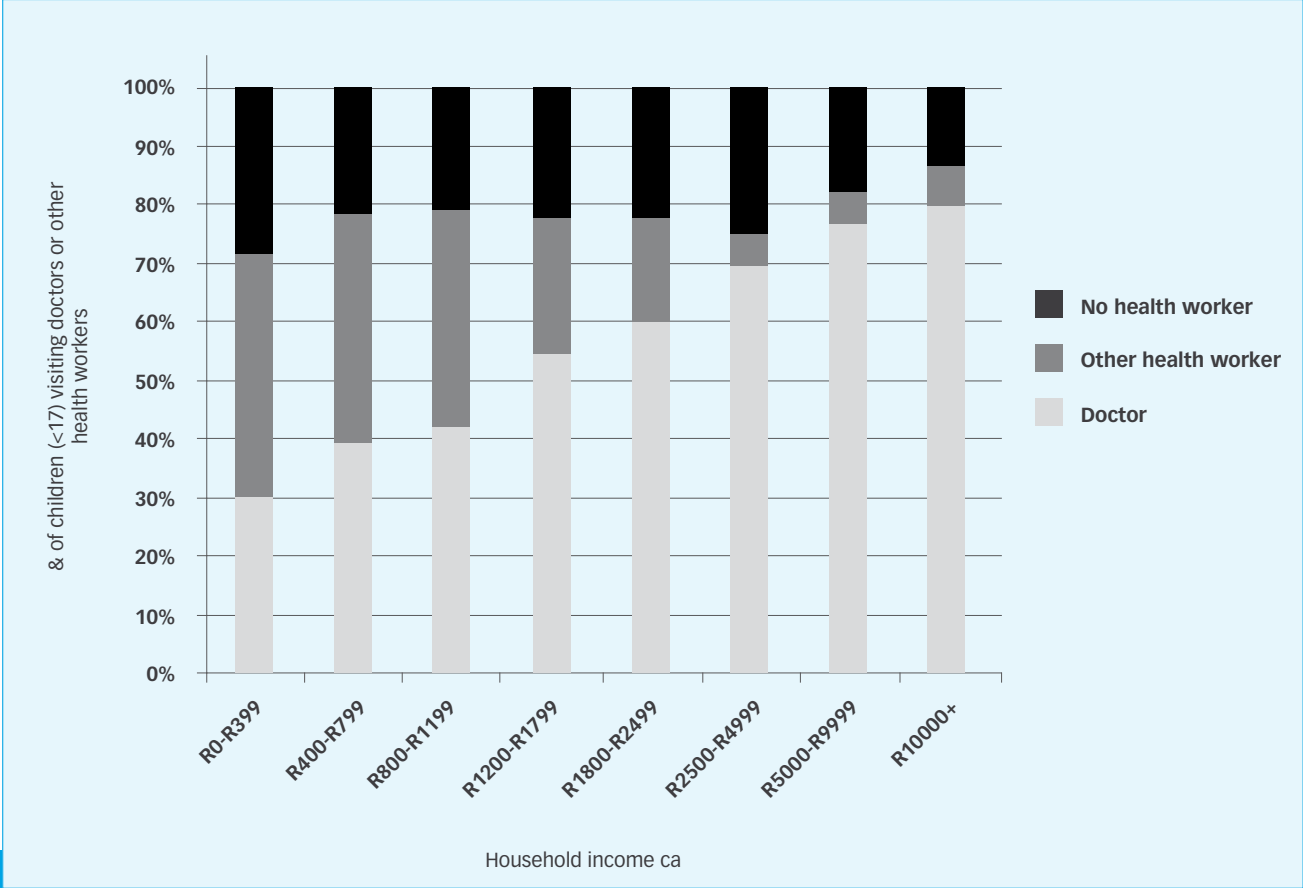
## 4. CONCLUSION AND RECOMMENDATIONS

This chapter has found that the global crisis interrupted the decline of child poverty and hunger. There is quite a strong effect on child poverty, but most of it is at extremely low-income levels, that is, amongst the very poorest children. The government has responded to the crisis in several ways. The broad principles of government's response include:

- 1. avoiding the risk of placing the burden of the downturn on the poor and vulnerable;**
- 2. ensuring that all activities are aimed at strengthening the capacity of the economy to grow and creating decent jobs during and beyond the crisis;**
- 3. maintaining the planned high levels of investment in public sector infrastructure; and**
- 4. encouraging the private sector to maintain and improve its levels of fixed direct investment wherever possible.**

Old schemes have been stepped up and new ones introduced. The Commission acknowledges the significant role that old schemes, especially the child support grant, have played in reducing the effect of the crisis on child poverty. Introducing social protection programmes in South Africa, especially the child support grant, has paid off in assisting poor families to stay above water in both ordinary and extraordinary times. The Commission commends the government of South Africa for continuing this policy during the crisis by extending the coverage of the child support grant.

Prudent management of the public finances before and during the crisis has also left South Africa in a much sounder fiscal position than many other countries. Our long-term modelling has indicated that the world economic crisis produced a huge drop in GDP. For both scenarios, GDP fell in 2008 and 2009 and then increased again, but it does not return to its business as usual value even by 2015. In other words, without positive shocks or deliberate and successful government interventions that stimulate the economy and counteract the negative effect of the world crisis, GDP will not recover to what it would have been without the crisis. This also has implications for fiscal variables. Fiscal consol-



Source: Calculated from GHS2008

Figure 8: Visits to doctors and other health workers by children who were ill, 2008

idation has become unavoidable in the short- to medium-term. Therefore, the 2011/2012 budget will not leave much room for introducing costly new programmes given this adjustment imperative.

**The Commission makes the following recommendations for the Division of Revenue:**

1. In the short-term, government should continue to strive for fiscal consolidation<sup>14</sup>:
  - a) By limiting the growth in entitlement spending to those programmes that have demonstrably worked while refocusing expenditures to ensure better coordination and to deepen access by focusing on improved service quality. In particular, the Commission recommends that the government should:
    - o Continue to expand the child support and old age pension grants (the best targeted of social spending programmes that also complement anti-poverty interventions while

- o building human capital and meeting other basic needs).
- o Maintain high access levels to education and health services that it achieved even during the period of the global economic crisis.
- o Reprioritise expenditure towards repair and maintenance by emphasising existing projects and initiating new ones.

2. In the medium- to long-term, the government should:
  - a) Introduce a block grant for education, health and social development to fund clearly defined and costed outcomes in these areas.
  - b) Undertake independent cost effectiveness and quality review (across both public and private sectors) of education, health and the social wage.
  - b) Undertake independent cost effectiveness and quality review (across both public and private sectors) of education, health and the social wage.

<sup>14</sup> By fiscal consolidation we mean a policy aimed at reducing government deficits and debt accumulation.

## OPTIONS FOR SOCIAL ASSISTANCE REFORM DURING A PERIOD OF FISCAL STRESS

### 1. INTRODUCTION

The social assistance components of social security systems consist of non-contributory cash or in-kind grants to protect the neediest. Extensive fiscal space and sweeping reforms during the past two decades have enabled South African policymakers to develop an unusually large social grants system by the standards of middle-income countries. This report reflects on the current state and likely future of the South African social assistance system. It focuses on its fiscal sustainability, its effectiveness as an instrument to combat poverty in a longer-term developmental sense and its effect on allocating resources.

### 2. THE SOUTH AFRICAN SOCIAL SECURITY SYSTEM

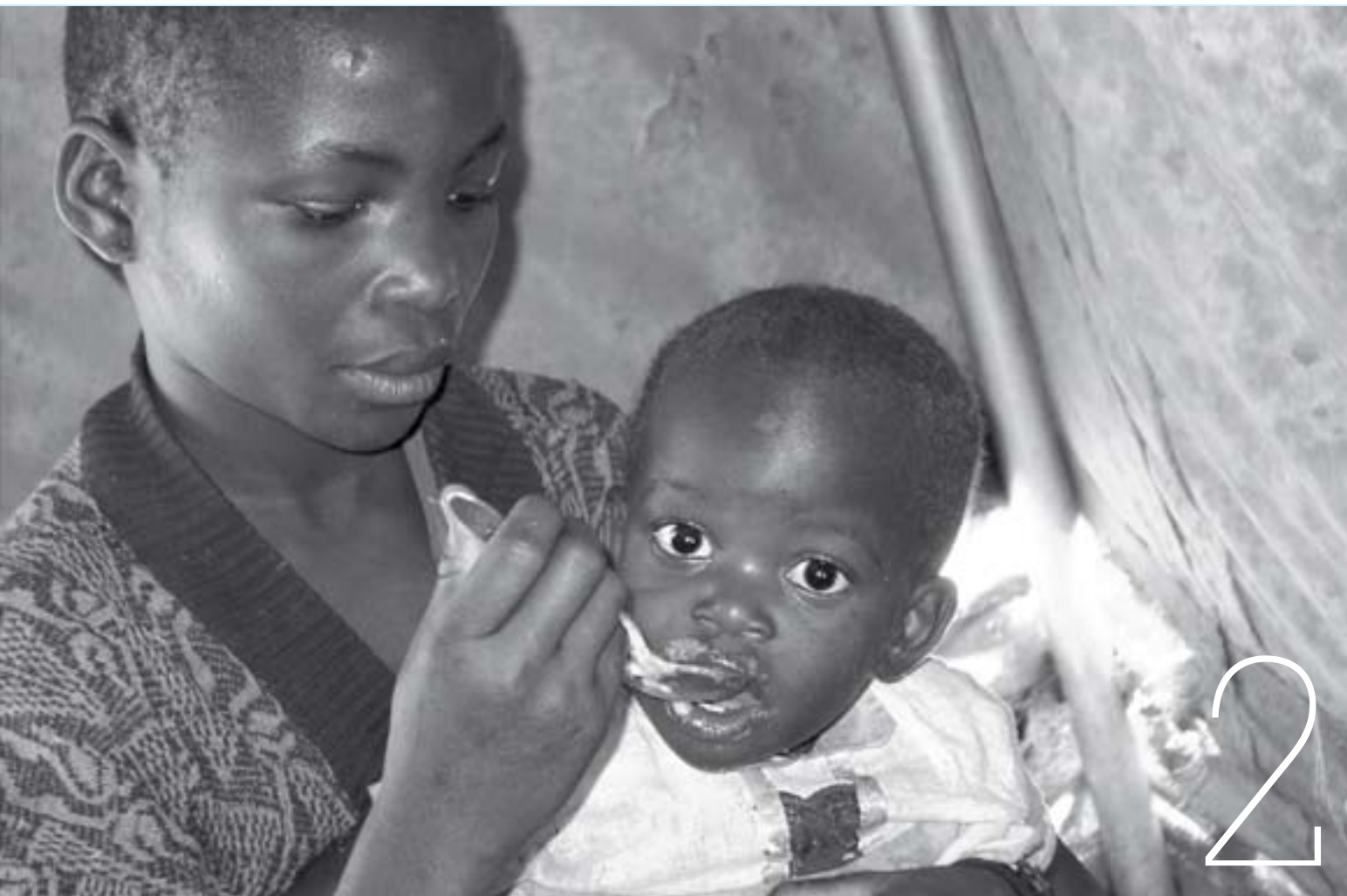
#### 2.1 Elements and coverage

The social assistance component of the South African social security system gives means-tested income support to the members of three vulnerable groups: children, the elderly and the disabled. More than 90% of the recipients of grants benefit from one of the three largest programmes (the old-age pension, the disability grant and the child support grant), which also account for more than 90% of total social assistance expenditure. The grants system has grown rapidly since the late 1990s. Government spending on social grants increased from 2.3% of GDP in the 1998 fiscal year to 3.1% in the 2009 fiscal year. The number of beneficiaries of social grants increased from 2 889 442 in April 1997 to 13 114 033 in April 2009 because of developments like equalising benefits across gender groups, adjusting grant amounts to counteract

the effects of inflation fully or partially, introducing and gradually expanding the child support grant and increasing disability and foster-care grants. The purchasing power of the old-age pension, war veterans' pension, disability grant, care dependency grant and foster care grant all increased, but only modestly between 1994 and 2009, while that of the child support grant has increased markedly since its introduction in 1998.

#### 2.2 The budgetary sustainability of the social assistance system

The rapid size and growth of the South African social grants system have given rise to concerns about its longer-term sustainability, within as well as outside of government. In 2004, for example, the National Treasury (2004a: 73) made this comment on trends in the ratio between social grants expenditure and GDP: "This ratio is high compared to most other developing countries, and also high relative to spending



on cash social assistance in some high income countries. Growth of this magnitude relative to GDP raises sustainability questions for the future.” In addition, the limited size of South Africa’s tax base also has contributed to concerns about the sustainability of the social assistance system. In this regard, critics sometimes point to the gap between the numbers of individual taxpayers and that of the beneficiaries of social grants. At the end of February 2009, for example, South Africa had about 2.3 recipients of grants for every registered individual taxpayer<sup>15</sup>.

Figure 9 shows that the fiscal situation has remained sustainable despite the rapid growth in government spending on grants and other social security programmes from the mid-1980s<sup>16</sup>. The thorough overhaul of tax administration and collection in the second half of the 1990s and sustained positive economic growth from 1994 until 2008 were the main reasons why increased social assistance spending has not caused fiscal problems. The subsequent rapid growth in tax revenues has enabled the government to increase spending on social grants steadily while reducing budget deficits and the public debt burden during the second half of the 1990s and

<sup>14</sup> On 28 February 2009, South Africa had 5 540 646 registered individual taxpayers and 12 972 828 grant recipients (National Treasury, 2009b: 6; South African Social Security Agency, 2009: 5)..

<sup>15</sup> A fiscal position is sustainable when the public debt burden does not pose the risk of an unmanageable upward deficit-debt spiral leading to debt default, given public spending commitments, tax capacity and compliance. An analysis of fiscal policy in South Africa between 1960 and 2008 by Calitz, Du Plessis and Siebrits (2009) showed that the post-1985 period formed part of a longer-term epoch of fiscal prudence during which South Africa avoided the fiscal policy-rooted macroeconomic crises that plagued many developing countries in Africa and elsewhere during this period.

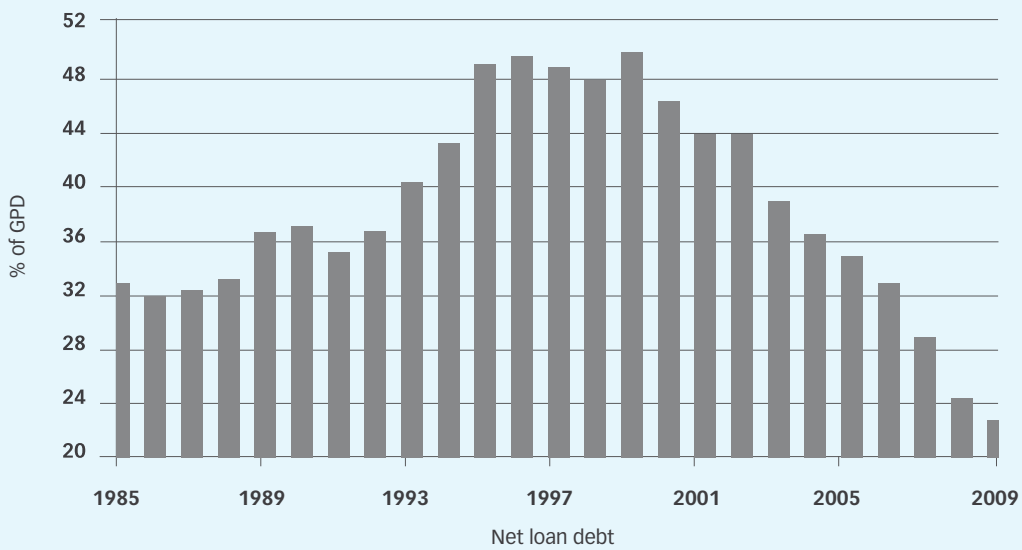
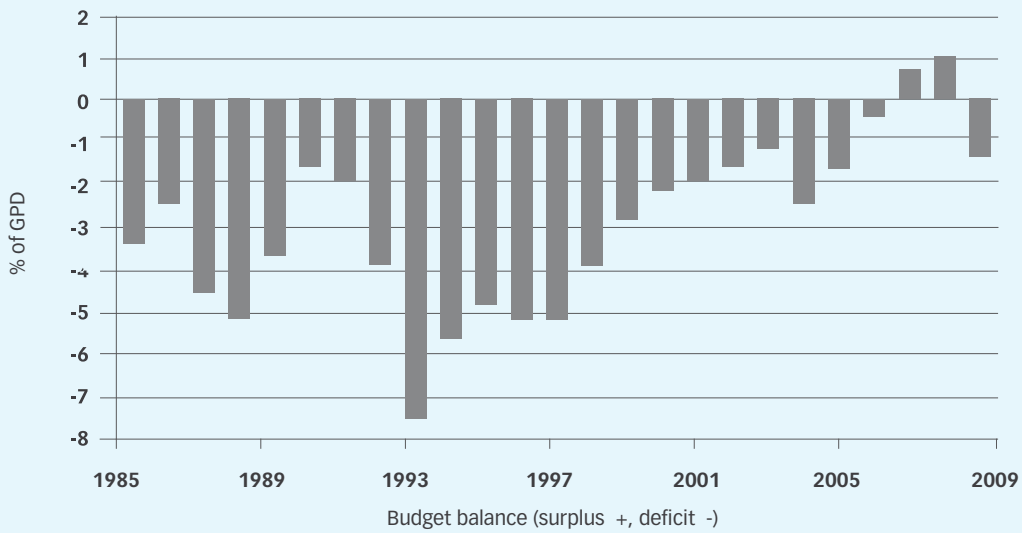
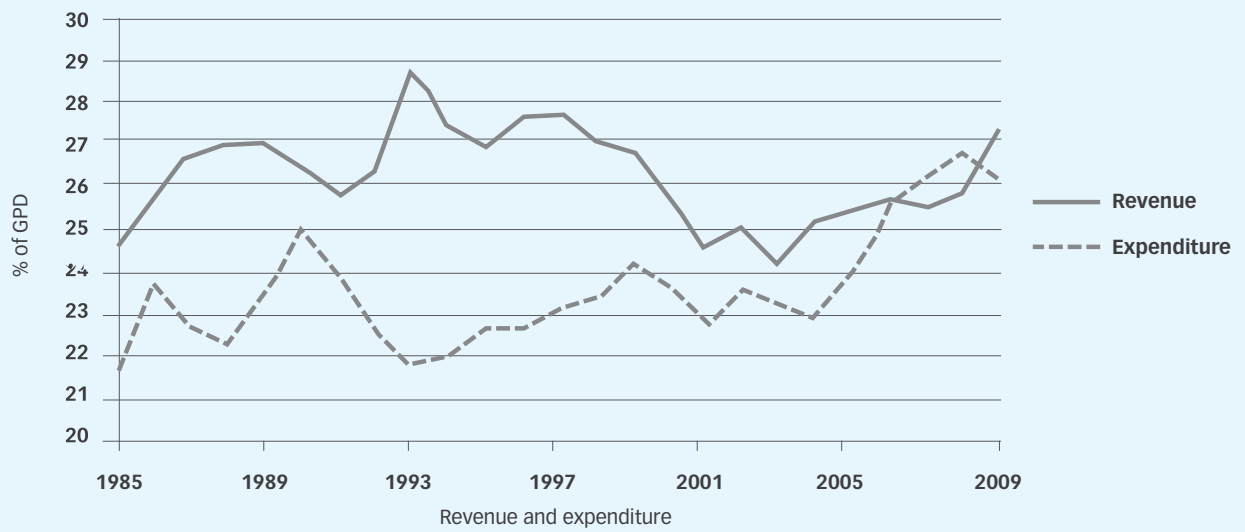


Figure 9: National government main fiscal aggregates (1985 - 2009)



**Table 4: Functional classification of general government spending (1995, 2001 and 2007)**

	PERCENTAGES OF GDP		
	1995	2001	2007
<b>General public services</b>	4.2	3.1	5.5
<b>Protection services</b>	5.3	4.5	4.8
<b>Social services</b>	15.0	14.8	15.6
Education	7.0	6.2	5.8
Health	3.1	3.1	3.2
Social protection	3.2	3.5	4.5
Other social services	1.7	1.9	2.2
<b>Economic services</b>	5.2	3.1	3.2
<b>Public debt transactions</b>	4.7	4.9	2.8
<b>Total</b>	34.4	30.3	32.1

Source: South African Reserve Bank electronic data

to keep these aggregates at manageable levels thereafter<sup>17</sup>.

Table 4 highlights how extensive the fiscal space available to the authorities was after the successful conclusion of the fiscal consolidation effort in 2000. Between 2001 and 2007, the combination of rapid revenue growth and steady decreases in the interest payments on public debt made it possible to increase the GDP shares of almost all functional spending categories in the context of an expansionary fiscal policy stance. This raised general government expenditure from 30.3% to 32.1% of GDP. Hence, compared to the period between 1995 and 2000 (when general government outlays decreased by 4.1 percentage points of GDP), expanding social security spending from 2001 until 2007 did not require

compensating reductions (as percentages of GDP) in expenditures on other general government functions.

Table 5 shows that the recent global financial crisis has dramatically changed the fiscal situation in South Africa. The sharp slowdown in economic activity reduced national government tax revenue from 26.9% of GDP in the 2008 fiscal year to an estimated 23.3% in the 2010 fiscal year. Expenditure (boosted by countercyclical outlays and the capitalisation of Eskom, inter alia) increased from 26.0% of GDP to an estimated 30.6% during the same period. These developments resulted in a sharp deterioration in the national government's budget balance from a surplus of 0.9% of GDP in the 2008 fiscal year to a projected deficit of 7.3%

**Table 5: National government fiscal framework (2008-2013)**

	PERCENTAGES OF GDP AT THE END OF FISCAL YEARS					
	2008	2009	2010	2011	2012	2013
	Outcomes			Estimates		
<b>Revenue</b>	26.9	26.2	23.3	23.8	24.3	24.5
<b>Expenditure</b>	26.0	27.4	30.6	30.3	29.9	29.3
Debt-service costs	2.5	2.3	2.4	2.6	3.0	3.2
<b>Budget balance</b>	0.9	-1.2	-7.3	-6.5	-5.6	-4.8
<b>Gross loan debtv</b>	27.7	27.0	32.5	37.1	40.9	43.1

Source: National Treasury (2010a: 61, 93)

<sup>16</sup> Increased spending on social grants contributed to relatively large budget deficits from 1990 onwards. However, it was a noticeably less important causal factor than several extraordinary expenditures (including spending on drought relief and transfer payments to the government pension fund to improve its actuarial position) and the depressing effect on tax revenues of the protracted recession that lasted from 1989 until 1993 (see Calitz et al., 2009: 5-6).

in the 2010 fiscal year. National government gross loan debt is projected to reach 43.1% of GDP in the 2013 fiscal year, up from 27.0% in 2009 (National Treasury, 2010a: 61).

In the short- to medium-term, fiscal consolidation has become unavoidable. The adjustment imperative will leave no room for introducing costly new social assistance initiatives between 2011 and 2013. However, the government remains committed to extending the child support grant to eligible children until their 18th birthday during this period. The available information does not suggest that the government spending-to-GDP ratio is likely to increase to such an extent over the next decade that severe cutbacks in social assistance would be required. However, the exceptionally high rates of growth in tax revenues during the late 1990s and early 2000s are unlikely to recur once the economy has recovered fully from the effects of the global crisis. This may well severely limit future growth in public spending (including outlays on social grants).

### 3. SOCIAL GRANTS, POVERTY AND DEVELOPMENT IN SOUTH AFRICA

#### 3.1 Social grants as a component of anti-poverty policy in South Africa

The post-apartheid South African government has consistently stressed the importance of job-creating economic growth as the main mechanism for reducing poverty. It argues that growth creates economic opportunities that enable poor households to earn better incomes through jobs or self-employment. Mindful of the high incidence of unemployment and deprivation in South Africa, the government has improved the poverty-mitigating effect of economic growth through other interventions. These include:

1. the Expanded Public Works Programme (EPWP);
2. the social insurance and social assistance components of the social security system;
3. human capital investments in health care, education and training;
4. a 'social wage' that consists of basic services and other non-financial transfers (including a raft of minimum free basic services for vulnerable groups); and
5. programmes that facilitate access to assets like housing,

land and capital.

The social assistance system plays a very specific role within this gamut of anti-poverty interventions. This is to assist needy groups who are not economically active (the disabled, poor children and elderly individuals).

The grants system is an important salient element of government spending on social services for at least three reasons. The first is its size. Expenditure on social grants is now more than one-third of government social spending, making it the second largest component of this spending after education. Secondly, social grant programmes are particularly effective instruments for ensuring that resources reach the poor, being the best targeted of all social spending categories. Thirdly, the social assistance system is the main cash-transfer component of poverty-focused public spending programmes in South Africa. By providing cash to individuals who are incapable of earning an independent living (like the disabled, poor children and elderly persons), the social grant schemes complement anti-poverty interventions that build human capital (like education and health services) and meet other basic needs (like housing, water and electricity subsidies).

#### 3.2 The effectiveness of the South African social assistance system

##### 3.2.1 Social grants and the incomes of poor households

Social grants have become an increasingly common and important source of income for poor South Africans who lacked access to adequate wage incomes over the past ten to fifteen years. Labour-market earnings constituted more than 80% of the total incomes of each of the three richest deciles in 2008, but only 18.7% of the total income of the poorest decile. Income from grants was an insignificant source of income for the three richest deciles, but the income shares of social grants ranged from 48.3% to 72.7% in the four poorest deciles. The three largest grant programmes (the old-age pension, the child support grant and the disability grant) more than doubled the income share of the two poorest quintiles in 2006 – from 3.3% of total pre-transfer income to 7.6% of income including grants. An analysis of data from Statistics South Africa's Income and Expenditure Survey 2005 showed that social grants reduced the headcount poverty rate from 45.5% to 31.5% (that is, by 13.9 percentage points or 30.5%) at a poverty line of R2 532 per person per annum. Additional evidence of the poverty-reducing effect of social grants includes the drop in the headcount poverty rate from 50% in 1993, and a peak of 53% in 1996, to 39% in 2008. The

percentage of children who had gone hungry in the previous year decreased from 31% in 2002 to 16% in 2006.

### 3.2.2 Developmental effects

Providing well-targeted cash transfers to the poor is, at best, a necessary condition for reducing poverty. The actual effect of these transfers depends essentially on how poor people use the money. No evidence of large-scale squandering of grant money has come to light yet. Instead, the available evidence suggests that the money is widely invested in sustaining and educating children. This should contribute to their productivity in the future.

Several studies have found that grants boost the amount of money that the beneficiaries spend on food, resulting in nutritional benefits to children. Using children's height-for-age ratios as *ex post* indicators of nutritional inputs, one study found that children in KwaZulu-Natal benefitted significantly from receiving child support grants during the first 36 months of their lives. Another study, based on data from all three rounds of the KwaZulu-Natal Income Dynamics Study (KIDS), found that nutrition-related improvements in child health lowered the age for starting school markedly, increased the grade reached and reduced grade repetition at the early stages of schooling. According to a third study, each grant received by a household reduced the probability that any child in that household went hungry significantly. With regard to old-age pensions, it emerged that the gender of the recipient influenced the nutrition and health-status effects of social grants. The nutrition of families with female pension recipients was more likely to improve than those with male recipients.

Receiving child support grants and old-age pensions has encouraged school attendance among recipients of child support grants and children living with pensioners. The positive effects on attendance have been small in absolute terms – a reflection of the relatively high school enrolment and attendance rates in South Africa – but have implied significant reductions in non-attendance.

### 3.2.3 Incentive effects

1. **The labour market.** The South African social grants system influences the supply of labour through direct and induced effects on retirement decisions, household formation and job search activities. Direct effects have to do with the incentives faced by the actual recipients of grants. The means test discourages elderly people of limited means from working after reaching the age of

eligibility for pension by imposing an effective marginal tax rate of 50% on non-pension incomes that exceed R606 per month (R7 272 per annum).

A similar poverty trap arises in the case of the disability grant, which is subject to the same means test. In the South African context, the exceptionally high unemployment rate and other labour-market disadvantages faced by elderly and disabled South Africans (many members of these groups have limited skills and reside in rural areas where job opportunities are scarce) probably exacerbate the discouraging effect of the means tests. An additional factor that affects people with disabilities is that the available job opportunities tend to be temporary and poorly paid.

With regard to the induced labour-market effects of elements of the South African social assistance system (that is, on persons other than the actual recipients), there are strong indications that the social pension has become a major source of support for unemployed South Africans of working age, especially in rural areas. Unemployed youths and younger adults often delay forming new households or return to their parents or relatives to share in the pension incomes of the elderly. Some individuals stop looking for work when they join these households, often because they are located in rural areas where job opportunities are scarce.

Researchers who have included migrant absentees in their definitions of households, however, found that access to income from pensions stimulates labour-market participation by enabling some household members to undertake job searches away from home. The labour-supply effects of the child support grant seem to be small, possibly because of its relatively small monetary value.

2. **Saving.** The means test imposes an onerous effective marginal tax rate of 50% on non-pension incomes that exceed R606 per month (R7 272 per annum). Hence, the means-tested nature of the social old-age pension reduces the incentive for low-income earners to save for retirement. The actual effect of this disincentive on the savings decisions of lower-income workers has not been established empirically yet.
3. **Fertility.** Empirical evidence on the possibility that the availability of child support grants has been encouraging needy women (especially teenagers) to have more children

remains scant. However, one study that has looked into trends in the incidence of pregnancy among teenagers and the extent of take-up of the child support grant among teenage mothers concluded that introducing the grant probably has not had a major effect. In all likelihood, a small grant of R250 per month or less would have been a decisive factor in the reproductive decisions of only a relatively small number of people. The introduction of the child support grant, at most, has slightly slowed the ongoing decline in the fertility rate in South Africa compared to what would have happened otherwise.

**4. Health.** People infected with the Human Immunodeficiency Virus (HIV) and the Acquired immune deficiency syndrome (Aids) qualify for disability grants when they become physically unable to work. However, payment of these grants is terminated if their health status improves sufficiently. This policy could give rise to perverse incentives. Given the difficulty of finding employment in the labour-saturated South African economy, HIV and Aids sufferers may be tempted to avoid or discontinue Highly Active Anti-retroviral Treatment (HAART) in order to remain eligible for disability grants. A study involving a large sample of the residents of the Khayelitsha Township in Cape Town, however, found no evidence of people compromising their health in this manner. Losing the disability grant because of successful anti-retroviral treatment nonetheless often subjected individuals and households to sharp decreases in incomes.

## 4. REFORM AND POLICY OPTIONS

### 4.1 Economic growth, job creation and poverty in South Africa

Relatively low per capita incomes limit the scope for reducing poverty by redistributing existing resources in developing countries. Therefore, job-creating economic growth is the primary vehicle for reducing poverty in a sustainable manner. In South Africa, employment growth during the post-1994 period has been inadequate to reduce unemployment and poverty sharply. Unemployment was already high at the time of democratisation and increased further during the second half of the 1990s and the early years of the millennium. The narrow and broad unemployment rates peaked in March 2003 and then decreased as economic growth accelerated, reaching lows of 23% in September 2007 and 30.2% in September 2008. Job losses resulting from the global financial crisis partially reversed this progress, however, and by the end of 2009, the narrow unemployment rate had risen to 24.3%.

International comparisons of unemployment are fraught with problems, but the evidence suggests that the level of open unemployment in South Africa is exceptionally high.

Research has suggested that supply-side and demand-side factors have hampered the ability of the South African economy to create enough jobs. On the supply side, South Africa has experienced rapid labour-force growth, especially during the second half of the 1990s. The labour force has expanded much more rapidly than that of the working-age population, which implied that labour-force participation rates increased markedly. Inadequate economic growth has been the major demand-side factor that has hampered job creation in South Africa. Furthermore, mismatches between the supply of, and the demand for, labour have restricted the labour intensity of economic growth. Most notably, the economy has experienced considerable structural change since 1970. This has contributed to an increase in the demand for more skilled labour, accompanied by a fall in the demand for unskilled labour. This development has markedly worsened the employment prospects of the large unskilled portion of the South African labour force.

The relationship between labour-market institutions and outcomes remains a controversial aspect of the unemployment debate in South Africa. It requires more research. Excessive wage growth, however, was probably not a strong driver of the increase in unemployment in South Africa between 1995 and 2003.

Analysis of the South African labour market has highlighted two additional constraints to overcoming the unemployment problem. First, the legacy of apartheid-era spatial planning (which separated black job seekers from job opportunities) and residual vestiges of racial discrimination may well undermine the effectiveness of search processes in the labour market. Secondly, young people seem to experience exceptional difficulty in obtaining their first jobs and are affected particularly harshly by the scarcity of jobs. Firms apparently put a high premium on work experience when making employment decisions, possibly as a screening mechanism in an environment where virtually all younger workers now have at least ten years of formal education.

Another notable feature of the South African labour market is the small size of the informal sector. Compared to the situation in most developing countries, the informal sector apparently has not expanded rapidly to compensate for the scarcity of formal sector jobs. In the fourth quarter of

2009, for example, some 2.1 million workers were active in the non-agricultural informal sector while 5.8 million were either openly unemployed or classified as discouraged work-seekers. Attempts to explain this anomaly have found no conclusive evidence of widespread involuntary unemployment in South Africa. In fact, surveys have consistently found that informal sector workers are markedly better off in terms of income and expenditure than the unemployed are. Members of the former group tended to be markedly more satisfied with their living standards than members of the latter. This has been interpreted as evidence of significant barriers to entry to the informal sector, including factors like the effect of apartheid education and restrictions on developing entrepreneurial skills among blacks, crime and insecurity, inadequate government support, and the lack of credit for start-up capital.

Future trends in economic growth and job creation will be major determinants of the numbers of people who will need government assistance in the form of social grants or other interventions. Simple projections indicate that even comparatively modest rates of economic growth, of the order of 3% per annum, should contribute to job creation and reductions in the unemployment rate, but will not necessarily affect the absolute number of unemployed. A growth rate of 6% per annum should result in large-scale job creation and marked reductions in the unemployment rate as well as the number of unemployed. Nevertheless, the extent of joblessness in South Africa is such that even a decade of rapid growth and job creation could still leave almost 10% of the labour force (roughly 1.9 million work seekers) unemployed.

#### 4.2 The future role of social grants in South African anti-poverty policy

The South African social grants system effectively combats dependency-related poverty (poverty that occurs when personal characteristics, like disability, old age or childhood prevent persons from earning an independent living). It also affects the chronic poverty that is related to low productivity when grants (especially old-age pensions) are used to sustain unemployed labour-force members in multi-generational households. This sharing of grant income, however, carries the risk of diluting grant money to such an extent that all members of households that support unemployed persons (including the targeted beneficiaries) could become poor.

The case for maintaining the existing targeted social grants is very strong. These grants effectively assist poverty groups who otherwise would be extremely vulnerable in an

environment where large-scale structural unemployment and the HIV and Aids pandemic put considerable pressure on informal social security systems. The most vexing questions about the future of the South African social assistance system stem from the reality that it was not designed to address the chronic poverty that results from structural unemployment. The absence of dedicated assistance to the long-term unemployed has restricted the ability of the social grants system to reduce poverty in two ways:

1. by excluding large numbers of poor households from coverage and;
2. by giving rise to sharing grants, thereby diluting the benefits of those who are covered.

The government has rejected calls to address this gap in the social assistance system by adopting a universal income grant. The introduction of such an expensive programme will be out of the question in the next few years because of the need for fiscal consolidation. It is unlikely to be sustainable in macroeconomic terms thereafter as well. A basic income grant could also be a disincentive to labour market participation and could contribute to unhealthy welfare dependency among the poor. Moreover, the introduction of such a large entitlement programme is a form of 'open-ended fiscal exposure'. It may expose future governments to strong pressure for increases in the amount of the grants.

Two interventions currently assist the unemployed: the Unemployment Insurance Fund (UIF) and the Expanded Public Works Programme. The effects of these interventions are considerable, but inadequate. In 2009/2010, the UIF assisted about 5% of the more than 4.1 million unemployed members of the labour force. This ratio falls to about 4% if the more than one million discouraged work seekers are also considered. One of the main reasons why this ratio is so low is that most of the unemployed have never worked and therefore do not qualify for UIF assistance.

The first phase of the EPWP, which ran from 2004 until 2009, comfortably exceeded its target by creating 1 709 675 work opportunities in net terms. The programme also supplied more than 7.1 million person-days of training. Wage payments to workers amounted to at least R6 725.9 million at an average minimum daily rate of R53. EPWP wage disbursements were nevertheless relatively small compared to the total expenditure on the programme (R49 687 million) and the total spending on social grants for the same period

(R285 807 million).

Phase II of the EPWP, which began in 2009, is a major expansion of the programme. Total spending is expected to amount to R52 billion over the next three years, and the aim is to create 4.5 million short-term jobs that will last an average of 100 days (the equivalent of about more than 2 million full-time jobs). The possible contribution of the second phase of the EPWP to reducing joblessness should be assessed against the scale of the unemployment problem in South Africa. Even exceptional economic performance over the next decade (a constant real output growth rate of 6% per annum) is likely only to reduce the number of unemployed from the current 4.1 million to about 1.9 million.

The South African government recently announced another intervention aimed at creating jobs. This is a wage subsidy scheme to encourage firms to employ young work seekers without work experience. The goal of the envisaged scheme is to increase the employment of young school-leavers by 500 000 by 2013. It is difficult to judge the feasibility of this target, because the job-creating effect of wage subsidy schemes is likely to depend on the flexibility of substituting production factors and the flexibility of the labour market.

### 4.3 Conditional cash transfers

#### 4.3.1 Overview and international experience

Conditional cash transfer (CCT) programmes make human capital investments by poor families (like sending children to school or making regular visits to health centres) conditions for receiving cash grants. The explicit aim of CCT schemes is to combat current poverty (by providing income support that enables consumption smoothing) and future poverty (by encouraging human capital accumulation among the young in an attempt to break the intergenerational poverty cycle). Several countries in Latin America, Central America and the Caribbean have adopted CCT schemes. They include Brazil, Colombia, Honduras, Jamaica, Mexico and Nicaragua. Adopting these schemes was a direct response to the shortcomings of traditional social assistance programmes. These include high administrative costs, poor targeting of the needy, fragmentation of projects and programmes and an overemphasis on the short-term relief of poverty while paying inadequate attention to longer-term structural poverty.

It is still too soon to gauge the longer-term developmental effect of conditional cash transfer programmes properly. However, preliminary assessments indicate that they have contributed to increases in primary and secondary

school enrolment rates and – in some countries – school attendance, higher consumption levels, improvements in child health and nutrition and reductions in the incidence of child labour. Evaluations have also suggested that CCT programmes are efficient (81% of the benefits have accrued to the poorest 40% of families) and cost-effective in terms of the ratio between benefits and administrative costs.

These findings are encouraging, but one should remember that these interventions are not panaceas for solving the challenges of designing effective social assistance systems (Rawlings, 2005: 154). CCT programmes can overcome the obstacles to the full use of schools and health clinics by the poor (these include high pecuniary and opportunity costs, difficult access and inadequate incentives for investing in the human capital of children), but cannot address the short-term consumption needs of poor households without young children. Furthermore, their effect on human capital accumulation will be negligible in areas where school enrolment and attendance among poor children are already high or where service delivery institutions are absent or incapable of providing high-quality education and health services. In these cases, introducing CCT programmes should be complemented by increased investment in, and institutional reform of, education and health care.

#### 4.3.2 Applicability in South Africa

In some ways, conditional cash transfer programmes are attractive interventions in the current South African context. In return for what should be a modest increase in the administrative costs associated with monitoring compliance, these schemes promise significantly higher returns on current spending on social grants (mainly accelerated human capital accumulation among children in poor households). Furthermore, adopting CCT programmes would not require modifying a design principle that is deeply entrenched in South Africa. This is that social assistance should be limited to the economically inactive vulnerable groups.

Conditions for the child support grant were introduced and became effective on 1 January 2010. This means that the caregivers of beneficiaries must:

1. ensure that they are enrolled and attending school, and
2. submit regular proof of enrolment and reports from the school to the Department of Social Development.

In cases where caregivers breach these conditions, the

Department of Social Development will send a social worker to investigate and introduce steps to ensure that the child attends school. However, punitive measures (such as terminating the grant) are not envisaged.

On balance, theoretical considerations and lessons from the experiences of other countries suggest that conditional cash transfer programmes are unlikely to be cost-effective interventions in the current South African context. CCT programmes work on the demand side of social-service provision, but this is not where the real problems are in South Africa as far as these services are concerned.

School enrolment and attendance figures, for example, are high already. General Household Survey data showed that the school attendance ratio among 5 to 19-year olds in grant-receiving households was 90% in 2007, up from 87% in 2003. The school attendance ratio increased from 86% in 2003 to 90% for 5 to 19-year olds living in low-earning households that received child support grants in 2007.

Furthermore, the success of existing targeting mechanisms precludes the need to use conditions for screening purposes. Inefficiency and effectiveness on the supply side of the social service provision are major obstacles to human capital accumulation among poor children in South Africa. Indeed, in some cases, supply-side problems are already weakening the demand for publicly provided social services for which private alternatives exist. Unless these problems are addressed, the most likely effect of adopting conditions is likely to be a dilution of the current poverty effect of the child support grant resulting from higher administrative and compliance costs. This would be most unfortunate, given the need for effective anti-poverty interventions and the situation of severe fiscal stress in South Africa right now.

The conditions the government introduced for the child support grant, which took effect on 1 January 2010, therefore make little sense. The constraint on human capital accumulation because of the schooling system is the supply-side problem of ineffectiveness in provision, not demand-side problems related to low enrolments or attendance. Furthermore, the intervention lacks credible sanctions for non-compliance by participants.

One reason for the absence of sanctions could be that making eligibility for the child support grant conditional upon school attendance sits uneasily with the rights-based approach of the South African Constitution. Section 27(1)(c)

of the Constitution of the Republic of South Africa (No. 108 of 1996) stipulates that everyone has the right to social security, including appropriate social assistance for those unable to support themselves. Be that as it may, whatever human capital investment may result from adopting the conditions will probably not outweigh the accompanying increase in the administrative and compliance costs of the child support grant scheme.

## 4.4 Workfare programmes

### 4.4.1 Nature and international experience

Workfare programmes provide income transfers to the needy and unemployed provided they undertake a work-related activity. Mandatory workfare requires actual work, while 'new-style' workfare requires participation in other employment-related programmes (like job seeking, community work, training and formal schooling).

Contemporary workfare programmes originated in OECD countries, where trends like rising long-term unemployment and changing family structures prompted concern about the work incentive effects of traditional social assistance systems and their ability to address growing social exclusion. Core elements of these programmes include:

1. steps to reduce the amounts and duration of benefits;
2. forcing beneficiaries to seek work actively, often complemented by other measures to encourage working and social inclusion, including terminating benefits when recipients obtain part-time work;
3. moving benefits from the household to individuals so that individuals do not jeopardise the household's access to benefits when they find jobs;
4. making benefits conditional on finding employment (like cash bonuses, wage supplements and tax credits); and
5. offering more assistance to job seekers (like labour-market information and training programmes).

The United States (US) pioneered modern welfare reforms aimed at integrating recipients of social benefits with the formal labour market. However, welfare reforms with workfare elements were also implemented in the United Kingdom by the labour government of Tony Blair and in the Scandinavian countries.

The available evidence therefore indicates that workfare programmes can be effective mechanisms for returning welfare recipients to work, especially in rapidly growing economies where sufficient numbers of jobs are created to absorb programme participants in the regular labour market. Inadequate availability of jobs may well be the most serious barrier to the successful implementation of workfare programmes. Moreover, the US experience showed that workfare programmes can be time-consuming and financially expensive. The costs to be considered are the work-related and childcare expenses of recipients as well as supervisory and administrative costs.

#### 4.4.2 *Applicability in South Africa*

The government is also considering using the existing grants as a mechanism for providing increased access to economic opportunities to able-bodied household relatives of grant recipients. This idea was the topic of a discussion document that the Department of Social Development released in 2006. The discussion document also suggested an anti-poverty strategy for South Africa. This suggested that the administrative structures of the grants system could be a facilitating mechanism for anti-poverty interventions.

The discussion document acknowledged that efforts that relied solely on conditions-based incentives are unlikely to make the poor and beneficiaries of social grants economically active in South Africa. It argued for a more holistic approach that provides for a range of supporting measures to enable these groups to access economic opportunities. It suggested two sets of specific interventions:

1. 'exit strategies' for the beneficiaries of child support grants and persons with disabilities capable of rehabilitation; and
2. measures to assist the care givers of beneficiaries of child support grants.

The document also outlined the rudiments of a process model for such interventions. According to the envisaged model, one agency would be responsible for compiling a so-called 'gateway profile' for targeted beneficiaries. This would assist them to explore options, provide them with income incentives and make a 'social contract' with them. This agency would also be responsible for referring beneficiaries to partner institutions that provide the actual economic opportunities, like the Department of Labour, the Department of Education and civil society organisations.

A report commissioned by the Department of Social Development fleshed out these principles and identified five policy instruments:

1. direct job placement and job creation;
2. top-up subsidies or vouchers;
3. credit for productive activities;
4. information; and
5. insurance.

It also identified four general policy options:

1. direct job creation;
2. improving job searching and employability;
3. support for self-employment; and
4. support to stabilise income from employment or self-employment.

These ideas have much in common with the 'new-style' workfare programmes of some OECD countries. Nevertheless, if such programmes were introduced in South Africa now, the purpose and systemic implications would differ in important ways from those in the OECD countries. These countries introduced workfare schemes to curtail dependence on social assistance and spending. Adopting such programmes in South Africa would mean expanding the social assistance system.

The fiscal costs of such programmes would depend on their scope and design, but large-scale interventions would be out of the question in South Africa in the present fiscal climate. As additions to the South African social assistance systems, however, workfare programmes would not leave any of the poor worse off – as imposing work requirements and term limits on eligibility for assistance sometimes did in the United States.

Workfare-type programmes could be useful elements of the anti-poverty policy in South Africa. However, their potential effects should not be exaggerated. The very high level of unemployment and relatively low level of informal-sector participation indicate a badly malfunctioning labour market. Workfare schemes and other job-creation initiatives could mitigate the symptoms of such malfunctioning, but lasting progress would require rectifying the causes of high unemployment in South Africa. These are likely to be found in the education system and in labour-market policy and practice. In the absence of job creation, the effect of workfare programmes could be severely restricted by the paucity of jobs available to participants.



While it makes no sense to adopt additional policy measures to rectify the distortions that existing interventions cause, workfare and other employment-creation initiatives can help to overcome market failures. If one uses market failures as criteria for judging the economic merits of workfare programmes, one should remember that the prevalence of market failure is at best a necessary condition for government intervention. In practice, government intervention often leads to bigger distortions than those caused by the market failures they were intended to address.

The risk of government failure in implementing workfare programmes would be relatively high. The process model envisaged by the Department of Social Development would require coordinated decision-making by various institutions that would also have to deal with the uncertainties about labour-market conditions and the ability and motivation of programme participants.

International experience has highlighted the importance of political economic considerations in designing workfare programmes. Workfare programmes often raise the ire of labour unions concerned about the possible development of a parallel labour market that might threaten worker rights and undermine the bargaining position of lower-skilled, lower-paid workers throughout the economy. Such opposition to workfare schemes from organised labour has come to the fore in public works programmes in developing countries like Argentina, Brazil and Chile.

The government obtained support for the EPWP from organised labour by negotiating a Code of Practice for Special Public Works Programmes. This governs setting wages and other aspects of employment. The government may need something similar, depending on the nature of the economic opportunities it provides as part of the workfare programmes.

## 5. CONCLUSION AND RECOMMENDATIONS

This report has shown that the South African social assistance system is an effective intervention. It reduces poverty significantly and apparently does not have severe undesirable behavioural effects.

The major lacuna in the social assistance system is the lack of support for unemployed members of the labour force. The Unemployment Insurance Fund and the Expanded

Public Works Programme only fill this gap partially. One of the effects of this situation is that the existing grants have become major sources of support for the unemployed.

Sharing grant incomes sometimes stimulates but, in other cases, hampers labour-market participation, while the implied dilution of benefits could make entire households (including the targeted beneficiaries of grants) poor.

There is very limited scope for strengthening anti-poverty policy in South Africa by expanding the social grants system further, however, especially because of the lack of fiscal space. Sustainable poverty reduction requires inclusive job-creating economic growth, and this should remain the primary focus of anti-poverty policy.

The Commission recommends that the government should:

1. Protect the overall amount of social-assistance expenditure as far as possible during the fiscal consolidation. These are the targeted social spending programmes and the main cash-transfer components of poverty-focused public spending that complements anti-poverty interventions (which build human capital and meet other basic needs).
2. Not compromise the relative simplicity of the social assistance system.
3. Pilot conditional cash transfer and workfare programmes on a smaller scale and continue to evaluate them in order to expand successful pilots.
4. Strengthen non-cash complementary social developmental services by emphasising quality improvements within a defined resource envelope.
5. Avoid universal income grants, as these are currently unaffordable and would need to be accompanied by a broader restructuring of the entitlement system.

## TOWARDS AN EFFECTIVE, EFFICIENT AND TRANSPARENT INTERGOVERNMENTAL FISCAL SYSTEM

### 1. INTRODUCTION

The tighter than usual economic conditions in which South Africa finds itself makes good governance imperative. Good governance means accountability to citizens, direct intervention in providing information, facilitating participatory, pro-poor policies and sound macroeconomic management. This is to ensure proper use of public funds, encouraging shared economic growth, promoting effective and efficient delivery of public services and consolidating the rule of law.

The debate over good governance becomes more important in the light of the asymmetries that resulted from the global economic recession and its aftermath. Both horizontal and vertical dimensions are important and are intertwined. More specifically for the Financial and Fiscal Commission, addressing these problems has important implications for equity and efficiency. They will have long-term consequences for the future of the country's intergovernmental fiscal and relations system. While there have been notable achievements in improving the workings of the intergovernmental fiscal relations system, there are still a number of problems preventing the achievement of an efficient, transparent and equitable fiscal transfer system. This chapter focuses on four particular aspects of this:

- 1. performance of conditional grants;**
- 2. inadequate revenue improvement strategies,**

**especially at the level of local government;**

- 3. reforms in the Local Government Equitable Share formula; and**

- 4. policy failures.**

### 2. THE PERFORMANCE OF CONDITIONAL FISCAL TRANSFERS IN THE INTERGOVERNMENTAL SYSTEM

Because of the great disparities in fiscal capacity between and within the three spheres of government, intergovernmental fiscal transfers are a dominant feature of provincial and local government finances in South Africa. Different countries use a spectrum of fiscal transfer methods. Each



tends to have different implications for equity, incentives, and distribution. Conditional transfers are reviewed yearly in South Africa after the promulgation of the Division of Revenue Act, which comes with amended grant frameworks and classifications. Classifications specify the conditionality of grants, whether they are specific-stand-alone grants or supplementary grants<sup>18</sup>.

The picture that emerges from a 10-year review of conditional fiscal transfers to provincial governments and municipalities in the South African intergovernmental fiscal relations system (from the 2000/01 to the 2009/10 financial years),

carried out by the Financial and Fiscal Commission, is that applying conditional grants has evolved over time, often in an ad hoc and incremental fashion. Some grants have been merged with the equitable share allocation. Others have been merged with other conditional grants. A few conditional grants have been terminated whilst others have existed for more than five years. This practice has meant that allocations for some conditional grants have been sporadic and infrequent over the years.

While the National Treasury has provided some guidelines on designing conditional grants, these have not been very

<sup>18</sup> According to the Division of Revenue Bill, conditional grants are classified as schedules 3, 4, 5, 6, 7 and 8 allocations. Schedule 3 allocations remain general allocations to provinces, while schedule 4 allocations are transfers made to provinces for general and nationally assigned priorities. Schedule 5 allocations refer to specific-purpose allocations to provinces. Schedule 6 and 7 allocations are explicitly for local government-related functions. Schedule 8 grants were introduced as incentive grants intended to motivate provinces and municipalities to meet or exceed prescribed extended public works programme targets.

effective and have been inconsistently applied<sup>19</sup>. It is therefore necessary to review the efficacy of conditional grants, specifically with regard to the necessity and purpose of some of the grants, the criteria for allocations, targeting, reporting on non-financial data, performance and value for money.

## 2.1 Introducing and terminating conditional grants

Before conditional grants are introduced in the IGFR system, with the exception of disaster-related grants, national departments must ensure that they have done the appropriate planning, in conjunction with provinces, to identify the purpose of the grant and the outputs and outcomes it is to achieve. The Commission recommends a mandatory, systematic process in designing and planning individual conditional grants, which would cover incentive effects and administrative accountability arrangements. It should also stipulate regular review periods and exit strategies for phasing out the grant.

Further, monitoring arrangements, which will measure whether the stated purpose is being achieved, also need to be identified upfront. The Commission recommends that there must also be an independent evaluation of the grant's performance or an existing strategy before grants are terminated or merged with other grants or into the equitable share allocation.

### 2.1.1 Transparency in the criteria used to allocate conditional grants

Identifying a public policy issue and the reasons why it should not be funded through an unconditional equitable share allocation are generally important for grant allocations. It is necessary to identify an area that will be affected by the grant and the change needed. Depending on the nature and magnitude of a problem to be resolved, not all provinces would necessarily be beneficiaries of the conditional grant system. Where individual provinces face different challenges, it may be more appropriate to have grants tailored to the particular problems. It is also important that the criteria, measures and baselines used are generally accepted throughout government to permit rigorous benchmarking of performance and evaluation of effect.

Criteria for the division of grant allocations amongst provinces need to be as transparent as possible and not simply mimic the equitable share formula, especially for infrastructure related grants. For infrastructure-specific grant

schemes, selection criteria must be established to decide which projects will receive funding. There must be project proposals, which are designed to meet pre-determined funding criteria that are transparent and understood by all.

A related issue is the cyclical nature of conditional grants and allocations in the outer years. Allocations to conditional grants tend to be cyclical. The reasons for that are introducing, terminating and sometimes merging grants into the equitable share. Allocations are rarely linked to the purpose of the grant, the results to be achieved, the strategies adopted to achieve those results and performance. Performance information should feed through to outer year allocations. Failure to do that creates perverse incentive and reduces scope for proper budgeting by some recipient governments. The Commission emphasises that the budget allocation process must specifically follow the grant frameworks and this should be monitored periodically through section 32 of the PFMA and section 72 of the MFMA.

### 2.1.2 Importance of non-financial performance data

There is a severe lack of credible data about the actual performance of conditional grants, even in cases where the outputs are, in principle, tangible and measurable. This makes it virtually impossible to evaluate the performance of grants systematically. It also undermines accountability for results. Accounting for delivery should be a prerequisite for most conditional grants. Provinces should be required to report on delivery as the basis for receiving grants, especially infrastructure-related grants where structure are visible and can be verified. It is essential that there is a written agreement in place between the department responsible for the grant and the recipient government. The outputs need to be the actual products of the provincial department, like houses, health facilities and schools, meals served to schoolchildren or the number of people completing a training course in financial management. This agreement should include the relevant costs and be gazetted. Performance agreements between spheres of government should be elevated to, and signed by, the relevant cabinet minister and members of executive councils.

### 2.1.3 Achieving results-based accountability through incentive-orientated grants

Government has already started experimenting with output-based or performance-orientated grants through the Extended Public Works Programme Incentive Grant to

<sup>19</sup> See National Treasury Circular number 2 of 2009/10 on the classification and structuring of earmarked and specific funds and conditional grants in the fund segment of the Standard Chart of Accounts (SCOA).

provinces and municipalities. These create incentives for good performance and set conditions for improvements in provinces and municipalities where service delivery is a challenge.

Conditional grants should be used to create a competitive service delivery environment by making finance available on similar conditions to different spheres of government. Output-based grants should link grant finance with service delivery performance (like the number of schools built, houses connected with electricity and kilometres of roads built). These types of conditional grants place conditions on the results to be achieved while they provide full flexibility in designing programmes and associated spending levels to achieve those objectives.

National Treasury, for example, can manage a pool of funding as an incentive for good performance while focusing capacity development on struggling provinces and municipalities. These grants can help to restore the recipient governments' focus on the results-based outputs and the alternate service delivery framework to achieve the desired results.

The intergovernmental grants system could also provide a mechanism to encourage judicious experimentation in service delivery modalities by sub-national governments. This will allow effective new development strategies and approaches to emerge from the bottom-up through trial and error.

The Commission supports the move towards adopting incentive-based grants and recommends that the future design of conditional grants explicitly considers how to promote innovation within sub-national governments and thereby strengthen incentives for optimal service delivery.

## 2.2 Recommendations

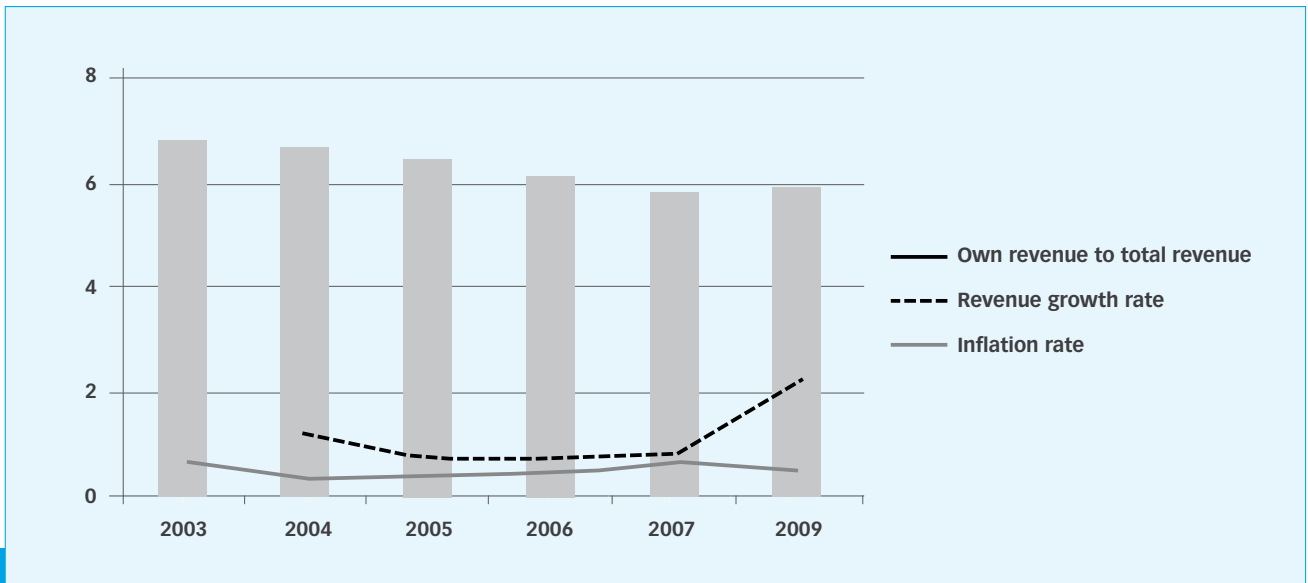
The commission recommends that:

1. When introducing and terminating conditional grants, national departments must:
  - a) Introduce a mandatory, systematic process to the designing and planning of individual conditional grants. It should cover incentive effects, administrative accountability arrangements and stipulate regular review periods and exit strategies of the grant.
  - b) Ensure that there is an independent evaluation of the grant performance at entry, midterm and end of the grant.
2. Government should make the criteria for dividing grant allocations transparent. At the moment, they are only explicitly reflected for the whole programme and not for each individual grant.
3. Government must continue to emphasise the importance of non-financial data reporting. In this regard it should link outer year allocations to independently evaluated performance information and gazette expected deliverables (like schools and kilometers of roads).
4. To ensure results-based accountability through incentive grants, national departments must make accounting for delivery a prerequisite for most conditional grants. They should encourage designing grants that explicitly consider promoting innovation within sub-national governments and strengthen incentives for optimal service delivery.
5. The Commission emphasises that the budget allocation process must specifically follow the grant frameworks and that this should be monitored periodically through section 32 of the PFMA and section 72 of the MFMA.

## 3. LOCAL GOVERNMENT REVENUE IMPROVEMENT STRATEGIES AND FISCAL STRESS

It is imperative that, as the global recession recedes, government pursues innovative recovery policies that are inclusive, support people below the poverty line and sustain service delivery, especially within the local government sphere. These policies should focus on deliberately propelling the economy out of recession and, most importantly, laying a firm foundation for future economic growth and development. Since local government services constitute a fundamental pillar of development, a strategic focus for laying the foundation for future growth should be targeted at this level through policies that, inter alia, improve the capacity to generate revenue.

A strategic focus on the sphere has already been demonstrated by prioritising local government service delivery as one of the key priority areas for government's five-year programme. Cabinet has recently adopted a new Local Government Turnaround Strategy (LGTAS), aimed at strengthening the ability of the sphere to perform its functions. What



Source: Heston et al (2006), Mullis et al (2007)

Figure 10: Municipal own revenue (and some peculiarities)

distinguishes this strategy from the previous assistance programmes is its audacious and evidence-based approach to identify contentious factors like political leadership, corruption and labour relations as key problems. The strategy further identifies a list of practical processes and solutions to resolve the underlying problems under the 'watchful eye' of a ministerial committee and monitoring body, although they are not independent.

One of the key success factors, against which the implementation of the LGTAS will be measured, is the extent to which municipalities optimise their own revenue collection. To be specific, municipalities will be evaluated on the basis of their ability to collect revenue at a level which reflects the size of their respective local economies (fiscal capacity) and their ability to collect revenue at the rate at which it planned to do at the beginning of the financial year (fiscal effort). Part of the reason for a strategic focus on revenue collection is that service delivery failures have consistently been attributed to shortage of funds, from both own revenue and national transfers.

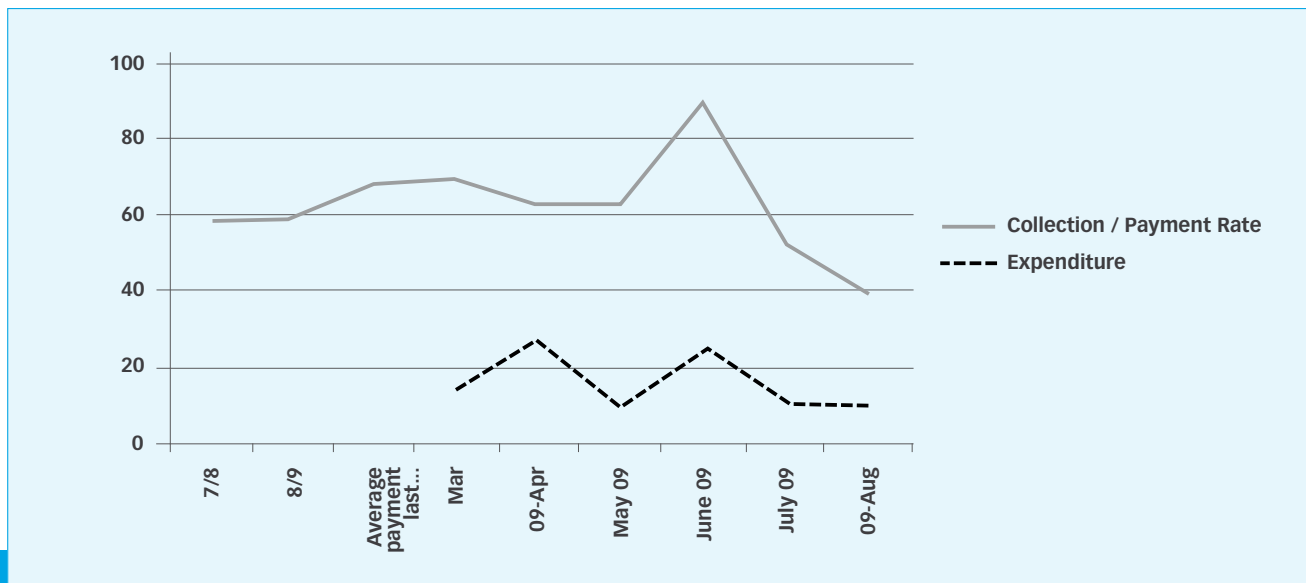
To understand this problem fully, the Financial and Fiscal Commission has investigated the possibility of improving local government revenue to address municipal revenue challenges. The study emanates from the growing perceptions and realisation of extensive fiscal stress among South African municipalities – which is likely to undermine municipal fiscal Executive Authority and jeopardise future local services delivery.

Figure 10 gives budget indicators. They show that municipal capacity to collect own revenue and the share of own revenue to total revenue has been declining over time, while grant support has been increasing.

The study notes that the design of South Africa's intergovernmental fiscal system is such that the local government sphere is generally self-financing. Municipalities generate about 77% of their revenue from constitutionally assigned own sources like rates, taxes and service charges (National Treasury, 2009). The remaining revenues come from transfers from the national and provincial governments. This system is an important feature of decentralisation where municipalities are directly accountable to local residents from whom they generate revenue.

Despite having access to a generous amount of own revenue sources, and having undergone a number of policy reforms, most municipalities in South Africa are generally perceived to be hard pressed for revenue or fiscally stressed (National Treasury, 2009). The extent of the problem is not confined only to small and rural municipalities. It also manifests itself profoundly within bigger cities. By March 2009, the National Treasury had classified nine of the top 21 local municipalities as fiscally stressed.

This study reveals that a number of municipalities are showing chronic signs of fiscal stress that can cripple the entire local government system. Own revenue is being rapidly eroded by national transfers and a combination of growing inability and unwillingness to collect revenues by municipalities or to pay



Source: Development Bank of Southern Africa, 2009

Figure 11: Revenue collection trend: Municipalities in North West Province

by residents.

Several trends show this. Firstly, consumer debt has constantly been rising. This reflects the inability to collect on the part of municipalities and the unwillingness, or inability, to pay by the consumers of basic services. Secondly, residents are increasingly developing creative ways to avoid payments on municipal accounts through taxpayers associations and on the grounds of poor service quality. Lastly, grant transfers to municipalities are growing at a relatively high rate compared to the growth rate of own revenue while at the same time acting as disincentives to maximise revenue collection. Revenue collection tends to rise significantly during the last few months before the end of financial years (April and May) and starts to decline at an increasing rate in

the month after receipt of equitable shares and other grant allocations.

Figure 11 shows this phenomenon in North West municipalities.

Perhaps more pertinently, the analysis indicates that revenue challenges within municipalities are attributable to a number of factors. They include the design of the intergovernmental system, poor service delivery, the interface between politics and administration as well as local economic, social and demographic circumstances.

More strikingly, the study finds that in many other municipalities low revenue is purely a function of low fiscal effort.

Table 6: Municipal composite revenue performance index

Municipality	Composite Revenue index	Demographic composite index	Socio economic index	Fiscal effort Comp index	Total Revenue Performance index
Bottom 3					
Ingwe	1.3	4.0	2.7	0.7	2.2
Moshaweng	1.3	4.7	2.8	0.7	2.3
Ntambanana	1.0	3.7	4.3	0.7	2.4
Top 3					
George	9.5	6.2	8.7	6.0	7.6
Saldanha Bay	9.3	6.2	9.1	6.7	7.8
Overstrand	9.5	8.2	8.1	6.7	8.1

Source: Own calculations

To arrive at this conclusion, the study has estimated fiscal capacity, fiscal effort and revenue performance indices for all municipalities using local economic, demographic and budgetary variables. The level of own revenue to taxable capacity or potentially available revenue in most municipalities is considerably lower. On average, municipalities generate about 7.2% or R99 billion of aggregate household income in own revenue against the 23% or R193 billion spent on municipality-related services by households. Municipalities with moderate levels of taxable capacity are increasingly attributing low revenue to factors associated with fiscal stress, while overlooking important aspects of improving overall fiscal effort. For example, Bella Bella municipality has a taxable capacity six times less than that of Thulamela municipality, yet the former generates twice the amount of own revenue compared to the latter. (We note the difference in service delivery authority between the two municipalities).

Table 6 shows the relative performance of the bottom and top three municipalities using various indices that reflect on their ability and willingness to generate revenue. A score of 1 means 'bad' and 10 means 'good'. Ingwe, Moshaweng and Ntambanana municipalities are ranked the lowest on the total composite revenue performance index because of a combination of factors that include a poor socioeconomic environment, unfavourable demographic conditions and little fiscal effort. George, Saldanha Bay and Overstrand municipalities in the Western Cape are the best performers on the composite revenue performance index. (Note that municipalities like Msinga collect the lowest amount of own revenue, but it is ranked fifth on the total revenue performance index. This bears testimony to the claim that there is considerable room to increase current collections).

Municipalities that face fiscal stress have tended to carry out revenue improvement programmes to augment their dwindling local resources without addressing important aspects that would ordinarily cause fiscal stress. However, because they have incorrectly diagnosed municipal challenges, they have carried out revenue improvement programmes to deal with issues that are out of harmony with factors that would ordinarily justify revenue improvement. For instance, it emerges that negligible fiscal effort is a critical predictor of fiscal stress in most cases. However, revenue improvement programmes remain incrementally administratively biased. As a result, a significant proportion of programmes conducted show little success, incompatible with the associated hefty inputs required to operationalise them.

The ineffectiveness of revenue improvement programmes is disturbing given the significant potential of municipalities to raise revenue. This could be an indication of the inappropriateness of these programmes to the problems of the day. Programmes tend to be restricted to revenue management and administration issues. These are part of the broader revenue collection value chain and do not necessarily improve revenue collection.

Although there are numerous practical avenues through which efforts to maximise revenue collection can be improved, it is also important to acknowledge that there are no quick fixes or 'magic bullets'. The rule of thumb is to get the basics right. This simply means that they must improve the quality of the services they deliver. Residents who receive good quality services promptly are inclined to honour their municipal accounts. Municipalities must also demonstrate visible signs of improvement in financial management and administrative capacity. Politicians must refrain from intervening in municipal revenue administration processes. They must encourage citizens to pay and change their mindsets through concerted marketing or consumer education exercises. Municipalities must drive the growth of their local economies through local economic development programmes. The municipalities that are politically and administratively established and have proven records of maximising revenue collection can pursue more contemporary revenue improvement initiatives, like introducing new taxes, expenditure-side and efficiency-based interventions.

### 3.1 Recommendations

To improve the general performance of municipalities in revenue collection, the Commission recommends that:

1. Government should adopt standard indicators or early warning systems to measure and detect fiscal stress in municipalities and reach consensus about them. In addition to the criteria prescribed in section 138 of the Municipal Finance Management Act of 2003 for identifying serious financial problems in municipalities:
  - a) These indicators should be pre-conditions for instigating mandatory provincial intervention in terms of section 139 of the MFMA and Municipal Financial Recovery Plans in terms of section 140 of the MFMA.
  - b) Section 71 of the MFMA, on monthly budget statements, should be amended to require that accounting officers report on actual revenue by source and on the percentage



of collected revenue to total value of billed revenue.

2. Government legislates, through section 43 of the Local Government Municipal Systems Act of 2000, revenue collection as one of the key performance areas against which to assess overall municipal performance.

a) Municipalities must use at least the following standard indicators to harmonise revenue collection performance assessment across municipalities:

o The collection ratio, which is the extent to which services are billed, collected and enforced.

o The coverage ratio, which is the extent to which all service users are captured on the tax or rates roll.

3. Excessive levels of municipal debt from residential customers, businesses and government, which undermine the long-term financial viability of the sphere, must be reduced through constant taxpayer education and incentives by way of general improvement in providing good quality services.

a) Government must provide for, or enable, local government, through the Municipal Systems Act of 2000, to issue garnishee orders on defaulting customers.

b) The judicial system should have dedicated courts to deal with outstanding municipal accounts until the debt is reduced to acceptable levels.

4. The Revenue Raising Component of the Local Government Equitable Share should be revised so that it rewards good performance in revenue collection as opposed to the current 'Robin Hood system', or stepped tax bands, which allocates more funding based on low revenue collection.

5. The government should support concerted efforts to estimate the fiscal capacity and fiscal effort of municipalities to dispel the perception that certain municipalities will never be financially viable.

6. Municipalities should have broad revenue improvement programmes. They should not focus only on administrative streamlining but also on revenue-side interventions, expenditure-side interventions and efficiency-based interventions.

a) The nature of the interventions must be specific to local economic circumstances so that small rural municipalities, which mainly face structural fiscal stress, develop efficiency based and expenditure-side revenue improvement interventions. Urban municipalities, which encounter cyclical fiscal stress, can pursue revenue side interventions.

b) Small rural municipalities must develop institutional arrangements or reforms that emphasise revenue assignment geared especially to sharing powers and functions between category B and C municipalities.

7. Effective revenue management processes, good financial management and the provision of good quality services should underpin revenue improvement programmes. Municipalities should only conduct them when they have maximised the collection of locally available and outstanding revenue sources.

a) Where feasible, bigger municipalities, which already have financial systems, should be encouraged to share their systems and expertise with smaller ones.

8. The performance of revenue improvement programmes should be subjected to empirical tests that cover changes in the effective tax rates, tax burdens for all service users, the total revenue yield, economic efficiency and overall fairness.

#### 4. REVIEWING THE LOCAL GOVERNMENT EQUITABLE SHARE FORMULA

The tighter economic environment of the current budget cycle has focussed increased attention on concerns about the institutional and operational efficiencies of several of the fiscal and revenue instruments of sub-national governments and the local government sphere in particular. The performance and efficiencies of these instruments of local government, which include intergovernmental transfers and own revenue sources, are pivotal to cushioning the effects of the recession on communities and providing a solid platform for buoyant and equitable growth as well as sustained service delivery in the long-term as South Africa emerges from the recession.

This section builds on the previous two sections, which

dealt with improving the performance and effectiveness of conditional grants and own revenue sources of municipalities. The focus of this section is on the review of the Local Government Equitable Share (LES) formula process that government is currently carrying out.

Local governments are entitled to an equitable share of nationally raised revenue to enable them to fulfil their constitutional mandates. It plays an important role in the finances of municipalities, topping up municipal own revenues where required and, in some cases, even accounting for most of the operating revenues of certain municipalities.

The aim of this section is twofold. Firstly, based on the key findings and conclusions of the static (one year) and dynamic (multi-year) analysis of allocations, undertaken by the Financial and Fiscal Commission via the formula, it raises key technical and policy considerations for taking the general review of the LES formula forward. Secondly, there are two substantial recommendations for improving the LES formula. The first includes technical reforms and proposals to improve operational efficiency in the short-term. The second covers longer-term strategies and research needed to improve and design a grant mechanism to fund the diverse characteristics and expenditure requirements of municipalities in South Africa appropriately.

#### 4.1 The LES formula in a nutshell

Sections 227 and 214 of the constitution provide the legal basis for the LES. The current formula comprises five components:

$$\text{LES} = \text{BS} + \text{I} + \text{D} - \text{RRC} \pm \text{C}$$

<b>Where:</b>	<b>BS</b>	<b>=</b>	<b>Basic Services Component</b>
	<b>I</b>	<b>=</b>	<b>Institutional Component</b>
	<b>D</b>	<b>=</b>	<b>Development Component</b>
	<b>RRC</b>	<b>=</b>	<b>Revenue Raising Component</b>
	<b>C</b>	<b>=</b>	<b>Correction Component</b>

Although the constitution does not prescribe a methodology for the horizontal division of revenue between the 283 municipalities, each component attempts to capture the

basic provisions in section 214 (2) of the constitution:

1. Basic Service Component (BS) – section 214 (2) (d) – the need to ensure that the provinces and municipalities are able to provide basic services and perform the functions allocated to them;
2. Revenue Raising Component (RRC) and Institutional Component (I) – section 214 (e) – the fiscal capacity and efficiency of the provinces and municipalities;
3. Development Component (D) – section 214 (f) – developmental and other needs of provinces, local government and municipalities; and
4. Correction Component (C) – section 214 (i) – the desirability of stable and predictable allocations of revenue shares.

Furthermore, in accordance with economic theory, the LES plays the role of an equalisation grant. It accounts for the imbalances between revenues and expenditure of local government in general (known as vertical fiscal imbalances) and between the different types of municipalities (known as horizontal fiscal imbalances) to ensure that municipalities are appropriately funded to fulfil their service delivery mandates. This service delivery mandate is drawn directly from the Bill of Rights and schedules 4B and 5B of the Constitution.

Important features to note in the formula are:

1. LES funds are unconditional.
2. The fundamental demographic and services-related data the current formula uses are based on the 2001 census.
3. Poverty is measured as households earning less than R800 per month.
4. Subsidies are given to support the provision of five services (water, sanitation, electricity, refuse and environmental health) in the BS component of the formula and a general subsidy to support municipal administrative and institutional costs via the I component of the formula.
5. Subsidies are allocated, by the national minister of local government via the BS component for specific services, to municipalities that are authorised to perform the

functions<sup>20</sup> (water, sanitation and electricity functions) or by the provincial member of the executive council for local government (in respect of the refuse function) in accordance with the provisions in the Municipal Structures Act<sup>21</sup>.

6. The RRC attempts to correct a municipality's LES allocations by considering its revenue potential and fiscal capacity. Currently property rates and the RSC levy grant are regarded as municipal own revenue in the component.
7. Currently the D component of the formula is inactive as there is no consensus among government and stakeholders on the funding role of this component.
8. The formula allocates funds according to the three-year budgeting cycles adopted by government as part of the Medium Term Expenditure Framework.
9. In order to ensure stable and predictable allocations, the correction component ensures that allocations to municipalities are guaranteed at 100% in the first year, 90% in the second year and 0% in the third year of the three-year budget cycle.
10. There is a stabilising (or scaling) feature of the formula that ensures that the entire local government resource pool for a given financial year is fully allocated.

#### 4.2 Key findings and conclusions

The Constitution, economic fundamentals and other policies are clear on the mandate and role of the LES and what needs to be funded. The various Free Basic Services (FBS) policies provide a basis for the required minimum level of services to be funded by the LES in order to ease the strain on municipal budgets. This submission outlines all of these basic theoretical and legislative elements of the formula and concludes that the formula attempts to adhere to most of these in general.

In the analysis of the structure of the formula, it appears that government has adopted the expenditure equalisation framework in that the formula attempts to estimate and

fund the potential fiscal gaps that exist in municipalities. This Submission supports the general structure of the formula. However, accurate measurements for expenditure needs and fiscal capacity are pivotal to developing a coherent equalisation framework. The Submission concludes that the current cost or subsidy estimates used in the formula have no theoretical or empirical basis that efficiently reflects the expenditure pressures that by municipalities and local governments in general face. This argument is mirrored in the measurement of fiscal capacity, that is, the RRC component. It also has several inefficiencies in its application.

There are also several technical features of the current formula that make it difficult to estimate and fund fiscal gaps and municipalities accurately. These include:

1. The lack of an accurate costing framework that defines the different expenditure needs of municipalities and informs the service and administration subsidies in the LES formula.
2. Inefficient calculation<sup>22</sup>, application and the diminishing influence of the RRC component. Because an extension was granted to municipalities to implement the Municipal Property Rates Act<sup>23</sup>, thus possibly prolonging the non-availability of municipal valuation roles for all municipalities, the calculation of a municipality's fiscal capacity and own revenue potential is proving difficult without appropriate data.
3. The lack of transparency of the stabilisation, or scaling, component to ensure that the entire resource pool of funds for a given year is allocated. This results in several inefficiencies. These include uncertainties about actual subsidy levels provided for in the formula, all costs being inflated by the same amount annually and an overestimation of expenditure requirements relative to fiscal capacity.
4. The simulations show that changes to the parameters of the model result in funds moving from one municipality to another. They are therefore ineffective and not sensitive enough to support targeted funding priorities. For example, specifically targeting a set of poorer or rural municipalities in the current formula cannot be done effectively.

<sup>20</sup> Currently the Minister of Cooperative Governance and Traditional Affairs.

<sup>21</sup> Act 117 of 1998, as amended in 2002.

<sup>22</sup> The use of actual property rates and general revenues collected and reported by municipalities can be seen as a contradiction of Section 227 (2) of the Constitution. The Commission is currently in the process of getting legal opinion on the issue.

<sup>23</sup> Act 6 of 2004.

5. Inefficiencies about using outdated 2001 census data and the implications for data updates associated with 10-year censuses, like shocks to allocations. The larger the period between data updates results in a larger adjustment in the underlying variables in the formula to include changes in data. This results in larger effects and changes to allocations, which undermines the principles of stability and predictability of allocations to municipalities
6. Identifying an appropriate and socially reflective indicator for poverty, with income being the least preferred method because of large inaccuracies when collecting this variable.

Conclusions from the dynamic analysis suggest that the reforms undertaken by government to solve certain identified problems have largely been ineffective given the technical structure and mechanics of the current formula and the fundamental issues of a poor calculation of expenditure needs and fiscal capacity in the LES formula. This is evident from the latest trend in district municipalities – service delivery responsibilities progressively receive smaller shares of allocations.

Conclusions from the single-year static analysis illustrate some degree of redistribution of the overall funds in recognition of the different fiscal capacities of municipalities, but only to a certain extent. It also illustrates the heavy reliance of most rural municipalities on LES funds. However, it does highlight the financial plight of these municipalities. Furthermore, it is unknown whether there is a shortfall at the vertical or horizontal division of revenue to local government because thorough expenditure need and costing analyses of municipalities are absent.

The Commission's simulations look at changes to some parameters and technical mechanics of the current formula. These proposed changes will result in several short-term operational efficiencies in the formula. Ultimately, however, the current formula is not sufficiently technically effective to be retained as the mechanism for the LES. The latter point is emphasised by the fact that all revenue neutral simulations (without additions to the overall revenue pool) simply result in moving funds from one municipality to another. Therefore, targeting a certain group of municipalities for a special policy priority, for example, is not possible with the current formula. In order for all municipalities to benefit, additions need to be made to the vertical division of revenue.

Therefore, a comprehensive review of the current formula

is urgently needed, and the Commission supports this. The Commission concludes that the current technical structure of the formula is not fully transparent and is mechanically flawed in certain aspects. A new method of equalisation and a new formula are urgently needed and should incorporate the following thoughts that are currently being debated:

1. The need for a differentiated approach to funding the different types of municipalities, while considering their unique expenditure needs, fiscal capacity and long-term planning and population dynamics.
2. The broader objectives of the local government fiscal framework, that is, linking the LES to conditional grants, especially infrastructure grants, so that any additional operating costs for municipalities are factored into the formula.
3. Increased operating costs associated with new social infrastructure funded by the Municipal Infrastructure Grant (MIG) where there is no financial return on the infrastructure.
4. The large maintenance backlogs and the continued difficulties in addressing these backlogs.
5. Sufficient flexibility to incorporate changes to current FBS policies and expenditure and tariff shocks.
6. Cognisance of the 'other' services that local governments provide and the effect these expenditure items have on their respective budgets. This can be extended to include the operating costs associated with maintaining road infrastructure.
7. The cross-subsidisation ability of certain municipalities to provide municipal services and account for fiscal capacity more accurately.

### 4.3 Recommendations

With regard to the reform of the Local Government Equitable Share formula, Commission supports the on-going review of the Local Government Equitable Share formula. It is the Commission's view, however, that as a matter of urgency (in view of the fact that the results of the review may only be ready for the 2012 budget) the institutional component and their revenue raising component are reformed as follows:

1. The institutional component of the Local Government

Equitable Share should be used to assist poor municipalities.

2. Related to the above, the Commission is of the view that the Revenue Raising Component should correct for those municipalities that are able to raise their own revenues better. The Commission makes the following short-term recommendations for the Revenue Raising Component:

a) Government should remove the step structure of the differentiated tax mechanism of the Revenue Raising Component, as this is inefficient. Government should develop a flat gradient structure so that municipalities on the outer ends of bands are not treated unfairly.

b) Using actual property rates revenue collected and reported by municipalities raises several inefficiencies in the system. Firstly, the poor fiscal effort of municipalities is used as a measure for additional funding. This also applies to poor reporting by municipalities. Secondly, it can create an incentive for municipalities to under report on collection rates, as this would result in a lower Revenue Raising Component calculation and more revenue from the Local Government Equitable Share. Lastly, the current methodology of using actual property rates and own revenues collected can be seen as a contradiction of section 227(2) of the Constitution. The Commission recommends that this practise is replaced with alternative methods of predicting revenue.

## 5. REGIONALISING MUNICIPAL SERVICES: THE CASE OF THE ELECTRICITY DISTRIBUTION INDUSTRY IN SOUTH AFRICA

Improving service delivery performance with regard to access to basic services and ensuring value for taxpayers' money is an ongoing concern for governments, especially in the wake of the global recession. In South Africa, the government has been grappling with local government service delivery challenges for many years. Its approach in tackling these challenges has taken the form of legislative promulgations like the Municipal Structures Act (No. 117 of 1998), as amended, and the Municipal Systems Act (No. 32 of 2000). Both these pieces of legislation are central to empowering local government to fulfil its constitutional mandate. The Constitution envisages a robust local government system that can ensure sustainable services to communities.

Other government efforts to deal with service delivery challenges have centred on the rationalisation and corporatisation of municipal services. A case in point is the Johannesburg metropolitan municipality iGoli 2002 programme. Through the programme, the Johannesburg metro made fundamental changes to its management of municipal functions. This was driven, inter alia, by new structures in local government, metropolitan demarcation and the management and service provision approach envisaged by the iGoli 2002 plan.

The other approach to improving service delivery at local government level has been capacity support to local governments. Project consolidate, 'a hands-on local government support and engagement programme', was initiated by the Department of Cooperative Government and Traditional Affairs (COGTA) in 2005. This was previously known as the Department of Provincial and Local Government (DPLG). The department tried to provide support to municipalities in order to ensure that they fulfil their functions.

The project was aimed at providing specific capacity in terms of human resources (civil, electrical and water engineers and project managers) in order to accelerate service delivery in providing free basic services like sanitation, water, electricity and refuse removal. Project consolidate was then linked to Siyenza Manje (SM). It is designed to enable national government to use the expertise and project management skills of the Development Bank of Southern Africa (DBSA) to build local government capacity. The initial focus was on technical engineering and project management capacity. However, this has expanded to include financial management capacity and the Young Professionals Programme that places interns in municipalities for two years. SM was in its third year of implementation in 2009.

In dealing with a specific municipal function challenges like electricity distribution, government has, since the late 1990s, been trying to rationalise the sector by creating six Regional Electricity Distributors (REDs). It did this to improve service delivery, foster economies of scale and ensure universal access to electricity. This approach has not realised its full potential and the Commission used it as a case study in this submission.

Notwithstanding all these intervention efforts, government tabled the Constitution Seventeenth Amendment Bill in 2009. The bill, if enacted, intends to empower the national government to regulate the Executive Authority of municipi-

policies further with regard to the local government matters listed in part B of schedule 4 and part B of schedule 5 of the Constitution. The government did this to achieve regional efficiencies and economies of scale with regard to a specific municipal function. It used the restructuring of the electricity distribution industry (EDI) by creating REDs as a proxy in the memorandum to the bill.

This section argues that the challenges facing service delivery at local government level are complex and dynamic and require a rigorous diagnosis. A blanket approach of shifting or regionalising services might not yield the desired results in efficiencies and economies of scale with regard to all municipal functions.

### 5.1 Literature review

This section sets out the key aspects associated with local government reforms, particularly regionalisation, to improve service delivery performance. Local government service delivery affects the welfare of communities, economy-wide resource allocations, and the financial performance of municipalities themselves.

There are various reasons why governments reform municipal services. These stem from *inter alia* good governance, financial stability, social and distributive justice, economic efficiency (economies of scale and scope) and fair pricing. These goals should ensure that municipal services are reliable and financially sustainable, are affordable for meeting basic needs and promote the efficient use of resources.

The key considerations include:

#### 5.1.1 Economies of scale

Economies of scale arguments are frequently used to justify arguments for regionalisation. This refers to a decrease in average costs as the quantity of output rises. Within the context of regionalisation, the rationale is that "...the larger the jurisdictional unit, the lower will be the per capita costs of service provision" (Dollery and Crase, 2004: 268). Several small municipalities are seen to be incapable of reaping the benefits of scale economies that larger municipalities can.

The concept of optimal community size or optimal service district is linked to debates around economies of scale. This is the point at which economies of scale can be captured. Diseconomies of scale arise above that point. The optimal service district varies according to municipal function – it will not necessarily be the same for fire services as it is for public

parks or sewerage treatment services. This implies that it is not possible to generalise about the optimal community size or service district with regard to local government functions.

A 2002 review of the evidence about economies of scale in providing local government services (both internationally and in the Australian context), conducted by Byrnes and Dollery, raises significant doubts about the strength of the economies of scale justification because of the view that bigger is better. According to Byrnes and Dollery, the research conducted on this topic in the United Kingdom and the United States of America shows that:

1. 39% of research papers find no statistical relationship between per capita expenditure and size;
2. 29% of research papers find evidence of a U-shaped cost curve;
3. 24% find diseconomies of scale; and
4. 8% find evidence of economies of scale (Byrnes and Dollery, 2002:393).

The Byrnes and Dollery review emphasises that existing research is largely uncertain about the existence of economies of scale when it comes to local government service delivery. This lack of conclusive evidence raises questions about using this argument to support the view that bigger is better. Notwithstanding the evidence presented above, it would not be prudent to draw any conclusions about the existence or otherwise of economies of scale. The reason for this is that the mix of services provided by local governments varies substantially within and between countries. However, if we look specifically at the possibility of economies of scale in distributing electricity, the conclusions are similar. Reviewing the restructuring of the Ontario electricity distribution industry, Cronin and Motluk (2004: 2, 7) drew two key conclusions:

1. The evidence does not support the premise that bigger utilities have cost advantages compared to smaller ones. In fact, evidence from the Ontario case study confirms that costs for smaller utilities were significantly lower than those for medium and larger utilities.
2. Size is not an important determiner of cost and that efficient and inefficient utilities can be found amongst all size classes –small, medium or large.

**Table 7: Types of local government service delivery arrangements underpinned by the concept of regionalisation**

MODEL TYPE	CHARACTERISTICS
Amalgamation	Refers to a force consolidation of individual councils. Great emphasis is placed on resource efficiency relative to representational effectiveness. Constituent councils completely surrender political autonomy and operational control to the new entity.
Ad hoc resource sharing models	Refers to voluntary arrangements between geographically adjacent councils to share resources on an ad hoc basis when the need arises – most flexible arrangement when compared against amalgamation. Happens spontaneously / when the need arises and must contain real prospect of cost saving/benefits – if this were not the case, then presumably these arrangements will not be entered into.
Regional Organisations of Councils (ROCs)	Refers to voluntary groupings of neighbouring councils that benefit from the free exchange of common concerns, potential solutions and development of common policy positions. ROCs are financed via a set fee from each member council as well as contribution based on proxy for the size of the participating council. Governed by a board composed of two members each of constituent municipalities.
Area integration or joint board Models	This is based on retention of autonomous existing councils and their existing spatial boundaries, but with shared administration and operations overseen by a joint board of elected councilors from each member of the municipality.
Agency Models	In this case municipalities completely surrender operational control of the services they direct but still retain and enjoy political autonomy as elected bodies for a spatially defined jurisdiction. In this model, the composition of municipal services is determined by municipal councils, whereas production and provision is carried out by the state owned agency.

*Source: Dollery and Johnson, 2005*

It appears then that generalisations are also not possible when it comes to the electricity distribution industry, size and the potential to reap economies of scale.

According to Dollery and Fleming (2006), even if economies of scale were possible with regard to local government functions, lower per capita costs is not a given. They provide two key reasons:

1. Consolidating municipalities or service delivery functions often leads to a harmonisation of service levels and wages – this is usually pitched at the level of the municipality with the highest expenditure.
2. Substantial transitional costs are incurred in trying to bring about compatibility in computer systems and other operational aspects of the municipalities involved (Dollery and Fleming, 2006).

Despite the fact that no conclusive relationship exists between size and economic efficiency (lower average costs), regionalisation-type reforms of local government functions

do bring certain advantages. These include “...the ability to coordinate services across municipal boundaries, the capacity to spread the costs of local government over a larger tax base, equalisation of service levels and a stronger voice for local government” (Dollery and Fleming, 2006:273).

**5.1.2 Economies of scope**

Economies of scope refer to a decrease in the cost of production because the number of goods produced has increased. As Dollery and Crase (2004) noted, this concept is also referred to as economies of joint production. They note that economies of scope arise particularly “...when the cost of producing a given set of services in a single organisation is lower than the cost of those services being produced by a number of specialised organisations.” Furthermore, “...a single organisation can attribute the cost of fixed inputs or overheads like central administrative staff, computing facilities, etc, across many of the services it produces” (Dollery and Crase,2004: 269). Unfortunately, economies of scope is a little researched topic and there is almost no empirical evidence on this concept (Dollery and Crase, 2004).

### 5.1.3 Capacity

Capacity arguments advanced to support regionalisation-type delivery arrangements are premised on the belief that larger local governments, because of their size, can acquire specialist expertise more readily. Dollery and Crase (2004) note that there is merit in this idea as small councils often struggle to acquire expertise.

### 5.1.4 Public choice considerations

Choice of institutional arrangement is thought to affect the relationship between citizens and governments. Public choice theory suggests that citizens in larger municipalities are generally less likely to participate in local affairs and find it more difficult to influence public decision-making processes. On the other hand, it is assumed that smaller municipalities have a greater degree of transparency and it is more likely that community members are able to contact elected officials. According to Dollery and Crase, "If smaller municipalities are indeed subject to closer and more informed scrutiny, then it can be anticipated a priori that they could experience greater public pressures to deliver local public goods more efficiently" (Dollery and Crase, 2004:272). This seems to imply that some of the benefits of the bigger is

better school of thought may be offset by a decline in local responsiveness.

## 5.2 Varieties of regionalisation reform types

A number of variations of regionalisation-type models exist. Table 7 below briefly describes the characteristics of a few of them. They vary from models of forced amalgamation, where the political Executive Authority of local governments is surrendered, to models that are based on voluntary cooperation.

The literature identifies factors that are associated positively with higher levels of consolidated service delivery. They include the wealth of the community, the poverty of the community as well as population size and density. Fiscal stress also induces cooperation. However, the extent of those gains in social welfare is not clear, (Dole and Bartlett, 2004). This study argues that the main driver for rationalising municipal services should go beyond cost savings and focus on improved service to the community.

## 5.3 Case studies of municipal service reform

### 5.3.1 Johannesburg Metropolitan Municipality and iGoli 2002 Plan

#### Creating independent municipal entities

**The City of Johannesburg Metropolitan Municipality was established in 2000. It combines the Greater Johannesburg Metropolitan Council (Northern, Eastern, Western and Southern Metropolitan Local Councils) with parts of Midrand and Modderfontein. The Metro faced a financial and institutional crisis between 1995 and 1998. This led to the development of the iGoli 2002 plan.**

The intention of the plan was to transform the city structurally. The thinking was that, by combining a new political governance structure with the establishment of utilities, agencies and corporatised entities, the city would work better.

City Power and Johannesburg Water were two of the utilities that were created. Whilst these two utilities are considered models of successful utilities, they do provide lessons that can be taken on board when considering this type of reform. This paper makes use of these examples because of certain similarities. For one, the reform process, particularly with respect to electricity, entails merging several electricity departments (Khumalo et al, 2003). This is similar to the notion of merging the various electricity distributors that established six regional distributors. With regard to management, a board of directors oversees both utilities. There are service delivery agreements with the city because the city remains ultimately accountable for service delivery. While these two examples are successful models for utilities, their experiences do provide good lessons that other models of reform can draw from.



### 5.3.1 Johannesburg Metropolitan Municipality and iGoli 2002 Plan cont.

- a. The reform was met with significant resistance by labour unions, which remain wary of reforms that tend, no matter how little, towards privatisation. Their unhappiness with the process includes the fact that labour is not represented on the board of directors and therefore has no say in decision-making processes.
- b. The issue of equity has been raised – it appears that City Power has concentrated its efforts to improve service delivery and customer care for a small, mainly higher end, corporate section of customers. This raises concerns about how electricity users will be affected should the customer base be expanded significantly – as would be the case if REDs were implemented.
- c. Related to the point above, concerns have been raised around the ability of municipalities to monitor the capacity of service providers to deliver quality services to all consumers.
- d. With regard to water services in Johannesburg, there are difficulties about generating surplus revenues while attempting to expand service delivery.
- e. Billing and revenue collection inefficiencies reduce the extent of the efficiency gains that can be made.
- f. Management struggles, epitomised by shareholder's struggles to reform in an environment characterised by mistrust amongst officials, councillors and others, has hindered progress and complicates governance.

### 5.3.2 The restructuring of EDI and creation of REDS

#### EDI Reforms and the creation of REDs

The current EDI restructuring process aims to implement a process of regionalisation that will see the consolidation of Eskom Distribution and current municipal distributors into six, wall-to-wall, regional electricity distributors. In terms of governance, each RED will be controlled by a board of directors appointed by shareholders – national and local governments (municipalities). Decision-making within the REDs will be through majority voting processes (Department of Minerals and Energy [DME], 2001:28). Essentially, the restructuring will shift the distribution of electricity towards a more business-like approach. Given that the REDs will be focussing solely on the distribution of electricity, and not on a variety of functions, it is unlikely that they would yield economies of scope – as opposed to an entity like Transnet that is responsible for national ports, rail engineering, freight rail et cetera. Municipalities are to be compensated for this shift in service delivery responsibility through a combination of dividends and a local government levy (surcharge). In the interim, prior to the full establishment and operation of the REDS, a holding company, EDI Holdings, has been established to oversee and direct the reform process.

## 5.4 Implications of the regionalisation and EDI processes

The following sub-sections discuss various concerns about, and implications of, the proposed restructuring.

### 5.4.1 Fragmented approach with regard to restructuring the electricity sector

In South Africa, the general electricity reform agenda has not been driven by factors considered common in the rest of the developing world like poor utility performance or the need for privatisation to alleviate public debt. Instead, reform has been informed by:

1. The shift to democracy, after which the government's focus was on redress. Electricity was one of the areas characterised by unequal access and the need for reform.
2. The move by government, during the mid-1990s, to improve efficiencies in state-owned enterprises through a process of corporatisation.
3. The introduction of a new energy policy in the late-1990s, which led to a reassessment of Eskom's performance (Eberhard, 2005).

As a result of these events, and as envisaged in the White Paper on Energy, South Africa was to embark on a two-pronged, all-encompassing reform process of the electricity sector – one focussing on EDI and the other on the electricity supply industry (ESI). The need to reform the ESI stemmed from the need to introduce wholesale and retail competition as well as to involve the private sector in the supply industry more. However, the reform of the ESI has largely been suspended. Independent power producers will be introduced but Eskom, will, for the foreseeable future, remain under state ownership and will not be unbundled (Eberhard, 2004:236). Debates around EDI restructuring continue unabated and have even prompted a proposed amendment to the Constitution.

The concern is that the vision for ESI, and the direction that it may take once reform is actively pursued, are not clear at present. This has implications for the current EDI restructuring process and the anticipated advantages it will bring. The ideal would be to restructure the various components of the industry in tandem or, at the very least, to clarify restructuring plans in an integrated manner. As a result, this raises questions about the assumptions and context within which the current EDI restructuring debate is proceeding.

### 5.4.2 Blanket approach to restructuring with compulsory participation

The blanket approach to restructuring is a concern for two reasons:

1. The Constitution 17th Amendment Bill, which requires a blanket regionalisation approach for municipal functions that are performing poorly or where it is necessary to improve economies of scale.
2. The EDI restructuring process.

The proposal is that six wall-to-wall REDs are established. Currently, there are several instances in South Africa where electricity distribution is not hindered by the general challenges that the restructuring process intends overcoming. An independent study, commissioned by the National Energy Regulator of South Africa (NERSA) in 2005, found that Eskom Distribution was managing distribution well in metropolitan and some larger municipalities compared to smaller municipalities, whose undertakings it described as being in poor shape (NERSA, 2005). When one considers the variable performance of different distributors, there is merit in calling for a differentiated approach to restructuring that recognises the differences because there is a danger of negatively affecting instances of good performance.

Dollery and Crase (2004:274) noted that, since there is no conclusive relationship between size and economic efficiency, restructuring should be on the basis "...of current performance rather than current size". Various options allow distributors that perform well to be unaffected by the restructuring process.

For example, Newberry (2008) found that the 12 largest municipalities in South Africa account for approximately 80% of municipal electricity sales. Restructuring could be tailored to leave these 12, and other municipalities that perform well, alone and to focus instead on poor performers. It should be noted that the current legislative provisions allow for creative service delivery arrangements that can assist municipalities to reap benefits similar to what the 17th Amendment Bill is proposing. For example, sections 82 and 87 of the Municipal Systems Act (No 32 of 2000) allow for:

1. One or more municipalities to work together to establish a company, co-operative trust, fund or corporate entity to provide a specific municipal service as a municipal entity under the control of the participating municipality or

**Table 8: Allocations to EDI Holdings Company, 2003/04 to 2011/12**

R' Million	AUDITED OUTCOME					ADJUSTED APPROPRIATION	MEDIUM TERM EXPENDITURE			ANNUAL GROWTH
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2003/04 - 2011/12
Annual Allocations	49.0	54.0	59.2.8	62.8	65.9	69.3	72.2	75.6	58.5	22

*Source: Estimates of National Expenditure, 2007, 2008 and 2009.*

municipalities (section 82). In addition, this section allows for a municipality, or group of cooperating municipalities, to acquire ownership of an existing business operation. It will agree to deliver a service as specified in an agreement with the municipality or municipalities. Section 82 also provides for the establishment of a service utility to deliver an identified service.

2. Establishing multi-jurisdictional municipal service districts (MMSDs). MMSDs comprise two or more municipalities that cooperate in order to facilitate improved service delivery. The agreement between the municipalities must specify the service that will be provided and the mechanism through which provision will occur. A governing body, comprising representatives of the participating municipalities, will manage the MMSDs (section 87).

The options with regard to the institutional arrangements described above are similar to the regionalisation-type forms described in Table 13, but the legislative provisions described are based on voluntary participation. Incentives to attract lagging performers to participate could be provided to facilitate restructuring within the context of the provisions of the Municipal Systems Act.

There are various ways in which restructuring can occur without needlessly affecting distributors that are already performing well and diluting the Executive Authority of the local sphere. Instead of restricting the rights of municipalities to decide whether to restructure (as is being proposed in the Constitution 17th Amendment), appropriate incentives should be provided to prompt them to participate willingly. Restructuring based on willing participation and a shared understanding of the need for, and potential benefits that can be derived from, the process will make for a much smoother process of reform.

#### 5.4.3 Updating benefits versus costs of restructuring

Before deciding whether to restructure or not, one needs to do a thorough assessment of the potential benefits that restructuring can produce versus the costs that it will incur.

An assessment was carried out at the inception of the restructuring process.

The EDI restructuring process has, however, been particularly drawn out and has yet to be concluded. Since this assessment was done, significant political, economic and social changes have occurred. This questions the current assumptions that underpin the restructuring process. Stalling the implementation of the REDs has generated new costs that require a total re-evaluation against the benefits that were perceived at the conception of the idea. Allocations to EDI Holdings alone will have cost government about R500, 000,000 between 2003 and 2011.

There are two key considerations when weighing up costs and benefits. They are capable of eroding the potential savings that need to be factored in. They are:

1. Consolidating municipalities or service delivery functions often leads to equalising service levels and wages. This is usually pitched at the level of the municipality with the highest expenditure. The success of the restructuring process will depend largely on how well human resource-related issues are handled.

Introducing REDs will necessitate amalgamating the employees of municipal distributors and Eskom Distribution, each of who have existing and varying basic conditions of service. According to guidelines on the restructuring process, the conditions of service of employees within a specific RED will be rationalised.

Given this, the obvious concern is whether the REDs will be able to absorb this fiscal requirement. It should be kept in mind that the REDs are not legally obliged to rationalise the employment conditions of employees. The following excerpt is noted from section 197 of the Labour Relations Act: "The new employer complies with subsection (2) if that employer employs transferred employees on terms and conditions that are on the whole not less favourable to the employees than those on which they were employed

**Table 9: Budgeted revenue from electricity sales as a percentage of total budgeted municipal revenues, 2008/09 to 2010/11**

MUNICIPALITY	2008/09	2009/10	2010/11
<b>Metros</b>			
Nelson Mandela Bay	33%	38%	37%
Ekurhuleni Metro	31%	33%	35%
City of Johannesburg	23%	26%	28%
City of Tshwane	30%	29%	29%
eThekweni	30%	31%	32%
Cape Town	24%	26%	28%
<b>Average: Metros</b>	<b>29%</b>	<b>31%</b>	<b>32%</b>
<b>TOP 21</b>			
Buffalo City	25%	25%	27%
Mangaung	26%	27%	26%
Matjhabeng	23%	24%	23%
Emfuleni	28%	27%	26%
Mogale City	31%	34%	35%
Msunduzi	31%	32%	32%
Newcastle	23%	23%	22%
uMhlathuze	35%	38%	41%
Govan Mbeki	23%	23%	23%
Emalahleni (Mp)	27%	30%	30%
Steve Tshwete	28%	29%	30%
Mbombela	26%	26%	26%
Sol Plaatjie	29%	30%	29%
Polokwane	12%	14%	17%
Madibeng	28%	29%	30%
Rustenburg	43%	46%	46%
Tlokwe	42%	41%	41%
City of Matlosana	22%	23%	23%
Drakenstein	43%	45%	46%
Stellenbosch	33%	32%	33%
George	31%	32%	33%
<b>AVERAGE: TOP 21</b>	<b>29%</b>	<b>30%</b>	<b>30%</b>

Source: National Treasury Local Government Database

by the old employer" (Department of Labour, 2002). Thus, it should be noted that, notwithstanding what the EDI Blueprint Report is implying, there is no legal requirement for equalising employment conditions. Therefore, it cannot be determined with certainty whether the status quo will be maintained or whether some employees will experience an improvement in their conditions of employment.

2. Substantial transitional costs are incurred when trying to bring about compatibility in the computer systems and other operational aspects of the municipalities involved (Dollery and Fleming, 2006).

In the case of the EDI restructuring, compatibility needs to be achieved amongst the various municipal distributors and the systems of Eskom Distribution. The intention, according to the recommendation in the EDI Blueprint Report is that "...REDs should operate on the basis of all of the operational processes and systems currently employed. This will inevitably mean use of a vast array of different practices at the outset ..." (DME, 2001:69-70).

Customer billing, for example, will remain with Eskom and municipal billing departments until the REDs are able to fulfil the task for themselves. Given that the quality of operational processes, including the billing and debt management

practices, of municipal distributors vary significantly, this may lead to negative implications for service delivery. No time line is attached to this arrangement – the Blueprint Report states that this arrangement will remain in place until the REDs are able to take on the task themselves.

World experience cautions about the costs associated with ensuring compatibility. Therefore, this is something that should be sorted out before establishing the REDs. Other unresolved aspects of the restructuring process, if further drawn out, can affect costs, relate to the need to ensure that the EDI Restructuring Bill and practical guidelines about moving municipal or Eskom distribution assets (via the Asset Transfer Guide) are finalised before moving towards more advanced stages in the restructuring.

#### 5.4.4 Effects on the municipalities and the broader local government sphere

##### 5.4.4.1. Financial considerations

Most municipalities, particularly the metros and the top 21 cities, derive significant income, around 30% of total revenue, from selling electricity to end users. Table 9 illustrates this.

Both the EDI Blueprint Report and the Constitution 17th Amendment Bill stress that local governments will be protected during the restructuring process and that municipalities will not suffer financially. Traditionally, municipalities have used surpluses earned from distributing electricity to cross-subsidise other municipal services. The shift to the REDs structure will require municipalities to redirect all resources related to electricity distribution to a relevant RED so that the RED can take over responsibility for distributing electricity. Two forms of compensation will be introduced to ensure the protection of municipalities. These are dividends and a local government levy. Dividends are compensation for the transfer of distribution-related assets while the local government levy is a recognition of the fact that surpluses earned through electricity distribution represent a significant source of income which, in many instances, is used to cross-subsidise other municipal functions.

According to the guideline on the restructuring process, municipalities will have to transfer all electricity distribution-related assets to the relevant RED. This has the ability to affect the credit rating of municipalities negatively, particularly in their ability to secure private sector funding. The result may be that municipalities will become more dependent on the national fiscus.

This seems more probable if we consider that dividend payouts to shareholders (of which municipalities form part) will be "...zero or very low initially and only begin to rise towards the target levels for most REDs by years four and five" (DME, 2001:53). This implies that municipalities should not expect significant returns from this income source in the medium term. An additional constraint about this source of revenue is that it is tied to the financial performance of the RED concerned. Given that the REDs will be new entities made up of combinations of municipal distributors and Eskom Distribution, it is nearly impossible to predict performance.

##### 5.4.4.2. Concerns about the autonomy of local governments

The EDI restructuring process has led to the Constitution 17th Amendment Bill that, if passed, has the potential risk of establishing a trend where functions are shifted if there is general unhappiness with performance – this as opposed to sorting out underlying issues and causes of poor performance. While this amendment is proposed in the context of a stalled EDI restructuring process, if it is passed the contents of the amendment will apply to any municipal function.

This will have an effect on the Executive Authority of the local government sphere. The Constitution of the Republic of South Africa establishes three spheres of government that are distinctive, interdependent and interrelated. The distinctive element refers to the Executive Authority enjoyed by the spheres: the degree to which each sphere is the final decision-maker on a particular matter that falls within its area of competence.

The proposed amendment thus dilutes the Executive Authority of municipalities with regard to the functions listed in sections 4B and 5B. The bill is heavily biased towards concerns for economic efficiency rather than on the Executive Authority of municipalities. According to de Visser (2008), one of the consequences of the fact that Section 156(4), relating to subsidiarity in South Africa, is that it is based on effectiveness (which alludes to effect). This means that arguments for delivery by larger units because they are able to deliver a service better, are acceptable.

This contradicts traditional views about the principle of subsidiarity, where most arguments are for centralisation. The reverse is true in South Africa and one would need to make a case to devolve a function. The Constitution 17th Amendment Bill highlights a weakened commitment to upholding the Executive Authority of the different spheres

of government and highlights the diluted nature of Section 156(4) of the Constitution (the principle of subsidiarity).

Restructuring the EDI towards the REDs model underlines a much deeper issue within the South African public service. It highlights a growing trend, in South Africa, to shift service delivery responsibilities continually when lack of performance becomes evident. The concern is that reforms may continue to be implemented without addressing the underlying reason for poor performance. The establishment of the Housing Development Agency is an example of how unhappiness with provincial housing departments was resolved.

With regard to electricity distribution, the proposal is that the responsibility for service delivery is shifted to an entity without addressing the root causes of inefficiencies and the poor performance of municipal distributors.

Municipal distributors are said to be characterised by high levels of debt because of non-payment. It is not clear why this is so and why reforms are not aimed at improving municipal performance in this regard. If the issue relates to current capacity, the challenges will be transferred to the REDs because all electricity distribution-related staff will be transferred to their relevant RED.

The question then is what prevents this type of challenge from characterising the various REDs? Without adequately assessing and addressing the real reasons for poor performance, we face a continued pattern of service delivery responsibility shifts. This will continue and will be supported should the 17th Constitutional Amendment be passed. In addition, fragmenting functions will present challenges about integrated planning and development.

### 5.5 Implications for Eskom

Eskom is a state-owned enterprise that currently dominates the electricity sector (generation, transmission, distribution) in South Africa. Municipal distributors and Eskom Distribution will now merge to form six REDs. All assets and distribution-related resources from municipal distributors and Eskom Distribution are to be amalgamated to form the six REDs. In return for assets or distribution-related resources, it is envisaged that shareholding rights will be granted.

While this is so in the case of municipal distributors, it is proposed that the national government will hold the rights accruing to Eskom Distribution. This has been proposed to counter the common stake and dominance that Eskom

enjoys in the segments of the electricity value chain other than distribution: generation and transmission.

REDs will buy power and transmission access from Eskom, thus including Eskom Distribution as a shareholder. This may create a conflict of interest (DME, 2001:27). The fact that Eskom will lose true ownership rights (shares) and significant assets may have a negative effect on its credit rating. This, in turn, can have a domino and negative effect on the rest of Eskom's business units.

This is particularly worrying when one considers that some rating agencies (like Moody's Investor Services) have been downgrading the organisation's rating in recent years – Moody's downgraded Eskom's rating by three points in 2008 mainly because of tariff increases that were lower than requested (Eskom, 2009).

### 5.6 Effects on households and other end users

At the moment, municipalities charge varying prices for electricity. The variation in consumer prices goes far beyond what can be expected because of the costs associated with distributing electricity, like distance from the grid. Should the REDs structure be implemented, municipalities (and Eskom Distribution) within a particular RED will need to agree on a single rate to be charged to electricity users residing within their particular service delivery parameters.

The methodology that will be used to arrive at the compromise prices and the effect on end-users is unclear. A balance needs to be achieved. While electricity tariffs need to be as cost-reflective as possible to assist customers to make rational decisions about consumption, tariffs for low-income households need to be kept below cost-reflective price levels for social development reasons. As a result, prices to end users could increase or decrease.

A similar situation exists with regard to the level of customer service that end users are currently receiving. End users enjoy either good or poor levels of service. Should the REDs model be adopted, end users may experience a change – it is however not possible to determine the direction of the change.

With regard to the electrification programme, the EDI Blueprint Report notes that, given the need for cross-subsidisation to maintain tariffs to poor customers at an acceptable level, the roll out of the electrification programme is burdensome to richer customers. There therefore exists a trade-off between

expanding access to new customers and cost increases for existing ones.

Clarity is needed about electrification. It must be made clear which sphere of government will take the responsibility to plan, budget and implement the electrification programme.

### 5.7 Conclusion and recommendations

This section was written in response to a myriad of interventions by national government to address service delivery challenges at local government level. The most recent of these is the Constitution Seventeenth Amendment Bill, which aims to widen the scope of national government interventions in local government matters listed in Part B of Schedules 4 and 5 of the Constitution.

The Explanatory Memorandum to the Bill uses the current restructuring of the electricity distribution industry as the first specific instance of proposed reform that could be applied to any other suitable municipal function where economies of scale may be realised through regionalisation.

The underlying gist of this paper, in addition to assessing the EDI restructuring process, is to emphasise the need for government to recognise that there are costs and benefits associated with any type of reform and that a key precondition for ensuring that a particular approach will succeed is a thorough diagnosis of the challenges that need to be overcome.

Because of the complexity of the issues at hand, the Commission has divided its recommendations into two groups:

#### 5.7.1 General recommendations

1. In the absence of an assessment of the specific performance challenges that the different municipalities face in implementing the functions listed in Part B of schedules 4 and 5, the Commission recommends that approving a blanket regionalisation approach, as proposed in the 17th amendment to the Constitution, is not supported. Current legislative provisions allow for alternative and creative service delivery arrangements that do not call for a dilution of local government Executive Authority.
2. Not all electricity distributors suffer from the challenges that the restructuring intends to overcome. As a result, the Electricity Distribution Industry (EDI) restructuring process should consider a differentiated approach that allows for

differences in performance.

#### 5.7.2 Recommendations should the EDI restructuring and establishment of REDS proceed

1. The government should revisit the Blue Print assumptions initially made to restructure the EDI. The EDI component was informed by restructuring the electricity industry as a whole, including the electricity supply industry. The government needs to clarify the policy issue of whether it is necessary to change ownership and structure in order to ensure efficiency, economies of scale, robust regulations and to deal with management challenges in the sector.
2. The government conducts an up-to-date re-evaluation and analysis of the benefits of restructuring the EDI. In addition to the political, economic and social changes that have happened in the last eight years and which raise questions about the current assumptions underpinning the restructuring process, delaying the implementation of the REDS has generated new costs that require a total re-evaluation against the benefits that were perceived at the conception of the idea.
3. The government finalises the EDI Restructuring Bill and the practical guidelines related to the shifting of municipal/Eskom distribution assets (the Asset Transfer Guide) first before moving towards more advanced stages of restructuring.
4. The government implements measures to ensure that municipalities are adequately compensated for their loss of assets, particularly in the early stages of implementing REDS, where dividends are expected to be zero or minimal.
5. The government should ensure the compatibility of operating systems that will underpin the activities of the REDS before establishing REDS as this can negatively affect smooth service delivery and significantly reduce any savings that could be derived from the restructuring.
6. It is important that the social objective of making access to electricity universal is not lost in the process of restructuring the EDI. The government must make it clear which sphere of government will be responsible for planning, budgeting for and implementing the electrification programme.

# CHAPTER 4:

## INTERGOVERNMENTAL FISCAL ISSUES IN URBAN PUBLIC TRANSPORT

### 1. INTRODUCTION

There is a growing awareness of the critical need to address public transport challenges in South Africa, particularly in the major urban centres. This chapter focuses on public transport in South African cities<sup>24</sup>.

Given its focus on laying the foundations for growth and development as well as responsibility for addressing inter-governmental fiscal issues, there are other important reasons for placing public transport high on the agenda of the Financial and Fiscal Commission.

Not only has there been a significant increase in public spending on public transport in recent years, but the inter-governmental fiscal system has also been instrumental in much of this expenditure.

Key items include the ongoing bus subsidies, the Gautrain, and the new bus rapid transit projects in cities like Johannesburg and Cape Town – all of which occur through sub-national governments. It has been argued that confusion about accountability in the three spheres of government has been amongst the biggest obstacles to investment in the improvement of public transport (van Ryneveld 2008). The new National Land Transport Act (No. 5 of 2009) introduces significant changes to the allocations among spheres of government which, in turn, demand a reassessment of inter-governmental fiscal mechanisms relevant to it.

Apart from this introduction, the paper is in six sections.

Section 2 describes some of the most significant features in public transport in South Africa briefly. It includes a discussion about the urban form of South African cities. Section 3 delineates some of the main features of key policy processes in public transport and related legislation since 1994. The new legislation passed in 2009, in effect, provides for asymmetrical devolution of power. It is an important advance on previous approaches to devolution. However, it was not introduced as a 'money bill' and so it does not provide for any substantial funding of public transport. Section 4 outlines major funding flows from national government and describes developments in key modes and projects. These include the subsidised bus services, the suburban Metrorail services, the taxi recapitalisation programme, the Gautrain and the new bus rapid transit projects that are now being implemented in Johannesburg and Cape Town. It also describes the Gauteng Freeway Improvement Project. Against this background, section 5 highlights a number of important strategic





questions. In particular, it raises issues around possible future approaches to funding public transport in South Africa and raises questions about the tension between spending on highways and on public transport. Section 6 contains concluding remarks and recommendations.

## 2. OVERVIEW OF POLICY DEVELOPMENT AND FUNDING FLOWS IN URBAN TRANSPORT

### 2.1 Policy development and legislation changes

Three policy documents on public transport and two important sets of legislation have been published since 1994. The three key policy documents have been:

**1. The White Paper on National Transport Policy (1996).**

**2. Moving South Africa (1999).**

**3. The Public Transport Strategy and Action Plan (2007).**

The National Land Transport Transition Act (No. 22 of 2000) was passed after completing the first two policy documents, while the National Land Transport Act (No. 5 of 2009) was passed after adopting the Public Transport Strategy and Action Plan in 2007.

The White Paper on National Transport Policy (1996) set the initial direction. Subsequent policies built on it with some shifts in emphasis rather than any substantial new direction. An important aspect of the developments in policy have

<sup>24</sup> There are clearly public transport challenges in rural areas also, but these challenges are different and require an analytically different approach.

related to the constitutional and institutional framework of responsibility for public transport. While policy documents have generally supported assigning responsibility to the local sphere of government, changes in the structure of local government and the wider debates and tensions about the roles of each of the three spheres of government influenced the process.

Many of the policy concepts that were originally adopted in the 1996 White Paper remain current and relevant. However, a notable feature of this discussion is the contrast between the sophistication of policy after 1996 and the comparative absence of implementation until recently. The failure to implement has probably been attributable to a wide range of factors. These are likely to include, firstly, that implementation requires confronting substantial vested interests across a range of stakeholders, existing transport providers like current minibus taxi and bus owners, as well as the interests of private motorcar owners. Secondly, the actions required are technically difficult, involving developing and applying complex insights across a range of operational, legal and financial areas in a context of limited experience. Thirdly, assigning responsibility to the different spheres of government, together with appropriate financial support, has often been insufficient.

The next section will outline recent progress. A key new development has been the growing involvement of metropolitan governments in new public transport projects. While this is to be welcomed, it does create significant financing risks at metropolitan level that need to be addressed.

## **2.2 Overview of the national government budget on public transport**

Most public funding on public transport, with the exception of Gautrain, originates from national government. The national and provincial governments – the latter through its equitable share – jointly fund Gautrain. Municipalities spend relatively limited amounts of their own funds on public transport, although this is set to increase.

The first main expenditure area comprises subsidies to the commuter bus system. Bus subsidies are paid to provincial governments via the Public Transport Operating Grant (PTOG). They, in turn, contract private bus companies to run subsidised services. There is minimal additional expenditure on these services by provincial governments.

The second key expenditure area comprises subsidies to the

commuter rail system, Metrorail. These transfers are made to PRASA (the Passenger Rail Agency of South Africa). It replaced the previous South African Rail Commuter Corporation, and is responsible for Metrorail as well as the intercity rail and bus services.

The third key expenditure area is the taxi recapitalisation programme. This is financed from the national budget and pays an inflation-linked capital grant of R54 300 (from April 2009) to assist taxi owners replace old taxis with new ones to meet nationally determined specifications.

The fourth area of expenditure is the Gautrain. This is a public-private partnership, but capital expenditure comes overwhelmingly from public resources.

The fifth area of funding is via the Public Transport Infrastructure and Systems Grant. An important feature of this grant is that it makes transfers primarily to municipal governments. This was a key instrument in beginning to shift the locus of responsibility for public transport in key cities to city governments. Capital funding for the new bus rapid transit projects originates mainly from this grant, with some local contributions.

Most municipalities spend resources on building and managing transport interchanges and taxi ranks, while some municipalities run, or subsidise, local bus services. However, this is relatively small in financial terms compared to the amounts that come from national government. Figures on municipal spending are somewhat difficult to identify since they are often combined with overall transport spending.

### *2.2.1 Allocation of national government spending on public transport*

National government spent R24 164.1 million on the Transport Vote (vote 36) in 2009/10. This was 3.23% of total expenditure on all functions. Table 10 below shows that it has climbed significantly since 2006/7, when expenditure was R13 360.4 million and was 2.84% of all expenditure.

The table that follows shows total public transport expenditure against the total proportion of transport expenditure by national government.

Note that the Gautrain figures give only the figures from national government. Gauteng matches it on a one to one basis and the province funds the project from its equitable share revenue.

**Table 10: Public transport expenditure by national government as a proportion of total transport expenditure (actual R millions)**

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	10
Public Transport	10 444.5	12 312.3	16 179.8	17 452.4	17 429.6	18 354.7	18 747.5	
Total	13 360.4	16 331.6	24 838.6	24 164.1	25 086.3	27 960.1	29 169.5	
Proportion	78.2%	75.4%	65.1%	72.2%	69.5%	65.6%	64.3%	
<i>Source: National Treasury (2010a)</i>								

**Table 11: National government spending on Public Transport by sub-program actual 2006/7 to 2009/10) and projected (2010/11 to 2012/13) R millions**

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	11
Public Transport Strategy and Monitoring	4.7	2.8	4.2	22.8	10.0	7.8	8.2	
Public Transport Management	9505.1	9831.4	12535.4	13540.2	12580.8	13302.1	13963.7	
Taxi Recapitalisation Project Office	231.8	679.8	575.7	754.9	626.8	606.6	636.7	
Public Transport Business Development	0.0	0.4	1.9	1.9	2.4	2.6	2.7	
Administration Support	3.6	2.2	3.0	6.0	5.9	6.2	6.5	
Public Transport Infrastructure and Systems	699.3	1795.7	3059.6	3126.7	4203.7	4429.5	4129.7	
TOTAL	10444.5	12312.3	16179.8	17452.4	17429.6	18354.7	18747.5	
<i>Source: National Treasury (2010a)</i>								

**Table 12: National government expenditure on key projects and programs (R millions)**

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	12
Bus subsidies/PTOG	2460.3	2836.0	3840.9	3531.9	3863.0	4153.2	4360.9	
Total PRASA subsidy	3959.9	4431.2	5417.3	7482.4	8765.2	9128.5	9587.0	
Current subsidy	2751.3	2259.1	3049.6	3185.8	3154.9	3343.7	3565.9	
Capital subsidy	1208.6	2172.1	2367.7	4296.5	5610.3	5784.8	6021.1	
Gautrain	3241.0	3029.4	3266.0	2976.7	438.4	5.3	0.0	
Public Transport Infrastructure and systems grant	699.3	1795.7	3059.6	3126.7	4203.7	4429.5	4129.7	
<i>Source: National Treasury (2010a)</i>								

### 2.2.2 Public transport infrastructure and systems grant

Table 13 gives a breakdown of the allocation of the Public Transport Infrastructure and Systems Grant to municipalities for the period between 2006/7 and 2012/13, according to the Division of Revenue Bill published at the start of each financial year. In some cases, there may have been revisions during the course of the financial year, but these have been relatively few. Note that the total figure does not correlate with the total grant since some of this grant was also paid to PRASA and the South African National Roads Agency Limited (SANRAL).

In the framework for the Public Transport Infrastructure and Systems Grant, as included in the 2010 Division of Revenue Bill, the 'strategic goal' is to support the Public Transport

Strategy (PTS) and Action Plan in promoting the accessible, reliable and affordable Integrated Rapid Public Transport Network (IRPTN) services in the major cities of South Africa. The 'grant purpose' is to provide for accelerated planning, establishment, construction and improvement of new and existing public transport and non-motorised transport infrastructure and systems.

### 2.2.3 Subsidised bus services

During the apartheid period, a system of subsidised commuter buses was established in order to mitigate the high transport costs that resulted from locating black residential areas far from commercial areas and other work opportunities. Rationalising this system, to ensure a more competitive

**Table 13: Budgeted allocation to municipalities from Public Transport Infrastructure and Systems Grant (R millions)**

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	13
Nelson Mandela Bay	69.0	132.0	305.5	147.1	408.3	600.0	800.0	
Buffalo City	0.0	0.0	8.6	31.2	71.5	400.0	700.0	
Amatole District	0.0	21.0	0.0	0.0	0.0	0.0	0.0	
OR Tambo District	0.0	9.0	0.0	0.0	0.0	0.0	0.0	
Mangaung	29.5	25.0	242.6	82.2	15.0	15.0	15.0	
Ekurhuleni	27.7	13.0	7.6	27.7	20.0	20.0	20.0	
Johannesburg	184.0	329.0	661.2	652.8	1070.5	1200.0	800.0	
Tshwane	11.0	105.0	510.2	565.2	864.2	500.0	800.0	
West Rand District	1.5	0.0	0.0	0.0	0.0	0.0	0.0	
eThekweni	11.8	125.0	624.9	376.9	330.0	20.0	20.0	
Msunduzi	0.0	0.0	2.1	7.7	15.0	15.0	15.0	
Greater Tubatse	0.0	14.0	0.0	0.0	0.0	0.0	0.0	
Polokwane	10.5	40.0	143.2	66.1	20.0	20.0	20.0	
Mbombela	1.0	55.0	170.5	60.8	15.0	15.0	15.0	
Sol Plaatje	1.5	11.0	0.0	0.0	0.0	0.0	0.0	
Rustenburg	0.0	15.0	68.7	67.8	20.0	20.0	20.0	
Potchefstroom	1.0	0.0	0.0	0.0	0.0	0.0	0.0	
Matlosana	0.0	22.0	0.0	0.0	0.0	0.0	0.0	
Klerksdorp	30.5	0.0	0.0	0.0	0.0	0.0	0.0	
Cape Town	120.0	230.0	424.8	332.5	850.0	1600.0	900.0	
Stellenbosch	20.0	0.0	0.0	0.0	0.0	0.0	0.0	
unallocated	0.0	28.0	0.0	0.0	0.0	0.0	0.0	

Source: Division of Revenue Bill 2006, 2007, 2008, 2009, 2010

operating model, was a key priority arising from the white paper process.

Information from the Department of Transport, compiled in 2007, gave the following statistics for bus fleets that received some form of subsidy from national government, via the provinces.

Some of the subsidised bus companies were the old municipally owned fleets that have now, in some cases, been privatised or corporatised and generally receive some subsidisation from municipal councils.

The numbers appear to have risen since then. Walters (2009) states that the passenger base rose by approximately 12% per year in recent years. The increase was driven by increased urbanisation improved services and the escalating costs of motoring.

The apartheid-era bus subsidy system was based on 'lifelong' permits. Operators who had permits to operate a route

could do so for as long as they wished. An economic fare was determined for the route based on cost estimations and a 'normal' profit. A subsidised fare was also set. Operators collected the subsidised fare from commuters and the government paid the difference between the economic and subsidised fare.

Soon after 1994, the Department of Transport sought to end this system and shift to a new system known as 'current tendered contracts'. However, this was not easy to achieve since the rights given by the existing open-ended system were generally more attractive. Initially the tenders were to be for a period of four years. However, from April 1997 this was changed to five years in an attempt to reduce costs. It was subsequently changed to seven years.

The new Constitution partly drove the shift to a tendered approach. However, new thinking in the Transport Department also motivated it. Apart from limiting the length of the concessions, among the objectives was that the department sought to provide for incorporating the minibus

**Table 14: Provincially subsidised bus fleets**

Province	Number of buses	Main operating companies	14
Eastern Cape	265	Algoa Bus Company	
Free State	240	Inter State Bus Lines	
Gauteng	2130	Putco, North West Services	
Mpumalanga	440	Putco	
KwaZulu-Natal	1600	Various	
Limpopo	190	Great North	
Northern Cape	40	Various	
North West	220	Various	
Western Cape	910	Golden Arrow	
<b>TOTAL</b>	<b>6035</b>	<b>2836.0</b>	

Source: Department of Transport (2007d)

**Table 15: Municipal subsidised fleets**

Province	Number of buses	Main operating companies	15
Johannesburg	530	Metrobus	
Tshwane	232	Tshwane Bus Company	
Ekurhuleni	76		
eThekweni	650		
<b>TOTAL</b>	<b>1488</b>	<b>Various</b>	

Source: Department of Transport (2007d)

taxi sector to the new system, formalising it at the same time. It also sought to lower the average age of the buses. In 1997, the average fleet age profile in the country was 13 years, with many of the buses using obsolete and inappropriate technology. The objective was to lower the average age to 10 years by specifying the maximum bus age requirement of 15 years and only allowing a bus younger than 15 years from date of first registration to be rebuilt or refurbished (Department of Transport 2004b).

The shift to a new tendered basis presented a threat to existing bus operators and to unions. Therefore, the Department of Transport, organised labour and the bus industry signed an agreement in an attempt to address labour's demands about potential job losses. This incorporated a 10% 'right of first refusal': if an existing operator's bid was within 10% of the winning bid, the existing operator could award the contract at the winning price.

From 1997, the contracts were shifted from the inherited approach to what were termed 'interim contracts' in

preparation for the tendering system as a first step. After its promulgation in 2001, the National Land Transport Transition Act (NLTTA) sought to govern the new approach to bus contracting. However, it became evident that the prices that were tendered, based on the new contracts, were generally too high to be affordable to the departmental budget.

Figure 12 compares the subsidy per bus prior to the new tendering approach and the subsidy in terms of the new approach for 18 contract areas. All of the new tender prices were higher (Department of Transport et al [2002]).

After February 2003, when the moratorium was lifted, contracts that were not re-awarded through a tender process were extended on a monthly basis and continued to be described as 'interim contracts'. The NLTTA also provided for this and carried it over to the National Land Transport Act (NLTA) to allow the authorities to negotiate new terms with an existing operator. This is allowed only once per contract, after which a full tendering process is mandatory.

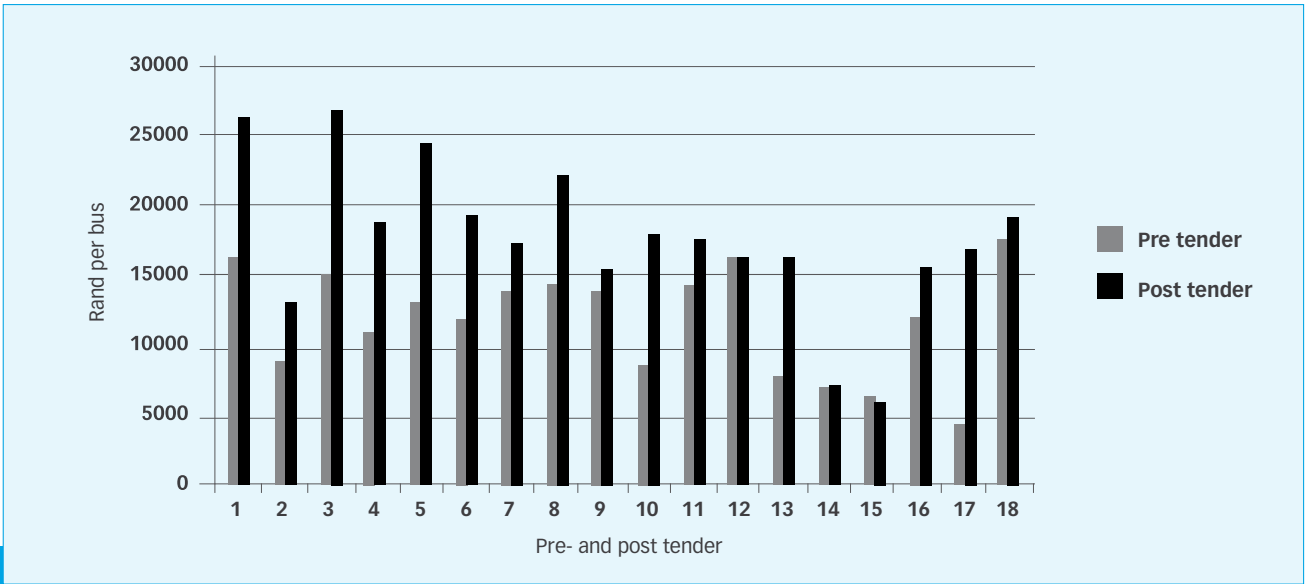


Figure 12: Comparison of subsidy per bus between old and new tender system

Because of the legal and financial problems, the shift to the new tendered – or even negotiated – contracts has not been as fast as might have been hoped. Although most contracts (in terms of number) have been shifted, most contracts (in terms of value) remain interim contracts. Table 16 summarises the position at mid-2009.

One of the difficulties, with a set subsidy per ticket sold, is that, as passenger numbers increase, the total amount payable in subsidy increases too, sometimes beyond the budgeted provision. The national government, which increased the allocation in the adjustments budget, and the provincial governments, which paid bus operators out of funds intended for the next financial year, managed this over the years. The upshot was that an accumulating deficit emerged and increased from year to year. Table 17 shows this developing situation between 2005/6 and 2008/9.

In late 2008, government indicated that it would not be able to fund the industry’s contracts for the last four months of the financial year. Bus operators from Cape Town and Pretoria

thus took the government to court. This resulted in the national government being compelled to make the payments.

The process, by which tenders and the relative responsibilities of the provincial and national governments in this regard have been managed, has been exceptional. While the subsidies have been managed at the provincial level, they did not appear on provincial budgets. In essence, provinces managed them on behalf of the national government. The court, which instructed National Treasury to pay the shortfall, confirmed this.

Part of the response by National Treasury has been to reconstitute the subsidy as a conditional grant to provinces. It is now known as the Public Transport Operating Grant and has a number of conditions attached to it. One of the responsibilities required of the provincial departments, with the introduction of this new approach in the 2009/10 fiscal year, was that all interim contracts had to be re-negotiated to pay subsidies per kilometre rather than according to the number of tickets sold.

Table 16: Contract types in operation in 2009

Contract type	Number	Percentage of subsidy budget
Interim contracts	39	68%
Tender contracts	66	28%
Negotiated contracts	10	4%
<b>TOTAL</b>	<b>115</b>	<b>100%</b>

*Source: Department of Transport quoted in Walters (2009)*

**Table 17: Accumulating deficit arising from difference between subsidy incurred and actual appropriation (R millions)**

	2005/06	2006/07	2007/08	2008/09	17
Initial allocation	2278.5	2415.2	2536.0	2829.6	
Adjustment	19.2	45.1	300.0	154.5	
Total allocation	2297.8	2460.3	2836.0	2984.1	
Actual subsidy expenditure	2383.7	2695.6	3110.0	3688.8	
Annual deficit	85.9	235.2	274.0	704.7	
Accumulated deficit		321.1	595.1	1299.8	

Source: Walters (2009)

**Table 18: Projected subsidy shortfall by province for 2009/10**

Province	Expenditure for 2008-09	Projection for 2009-10	DORA allocation 2009-10	Projected shortfall 2009-10	18
Limpopo	172.7	190.0	174.5	-15.5	
Gauteng	1,466.3	1,613.0	1,403.8	-209.1	
Mpumalanga	383.9	422.3	370.7	-51.6	
KwaZulu-Natal	691.9	761.1	647.4	-113.7	
Free State	158.0	173.8	151.8	-22.0	
Eastern Cape	122.3	134.5	126.5	-8.0	
Western Cape	628.4	691.2	593.7	-97.5	
Northern Cape	23.7	26.1	22.2	-4.0	
North West	41.6	45.8	41.3	-4.5	
	3,688.8	4,057.7	3,531.9	-525.8	

Source: Walters (2009)

The conditions of the grant also require Public Transport Integration Committees to be established. These would consist of all three spheres of government in order to ensure, *inter alia*, that the subsidies paid to the bus operators were paid in a manner that was consistent with the introduction of the new Integrated Rapid Public Transport Networks as provided for in national government's new public transport strategy and the new National Land Transport Act.

Despite the changes, a number of unresolved issues remains. It would appear that the allocations, in terms of the Division of Revenue Act of 2009, were insufficient to cover the costs of

the agreed contracts in the 2009/10 financial year, even taking into account the revision of the contracts to be payable on a per kilometre basis. Table 18 (in Walters (2009) and attributed to the Department of Transport) gives the actual expenditure for 2008/9 and the projected expenditure for 2009/10 as well as the projected shortfall against the appropriated amount in terms of the act.

Table 19 shows the actual subsidy amounts paid nationally per annum from 2004/5 to 2008/9 and the budgeted amounts for the three years from 2009/10 to 2011/12. It also shows the annual increase over the previous year's provision.

**Table 19: National bus subsidy and yearly increase**

Year	2004/5	2005/6	2006/7	2007/8	2008/9	2009/10	2010/11	2011/12	2012/13	19
Amount of subsidy R millions	2172.7	2297.8	2460.3	2836.0	2984.1	3531.9	3863.0	4153.2	4360.9	
Percentage increase on previous year's provision		5.8%	7.1%	15.3%	5.2%	18.4%	9.4%	7.5%	5.0%	

Source: National Treasury (2009a; 2010a), Division of Revenue Act, 2009, Division of Revenue Bill 2010

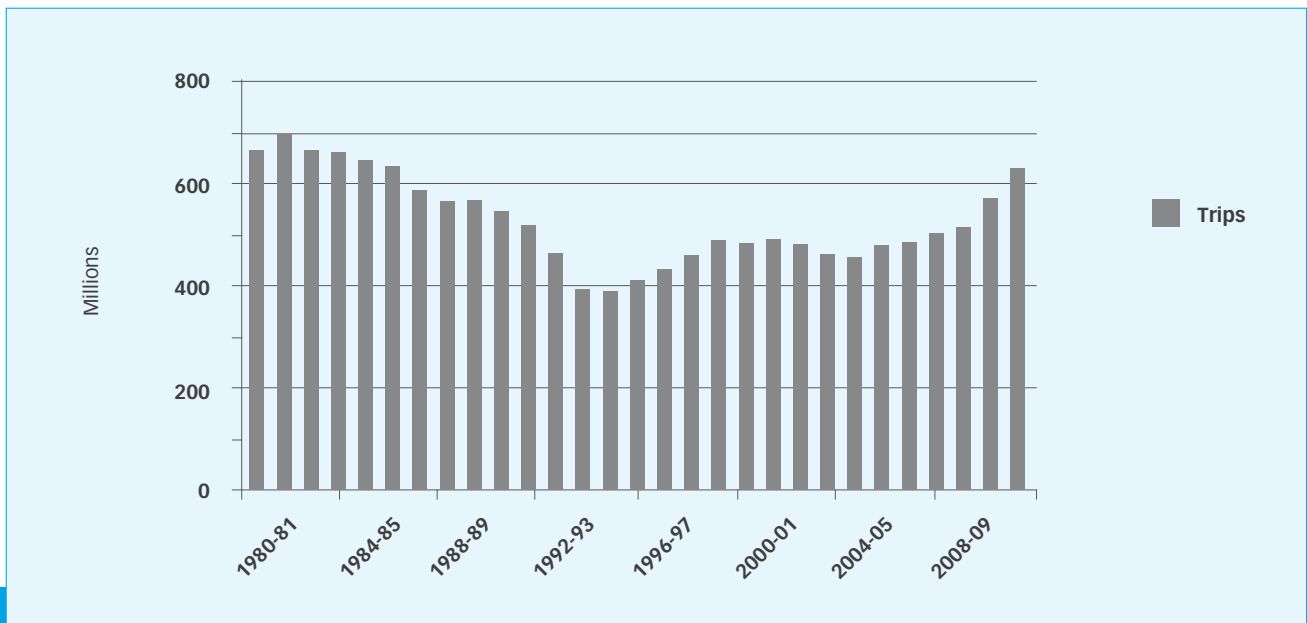


Figure 13: Rail trips per annum from 1980 to 2009

Apart from these amounts, the 2009 Estimates of National Expenditure (National Treasury, 2009a) indicate that “the programme expenditure is expected to exceed the appropriated allocation by R1.2 billion in 2008/09 due to legal action relating to bus subsidies”. In essence, this means that an additional R1.2 billion has been provided. However, this is to cover the accumulated shortfall indicated in tables 7 to 14 and not the projected shortfall of R525 million shown in tables 7 to 15.

The new approach by national government would suggest that provinces will have to either cut the subsidies or find additional revenue to supplement the amounts provided by national government. This would have to come out of the general unconditional grant allocations to provinces.

A significant thrust of the new National Land Transport Act is that it provides for metropolitan governments to become responsible for managing the bus contracts previously managed by the provinces. The requirement in the Division of Revenue Act, 2009, and repeated in the Division of Revenue Bill, 2010, that Public Transport Integration Committees are established, is fully consistent with this.

To the extent that operating subsidies must be paid to provide road-based public transport, the Public Transport Operating Grant will be the channel. One of the critical issues to be addressed is how these legacy services and the associated funding will be moved into the new bus rapid transit systems. A further crucial issue to be considered is how provinces will

manage the ongoing provision of subsidised bus services to the distant areas of displaced urban areas like Botshabelo and the former homeland areas to the north of Tshwane.

#### 2.2.4 Commuter rail

Some of the South African urban areas have significant commuter rail services, although rail only carries 11.2% of metropolitan area commuter trips and 5.9% of all metropolitan trips on average. It was hit hard by the growth of the minibus taxi industry, which is particularly effective at competing for the off-peak market. Low passenger numbers in off-peak periods meant that even infrequent trains were largely empty.

Figure 13 shows commuter rail trips per year for a thirty-year period from 1980 to 2009. Despite high and sustained population growth in the cities over the period, the total number of rail trips in 2009 remains lower than it was in 1980. The decline can be traced from the early 1980s to a low point around 1994. It largely stagnated for a decade before climbing again in recent years. Opening new lines in Khayelitsha in Cape Town has contributed significantly to a growth in passenger numbers in recent years.

The decline in investment in the commuter rail system over a long period has resulted in a generally poor service in much of the country. Frustration with services has led to a number of serious cases of vandalism, with whole trains being burnt in protest about delays and other problems in recent years.



**Table 20: Classification of rail corridor priority grading**

A	Clear case for rail (High service level – ranks amongst top corridors and rail is clearly more appropriate and cost effective than other modes with passenger numbers at > 20 000 – 30 000 passengers per hour)	20
B	Rail still justified (requires lower level of service than for 'A' but higher than current)	
C	Case for rail uncertain (needs further review)	
D	No case for rail at present	
<i>Source: SARCC/Metrorail 2006</i>		

The government had tried to address the problems in commuter rail by introducing a South African Rail Commuter Corporation (SARCC) to act as a 'buyer' of services from the 'operator' Metrorail in 1989. Metrorail was part of Transnet, the national transport services parastatal. The mandate of SARCC was to "ensure rail commuter services were provided in the public interest and to promote rail as the primary mode of mass commuter transport". Its functions included managing finances and subsidies, the asset base and property portfolio and providing passenger rail information.

With the restructuring of Transnet in 2004, it was decided to combine SARCC and Transnet under the national Department of Transport and consolidate it with the long distance rail services known as Shosholozha Meyl, the associated long distance bus company known as Autopax and the property company that controls all property owned by the rail services known as Intersite. Metrorail was moved to the Department of Transport in March 2007, and in March 2009 the new consolidated passenger rail entity, known as PRASA, was established. Transnet continues to report to the Department of Public Enterprises.

PRASA is thus positioning itself as the provider of urban commuter rail services and long distance and rural public passenger transport services. These may include operating and delivering essential feeder and distribution services where this is considered feasible and necessary. It is also responsible for the properties around its stations, which hold considerable potential, particularly if rail services can be improved.

The intention has been that rail will eventually be devolved to provincial or metropolitan governments. However, this idea has not been substantially developed other than to require rail authorities to consult local governments on plans.

The National Rail Plan was agreed in 2006 as the basis for re-investing in the industry. Since the mid 1980s no new trains had been bought and much of the technology dated from the 1950s. The National Rail Plan sought to assess the viability of the various corridors across the country as a basis for deciding on investment priorities. Based on a set of agreed criteria, each corridor was graded A to D (See table 20)

Table 21 shows all the corridors classified in the National Rail Plan as either A or B. It therefore indicates all the important commuter rail corridors currently in the country. It gives some salient statistics about those services. Most of the regions correlate with a single metropolitan authority, although the Wits Region covers both Johannesburg and Ekurhuleni. The corridor that carries the largest number of passengers is the link between Khayelitsha and the Cape Town Central station. The second largest number of passenger trips is on the route between Mabopane and Pretoria, although the Cape Town to Simonstown line records more passenger kilometres per day.

Flowing from this assessment, a capital investment plan for the short-, medium- and long-term was developed. Table 22 shows the assessment. Note that the largest required allocations for upgrading the network are in the Wits region. According to the National Rail Plan, the corporation aims to boost revenue by:

1. replacing the ticketing system;
2. focusing on fare evasion;
3. re-balancing fares; and
4. increasing patronage by arresting the decline in passenger numbers and capturing key strategic corridors.

Since Cabinet adopted the National Rail Plan, there has been

Table 21: Key statistics for A and B rail corridors

Region & Corridor		Daily Passenger Trips	Daily Passenger Km's	Daily Train Journeys	Daily Train Km's	Route Length (km)	No. of Stations
Tshwane	Mabopane-Pretoria (A)	266,700	3.55m	93	1,660	39.5	18
	Piensaarspoort-Pretoria (A)	182,600	1.22m	48	1,275	26.6	14
	Olifantsfontein (B)	60,100	1.74m	79	2,820	31.7	9
	Saulsville (B)	107,200	0.54m	57	801	14.1	7
Wits	Core network (A)	248,410	1.93m	260	8,169	42.8	27
	Naledi-New Canada (A)	85,483	0.54m	185	2,975	16.1	8
	Kwaggastroom-NC (A)	86,290	0.49m	108	5,173	52.6	15
	Olifantsfontein/Tembisa (A)	110,339	2.16m	105	4,022	43.5	13
	Daveyton-Germiston (B)	60,306	0.92m	82	2,843	31.5	11
	Springs-Dunswart (B)	29,086	0.59m	65	1,311	20.2	9
	Kwesine-Germiston (B)	36,704	0.46m	56	1,784	27.1	12
	Randfontein-Langlaagte (B)	27,804	1.05m	72	2,723	37.8	23
Ethekwini	Umlazi (A)	221,300	N/A	167	3,955	45.3	20
	Kwa-Mashu (A)	144,000	N/A	36	3,955	45.3	20
	Duffs Road (B)	35,200	N/A	36	2,750	74.7	19
	Isipingo (B)	36,700	N/A	64	2,890	50.7	16
	Crossmore (B)	17,500	N/A	30	730	20.2	5
Western Cape	Khayelitsha (A)	338,000	6.62m	171	5,610	34.0	18
	Kraaifontein (A)	75,000	2.32m	134	1,790	31.0	27
	Simonstown (A)	130,000	3.68m	204	5,660	36.0	42
	Balance of corridors	160,000	1.05m	154	5,890	N/A	N/A
Eastern Cape	(NMMM) (B)	9,800	0.15m	12	380	33	11
	(BCC) (B)	22,100	0.53m	23	957	41.6	18

Source: SARCC/Metrorail 2006

a marked increase in investment in what was then referred to as SARCC (now PRASA). Transfers to SARCC increased at an annual rate of 24% in the three years to 2009/10 and are projected to increase at an annual rate of 17.1% in the medium-term (National Treasury 2009).

Table 23 shows the amounts transferred to SARCC for current and capital subsidies.

The significant increase in capital expenditure is vital to improving commuter rail services, and the focus of the investment on priority corridors means it is easier to make improvements in key areas.

Table 24 shows some key statistics about the investment

for improving the services and some resultant actual and projected service delivery indicators.

The recent indications are that, having achieved more funding support, Metrorail now appears to support expensive projects outside of the priority projects indicated above. They are slightly disturbing. Two examples that require further examination are:

1. The Moloto Corridor project. This involves expenditure of R8.6 billion to build a high-speed train to serve a dispersed rural route of 118 kilometres currently used by approximately 30 000 subsidised bus passengers between Tshwane and KwaMhlanga, the former KwaNdebele homeland.

**Table 22: Capital investment plans for Category A corridors by region for Metrorail excluding rolling stock requirements**

Region	Short term (Rm)	Medium term (Rm)	Long term (Rm)	22
Tshwane	R55.5m	R126.0m	R105.3m	
Wits	R2,202m	R599m	R2,000m	
KwaZulu Natal	R786m	R150.7m	-	
Western Cape	R740m	R90m	R142.5m	
Eastern Cape	R218m	R60m	-	
<b>Total</b>	<b>R4,001m</b>	<b>R1,026m</b>	<b>R2,248m</b>	

Source: SARCC/Metrorail 2006

**Table 23: Transfers from National Government to Metrorail and SARCC (R millions)**

	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	23
Current	1 843.5	2 156.4	2 751.3	2 259.1	3 049.6	3 185.8	3 154.9	3 343.7	3565.9	
Capital	655.0	688.3	1 029.6	1 696.1	2 367.7	3 831.8	4 813.3	5 784.8	6021.1	
Additional transfers from PTISG			179.0	476.0		464.8	797.0	0.0	0.0	

Source: National Treasury (2008a, 2009a, 2010a)

2. A Cape Town Central Business District (CBD) to airport rail link. It is estimated to cost R1.8 billion, yet is expected to carry very few passengers. The recently published 2008/9 PRASA Annual Report shows the Cape Town-CBD-airport link as a current project which is 'on track' with only minor problem. It notes that "the technical feasibility, environmental assessment and detailed implementation programme have been completed", "negotiations with bidders have been approved by the FCP committee" and "transaction advisors are due to be concluded during the 2009/10 financial year" (PRASA Annual Report 2008/9 p22). The project will duplicate the Cape Town bus rapid transit route from the airport, for which infrastructure has already been built, and that is due to open before the 2010 World Cup.

It is clear that creating a governance framework that places effective planning and prioritising commuter rail at the city level or, in the case of the Wits and Tshwane regions, in combination with Johannesburg, Ekurhuleni and Tshwane within a rational fiscal framework is a priority, even if more substantial devolution in line with stated policy intentions will take longer.

### 2.2.5 Taxi recapitalisation

The Taxi Recapitalisation Programme was presented to Cabinet and agreed in September 1999. At that point, the estimated number of taxis to be recapitalised was 97,000. The idea of taxi recapitalisation was a creative one, arising from the work of the National Taxi Task Team. The government created it in the mid 1990s to address the many challenges in the taxi industry – including challenges around the profit-

**Table 24: Selection of key commuter rail performance statistics**

		2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	24
		Actual				Projections			
Number of coaches overhauled and upgraded	Metrorail	375	310	489	709	531	450	450	
	Shosholoza Meyl					30	40	50	
Percentage trains on time (A corridors)		89%	87%	86%	87%	90%	92%	93%	
Passenger trips per year		512m	530m	592m	646m	677m	745m	815m	
Fare Revenue (R million)		R1020.0	R1060.0	R1191.0	R1335.0	R1347.0	R1465.0	R1610.0	
National operational subsidy		R2156.4	R2751.3	R2259.1	R3049.6	R3185.8	R3154.9	R3 343.7	

Source: Compiled from National Treasury (2009a; 2010a) and PRASA Annual Report 2008/9

**Table 25: Transfers to taxi owners in respect of taxi recapitalization**

R millions	Actual					Estimated			
	2004/5	2005/6	2006/7	2007/8	2008/9	2009/10	2010/11	2011/12	2012/13
Taxi scrapping allowances	0	0	99.5	571.6	460.5	630.8	497.6	471.5	495.0
Taxis scrapped in the financial year			1990	11429	9208	11616	9164	8682	9117
<i>Source: National Treasury (2009a, 2010a)</i>									

ability of the industry, safety levels, and the high level of taxi violence. Recognising the very significant role played by the taxi industry, the objective was to improve its quality while retaining many of its key market-driven characteristics within a better-managed overall framework.

There were a number of motivations for the taxi recapitalisation programme. Firstly, it was hoped to reduce average fleet age and improve safety, together with other improvements arising from using technology that is more modern. Secondly, the larger vehicles it would introduce should result in more operational efficiency, thus permitting a more efficient service. Thirdly, it was expected to assist in formalising the taxi industry. Fourthly, it was a response to arguments that there was unfair discrimination against the taxi industry because it was not subsidised while the bus industry was. The Taxi Recapitalisation Programme offered a more manageable and restricted form of subsidy than replicating the operating subsidy of the buses.

Taxi recapitalisation did not exclude the possibility of taxi owners getting operational subsidies. It was argued that, by improving efficiency through the once-off recapitalisation process, taxi operators would be in a better position to tender for subsidised public transport contracts. Unfortunately, implementing the Taxi Recapitalisation Programme has been somewhat slow. There were disputes about the specifications of the new taxi vehicles that could qualify as replacement vehicles and the scrapping administrator was only appointed in October 2006.

The Estimates of National Expenditure (National Treasury 2009a and 2010a) give the following figures on the Taxi Recapitalisation Programme.

The figures thus indicate that 34 243 taxi-scrapping allowances have been granted as at end 2009/10.

Logistical problems are amongst those that present obstacles. For example, operators cannot afford significant downtime and there can be a considerable delay between the scrapping

of the vehicle, the issuing of the R54 300 allowance and the delivery of a new one. Many in the industry also argue that the R54 300 is insufficient to have a real effect. However, it is difficult to change this amount significantly. The amount was R50, 000 before April 2009, but an annual inflation linked increase was introduced after that date.

Recent figures from the Department of Transport give the following total estimated number of minibus taxis by province.

A recent report quoted that an official of the Department of Transport had estimated the total figure at 135 000 (Business Report, 11 March 2010).

If the taxi recapitalisation programme is rolled out in line with the budget and concomitant taxi scrapping expectations, 61 200 taxi-scrapping allowances will be paid out. This accounts for a little over 40% of the estimated 135 000 taxis nationally.

### 2.2.6 Gautrain

The Gautrain is possibly the best known of the current public transport projects in South Africa. It has become controversial largely because of its high cost and because it is aimed at serving existing motorists and airport customers rather than those most dependent on public transport. It is described as a rapid rail link that connects Johannesburg, Tshwane and Johannesburg's OR Tambo Airport – all of which fall within the extended urban region of Gauteng. Once completed, the total track length will be 80 kilometres, running between Park Station in Johannesburg in the south and Hatfield, Tshwane, in the north, with a line connecting from Marlboro Station north east of Sandton to the OR Tambo Airport.

South Africa currently uses a narrow gauge (1067mm) rail. Gautrain, however, will run on a standard gauge (1435mm). Once completed, there will be 24 trains with four cars each. Trains will have a maximum speed of 160 kilometres per hour with six trains an hour travelling in both directions. However, it would appear that, because of the distance between stops, their speed will seldom exceed 80 to 100 kilometres per

**Table 26: Total estimated number of minibus taxis by province**

Province	Number of taxis	26
Eastern Cape	10000	
Free State	6000	
Gauteng	44000	
Mpumalanga	9000	
KwaZulu-Natal	21000	
Limpopo	9000	
Northern Cape	1200	
North West	10000	
Western Cape	15000	
<b>TOTAL</b>	<b>125200</b>	

*Source: Department of Transport (2007d)*

**Table 27 National government's matching contribution to Gautrain (R millions)**

2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	27
0	0	3241.0	3029.4	3266.0	2976.7	438.4	5.3	

*Source: National Treasury (2010a)*

hour. The system will operate for 18 hours a day and have 10 stations. Fifteen kilometres of the route will be tunnelled – mainly in the current built-up area of Johannesburg around Rosebank and Sandton.

The project feasibility study shows that approximately 100 000 trips per day are projected. This will increase by 4.8% a year to reach 120 000 by 2010 and eventually to 130 000 once the project is completed. The 2004 feasibility study assumed that 20% of motorists using the Ben Schoeman highway would use the Gautrain.

Gauteng premier, Sam Shilowa, originally announced the Gautrain as a provincial project in 2000. The provincial government projected its cost at between R3.5 and R4 billion in 2000. However, costs escalated as planning proceeded. In October 2005, the Minister of Finance announced that the project had 'national status' and that it would be supported financially on a matching 50:50 basis between the national and provincial governments. The Bombela consortium building the project needs to contribute a further amount.

The cost escalation has been significant. The estimated figure was revised upwards to R7 billion at the time of the Environmental Effect Approval process in 2004. However, the Minister of Finance put the cost at R20 billion in October

2005. It currently appears that costs are around R28.4 billion. Table 23 shows actual and projected cost contributions from national government.

This amounts to a total of R12,956.8 million, which would match an equivalent amount by the provincial government. An additional amount of approximately R3 billion should be added to this. The Bombela Consortium is borrowing this to give an approximate total project cost of R28.9 billion.

This compares with an estimated R73.8 billion (including the R12.957 billion on Gautrain) that the national government projected to spend on all public transport related services between 2006/07 and 2010/11. This is the period during which expenditure on the Gautrain will take place (National Treasury 2010a). If one adds Gauteng's own contribution for the Gautrain to the figure of the national government, it makes the total during this period R86.8 billion. This would be close to the figure for expenditure on public transport by all spheres of government during this period, as there would be limited spending by other provinces or municipalities from own revenues.

The Gautrain has thus accounted for approximately a third of all public spending on public transport in the country. This includes all publicly funded capital projects and operating

subsidies over the five-year period from the 2006/7 financial year to the 2010/11 financial year.

The Gautrain may require further operating subsidies. This will happen if use does not reach the envisaged minimum levels needed to ensure profitability. Government has given minimum guarantees should this occur. In 2006, the maximum theoretical exposure of government was calculated at R14.3 million per month for 15 years. The likely maximum exposure was R7.5 million per month, while a more likely figure, based on simulations, is R5.9 million per month.

After the announcement that the project had national status, the Transport Portfolio Committee in the National Assembly held hearings in terms of its oversight obligations. The committee expressed serious misgivings about the project. It found that:

1. there had been insufficient transparency and effective participation by key stakeholders;
2. the costs were very high compared to other more pressing public transport requirements – and these were possibly still underestimated;
3. it was a high risk project aimed mainly at an affluent target market; and
4. it represented a fragmented approach that would address only a very limited part of total public transport corridor needs in Gauteng.

The committee advised against going ahead with the project in its current form. It argued that much greater attention was needed to show how the Gautrain would integrate with other public transport systems. It suggested that the best approach would be to develop a more comprehensive network based on the integrated transport plans of the three metropolitan governments rather than a single costly project.

However, Cabinet finally approved the project on 7 December 2005. Construction on the airport to Sandton link began on 28 September 2006. Although Gautrain is not a requirement for the 2010 World Cup in terms of the agreement with FIFA, it had been hoped that the link between OR Tambo Airport and Sandton would be in place in time for the World Cup. This remains a possibility according to recent radio reports.

As with many projects of this nature, its effect is not entirely

predictable. It is possible that it will become an important facility for middle class users, and that this in turn will drive property development in a manner that contributes to a more compact urban area. The best possible outcome is that it contributes to a different vision of future spatial development of the Gauteng area. However, there is a danger that it makes less of a real impact on travel patterns than was hoped and that it fails to run at adequate capacity, resulting in ongoing operating deficits.

### 2.2.7 Bus Rapid Transit (BRT)

Some cities, like Johannesburg, eThekweni and Tshwane, have, over the years, continued to run a somewhat limited municipal bus service. Both managing and financing these services has been problematic. Furthermore, the locus of responsibility for making decisions about bus services has generally been with national and provincial governments.

However, the concept of bus rapid transit was introduced to Johannesburg in 2006. Cape Town, Tshwane and Nelson Mandela Bay subsequently adopted it in different forms. Other cities, like Buffalo City and eThekweni, are now investigating the potential for similar systems.

The BRT model that is being used as a benchmark in South Africa originates in South America. The concept was first introduced in Curitiba approximately 30 years ago. However, a more sophisticated version was opened in Bogota, Colombia, in 2000. This model has subsequently been the basis for developing many new systems around the world.

BRT usually consists of trunk and feeder systems. The trunk system tries to replicate a metro system, but uses buses rather than rail. The key features of the trunk system include:

1. *Dedicated roadways for the vehicles in the median.* The dedicated roadways permit much higher speeds because there is little interference with traffic. The reason for using the median is that this greatly reduces interference with other traffic. If the buses were to use the sides of the roads they would constantly need to make allowances for traffic turning left (in countries which drive on the left hand side of the road). Vehicles turning right, across the oncoming traffic, have to give way to this traffic anyway, but traffic lights in busy intersections can regulate this.
2. *Stations with pre-boarding ticket verification.* One of the drawbacks of conventional bus services is that passengers usually have to board one at a time in order to show their



Figure 14: Transmilenio system showing median lane and station

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tickets. With stations, passengers can have their tickets verified at the entrance. Many people can therefore board and alight quickly when the vehicle arrives. BRT vehicles have wide doors to facilitate this. This greatly reduces time at stations, significantly increasing the speed of the service.

These features do mean that users must cross traffic flowing in one direction to reach the station. However, users either have to cross no traffic or two directions of traffic in conventional systems. The amount of crossing required is the same for each system. However, it tends to be easier to cross traffic if it is only moving in one direction.

3. *Level boarding.* BRT systems are designed so that the platform and the bus floor are level with each other. This permits easier access, including wheel chair access.

4. *Private operators are paid on a per kilometre basis.* One of the problems with South Africa's minibus system is that operators compete to be the first at stops to pick up passengers. They will also generally wait until their vehicles are full before leaving. In a BRT system, private operators are used, but they are contracted on a per kilometre basis and drive according to routes and times set by the public

authority. Systems generally have more than one operating company. Private operators compete for the market, but not in the market.

6. *A public authority directs the system and collects fares.* BRT systems require a public authority – or company working under a public authority – that contracts the vehicle operators and sets the routes, times and fares. These authorities run a control centre that is constantly monitoring and in contact with all vehicles. Vehicles can be directed to slow down or speed up to reduce bunching. Detailed passenger information is received every day. This enables the public authority to tailor services to meet demand regularly.

It should be noted that this shifts a significant amount of financial risk onto the public authority. If use falls below expectations, vehicle operators can be required to reduce their vehicle kilometres. However, this needs to be limited so that they have a reasonably secure basis upon which to tender for services. Setting fares becomes the responsibility of the public authority. The authority usually employs an independent company to collect fares.

In South Africa, the banking sector will introduce a new smart card system from April 2010. It can be loaded with electronic cash and with 'transit products' (a set of public transport tickets). They will become the basis for fare systems on BRT and other transport modes.

6. *Appropriate vehicle sizes.* BRT systems are able to size vehicles according to demand. Articulated vehicles are able to carry 160 passengers or more. Size can be set in order to optimise frequency.

7. *Frequent service.* BRT systems try to provide services at sufficiently frequent intervals so that timetables are not required. The outer limit for such a system is one vehicle approximately every 20 minutes. Beyond that timetabling tends to become necessary.

8. *Free transfers on trunk routes.* The system of stations means that passengers can alight from a vehicle and board another vehicle travelling in a different direction from the same station.

9. *Feeder systems integrate with trunk systems.* Most BRT systems have feeder systems designed to integrate with the trunk systems. The feeder systems do not have dedicated lanes or pre-board fare verification. However, fare systems can be designed to allow free transfers or to integrate the feeder routes into a single distance or zone-based fare.

10. *Use of existing operators.* Most BRT projects try to use existing operators to run the system. Where the informal sector serves the existing system, as in South Africa, this presents very significant challenges.

### 3. KEY STRATEGIC FINANCIAL ISSUES

The over-riding financial question is how public resources should be spent to optimise mobility and access in cities from an economic, social and environmental perspective. The key question becomes how revenue raising powers and subsidy flows between the different spheres of government should be configured to lead to optimal solutions.

There are two related issues. The first is whether existing subsidies are optimally used. Existing public transport subsidies are in excess of R15 billion for the 2010/11 financial year. Combined rail and bus operating subsidies are R7.017 billion (of which bus subsidies constitute R3.863 billion and rail

subsidies R3.154 billion). Capital subsidies amount to R9.814 billion (of which R5.610 billion is for rail and R4.203 billion is for the Public Transport Infrastructure and Systems Grant). Most expenditure on Gautrain has now been completed.

Subsidies can have a distributional purpose or an efficiency improvement purpose aimed at correcting market failure. Where public transport systems that function well can improve the efficiency of urban economies substantially when compared to car-based systems, there is a rationale for subsidies to increase public transport usage to levels that are optimal from an economic perspective.

Historically in South Africa, subsidies have only been available for weekly or monthly tickets. This means that workers are subsidised to travel to work from distant townships. However, those not travelling on most working days can therefore not use the subsidised fares. The result is that the costs for those travelling from townships tend to become prohibitively expensive.

It could be argued that subsidies are being used to maintain an inefficient status quo, rather than to improve efficiencies, and that incentives are required to encourage relocation. However, ending these arrangements is likely to be highly contentious and could have negative distributional effects. Furthermore, given the fact that communities are now established, it could be more efficient to maintain the current arrangements than to force changes in residence.

In South Africa, given its severe income inequalities, it is likely that transport subsidies will contain both efficiency and distributional components.

The second financial issue is how responsibility for revenue and expenditure is configured. An example of this relates to bus subsidies. It has been shown how bus subsidy requirements have risen above the amounts budgeted. To contain this risk, national government has now altered arrangements to place responsibility for exceeding the budget on provinces rather than cover the amounts itself. While the shift may be correct in that provinces are probably in a better position than national government to allocate these subsidies efficiently, the change is likely to lead to existing subsidised bus services being reduced. Provinces will need to find additional funds from their equitable share or face the political consequences of the cutbacks.

The implications for local government are more concerning,



especially in the medium- to long-term. The thrust of the current changes introduced by the new National Land Transport Act places responsibility increasingly on metropolitan and city governments. Yet the potential financial risk to them could be overwhelming. The general tax revenues, which cities control, are property taxes and a share of the fuel levy. The property tax does not offer the scope or depth to manage this level of risk. The fuel levy is discussed below.

Modelling in Cape Town indicates that, if the proposed bus rapid transit system is fully rolled out as planned, total fare revenue and expenditure will be similar to electricity sales. This is despite the fact that rail will provide perhaps half of all public transport services. Yet, despite recent power tariff increases, the electricity market is far more reliable commercially than the public transport market: well over half of electricity sales are to the non-residential sector while middle class households consume most of the electricity in the residential sector. The public transport market consists largely of poor households.

When Johannesburg and Cape Town embarked on their bus rapid transit projects, it was thought that the investment in capital would improve operational efficiency so that operating subsidies would not be required. However, a combination of actual experience and modelling for the first phases of both projects now indicates that annual operating subsidies will be required. Both cities are having difficulty marshalling the resources to cover these deficits, particularly in the current constrained financial environment.

There is a danger that, if public transport responsibilities are shifted to metropolitan and city governments without addressing the concomitant financial implications, city finances could be severely affected. This matter needs to be addressed urgently if the new city-level public transport initiatives are to be extended as envisaged.

Addressing this financial challenge will require determining the extent to which it will be covered by grants or by own revenues. If suitably designed, own revenues are preferable since they tend to be more predictable and reliable for local governments. This is critical when making decisions about public transport, which has long-term implications. There is also a natural tendency in government to take greater responsibility when allocating own revenues as opposed to grants. However, it may be that a combination of both is best.

In principle, there are strong arguments that private road

users should fund public transport except for fare revenues. Currently, the key source of revenue from private road users is the fuel levy. Other sources include road licences and tolls.

Metropolitan governments currently receive a share of the national fuel levy. However, this is to replace the previous Regional Services Council levies and therefore cannot be assumed now to cover an additional obligation. On the other hand, since this mechanism exists, either the city share could be increased or the long-term proposals that National Treasury has made around the possible implementation of a local business tax pursued. This would free up a portion of the fuel levy for allocation to transport. The scale of own resources required depends on how risk is to be shared and the proportion of grant funding to own revenues.

The National Land Transport Act provides for Municipal Land Transport Funds. Considering how these funds are to operate, what their responsibilities are, and how they are to be funded may be a useful approach to addressing some of the issues as they relate to municipal governments.

## 4. RECOMMENDATIONS

The Commission recommends that:

The following recommendations flow from this chapter:

1. Passenger Rail Agency of South Africa and cities should ensure that investment projects on rail and roads infrastructure are aligned and coordinated. This will ensure that limited resources are used optimally to a targeted area or group of passengers instead of each mode investing independently on its own infrastructure to service the same target group of passengers
2. The government should make a decision without further delays on the funding streams that will contribute to the Municipal Land Transport Fund as delays could negatively affect the financial position of affected municipalities.
3. Passenger Rail Agency of South Africa should ensure that funding that has been made available for investment on the commuter rail sector should prioritize corridors already identified as A and B in the National Rail Plan.
4. A comprehensive review should be conducted by relevant stakeholders including national departments, cities and the

Financial and Fiscal Commission into the costs associated with current urban form in a selection of major South African cities in order to improve the efficiency of land use patterns.

5. The current mechanisms and basis for distributing transport subsidies should be reviewed by the Department of Transport, National Treasury and other key stakeholders in order to promote the efficiency of urban transport and land use systems, taking into account equity and distributional effects on households.
6. The potential financial implications resulting from the promulgation of the National Land Transport Act on municipalities should be examined by the Department of Transport and the National Treasury and dedicated funding streams for public transport identified.
7. The Department of Transport should regularly update the South African National Household Travel Survey.

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# ANNEXURE A: ALPHABETICAL LIST OF ABBREVIATIONS AND ACRONYMS

ABET	Adult Basic Education and Training
AES	Adult Equivalent Scale
AIDS	Acquired immune deficiency syndrome
BAU	business as usual'
BMP	Basic Minimum Package
BRT	Bus Rapid Transitt
CBD	Central Business District
CCT	conditional cash transfer
CDFs	cumulative density functions
CEPD	Centre for Education Policy, Development, Evaluation and Management
CGE	computable general equilibrium
COGTA	Department of Cooperative Government and Traditional Affairs
DBSA	Development Bank of Southern Africa
DME	Department of Minerals and Energy
DoE	Department of Education
DORA	Division of Revenue Act
DPLG	Department of Provincial and Local Government
EDI	electricity distribution industry
EPWP	Expanded Public Works Programme
ESI	electricity supply industry
FBS	Free Basic Services
FET	Further Education and Training
FGT	Foster-Greer-Thorbecke
GDP	gross domestic product
GER	Gross Enrolment Rate
GHS	General Household Survey
HAART	Highly Active Anti-retroviral Treatment
HIV	Human immunodeficiency virus
IES	Incomes and Expenditure Survey
IES	Income and expenditure of households
IGFR	Intergovernmental Fiscal Relations
IRPTN	Integrated Rapid Public Transport Network
KIDS	KwaZulu-Natal Income Dynamics Study
LES	Local Government Equitable Share
LGTAS	Local Government Turnaround Strategy
MDGs	Millennium Development Goals

MFMA	Municipal Finance Management Act
MIG	Municipal Infrastructure Grant
MMSD	multi-jurisdictional municipal service district
MTEF	Medium Term Expenditure Framework
NER	Net Enrolment Rate
NERSA	National Energy Regulator of South Africa
NIDS	National Income Dynamics Survey
NIEP	National Institute for Economic Policy
NLTA	National Land Transport Act
NLTTA	National Land Transport Transition Act
OECD	Organisation for Economic Co-operation and Development
OHS	October Household Survey
PFMA	Public Finance Management Act
PIRLS	Progress in International Reading Literacy Study
PRASA	Passenger Rail Agency of South Africa
PSLSD	Project for Statistics on Living Standards and Development
PTOG	Public Transport Operating Grant
PTS	Public Transport Strategy
REDS	Regional Electricity Distributors
RRC	Revenue Raising Component
RSC	Regional Services Council
SACMEQ	Southern African Consortium for Monitoring Educational Quality
SAM	Social Accounting Matrix
SANRAL	South African National Roads Agency Limited
SARCC	South African Rail Commuter Corporation
SCOA	Standard Chart of Accounts
SETA	Sector Education and Training Authority
SM	Siyenza Manje
StatsSa	Statistics South Africa
TIMMS	Trends in International Maths and Science Survey
UIF	Unemployment Insurance Fund
US	United States





The Financial and Fiscal Commission's submission on the 2011/12 Division of Revenue focuses on the process of adjusting to the recession and global economic crisis from which the South African economy is emerging.

The broad principles governing government's response include avoiding the risk of unfairly placing the burden of the global economic downturn on the poor and vulnerable.

[www.ffc.co.za](http://www.ffc.co.za)

**Midrand**

1st & 2nd Floor,  
Montrose Place  
Bekker Street, Waterfall Park  
Vorna Valley, Midrand  
South Africa

Private Bag X69  
Halfway House 1685

Tel: 086 1315 710  
Fax: +27 (0) 11 207 2344

**Cape Town**

12th Floor  
Constitution House  
124 Adderley Street  
Cape Town  
South Africa

P.O. Box 1505  
Cape Town 8000

Tel: 086 1315 710  
Fax: +27 (0) 21 426 4935

*For an Equitable Sharing of National Revenue*

