Comments on Chapter 14 of Transforming the Present Protecting the Future (draft consolidated report) Report of the Committee of Inquiry into a Comprehensive System of Social Security for South Africa

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1 Introduction

In this document I address myself specifically to "Chapter 14: Financial Framework for Comprehensive Social Protection" of the Draft Final Report of the Committee of Inquiry into a Comprehensive System of Social Security for South Africa.

I would like to state up-front that in my view the Committee has done a good job in highlighting a range of important issues relating to social protection in South Africa and in proposing options for closing the gaps in South Africa's 'loosely woven' social security net. More specifically I would like to single out the Committee's balanced treatment of the proposals for a Basic Income Grant or 'solidarity grant' in Chapter 5. In doing so I would like to align myself with the Committee's conclusions regarding BIG, namely:

> A universal Basic Income Grant has the potential to fortify the ability of the poor to manage risk thus contributing to socio-economic multiplier effects related to improved household self-reliance, efficiency of social capital and social cohesiveness.
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> Moreover, in the view of the Committee, income support of this nature would assist the poor to access Government services, thereby improving the effectiveness of many service delivery programmes and social policies.
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> The Committee notes, however, that the conditions for an immediate implementation of a Basic Income Grant do not exist. In particular there is a need to first put in place appropriate capacity and institutional arrangements to ensure effective implementation. Therefore the Committee recommends the gradual development of a comprehensive and integrated income support that can underpin South Africa's comprehensive social protection system.

Although this document may appear to be critical of specific findings and recommendations, the aim is not to undermine the overall thrust of the Committee's proposals, but rather to suggest areas that require further consideration and analysis, with a view to supporting informed policy making in this important area.

The remaining sections address the following issues:

- The Committee's critique of the intergovernmental system
- The affordability of BIG and other proposals; and
- The financial implications of the reform proposals.
- Concluding comments on Chapter 14

I have also included an Appendix that presents a checklist of issues that need to be assessed when considering proposals for a basic income grant. This checklist was developed by Nick Wilkins, senior economist with AFReC (Pty) Ltd.

2 The Committee's critique of the intergovernmental system

The Committee is critical of a number of aspects of South Africa's intergovernmental system. To start with it is important to keep in mind the fact that the system is the product of political compromises forged by the Constitutional Assembly. As such it is one of the pillars on which our new democracy is built – and therefore rather than trying to reduce provinces to hollow shells by removing functions from them, we should all be seeking to make the system work by strengthening provinces' capacity to carry out their responsibilities and by continuing to develop the mechanisms needed to ensure proper policy implementation, co-ordination, and to strengthen the system of intergovernmental fiscal relations.

It would also appear from the nature of the intergovernmental fiscal issues raised and some of the fiscal information given that section 14.3 (and possibly also section 14.6) is based on 'old' information – relatively speaking. The analysis would appear to relate to the period 1996-2000. This was a particularly challenging period in the development of South Africa's system of intergovernmental fiscal relations. Both the national and provincial governments were finding out how this new system should function. Everyone was on a steep learning curve. Certain provinces sought to test the national government's resolve to enforce hard budget constraints by under-budgeting for social grants. National departments were learning how to manage conditional grants effectively. The National Treasury was seeking to put in place and consolidate complicated processes for intergovernmental budgeting and financial management. However, since the beginning of 2000 there have been significant improvements in the quality of provincial budgets, there has also been better co-ordination between national and provincial departments, and overall the system of intergovernmental fiscal relations now functions relatively smoothly. Obviously not all provinces are functioning as well as they should, but then neither are all national departments. I did not get a sense from reading Chapter 14 that the Committee is fully aware of the developments around the system of intergovernmental fiscal relations, provincial budgeting and national-provincial policy co-ordination that have taken place over the last two years.

The Committee's discussion of the intergovernmental system also left the distinct impression that it did not have an overarching understanding of all the different components of system and how they fit together and function. For instance the Committee makes no mention of the National Council of Provinces (NCOP) and the important constitutional role it plays in representing the provinces' interests in the national legislative and budget approval processes. Nor is any mention made of policy development and co-ordination forums such as HeadComs (in which the national and provincial heads of departments in particular sectors meet) or MinMECs (in which the Ministers and MECs in each sector meet). Thus the impression that policy is developed in the rarefied sphere of national government and then imposed on the provinces is generally not true.

Furthermore the Committee makes no mention of the institutions involved in developing and approving the actual division of revenue. The Committee seems to be under the impression that the provinces are passive recipients of whatever funds the National Treasury decides to give them. This is simply not the case. The MTEF process involves extensive joint planning between the National Treasury and all national and provincial departments. At a political level all the provinces are represented on the Budget Council. Here the Minister of Finance and the MECs of Finance discuss and agree on the principles guiding the division of revenue, as well as the actual numbers, and put forward recommendations to the extended Cabinet. The extended Cabinet consists of the national Cabinet plus all the provincial premiers and is responsible for approving the final Division of Revenue Bill before it is sent to Parliament. Thus the provinces are extensively involved in the technical processes and political decisions that underpin the division of nationally collected revenue. Within this context it is difficult, in my view, to argue that social security is an unfunded mandate – after all the provinces are extensively involved in the decision-making that determines both the content of national policy on social security (through the Social Development and other MinMECs) and the allocation of resources through the Budget Council and extended Cabinet, as well as in Parliament through the NCOP.

Particularly surprising is that when dealing with fiscal and financial management issues the Committee failed to make even passing reference to the Public Finance Management Act (PFMA). This Act impacts directly on all institutions responsible for the management of public funds, whether departments or other public entities. Even institutions that receive public funds by way of transfers or grants are affected by the provisions of the Act. Consequently, at the vary least the Committee should have indicated to what extent the provisions of the Act impact on its various proposals to establish extra-budgetary funds and public entities for the management of a comprehensive system of social protection.

The following sections critique some of the specific assertions made by the Committee regarding the South Africa's intergovernmental system.

2.1 Allocation of the vertical division [1]

In its overview of social security financing the Committee discusses the division of responsibilities between the three spheres of government, and makes particular reference to the division of responsibilities between national and provincial governments in the case of concurrent functions. The Committee's concluding comment in this regard is as follows:

> Treasury currently sees a division of responsibility between national and provincial Government whereby national focuses on policy while the provinces deal with delivery. This strict division of responsibility is a policy construct and does not derive from the Constitution. As such the rationality of the relationship between the determination of national policy and its ultimate achievement in provincial allocations needs to be assessed.

I disagree with the Committee that the current division of responsibilities between national and provincial government does not derive from the Constitution and is not 'rational'.

Firstly, the Committee implies that the current division of responsibilities has been imposed on the country by the National Treasury. This is simply not true. The initial allocation of functions was made by the Constitutional Assembly and ratified by Parliament. Subsequent decisions to change the allocation of functions – for instance the shifting of responsibility for water and sanitation projects from national to local government – have all been made by the national Cabinet.

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[1] I thank Professor Christina Murray for a useful discussion relating to this section. I remain responsible for the views expressed.

Secondly, while the Constitution does not explicitly say that national government should be responsible for policy and provinces responsible for delivery this division is clearly implied by the overall structure of the Constitution. The very existence of the National Council of Provinces and the provinces themselves, concurrent responsibilities, a revenue sharing mechanism, oversight responsibilities and provisions governing the establishment of national norms and standards all point to a division of responsibilities between national and provincial governments along policy and implementation lines. In addition a number of sections suggest that this division of responsibilities is intended to be the 'default position' and any deviation from it would have to be deliberate and exceptional:

- Section 125(2)(b) states that the Premier of a province, together with the other members of the Executive Council, exercises the executive authority by implementing all national legislation within the functional areas listed in Schedule 4 and 5 (i.e. all concurrent functions) except where the Constitution or an Act of Parliament provides otherwise. Indeed section 125(3) goes further and states that "the national government, by legislative and other measures, must assist provinces to develop the administrative capacity required for the effective exercise of their powers and performance of their functions referred to in subsection (2)".
- Section 146 deals with conflicts between provincial and national legislation falling within a functional area listed in Schedule 4 (i.e. concurrent functions). According to section 146(5) should a province legislate on concurrent functions then provincial legislation will prevail over national legislation unless the latter meets certain conditions which are set out in sections 146(2) and (3). These conditions clearly suggest that national government's primary responsibility is to ensure uniformity, national security, economic unity etc. in the way provinces deliver services.
- Section 227(1) states that "each province is entitled to an equitable share of revenue raised nationally to enable it to provide basic services and perform the functions allocated to it". Again there is an emphasis on the fact that provinces are expected to provide basic services, which include health, education and social security, and that the division of revenue process must provide resources to them for this purpose.

Given the above, the current division of responsibilities is not merely 'a policy construct', it is a rational interpretation of the system envisaged by the Constitution. Therefore, rather than seeking to undermine the system envisaged by the Constitution, the Committee should have focussed on identifying and recommending ways of ensuring the system functions more effectively. For instance, what should the national Department of Social Development be doing to assist the provinces to fulfil their obligations better?

I agree with the Committee that there is an ongoing need to evaluate the allocation of functions between the different spheres of government with a view to ensuring greater efficiency and effectiveness of Government as a whole. In this regard it is pertinent to note that there is general agreement that it is good practice to try and decentralise the implementation of policies as much as possible so as to utilise local knowledge, and promote local accountability. In the case of social assistance, it may be logical to distinguish between (a) client interaction (i.e. registration and complaints) and (b) the management of payments. If the latter can be done electronically – directly to clients' bank accounts – there would be a strong case for setting up a single national system[2]. However, there does not seem to be any reason to centralise control over client interaction. If anything consideration should be given to decentralising it further from provincial to local government.

[2] This idea was developed by Christina Murray and Joachim Wehner - personal communication.

2.2 The 'loss of explicit budgeting control'

The Committee refers to the post-1994 process of re-orientating government policy. Noting that there has been progress in the areas of transparency and linking policy to budgets, and then goes on to say:

> However, residual problems appear to remain. A key concern relates to the fact that three social policy areas of major national significance, social security, health and education, are budgeted for at a provincial level. The link between national policy determination and provincial decision-making is consequently weak. This affects the degree to which provinces adhere to national policy, and the extent to which financial resources are allocated to national priorities. The process by which the largest and most important social allocations are determined is both indirect and fragmented. As a consequence, changes in global and inter-provincial allocations are not explicitly determined.
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> The loss of explicit budgeting control over national priorities appears to result in particular problems in the following areas:
> - Poverty alleviation
> - Social transfers
> - Inter-provincial co-ordination and planning of healthcare services
> - The achievement of equity in the physical allocation of health resources.

The Committee certainly identifies a pressing problem namely a weak link between national policy determination and provincial resource allocation. However I do not agree that the problem is a 'consequence' of the fact that provinces are responsible for budgeting for social security, health and education.

Chapter 3 of the Constitution sets out a range of principles for co-operative government and intergovernmental relations, among them a requirement that all spheres of government must "provide effective, transparent, accountable and coherent government for the Republic as a whole" and that they should "co-operate with one another in mutual trust and good faith by … assisting and supporting one another, informing one another of and consulting one another on matters of common interest, co-ordinating their actions and legislation with one another" and "adhering to agreed procedures".

Firstly, it is my view that the principle reason for the weak link between national policy and provincial budgets arises from a failure to follow the above principles of co-operative government. I would go further and say that national ministers and the national departments have probably been most at fault:

- National policies have been announced without there being proper consultation with the provinces, e.g. free health care for pregnant women and children under six, mid-year increases in social pensions, the release of children from prisons and education norms and standards to name a few;
- The national departments have been slow to assist provincial departments with their planning and budgeting. For instance the national Department of Social Development has to date provided very little assistance to the provincial social development departments in the area of planning and budgeting for the delivery of social grants. Indeed as far as I am aware the national Department does not even have its own model for forecasting the demand for social grants – so as to be able to check provincial budgets. The National Treasury does this checking;

- The national departments in the three social sectors have been weak in representing the interests of their sectors in the prioritisation and resource allocation processes in Government. They are more concerned about enlarging their own budgets, than about arguing for additional resources to be made available to the provinces for social services.
- The national departments' management of conditional grants has left much to be desired. The scandalous mismanagement of the poverty relief funds by the national Department of Social Development is a case in point.

Secondly, I am not persuaded that the solution that the Committee seems to be indicating for "the loss of explicit budgeting control over national priorities" is appropriate, or whether it is indeed a solution at all. If the only way to effectively co-ordinate budgets with national priorities is to consolidate and centralise control with the relevant national departments then why is the Department of Justice and Constitutional Affairs so singularly unsuccessful in aligning its budgets with its policy priorities? And what is there to suggest that the national departments of health, education and social development would not experience similar difficulties? Further the idea of consolidating and centralising control over budgeting is based on a 'top-down' model of public sector management, i.e. head office compiles the budgets that the line-officials have to implement. This model is generally regarded as flawed because (a) head office has limited knowledge of the service demands and implementation processes that drive the budgets and (b) if managers are going to be held responsible for keeping to their budgets they need to be involved in compiling them. Consequently, it is generally agreed that good practice in budgeting and financial management involves decentralised processes that are co-ordinated from the centre.

Thirdly, if the 'indirect and fragmented' process of budgeting for social services is *the problem*, why is it only a problem in certain provinces and not in others? Not only that, why has it become less of a problem over time? What this indicates is that the ability of provinces to translate national priorities into provincial budgets is directly linked to their planning, budgeting and implementation capabilities. Therefore the solution is not to centralise control, but to ensure that the provinces that are struggling are given the necessary support (as required in terms of the Constitution) by the relevant national departments. As already noted most national departments have been slow to come to grips with this aspect of our now not so new intergovernmental system, though things are definitely improving in certain sectors, such as health and education.

2.3 Critique of the current funding of social services

The Committee notes that the formulae used to divide the provincial equitable share between provinces 'does not guarantee that funds will be available' to give effect to mandates established at the national level. In section 14.6.1 of its draft final report the Committee also provides the following critique of current arrangements for the management and funding of social services:

> - Separation between responsibility for policy and for budgeting leads to inappropriate incentives. On the one hand, policy could be made without sufficient consideration of cost implications while, on the other hand, budget gaming may ensue because welfare expenditure is seen as a national mandate.
> - The current formula is seen as not redistributive enough, particularly in the light of substantial backlogs in some provinces.

- The financing mechanism (based on the relative demand for social services and not a set of costed norms) results in unfunded mandates on provincial Governments.
- Given uncertainty about likely take-up of grants and the absence of substantial own revenues, individual provinces cannot absorb the risk associated with different possible scenarios.

The issue of what is the most appropriate way to allocate funds between the different spheres of government and between the provinces themselves is the subject of an ongoing debate, particularly between the Government and the Financial and Fiscal Commission (FFC). The Government has presented a full response to the FFC's 'costed norms' approach proposals in Annexure E of the *2001 Budget Review.* The Committee makes no reference to this response. This is unfortunate as it sets out very clearly why the Government has chosen to continue to use the current approach, along with the current formula. (I have not summarised the points here since they are best read in the original).

It is also worth noting that the Committee's critique is misdirected in most instances. The issue of whether provinces are adequately funded or not, does not relate to the horizontal division (which is done by formulae), but to the vertical division. If the vertical division is inequitable then the provincial sphere of government as a whole will be under-funded. The formula used to effect the horizontal division determines whether each province gets a fair share of the provincial equitable share. It is therefore entirely appropriate that this formula is based on the relative demand for services between the provinces, since this ensures that each province gets its fair share of the resources that are allocated to the provinces as a whole. In other words if there are too few resources in the pool then all the provinces should be under-funded by the same proportion and vice versa.

In the second bullet point above the Committee does observe that the formulae is not redistributive enough in the light of substantial backlogs in certain provinces. It is not clear what backlogs are being referred to. If the Committee is referring to infrastructure backlogs in the social service functions, then the criticism is misdirected since the Government uses conditional grants to provide funding to redress such backlogs. In 2001 the national Government allocated some R 2 billion towards provincial infrastructure – with a specific emphasis on redressing backlogs. If the Committee is referring to backlogs in actual service provision then the provinces with these backlogs should be 'cash rich' – since the formula is allocating funds to them for services that they are not providing. These extra funds tend to be absorbed by high expenditures on personnel salaries. The following table shows that this is indeed the case. It is generally accepted that the Eastern Cape and Limpopo have the highest service delivery backlogs, but they are the provinces with the highest personnel expenditures per 1000 people. In other words instead of spending on actual services they are allocating their funds to employing civil servants (many of whom do not contribute meaningfully to service delivery).

All data relates to 2000/01	**No of civil servants**	**Average annual salary (Rands)**	**Civil servants per 1000 people**	**Average Personnel Expenditure per 1000 people (Rands)**	**% of budget allocated to personnel costs**
Eastern Cape	127262	83772	18.9	1 583 292	58.7
Free State	57042	81151	20.3	1 647 360	62.4
Gauteng	108040	91910	13.9	1 277 555	54.6
Kwazulu-Natal	143580	85667	16	1 370 664	56.4

Limpopo	111761	81111	21	1 703 322	62.4
Mpumalanga	49197	84721	16.4	1 389 418	59.2
Northern Cape	15162	86202	17	1 465 440	49.8
North West	63203	83936	17.6	1 477 272	57.5
Western Cape	64711	94605	15.6	1 475 842	53.2
All provinces	**739958**	**85798**	**17.4**	**1 492 887**	**57.5**

Calculated from information published in the *Intergovernmental Fiscal Review 2001*

In addition the National Treasury has in the past made specific conditional grants to provinces to deal with social security backlogs. For instance in 2001 R2 billion was made available to provinces via a conditional grant for this purpose.

As regards bullet point three, alleging the existence of unfunded mandates is relatively simple, proving that they actually exist in the system as it currently functions is very difficult. The following sections quoted from a report I did on 'Transparency and participation in the budget process'[3] makes this point:

> When the national government requires a provincial government to implement a given national policy but does not supply the funding to do so, that policy is an unfunded mandate. This may seem simple enough, but the issue has been the source of much confusion, and often different role-players have sought to use this confusion to game the system - either to shift responsibility for service delivery failures, or to extract additional funds from the national government. The problem was probably most acute in the period 1996 to 1998, when a number of national decisions relating to civil servant salary increases and increases in social grants placed enormous pressure on provincial budgets. However since then the executive, particularly the National Treasury, has developed a range institutional mechanism for managing the development of policies that have provincial expenditure implications. Foremost amongst these is the requirement in the PFMA that any national legislation that has financial implications for provinces must be costed before it is tabled in Parliament. This makes the cost of the policy explicit. If the NCOP, representing the provinces' interests, passes the legislation without requiring the national government to allocate funding for its implementation, the provinces cannot complain of an unfunded mandate, since they, through the NCOP, agreed to the policy and the funding implications. However, this does not resolve the case where national departments regulate national norms and standards in areas of concurrent responsibility that bind provinces to deliver services of a particular quality, and so by implication impose on them certain spending obligations… . The teacher/pupil ratio is a case in point. To comply certain provinces needed to employ many extra teachers. Similarly, if the minister of social development were to unilaterally decide that the value of social pensions should increase, this would impose enormous expenditure responsibilities on provinces. During the period 1995 to 1999 many problems in this regard arose. These have largely been resolved by, in some instances, describing such norms as targets rather than making them mandatory, and also by engaging provinces in the norms setting process, and so getting their buy-in and support from the start.

While there may have been problems in the past, there is no proof that the current division of revenue does not provide sufficient funds for the total cost of social assistance grants in the vertical division of resources (see for instance the new priorities and pressures noted by the Government when it discussed the additional allocations in Annexure E (page 240) of the 2001 *Budget Review*). In the case of other services it is a matter of emphasis and political judgement as to whether one argues that they are under-funded or not. I for one

[3] This report is available from IDASA.

believe that if provinces managed their resources more efficiently they would find that they have more than enough funds to meet their core social service obligations.

As regards the last bullet point: budgeting for social grants is one of the simpler areas of government budgeting – the problem is that certain provincial social development departments do it exceptionally badly, and the national Department of Social Development has by and large failed to give them proper assistance. Most of the uncertainty that exists arises from poor management rather than real uncertainty about the take-up rates – these can be predicted with a high degree of accuracy if the departments chose to invest in the time and the capacity to do so. This point is supported by the fact that a number of provinces produce very accurate budgets for social grants.

3 Discussion of principles to guide the use of financing mechanisms

I found it very difficult to know how to respond to section 14.9. While the subject matter is most definitely very important, the Committee by relying very heavily on a limited range of technical, academic sources did not get to dealing with the practical issues involved in setting principles to guide the use of different funding instruments in the context of social services. The Committee gave a textbook response (in a very real sense). Did the plain language editor skip this section? Economists can follow the jargon, but what percentage of readers of the report is likely to know what the following sentence is getting at:

> Negative and distributional non-neutralities tend to be reduced as output is expanded toward marginal cost equals average revenue equality (the social welfare optimal allocation point).

The discussion in section 14.9 also made a number of assertions that could have far reaching, and possibly unintended implications if their logic is applied consistently. For instance, the discussion of consumer tariffs notes that:

> Where local Governments are allowed to compile tariffs in such a way as to deliberately induce a surplus, this becomes an indirect tax on particular services with a redistribution of wealth effect which is unacceptable as the benefit-received principle is violated. There is no moral justification for consumers of particular services to be taxed in order to subsidise the users of collective services. It is unfair because not all users are tax payers. These arguments apply in all instances also at the central government level where consumer tariffs for particular services are pooled with all other revenue in the State Revenue Fund.

Firstly, the practice of local Governments deliberately setting tariffs for certain services at a level intended to generate a surplus is well established and widely practiced. Most metropolitan municipalities generate a very substantial proportion of their revenue from surpluses generated from on-selling electricity. By labelling this practice ‘unacceptable’ and devoid of ‘moral justification’ is the Committee suggesting that it should be discontinued? If so, it would have been useful to have some proposals on the table as to how the surplus should be transformed into tax revenue, or where the local Governments can find alternative revenues.

Secondly, what is so sacrosanct about the so-called ‘benefit-received principle’ that it should not be ‘violated’. Every time the government imposes an excise tax on a particular good or service the principle is ‘violated’ – since the consumer ends up paying more for the good or service than the benefit they receive. One may object to the fact that using tariffs to generate a surplus is a non-transparent form of taxation (transparency principle of taxation), but other than that there is little difference between revenue raised from the sale of electricity through a tariff, and revenue raised from the sale of petrol through a levy.

Thirdly, why is there ‘no moral justification’ for consumers of particular services to be taxed in order to subsidise the users of collective services. In economics there are different ways of defining what is fair and just – or what is moral. Which definition is being applied here? It would seem that a very narrow consumerist (or may be capitalist) concept of morality underpins the so-called ‘benefit-received principle’. This would seem to be at odds with the Committee’s own commitment to morality informed by social solidarity. Moving from the social solidarity perspective, is it morally wrong to tax well-to-do electricity consumers to pay for general street cleaning? Is it also morally wrong to tax the consumers of particular goods (e.g. cigarettes) to raise general revenue (which is used to provide collective services)?

Fourthly, the logic of the statement ‘It is unfair because not all users are taxpayers’ escapes me. What group of users are being referred to: the users of the particular services or the users of the collective services? If it is the former, then we are dealing with a situation where there is both cross-subsidisation and revenue raising built into the tariff which works in favour of low volume consumers (in the case of electricity). If it is the latter, then the Committee is suggesting that all services that are financed from revenue sources to which the consumers of the service did not contribute are tainted by a measure of ‘unfairness’, i.e. virtually all redistributive programmes. This is surely not a conclusion the Committee intended to reach!

The Committee’s critique of the Government’s (represented by the National Treasury) lack of a clear policy framework in this area is spot on and something that needs urgent attention. Despite misgivings about this section I trust and hope that it will spur the Government (again represented by the National Treasury) to develop a clear framework to guide the use of user charges, consumer tariffs, excise levies, earmarked taxes etc. generally and not only in the area of social protection.

4 The affordability of BIG and other proposals

4.1 Relative prioritisation

In its discussion of the MTEF the Committee notes that the “MTEF process is clearly in its infancy in terms of achieving more advanced and complex budget planning and prioritisation objectives” and concludes that existing budgets “were largely devoid of relative prioritisation”. This is an important point, and the Committee is right when it says that the Government needs to strengthen the MTEF process, and use it more proactively in the process of analysing and deciding on relative priorities. To do this effectively the Government needs to invest in analysing the costs and benefits of different policy options and then seek to prioritise the implementation of policies that will contribute most to improving the welfare of society. Although this is unlikely to be a precise process – more information will greatly assist.

Obviously, all the Committee's policy options should be subjected to the same process of evaluation, comparison and prioritisation. It would, however, seem that the Committee has tended to emphasise the social benefits of its different policy proposals, while underplaying the costs and the risks associated with the various options. Also the Committee does not present any comparative analysis showing that for instance the BIG is the best way Government can spend R46 billion per annum. Rather than putting the full amount into a single grants programme would it not increase social welfare more to use the funds for a variety of social programmes - housing, public works schemes, infrastructure investments, small business development etc? There is no clear answer to this question because neither the Committee nor anyone else (as far as I know) has done a relative study of the opportunity costs of the BIG.

In Chapter 5 the Committee presents an analysis of the relative impact of BIG versus the existing social security system on closing the poverty gap. This analysis is flawed because it is not comparing apples with apples – since the budgets for the different programmes differ vastly. Obviously the BIG option is more effective in closing the gap: it redistributes more than twice the resources than the current system. A question that is not answered is whether it is more cost effective? The issue is rand for rand which programme or set of programmes is likely to contribute most to the closing of the poverty gap? I fully acknowledge that this is not an easy analysis to do, but given the magnitude of the BIG commitment the Government needs to be absolutely certain that it is getting its relative prioritisation right if it decides to forego other programmes in favour of a BIG.

4.2 The net burden of financing an income grant

The Committee is correct to consider the "gross burden" and not the "net burden" when considering the fiscal impact of the income grant. Firstly, if one were to apply the "net burden" logic to other government expenditures one could argue that the actual cost of providing health or education is 30 percent less than the current budget shows because most of it is paid in the form of salaries and the funds are therefore 'clawed-back' via the income tax system. By extension this would mean that employing highly paid civil servants is the best form of government expenditure because of its low 'net burden' on the fiscus. It would also change the complexion of salary negotiations in the public sector – with the Government tending to favour higher increases for well-paid civil servants because of the lower net burden of such increases, while arguing for low increases for those workers at the bottom of the salary scale.

Secondly, the Government needs to manage the fiscal risk of the full R46 billion. Obviously, one of the factors it will take into account is the extent to which it can claw-back some of the funds through the income tax system. Thus the issue of the net burden is important, but it should not be allowed to dominate the debate in the way that it has to date. When evaluating fiscal risk the Government needs to be cognisant of what might happen in a worst-case scenario, of lets say persistent stagnation, resulting in falling real incomes and a consequent drop in tax receipts. Under these circumstances the Government would still need to be able to finance the full R46 billion per year – irrespective of what happens to its revenue base. This would place enormous pressure on all other forms of government expenditure.

Thirdly, when comparing the BIG proposal to other programmes, it is misleading to compare the net burden of the BIG with the gross burden of the other programmes. This is not comparing apples to apples.

4.3 The Committee's discussion of fiscal capacity

In section 14.11.1 the Committee discusses the issue of whether there is fiscal capacity for increased spending on social security. I agree with the Committee's main conclusion that "overall there is evidence of sufficient fiscal capacity for improved social sector spending without adverse macro-economic impacts". Firstly, the Government needs to be complimented on its prudent management of the deficit and of the economy since 1996 that has created this fiscal capacity, and that it needs to guard against taking decisions that would undermine this strong position. Secondly, the fiscal capacity, even as calculated by the Committee, does not cover the full R46 billion that is required to implement its income grant proposals, let alone all its other proposals. Thirdly, I disagree with various aspects of the Committee's analysis in this section, as detailed below:

(a) Treatment of the contingency reserve

The Committee correctly identifies the contingency reserve as an unallocated amount, however, it then proceeds to allocate the entire contingency reserve to the national equitable share. This enables it to argue that the growth in the national allocation when expressed as a percentage of consolidated expenditure "substantially outstrips the changes in the provincial allocation which reduces…". This analysis is wrong, and shows a lack of understanding of the reasons why the Government set aside a contingency reserve within the MTEF framework. The 2001 *Budget Review* observes the contingency reserve "allows for allocations by the Treasury Committee in 2001/02 to meet unforeseen and unavoidable expenses, and provides a reserve in subsequent years to accommodate macroeconomic uncertainty and any new spending priorities". The following points are worth noting:

- The Treasury Committee is a committee of the national Cabinet;
- The unforeseen and unavoidable expenses that end up being financed may occur in any sphere of government;
- The macroeconomic uncertainty would affect all three spheres of government and so the contingency reserve serves as an insurance for all of them;
- The new spending priorities may occur in any of the spheres of government and the funds would then be allocated appropriately.

In essence the contingency reserve is a fiscal management tool that allows the Government to provide funds for unforeseen circumstances, and enables it to retain some flexibility in the MTEF planning process. So it is wrong to assume that the entire contingency reserve will be added to the national allocation. The table below shows that in the past the Government has tended to allocate any extra funds in favour of the provinces.

	2001/02	2002/03	2003/04
Addition to the MTEF baseline	R10.2 billion	R16 billion	R21.6 billion
National	44.6%	37.5%	36.2%
Provincial	50.3%	56.5%	57.3%

Local	5.0%	6.0%	6.4%

Calculated form Budget Review 2001 page 124

It is also unrealistic to assume that the entire contingency reserve is available to fund new social security programmes. At best only a part of it will be available for this purpose since Government also has to allocate funds to priorities in other functional areas, as well as keep some to provide for emergencies.

(b) *Translating economic growth into additional Government expenditure*

The Committee observes that "Overall consolidated expenditure has also declined as a proportion of GDP, reflecting the position that increased economic growth should not be translated into additional public goods and services." This misstates the Government's position. It is clear from the *Budget Reviews* for 2001 and 2002 that the Government continues to increase expenditure on social services, while at the same time seeking to foster job creation through economic growth. The decision not to translate economic growth into increased government expenditure on a one-to-one ratio is based on the Government's view of its own poor capacity to productively spend additional resources, and its view that job creation should be encouraged by leaving resources in the private sector.

It is also unrealistic to assume, as the Committee does, that the increased revenue resulting from economic growth will all be available for social services. Government has multiple objectives and priorities, and so it is more than likely that only a percentage of any 'growth dividend' will go towards social services. There is also no guarantee that the economy will in fact grow at the rate predicted, it may do better or worse. The Committee ignores the down-side risk which undermines the credibility of its calculations.

(c) *Who should decide on the use of extra resources?*

Related to the above issue is the fact that somewhat ironically, the Committee and Government appear to be in full agreement that private citizens are well-positioned to be able to decide on how to use resources in order to meet their various needs, rather than having such decisions made for them by some bureaucracy. For this reason the Committee proposes an income grant, and for this reason the Government has been very proactive in cutting income taxes. There are, however, a number of differences between the Committee's and the Government's approaches:

- The Government targets low income earners, while the Committee is seeking to target everyone, but most importantly those that earn no or very little income;
- The tax cuts can be easily reversed in the light of changing priorities and circumstances, while the income grant proposal is irreversible once implemented;
- The Government's approach does not require any extra administration, while the Committee's approach requires the establishment of a large, complicated and costly bureaucracy;
- The Government's approach enhances budget flexibility and is not counted as a fiscal expenditure, while the Committee's approach decreases budget flexibility and has to be financed through the fiscus;

- The Government's approach is generally regarded to be good for economic growth, while views of whether the Committee's approach will foster growth are mixed.

4.4 Introducing solidarity principles increases fiscal risk

The Committee argues that "Overall, when phased in over a long period, the strategic reform of the system of social security involves a significant shift toward social security funding allocated to funds that incorporate social solidarity principles with little net effect on the fiscal framework".

This statement is based on a very limited understanding of factors that impact on the fiscal framework – on the surface there may appear to be little net effect, but the real impact of incorporating social solidarity principles is to vastly increase fiscal risk – and so destabilise the entire fiscal framework. The Committee's failure to consider the impact of its proposals on the Government's exposure to fiscal risk is a serious omission, since every one of its proposals is likely to increase fiscal risk.

Some of the increase in fiscal risk is likely to fall into the 'explicit, contingent fiscal risk' category. For instance where the state guarantees minimum returns on mandatory retirement schemes or provides a guarantee that a universal medical scheme will pay its bills. However, most of the increase in fiscal risk is likely to fall into the 'implicit fiscal risk' category. This is where the Government is under a moral obligation to pay out funds due to the general expectations of the public. The most important of these is the implicit direct fiscal risk implied by the Committee's proposed income grant. If implemented, this proposal ties the Government to having to find R46 billion (increasing with inflation) every year irrespective of economic circumstances, and demographic changes. It would significantly reduce the Government's room to manoeuvre in the face of economic shocks. It would also reduce the Government's flexibility to adjust programmes to changing priorities. Once instituted there would be no changing the income grant.

The proposals for mandatory pension schemes and national medical insurance schemes increase the Government's 'implicit contingent fiscal risk'. Should either of these schemes fail the Government would be under a moral obligation to attempt to bail them out (similar to the pressure the Government was under to provide a bailout for Saambou). I say 'attempt' since the Government is unlikely to be able to do so without itself running the risk of total collapse. The likelihood of such schemes failing is small, but the consequences are potentially devastating, and therefore the risks need to be analysed and understood.

As noted above, I would have expected the Committee to discuss the full fiscal implications of its proposals, including their impact on the Government's exposure to fiscal risk.

5 The financial implications of the reform proposals

It is not possible to comment meaningfully on section 14.12 since the Committee does not give sufficient information on the model that it uses. It is therefore impossible to evaluate how the Committee arrives at the results it does, and comment on whether such results are realistic or not.

The one observation I can make is that in the section on the assumptions no reference is made to demographic projections. This is surprising since demographic trends are central to costing social security programmes. What, for instance, is the likely impact of HIV/AIDS on future health expenditures and therefore the expected cost of the mandatory health insurance scheme? How is the cost of the income grant likely to increase (or decrease) with changing population over the next 20 years?

6 Concluding comments on Chapter 14

The title of Chapter 14 promises much, but the contents of the chapter fails in its primary objective, namely to propose of clear 'financial framework for comprehensive social protection'. I would have expected the chapter to address itself to the following issues:

- An evaluation of the macro-economic circumstances in which South Africa finds itself, and the Committee's evaluation of prospects over the next twenty years (since this is the time-period over which the fiscal sustainability of social protection programmes should ideally be evaluated);
- An evaluation of the Government's current fiscal stance, and a set of proposals as to how the Committee believes this should change (if necessary) in order to realise the objective of comprehensive social protection;
- A clear set of principles to guide the financing of social protection, and specific proposals for the funding of the different recommendations made by the Committee;
- An analysis of the macro-economic and fiscal impacts of these different funding proposals, focusing particularly on the issues of fiscal risk and the creation of contingent liabilities, and ways in which these can be mitigated or managed to ensure that the process of extending comprehensive social protection is sustainable; and
- A discussion of the intergovernmental fiscal issues relevant to the implementation for the Committee's proposals.

As it stands Chapter 14 is an amalgam of issues and ideas with no clear line of analysis and consequently it does not present a coherent, integrated set of recommendations for a financial framework for comprehensive social security in South Africa. This is a central weakness of the overall report – for Committee's other recommendations to be implemented such a financial framework is absolutely essential.

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Appendix: Checklist of BIG Design Issues

This checklist was developed by Nick Wilkins in a paper on *Basic Income Grants* (AFReC, 2001). The Committee addresses some of the issues noted here, but it is silent on many more of them. However, each of these issues should be fully analysed and understood before a final decision regarding the feasibility, sustainability and desirability of a basic income grant is taken.

Fiscal implications

- *Fiscal sustainability*: A BIG would have a significant impact on the overall government budget deficit, even if the grant were set below subsistence level, due to the large numbers of beneficiaries determined by its unconditional nature.
- *Discretionary vs. non-discretionary budget spending*: A BIG would create a contingent liability that would change the balance between discretionary and non-discretionary spending. This point is associated with the asymmetrical politics of creating such entitlements: it would be politically possible to introduce a BIG, but politically very difficult to remove it.
- *Fiscal risk*: The higher level and increased inflexibility of government spending associated with a BIG would make the budget more vulnerable to macroeconomic shocks, because it would not be politically possible to adjust the level of the grant downwards.
- *Implications for taxation structure*: The additional revenue needed to finance a BIG could necessitate increasing tax revenue and implementing mechanisms for clawing-back BIG payments to higher-income beneficiaries.
- *Impact of BIG design on actual take-up rate*: If access to the grant is made easy, i.e. associated transaction costs are low, due to ease of registration and payment the actual take-up will be increased, even among higher-income earners. Also, the higher the level at which the grant is set, the higher will be the actual take-up rate among higher-income groups. These factors in turn will naturally affect the fiscal sustainability of a BIG.
- *Social welfare vs. non-social welfare spending*: The balance of government spending will of course be tilted further towards social welfare spending by the introduction of a BIG.
- *Capital vs. current spending*: A BIG will also move the composition of government expenditure further towards current rather than capital expenditure.
- *Inter-generational equity*: If government debt is increased to fund a BIG, inter-generational equity would be adversely affected as future obligations were incurred to fund current consumption.
- *Fiscal incidence patterns*: The degree to which a BIG would involve a higher tax burden on middle- and higher-income groups would depend on the precise design of the funding mechanisms involved. In addition, the extent to which a BIG would shift social welfare benefits from narrowly-defined groups (the elderly, disabled, children) to the wider population would depend on the degree to which the BIG replaced other grants.

- *Indexation to inflation*: Indexing the BIG to inflation would be politically popular, but would naturally decrease discretion over the grant's future level and increase fiscal vulnerability to macroeconomic shocks.
- *Inter-governmental fiscal implications*: Transfers to provinces (and administrative capacity-building support to relevant provincial departments) must be adequate in order to cover BIG disbursements and support the grant's administration, or litigation to enforce access to the BIG could result.

Macroeconomic impact

- *Composition of aggregate demand*: A BIG would tend to increase the proportion of aggregate demand made up by government spending as opposed to investment and other components. Likewise, consumption expenditure will increase relative to savings, etc., given the probable low propensity to save of the majority of BIG beneficiaries.
- *Savings rates*: Aggregate private savings rates may increase slightly under a BIG, as the disposable income of the lower income groups increases. A BIG would, however, tend to reduce the aggregate government savings rate.
- *Financial sector impact*: The impact on personal credit expansion, the rate of CPI inflation and interest rates will depend *inter alia* on:
  - the consumption patterns of particular income categories of beneficiaries, and the ways in which these are changed by the BIG;
  - the extent to which there is free manufacturing production capacity, particularly in sectors supplying the food, clothing, building materials and other basic goods and services whose per capita demand will increase under a BIG; and
  - the potential for the expansion of credit and hence the monetary supply due to a BIG, and the extent to which Reserve Bank monetary policy is altered to sterilise this increase and/or constrain credit expansion.
- *Balance of payments impact*: A BIG is likely to have a positive impact on the balance of payments, given that the import component of the bulk of the increase in consumer demand due to the BIG is likely to be lower than average.

Impact on poverty and inequality

- *Income support*: The poorest groups would receive some income support under a BIG, which would constitute its most important positive impact.
- *Progressivity of tax funding*: Financing a BIG largely by increasing VAT could have a net regressive impact on tax incidence, even if the range of zero-rated items is increased. In contrast, financing a BIG largely through increasing income tax (whether personal or corporate) would probably have a net progressive impact.
- *Social welfare expenditure displacement*: Depending in particular on the extent to which a BIG replaced existing social welfare grants, social welfare spending might be displaced from the elderly and poor to the broader population.
- *Support for the unemployed*: A BIG would provide vital support particularly for the long-term unemployed. The small minority of these who would have benefited from

UIF payments by virtue of having at one time enjoyed formal employment would by definition have exhausted their UIF benefits. A BIG would also provide some economic security on which people could base attempts to search for jobs or develop informal enterprises. The grant could be used as collateral, but has the advantage that it could not be transferred in advance to third parties.

- *Removing stigma from welfare benefits*: The unconditional, universal coverage of a BIG would remove the stigma attached to claiming welfare benefits, as everyone would be entitled to the grant regardless of their socio-economic status or other characteristics.
- *Support for the disabled*: A BIG would provide unconditional support for the disabled, including people living with HIV/AIDS who might be unwilling to apply for disability grants because of the social stigma attached to their medical condition.
- *Smoothing of income variance*: A BIG would help smooth out the time variances in the irregular income streams of many lower-income people.

Labour market effects

- *Substitute for a minimum wage*: A BIG is in effect a social minimum wage, which to some extent substitutes for a legislated private minimum wage.
- *Labour absorption capacity*: A BIG is in effect a public social wage, and hence subsidises the cost of employing labour by shifting employers' private costs to social costs borne by taxpayers. A BIG should therefore tend to increase the labour absorption capacity of the economy.
- *SME support*: By providing a measure of income support and security, a BIG would empower people to take advantage of SME development opportunities.
- *Labour flexibility*: The greater income security provided by a BIG, and the lack of perverse incentives it offers relative to conventional social assistance grants, would encourage greater flexibility by job seekers.
- *Education and human capital investment*: Women are known to have a higher average propensity to spend on their children's welfare and development than men. By delivering income support to women in general, therefore, a BIG would tend to promote investment in education and human capital development.
- *Impact on labour bargaining positions*: This would depend on the skills composition of sectors affected by BIG-funded spending. Workers in menial jobs might be able to bargain for better working conditions due to the 'social wage', while more skilled workers in sectors facing significantly increased demand might be able to bargain for higher wages. Conversely, however, employers facing lower labour costs and hence able to replace labour more easily might enjoy an enhanced bargaining position relative to labour.

Social considerations

- *Gender issues*: A BIG could shift intra-household income distribution in favour of women. Gender tax incidence could also improve, because women constitute the majority of the general population.

- *Child welfare*: A BIG should improve child welfare because their mothers would receive income support, and women have a higher propensity than men to spend on their children.

Political considerations

- *Rent-seeking*: A BIG offers few opportunities for rent-seeking behaviour by interest groups, particularly relative to a wage subsidy.
- *Political support*: A BIG would generate significant net political support for the government at its introduction.
- *Irreversibility*: The decision to introduce a BIG would to a large extent be politically irreversible; once in place, and accepted by voters, it would be very difficult to remove.
- *Political pressures*: Subsequent to introduction, political pressure to increase the level of the grant is bound to be experienced.
- *Ease of enforcement*: It would be easier for civil society to enforce the right to a BIG than the right to receive government services.
- *Political opposition*: People (in particular those in the business community) who disapprove of the unconditionality of a BIG on ideological grounds are likely to signal their disapproval to the wider investment community.

Administrative considerations

- *Budget appropriation*: If a BIG was structured like a negative income tax (NIT) rather than a true BIG, how would the associated funds be budgeted? Tax expenditure is not budgeted for, so the budget would not reflect the true cost of appropriation of an NIT.
- *Security of grant payments*: Particularly if BIG payments are made electronically directly into beneficiaries' bank accounts, the grant should not be vulnerable to corruption, interception or theft by administering officials or third parties.
- *Administrative capacity*: The capacity of the relevant provincial administering departments must be equalised across provinces sufficiently to ensure equitable distribution of BIGs by provincial governments.
- *Administering department*: Which department should pay out a BIG? If it is structured like an NIT rather than a true BIG, SARS should administer it. But it could be more feasible if the national and provincial departments of social development administer a true BIG, and SARS simply claws back as much equivalent funds as possible from registered taxpayers.
- *Banking transaction costs*: The transaction costs of processing the BIG by the banking system both to the state and beneficiaries (e.g. in receiving and processing BIG payments and allowing beneficiaries to draw on them) should be minimised, or the net benefit conferred by the grant will be significantly reduced.
- *Database sharing*: In registering beneficiaries, compiling a BIG payroll and processing tax returns to claw-back payments, sharing of databases by the relevant departments would greatly facilitate grant administration. For example, the Home

Affairs ID database could be used as a basis for compiling a BIG payroll. Alternatively, claimants could register by producing ID document and supplying their bank details, in which case dedicated regional offices to co-ordinate and implement registration would help.