

# Chapter 14

## Financial Framework for Comprehensive Social Protection



### 14.1 Introduction

There is no single approach to financing or delivering social security. A range of approaches including user charges, earmarked taxation of one form or another, Government regulation or general tax financing exists. In some instances, non-contributory social assistance is combined with contributory social insurance to achieve greater institutional integration.

Mixed financing options for public and semi-public goods and services are not the exclusive domain of social security. Establishing these principles generically for Government is, however, essential quite aside from its applicability to social security. In this chapter of the Report consideration is given to:

- The Constitution, particularly where it refers to aspects of Government finance
- An overview of South Africa's social security system and the key issues in social security financing
- The principles underlying the use or selection of particular forms of taxation, levy or user fee for the social security system as a whole, or individual programmes
- Accounting for alternative revenue sources in the national accounts, and their relationship to the National Revenue Fund
- Financial management issues where mixed financing options are considered.

### 14.2 Constitutional provisions affecting social security financing

An important issue for the Committee to consider was whether any “prohibition” to the use of earmarked taxes or contributory financing existed in terms of the Constitution. These forms of funding social security are well established internationally and will need to be introduced more extensively in South Africa over the medium-to long-term.

Section 185 of the Constitution prescribes that a National Revenue Fund be established, “into which shall be paid all revenues, as may be defined by an Act of parliament, raised or received by the national Government, and from which appropriations shall be made by an Act of parliament, raised or received by the national Government, and from which appropriations shall be made by parliament ...”

Section 186 stipulates that an annual budget reflecting the estimates of revenue and expenditure shall be laid before the National Assembly for each financial year. Provision is similarly made in section 159 as amended, for provincial revenue funds in each province:

*... into which shall be paid all revenue accruing to the provincial government, and all financial allocations ... made by the national government to such a provincial government and to local governments within the province of such a provincial government.*

The Constitution stipulates, in effect, that the national Government and provincial Governments should receive revenue into, and make appropriations from, single general purpose funds. The Constitution lays the basis for consolidated national and provincial revenue and expenditure accounts, thereby contributing to the transparency and the effective accountability to the legislative authorities of the public finances.

According to the Katz Commission, although the notion of “revenues” in section 185 is not defined and the sections of the Constitution dealing with financial matters are open to various possible interpretations, these provisions appear to bar the extra-budgetary assignment of national or provincial Government revenues to special purpose funds.

The Katz Commission also notes that although the constitutional provisions:

*... do not altogether preclude the earmarking of nationally collected taxes for the (conditional) financing of specific schedule 6 services within the budgetary process, it is clear that such arrangements could only be considered as an integral part of the broader inter-governmental financial framework. (Katz Commission, par.3.5.4).*

The Constitution also provides for the imposition by provincial legislatures of user charges, taxes, levies and duties other than income tax, value added tax or other sales taxes, and surcharges on taxes. These may not discriminate against citizens who are not residents of the provinces concerned.

The Committee finds that the Constitution in no way prohibits the creation of dedicated taxes, earmarked funding or for tax and non-tax forms of revenue for public or quasi-public institutions. Choices about revenue or spending mechanisms fall into the realm of policy determination and their merits have to be evaluated on a case-by-case basis.

## 14.3 An overview of South African social security financing

This section provides a review of specific issues and concerns brought to the attention of the Committee. These came by way of written and oral submissions, and reports made available.

### 14.3.1 Determination of the allocation to the social sector functions

The determination of the social sector allocation is said to be based largely on available funds rather than an objective relationship between priorities and available resources. The issue in question is not whether or not financial constraints actually exist, but rather whether the constraint is related to objective criteria that takes into account social impact and relative priorities.

The constitutional obligations imply that a proper budgetary assessment must be carried out which takes into consideration *all* the available resources of the state, not simply those in the relevant department’s budget. If resource constraints prevent the state from discharging all of its obligations then it must give priority to the most vulnerable sections of the community. Further, it must demonstrate that every effort has been made to use all of the resources that are its disposition.

### 14.3.2 Budget prioritisation

The process of prioritising the allocation of the Government’s budget is a complex political and institutional exercise. From 1994 a substantial change in the process and the policy direction of Government occurred. These changes included a number of attempts to improve budget prioritisation and planning. Substantial improvements have occurred in areas such as transparency and explicit links between intentions and fiscal resources.

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 according 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.

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.

### 14.3.3 Mixed financing principles

No clear framework, consistent with generally accepted public finance principles, exists in relation to non-general tax revenue sources of finance. Alternative financing will always exist for goods and services that are quasi public or quasi private in nature. Sources will derive from levies, user charges and earmarked taxes of one form or another. The approach used to price and operate public entities that are fully or partially funded on such a basis needs to be consistent and uniformly applied.

### 14.3.4 Allocation of the horizontal division

The formula used to divide up the allocation between provinces was cited as a problem. Mismatches can occur between the funds made available through the formula and actual needs resulting from mandates established at the national level. A key example is the social assistance system, whereby national legislation establishes the entitlement but the provincial allocation system does not guarantee that funds will be available.

### 14.3.5 Medium-term Expenditure Framework

The Medium-term Expenditure Framework (MTEF) is intended to improve budget planning. The MTEF process is clearly in its infancy in terms of achieving more advanced and complex budget planning and prioritisation objectives. To date it has assisted in collating budgets within fiscal envelopes. These were largely devoid of relative prioritisation.

### 14.3.6 Conditional grants and special projects

Conditional grants are allocations voted for transfer to a lower level of Government subject

to certain conditions being met. South Africa has used this fiscal mechanism since the introduction of the fiscal federal system in 1997 for a number of special programmes and spillover problems. The largest system of conditional grants occurs within the health sector, with around R6 billion voted to the national Department of Health for allocation to provinces with supra-regional services and teaching and research activities.

A number of the smaller grants linked to poverty alleviation, HIV/AIDS, hospital rehabilitation, primary school nutrition, all faced difficulties at various stages in fully utilising the available funds. Problems appear to have been related to the following:

- Onerous application requirements are placed on accessing the funds.
- Treasury, in advance of adequate planning in departments, often determines the availability of funds. This results in significant delays in complying with planning and tendering requirements and has an impact on the utilisation and disbursement of the allocations.

### 14.3.7 Allocation of the vertical division

According to the 2001 Budget Review the national provincial and local spheres of Government provide different services, so that the allocation of resources between the spheres also reflect the prioritisation of different services.

The Budget Review explains that the Constitution establishes three distinct spheres of Government. It identifies the responsibilities of each sphere and requires an inter-Governmental fiscal system that meets these requirements. According to Treasury, local and provincial Governments are responsible for delivering social and municipal services as well as a range of services that contribute to the economic and social well-being of South Africans:

A system of concurrent or joint responsibilities applies between national and provincial governments for functions like school education, health, welfare, housing, agriculture and urban and rural development. This in practice means that national government determines policy and regulates compliance,

while provincial governments are responsible for implementation. Exclusive functions for provinces include provincial roads and traffic, ambulance services, planning responsibilities, abattoirs, liquor licences etc.

This leaves national government largely responsible for policy and regulatory functions over school education, health, welfare, housing and agriculture, resulting in small budgets for these departments. Only education has a large budget, but this is for transfers to institutions of higher education.

Treasury currently sees a division of responsibility between national and provincial Government whereby national focuses on policy while 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.

## 14.4 Key issues in social security financing

In the design of a social security system four key issues around financing need to be confronted.

Firstly, there is the issue of *how much society wants to or should spend on social security*. Answers in this regard depend on the values of the society and the nature of its economic system. This also relates to issues of affordability and sustainability. Clearly the question of how much should be spent on a social security system cannot be approached only from a narrow financial or fiscal perspective. Such a perspective does, however, enable us to highlight certain key questions. These relate to the implications of reprioritising in favour of social security spending within the current fiscal framework, the macro-economic implications of a less constrained fiscal stance and the micro-economic implications of larger fiscal transfers based on larger tax revenues.

A second set of issues has to do with choosing between the *variety of different mechanisms for financing social security*. A first choice is between public and private financing, but each route holds a number of alternatives. Public financing,

for example, can be from general revenues or through earmarked taxes. A range of options are possible and indeed in operation internationally. The issue is clearly related to questions about the appropriate balance between public and private provision but also relates to the particular role of the state in ensuring availability of social security. Tax expenditures (including tax deductibility of contributions) provide a mixture of public and private financing with Government providing “subsidies” in the event of private procurement of social security cover (such as medical and retirement insurance). Indeed the whole tax framework with regard to social security benefits becomes an important issue.

The possible use of earmarked taxes also raises the third issue of how social security benefits and its financing should fit into the *budgeting process and the inter-governmental system in the context of fiscal federalism*. At what level should the function lie and how is budgeting done given the centralisation of the major revenue sources at the national level.

A prominent issue surrounding state financing of social security benefits, and retirement provision in particular, is the advisability or not of *pre-funding benefits in contrast to a pay-as-you-go system*. While ageing populations and projected actuarial deficits in state retirement schemes have led, in many countries, to arguments for pre-funding as a corrective pre-measure, there are questions about whether pre-funding necessarily provides the appropriate response in South Africa.

## 14.5 The existing framework for financing social security in South Africa

An important consideration for mandating this investigation into the South African social security system is the fragmented nature of the current system. This fragmentation is mirrored on the financing side.

A recent ILO estimate puts the total social security expenditure in South Africa in the 1998/99 financial year at R147,8 billion. This comprised 22,6 per cent of Gross Domestic Product (GDP). Social security expenditure included in this “social budget” comprises:

- Retirement and disability benefits – a total of R72,7 billion, or just less than 50 per cent of social security expenditure. Nearly 69 per cent of these benefits were from private, mostly occupational benefits financed from employer and employee contributions, either voluntary or in terms of conditions of employment or union agreements. About 8 per cent relate to occupational pensions for civil servants and 17 per cent to means tested old age and disability grants funded from general revenues.
- Unemployment benefits, employment injury benefits and road accident benefits – a total of R5,9 billion or 3 per cent of social security. Work injury is financed through contributions levied on employers (industry-specific and risk-rated) and unemployment insurance through employee and employer contributions – these are essentially earmarked payroll taxes. The Road Accident Fund (RAF) is financed through a dedicated proportion of the fuel levy.
- Healthcare spending – R51,2 billion or 35 per cent of social security expenditure. Forty-five per cent of this expenditure is in the public health sector, financed from general Government revenues. “Private” expenditure is financed through private or employer based medical schemes and some out-of-pocket expenditure.
- Family benefits – R2,3 billion (1,6 per cent of social security expenditure), all means tested and financed from general Government revenue.
- Other benefits, primarily social assistance and housing benefits (R12,7 billion), also funded from general Government revenue.

Of the above social security expenditure R58,4 billion (about 9 per cent of GDP) can be seen as publicly funded, the bulk from general revenues (R52,5 billion) in contrast to dedicated levies or charges. Private and occupational funding then comprises nearly R90 billion.

To the above estimates must be added tax expenditure related to favourable treatment of contributions to retirement annuity funds (estimated at R11 billion per year by the Katz Commission). Employer contributions are

made to medical schemes on behalf of employees (estimated to be approximately R7,8 billion). These tax expenditures imply large fiscal subsidies to individuals and are regressive in the sense that higher income earners benefit from them to a larger extent.

A key issue in the South African debate is the relatively large role, particularly in retirement provision, of private funding and the absence of a comprehensive, compulsory first tier retirement insurance mechanism.

The current fragmentation of funding sources also raises the possibility of generating greater efficiency through establishing a more integrated system financed to a greater extent through taxation, either general taxes or earmarked taxes.

## 14.6 Overall allocations to social security

For a number of reasons it is difficult to judge the appropriateness of current levels of social security expenditure. Not only are international comparisons fraught with difficulties because of institutional differences and gaps in the data but it is also difficult to decide which appropriate countries to use for comparisons.

With regard to social service expenditure as a whole (education, health and welfare) it has often been argued that relative to GDP, South Africa compares relatively well, particularly among developing countries. Social outcomes are, however, not in line with such high levels of expenditure because of spending on inappropriate services, insufficient targeting towards the poor and inefficiency in service delivery. Other factors that must also be taken into account are the apartheid backlogs, the lack of waged work and overall levels of income poverty.

A similar conclusion may be justified with regard to social security. While 23 per cent of GDP towards social security expenditure is towards the lower end among OECD countries it is fairly respectable among developing countries. Because of the dominance of private provision and substantial tax expenditure in South Africa, however, benefits are substantially skewed towards the wealthy and less subject to cost containment. This calls for careful scrutiny of the current system and the identification of options that will be more redistributive, cost-effective and pro-poor.

Given this diagnosis three avenues for reforming social security can be identified:

1. Restructure within the current social security spending envelope;
2. Reprioritise towards social security within the current spending framework; and
3. Allocating more resources towards social security and fund it through increasing tax to GDP ratios or relaxing deficit targets.

In many quarters the distribution of public expenditure is not seen as the key problem with regard to social security reform. It is often argued that self-imposed fiscal constraints (particularly tax to GDP ratios and deficit targets) translate into sub-optimal levels of public spending. Not only, it is argued, will substantially increased spending on social security directly alleviate poverty and improve income distribution (and so satisfy constitutional mandates), it will also have dynamic benefits leading to higher growth and increased socio-economic stability. Widening inequality and poverty is seen as fuelling socio-economic instability and development prospects and must therefore be turned around urgently. On the other hand, proponents of fiscal constraint maintain that conservative fiscal targets are indicated by:

- International norms in a globalising economy, in order to ensure positive expectations, business confidence and international competitiveness.
- The need to reduce indebtedness in order to avoid a debt trap, to release resources for increased social and economic investment and contribute to declining real interest rates.
- The fact that given public sector capacity, increased levels of expenditure will not necessarily translate into improved levels of service delivery.
- The possibility that increased spending will not enhance growth but more likely translate into macro-economic imbalance and inflationary pressures.

Indeed, fiscal restraint is argued not to be an end in itself but motivated by the desire to enhance economic growth and make more resources available for human and social development. While recent South African

growth experience has been disappointing, current 3-year projections indicate an improvement in the fiscal situation with debt reduction and stronger revenue projections creating the fiscal space for possible significant real growth in service expenditures.

Progress in reconciling these different perspectives will depend to some extent on more detailed analysis of the macro- and micro-economic implications of alternative fiscal stances and different tax regimes.

### 14.6.1 The budget framework and inter-governmental system

The category “welfare services” is a concurrent function of national and provincial Government. Currently national Government is mainly responsible for setting overall policy and monitoring implementation while provincial Governments deliver the actual services (primarily grant payments). Provinces also budget for grant expenditure from their equitable share of national revenue. This equitable share is based on a formula, using weighted demographic structure, reflecting primarily the relative demand for social services between the provinces. The current arrangement has been criticised on a number of points:

- 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 provincial own revenues, individual provinces cannot absorb the risk associated with different possible scenarios.

In addition to the above, provincial budget processes has been criticised in the past for not establishing sufficient certainty about allocations and for not accepting the legislative force of entitlements to social grants. These institutional and process issues must clearly be addressed in a reformed social security system.

### 14.6.2 Sources of financing

As indicated above, current social security benefits in South Africa are financed from a range of different sources. Key characteristics are the large proportion coming from private finance and, of public funding, the dominance of funding from general revenues.

The current balance between public and private funding is chiefly due to the large extent of private/occupational provision for retirement and medical cover subsidised via the tax system. This balance would be altered through the introduction of mandatory first-tier retirement insurance and/or the introduction of social health insurance in one or other format.

The bulk of state-provided income support is currently funded from general revenues. General tax-financed benefits (social grants) dwarf the insurance type benefits (unemployment and work accident insurance and RAF) which are funded from earmarked (payroll) taxes and dedicated taxes.

This situation, coupled to the extensive use of earmarked social security taxes in many countries, raises the issue about the appropriate balance between earmarked and general revenue funding in South Africa.

A large number of earmarked taxes, levies and user charges are currently in place in South Africa. Most of these were instituted prior to 1994 and serve a number of functions. Some are used to fund regulatory bodies (e.g. the National Electricity Regulator, Independent Communications Authority of South Africa, etc) and industry ombudspersons. Others fund Government service delivery and programmes. Examples of the latter are the unemployment insurance fund (through an earmarked payroll tax), provision for workplace accidents and the RAF (through an earmarked portion of the fuel levy).

The period post-1994 saw the introduction

of some new earmarked taxes as well as levies. The most important example is the skills development strategy which is funded through a levy grant system on all private sector employers, introduced in 1999. There has also been a consistent trend towards setting up public entities at arms length from Government, mainly to regulate a variety of industries. In many cases these regulatory bodies are funded through levies on the industry/consumers. Examples are the Council for Medical Schemes and regulators in the aviation industry. There has also been an increase in the use of user charges, particularly through more extensive use of toll roads and creating an enabling environment for the charging of fees by schools.

In recent years there has been increasing efforts from Government departments and agencies to secure dedicated sources of funding outside the normal Government budgetary allocations from general revenues.

The merits and demerits of allowing dedicated or earmarked funding sources are again being raised in the context of the Committee. Specifically, the funding of healthcare through a social health insurance tax and funding a Basic Income Grant to address poverty through some dedicated tax have been raised. The solvency problems of the UIF also raise the issue of how and when earmarked taxes should be adjusted. An additional aspect of social security reform that has been considered is the gains to be had from consolidation of the current fragmented “social security taxes” and the extension of this financing mechanism to a broader set of social security benefits.

Arguments against such taxes and levies are that they fragment and complicate the tax system and that they allow departments and agencies to escape the discipline of the budget process. In addition it could be argued that dedicated funding sources allow agencies to avoid prioritisation through the budget and political process. This aspect could be addressed with appropriate changes to the institutional framework and an integrated policy framework with clear political and financial oversight. Proponents of earmarked taxes point to greater funding certainty resulting from dedicated funding and a more direct relationship between payments and benefits that may enhance both equity and efficiency.



### 14.6.3. Net burden of financing an income grant

In evaluating the costs of a Basic Income Grant financed by increasing income taxes or increases in the value added tax, it was argued in the presentations to the Committee that one should take note of the difference between “gross burden” and the “net burden” of the income grant. For example, although the additional costs of a R100 monthly Basic Income Grant to all (given existing grant obligations) could be R46 billion, evidence was given that R22 billion of this could be clawed back through the tax system, this means that the net additional funds needed would amount to a much reduced R24 billion.

Similarly, the Committee was presented with the argument that, if universal income grants should be funded out of increases in the VAT rate, the net additional burden of a R100 grant would be about R13,5 billion.

The Committee took note of these arguments, but since it is not within its brief to consider potential tax increases, the calculations in the rest of the chapter are based on gross additional costs.

## 14.7 The tax system and social security benefits

Reference has previously been made to the tax treatment of contributions to retirement funding. The tax structure related to retirement provision can be characterised as “exempt-tax-tax”, with contributions being tax exempt and investment incomes and benefits being taxed. This system of contribution deductibility provides a positive incentive to make private provision for retirement. Other issues related to taxation of retirement that need to be addressed are the taxation of investment and trading income of retirement funds and the current treatment of lump-sum benefits.

Current deductibility of a maximum of two-thirds of medical aid contributions in the hands of the employer provides an incentive for private provision as well as favouring those with higher incomes disproportionately. The appropriateness of this arrangement need to be reviewed along with issues related to the treatment of savings accounts.

## 14.8 Review of the current tax dispensation

User charges by Government and Government

agencies currently amount to 2 per cent of GDP. Some fees contribute to general Government revenue, some are retained in trading accounts or extra-budgetary entities, and some fees are not reflected in public sector accounts at all. They include departmental sales, registration and inspection fees, hospital fees and charges, motor licence fees, payments for research and other sales of research councils, road tolls, university and technikon tuition and residence fees, public school fees, state water scheme tariffs and sales of various other Government enterprises.

Dedicated levies not reflected in national and provincial budget appropriations currently amount to about 1,5 per cent of GDP or about 6 per cent of total tax revenue. International accounting standards count statutory levies as Government revenue and their spending as public expenditure. The largest of these are social security taxes, i.e. unemployment insurance contributions and workmen’s compensation levies (R4 billion), fuel levies for the RAF (R2 billion) and for the subsidisation of Sasol and Mossgas (R0,8 billion), and regional services councils levies on turnover and payroll for financing local infrastructure (R3 billion).

Levies also finance various industrial, research and regulatory bodies, such as the South African Tourism Board, Financial Services Board and South African Bureau of Standards. Television licence fees are assigned to the South African Broadcasting Corporation. Local property taxes and surpluses on municipal water and electricity trading accounts are earmarked for municipal services.

## 14.9 Review of principles underlying the classification and use of mixed financing options

This section reviews the current evaluation and principles underlying user-fees, earmarked taxes and levies and proposes a way of providing guidance on their use within public policy and the overall system of social security. This is done where appropriate with reference to views expressed by the Katz Commission and the Treasury Department. Extensive use has been made of the views of Herber (1975),

Fisher (1996) and Gildenhuys (1993) as part of the review.

### 14.9.1 General taxation

Broad-based taxes such as the personal income taxes such as personal income tax, value-added tax, and corporate taxes are most appropriate for financing those public goods for which considerable difficulty arises in applying the exclusion principle.

Earmarked taxes, user fees, and administrative revenues are all capable, at least to some extent of utilising or approximating the exclusion principle when used as financing techniques.

According to Herber it should be emphasised that the “presence” or “absence” of strong traits of “publicness,” whether deriving from some externality or from some other source, does provide a logical “tie-in” with the institutional sector, public or private, which is likely to be the more efficient in influencing the allocation of a particular economic good. None-the-less, a “case-by-case” approach is still; required.

If “Government” production and/or distribution of a quasi-public good is considered desirable, a variety of financing techniques are available to the unit of Government providing the good. Pure public goods, which are not subject to the exclusion principle, cannot be allocated by the commercial principle.

Quasi-public goods can be allocated according to at least a degree by utilising commercial principles as their benefits are often partially subject to the exclusion principle. Quasi-public goods can also be allocated and financed through general taxation. The choice between general taxation and the application of some commercial principle as financial allocative techniques is relevant for quasi-public goods but irrelevant for pure public goods.

The case for general taxation as a means of financing quasi-public goods rests upon several related points.

- General tax financing is preferred in those instances where the short-run marginal cost of an additional unit of output is very low or zero and the price elasticity of demand of the good is highly elastic. The low or zero marginal cost means that additional units of the good do not withdraw resources in any way from alternative uses. A very inelastic good

would imply little purpose in using price as a rationing technique.

- General tax financing would also be preferred in the case of quasi-public goods where important joint consumption characteristics exist that may cause a serious supply shortage of these goods (e.g. tuition costs).
- General tax financing of a quasi-public good would also be preferred in instances where the collection costs of user fees are substantial (administration costs). Severe inconvenience to users from the collection system would also be important (consumption disutility).
- General tax finance may also be preferred where certain distributional objectives are being pursued. For instance, medical services or school lunches may not be available in adequate quantities to certain low-income people if they are available only on a direct pricing basis.

Under certain conditions, mixed financing using both user prices and general tax revenues would constitute the most rational alternative for financing quasi-public goods. Under other circumstances, it may provide negative allocational and distributional non-neutralities. The use of mixed financing may be rational if the good possesses both substantial joint consumption effects, which benefit the society as a whole and which remain outside the exclusion principle, and also private benefits. Tax funds would finance the community or social benefits while user prices would finance the individual or private benefits.

The use of general fund financing to cover the losses associated with Government pricing, e.g. the case of optimum social output under conditions of decreasing production costs, is rational if it is collectively determined by the community that fiscal means of this sort should be used to redistribute real income by increasing the allocation of the quasi-public good in question. The combined use of general fund financing and user pricing to finance public university education meets this rationale since the benefits of education are both social and private in nature and, in addition, improving the education of the poor is an effective means of improving their long-term real income position.

The absence of sufficient joint consumption benefits to justify tax (or debt) subsidisation of any loss, or the absence of a sufficient community-approved redistribution objective, would make the mixed financing technique irrational. This could be true because private users would derive most or all of the benefits from the consumption of the good and few, if any, social benefits would result. Yet, general tax funds collected from society as a whole would subsidise part of the cost of the private consumption. The results would be both a redistribution of income in favour of private consumers of the quasi public good as well as an allocational distortion.

Herber also raises the issue about what he terms the size of the “relevant interacting group.” The term “relevant” here suggests the connotation of “inter-dependent” consumption. Essentially, it asks the question: is the group small enough to reach a market-type agreement without encountering a serious “free-rider” problem?

### 14.9.2 User charges

User charges should operate as benefit taxes with an individual’s charge depending both on benefit (use) and cost of provision. The principal rule for economic efficiency requires that marginal benefit equal marginal cost. For services that primarily benefit the direct consumer then, the price charged should equal marginal cost.

The arguments in favour of user charges are largely the converse of those used to motivate general taxes in the case of quasi-public goods. The argument for use of the commercial principle is found in those quasi-public goods whose *economic effects* are mostly subject to the exclusion principle. The following issues are important considerations:

- The absence of significant positive externalities may suggest that user pricing may be preferable. Significant negative externalities may, however, require high user prices to discourage consumption – to the extent that the exclusion principle can be applied to the good.
- Where the cost of collecting user fees is lower than general tax administration for the same revenue yield, user fees are preferred. (This was the case with primary care clinics in South Africa until 1996.)
- Distributional goals may be better met

through user fees than tax financing. This is particularly important for goods such as electricity or water where an approximation of the benefit principle is important.

The pricing of user-charges face a number of alternatives depending upon the nature of the good and the goals to be pursued. These will include:

- Profit maximising pricing
- Average cost pricing
- Marginal cost pricing.

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). However, “isolated” examples of marginal cost pricing in a society where imperfect markets prevail do not necessarily constitute an optimal allocation solution, though in many cases they would constitute an improvement in allocation.

The strongest case for *marginal cost pricing* would likely centre around an important economic good possessing significant joint consumption characteristics over a *large group* and/or the presence of decreasing production costs at the relevant output scales. An administration problem of effectively applying the exclusion principle may nevertheless still occur. The implicit danger remains that pursuit of the marginal cost pricing rule for public-type goods, at a time when it is not being followed generally within the economy as a whole, will irrationally expand the supply of public versus private goods. Nevertheless, the use of the marginal cost pricing technique in the allocation of quasi-public goods may be considered, at times, as an acceptable “second-best” solution in a world inextricably associated with imperfect market structures, joint consumption, and externalities.

Use by Government of the *profit maximising price*, as determined by the intersection of marginal cost and marginal revenue, would best serve only the revenue goal unless society needs to reduce consumption of an undesirable good.

Average cost pricing is the preferred alternative to profit maximising pricing for governmental pricing of quasi-public goods as it helps to reduce negative allocational and distributional distortions.

Marginal cost pricing appears to be the most desirable apart from the problems already mentioned.

Gildenhuis draws attention to a common classification error in which user charges, levies and consumer tariffs are confused. In most of the literature a common term is used to describe all three, namely user charges. There are in fact fundamental differences.

User charges and consumer tariffs, however, have certain common characteristics, namely:

- The absence of compulsion – their payment is voluntary because the user or the consumer has a choice of buying the services.
- They are both based on the benefit-received principle, which means that the user charge or consumer tariff which has to be paid is based on the direct benefit of the service to the user or consumer; in other words there is a direct quid pro quo which means that the user or consumer receives actual value in services to the amount paid.
- The user charge or consumer tariff is established according to the costs for delivering the service. Consumer tariffs, therefore, are comparable to prices of goods traded in the private sector, while user charges are levied to recover additional operational (direct) costs incurred on behalf of a specific user of a service.

Gildenhuis proposes that consumer tariffs should be used in the case of quasi-collective services to pay for the extra operational costs incurred of quasi collective services. In this way there can be an efficient and effective allocation of the costs of public services. This also relieves the pressure on tax revenue because if consumer tariffs and user charges are not imposed, the cost of all particular and quasi-collective services has to be met from taxation.

User charges do not cover the full costs of quasi-collective services. If users were expected to pay the full cost of collective services they would in all probability be beyond the means of the larger part of the population.

User charges have the advantage of raising additional revenue. However, they also serve the important function of limiting the misuse of quasi-collective services and improved equity resulting from direct pricing (i.e. non-users do not subsidise users, e.g. toll roads, foreign users). Furthermore, user charges can register and record public demand for services. User charges can also serve to correct price signals in the

market. This is particularly important in conserving a resource which otherwise would appear free.

Fisher points out several general principles of efficient user charges:

- User charge financing becomes more attractive as the share of marginal benefits that accrues to direct users increases.
- User-charge financing requires that direct users can be easily identified and excluded (at reasonable cost) from consuming the service unless the charge is paid, assuming that most of the benefits of a service or facility go to direct users.
- The efficiency case for user-charge financing is stronger when demand is more price elastic. In the special case of a perfectly inelastic (vertical) demand, price does not matter. No inefficiency would result if consumers underestimate cost. Obviously, the more price elastic demand is, the greater the potential for inefficiency if consumers do not face true costs.
- Marginal benefits, not total benefits, matter for the determination of user charges.
- The costs for construction of a public facility should be paid by those groups in society who will benefit directly from the existence of the facility, which may be different from those who benefit from using the facility directly. Two reasons are given for this:
  - The existence of a facility provides individuals the option of use in the future, should their demands change.
  - Individuals who are not direct users also might benefit if the facility generates spillovers in the form of additional economic activity.

If all residents as well as users should pay all or part of the long-run production costs of public facilities, these charges should be independent of the amount of actual use of the facility. Some charges could be applied to everyone to cover that part of the capital cost that benefits all, and different charges could be applied to everyone to cover their share of the capital costs.

In practice, however, standard recommendations on the pricing policy guidelines prove quite difficult to implement. For instance, in the United Kingdom (UK) the following guide-

lines were provided in various White Papers the instructions to public corporations were:

- To balance their accounts, taking one year with another over a period of five years, after providing for interest and depreciation at historic cost (1961 White Paper).
- To adopt pricing policies so that “revenues should normally cover their accounting costs in full” and take into account both short-run and long-run marginal costs, i.e. costs of producing an additional unit of output (1967 White Paper).
- To take the opportunity cost of capital into account in pricing their output (1978 White Paper).

The pricing policies of nationalised industries had been based on the following general principles:

- Consumers should pay the true cost of the provision of goods where it can be identified.
- Cross-subsidisation between profitable and unprofitable services within the industry might be permitted in some circumstances. For example, British Rail could use a surplus earned by commuter services to subsidise loss-making rural services.
- Below cost prices could be charged when there was a surplus capacity and a reduction in price would stimulate demand.
- Differential prices might be charged when demand fluctuated and was heavier at certain times, so that prices were higher at peak times and lower at the off-peak time.
- Multi-tariffs could be introduced, listing charges that were related to the volume of goods transported or purchased and customers could be offered reduced charges.

British corporations had found implementation of marginal cost pricing policies difficult. British Rail could not price some of its services on the basis of marginal costs. The Post Office estimated that marginal cost pricing would have added to its costs as it would have required the establishment and operation of computer models, and results would not have been substantially different from those of a pricing policy based on average costs.

### 14.9.3 Consumer tariffs

The primary and only objective of consumer tariffs is that they should yield enough income to pay the full costs of supplying such services to individual consumers. For this reason it is necessary to keep full operational accounts for each particular service. The purpose is for each consumer to pay the full cost of each unit of a particular service consumed. The full cost includes the fixed production cost as well as the variable operational cost for supplying each service unit.

As is the case with the prices of private consumer goods, consumer tariffs, therefore, fulfil the same function as prices of private consumer goods by allocating consumer spending to different factors of production. Consumer tariffs have no consumer regulation function, nor a redistribution of wealth function.

Governments are supposed to deliver particular public services at cost with no deliberate profit element built into the consumer tariff structure – the tariff is supposed to cover only the per unit of the services supplied. Casual surpluses or deficits on the operational accounts of particular services should be carried forward to the next financial year so that the surplus or deficit of the previous year can be taken into account when establishing the new tariff for the ensuing year.

Surpluses and deficits are inevitable as it is impossible to make absolutely correct budget forecasts. The proper way of dealing with casual surpluses and deficits is to establish a tariff stabilisation fund for each particular service and to credit or debit any casual surpluses or deficits against such a fund.

Where local Governments are allowed to compile their 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.

To comply with the objective of a consumer tariff, an operational account should be

established for each particular service, while the structure of the consumer tariff should be of such a nature that it covers the expenditure of such service without surpluses or deficits.

If certain consumers need to be subsidised for some acceptable reason, they should be openly and directly subsidised from the tax revenue. Governments should not hide their social policies behind indirect and invisible subsidies from consumer tariffs.

#### 14.9.4 Nominal levies and sundry revenue

There are some sources of revenue, such as nominal levies and sundry charges, that are similar to user charges and sometimes based on the benefit-received principle. Nominal levies sometimes do not recover the full cost of the service rendered but, just as in the case of user charges, imposing nominal levies is an effort to relieve the burden on the ordinary taxpayer by trying to recover part of the cost from the beneficiaries of a special service.

Nominal levies partially compensate Governments for the costs of special services rendered on request to identifiable individuals, or for special paperwork, such as extracts from official records and the issue of various certificates and documents. The services related to nominal levies are not continuous services offered for sale on a regular basis but are delivered sporadically at the request of an individual or business enterprise.

Nominal levies are seldom charged for public goods or services in the normal sense of their meaning and cannot therefore be regarded consumer tariffs or user charges.

Sometimes a nominal levy is paid for a privilege or right granted by Government to an individual or business enterprise. The enjoyment of such a right may cause expenses for the Government and the purpose of a nominal levy is then to recover all or some of these expenses. Various form of licence fee fall into this category.

The fees for trading licences with a regulation function should be no more than a nominal amount to cover only the application and registration costs, because the regulation of businesses is a collective service for the protection of the public, which should be financed from taxation.

Fines, forfeitures and traffic fines are casual sources of revenue which should not be deliberately budgeted for in order to balance the operational account of some service.

Administrative revenues are collected by a unit of Government from individuals as part of the performance of general governmental functions. These governmental functions are primarily regulatory in nature. It must also provide a certain basic framework within which private economic activity will take place. In the performance of these and other general functions, Government frequently charges a fee, levies a fine, escheat, or otherwise collects revenue from individuals. The correlation between the payment of administrative revenue by the individual is usually broad and imprecise. Only in a general sense, therefore, may it be said that a quid pro quo relationship exists in the case of administrative revenues.

#### 14.9.5 Earmarked taxes

There is some disagreement concerning the economic efficiency results of earmarked taxes. Some suggest that earmarking tends to reduce the willingness of taxpayers to approve expenditures on specific public services. Others argue that earmarking is important as a device to generate taxpayer support for the expansion of certain governmental services.

Earmarking may increase allocational efficiency by insuring more rational individual choice since, with earmarking, the individual can appraise more closely the relevant costs and benefits of a particular project. The individual is thus able to adjust the amount consumed of each public good in order to attain his or her most preferred consumption position. This is not true in general fund financing which is similar to a "joint-product sale" in the sense that to get one commodity the consumer must also purchase another. The individual consumer of quasi-public goods, in the latter case, is subject to an allocational distortion since his or her independence of choice is reduced.

General fund financing will tend to attract a greater supply of publicly-supplied economic goods with elastic demands than will earmarked financing. Thus, when "general fund financing" is used, society receives a greater proportion of those economic goods with highly elastic demands since they are tied in with the acquisition of other goods, and it receives a

smaller proportion of those goods which possess less elastic demands.

It is sometimes argued that the social security programmes should be financed from “general” instead of “earmarked” taxes since negative allocational non-neutrality can result from an excise tax on the wage alone, but not on capital. It is claimed, for example, that payroll taxes, by increasing the cost of hiring new employees, encourage the substitution of capital for labour since capital is not subject to the payroll tax. Therefore, it is argued that labour will be forced into “non-covered” employment while capital is drawn to employment “covered” under social security. It is thus concluded that important non-neutrality takes place.

Consideration can be given to the general tax financing of social security benefits from the progressive personal income tax. This would make the financing of social security more equitable in ability-to-pay terms. This would be a move away from any initial “private insurance” intent for the social security programme and would recognise, instead, that its benefits primarily represent a “redistributional” programme toward lower-income groups rather than a precise quid pro quo exchange of costs and benefits. (The schedule of benefits may be designed to favour workers whose lifetime earnings are below average. However, part of this redistribution could also reflect a transfer from the “youthful poor” to the “elderly poor”.) Such considerations may be quite pertinent to state run health and unemployment insurance programmes.

The overall focus of the Treasury Department on user charges, levies and earmarked taxes is limited to offering definitions and general positions on desirability.

The review of the public finance literature looks at the issue from a different direction. It looks primarily at the relative “publicness” or “privateness” of a good as a basis for assessing options with respect to finance and provision. The particular character of the good or service will also determine what financing technique is feasible or available to policy-makers. A user fee or earmarked tax option may be desirable, but excluded as a policy option due to technical reasons (collection costs, inability to apply exclusion principle, etc).

The differentiation between user charges and levies is unclear in the Treasury documentation.

For instance it recommends that “a policy preference [should favour] user charges above levies on economic efficiency and equity grounds” (Department of Finance, 1998). As levies are used in very different circumstances to user charges a general preference is inappropriate as the options are not substitutes. A similar inconsistency arises with comments such as: “Levies are a last resort and should only be considered where costs are borne by the targeted group benefiting from the service to be financed.”

The idea of a “quasi-user charge”, to be used where a “user charge” proves unattainable, is described by the Treasury as “essentially a levy”. Television licence fees are used as an example. This is confusing and probably should be considered as a levy without any reference to a user charge. Levies are determined by statute and benefits are not directly linked to use. The use of a term such as “quasi user charge” in this context does not serve to improve clarity.

The Treasury does not make the distinction drawn by Gildenhuis between “user charges” and “consumer tariffs”. Consumer tariffs would be used in the case of “quasi-collective-services” to pay for the extra operational costs incurred of supplying services to individuals. User charges, by contrast, do not cover the full costs of such services. This would occur in services where full-cost collective services would exceed the affordability of the larger part of the population. An example would be primary healthcare services.

“Consumer tariffs” would therefore seek to recover the full cost of each unit of a particular service consumed. An example in South Africa would be the billing of private medical schemes by public hospitals. The full cost would include full production and variable costs. A separate operational account is appropriate in such circumstances.

In the conclusions offered by the Treasury Department the proposal is made that in considering levy proposals, “the agency so funded is accountable to the constituency who bears the charge”. This proposal is too broad and consequently difficult to apply.

- No distinction is made between a user charge, a consumer tariff, or an administrative levy of one form or another. Clearly the circumstances in each of these instances would vary so substantially that the term “accountability” is confusing.

- If it is assumed that this is a reference to an administrative levy and not a user charge, then it is difficult to understand what is meant by constituency and how this might practically be applied to a specific instance. Particularly if the levy has a regulatory function. The levy may be imposed in the broader interests of the country and be opposed by a particular constituency. Distinguishing between broader and narrower interests lies in the domain of Government policy.
- Thirdly, accountability to narrower interests, if it assumed they can be disentangled in some democratic manner, could have perverse consequences, e.g. in the case of regulatory authorities or bodies where regulatory capture is facilitated.

There are therefore numerous instances where a levy must be applied and administered in a manner that is accountable to Government in a transparent manner, but for which clear separation from the paying public is required. A case-by-case assessment is required. For instance, a distinction should be made between a licence fee paid to a commercial television station and levies used to finance a regulatory authority.

The Katz Commission suggestion that the distinction between user charges and general taxes on the basis of the benefit received principle can be blurred as “many taxes can be based on benefits received” is not correct. The distinction is typically made between benefits that are received in exchange for payment, e.g. an electricity and water charge, and those that are received collectively, e.g. through a defence force. The distinction is not based on the existence of a benefit, but rather on how directly the benefit is linked to the person paying.

The Katz Commission refers to instances where an “impost was merely used as a revenue generation device” and as such the “charge is more akin to a tax”. It should be pointed out that crude examples of this, such as “traffic tickets,” will have to be distinguished from a policy which has as its objective to make a particular class of person pay directly for services which they previously received free. This would have redistributive consequences but would not necessarily be regarded as a tax. In all instances Government authorities should clearly and transparently implement policy, making clear what its distributive and administrative

objectives are. Poor policy making should be seen as a separate issue from the *a priori* appropriateness of a particular form of provision or finance.

Consideration needs to be given to the principles required to determine the initial grounds for the application or non-application of a particular form of finance or provision. Where grounds exist, certain pre-requisites should then be satisfied before implementation.

Social security systems typically make use of variety of funding sources and provider systems. These range from general tax-funding to regulated private markets, with many options in-between. South Africa has a fairly under-developed social security framework, and makes use of either direct state provision or partially regulated private markets. There is a need therefore to broaden the range of social security instruments, and to modernise existing approaches.

## 14.10 Generic financial framework for social security

Social security systems usually have the following features as reflected in their financial framework (see figure 19):

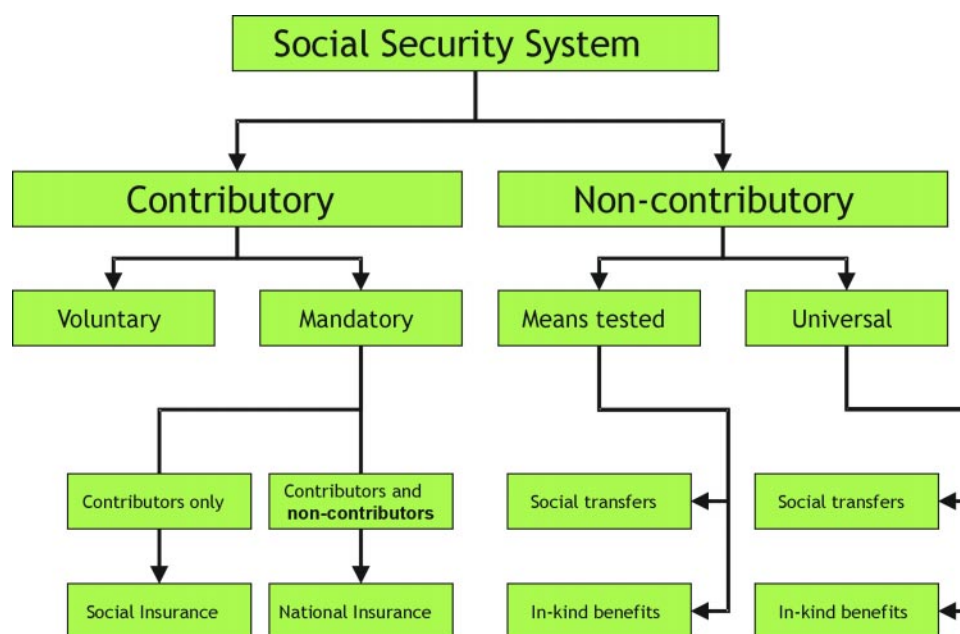
- *Non-contributory*: This reflects benefits provided directly by the state, either as social transfers or benefits in kind. These benefits can be either means-tested or universal.
- *Contributory*: These benefits are funded through some form of contribution. These can be voluntary, as in the case of medical schemes and private retirement, or mandatory where social insurance schemes (UIF, COIDA) are involved. Mandatory contributions can either provide universal cover (National Health Insurance) or be limited to contributors only (Social Health Insurance). Voluntary contributions can either occur in relatively unregulated environment (private short-term insurance) or in regulated environments (medical schemes in South Africa).

### 14.10.1 Principles underpinning social security financial management

A clear need has emerged to specify the underlying public finance principles that underpin South Africa’s social security system, both from a technical



**Figure 19**  
**Generic financial framework of a social security system.**



and a social point of view. The former refers to technically efficient approaches to managing funds appropriated and spent differently from the conventional Government budget. The latter refers to redistributive and social solidarity goals. The overall objective is to harmonise technical efficiency with social solidarity requirements, so that the needs of the one do not undermine the other.

The principles underlying mixed financing options should arise logically from the character of the good or service and the key related policy objectives. Where variations from the general budget approach occur, operational requirements should be fairly easy to determine.

### 14.10.2 Recommendations

Mixed financing options, which include user charges, consumer tariffs, levies, and earmarked taxes, are of relevance only in cases of quasi-public or quasi-private goods and services. Once a good clearly fits into this range, efficiency gains are very likely through a move toward a mixed system.

As the grounds for mixed financing options relate primarily to the specific circumstances and nature of the good or service in question, no predisposition for or against such options can exist. For this reason, options should be assessed on a case-by-case basis. The level of funding always remains a policy decision based on Government priorities.

Once the nature of the good or service establishes that significant efficiency gains are achievable through mixed financing approaches, then a consistent operational environment should be established noting the following:

#### 14.10.2.1 Use of alternative revenue sources

In all instances where user charges, consumer tariffs, or levies are charged, the relevant institution or authority should maintain separate operational accounts.

#### 14.10.2.2 Financial accountability

Financial accountability should be delegated to the lowest appropriate level where separate operational budgets exist.

#### 14.10.2.3 Earmarked taxes

Earmarked taxes should not be considered as an alternative to the general budget but rather be used only in specific instances where the quasi-public nature of the good or service requires a direct relationship to be established between the contributor and the good or service to be provided. Insurance of one form or another and retirement contributions, where compelled by the state, would fall into this category.

Where earmarked taxes are considered, separate operational budgets are recommended to ensure consistency between the funds raised and the entitlements to be funded.

#### 14.10.2.4 Redistributive goals

As far as possible, specific redistributive goals should be achieved through general tax and budget allocations. It would not be inconsistent, however, for certain redistributive goals to be achieved amongst those paying a dedicated tax.

#### 14.10.2.5 Trading accounts

Where trading accounts are in place, appropriate mechanisms must be established to manage surpluses or deficits through either:

- A stabilisation account used to equalise balances on a multi-year basis
- An approach for topping up and repaying (i.e. lending) money from the general budget, where a surplus or deficit occurs
- The establishment of consistent criteria as to how redistributive elements interact with the general budget.

#### 14.10.2.6 Governance structures

An appropriate governance structure must be put in place if funds are managed outside of the usual public sector framework.

## 14.11 Social budget

Important to the revision of the social security system, is the development of a broader understanding of the inter-relatedness of all areas of social security, whether public, social insurance or private. The financial system is essentially a reflection of the institutional framework of social security. For this reason

social budgets, which measure all of social security expenditure, and not merely the on-budget items, have become important measures to evaluate the performance of such spending within a nation.

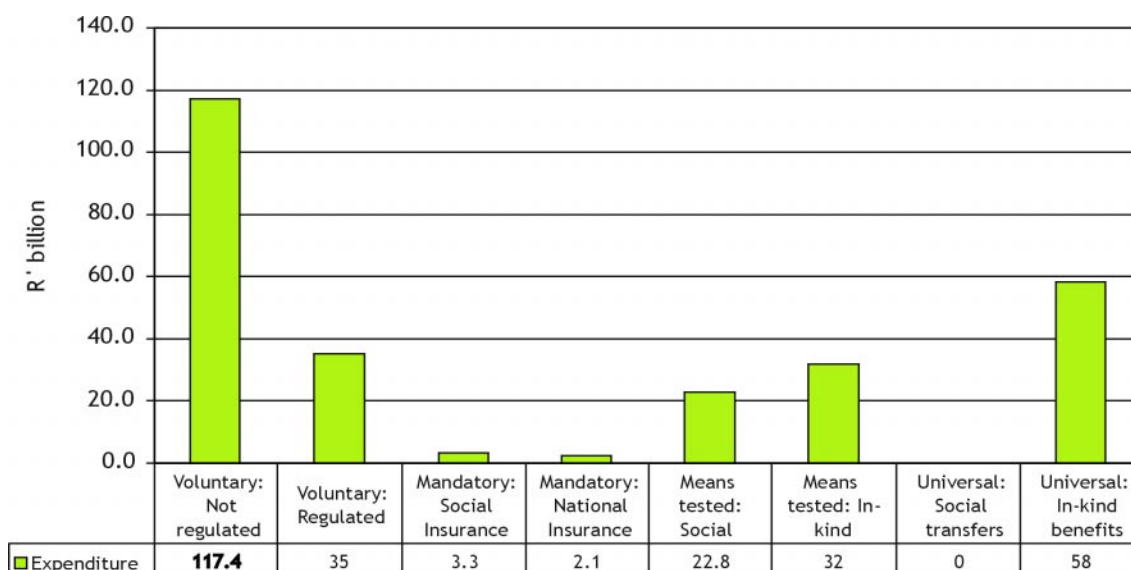
An evaluation of the South African system of social security shows (estimates for 2001) that overall 30,1 per cent of GDP is spent on both contributory and non-contributory benefits (including education) in both the public and private sectors. Around 12,6 per cent (R112,8 billion) occurs within the non-contributory public sector environment, while 17,6 per cent (157,8 billion) occurs in the contributory environment (figure 20 and table 12). Most social security expenditure or contributions occur within the largely unregulated private contributory environment (by this is meant that social solidarity principles are not protected).

### 14.11.1 Fiscal capacity and the prioritisation of social security expenditure

According to the 2001 Budget Review the total budget for 2001/02 is R258,3 billion up from R255 billion in 2000/01. Overall this allocation implies a reduction in Government expenditure from 28,8 per cent of GDP in 2000/01 to 27,4 per cent of GDP by 2003/04. Despite the reduced percentage of GDP, these allocations involve slight real increases over the period of the MTEF.

The 2001/02 financial year provides for the introduction of a contingency reserve of R2

**Figure 20**  
Social security expenditure in South Africa (estimates for 2001).



**Table 12**  
**Financial estimate of the total expenditure**  
**within the South African social security system**

		Total	Contributory				Non-contributory			
	<i>R' billion</i>	270,6	157,8				112,8			
	<i>% of GDP</i>	30,1%	17,6%				12,6%			
Contingency		Voluntary	Mandatory		Means tested		Universal			
	<i>R' billion</i>	270,6	152,4		5,5		54,8		58,0	
	<i>% of GDP</i>	30,1%	17,0%		0,6%		6,1%		6,5%	
			Not regulated	Regulated	Social Insurance	National Insurance	Social transfers	In-kind benefits	Social transfers	In-kind benefits
Total	<i>R' billion</i>	270,6	117,4	35,0	3,3	2,1	22,8	32,0	0,0	58,0
	<i>% of GDP</i>	30,1%	13,1%	3,9%	0,4%	0,2%	2,5%	3,6%	0,0%	6,5%
Education	<i>R' billion</i>	52,8	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	52,8
	<i>% of GDP</i>	5,9%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	5,9%
Health	<i>R' billion</i>	68,5	0,7	35,0	0,3	0,5		32,0	0,0%	0,0%
	<i>% of GDP</i>	7,6%	0,1%	3,9%	0,0%	0,1%	0,0%	3,6%	0,0%	0,0%
Housing	<i>R' billion</i>	5,2	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	5,2
	<i>% of GDP</i>	0,6%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,6%
Retirement	<i>R' billion</i>	62,5	50,2				12,3			
	<i>% of GDP</i>	7,0%	5,6%	0,0%	0,0%	0,0%	1,4%	0,0%	0,0%	0,0%
Disability	<i>R' billion</i>	14,1	8,7		0,3	0,8	4,2			
	<i>% of GDP</i>	1,6%	1,0%	0,0%	0,0%	0,1%	0,5%	0,0%	0,0%	0,0%
Children	<i>R' billion</i>	6,4	0,0%	0,0%	0,0%	0,0%	6,4			
	<i>% of GDP</i>	0,7%	0,0%	0,0%	0,0%	0,0%	0,7%	0,0%	0,0%	0,0%
Adult poverty	<i>R' billion</i>	0,0	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%
	<i>% of GDP</i>	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%
Unem-ployed,	<i>R' billion</i>	32,4	29,8		2,6					
	<i>% of GDP</i>	3,6%	3,3%	0,0%	0,3%	0,0%	0,0%	0,0%	0,0%	0,0%
Survivors	<i>R' billion</i>	28,8	27,9		0,1	0,8				
	<i>% of GDP</i>	3,2%	3,1%	0,0%	0,0%	0,1%	0,0%	0,0%	0,0%	0,0%

billion in 2001/02 but increases substantially to R8 billion by 2003/04. This contingency reserve is an unallocated amount.

Although interest payments appear to be rising, in real terms they are decreasing significantly over the period of the MTEF. In theory this should improve the capacity for improved Government services.

Social services receive a declining share of overall GDP over the MTEF period, from 13,3 per cent of GDP in 2000/01 to 12,7 per cent in 2003/04. Of all the most significant sectors, this decline is the largest reprioritisation (table 13).

Over the period interest payments decline significantly as a percentage of GDP, from 5,3 per cent of GDP in 2000/01 to 4,5 per cent in 2003/04 (figure 21). If Government expenditure were to remain a constant proportion of GDP, this in itself would have provided an additional 0,9 per cent of GDP for Government services.

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.

When the national allocation is added to the contingency reserve, and expressed as a percentage of the overall consolidated expenditure, the national allocation rises from 31,7 per cent in 2000/01 to 34,8 per cent in 2003/04. This substantially outstrips the changes in the provincial allocation which reduces from 46,3 per cent of the total consolidated expenditure in 2000/01 to 45,4 per cent in 2003/04.

Of interest is the decision to leave a substantial portion of the gains from the reduced interest payments unallocated. According to the medium-term budget, all reductions in debt service costs are effectively added to the Contingency Reserve. (The space calculated here is an estimate, and could in fact be larger or smaller depending on what in fact transpires.)

**Table 13**  
**Consolidated provincial and national expenditure from**  
**2000/01 to 2003/04 (nominal prices) R' million**

	1997/98	2000/01	2001/02	2002/03	2003/04
R' million	Estimated outcome	Revised estimate	Medium-term estimates		
Protection services	31 214	40 975	45 778	49 221	52 031
Social services	99 230	116 577	126 242	135 444	144 156
Economic services	18 123	19 589	22 645	24 409	25,574
General Government services and unallocated expenditure	17 020	22 276	25 046	26 795	28 760
Interest	38 820	46 186	48 138	49 651	51 022
Subtotal: Votes and statutory amounts	204 407	245 603	267 849	285 520	301 543
Contingency reserves	0	0	2 523	4 378	8 766
Consolidated expenditure	204 407	245 603	270 372	289 898	310 309

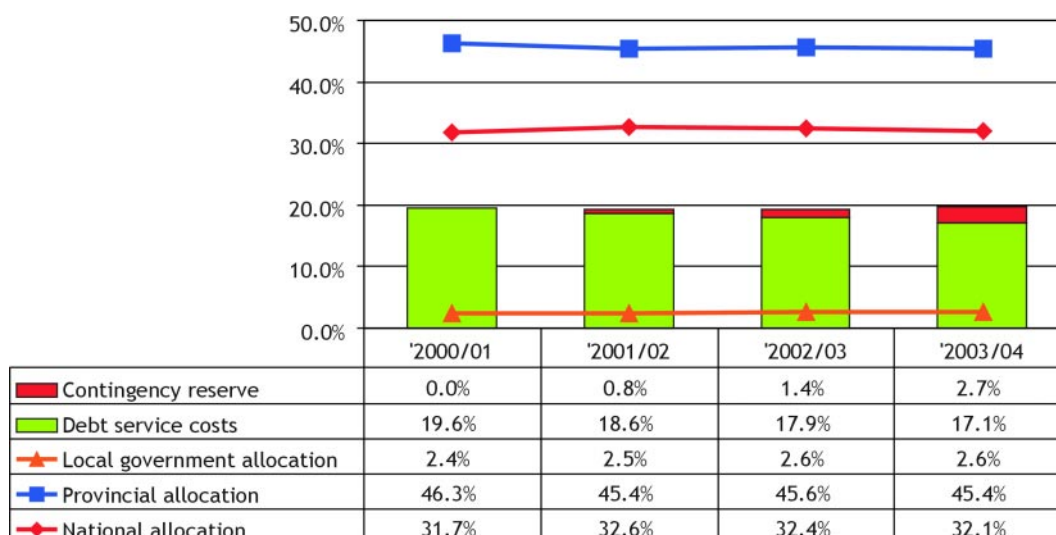
Overall there is evidence of sufficient fiscal capacity for improved social sector spending without adverse macro-economic impacts.

The following potential sources of improved fiscal capacity (expressed in nominal terms) are noted by the Committee:

- **Economic growth:** If consolidated expenditure was to remain at 28 per cent of GDP for the MTEF, an additional R3,7 billion would be available in the 2002/03 financial year, and R6,1 billion in the 2003/04 financial year.
- **Reduced debt servicing:** Effectively this is the allocation provided within the Contingency Fund. In 2002/03 this amounts to R4,4 billion, while in 2003/04 it rises to R8,8 billion.
- **Expenditure increased as a percentage of GDP:** If Government were to increase targeted expenditure to 29 per cent of GDP a further R9 billion would be available in 2002/03 and R9,7 billion in 2003/04.

Thus, in 2002/03 the combined additional funds would amount to R8,1 billion and in 2003/04

**Figure 21**  
**Consolidated provincial and national expenditure from 2001/02 to 2004/05.**



R14,9 billion without any increase in expenditure as a percentage of GDP. This increases to R17,1 billion in 2002/03 and R24,5 billion in 2003/04 if expenditure is allowed to increase to 29 per cent of GDP (figure 22).

## 14.12 Reform proposals and their financial implications

This section provides an estimate of the financial implications of major policy recommendations of the Committee. The evaluation is provided for the period 2001–2015. The assessment is provided both in 2001 prices and expressed as a percentage of GDP. A summary of the policy areas evaluated

### 14.12.1 Assumptions

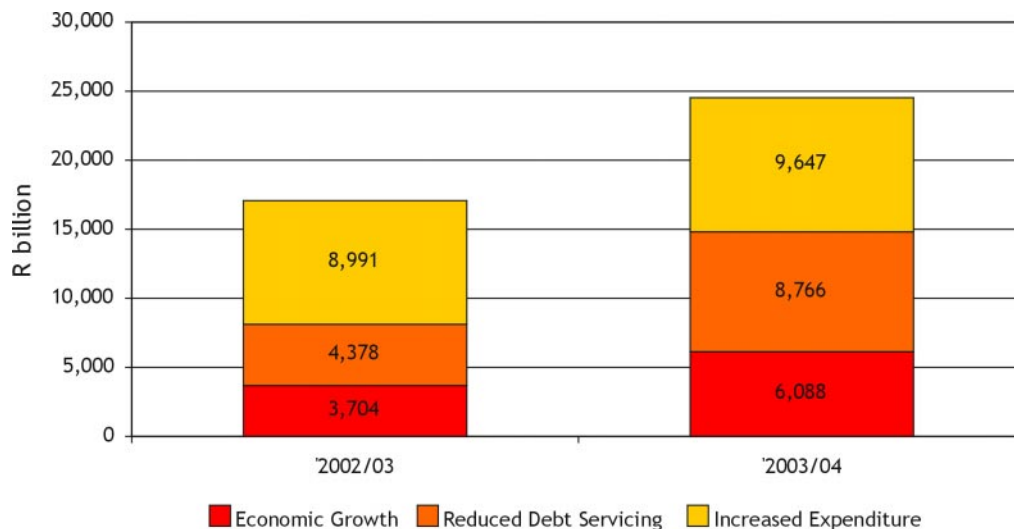
The following assumptions underpin the financial evaluation presented below:

- The policy evaluation occurs over a period 2001 to 2015
- GDP growth is assumed to be 2 per cent per annum from 2001 to 2005 and thereafter until 2015 to be 3 per cent
- GDP in 2001 is taken as R897,9 billion
- Government expenditure in 2001 is taken as R245,6 billion
- Costs are assumed to be in constant 2001 prices.

Due to the complexity and inter-relatedness of the policies under review a central scenario has been chosen for illustrative purposes, based both on recommendations of the Committee as well as scenarios assessed.

- **Education:** Here it is assumed that Government expenditure on education will remain a constant percentage of GDP consistent with the current ratio.
- **Health:** The policy framework provided for in the section above on Generic Financial Framework for Social Security is modelled here, reflecting the introduction of low-cost medical schemes, the conversion of the current tax rebate to an explicit subsidy for medical scheme members, the gradual mandating of cover, and the ultimate shift away from general tax funding to a universal contributory system.
- **Housing:** Here it is assumed that Government expenditure will remain a constant percentage of GDP consistent with the current ratio.
- **Retirement:** The policy framework outlined in the section above on Reform Proposals and their Financial Implications is modelled here, reflecting the shift of funding from unregulated to regulated and mandatory cover. The removal by 2005 of the means test on the state old age pension is also assumed (funded from the removal of the inequitable tax rebate for people over 65).

**Figure 22**  
Fiscal capacity over and above the existing MTEF with no negative macro-economic implications.



- **Disability:** Here it is assumed that all current areas covering disability will remain a constant proportion of GDP.
- **Children:** The extension of the CSG in accordance with the medium- to long-term income support scenarios examined earlier is assumed here. It is assumed that a gradual extension of the CSG will occur including older age categories. Coverage for children up to 18 years is assumed to be implemented by 2005 (with a delayed take-up).
- **Adult poverty:** Scenarios consistent with the medium- to long-term income support scenarios are provided with a “solidarity grant” introduced in 2006 (with a delayed take-up).
- **Unemployment:** Here it is assumed that Government expenditure on unemployment will remain a constant percentage of GDP consistent with the current ratio.

- **Survivors:** Here it is assumed that Government expenditure will remain a constant percentage of GDP consistent with the current ratio.

## 14.12.2 Results

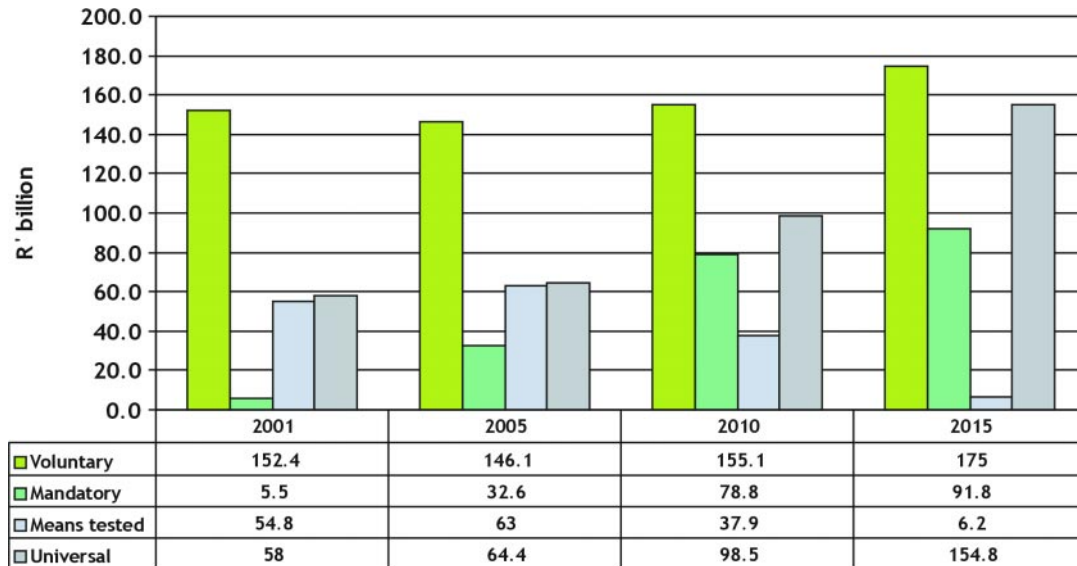
The reforms show that overall expenditure on social security (both public and private) increases in real terms from R270,6 billion (30.1 percent of GDP) in 2001 to R427,8 billion (32,4 per cent of GDP) in 2015, largely in accordance with growth in the economy (figures 23 and 24, and table 13). Overall there is an additional 2,3 per cent of GDP spent on social security, primarily as a result of expected increases in the cost of private voluntary cover for social security benefits.

The most significant change over the period involves the increase in mandatory forms of contributory social security cover and universal benefits offered directly by the government. The former primarily involve healthcare and

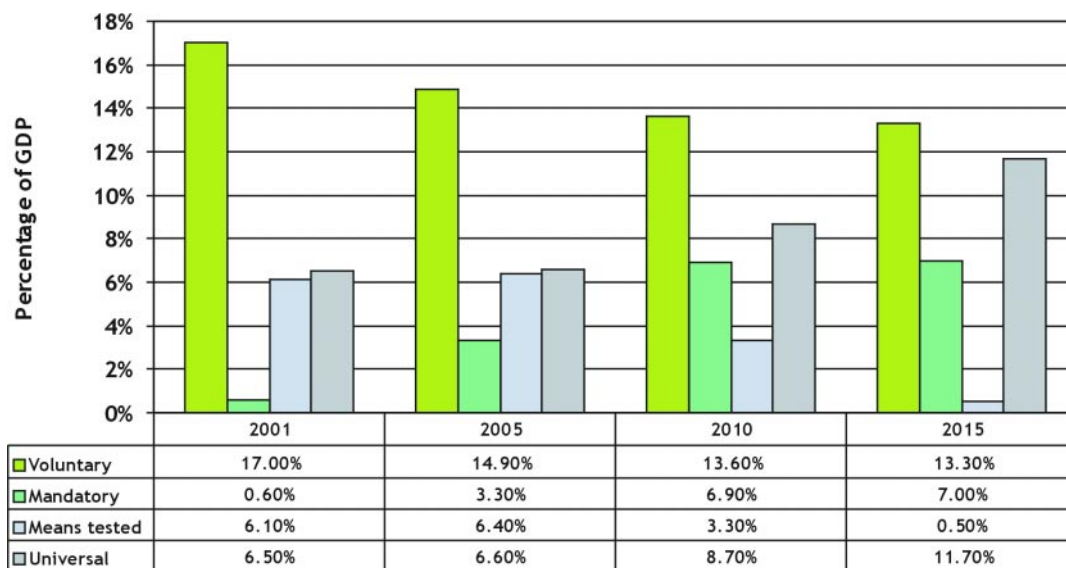
**Table 14**  
Social security expenditure in 2015 if all the maximum scenarios evaluated by the Committee are implemented

		Total	Contributory				Non-contributory			
	<i>R' billion</i>	427,8	266,7				161,0			
	<i>% of GDP</i>	32,4%	20,2%				12,2%			
Contingency			Voluntary		Mandatory		Means tested		Universal	
	<i>R' billion</i>	427,8	175,0		91,8		6,2		154,8	
	<i>% of GDP</i>	32,4%	13,3%		7,0%		0,5%		11,7%	
			Not regulated	Regulated	Social Insurance	National Insurance	Social transfers	In-kind benefits	Social transfers	In-kind benefits
Total	<i>R' billion</i> <i>% of GDP</i>	427,8 32,4%	145,0 11,0%	30,0 2,3%	31,1 2,4%	60,6 4,6%	6,2 0,5%	0,0 0,0%	69,7 5,3%	85,1 6,5%
Education	<i>R' billion</i> <i>% of GDP</i>	77,5 5,9%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	77,5 5,9%
Health	<i>R' billion</i> <i>% of GDP</i>	88,6 6,7%	0,0 0,0%	30,0 2,3%	0,3 0,0%	58,2 4,4%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%
Housing	<i>R' billion</i> <i>% of GDP</i>	7,6 0,6%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	7,6 0,6%
Retirement	<i>R' billion</i> <i>% of GDP</i>	96,1 7,3%	47,4 3,6%	0,0% 0,0%	26,4 2,0%	0,0% 0,0%	1,4% 0,0%	0,0% 0,0%	22,3 1,7%	0,0% 0,0%
Disability	<i>R' billion</i> <i>% of GDP</i>	20,7 1,6%	12,8 1,0%	0,0% 0,0%	0,5 0,0%	1,2 0,1%	6,2 0,5%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%
Children	<i>R' billion</i> <i>% of GDP</i>	26,2 2,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	26,2 2,0%	0,0% 0,0%
Adult poverty	<i>R' billion</i> <i>% of GDP</i>	21,2 1,6%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	21,2 1,6%	0,0% 0,0%
Unemployed	<i>R' billion</i> <i>% of GDP</i>	47,6 3,6%	43,8 3,3%	0,0% 0,0%	3,8 0,3%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%
Survivors	<i>R' billion</i> <i>% of GDP</i>	42,3 3,2%	41,0 3,1%	0,0% 0,0%	0,1 0,0%	1,2 0,1%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%	0,0% 0,0%

**Figure 23**  
**Social security policy evaluation for the period 2001 to 2015**  
**expenditure in constant 2001 prices.**



**Figure 24**  
**Social security policy evaluation for the period 2001 to 2015:**  
**expenditure expressed as a percentage of GDP.**



retirement, while the latter involve the removal of the means test on the state old age pension, and other poverty measures becoming more universal. 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 affect on the fiscal framework.

The reform path assessed is affordable when seen from a long-term perspective, as all improvements in the social security system occur broadly within current macroeconomic constraints. No significant changes in the proportion of GDP allocated to social security are required if these scenarios are implemented. In particular, the implementation of a universal system of social assistance grants in key areas becomes both feasible and affordable. Importantly, the restructured social security system removes gaps in coverage that exist in the present, without changing the overall proportion of GDP used.