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.