



BRIEFING BY THE FINANCIAL AND FISCAL COMMISSION ON THE 2016 MEDIUM TERM BUDGET POLICY STATEMENT

Friday, 04 November 2016

For an Equitable Sharing of National Revenue

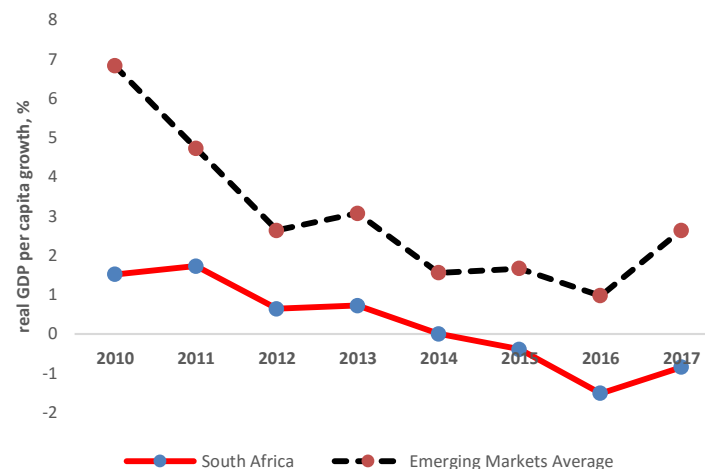
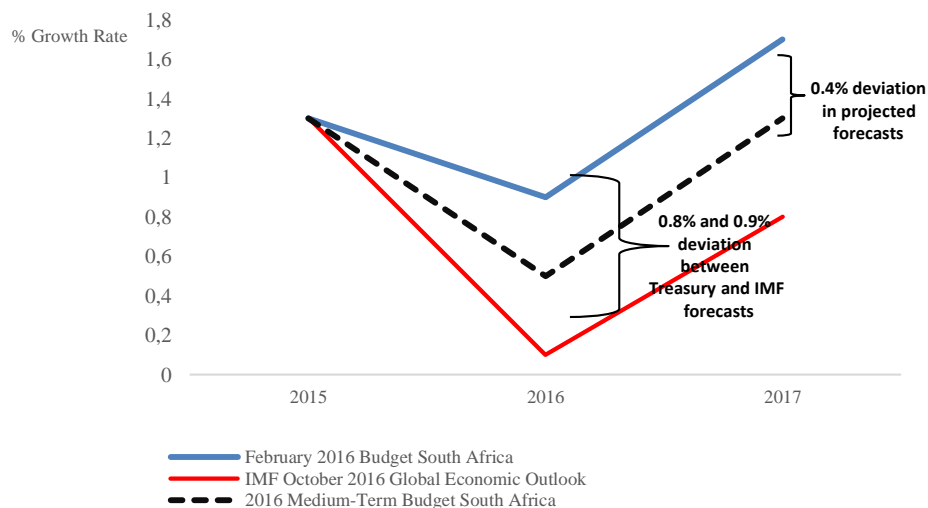
BACKGROUND

- This submission on the 2016 MTBPS is made by the Commission in terms of:
 - Section 4 (4c) of the Money Bills Amendment Procedure and Related Matters Act (MBAPRMA) (2009), which requires Committees of Parliament to consider FFC's recommendations when dealing with money bills and related matters
 - Part 1 (3) {1} of the FFC Act (2003) as amended, which provides for the Commission to act as a consultative body and make recommendations to organs of state in all spheres on financial and fiscal matters

BACKGROUND [CONT.]

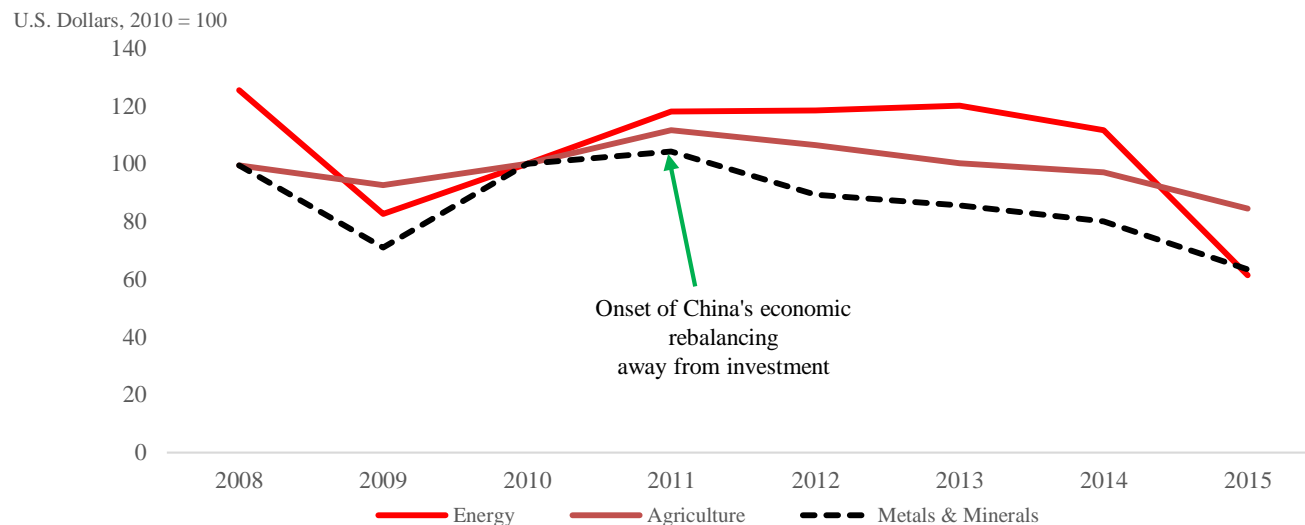
- The 2016 MTBPS has been crafted in a severely constrained environment characterised by downward economic growth forecasts and government's debt-to-GDP ratio having doubled since the global economic crisis in 2009
- Low economic growth places pressure on tax revenue growth and this has necessitated tighter spending to ensure that debt does not become unsustainable
- Government has also had to contend with severe pressure from students to spend more on higher education and to ensure fee-free education
- Overall, the 2016 MTBPS re-affirms and reflects the major thrust and spirit of the recommendations that the Commission has been making since the onset of the global economic crisis:
 - Over the MT, **government should continue with a gradual programme of fiscal consolidation** that entails reducing moderately but consistently the budget deficit. Such efforts to preserve fiscal sustainability must be sustained in future, even with addition of longer-term programmes such as proposals for NHI
 - **Government tabling of a Risk Report** for the first time should be commended
 - Encouraging that despite fiscal consolidation, social services protected

2016 OUTLOOK: WALKING AN ECONOMIC TIGHTROPE



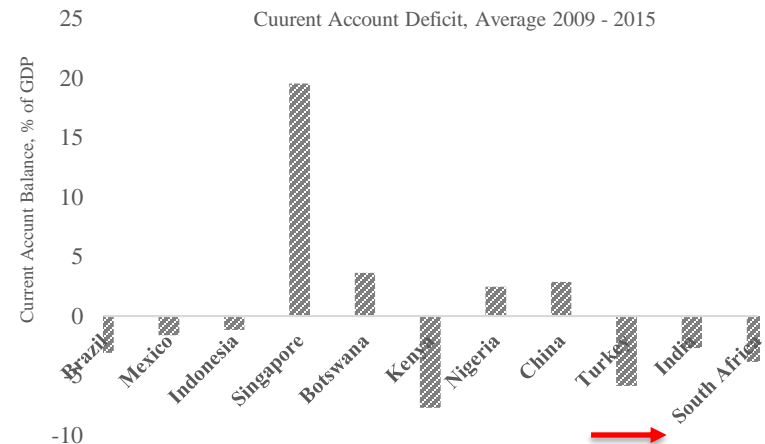
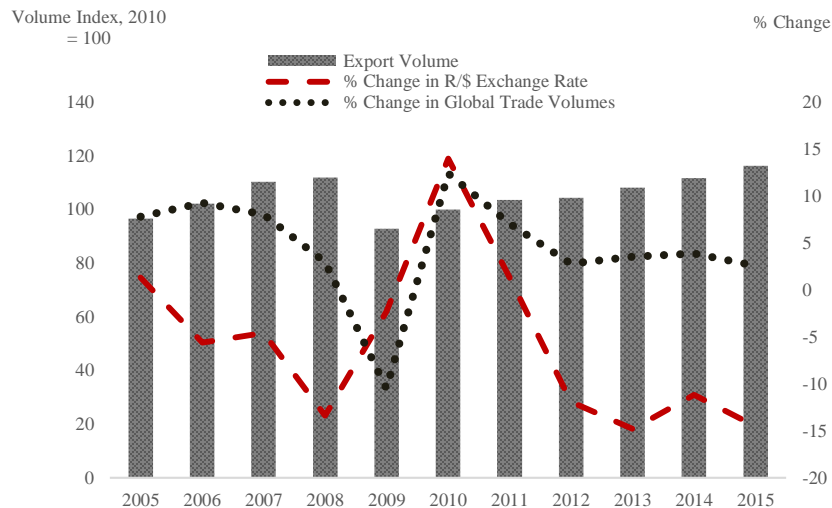
- Medium term budget mirrors Commission's previous severe scenario of protracted slow global growth feeding into South Africa's economy
 - Between 2015 and 2017, economic growth is less than 1.5% while its per capita income growth is markedly less than those obtained in peer emerging market economies

WHY THE TIGHTROPE? EXTERNAL DYNAMICS [1 OF 2]



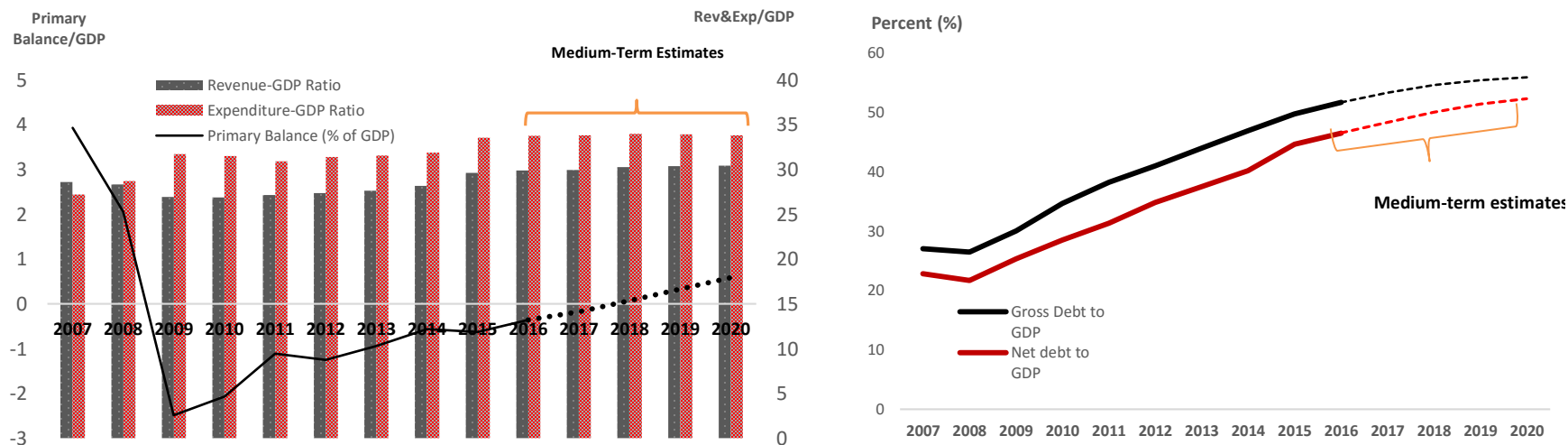
- In the main, major spillover from significant reliance on a Chinese economy that is rebalancing
 - Chinese shift to consumption-led growth + overcapacity in certain sectors (energy, construction) = dampened commodity prices (**50% of SA's total exports to China**)
 - Impact amplified by intersectoral linkages (corporate profitability and non-mining employment)

WHY THE TIGHTROPE? EXTERNAL DYNAMICS [2 OF 2]



- Notable depreciation of the Rand, but no appreciable impact on export
 - Reflective of slowing global trade volumes and declining export growth relative to pre-2008 period
- Main outcome: **rising current account deficit** and **increased borrowing requirements**

NOTABLE IMPACT ON DEBT PROFILE

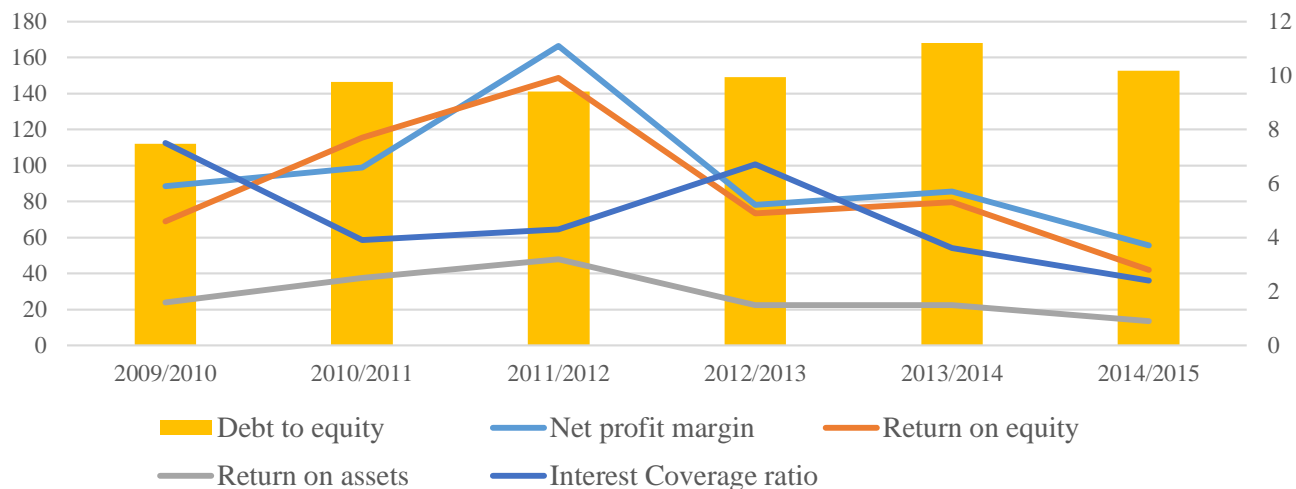


- Ongoing process of fiscal consolidation aimed at stabilising debt levels. HOWEVER burden of addressing economic vulnerabilities within low growth environment disproportionately borne by fiscal policy
- Upward revision in debt-to-GDP ratio (implications for borrowing costs, direct investment flows and further currency depreciation)

DOMESTIC DYNAMICS: STATE OWNED ENTERPRISE

- The 2016 Budget outlines four areas of reform to strengthen state owned enterprises (SOEs): 1) financial and operational stabilization 2) coordination and collaboration among different entities 3) rationalization and consolidation 4) the enactment of a new governance framework
- PetroSA, SAA, SAPO, Eskom and SANRAL are still hamstrung by inefficient operations, poor governance, and weak balance sheets. This highlights the need for more comprehensive and extensive reforms in order to ensure that SOEs deliver essential economic and social services that will enhance growth and the fiscal outcomes
- Given their strategic position in network industries and their role in carrying out the government's infrastructure build program, SOEs play an important role in the economy, particularly in enabling the environment for the private sector investment

SOE PERFORMANCE 2009/10 – 2014/15



The financial performance of most SOEs has deteriorated. Their profitability and leverage have worsened. Shocks to borrowing costs and earnings could undermine their own ability to service debt and the containment of government debt through contingent liabilities

❑ PetroSA, SAA and SAPO are recording losses and their dependence on government guarantees has increased to R553bn or 14% of GDP in 2015/16 from R177bn or 8% of GDP in 2007/08

RISK REPORT

- The Commission's 2010's submission proposed a “multi-pronged” strategy to take long-term fiscal concerns into account in the short to medium-term. The tenets of this were to include a budget process and framework more clearly recognizing long-term fiscal risks that builds on existing work, strengthened analytic approaches and a blend of aggregate fiscal rules
 - It is in this regard that the Commission welcomes that Government has for the first time tabled a Risk Report with the MTBPS which was the next step following guidelines for fiscal sustainability aimed at protecting fiscal gains for future generations
- The Commission is of the view that fiscal risks identified including pressures on public sector wages, infrastructural underspending and the possibility of renewed depreciation in the exchange rate, increasing age profile of the country and the realigned low economic growth of under 2% over the longer term are indeed the pressing ones. These impact on public spending and the ability of the country to sustain a stable debt path

OVERVIEW OF 2017 FISCAL FRAMEWORK

	2013/14	2014/15	2015/16	2016/17		2017/18	2018/19	2019/20
R billion/% of GDP	Outcome			Budget	Revised	Medium-term estimates		
Main budget								
Revenue	887	965	1 075	1 162	1 144	1 249	1 360	1 482
Expenditure	1 048	1 132	1 245	1 318	1 309	1 410	1 522	1 652
of which								
Non-interest allocations	947	1 017	1 116	1 165	1 161	1 240	1 331	1 435
Debt-service costs	101	115	129	148	148	164	181	197
Contingency reserve	0	0	0	6	0	6	10	20
Main budget balance	-160	-166	-169	-156	-165	-161	-162	-170
	-4.4%	-4.3%	-4.1%	-3.6%	-3.8%	-3.4%	-3.2%	-3.1%
Primary balance	-59.2	-51.6	-40.6	-8.6	-17.3	2.7	18.5	27.6
	-1.6%	-1.3%	-1.0%	-0.2%	-0.4%	0.1%	0.4%	0.5%
Budget balances of social security funds, public entities and provinces	25	29	17	17	15	14	24	31
Consolidated budget balance	-136	-137	-152	-139	-150	-147	-138	-139
	-3.7%	-3.6%	-3.7%	-3.2%	-3.4%	-3.1%	-2.7%	-2.5%

- Government is expected to spend R4.584 trillion over the 2017 MTEF period, relative to a revenue envelope of R4.091 trillion
 - Over the 2017 MTEF expenditure is projected to increase by a real annual average of 2% per annum with relatively stronger real annual average growth of 2.9% projected for revenue

PROPOSED DIVISION OF REVENUE AMONGST THE THREE SPHERES

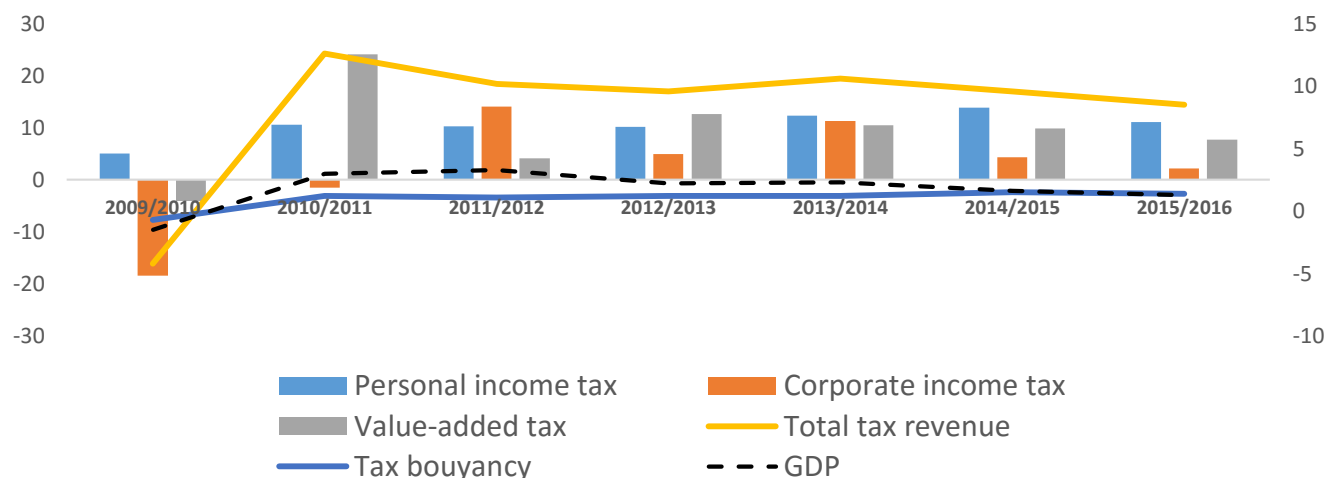
	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	Real Annual Average Growth 2017/18-2019/20
R billion	Outcome			Revised	Medium-term estimates			
<i>Division of available funds</i>								
National departments	453	490	546	560	590	631	682	0.8%
Provinces	411	440	471	501	538	579	621	1.4%
Equitable share	336	360	387	411	441	472	506	1.2%
Conditional grants	74	80	85	90	97	107	115	2.5%
Local government	83	88	98	105	113	121	132	2.0%
Equitable share	39	42	49	53	57	63	69	3.5%
General fuel levy sharing with metropolitan municipalities	10	10	11	11	12	12	13	-0.4%
Conditional grants	34	36	38	41	44	46	50	0.6%
Total	947	1 017	1 116	1 165	1 240	1 331	1 435	1.2%
<i>Percentage shares</i>								
National departments	47.9%	48.2%	48.9%	48.0%	47.5%	47.4%	47.5%	
Provinces	43.4%	43.2%	42.2%	43.0%	43.4%	43.5%	43.3%	
Local government	8.7%	8.6%	8.8%	9.0%	9.1%	9.1%	9.2%	

- Division of revenue amongst three spheres will generally be characterised by low growth increases over 2017 MTEF
 - Main driver of growth are allocations to municipalities
 - Proportion of resources to LG sphere increases from 8.7% to projected 9.1% in 2017/18

REVENUES AND TAX PROPOSALS

- The growth of gross tax revenue has decreased significantly from a peak of 12.2% in 2011/12 to 8.5% in 2015/16, the lowest growth rate recorded after the global financial crisis
- The 2016 MTBPS proposes to raise an additional R28 billion in 2017/18 and R15 billion in 2018/19. The specific tax proposals will be elaborated upon in the 2017 Budget
- There is a strong correlation between tax revenue and economic growth as tax revenues rise and fall in tandem with economic growth. The recent poor economic performance and outlook effectively represents a critical constraint to fiscal consolidation that is partially premised on tax revenue growth

REVENUE PERFORMANCE 2009/10 – 2014/15



- The major constraints in raising tax revenue are narrow tax bases and a concentrated industrial structure that results in highly concentrated industries with large rents prominent in the financial services and mining sectors
- VAT is raising revenue comparable to that of OECD countries but reducing the number of items with preferential tax treatment or improving compliance could raise the VAT revenue ratio and consequently the VAT revenue
- Since consumption taxes are one of the more growth-friendly forms of taxation and given that the current VAT rate is relatively low, there is scope to raise additional revenue using the VAT

UNALLOCATED RESOURCES

- Government has adopted a new policy of keeping unallocated reserves consistent with forecasts in the 2016 Budget
 - Previously there were significant drawdowns on allocated reserves to accommodate new priorities
- Even though the amount being put aside (R 6 billion in 2016/17, increasing to R15 billion in 2018/19) is still relatively small, the Commission welcomes this move as it provides the fiscus with some room to manage ongoing fiscal pressures. It is also in line with a recommendation the Commission made at the time of the 2015 MTBPS

Adjustments to the unallocated reserves, 2013/14-2017/18

R' billion	2014/15	2015/16	2016/17	2017/18	2018/19
Budget 2014	3	6	18		
MTBPS 2014		5	15	45	
Budget 2015		5	15	45	
MTBPS 2015			2.5	9	15
Budget 2016			6	10	15
MTBPS 2016			6	10	15

EXPENDITURE BY ECONOMIC CLASSIFICATION

- The compensation budget outpaces inflation by 1% on average over MTEF period
 - Growth in compensation is marginally lower than forecasted at the time of Budget 2016 largely as a result of steps being taken to manage the wage bill such as reducing headcounts in administrative and management posts in the main
- In its efforts to strengthen the link between pay and performance, Government should note a recommendation in the Commission's Submission on the 2016/17 DoR which called for a framework for measuring productivity as a first step to benchmark improvements in the public sector overtime

R' billion	2015/16	2016/17	2017/18	2018/19	2019/20	Real Annual Average Growth Rate
Compensation of employees	472.8	515	549.4	587	629.7	1.0%
Goods and services	190.9	204.5	219.7	234.6	249.9	0.7%
Transfers and subsidies	441.4	402.5	436.5	464.3	499.2	-3.1%
Payments capital assets	102.6	101.1	104.4	109.2	117.9	-3.0%
Real Year on Year Growth (%)	2014/15-2015/16	2015/16-2016/17	2016/17-2017/18	2017/18-2018/19	2018/19-2019/20	
Compensation of employees		2.5%	0.6%	0.9%	1.5%	
Goods and services		0.7%	1.3%	0.9%	0.7%	
Transfers and subsidies		-15.2%	2.3%	0.5%	1.7%	
Payments capital assets		-7.9%	-2.8%	-1.3%	2.2%	

EXPENDITURE PRIORITIES

- Total consolidated government spending is expected to grow by 1.6% in real terms
- New revenue baseline additions have been used to protect social spending against inflation
 - Health and social service allocations grow the highest at 2% in real terms
 - Basic education budget increase by 1.1% in real terms
- Lower baseline increase will affect expansion of services and quality of services
- Budget reprioritisation at national level must be accompanied by sectoral reprioritisation and expenditure reviews

EXPENDITURE PRIORITIES

- Economic services account for 14% of total spending in 2017
 - Experience a negative growth rate of 1.1%
 - Emphasis should be placed on improving the quality of expenditure outcomes – to boost growth
- The Commission notes with concern the displacement of resources and pressure placed on protection services allocation by protest actions
 - A more proactive approach to dealing with community protests could free resources for use by other priorities

EXPENDITURE PRIORITIES: POST SCHOOL EDUCATION AND TRAINING

- The Commission welcomes the extra R5 billion in 2017/18 and R18 billion over MTEF made available to address post school education and training (PSET) funding concerns
- Higher education is fastest growing expenditure line item in 2017/18
- Demands for bigger PSET allocations must be accompanied by policy changes...‘not just money’
 - The Heher Commission report will be useful in clarifying this policy changes
- The Commission’s costed norms can be useful in implementing changes to the funding formulas

EXPENDITURE PRIORITIES: JOB CREATION

- The Commission welcomes the results of government direct job creation schemes and private sector investment incentives
- Incentives and job creation schemes alone cannot reduce unemployment
 - Attention should be placed on improving quality of education, increasing attainment levels and removing investment constraints associated with a centralised economic structure
- Further attention must be placed on improving the design of Public Employment Programmes (PEPs) and their labour market outcomes

CONDITIONAL GRANT ADJUSTMENTS

[1 OF 2]

- The Commission notes reductions made to conditional grant baselines
 - Reductions were necessitated by the weak economy
 - Most of the reductions kept to minimum to mitigate adverse effects on service delivery
- HIV, AIDS and TB grant reduced by 0.57% only
- The few welcome cases where allocations are increasing
 - Additional R390 million for National School Nutrition Programme (NSNP)
 - R307 million for rehabilitating schools in Vuwani

CONDITIONAL GRANT ADJUSTMENT

[2 OF 2]

- Government must use the low revenue environment to introduce the necessary conditional grant reforms recommended by the Commission
 - On Housing – Government must expedite the process of municipal accreditation and encourage coordinated planning
 - On Health – streamline the process for transferring funds between indirect and direct component of conditional transfers
 - On Education – align the provincial and national quintile classification with NSNP

REVIEW OF ACTUAL SPENDING

[1 OF 2]

- Expenditure smoothing implies government spending that is evenly distributed across the four quarters of the financial year
 - If such smoothing were to occur, it would be expected that total expenditure up to September would be at 50% of the main budget
- Highlights based on analysis of aggregate spending and percentage spent six months into the 2016/17 financial year indicate:
 - Total government spending (49%), spending by all votes (49%) and transfers to the PES (50%) are close to the assumed norm of 50%

REVIEW OF ACTUAL SPENDING

[2 OF 2]

- Notwithstanding overall positive performance, an assessment of individual departmental performance shows somewhat uneven spending patterns
 - On the one hand certain departments far exceed the norm (Higher Education and Training spent 68% of its budget) whereas others such as the Human Settlements and Rural Development and Land Reform have recorded spending of 42% and 43% respectively
 - Excessive deviations below or above the norm is undesirable from an expenditure smoothing perspective. Unless a department's annual performance or strategic plan explicitly identifies under or over spending as a chosen spending profile, departments should attempt to remain within the confines of spending performance guidelines

TOTAL ALLOCATIONS TO LOCAL SPHERE

- The main transfer streams to the local government sphere are conditional grants and the LES
 - Allocations to the local government sector continue to increase both in nominal and real terms
 - Real annual average growth rate for transfers to local government over the 2017 MTEF is 2% and the LES is expected to grow faster (at 3.5%) than local government conditional grants and the fuel levy allocations, which grow at 0.6% and -0.4% respectively
 - **The LES:** The Commission welcomes the redistribution of resources through the LES as it enables municipalities to fulfil their constitutional mandate of affording poor members of society with basic services
 - Over the 2017 MTEF period, the sector is expected to receive an additional R16.7 billion through the LES or it will grow by 8.5% in 2017/18, 10 percent in 2018/19, and 10.4% in 2019/20 (in nominal terms)

LOCAL GOVERNMENT CONDITIONAL GRANTS

- Over the 2017 MTEF, local government (LG) conditional grants will receive an additional R8.7 billion
 - The Commission notes subdued growth (0.6% average real growth rate) in LG conditional grants over the 2017 MTEF, which is understandably part of the fiscal consolidation process
 - The Commission notes reductions in the public transport network grant, the water services infrastructure grant, the municipal infrastructure grant and the urban settlements development grant, and understands the motive behind these reductions
 - However, the Commission reiterates its previous recommendation that the historical performance of a grant should be taken into account, before a decision on grant reductions is made. In principle, the Commission supports reprioritisation of funds provided they are from historically underperforming grants, that service delivery is not affected and plans to improve grant performance are put in place
 - The Commission supports the proposal to absorb the Integrated National Electrification Programme (INEP) municipal grant in metropolitan municipalities into the USDG as this will ensure a holistic approach to the delivery of electricity infrastructure and contain the proliferation of grants
- This will also curb the current uneven and disintegrated manner in which electrification projects are funded in cities

REVISED DIVISION OF REVENUE 2016/17

[1 OF 2]

- Declared unspent funds amount to R1.3 billion in 2016/17, which is a significant decline when compared to R3.18 billion declared in the 2015/16 revised division of revenue
- There is R3 billion projected underspending
- Roll-overs amount to R412 million
 - This represents a substantial decrease when compared to 2015/16, when R1.6 billion worth of roll-overs was declared
 - The decline in rollovers suggests that government is exercising stricter controls with respect to monitoring expenditure and rollover requests
 - The Department of Transport has the largest roll-over, amounting to R275.7 million
 - The Department of Cooperative Governance and Traditional Affairs has drastically improved and reduced the extent of its roll-overs from R1.5 billion in 2015/16 to R27.9 million in 2016/17

REVISED DIVISION OF REVENUE 2016/17

[2 OF 2]

- A rollover has been granted for a total of R275.7 million in respect of the provincial Roads Maintenance grant in KwaZulu-Natal
 - The Commission however, submits that grant funding rolled over for roads maintenance which is an infrastructure-related project, suggests possible implementation and project management weaknesses
 - Furthermore, rollover of grant for road maintenance means postponing road maintenance
 - The Commission emphasises the importance of regular road maintenance as well maintained roads make a crucial contribution to economic development and growth
- Unforeseen and unavoidable (U&U) expenditure amounts to R1.2 billion. The departments that dominate the U&Us are: International Relations and Cooperation (R950 million) and Basic Education (R179.9 million)

CONCLUSION [1 OF 2]

- Lower than forecast growth has compelled Government to raise budget deficits in the 2016 MTBPS
- The Commission fully supports Government's new position on 'gradual' fiscal consolidation and tabling of Risk Report which is in line with previous Commission recommendations and tightening measures to maintain expenditure sustainability
 - Moderates rise in public debt and debt servicing costs while limiting negative impact on future growth and protects much needed social services
- Measures to improve running of SOE's with a view to improving service delivery and limit government's potential liability (guarantees) supported
- More needs to be done to reignite higher economic growth consistent with NDP and also requires structural reforms

CONCLUSION [2]

- The political economy challenge of dealing with long-term fiscal policy issues in relation to free higher education requires provocation of public debate on long-term fiscal challenges
 - Policy pronouncement on free education by Government will be a big positive step in this direction. Pertaining to fairness, Government should be required to publish analysis of the distributional impact of such new policies. Requiring such analysis as a rule on all new policy would be welcome, as would be a requirement to publish assessments of the inter-generational or long-term impact of policies whose effects vary over time and/or generations such as free education
- The Commission commends efforts by Government to protect conditional grants. The Commission supports the proposed conditional grant changes addressing identified weaknesses it has raised in the past and will continue engaging with government and other stakeholders in the exercise
- The proposed adjustments estimates are supported subject to matters raised by the Commission in this Submission

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