Briefing on the 2015 MTBPS by the Financial and Fiscal Commission to the Joint Meeting of the Standing and Select Committees on Finance

28 October 2015

For an Equitable Sharing of National Revenue

BACKGROUND

- The 2015 Medium Term Budget Policy Statement (MTBPS) is formulated against the backdrop of an economy ***that is vulnerable to negative domestic and external factors***
- Low, fragile growth is making it difficult to tackle the triple challenges of high social ills (unemployment, poverty and inequality), fiscal and external imbalances
  - Rising levels of impatience with deteriorating social conditions has made this one of the toughest MTBPS to craft
  - Student protests at universities culminated in a moratorium on fee increases next year that was unbudgeted for at the time of tabling the MTBPS

FINANCIAL AND FISCAL COMMISSION

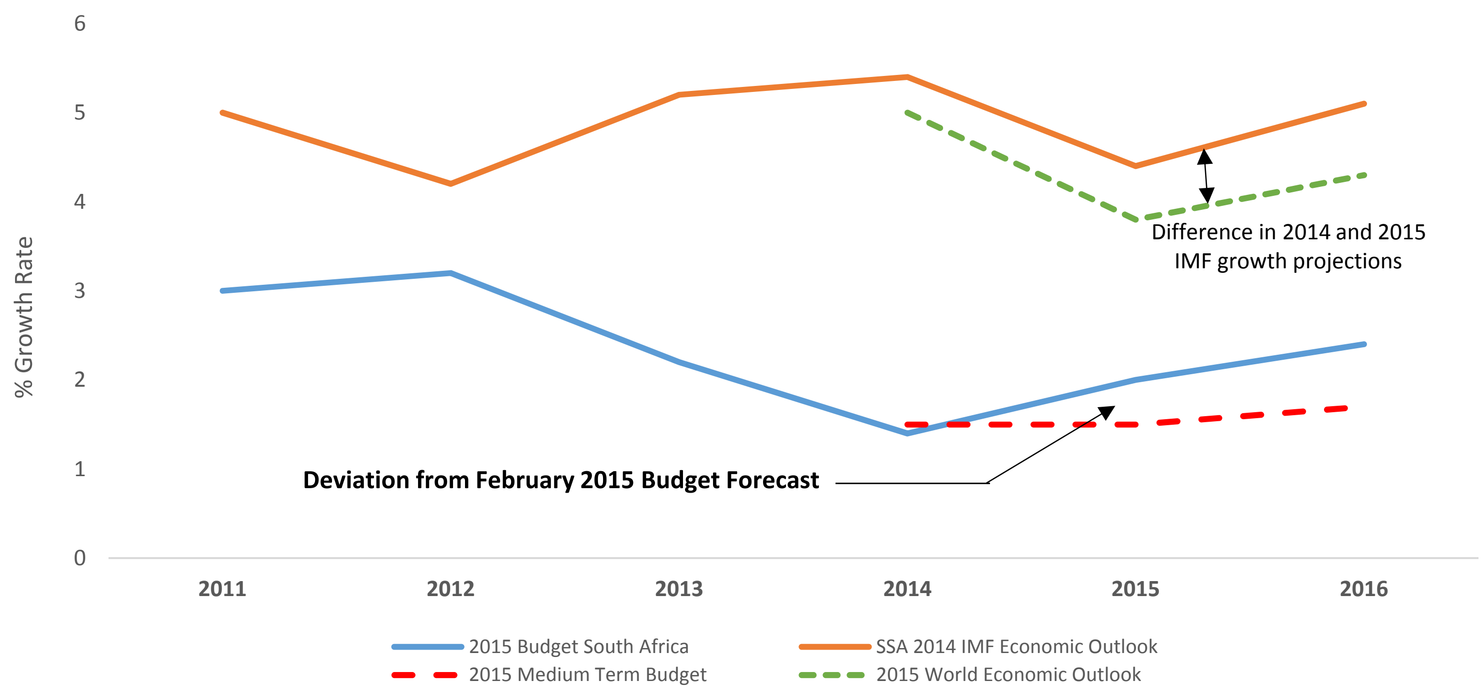
BACKGROUND [CONT.]

  - The public sector three-year wage agreement is way higher than what was allocated in the February 2015 Budget and will largely be absorbed by the cumulative contingency reserve, leaving little over to cater for unforeseen emergencies
  - Spending levels are highly constrained and exacerbated by economic shocks to gross fixed capital formation, households, continuing unemployment and increasing levels of poverty and inequities

- It is against this background that this submission on the 2015 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 pprovides for the Commission to act as a consultative body and make recommendations to organs of state in all spheres on financial and fiscal matters

FINANCIAL AND FISCAL COMMISSION

2015 Economic Outlook: Navigating Headwinds



- 2015 Budget emphasised fiscal consolidation in response to weaker than expected economic outlook
  - October 2015 MTBPS will occur against the background of further downward revisions to economic prospects of South Africa’s economy.

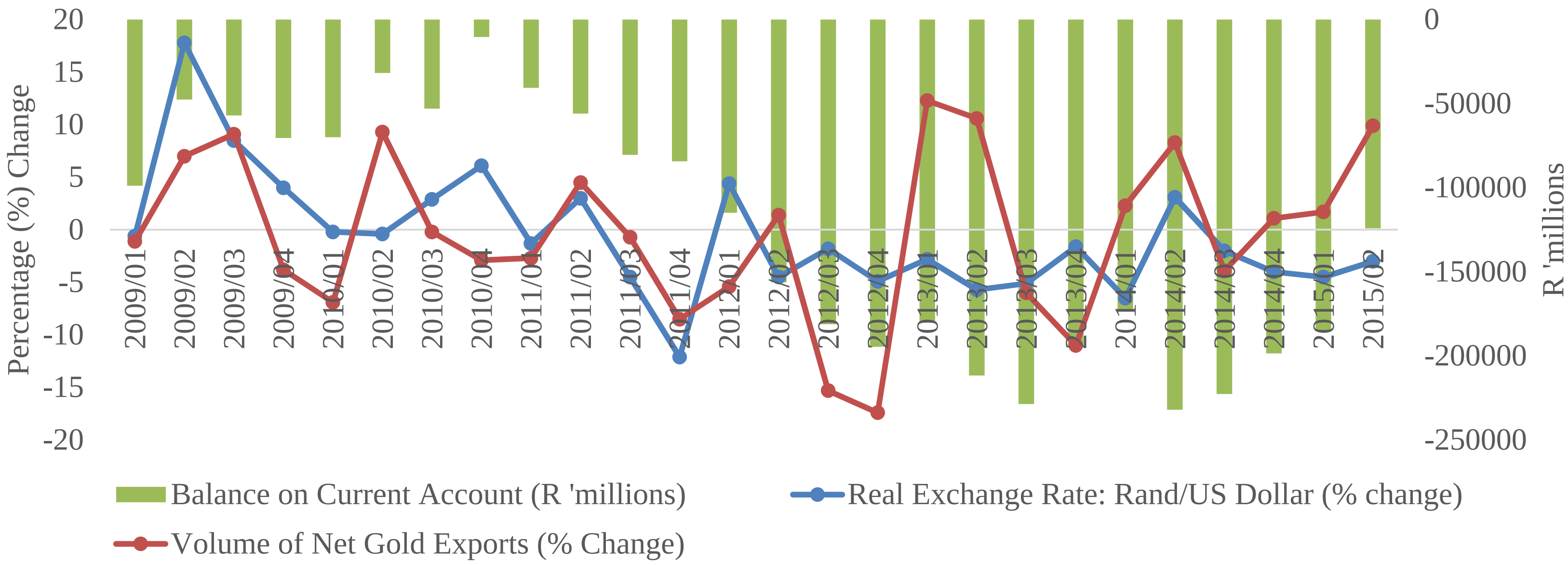
FINANCIAL AND FISCAL COMMISSION

Main Issues Around Economic Outlook

- Based on the International Monetary Fund's October 2015 projections, South Africa's GDP growth will be 0.5 and 0.7% lower than originally forecast in February 2015 Budget.
- Dampened growth projections driven by internal and external dynamics
  - Externally: Volatile global economic conditions in which modest growth in advanced economies of Europe, North America and Japan has been tempered by economic distress in a number of emerging market and developing economies. The result is that in 2015 and 2016, respectively, global economy is expected to grow at 0.2% point below initial 2015 forecasts.
  - Internally: structural dynamics of South Africa's economy; labour market productivity and relations, and continued concern around South Africa's capacity to address pressing key infrastructure challenges

FINANCIAL AND FISCAL COMMISSION

RECENT EXTERNAL DEVELOPMENTS IMPACTING ON SA'S GROWTH PROSPECTS



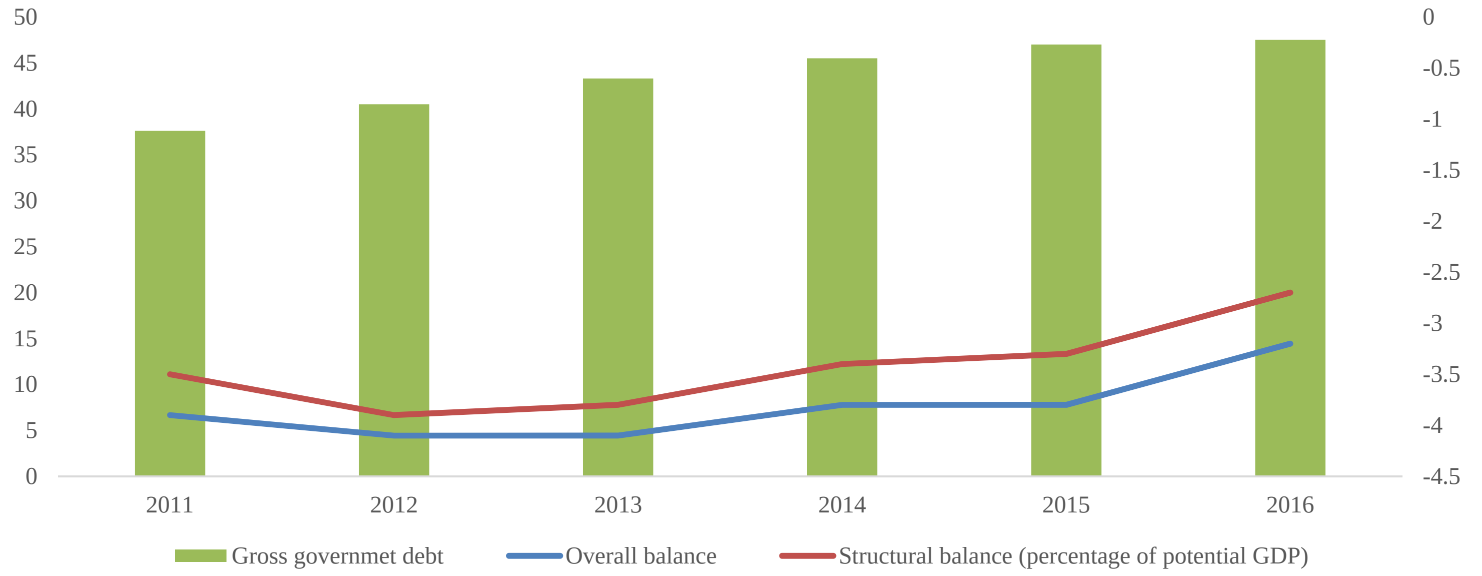
- Depreciation of Rand has coincided with declining growth in net gold exports widening current account deficit
  - Slow growth in economies of major trading partners and significant drop in commodity prices limited positive effect of depreciation
  - Depreciation exacerbated reversal in U.S. interest rate policy and deceleration in growth of China's economy which accounts for 15% and 80% of South Africa's total exports and commodity exports, respectively.

INTERNAL DYNAMICS IMPACTING ON SA'S GROWTH PROSPECTS

- Severe pressure faced by mining industry
  - Significant drop in China's imports (14.6%) affecting South Africa for which over 80% of exports to China are commodities based
  - Currency depreciation offset by declining prices (platinum, gold, iron ore and coal) and slide in output.
  - Despite business, government and union compact, industrial tensions remain affecting productivity and heightening uncertainty
- Infrastructure bottlenecks remain
  - Need to solve electricity supply constraints still a top priority
  - More coordinated policies to enhance SMMEs and address skills mismatch within labor market.
  - Enhance efficiency of infrastructure spend across the three spheres of government.

FINANCIAL AND FISCAL COMMISSION

FISCAL AND PUBLIC DEBT OUTLOOK



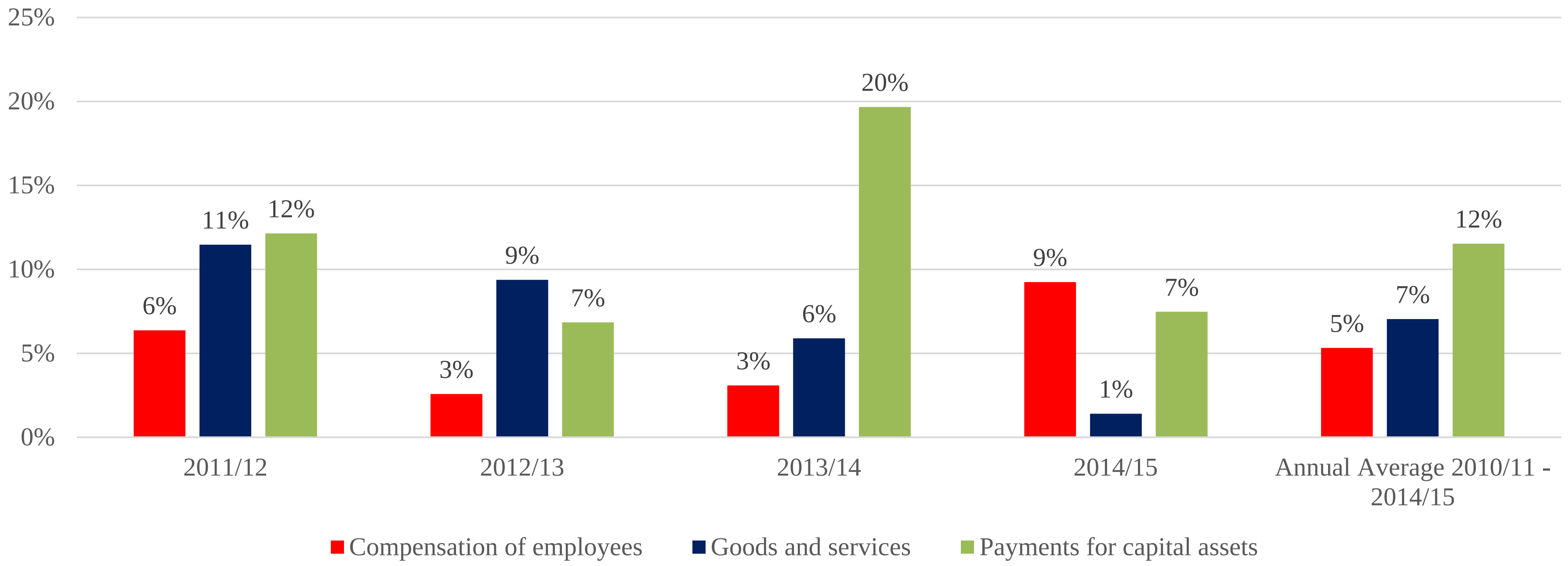
- 2015 MTBPS contains an upward revision in net debt/GDP ratio (45.7% compared to 2015 Budget of 43.7%)
- Progressive decline in primary balance that suggests Government sticking to its plans to reduce its debt costs and overall budget deficit..

RISKS TO FISCAL OUTLOOK

- Risks to the fiscal outlook in the medium term:
  - Further deterioration in economic growth,
  - Very limited room to respond to unexpected/unplanned spending pressure or revenue underperformance
  - Weak financial positions of several major public entities
- Measures to manage these risks:
  - Alleviating short-term power constraints, and limiting delays to additional generation capacity coming online
  - Implementing reforms to public sector remuneration framework
  - Working with state-owned entities to develop and implement realistic turnaround plans
- A manifestation of any one of the risks to the fiscal outlook could result in fiscal slippage given the precarious fiscal position

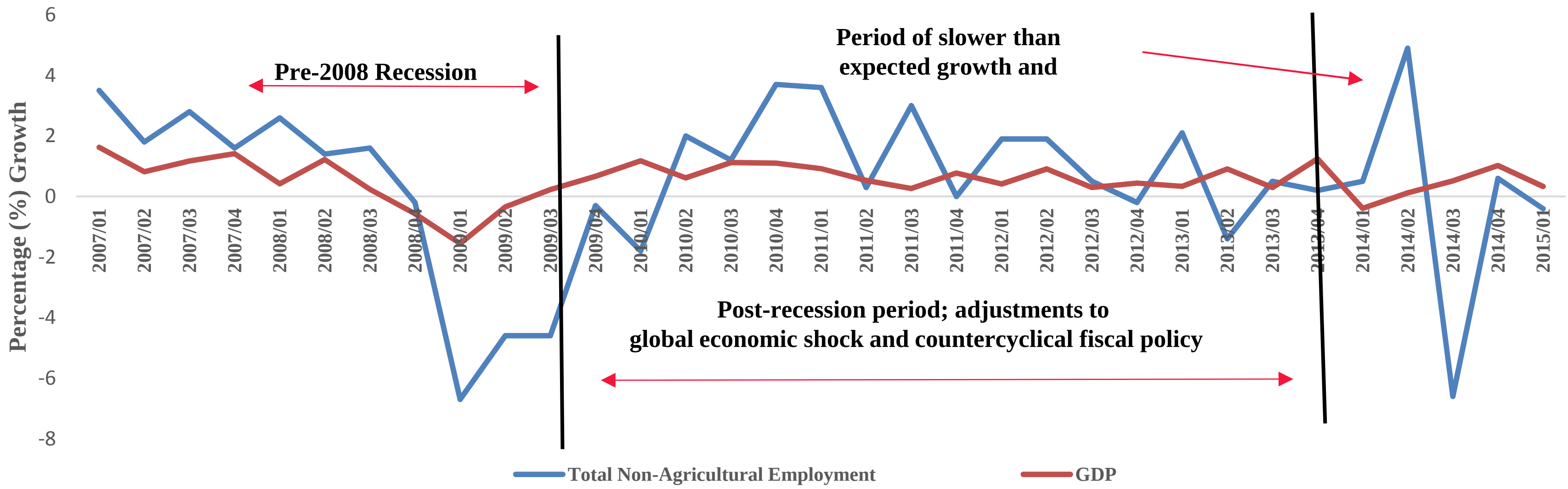
FINANCIAL AND FISCAL COMMISSION

Areas of Risk To Fiscal Frameworks: Wage Bill Challenge



- Absolute growth in public sector wage bill despite relative declines in headcount at national and provincial levels.
  - Current above-inflation increases has wiped out contingency reserve of R65 billion; while growth in public (and private) sector remuneration has outstripped total labour productivity
  - To ensure sustainability of wage bill and guarantee fiscal stability need for fundamental reforms that link public sector remuneration with performance and productivity – work of the PRRC will be welcome in this regard

CURRENT ECONOMIC OUTLOOK AND SOUTH AFRICA'S LABOUR DYNAMICS



- End of stimulus/countercyclical policy in 2013 has caused a reversal in South Africa's unemployment trajectory
  - Slow economic growth limits Government's strategy to address significant labour surplus, especially for low-skilled segment of the working population
  - Raising job creation potential and addressing skills mismatch important, BUT appropriate balance needed between workers right and economic efficiency
  - Greater flexibility and decentralization, especially with respect to regulations governing small enterprises and collective bargaining arrangements in the public and private sectors

Higher Education and Training and Recent Developments

- Spending prioritisation framework proposed in MTBPS 2015 poses a challenge in terms of addressing government's resolution to implement a 0% fee increase in 2016
- There are **short term** implications with respect to the 0% fee increase for 2016 and **longer term** considerations around the broader issue of free tertiary education
  - **Short term considerations**: Issue revolves around finding the resources to respond to the R2.5 – R4 billion shortfall that the zero fee increase will result in
    - Option A: universities to reduce their expenditure – may compromise the standard/quality of education (in the form of fewer purchases of academic materials from abroad, less maintenance work at institutions and/or less funding for research) therefore not a desirable option

FINANCIAL AND FISCAL COMMISSION

Higher Education and Training and Recent Developments

- Option B: state to intervene with financing
  - Sub-option 1: Reprioritisation within the DHET itself and thereafter, more broadly across government
  - Sub-option 2: Utilising the unallocated (contingency) reserves
    - » Due to higher than anticipated public sector wage increases, unallocated reserves have been significantly reduced to the extent that only R2.5 billion has been set aside for 2016/17
    - » Some of the R4 billion shortfall could be financed utilising these reserves - risk is that should any natural/other disasters strike during 2016, there would be no cushion available to Government
  - Sub-option 3: Sale of state assets –same approach was used to fund the R23 billion equity injection to Eskom
    - » Attractive feature of this approach is that it demonstrates commitment to fiscal consolidation as steps to avoid increasing the budget deficit are being taken
- Sub-option one together with universities exercising greater fiscal austerity would, in the view of the Commission set the example for the private sector to respond

FINANCIAL AND FISCAL COMMISSION

Higher Education and Training and Recent Developments[cont.]

- **Long term considerations:** revolve around the provision of free education at tertiary institutions which will require a significant amount of additional funding
  - Options around financing revolve around: (a) Significantly reprioritising state funding, (b) Committed implementation of plans to sell nonstrategic assets, (c) Increasing the tax burden or (d) Borrowing
    - To estimate the implications of each of the reforms requires substantive research

- In absence of such research, the Commission past submission are instructive - conducted a budget review of SA public universities in 2012 which already alluded to the challenges currently being faced
  - The research identified that the funding framework underpinning universities is in dire need of differentiation
- On the basis of this previous research and ongoing interactions, the Commission views the following considerations are vital to a new long term funding and finance system.

FINANCIAL AND FISCAL COMMISSION

Higher Education and Training and Recent Developments [cont.]

- Additional pressures presented by limited state funding go further than just universities - the DHET is confronted by pressing contending priority areas, for example, the need to adequately fund colleges (TVET and CET) which have also been historically underfunded
- Commission supports the task team that has been set up to review the funding model underpinning the existing high university fees - the task team should consider the broader system within which universities operate and avoid a situation where shifting of high fees in one part of the system leads to pressures in another part
  - Further it is advised that a clear system of differentiation in the determination of free education be devised, but more importantly if the shift to free tertiary education is to be sustained, it is critical for government to clarify its policy stance around access to education and, more precisely the definition of free education should be determined

FINANCIAL AND FISCAL COMMISSION

CONCLUSION

- The 2015 MTBPS has been crafted in very difficult circumstances characterised by downward economic growth forecasts and rising impatience with social outcomes
  - Bearing this in mind, government has done a good job that promises a deficit reduction programme for 2015/16 and slight increase in the two outer years and thereby prevent public debt from spiralling out of control
- The Commission is of the view that:
  - MTBPS 2015 is noteworthy in one major respect in that it takes account of long-term issues in budget formulation in the form of guidelines that are a hybrid of (a) an expenditure rule, (b) a structural budget balance rule (where outer year is targeted for operational traction) and (c) a revenue rule
  - South Africa should continue to focus its strategy for reigniting growth (improving education expenditure outcomes, increasing skills bases, maintaining strong growth on social safety net spending and increasing productivity of public infrastructure)

FINANCIAL AND FISCAL COMMISSION

CONCLUSION [CONT.]

- Plans to intensify efforts to carry out expenditure reviews aimed at increasing efficiency of spending and combating waste should be supported. In particular, in-house reviews should be complemented by independent expenditure reviews
- The moratorium on university fee increases and prospects of other far reaching reforms necessitate government finding additional funding to fill gaps that were not addressed at the tabling of the 2015 MTBPS
  - The Commission's concern is with the size, direction and impact of funding higher education and the post-school system as a whole. In order to build a higher education system that endures over the long term, the past investment in the Higher Education and Training sector should be consolidated and further increased but it needs to be affordable within the current public financial pressures
- Serious concern should be expressed with regard to reduced national efforts to facilitate economic growth through infrastructure-led growth. To this end growth in the percentage of gross fixed capital formation is lower than last period

FINANCIAL AND FISCAL COMMISSION

Conclusion [cont.]

– In the medium-term, managerial interventions (controls on automatic pay progression and performance bonuses, reduction in the rate of hiring in noncritical areas) may assist government in its commitment to ensuring that the upward trend in the wage bill does not adversely impact its budget deficit targets

FINANCIAL AND FISCAL COMMISSION

FFC WEBSITE: WWW.FFC.CO.ZA