BRIEFING ON THE 2015 MTBPS BY THE FINANCIAL AND FISCAL COMMISSION TO THE JOINT MEETING OF THE STANDING AND SELECT COMMITTEES ON APPROPRIATIONS

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

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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

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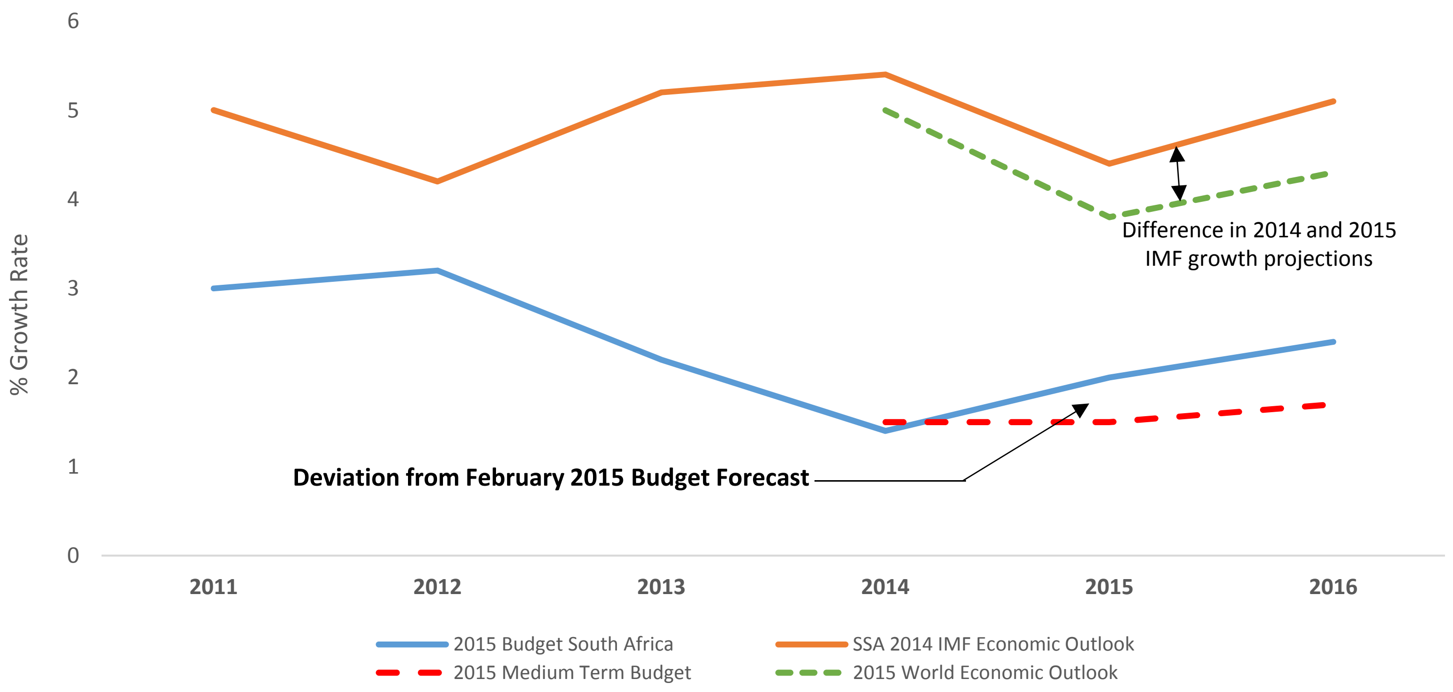
2015 Economic Outlook: Navigating Headwinds



- 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.

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MAIN ISSUES AROUND ECONOMIC OUTLOOK

- Based on the International Monetary Fund's October 2015 projections, South Africa's GDP growth will be 0.6 and 0.8% 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

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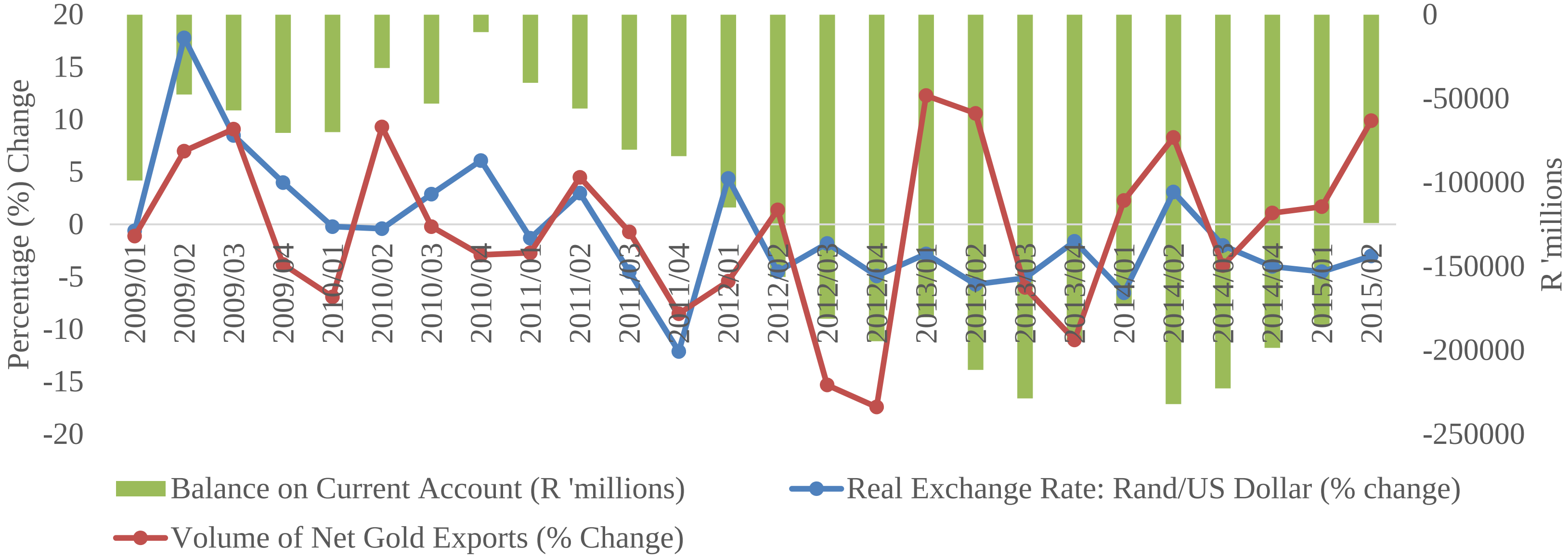
Recent External Developments Impacting on SA's Growth Prospects



- 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.

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RISKS TO FISCAL OUTLOOK

- Risks to the fiscal outlook in the medium term:
  - Further deterioration in economic growth,
  - Inflationary pressures
  - Weak financial positions of several major public entities
- Measures to manage these risks:
  - Alleviating short-term power constraints,
  - Limiting delays to additional generation capacity coming online
  - 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

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Specific Key Areas of Risk To Fiscal Framework

- Persistent weakness in the balance sheets of certain state owned companies (SOCs) could trigger calls for additional government support
  - Continuous cash injections to assist ailing SOCs places undue stress on the fiscal framework and redirects funding away from core service delivery areas
  - Also brings into question ability of SOCs to effectively drive infrastructure-led growth
- Intentions to reform health-care and social protection pose significant areas of impact on the national and provincial fiscal frameworks
- The use of contingency reserve to accommodate higher public wages poses significant risk to target of ensuring that the national budget over the MTEF period adjusts to modest potential economic growth and lower revenue collection
  - There is a need to ensure that wage increases are linked to increased productivity and performance across public sector

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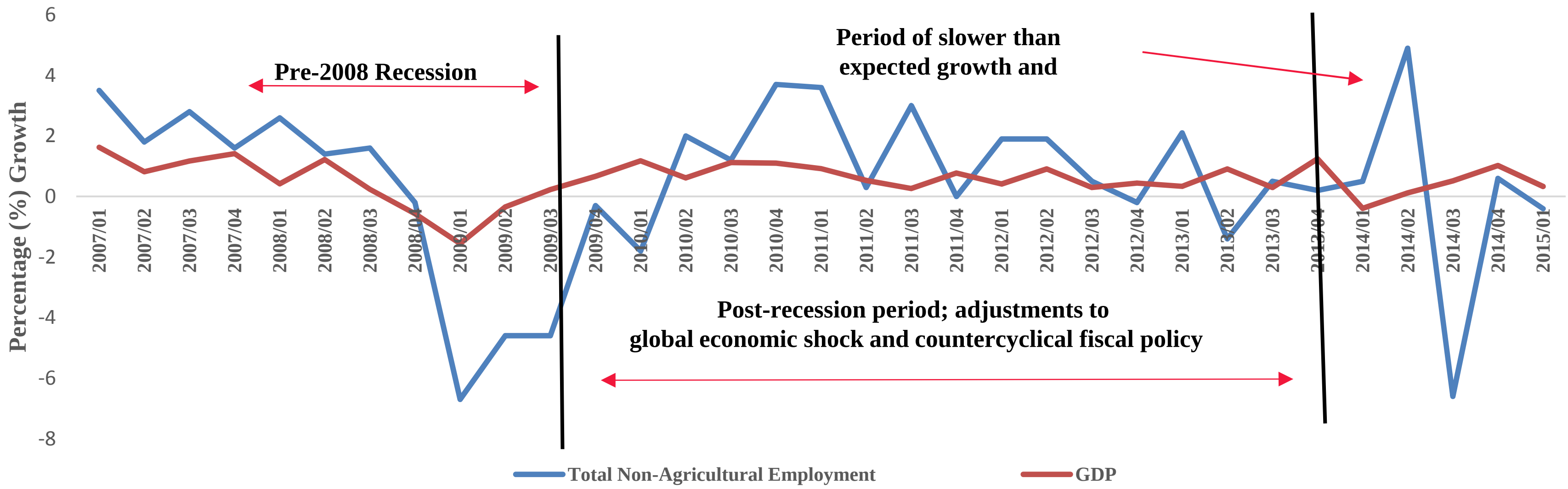
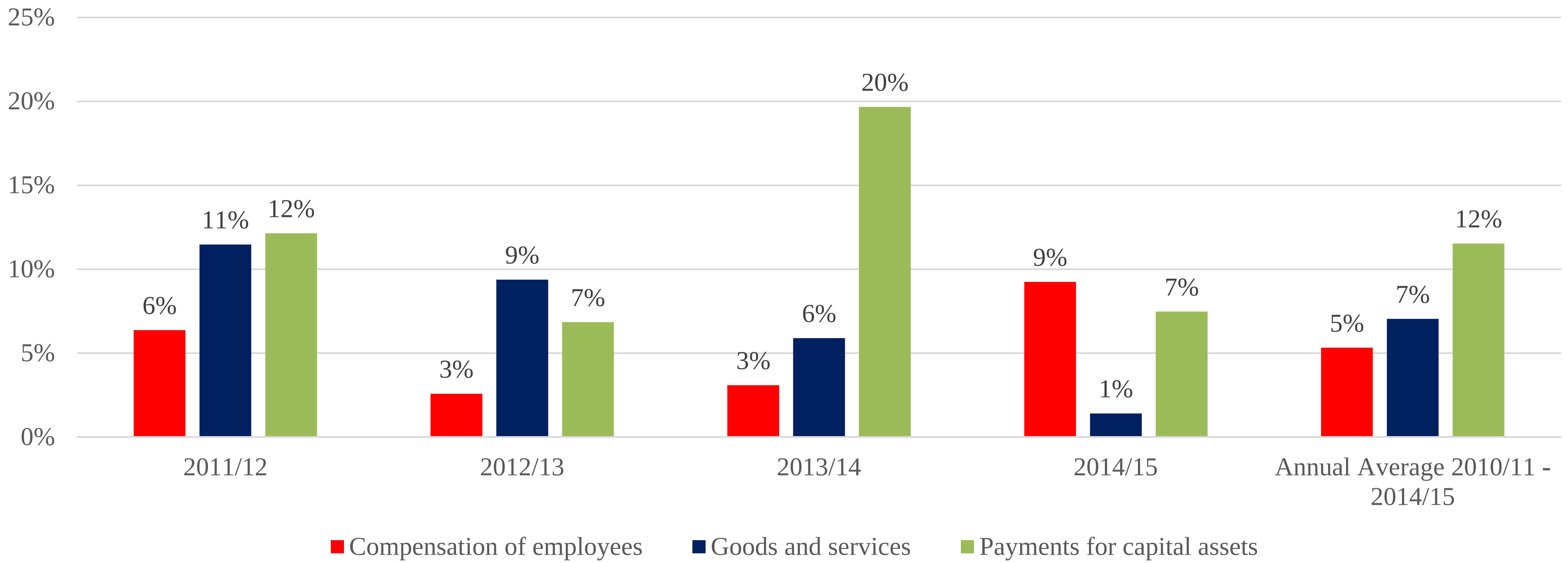
Current Economic Outlook and South Africa's Labour Dynamics



- 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

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

CONSOLIDATED FISCAL FRAMEWORK

	2012/13	2013/14	2014/15	2015/16		2016/17	2017/18	2018/19
R billion/% of GDP		**Outcome**		**Budget**	**Revised**	**Medium-term estimates**		
Main budget								
Revenue	**800.1**	**887.3**	**963.6**	**1 049.3**	**1 070.7**	**1 147.7**	**1 249.1**	**1 365.0**
of which: asset disposals	–	–	–	–	25.4	–	–	–
Expenditure	**965.5**	**1 047.8**	**1 132.0**	**1 222.3**	**1 246.9**	**1 313.1**	**1 426.9**	**1 551.1**
of which:								
Non-interest allocations	877.4	946.6	1 017.2	1 095.9	1 093.8	1 168.0	1 260.8	1 361.5
Special appropriations	–	–	–	–	25.2	–	–	–
Debt-service costs	88.1	101.2	114.8	126.4	127.9	142.6	157.2	174.6
Contingency reserve	–	–	–	–	–	2.5	9.0	15.0
Main budget balance	-165.4	-160.5	-168.4	-173.1	-176.3	-165.4	-177.8	-186.1
	-5.0%	-4.4%	-4.4%	-4.1%	-4.3%	-3.7%	-3.7%	-3.5%
Primary balance	-77.2	-59.3	-53.6	-46.6	-48.4	-22.8	-20.7	-11.5
	-2.3%	-1.6%	-1.4%	-1.1%	-1.2%	-0.5%	-0.4%	-0.2%
Budget balances of social security funds, public entities and provinces	29.5	24.3	31.5	10.9	18.4	20.1	25.1	28.0
Consolidated budget balance	**-135.8**	**-136.2**	**-136.9**	**-162.2**	**-157.9**	**-145.3**	**-152.8**	**-158.2**
	-4.1%	-3.8%	-3.6%	-3.9%	-3.8%	-3.3%	-3.2%	-3.0%

Consolidated Fiscal Framework [cont.]

- The depressed macroeconomic outlook with projected weaker revenue and higher debt services costs imposes constraints on the broader fiscal framework
- In total, Government is expected to spend R4.291 trillion over the three years relative to a revenue envelope of R3.762 trillion
  - Over the 2015 MTEF period, real annual average growth in expenditure is projected at 2.6%. A marginally stronger 3.0% growth is projected for revenue
  - The bulk of resources are allocated in respect of non-interest allocations in the form of equitable share and conditional grant funding to the provincial and local spheres

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Non-Interest Allocations: Division of Revenue

- After accounting for national debt, there are estimated receipts of R1, 2 trillion to share amongst the three spheres in 2016/17 financial year
  - The budget available for sharing between the three spheres is projected to increase to R1.3 trillion in the 2017/18 financial year and R1.4 trillion in the outer year
- Over the 2016 MTEF period, the division of revenue amongst the three spheres is projected to grow by a real annual average of 1.9% - main driver of growth is allocation to local government

Division of Revenue	2015 Budget	2015 MTBPS	2015 MTBPS			Real Annual Average Growth Rate (2016/17-2018/19)
	2015 M/term Estimate	2015/16 Revised	2016/17	2017/18	2018/19	
National allocations	**523**	**550**	**558**	**597**	**642**	**1.2%**
Provincial allocations	468	472	503	549	591	2.3%
Equitable share	383	387	412	448	482	2.1%
Conditional grants	85	85	91	101	109	3.1%
Local government allocations	**100**	**101**	**107**	**115**	**128**	**3.5%**
Total allocations	**1 091**	**1 123**	**1 168**	**1 261**	**1 361**	**1.9%**

UNALLOCATED RESOURCES

- Consistent with the historical trend, there are significant drawdowns to unallocated reserves, with cuts in 2016/17 and 2017/18 from R15 billion and R45 billion to R9 billion and R15 billion respectively in order to accommodate higher than expected wage-bargaining settlement and social priorities
- The Commission is concerned that by depleting the unallocated reserves to settle weaknesses in the wage bargaining arrangements process removes the fiscal buffer that is necessary to protect public finances in an economic environment facing prospects of a ravaging drought as well as an uncertain global economy and rising social demands of entitlement

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

R' billion	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Budget 2013	4	6.5	10			
MTBPS 2013		3	6	18		
Budget 2014		3	6	18		
MTBPS 2014			5	15	45	
Budget 2015			5	15	45	
MTBPS 2015				2.5	9	15

Expenditure by Economic Classification

- The compensation budget outpaces inflation by 3% on average over the MTEF period. Growth in compensation is higher than forecasted at the time of Budget 2015 largely as a result of the three year wage bargaining agreement
- 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	2014/15	2015/16	2016/17	2017/18	2018/19	Real Annual Avg Growth Rate
Compensation of employees	441.1	486.2	524	569.4	615.6	3.0%
Goods and services	173.9	186.1	198.1	212.6	226.1	1.1%
Transfers and subsidies	400	445.5	479.9	435.7	468.9	-1.3%
Payments capital assets	87.6	97.2	98.4	104.2	110.4	0.3%
Real Year on Year Growth (%)		**2014/15-2015/16**	**2015/16-2016/17**	**2017/18 - 2018/19**	**2017/18-2018/19**	
Compensation of employees		5.4%	1.6%	2.8%	2.3%	
Goods and services		2.2%	0.2%	1.4%	0.5%	
Transfers and subsidies		6.6%	1.5%	-15.1%	1.8%	
Payments capital assets		6.2%	-5.0%	0.0%	0.2%	

EXPENDITURE PRIORITISATION

- Overall consolidated government expenditure expected to increase by 2.1% in real terms of 2016 MTEF
  - Education and health allocation have been prioritised with a 2.6 and 2.7 % real increase respectively
  - Social protection allocations grows at average real rate of 1.9%
- The 2016 budget must prioritise activities that stimulate growth – infrastructure and industrial development.

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Expenditure Prioritisation: Housing Development and Municipal Infrastructure

- Funding and provision of human settlements has to be implemented in a coordinated manner
  - Aligned and coordinated infrastructure investment plans have to remain a key government's priority
- While the Commission supports a differentiated approach, there are concerns with uncertainties associated with the housing function shift to six metros and performance of Municipal Human Settlements Capacity (MHSCG)
  - MHSCG was stopped in July 2014 and released in March 2015 hence the spending of 8.5% of the allocated funds. The Commission is of the view that this undermines the credibility of the DOR processes
- The allocation for human settlements and municipal infrastructure will grow at an annual average rate of 7.6% between 2015/16 and 2018/19
  - While the Commission welcomes this growth as it indicates government's commitment to investment in basic infrastructure, it maintains its previous position that the current approach to funding and housing delivery is fiscally unsustainable and needs to be reviewed with the view of promoting active citizenry and self-build housing initiatives

Expenditure Prioritisation: Health

- The Commission notes with concern the proposed changes to the indirect component of the National Health Grant in funding of Human Papillomavirus (HPV)
  - Instead of being phased into the PES the grant will be extended for the next two financial years as an indirect grant and thereafter be converted into a direct grant - these changes indicate improper planning regarding the introduction of the grant. The Commission in the DoR Bill 2014 recommended the need for proper financial planning and infrastructure towards the roll out of the HPV
- Comprehensive HIV/AIDS grant
  - The Commission notes the expansion of the grant to cover tuberculosis (TB) - the Commission supports this as long as new priorities do not displace the original intentions of this grant

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EXPENDITURE PRIORITISATION: BASIC EDUCATION [CONT.]

- Regarding basic education related infrastructure grants the Commission welcomes the merging of grants with same purpose for efficiency and effectiveness
  - The Commission would like to re-iterate a previous recommendation that merging of grants due to non performance is not a panacea as causes for non performance need to be investigated and addressed
- The Commission also notes and welcomes the review of the National School Nutrition Programme (NSNP) given the misalignment between the provincial and national school quintile classification
  - The Commission would like to emphasise that the programme needs to meet the minimum requirements in providing meals to all learners in national quintiles (1-3) as per the National Norms and Standards for School Funding

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EXPENDITURE PRIORITISATION: 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

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Expenditure Prioritisation: 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

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EXPENDITURE PRIORITISATION: 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:

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Expenditure Prioritisation: 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

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Expenditure Prioritisation: Job Creation, Labour and Social Security Funds

- The 2015 Budget prioritised public employment programmes (PEPs)
  - Over the 2016 MTEF growth in allocations to employment programmes slow down to -0.1%
  - Low growth likely to increase pressure on social services
- PEPs not to be seen as strategy to increase available jobs but to improve labour market outcomes

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TOTAL ALLOCATIONS TO THE LOCAL GOVERNMENT SPHERE

- The MTBPS is allocating more funds to local government (LG) than the February 2015 Budget. The allocations to the LG sphere continue to grow at a faster rate than those for national and provincial spheres:
  - The sphere will receive R101.2 billion in 2015/16, and this is expected to increase to R128.4 billion by 2018/19.
  - On average and in real terms, total allocations to the sphere are expected to grow by 3.5% between 2016/17 and 2018/19
  - During the same period, conditional grant allocations will exhibit faster real growth (5.5%) than the local equitable share (LES) allocation (at 2.9%)

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Local Government Equitable Share

- The Commission welcomes the additional resources channelled to the LG sector through the LES formula
- These allocations increased from R41.6 billion in 2014/2015 to R51.7 billion in 2015/16 and are expected to grow from R52.9 billion in 2016/17 to R62.7 billion in 2018/19
- The worrying development is that the LES in outer years will grow far less than the growth in the cost of basic services: bulk electricity and bulk water

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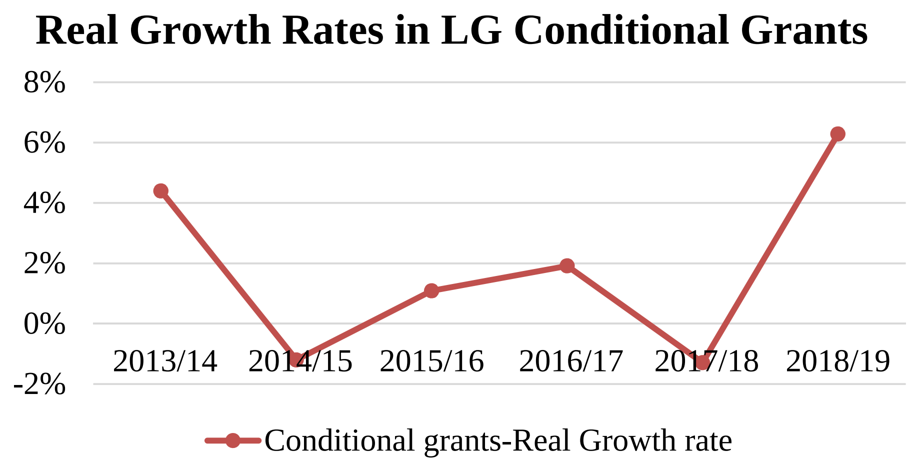
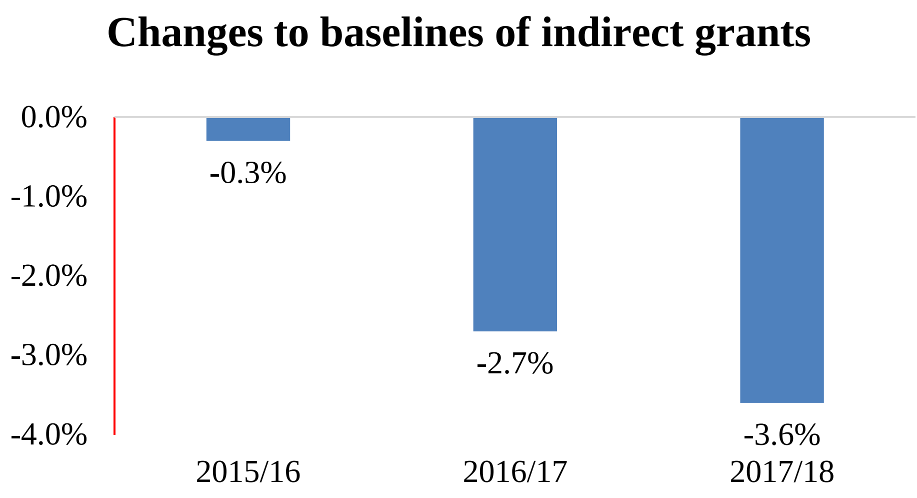
CONDITIONAL GRANTS

- Conditional grant allocations to municipalities increased from R36.0 billion in 2014/15 to R38.9 billion in 2015/16 and are forecast to increase to R53.2 billion in 2018/19
- In line with the Commission's previous observations that indirect grants are proliferating and performance is weak, it is important to note changes to baselines of indirect grants to LG in the 2015 MTPBS. As noted previously by the Commission, indirect grants should be used as a mechanism of last resort
- The Commission welcomes the shift towards direct grants





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Infrastructure Grant Reviews

- Subsequent to FFC's 2011 review of the local government fiscal framework (LGFF) a comprehensive review of infrastructure grants is underway with a view to enhancing "value for money" of these grants
- The Commission therefore welcomes the reforms to the infrastructure grants in the MTBPS including among others:
  - The merger of a multiple of water and sanitation grants
  - Introduction of a formula-driven Public Transport Network Grant
  - Introducing greater differentiation for secondary cities and creating a MIG-Cities (MIG 2)
  - Merging urban grants (USDG, NDPG, INEP) over the MTEF, and
  - Amendments to the MIG to allow its funds to be used for the maintenance and refurbishment of municipal roads
- These reforms will, among other things, enhance the administrative efficiency and reporting; see municipalities pay more attention to asset care and maintenance; introduce predictability and transparency by a formula driven Public Transport Network grant

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OTHER LG ISSUES

LES Withdrawal

- As many municipalities had persistently not complied with measures specified in Section 216 (1) of the Constitution, i.e. 30 day debt payment rule, National Treasury had to take punitive measures in the form of stopping LES allocations of municipalities owing Eskom and Water boards
- The 2015 MTBPS notes that NT, COGTA and SALGA have assisted municipalities that had defaulted on their debt to Eskom to enter into payment agreements with Eskom
- Commission is concerned that many municipalities have ignored agreements. To this end, the Commission encourages municipalities to take their fiduciary responsibilities seriously

Boundary Re-determinations

- The Commission welcomes MTBPS proposals to grant each major re-demarcation an allocation in the 2016 Budget as boundary re-determinations are costly
- The Commission recommends an objective full financial impact of the demarcations to be determined and that the receiving municipality is made fully aware of this
- The Commission welcomes the spirit of differentiation embraced in the grant
- The Commission encourages Provincial Treasuries and CoGTA to closely monitor this grant to ensure that these resources are strictly used to defray costs related to demarcations
- .

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REVIEW OF ACTUAL SPENDING

- 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
  - This would of course differ depending on whether a government program that the department is dealing with is recurrent or capital-expenditure driven
  - Expenditure smoothing would most likely lead to improved quality of spending and reduced level of unauthorised spending
- Highlights based on analysis of aggregate spending and percentage spent six months into the 2015/16 financial year indicate:
    - Spending performance has improved compared to 2014/15, with total government spending, spending by all votes and transfers to the PES in line with the assumed norm of 50%

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REVIEW OF ACTUAL SPENDING [CONT.]

- 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 70% of its budget) whereas others such as the Public Works, Rural Development and Land Reform and Water and Sanitation departments have recorded spending rates of below 40%
  - 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

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ADJUSTMENT ESTIMATES

- Declared unspent funds amounted to R3.18 billion the bulk of which relates to underspending by national departments
- The Adjustments Budget makes provision amounting to R1.6 billion for roll-overs:
  - Unlike previous years, the roll-over amount has increased while the number of departments receiving roll-overs has declined in the 2015/16 adjustments budget
  - The Department of Cooperative Governance dominates the roll-overs, with R1.5 billion approved in the adjustments budget. The roll-over funds is for the local government equitable share for municipalities to pay ESKOM and the Water Board accounts

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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)

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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

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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

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