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COMMISSION

Briefing to the Finance Committees on the 2017 Fiscal Framework and Revenue Proposals

28 February 2017

For an Equitable Sharing of National Revenue

THE CONTEXT

- Submission made in terms of S4(4c) of MBPARMA (Act 9 of 2009)
  – Requires Parliamentary Committees to consider any recommendations of FFC during their deliberations on Money Bills
- Also made in terms of FFC Act of 1997 a
  – Requires that FFC responds to any requests for recommendations by any organ of state on any financial and/or fiscal matter(s) relevant to its mandate

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BRIEF REVIEW OF THE 2017 FISCAL FRAMEWORK

- The 2017 Fiscal Framework is enacted in an environment of exceptionally difficult domestic and global conditions
  - Commission notes and welcomes continued emphasis on fiscal consolidation and resulting impact on overall budget credibility.
    - Revenue is able to cover non-interest expenditure for first time since 2008/9 recession
  - Economic growth forecasts (1.3% in 2017) kept at 2016 MTBPS levels hence not revised downwards for first time in several years, therefore not necessary to change budgeted growth in tax revenue downwards.
  - Budget continues to be pro-poor: health, social grants and basic education have been protected. Reasonable increase in social grants that we know reduce poverty.
- Yet fiscal measures are not enough. Expansion of the social wage in sustainable manner, create jobs and reduce poverty needs much faster rates of inclusive economic growth

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Brief Review of the 2017 Fiscal Framework [cont.]

- The tax proposals are heavily reliant on personal income tax, across board but more harshly on upper income groups; substantial increase in taxation of dividends; minor changes to fuel levy, sin taxes.
- Evidence from previous FFC project on tax and <u>economic growth</u>
  - Macro findings suggest a "ranking" of taxes in terms of their negative impact on GDP per capita: property taxes < VAT < personal income taxes < corporate income taxes
  - Broad simplistic implication for the tax structure: Shift towards more use of VAT and property taxes and less income taxes, needs to be put into perspective of our tax system. Distributional concerns can be an obstacle.
  - Reducing income tax progressivity: Trade off between enhancing GDP per capita and increasing wage inequality

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Brief Review of the 2017 Fiscal Framework [cont.]

- Continuous infrastructure investment done by government, specifically the major infrastructure expenditure by State Owned Companies, Provinces and Local government, is welcomed.
  - The Commission reiterates the point it raised in its 2016 Medium Term Budget Policy Statement (MTBPS) submission, that regular road maintenance and a well-maintained road network are key to economic development and growth.
- As part of the reforms aimed at improving the country's medium-term growth outlook, there are several specific imperatives that government has announced, to boost investment in the short term, safeguard South Africa's investment-grade credit rating and measures to stabilize government debt.
  - Government debt will stabilise at about 48% of GDP over the next three years.

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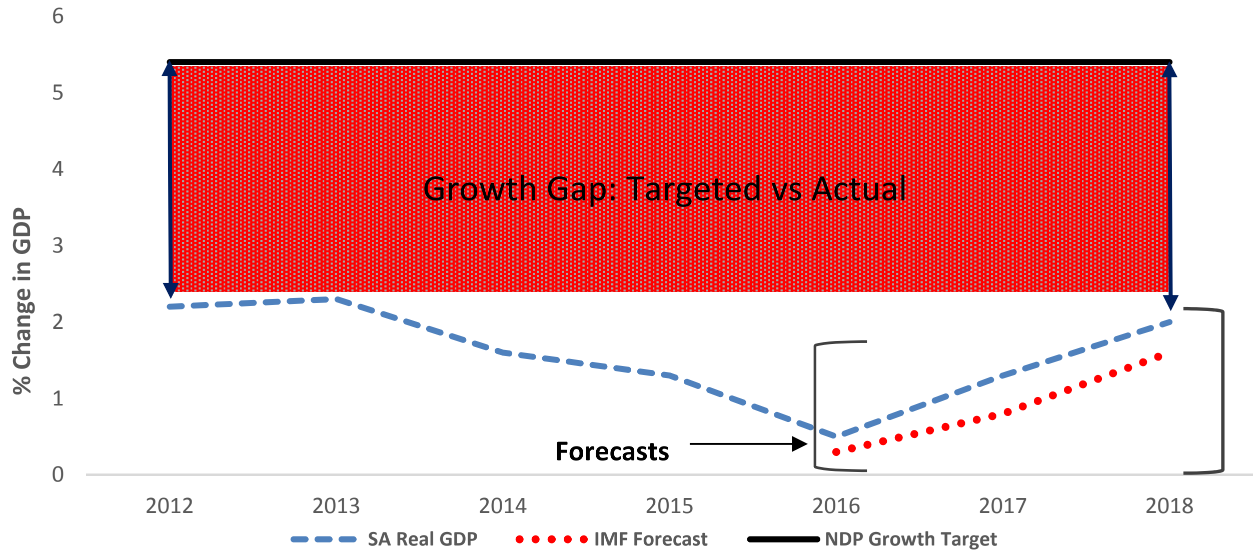
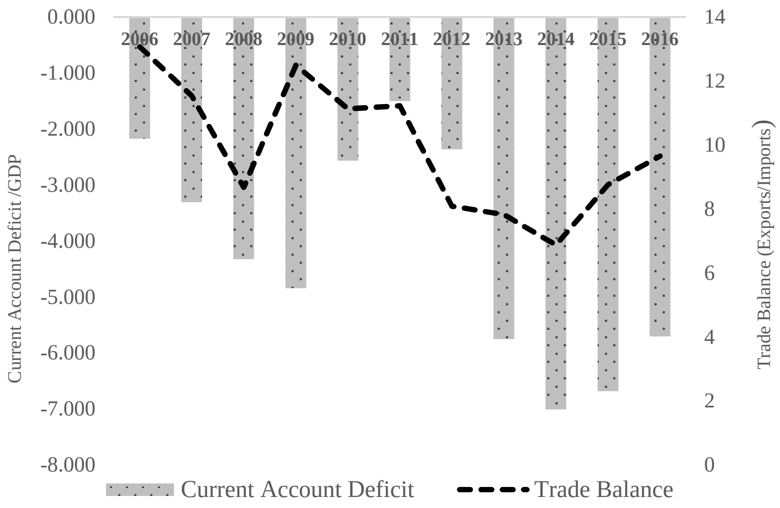
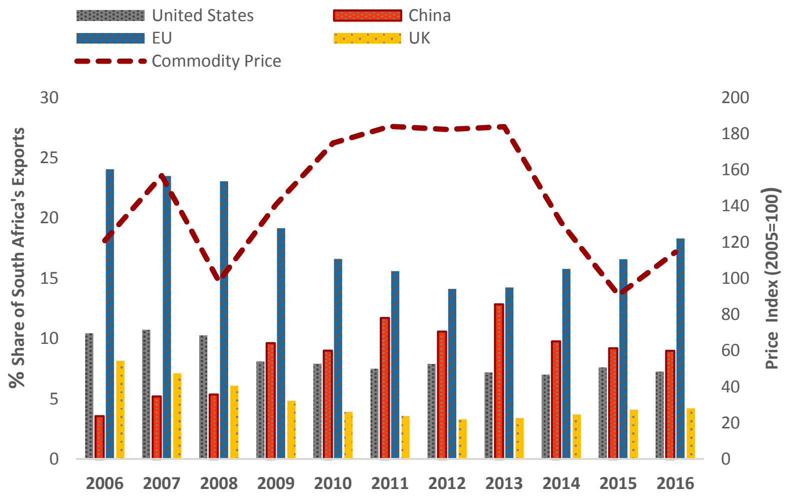
2017 Economic Outlook: Restoring Growth In A Shifting Landscape



- Declining trend in economic growth appears to have run its course
  - Rather than downward revision, we have upward revision for 2017 and the medium-term
  - Implications for path of reduction in budget deficit
- Economic prospects boosted by changing global landscape
  - Strong recovery in the US; rebound in major economies of Western Europe spilling over to the EU; Chinese stimulus enhancing resource/commodity linked investments.
- Growth however remains below needed targets for addressing unemployment and inequality.

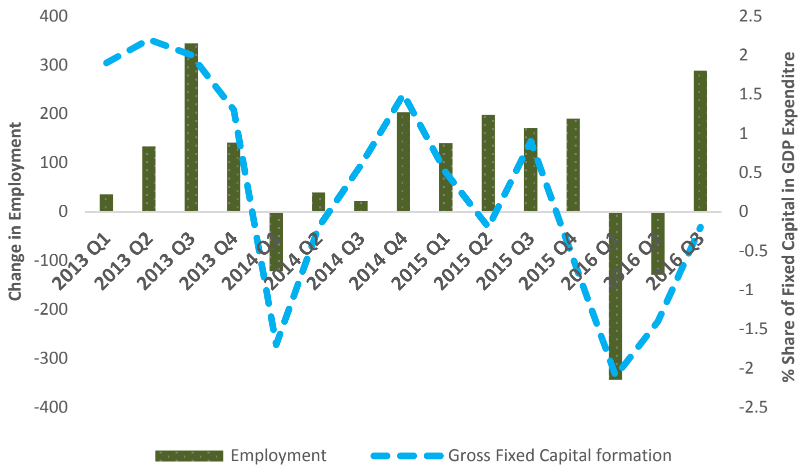
TEMPERING OPTIMISM: VULNERABILITIES WITHIN EXTERNAL SPACE

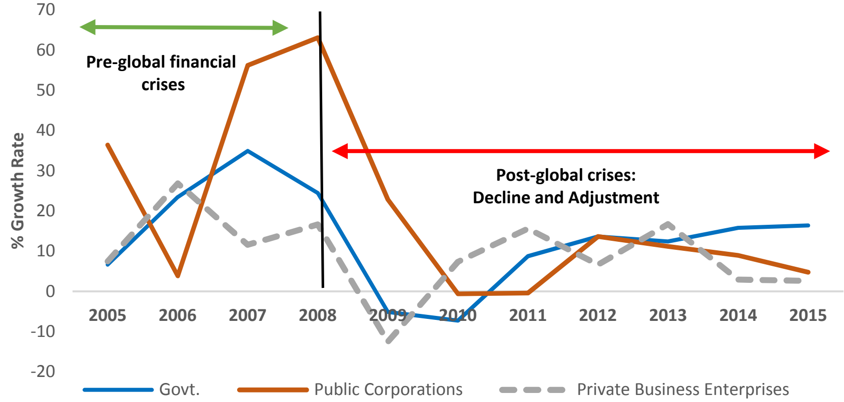




- Trade balance showing signs of improvement in line with moderate commodity price increases prices
- Need to acknowledge **downside** risks
  - Policy direction of new US administration: increased protectionist pressures
  - Uncertainty around outcomes of negotiations over Brexit; sentiments against global integration and political dynamics in key EU states
  - Sustainability of Chinese stimulus given vulnerabilities of SoEs and nascent credit bubble..

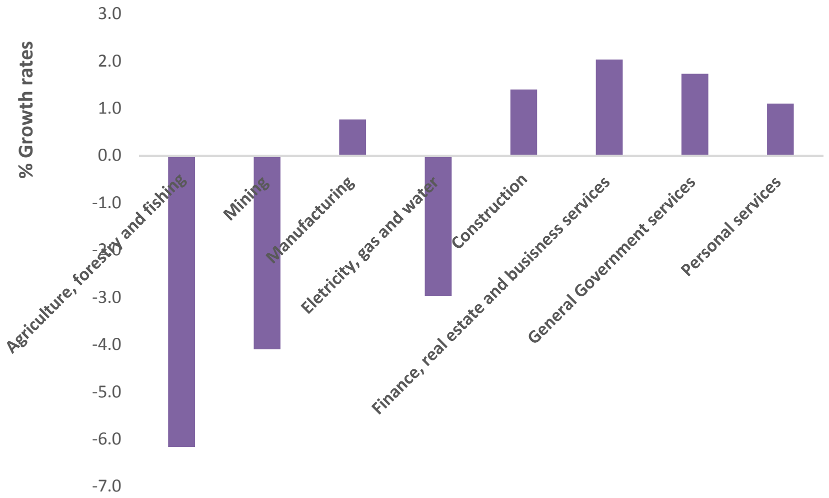
Shifting Domestic Landscape : Slowing Investment, Rising Unemployment

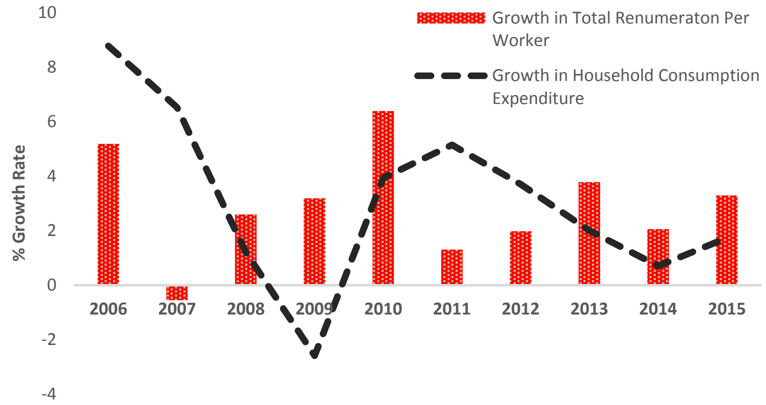




- Worrisome trend of weakening investment growth working in tandem with low employment levels
  - Weakness pronounced within private sector (investment growth in 2015 = 2.6% compared to 26% in 2006)
  - Net effect of changes within labour market was an increase in number of unemployed by 587 000

SLOWING SECTORAL GROWTH IMPACTING HOUSEHOLDS





- Employment dynamics driven by sectoral dynamics
  - Sharp contraction in agricultural sector; rebound expected on back of good rainfall but lag in recovery to 2012 levels. Drought also impacted water and electricity sectors
  - Mixed fortunes for mining and manufacturing sectors which account for one-fifth of GDP
- Sluggish growth and weak labour market has adversely affected wage growth and household consumption expenditure
  - Household consumption growth slowed to 2% in post-2008 period
  - Weakness exacerbated by low levels of investor confidence and pressures on disposable incomes from high levels of indebtedness.

Consolidated Fiscal Framework

	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
R billion/percentage of GDP	Outcome			Revised estimate	Medium-term estimates		
Revenue	1,008.1	1,098.9	1,222.0	1,297.3	1,414.1	1,535.2	1,668.5
	27.8%	28.4%	29.9%	29.4%	29.8%	29.9%	30.1%
Expenditure	1,143.4	1,233.5	1,364.2	1,445.2	1,563.1	1,677.1	1,814.3
	31.5%	31.9%	33.4%	32.8%	33.0%	32.7%	32.7%
Non-interest expenditure	1,033.8	1,112.1	1,227.9	1,291.8	1,393.8	1,489.5	1,608.0
	28.5%	28.8%	30.0%	29.3%	29.4%	29.0%	29.0%
Interest payments	109.6	121.4	136.3	153.4	169.3	187.6	206.4
	3.0%	3.1%	3.3%	3.5%	3.6%	3.7%	3.7%
Budget balance	-135.4	-134.6	-142.2	-147.9	-149.0	-141.9	-145.8
	-3.7%	-3.5%	-3.5%	-3.4%	-3.1%	-2.8%	-2.6%
Primary balance	-25.8	-13.2	-5.9	5.5	20.3	45.7	60.6
	-0.7%	-0.3%	-0.1%	0.1%	0.4%	0.9%	1.1%

- Consolidated revenue target of R1.41 trillion estimated for 2017/18 (29.8% of GDP)
- Expenditure is projected at R 1.56 trillion, leaving a budget deficit of R 149 billion or 3.1% of GDP
- Deficit estimated to decline from 3.1% in 2017/18 to 2.6% in 2019/20

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DIVISION OF NATIONALLY RAISED REVENUE

Real Year on Year Increases	2013/14-2014/15	2014/15-2015/16	2015/16-2016/17	2016/17-2017/18	2017/18-2018/19	2018/19-2019/20	Real Annual Average Growth over 2017 MTEF
National departments	**2.4%**	**6.5%**	**-4.0%**	**-0.2%**	**1.0%**	**2.0%**	**0.9%**
of which:							
Indirect transfers to provinces	104.3%	-43.1%	-0.7%	9.8%	-60.9%	-0.2%	-17.1%
Indirect transfers to local government	31.5%	20.2%	-29.1%	-11.6%	-2.3%	-0.3%	-4.7%
Provinces	**1.4%**	**2.5%**	**-0.2%**	**1.4%**	**1.5%**	**1.4%**	**1.4%**
Equitable share	1.3%	2.7%	-0.1%	1.3%	0.9%	1.5%	1.2%
Conditional grants	1.8%	2.0%	-0.7%	1.8%	4.4%	1.4%	2.5%
Local government	**0.4%**	**7.4%**	**-1.3%**	**2.7%**	**1.9%**	**2.9%**	**2.5%**
Equitable share	1.1%	13.5%	-2.6%	5.0%	3.9%	4.4%	4.4%
Conditional grants	-0.3%	2.3%	0.2%	0.9%	-0.1%	1.8%	0.9%
General fuel levy sharing with metros	0.4%	0.0%	-1.0%	-1.0%	-0.1%	-0.2%	-0.4%
Non-interest allocations	**1.8%**	**4.9%**	**-2.2%**	**0.7%**	**1.3%**	**1.9%**	**1.3%**

- Despite strained fiscal environment, Commission notes that Government has maintained real growth in allocations to all three spheres
- Commission welcomes relative priority attached to funding municipalities, especially strong growth in LES allocation
- No baseline adjustments to the provincial fiscal framework over the period could be a signal that any further reductions could have an adverse impact on service delivery
- Commission welcomes declining trend in indirect conditional allocations

TAX PROPOSALS

- The 2017 tax proposals are projected to raise R28 billion. There is a heavy reliance on income tax to plug the gap in tax revenue at the expense of growth imperatives
- The proposed top personal income tax bracket of 45% for taxable incomes above R1.5 million will raise an additional R4.4 billion in tax revenue
  - Progressive income taxes reduce the returns to education and the incentive to build human capital which is vital for growth. It reduces investment, risk taking, and entrepreneurial activity. Since high income earners save most of their income, increasing their tax rate represents a higher tax on savings. Luckily the high income group tends to have lower consumption propensities hence effect on growth likely to be muted in the short term
  - Broadening the base of personal income taxes is better for growth than increasing the rate.
  - There is limited scope to improve growth by raising portions of personal income tax rates, and their equity effects are best achieved by other means

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TAX PROPOSALS [CONT.]

- The proposal to expand the VAT base by removing zero-rating on fuel and broadening the scope of electronic services that are subject to VAT is welcomed. Given that the current VAT rate is relatively low, there is scope to raise additional revenue using the VAT
- The proposed sugar tax has a potential to incentivise behavioural change but cautionary measures must be taken to ensure that its effective tax rate does not erode competitiveness

TAX PROPOSALS [CONT.]

- The increase in general fuel levy will raise an additional R3.2 billion in tax revenue. The anticipated increase in crude oil prices is likely to worsen the burden on tax payers with regards to this source
- The proposed increase in the dividend withholding tax rate from 15% to 20% will raise an additional R6.8 billion and must be reconciled with necessary caution to guard against the negative impact on investment portfolios and savings mechanisms of investors

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UNALLOCATED RESOURCES

- Contingency reserve for 2017/18 remains unchanged at R 6 billion in the 2017 Budget compared to the 2016 MTBPS
  – Contingency reserve for the outer years has also remained more or less unchanged
- Amounts being put aside for the contingency reserve still far from adequate even though the new policy approach of maintaining consistency in the contingency reserve is welcomed as it provides the fiscus with at least some room to manage ongoing fiscal pressures

Adjustments to Unallocated Reserves, 2014/15 – 2019/20

R'billion	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20
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	20
Budget 2017				6	10	20

Expenditure by Economic Classification

- The compensation budget outpaces inflation by 1.3% on average over 2017 MTEF – this despite efforts to curb its growth. A radical re-think of current labour policies should go hand-in-hand with efforts to streamline government operations and reduce duplication across government
  - The Commission would like to reiterate a previous recommendation made which emphasizes the need to link the salary of public officials with productivity increases
- In contrast, allocations to capital assets take a severe knock with a 0.8% decline in real annual average growth over 2017 MTEF period - this decline is of concern especially since government's growth path is dependent on an infrastructure-led strategy

R'billion	2016/17	2017/18	2018/19	2019/20	Real Annual Average Growth Rate
Compensation of employees	512.2	550.4	588.7	631.1	1.31%
Goods and services	208.3	221.7	237.5	253.6	0.9%
Transfers and subsidies	471.9	508.8	543.7	590.2	1.84%
Payments capital assets	93	101.4	104.6	107.8	-0.8%
Real Year on Year Growth (%)		2016/17-2017/18	2017/18 - 2018/19	2018/19-2019/20	
Compensation of employees		1.1%	1.3%	1.6%	
Goods and services		0.03%	1.43%	1.18%	
Transfers and subsidies		1.4%	1.2%	3.0%	
Payments capital assets		2.63%	-2.54%	-2.54%	

Changes and Additions to the Local Government Fiscal Framework

- The local government sphere to receive R389.3 billion worth of transfers over the 2017 MTEF,
  - R366.3 billion transferred in the form of direct grants
  - R23 billion transferred as indirect grants
- LG transfers translate to about 9.1% of government non interest expenditures
  - Local Government Equitable share allocated R187 billion and will grow by 4.4% over the 2017 MTEF
  - R37.4 billion through the general fuel levy
  - R140 billion in conditional grants, i.e 44% of transfers to the LG sphere
- Commission welcomes the addition of resources to the LES to offset the ever increasing costs of basic services and enable the sector to provide basic services to the poor households
  - However the Commission is of the view that municipalities can be realistically compensated for the rising cost of basic services only if the true cost of municipal operating and maintenance services are used
  - To assist in determining the true costs of basic services FFC and SALGA developed (still being refined) a model that accounts for different cost influencing factors

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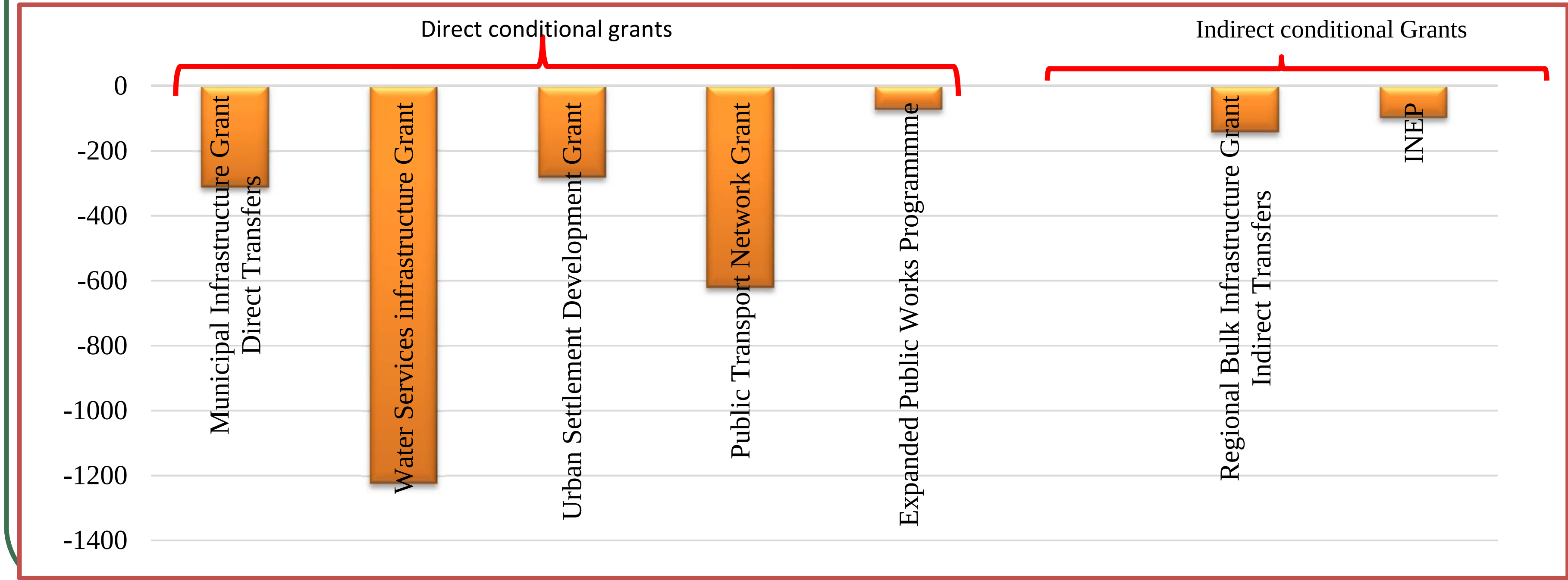
CONDITIONAL GRANTS

- Many local government conditional grants will see their baselines reduced over the 2017 MTEF.
- While R4.3 billion will be added to the baselines of local government grants (mainly on the LES and INEP grants), R2.8 billion will be deducted from a number of grant baselines



CONDITIONAL GRANTS [CONT.]

- Worst affected grants (in terms of reductions) are the MIG, Water Services Infrastructure grant, USDG and the Public Transport Network Grant
- Although the addition of resources to the sector is commendable as it will go a long way in supporting the 'Back to Basics' plan and the National Development Plan (NDP), the Commission wishes to reiterate its long standing position that reductions should prioritise underperforming grants
- The Commission is also concerned that these reductions will affect key municipal deliverables: infrastructure, water, human settlements and transport services
- Furthermore, the Commission is concerned that cuts to baseline disproportionately affect direct grants
- With respect to the Water Services Infrastructure grant, the Commission is further concerned that this grant is affected more than any other grant despite the fact that its scope has been increased to include sanitation and sanitation backlogs have refused to go away, and the government set target of achieving universal access to sanitation by 2014 has remained elusive

CONSUMER AND MUNICIPAL DEBT

- The Commission is concerned about the ever-escalating consumer and municipal debt which is affecting the fiscal health on municipalities and public entities alike
  - Municipalities currently owe Eskom over R10 billion, and are owed R113 billion (as of June 2016) by national and provincial spheres, businesses and households
- The Commission notes the provisions in Section 216(2) of the Constitution and Section 19 of the Division of Revenue Bill, which allows National Treasury to apply pressure to municipalities that persistently continue to flout provisions of Section 38(1)(b) (i) of the Municipal Finance Management Act, in particular the 30-day payment rule
- The Commission is of the view that the provision of the Act should be extended to apply to national and provincial government and National Treasury should apply the same pressure to all national and provincial departments that are not complying with the 30-day payment rule on municipal bills as per requirement of the Public Finance Management Act (PFMA)
- The Commission would also like to see a speedy conclusion of the work of the task team examining intergovernmental debt

IMPROVING THE PERFORMANCE OF LG

- The Commission welcomes the realisation of the disparities in the funding of district municipalities (DMs). A number of DMs have been receiving very low allocations from the RSC levy replacement grant, a development that has impacted negatively on their ability to deliver services and support local municipalities
  - Although the Commission welcomes the interim measures taken by government to relieve the funding bottleneck faced by some 13 DMs it is of the view that a long term sustainable funding model for DMs should be found and such a model should be based on a clear identification of the powers and functions of DMs
- The Commission also welcomes 4 government focus areas to improve the performance of municipalities, namely:
  - The mSCOA to improve municipal information and better financial management
  - Supply Chain improvements to minimise irregular expenditure or outright corruption
  - Proposed guidelines to set tariffs. This will minimise disparities in costs of services and tariffs, especially electricity
  - Improved assets management and asset maintenance

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Financing SA's Social Programmes: Health

- Health continues to be a priority in line with NDP goals of reducing the burden of disease
- In 2017/18 R187.5 billion has been allocated to the sector accounting for 12% of government expenditure
  - Of this amount, R17.6 billion is allocated to the HIV/Aids and TB programme, illustrating the commitment by government towards reduction of the burden of disease in the country

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FINANCING SA'S SOCIAL PROGRAMMES: HEALTH [CONT.]

- Budget Review 2017 notes the closure of NHI piloting sites which were meant to test the readiness of the NHI
  - The Commission notes this closure and more so its poor performance
  - The Commission would like to highlight the need for the urgency in addressing issues of poor performance of the grant so as to be able to realise the benefits of NHI before its full roll out take into effect as its vision would still be carried over by the NHI (indirect grant)
- Commission welcomes the establishment of the NHI fund during the 2017/18 financial year
  - The Commission would like to emphasise the need for clarity around the powers and functions of the NHI Fund - these need to be clearly defined so as to ensure accountability. Once this is clear, sources of funding can be identified
  - In terms of funding for the NHI and flow of funds from the central fund to institutions that would be delivering health care services, FFC in its (2016) report recommended the need for giving transfer recipient autonomy

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FINANCING SA'S SOCIAL PROGRAMMES: HEALTH [CONT.]

- In light of the recent deaths of psychiatric patients in Gauteng, the Commission would like to highlight the need for setting norms and standards for care, treatment and rehabilitation of mental health care in line with S(66) of Mental Health Care Act (2002)
- The World Health Organisation (WHO, 2003) proposes a policy package that can assist countries to improve mental health care of their citizens
  - The Commission proposes the use of a similar policy package and that it be implemented in a phased approach to assist in realising inclusive health care for all as per the NDP objectives

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FINANCING SA'S SOCIAL PROGRAMMES: EDUCATION

- Funding is largely driven by personnel through public sector wage agreements accounting for about 80% of the budget, with the balance of resources allocated to non personnel non capital expenditure
- Expenditure in the sector for 2017/18 is R232.6 billion and accounts for 15% of government expenditure - this is welcomed as it is in line with meeting NDP goals of improved access and improved learner outcomes
- Basic education loses half of its cohort learners that enter the school system by the end of the 12 year period with 70% completion of secondary education
- Improved learner outcomes and access to basic education will play a critical role in raising skills needed in South Africa particularly with respect to technicians and other professionals – in this regard access and funding by the institutions of higher learning is critical

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FINANCING SA'S SOCIAL PROGRAMMES: EDUCATION [CONT.]

- The Commission welcomes the R12. 7 billion to be allocated to learner teacher support materials over the 2017 MTEF – this is in line with findings off FFC research on the financing of learner support materials which highlighted inadequate and erratic expenditure on learner support material
- Another major change in basic education is the introduction of a new grant for learners with profound intellectual disabilities. The following is allocated over the 2017 MTEF: R72 million in 2017/18, R185.5 million in 2018/19 and R220.8 million in 2019/20
- The Commission welcomes this approach of expanding access to these learners which is in line with meeting international and local obligations in terms of creating an inclusive society for all
- This is also in line with past FFC recommendations around the need for government, through the use of input and output norms and standards, to take reasonable measures to give effect to inclusive education
  - The recommendation further advised that the norms should indicate human, physical, administrative and regulatory resources by government dedicated to achieving targets for inclusive education

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CONCLUSION

- The Commission fully supports Government's position on 'gradual' fiscal consolidation and tabling Fiscal Frameworks with a positive *primary balance* 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
- Revenue proposals made supported subject to matters raised
- More needs to be done to reignite higher economic growth consistent with NDP and also requires structural reforms that include:
  - Measures to raise total savings
  - Structural and economic reforms in product, service and labour markets
  - Reinvigorating agriculture and rural development
  - Strengthening state capabilities should continue to be prioritised with efforts aimed at both economic and social capabilities for citizens and infrastructure and how these will be managed within the context of current consolidation measures

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