FINANCIAL
AND FISCAL
COMMISSION

BRIEFING BY THE FINANCIAL AND FISCAL COMMISSION ON THE 2014 MEDIUM TERM BUDGET POLICY STATEMENT

28 October 2014

For an Equitable Sharing of National Revenue

BACKGROUND

- Submission made in terms of:
  - Section 4 (4c) of the Money Bills Amendment Procedure and Related Matters Act (MBAPRMA) (2009)
    - 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
    - Provides for 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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BACKGROUND [CONT.]

- The Commission welcomes the main themes in the 2014 MTBPS which resonate very well with the Commission's Submission for the Division of Revenue 2015/16 that was tabled in Parliament in May 2014
- In that Submission, the Commission argues that South Africa is facing economic and fiscal challenges that are more severe than many people realise. According to the Submission:
  - The economy is still feeling the effects of global economic downturn
  - Revenue levels are declining and social demands are rising
  - With heightened levels of social deprivation demands, hard trade-offs are required to balance fiscal sustainability and protect social gains at all levels of government

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Background: Balancing Fiscal Sustainability With Socio Economic Impact

- Key recommendations
  - Avoid across the board cuts when implementing expenditure ceiling to control debt
  - Maintain (if not expand) effective and efficient use of social expenditure
  - Encourage participation in the economy and improve equity
  - Investment in physical infrastructure and innovation

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Background: Balancing Fiscal Sustainability With Socio Economic Impact

- Key recommendations
  - Distribute resources to schools more equitably to improve outcomes
  - Improve allocations to Primary Health Care
  - Improve the financing of municipal capital investments
  - Implement a transport subsidy framework that incorporates social welfare
  - Introduce a transitional demarcation grant to deal with the fiscal effects of municipal boundary changes

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BACKGROUND: OVERALL ASSESSMENT

- The Commission welcomes efforts geared towards fiscal consolidation
- From previous recommendations, a successful fiscal consolidation requires
  - Deciding on which components of the budget need to be consolidated, and the pace at which to achieve fiscal consolidation.
- There is a need to rebuild some of the fiscal buffers that provided the fiscal space for countercyclical measures
  - Credible commitment to fiscal targets to ease frequency of sovereign debt downgrades
  - Actual implementation of planned measures to remove waste, inefficiency and corruption in utilization of public resources across the three spheres of government.

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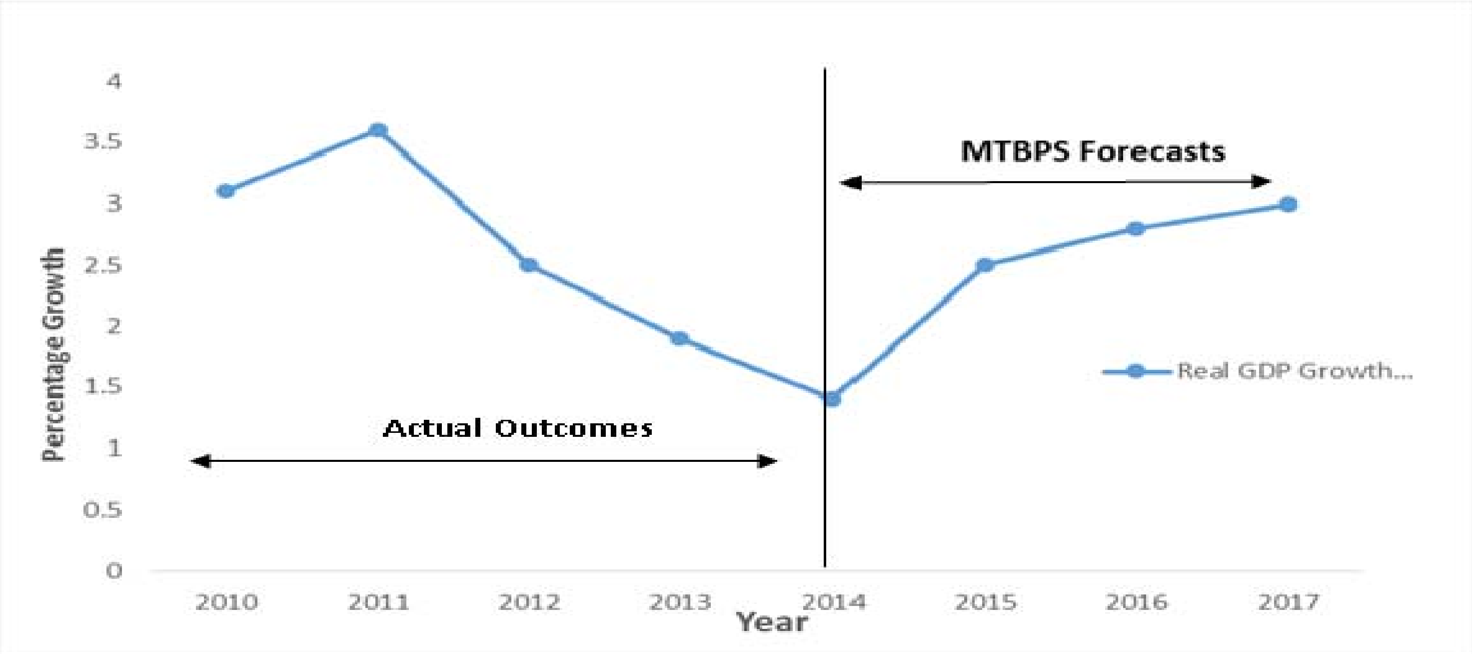
Economic Outlook and Public Finance Overview

- Economic growth tracking FFC pessimistic scenario
  - For 2014: Growth is 1.4% in MTBPS compared to 2.7% growth in 2014 Budget
  - For 2015: Growth forecast has been revised downwards to 2.5% from 3.2%
  - For 2016: Growth as been revised downwards to 2.8%, from 3.6% previously



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ECONOMIC OUTLOOK AND PUBLIC FINANCE OVERVIEW [CONT.]

- Pessimistic outlook exacerbated by dual factors
  - External: Slowdown in Eurozone, vulnerability of capital flows to the end of quantitative easing (QE) and the cooling down of Chinese economy
  - Internal: Adverse impact of labour related disturbances and infrastructure bottlenecks on consumer spending and private fixed investments
- Commission notes that a key component is containing public sector wage bill across the three spheres in line with its past work
  - Emphasis of cuts fall on a lower rate of increase in public sector remuneration and on Government needing to improve its efficiency to generate more productivity out of less spending
  - In the 2014 MTBPS, growth in compensation of employees is set to decrease from an average of 8.5% per annum between 2011/12 and 2014/15 to 6.5% per annum between 2014/15 and 2017/18
  - Cumulatively, whereas compensation of employees rose by 27.4% over the former three-year period, it is budgeted to grow by just 21.1% over the coming three-year period.
- Commission wishes to emphasise that whatever deal is struck should be a multi-year agreement so as to encourage certainty and stability

ECONOMIC OUTLOOK AND PUBLIC FINANCE OVERVIEW [CONT.]

- Downward revisions in GDP forecast translate to lower growth in revenues and an increase in budget deficit
  - Not much deviation from planned deficit reduction contained in 2014 Budget
  - However, forecasted estimates in MTEF show that economic growth less than Budget deficit
    - Implies higher than anticipated public debts and debt servicing costs.
  - Carrying debt requires spending on interest payments on outstanding bonds and other obligations.
  - Interest rates have been low in recent years and SA has been able to borrow cheaply. The government's interest payments have been trading at around their lowest levels in the past 20 years, both in relation to GDP and to SA's total spending
  - Danger that as interest rates increase to more normal levels, so will the cost of servicing growing debt, diverting Rands away from public programmes

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CONSOLIDATED FISCAL FRAMEWORK

	2011/12	2012/13	2013/14	2014/15		2015/16	2016/17	2017/18
R billion/Percentage of GDP								
	Outcome			**Budget**	**Revised**	**Medium-term estimates**		
Main budget								
Revenue	**745.3**	**799.2**	**886.1**	**962.8**	**956.6**	**1 055.1**	**1 169.4**	**1 272.9**
Expenditure	**889.9**	**965.5**	**1 047.8**	**1 142.6**	**1 136.3**	**1 222.3**	**1 308.4**	**1 416.7**
of which:								
Non-interest allocations	**813.5**	**877.4**	**946.6**	**1 024.7**	**1 021.9**	**1 090.8**	**1 153.9**	**1 222.0**
Debt-service costs	**76.5**	**88.1**	**101.2**	**114.9**	**114.5**	**126.5**	**139.4**	**149.7**
Unallocated reserves	**–**	**–**	**–**	**3.0**	**–**	**5.0**	**15.0**	**45.0**
Main budget balance	**-144.6**	**-166.3**	**-161.7**	**-179.8**	**-179.7**	**-167.2**	**-139.0**	**-143.8**
	-4.9%	**-5.2%**	**-4.7%**	**-4.7%**	**-4.8%**	**-4.1%**	**-3.2%**	**-3.0%**
Cash balances of social security funds, public entities and provinces	**33.8**	**30.1**	**27.0**	**26.7**	**26.5**	**22.7**	**25.0**	**25.0**
Consolidated budget balance	**-110.8**	**-136.2**	**-134.7**	**-153.1**	**-153.2**	**-144.5**	**-114.1**	**-118.7**
	-3.7%	**-4.3%**	**-3.9%**	**-4.0%**	**-4.1%**	**-3.6%**	**-2.6%**	**-2.5%**

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 R3.947 trillion over the three years relative to a revenue envelope of R3.497 trillion
  - Over the 2015 MTEF period, real annual average growth in expenditure is projected at 4.7%. A relatively stronger 6.8% 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, 02 trillion to share amongst the three spheres in 2014/15 financial year
  - The budget available for sharing between the three spheres is projected to increase to R1.09 trillion in the 2015/16 financial year and R1.2 trillion in the outer year
- Over the 2015 MTEF period, the division of revenue amongst the three spheres is projected to grow by a real annual average of 2.9%

Division of Revenue	2014 Budget **2014 M/term Estimate**	2014 MTBPS **2014/15 Revised**	2014 MTBPS **2015/16**	**2016/17**	**2017/18**	Real Annual Average Growth Rate (2015/16-2017/18)
National allocations	489.4	494.7	523.1	553.2	585.0	2.8%
Provincial allocations	**444.4**	**440.2**	**468.5**	**496.8**	**527.0**	**3.1%**
Equitable share	362.5	360.2	383.0	405.6	429.3	2.9%
Conditional grants	**82.0**	**80.0**	**85.4**	**91.2**	**97.7**	**4.0%**
Local government allocations	90.8	91.1	99.2	103.9	110.0	2.4%
Total allocations	**1024.6**	**1 026.0**	**1 090.8**	**1 153.9**	**1 222.0**	**2.9%**

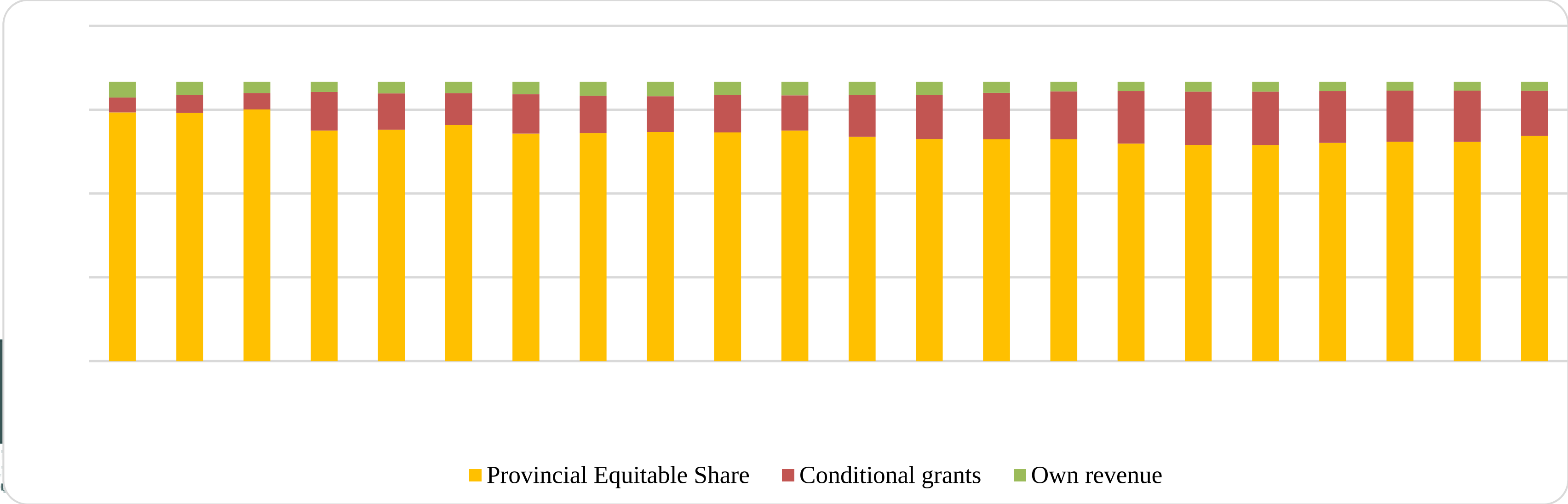
MTEF DIVISION OF REVENUE [CONT.]

- Government has proposed to lower the expenditure ceilings for the first two years of the 2015 MTEF by R10 billion and R15 billion respectively
  - With respect to the national sphere, staying within the confines of the expenditure ceilings will be achieved through the freezing of posts, withdrawing posts where vacancies have been persistent and reducing the growth in transfers to entities
  - The baseline allocations for provinces is revised downwards by R11 billion, while local government is reduced by R2.4 billion within the two years
  - Government's current position on fiscal consolidation is in line with the Commission's submission for the 2014/15 Division of Revenue which emphasised the need for South Africa to accelerate the pace of fiscal consolidation

DIVISION OF REVENUE: PROVINCIAL SPHERE

- Share of own revenue has declined from 6% in 1995/6 to 3% in 2013/14
- The largest share of provincial funding is in the form of intergovernmental transfers, which comprises the provincial equitable share and conditional grants
  - The inability of provinces to maximise own revenue collection has created a heavy reliance on intergovernmental transfers and a mismatch between provincial own revenues and expenditure needs which widens the vertical fiscal imbalance

Provincial Revenue by Source, 1995/96 – 2016/17



DIVISION OF REVENUE: PROVINCIAL SPHERE

- It is the Commission's view that following the recent review of the Local Government Fiscal Framework (on-going) it is now time to review the provincial fiscal framework so that provinces' role in economic development can be better appreciated
- Current practice has had the unintended consequence of characterising provinces as implementation agents for government's social programs, namely education, health and social development
  - As a result, resources for other provincial functions become a residual (particularly economic development) resulting in inherited disparities being perpetuated

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DIVISION OF REVENUE: LOCAL SPHERE

- Commission notes the growth in local government equitable share (LES) and conditional grants to municipalities
  - LES grow by 8% and grants by 5% annually between 2014/15 to 2017/18, respectively
- LES in the 2014 MTBPS has risen faster (14%) than in the 2014 budget (11.8%), indicating that more resources have been channelled to the local government sector since February 2014. In real terms the LES has grown quite slowly
  - In outer years the rate of growth of the LES allocations would progressively decline
- Of concern for local government fiscal frameworks is not only that fiscal capacity varies substantially across various municipalities, but also that fiscal capacity appears to have declined over time
  - In 2004/5, aggregate municipal own revenues amounted to 90% of aggregate expenditure. In 2014, this has declined to about 75% of aggregate municipal expenditure

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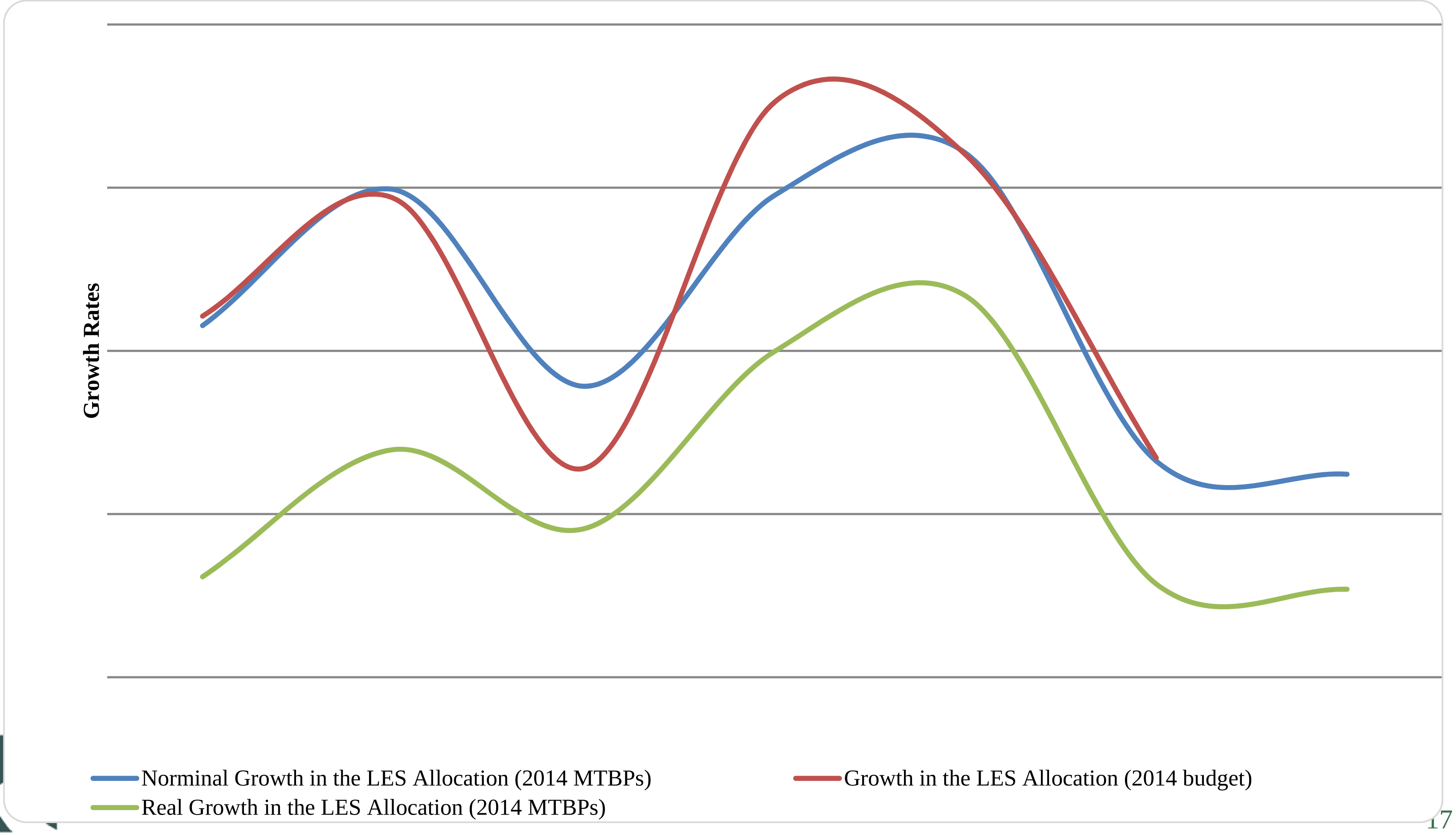
GROWTH IN LES



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Division of Revenue: Local Sphere [cont.]

- Local government is faced with huge challenges as it moves into the future
  - Responding to recent calls around the need for a differentiated approach and adequate funding to increase basic service provision, the Local Government Fiscal Framework (LGFF) and related matters such as addressing service backlogs are becoming significant issues for local government
  - Other challenges that need to be met at a local level include coping with an ageing infrastructure and delivering affordable housing
  - In light of these inefficiencies on the part of local government, there is the general perception that the local government financing system is inadequately funding municipalities
- Key developments over the 2014 MTEF, relevant for the LGFF, include assignment of the housing function (currently a provincial mandate) to six metros and a greater distribution of resources to rural municipalities following introduction of the new local government equitable share formula. It is important to critically assess these key developments in local government financing

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ADJUSTMENTS TO CONDITIONAL GRANTS

- In 2011, the Commission initiated a comprehensive review of the LGFF – the conclusions and recommendations of which were tabled in Parliament in April 2013
  - The Commission raised concerns on the performance of infrastructure grants (e.g., on recurrent under-spending, proliferation, perverse incentives, and whether they reflect priorities of the NDP or government policy in general)
  - To this end, the Commission welcomes the ongoing review of infrastructure grants by Government that the Commission is a member of, whose key objective is to make evidence-based recommendations on how the current system of funding municipal infrastructure can be enhanced

Adjustments to Conditional Grants [cont.]

- The Commission also welcomes the timely implementation of two recommendations emanating from the review process alluded to above, namely:
  - (a) the rationalisation of four grants administered by Department of Water Services (the municipal water infrastructure grant, water services operating subsidy grant, rural households infrastructure grant and the regional bulk infrastructure grant) and
  - (b) the merging of the public transport infrastructure grant and the public transport network operations grant into a single grant
- The rationalisation of grants and merging of two transport grants has potential to minimise inefficiencies associated with overlap of grant mandates, and also helps improve grant management
  - However, rationalisation and merging of grants should not be seen as substitute to efforts at uncovering the root cause of underperformance and decisively dealing with them

REVENUE AND TAX PROPOSALS

	2014/15			2015/16
R billion	**Budget**	**Revised**	**Deviations**	**Estimates**
Persons and individuals	**335.9**	**341.5**	**5.6**	**377.2**
Companies	**198.9**	**192.3**	**-6.7**	**211.7**
Value-added tax	**267.2**	**262.7**	**-4.5**	**288.5**
Dividend withholding tax	**19.3**	**19.8**	**0.6**	**21.3**
Specific excise duties	**31.1**	**32.5**	**1.5**	**33.4**
Fuel levy	**47.5**	**46.0**	**-1.5**	**47.2**
Customs duties	**50.3**	**45.0**	**-5.3**	**49.3**
Other	**43.5**	**43.8**	**0.4**	**47.3**
Tax policy and administration reforms	–	–	–	**12.0**
Gross tax revenue	**993.7**	**983.6**	**-10.0**	**1 088.1**

- Revenue projections have been revised downwards amounting to R10 billion, R7 billion and R16.8 billion in 2014/15, 2015/16 and 2016/17 respectively
  - Commission predictions (as at February 2014 submission on fiscal frameworks and revenue proposals) in respect of VAT slowing down due to lower consumption, have been realised
  - Improved performance in corporate tax has not been sustained. Underperformance with respect to corporate income tax, customs duties and VAT were the largest contributors to the R10 billion shortfall. MTBPS 2014 indicates that these same taxes have underperformed during the first half of the current fiscal year

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Revenue and Tax Proposals [cont.]

- In his 2014 MTBPS speech, the Minister of Finance indicated that in order to avoid real cuts in expenditure, additional revenue of R15 billion per annum will need to be raised
  - Commission of the view that a proposal to tax increases as part of debt stabilisation could be viewed as a reasonable price to pay in order to avoid a debt trap down the line which in itself would fuel significantly weaker growth and exacerbates poverty and inequality
  - Commission notes intended measures at addressing shortfalls experienced by state owned enterprises
    - Move welcome insofar as it removes the "soft budget constraint" and encourage more fiscal prudence, efficiency in operations and resource utilisation
    - Commission awaits details of intended sale of non strategic assets and equity conversion

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UNALLOCATED RESOURCES

- In its submission on the 2014 fiscal framework and revenue proposals, the Commission noted that allocations in respect of the unallocated reserves were markedly lower than Budget 2013. MTBPS 2014 continues with this trend, at least in the first two years of the 2015 MTEF period. By 2017/18, the amount set aside grows to R45 billion.
- At the time Budget 2014 was tabled, the Commission raised concern around the danger of excessive drawdowns on this resource and in so doing creating a risk of having too low reserves should an emergency situation arise. The maintenance of this fiscal buffer is therefore welcomed, particularly in the unstable economic environment

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

R' billion	2013/14	2014/15	2015/16	2016/17	2017/18
Budget 2013	**4.0**	**6.5**	**10.0**		
MTBPS 2013		3.0	6.0	18.0	
Budget 2014		**3.0**	**6.0**	**18.0**	
MTBPS 2014			5.0	15.0	45.0

CONCLUSION

- In May 2014, the Commission tabled at Parliament its Annual Submission for the 2015/16 Division of Revenue under the theme of "balancing fiscal sustainability with socio-economic impact"
  - The Submission agrees in most aspects with the 2014 MTBPS that has been crafted in a constrained environment characterised by downward economic growth forecasts
  - Government has done a good job that promises a deficit reduction programme for the next three years and thereby prevents public debt from spiralling out of control
  - Overall, the 2014 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: that growth and employment in South Africa can only be achieved by combining fiscal consolidation and investment into future growth given the prevailing economic climate

CONCLUSION

- The Commission fully agrees with the position in the MTBPS of emphasising the need to get value for money from Government programmes
- Given the current negative economic outlook, the Commission agrees with the government stance on fiscal consolidation and tightening measures to maintain expenditure sustainability
- To enhance growth and employment, Government should continue re-directing government spending towards activities that directly or indirectly create jobs through enhancing productivity performance. The emphasis on education as the number one priority is commendable in this effort towards productivity improvements

CONCLUSION [CONT.]

– Given the tight fiscal framework, the Commission commends efforts by Government to protect conditional grants, which are fundamental in maintaining and improving service delivery to communities. The Commission supports the proposed review of conditional grants, addressing identified weaknesses it has raised in the past and will continue engaging with government and other stakeholders in the exercise

- Government should review the Provincial Government Fiscal Framework with a view to ensuring its long term viability and emphasis on economic development

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CONCLUSION [CONT.]

- It is very clear that the economy remains far below the economic growth rates required to make the dent on unemployment and inequality
  - Rebuilding state capabilities should be prioritised with efforts aimed at both social capabilities for citizens and infrastructure and how these will be managed within the context of current consolidation measures.
  - In this regard, much more still needs to be done to implement the NDP and the MTSF

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