



Financial and Fiscal Commission

Submission on the 2022 Budget

For an Equitable Sharing of National Revenue

28 February 2022

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Contents

1. Background.....	3
2. Economic Overview and Prospects	3
Global Economic Outlook	3
Domestic Economic Outlook.....	5
Savings.....	6
Investment.....	7
Employment.....	7
Debt.....	8
Recommendations.....	9
3. Fiscal Framework and Revenue Proposals	9
Overview of the 2022 fiscal framework	9
Revenue trends and tax proposals.....	12
Recommendations.....	13
4. 2022 Appropriation Bill.....	13
Recommendations.....	17
5. 2021 Division of Revenue Bill – Provinces.....	17
Overview of provincial government allocations	17
Conditional grants for provinces.....	19
Recommendations.....	20
6. 2021 Division of Revenue Bill – Local Government	20
Overview of local government allocation.....	20
Local government equitable share and formula.....	21
Conditional grants for local government	22
Recommendations.....	23
7. Public-sector institutions and investment	24
Guarantees to state-owned entities.....	24
Financial performance of state-owned entities	25
Public sector infrastructure spending.....	29
Recommendations.....	31
8. Achieving a balance between economic and social recovery and ensuring sustainable public finances	31
Recommendations.....	33
9. Concluding Remarks.....	33

1. Background

- 1.1. This Submission on the 2022 Division of Revenue (DoR) Bill is made in terms of Section 214 (1) of the Constitution of the Republic of South Africa (1996) and Section 35 of the Intergovernmental Fiscal Relations (IGFR) Act (1998) as well as S4(4c) of Money Bills Amendment Procedure and Related Matters Act or MBARARMA (Act 9 of 2009), as amended.
- 1.2. In March 2020, the COVID-19 pandemic reached South Africa. Responding to and containing this health crisis and its wide-ranging socio-economic impacts has dominated the government's plans and priorities over the past two years and will continue to do so over the foreseeable future. The government has had to go to extraordinary measures to ensure funding to purchase vaccines and ensure income and other support for the most vulnerable. The pandemic and the associated lockdown have redefined the vulnerable as people's lives and livelihoods were lost. The shocks brought on by the COVID-19 pandemic have led to contractions in the gross domestic product (GDP), increased debt levels and high unemployment and income losses – all of which have served to exacerbate inequality and poverty further.
- 1.3. The outbreak of the July 2021 civil unrest in KwaZulu-Natal and Gauteng caused strain on the government, as public resources had to be further extended in the form of provisions of income support to households and to aid the recovery of businesses, especially small and medium-sized enterprises.
- 1.4. As with the 2021 Budget and then the 2021 Medium Term Budget Policy Statement, Budget 2022 is premised on balancing the priorities of placing South Africa on the path to economic and social recovery and restoring the sustainability of public finances. The multifaceted social and economic impacts of the COVID-19 pandemic over the last two years mean that Budget 2022 is tabled in a fiscally constrained environment, making the fulfilment of these priorities challenging. In providing the Commission's view on Budget 2022 and the government's progress towards recovery and fiscal sustainability, this document is divided into nine sections as follows:

By homing in on key macroeconomic metrics (such as investments, savings, employment and debt), Section 2 provides an overview of South Africa's economic outlook and prospects. Section 3 provides an analysis of the overall fiscal framework and revenue proposals underlying Budget 2022. Section 4 focuses on allocations in the national sphere (Appropriation Bill). Sections 5 and 6 assess Budget 2022 in terms of division of revenue issues pertaining to provinces and local government, respectively. Section 7 looks at the issues related to public institutions and investment, whilst Section 8 provides an FFC commentary on the government's progress towards meeting the twin goals of recovery and fiscal sustainability. Section 9 concludes.

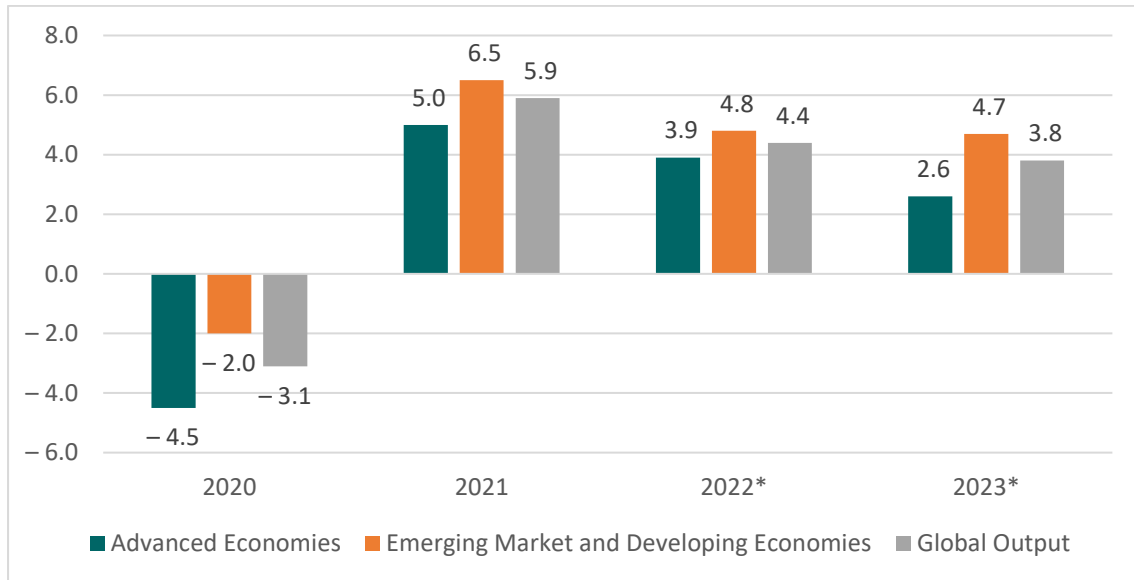
2. Economic Overview and Prospects

Global Economic Outlook

- 2.1. The global economic prospect looks dim and even more fragile in 2022, after the unprecedented downturn in 2020 with the onset of the COVID-19 pandemic. Although the International Monetary Fund estimated a rebound at 5.9% in 2021, 2022 is anticipated to show slower growth in both emerging and advanced economies. This moderation is

due to the uncertainties of the ever-mutating COVID strains, with poorer economies most exposed to downside risks due to lack of equitable access to vaccines and the ability to build fiscal resilience.

Figure 1: Economic Outlook Projections, % change

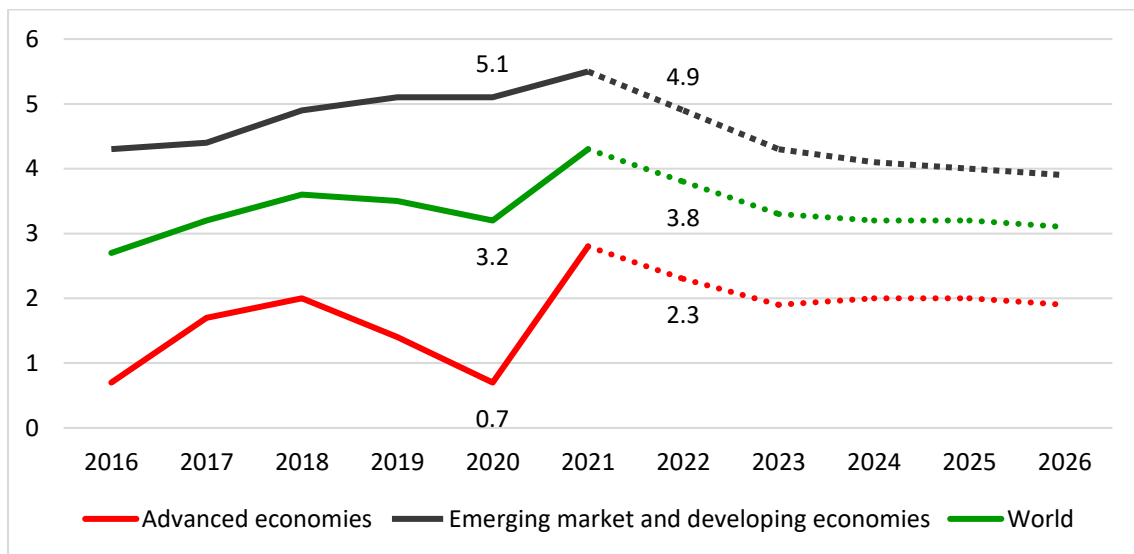


Note:

An asterisk (*) denotes forecast values
 Source: International Monetary Fund 2022

2.2. Due to energy price shocks, disrupted supply chains, extraordinary fiscal and monetary interventions and increasing debt levels, inflationary pressures are expected to continue rising in 2022 (see FFC's Annual Submission for the 2022/23 Division of Revenue). Policymakers must strike a delicate balance of sustaining debt levels and ensuring social protection in lower-income economies and emerging markets. Inflation Price pressures in 2022 will average about 3.9% in advanced economies and 5.9% in emerging market and developing economies. Crude prices will increase to an estimated 12% this year as natural gas prices rise to approximately 58%.

Figure 2: Inflation rate, average consumer prices (annual % change)



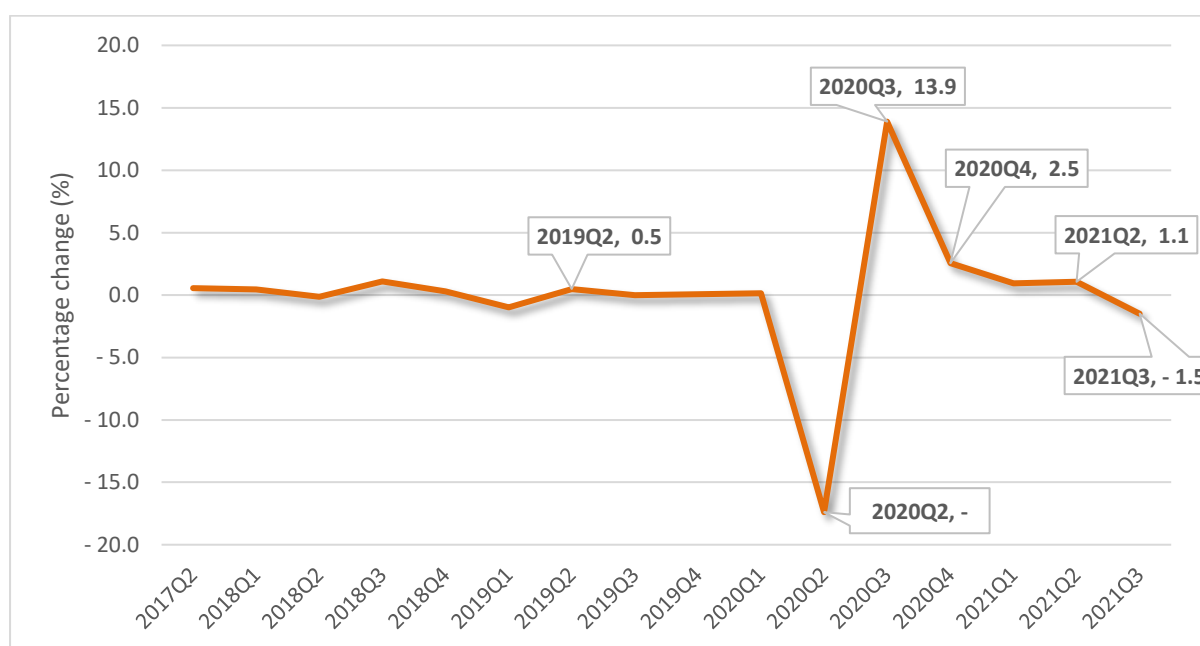
Source: International Monetary Fund 2021

2.3. The Ukraine-Russia conflict presents a global economic threat that has destabilised the trajectory and pattern of recovery and general trade. Military action interruptions and sanctions add one more challenge to global supply chains already under strain. Countries that depend on the region's rich supply of energy, wheat, and other staples will feel the pain of price spikes transmitted throughout the global economy.

Domestic Economic Outlook

2.4. The South African economy continues to experience slow economic growth with low private and public investment growth, poor export capacity, and low productivity, leading to a 6.4% contraction in 2020 (% change year-on-year). Signs of a slow economic recovery since 2020Q3 were disrupted by the unrest in KwaZulu-Natal and Gauteng in 2021Q3.

Figure 3: Gross domestic output, annualised quarterly % change (seasonally adjusted)



Source: Statistics South Africa, 2021

Table 1: % change quarter-on-quarter (seasonally adjusted)

	2019	2020				2021		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Agriculture, forestry and fishing	0.2	9.8	-4.3	-0.1	6.6	-1	6.2	-14
Mining	1.3	-5	-31	45	-1	4.3	1.9	-0.9
Manufacturing	-0.6	-1	-31	35	5.3	0.5	-1	-4.2
Electricity, gas and water	-1.6	-1	-12	13	-0	-0	0.7	0.4
Construction	-1.5	-3	-30	16	1.5	2.6	2.2	-0.5
Trade, catering and accommodation	-1.1	-1	-27	25	1.5	2.6	2.2	-5.5
Transport, storage and communication	-1	-1	-27	17	2.9	-1	6.9	-2.2
Finance, real estate and business services	2.2	2.7	-11	6.6	2.9	1.3	-0	1.2
General government services	-0.2	0.2	-0.3	0.2	0.2	0.3	-1	0.4
Personal services	-0.2	-0	-5.9	4.1	1.7	0.6	2.5	0.5

Source: Statistics South Africa 2021

- 2.5. On the production side of the economy, six industries recorded negative growth between 2021Q2 and 2021Q3, with the agriculture industry decreasing most significantly by 13.6%. The trade and manufacturing industries also contributed to the negative growth, falling at 5.5% and 4.2%, respectively. The July social unrest, the cyberattack on Transnet, higher input costs, notably fuel and electricity, undermined domestic economic activity, external disruptions in global value chains, and global demand weighed in on the negative growth.
- 2.6. Strong commodity exports and commodity prices have helped the domestic economic recovery and increased revenue for consumption expenditure. However, the recovery may be limited by persistent policy uncertainty, constrained fiscal space, subdued business confidence, infrastructure bottlenecks, and the slow pace of structural reforms.

Savings

- 2.7. South Africa's household and businesses savings have been constrained because it does not generate enough employment for income and revenue for savings after spending. South Africa's national saving rate (gross saving as a percentage of nominal GDP) decreased to 16.9% in 2021Q3, from 17.3% in the second quarter. Despite this, the majority of gross saving is by the private, corporate business sector, which increased from 16.1% in 2021Q2 to 16.6% in the third quarter, as the corporate tax payments declined. Similar to businesses, gross savings by households increased marginally from 2.4% of nominal GDP to 2.8%. The general government's savings has remained negative due to persistent overspending and inefficiencies. Limited savings as a proportion of GDP mean that South Africa must rely on foreign capital to fund its investment needs.

Table 2: Gross saving as a percentage of GDP, at seasonally adjusted annualised rates

	2020				2021		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Corporate business	15.9	23.5	22.3	16.3	17.9	16.1	16.6
General government	-3	-12.7	-9.5	-4.2	-3.8	-1.1	-2.4
Household	2.1	2.8	3.1	2.4	2.5	2.4	2.8
Total	15	13.6	15.8	14.4	16.6	17.3	16.9

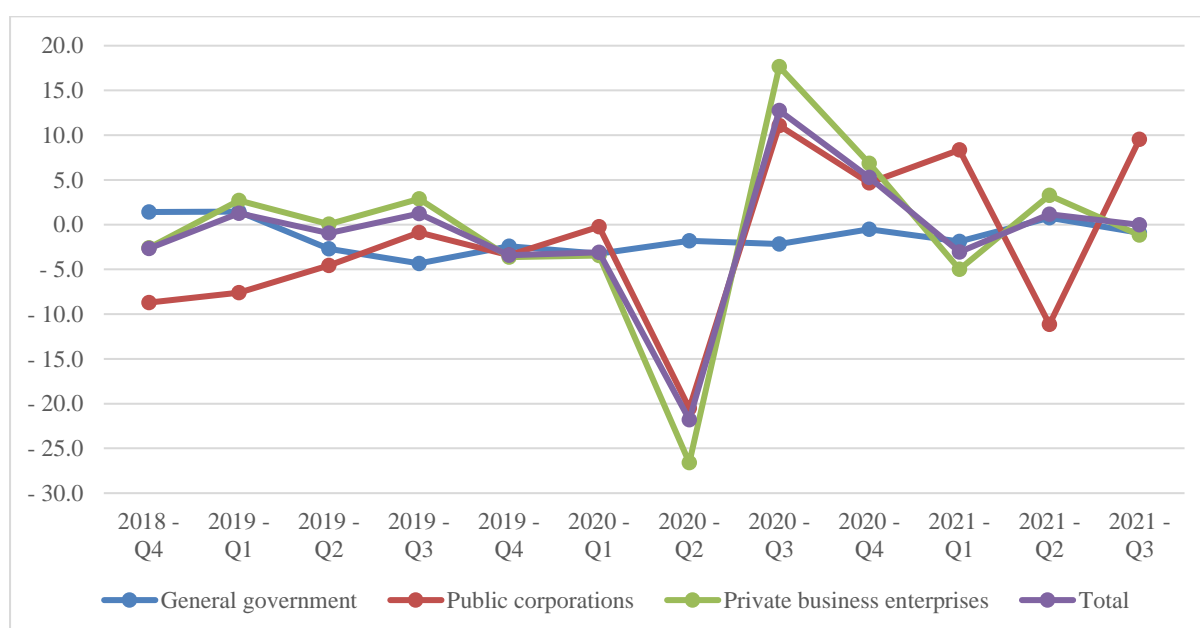
Source: South African Reserve Bank, 2021

- 2.8. South Africa as a developing country should prioritise programmes that promote domestic savings for capital to be invested towards the most productive economic activities. Overcoming the savings constraint requires forcing down consumption in the short term. To improve savings will therefore mean reducing consumption expenditure in favour of large capital investment. Achieving economic growth will therefore require an optimal balance between savings and investment to avoid the dampening effect of reduced consumption expenditure. The level of national savings is vital for the successful and sustained development of the country, especially fixed investment activity and job creation.

Investment

- 2.9. The levels of fixed investment in South Africa have been muted for a considerable time. The slow growth of fixed investment raises questions about the recovery's durability and the economy's growth potential over the longer term. Total Gross Fixed Capital Formation (GFCF) improved following a sharp decline due to the impact of COVID-19. Government investment declined by -0.9% in the third quarter of 2021. The private fixed capital formation also declined by -1.2%, while public corporations fixed capital formation increased by 9.5%.
- 2.10. The low levels of growth in gross fixed capital formation, particularly that of the general government's contribution, remains a significant challenge and impediment to the long-term recovery of economic growth. On the other hand, boosting private investment by private businesses requires addressing policy uncertainty and fiscal sustainability.

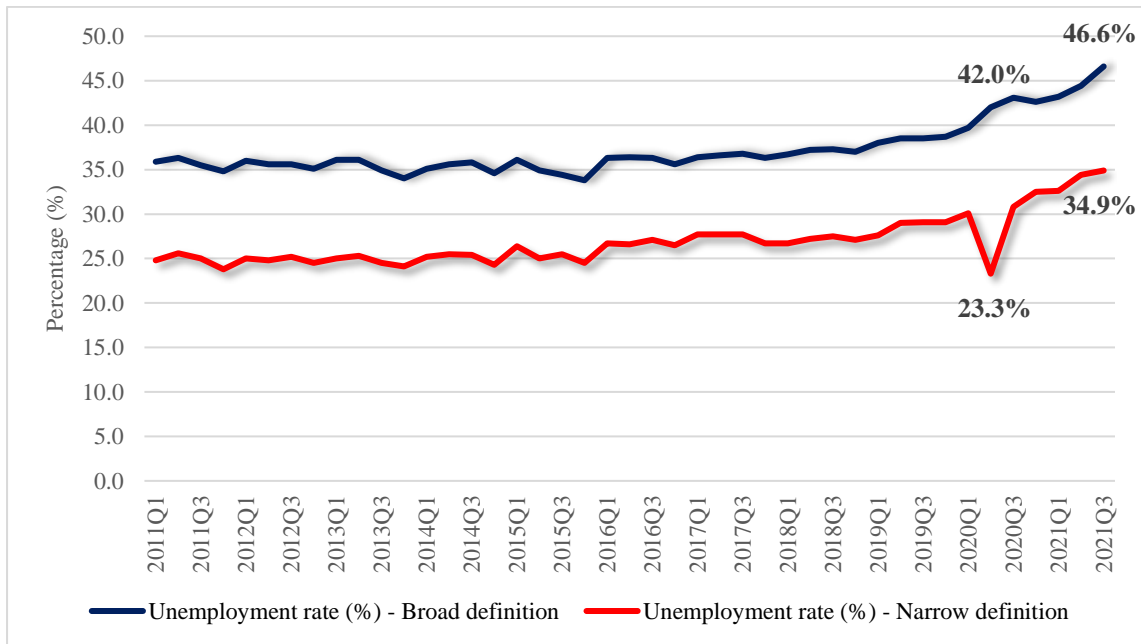
Figure 4: Investment, quarter-on-quarter change (%)



Source: Statistics South Africa, 2021

Employment

- 2.11. Structural challenges in the labour market and weak economic growth have undermined progress in reducing poverty, unemployment and inequality, which the COVID-19 pandemic has heightened. The rising unemployment constrains the achievement of economic inclusion. The official unemployment rate went from 34.4% in the second quarter of 2021 to 34.9% in the third quarter of 2021 - the highest recorded unemployment rate in South Africa in its economic history since democracy. According to the expanded definition of unemployment, the unemployment rate increased by 2.2 percentage points to 46,6% in 2021Q3 compared to the previous quarter.

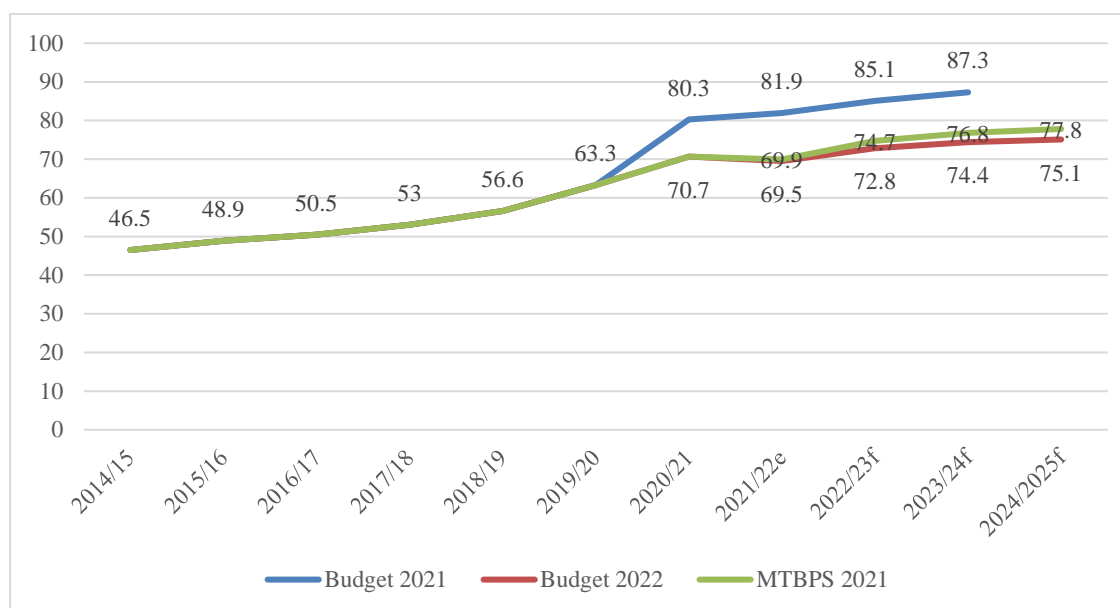
Figure 5: Unemployment rate (%)

Source: Statistics South Africa 2021

2.12. The employment recovery continues to be sluggish and has not recovered to pre- COVID-19 levels. The government is making efforts to stimulate employment growth through various interventions such as public employment programmes and tax incentives, implementing programmes to address the skills constraint and making it easier to do business. Many of these interventions have a strong youth focus since youth unemployment is disproportionately higher than other age groups. In the 2022 Budget, a total of R18.4 billion is allocated to support youth employment and the creation of short-term jobs over the medium term. Labour market interventions and public employment programmes have successfully created short-term and permanent jobs (in some instances), but this has not translated into changing the macro-level picture of unemployment. More fundamental structural reforms are required to address unemployment in the long run.

Debt

2.13. South Africa's growing debt has the potential to jeopardise growth and stability. Rising government debt poses a threat to fiscal sustainability, especially when South Africa continues to experience low economic growth. Government debt increased from 63.5% of GDP in the 2019/20 fiscal year to 70.7% in the 2020/21 fiscal year. The increase is lower than what was estimated in the 2020 Budget. Debt is forecast to stabilise at 75.1% in 2024/25, which is down from 80.5% of GDP in 2025/26 forecast in the 2021 Budget.

Figure 6: Government debt as a percentage of GDP, 2014/14-2024/25

Source: National Treasury, 2022

2.14. The Commission welcomes the idea that over the medium term, a portion of the higher revenue will be used to lower the government's gross borrowing requirement and the reduction of debt issuances. However, some of the challenges facing debt stabilisation include rising inflation (both on the domestic and international prices pressures), expectations that higher interest rates could increase borrowing costs and the resurgence of COVID-19 infections resulting in spending pressures.

Recommendations

- The Commission notes that the economic recovery is susceptible to multilateral, multifaceted risks from international and domestic developments. The economy may take time to return to pre-COVID growth levels. Stimulating growth and economic recovery requires addressing the long-standing structural constraints, supporting growth-inducing activities and eradicating inefficiencies and corruption. There is a need to unlock private sector investment and participation by market competitiveness and concentration to lower barriers to entry for small businesses.

3. Fiscal Framework and Revenue Proposals

Overview of the 2022 fiscal framework

3.1. Over the MTEF, the consolidated government spending is expected to grow at an annual average of 3.2%. A consolidated budget deficit of 6% of GDP is projected for 2022/23, narrowing to 4.2% of GDP in 2024/25. The projected moderate increases in government spending aim to reduce the budget deficit. The poor and inefficient financial performance of State-Owned Entities still weighs on public finances and rising budget deficit. A narrowing tax base due to rising unemployment may pressure public spending, increase the budget deficit, and increase borrowing requirements. Debt servicing costs will exceed R300 billion per year from 2022/23, becoming the fastest-growing spending item.

Table 3: Consolidated government fiscal framework

	2021/22	2022/23	2023/24	2024/25
R billion/percentage of GDP	Revised estimate	Medium-term estimates		
Revenue	1721.3	1770.6	1853.2	1977.6
	27.5%	27.5%	27.2%	27.3%
Expenditure	2077.0	2157.3	2176.8	2281.8
	33.2%	33.5%	32.0%	31.5%
Budget balance	-355.7	-386.6	-323.6	-304.2
	-5.7%	-6.0%	-4.8%	-4.2%
Debt-service costs	268.3	301.8	335.0	363.5
	4.3%	4.7%	4.9%	5.0%
Gross Domestic Product (est.)	6251.5	6441.3	6805.3	7233.7

Source: National Treasury, 2022

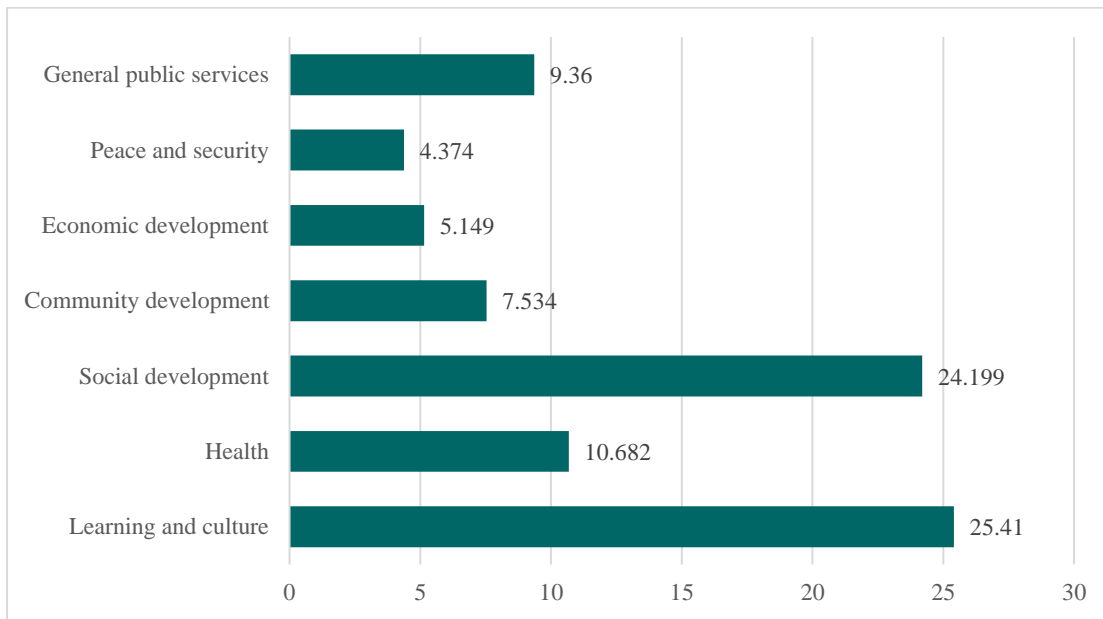
3.2. Table 4 shows that over the MTEF period, capital payments will receive an allocation of R327.7 billion representing an average growth of 12.2% over the 2022/23 to 2024/25 period. Capital transfers will receive a total allocation of R260 billion over the MTEF period, representing an average growth of 7.9%. The average growth of employees' compensation will be 1.8% over the MTEF period, and the average growth of goods and services will be 2.6% over the MTEF. Spending on the compensation of employees and spending on transfer and subsidies are the two largest components of the current account.

Table 4: Allocations by economic classification

	2021/22	2022/23	2023/24	2024/25	Total MTEF
R billion	Revised estimate	Medium-term estimates			
OPERATING ACCOUNT					
Current payments	1 847.30	1 936.30	1 926.10	2 013.90	5 876.30
Compensation of employees	665.1	682.5	675	702	2 059.50
Goods and services	277.9	284.8	281.6	299.9	866.2
Interest payments	276.9	310.8	343.7	372	1 026.50
Current transfers and subsidies	627.4	658.2	625.8	640	1 924.00
CAPITAL ACCOUNT					
Capital receipts	0.2	0.2	0.2	0.2	0.7
Capital payments	82.2	102.4	109.1	116.2	327.7
Capital transfers	73	81.4	86.8	91.8	260

Source: National Treasury, 2022

3.3. The 2022 Budget presented a consolidated expenditure framework and functional allocation that revised estimates upwards compared to the 2021 Budget. The spending allocation for the Learning and Culture function received R25.41 billion for the 2021/22 financial year and has the most significant increase relative to other functions. This increase supports policy priorities in higher education and teacher retention in basic education. The social development function receives an allocation of R24.1 billion, which is mainly driven by the extension of the Social Relief of Distress grant.

Figure 7: Change between the 2021 Main Budget and revised estimate in 2022 Budget for the 2021/22 financial year

Source: National Treasury 2022

3.4. Allocations across functions support the implementation of existing policy priorities around protecting the vulnerable. However, over the MTEF period, real spending in education, health, and social development may decrease after inflation over the MTEF, impacting the reversal of protection of vulnerable sections of society. The decreases in spending over the MTEF may also affect the number of people employed in these functions. The budget cuts must consider the effect of these cuts on employment, a balance between budget cuts and employment preservation.

Table 5: Real consolidated non-interest expenditure by function

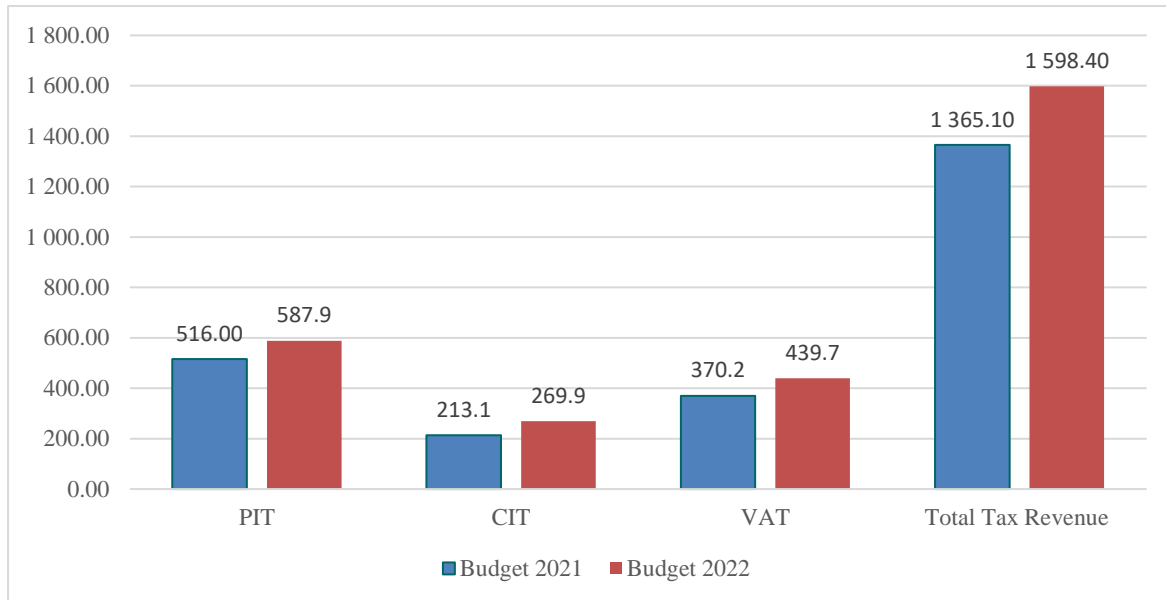
R billion	Total allocation between 2021 Budget and 2022 Budget		Change between MTBPS 2021 and Budget 2022	Average annual change 2021/22 to 2024/25
	2021/22 Main Budget	2021/22 Revised estimate		
Learning and culture	389.8	415.2	25.4	-1.1%
Health	227.7	238.4	10.7	-1.8%
Social development	280.4	304.6	24.2	-2.5%
Community development	204.2	211.7	7.5	3.4%
Economic development	187.7	192.9	5.1	4.2%
Peace and security	214.0	218.4	4.4	-3.1%
General public services	62.4	71.7	9.4	-4.9%
Consolidated non-interest expenditure	1566.1	1652.8	86.7	
Consolidated non-interest expenditure including payments for financial assets	1662.7	1727.4	64.7	
Consolidated non-interest expenditure excluding compensation of employees	935.5	987.8	52.3	

Source: National Treasury, Budget Review 2022; FFC Own Calculations

Revenue trends and tax proposals

3.5. The increase in commodity prices has improved the in-year revenue outlook resulting in higher-than-expected revenue collection. Gross tax revenue for 2021/22 is R61.7 billion above projections. The upward revision shows an improvement in Personal Income Tax (PIT), Company Income Tax (CIT), and Value Added Tax (VAT).

Figure 8: Tax Revenue Budget 2021 and Budget 2022 (R billion)



Source: National Treasury, 2022

- 3.6. The government is restructuring the corporate income tax system without negatively impacting net revenue collections. The corporate income tax rate is reduced by one percentage point to 27%. The rationale for the reduction is that the relief provided through a reduction in corporate tax can divert the savings towards investment to create jobs and support an inclusive recovery. The Commission notes that South Africa has been experiencing low investment, contributing to sluggish growth while decreasing corporate taxes and encouraging further research on alleviating the structural constraints and uncertainties impacting investor behaviour.
- 3.7. On revenue, the Commission notes that tax policy has focused on broadening the tax base, improving administration, and lowering tax rates over the past two years. As outlined in Budget 2022, the government intends to continue with this approach by avoiding tax rate increases where possible. The Commission supports this stance to grow the tax base instead of a rate-based approach.
- 3.8. The government is also expanding the employment tax incentive to encourage businesses to employ young people. The incentive increases to a maximum of R1 500 monthly in the first 12 months and from R500 to a maximum of R750 in the second 12 months of eligibility. The Commission welcomes the expansion of the incentive to address youth unemployment, subject to impact monitoring and evaluation of its implementation and outcome.

Recommendations

- The Commission welcomes the fiscal framework and revenue proposals of the 2022 Budget and aims to narrow the budget deficit and stabilise the debt. The Commission also welcomes the tax proposals of not increasing taxes, as this will provide much-needed relief to households in the face of price increases.
- The Commission further encourages investigating the relationship and driver between tax reduction and revenue, to ensure the growth-optimality of guiding changes in the tax regimes.

4. 2022 Appropriation Bill

- 4.1. The 2022 Appropriation Bill makes provision for the appropriation of funds from the National Revenue Fund for the state's requirements in relation to the 2022/23 financial year.
- 4.2. Total appropriation by vote amounts to R1.057 trillion in 2022/23 (or R3.1 trillion over the next three years). This allocation represents a nominal increase of 3% when compared to the revised estimate for 2021/22. However, the positive growth does not last beyond 2022/23, when total allocation is projected to decline by 4% before recovering in 2024/25. Considering these trends, it is clear that the benefits of increased, and in some cases, temporary, funding will be limited to 2022/23. National departments will feel the pinch of constrained resources more strongly in 2023/24.
- 4.3. Focussing on 2022/23, the increase in the total appropriation by vote is driven mainly by funding priorities in the Social Development, Higher Education and Training and Cooperative Governance votes. Table 6 illustrates the allocations, year-on-year, and average growth rates across a selection of key Votes, whilst the rest of the section discusses key developments characterising specific national votes.
- 4.4. In absolute terms, the largest allocation at the national sphere is the **Social Development** vote, which will receive R257 billion in 2022/23, primarily to fund the social protection programmes. More specifically, three new developments will be effected over the next three years.
 - i. First is the temporary, twelve-month extension of the Social Relief of Distress (SRD) grant, calculated at a projected cost of R44 billion, which is made possible by additional resources from higher than anticipated revenue collection. Government is clear that this extension is temporary and will end in March 2023. Given the effects of the health and economic crisis, the extension of this grant which provides income relief to 10.5 million people, is supported.
 - ii. Second, the Child Support Grant (CSG) will be extended to provide support for double orphans, starting in 2023/24. The extension of this grant is geared at promoting the care of orphans within families instead of foster care.
 - iii. Third, social security grants will be adjusted in line with inflation as of 2023/24.

Table 6. Allocations and growth for selected national votes

R million	Revised estimate	Medium-term expenditure estimates			2021/22-2022/23	2022/23-2023/24	2023/24-2024/25	Average growth 2022/2023-2024/2025
	2021/22	2022/23	2023/24	2024/25				
Cooperative Governance	98,984.9	111,364.9	119,225.8	127,419.4	12.5%	7.1%	6.9%	8.8%
Home Affairs	9,431.4	9,406.0	9,332.6	9,751.7	-0.3%	-0.8%	4.5%	1.1%
Basic Education	28,256.6	29,560.2	30,388.0	31,406.7	4.6%	2.8%	3.4%	3.6%
Higher Education and Training	97,522.5	109,514.9	113,235.2	119,647.9	12.3%	3.4%	5.7%	7.1%
Health	65,108.7	64,531.0	60,620.5	62,157.6	-0.9%	-6.1%	2.5%	-1.5%
Social Development	233,697.9	257,001.4	221,042.0	232,975.0	10.0%	-14.0%	5.4%	0.5%
Justice and Constitutional Development	19,508.7	20,021.9	19,802.2	20,692.4	2.6%	-1.1%	4.5%	2.0%
Office of the Chief Justice	1,241.8	1,265.8	1,232.9	1,288.3	1.9%	-2.6%	4.5%	1.3%
Police	100,473.8	100,695.3	99,018.8	104,373.7	0.2%	-1.7%	5.4%	1.3%
Agriculture, Land Reform and Rural Development	18,023.3	17,287.7	17,387.7	18,168.6	-4.1%	0.6%	4.5%	0.3%
Employment and Labour	3,783.5	3,956.0	3,983.5	3,772.6	4.6%	0.7%	-5.3%	0.0%
Forestry, Fisheries and the Environment	7,544.9	8,947.9	8,947.2	9,348.9	18.6%	0.0%	4.5%	7.7%
Human Settlements	31,624.8	33,024.7	34,457.6	35,508.7	4.4%	4.3%	3.1%	3.9%
Small Business Development	2,637.1	2,563.1	2,569.9	2,685.3	-2.8%	0.3%	4.5%	0.7%
Trade, Industry and Competition	11,727.0	10,859.3	10,887.7	10,553.3	-7.4%	0.3%	-3.1%	-3.4%
Transport	65,286.5	69,125.9	76,894.6	81,645.0	5.9%	11.2%	6.2%	7.8%
Water and Sanitation	17,735.1	18,539.7	20,155.2	20,913.3	4.5%	8.7%	3.8%	5.7%
Total appropriation by vote	1,025,806.5	1,057,028.6	1,013,672.6	1,059,387.2	3.0%	-4.1%	4.5%	1.2%

Source: ENE Summary Table No. 2.

- 4.5. The Commission supports these interventions to bring a breath of relief to poor and vulnerable households who rely on social security grants especially given the detrimental effects of COVID-19. Regarding possibilities around a more permanent replacement for the SRD grant, the Commission notes that the technical work to identify fiscally feasible and financially viable options to replace SRD is incomplete and ongoing. For the Commission, a key consideration regarding the viability of any potential replacement for the SRD grant will be the long-run, dynamic, economic impact and implementation of such a universal grant would have on the sustainability of the fiscus.
- 4.6. The Department of Higher Education and Training (DHET) allocation will increase from R98 billion in 2021/22 to R110 billion in 2022/23. Additional funding of R32.6 billion is directed at the National Student Financial Aid Scheme (NSFAS) for strengthening fee-free higher education through (1) continuation of bursaries to existing students from households earning below R350 000 per annum and (2) funding new entrants into the system. The additional funding for 2022/23 is made possible due to the revenue windfall. The underlying risk that government should bear in mind is the sustainability and ability of the government to continue with this support over the medium term, especially if revenue recovery is not realised. If revenue collection is poor, the DHET will be under severe pressure. The 2022 Budget Review refers to developing a new higher education funding model to be introduced in 2023. The Commission acknowledges the strain placed

on the fiscus by the fee-free higher education policy and thus awaits the contents of the new funding model. In light of the high unemployment characterising South Africa and the pivotal role that TVET colleges play in building artisanal skills, the Commission welcomes the increased allocation to this programme which averages 2.7% per annum in nominal terms over the next three years.

- 4.7. Positive growth is projected for allocations to the **Basic Education** vote over the next three years. However, given that this is a concurrent function with implementation primarily executed within provinces, the Commission is hopeful that this positive growth can be replicated across the nine provincial departments.
- 4.8. As a result of the shortfalls in provincial education compensation budgets, additional funding is being added to the provincial equitable share allocation to assist provinces. However, as noted in the 2022 Budget Review, slow growth (of 1.9%) for the compensation of employees over the medium term will result in fewer teachers and increased class sizes in some provinces. Factors such as the capability of teachers and class size, amongst others, influence pupils' learning outcomes. Thus, if this scenario is realised, it threatens the sector's performance and provision of quality education. It is also more likely to affect poorer, lesser resourced schools that cannot rely on school fees to pay teachers. To this end, the Commission welcomes the additional R24.6 billion added to the PES to address teacher shortages. Should teachers be hired, it creates future funding obligations. Should the sector face slower or negative growth over the coming years, education department budgets will be under severe pressure.
- 4.9. A notable development within the basic education sector is the shift of ECD from the Department of Social Development to the Department of Basic Education by April 2022/23. This function shift will result in a baseline increase of R3.7 billion over the next three years. International and national research have established the positive spillovers of investing in quality early learning programmes for the individual and society. Investing in ECD is also less costly than interventions later in the human capital pipeline. Now that ECD will be part of the formal schooling system, the Commission recommends that early learning be afforded the priority it deserves. To this end, outstanding issues integral to the shifting of this function, including the funding model and the implications of the shift for the existing ECD workforce, must receive urgent attention.
- 4.10. Over the medium term, the **Health** vote will continue focusing on the COVID-19 pandemic with the roll-out of its vaccination strategy. Funding amounting to R8.8 billion over the next three years is allocated in respect of the phased implementation of the National Health Insurance (NHI). Much of the funding is geared at ensuring the readiness of the sector for the NHI implementation. As indicated in the 2022 Estimates of National Expenditure, one of the department's objectives over the next three years is to enable the passing of the NHI Bill through Parliament. The Commission supports the principle of universal health coverage and looks forward to progress in this regard.
- 4.11. In terms of community development, strong increases are noted in the **Cooperative Governance** vote. The increased funding will be used to strengthen the equitable share allocations to municipalities by a projected R28.9 billion over the next three years. Given the role that municipal services such as water, sanitation, electricity and refuse removal

play in social and economic development, the Commission welcomes the government's efforts to protect this pool of funding.

4.12. The 2022 SONA highlighted the importance of infrastructure investment to South Africa's economic reconstruction and recovery. Budget 2022 reaffirms this stance with strengthened funding towards infrastructure evident across the Departments of Water and Sanitation and Transport:

- i. The **Water and Sanitation** vote is allocated R59.6 billion over the MTEF. Total expenditure is expected to increase at an average annual rate of 5.6% cent, from R17.7 billion in 2021/22 to R20.9 billion in 2024/25, mainly due to additional allocations of R5.3 billion over the medium term for capital projects involving water resource and regional bulk infrastructure. The Commission welcomes the increase in the funding for regional water resources because water is critical for the health and safety of our people and fundamental to growth and development.
- ii. The **Transport** vote allocation will increase by 7.7% over the MTEF from R65.4 billion in 2021/22 to R81.7 billion in 2024/25, mainly to fund road infrastructure. A large fraction of the vote allocation (R76.4 billion) will be transferred to the South African National Roads Agency (Sanral) to upgrade, strengthen and maintain the national road network. Over the MTEF period, 59.3% (R45.3 billion) of allocations will fund upgrading, strengthening, and refurbishing the national non-toll roads network. R2.8 billion is allocated for the R573 (Moloto Road) development corridor, R3.7 billion for the N2 Wild Coast project, and R2.1 billion is allocated to fund reduced tariffs for the Gauteng freeway improvement project. The Commission welcomes the allocation for road infrastructure because it enables and facilitates the trade of goods and services critical for economic growth and development.
- iii. The **Trade and Industry** vote total allocation is expected to decrease at an average annual rate of 3.7%, from R11.8 billion in 2021/22 to R10.6 billion in 2024/25. The vote received additional allocations amounting to R2.1 billion in 2021/22. Of this amount, R800 million was to create work opportunities through the presidential employment initiative, and R1.3 billion was to respond to the social unrest in July 2021 and the negative impact of the COVID-19 pandemic. The Commission welcomes the additional allocations for job creation and inclusive growth and the support to resuscitate businesses that had their operations decimated by the social unrest.
- iv. The **Employment and Labour** vote will receive R677.2 million over the first two years of the MTEF period for the pathway management network for supporting the presidential employment initiative. The Commission welcomes this initiative, subject to monitoring and evaluation of implementation and outcome.

4.13. Budget 2022 attempts to address some of the shortfalls affecting key departments within the peace and security cluster, which came to the fore during the July 2021 civil unrest. To this end, R8.7 billion has been added to the **Police** budget. This funding will be used to recruit and train 12 000 individuals for entry-level constable positions to meet the

police-population benchmark ratio of 1:450 (one police officer to 450 people). The Commission welcomes the capacitation of the South African Police Services, particularly for its Detective Services and Visible Policing programmes.

- 4.14. Despite projected reductions in allocations to the **Home Affairs** vote, the Commission welcomes the reprioritisation of R10 million in 2022/23 to spearhead the simplification of the visa regime.

Recommendations

- The Commission welcomes the government's twin approach of prioritising funding for social protection alongside increases for key votes within the economic development cluster. Since the additional funds are temporary as the revenue windfall, the spending of these functions must be expeditiously executed with impacts.
- The Commission cautions that certain increases across some sectors will create recurring funding obligations for departments – this includes NSFAS funding for existing bursary holders and the new cohort of students entering institutions of higher learning as well as the R24.6 billion allocated to hire teachers. Should revenue recovery not be realised, departments will be under severe pressure to implement beyond the 2022 financial year, where it is already showing a decline in allocation. Therefore, the Commission advises the department to be aware of this potential threat and be proactive in developing contingency plans to accommodate such a scenario.
 - In particular, we emphasise the urgency of ensuring that the processes related to the introduction of the new higher education funding model unfold swiftly and are concluded in time for introducing the new funding model in time for the 2023/24 financial year.

5. 2021 Division of Revenue Bill – Provinces

Overview of provincial government allocations

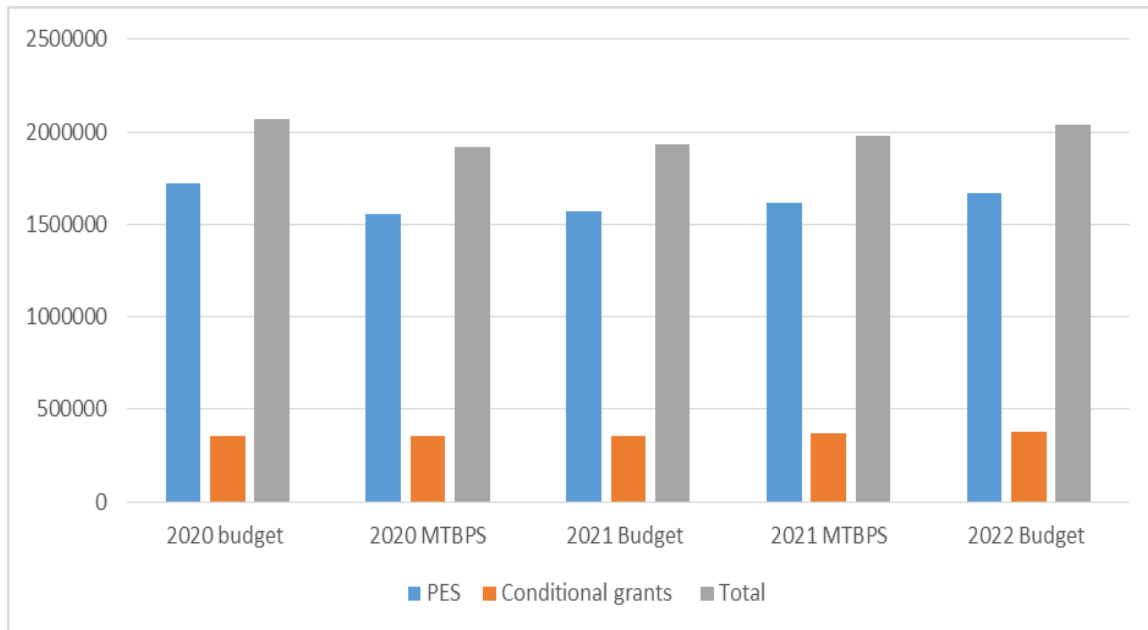
- 5.1. Table 7 below depicts the trajectory of the provincial fiscal framework since the outbreak of the COVID-19 pandemic and the crises-induced supplementary/adjustment budget in 2020. After tabling a total provincial budget allocation of R649 billion in 2020/21, the Minister of Finance revised the allocation downwards to R645 billion during the 2020 supplementary budget to account for the stagnating economic growth and revenue. The lingering effects of the crises on the economy necessitated further baseline cuts to the provincial fiscal framework in the 2020 MTBPS and 2021 Budget.
- 5.2. For the 2021/22 financial year, instead of the R691 billion forward allocation proposed in the 2020 Budget, the MTBPS projected to allocate R629 billion, revised upward to R639 billion in the 2021 Budget supported by revenue collection recovery. The allocation has since revised upwards to R661 billion (because of inflationary and special COVID-19 budget adjustments) but still falls short of the projected estimate of R691 billion in the 2020 Budget.

Table 7. Provincial fiscal framework trajectory since the COVID-19 pandemic

	2020/21	2021/22	2022/23	2023/24	2024/25	MTEF
2020 budget						
PES	538,472	573,990	607,554			1,720,016
Conditional grants	110,785	117,962	123,137			351,884
Total	649,256	691,951	730,690			2,071,897
2020 supplementary budget						
PES	538,472					
Conditional grants	106,823					
Total	645,295					
2020 MTBPS						
PES	520,717	513,973	521,988	523,111		,559,072
Conditional grants	107,594	115,381	119,766	122,452		357,599
Total	628,311	629,354	641,754	645,563		1,916,671
2021 budget						
PES	520,717	523,686	524,088	525,304		1,573,078
Conditional grants	107,594	115,783	119,260	121,520		356,563
Total	628,311	639,469	643,343	646,824		1,929,636
2021 MTBPS						
PES		544,800	538,800	525,300	548,900	1,613,000
Conditional grants		116,400	119,600	121,900	127,200	368,700
Total		661,200	658,400	647,200	676,100	1,981,700
2022 Budget						
PES			560,577	543,149	562,018	1,665,744
Conditional grants			121,782	124,161	128 138	245,943
Total			682,359	667,310	690,156	2,039,825

Source: Budget Review, 2020, 2021 and 2022.

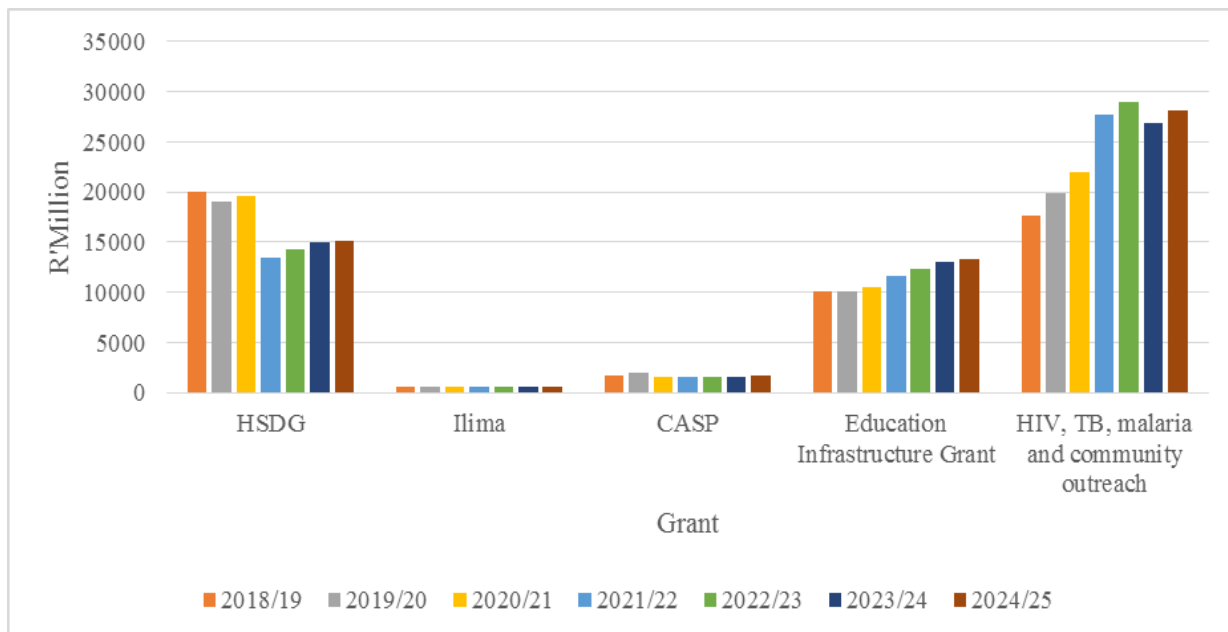
- 5.3. The forward estimates of the 2021 MTBPS were cautiously optimistic in anticipation of muted economic recovery and in consideration of debt and cost of employment (COE) reduction goals to improve fiscal stability, projecting a total provincial allocation of R1.98 trillion over the MTEF period.
- 5.4. The 2022 Budget proposes allocating a total of R2.039 trillion to provinces because of over R50 billion in adjustments to cater to the appointment of teachers and education assistants and strengthen the health care responses to the COVID-19 pandemic in implementation.
- 5.5. Figure 9 gives a graphical depiction of the static provincial allocations despite the upward adjustments made in the 2022 Budget, without adjusting for inflation and population growth (service demands). Whereas expenditure moderation is inevitable, provinces and governments as a whole must develop a systematic method of assessing and reporting the impact of declining allocation (in real terms) on the delivery of basic services. These are indicators such as learner-teacher ratios, the quantity of learner support material, medical supply shortages or inventory. In this way, both the national and provincial legislature would be able to direct resources (as they become available) to service areas severely affected by cost increases.

Figure 9. Total provincial MTEF allocations - PES and conditional grants

Source: Budget Review, 2020, 2021 and 2022

Conditional grants for provinces

- 5.6. The total provincial conditional grants allocation for the 2022/23 financial year amounts to R121.8 billion, increasing from R116.4 billion in the 2021/22 financial year (a nominal increase of R5.4 billion).
- 5.7. Figure 10 below depicts the growth trajectory of some of the key and most significant provincial conditional grants. The Human Settlement Development grant, a pivotal instrument to address historical and growing housing backlogs, has been reduced from R19.6 billion in 2020/21 to R13.4 billion in 2021/22, before increasing over the 2022 MTEF.
- 5.8. Education Infrastructure grant is exhibiting a steady increase as it is key in addressing the necessary infrastructure needs at schools. The HIV/AIDS, TB, Malaria and Community Outreach grant, which changed to the District Health Programmes grant, has shown significant growth over the past few years. While the Commission commends the protection of the District Health Programmes grant, it is of the view that prioritisation of spending should be focussed on hospital systems and healthcare facilities.
- 5.9. Whereas the agriculture grants have been historically marred by underspending, it is concerning that their allocations remain relatively insignificant considering that agriculture is identified as one of the pillars of the Economic Reconstruction and Recovery Plan. The two grants (Illema and Comprehensive Agriculture Support Programme (CASP)) are projected to receive R1.8 billion and R4.9 billion over the MTEF, respectively, representing 2% of the total provincial conditional grant's allocation.

Figure 10. Key provincial conditional grant allocations

Source: Budget Review, 2018/19 – 2024/25; FFC Own Calculations

Recommendations

- The Commission recommends that provinces identify selected delivery indicators and provide assessments of service levels using the 2020 financial year as a point of reference to determine the impact of static allocations on service delivery. The assessments must also incorporate provincial conditional grant delivery targets set out in the 2020 DoRA in comparison to the year of the evaluation as the benchmark.
- The Commission notes that despite the R24.6 billion over the 2022 MTEF for provincial education departments to address the shortage of teachers, the Commission recommends that the government consider the carry through cost for teachers going forward.

6. 2021 Division of Revenue Bill – Local Government

Overview of local government allocation

- 6.1. 2022 will be a challenging year for municipalities as the 2021 municipal elections resulted in municipalities having hung councils forming coalitions. While coalition councils have advantages such as providing checks and balances and allowing diverse and potentially innovative solutions. However, there are also risks such as policy uncertainties, lack of intra-cooperative governance and coherence in the execution of municipal functions, resulting in suboptimal service delivery within the local sphere of government. The Commission urges the government to ensure that people are always at the centre of decision-making, including programmes and resources in place that will capacitate councillors better to perform their mandated functions.
- 6.2. All these changes are taking place against the backdrop of COVID-19, which amplified challenges related to access to basic services (water, electricity, and sanitation) with wider fiscal gaps - municipalities (68%) are in financial distress. In addressing some of these

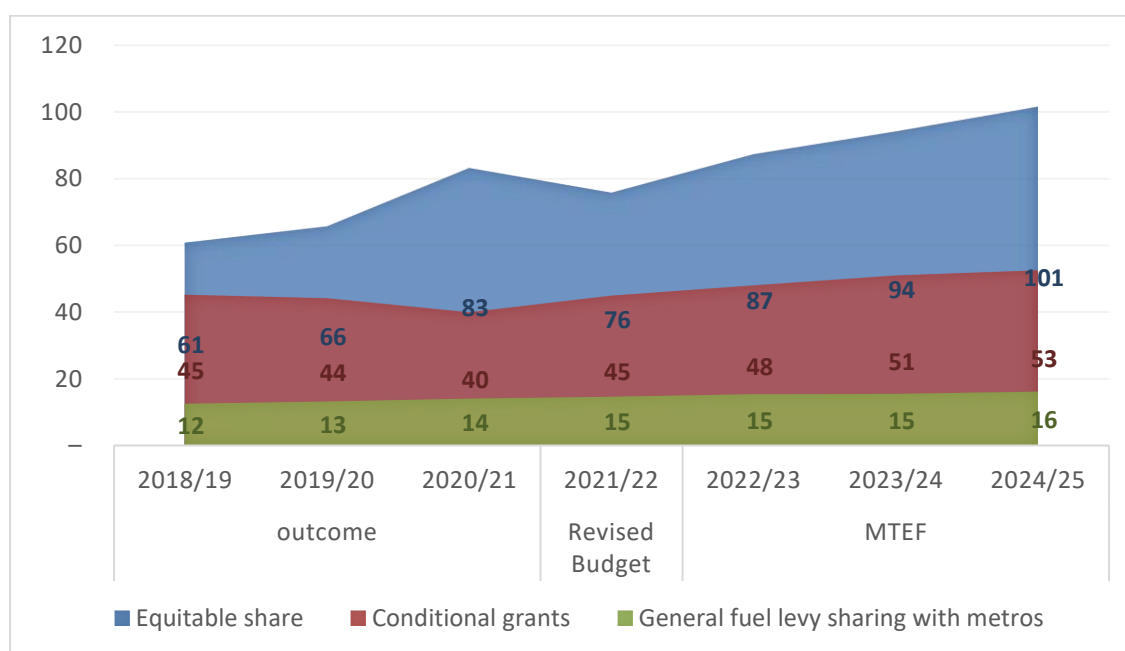
challenges, the Commission notes and welcomes the review of the Local Government Capacity Building system, which started in 2021 with its implementation envisaged to kick start in 2023. The Commission is of the view that such initiatives will enhance municipal performance and move the local government sector forward and quicken the recovery process.

6.3. Another welcomed development in the local government sphere is strengthening own municipal revenue through development charges, which plays a critical role in financing infrastructure-related projects and boosting economic growth. The Commission welcomes this approach as it aligns with the FFC 2020/21 Submission for the Division of Revenue for revenue sources to supplement municipal revenue. The Commission further stresses that these reviews should be synchronised with the District Development Model (DDM), which seeks to address critical issues of municipal finances service delivery failures.

Local government equitable share and formula

6.4. Over the 2022 MTEF, the Local Government sphere is set to receive total transfers amounting to R481.2 billion in direct transfers and R25 billion in indirect local government conditional grant transfers. R282.9 billion is allocated through the local government equitable share (LES), R151.5 billion as conditional grants, and R46.8 billion in the form of fuel levies. The vertical division of revenue share of local government allocations is expected to increase over the MTEF, from 9% in 2022/23 to double-digit of 10% 2023/24. The increase in the allocations will alleviate some of the pressures the poor municipalities face and subsidise their operations to provide basic services to poor households. The Commission welcomes this reallocation and stresses that municipalities must improve on the efficiency of spending with monitoring, reporting and evaluation to fulfil their constitutional mandate. National and provincial spheres should strengthen the capability of municipalities to improve their efficiency.

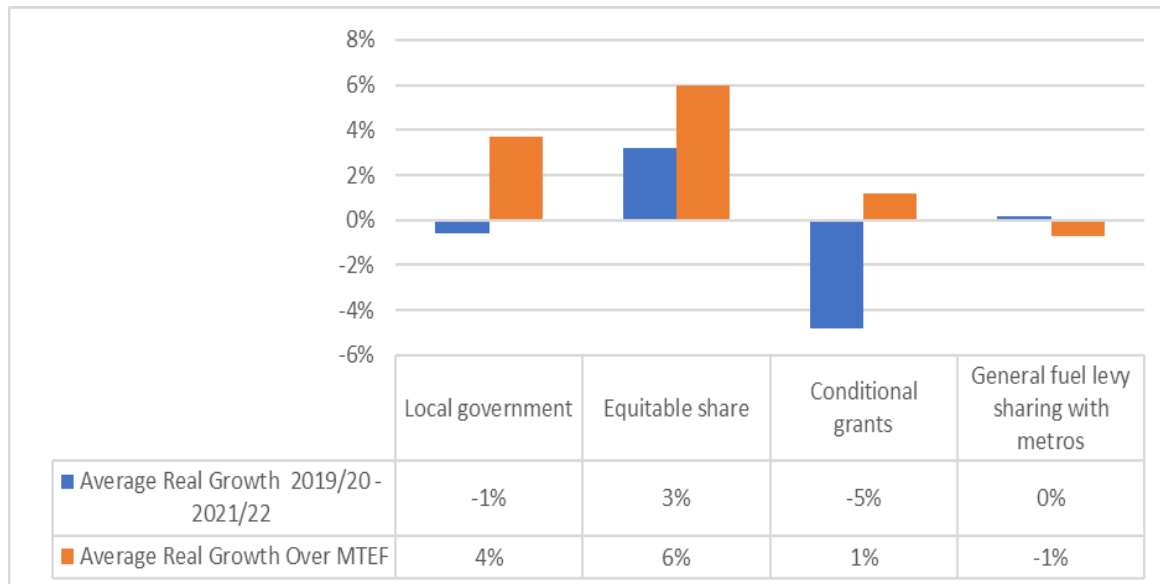
Figure 11. Allocations to the local government



Source: National Treasury Database; FFC Own Calculations

6.5. Figure 12 below shows that the increase in LES allocation is the main driver behind the positive real growth of 6%. The Commission welcomes the government's efforts to keep LES growth rates above inflation as it will go a long way in offsetting the ever-increasing costs of basic services and enable the delivery of basic services to poor households.

Figure 12. Local government average real growth rates

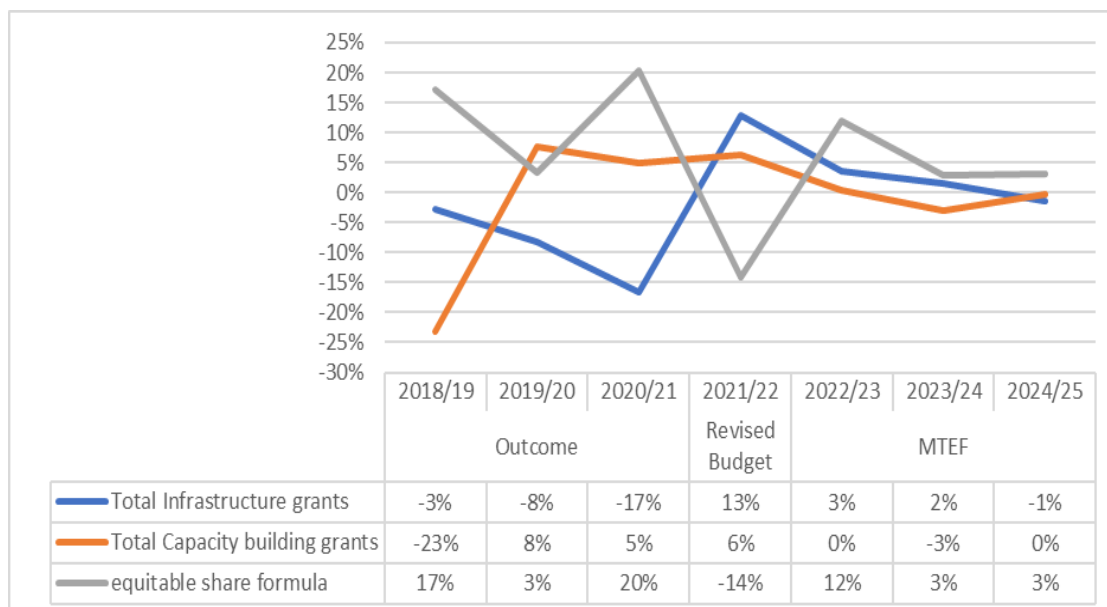


Source: National Treasury Data Base; FFC Own Calculations

Conditional grants for local government

6.6. The local government sector is set to receive R151.5 billion as direct conditional grants and R25.5 billion in indirect grants over the 2022 MTEF, with infrastructure grants accounting for 95% of the allocations and capacity grants at 5%. Figure 13 below compares the real growth rates of infrastructure and capacity grants with the local government equitable share allocations. The results show a steady decline in real growth rates of the infrastructure grant over the MTEF, while the capacity grants are at a standstill and even negative growth rate in 2023/24. The Commission notes the long-overdue reviews of capacity-building systems and infrastructure grants undertaken by the government. In its previous submissions, the Commission recommended, among other things, the need for conditional grants with a similar purpose to be streamlined to maximise efficiency.

Figure 13. Real growth rate in the three local government transfer windows



Source: National Treasury Data Base; FFC Own Calculations

6.7. Additions to the baseline on direct conditional grants are noted over the 2022 MTEF at R3.6 billion, mainly comprised of the *Neighbourhood Development Partnership Grant* (R1.6 billion), *Regional Bulk Infrastructure* (over R1 billion), and the *Public Transport Network Grant* (R621 million). The Commission welcomes the additions to these infrastructure-related grants as they are in line with the Economic Recovery Plan (ERP) for boosting economic growth and employment opportunities.

6.8. However, reductions to the *Public Network Grant* (R859 billion), *the Energy Efficiency Demand and demand-side management* (R16 million), the indirect grant -*Regional Bulk Infrastructure* (R95 million), and the *Integrated National Electrification Programme* (R50 million) over the 2022 MTEF, due to underspending, are of concern. The Commission is of the view these reductions send a negative signal to what the government is trying to accomplish by investing in catalytic infrastructure projects.

Recommendations

- The Commission welcomes the government's efforts to keep LES growth rates above inflation as it will go a long way in offsetting the ever-increasing costs of basic services and enable the delivery of basic services to poor households.
- Commission notes and welcomes the reviews of capacity-building systems and infrastructure grants. The Commission is of the view that such initiatives will enhance municipal performance and move the local government sector forward and quicken the recovery process.
- The Commission further stresses that these review initiatives should be synchronised with the District Development Model (DDM), which seeks to focus development initiatives through districts.

- Lastly, the Commission stresses that municipalities must improve the efficiency of spending with cooperative supports from the national and provincial spheres of government through monitoring, reporting and evaluation to fulfil their constitutional mandates.

7. Public-sector institutions and investment

Guarantees to state-owned entities

- 7.1. Contingent liabilities are becoming real liabilities to the fiscus and worsening the government debt outlook. Government guarantees help fulfil particular policy objectives through reducing borrowing costs and increasing investment for strategic public institutions. However, government guarantees entail risks to public finances. Guarantees are sources of fiscal risks because their materialisation can generate fiscal costs and undermine fiscal sustainability. In issuing credit guarantees, the government pledges to the respective creditor to service the debt the borrowing entity has contracted if the entity is unable to do so. Therefore, credit guarantees constitute an explicit contingent liability on the government's balance sheet.
- 7.2. In the last five years preceding the COVID-19 pandemic, contingent liabilities increased by 76% from R601 billion to R1.1 trillion and accounted, on average, for 15% of GDP. In 2022/23, contingent liabilities will reach R1.17 trillion, accounting for 18.11% of GDP due to tenacious State-Owned Entities' cash shortfalls and stringent borrowing requirements. Guarantees to State-Owned Entities (SOEs) primarily drive contingency liabilities and account, on average, for more than 50% of the total contingency liabilities. In the medium term, contingent liabilities will reach R1.23 trillion in 2024/25, accounting for 16.5% of GDP. The substantial support from the fiscus to the SOEs through transfers and guarantees constitutes a significant fiscal risk in contingent liabilities. Direct transfers from the government to SOEs increased to 1.6% of GDP, reflecting a sizeable increase compared to the average of 1% of GDP in the preceding five fiscal years. Government guarantees on SOE borrowing increased by 2% of GDP to 10.3% GDP in 2020/21, compared to 2015/16. Over the 2021 MTEF period, transfers to SOE borrowing will average approximately 0.5% of GDP.
- 7.3. Government exposure to SOEs is high and represents a risk to debt sustainability and public finances (See table 8 below). In 2021/22, the total guarantee to major SOEs will amount to R560 billion, with associated exposure estimated at R417 billion. The financial performance of SOEs is putting considerable pressure on public finances. The COVID-19 crisis is worsening the financial situation of many SOEs, and transfers to SOEs will likely be higher in the medium term. The underperformance of SOEs is widespread due to mismanagement, corruption, overstaffing, and uncontrolled spending. Most SOEs are in a precarious financial situation, with some resorting to borrowing to finance their operational costs and not meeting their debt and interest payments.
- 7.4. The total guarantees to all SOEs will amount to R602 billion in 2021/22 before decelerating to R552 billion in 2024/25. Government guarantees to the three most prominent Development Finance Institutions (DFI-s), Land Bank, Development Bank of Southern Africa (DBSA) and Industrial Development Corporation (IDC), will amount to R20.3 billion in 2021/22. A contingent liability to the government by these DFIs

constituted by the exposure amount, meaning the portion of the guarantees these companies have borrowed amounted to R7.2 billion in 2021/22.

- 7.5. Government guarantee to Eskom amounted to R350 billion in 2021/22, and contingent liability to government by Eskom constituted by the exposure amount amounted to R328 billion in 2021/22 before decreasing to R6.5 billion in 2026/27. The government guarantee to Eskom amounts to 5.6% of GDP with a corresponding exposure accounting for 5.25% of GDP (See Table 8 below). This means that Eskom constitutes a significant single fiscal risk through to sizeable government guarantee it receives from the public purse. Government guarantee and exposure to Sanral account for almost one per cent of GDP in 2021/22.
- 7.6. It is worth noting that if all the SOE guarantees were to be called, government debt would increase to more than 100% of GDP by 2026, highlighting the urgency and importance of reforming SOEs in light of the immediate risk they pose to the fiscus.

Table 8. Government guarantee exposure as a percentage of GDP, 2017/18-2021/22

% of GDP	2018/19		2019/20		2020/21		2021/22	
	Guarantee	Exposure	Guarantee	Exposure	Guarantee	Exposure	Guarantee	Exposure
Eskom	6.46	5.27	6.15	5.75	6.29	5.36	5.60	5.25
SANRAL	0.72	0.73	0.67	0.69	0.68	0.67	0.61	0.79
SAA	0.35	0.28	0.34	0.31	0.34	0.12	0.31	0.05
Land Bank	0.18	0.00	0.17	0.05	0.17	0.04	0.15	0.00
DBSA	0.21	0.08	0.02	0.08	0.02	0.09	0.16	0.08
Transnet	0.06	0.07	0.06	0.07	0.06	0.07	0.06	0.06
Denel	0.06	0.06	0.12	0.08	0.12	0.06	0.05	0.05
SA Express	0.05	0.00	0.03	0.00	0.00	0.00	0.00	0.00
IDC	0.01	0.00	0.01	0.00	0.01	0.00	0.01	0.00

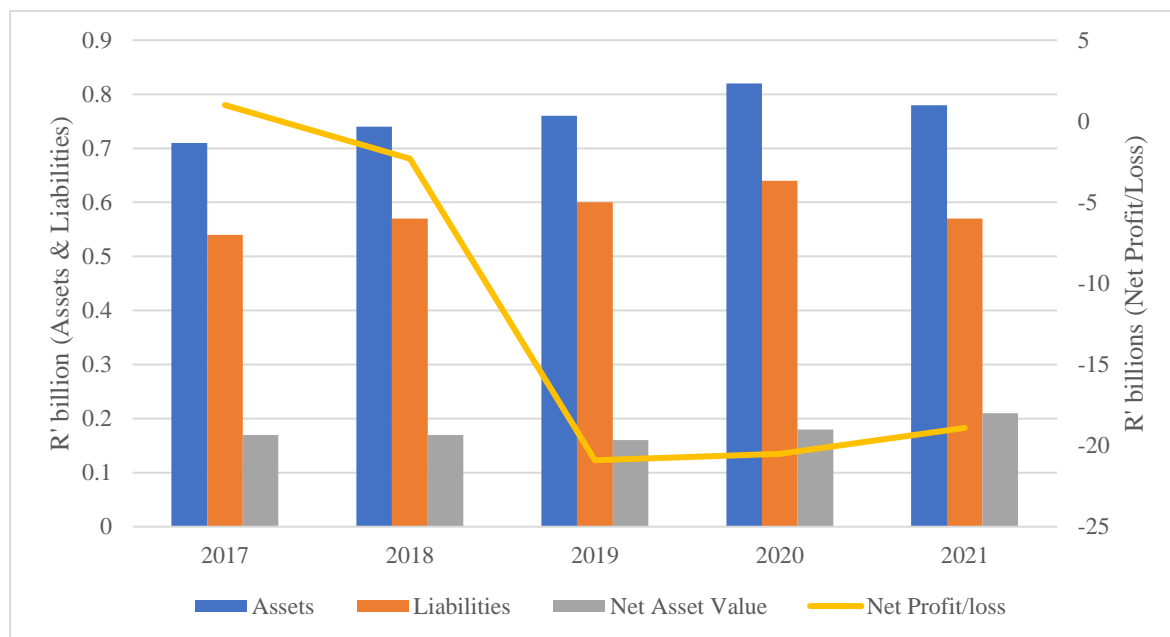
Source: National Budget Review, various editions

Financial performance of state-owned entities

- 7.7. SOEs have a very significant and strategic role in economic development. They are collectively responsible for major industrial inputs and capital formation. Nevertheless, the worsening of their operational and financial performance coupled with the growing burden they place on the fiscus underscores the urgency to address their weak performance, without which they will remain a drain to the fiscus through contingency liabilities and the main impediments to economic efficiency and competitiveness. The constrained fiscal environment and the rising liability of SOEs on the fiscus underscore the urgency of their reform.
- 7.8. In 2019/20, the assets of SOEs accounted for 34% of GDP, reflecting their strategic importance to the economy. The assets of non-financial SOEs amount to 86% of total assets, making them strategically more significant than financial SOEs, whose assets amount to only 14%. The two largest non-financial SOEs, Eskom and Transnet, account for more than half of the total assets of non-financial SOEs. DBSA, IDC, and Land Bank assets amount to 94% of the total assets of financial SOEs.

- 7.9. The poor and worsening financial performance of SOEs primarily relates to non-financial SOEs. The underperformance of the non-financial SOEs is reflected in their collective and consistent cash shortfalls between 2004 and 2020, which averaged approximately 1.1% of GDP. Consequently, non-financial SOE debt in 2020 reached 12.1% of GDP compared to only 2.3% in 2004.
- 7.10. Several non-financial SOEs, including Eskom, SAPO, SABC, Denel, and SAA, have benefited from direct fiscal transfers. Others such as Eskom, TCTA, SAA, and Transnet have enjoyed government guarantees on their borrowing. The cost to the fiscus incurred from direct transfers accelerated from 1 to 1.6% of GDP between 2015/16 and 2020/21, and government guarantees on major SOE borrowing increased from 8 to 10.2% of GDP over the same period.
- 7.11. The financial health of SOEs as measured by key financial ratios reflects weak financial performance as both the profitability and solvency ratios are deteriorating. The earnings before interest, taxes, depreciation, and amortisation (EBIDTA) margin for ESKOM, which measures its operating profit as a percentage of its revenue, declined from 25.57% in 2018 to 16.06% in 2021, implying that Eskom's operating costs are very high compared to total revenue. And this translated to low or negative profitability margins. The debt to equity ratio, which measures the degree to which a company is financing its operations through debt as opposed to own funds, increased from 2.58 in 2018 to 3.17 in 2019 and remained above 2.0 until 2021. This means that Eskom uses more debt than equity to fund its business.
- 7.12. The EBIDTA margin for Transnet decreased from 45.6% in 2019 to 28.9% in 2021, reflecting less profitability. The debt to equity ratio increased from 0.43 in 2018 to 0.49 in 2019, implying that Transnet is increasingly using debt than equity to fund its business. The profitability ratios of most of the SOEs reflect similar trends and attest to the fact that they are in a weak financial position.
- 7.13. In 2020/21, none of the major SOEs posted a net profit, and only Transnet consistently posted a positive net profit over the past five years before 2020/21. Eskom continues to face liquidity constraints resulting from high debt service costs of the outstanding debt, working capital requirements, escalating municipal arrear debt, and sub-investment grade level credit ratings. The net asset value for Eskom decreased from R175 million in 2017 to R170 million in 2018, and then increased to R215 million in 2021. Eskom's liabilities increased from R534 million in 2017 to R637 million in 2020, and its net loss increased from R2.3 billion in 2018 to R20.9 billion in 2019. It remained high at R20.5 billion in 2020 before marginally declining to R18.934 billion in 2021 (See Figure 14 below).

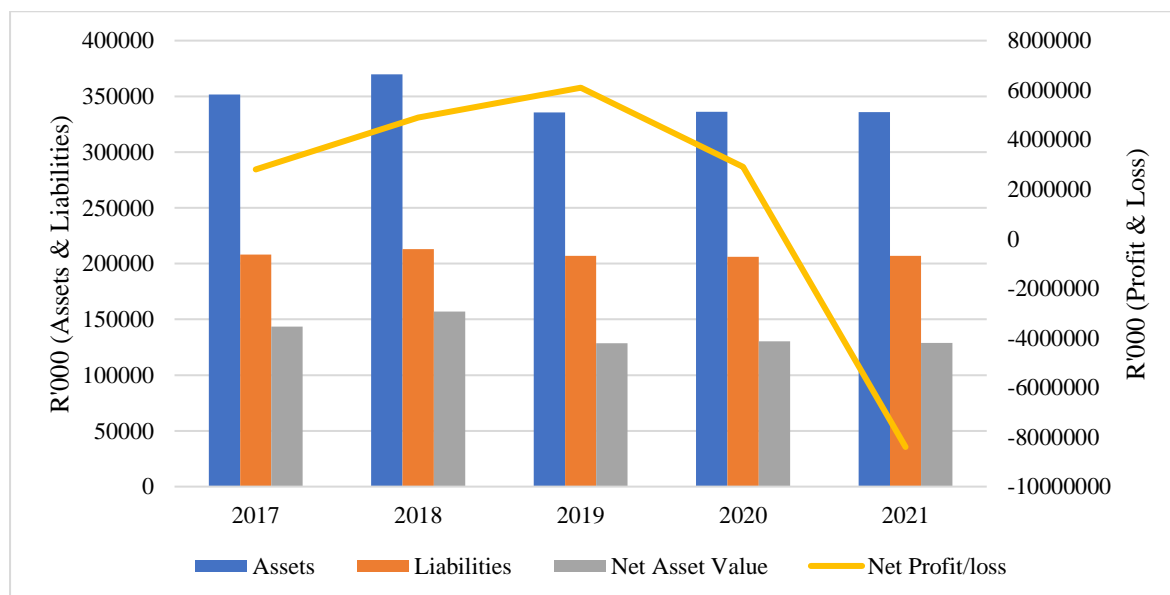
Figure 14. Asset, liabilities and profit/loss margins for Eskom, 2017-2021



Source: Eskom Annual Reports, various editions

7.14. Transnet's operational performance has been declining in recent years, and its financial position remains marginally constrained. Over the four-year horizon between 2017 and 2021, Transnet's net value decreased from R143 million to R129 million. Transnet posted a net loss of R8.4 billion in 2020/21 (See Figure 15 below). Despite Transnet's improvement in implementing severe remedial action plans to prevent irregular spending, irregular spending amounted to R183,5 billion in 2021.

Figure 15. Asset, liabilities and profit/loss margins for Transnet, 2017-2021

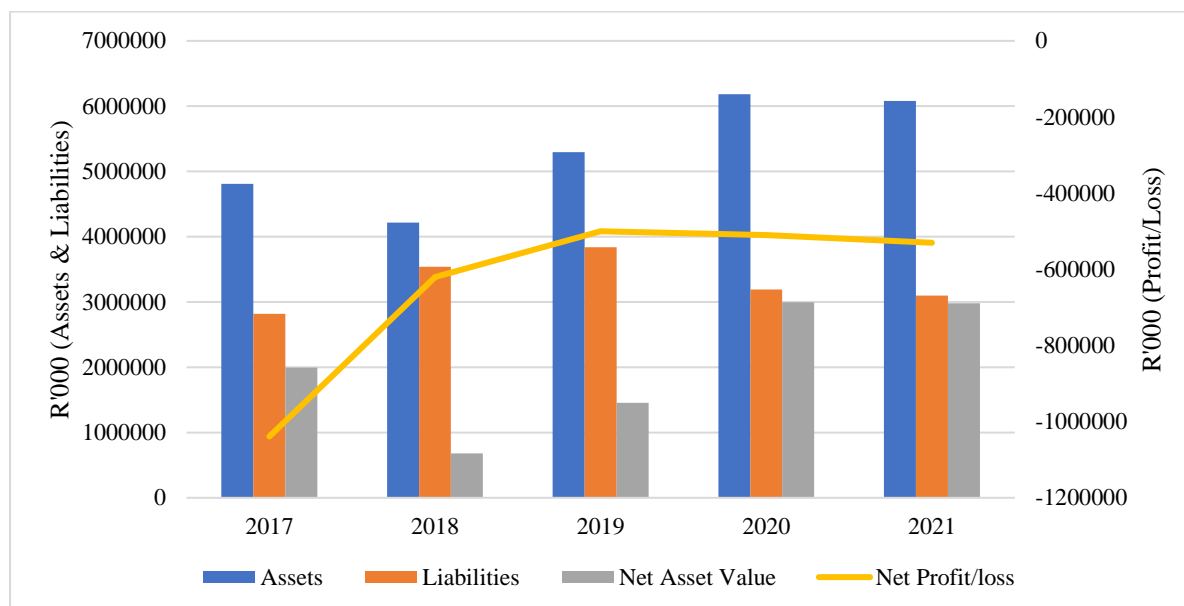


Source: Transnet Annual Reports, various editions

7.15. South African Airways (SAA) has been technically declared insolvent since 2013 and has heavily relied on government support, and has accrued a net loss of R34 billion in the previous 13 years. The SABC has consistently posted a net loss for the past five years.

The SABC net loss reached R1,03 billion in 2017 before declining to R524 million in 2021, after a net loss of R511 million in 2020 (See Figure 16 below).

Figure 16. Assets, liabilities and profit/loss margins for SABC, 2017-2021



Source: SABC Annual Reports, various editions

- 7.16. Denel is technically insolvent and is unable to cater operational expenses, including the payment of salaries and suppliers. Despite government support, Denel's debt situation has worsened. In March 2021, Denel was declared insolvent with an accelerated debt position of R3.4 billion. The severe liquidity state and the absence of sovereign support have led to a further credit rating downgrade.
- 7.17. A clear indication of the depth of the financial crisis engulfing some of the key SOEs was exemplified by the failure of the South African Post Office, Land Bank, Denel, SAA, SA Express, and Armscor to submit their financial statements to Parliament when they were due in September 2021. This means that the true financial health of these SOEs remains unknown, thus constituting a fiscal risk.
- 7.18. Most of the challenges contributing to the poor financial health of the SOEs are adequately captured by the 2012 Presidential Committee Report on State-Owned Entities (PCRSOE). The key challenges include unclear objectives, the diversity of mandates within their business models, improper costing of mandates, and weaknesses in governance and oversight. The PCRSOE has recommended, among other things, a centralised shareholder model for commercial SOEs. The government has adopted this recommendation and is establishing a state-owned Holding Company to house strategic SOEs to exercise coordinated shareholder oversight. The Commission welcomes this initiative because it will improve the governance of SOEs.
- 7.19. Corruption has contributed significantly to the weak financial position of most of the SOEs. The two reports of the Zondo Commission released thus far fingered the SAA, Denel, and Transnet as entities that were part of the State Capture. According to these reports, members of the Gupta family and their business associates swayed board

appointments at these SOEs by positioning bendable persons and plundered these institutions through seizing their procurement budgets.

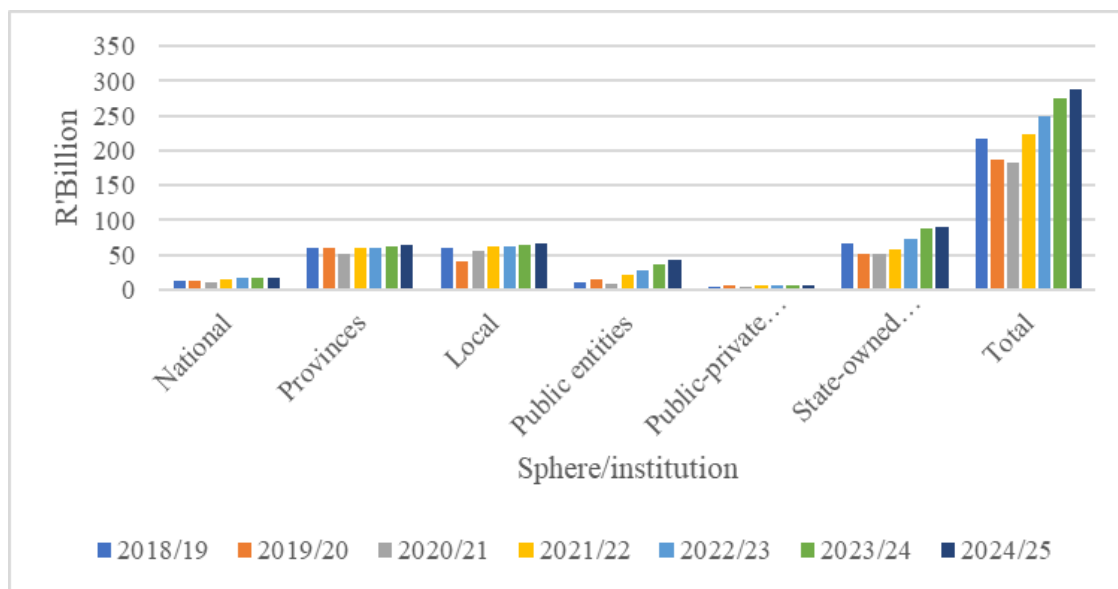
7.20. The Commission welcomes the government initiative to publish a framework outlining the criteria for government funding of SOEs because this will ensure that the fiscus support SOEs is principle-based.

Public sector infrastructure spending

7.21. Infrastructure such as roads, water infrastructure and electricity is key for national economic growth and development. Provision of infrastructure is crucial for households' access to basic services and improving socio-economic conditions. Investment in infrastructure is also key for employment creation and can play an important role on mitigating the impact of COVID-19 pandemic. While the extent and nature varies, all spheres of government, including other public sector institutions, have crucial roles in the provision of infrastructure.

7.22. Figure 17 illustrates public sector infrastructure investment from 2018/19 to 2024/25. Notable is the decrease in the total public sector infrastructure investment between 2018/19 and 2019/20 from R216.2 billion to R187.4 billion. Public infrastructure investment picked up in 2021/22 with an investment of R249.5 billion and is expected to increase further in the outer years of the 2022 MTEF. The Commission supports this increase in total public infrastructure investment as it is important for economic recovery and growth, particularly given the effects of the COVID-19 pandemic. It is worth noting that state-owned companies' investment increased from R58.6 billion in 2021/22 to R73.6 billion in 2022/23, a significant increase of 20.4%.

Figure 17. Public infrastructure investment

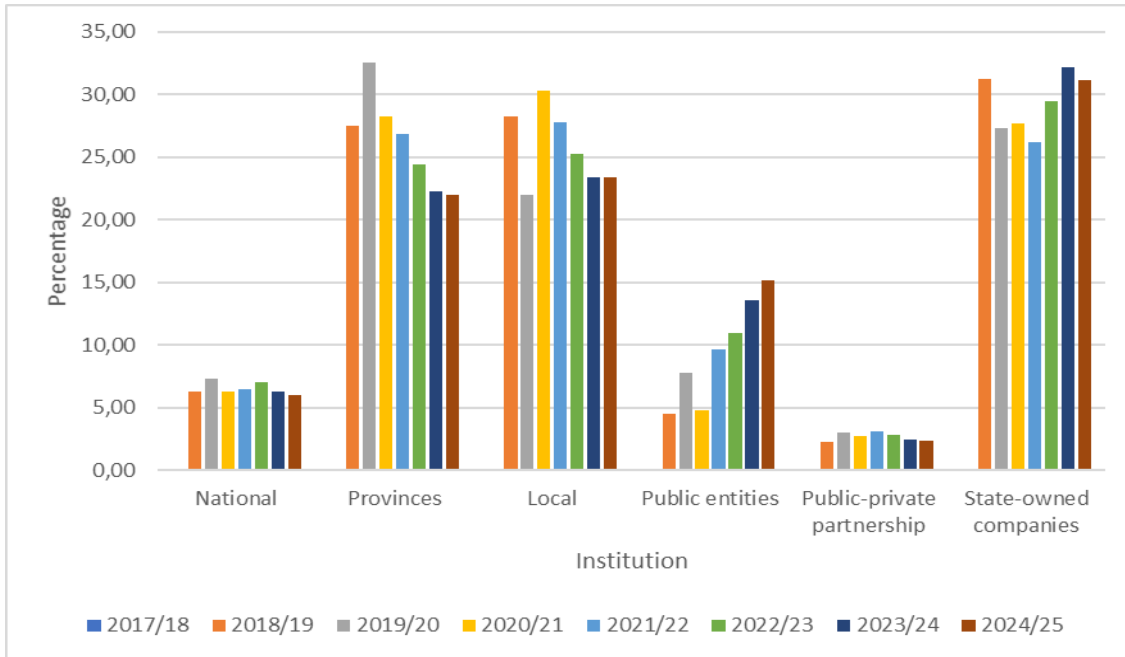


Data source: National Treasury, Budget Review, 2018/19 – 2022/23

7.23. With respect to the share of public infrastructure investment, state-owned companies dominate at 31.2% in 2018/19. While the share of public infrastructure investment implemented through the national sphere has remained relatively consistent since 2018, shares of provinces have been on the decline since 2019/20 from 32.6% to 24.5% in

2022/23 and will continue to decrease in the outer years of the 2022 MTEF. Share of the local government sphere is also on the decline. This is of concern to the Commission given huge infrastructure backlogs in municipalities (new infrastructure and rehabilitation and maintenance of existing infrastructure). Public infrastructure investment through public entities is also increasing, indicating that the government is increasingly implementing public infrastructure investment through public entities, from 9.8% in 2021/22 to 13.6% in 2022/23, to reach over 15% in 2024/25.

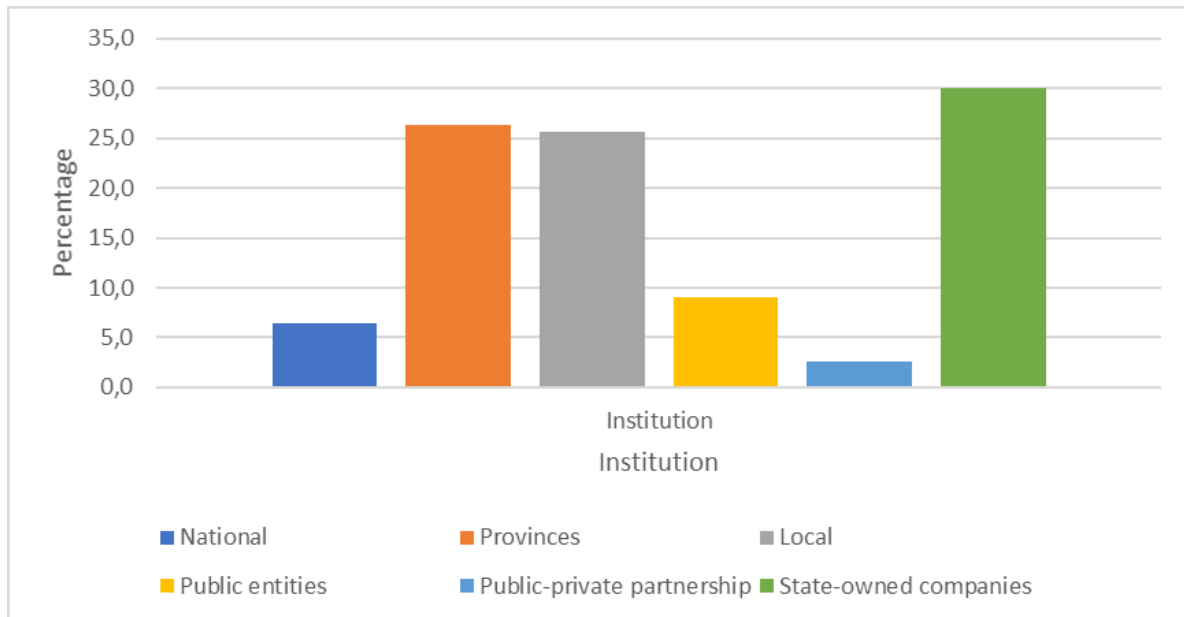
Figure 18. Public infrastructure investment shares



Data source: National Treasury, Budget Review, 2017/18 – 2022/23

7.24. With respect to the average public infrastructure investment share over seven years (2018 to 2024), the national government's share of infrastructure investment is only 6.5%, as the sphere is not directly involved in infrastructure delivery but is more on the administrative functions. Provincial and local government average shares are about 26%. In contrast, local government plays a key role in the delivery of basic infrastructure. Provinces also deliver key infrastructures such as schools, hospitals, and human settlements.

7.25. The shares of state-owned companies and public entities combined are about 40% (30% and 9% respectively) as critical drivers of public infrastructure investment. Therefore, it is of concern that these crucial state-owned companies and public entities should fail to deliver to the expectations as engines of economic growth. And even in some instances, fail to produce credible financial statements/reports.

Figure 19. Average public infrastructure investment, 2017-2024

Data source: National Treasury, Budget Review, 2017/18 – 2022/23

Recommendations

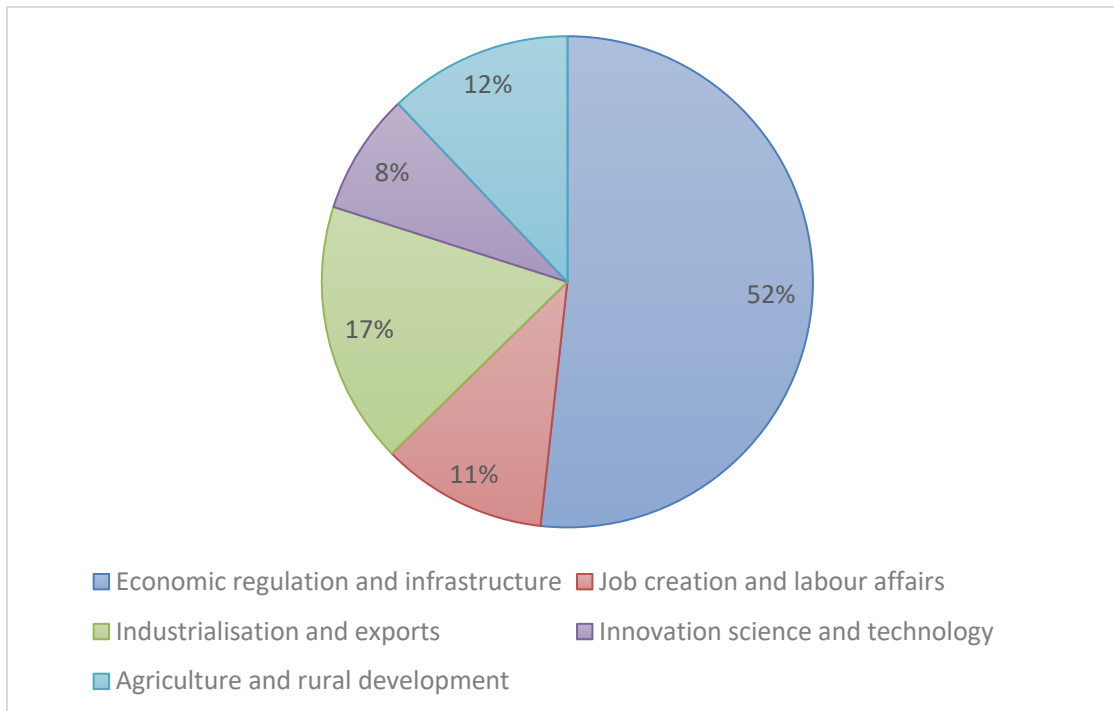
- The Commission recommends that the government appraise the SOEs' profitability, business sustainability, operational efficiency, track record in resolving market failures, and attaining developmental goals.
- The Commission recommends that the government homogenise the legislative framework to remove the legal ambiguity between SOEs as companies and as entities under the Public Finance Management Act (PFMA) with statutory obligations to disclose financial and non-financial information for transparency.
- The Commission recommends that the government implement the necessary operational, governance, and financial reforms that would compel SOEs to effectively and efficiently deliver infrastructure investment to realise return-to-investment or be restructured, sold off or shut down.

8. Achieving a balance between economic and social recovery and ensuring sustainable public finances

- 8.1. Economic and social recovery and sustainable public finance are three complementary objectives that reinforce and depend on each other. As with many complementary goals, the direction of causality between the three is not always clear. Governments across the world are juggling all three simultaneously with the hope for simultaneous improvement. South Africa's initial response to the COVID-19 pandemic holds lessons for a balanced and synchronised approach to recovery while maintaining stable public finances.
- 8.2. As this Submission indicates, the economy is yet to recover to the levels seen in 2017, the unemployment rate has reached a record high of 34.9%, and public finances remain under pressure, exemplified by growing demands, rising debt and sluggish revenue. In navigating these three complimentary objectives, the Budget 2022 placed stronger emphasis on a people-centred or social recovery by allocating over R1.1 trillion of the

total budget to social wage programmes and boosting consumption and investment by halting fuel and Road Accident Fund (RAF) levy increments and reducing CIT rate to 27%. The R3.5 billion relief from fuel levy and RAF levy capping will stimulate demand for consumer goods. At the same time, firms are likely to invest in new technology or capital from the tax savings. However, the actual impact and outcome will depend on the implementation of the budget. The Commission is of the view that government should publish the underlying research papers pertaining to tax changes to allow public scrutiny.

- 8.3. The 2022 Budget further provides for the expenditure side economic recovery levers through the economic function. This function receives R227 billion in the 2022/23 financial year growing to R256 billion in the outer year, representing 8.4% growth in nominal terms. Figure 20 shows that the economic function expenditure is dominated by economic regulation and infrastructure at 52%, followed by industrialisation (17%) and agriculture at 12%. As with other growth-supporting measures, the impact of this expenditure depends on the design and efficacy of the programmes. In its Submission for the 2022/23 Division of Revenue, the Commission highlighted infrastructure management and delivery flaws as a key factor impinging on infrastructure spending effects on the economy. Delays in completion of projects, poor workmanship and rectification budgets erode the potential growth effects of infrastructure spending.
- 8.4. The Commission welcomes ongoing reforms to improve public investment management processes, especially the Infrastructure Fund, which is set to receive a provisional allocation of R17 billion over the MTEF. This fund aims to crowd-in private investment and fast track approval processes for large-scale infrastructure projects. As much as the fund is likely to unblock infrastructure delivery bottlenecks, it is equally crucial that the allocation and application processes adhere to established IGFR principles of equity and fairness. Projects funded through the fund must be equitably distributed across provinces and districts to avoid entrenching spatial development inequities via a national custodian department for accountability, to minimise the risks of losing focus of the fund associated with extrabudgetary allocations.
- 8.5. It is further worth noting that the composition of economic function expenditure or the priorities thereof is not entirely aligned to the Economic Reconstruction and Recovery Plan, especially in relation to the priorities identified as high impact job creation interventions, namely, infrastructure roll-out, localisation through industrialisation and food security. By way of example, allocations to Programme 6: Industrial financing of the Department of Trade, Industry and Competition (DTIC) are aimed at recovery to pre-COVID-19 levels. However, allocations to manufacturing incentives for product and systems development are projected to decrease by 9% and 6.3% over the MTEF, respectively. Similarly, the 2022/23 allocation to the food security and agrarian reform program under programme 3 in the Department of Agriculture, Land Reform and Rural Development declines by 10.5% when compared to the 2021/22 appropriation before increasing.

Figure 20. Share of economic function expenditure

Source: Estimates of National Expenditure, 2022.

Recommendations

- The Commission reiterates its recommendation in the 2022/23 Annual Submission that the budget process focuses on aligning the allocations to the Economic Reconstruction and Recovery Plan – informed by comprehensive budget and expenditure reviews.

9. Concluding Remarks

9.1. Considering the significant internal and external constraints that Budget 2022 was crafted under, the Commission broadly supports Budget 2022 and the government's continued commitment to consolidating public finances while supporting the pandemic response, job creation, and social protection. The Commission would like to emphasise the following points further:

- i. In terms of South Africa's growth prospects, the Commission is of the view that it is improbable that the economy will return to pre-pandemic production levels within the year as predicted by the National Treasury. This is because, despite growth between 2020Q3 and 2021Q2, the trend remains temperamental as the latest GDP figures showed a significant 1.5% decline in 2021Q3. In terms of levels, the current productivity is equivalent to that last seen in 2016 at real prices.
- ii. On revenue, the Commission notes that tax policy has focused on broadening the tax base, improving administration, and lowering tax rates over the past two years. As outlined in Budget 2022, the government intends to continue with this approach by avoiding tax rate increases where possible. The Commission supports this stance to grow the tax base instead of a rate-based approach.
- iii. The Commission welcomes the government's decision to use a portion of the revenue windfall to lower the gross borrowing requirement and reduce debt

issuances. However, the Commission cautions that debt stabilisation risks remain elevated and pose significant challenges to public finances. Some of the challenges include rising inflation (both on the domestic and international prices pressures), expectations that higher interest rates could increase borrowing costs and the resurgence of COVID-19 infections resulting in spending pressures.

- iv. The increase in non-interest spending over the MTEF period 2022-2025 is accommodated by the shift in trajectory to follow zero-based budgeting due to improving tax revenue collections. Furthermore, the increases are directed at pro-poor spendings, such as the extension of the SRD grant, the continuation of bursaries for students benefiting from the NSFAS, and the presidential employment initiative. The Commission supports this as it is a balanced approach that does not jeopardise the path to deficit reduction and fiscal consolidation while seeking to support economic growth.
- v. The Commission applauds the government's efforts to stimulate employment growth through various interventions such as public employment programmes tax incentives, implementing programmes to address the skills constraint and making it easier to do business. However, it should be noted that while labour market interventions and public employment programmes have successfully created short-term and permanent jobs (in some instances), this has not translated into changing the macro-level picture of unemployment. In this regard, more significant structural reforms focused on artisanal skills are required to address unemployment in the long run.
- vi. The SRD Grant has been extended multiple times over the past two years. The Commission looks forward to the outcome of the ongoing technical work on the different replacement options for the SRD grant as announced in the 2022 SoNA. When evaluating various options, key considerations for the Commission will be the long-run viability, market dynamics, and effects on the fiscus. Given that the SRD will be stopped in March 2023, it would also be useful for the government to have a definite timeline around this issue's decision-making process.
- vii. Provinces and municipalities, in particular, are responsible for the delivery of critical social and basic services. Moreover, municipalities are responsible for the delivery of free basic services to indigent households. Given the important role that the delivery of these services plays in facilitating social and economic development, the Commission thus welcomes the strong growth in the allocation to the sub-national spheres of government while urging for more value-for-money via monitoring and evaluation of spending.
- viii. Fraud, corruption and fiscal mismanagement (in the form of fruitless and wasteful expenditure) remain rampant. Findings by the Commission of Inquiry into State Capture, the Special Investigating Unit's report into allegations of corruption and misuse of public funds related to personal protective equipment (PPE) for the COVID-19 pandemic and the Auditor-General (AG) confirm this. According to the AG's 2020/21 Public Finance Management Act (PFMA) report, irregular expenditure was R177.4 billion, and fruitless and wasteful expenditure at R2.7

billion. At the local government level, the 2019/20 Municipal Finance Management Act (MFMA) report cites irregular expenditure at R22.7 billion and fruitless and wasteful expenditure at R2.1 billion. These staggering amounts in dubious use suggests that better spending with higher value could be achieved through improving compliance and efficiency. The government must take decisive and prompt actions against the perpetrators of these wastages and leakages to send a clear message that the government is serious about addressing this challenge.

- ix. With respect to progress towards the goals of economic and social recovery alongside fiscal sustainability, the Commission is of the view that Budget 2022 has placed stronger emphasis on a people-centred or social recovery by allocating over R1.1 trillion of the total budget to social wage programmes. The budget further provides for expenditure side economic recovery levers through the economic functions, which is set to receive R227 billion in 2022/23. Much of this funding is focused on infrastructure. As with other growth-supporting measures, the impact of this expenditure depends on the design and efficacy of the programmes – to this end, infrastructure management and delivery flaws are key factors hampering the potential economic gains that can be derived from infrastructure spending. There is also a need to address the misalignment between the spending within the economic function relative to the priorities identified as high impact, job-creating interventions in the Economic Reconstruction and Recovery Plan.

Approved by:

Dr Patience Nombeko Mbava

Chairperson

Date: 28 February 2022