Financial and Fiscal Commission Submission on the 2022 MTBPS

For an Equitable Sharing of National Revenue

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1. Background

Macroeconomic environment

1.1. The 2022 Medium Term Budget Policy Statement (MTBPS) is presented when the world economy has been hit by successive external, unforeseeable shocks: the Covid-19 pandemic, the war between Russia and Ukraine, and climate disasters. As a result, according to the October 2022 IMF World Economic Outlook, global growth will slow from 6 per cent in 2021 to 3.2 per cent in 2022 and 2.7 per cent in 2023, reflecting its weakest growth profile since 2001. As a small open economy heavily dependent on commodity exports, South Africa is exposed to the downside of lower global growth.

1.2. The economy declined by 0.7 per cent in the second quarter of 2022 after a brief rebound in the two quarters prior. The level of gross domestic product (GDP) was 0.3 per cent lower than the average level in 2019, thus reverting to productivity levels just before the onset of the Covid-19 pandemic. The sectoral disaggregation shows that six industries remain weak: The construction industry is 24 per cent smaller than before the pandemic, while mining is still below the fourth quarter of 2019. Agriculture, general government services, finance and real estate, and personal services are the only four industries at or above their pre-pandemic production levels. The domestic factors weighing heavily on economic growth include, amongst others, macro-policy uncertainty; patchy policy implementation; low rates of fixed capital investment; deficient and intermittent power generation.

Intensified load shedding and economic growth

1.3. South Africa continues to face a deepening energy crisis. Load shedding increased by 37 per cent from 1798 Gigawatt hours (GWh) in 2020 to 2455 (GWh) in 2021. In the first six months of 2022, Eskom implemented load-shedding amounting to more than 90 per cent of the entire 2021. The direct impact of load shedding on the economy closely correlates with the duration and intensity of load shedding. Furthermore, the indirect effect of low consumer and business confidence resulting from the wait-and-see attitude from households and businesses compounds the threat to the GDP recovery. The South African Reserve Bank (SARB) estimated that Stage 4 load shedding costs the economy R773 million per day. Given that load shedding was escalated to Stage 6 in June this year, the cumulative impact on lost productivity is likely higher.

Rising inflation, the cost of living and financial credibility

1.4. Monetary policy tightening in hiking interest rates has been instituted globally in response to rising inflation, thus raising the risk of global recession and financial crises in emerging markets. On the domestic front, the inflation rate breached the upper limit of the 3–6 per cent SARB inflation target range for the first time in four years when it increased to 6.5 per cent in May 2022 before further accelerating to a 13-year high of 7.8 per cent in July this year. The SARB responded by hiking the repo rate by a cumulative 275 basis points to 6.25 per cent to restore financial credibility, in line with the global monetary stance.

1.5. The rising cost of living has resulted in protracted wage negotiations as employees demand above-inflation salary increases. The wage negotiations are ongoing, and the wage settlement uncertainty represents a risk to the fiscus and the fiscal consolidation exercise. Transnet workers embarked on an economy-crippling industrial action that lasted for 12 days. The Transnet strike cost bulk mineral exporters as much as R9.8bn. It cost exporters of iron ore, coal, chrome, ferrochrome, and manganese about R815m a day as they could not rail and load their goods onto ships, according to the Minerals Council South Africa. Sasol lost R16bn in market value.

1.6. In 2021, the Financial Action Task Force (FATF) ruled that South Africa failed in 20 of the 40 FATF standards and had deficiencies in all eleven steps required to prevent money laundering and gave the country up to February 2023 to rectify these shortcomings or face possible grey listing. If this materialises, it will dampen the prospect of economic growth as foreign investors become reluctant to do business in South Africa, raising rating concerns at many international institutions and capital outflows.

Fiscal Policy

1.7. The impact of the Covid-19 pandemic, the Ukraine war, and the inflation shock has been cushioned by the improvement in the country's fiscal fortunes. The 2022 MTBPS presented better-looking fiscal metrics than the 2022 Budget due to the commodity boom resulting in windfall mining profits and revenue overruns. The 2022 MTBPS estimates revenue overruns to amount to R106 billion compared to the 2022 Budget projections. According to the 2022 MTBPS, the primary budget balance, which is the difference between revenue and non-interest expenditure, is forecasted to be in surplus in 2023/2024 for the first time in 15 years and will remain in surplus over the medium term if all else remains equal.

1.8. The 2022 MTBPS forecasted gross government debt to stabilise at 71.4 per cent of GDP in 2022/23, two years earlier and at a lower level than projected in the 2022 Budget. Hence, the consolidated budget deficit is estimated to decelerate from 4.1 per cent of GDP in 2023/24 to 3.2 per cent in 2025/26. However, low growth and rising borrowing cost mean that debt-service costs will continue to accelerate over the medium term to peak at R381 billion or 19 per cent of the main budget revenue.

1.9. Most importantly, the positive increase in corporate income tax receipts is unlikely to become permanent because it results from cyclically elevated commodity prices translated into substantial mining sector profits. The Commission supports that the windfall has not been used to fund permanent spending increases but primarily to address the most critical issues at strategic state-owned companies (SOCs), to counteract the effect of the pandemic, reduce debt, and support growth.

Expenditure pressures on the fiscus and sustainability of public finances and SOCs

1.10. The 2022 MTBPS extended the social relief of distress grant (SRD) for another year and did not provide details on the basic income grant (BIG). There was also an emphasis on the reliance of the fiscal framework on continued spending restraints, in particular, moderating the public sector wage increases. As a result, the 2022 MTPS assumes no

wage increase in the next fiscal year and only pencilled in a three per cent increase for this year.

1.11. The 2022 MTBPS additional spending targets health, education, safety and security, and infrastructure investment. Medium-term spending changes relate primarily to the policy decision to extend the COVID-19 social relief of distress grant by one year until 31 March 2024. Funding has also been provided for safety and security, addressing shortfalls in compensation budgets in provincial education, retaining additional health workers appointed during the pandemic, and supporting free municipal basic services, rehabilitation of damaged municipal infrastructure, and refurbishment of provincial roads.

1.12. The fiscal framework's credibility and sustainability depend on consistency in the policy stance of fiscal consolidation. However, if a higher-than-budgeted wage agreement materialises, it constitutes a significant risk to attaining budgetary targets. Similarly, a permanent extension of the COVID-19 social relief without a corresponding permanent increase in funding by revenue means (not debt with interest costs), a decrease in spending, or a mixture of both would threaten the sustainability of the fiscal framework.

1.13. The 2022 MTBPS provided financial support to Denel, SANRAL, and Transnet. It also announced plans to transfer up to two-thirds of Eskom’s debt to the government balance sheet. The financial support for strategic SOCs is essential but does not change the fact that it constitutes a fiscal risk. Moreover, the conditionalities of the financial backing require solid turnaround plans to ensure that the bailouts are not a permanent feature of the fiscus.

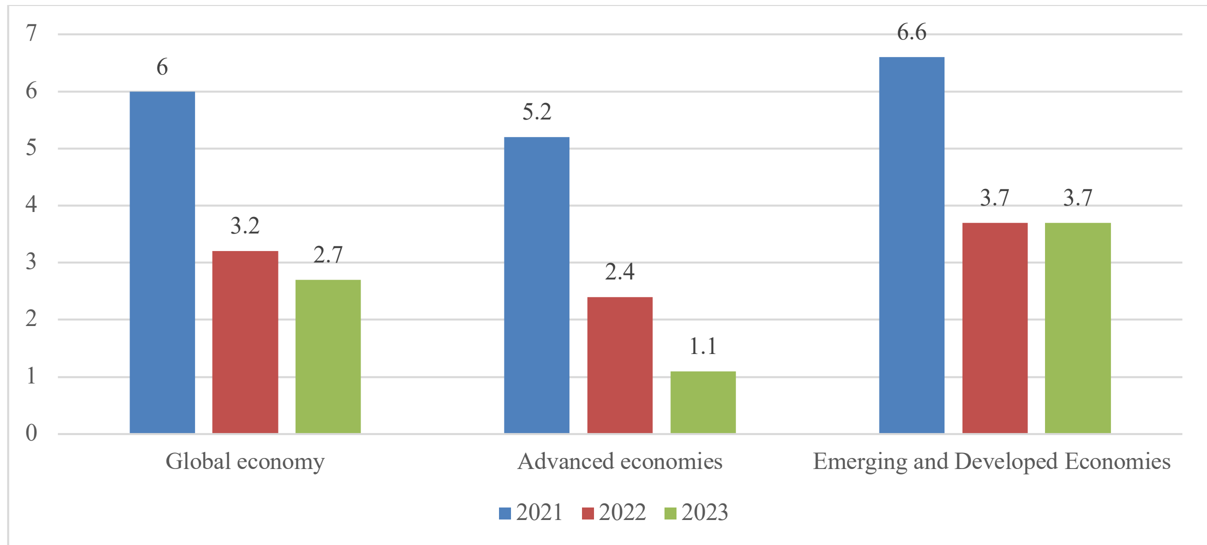
1.14. The poor financial health of most state-owned companies (SOCs) constitutes a fiscal risk in the form of contingent liabilities. According to the 2022 MTBPS, some of these risks have already materialised, thus requiring financial resources from the fiscus. By 2024/25, contingent liabilities are expected to exceed R1 trillion after gross debt. Whereas government guarantees have marginally decreased, government exposure has increased.

2. Economic Overview and Prospects

Global growth and prospects

2.1. The global economy is experiencing several challenges, including the Russian-Ukraine war and a cost-of-living crisis caused by persistent and broadening inflation pressures. The International Monetary Fund's (IMF) latest forecasts (September 2022) project global growth to remain unchanged in 2022 at 3.2 per cent, with advanced economies growing at 2.4 per cent and emerging market and developing economies growing at 3.7 per cent (see Figure 1 below). The world economy will experience slow growth in 2023, at 2.7 per cent, with advanced economies growing at 1.1 per cent and emerging market and developing economies at 3.7 per cent. The slow growth in major economies and the effects of supply chain disruption-induced inflation caused by the Russia-Ukraine war is leading to a global recession in 2023.

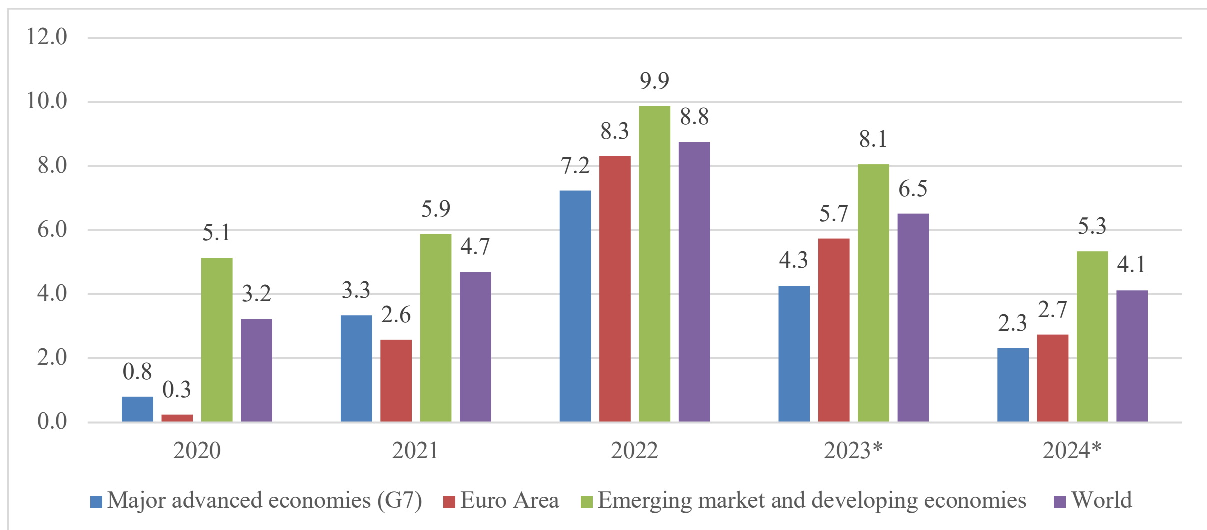
Figure 1: Global economic outlook



Source: International Monetary Fund (September 2022)

2.2. High inflation and lower growth forecasts present a risk of global stagflation, where slow economic growth is coupled with higher inflation. For example, despite a temporary decline in the consumer price index in July and August of 2022, the USA inflation reached one of its highest levels in about 40 years, with prices in August increasing by 8.3 per cent. The Euro area saw inflation reached 10 per cent in September, while the UK saw annual inflation of 9.9 per cent. Emerging markets and developing economies are estimated to reach inflation levels of 10.1 per cent in the second quarter of 2022 and face a peak inflation rate of 11 per cent in the third quarter.

Figure 2: Inflation-average consumer prices by country groups (%)

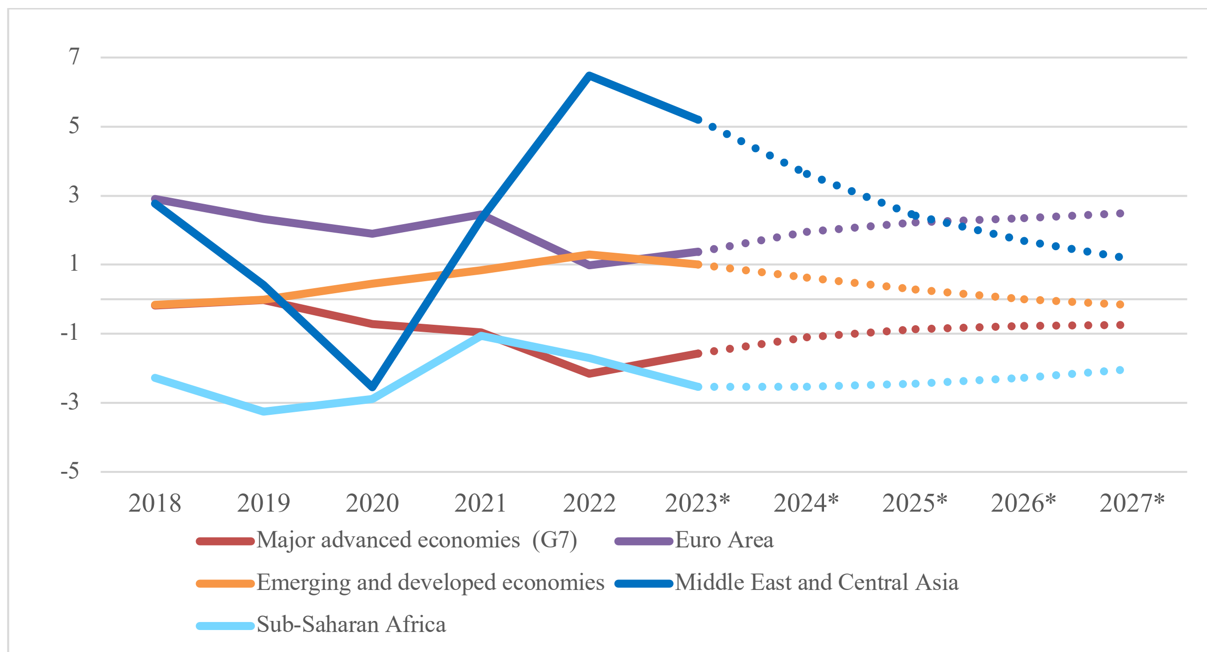


Source: International Monetary Fund

2.3. Global current account balance in trade and capital transfer activities is projected to experience a further deficit in 2022, caused by oil exporters' holding of oil reserves and

the US's trade deficit. In addition, monetary tightening by the Federal Reserve in response to inflation pressures contributes to the dollar's appreciation and tapering of liquidity flows. However, over the medium term, the current account deficit is expected to narrow gradually over 2023–2027 as these factors moderate. Hence, China's current account surplus in emerging market economies is projected to decline by 0.4 per cent of their GDP.

Figure 3: Current account balances (% of GDP)



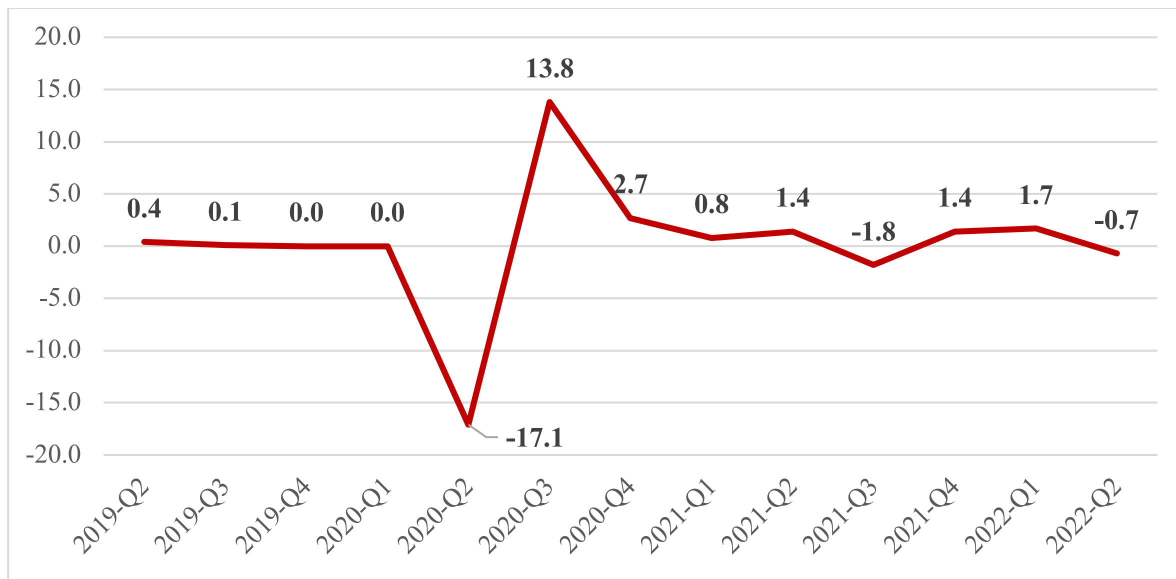
Source: International Monetary Fund

2.4. The global economy will likely experience stagflation as it continues to experience low growth and higher inflation. In addition, the developments in the Russia-Ukraine war pose supply-side risks and increase investment uncertainty in the global growth outlook. The disruptions in growth in China, Russia, and the USA, as well as sharp slowdowns in eastern European countries directly affected by the war in Ukraine, are some of the downside risks to global growth.

Domestic growth and prospects

2.5. The South African economy declined in the second quarter of 2022, despite a slight decrease in unemployment. The economy is facing risks of rising fuel and food prices, electricity supply constraints, and deteriorating infrastructure, combined with a rising interest rate due to monetary tightening globally. As a result, GDP, which measures economic productivity, declined by 0.7 per cent in the second quarter of 2022 (see Figure 4 below). The decline follows two consecutive increases of 1.4 per cent and 1.7 per cent in the last quarter of 2021 and the first quarter of 2022, respectively.

Figure 4: Growth in the real GDP, quarter-on-quarter change (seasonally adjusted)



Source: Statistics South Africa, Q2 2022

2.6. Government final consumption expenditure and net exports were the two components that contributed negatively in the second quarter of 2022. Household final consumption expenditure grew by 0.6 per cent, which amounts to a contribution of 0.4 of a percentage point to total GDP growth (see Table 1 below). Government final consumption expenditure declined by 0.7 per cent, contributing -0.1 per cent to overall growth. Gross fixed capital formation grew by 0.5 per cent. Net exports contributed negatively to total GDP growth with 1.5 percentage points, the outcome of increases in exports of 0.3 per cent and declines in imports worth 5.6 per cent.

Table 1: Growth rates in expenditure on GDP (% change quarter-on-quarter)

	2020				2021				2022	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Household consumption	1.0	-20.5	17.8	3.1	0.5	1.6	-2.8	3.0	1.2	0.6
General government consumption	0.0	-0.5	0.3	0.7	-0.6	0.4	0.5	0.2	1.1	-0.7
Gross fixed capital formation	-3.0	-22.1	14.1	5.3	-3.1	-0.3	-1.1	1.6	3.4	0.5
Exports of goods and services	-0.9	-29.9	28.5	6.1	1.7	3.0	-6.9	8.3	3.8	0.3
Imports of goods and services	-4.5	-18.2	-0.6	10.9	6.7	0.2	-3.4	8.4	5.1	5.6

Source: Statistics South Africa

2.7. On the production side, transport, finance and personal services are the only three industries to contribute positively to the production growth of GDP in the second quarter of 2022. In the primary sector, agriculture, forestry, and fishing declined by 7.7 per cent in the second quarter of 2022 while contributing a negative 0.2 per cent to GDP growth (see Table 2 below). The changes are primarily caused by decreases in the production of animal products. The mining industry declined by 3.5 per cent due to declines in output

for gold, coal, manganese ore and diamonds. In the secondary sector, manufacturing fell by 5.9 per cent in the second quarter of 2022, contributing a negative 0.7 per cent to the growth of GDP. The decrease offset a 5 per cent increase in growth from the previous quarter. The tertiary sector comprising trade, catering and accommodation, recorded a 1.5 per cent decline, while transport, storage and communication grew by 2.4 per cent. The exact rate of increase is recorded for the finance, real estate and business services industries. On the production side, most industries experienced contraction.

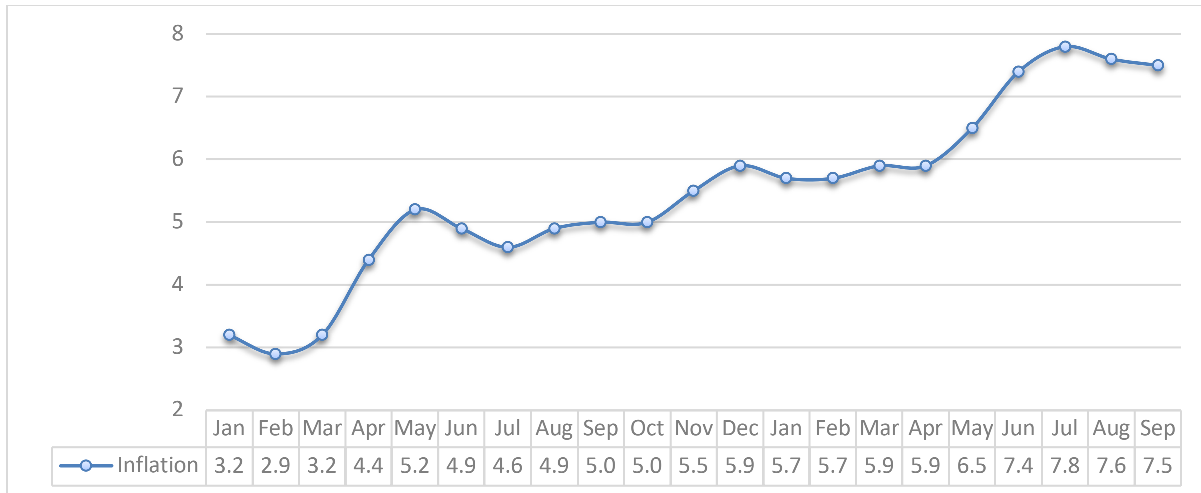
Table 2: Growth rates in industry value added and GDP (% change quarter-on-quarter)

	2020	2021				2022	
	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Agriculture, forestry and fishing	7.1	6.1	11.3	-24.7	16.4	-2.4	-7.7
Mining	-1.3	4.1	2.0	-1.1	-3.2	-2.1	-3.5
Manufacturing	5.5	0.4	-1.8	-4.3	2.4	5.0	-5.9
Electricity, gas and water	0.5	-0.6	0.6	0.3	-3.1	2.0	-1.2
Construction	2.3	0.2	-1.6	-1.1	-2.6	-0.8	-2.4
Trade, catering and accommodation	1.5	0.9	3.2	-4.4	3.9	3.1	-1.5
Transport, storage and communication	4.6	-2.8	6.7	-1.6	2.9	1.8	2.4
Finance, real estate and business services	2.8	0.9	-0.5	1.2	-0.7	1.8	2.4
General government services	0.2	0.2	-0.5	0.3	-0.3	1.4	-1.4
Personal services	1.6	1.0	2.7	0.3	2.5	0.8	0.1

Source: Statistics South Africa

2.8. Elevated domestic inflation and rising interest rates exacerbate existing social inequalities and exact significant hardships on those in deep poverty in South Africa. Headline, consumer price inflation was 7.5 per cent in September 2022 (see Figure 5 below). September's consumer price inflation has exceeded the South African Reserve Bank upper bound target of 6 per cent from May 2022 due to external supply disruptions, thus *supply-side inflation*. The primary contribution to the 7.5 per cent were food and non-alcoholic beverages, housing and utilities, transport, and miscellaneous goods and services. On closer examination, the declines in transportation price inflation worked to counteract faster price increases for food and non-alcoholic beverages and housing and utilities. The immediate effect of the Russian invasion of Ukraine is reflected in rising inflation, low growth and supply chain restrictions that directly impact inflation expectations, wage bill negotiations, post-COVID-19 recovery plans, and budget reprioritisation within the government.

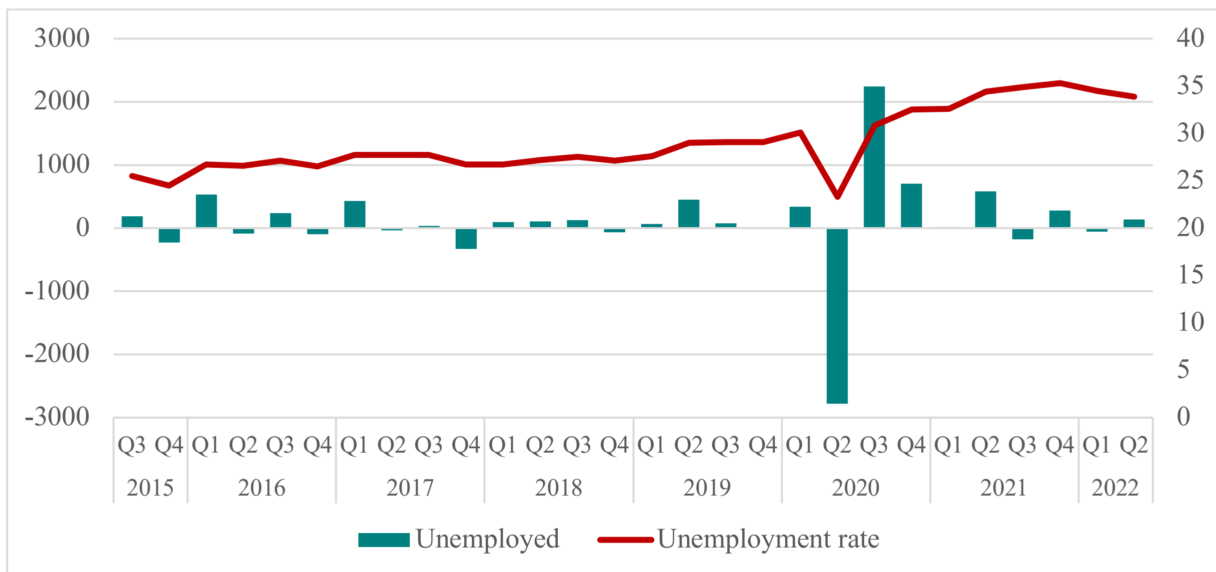
Figure 5: CPI headline year-on-year rates (%)



Source: Statistics South Africa

2.9. Employment growth remains sluggish, and unemployment continues to be persistently high. Although the number of employed individuals increased by 420 000, thereby decreasing the unemployment rate. However, the number of unemployed persons increased by 132 000 to 8 million in the second quarter of 2022 relative to the first quarter. With an unemployment rate sitting at 33.9 per cent, significant structural changes are required to decrease unemployment at a steady pace.

Figure 6: Quarter-to-quarter changes in unemployment, Q3:2015 to Q2:2022



Source: Statistics South Africa

2.10. In sum, South Africa's economic growth continues to be sluggish. Inflation is expected to continue its upward trend and slow growth as the rising cost of living affects household and business expenditure decisions. The energy crisis will likely exacerbate uncertainty weighing on global and domestic investor sentiments, thus affecting growth prospects. The rising government debt, debt service cost and interest will likely result in tightening

financing conditions. Lastly, the slowdown in global economic growth and geopolitical tensions are causing supply chain disruptions, negatively affecting commodity price certainty, and resulting in lower investments and domestic tax revenue collections.

3. Tax Proposals and Revenue Outlook

Changes in taxation

3.1. Proposals of changes to the Income Tax Act affecting the efficiency of tax collection entail special permission for variable remuneration and provide for the postponement of the taxation of variable remuneration from the date when the amount accrues to the employee to the date the employee receives it. Also, it is proposed that the Income Tax Act be amended to allow retirement fund members to transfer one or more contracts in a particular retirement annuity fund to ensure that the current de-minimis thresholds are not contravened, contingent on certain conditions being met.

3.2. The 2022 draft Taxation Laws Amendment bill proposes amendments to be made in the proviso to the definition of "contributed tax capital" in section 4 subsection 1 of the Tax Laws Amendment Act to include an anti-avoidance measure. Similarly, a further proposed change to the Tax Laws Amendment Act relates to the International Financial Reporting Standards (IFRS) amendments.

3.3. Concerning the VAT Act, it is proposed that amendments be made to section 1(1) regarding the definition of "enterprise" to broaden its scope and add the Customs and Excise Act regarding vaping. In addition, it is proposed that the carbon tax rate should be increased progressively from 2023 to 2030. The proposed amendments will come into operation on 1 January 2023.

3.4. The 2022 draft Rates bill proposed amendments to personal income taxes. The changes to the rates and monetary thresholds in the personal income tax tables consist of increases to the primary rebate (R15 714 to R16 425), the secondary rebate (R8 613 to R9 000) and the tertiary rebate (R2 871 to R2 997). The amendments to the thresholds were effective from 1 March 2022. Furthermore, personal income tax brackets are adjusted to the expected inflation rate of 4.5 per cent for the 2022/2023 financial year.

3.5. A key proposal in the draft Revenue Laws Amendment bill relates to the current design of the retirement system. The retirement pot will comprise two-thirds of the retirement contributions for long-term preservation, and a third constitutes savings for short-term financial relief. The changes are an intervention to encourage a savings culture in South African households. The implementation date for the retirement fund two-pot system has been extended to March 2024.

3.6. There have been cases of abuse of the Employment Tax Incentive Act 2011 through ETI reimbursements claimed improperly by employers. Reclassifying reimbursements as refunds will facilitate the imposition of understatement penalties on ETI reimbursements claimed improperly.

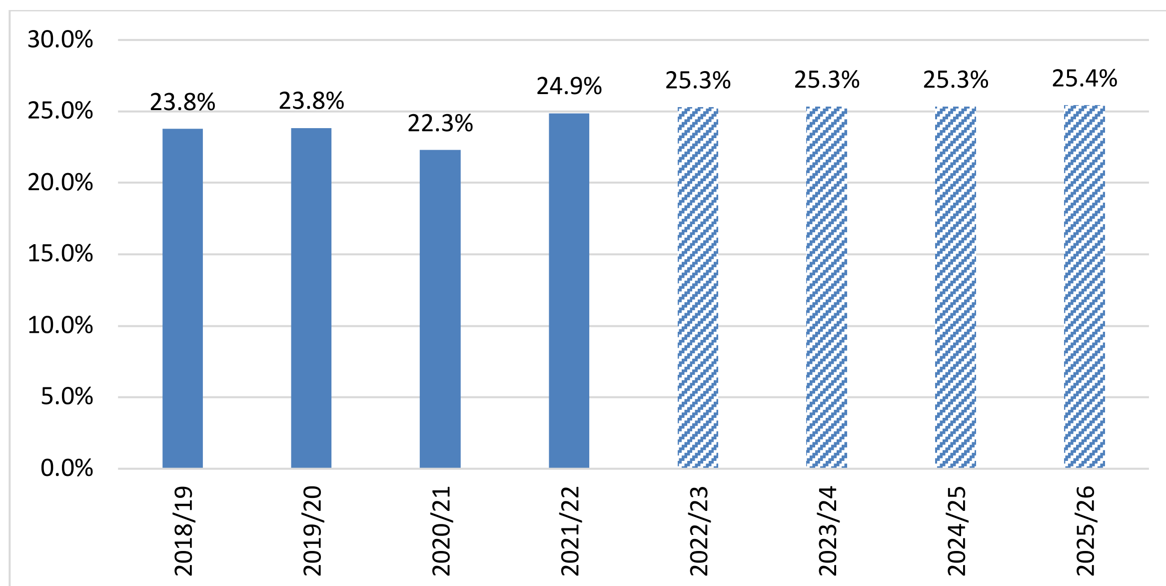
Revenue performance and outlook

3.7. Revenue performance exceeded the 2022 Budget estimate, driven mainly by improvements in corporate tax collections. Specifically, higher profitability in the finance and manufacturing sectors contributed to strong corporate income tax collections. In addition, personal income taxes also partially contributed to revenue collection due to improved earnings and bonus payments for employees in the finance sector.

3.8. Due to large import volumes and elevated prices, substantial revenue was collected via customs duty and value-added import tax (VAT) collections. However, net VAT collections were revised downwards compared to the 2022 Budget projections. In addition, as noted in the 2022 MTBPS, fuel levy collections are estimated to be lower than expected due to the additional fuel levy relief provided in the first half of 2022/23.

3.9. Due to improved revenue targets, the tax-to-GDP ratio will increase from 24.9 per cent in 2021/22 to 25.4 per cent of GDP by 2025/26. The 2022 MTBPS notes that the revised projections assume that majority of the windfall tax receipts from elevated commodity prices will subside over the next two years. It is also said that the higher projections partly reflect a permanent increase in revenue, likely due to improvements in efficiency at the South African Revenue Service. However, the medium-term employment growth outlook remains weak limiting personal income tax projections.

Figure 7: Tax as % of GDP



Source: South African Revenue Service

3.10. While the upward revisions of the revenue projections are encouraging, revenue could decline if global growth slows further, power cuts escalate, or the Russia-Ukraine conflict intensifies.

The adjusted fiscal framework

3.11. The fiscal outlook has somewhat improved owing to better-than-expected revenue collection. As shown in the table below, primary budget revenue is expected to increase

to 25.5 per cent of GDP in 2022/23 due to higher revenue collections, averaging 24.9 per cent of GDP over the medium term. As a result, the main budget expenditure (including debt service costs) is expected to reach 30.3 per cent of GDP in the current year, reducing to 28.3 per cent of GDP by 2025/26. The expected moderation in main budget expenditure broadly reflects fiscal consolidation measures enforced over the last few years.

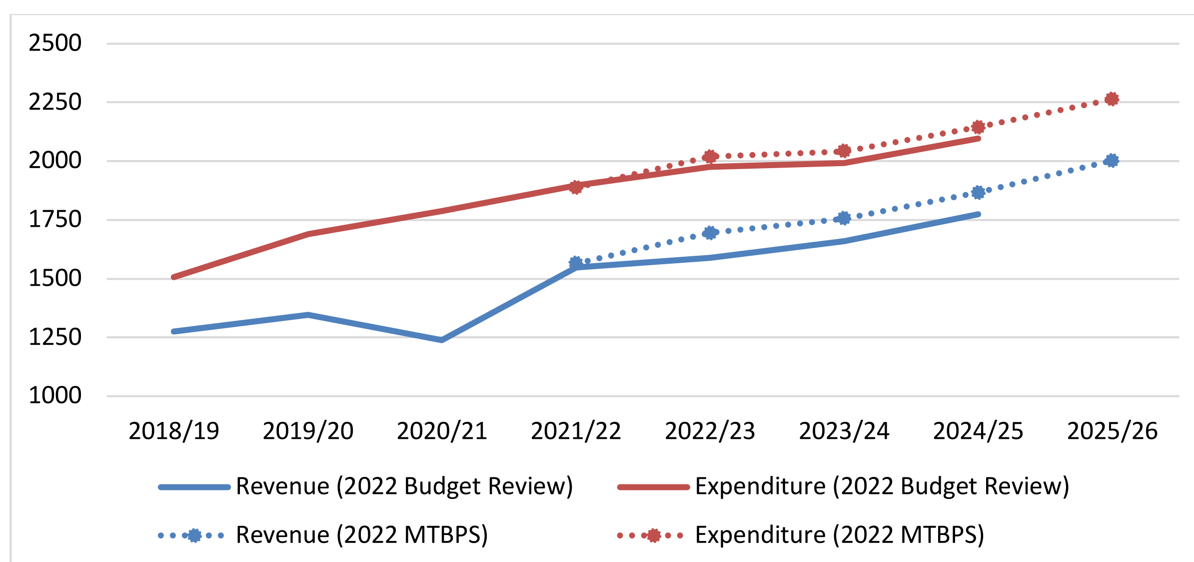
Table 3: Main budget revenue and expenditure (percentage of GDP)

	Outcome			Revised	Medium-term estimates		
	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
Main budget revenue	23.6%	22.1%	24.9%	25.5%	24.9%	24.8%	25.0%
Main budget expenditure	29.7%	31.9%	30.0%	30.3%	28.9%	28.5%	28.3%
Main budget balance	-6.1%	-9.8%	-5.1%	-4.9%	-4.1%	-3.7%	-3.3%

Source: National Treasury 2022 MTBPS

3.12. Through increased tax revenue and expenditure containment, the main budget revenue-expenditure gap will narrow from 4.9 per cent of GDP in 2022/23 to 3.3 per cent of GDP by 2025/26.

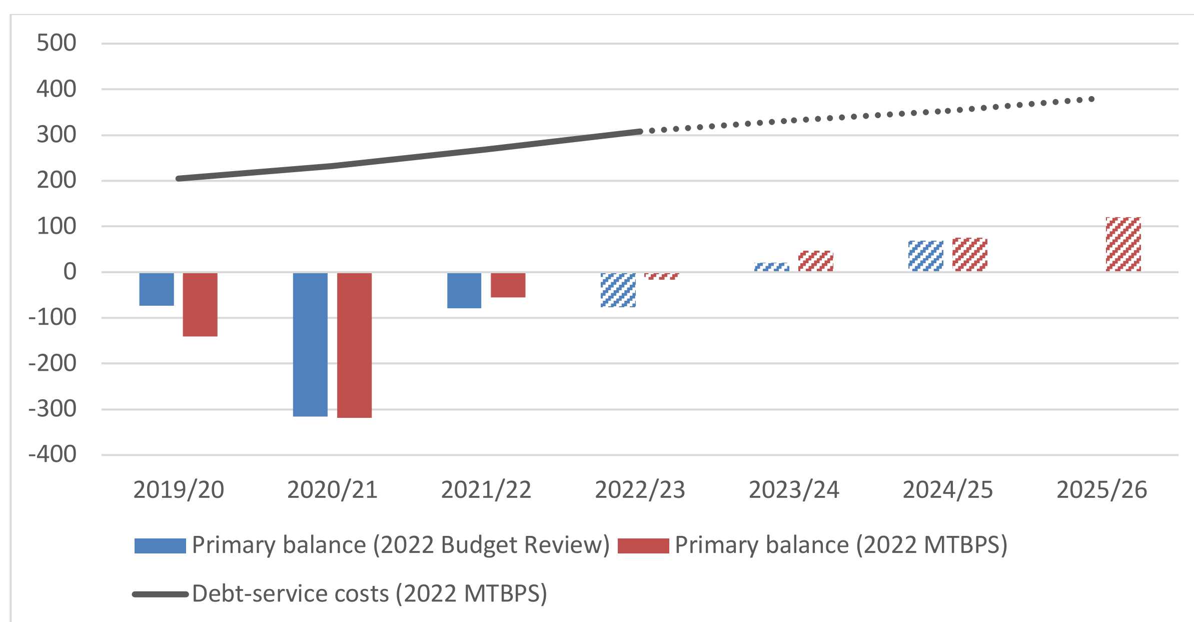
Figure 8: Main budget revenue and expenditure, 2022 Budget vs 2022 MTBPS (R billion)



Source: National Treasury

3.13. A primary budget (excluding debt service costs) surplus is projected from 2023/24 and will increase in 2024/25 and 2025/26. This reflects the government's commitment to fiscal discipline, consistent with its fiscal stance in ensuring fiscal credibility and sustainability. However, debt-service costs present an escalating risk to the fiscal framework over the medium term, as shown in the figure below.

Figure 9: Primary balance and debt-service costs (R billion)



Source: National Treasury

3.14. Relative to the 2022 Budget, non-interest expenditure is estimated to increase by a net R52.4 billion in 2023/24 and R58.5 billion in 2024/25. Over the medium term, 59.2 per cent of consolidated non-interest expenditure will be allocated to public spending on education, healthcare, housing, transport, employment, free basic services by local government, and social protection. The Commission welcomes the one-year extension of the Covid-19 social relief of distress grant to support poor and vulnerable households.

3.15. Infrastructure spending is also expected to increase over the medium term due to additional project allocations. The Commission supports the increased funding on infrastructure spending as it will support longer-term growth prospects. However, the government should remain committed to improving the management of infrastructure spending as public infrastructure projects are often characterised by cost overruns, mismanagement, wasteful expenditure, delayed completion, and defective workmanship.

3.16. The government proposes conditional in-year allocations to key public entities, including Denel, SANRAL and Transnet, to reduce contingent liabilities and enable them to support economic recovery and national security. In addition, the size of the contingency reserve will be increased over the next two years to improve the government's responsiveness to disasters. In addition to the contingency reserve, funds will be earmarked for the unallocated reserve to safeguard against other fiscal risks.

3.17. Overall, the fiscal outlook has improved relative to the 2022 Budget estimates, due to higher nominal GDP projections and higher revenue estimates from increased corporate income tax collections, albeit with inflationary risks. As a result, a primary budget surplus is projected from 2023/24, reflecting the government's commitment to fiscal discipline. However, uncertainty remains on whether the government will be able to control the growth in the public wage bill over the medium term. In addition, continued increases in tax revenues may not be feasible due to the low growth projections.

Recommendations

- *The Commission welcomes the changes in taxation and the fiscal decision to use the revenue windfall to support increased allocation to pay off debt where possible, increase infrastructure spending to stimulate growth; allocate funds to reduce fiscal and economic risks; fund safety, security, and social services. This includes the one-year extension of the Covid-19 social relief of distress grant to support poor and vulnerable households.*
- *While the Commission acknowledges the poor state of SOCs, the in-year allocation to public entities erodes the resources available for other policy priorities. Therefore, the Commission reiterates its view on the need to find a sustainable solution for the management and performance of public entities by addressing capacity shortcomings, accountability failures, and corruption.*
- *The Commission supports the proposed amendments found in the 2022 draft Taxation Laws Amendment bill, draft Rates bill, draft Revenue Laws Amendment bill, and draft Tax Administration Laws Amendment bill. While the amendments are consequential, several of the proposed changes will assist in increasing tax revenues, mitigating fiscal leakages, and further improving the efficiency of tax collection by SARS. However, it is essential to note that the high inflation and low growth environment make raising revenue through tax increases challenging. Therefore, the Commission recommends that the implementation of tax reforms needs to be done in a manner that does not harm growth.*

4. 2022 Adjustment Appropriation Bill

4.1. The Adjustments Appropriation bill aims to effect adjustments to the appropriations made in the Appropriation Bill of a particular year. The 2022 Adjustment Appropriation bill thus affects changes to the appropriation of funds in respect of 2022/23. These adjustments are also referred to as in-year spending adjustments. Table 4 summarises the in-year adjustments that have been implemented.

Table 4. In-year adjustments to the main budget

R million	Appropriation (ENE)	Special appropriation	Adjustments appropriation allocations	Adjusted appropriation
Appropriation by vote	1 057.029	–	7.454	1 064.483
Unforeseeable and unavoidable expenditure			6.347	
Expenditure earmarked in the 2022 Budget speech for future allocation			500	
Rollovers			990	
Self-financing expenditure			1.580	
Declared unspent funds			-1.963	
Direct charges against the National Revenue Fund	902.658		7.238	909.896
Subtotal	1 959.687	–	14.692	1 974.379
Provisional allocations not assigned to votes	1.372		13.380	14.752

Infrastructure Fund not assigned to votes	4.197		-4.197	–
Contingency reserve	10.000		-5.000	5.000
National government projected underspending			-3.917	-3.917
Local government repayment to the National Revenue Fund			-2.000	-2.000
Total adjustments expenditure estimate	1 975.257		12.957	1 988.213
Special Appropriation Bill, 2022		30.014		30.014
Total	1 975.257	30.014	12.957	2 018.228

Source: MTBPS 2022 (Table 4.2)

4.2. In total, the 2022 in-year spending adjustments amount to R13 billion. Of this R13 billion, R7.45 billion is in respect of adjustments to vote appropriations - the bulk of which (R6.3 billion) relate to unforeseeable and unavoidable expenditure prompted by flood damage. These funds are directed mainly to two votes. (1) The Cooperative Governance vote, where R3.6 billion is allocated towards municipal and provincial disaster-related grants and (2) The Transport vote, where R1.8 billion is in respect of the disaster relief component of the provincial road maintenance grant funding and for SANRAL to address flood damage to toll roads. The Human Settlements vote also allocated R442 million to top up the provincial emergency housing grant and eThekwini metro's allocation of the informal settlements upgrading partnership grant.

4.3. Regarding expenditure earmarked in the 2022 Budget Speech for future allocation, the adjustment (amounting to R500 million) is in respect of the Presidential Employment Initiative (PEI). It will be focussed on spearheading a digitisation programme for the Department of Home Affairs.

4.4. Rollovers amount to R990 million. The bulk of the rollovers emanates from two votes relating to Phase 2 of the PEI roll-out. In the first instance, a rollover, amounting to R231 million, stems from the Agriculture, Land Reform and Rural Development vote and relates to the payment of subsistence producers selected in Phase 2 of the PEI. Again, the Commission raised the issue of poor spending concerning the PEI implemented in this department when assessing rollovers relating to Phase 1 of the initiative. The second largest rollover amounting to R200 million is recorded for the Communications and Digital Technologies vote, and again, it relates to Phase 2 of the PEI.

4.5. Total declared unspent funds amounting to R1.96 billion is primarily driven by Social Development, where R1.8 billion was unspent due to lower than anticipated take-up of the SRD grant, caused by relatively more stringent grant eligibility criteria.

4.6. An upward adjustment of R7.2 billion is made to the Direct Charges Against the National Revenue Fund. This primarily caters to an R5.9 billion addition to debt service costs.

4.7. Categorised as unforeseeable and unavoidable expenditure, the provincial equitable share (PES) also receives an additional allocation of R48.5 million to assist provincial departments of social development to continue caring for flood victims placed in shelters

as a result of the April 2022 KZN floods. While the Commission welcomes assistance to households affected by the floods, the Commission advises that the government initiates a more permanent solution insofar as rehoming the flood victims is concerned. To this end, a timeline and milestones should be shared with the Committees so that oversight can be exercised.

4.8. Denel and the Land and Agricultural Development Bank of South Africa receive additional funding amounting to R204.7 million and R101 million, respectively. This adjustment is made in Section 70 of the Public Finance Management Act (PFMA), which relates to guarantees, indemnities and securities by cabinet ministers[1].

4.9. R618.8 million is added to the skills levy and sector education and training authorities (SETAs). While additional funding in support of skills development is essential, utilising funding efficiently and effectively is equally important. To this end, the Auditor-General, in a recent presentation to the Portfolio Committee on Higher Education and Training on the 12th of October 2022, highlighted some challenges characterising the SETAs. It is thus pertinent to ensure that the addition of funding is coupled with strong oversight of the use of the resources to avoid further maladministration.

4.10. The adjustment will be funded through a combination of infrastructure funds not assigned to votes (R4.2 billion), a drawdown on the contingency reserve (R5 billion) and projected government underspending (R5.9 billion).

2022 Special Appropriation bill

4.11. The purpose of a special appropriation bill is to appropriate additional amounts or effect changes to specific votes. The 2022 Special Appropriation bill focuses solely on additional funding, amounting to R30 billion, to three state-owned companies across the Public Enterprises and Transport votes. The specific allocations are as follows:

- R23.7 billion is in respect of the South African National Roads Agency (SANRAL) to assist it in paying off government-guaranteed debt.
- R6.2 billion is in respect of the Public Enterprises vote, specifically Denel (R3.4 billion) and Transnet (R2.9 billion). In the case of Denel, additional funding is to support the implementation of a turnaround strategy aimed at bringing stability to the entity, whilst the funding for Transnet is to accelerate the repair and maintenance of locomotives.

4.12. National Treasury suggests that the proposed conditional in-year allocations to Denel, SANRAL and Transnet will reduce contingent liabilities and enable these entities to continue supporting economic growth and national security.

[1] Section 70 of the PFMA states that: “A Cabinet member, with the written concurrence of the Minister… may issue a guarantee, indemnity or security which binds the National Revenue Fund in respect of a financial commitment incurred or to be incurred by the national executive. The section further states that any payment under a guarantee, indemnity or security issued in terms of the above, “is a direct charge against the National Revenue Fund, and any such payment must in the first instance be defrayed from the funds budgeted for the department that is concerned with the issue of the guarantee, indemnity or security in question”.

4.13. The FFC appreciates the government's commitment to continue promoting a growth-friendly, fiscal consolidation policy path geared towards stabilising government debt. However, the maturity of SOCs' debt payments and poor functionality poses a substantial risk to the fiscus. The challenges of SOCs have resulted in poor service delivery, poor financial management, less growth, massive unemployment, corruption and low business confidence. The poor performance of SOCs will result in persistent government guarantees and bailouts to ensure the survival of these entities. Should SOCs consider themselves too big to fail and expect constant bailouts, it imposes further pressure on contingent liabilities.

4.14. SOC bailouts are not fiscally sound. The FFC implores the government to include stringent conditions that deter SOCs from indulging in moral hazard behaviour. National Treasury advises that the pre-conditions and conditions required for a bailout include financial and operational reports to ensure that money is used to repay debt and facilitates sustained development of the SOCs. The FFC recommends that National Treasury and the respective SOC be transparent during the bailout period and make all reports and conditions publicly available.

Expenditures from a functional perspective

4.15. As illustrated in Table 5, consolidated spending is projected to increase from R2.21 trillion in 2022/23 to R2.24 trillion in 2023/24, R2.36 trillion in 2024/25 and finally, R2.48 trillion in 2025/26. This represents a nominal annual average growth of 4 per cent from 2022/23 to 2025/26. The year-on-year increases show that in the coming financial year, 2023/24, overall consolidated spending is projected to grow by 1.6 per cent. More robust growth is projected for 2024/25 (5.5 per cent) and 2025/26 (4.8 per cent). However, it should be noted that the growth rates of the outer two years are subject to wide variation.

Table 5. Projected Allocations and Growth by Functional Category, 2022/23 - 2025/26 (R billion)

Functional Category	Revised	Medium Term Estimates			Projected Year-on-Year Growth		
	2022/23	2023/24	2024/25	2025/26	2022/23-2023/24	2023/24-2024/25	2024/25-2025/26
Learning and Culture	447.4	455.6	473.4	496.5	1.8%	3.9%	4.9%
Health	258.4	256.1	267.5	279.4	-0.9%	4.5%	4.4%
Peace and security	227.6	226.4	235.4	246.5	-0.5%	4.0%	4.7%
Community development	236.7	258.7	274.9	291.7	9.3%	6.2%	6.1%
Economic development	222.9	237.6	262.4	280.8	6.6%	10.4%	7.0%
General public services	71.4	73.1	74.8	78.0	2.4%	2.3%	4.4%
Social development	365.6	370.9	350.2	340.3	1.4%	-5.6%	-2.8%
Allocated by function	1 892.6	1 903.5	1 963.9	2 039.7	0.6%	3.2%	3.9%
Debt-service costs	307.7	332.2	352.9	380.7	7.9%	6.2%	7.9%
Consolidated expenditure	2 205.3	2 241.7	2 364.1	2 477.7	1.6%	5.5%	4.8%

Source: MTBPS 2022 (Table 4.3) and Commission calculations

4.16. In the 2023/24 financial year, the projected 1.6 per cent growth in spending is driven by increases to the community development function of 9.3 per cent and the economic development function at 6.6 per cent 2023/24. Whereas the last few years have seen the growth in debt service costs dominating and outstripping growth in allocations to service delivery, the Commission strongly supports funding basic services such as water, sanitation and electricity to indigent households for development. Kickstarting growth is equally critical; thus, the stronger growth projected for the economic development function, which is centred on infrastructure, is similarly welcomed. Furthermore, consolidated spending on building new and rehabilitating existing infrastructure over the medium term will increase from R66.7 billion in 2022/23 to R112.5 billion in 2025/26. This includes roads, bridges, storm-water systems, and public buildings.

4.17. The largest allocation is in respect of the learning and culture function, which is projected to receive R455.6 billion in 2023/24. In particular, basic education is set to receive R308.4 billion in 2023/24. This represents a nominal increase of 2.2% relative to the 2022/23 allocation. The additional funding is earmarked for: compensation to employees to fill teacher vacancies and additions to the National School Nutrition Programme and early childhood development (ECD). Filling teacher vacancies is critical; however, as alluded to in the MTBPS, a balance needs to be struck in, on the one hand bringing in the required teachers and, on the other, ensuring that personnel costs do not crowd out spending on complementary and equally critical educational inputs. The Commission has, in previous submissions, recommended the need for strengthening the funding and quality of ECD services and thus looks forward to more detail on ECD when the 2023 Budget is tabled.

4.18. When Budget 2022 was tabled, the government provided additional, once-off funding for fee-free higher education amounting to R32.6 billion. The 2022 Budget Review also noted that a revised funding framework was being developed for implementation in 2023. At that point, the Commission urged the government to finalise the funding framework with haste, especially in light of the strain the free education provision places on the fiscus. According to the update provided in the 2022 MTBPS, the report by the ministerial task team on student funding noted that more work is required. The Commission urges the government to determine clear timelines around the completion of this process.

4.19. Social protection, provided through the Social Development vote, received the second-largest share of the consolidated budget over the MTEF period. An increase in the old age, war veterans, disability and care dependency grants (by an additional R10 per month) contributes to the growing share of this vote over the MTEF period. Further, over 7.4 million South Africans are recipients of the Covid-19 SRD grant. The 2022 MTBPS notes that the Covid SRD grant has been instrumental in saving millions from destitution by supporting household income and boosting consumption[2]. The FFC endorses this statement by National Treasury as the Commission noted similar results in research

[2] See page 17 of the 2022 MTBPS.

undertaken in its 2023/24 Annual Submission on the Division of Revenue. Due to the weakening economy, persistent unemployment and worsening socio-economic conditions, social grants are instrumental in securing the basic needs of households. The Covid SRD grant was initiated in May 2020 and has been extended numerous times since then. According to the 2022 MTBPS, the Covid SRD grant will now be extended to March 2024 as National Treasury is still considering the financial impact of a permanent BIG that caters to economically vulnerable working-aged individuals. The Commission's view is that the continuous extension of the grant allows markets to align themselves with the government's medium-term plan but leaves much room for uncertainty, especially among the poor, that rely on social grants to secure their livelihoods. In adding its voice to this critical issue, the FFC is researching the fiscal incidence of social grants and whether a BIG is feasible in the current fiscal climate. National Treasury must reach a consensus to ensure that the government can maintain its goal of fiscal consolidation without leaving the poor more vulnerable, given the increasing cost of living relative to the non-inflation-linked adjustments to existing social security grants.

4.20. Concerning the health function, MTBPS 2022 notes that additional funding will be allocated to address a range of challenges related to healthcare personnel, medicine, laboratory services, and medical supplies. This includes service delivery backlogs in surgery, oncology, antiretroviral treatment and tuberculosis screening and treatment. Given the projected allocations, the additional funding to address the above challenges will be allocated during the two outer years of the MTEF period. As a result, for 2023/24, allocations to the health function, including free public healthcare, are set to decline marginally. In sum, the total allocation to the function decreases by 0.9 per cent in 2023/24, from R258.4 billion to R256.1 billion; while free healthcare services, which form part of the social wage, are projected to decline from R232 billion in 2022/23 to R231.9 billion in 2023/24.

4.21. The 2022 MTBPS notes that the peace and security function will receive additional funding to improve safety and security, including funding for increasing the number of student constables and funding to assist the special investigation unit in taking forward recommendations by the State Capture Commission. These increases are, however, set to come online during the two outer years of the MTEF period. Accordingly, for 2023/24, the allocation to this functional category is set to decline by 0.5 per cent.

Recommendations

- *The Commission welcomes the in-year adjustments relating to the provision of funding to repair flood-related damages to assist in rebuilding damaged infrastructure and support provided to affected households. However, to ensure minimal delays and quality insofar as repairing and rebuilding damaged infrastructure is concerned, Parliament should receive regular updates on progress.*
- *The Commission, however, cautions the use of Special Appropriation bill (2022) to provide funding for SOCs, namely Sanral, Denel and Transnet, atop the adjustment bill, as it signals fiscal uncertainty, perpetuating the cycle of bailing out poorly performing SOCs.*

Accordingly, the FFC recommends applying stringent conditions to the provision of funding, that National Treasury and the respective SOCs are transparent during the bailout period, and that all reports and conditions be publicly available.

- *Concerning projections for 2023/24, the Commission welcomes the prioritisation of growth in funding directed at the Community Services function as it relates to providing free basic services to indigent households. However, the Commission advises national and provincial governments and Parliament to exercise strict oversight over utilising these funds to ensure no misuse. This is particularly important given the number of municipalities in financial distress.*
- *The projected growth in allocations to basic education is noted. As previously mentioned, the Commission believes that shifting the ECD function from Social Development to Basic Education allows the government to strengthen its investment in ECD. In addition, the MTBPS mentions that additional funding is being added to the function for ECD to improve monitoring, oversight and service delivery in provinces. The Commission looks forward to more detailed information around these aspects in the 2023 Budget.*
- *Policy certainty is required in the social development sector insofar as finding a permanent and fiscally sustainable solution to providing comprehensive support for economically vulnerable and working-aged individuals is concerned.*
- *Concerning higher education and training, the Commission reiterates its recommendation in its response to Budget 2022, which called for the urgent finalisation of a new funding framework for the sector. Furthermore, following the proposal by the ministerial committee on student funding to investigate the matter further, the Commission advises that clear timelines and milestones be determined.*

5. 2022 Division of Revenue Amendment bill – Provinces

Overview of provincial government allocation

5.1. The 2022 MTBPS proposes a total provincial allocation of R1.7 trillion over the 2023 MTEF. This represents a nominal growth of 2 per cent from the budget allocation of 2022, as shown in Table 6. However, data from the table also shows a slight decrease concerning total provincial allocation between the 2022/23 and 2023/24 budget allocation, as the budget will decrease from R684.5 billion to R684.3 billion in nominal terms (-0.03 per cent) and pick up in the outer years of the 2023 MTEF. As a result, over the 2023 MTEF, the average growth in the total allocation for provinces shall remain at 2.8 per cent. A decrease of 0.03 per cent between 2022/23 and 2023/24 and marginal growth of 2.8 per cent over the MTEF will negatively impact provinces as provincial funding has been affected by fiscal consolidation in recent years.

5.2. Equitable Share to provinces is expected to decrease from R560.8 billion in 2022/23 to R556.4 billion in 2023/24, a decrease of 0.8 per cent. On the other hand, the equitable share to provinces is projected to increase by 2.5 per cent in nominal terms over the 2023 MTEF, which is insignificant and would negatively affect the provinces' finances.

5.3. Over the 2023 MTEF, provincial conditional grants will increase and reach R401.4 billion in 2025/26. On average, the conditional grants' growth rate is expected to increase marginally by 4.3 per cent in nominal terms over the MTEF. An additional R116.8 million has been made available to the Eastern Cape and KwaZulu-Natal provinces through the Education Infrastructure grant for repairs to schools that were affected by natural disasters. Furthermore, an additional R1 billion has been allocated through the provincial roads maintenance grant to repair roads infrastructure damaged by floods. While the Commission supports additional funding to restore essential and basic infrastructure, it is of the view that there is a need to develop or update climate change and adaptation strategies, particularly for provinces and areas prone to natural disasters.

Table 6: Provincial allocation – 2022/23 baseline and 2022 MTBPS

Provincial budget allocations	2021/22	2022/23	2023/24	2024/25	2025/26
2021 budget					
PES	523.7	524.1	525.3		
Conditional grants	115.8	119.3	121.5		
Total	639.5	643.3	646.8		
2021 MTBPS					
PES	544.8	538.8	525.3		
Conditional grants	116.4	119.6	121.9		
Total	661.2	658.4	647.2		-
2022 budget					
PES		560.8	543.1	562.0	
Conditional grants		121.8	124.2	128.1	
Total		682.5	667.3	690.2	
2022 MTBPS					
PES		560.8	556.4	576.5	602.9
Conditional grants		123.7	128.0	133.0	140.4
Total		684.5	684.3	709.5	743.3

Source: (National Treasury, MTBPS 2021 & 2022 and national budget 2021 & 2022)

Recommendations

- *The Commission reiterates its recommendation made in its 2021 MTBPS submission that given expenditure moderation, comprehensive reports should be compiled by affected government departments indicating how such moderation is likely to affect the delivery of basic services and how tighter budgets would be managed.*
- *Though the Commission supports the 2022 Division of Revenue bill amendments for provinces, it recommends that the grant framework for Part A of schedule 7 grant: Provincial Disaster Response Grant be examined to improve its grant efficiency, appropriateness and effectiveness, in light of the recent flood disasters.*

6. 2022 Division of Revenue Amendment bill – Local Government

Overview of local government allocation

6.1. When reviewing the local government budget allocation, it's important to note that multiple risks impact the municipality's ability to deliver services. These challenges are further exacerbated given the backdrop of Covid-19, which relates to access to basic services and highlighting fiscal gaps. Research conducted by the Bureau of Economic Research (BER) has found eight core reasons municipalities are in the current predicament; the findings cut across multiple municipalities despite differences in operating environments and demands. This includes lack of skills, municipal audits, revenue management, irregular and wasteful expenditure, repairs and maintenance, supply chain management and general lack of spending. During this year, the government has focused on improving the challenges experienced by local governments to develop key policy recommendations.

6.2. Therefore, to achieve the objectives of local economic development and improved municipal service delivery, it requires that municipalities focus on strengthening municipal finance and investments. These underpin the ability to broaden economic activity and reverse unemployment trends by creating a conducive economic environment to facilitate and promote social and economic development activities.

6.3. This is supported by the approval of the Municipal Powers and Functions Amendment bill in the local government sphere, as it will strengthen the municipal revenue through development charges which play a critical role in financing infrastructure-related projects and thereby boost economic growth. Accordingly, the Commission welcomes the amendment as it is in line with the FFC 2020/21 Submission for the Division of Revenue for the need for municipalities to be allowed supplementary revenue sources to supplement transfers (i.e., development charges).

Table 7: Division of revenue-local government

	Outcome			Revised	Medium-term estimates			Total MTEF
	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	
Local Government	123	137.1	135.6	154.2	164.9	174.6	183.5	523.0
LG Equitable share	65.6	83.1	76.2	87.3	95.1	102.4	109.4	306.9
General fuel levy sharing with metros'	13.2	14	14.6	15.3	15.4	16.1	16.8	48.3
Conditional grants	44.2	40.0	44.8	51.5	54.4	56.1	57.3	167.8
Real growth rates	**2020/21**	**2021/22**	**2022/23**	**Average Growth 2021-2023**	**2023/24**	**2024/25**	**2025/26**	**Average growth MTEF**
Local Government	5%	-7%	9%	2%	3%	1%	0%	2%
LGES growth in real terms	20%	-14%	9%	5%	5%	3%	2%	3%
General fuel levy sharing with metros'	0%	-2%	0%	0%	-3%	0%	0%	-1%
Conditional grants	-14%	5%	10%	0%	2%	-1%	-2%	-1%

Source: Commission calculations from National Treasury MTBPS data

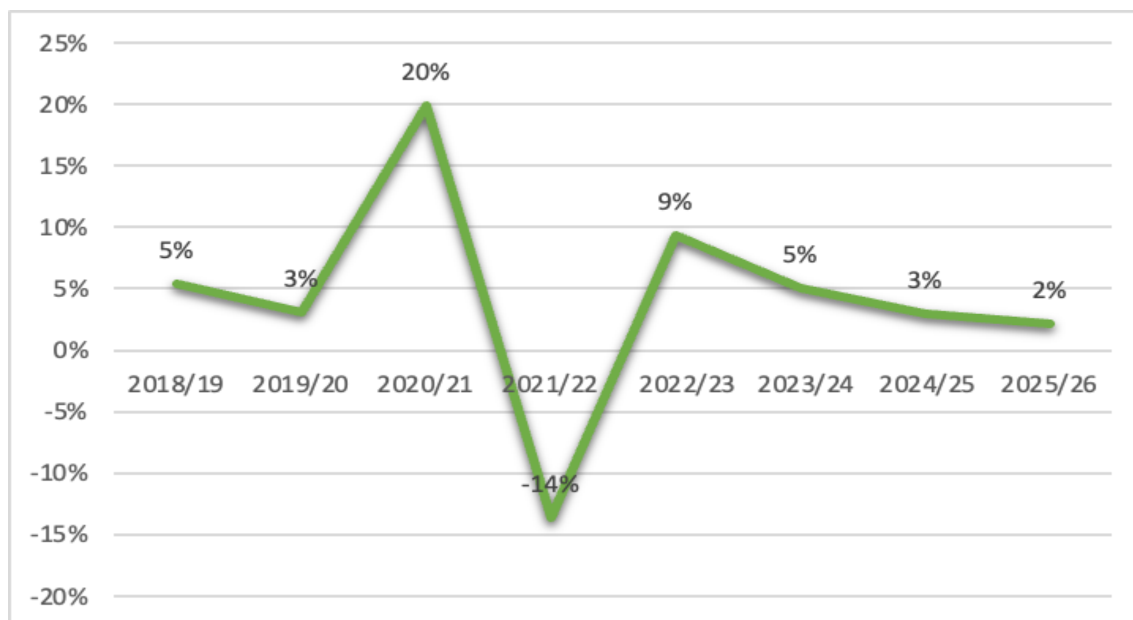
6.4. Given the insufficient capacity and challenges engulfed by the local government sphere in fulfilling their mandates, the Commission notes and welcomes the review of the conditional grant system concerning infrastructure development, building capacity and providing operational support. These reviews will enhance municipal performance and capabilities if they are comprehensively applied. Furthermore, these reviews align with the FFC 2013/14 Submission for the Division of Revenue, where the FFC recommended capacity-building programmes that should include technical support for new systems, business processes and redesign and change management based on the assessment of the respective municipality.

6.5. For the 2022 MTEF, local government is expected to receive a total of R523 billion from the nationally raised revenue. The total allocation to local government increases by an average growth rate of 6 per cent over the MTEF. The Commission notes the additional allocations to local government; however, it emphasises the importance of strengthening its municipal revenue through improved revenue management and reviewing alternative revenue streams.

Local government equitable share

6.6. The local government equitable share allocation is estimated to receive R306.9 billion over the 2022 MTEF. The unconditional allocation is envisaged to increase by 3 per cent. The Commission notes the proposed increase in the total allocation to the local government's equitable share over the medium term. However, the marginal increase puts added pressure on municipalities' ability to deliver services given the economic backdrop. In addition, the sufficiency of the allocations becomes a concern, with many cost drivers of service delivery increasing by more than inflation.

Figure 10: LGES growth rates



Source: Commission calculations from National Treasury MTBPS data

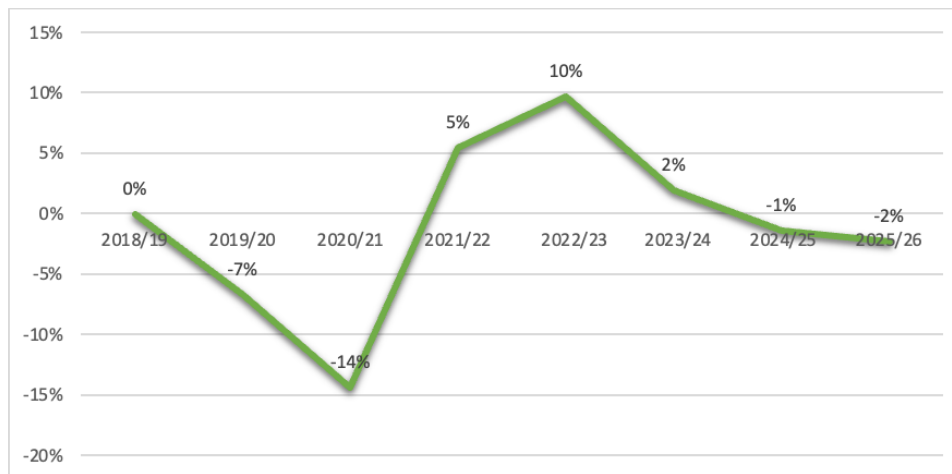
Conditional grants for local government

6.7. A total of R167.8 billion is set to be transferred to municipalities through conditional grants over the 2022 MTEF. Conditional grants in real terms grew by a whopping 10 per cent in the current financial year (2022/23), followed by a sharp declining trend of 2 per cent in 2023/24, with further negative growth rates recorded (-1% and -2%) in the outer years (2024/25 and 2025/26) respectively, see Figure 11 below. The Commission welcomes the sharp increase in conditional grants in the year 2022/23, given that bulk of conditional grants in the local government are for infrastructure-related projects and programmes; thus, this approach is in line with government economic growth and development. However, this process will be short-lived as conditional grants exhibit downward trends and negative growth rates over the 2022 MTEF. This is happening against the backdrop of municipalities under fiscal stress due to increased demand for infrastructure-related services.

6.8. In relation to disaster funding due to devastating floods that have occurred, the Commission notes the shifting of disaster funding, the R145 million from the provincial disaster response grant to the municipal disaster response grant, as well as the R120 million shifted from the municipal emergency housing grant to the provincial emergency housing grant. While the Commission support, in principle, the grant immediate disaster response because recipients do not have to wait for the adjustment period before funds can be dispersed. The Commission would like to caution that this process does not resolve challenges engulfing the financing and management of disasters in the intergovernmental relations system, as conditional grants for disasters are ex-post allocations. In its 2013/14 Submission for the Division of Revenue, the Commission recommended 'an alternative financing mechanism for disaster management in South Africa'. The Commission recommended that an integrated approach to disaster risk management and funding be implemented. Such as, disaster risks and vulnerability need to be incorporated into the design of key existing municipal grants to promote disaster risk reduction mechanisms (ex-ante approach) while enhancing municipal resilience. Considering the recent floods, the FFC would like to reiterate its previous recommendation, which indicated for government to consider providing municipalities with performance-based conditional grants with rewards or incentivising actions that are environmentally efficient and responsive to the adaptation and mitigation challenges of climate change.

6.9. The Commission notes with concern the reprioritisation and the shifting of the R100 million from the neighbourhood development partnership grant direct component to the indirect component of the grant. The FFC would like to reiterate its previous stance on this matter, highlighting the need for principles in place and a systematic and transparent process to guide the reclassification and shifting of grants from direct to indirect (and vice versa). Further, in its Submission for the Division of Revenue 2016/17, the Commission found that, generally, direct grants performed better than indirect grants and recommended the need for continued building capacity of the municipality with the use of indirect grants as a last resort.

Figure 11: Real growth rates on Conditional grants



Source: Commission calculations from National Treasury MTBPS data

Recommendations

- *The Commission recommends fundamentally reviewing the local government transfers, especially from a vertical perspective of division of revenue, taking into account of the factors of geography, rurality and the people i.e. the nature of local development to ensure proper equitable sharing of nationally raised revenue amongst the three spheres of government towards local government. This must include a proper re-examination of the assumptions used in the local government White Paper.*
- *FFC would like to reiterate its previous recommendations for government to develop a policy framework for municipal disaster risk financing. FFC supports and recommends a systematic review and process in the design of conditional grants based on an assessment of respective municipalities.*

7. Fiscal Risk Statement

Debt management risks

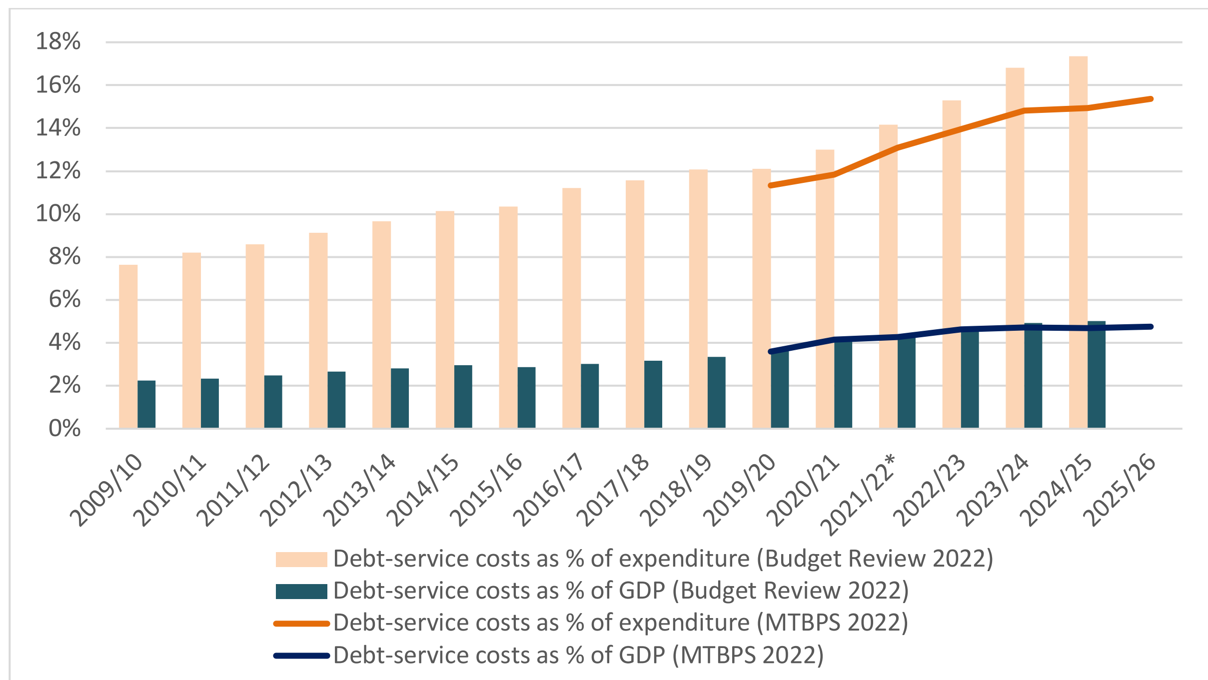
7.1. High debt-service costs make it more challenging to stabilise government debt, representing a significant risk to the sustainability of public finances because debt-service costs crowd out fiscal space and productive expenditure. As a result, debt-service costs have been revised upward by R5.9 billion compared to the 2022 Budget, increasing to R307.7 billion in 2022/23. The MTBPS projects that debt-service costs will continue to increase over the medium term, reaching R380.7 billion in 2025/26, or 4.8 per cent of GDP. As a proportion of the main budgeted expenditure, debt-service costs are expected to increase from 15.2 per cent in 2022/23 to 16.8 per cent in 2025/26.

7.2. Figure 12 below shows the upward trajectory of debt-service costs as a proportion of GDP and expenditure, which are key indicators of debt sustainability. Figure 12 shows that debt-service costs as a proportion of spending are upward, essentially eroding government expenditure over the medium term. While debt-service costs as a proportion

of GDP are projected to stabilise in 2025/26, this will hinge on sustained economic growth over this period.

7.3. The government maintains its stance to stabilise debt through fiscal consolidatory reforms and projects that gross debt will stabilise a year earlier than expected since the 2022 Budget Review, at 71.4 per cent of GDP in 2023/24. The 2022 MTBPS indicates an improved fiscal position has mainly been driven by higher-than-anticipated revenue collection, which will be used to reduce the budget deficit and address contingent liabilities.

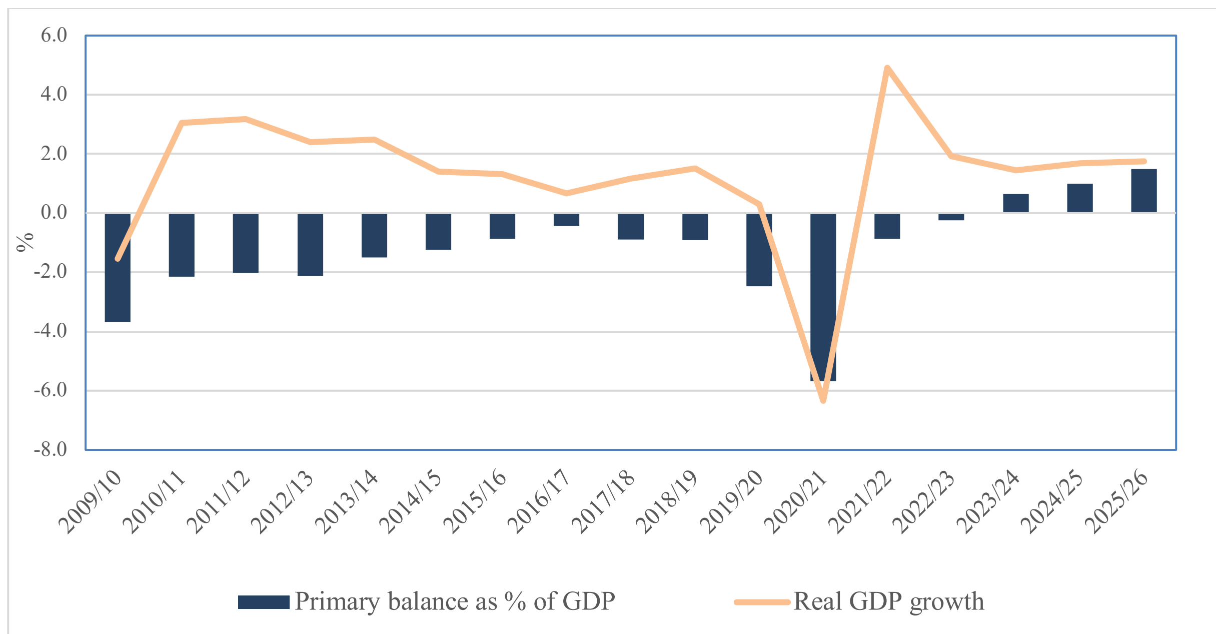
Figure 12: Debt-service costs as a percentage of government expenditure and GDP, 2009/10-2025/26



Source: 2022 Budget and MTBPS

7.4. Various macroeconomic factors play a role in influencing public debt levels and the cost of debt. The primary balance, the difference between total revenue and non-interest expenditure, has been in deficit for over a decade, as Figure 13 shows. The 2022 MTBPS projects that a primary balance surplus will be attained by 2023/24 and that a surplus will be maintained over the medium term. While this would mitigate some of the risks associated with increasing debt, weaker economic growth forecasts over the medium term may deteriorate the primary balance, as low growth is typically associated with lower cyclical revenues and more primary expenditure (Financial and Fiscal Commission 2022). In addition, GDP growth has been revised downwards, from 2.1 per cent at the 2022 Budget review to 1.9 per cent, averaging at 1.6 per cent in the medium term, adversely impacting debt dynamics.

Figure 13: Primary balance as % of GDP and real GDP growth, 2009/10-2024/25



Source: National Treasury MTBPS 2022.

7.5. The uncertain global economic landscape and persistent unfavourable domestic conditions, such as continued energy supply shortages and high domestic interest rates, may negatively impact debt dynamics over the medium term. Therefore, despite the improved fiscal stance, South Africa still faces much uncertainty and challenges ahead concerning its public debt levels, debt-service costs, and the future debt path, especially given that debt-service costs still appear to be escalating.

Contingent liabilities

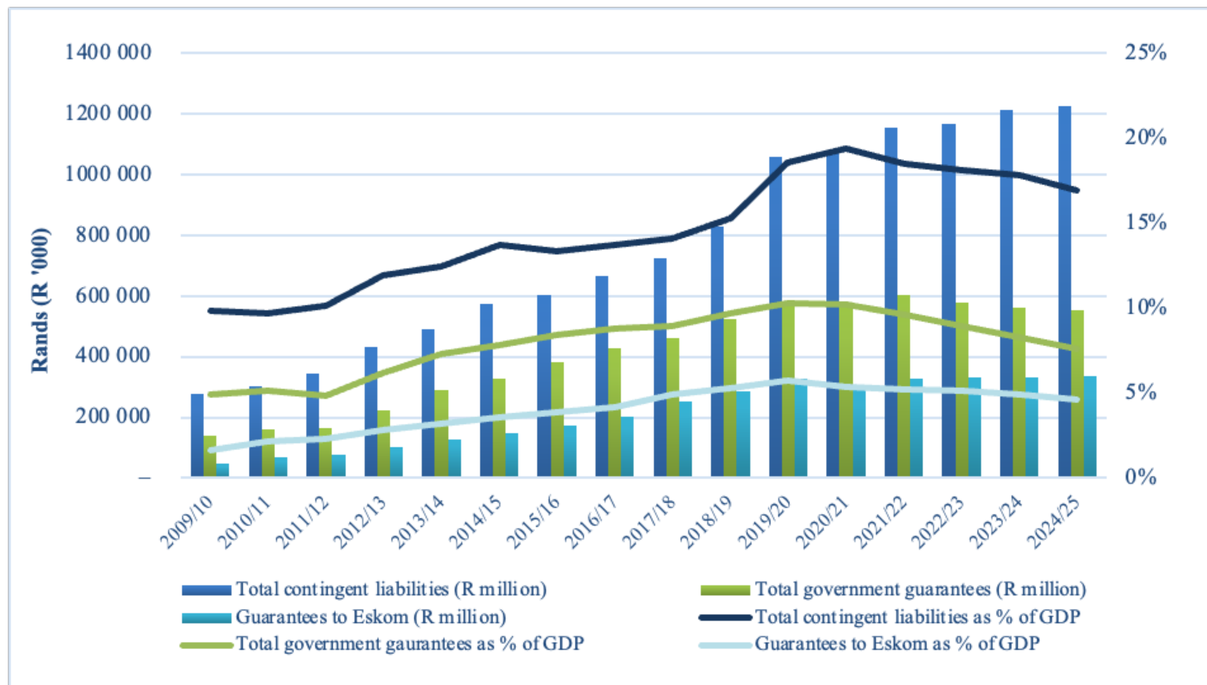
7.6. Contingent liabilities are obligations that only materialise when a specific event occurs in the near future. The 2022 Budget Review anticipated contingent liabilities would increase from R1.15 trillion in 2021/22 to R1.23 trillion in 2024/25. Figure 14 below shows that total contingent liabilities as a proportion of GDP peaked at 19.4 per cent in 2020/21 and that a downward trend may be expected, reaching 16.9 per cent of GDP in 2024/25. However, weaker economic growth projections over the medium term suggest that attaining this downward trajectory might prove cumbersome.

7.7. When contingent liabilities materialise, so do additional spending pressures, adding strain to the fiscus. In 2022 MTBPS contingent liabilities are still expected to exceed R1 trillion, posing a significant risk to the fiscus. If materialised, funds will have to be redirected elsewhere, adversely impacting the sustainability of public finances. The risk of materialising contingent liabilities is heightened due to the poor state of many SOCs that rely heavily on government guarantees to sustain their weak financial positions.

7.8. Government guarantees are legally binding responsibilities offered by the government to accept liability for servicing debt on behalf of another entity and under specific conditions. Figure 14 shows that government guarantees continue to comprise a substantial portion of the government's contingent liabilities. Government guarantees as

a proportion of GDP have more than doubled over the past decade, from 4.5 per cent in 2009/10 to 10.3 per cent in 2019/20. A decline to 7.6 per cent of GDP by 2024/25 is expected, although this would require more robust GDP growth than anticipated. A sustained decrease in contingent liabilities and government guarantees will be significant for investor confidence as these liabilities weaken the economic and fiscal position of South Africa.

Figure 14: Contingent liabilities, government guarantees and guarantees to ESKOM, 2009/10-2024/25



Source: National Treasury Budget data over various years

7.9. In 2022 MTBPS guarantee exposure increased from R567 billion in 2021 to R594 billion by the end of March 2022, driven mainly by Eskom's deteriorating performance. Eskom accounts for 78 per cent of total government guarantees and remains the most significant long-term risk to the economy due to its unsustainable business model. As a result, the government plans to provide debt relief to Eskom under strict conditions. However, there is still much uncertainty over the amount of debt the government will absorb under certain conditions. For instance, although it is favourable that they include "the timeous execution of measures to address the sustainability of newly unbundled businesses", this may suggest the restructuring of Eskom to a more sustainable business model is being prioritised (2022 MTBPS).

7.10. Notwithstanding this, government guarantees to Eskom still present a significant risk. Despite continuous bailouts over the years, inefficiencies have persisted, and the supply of energy continues to be constrained, with devastating consequences for the fiscus and the economy. While it is encouraging that the 2022 MTBPS indicates measures have been taken to remove regulatory barriers to improve private sector investment and energy generation capacity. However, if broader reforms to transform the energy sector through

the restructuring and unbundling of Eskom are not fast-tracked, the risk of materialising contingent liabilities will not be mitigated.

7.11. The accumulation of contingent liabilities is a significant risk to fiscus because the government could lack adequate resources to service its commitments. This risk has been amplified since the release of the Zondo Commission reports, which detailed corruption and state capture within many SOCs that continue to receive debt relief. The Zondo reports provide evidence of improper procurement practices, poor and unstable leadership and the mismanagement of funds within various SOCs. The 2022 MTBPS recognises the need to combat corruption, but more urgent institutional reforms, particularly in public procurement, will be needed to ensure the viability of many SOCs.

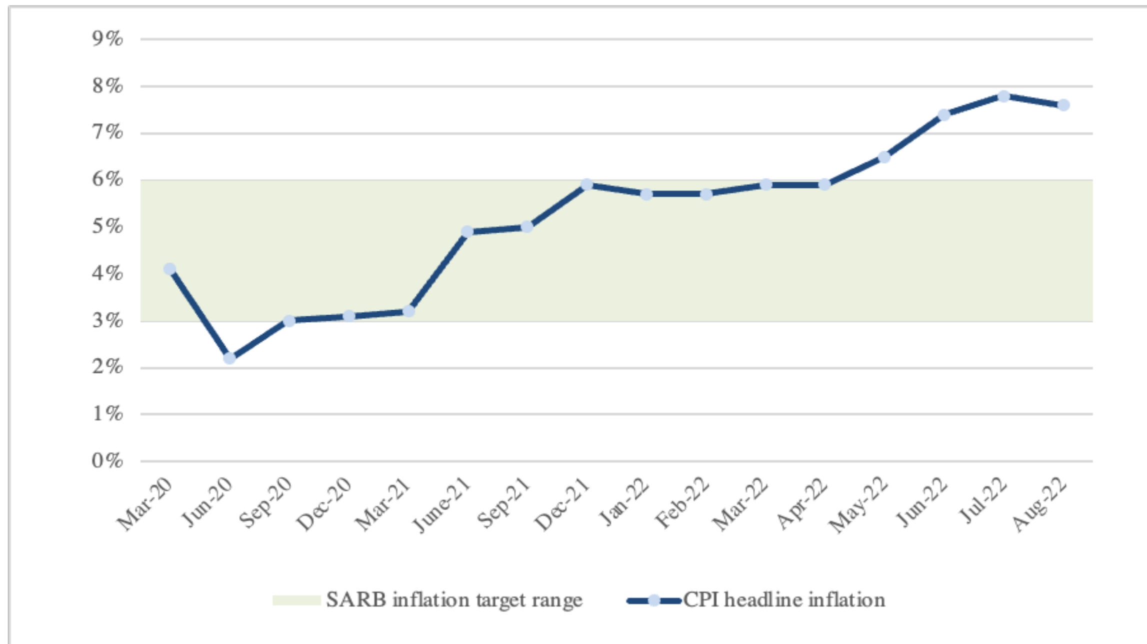
Inflation and monitory policy tightening

7.12. High inflation is a significant risk to the economy and the fiscus, particularly amidst sluggish levels of economic growth, as this could lead to stagflation. In 2022, the upsurge in inflation has been driven primarily by supply-side factors due to the ongoing war in Ukraine. Russia's invasion of Ukraine in February of 2022 triggered severe economic sanctions and global supply shocks, which caused the prices of essential food products, fuel and other commodities to escalate. Rising global food and fuel prices and the corresponding inflation surge have triggered monetary policy tightening across many emerging and advanced economies.

7.13. In South Africa, rising inflation in the current year has mainly been driven by food and fuel price hikes due to ongoing supply-side disruptions rather than demand-side caused by increased consumer spending. As a result, inflation accelerated to reach a 13-year high of 7.8 per cent in June, as shown in Figure 15 below. As a result, the cost of living has increased faster than previously anticipated, dampening South Africa's prospects of a quick economic recovery post-Covid.

7.14. As fuel prices eased and monetary policy tightened, inflation slowed for two consecutive months, from 7.6 per cent in August to 7.5 per cent in September, which may suggest some indication of price stability going forward. However, persistent supply-chain bottlenecks and global uncertainty might cause inflation to rise over the medium term, further eroding consumers' purchasing power.

Figure 15: CPI headline inflation trend from March 2020 to August 2022



Source: Stats SA 2022

7.15. The SARB increased the repo rate in November 2021 and continued this trend throughout 2022. When headline inflation breached the upper bound of the inflation target of 6 per cent in April 2022, the repo rate was hiked by a further 50 basis points between March and May. The repo rate reached 6.25 per cent in September, pushing market lending rates up. The increase in interest rates has slowed down spending in the economy by increasing the cost of borrowing, further dampening South Africa's growth prospects over the medium term. While the slight downturn in headline inflation indicates that monetary policy tightening has assisted in keeping inflation expectations somewhat anchored, interest rates and the cost of living remain high.

7.16. Suppose advanced economies, such as the US, UK and Europe, continue to hike interest rates. In that case, there is a risk that this might worsen debt dynamics through declining GDP, raising concerns about debt sustainability in South Africa, mainly since debt service costs are already high.

Recommendations

- *The Commission supports and commends pro-growth fiscal consolidation that aims to stabilise and reduce government debt and rein in debt-service costs. However, significant global and domestic risks remain and should be mitigated. Therefore, careful attention should be given to the budget and debt financing strategy to slow the annual growth rate of debt service costs. And ensure that interest expenditure does not continue to consume fiscal space and crowd out spending on basic services and realising socio-economic rights.*
- *Weak productivity in expenditure needs to be addressed to create job-enhancing, inclusive growth through quality expenditure and investment-enticing reforms. In addition, the Commission has stressed that long-term growth prospects will require addressing*

structural constraints. To that end, reforms that address vulnerabilities to corruption (such as procurement reform); ensure energy security by enticing private sector investment and fast-tracking the unbundling of Eskom. Lastly, the overall increase in competitiveness of the economy through the reduction of regulatory barriers that support small and medium enterprises (SMEs) is urgently needed. Furthermore, proper expenditure management is also required to prevent fiscal leakages and fruitless spending.

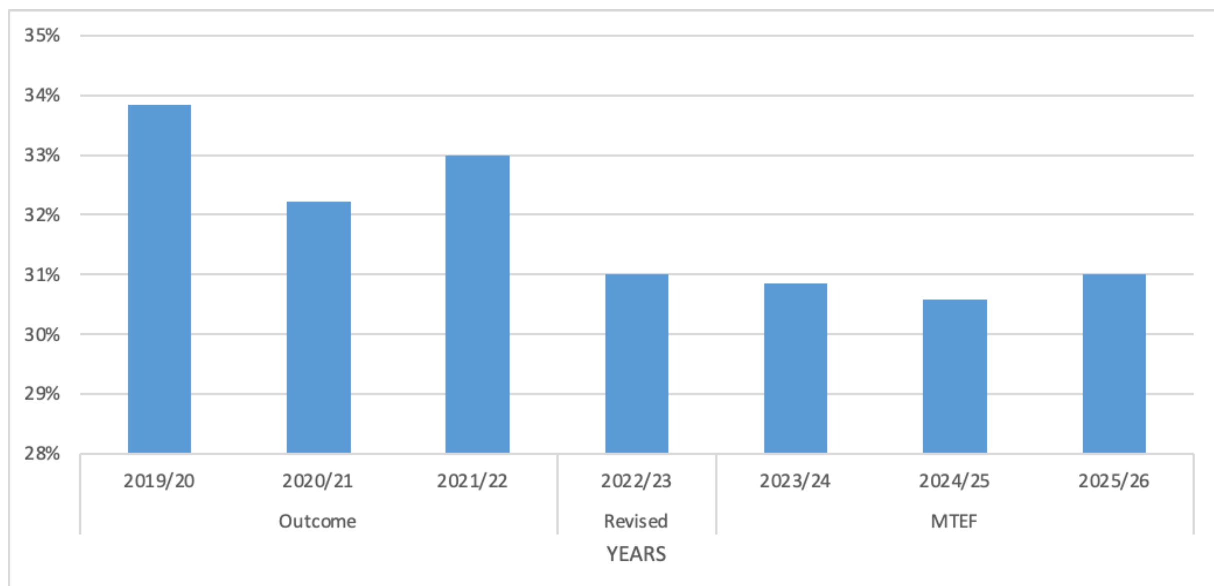
8. Compensation Data

The drivers of rising compensation spending

8.1. Compensation of Employees (CoE) remains one of the most significant expenditure items from the fiscus. According to National Treasury, compensation of employees in the public sector absorbs 31.4 per cent of government revenue in 2022/23. This represents a 3.1 per cent decrease from 2019/20 and is part of the government's deliberate attempt to contain compensation of employees' costs. This implies that for every R1000 of government revenue in the 2022/23 financial year, R314 is spent on CoE. Although the Commission commends the government's effort to lower CoE, care should be given to wage negotiations in 2022/23. If a wage agreement exceeds the available budget, it will pose significant challenges to the medium-term fiscal projections.

8.2. Figure 16 shows that the CoE as a percentage of total expenditure decreased in the first two years of the Covid-19 Pandemic (2019/20-2020/21), from 34 per cent to 32 per cent. However, the ratio increased to 33 per cent in the 2021/22 financial year. Due to ongoing fiscal consolidation, CoE expenditure remains at 31 per cent in the 2022/23 financial year and is projected to stabilise at this level over the 2022/23 MTEF.

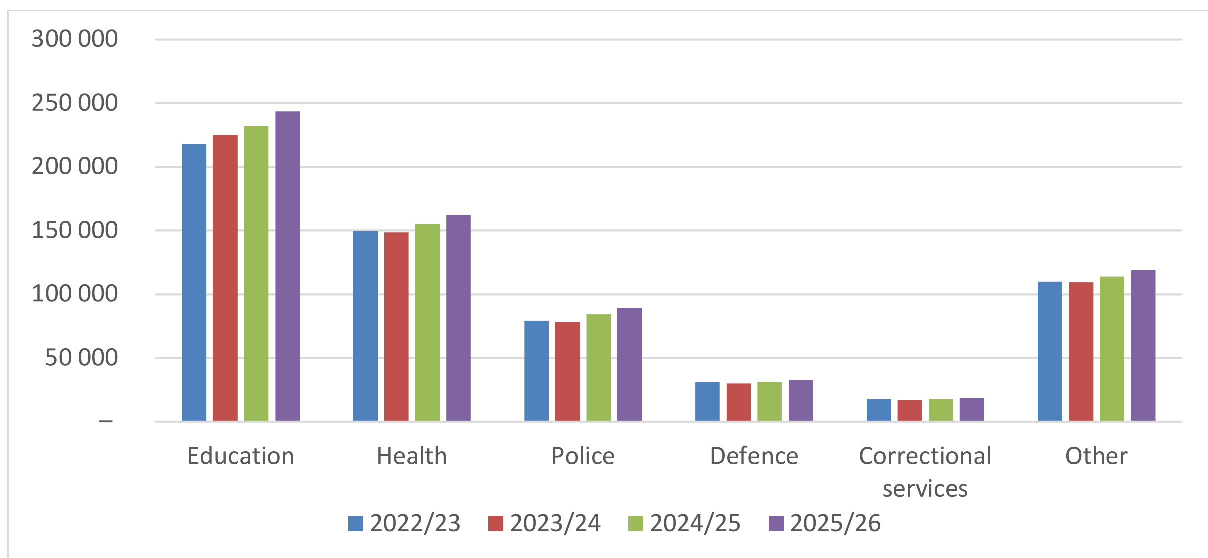
Figure 16: Compensation of employees as % of total expenditure, 2019/20-2025/26



Source: National treasury, 2022 medium-term budget policy statement

8.3. In estimating the public-service wage bill over the 2023 MTEF period, the National treasury notes two key cost drivers: remuneration and other employee allowances and benefits and the number of employees. A once-off payment can skew the wage trend in any particular financial year. For example, the once-off cash gratuity allocated in 2021/22 and 2022/23 in line with the 2021 public-service wage agreement explains most departments' decline in the 2023/24 wage bill baseline. To avoid pre-empting the wage negotiation process, no provisions have been made for wage increases in 2023/24. However, additions must remain within the available fiscal resources to not compromise other spending priorities. Figure 17 below reflects the consolidated wage bill for four budget votes for 2022/23 and the MTEF. Over the MTEF, the consolidated public service wage bill will grow at an annual rate of 3.1%, with Police growing at a rate of 4.1 per cent annually due to the government's commitment to increase the number of constables in the police force in response to high crime statistics in the country. While the government is committing to increase capacity in services such as education, health and police, the commission believes that this should be done within the constraints of available budgets to avoid additional pressures on the wage bill.

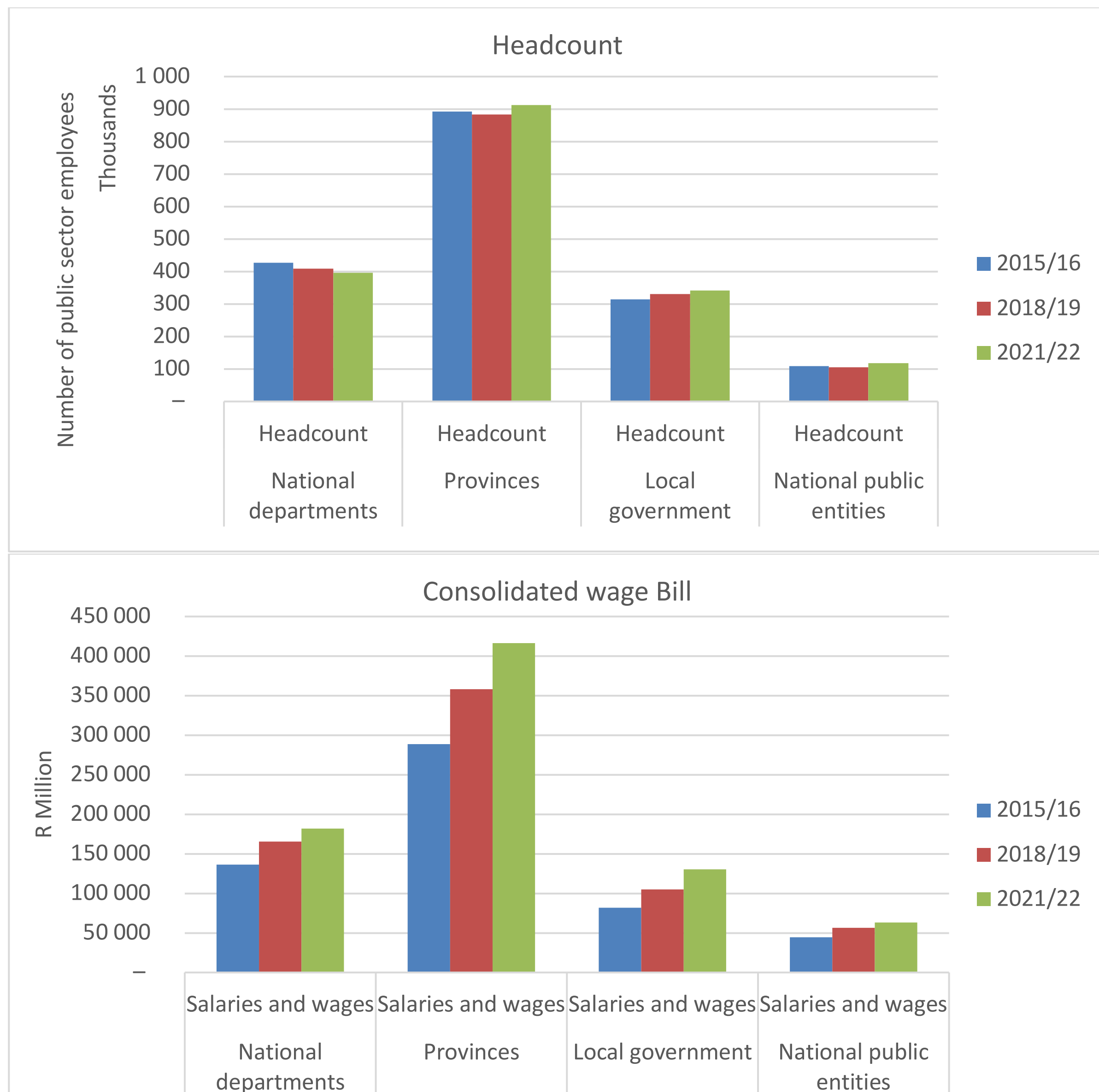
Figure 17: Consolidated Public service wage Bill, 2022/23-2025/26



Source: National treasury, 2022 medium-term budget policy statement

8.4. Contrary to common belief, the key driver to rising CoE over the years is attributable to increases in remuneration rather than increases in the number of people employed in the public sector. Figure 18 below reflects how headcounts have grown relative to salaries across various parts of the government from 2015/16 to 2021/22. The figure shows that while headcounts decreased in the national departments, Provinces and National public entities, salaries and wages decreased. The exception is at the local government level, where the figure shows that the headcount is increasing in tandem with salary and wages.

Figure 18: Headcount trends and Consolidated wage Bill, 2015/16-2021/22



Source: National treasury, 2022 medium-term budget policy statement

8.5. The government has been implementing fiscal consolidation in recent years. The Commission believes that reducing public spending is key to achieving fiscal consolidation measures to boost public sector productivity.

Recommendations

- *The Commission reiterates its recommendation in its 2021 MTBPS submission that the government should develop a long-term plan incrementally to address unsustainable public sector wage bill and that the plan should seek to improve public sector productivity at a lower cost.*

9. The 2022 MTBPS and FFC's Recommendations

I. *The Commission welcomes the MTBPS 2022 and recommends that the government continue to stay consistent in its policy stance towards maintaining fiscal credibility, ensuring fiscal sustainability to minimise economic risks.*

II. *Elevated domestic inflation and rising interest rates may exacerbate existing social inequalities and create vulnerabilities in South Africa. Accordingly, the Commission recommends that medium-term spending be reprioritised towards social and economically inclusive growth-supporting expenditures to mitigate the exacerbation of inequalities and socio-economic vulnerabilities in the long run.*

III. *SOCs continue to drain the fiscus, thus threatening the sustainability of public finances. The Commission appreciates the need to tackle SOC's balance sheet weaknesses. However, the fiscal support to SANRAL, Transnet, and Denel of R33 billion represents a continuing trend to bail out SOCs despite a government commitment to end financial aid to SOCs. SOCs bailout constitutes a sovereign credit risk and threatens fiscal consolidation efforts by the government. Meaningful financial, operational, governance, and business model reforms are required to comprehensively address SOC's fundamental challenges. The Commission recommends transparent processes regarding fiscal support to SOCs, publicly available reports and conditions, and reforming the evaluation criteria for granting government guarantees to SOCs. This includes establishing a SOC governance framework with public reporting criteria that clearly defines detailed and precise profitability and non-financial objectives for transparency.*

IV. *The Commission welcomes the government's efforts to stabilise government debt earlier and at a lower rate. However, debt service costs remain very high, signalling the rising cost of borrowing and slow growth. Therefore, the Commission recommends that the debt financing strategy be aligned to economic growth initiatives to slow down the debt service costs and ensure that interest expenditure does not crowd out critical spending in vital functional areas such as health and education. In addition, the Commission recommends improving expenditure management by preventing fiscal leakages and fruitless spending. This entails reforms that will address vulnerabilities to corruption (such as procurement reform).*

V. *The Commission reiterates its recommendation for the urgent finalisation of a new funding framework for higher education and training and local government fiscal framework. Furthermore, given expenditure moderation, comprehensive reports should be compiled by affected government departments indicating how such moderation is likely to affect the delivery of basic services and how tighter budgets would be managed.*

For and on behalf of the Commission

Dr Patience Nombeko Mbava
Chairperson