Financial and Fiscal Commission Submission on the 2009 Medium Term Budget Policy Statement

November 03 2009

FINANCIAL AND FISCAL COMMISSION

Financial and Fiscal Commission Submission on the 2009 Medium Term Budget Policy Statement

1. BACKGROUND

- This submission is made in terms of Section 3 (1), Part 1 of the Financial and Fiscal Commission Act 99 of 1997 as amended which provides for the Commission to act as a consultative body for and to make recommendations to organs of state in the national, provincial and local spheres of government on financial and fiscal matters..

- In the case of the Medium Term Budget Policy Statement (MTBPS), Section 4 (4) (c) of the Money Bills Amendment Procedure and Related Matters Act 9 of 2009, requires Committees of Parliament to consider the Commission's recommendations when dealing with money bills and related matters.

- This submission highlights the key issues emerging from the 2009 Medium Term Budget Policy Statement (MTBPS) that the Commission believes need to be taken into consideration by the Committees in as far as those matters provide an indication of what factors will inform the budget for the 2010 fiscal year. A further issue is to make specific reference to matters that have a bearing on the Commission's recommendations for 2010 Division of Revenue (consultations with Government through the offices of the National Treasury are still ongoing) that the Committee may wish to consider.

2. OVERAL FISCAL FRAMEWORK AND BLEAK ECONOMIC OUTLOOK OVER THE NEXT MTEF PERIOD

- The Medium Term Budget Policy Statement tabled in Parliament on 27 October 2009 contains the proposed budget framework for the next three years.

- The extent of the global financial crisis influence on the MTBPS is discussed in this submission. The assumptions about growth underpinning government's MTEF are shown below.

National Treasury's Macroeconomic Outlook

%	2009	2010	2011	2012
Gross domestic product (GDP)	-1.9	1.5	2.7	3.2
Household consumption	-3.1	0.9	2.3	2.5
Capital Formation	3.5	4.4	7.1	6.6
Consumer Price Inflation	7.1	6.3	6	5.7

Source: National Treasury, MTBPS

The Medium-term spending priorities over the MTEF are:

- Expanding employment and safeguarding social security through skills building and the new phase of the EPWP (Expanded Public Works Programme)
- Improving the quality of education and skills development
- Enhancing the quality of healthcare
- Rolling out of a comprehensive rural development strategy
- Creating a built environment to support economic development, and
- A broad based approach to fighting crime

3. ASSUMPTION UNDERPINNING THE MTBPS

- The Commission broadly **agrees** with the fiscal easing proposed in the 2009 MTBPS given the sharp recession and weak economic outlook
- The substantially bigger borrowing requirement is linked to large infrastructural investment projects that would be key for long term growth as well as the being of future generations. (Eskom& Transnet)

- These assumptions lead government to forecast revenue reductions in real terms when compared to the February 2009 Budget. The reduction in collections is shown in the table below:

Revenue Projections

R billions	****2009/10**	****2010/11**	****2011/12**	****2012/13**
Revenue MTBPS	657.5	743.5	833.4	921.3
Revenue Budget Review	642.9	709.1	781.2	-
Difference	14.6	34.4	52.2	921.3

Source: National Treasury, MTBPS

- Even though the revenue collection shows an improvement in nominal terms from the point of tabling the 2009 Budget Review, such an adjustment is insignificant when offset against inflation

- In the context of the global economic climate the assumptions underpinning Government's projections on economic growth, revenue growth, and hence the division of revenue are largely not unexpected.

- In the same light, the Commission's own modelling raises the possibility that the assumptions underpinning Government projections about growth might be optimistic. For this reason, the Commission would like to caution against the possibility that the anticipated recovery in industrial economies may not come as early as predicted. The recession may continue much longer than what Government's assumptions suggests. Therefore things may get much worse before they get any better.

- Should the recovery be delayed, Government's assumptions with regard to growth and inflation for the next three years upon which the budgetary parameters were based may be overly optimistic. Going forward, the Commission suggests focusing on the issue of cutting indicative allocations in circumstances where projections indicate that revenue collection is likely to plummet.

- With respect to job creation through EPWP, the Commission would like to re-emphasise its previous position that there be an evaluation of the performance of the first EPWP programme. Such an evaluation will go a long way in enhancing Government insight into its successes and failures.

- On the expenditure side, the Minister of Finance is proposing a large easing of Government expenditure driven largely through its budget and public enterprise investment. With declining government revenue induced by the recession, the budget deficits are inevitable. The budget deficit for the next three years has therefore had to be increased from forecasts of 3.8%, 3.2%, and 1.9% of gross domestic product in the February 2009 Budget to 7.6%, 6.2% and 5.0% of GDP.

- Within the government budget, the main drivers of the high budget deficit are a substantial discretionary fiscal impulse in the form of a continued increase in infrastructure investment, an expansion of the social safety net and a larger than anticipated wage bill (driven by the implementation of the Occupation Specific Dispensation (OSD) in Health and Education.

- The Commission broadly agrees with this fiscal easing proposed in the 2009 MTBPS given the sharp recession and weak economic outlook. In fact Chapter 2 of the Commission's 2010/11 Annual Submission on the division of revenue, supports this position (See Box 1 below).

- Looking at the non financial sector public enterprises, we note that there is increased funding for Eskom and Transnet. The public sector borrowing requirement rises cumulatively over the three years by R331 billion compared with what was budgeted for in February or a large R1.11 trillion over the next four years. Given that the increases in the budget deficit will drive public investment in the next three years, we find the proposal sound and understandable. The substantially bigger borrowing requirement is linked to large infrastructural investment projects that would be key for long term growth and well being of future generations,

Box 1

Quantitative Effects of FFC's model simulations finds that a strategy that increases public investment in the areas identified strike broadly the right balance between supporting demand and maintaining macroeconomic stability. The FFC's computable general equilibrium model was used for simulating the dynamics of the economy under a package of public infrastructure increases and maintenance. We find that these policies would raise output and employment by about 2 percentage points, at the expense of higher inflation (by about 2 percentage points), higher trade deficit (by about 0.5 percentage point of GDP), and a mild crowding out of private investment, relative to a counterfactual of no discretionary policies. These results can be extrapolated for working as a demand stimuli in the current depressed environment.

Source: The 2010/11 Annual submission can be downloaded from the FFC website: http://www.ffc.co.za/

- Although the Commission did not go on to make a specific recommendation in Chapter 3 of its Annual Submission on an assessment of social grants, the Chapter confirmed that South Africa has a well-developed social assistance system and its social grants are very well targeted and have a significant mitigating impact on poverty. It pointed out though that considerable uncertainty remains about some of the incentive effects of these grants and their long term sustainability. Government to some extent has taken into account this long term sustainability. Other than interest payments, the highest proposed functional growth is for housing and community development rather than for social services such as education, health and welfare.

- The Commission is however concerned about the unanticipated wage bill. While the Commission understands and supports Government in honouring its commitments to pay the rising wage bill, the Commission is of the view that such increases should not use a blanket approach but be targeted to specific employees and retraining those that are not in possession of the requisite skills in their employment so as to improve efficiency. The Commission's view is that there should be a deliberate attempt to synchronise the centralized bargaining process of the public sector with the budget process to ensure that provinces and municipalities are not unnecessarily overburdened by decisions over which they have no direct control. This assumes greater importance during a period of recession wherein the country should not borrow to fund personnel costs but rather benefit infrastructure development which will result in job creation. There is a need for collective responsibility to be taken if a balance is to be struck between bargaining chamber agreements and investments that create jobs.

4. PROVINCIAL AND LOCAL GOVERNMENT FISCAL FRAMEWORK

- Table 4.2 of the MTBPS shows the provincial and local government fiscal framework. Transfers to provinces from national government have in the past had a healthy growth of more than 10 per cent on average. Provincial baselines are expected to grow by only 7.5 per cent over the 2010/11 Medium Term. With an assumed CPI of 6.5 percent, the real growth of the provincial fiscus is therefore only 1.0 per cent. A year on year growth gives a true picture of the extent of the slow down in the growth especially the outer year which show a 4.7 per cent growth from 8.9 per cent in 2010/11. Government projects a growth of 8.9 per cent in 2010/11, 8.5 per cent in 2011/12 and 5.0 per cent in 2012/13.

- The Table below is also a representation of the division of revenue or expenditure allocation between the three spheres of government. The table shows that the total expenditure by the three spheres is R692.5 billion as at 2009/10, broken down in to 50.1 per cent for National, 42.6 per cent to provinces and 7.3 per cent to local government. This position changes slightly in to the new MTEF, with national declining in share as and both provinces and local government steadily increase. The overall expenditure is projected to be R833.2 billion in 2012/13, after a total baseline addition of R78 billion. Of this R78 billion, provinces receive the highest amount at R39 billion, National R25 billion and Local government R12.4 billion.

- As far as the division of revenue amongst the three spheres is concerned, revenue allocated to national government will continue to decline steadily over the MTEF from 50.1% to 46.9% of the budget between 2009/10 and 2012/13. The revenues allocated to local government will steadily rise from 7.3% in 2009/10 to 9.1% 2012/13. Finally, the provincial share of revenue rises from 42.6% to 44.0% over the same period.

- A larger portion of the R39.9 billion added to the provincial framework sees the equitable share rise by an additional R32.7 billion (or 8.6 percent) off its baseline of the revised R236.9 billion in 2009/10, conditional grants increase by R7.1 billion (or 28.3 per cent), of the revised baseline of R58.4 billion. This signifies a considerable increase in the pace at which non-discretionary funding increases compared to the discretionary part over the MTEF.

Table 4.2 Division of revenue, 2009/10 – 2012/13

R million	2009/10 Revised	2010/11 Medium-term estimates	2011/12 Medium-term estimates	2012/13 Medium-term estimates	2010 MTEF
National	**346 642**	**356 350**	**368 986**	**390 531**	
Provincial	**295 353**	**321 369**	**348 720**	**366 983**	
Equitable share	236 878	260 623	280 317	294 386	
Conditional grants	58 475	60 747	68 403	72 597	
Local	**50 533**	**59 322**	**67 964**	**75 718**	
Equitable share	24 356	30 468	34 390	37 984	
Conditional grants	19 377	21 312	25 043	28 776	
General fuel levy sharing with metropolitan municipalities	6 800	7 542	8 531	8 958	
Total	**692 528**	**737 042**	**785 670**	**833 232**	
Percentage shares					
National	*50.1%*	*48.3%*	*47.0%*	*46.9%*	
Provincial	*42.6%*	*43.6%*	*44.4%*	*44.0%*	
Local	*7.3%*	*8.0%*	*8.7%*	*9.1%*	
Changes to baseline					
National	**3 565**	**3 730**	**8 200**	**13 788**	**25 718**
Provincial	**10 834**	**11 670**	**12 800**	**15 412**	**39 882**
Equitable share	8 995	10 330	10 930	11 530	32 790
Conditional grants	1 839	1 340	1 870	3 882	7 092
Local	**835**	**1 600**	**3 000**	**7 800**	**12 400**
Equitable share	509	1 200	2 500	4 500	8 200
Conditional grants	326	400	500	3 300	4 200
General fuel levy sharing with metropolitan municipalities	–	–	–	–	–
Total	**15 233**	**17 000**	**24 000**	**37 000**	**78 000**

Source: National Treasury

- The Commission notes in particular the revision in the Provincial Equitable Share (PES) baseline due to the shifting of the Further Education Training (FET) colleges funding to the national sphere of Government. There is an immediate downward revision of the PES baseline.

- If this funding reverts to national government in the form of a conditional grant. It would be important for government to indicate what the quantum or amount is that will be taken from the PES and what criteria will be followed to allocate it back to provinces. The Commission further advises that the positive lessons learnt when

Social Security was transferred to the national sphere of government should be used.

- Another possible challenge is the budgetary procedure. If such A shift was to be made in-year, consideration must be given to minimizing disruption of provincial budgets. If possible, Government may need to defer such a shift until the economic outlook improves as this may impose further pressure on current provincial baselines especially if provinces were using this funds to cross subsidise other services.

- Another dimension that the Commission would wish to raise is that of a constitutional nature if the conditional grant route is taken. Work on the review of the Provincial Equitable Share formula has led to the realisation that the outright ring fencing of the Equitable Share can be unconstitutional in terms of the provisions of Section 227 (3) of the Constitution of the Republic of South Africa Act 108 of 1996 as amended. That provision requires a prompt and without deduction approach to allocation of the provincial equitable share.

- The full extent of the economic pressure on provincial finances is already evident from the Treasury's 2009 Early Warning System (Summary of Provincial Budgets and Expenditure as at 31 August 2009) which shows a projected overall over expenditure of R12 billion by provinces.

- As pointed out earlier, except for roll-overs in conditional grants and accruals from the previous financial year, the biggest challenge is that budgetary pressures emanate from the area of personnel. Given its nature and if allowed to grow out of control, personnel costs could be difficult to contain due to the nature of the carry through and mandatory costs associated with it. As a result, it's not uncommon that provinces redirect funds away from "non core" to education and health within which the main cost drivers is personnel. The consequence of this is that service delivery can be expected to slow down in preference to wage agreements.

- Going forward the Commission would wish to suggest that the current trend as displayed in the current MTBPS should be maintained. National policy priorities should be limited and be stable for a particular period to avoid a situation where new priorities erode older ones in terms of focus and funding commitment. These result in under-provision of services or piecemeal implementation of policies, especially because future funding streams or allocations do not usually find expression in subsequent budgets and more importantly are not adequately monitored. Again, provinces are at different stages of development or capacity levels. Therefore national policy priorities, in an attempt to achieve uniformity, must also recognise the capacity of various provinces to implement.

5. ISSUES AROUND THE LOCAL GOVERNMENT OVER THE NEXT THREE YEARS

- Unlike the provincial transfers, allocations to local government have grown by a resilient 14.5 per cent over the MTEF. Assuming that the CPI is 6.5 percent, the real growth of the local government fiscus is 8.0 per cent. The biggest increase is in the equitable share (16 per cent) to mainly assist municipalities deal with electricity increases, while local government conditional grants framework (14.8 per cent) are the fastest growing to mainly expand the basic infrastructure services to households. Revisions to this effect are directed towards the Municipal infrastructure Grant (MIG). Of the total R12.4 billion added to the local government fiscal framework, R8.2 billion or 66 percent goes to the equitable share.

- In making allocation to this sphere, the Commission would like to caution against increased allocation to non-performing grants, including the MIG. The Commission would like to re-iterate its previous recommendation that there be link between MIG and the LES. This is such that as infrastructure is rolled out through MIG, allocations to municipalities in the form of the LES should reflect the need associated with the infrastructure that is been rolled out.

- As with the provincial framework, though the LES allocation illustrates positive growth over the period, the pace of growth becomes progressively slower, particularly over the outer years of the medium term as a result of the economic down turn. According to National Treasury, Category B and C municipalities are particularly reliant on transfers from the centre. The number of Category B municipalities in particular, who rely on national transfers for 50% of their revenues has grown from 69 in 2004/05 to 97 in 2008/09. For Category C municipalities, the situation is as grim with 38 of the total 46 Category C municipalities now reliant on national transfers for more 50% of their revenues.

- The Commission commends government for the recognition it has given to ensuring that there is expansion of access to free basic services including the upgrading and rehabilitation of key municipal infrastructure. The Commission has raised the issue of the qquality of services / spending in its Submission for the Division of Revenue for 2010/11 recommendations and would wish to reiterate the points made there within this context. The Commission suggested programme restructuring to improve outcomes in local government capacity building and for the built environment. The thrust here is effective functional allocations and programme design in achieving value for money and improving outcomes, rather than merely increasing allocations.

- A related issue underlying the MTBPS is the replacement of the RSC levies for district municipalities. This raises the important issues of local government revenue enhancement and whether sub-national tax incentives such as property rates rebates would be appropriate. The Municipal Fiscal Power and Functions Act 12 of 2007 addresses issues relating local government tax. Municipalities can individually or collectively through SALGA implement taxes assigned to them as long as they follow the prescripts of this Act.

- The overspending of operational budgets versus the underspending of capital budgets presents two additional areas of concern reflecting poor financial management practice and which negatively affects the performance of municipalities. Over or underspending of budgets runs contrary to the principles of sound budgeting practice and reflects lack of credible budgets (in the case of operational expenditure) and poor planning with respect to capital projects. Given that changes to the baseline allocation to conditional grants are projected to increase by R3 billion by the end of the MTEF, the Commission raises concern around whether municipalities will be able to adequately absorb such an increase in the absence of a radical approach to fundamentally reform and strengthen them or whether current inefficiencies will persist, with significant proportions of resources being unspent..

- Adequate capacity is a critical concern for municipalities. The availability of appropriately skilled human capital, capable of ensuring solid financial management practices and strategic planning, is an asset for any municipality. Lack of capacity in this regard has a definite impact on the performance of a municipality. Constant growth in capacity building grants should, as noted in the Commission Submission on the Division of Revenue for 2010/11, take into consideration current weaknesses in the framework underpinning capacity building initiatives. The concern is that interventions are fragmented, uncoordinated and largely unresponsive to the nature and underlying causes of the challenges experienced. Thus, allocating additional funding within this context would not be fiscally prudent and would certainly not adequately address current capacity challenges.

- Finally, the recapitalisation of the Development Bank of Southern Africa (DBSA) (allowing an increase in its callable capital) is a significant development as it constitutes the first recapitalisation in over a decade. This raises significant issues in terms of the current focus of DBSA lending (largely on highly creditworthy municipalities). The issue is whether it has exhausted its current lending capacity and the nature of the impact that it has had on the overall debt market. This may have the unintended consequence of squeezing out private lenders or actually growing the size of lending to municipality. The Commission wishes to highlight these risks, as well as the need for the communication of clear policy objectives to the DBSA.

- The Commission further re-iterates its previous recommendation that the DBSA should have a role to play in building the creditworthiness of low capacity municipalities.

- The Commission finally recommends that allocations flowing through the Bank including Siyenza Manje, must be subjected to the prescripts and reporting requirements of the Division of revenue Act.

Dated in Midrand this 2nd day of November 2009

Signed:

Dr Bethuel Setai
Chairperson/CE
Financial and Fiscal Commission