FINANCIAL
AND FISCAL
COMMISSION

Media Release

Submission for the 2015-16 Division of Revenue

For an Equitable Sharing of National Revenue

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[2 June 2014] On 30 May 2014, the Financial and Fiscal Commission (the Commission) tabled at Parliament its Annual Submission for the 2015/16 Division of Revenue. The Submission is made in terms of Section 214(1) of the Constitution of the Republic of South Africa (1996), Section 9 of the Intergovernmental Fiscal Relations Act (1998) and Section 4(4c) of the Money Bills Amendment Procedure and Related Matters Act (Act 9 of2009).

Government has set a clear course of comprehensive economic and social reforms, with the National Development Plan (NDP) being the foundation. In order to fund these socio-economic programmes, government requires steady and dependable revenue growth. This implies that the economy needs to grow fast enough ensure that revenue necessary for these programmes is generated. Ensuring that public spending has a greater impact through the efficient and effective delivery of public services will also stimulate growth. However, trade-offs still have to be made, in order to strike a balance between fiscal sustainability and protecting (if not extending) existing socio-economic gains. Under the theme of "balancing fiscal sustainability with socio-economic impact", the Commission's Submission for the Division of Revenue (2015) explores ways of achieving this balance and the need for excellent and affordable public services.

South Africa's public finances have become increasingly vulnerable with prolonged sluggish domestic economic growth rates and continued negative global international pressures. Rising levels of public debt are of concern as they can compromise the ability of government to meet other expenditure needs. For the current fiscal year, the interest payable on government debt is estimated at R100-billion, or close to 10% of government's annual expenditure. However, this is in an environment of exceptionally low interest rates, as the South African Reserve Bank (SARB) has adopted a low- interest rates policy due to the slow economic growth and protracted recovery from the financial crises in major economies. However, should circumstances change, and the SARB feel compelled to increase interest rates significantly (which could is a possibility in the medium term), the interest payable on government debt could put pressure on available finances to meet debt obligations and other expenditures.

The way in which government manages its debt also has an impact on the economy. Government debt management has evolved quite substantially since the 1970s when the need to develop the debt capital market was identified. Prior to 1990 the state only issued debt three or four times per annum. Beginning in 1994, government commenced using macroeconomic frameworks to inform guidelines and active debt management strategies. Post 1999, focus shifted to reducing the cost of debt to within acceptable risk limits, ensuring government's access to domestic and international financial markets, and diversifying funding instruments. These objectives continue to anchor government's debt management strategy today. Government has only recently adopted a fiscal stance that is built on three principles of (a) counter-cyclicality which means spending more relative to GDP during periods of economic weakness and less during periods of strong economic growth, (b) long-term debt sustainability which means ensuring that spending levels do not continually increase debt and interest costs and (c) intergenerational equity which means that future generations should not be overburdened by the costs of current spending and that the upfront cost of capital infrastructure assets should be expensed over their useful lives. It is hoped that applying these principles consistently will improve economic conditions as well as strengthen the fiscal position. Looking forward, however, debt managers will face different challenges as the evolution of debt to-GDP ratios has begun to rise again, thus an emphasis on improving the efficiency of debt management techniques has the potential to produce budgetary savings but with economic ramifications. The situation could easily get worse if the government's actions and policies caused some doubt on its ability to repay its bonds, which would increase the risk portion of bond interest rates and make raising new bonds more difficult. Were the government to implement more aggressive programmes to lower debt levels, this could depress demand and deter investment, which could threaten prospects of meeting the NDP goals. This is why the Commission recommends that Government avoids uniform across-the-board cuts or expenditure ceilings as a means of debt control. Such blunt tools treat valuable, efficiently run programmes and outdated, poorly managed programmes in the same way. Spending should be aligned with government priorities, to ensure adequate funding of high-priority initiatives and elimination or substantial reduction of lower priority programmes.

The issue of demarcation and the impending mergers following the recent re-determination of municipal boundaries are a key issue for the 2015 division of revenue as preparatory work will have to start before the 2016 election when the mergers take effect. The Submission makes proposals around how any potentially negative financial and fiscal impacts of mergers can be mitigated before and after the mergers take effect.

The economy has to grow fast enough to provide the necessary revenue for government's socio-economic programmes. Creating a dynamic economy requires three basic investments: in people **(human capital),** in equipment and physical structures **(infrastructure)** and in new ideas and technologies **(innovation).** The Commission has in its 2013/2014 and 2014/2015 submissions made recommendations for promoting excellence in higher education and innovation, as well as dealing with other longstanding problems in pre-school education, e-learning and adult skills.. This Submission therefore examines the other two basic investments that are critical inputs for economic growth: human capital and infrastructure.

Upgrading **human capital,** through quality education, health and nutrition, produces an economic growth dividend. By making growth more inclusive, it also reduces inequality, as the less well-off are also able to enjoy many of the gains from growth. South Africa already spends significant amounts of money on health, education and other human capital investments but, while access has improved dramatically, quality has lagged.

Upgrading and extending **infrastructure,** such as transport, energy, telecommunications and housing, is also crucial for economic and social development. The focus of this submission is on municipal infrastructure, as local government has an important developmental role to play through the roll out and maintenance of infrastructure. The outcomes of the substantial investment in infrastructure have not been as high as expected, in part because of poor planning and implementation, escalating costs, supply chain management fraud and inefficiency, and inadequate maintenance.

Excellent public services, at a cost that South Africans can afford, are fundamental to ensuring these investments produce the desired outcome, and fulfil the NDP vision. The Commission believes that affordability and excellence are not incompatible and can be accomplished through greater efficiency, which makes sense fiscally and will mean better-run socio-economic programmes. Such programmes will need to be integrated across different departments and spheres of government, so that the population's needs are met. Vulnerable people and their families do not care which sphere of government or which department is responsible for providing support – they just want help.

The Commission's recommendations for the 2015/16 Division of Revenue cover:

- Public debt challenges and the need for reform of the fiscal frameworks.
- Social programmes and the need for reform.

- Equitable resourcing of schools for better outcomes.
- Adequacy and efficiency in primary health care financing.
- Impact of public expenditure on food security.
- Financing of municipal capital investments.
- Improving public transport for better mobility.
- Impact of administered electricity prices on municipalities.
- Housing demand and self-built housing initiatives.
- Impact of demarcations on the financial performance and sustainability of municipalities.

The Commission is of the view that South Africa can create better conditions for inclusive growth, encourage participation in the economy and improve equity through the intergovernmental system of allocating resources. While government will need to take some tough decisions in order for all the proposed measures in this Submission to bear fruit, the Commission is of the view that implementing these recommendations will significantly contribute towards increasing economic growth, reducing poverty and inequality, and excellent and affordable provision of public services.

For and on behalf of the Commission

Mr Bongani Khumalo

Acting Chairperson/Chief Executive