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BRIEFING ON THE 2016 FISCAL FRAMEWORK AND REVENUE PROPOSALS AND DIVISION OF REVENUE

01 March 2016

For an Equitable Sharing of National Revenue

OUTLINE

- Key Messages and General Economic Outlook
- Macro Outlook and Long-Term Fiscal Risks
- Fiscal Frameworks and Budget Consolidation
- Fiscal Frameworks and Revenue Proposals
- Division of Revenue over 2016 MTEF
- Responses to Recommendations by FFC and SSCOA
- 2016 Division of Revenue Bill Clauses
- Provincial Allocations
- Local Government Allocations
- Ongoing Conditional Grants Reforms
- Conclusion

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KEY MESSAGES

- **Stronger economic growth remains elusive**
  - Global growth flat-lined due to continued weak trade, investment and commodity prices
  - China rebalancing and EMEs hit by slowdown in trade and falling commodity prices
  - Disappointing weather outcomes leading to drought conditions
  - Despite the boost from low oil prices and interest rates, the most likely scenario is weak growth in 2016/17 and 2017/18
- **Urgent need for a ‘growth-friendly’ fiscal consolidation**
  - Low growth and high expenditures have translated into persistent fiscal deficits
  - Sound public finances are a prerequisite for national development. Commission supports the measures taken by provinces and organised local government to achieve savings to support fiscal consolidation targets
  - ‘Growth-friendly’ fiscal consolidation can create a solid foundation for long term development
- **Structural policy implementation is still urgent**
  - Human capacity issues
  - Rapid rate of urbanisation
  - Revive pace of productivity – and growth-enhancing structural reforms

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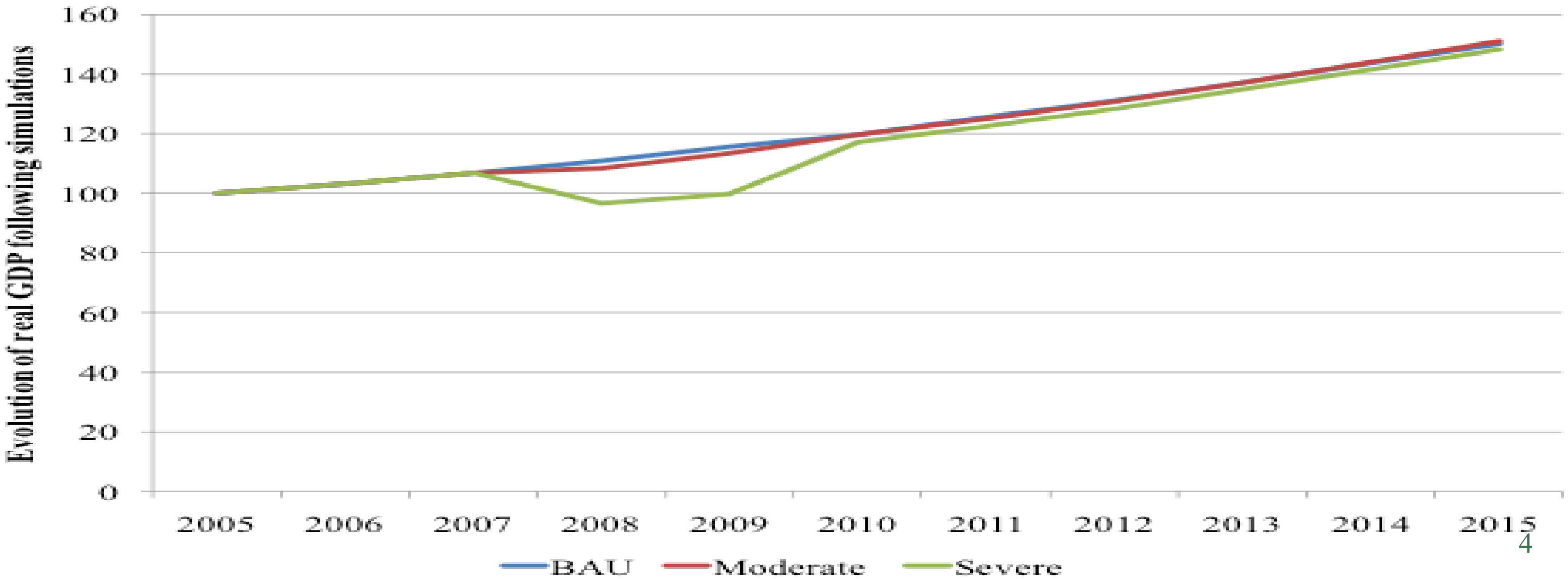
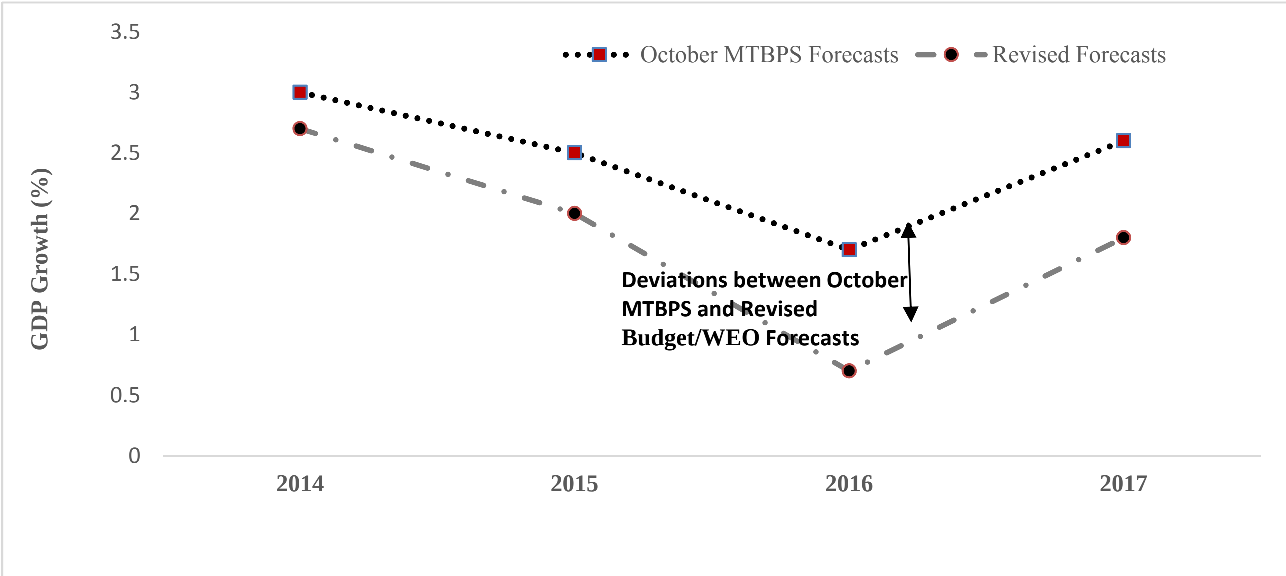
GENERAL ECONOMIC OUTLOOK

- Economy remains vulnerable to slow global recovery and domestic challenges
- ↓ revisions to economic growth
  - Confirms Commission's GDP projections

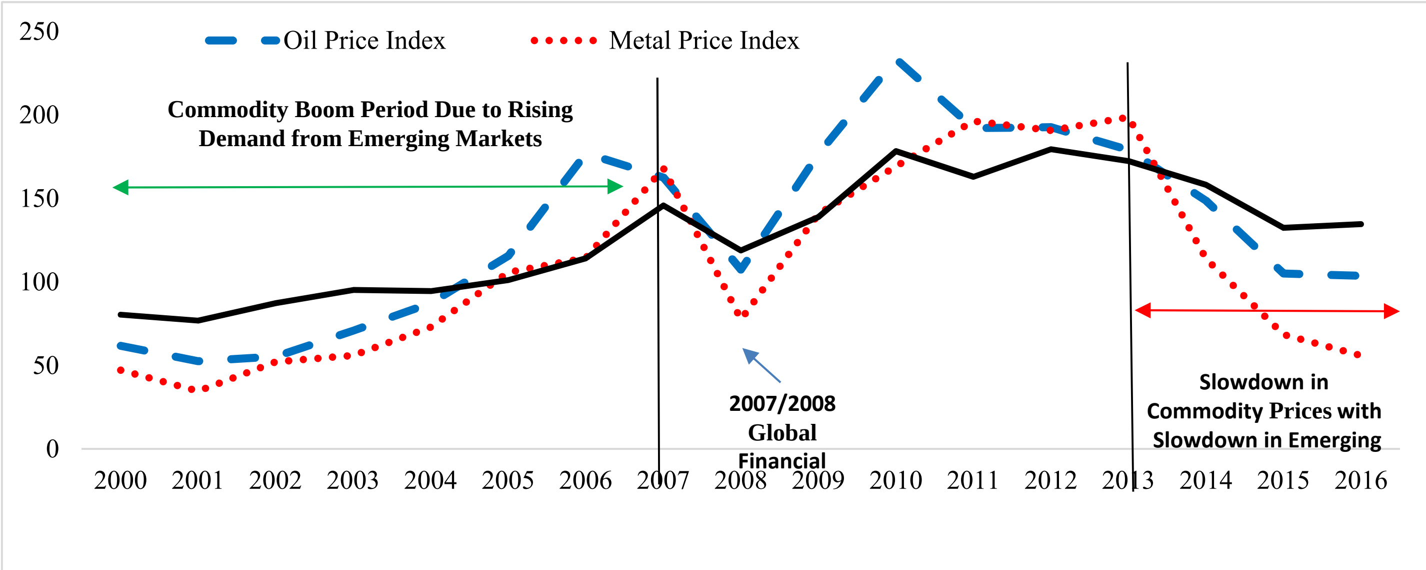


2016 Economic Outlook: Navigating Economic Turbulence



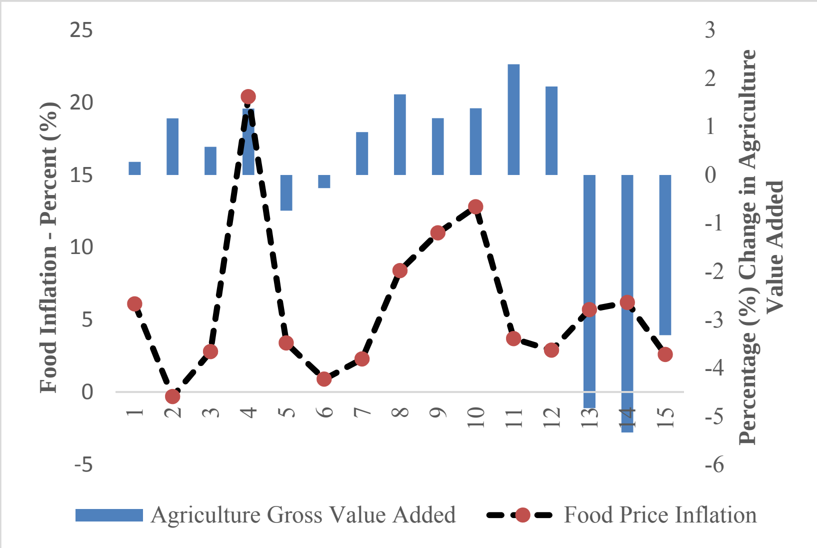
- Progressive slowdown in growth trajectory of South Africa's economy
  - Third straight year of downward revision to growth forecasts – cumulative 2.5% between 2014 – 2017
  - Low fragile growth below NDP targets substantially constrains Government's ability to address triple challenges – unemployment, inequality and poverty
  - Slow growth will see South Africa's external competitiveness lag behind those of its peers

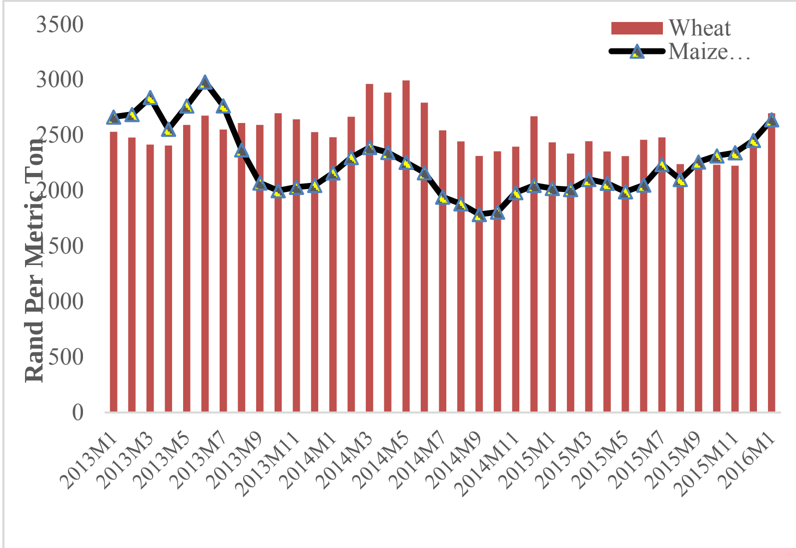
Underlying Constraints To Growth: External Risks/Factors – Global Effects



- Rebalancing of Chinese economy has placed substantial downward pressure on global commodity prices:
  - Adverse impact on South Africa's export earnings and trade account deficit.
- Institutional investors have reduced exposure across developing and emerging economies stock markets
  - Declining confidence in long-term growth prospects of commodity-intensive export nations
  - Normalization of monetary policy in the United States
  - Contagion effect from recent significant volatility in Chinese equity markets.

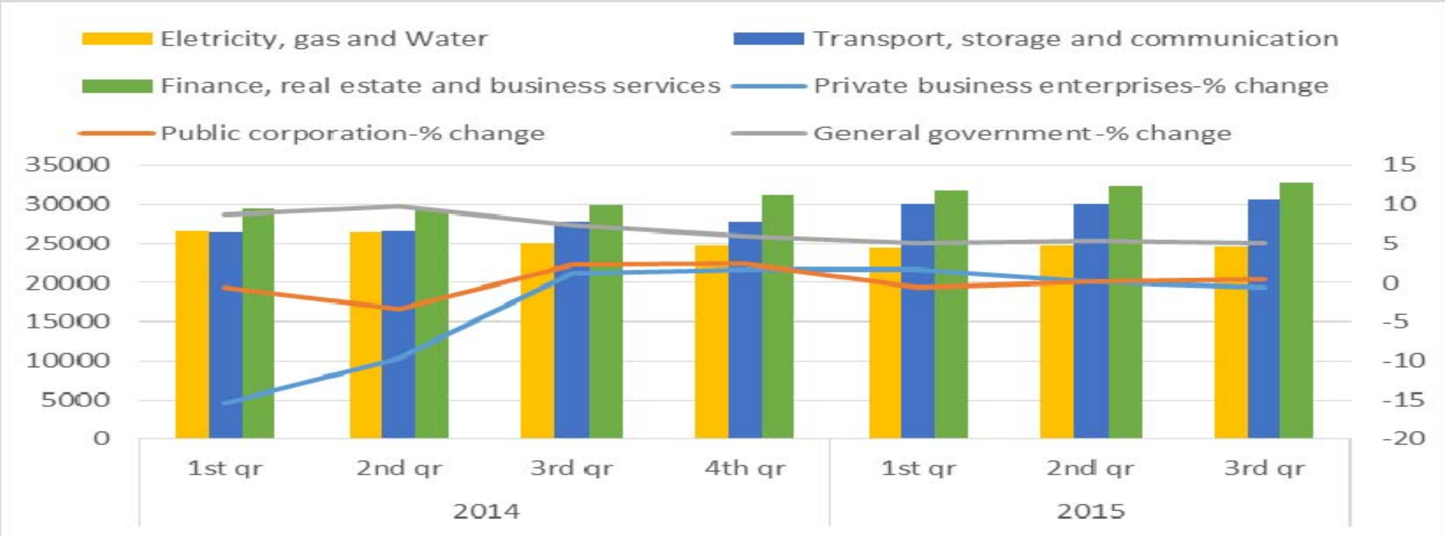
UNDERLYING CONSTRAINTS TO GROWTH: DOMESTIC RISKS/FACTORS – DROUGHT





- Already noticeable impact of drought – average contraction of about 5% through first 3 quarters of 2015 in contrast to average growth of 1.5% in normal years 2013 – 2014
  - South Africa set to become significant net importer of grains in 7 years: Estimated 5 million tons of maize and 2 million tons of wheat between May 2016 – April 2017
  - Rising imports against backdrop of currency depreciation and rising global grain prices
  - Significant costs: R11.5 billion for imported grains PLUS increased pressure on timeous and efficient delivery of imports due to constrained infrastructure capacity for agricultural bulk operations at Transnet.

INFRASTRUCTURE INVESTMENT AND GROWTH



- Gross Fixed Capital Formation is an indicator of how much of the new value added in the economy is invested as opposed to what is consumed. Real gross fixed capital formation was outpaced by real final consumption expenditure by general government in 2015, meaning more resources went to consumption rather than investment.
- Capital investment by private business enterprises, contracted while capital outlays by general government increased at a slower pace. This means that there was less of the new value invested in the economy by the private sector.

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FISCAL POLICY RESPONSE….

- Sluggish growth and sticky expenditures have translated into persistent fiscal deficits. Government has responded by:
  - Support for economy with accelerated consolidation of SA's fiscal position to ensure LT health of public finances
    - Fiscal consolidation = ↓ budget deficit + stabilise (↓) public debt as % of GDP = R18bn (16/17), R25bn (17/18) and R30bn (18/19) through Tax Measures, Spending Ceiling and Reprioritisation
      - Accelerated as SA economy recovers (NB assumption)
      - Preemptive/precautionary action: government wants to avoid social and economic dislocation associated with rapid adjustments
    - Announced State Owned Companies reforms in 4 areas: *Stabilisation*, *Coordination and Collaboration*, *Rationalisation and Consolidation* and *Governance Framework*
      - Desired outcome: strengthen ability of public sector institutions to support NDP outcomes

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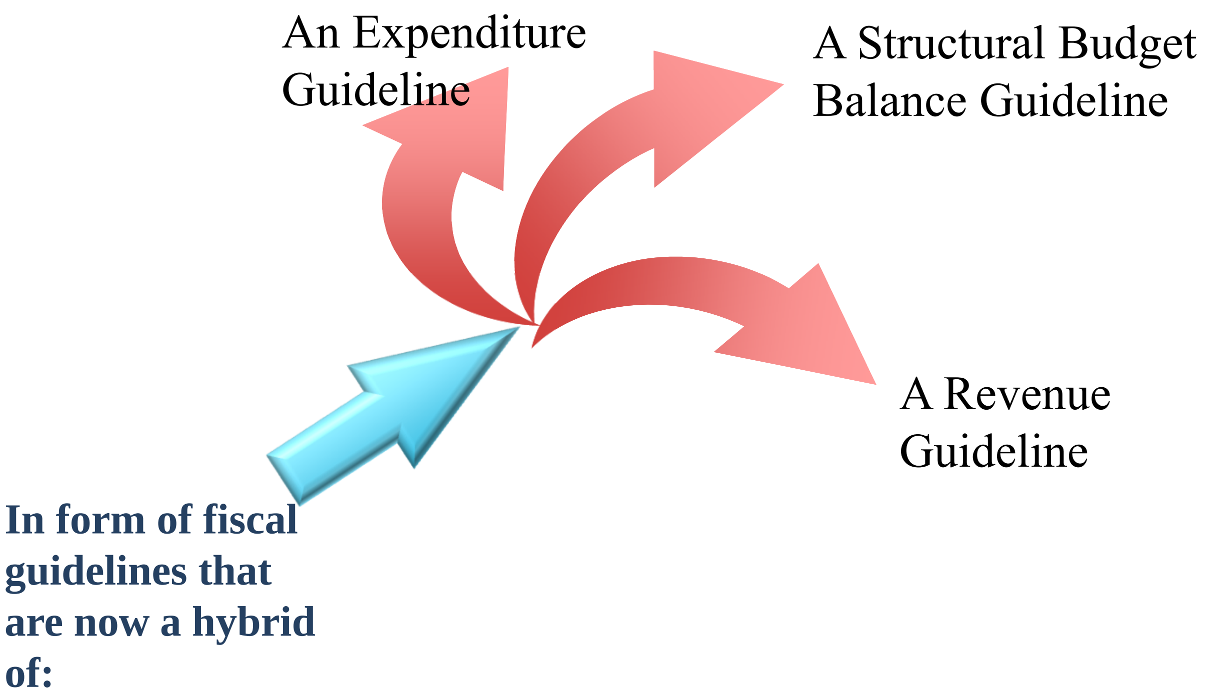
AND RECOGNITION OF NEED TO TAKE ACCOUNT OF LT ISSUES IN BUDGET FORMULATIONS IN MTBPS….



- This is one effective way of accommodating fiscal dimensions of addressing structural impediments impacting social stability. Question is what tax/GDP ratio? This is still a guideline to help debate the broad direction of fiscal policy and growth of spending over the medium to long term, not a numerical fiscal rule. FFC, Budget Office, Parliament and others should give input here that could help the Executive develop the proposal for 2016 MTBPS debate.

Fiscal Consolidation: Pros and Cons

Pros

- Process is contractionary (austerity) and eliminates potential to respond to current market conditions and trigger growth
- Costly to implement (↓ AD in ST, higher unemployment)
- Difficult to implement
- Output (GDP) can decrease faster than decrease in debt (implications for debt-to-GDP ratio)

Cons

- Process is difficult but end result is beneficial for all
- Can increase economic growth (credible commitment to austerity increases investor confidence and decreases interest rates)
- Can be expansionary (expect lower taxes in the future, thus encourages private spending)

Both proponents agree that fiscal consolidation can be beneficial in certain instances - what are those instances in the case of SA?

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FFC RECOMMENDATIONS

- Government should continue its efforts to moderate growth in expenditure components such as the public sector wage bill (which constitutes 60% of government expenditure), as decreases in government expenditure increase probability of a successful fiscal consolidation in SA
  - More effort must be made to improve effectiveness of public finances, through greater and more rigorous oversight to ensure elimination of fruitless, wasteful, and unauthorised expenditure, and corrupt practices in managing public finances
- Government to explicitly consider economic growth as an important factor for fiscal consolidation in SA
  - The most obvious manner in which SA could improve its fiscal situation is if the economy grew faster using structural policies recommended in past
    - This would help generate higher growth in tax revenue and thus budget deficits could decline a lot faster, and public debt would begin to reduce accordingly

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REVENUE ESTIMATES AND TAX PROPOSALS

- Government has made the following tax proposals that the Commission has supported before with caution:
  - A 30c/l increase in the fuel levy, equivalent to 13.7%, is expected to raise R6.8bn in additional tax revenue
  - Marginal personal income tax brackets and rebates increased for inflation – expected R7.6bn billion in additional revenue
  - Other small changes include capital gains tax (R2bn), excise duty on tobacco and alcohol (R2.3bn) and a new sugar tax on sugar sweetened beverages, increase in maximum transfer duty rate on properties (R10m), a tyre levy and change to tax treatment of trusts
- The learnership and employment tax incentives to be reviewed

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FFC Research To Broaden Tax Base To Meet Revenue Raising Challenge

- Research highlights mainly two channels that translate into a “successful” consolidation
  - Mobilising Finance
    - Tax revenue buoyancy is a concern
      - Tax revenues to GDP ratio indicates a progressive decline in the buoyancy ratio
      - Commission to continue engagement with Davis Tax Committee
  - An increase in VAT
    - People cannot simply shift their income away from this tax as it is the only tax that taxes consumption
    - Can be considered regressive – burden borne by the rich and the poor
      - Certain consumption goods can be exempt if they bring significant relief to the poor
      - VAT revenue can be recycled back directly to poorest HH

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Division of Revenue

- After accounting for national debt, there are estimated receipts of R 3.76 trillion to share among the three spheres over the 2016 MTEF period
- Over the 2016 MTEF period, total receipts still expected to grow by real annual average of 0.2 percent, even though at a slower pace than the 0.7 percent projected in the 2015 MTBPS

Medium Term Expenditure Framework: Division of Revenue, 2016/17 – 2018/19

Division of Revenue	Total 2016/17 - 2018/19 (R'billion)		Real Annual Average Growth Rate	
	2015 MTBPS	2016 Budget	2015 MTBPS	2016 Budget
National Allocations	1796.3	1791.7	-0.7%	-0.9%
Provincial Allocations	1643.3	1625	1.8%	1.1%
Equitable Share	1342.3	1327.4	1.7%	0.9%
Conditional grants	301	275.3	2.4%	-5.1%
Local government allocations	350.6	344	2.3%	1.9%
Equitable Share	173.1	171.3	0.7%	0.7%
Conditional grants	142.1	137.2	5.1%	4.1%
Total	3790.2	3761	0.7%	0.2%

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UNALLOCATED RESOURCES

- The contingency reserve for 2016/17, has risen from R 2.5 billion at the time of the 2015 MTBPS to R6 billion in the 2016 budget. The contingency reserve for the outer years has remained more or less unchanged
- In the face of tight fiscal constraints, the Commission welcomes the increase in the contingency reserve for 2016/17 even though the amount of the increase is far from sufficient to provide an adequate fiscal buffer against any major fiscal crisis

Adjustments to Unallocated Reserves, 2013/14 – 2018/19

R' billion	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19
Budget 2013	4	6.5	10			
MTBPS 2013		3	6	18		
Budget 2014		3	6	18		
MTBPS 2014			5	15	45	
Budget 2015			5	15	45	
MTBPS 2015				2.5	9	15
Budget 2016				6	10	15

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Government Responses to Commission Recommendations

- The commission tabled its submission for the 2016/17 division of revenue in May 2015.
- The submission comprised 7 chapter and 27 recommendations
- Government agrees with the recommendations and is already implementing some of them
  - Proposal to incentivise maintenance budget
  - An ECD grant has been introduced to fund infrastructure maintenance and number of subsidised children

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Government Responses to SSCoA Recommendations

- SSCoA made a comprehensive list of recommendations to government which have been responded to.
- The FFC fully supports the recommendations and agree with most of the responses.
- In certain cases, more work is needed to address the concerns
  - For example, in the case of managing shortfall budgets the Commission is of the view that staff verification must be carried out throughout government

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Major Revisions To Clauses of 2016 DORB

- There are 5 main revisions to Bill clauses:
  - **Clause 20(3): Allowing grant funds to be reprioritised for disaster relief**
  - **Clause 21(2): Responding to corruption in procurement**.
  - **Clause 39: Transitional measures for municipal elections in 2016**
  - **Clause 19: Clarifying provisions for withholding and stopping of allocations**
  - **Clause 10(10): Gazetting Human settlement allocations to cities**

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Allowing Grant Funds to be Re-Prioritised (1)

- The Commission welcomes inclusion of this clause seeking to institutionalise disaster risk management strategies as a response to the drought within the existing grant framework
  - This allows for trade-offs between planned expenditures and pressing expenditures necessitated by previously unforeseen vagaries of weather to be transparent and in line with fiscal prudence

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Responding To Procurement In Corruption (2)

- The Commission welcomes this clause because it is in line with the Commission recommendation for 2016/17 division of revenue to raise procurement to a strategic level
  - As well as using conversion to indirect grants as a measure of last resort. Transgressions in procurement do constitute serious reasons that warrant such intervention.
  - Furthermore, the clause is welcome as it puts in place a mechanism that ensures fast-tracking of spending and reclassification of grants in accordance with justifiable and necessary processes
  - There is need to ensure that the clause is much clearer in setting the threshold levels of procurement transgression at which point the grant is converted to an indirect grant and the timeframe within which the grant remains an indirect grant after conversion

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TRANSITIONAL MEASURES FOR MUNICIPAL ELECTIONS (3)

- The Commission supports this measure as it is prudent and shows good forward planning
  - The Commission recommended a conditional grant be designed in order to support the affected municipalities with the restructuring process and this has been taken on board
  - Commission proposes ex-post work on impact on finances of current and past re-demarcation decisions on municipalities and learning from those experiences

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Clarifying Provisions for Withholding and Stopping of Funds (4)

- On withholding of funds, a new clause 19 clarifying provisions for withholding and stopping of allocations has been inserted
  - The Commission would like to reiterate its previous recommendations that:
    - Proper diagnostics of the root cause of non-payment be done and if it is due to bad management, appropriate consequences should be rendered;
    - Stricter measures should be imposed on individuals within municipalities that are responsible for continuously flouting MFMA rules;
    - The electricity and water undertakings must be ring fenced; and
    - IGFR forums dedicate sufficient time to find lasting solutions to the debt problems within the Local government sector.

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GAZETTING HUMAN SETTLEMENT ALLOCATIONS (5)

- Efforts are made to address anticipated shift of transport function to Metros
- A new clause (Clause 10(10)) requires provinces to gazette housing allocations to Metros before they receive the funds
  - This is a welcome development as it enable metros to undertake integrated planning
  - Gazetted allocations must be aligned to APPs

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PROVINCIAL FISCAL FRAMEWORK

- The provincial fiscal framework [inclusive of conditional grants] is revised downwards by R19 billion over the 2016 MTEF in comparison to 2015 MTBPS
- Despite downward revisions, both PES and conditional grants still expected to grow on average at above the rate of inflation over 2016 MTEF. Nevertheless, PES and conditional grants decline in real terms in 2016/17, with conditional grants hardest hit at -2.3%
  - Provinces should still be able to deliver their constitutionally mandated basic services without any serious service delivery implications, while national priority expenditure areas funded through conditional grants may come under pressure in 2016/17

	2016/17	2017/18	2018/19	Annual Average Real Growth
PES	-0.3%	1.4%	1.6%	0.9%
Conditional grants	-2.3%	6.7%	1.7%	2.0%

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PROVINCIAL FISCAL FRAMEWORK [CONT.]

- Provincial Equitable Share
  - An amount of R2.3 billion that was previously part of the devolution of property rates funds grant will be fully phased into PES during 2016/17
  - Funds from the PES will also be used to expand the human papilloma virus grant so that the programme continues
  - The Commission supports both initiatives as they enhance efficiencies and mainstream these activities into the workflows of provinces
- Provincial Equitable Share formula
  - The weights assigned to the six components of the PES remain the same in 2016/17
  - Given the potential disruptive nature of Census 2011, the Commission supports the ongoing assistance provided to the Eastern Cape, KwaZulu-Natal, Free State and Limpopo to cushion the impact of declining provincial equitable shares due to reduction in population figures
- At present, a review of the PES formula is underway

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CHANGES TO PROVINCIAL CONDITIONAL GRANTS

- Provincial conditional Grants are revised downwards by R3.5 billion over MTEF
- Total allocation are still considerably high with projected allocation of R108bn in 2018/19
  – HSDG is revised downward by R1.6 billion
  – HFRG is reduced by R200 million
- The Commission supports reprioritisation of funds to the extent that cuts are equitably distributed and targeted at non preforming grants

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IMPLICATION OF CUTS ON HOUSING DELIVERY

- The Commission welcome the cuts on HSDG that was driven in part by underspending and administrative reasons
  - The Commission however recommends the government should finalize policy changes within the sector without further delays and that an upward adjustment in the baseline in future be effected to reverse the rate of decline in the number of houses delivered per annum
- Government must support other housing programs (self-built & FLISP) to reduce pressure on HSDG
- Housing investment in mining towns must be carefully considered and informed by needs and preferences

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Health Grants Changes and Performance Review

- Health grants are showing good spending trajectory
- The comprehensive HIV/AIDS and HFRG are revised downward by R176 million (once-off) and R365 Million over MTEF
- This reduction must be carefully managed to minimise impact on delivery
- Budget cuts must be informed by thorough expenditure reviews

Health	2009/10	2010/11	2011/12	,2012/13	2013/14	2014/15
Comprehensive HIV and Aids Grant	98%	98%	97%	99%	99%	99%
Health Facility Revitalisation Grant	-	-	-	-	84%	94%
Health Infrastructure Component	-	-	93%	93%	88%	-
Hospital Revitalisation Component	73%	76%	90%	85%	83%	-
Nursing Colleges and Schools Component	-	-	-	77%	69%	-
Health Professions Training and Development Grant	108%	99%	100%	99%	100%	100%
National Health Insurance Grant	-	-	-	55%	82%	72%
National Tertiary Services Grant	109%	99%	100%	99%	100%	99%

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Basic Education Grants Changes and Performance Review

- Key changes to basic education conditional grants are
  - Reduction of the EIG baseline by R160 million
  - Merger of school infrastructure backlog grant with EIG
  - Introduction of ECD grant as recommended by the Commission in its 2016/17 submission
- Education grants that cannot expend 100% of their allocation must be used to relieve budget pressures in other areas.

Basic Education	2009/10	2010/11	2011/12	,2012/13	2013/14	2014/15
Dinaledi Schools Grant	-	-	88%	82%	80%	82%
Education Infrastructure Grant	-	-	97%	93%	100%	94%
HIV and Aids (Life Skills Education) Grant	92%	87%	90%	86%	74%	88%
National School Nutrition Programme Grant	98%	95%	96%	98%	98%	99%
Technical Secondary Schools Recapitalisation Grant	-	76%	71%	74%	67%	87%
Occupation Specific Dispensation for Education Sector Therapists Grant	-	-	-	-	-	90%

Local government Fiscal Framework

- Local Governments will
  - Be affected by the slowdown in economic growth, the current recession facing the mining and agriculture sectors, the prevailing drought, and the oncoming local government elections
  - Experience one of the most wide ranging boundary redeterminations the country has witnessed since introduction of the current system of local government in 2000
  - Be affected by tariff hikes larger than inflation rates
- The sphere continues to receive increasing amounts of nationally acquired revenues:
  - It will receive about R334 billion in total revenues over the 2016 MTEF, which translates into an average share of 9.1%.

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Local Government Baseline Adjustments

- Over the 2016 MTEF, the total baseline allocations to Local Government are set to decrease by R6.3 billion, and of this amount,
  - R5.5 billion will be in the form of direct conditional transfers to municipalities and R500 million will be transferred as indirect conditional grants
  - R300 million will be on the LGES
- However, government has made additions to baselines totalling R5.3 billion giving a nett reduction in allocations of R968 million
- The reductions in the LES are mainly on the institutional and community services components, which had risen very rapidly in value in 2015/16 financial year with a growth of 28% in one year.
- The Commission,
  - Supports the option of reducing these components by not more than 10%
  - Is of the view that reductions on the institutional and community services and preservation of basic services component is not likely to affect service delivery directly
  - The electricity and water undertakings must be ring fenced for serial offenders

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DEMARCATION PROCESSES

- The number of municipalities will be reduced from 278 to 257
- Each major amalgamation will be provided with a transitional grant to assist municipalities defray all costs associated with transition
- The Commission encourages National Treasury, Provincial Treasuries and CoGTA to put in place mechanisms for monitoring this grant in order to make sure that these resources are strictly used to offset costs related to demarcations
- The Commission underscores the point that the full financial impact of all demarcations should be established prior to boundary changes, and affected municipalities made aware of such costs
- All stakeholders in the demarcation process should also consider a post demarcation review to assess the full impact of current and previous demarcations. This review will assist all stakeholders to fully appreciate the impact of boundary changes on local government viability, budgets and overall local economic development.

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Review of Local Government Infrastructure Grants

- Local government infrastructure grant are currently undergoing review
- The review intends to improve the efficacy and effectiveness of the entire system
- The Commission welcomes the review and is encouraged that government is implementing some of the ensuing recommendations
  - Sanitation and water grants have been merged
  - MIG has been amended to allow maintenance and refurbishment of roads
  - Public Transport Network Grant is allocated through a formula

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NHI Reforms

- Health conditional grants have undergone numerous reform since introduction of NHI
- For 2016 the NHI grant is merged into a new National Health Grant intended to fund Ideal Clinic Initiative among other things
- The commission is concerned with endless changes to grants synonymous with the sector as this introduces uncertainties, duplications and erodes old priorities.

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INCENTIVISING MAINTENANCE

- With need to make better use of scarce resources, the Commission supports current reforms to use a larger share of infrastructure conditional grants, specifically in education and health, to beef up maintenance spending
- This will assist government in addressing maintenance backlogs that have accumulated in the health and education sector over the years
- The principle of rewarding provincial departments through the incentive grant component for meeting maintenance targets is supported, although under-capacitated provinces should not unduly lose out for not being able to meet targets due to lack of capacity

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Conclusion

- The Commission welcomes the fiscal stance highlighted in the 2016 Fiscal Frameworks
  - The fiscal position recognises need for accelerated fiscal consolidation in order to ensure government spending and debt levels are sustainable going forward while also being relatively expansionary in supporting a flat economy
- From an aggregate fiscal policy perspective, the Commission is of the view that Government has done enough to stave off downgrades from rating agencies
  - There is much work, however, on
  - Ensuring successful implementation of SOCs reforms promised and successful fiscal consolidation broadly
  - Improving the value-for-money and impact of public spending.
    - These micro fiscal goals lie in the domain of individual portfolios and accounting officers of departments.
    - The capability of provincial treasuries and Offices of the Premier to drive improvements in financial management practice within provincial departments and municipalities is crucial

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CONCLUSION

- The Commission welcomes the major changes to sections of 2015 DORA
- The Commission is aware that cuts on baseline allocations were unavoidable consequences of poor economic growth and reprioritisation of allocations to more urgent government priorities
- Reductions due to reprioritisation should as a matter of principle take into account the historical performance of individual grants
- The Commission urges government to minimise the unintended consequences of such cuts, especially considering the fact that incidences of the cuts will fall disproportionately on poor households due to their heavy reliance on grants
- The government should ensure that such cuts do not compromise delivery of free basic services and the overall government infrastructure investment programme
- The Commission implores the Provincial and Local Government sector to manage resources efficiently.

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CONCLUSION

- Weak educational and labour market outcomes and research and innovation still need attention. The Commission believes that 2016 Budget could have addressed these issues in more detail
  - A major macroeconomic risk = the tightening financial and capacity constraints which threaten a public infrastructure-led growth strategy and the poor investment climate that has subdued both internal and foreign investment
  - In this regard a better understanding of the obstacles causing the delays in the rollout of the infrastructure strategy is critical

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