FINANCIAL
AND FISCAL
COMMISSION

BRIEFING ON THE 2018 APPROPRIATION BILL

8 May 2018

For an Equitable Sharing of National Revenue

BACKGROUND

- Submission made in terms of S4(4c) of MBPARMA (Act 9 of 2009)
  - Requires Parliamentary Committees to consider any recommendations of FFC during deliberations on Money Bills
- Also made in terms of FFC Act of 1997 as amended
  - Requires that FFC responds to any requests for recommendations by any organ of state on any financial and/or fiscal matter(s) relevant to its mandate

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PRESENTATION OUTLINE

- In accordance with the Standing Committee on Appropriations request, the 2018 Appropriation Bill is assessed with respect to:
  - The economic outlook, investment and job creation
  - Revision and additions contained in the 2018 Appropriation Bill
  - Baseline changes across votes and risks to the fiscal framework
  - Effecting government's five priority areas in the MTSF
  - Infrastructure investment in national government
  - Challenges and opportunities of SOCs funded through the 2018 Appropriation Bill
  - Possible or existing institutional arrangements, policy areas or mechanisms that can stimulate cost efficiencies.

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2.1 Economic Overview, Investment and Job Creation

- Economic outlook, business and consumer confidence have improved recently
- The SARB projects growth to accelerate, averaging 1.7 per cent in 2018, 1.5 per cent in 2019 and 2.0 per cent in 2020
- The acceleration of economic growth in 2017 exceeded expectations. The recovery in quarter-to-quarter real gross domestic product (GDP) growth in the last three quarters of 2017 translated into an acceleration in annual growth of 1.3 per cent in 2017 from a revised 0.6 per cent in 2016
- The main growth drivers in 2017 were agriculture and mining. Agriculture as a sector grew by 17.7 per cent, contributing 0.4 percentage points to headline GDP.
- Mining also contributed significantly to growth during 2017.

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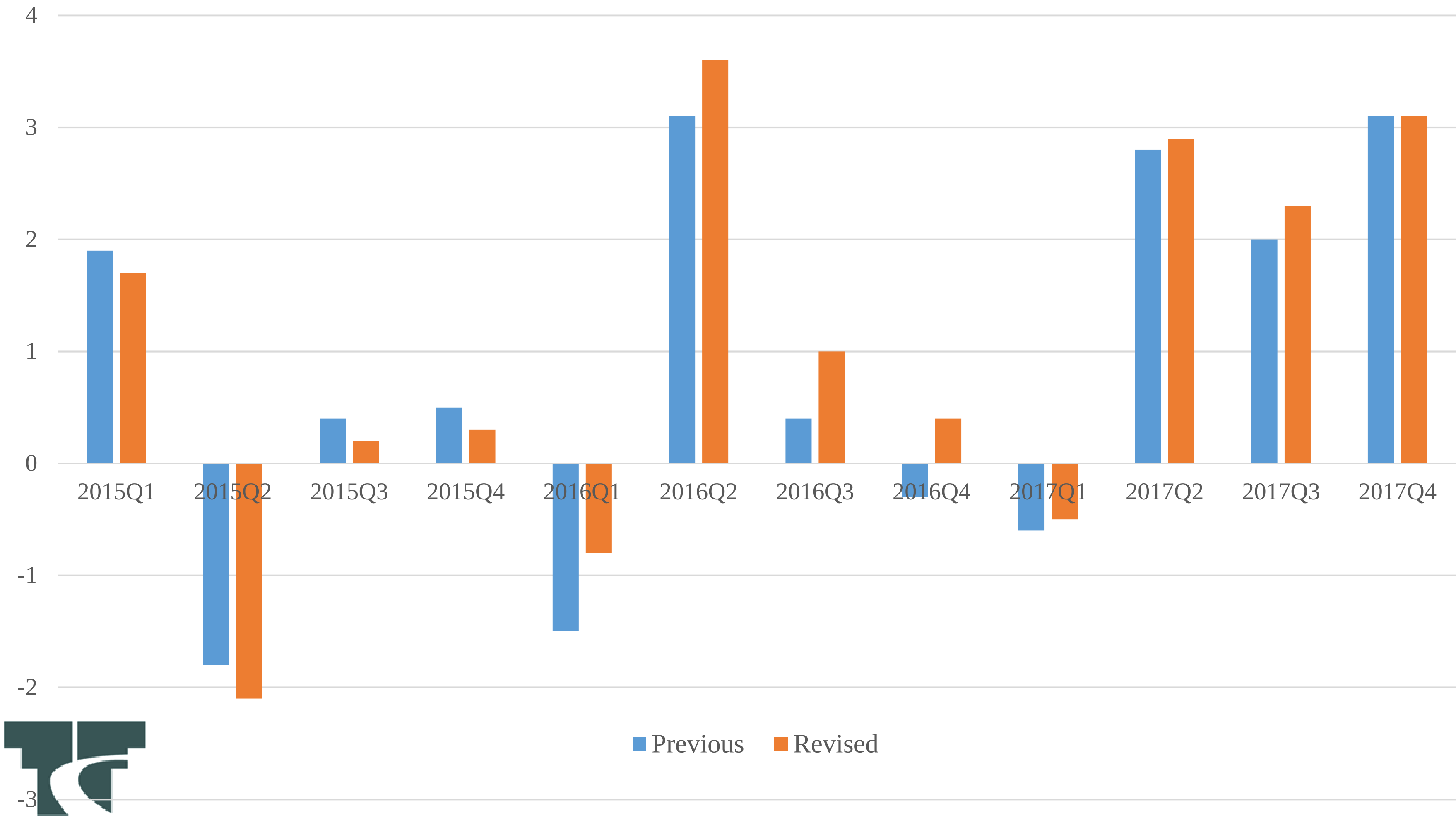
Economic Growth



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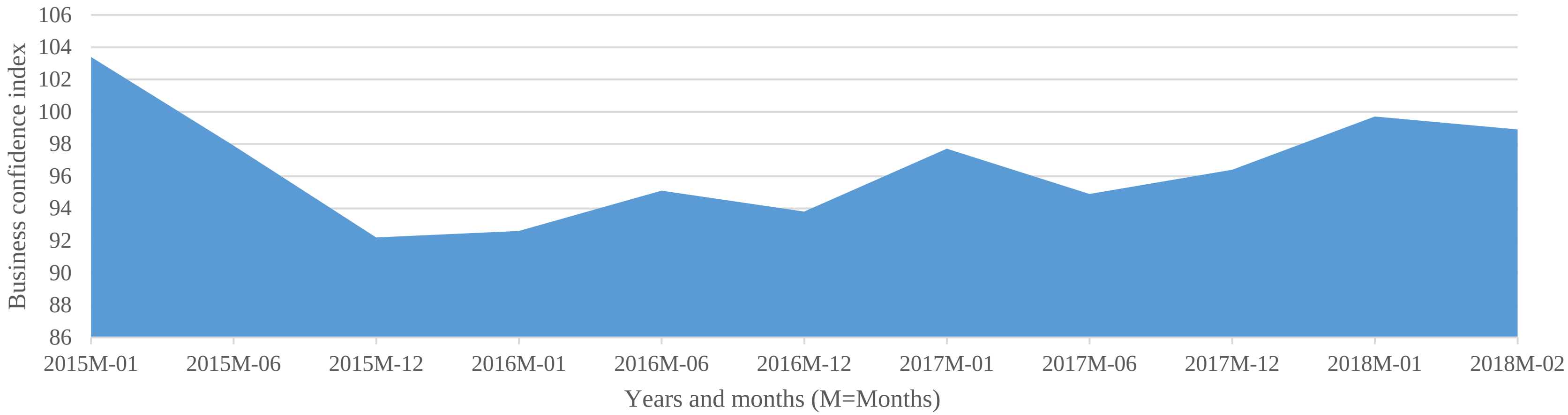
2.2. Investment Rebounds As Business Confidence Improves

- Investment rebounded from a 4.1 per cent contraction in 2016, with gross fixed capital formation accelerating marginally by 0.4 per cent in 2017



- Improved business confidence is also reflected by several indices. The SACCI business confidence index rebounded to 2015 levels.
- While this improvement in reflects more optimistic expectations, actual conditions are yet to translate into sustained investment growth though improved investor sentiment is expected to translate into higher investment in 2018.

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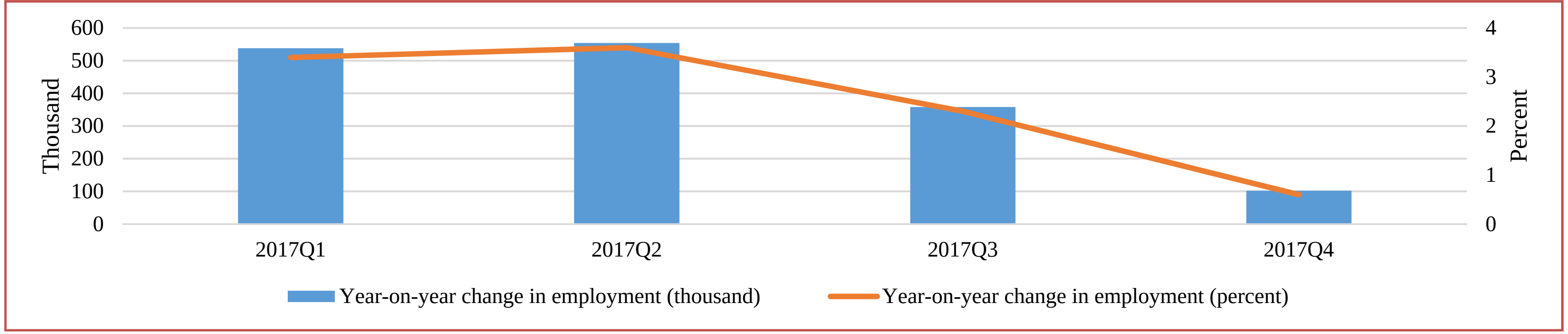
2.3. EMPLOYMENT GROWTH REMAINS SLUGGISH

- Number of people employed decreased by 21 000 from the third to the fourth quarters of 2017, lowering total employment to approximately 16.2 million. Total employment increased by 102 000 in the full year. However, the year-on-year growth rate decelerated substantially from 2.3 per cent in the third quarter of 2017 to 0.6 per cent in the fourth quarter.



- Skilled employment grew the fastest at 2.8 per cent in 2017, followed by semi-skilled employment (2.7 per cent). Unskilled jobs had the slowest growth rate (1.8 per cent), reflecting a deep mismatch between an economy that demands skills and a labour force that is not fully able to respond to such demand.

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3.1 Baseline Changes and Service Delivery Implications of the 2018 Appropriation Bill

- Government has reduced the overall baseline to national votes by 0.5 per cent in the 2018 Appropriation Bill, which is below the annual growth rate of 1.5 per cent forecast for 2018.
- The strategy of reducing appropriations in real terms implies that service delivery is likely to be affected unless national departments take active steps to improve operational efficiencies and service delivery innovations.
- Of selected votes, Higher Education (12 per cent), Economic Development (9 per cent) and Health (3 per cent) reflect the fastest growth on average per annum in real terms over the period 2015/16 – 2017/18.
  - These growths maintain trends established by previous Appropriation Acts
- Agriculture, Forestry and Fisheries (-3 per cent), Rural Development and Land Reform (-3 per cent) and Human Settlements (-3 per cent) record negative growth rates over this period despite the votes playing an important role in the socio-economic development of rural areas.

Baseline Changes of Key National Votes, 2015/16 - 2018/19

	National Votes	2015/16	2016/17	2017/18	2018/19 Appropriation (A)	Annual Avg. Real Growth (B)
11	Public Works	-1%	-4.4%	4.0%	1.4%	0%
14	Basic Education	1%	-3.0%	-0.5%	-4.2%	-2%
15	Higher Education and Training	2%	10.9%	1.6%	34.1%	12%
16	Health	2%	0.7%	5.7%	5.2%	3%
18	Correctional Services	0%	-1.7%	1.0%	-1.0%	0%
21	Justice and Constitutional Development	0%	0.8%	-0.2%	-3.9%	-1%
23	Police	1%	-0.7%	2.2%	0.3%	1%
24	Agriculture, Forestry and Fisheries	-9%	-4.9%	0.6%	-0.9%	-3%
25	Economic Development	22%	-31.0%	32.6%	11.8%	9%
26	Energy	10%	-1.1%	3.5%	-19.0%	-2%
38	Human Settlements	-3%	-4.5%	4.5%	-8.9%	-3%
39	Rural Development and Land Reform	-8%	4.1%	-3.7%	-3.1%	-3%
Total appropriation by vote		6%	-3.9%	3.4%	$\boxed{-0.5\%}$	1%

- Baseline changes in the 2018 Appropriation Bill for selected votes are mostly negative.

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BASELINE CHANGES OF KEY NATIONAL VOTES, 2015/16 - 2018/19

- Key service delivery areas such as Energy (-19 per cent), Human Settlements (-8.9 per cent) and Basic Education (-4.2 per cent) are targeted for major reductions.
- Baseline reductions within these national votes do not just target non-core spending areas such as administration, but also service delivery areas such as solar energy, housing and education infrastructure.
- The Commission is also concerned about the disproportionate cuts to infrastructure grants. Cutting infrastructure grants without a detailed performance and effectiveness review of such grants potentially reinforces the widespread historical disparities that prevail in the country which such grants are meant to redress.
- Going forward, the Commission would like to reiterate the need for a rigorous analysis to be undertaken to ascertain the exact impact of such cuts on households, business and the economy at large.

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3.2. Changes to Spending Outcomes

- While most votes spent are on par or above the national average (98.2 per cent), uneven spending patterns are a feature of most votes
- Votes that spent below the national average for the period 2014/15 to 2016/17 are Energy (93.8 per cent) and Basic Education (97.6 per cent), whilst Police spent 100 per cent of its budget.
  - The underspending by the Department of Energy is linked to poor performance of the Integrated National Electricity Programme (INEP).
  - The underspending by the Department of Basic Education (DBE) is in relation to delays in implementing school infrastructure projects.
- Total national spending as at February 2018 amounted to 88 per cent of total budget allocated for 2017/18. If national spending were done on a straight-line basis, benchmark spending as at February 2018 would amount to 92 per cent.
  - Departments significantly below the notional 92 per cent benchmark are Energy (84.4 per cent) and Economic Development (85 per cent).

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AGGREGATE SPENDING AND DEVIATION FROM THE FINAL BUDGET, 2014/15 - 2017/18

Percentage	% expenditure (2014/15)	% expenditure (2015/16)	% expenditure (2016/17)	Avg.% expenditure (2014/15 - 2016/17)	% expenditure at Feb 2018 (11 months)
National Sphere	96.7	98.9	98.9	98.2	88.0
Selected Key budget Votes					
11. Public Works	98.4%	99.5%	98.3%	98.7%	96.6%
14. Basic education	99.2%	97.7%	95.8%	97.6%	93.5%
15. Higher Education and Training	97.7%	100.2%	99.9%	99.2%	92.2%
16. Health	97.7%	99.3%	99.7%	98.9%	92.3%
18. Correctional Services	99%	100%	99.8%	99.6%	89.0%
21. Justice and Constitutional Development	97.6%	99.7%	100.0%	99.1%	87.0%
23. Police	100.0%	100%	100%	100%	90.0%
24. Agriculture, Forestry and Fisheries	99.1%	99.9%	99.6%	99.5%	93.0%
25. Economic Development	99.7%	99.8%	98.6%	99.4%	85.0%
26. Energy	83.6%	98.3%	99.5%	93.8%	84.4%
38. Human Settlements	99.8%	98.3%	99.6%	99.3%	87.0%
39. Rural Development and Land Reform	99.4%	99.1%	99.4%	99.3%	80.0%

3.3. Risks to the 2018 Appropriation Bill

- *Water Scarcity:* Due to climate change, many areas in the country have experienced drought, placing significant strain on the water resources of municipalities and other water authorities. This has potential to adversely affect economic growth and employment especially in the agriculture and tourism sectors.
- *Public-service wage negotiations:* If the wage agreement is above the consumer price index, it will be difficult to meet expenditure ceiling targets without further measures
- *The financial position of state-owned companies:* Government has extended substantial guarantees to state-owned companies and should there be a call on these guarantees, the government debt and borrowing costs would rise substantially.
- *Sovereign credit-rating downgrade:* Further downgrades cannot be discarded for now given other risks such as those above. Any further downgrades would lead to the exclusion of South Africa from the Citi World Government Bond Index which will then trigger compulsory bond sell-offs by some institutional investors.

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3.4. Government's Response to the Risks

- Allocated R91.6 billion over the next three years to extend, upgrade and maintain water resource infrastructure.
- Reduced the compensation ceiling by R15 billion in 2018/19, resulting in a likely decline in national and provincial headcounts.
- On SOCs government has:
    - Proposed spending cuts amounting to R85 billion over the medium term and marginally reduced the expenditure ceiling to boost investor confidence.
    - Appointed a new board and acting chief executive officer at Eskom
    - Granted SAA R10 billion to settle its short-term debt obligations and appointed a new board, Chief Executive Officer and a restructuring officer at the airline.
    - Made a commitment to reduce its guarantees as part of efforts to maintain fiscal prudence.

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3.5. Commission's Observations on the Risks

- The Commission welcomes measures taken to mitigate fiscal risks to the fiscus. They potentially improve budget credibility and support fiscal consolidation efforts.
- With respect to the water crisis, the Commission calls on government to be cognizant of the likely long-term impact on the economy and that South Africa is generally a water scarce country.
  - In its submission on the 2014/15 Division of Revenue, the Commission emphasized that inadequate infrastructure maintenance has the potential to undermine service delivery, increase backlogs and place strain on public finances.
  - Furthermore, efforts towards fostering behavioural change when it comes to water use and natural resource use in general should be prioritized now and going forward.
- On public sector wages, the Commission's view is that government and unions should aim to reach a settlement that supports government's current fiscal position as this would be in the national interest.
- On guarantees to SOCs, the Commission calls on National Treasury review the guarantee framework and the process.

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4. Progress in Achieving MTSF Goals: 2018 Appropriation Bill

- Four overarching Government priorities that inform the assessment:
  - 4.1. Promoting economic growth
  - 4.2. Job creation
  - 4.3. Education
  - 4.4. Health

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4.1. Assessment: Economic Growth

- GDP growth has decelerated from 2.5 percent in 2013 to 0.6 percent in 2016, before slightly recovering to 1.3 percent in 2017, averaging 1.5 percent over the past five years. Current forecasts are at less than 2 percent in the medium term, reflecting that the MTSF GDP target for 2019 of 5 percent will most likely be missed.
- Trends in economic growth and investment are closely aligned to the government consumption spending which also decelerated from 3.3 percent in 2016 to 0.6 percent in 2017
- On current trends, by 2020/21, government is expected to spend 12.2 per cent of available revenue on servicing debt, implying even less spending available to boost growth

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4.2. Assessment: Job Creation

- The MTSF outcome on decent employment through inclusive economic growth is aimed at creating jobs and addressing unemployment. Government has embarked on numerous labour-market interventions and programmes aimed at alleviating youth unemployment. They entail supporting training and skills development, promoting entrepreneurship and providing employment services.
- In order to create large numbers of jobs, a strong, sustained expansion in economic growth is required, coupled with skills development and innovation.
- Unemployment rate has risen from 22.5 percent in 2008 to 26.7 percent in the fourth quarter of 2017. At the current rate, the MTSF target of reducing the unemployment rate from 25 percent to 14 percent in 2020 is unlikely to be met.

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4.3. EDUCATION…(1)

- Education plays a key role in human development and is a tool for the eradication of poverty and the reduction of inequality
- According to the MTSF for 2014 to 2019 period there are a number of initiatives set and targeted to sustain and accelerate improvements in school performance. While in some programs remarkable progress has been made, some targets are likely to be missed
  - One of the targets set was to ensure that all schools have adequate sanitation, water and electricity (set for 2017/18)
    - To date there are schools without such key infrastructure and this has resulted in the continuation of the School Infrastructure Backlog Grant in 2018
  - On ensuring that every Grade 1 learner received Grade R every year from 2015, the target was also missed and only 87% of Grade 1 learners had received Grade R by 2016/17

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4.3. Education…(2)

- For 2018/19 – Basic Education remains one of the priority areas, accounting for 16.5% of total consolidated government expenditure, growing at an average annual growth rate of 6.8%
  - While this average growth rate is lower than the 2017 MTEF of 7.3%, the Commission welcomes it given the tight fiscal constraints
- During the 2018 MTEF, the basic education sector will continue to focus on various key strategic interventions, including the replacement of inappropriate and unsafe schools, the provision of water and sanitation to a number of schools lacking these services, and building new schools and maintaining existing school infrastructure
  - Prioritization of these programs is in line with the MTSF and is hence to be supported

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4.3. EDUCATION…(3)

- With respect to Post-School Education and Training, expenditure has increased by 13.7% per year, largely driven by the additional allocation to the National Student Financial Aid Scheme for fee-free higher education and training
  - While the Commission supports these initiatives since they are in line with the current MTSF, it makes the following recommendations:
    - With respect to the building new schools, the Department of Basic Education needs to take into account spatial demographic patterns and forecasts before deciding to build or expand schools as the research by the Commission has revealed that there is high mobility of learners inter-and intra-regional
    - Concerning fee-free higher education and training, the Commission in its submission to the Heher Commission indicated that it is important to maintain fees as part of the mix to take advantage of equity, price-mechanisms, private funding sources and expenditure side management

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4.4. HEALTH…(1)

- According to the MTSF for 2014 to 2019, priorities within the health sector include improving access to health-care facilities, increasing the number of people on anti-retroviral medicine and increased attention to curing tuberculosis (TB)
- For the 2018 MTEF, priority areas within the health sector include following areas all in line with the MTSF:
  - Expansion of HIV and AIDS treatment and prevention: expanding access to people with HIV and AIDS to reach 5 million patient by 2019.
  - Implementation of a National Health Insurance: this includes phasing in of the NHI
  - Treatment of TB: increase the number of people screened for TB annually reaching 20 million in 2019

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4.4. HEALTH…(2)

- The fastest growing programmes within the health sector are HIV and AIDS, and TB because of the implementation of a universal test-and-treat policy
- With respect to the progress on MTSF targets, the sector is not far from achieving targets:
  - The target set for 2019 with respect to individuals on antiretroviral treatment is 5,1 million, compared to 3.9 million currently
    - The government therefore is not far from reaching its target by 2019 given that two years (2018 and 2019) still remain and also that funding is prioritised towards the implementation of the program
  - With respect to the preparations for the implementation of NHI, the draft NHI Bill was gazetted for public comments in 2017/18 and it is expected that a revised NHI Bill will be submitted to Parliament in 2018

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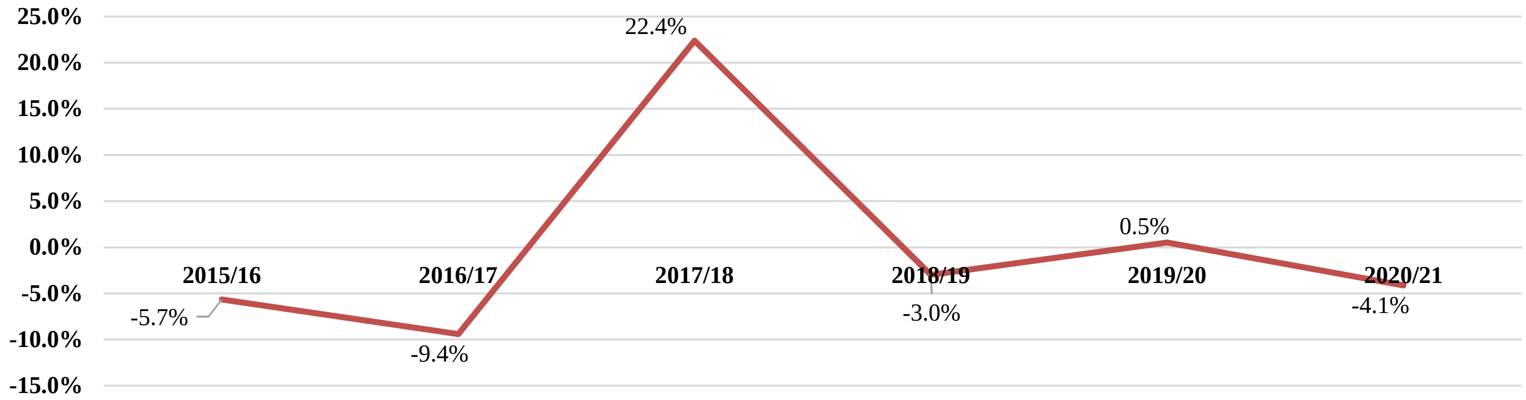
5. INFRASTRUCTURE

- In a bid to moderate spending within the current constrained economic environment, Budget 2018 proposes significant cuts and deprioritisation of infrastructure spending – largely achieved through cutting of infrastructure-related conditional grants

Real Growth in Total Public Sector-Sector Infrastructure Expenditure, 2015/16 - 2020-21



- SOCs at 43.4% of the total public infrastructure spend in 2018/19 are the biggest spenders on public infrastructure. In addition, their real growth in infrastructure spending between 2017/18 and 2018/19 is significant at 12.3%
- Commission has in past submissions raised concern around ability of SOCs to prudently spend infrastructure funds – there is need to ensure that renewed commitment by government to overhaul performance of SOCs will bring about more effective and efficient SOC spending

5. Infrastructure [cont.]

- In a number of instances it is unclear why cuts have been effected especially where grants are relatively well spent
  - If the challenge is a non-financial bottleneck such as ineffective spending, national sector departments need to assist provincial counterparts with capacity building or technical expertise to improve spending capabilities in line with requirements of the conditional grant in question
- Commission reiterates need for government to design a plan to reprioritise infrastructure funding in the coming years
  - There should be a prioritisation of what should be cut/delayed and priority should be afforded to infrastructure related to schools, hospitals, electricity and water
  - Departments also need to be more efficient and should be required to indicate the measures that they will take in this regard (i.e. not only for infrastructure projects)
- In absence of additional funding for infrastructure, greater emphasis should be placed on improving the quality of capital stock delivered, maintaining existing stock and reducing cost overruns on current projects

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6.1. SOCs Challenges and Opportunities…(1)

- SOCs remain the largest driver of public capital investment, with a projected appropriation of R366 billion over the 2018 MTEF
  - Altogether SOCs accounts for 76% of total public infrastructure investments
    - Eskom accounts for a bigger share of the total spend (81% in 2018/19)
- The return on investment from SOCs has been suboptimal partly due to growing concerns of poor governance and corruption
- Persistent governance problems have lowered investment appetite from capital markets for ESKOM and SAA
- Protracted governance risks jeopardise fiscal stability as result of cash injection requirements, contingent liabilities and higher debt service cost

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6.2. SOCs Challenges and Opportunities…(2)

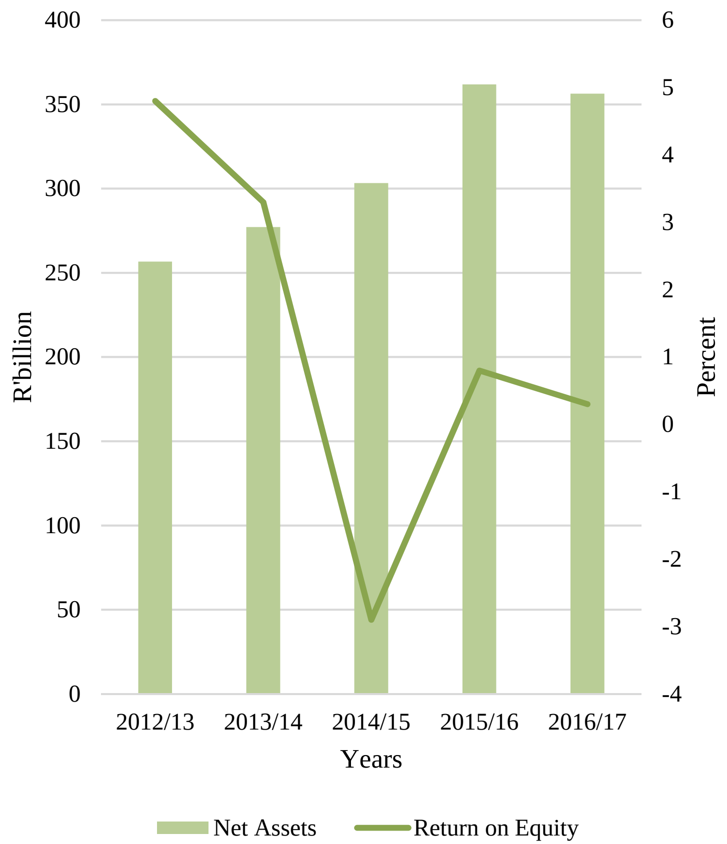
- While SOCs guarantees remain flat, exposure has notably increased
- Eskom poses a greater risk to government's contingent liabilities
  - Over 62% of the guarantee has been drawn out
  - Low electricity sales and tariffs pose a threat to long tern financial viability
- ESKOM and other SOCs should look to internal operational cost structures to drive efficiency while NT reviews the guarantee framework and the processes

	2015/16		**2016/17**		**2017/18**	
	Guarantee	Exposure	Guarantee	Exposure	Guarantee	Exposure
Eskom	350	174.6	350	202.8	350	220.8
SAA	14.4	14.4	19.1	17.8	19.1	11.8
SANRAL	38.9	27	38.9	29.4	38.9	30.1
SAPO	4.4	1.3	4.4	4	0.4	0.4
Denel	1.9	1.9	1.9	1.9	2.4	2.3
Transnet	3.5	3.8	3.5	3.8	3.5	3.8
Land Bank	13.9	4.4	12.5	4.1	12.3	4.2
DBSA	13.9	4.4	12.5	4.1	12.3	4.2
IDC	2	0.2	0.4	0.2	0.5	0.1
Total	469.9	255.8	475.7	290.4	466	300.4

6.3. SOCs Challenges and Opportunities…(3)

- The financial position of SOCs has been deteriorating
  - Net asset value decelerated from R361.8 billion in 2016/16 to R356.3 billion in 2016/17
  - Return on equity decelerated from 4.8 per cent in 2012/13 to -2.9 per cent in 2014/15 before slightly recovering to 0.3 per cent in 2016/17
- SOCs need to generate higher return to equity to ensure increased value and low reliance on debt and transfers

Combined balance sheet



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6.4. SOCs Challenges and Opportunities…(4)

- Well managed SOEs play a crucial developmental role.
- If poorly managed and governed, they burden the country with significant costs
- Thus the Commission welcomes measures taken by government to stabilise large SOCs over the past year
  - New boards, engagement with lenders and reviewing project plans
- These measures should be completed by tighter executive and managerial oversight and accountability
- National Treasury should be required to review the guarantee framework and processes

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7. Measures to Stimulate Cost Efficiencies

- The public sector should continually strive to improve efficiency and do more with less.
- By the sheer scale of government operations, there are many opportunities for creating meaningful and sustainable efficiency savings through, *inter alia*, building on the achievements already made in the following areas:
  - The consolidated procurement processes initiated by the Chief Procurement Office
  - Efforts to link public sector wages and productivity,
  - Strengthening oversight and accountability institutions at subnational levels, and
  - Inculcating the values of incorruptibility among civil servants and citizens more broadly.
- The Commission has identified additional areas of focus, namely:
  - Modernisation and leveraging on technology
  - Minimising unnecessary outsourcing of services and tasks that can be performed by civil servants.

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CONCLUSION

- 2018 Appropriation Bill was tabled in an environment of persistently low economic growth, revenue collection underperformance and policy decisions that have necessitated a re-orientation of public finances relative to what was anticipated at time of the 2017 Medium Term Budget Policy Statement
- Budget 2018 had to make hard trade-offs to balance achievements of socio-economic objectives with putting the country onto a solid, more stable financial and fiscal footing
  - To bring about this balance, a combination of reprioritisation, expenditure cuts and tax policy adjustments have been effected
  - Social security grants and delivery of basic services are protected from cuts but spending on public infrastructure, a key economic growth catalyst, bears the brunt of the need to moderate spending

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CONCLUSION

- The Commission welcomes measures taken to mitigate fiscal risks to the fiscus
  - With respect to the water crisis, the Commission calls on government to be cognizant of the likely long-term impact on the economy and that South Africa is generally a water scarce country.
    - Furthermore, efforts towards fostering behavioural change when it comes to water use and natural resource use in general should be prioritized now and going forward.
  - On public sector wages, the Commission's view is that government and unions should aim to reach a settlement that supports government's current fiscal position as this would be in the national interest.
  - On guarantees to SOCs, the Commission calls on National Treasury review the guarantee framework and the process.

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CONCLUSION

- Whilst Government has managed to protect spending aimed at social security grants and the delivery of basic services, allocations in respect of public infrastructure have essentially borne the brunt of the need to moderate spending.
  - Commission advises that government actively ensures that effects of cuts to infrastructure spending are continuously monitored with a view at ensuring they do not result in deterioration of current and future service delivery
  - Line departments should also be required to indicate the measures that they will take in this regard (that, is, not only for infrastructure projects)

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CONCLUSION

- Commission agrees with thrust of the 2018 Appropriation Bill
  - Budget 2018 provides evidence of a tight balancing act between maintaining social spending with measures to ensure fiscal consolidation
  - Now is the opportune time to put into practice firm reforms capable of rooting out corruption and identify areas of innovation and cost saving so as to ensure sustainability going forward

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THANK YOU.

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