



FINANCIAL AND FISCAL COMMISSION SUBMISSION ON THE 2014 FISCAL FRAMEWORK AND REVENUE PROPOSALS

“For an Equitable Sharing of National Revenue.”

Financial and Fiscal Commission
Montrose Place (2nd Floor), Bekker Street,
Waterfall Park, Vorna Valley, Midrand,
Private Bag X69, Halfway House 1685
www.ffc.co.za
Tel: +27 11 207 2300
Fax: +27 86 589 1038

CONTENTS

| | |
|---|-----|
| LIST OF TABLES AND FIGURES | ii |
| LIST OF ACRONYMS | iii |
| 1. BACKGROUND | 1 |
| 2. OVERVIEW OF ECONOMY AND PUBLIC FINANCES | 2 |
| 3. GLOBAL DEVELOPMENTS AND RISKS | 3 |
| 4. DOMESTIC DEVELOPMENTS AND RISKS | 4 |
| 5. FISCAL FRAMEWORKS AND REVENUE PROPOSALS | 6 |
| 6. LONGER TERM DEBT CHALLENGE | 13 |
| 7. DEVELOPING SOUTH AFRICA'S INFRASTRUCTURE | 16 |
| 8. CONCLUSION | 19 |

LIST OF TABLES AND FIGURES

| | |
|--|----|
| Table 1. Medium term expenditure framework division of revenue (R'billion) | 7 |
| Table 2. Budget deficit as % of GDP, 2013-2016 | 7 |
| Table 3. Revenue source revisions | 8 |
| Table 4. Adjustments to the contingency reserve, 2013/14-2016/17 | 9 |
| Table 5. Expenditure component revisions (functional classification) | 10 |
| Table 6. MTEF growth in operating and capital expenditure items, 2013/14-2016/17 | 12 |
| Table 7. Public sector infrastructure expenditure by sector - February 2014 | 17 |
| Figure 1: Gross Loan Debt and Growth in Real State Debt Cost | 15 |

LIST OF ACRONYMS

| | |
|-------|---|
| BEPP | Built Environment Performance Plan |
| CWP | Community Works Programme |
| EPWP | Expanded Public Works Programme |
| FFC | Financial and Fiscal Commission |
| GDP | Gross domestic product |
| IDP | Integrated Development Plan |
| IMF | International Monetary Fund |
| MISA | Municipal Infrastructure Support Agency |
| MTBPS | Medium Term Budget Policy Statement |
| MTEF | Medium Term Expenditure Framework |
| NDP | National Development Plan |
| PICC | President's Infrastructure Coordinating Committee |
| R&D | Research and Development |
| SOC | State Owned Company |
| USA | United States of America |

1. BACKGROUND

- 1.1 The submission is made in terms of Section 4 (4c) of the Money Bills Amendment Procedure and Related Matters Act (Act 9 of 2009) which requires Parliamentary Committees to consider any recommendations of the Financial and Fiscal Commission (FFC) (hereafter the Commission) when considering Money Bills. It is also made in terms of the FFC Act (1997) as amended which requires the Commission to respond to any requests for recommendations by any organ of state on any financial and fiscal matter.
- 1.2 In its submission on the 2013 Medium Term Budget Policy Statement (MTBPS), the Commission noted that Government had done a commendable job in signalling, through its fiscal policy, its intent and commitment to implementing the National Development Plan (NDP) but that the Commission would be interested to see further detail being tabled with the 2014 Budget. NDP goals around building a capable state and maximising the efficiency of public expenditure as well as fighting corruption and increasing accountability amongst public servants, are particularly pronounced in Budget 2014. The Commission welcomes the strong emphasis on entrenching fiscal discipline as evidenced by the cost-containment instructions issued by Government in January 2014. Similarly spending reviews currently underway and which aim to bring about efficiency and value for money at the provincial sphere in particular and across government in general are welcomed and should be extended to local government as well. These reviews are very consistent with the Commission's recommendations that were first tabled in 2009 and subsequently reiterated in 2013.
- 1.3 The Commission's view is that attainment of the NDP should be predicated on enhanced efficiency in the use of resources and scaling up investment in both human capital and infrastructure investment so as to enhance economic growth, employment and reduction in poverty and inequality.
- 1.4 This submission on the 2014 fiscal framework and revenue proposals is informed by the imperatives listed above and consists of six sections. The second section gives an overview of the economy and public finances. The third and fourth sections look at global and domestic developments and risks respectively. Section 5 discusses the fiscal framework and revenue proposals for 2014. Section 6 evaluates long term debt challenges while section 7 discusses developing South Africa's infrastructure. Section 8 concludes.

2. OVERVIEW OF ECONOMY AND PUBLIC FINANCES

- 2.1 It is almost six years since South Africa was first hit by the most damaging global economic and financial crisis in generations. The crisis led to prolonged and previously unforeseen fiscal deterioration that has left the country with serious challenges. The height of the crisis is now well past, but its aftermath remains pervasive, with South Africa still some way from restoring strong and sustainable economic growth rates per annum required by the NDP. These developments have directly affected the level and composition of public debt.
- 2.2 The economy was in a negative growth situation commencing in 2008, but the full effects of the international crisis played out in the domestic economy in 2009, with a negative growth rate for the year of 1.5 percent. Although financial institutions remained stable and robust over the financial crisis period, the economy was severely affected by the fall-off in exports which resulted from the recessionary conditions in major developed economies to which country is a supplier. The economy was able to recover to growth rates slightly above 3percent in 2010 and 2011, still with slow demand for its exports to developed countries. However, with the continuation of poor developed economy growth, and somewhat slower growth in large developing economies, the economy struggled to achieve growth rates much above 2 percent in 2012 and 2013. Growth for 2012 came in at 2.5 percent before slowing to 1.9percent for 2013, which had immediate consequences for tax revenue derived from corporate income tax.
- 2.3 Through this period of uncertainty, Government's countercyclical policy has protected the economy and helped drive the current modest economic recovery. Budget 2014 is formulated against the backdrop of global signs of recovery from the effects of the 2008 financial crisis. Whilst tax revenue is projected to be R1 billion higher than what was predicted when Budget 2013 was tabled, economic growth is at 2.7 percent, falling short of the 5.4percent growth rate cited by the NDP as what is needed to achieve national goals around job creation and poverty reduction. Government is pinning advances in the level of economic growth on targeted investment in transport and electricity. A relatively more aggressive approach is being taken to reduce the deficit towards the end of the 2014 Medium Term Expenditure Framework (MTEF) period. Plans in this regard are heavily

based on containing expenditure, thus bringing into sharp focus, efforts at more efficient and effective spending by government departments.

3. GLOBAL DEVELOPMENTS AND RISKS

3.1. From the Commission's perspective, Budget 2014 faces three key global risks: the euro area sovereign debt crisis, the United States of America (USA) 'fiscal cliff' and tapering in USA Federal Reserve quantitative easing; slowing Chinese/emerging markets growth. A more complex global picture has emerged over 2014, with an easing of some tail risks¹, particularly in the euro area. The International Monetary Fund (IMF) has issued forecasts that have seen an upward (instead of downward) revision of economic growth forecasts for the world for the first time in three years. Advanced economies are expected to accelerate growth to 2.2 percent and 2.3 percent in 2014 and 2015. But political and economic risks remain, for example the USA fiscal risks and further slowdowns in several major emerging markets. In addition, the possibility that the USA Federal Reserve will slow the rate of monetary policy asset purchases has triggered significant movements in global capital flows.

- a. The USA is forecast by the IMF to have growth strengthening in 2014, despite the impact of the March 2013 sequester (automatic spending cuts). The USA fiscal and economic outlook in 2014 is dependent on the progress of further budget and fiscal negotiations scheduled for later in the year. The USA Federal Reserve has also signalled that it will begin to slow the pace of asset purchases in the coming months, but the exact timing is dependent on the underlying USA economic outlook and fiscal negotiations. It should also be noted that the existing decline in quantitative easing from \$85 billion to \$75 billion has precipitated a depreciation of the exchange rate, thereby exacerbating the already concerning current account deficit.
- b. The euro area is a key market for South African exporters. In the case of the Eurozone, following negative growth in 2013, recent positive growth figures for several European countries, augurs well for the maintenance of positive growth in 2014 and 2015, albeit modest, of 1.0 percent and 1.4 percent respectively.

¹Tail risk refers to the risk of an asset or portfolio of assets moving more than 3 standard deviations from its current price or, less strictly, refers to risks at the tail end of a distribution with the least probability of occurring.

This followed an improvement in financial market conditions throughout 2013, as policy decisions such as the ongoing effect of the European Central Bank's announcement of Outright Monetary Transactions, alongside a gradual process of macroeconomic rebalancing in the key vulnerable countries, have lessened risks. Despite this improving economic outlook, activity across the euro area remains subdued.

- c. There are concerns that a slowdown in the growth of the Chinese economy and the switch towards a more consumption- rather than investment-oriented dispensation in that economy will cause the demand for commodities from emerging markets to diminish. Many of these markets have already seen their current account deficits expanding, in part due to declining export performance. Currencies of such economies have been sold off heavily, especially in the case of the so-called "fragile five" (Brazil, India, Indonesia, Turkey and South Africa), whose current account deficits are widest relative to their gross domestic product (GDP). Nonetheless, many of these emerging markets are still growing at rates more than double the pace of advanced economies. Their public debt levels remain at about half or even less of those of advanced economies, while their demographic profiles remain far more conducive to more rapid economic growth in the longer term.
- 3.2. Further to these international risks, oil prices in 2013 peaked in August at \$117 per barrel in response to instability in the Middle East. However, prices have since fallen back, and at around \$108 per barrel, the 2013 average has been slightly down compared with recent years. The pressures created by rising prices between 2009 and 2011 have largely worked through the system. Nevertheless, risks remain, and a significant commodity price shock has the potential to destabilise the South African recovery.

4. DOMESTIC DEVELOPMENTS AND RISKS

- 4.1. The key domestic risks South Africa's economy remains vulnerable to include labour unrest, inadequate education and skills base, insufficient infrastructural investment and service delivery, perceptions of rising corruption and stress on consumers to cope with increased inflationary pressures.

- a. The impact of strikes and labour-related violence continues to cause damages to economic growth. The Government should consider establishing levers that can serve to strengthen accountability of both employers and unions in the collective bargaining framework. Such an approach is particularly urgent given that the mining sector, where most of the strikes currently emanate, is also a key foreign exchange earner, which places further pressure on the current account.
- b. Growth prospects for 2014 and the medium-term will continue to be plagued by structural factors such as inadequate education and skills base. High economic growth needs to be accompanied by improvements in skills and education. South Africa faces enormous pressure to upgrade human capital skills. The country suffers from competitive disadvantage in terms of quality of its human capital, its investment in research and development (R&D), and information and communication technology penetration. South Africa will need to increase investments and quality of spending in education and bolster spending on R&D. These supply-side factors constitute most pressing key long-term challenges confronting South Africa and necessitate consideration of long-term fiscal risk. The Commission is aware that at the basic education level Government has initiated a process to enhance quality improvements whilst at the post school level, the Department of Higher Education has implemented a turnaround strategy in a bid to address the challenges described above. It is hoped that these interventions will be capable of yielding the required outcomes in terms of better and appropriately skilled and competitive human capital.
- c. Coupled with the perceived inability on the part of the State to deliver fully on implementing its own public investment programmes, the reluctance of the private sector to invest is contributing towards lower-than-anticipated capital investment and overall economic growth. This relative dearth of direct investment has been exacerbated by fears of electricity shortages in many businesses.
- d. Growth of household consumption expenditure has been slowing down markedly. The continuing fairly sharp depreciation in the value of the Rand over the last 2½ years has resulted in upward pressure on inflation, which has contributed towards both depressing consumer confidence and eroding

disposable income. The low rate of employment creation has also dampened consumer spending.

e. Recent tightening of monetary policy in the wake of quantitative easing and foreign exchange depreciation is an important domestic risk.

4.2. In summary, South Africa is faced with limited fiscal space alongside international market pressure to speed up consolidation. Limited room to push taxes up further constrains the economy.

5. FISCAL FRAMEWORKS AND REVENUE PROPOSALS

FISCAL FRAMEWORK

- 5.1. Government tabled a total national budget of R3.3 trillion over the 2014 MTEF period to be spent amongst the three spheres Government. A significant portion of this allocation is directed at national (47.6 percent) and provincial level (43.4 percent), while the local government receives 9 percent of this allocation. Most municipalities fund the majority of their spending through charges and taxes.
- 5.2. In line with the 2013 MTBPS, a total of R1.4 trillion is allocated to provinces over the 2014 MTEF period. This represents a net increase of R11.2 billion when compared to the 2013 MTEF provincial baseline allocations. Increases in the provincial allocation are mainly to fund carry through costs of higher than projected inflation on the 2012 wage agreements; construction of facilities for substance abuse; new vaccine for papillomavirus; housing acceleration; infrastructure repairs due to floods and the increased cost of provincial bus services. Taking inflation into account, a real annual average growth of 1.25 percent is projected for the provincial allocation over the 2014 MTEF period.
- 5.3. Funding to local government is targeted at the acceleration of the provision of bulk water and sanitation, promotion of more integrated and efficient cities and to build capacity for development of human settlements. Local government receives an allocation of R300 billion over the 2014 MTEF (R91.9 in 2014/15, R101.4 in 2015/16 and R106.7 in 2016/17). Increases to discretionary funding to municipalities are aimed at funding delivery of basic services to poor households whilst funds to incentivise improved spatial

planning particularly within metropolitan municipalities are being funded through conditional grants.

Table 1. Medium term expenditure framework division of revenue (R'billion)

| Division of Revenue | 2013 Budget | 2013 MTBPS | 2013 MTBPS | | | Real Annual Average Growth Rate (2014/15 - 2016/17) |
|---------------------------|----------------------|-----------------|----------------|----------------|----------------|---|
| | 2013 M/Term Estimate | 2013/14 Revised | 2014/15 | 2015/16 | 2016/17 | |
| National Allocations | 452.5 | 452.5 | 487.9 | 520.4 | 550.1 | 0.60% |
| Provincial Allocation | 414.2 | 415.8 | 444.7 | 478.2 | 507.8 | 1.25% |
| <i>Equitable Share</i> | 337.6 | 338.9 | 362.5 | 388.0 | 412.0 | 1.01% |
| <i>Conditional Grants</i> | 76.6 | 76.9 | 82.3 | 90.2 | 95.8 | 2.22% |
| Local Allocations | 84.7 | 84.8 | 91.9 | 101.4 | 106.7 | 2.09% |
| TOTAL | 951.4 | 953.1 | 1 024.5 | 1 100.0 | 1 164.6 | 1.02% |

Source: 2013 MTBPS, Commission's calculations.

5.4. For 2014/15, the budget deficit is at 4.0 percent of GDP, with government planning to reduce it to 2.8 percent of GDP by 2016/17. Government's plan at the time of the 2013 MTBPS was to reduce progressively the budget deficit from 4.2 percent of GDP in 2013/14, to 4.1 percent of GDP in 2014/15, 3.8 percent of GDP in 2015/16 and 3.0 percent of GDP in 2016/17. Budget 2014 deficit reduction forecasts particularly over the two outer years of the 2014 MTEF reflect a much more aggressive approach relative to what was projected at the time of the 2013 MTBPS.

Table 2. Budget deficit as % of GDP, 2013-2016

| | 2013 | 2014 | 2015 | 2016 |
|--------------------|-------|-------|-------|-------|
| Budget 2013 | -4.6% | -3.9% | -3.1% | |
| MTBPS 2013 | -4.2% | -4.1% | -3.8% | -3.0% |
| Budget 2014 | -4.0% | -4.0% | -3.6% | -2.8% |

Source: Budget Review (2013, 2014); MTBPS (2013).

REVENUE ESTIMATES AND TAX PROPOSALS

5.5. On aggregate, tax revenue estimates presented in Budget 2013 have been revised upward by R1 billion, thus increasing total tax revenue for 2013/14 to R899 billion. Table

3presents revisions to revenue sources by comparing the 2013 MTBPS estimates with the 2014 Budget estimates.

- 5.6. Government was able to accommodate personal tax relief to compensate for the effects of bracket creep arising in an inflationary environment. An amount of R9.25 billion was allocated for such purposes. This reduced the burden of personal income tax within overall tax revenue.
- 5.7. The increases in other forms of taxation are less in line with inflation. There have been significant upward revisions to the fuel levy since MTBPS 2013, with the fuel levy increasing by 12c per litre in 2014/15. This is in line with inflation and lower than the increase in 2013/14.

Table 3. Revenue source revisions

| R'million | 2014 Figures | | |
|----------------------------|--------------|-------------|----------|
| | 2013 MTBPS | 2014 Budget | % Change |
| Persons and Individuals | 340 574 | 335 944 | -1.4% |
| Companies | 190 490 | 198 935 | 4.4% |
| Value Added Tax | 266 930 | 267 160 | 0.1% |
| Secondary Tax on Companies | 18 750 | 19 249 | 2.7% |
| Specific Excise Duties | 30 080 | 31 079 | 3.3% |
| Fuel Levy | 44 810 | 47 516 | 6.0% |
| Customs Duties | 50 830 | 50 300 | -1.0% |

Source: MTBPS (2013); Budget Review (2014); Commission Calculations.

- 5.8. The Commission supports the establishment of the Davis Tax Committee to review the country's tax system. In this regard, the Commission did not expect major changes to the current tax structure before the Committee tables its full recommendations.
- 5.9. An interesting and welcoming trend in the 2014 Budget relative to the 2013 budget is the better performance of direct taxes, notably corporate tax. However, VAT is expected to slow down, possibly indicating lower consumption in the economy.

EXPENDITURE REDUCTION AND PRIORITISATION

- 5.10. The important question arises as to how so much from a tax point of view could be afforded in the context of relatively low economic growth. The answer is readily

discernible from the statement that real growth in expenditure is budgeted to amount to no more than two percent per annum over the next three years. To cater for increased spending pressures over the 2014 MTEF period, Government has reduced the contingency reserve allocation and reprioritised funding away from underperforming items with a specific focus on conditional grants.

5.11. Allocations in respect of the contingency reserve² are markedly lower than Budget 2013. The contingency reserve allocation is reduced by R3 billion and R4 billion in 2014/15 and 2015/16 respectively (Table 4). The space for reducing this further without creating a risk of having too low reserves should an emergency situation arise is the danger of excessive drawdowns on this resource.

Table 4. Adjustments to the contingency reserve, 2013/14-2016/17

| R'billion | 2013/14 | 2014/15 | 2015/16 | 2016/17 |
|------------------|----------------|----------------|----------------|----------------|
| Budget 2013 | 4.0 | 6.5 | 10.0 | |
| MTBPS 2013 | | 3.0 | 6.0 | 18.0 |
| Budget 2014 | | 3.0 | 6.0 | 18.0 |

Source: Budget Review (2013; 2014); MTBPS (2013).

5.12. The main budget deficit is partly offset by the cash surpluses of social security funds, public entities and provincial governments. While government is borrowing to finance revenue shortfalls, these institutions are accumulating reserves. The projected cash balances of public entities have been revised upwards. While the 2013 Budget projected deficits, these entities are now expected to run a combined surplus over the MTEF period. Government's expenditure ceiling is set at main budget level, but the cash flows of social security funds and public entities affect the consolidated deficit.

5.13. Table 5 reports changes to the 2014/15 financial year, comparing MTBPS 2013 and Budget 2014. Welcome developments include upward revisions of science and technology, economic services, education and related functions, local government, housing and community amenities and health. Prioritising expenditure on such functions indicates government's aim to promote long-term economic growth with increased investment in human capital and research and development.

²The contingency reserve refers to an amount set aside but not allocated in advance to accommodate changes to the economic environment and to meet unforeseeable spending pressures (Budget Review, 2014).

Table 5. Expenditure component revisions (functional classification)

| R'billion | 2014/15 Figures | | % Change from 2013 MTBPS to 2014 Budget |
|--|------------------------|--------------------|--|
| | 2013 MTBPS | 2014 Budget | |
| Defence, public order and safety | 163.6 | 163.6 | 0.0% |
| Economic infrastructure | 94.1 | 92.8 | -1.4% |
| Communication | 2.9 | 2.6 | -9.5% |
| Fuel and energy | 8.9 | 8.6 | -3.7% |
| Transport | 82.3 | 81.6 | -0.8% |
| Economic services | 48.7 | 50.0 | 2.7% |
| Education and related functions | 250.2 | 253.8 | 1.5% |
| Employment and social security | 60.0 | 57.3 | -4.5% |
| General public services | 65.3 | 65.1 | -0.3% |
| Health | 144.2 | 145.7 | 1.0% |
| Local government, housing and community amenities | 141.2 | 142.9 | 1.2% |
| Science and technology and environmental affairs | 18.1 | 18.7 | 3.1% |
| Social protection | 145.0 | 144.5 | -0.4% |

Source: MTBPS (2013); Budget Review (2014); Commission Calculations.

5.14. The following areas were revised downwards: economic infrastructure, employment and social security, social protection and general public services. Given the emphasis on electricity and transport as drivers of growth, downward revisions to these allocations are surprising. Expenditure in respect of social protection and employment and social security provide an important buffer for the poor, making the marked downward revision to employment and social security a concern.

5.15. While post-apartheid South Africa has witnessed many positive developments, unemployment and poverty remain serious challenges. Unemployment has been consistently very high in the last two decades. Unemployment increased from 1995, and from 1996 rates remained stubbornly above the 20% threshold. Persistently high unemployment has many negative repercussions on individuals, families, government and broader society. Not only does it place psychological and financial strains on those unable to find work and their families especially given the high dependency ratios in South Africa, it also places budgetary pressures on the national government and on provincial and local governments, as tax revenues decline and expenditures increase. In

the long term, unemployment erodes skills thereby reducing future national productivity and income³.

- a. Government has maintained focus on job creation as a key priority over the MTEF. Job creation and social security expenditure increased with 68.3 percent of this allocated for social security funds. The total social security funds include unemployment insurance fund, compensation funds and road accident fund.
- b. The budget also makes provision for other job creation initiatives such as expanded works programme (EPWP) and community work programme (CWP). Through its coordination of the EPWP, the Department of Public Works aims to create 3.7 million work opportunities by the end of 2016. In addition, it also makes provision to support the work of the Commission for Conciliation, Mediation and Arbitration in preparation for amendments to labour legislation. The EPWP Integrated Grant and the Social Sector EPWP incentive grant for provinces are the main job creation funding streams identified in the Appropriation Bill for provinces. Both grants steadily increase over the MTEF and are solely for job creation projects. Several other grants also have a job creation component, but there are also other objectives these grants have to achieve. For example, the grants under the Provincial Departments of Agricultural all aim to create jobs, but also include objectives such as training, and capacity development, technical advice, disaster relief and support.
- c. At the local sphere, CWP grant provides work opportunities for historically marginalized communities and is projected to grow over the MTEF period. The EPWP Integrated Grant for Municipalities is a conditional grant aimed at promoting greater use of labour intensive methods in delivering municipal services. On their own, the initiatives are unlikely to make a significant dent on unemployment. Part of the problem lies in the inability of municipalities to effectively spend allocated resources.

³ A critical ingredient in attaining NDP goals around poverty reduction and job creation involves fostering better partnerships between government, business and labour. Government has increased funding and incentives for special economic zones and increased support and tax relief for entrepreneurs and small businesses. Other ways in which the commitments towards the implementation of the NDP are expressed include the introduction of the Employment Tax Incentive, as well as the funding of various educational institutions and the development of educators. Finally, the government has also outlined various infrastructural investment projects as well as extracting efficiencies from public expenditure, such as fighting corruption, improving the machinery of state and increasing accountability amongst public servants for what is spent.

5.16. In terms of current payments, compensation is the largest item, accounting for just under 40 percent of consolidated non-interest spending (Table 6). Over the 2014 MTEF period this item is projected to grow marginally by a real annual average of 1 percent. Whether this subdued level of growth in compensation will be realised given that the three year wage bargaining cycle is coming to an end, remains to be seen and will be particularly important in light of Government plans to ensure moderate growth in spending over the MTEF period. Growth in transfers and subsidies is relatively higher when compared to compensation and capital payments – growth in this expenditure component is driven mainly by transfers to households in the form of social grants.

Table 6. MTEF growth in operating and capital expenditure items, 2013/14-2016/17

| R'Billion | 2013/14 | 2014/15 | 2015/16 | 2016/17 | Real Annual Average Growth 2014/15-2016/17 |
|---------------------------------|----------------|----------------|----------------|----------------|---|
| Compensation | 312.1 | 317.3 | 322.6 | 323.4 | 1.0% |
| Current transfers and subsidies | 236.9 | 248.0 | 257.9 | 258.4 | 2.1% |
| Capital payments | 59.5 | 65.9 | 68.1 | 68.6 | 2.0% |

Source: Budget Review (2014); Commission Calculations.

5.17. There is a significant slowdown in the growth of Government spending which had increased in real terms at a rate of around 9 percent per annum between 2003/04 and 2009/10. While the Commission applauds Government for the idea of setting an expenditure ceiling that has proven effective in controlling expenditure and maintaining stability for following periods, going forward Government should give guidelines on scope of the ceilings (e.g., will they apply to all expenditures or will there be exceptions and basis for that), setting of the precise level of the ceiling and assessment of whole of Government's performance against the ceiling and progressive realisation of constitutional mandates. Importantly, while expenditure ceilings have been guided by issuance of circulars and practice notes, the approach will need to be put in legislation such as the PFMA in order to avoid confusion between the output and outcomes based PFMA and the input controlling thrust of expenditure ceilings.

6. LONGER TERM DEBT CHALLENGE

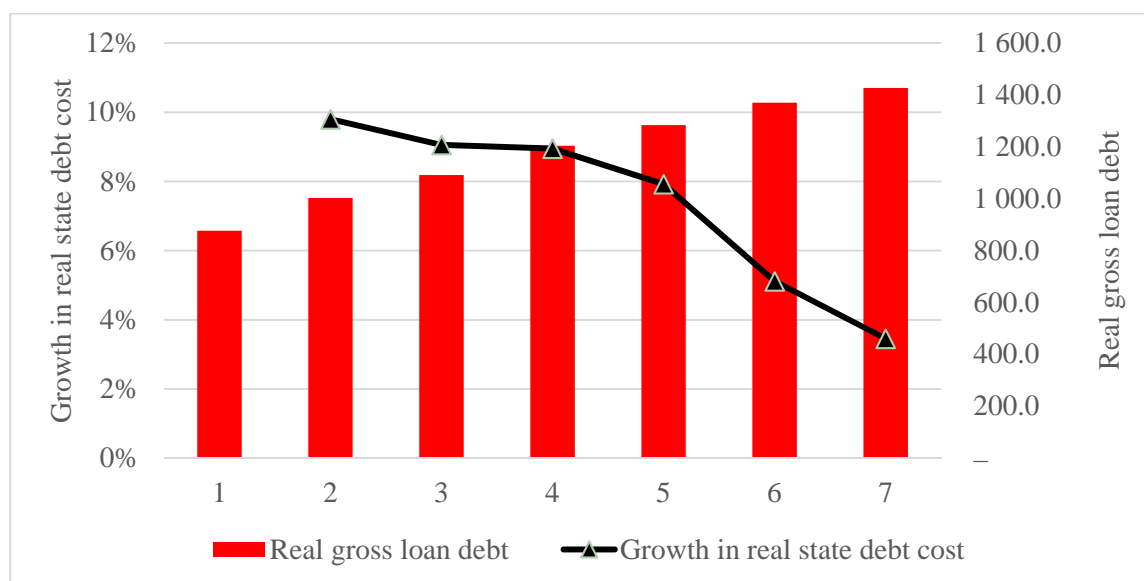
- 6.1. In recent years, South Africa's debt has increased considerably. Prior to the global economic crisis policy succeeded in the sense that the public debt to GDP ratio fell enormously from close to 50 percent of GDP at the time of the arrival of democracy in 1994 down to 45 percent from 1995. Measures from 1996 had the result of forestalling further increases in the debt level, but it was not until the year 2000 that measures were sufficient to gradually reduce the debt level as a percentage of GDP. The surpluses and low deficits thereafter were able to bring the debt level materially down to reach a low of less than 24 percent in 2008. From there, the percentage to GDP inevitably increased as deficits were incurred in light of the international crisis and local economic consequences. The debt level exceeded 36 percent of GDP in 2012 and will continue to increase over the next few years as deficits continue, though the increase is moderate. Thus, some fiscal adjustment becomes compelling in order to stabilize the debt dynamics.
- 6.2. The total balance of government debt in relation to the domestic bond market is high, and government bonds are a major determinant of the characteristics of the local bond market. The value of new government bonds being raised in the domestic market has increased significantly over time, and is markedly higher currently than it was during the decade 1990 to 2000. The proportion of foreign debt, foreign bonds in particular, has been far higher in recent years than it was in 1995 to 1998, during which it comprised only around 5 percent of total government debt. It has expanded by a multiple of 8.6 times in rand value since then. These characteristics already give an indication of a need for careful consideration to be given to the extent and manner of raising new public debt.
- 6.3. Figure 1 shows that real gross debt is increasing over the medium term and also that growth in real state debt costs, while still increasing, is slowing. Increasing debt levels coupled with slowing growth in debt costs reflects Government's continued debt restructuring efforts through the switch programme⁴, which was announced during the 2012 Budget.
- 6.4. The Commission noted in its response to the 2012 MTBPS that while the switch programme reduces the current debt burden and limits the consolidation measures that are imposed on South African citizens (which is necessary in order for government to

⁴ Switch programme entails the exchange of near-maturing bonds for longer dated debt in order for the Government to manage redemptions.

have the necessary resources to stimulate the economy and maintain the social net), sluggish economic growth may put pressure on Government to extend its switching programme. Refinancing near-dated debt with longer term maturity bonds is likely to put pressure on bond yields as investors will likely seek to be compensated for increased risks associated with deteriorating economic conditions and a wide budget deficit. Hence, although South African bonds are currently still over-subscribed, extending the duration of public debt combined with higher yields could result in increased costs for Government in the future. Further downgrading of South Africa's sovereign credit rating will further exacerbate the situation in that it may also negatively affect the longer-term prospects of debt sustainability in South Africa as it is likely to result in higher costs of borrowing due to negative investor perception. This will not only affect the national fiscus but also metropolitan municipalities which have accessed the capital markets in recent years as well as State Owned Companies (SOCs) which increasingly borrow on the strength of their balance sheets in order to fund infrastructure-led growth strategy.

- 6.5. As positive as the reduction of the principal consolidated government budget deficit might be, the overall public sector borrowing requirement is still set to increase sharply. This is because the borrowing requirement for SOCs has been increased markedly compared with the 2013 Budget. For 2013/14, this borrowing requirement for state-owned enterprises has been raised by R20.8 billion, to R78.7 billion, for 2014/15 it has been raised by a further R25.2 billion, to R68.8 billion and for 2015/16 it has been increased even further, by R36.7 billion, to R82.7 billion. This makes for a cumulative increase in the SOCs borrowing requirement, of 82.7 billion. This might be interpreted negatively both by the ratings agencies and by the domestic bond market.

Figure 1: Gross Loan Debt and Growth in Real State Debt Cost



Source: Budget Review (2014); Commission Calculations.

6.6. High levels of public debt risk undermining growth and economic stability because (1) high levels of debt damage growth through a number of channels, including by increasing levels of taxation, by crowding-out private investment and by increasing uncertainty, (2) high levels of public debt limit the scope to absorb the impact of future economic shocks and (3) high debt interest payments crowd out spending on public services. The interest payable on government debt is already a significant item in government annual expenditure, estimated at R100billion for the current fiscal year. This is close to 10percent of government expenditure. This is in an environment of exceptionally low interest rates, with the Reserve Bank just coming out of a policy regime of low rates in view of tardy economic growth and the slow recovery in major economies from the financial crises of recent years. If the Reserve Bank feels compelled to continue increasing interest rates significantly, which could easily occur given continuing quantitative easing tapering intent following upbeat USA growth expectations, the effect on the ability of government to effect other desired expenditure could be compromised. For instance, if the policy interest rate were increased successively to reach 10 percent, the likely long bond rate could then move to 13 percent, and the annual commitment to debt servicing costs would increase by 50percent on account of the interest rate change alone. This could take the figure to around R150billion under that situation, with a R50billion annual constraint on other expenditure. In addition, placing pressure on the domestic bond market in raising new government debt could increase the spread of long

bonds relative to short term financing, which would place further strain on long term debt financing. The situation could easily be worsened further if the actions and policies of government are such as to cause some doubt on its ability to meet repayment terms of its bond financing. This would increase the risk portion of bond interest rates, as well as making it more difficult to raise new bonds to the full extent sought. With an ambitious set of goals under the NDP, circumstances could thereby arise whereby it becomes difficult or impossible to meet the financing requirements to enable the plan to be translated into reality. The financial pressures recently experienced by the country have brought to light the need for an analysis of debt sustainability accompanied by an appropriate management of the debt in the more difficult external and domestic environment faced by the country.

- 6.7. South Africa therefore faces a long-term challenge in reducing debt levels. Ongoing work at the Commission shows an illustrative scenario for debt reduction from 2019-20 onwards. A two percent deficit is broadly in line with the average deficit over the five years before the financial crisis and would be consistent with meeting the fiscal tenets of the NDP. It would leave debt at an elevated level through to 2035 and beyond creating significant economic vulnerabilities. If sustained, running a small surplus would lead to a significant improvement in the path of debt over the longer term.

7. DEVELOPING SOUTH AFRICA'S INFRASTRUCTURE

- 7.1. Infrastructure is the backbone of the economy, vital to growth and generating jobs now and in the future. The government is committed to providing the infrastructure necessary to address a legacy of historical under-investment and for South Africa to be competitive. At February 2014 budget, the Government set out a long-term programme of capital investment, committing to publicly fund a pipeline of specific projects worth over R847 billion over the next MTEF, including for transport, science, housing and flood defence. The National Infrastructure Plan 2013 provides more detail on the projects.
- 7.2. Table 7 indicates that much of the investment in infrastructure takes place within municipalities and is channeled to the local sphere through conditional grant funding. There is particular emphasis on water (through the newly created Municipal Water

Infrastructure Grant) and electricity (through the Integrated National Electrification Programme).

Table 7. Public sector infrastructure expenditure by sector - February 2014

| | R Billions | | % of Total | |
|--|---------------------|---------------------|---------------------|---------------------|
| | 2013/14- 2016/17 | 2014/15- 2016/17 | 2013/14- 2016/17 | 2014/15- 2016/17 |
| Energy | 268.90 | 188.30 | 24.45% | 22.22% |
| Water and sanitation | 144.30 | 111.90 | 13.12% | 13.21% |
| Transport and logistics | 425.70 | 347.10 | 38.70% | 40.97% |
| Other economic services | 55.10 | 42.20 | 5.01% | 4.98% |
| Health | 43.20 | 33.40 | 3.93% | 3.94% |
| Education | 53.20 | 41.00 | 4.84% | 4.84% |
| Other social services | 55.30 | 41.40 | 5.03% | 4.89% |
| Justice and protection services | 21.30 | 16.40 | 1.94% | 1.94% |
| Central government services | 32.90 | 25.60 | 2.99% | 3.02% |
| Total | 1099.90 | 847.30 | 100.00% | 100.00% |
| National departments | 56.40 | 45.10 | 5.13% | 5.32% |
| Provincial departments | 176.60 | 134.80 | 16.06% | 15.91% |
| Local government | 238.80 | 183.60 | 21.71% | 21.67% |
| Public entities | 86.00 | 69.60 | 7.82% | 8.21% |
| Public private partnerships | 12.90 | 9.90 | 1.17% | 1.17% |
| Public enterprises | 529.20 | 404.40 | 48.11% | 47.72% |
| Total | 1099.90 | 847.40 | 100.00% | 100.00% |

Source: Budget Review (2014); Commission Calculations.

7.3. Historically, municipalities have not been able to spend infrastructure budgets effectively. Performance has been characterized by delays, poor planning, lack of project management capacity and poor oversight on the part of provincial and national government. If planned investment is to foster stronger economic growth, these challenges will need to be overcome. Existing capacity building initiatives such as the Infrastructure Skills Development Grant and the recently established Municipal Infrastructure Support Agency reflect attempts to address these long-standing issues.

Given that these two interventions are relatively new, it would be premature to judge their performance at this early stage.

- 7.4. A general concern with Government's infrastructure investment plan, particular in the core areas of electricity and transport, is around the capacity of the entities that deliver such infrastructure. State Owned Companies and municipalities roll out electricity and transport infrastructure. There continues to be financial and capacity challenges within certain State Owned Companies and municipalities in general, bringing into question the ability to support the infrastructure investment plans.
- 7.5. The Commission would like to emphasise that alongside investment in new infrastructure, there is a pressing need to maintain and renew existing infrastructure adequately. Research conducted as part of the Commission's Submission for the 2014/15 Division of Revenue indicates that municipalities underfund and underspend on maintenance and renewals, thus putting at risk the potential benefits that could be reaped as a result of Government's large investment in infrastructure.
- 7.6. Infrastructure Development Bill: In 2013, Government introduced the Infrastructure Development Bill and subsequently passed it in 2014. Its intentions are to speed up and improve the delivery and implementation of social and economic infrastructure and to maximise the developmental impact through provisions that deal with structures, timeframes, processes and outcomes. The Bill provides a legal mandate of the Presidential Infrastructure Coordination Committee (PICC)⁵ established by Cabinet in 2011. Given that this legislation will have IGFR-wide implications for all three spheres, the Commission is in the process of reviewing the Bill. Key issues being evaluated include the interface between what the Bill is proposing and existing municipal planning processes in particular integrated development plans (IDPs) which set out the development vision for a municipality in terms of infrastructure investment and planning as well as the newly introduced built environment performance plans (BEPPs) for cities.

⁵The PICC is chaired by the President, with the Deputy President as deputy chairperson. In addition membership is composed of ministers, premiers and metropolitan municipality mayors as well as the chairperson of the South African Local Government Association (SALGA)

8. CONCLUSION

- 8.1. Budget 2014 places strong emphasis on resource allocations in relation to the implementation of the NDP. The Commission welcomes these ongoing efforts to attain the targets set in the NDP. On the whole, the budget is very much in line with the Commission's expectations expressed when it made its submission on the 2013 MTBPS. Government has succeeded in pursuing fiscal discipline whilst balancing priorities and investment in constitutionally mandated basic services like education, health and water.
- 8.2. Despite the positive outcomes for the state of fiscal finances at present and the downward revision of budget deficits for the next three years incorporated into the 2014 Budget, ratings agencies still remain cautious with regard to confidence that the South African government will indeed succeed in achieving its deficit reduction programme. To address the perceived risk, Government needs to ensure that the 2.7 percent and 3.2 percent economic growth rates used in the budgetary parameters in the 2014 Budget for domestic economic growth translate to reality. The Commission's view is that there is a significant likelihood that economic growth will improve, albeit moderately, in the next two years, on the back of improved global economic growth and increased exports arising from the enhanced competitiveness of South African production as a result of the steep depreciation of the Rand's exchange rate in recent years.
- 8.3. It is essential for Government to ensure that the rising trend of public debt to GDP is staved off. The public debt to GDP has already risen from a low point of 22 percent in 2007, to close on 40 percent of GDP at present, and is projected to peak at a level of 45 percent of GDP in two years' time. The deficit reduction programme incorporated into the latest budget has to be achieved to prevent the rising trend of the public debt.
- 8.4. The Commission welcomes Government efforts at setting an expenditure ceiling. Government should give guidelines on scope of the ceilings as well as an assessment of whole of Government's performance against the ceiling and progressive realisation of constitutional mandates. While expenditure ceilings have been guided by issuance of circulars and practice notes, the approach will need to be put in legislation such as the PFMA in order to avoid confusion between the output and outcomes based PFMA and the input controlling thrust of expenditure ceilings.

For and on behalf of the Financial and Fiscal Commission



Mr Bongani Khumalo
Acting Chairperson/CE
4 March 2014