



# Financial and Fiscal Commission

## Submission on the 2018 Medium Term Budget Policy Statement

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*For an Equitable Sharing of National Revenue*

29 October 2018

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

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**List of Acronyms**

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CHW	Community Health Worker
CPI	Consumer Price Index
FFC	Financial and Fiscal Commission
GDP	Gross Domestic Product
LGES	Local Government Equitable Share
MTBPS	Medium Term Budget Policy Statement
MTEF	Medium Term Expenditure Framework
MTSF	Medium Term Strategic Framework
NDP	National Development Plan
PES	Provincial Equitable Share
HET	Higher Education and Training
SOC	State Owned Company
VAT	Value Added Tax

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## EXECUTIVE SUMMARY

It is evident that the 2018 Medium Term Budget Policy Statement (MTBPS) was formulated in an economic environment characterised, inter alia, by extremely low growth, escalating public debt, and low levels of investment. The ability of government to address the key socio-economic challenges – unemployment, poverty, and inequality – was severely compromised furthermore by weak governance during most of the past decade, reflected, amongst other things, in public and private sector corruption, the failure of state-owned entities to deliver on their development mandate, and the rapid decline of the South African Revenue Services (SARS) from its pinnacle of efficiency and effectiveness in the twenty year period between 1999 and 2009 to a situation where it is clearly failing badly on its revenue collection mandate.

Given this scenario, the government's short-term prognosis is understandably pessimistic in terms of its growth projections, and hence its ability to generate sufficient levels of revenue both to meet growing expenditure needs and pay off debt at a more rapid rate than it has been able to do so up to the present time.

It is against this background that this Submission on the 2017 MTBPS is made by the Financial and Fiscal Commission in terms of section 4 (4c) of the Money Bills Amendment Procedure and Related Matters Act (2009). The Submission is also made in terms of part 1, section (3) (1) of the Financial and Fiscal Commission Act (2003) as amended. This provides for the Commission to act as a consultative body for, and to make recommendations to, organs of state in the national, provincial and local spheres of government on financial and fiscal matters.

### **Economic and Public Finance Overview**

In the 2018 Budget tabled in February, government efforts to combat corruption, implement outstanding policy reforms and address systematic governance failures at state-owned entities were highlighted as an opportunity to restore confidence and revive economic growth. With this expectation, the 2018 Budget projected that gross domestic product (GDP) will grow by 1.5% in 2018, eventually rising to 1.8% in the 2019/20 fiscal year. However, South Africa's growth forecast has now been revised downwards, in 2018 and 2019 to between 0.1 – 0.8%, thus significantly lower than what was envisaged in the 2018 Budget announcement. These growth predictions do not augur well for government's efforts to reduce poverty, unemployment and inequality.

The 2018 Budget managed to thrust South Africa to a more sustainable path. However, the deteriorating economic performance and revenue shortfalls have resulted in some slippage in fiscal projections. The risks identified in the 2018 Budget such as a public service wage agreement significantly above the inflation rate, and the continued decline in the financial condition of some state-owned entities have materialised. The consolidated budget deficit is estimated at 4% in 2018/19, compared with the 2018/19 Budget projection of 3.6% of GDP. It accelerates to 4.2% in 2019/20 and 2020/21 before stabilising at 4% in 2021/22. The 2018/19 main budget deficit is estimated to widen to 4.3% of GDP compared with the 2018 Budget estimate of 3.8%, mainly as a result of tax revenue shortfalls. The primary deficit will now



narrow from 0.7% in 2018/19 to 0.6% in 2019/20 and 0.5% in 2020/21 compared to the narrowing of the primary deficit to 0.2% in 2018/19, 0.1% in 2019/20, and 0% by 2020/21 announced in the 2018/19 Budget.

The higher projected GDP in the 2018 budget was expected to reduce both the fiscal deficit and public debt as a percentage of GDP. However, the slump in growth in the first half of 2018 has put such optimism in jeopardy. The 2018 Budget presented a stronger fiscal position when compared to the 2017 MTBPS. This was further validated by the retaining of South Africa's creditworthiness above the sub-investment grade by Moody's and the movement of the rating outlook to stable. However, the 2018 MTBPS announced a fiscal slippage since the 2018 Budget. Tax revenues have been revised downwards, partly due to higher value-added tax refunds even though the expenditure ceiling remains intact to anchor fiscal policy.

Public debt as a share of GDP has increased twofold in the last ten years driven primarily by higher primary expenditure coupled with higher interest payment levels during periods of sluggish growth. The fiscal deficit has thus widened significantly, and public debt has ballooned from 27% of GDP in 2007/08 to 53% in 2017/18. High public debt and public gross financing needs have translated into expenditure inflexibilities and reduced the capacity of public finances to respond to temporary shocks.

The upside risk to the forecasts announced in the 2018 MTBPS is that there appears to be a political consensus to address structural bottlenecks that could boost growth beyond 2%. Downside risks emanate from domestic and external sources. Domestically, renewed spending pressures such as funding for higher education, public sector wages, and materialization of state owned company (SOC) contingent liabilities could result in the deterioration of public finances thus triggering further rating downgrades and an upsurge in financing costs. Continued policy uncertainty could reduce capital inflows, investment, and growth.

The proposed 2019 medium-term estimates are presented in the context of a depressed macroeconomic outlook with weaker growth and revenue projected alongside high debt service costs. Government's commitment to fiscal consolidation as a means to stabilise debt and narrow the deficit sets the tone for the 2019 medium term estimates. In order to fund continued rollout and improvements in critical areas of service delivery whilst simultaneously trying to kick-start growth in the economy, government is relying on a four pronged approach namely: (1) maintaining the expenditure ceiling: (2) maintaining national government's personnel expenditure ceiling: (3) reprioritising spending towards the roll-out of the President's economic stimulus package (especially infrastructure investment): and (4) rebuilding state institutions.

## **Recommendations**

### **The Political Transition**

1. The recent political transition led by the Ramaphosa Presidency has ushered in renewed prospects for reforms aimed at exploiting the full potential of the economy. The new administration has announced measures aimed at boosting business and consumer confidence, including changes to the management and boards of strategic SOCs to address poor governance, weak balance sheets and liquidity challenges; a judicial inquiry into state capture, signing renewable energy contracts with independent power producers, and a wide ranging economic stimulus package. The Commission welcomes these measures which should receive implementation traction in government with haste.

### **Economic Challenges**

2. With respect to the economic challenges facing the country, the Commission recommends addressing structural bottlenecks in order to boost growth. Structural reforms should focus on accelerating private investment, invigorating product market competition (particularly in network industries such as telecommunications, energy, logistics and water), correcting skills mismatches, and confronting and tackling corruption. There is a need to build on comparative advantages to develop new domestic and international markets through higher productivity and innovation instead of depending on higher commodity prices. Clarifying the framework governing the proposed “land expropriation without compensation” to prevent uncertainty by focusing it on intensifying agricultural productivity, enhancing land administration and reinforcing security of tenure is also critical.
3. The Commission also reiterates the need to build fiscal space through conservative debt levels and managing downward expenditure diversion to debt service costs, reducing the wage bill through natural attrition coupled with a review of government’s functional organisation and abandoning the strict linking of wage increases to the consumer price index, deepening the fight against corruption, assessing the recent increases in the scope of service delivery priorities, addressing governance issues and rethinking the business models of state-owned entities.
4. In its submission to the 2017 MTBPS the Commission lamented the persistent inability of government to achieve MTBPS economic growth targets and emphasised the need for government to lay a solid foundation for future growth during the downturn, through a comprehensive review of budget programmes aimed at promoting growth. The latter point is especially pertinent in that smaller economies, the size of South Africa, lack the fiscal levers similar to bigger developed economies, which can tap into the reserves or access capital markets for additional funding to boost aggregate demand. It was especially evident in the 2018/19 budget that government was unable to reverse output declines, through increased borrowing, as there are growing fears of sovereign credit risk. Government must manage the debt portfolio in order to minimise debt service costs and sovereign credit risk.



5. It is not apparent that the current stimulus package was underpinned by the earlier programme review envisaged by the Commission. Stimulus interventions that are superimposed on a structurally deficient economy will yield less than desirable results. Essentially, there are two fundamental tenets of a stimulus package from a fiscal policy perspective that is, lowering taxes and increasing spending. Counterintuitively, the current fiscal policy trajectory has been one of contraction, with the recent increase in Value Added Tax (VAT) and the ongoing budget consolidation programme.

### **Enhancing Efficiency in the Public Sector**

6. The Commission advises that in order to ensure real productivity within the public sector, value for money must be sought more resolutely, for example, by costing institutional outputs and assessing performance and then comparing them, being mindful to innovate for constant improvement.

### **The Provincial Wage Bill**

7. With regard to provinces, it is evident that that over half of their budgets are dedicated to personnel. A key risk to the provincial government fiscal framework is the higher than anticipated wage agreements for which additional funding will not be received. The Commission is of the view that provinces will have to carefully manage this pressure and practise financial prudence to ensure that wage pressures do not divert resources away from key health and education inputs

### **Local Government**

8. The 2019 MTBPS was tabled against a backdrop of many challenges facing the local government sector. A significant proportion of municipalities are distressed and dysfunctional. In fact, the fiscal health of a majority of municipalities has deteriorated over the past few years. The Commission notes that a thorough and comprehensive rethink of the local government fiscal framework is necessary, including the governance and institutional regimes in the sector. As the municipalities are the face of government in communities, it is important to underscore the point that they should not compromise on service delivery, and the division of revenue needs to respond to this call.
9. The Commission notes the subdued growth in allocations to the Local Government sphere in 2019 MTEF. In a fiscally constrained environment, where resources available for sharing are progressively diminishing, it is imperative that the efficiency problem in the local government is eliminated. Section 195(1) (b) of the Constitution implores all organs of state to use resources efficiently and effectively. Essentially, the production and delivery of public services within the government should be provided at the minimum opportunity cost, and cases of unproductive, wasteful, irregular or fruitless expenditure, duplication and wastage in procurement processes, among others, should be eradicated.

10. At the same time, the Commission welcomes efforts to improve capacity within municipalities such as the recent deployment by CoGTA of a critical mass of experts to assist municipalities improve their performance and operational efficiencies. In the past 5 years, government has invested an average of R2 billion a year on improving capacity through various grants to municipalities, training and skills development programmes as well as the deployment of experts. Over the 2019 MTEF, government will invest a further R9 billion on local government capacity development initiatives. The returns to such investment in the past have been poor as many municipalities continue to perform dismally. There is therefore an urgent need for a thorough review of government capacity initiatives within the local government space.
11. The Commission would encourage government to reconsider the rate of growth of the LGES in outer years so that poor households are cushioned against the rising cost of free basic services. The Commission is of the view that while there is a need to ensure that the functions of local government are equitably funded from nationally raised revenues, municipalities should also efficiently utilise the available resources and where possible, optimise their existing own revenue bases.
12. In line with previous FFC recommendations against the proliferation of grants, it is envisaged that some of the grants will be consolidated over the 2019 MTEF. The Commission notes the envisaged increase in the amount of funds allocated to municipalities in the form of conditional grants, and welcomes the increasing consolidation of such grants, as it will improve efficiency in their administration and promotes integrated planning and service delivery.

### **Roll-Overs**

13. The Commission notes the reported roll-overs for this financial year amount to R258 million compared to the year 2017/18 where there were no proposed (national) roll-overs for either the direct or indirect provincial conditional grants. The Commission would like to re-iterate the importance of the use of roll overs as per the Treasury Regulations section 6.4, which restricts roll-overs to among others; unspent funds on payments for capital assets which may only be rolled over to finalise projects or the acquisition of assets already in progress. The Commission would like to highlight the importance of using roll overs as per legislation to avoid wasteful and fruitless expenditure.

### **Infrastructure**

14. The Commission reiterates its concerns regarding the structural impediments in the bidding process of provincial infrastructure programmes that were made in its Submission on the 2018/19 Division of Revenue. It is also recommended that the government take heed of the Commission's recommendations on State-owned companies and Rural Development in the 2017/18 Submission on the Division of



Revenue. The issue of infrastructure inefficiency no longer stops at the speed or the proportion of the conditional grant and indirect grant spending. The issue lies with what infrastructure spending delivers in terms of goods and services as real returns.

15. Conditional grants to local government are primarily used to fund development of bulk infrastructure that underpin the delivery of water, sanitation, electricity. Allocations in this regard are projected to decline by a real annual average of 1.1% over the next three years. The most significant reduction in local government conditional grants is in 2019 with a projected 8% real decline. In the context of Budget 2018 where broad ranging cuts that disproportionately affected infrastructure conditional grants were announced, this trend is not surprising. However, given the general sentiment and thrust of MTBPS 2018 which is heavily focussed on infrastructure development, this particular trend is inconsistent. In addition, the Commission notes the introduction of one new local government conditional grant (the integrated urban development grant) that is targeted at intermediate cities and which aims to inject some flexibility into the way in which these municipalities infrastructure development.
16. The Commission notes the utilisation of earmarking or ring-fencing of pockets of funding within existing conditional grants (specifically the Human Settlements Development Grant and the Urban Settlements Development Grant) so as to fund particular priorities. As noted in the Commission's Submission on the 2018 Division of Revenue, whilst the principle of earmarking is not entirely intolerable, it is of greater concern that government continuously seeks to address subnational delivery deficiencies through tighter expenditure discretion. Earmarking funding within a conditional grant creates excessive rigidity and curtails the ability of subnational governments to adjust their allocations in accordance with their specific circumstances. Research carried out as part of the Commission's Submission for the 2019/20 Division of Revenue confirms that earmarked conditional grants do not ensure better spending or delivery<sup>1</sup>.
17. The Commission welcomes efforts to publish expenditure reports of existing infrastructure projects to enhance accountability and transparency. This will minimise projects cost overruns and ensure timely completion of the projects. In addition to publishing expenditure records, government needs to invest in an infrastructure delivery inspectorate to ensure that projects are delivered in accordance with the required standards and quality.

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<sup>1</sup> For further information see Chapter 2 of the FFC's Submission for the Division of Revenue 2019/20 entitled: Recentralisation – Implications for Service Delivery and Intergovernmental Fiscal Relations.

18. The 2018 MTBPS further proposes establishment of an infrastructure fund that will comprise contributions from government, the private sector and development finance institutions (DFIs). While the operational details of the fund are being designed, government needs to consider the intergovernmental fiscal arrangements and ensure balance in the allocation of resources across the three spheres of government.
19. It is the view of the Commission that allocating funds and observing its spending trends alone will not yield the desired results of efficiency and impact. Government should take a new approach of “costing” its functions and performance with empirical data, to ensure the real productivity of the public sector. Related to this, greater efforts should be made on the part of government at all levels to develop a more effective public sector monitoring and evaluation framework to ensure public sector productivity and proper costing when deciding on budget allocations and timelines.

### **State-Owned Companies**

20. The poor financial health of the SOCs remains the biggest fiscal risk to economic recovery and the overall budget balance. Many SOCs remain in dire fiscal distress, are highly indebted and unable to meet both their financial and delivery obligations. The failure of these enterprises would spell disaster for the economy at large, given their heavy reliance on state guarantees and grants for recapitalisation and operational capital. The Commission has, on numerous occasions, cautioned against the long-term risks of contingent liabilities for the national budget and overall macro-economic balance. Without a stable and credible macro-economic climate, the proposed stimulus and recovery plan will not yield desirable results.
21. The Commission notes with concern that there has not been any action towards implementing previous budget statements regarding the proposal to either privatise SOCs or dispose equity stakes to private partners. The paucity of action in implementing such proposals undermines the credibility of the budget statement. Government should have a clearly set out framework outlining, tasks, processes and timelines towards diversifying the capital structure of SOCs. Most importantly, there should be a concerted effort to improve the balance sheet of SOCs and government's equity, prior to embarking on equity sales.
22. The selling of SOC equity stakes should not be carried out indiscriminately but instead it should consider government's delivery and developmental obligations. There is a compelling “public good” argument for government to maintain effective and continued control of entities responsible for providing basic and transport services. The restructuring agenda within these entities should focus on addressing the mismanagement maladies and strengthening accountability structures. The Commission thus reiterates the need for government to set uniform rules and procedures



for guarantees and bailouts taking into account the public value of services provided by the SOC, historical financial and non-financial performance and adherence to guarantee/bailout conditions.

### **Higher Education and Training**

23. In the higher education and training (HET) sector, in order to ensure optimal utilisation of the additional resources allocated to HET, the Commission recommends that the government should develop a much clearer plan for implementing the comprehensive fee-free higher education policy both to address uncertainty in the institutions of higher learning and to ensure efficient and effective utilisation of these resources.
24. While implementation of fee-free higher education and training is to be welcomed as it is expected to increase access for students from poor households, government needs to implement measures to improve the quality of outputs and outcomes at all levels of the education system. In HET this is particularly urgent in the rural universities and the Technical Vocational Education and Training (TVET) colleges.

## **1. INTRODUCTION**

It is evident that the 2018 Medium Term Budget Policy Statement (MTBPS) was formulated in an economic environment characterised, inter alia, by extremely low growth, escalating public debt, and low levels of investment. The ability of government to address the key socio-economic challenges – unemployment, poverty, and inequality- was severely compromised by weak governance during most of the past decade, reflected, amongst other things, in public and private sector corruption, the failure of SOCs to deliver on their development mandate, and the

rapid decline of the South African Revenue Services (SARS) from its pinnacle of efficiency and effectiveness in the twenty year period between 1999 and 2009 to a situation where it is clearly failing badly on its revenue collection mandate.

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It is against this background that this Submission on the 2017 MTBPS is made by the Financial and Fiscal Commission (hereafter the Commission or FFC) in terms of section 4 (4c) of the Money Bills Amendment Procedure and Related Matters Act (2009). The Submission is also made in terms of part 1, section (3) (1) of the Financial and Fiscal Commission Act (2003) as amended. This legislation provides for the Commission to make recommendations to organs of state in the national, provincial and local spheres of government on financial and fiscal matters.

Section 2 examines the economic outlook of South Africa (focusing particularly on growth and employment) and provides an overview of its public finances. Section 3 provides an overview of the fiscal framework through an analysis of revenue and expenditure over the 2019 Medium Term Expenditure Framework (MTEF) period and also specifically in comparison with the 2017 MTBPS. This section also analyses the trends in the division of revenue between the three spheres of government for the period 2015/16 to 2021/22.

Section 4 provides an analysis of "special" issues that is, those not necessarily directly related to the proposal announcements, but regarded by the Commission as being of critical importance to achieving the country's socio-economic objectives. These issues are the recently announced Stimulus Package, the challenges associated with State-Owned Companies, and Higher Education and Training. Section 5 reviews actual spending undertaken by national and provincial government between 1 April and 30 September 2018. Section 6 provides a breakdown of local government finances over the 2019 MTEF while Section 7 refers briefly to the revised Division of Revenue. Section 8 concludes with a set of recommendations.

## **2. ECONOMIC OUTLOOK AND OVERVIEW OF PUBLIC FINANCES**

### **2.1. Economic Overview: Growth and Employment**

2.1.1. Since mid-2016, the global economy has entered a period of steady expansion that has ensured relatively sustained recovery in growth. On the back of this positive momentum, global economic growth is projected to remain steady at 3.7% in 2018 and 2019, respectively. Despite the global upswing, economic growth continues to disappoint in South Africa. In the 2018 Budget tabled in February, government efforts

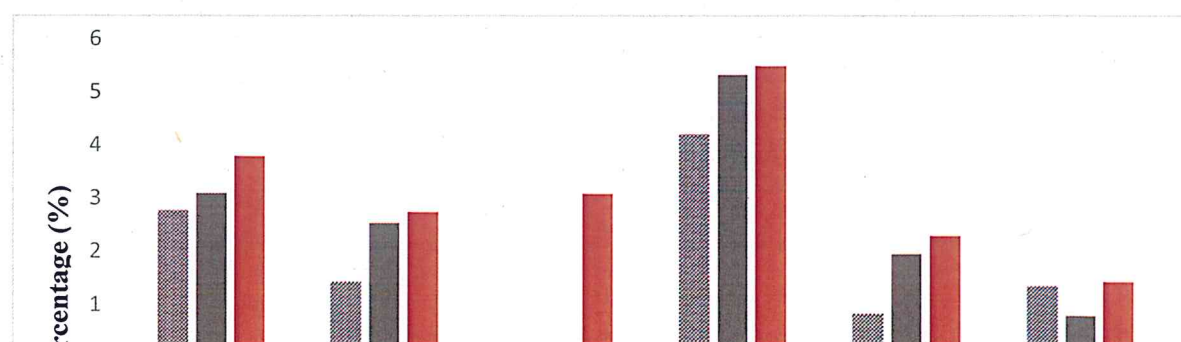


to combat corruption, implement outstanding policy reforms and address systematic governance failures at SOCs were highlighted as an opportunity to restore confidence and revive economic growth. With this expectation, the 2018 Budget projected that gross domestic product (GDP) will grow by 1.5% in 2018, eventually rising to 1.8% in the 2019/20 fiscal year. In line with recent assessments of the global economic outlook, South Africa's growth forecast has now been revised downwards, in 2018 and 2019 to between 0.1 – 0.8%, thus significantly lower than what was envisaged in the 2018 Budget announcement.

2.1.2. In 2011, the Commission's GDP simulation models predicated that under a severe scenario of protracted slow global growth that results in a sustained period of constrained public budgets, South Africa's GDP will not recover to its pre-2008 levels without shocks and deliberate interventions to counteract the negative impact of the world economic crisis. The country's subsequent economic underperformance continues to mirror the Commission's simulation results under the "severe scenario" and constraints imposed by domestic factors.

2.1.2.1. Renewed investment spending has contributed to positive growth prospects in many of the world's advanced economies, while the combined effects of increased domestic consumption and higher oil prices have lifted growth in emerging market and oil-exporting countries in Asia, the Middle East and sub-Saharan Africa. Figure 1 shows that South Africa's growth continues to underperform against the African continent's other large economies where better global economic conditions, and the recovery in oil and metal prices as well as improved agricultural production have combined to boost previously tepid growth.

**Figure 1: Real GDP per capita growth in South Africa and Africa's Largest Economies, 2017-2019**



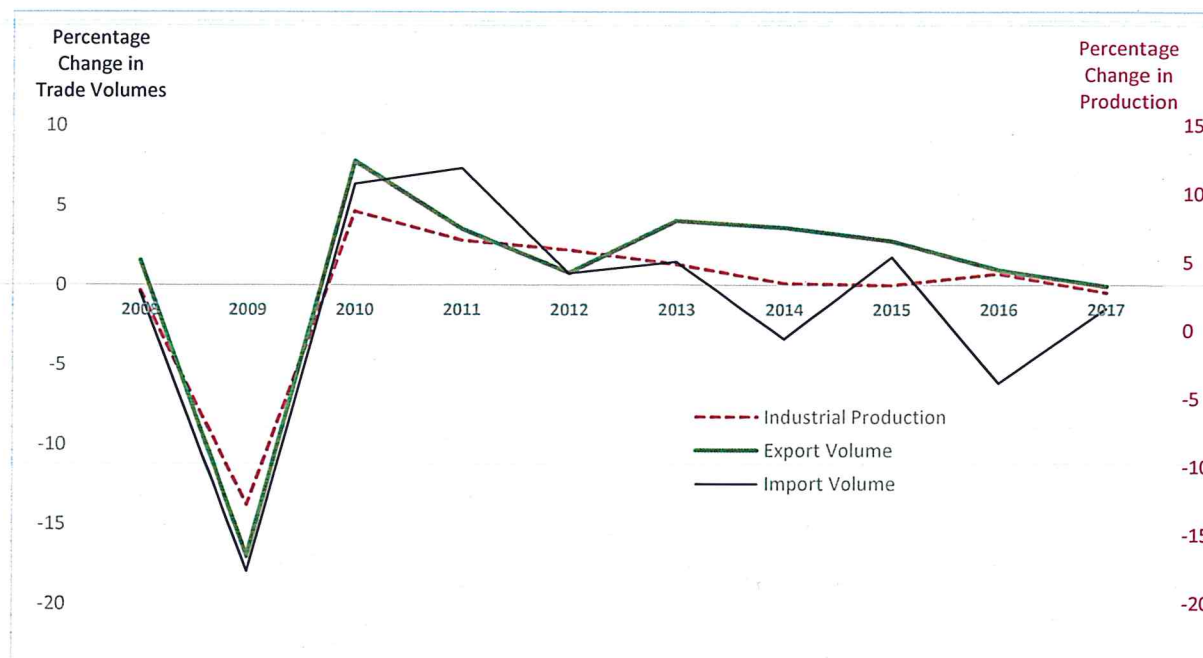


*Source: International Monetary Fund (IMF) World Economic Outlook Database*

- 2.1.2.2. Higher growth is predicted in South Africa for the 2020/21 fiscal year, reflecting expectations that combined effects of reduced policy uncertainty and government's structural reform agenda will gradually gather speed, helping to boost investment growth. The South African Reserve Bank (SARB) has lowered its growth forecasts for 2018 from 1.2% to 0.7%. Its forecasts for 2019 and 2020 remain unchanged at 1.9% and 2% respectively. The National Treasury also forecasts that GDP growth will slow to 0.7% in 2018, down from 1.3% last year, before rising to 1.7% in 2019 and 2.1% in 2020. The revisions reflect lower production in agriculture and mining in the first half of the year, as well as lack of new investment
- 2.1.3. Export-led economic activity has not materialised in South Africa despite the opportunities offered by a resurgent global economy. As Figure 2 indicates, South Africa's share of global exports remains stubbornly low at 0.5%, far less than the 2% average of its peers - Brazil, Russia and India, in the BRICS grouping. Underperformance in the external sector is highlighted by a slowdown in trade volumes and industrial production. With manufacturing accounting for almost half of the country's total exports, the continued decline in the sector's output reflects a failure to expand the country's contribution in the global trade value chain. This constrains efforts to ensure that export-led activity acts a catalyst to opportunities for collaboration between large and small businesses as well as bolstering the share of small and medium-sized enterprises in output, both of which are key to the National

Development Plan's (NDP) objectives of reducing poverty, inequality and unemployment.

**Figure 2: Trade volumes and industrial production, 2010-2017**



Source: South African Reserve Bank.

2.1.3.1 South Africa's trade balance with the rest of the world changed from a small deficit in the first quarter of 2018 to a surplus, as the value of net gold and merchandise exports increased much more than that of merchandise imports in the second quarter. The value of merchandise exports was boosted by increased volumes and, to a lesser extent, higher rand prices. The value of mining exports in particular, increased significantly in the second quarter, while agricultural and manufactured exports also increased. The slight increase in the value of merchandise imports resulted primarily from mineral products, in particular, crude oil. South Africa's terms of trade improved in the second quarter of 2018, as the rand price of exported goods and services increased at a faster pace than that of imports. The improvement in the trade balance far outweighed the small widening in the shortfall on the services, income and current transfer account and ultimately rendered an improvement in the deficit on the current account of the balance of payments, from 4.6% of GDP in the first quarter of 2018 to 3.3% in the second quarter.

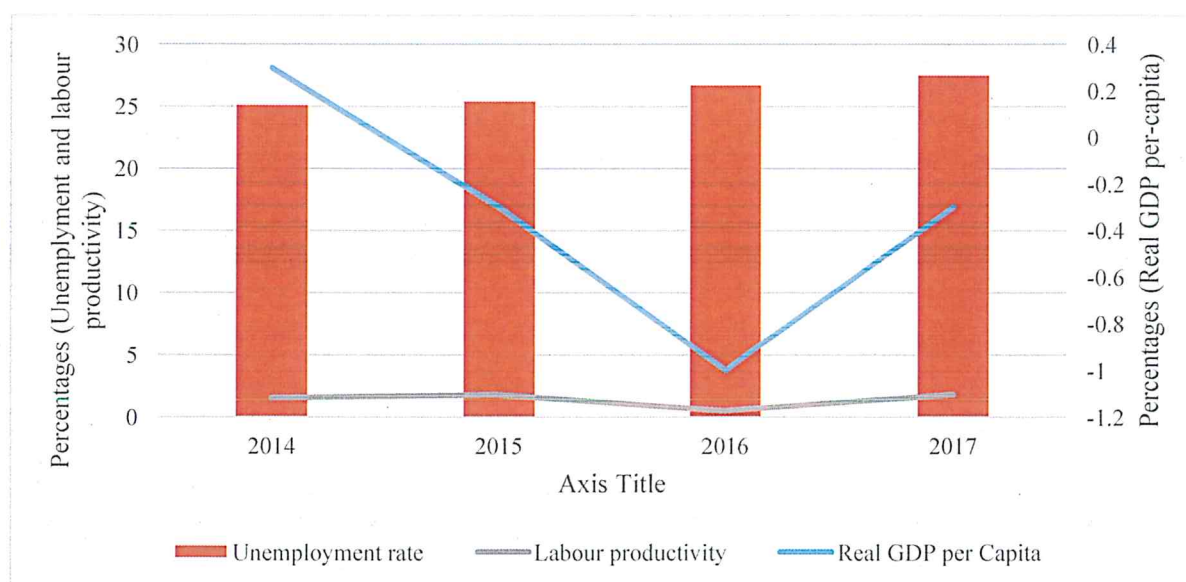
2.1.4. The dynamics of the domestic economy have also dampened South Africa's growth outlook. The recent political transition has ushered in a renewed prospect for reforms aimed at exploiting the full potential of the economy. The new administration has announced measures aimed at boosting business and consumer confidence, comprising changes to the management and boards of SOCs to address poor governance, a judicial inquiry into state capture, renewable energy contracts with independent power producers (IPP), and a wide ranging economic stimulus package. The Commission welcomes these future-facing measures. Nevertheless, the economy has entered a technical recession for the first time since 2009, as real GDP contracted further at an



annualised rate of 0.7% in the second quarter of 2018 following a decline of 2.6% in the first quarter.

- 2.1.5. Private investment and consumption growth have been the main casualties of policy uncertainty resulting in stubbornly high levels of unemployment and income inequalities. Slow private investment growth and inadequate integration into global value chains precludes South Africa from exploiting new economic opportunities being offered by the global economy. Low business and consumer confidence is constraining productivity growth. Consequently, GDP per-capita growth has decelerated from 0.3% in 2013 to -0.3% in 2017, unemployment has surged to 27% and with an income Gini coefficient of 0.68, South Africa remains a highly unequal society. Figure 3 shows the deceleration of GDP per-capita growth, rising unemployment and flat labour productivity growth. Going forward, private sector investment will depend on policy certainty in key areas of the economy, especially mining, energy, telecommunications, tourism and other structural reforms.

**Figure 3: Unemployment, labour productivity and real per capita growth for South Africa, 2014-2017**



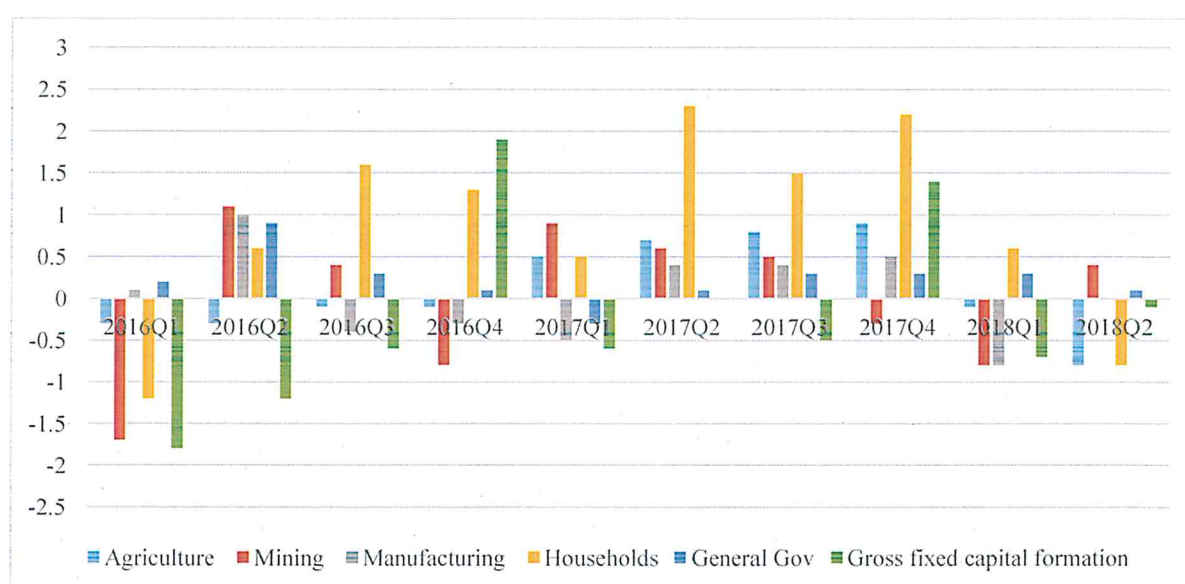
Sources: Statistics South Africa and South African Reserve Bank.

- 2.1.5.1 Real gross domestic expenditure contracted in the second quarter of 2018, in line with the contraction in real final household consumption expenditure and real gross fixed capital formation. Real final consumption expenditure by households contracted in the second quarter of 2018, as spending on goods fell sharply while spending on services accelerated albeit at a decreasing rate. Real outlays on goods decreased, as household real disposable income suffered from tax increases and successive fuel price hikes. However, net real exports and real

final consumption expenditure by general government contributed positively to growth in real GDP.

2.1.5.2 Real gross fixed capital formation decelerated in the second quarter of 2018 as a result of a contraction in capital spending by general government and by public corporations reflecting the financial, operational and governance challenges faced. Fixed investment spending by the private sector increased because of an acceleration in capital expenditure on non-residential buildings. Figure 4 shows how sectoral contributions to growth have changed since 2016.

**Figure 4: Sectoral Contributions to growth (%) in GDP, 2016Q1-2018Q2**



Source: Statistics South Africa, 2018.

2.1.6. South Africa's official unemployment rate increased from 26.7% in the first quarter of 2018 to 27.2% in the second quarter, as employment decreased, and the number of unemployed persons increased. The seasonally adjusted unemployment rate also increased in the second quarter. A total of 90 000 people lost their jobs and in total 102 000 more people became unemployed. The labour force participation rate decreased by 0.2% signalling that a number of people exited the labour force. Consequently, an additional 141,000 people were economically inactive, of whom 77,000 are "discouraged" job seekers. The high increase in the number of discouraged work seekers is indicative of poor domestic employment prospects.

2.1.6.1. In a bid to address unemployment, government hosted a Jobs Summit in October 2018 which culminated in the signing of a framework agreement between government, the private sector, unions and community organizations on how to accelerate the creation of jobs. The framework comprises five pillars: skills



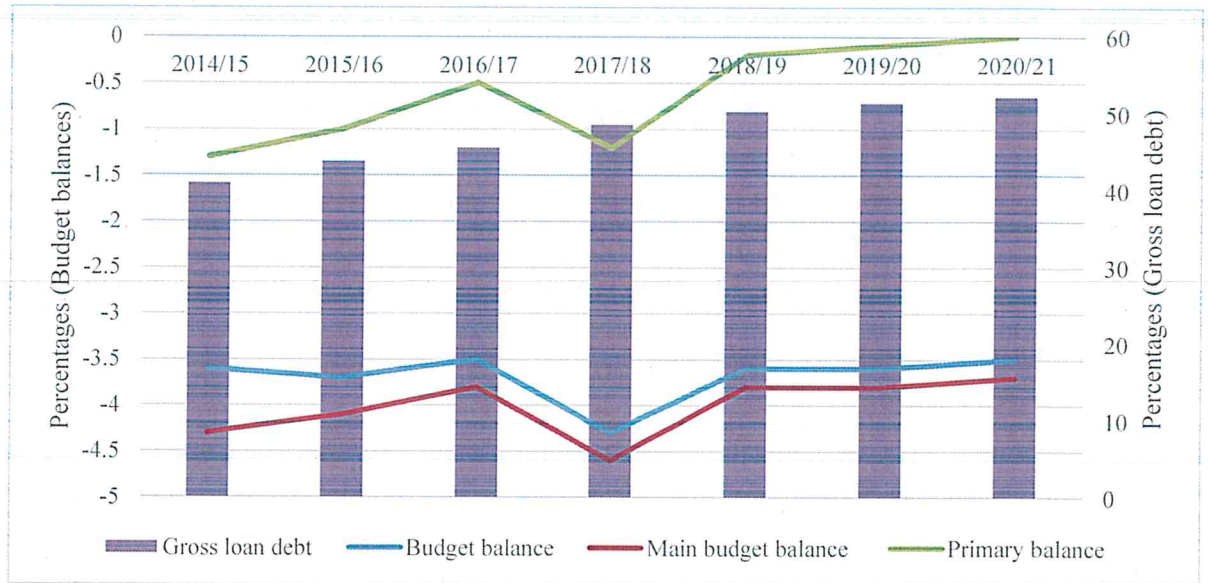
development, small, medium and micro sized enterprises (SMME) support, regulatory reforms, inclusive growth and transformation. The framework agreement is designed to create an additional 275 000 direct jobs annually. This will be over and above the jobs that would have been created in the economy without these interventions (amounting to an average about 300 000 a year). The monitoring framework agreed to will encompass quarterly progress reports on the implementation plans to be received by the Presidential Jobs Committee.

## 2.2. Overview of Public Finances

- 2.2.1. The 2017 MTBPS announced a significant departure from the 2017 Budget deficit target. Tax revenue was substantially below projections by R50.8 billion while expenditure was hiked by R13.7 billion. Consequently, the consolidated budget deficit widens to 4.3% of GDP, exceeding the 2017 Budget target of 3.1% of GDP by more than 1 percentage point. The public debt trajectory accelerated substantially, to a projected 60% of GDP by 2021/22, implying an abandonment of long-term debt stabilization targeting. This resulted in the further downgrading of South Africa's creditworthiness by Standard and Poor. The country faced a precarious position of also being downgraded by Moody's to sub-investment grade, which most probably, would have triggered substantial capital outflows from index-tracking funds. A complete turnaround to the long-term debt stabilization target became absolutely critical.
- 2.2.2. The 2018 Budget managed to thrust South Africa onto a more sustainable path. However, the deteriorating economic performance and revenue shortfalls have resulted in some slippage in these fiscal projections. The risks identified in the 2018 Budget - a public service wage agreement significantly above the inflation rate, and the continued decline in the financial condition of some SOCs - have materialised. The consolidated budget deficit is estimated at 4% in 2018/19, compared with the 2018 Budget projection of 3.6% of GDP. It accelerates to 4.2% in 2019/20 and 2020/21 before stabilising at 4% in 2021/22. The 2018 main budget deficit is now estimated to widen to 4.3% of GDP compared with the 2018 Budget estimate of 3.8%, mainly as a result of tax revenue shortfalls. The primary deficit will now narrow from 0.7% in 2018/19 to 0.6% in 2019/20 and 0.5% in 2020/21 compared to the narrowing of the primary deficit to 0.2% in 2018/19, 0.1% in 2019/20, and 0% by 2020/21 announced in the 2018/19 Budget. Figure 5 shows the deteriorating budget balance and the government gross loan debt.

**Figure 5: Main budget balance, budget balance, primary balance and gross loan debt for South Africa, 2014/15-2020/21**





Source: National Treasury Budget Review, 2018.

- 2.2.3. As part of the ongoing process of fiscal consolidation, the 2018 Budget considerably lowered public investment spending, across all spheres of government. SOCs also received less support from government. However, social grants were increased above the rate of inflation. While the main budget expenditure was reduced, overall spending is estimated to be higher than was anticipated in the 2017 MTBPS given the higher contingency reserve which historically is normally spent.
- 2.2.4. Contingent liabilities emanating from SOCs remain a fiscal risk. The debt-to-GDP ratio will increase in the medium term if contingent liabilities materialize, thus accelerating debt accumulation. Moreover, the projected costs of contingent liabilities that materialize would be even higher if the overall macroeconomic and financial situation further deteriorates from projections in the 2018 Budget's medium-term expenditure framework
- 2.2.5. On the revenue side, the weakening tax buoyancy highlighted in the 2017 MTBPS could worsen implying that an increase in nominal GDP is correlated with even lower revenue generation than anticipated. In 2017/18, tax buoyancy fell to 0.91 despite additional tax policy measures designed to add R28 billion to revenue. The 2018 Budget announced measures aimed at raising R36 billion in additional revenue, with an anticipated buoyancy of 1.51. As a result of the higher VAT refund payments and revisions to estimates discussed earlier, the buoyancy is expected to decrease to 1.21.
- 2.2.6. The higher projected GDP was expected to reduce both the fiscal deficit and public debt as a percentage of GDP. However, the slump in growth in the first half of 2018 has put such optimism in jeopardy. The 2018 Budget presented a stronger fiscal position when compared to the 2017 MTBPS. This was further validated by the retaining of South Africa's creditworthiness above the sub-investment grade by Moody's and the

movement of the rating outlook to stable. However, the 2018 MTBPS has announced a fiscal slippage since the 2018 Budget. Tax revenues have been revised downwards, partly due to higher value-added tax refunds albeit that the expenditure ceiling remains intact to anchor fiscal policy.

- 2.2.7. Public debt as a share of GDP has increased twofold in the last ten years driven primarily by higher primary expenditure coupled with higher interest payment levels during periods of sluggish growth. The annual fiscal deficits have widened significantly, and public debt has ballooned from 27% of GDP in 2007/08 to 53% in 2017/18. Expenditure diversion to interest payments and increases in the scope of public service delivery priorities have translated into expenditure inflexibilities and reduced the capacity of public finances to respond to temporary shocks.

### **2.3. Policy Overview**

- 2.3.1. The upside risk to the forecasts announced in the 2018 MTBPS is the apparent political consensus to address structural bottlenecks that could boost growth beyond 2%. Downside risks emanate from domestic and external sources. Domestically, renewed spending pressures such as funding for higher education, public sector wages, and materialization of SOC contingent liabilities could result in the deterioration of public finances thus triggering further rating downgrades and an upsurge in financing costs. Continued policy uncertainty could reduce capital inflows, investment, and growth. Externally, tightening of the US monetary policy or contagion from other Emerging Markets could trigger capital outflows thus undermining South Africa's ability to meet its large gross external financing requirements.
- 2.3.2. The Commission recommends the addressing of structural bottlenecks in order to boost growth and place it on a long-run stepped-up trajectory. Structural reforms should focus on accelerating private investment, invigorating product market competition, correcting skills mismatches, and confronting and tackling corruption. There is a need to build on comparative advantages to develop new domestic and international markets through higher productivity and innovation. Clarifying the framework governing the "proposed land expropriation without compensation" to prevent uncertainty would enable greater focus on intensifying agricultural productivity, enhancing land administration and reinforcing security of tenure.
- 2.3.3. The Commission also reiterates the need to build fiscal space through conservative debt levels, reducing the wage bill through natural attrition linked to an overview of functional organisation of the state and abandoning the strict linking of wage increases to the consumer price index (CPI), deepening the fight against corruption, addressing governance issues and rethinking the business models of SOCs

## **3. FISCAL FRAMEWORK AND REVENUE PROPOSALS**



### 3.1. Overview of the Fiscal Framework

- 3.1.1. The proposed 2019 medium-term estimates are presented in the context of a depressed macroeconomic outlook with weaker growth and revenue projected alongside high debt service costs. Government's commitment to fiscal consolidation as a means to stabilise debt by narrowing the deficit sets the tone for the 2019 medium term estimates. In order to fund continued rollout and improvements in critical areas of service delivery whilst simultaneously trying to kick-start growth in the economy, government is relying on a four pronged approach namely: (1) maintaining the overall expenditure ceiling; (2) maintaining government's personnel expenditure ceiling; (3) reprioritising spending towards the roll-out of the President's economic stimulus package (especially infrastructure investment); and (4) rebuilding state institutions. Table 1 outlines the proposed fiscal framework for the 2019 Medium Term Expenditure Framework (MTEF) period.
- 3.1.2. Relative to 2017/18, both revenue and expenditure have shown an upswing in real growth in 2018/19: whereas revenue showed a decline of 0.4% in 2017/18, a solid 3.6% real growth is projected for 2018/19. However, this growth will not necessarily translate into more money for public service delivery but rather when payments of overdue VAT refunds are effected and the over-optimistic forecasts are adjusted, the fiscus will be faced with a R27.4 billion shortfall. With respect to expenditure, 2.8% real growth is projected for 2018/19, relative to 2% recorded for 2017/18. Overall, whilst real growth in revenue is projected to slow down from 3.6% in 2018/19 to 2.5% over the rest of the 2019 MTEF period, it should be noted that over the next three years, average growth in both revenue and expenditure will mirror each other. This implies that, everything else being equal, there will be little fiscal space for anything except servicing existing budget commitments.
- 3.1.3. Real growth in expenditure, especially non-interest expenditure (which includes spending on basic and social services) is crowded out by strong real growth in debt service costs which is projected to grow by 6.3% in 2018/19 – this as compared to the relatively more restrained growth of non-interest expenditure which exhibits real annual average growth of 2% over the 2019 MTEF period.
- 3.1.4. Whilst the fiscal buffer provided by the contingency reserve has been adversely affected due to amongst other things, bailouts to SOCs, projections show that an attempt will be made to rebuild these reserves over the 2019 MTEF period. Allocations in this regard are projected to reach R12 billion by 2021.

**Table 1: Consolidated fiscal framework, 2015/16-2021/22**

R billion/percentage of GDP	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Main budget revenue	1,076.2	1,137.9	1,196.4	1,298.3	1,400.3	1,512.2	1,636.8

Main budget expenditure	1,244.6	1,305.5	1,405.0	1,513.4	1,637.9	1,766.0	1,899.6
of which							
Non interest allocation	1,115.8	1,159.0	1,242.3	1,332.3	1,435.4	1,544.2	1,652.3
Debt service costs	128.8	146.5	162.6	181.1	202.5	221.7	247.2
Contingency reserve					7.0	8.0	12.0
Main budget balance	-168.39	-167.59	-208.59	-215.17	-237.58	-253.75	-262.73
As % of GDP	-4.1%	-3.8%	-4.4%	-4.3%	-4.4%	-4.3%	-4.2%
Primary balance	-39.59	-21.09	-45.95	-34.07	-35.04	-32.00	-15.50
As % of GDP	-1.0%	-0.5%	-1.0%	-0.7%	-0.6%	-0.5%	-0.2%
Consolidated budget balance	-151.0	-156.7	-189.6	-202.0	-226.4	-245.8	-251.1
As % of GDP	-3.7%	-3.6%	-4.0%	-4.0%	-4.2%	-4.2%	-4.0%

Source: MTBPS, 2018.

### 3.2. Non-Interest Allocations: Division of Revenue

- 3.2.1. Table 2 summarises the division of non-interest allocations amongst the three spheres of government. These allocations finance the delivery of basic and social services and are generally comprised of discretionary, equitable share and conditional grant allocations. Whilst projected real growth of non-interest allocations in the current financial year (2018/19) is 2.6 %, real growth in this item is projected to slow to a real annual average of 1.6% over the 2019 MTEF period. This constrained growth will require strong efforts by government departments to enhance the efficiency and effectiveness of their spending. The effects of the constrained budget is strongly evident in the slower growth that is projected to characterise the first year of the 2019 MTEF period. Allocations to provinces will increase marginally by 1.8% relative to a significant slowdown in the real growth to national departments (from 3.6% in 2018 to 1.9% projected for 2019) and a marginal decline in allocation to the local government sphere (whereas allocations to municipalities grew by 4.6% in 2018/19, allocation growth is projected to decline by 0.7% in 2019).

**Table 2: Division of revenue amongst the three spheres of government, 2015/16-2021/22**

R billion	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	Real Annual
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Division of available funds	Outcome			Revised	Medium-term estimates			Average Growth 2019/20–2021/22
National departments	546.1	555.7	592.7	641.5	688.1	739.4	786.4	1.6%
Provinces	471.4	500.4	538.6	572.2	613.0	658.6	704.0	1.7%
Equitable share	386.5	410.7	441.3	470.3	505.5	543.0	578.7	1.7%
Conditional grants	84.9	89.7	97.2	101.9	107.4	115.6	125.3	1.7%
Local Government	98.3	102.9	111.1	121.8	127.3	138.2	149.9	1.7%
Equitable share	49.4	50.7	55.6	62.7	69.0	75.7	82.2	3.8%
General fuel levy sharing with metropolitan municipalities	10.7	11.2	11.8	12.5	13.2	14.0	15.2	1.3%
Conditional grants	38.3	40.9	43.7	46.6	45.1	48.5	52.6	-1.1%
<b>Total</b>	<b>1,115.8</b>	<b>1,159.0</b>	<b>1,242.3</b>	<b>1,335.5</b>	<b>1,428.4</b>	<b>1,536.2</b>	<b>1,640.3</b>	<b>1.6%</b>

Source: 2018 MTBPS, Commission's calculations.

- 3.2.2. Of the total transfers to provinces, 82.2% is in respect of the provincial equitable share (PES) and 17.8% is for conditional grants. This proportional split between the PES and provincial conditional grants has remained, and is projected to remain, relatively stable until the end of the 2019 MTEF period. In 2019, allocations in the PES grow more strongly relative to provincial conditional grants – this is largely attributed to the incorporation of two grants, namely the social worker employment grant and the substance abuse grant, into the PES. Over the rest of the 2019 MTEF period, real growth in conditional grants (mostly in respect of education and health) outstrips projected growth in the PES. Given that over half of provincial budgets are dedicated to personnel, a key risk to the provincial government fiscal framework is the higher than anticipated wage agreement. Provinces will have to carefully manage this pressure and practice financial prudence to ensure that wage pressures do not divert resources away from key health and education inputs such as medical supplies and learner support materials.
- 3.2.3. Whilst allocations to the local government sphere are projected to decline marginally (by 0.7%) in 2019/20, the local government equitable share (LGES) remains protected. In fact, strong real growth with respect to the LGES is the main driver of growth in non-interest spending over the next three years. Given that the focus of the LGES is to fund the delivery of basic services particularly to indigent households, the priority attached



to this item is supported. In light of the alarmingly high number of municipalities that have adopted unfunded budgets and to ensure value for taxpayers' money such that these real increases translate into expanded access to quality basic services, strong oversight must be undertaken by provincial and national treasuries as well as sector departments. These increases must also be utilised to offset the large amounts owed by municipalities to Eskom and water boards.

- 3.2.4. Conditional grants to local government are primarily used to fund the development of bulk infrastructure that underpin the delivery of water, sanitation, and electricity. Allocations in this regard are projected to decline by a real annual average of 1.1% over the next three years. The most significant reduction in local government conditional grants is in 2019 with a projected 8% decline. In the context of Budget 2018 where broad ranging cuts that disproportionately affected infrastructure conditional grants were announced, this trend is not surprising. However, given the general sentiment and thrust of MTBPS 2018 which is heavily focussed on infrastructure development, this particular trend is inconsistent. The Commission in its Submission on the 2018 Division of Revenue called for efficiencies in infrastructure spending, especially in the scenario of budget cuts. In addition, the Commission notes the introduction of one new local government conditional grant (the integrated urban development grant) that is targeted at intermediate cities and which aims to inject some flexibility into the way in which these municipalities fund infrastructure development.
- 3.2.5 The Commission notes the utilisation of earmarked pockets of funding within existing conditional grants (specifically the Human Settlements Development Grant and the Urban Settlements Development Grant) so as to fund particular priorities. As noted in the Commission's Submission on the 2018 Division of Revenue, whilst the principle of earmarking is not unacceptable, it is of greater concern that government continuously seeks to address subnational delivery deficiencies through tightening expenditure discretion. Earmarking funding within a conditional grant creates excessive rigidity and curtails the ability of subnational governments to adjust their allocations in accordance with their specific circumstances. Research carried out as part of the Commission's Submission for the 2019/20 Division of Revenue confirms that earmarked conditional grants do not ensure better spending or delivery<sup>2</sup>.
- 3.2.6 The general fuel levy sharing with metropolitan municipalities is the replacement for the abolished regional services council (RSC) levy and is allocated to the eight metropolitan municipalities. The proportional allocation of total local government transfers in respect of the fuel levy, shows a marginal decline over the period reviewed – from 10.8% in 2015/16 to a projected 10.1% by 2021/22. The drop in the proportional allocation emanates from the marginal real annual average growth of 1.3% projected over the 2019 MTEF period.

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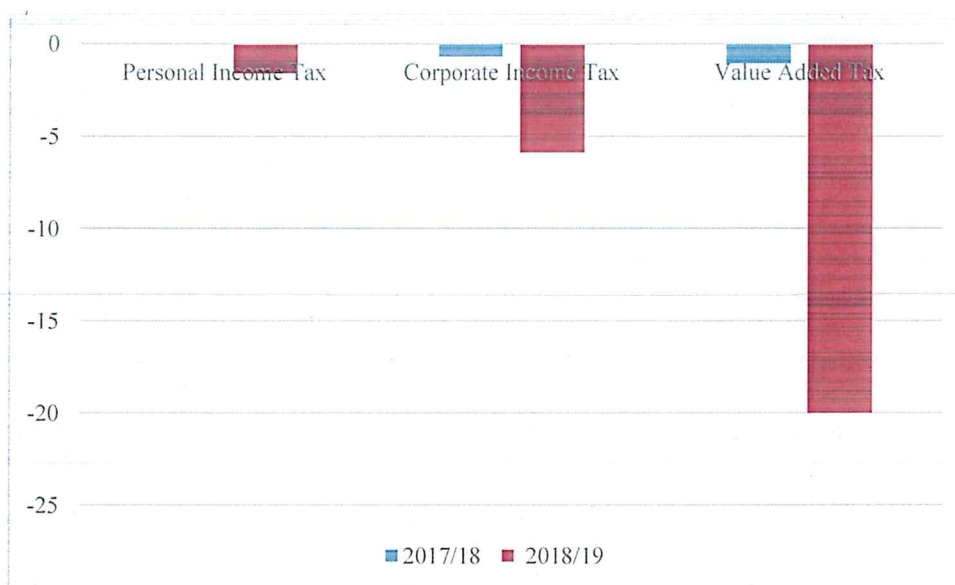
<sup>2</sup> For further information see Chapter 2 of the FFC's Submission for the Division of Revenue 2019/20 entitled: Recentralisation – Implications for Service Delivery and Intergovernmental Fiscal Relations.

### 3.3. Revenue and Tax Proposals

- 3.3.1. The efficacy of the tax system has been undermined by various developments and preliminary indication of a weakening of key functions in the SARS. According to the Davis Tax Committee, the SARS has been constrained in collecting taxes by personnel and policy changes which translated into poor compliance of high net worth individuals and multinationals. There has also been a decline in tax morality which has largely been attributed to the unwillingness of taxpayers to comply in the absence of improved public services. Corporate income tax and non-tax revenue have declined substantially. There are a number of factors that could be attributed to this decline. Governance weaknesses, the slowdown in private investment and the SARS capacity constraints are all potential explanatory factors. The Commission of Inquiry into tax administration and governance at SARS has also underscored the seriousness of weaknesses within SARS over the past several years.
- 3.3.2. Nonetheless, revenue shortfalls have widened over the past four years, with under-collections rising from R7.4 billion in 2014/15 to R49 billion in 2017/18. Moreover, the technical recession experienced in the first half of the year is now translating into a deceleration in revenue collection. Consequently, sluggish growth, coupled with once-off payment of overdue VAT refunds, will result in an in-year revenue shortfall of R27.4 billion, relative to the 2018/19 Budget estimate. Net VAT collections account for about R20 billion of the in-year revenue shortfall. The remaining R7.4 billion of the shortfall in the current year mostly reflects slower corporate income tax collections due to weak growth in wholesale and retail trade, manufacturing and transport. Figure 6 shows the significant VAT revenue shortfalls and to a lesser extent, company tax shortfalls for the period spanning 2017/18 and 2018/19.

**Figure 6. Gross tax revenue shortfalls for income tax, company tax and VAT, 2017/18 and 2018/19**





Source: National Treasury MTBPS, 2018.

3.3.2.1. Lower revenue growth is projected over the next three years because of slower growth in major tax bases and a reduction in the anticipated buoyancy for domestic VAT from 1.1 to 1.0. Gross tax revenue is projected to fall short of the 2018 Budget estimates by R27.4 billion in 2018/19, R24.7 billion in 2019/20 and R33 billion in 2020/21. A panel of experts commissioned to investigate mitigating the effect of the VAT rate increase on low-income households' recommended that six items be considered for zero-rating. However, government only proposed zero-rating white bread flour, cake flour and sanitary pads from 1 April 2019. The revenue loss associated with zero-rating these items is estimated at R1.2 billion.

### 3.4 Revisions to the 2019 Expenditure Ceiling

According to the adjusted budget in Table 3, the overall government expenditure ceiling for the 2018/19 financial year is well sustained with R136.8 million in savings. However, this is achieved through exhausting all available contingency resources set aside at the beginning of financial year, as well as taking resources in disproportionate cuts in subnational spheres of provincial and local governments (see FFC's Submission on the 2018 Division of Revenue Bill). Additions overwhelmingly favour SOC's.

**Table 3. Revision to the 2018/19 expenditure ceiling<sup>3</sup>**

	R million	Percentage of adjustments
Expenditure ceiling: 2018 Budget Review	1 315 002	

<sup>3</sup> Spending financed from revenue derived from departments' specific activities.

Upward expenditure adjustments	17 392	100.0%
<b>Budget Facility for Infrastructure projects and project preparation</b>	870	5.0%
<b>Schools infrastructure backlogs grant</b>	800	4.6%
<b>Drought relief</b>	3 412	19.6%
<b>Financial support to state-owned companies:</b>		
<b>Special Appropriation Bill: South African Airways</b>	5 000	28.7%
<b>South African Express Airways</b>	1 249	7.2%
<b>South African Post Office</b>	2 947	16.9%
<b>Commissions of inquiry into tax administration and state capture</b>	409	2.4%
<b>Self-financing<sup>1</sup></b>	1 777	10.2%
<b>Roll-overs and unforeseeable and unavoidable expenditure</b>	927	5.3%
Downward expenditure adjustments	(17 529)	100.0%
<b>Declared unspent funds</b>	(329)	1.9%
<b>Contingency reserve</b>	(8 000)	45.6%
<b>Provisional allocation for contingencies not assigned to votes</b>	(6 000)	34.2%
<b>National government projected underspending</b>	(2 700)	15.4%
<b>Local government repayment to the National Revenue Fund</b>	(500)	2.9%
<b>Revised expenditure ceiling</b>	1 314 865	

Source: National Treasury and FFC's calculations.

3.4.1 As Table 3 shows, the main drivers for the downward adjustments of the expenditure ceiling are funds released from: contingency reserve set aside for the 2018/19 financial year at R8 billion or 45.6% of the total downward expenditure adjustments, and provisional allocation for contingencies not assigned to votes at R6 billion (34.2%). These released funds are then used to finance South African Airways through a Special Appropriation Bill of R5 billion or 28.7% of total upward expenditure adjustments; South African Express Airways' funding is at R1.249 billion (7.2%); and the South African Post Office at R2.947 billion (16.9%). In sum, total financial support to state-owned entities comprises 52.9% of the funds released from unallocated resources for the 2018/19 financial year.

3.4.2 From a fiscal policy point of view, it is noteworthy that of the R6 billion "provisional allocation for contingencies not assigned to votes for drought management, assistance to the water sector, and to improve the planning and execution of national priority infrastructure projects" (2018 Budget Review), only R3.412 billion is being used for drought relief and R870 million for infrastructure projects and project preparation. Hence, there is some degree of planning discontinuity between the 2018 Budget Review tabled in February and this 2018 MTBPS in October.

### 3.5. Consolidated expenditure by economic classification

3.5.1 Examining the CPI inflation projections used to estimate the medium term budget, it is worth noting that the forecast in the 2019 MTEF guideline is slightly lower than the macroeconomic projections except for the outermost year of the MTEF.



Table 4. Real growth in consolidated expenditure by economic classification<sup>4</sup>

R billion	2018/19	2019/20	2020/21	2021/22	Average
	Revised	Medium-term estimates			
Compensation of employees	587.2	630.4	676.9	722.9	7.2%
Goods and services	234.2	254.5	268.9	283.6	6.6%
Interest and rent on land	188.8	211.0	231.7	257.8	10.9%
<i>of which: debt-service costs</i>	<i>181.1</i>	<i>202.5</i>	<i>221.7</i>	<i>247.2</i>	<i>10.9%</i>
Transfers and subsidies	553.4	604.8	654.7	696.5	8.0%
Payments for capital assets	90.6	94.7	104.0	111.4	7.1%
Payments for financial assets	15.1	6.1	6.7	7.1	–
<b>Total</b>	<b>1 669.2</b>	<b>1 801.4</b>	<b>1 942.9</b>	<b>2 079.1</b>	<b>7.6%</b>
Contingency reserve	–	7.0	8.0	12.0	–
<b>Consolidated expenditure</b>	<b>1 669.2</b>	<b>1 808.4</b>	<b>1 950.9</b>	<b>2 091.1</b>	<b>7.8%</b>
CPI Inflation (%)					
<b>2019 MTEF guidelines</b>		5.3	5.5	5.5	5.4
<b>2018 MTBPS</b>		5.4	5.6	5.4	5.5
Real growth (%)					
Compensation of employees		2.1	1.9	1.3	1.7
Goods and services		3.4	0.2	-0.1	1.2
Interest and rent on land		6.5	4.4	5.7	5.5
<i>of which: debt-service costs</i>		<i>6.5</i>	<i>4.0</i>	<i>6.0</i>	<i>5.5</i>
Transfers and subsidies		4.0	2.8	0.9	2.5
Payments for capital assets		-0.8	4.3	1.6	1.7
Payments for financial assets					
<b>Total</b>		<b>2.6</b>	<b>2.4</b>	<b>1.5</b>	<b>2.2</b>
<b>Contingency reserve</b>					
<b>Consolidated expenditure</b>		<b>3.0</b>	<b>2.4</b>	<b>1.7</b>	<b>2.4</b>

Source: National Treasury and FFC's calculations

3.5.2 Data on real growth in expenditure by economic classification indicate that debt-service costs is the fastest growing item by economic classification at a real growth of 5.5%. Compensation of employees is also growing at a faster pace than goods and services, suggesting that despite the Commission's recommendation to reduce the public sector wage bill, government is still growing its compensation of employees (COE) at the expense of delivery. More specifically, in the 2020/21 and 2021/22 financial years, real growth in goods and services grows marginally at 0.2%, before contracting by 0.1% respectively.

<sup>4</sup> Consisting of national and provincial departments, social security funds and public entities; some calculations missing due to interpretative limitations of the data

## 4. SPECIAL ISSUES: STIMULUS PACKAGE, STATE OWNED COMPANIES AND HIGHER EDUCATION

### 4.1. Economic Stimulus Package

- 4.1.1. In the 2017 MTBPS submission, the Commission advocated for a package of effective stimulus measures to re-ignite short term demand and investment for economic growth. In its Submission on the 2018 Division of Revenue, the Commission made the case that “business as usual” would never enable South Africa to reach its 2030 national development goals. Government has recently announced plans to introduce an economic stimulus and recovery package to lift the economy out of the current technical recession and protracted low growth. The economy has been growing at an average rate of 1.5% since 2010 – far below the 5% growth target set in the NDP. The stimulus and recovery package seeks to redirect government spending into programmes that promote growth, create jobs, improve infrastructure delivery, and enhance the quality of education and health services.
- 4.1.2 Much of the government stimulus and recovery plan is driven by infrastructure spending with an estimated allocation of R855 billion. The 2018 MTBPS revised this programme’s allocation to R870 million for the 2018/19 financial year. The Commission especially welcomes efforts to improve The Commission especially welcomes efforts to improve infrastructure planning and implementation within SOCs, provinces and municipalities. Poor infrastructure project design and corrupt and inefficient implementation reduce the economic growth effect of public infrastructure spending. A project preparation facility is established, a collaboration between National Treasury, Development Bank of Southern Africa (DBSA) and the private sector, to assist or sponsor implementing departments with technical expertise. However, as with many capacity support programmes, caution should be exercised so as not to create unintended perverse incentives – of dependency on external capacity, while neglecting to address the underlying causes such as availability of adequate skills, poor performance management, lack of accountability and oversight and other intergovernmental relations barriers.
- 4.1.3 The Commission further welcomes efforts to publish expenditure reports of existing infrastructure projects to enhance accountability and transparency. This should minimise projects cost overruns and ensure timely completion of the projects. In addition to publishing expenditure records, government needs to invest in an infrastructure delivery inspectorate in addition to the project preparation facility to ensure that projects are delivered in accordance with the required standards and quality.
- 4.1.4 The 2018 MTBPS further proposes the establishment of an infrastructure fund that will comprise contributions from government, the private sector and development finance institutions (DFIs). While the operational details of the fund are being designed, government needs to consider the intergovernmental fiscal arrangements and ensure balance in the allocation of resources across the three spheres of government.



Importantly, the project preparation facility should not be used as a parallel budget platform that replaces existing IGFR budgeting processes.

4.1.5 In its submission to the 2017 MTBPS the Commission lamented the persistent inability of government to achieve MTBPS economic growth targets and emphasised the need for government to lay a solid foundation for future growth – during the downturn, through a comprehensive review of budget programmes aimed at promoting growth. The latter point is especially pertinent in that smaller economies, the size of South Africa, lack the fiscal levers of the industrialised economies, which can tap into the reserves or access capital markets for additional funding to boost aggregate demand. It was especially evident in the 2018 Budget that government was unable to reverse output declines, through increased borrowing, as there are growing fears of sovereign credit risk. Government must manage the debt portfolio in order to minimise debt service costs and sovereign credit risk.

4.1.6 It is not apparent that the current stimulus package was underpinned by the programme review envisaged by the Commission. Stimulus interventions that are superimposed on a structurally deficient economy will yield less than desirable results. Government's previous 6-year stimulus package which ended in 2016/17 is a case in point. Essentially, there are two fundamental tenets of a stimulus package from a fiscal policy perspective that is, lowering taxes and increasing spending. Counterintuitively and of necessity, the current fiscal policy trajectory has been one of contraction, with the recent increase in VAT and the ongoing budget consolidation programme. As the stimulus package is implemented, the Commission advises that this should be monitored as an outcome of its success. Further, there should be a coherent and consistent policy trajectory and coordination between fiscal and monetary policy.

## **4.2 State Owned Companies**

4.2.1. The poor financial health of the SOCs remains the biggest fiscal risk to economic recovery and the overall budget balance. Many SOCs remain in dire fiscal distress, are highly indebted, and unable to meet both their financial and delivery obligations. The ultimate collapse of these enterprises would spell disaster for the economy at large, given their heavy reliance on state guarantees and grants for recapitalisation and operational capital. The Commission has, on numerous occasions, cautioned of the long-term risks of contingent liabilities for the national budget and overall macro-economic balance. Without a stable and credible macro-economic climate, the proposed stimulus and recovery plan will not yield desirable results.

4.2.2. Government's guarantee portfolio to SOCs remains excessively high at R670 billion, while profits and return on equity remains on a downward spiral. The continuous financial under-performance of these enterprises definitely does not justify the underfunding of other crucial expenditure programmes and the erosion of government borrowing capacity owing to continuing bailouts. The 2018 MTBPS provides for a

bailout allocation of R9.1 billion to three SOCs, the South African Airways (SAA), SA Express and the South African Post Office (SAPO). Government should refrain from calling such allocations “recapitalisation”, especially in the case of airlines, since it is evident that the funding is directed towards debt redemption in 2019. “Recapitalisation” instead implies investment in future profitability and equity returns to government. As the airlines’ financial losses persist, government will be required to provide bailouts continuously much to the detriment of essential unemployment and poverty relief spending programmes. SAA will need to renegotiate its outstanding debt of R14.5 billion that matures in 2019. This will prolong the airlines financial distress and imply further bailouts. The national carrier and other SOCs in a similar financial position must commit to a short and long term agenda for reform and overall reorganisation of their structures, addressing internal management deficiencies, aggressive cost containment, strict procurement controls and market repositioning.

- 4.2.3. The Commission notes with concern that there has not been any action towards implementing previous budget statements regarding the proposal to dispose of SOC equity stakes to private partners. The paucity of action in implementing such proposals undermines the credibility of the budget statement. Government should have a clearly set out framework outlining tasks, processes and timelines towards diversifying the capital structure of SOCs. Most importantly, there should be a concerted effort to improve the balance sheet of SOCs and government’s equity, prior to embarking on equity sales.
- 4.2.4. The selling of SOC equity stakes should not be carried out indiscriminately but should instead consider government delivery and developmental obligations. There is a compelling “public goods” argument for government to maintain effective and continued control of entities responsible for providing basic and transport services. The restructuring agenda within these entities should focus on addressing the mismanagement maladies and strengthening accountability structures. It is critical that the SOC Council as mentioned by the President be given the opportunity to address the multiplicity of SOCs and rationalise them to ensure alignment in key sectors, for instance within the airline and aviation space (SAA, SA Express, Mango and the small percentage share in Airlink) on the one hand, and on the other, the transport space (Transnet and Prasa). The Commission thus reiterates the need for government to urgently set uniform rules and procedures for both guarantees and bailouts taking into account the public value of services provided by the SOC, historical financial and non-financial performance, and adherence to guarantee/bailout conditions.

#### **4.3. Higher Education**



- 4.3.1. Higher education and training (HET) is a priority funding area especially since the decision to implement fee-free higher education to qualifying groups of students was taken by the government and provided for in the 2018/19 budget.
- 4.3.2. The implementation of fee-free higher education and training especially during the current fiscal crisis presents a major funding challenge. Moreover, the manner in which this policy has been funded and implemented so far has lent itself to a high degree of policy uncertainty.
- 4.3.3. Of concern is the fact that the government does not appear to have a clear fee-free higher education policy and funding plan to facilitate roll out. Hence the scope of qualifying students keeps changing. Moreover, the additional funding for HET has been ad hoc in terms of the timing of allocation decisions, mainly at the cost of reduced funding for other important programs. The impact of this decision on social equity will be far reaching.
- 4.3.4. In order to ensure optimal utilisation of the additional resources allocated to HET, the Commission recommends that the government should develop a much clearer plan for implementing comprehensive fee-free higher education policy both to address uncertainty in the institutions of higher learning and to ensure efficient and effective utilisation of these resources.
- 4.3.5. While implementation of fee-free higher education and training is to be welcomed as it is expected to increase access for students from poor households, government needs to implement measures to improve the quality of outputs and outcomes at all levels of the education system. Funding must be consistently available across all the students' years of study and be focused on the economic sectors that enhance our national development. In HET, enhancing educational outcomes is particularly urgent in the rural universities and the Technical Vocational Education and Training (TVET) colleges.

## **5. REVIEW OF ACTUAL SPENDING BY NATIONAL DEPARTMENTS AND PROVINCIAL GOVERNMENT – 1 APRIL TO 30 SEPTEMBER 2018**

- 5.1. On average, it would be expected that total expenditure up to September would be at roughly 50% of the projected total. This would of course differ depending on whether a government program that the department is dealing with is recurrent or capital-expenditure driven, the latter spending tends to be "lumpy".
- 5.2. Excessive deviations below or above planned expenditure is undesirable. A department's in-year cash management plan explicitly identifies its spending profile.
- 5.3. Table 5 shows aggregate spending and the percentage spent six months into 2018/19 financial year. Total government spending is approximately 2% below the norm of 50%. Spending by all votes is at 48% mark (R390 billion of the main budget). With

respect to the provincial equitable share, predictably 50% of the total amount has been transferred.

- 5.4. Using selected national departments that are driving government priorities (education and health) and key built environment programmes for example, transport, energy and water and sanitation, government has spent R207 billion which is the norm of the 50% mark. An assessment of individual departmental performance shows somewhat uneven spending patterns. On the one hand, certain departments such as Higher Education and Training, Basic Education, and Telecommunications and Postal Services, far exceed the norm at 60% and above, whereas others such Environmental Affairs, Trade and Industry, Transport, Human Settlements have recorded spending rates below 40%.

**Table 5. Aggregate spending, April-September 2018**

	2018/19		
R million	Main budget	Actual spending April to September	% Spending
Total	1 456 686	703 562	48%



Total appropriation by vote	814 509	390 732	48%
<b>Total direct charges against the National Revenue Fund</b>	636 178	312 830	49%
General Fuel Levy	11 785	3 928	33%
Debt service costs	162 353	78 626	48%
Provincial equitable share (National Treasury)	441 331	220 666	50%
Selected key budget votes	416 838	207 930	50%
<b>10 Public Service and Administration</b>	957	423	44%
<b>11 Public Works</b>	7 453	3 658	49%
<b>14 Basic Education</b>	22 722	13 591	60%
<b>15 Higher Education and Training</b>	73 021	53 309	73%
<b>16 Health</b>	47 143	22 780	48%
<b>18 Correctional Services</b>	23 849	10 902	46%
<b>23 Police</b>	91 834	44 029	48%
<b>24 Agriculture, Forestry and Fisheries</b>	7 165	3 754	52%
<b>26 Energy</b>	7 045	3 054	43%
<b>27 Environmental Affairs</b>	7 113	2 785	39%
<b>32 Telecommunications and Postal Services</b>	923	558	60%
<b>34 Trade and Industry</b>	9 463	3 414	36%
<b>35 Transport</b>	59 798	22 147	37%
<b>36 Water and Sanitation</b>	15 572	7 142	46%
<b>38 Human Settlements</b>	32 356	12 201	38%
<b>39 Rural Development and Land Reform</b>	10 425	4 183	40%
Provincial Level	591 544	239 369	40%
<b>Education</b>	240 851	98 711	41%
<b>Health</b>	194 622	82 692	42%
<b>Social Development</b>	20 634	7 968	39%
<b>Other functions</b>	135 437	49 999	37%

Source: MTBPS 2018, Commission's calculations.

## 6. LOCAL GOVERNMENT ISSUES

### 6.1 Overview of Local Government Allocation

- 6.1.1 The 2018 MTBPS was tabled against a backdrop of a myriad of challenges facing the local government sector. A significant proportion of municipalities are distressed and dysfunctional. In fact, the fiscal health of a majority of municipalities has deteriorated over the past few years. The Commission notes that a thorough and comprehensive rethink of the local government fiscal framework is necessary, including the governance and institutional regimes currently in the sector. As the municipalities are the face of government in communities, it is important to underscore the point that they should not compromise on service delivery, and the division of revenue needs to respond to this call. Allocations to the sector need to be deployed and used efficiently and effectively to uplift the living conditions in households.
- 6.1.2 Over the 2019 MTEF, local government is envisaged to receive a total direct allocation of R415 billion, with annual real growth rates of -0.7% in 2019/20, 3.1% in 2020/21,

and 2.8% in 2021/22. The real annual average growth rate for the transfers to local government over the 2019 MTEF is 1.7% and the LGES is expected to grow faster (at 3.8%) than local government conditional grants and the fuel levy allocations, which grow at -1.1% and 1.3% respectively.

6.1.3 The Commission notes the subdued growth in allocations to the Local Government sphere in the 2019 MTEF. In a fiscal constrained environment, where resources available for sharing are progressively diminishing, it is imperative that the efficiency problem in the local government is eliminated. Section 195(1) (b) of the Constitution implores all organs of state to use resources efficiently and effectively. Essentially, the production and delivery of public services within the government should be provided at minimum opportunity cost, and cases of unproductive, wasteful, irregular or fruitless expenditure, duplication and wastage in procurement processes, among others, should be eradicated.

6.1.4 The Commission welcomes efforts to improve capacity within municipalities such as the recent deployment by CoGTA of a critical mass of experts to assist municipalities improve their performance and operational efficiencies. In the past 5 years, government has invested an average of R2 billion a year on improving capacity through various grants to municipalities, training and skills development programmes as well as deployment of the experts. Over the 2019 MTEF, government will invest a further R9 billion on local government capacity development initiatives. The returns to such investments in the past have been poor as many municipalities continue to perform dismally. There is therefore an urgent need for a thorough review of government capacity initiatives within the local government space, specifically focussed on skills transfer to the recipient municipalities.

## 6.2 Local Government Equitable Share, Conditional Grants and Fuel Levy

6.2.2 The local government sphere receives its allocations from nationally raised revenues in three forms, that is, the LGES, general fuel levy and conditional grants. The allocations and real average growth rate for each of these components are shown in Table 6.

**Table 6. MTEF division of revenue focussing on local government (R'billion)**

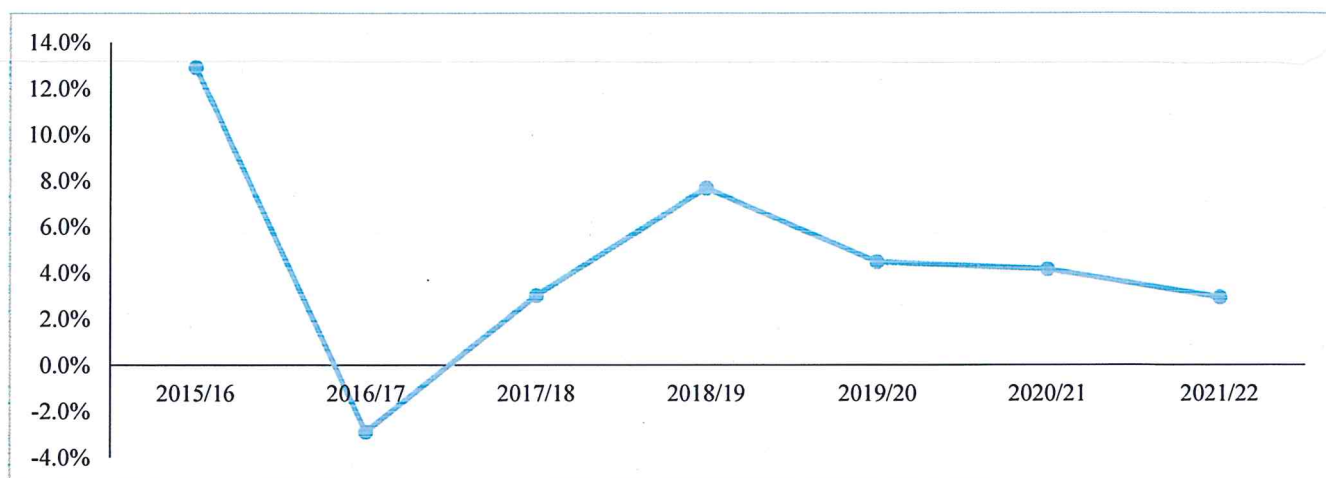
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	Real Average Growth Rate (2018/19-2021/22)
R billion	Outcome			Revised	2019MTEF			
Direct Allocations to Local Government	98.3	102.9	111.1	121.8	127.3	138.2	149.9	1.7%
Equitable share and related <sup>1</sup>	49.4	50.7	55.6	62.7	69.0	75.7	82.2	3.8%
General fuel levy sharing with metros	10.7	11.2	11.8	12.5	13.2	14.0	15.2	1.3%



Conditional grants	38.3	40.9	43.7	46.6	45.1	48.5	52.6	1.1%
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Source: MTBPS 2018

**Figure 7. MTEF division of revenue focussing on local government (R'billion)**

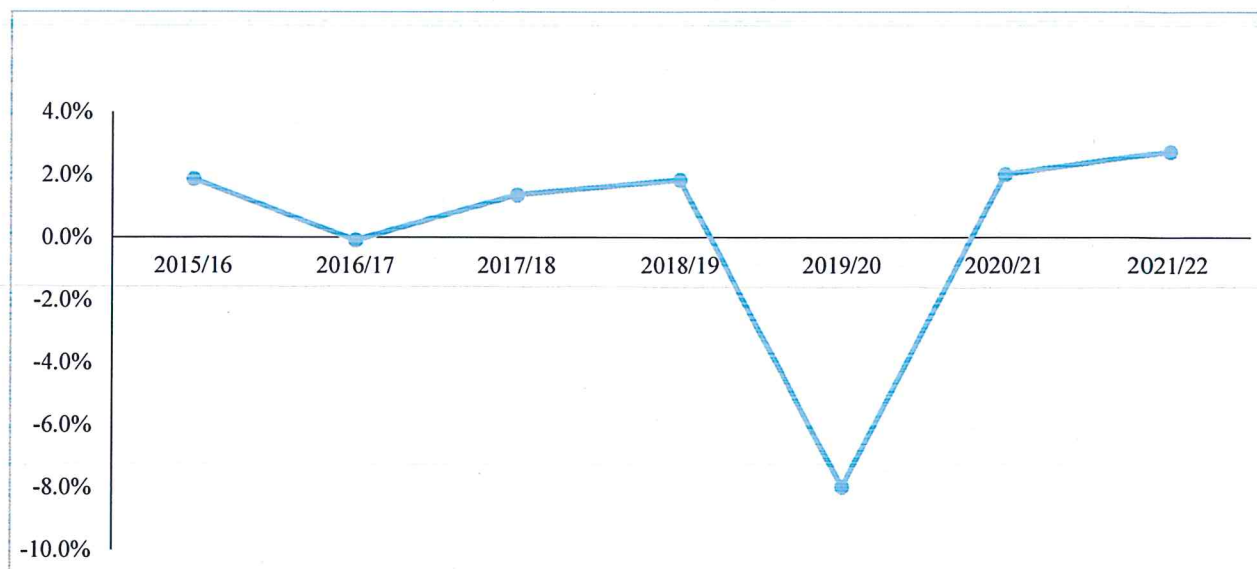


Source: Division of Revenue Bill, 2018; MTBS 2018.

6.2.3 The total LGES allocation is estimated to increase from R56 billion in 2017/18 to R63 billion in 2018/19 and to grow over the next three years from R69 billion in 2019/20 to R82.2 billion in 2021/22 (see Table 6 and Figure 7). Although the Commission commends efforts by Government to protect the LGES, which is essential in maintaining and improving service delivery to communities, it remains concerned about the expected progressive slowdown in the real growth rates of the LGES in outer years (2020/21 and 2021/22). This may have a negative impact on the provision of basic services, as the sector is subjected to increasing cost pressures, due to, inter alia, bulk electricity and water price increases above inflation, and the growth in the number of poor households and population. The Commission is of the view that while there is a need to ensure that the functions of local government are equitably funded from nationally raised revenues, municipalities should also efficiently utilise the available resources and where possible, optimise their existing own revenue bases.

6.2.4 The general fuel levy is shared between metropolitan municipalities. During the 2019 MTEF, this allocation is envisaged to increase by an annual average (in real terms) of 1.3% from R 13.2 billion in 2019/20 to R 15.2 billion in 2021/22.

**Figure 8. Real growth in conditional grant allocations**



Source: Commission's Calculations based on 2017 MTBPS.

6.2.5 The direct conditional allocations to the local government sector have grown over recent years. They have increased from R43.7billion in 2017/18 to R46.6billion in 2018/19, and the sector is projected to receive a total amount of R 146.3 billion over the 2019 MTEF. As Figure 8 shows, although conditional grants to the local government sector have been general growing in real terms, a sharp decline of 3% is expected in 2019/20. This is due to the envisaged reductions on conditional allocations that were highlighted in the 2018 division of revenue bill.

6.2.6 In line with previous FFC recommendations against the proliferation of grants, some of the grants will be consolidated over the 2019 MTEF. For example, the municipal infrastructure grant (MIG) allocations for the Integrated Urban Development Grant (IUDG) recipients will be incorporated into the IUDG grant. In addition, some of the major infrastructure grants, such as Integrated National Electrification (INEP) Grant, Water Services Infrastructure Grant (WSIG) and Neighbourhood Development Partnership Grant will be incorporated into the IUDG; and there are proposals to merge the INEP into the USDG as electrification forms part of informal settlement upgrading.

6.2.7 The Commission notes the envisaged increase in the amount of funds allocated to municipalities in the form of conditional grants over the 2019 MTEF, and welcomes the increasing consolidation of such grants, as it has the potential to improve efficiency in their administration, provided that it promotes integrated planning and service delivery.

## 7 REVISED DIVISION OF REVENUE 2018/19

7.1 Annually government makes adjustments to the budget that was approved in February. The purpose of the adjustments is to cater, amongst others, for unexpected and



unavoidable expenditure. Declared unspent funds amount to R329 million in 2018/19, which is a significant decline when compared to R1.7 billion declared in the 2017/18 revised division of revenue and a sign of departmental fiscal tightness. With respect to underspending, R2.7 billion is projected in 2018/19 which is a slight decline when compared to the R3 billion in 2017/18.

- 7.2 The Commission notes the reported roll-overs for this financial year amount to R258 million compared to the year 2017/18 where there were the no proposed (national) roll-overs for either the direct or indirect provincial conditional grants. The largest roll overs registered were by the Department of Energy at R118.5 million. The second largest roll-overs were recorded by the Department of Telecommunications and Postal Services at R110.3 million. The Commission would like to highlight the importance of using roll overs only as per Treasury Regulations section 6.4 to avoid wasteful and fruitless expenditure.
- 7.3 Unforeseen and unavoidable expenditure (UUE) amount to R669 million for 2018/19 for post disaster reconstruction and rehabilitation, of which the health and the basic education departments have the largest portion amounting to R375 million in total followed by the Department of Cooperative Governance and Traditional Affairs at R160 million for floods. The Commission notes that the reason for the UUE was the disaster related events in KwaZulu-Natal Province in 2017 and the need to rehabilitate infrastructure in the areas/sectors affected. The FFC in its 2014/15<sup>5</sup> division of revenue highlighted the fact that in the face of recurring disasters it is unlikely that public funds will cope with the demands; hence, alternative funding measures must be considered and applied so as to reduce the impact through mitigation, prevention and adaptation strategies. This recommendation is reiterated.

## **8. RECOMMENDATIONS**

Following the analysis in sections 2-7, the Commission makes the following comments and recommendations with regard to the 2018 MTBPS:

### **The Political Transition**

1. The recent political transition culminating in the Ramaphosa Presidency has ushered in renewed prospects for reforms aimed at exploiting the full potential of the economy. The new administration has announced measures aimed at boosting business and consumer confidence, including changes to the management and boards of strategic state-owned companies to address poor governance, a judicial inquiry into state capture,

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<sup>5</sup> FFC Submission for the Division of Revenue, 2014/15: Alternative Financing Mechanisms for Disaster Risk Management in South Africa

signing renewable energy contracts with independent power producers, and a wide ranging economic stimulus package. The Commission welcomes these measures.

### **Economic Challenges**

2. With respect to the economic challenges facing the country, the Commission recommends the addressing of structural bottlenecks in order to boost growth. Structural reforms should focus on accelerating private investment, invigorating product market competition, correcting skills mismatches and unemployment, and confronting and tackling corruption. There is a need to build on comparative advantages to develop new domestic and international markets through higher productivity and innovation instead of depending on higher commodity prices. Clarifying the framework governing the proposed “land expropriation without compensation” to prevent uncertainty by focusing it on intensifying agricultural productivity, enhancing land administration and reinforcing security of tenure is also critical.
3. The Commission also reiterates the need to build fiscal space through conservative debt levels and managing diversion to debt service costs, reducing the wage bill through natural attrition coupled with a review of government’s functional organisation, and abandoning the strict linking of wage increases to the consumer price index, deepening the fight against corruption, assessing the recent increases in the scope of service delivery priorities, addressing governance issues and rethinking the business models of state-owned entities.
4. In its submission to the 2017 MTBPS the Commission lamented the persistent inability of government to achieve MTBPS economic growth targets and emphasised the need for government to lay a solid foundation for future growth during the downturn, through a comprehensive review of budget programmes aimed at promoting growth. The latter point is especially pertinent in that smaller economies, the size of South Africa, lack the fiscal levers similar to bigger developed economies, which can tap into the reserves or access capital markets for additional funding to boost aggregate demand. It was especially evident in the 2018/19 budget that government was unable to reverse output declines, through increased borrowing, as there are growing fears of sovereign credit risk. Government must manage the debt portfolio in order to minimise debt service costs and sovereign credit risk
5. It is not clear apparent that the current stimulus package was underpinned by the earlier programme review envisaged by the Commission. Stimulus interventions that are superimposed on a structurally deficient economy will yield less than desirable results. Essentially, there are two fundamental tenets of a stimulus package from a fiscal policy perspective that is, lowering taxes and increasing spending. Counterintuitively, the current fiscal policy trajectory has been one of contraction, with the recent increase in VAT and the ongoing budget consolidation programme.



### **Enhancing Efficiency in the Public Sector**

6. The Commission advises that in order to ensure real productivity within the public sector, value for money must be sought more resolutely; by costing institutional outputs and assessing performance and then comparing them being mindful to innovate for constant improvement.

### **The Provincial Wage Bill**

7. With regard to provinces, it is evident that that over half of their budgets are dedicated to personnel. A key risk to the provincial government fiscal framework is the higher than anticipated wage agreements. The Commission is of the view that provinces will have to carefully manage this pressure and practise financial prudence to ensure that wage pressures do not divert resources away from key health and education inputs

### **Local Government**

8. The 2019 MTBPS was tabled against a backdrop of many challenges facing the local government sector. A significant proportion of municipalities is distressed and dysfunctional. In fact, the fiscal health of a majority of municipalities has deteriorated over the past few years. The Commission notes that a thorough and comprehensive rethink of the local government fiscal framework is necessary, including the governance and institutional regimes in the sector. As the municipalities are the face of government in communities, it is important to underscore the point that they should not compromise on service delivery, and the division of revenue needs to respond to this call.
9. The Commission notes the subdued growth in allocations to the Local Government sphere in 2019 MTEF. In a fiscally constrained environment, where resources available for sharing are progressively diminishing, it is imperative that the efficiency problem in the local government is eliminated. Section 195(1) (b) of the Constitution implores all organs of state to use resources efficiently and effectively. Essentially, the production and delivery of public services within the government should be provided at the minimum opportunity cost, and cases of unproductive, wasteful, irregular or fruitless expenditure, duplication and wastage in procurement processes, among others, should be eradicated.
10. At the same time, the Commission welcomes efforts to improve capacity within municipalities such as the recent deployment by CoGTA of a critical mass of experts to assist municipalities improve their performance and operational efficiencies. In the past 5 years, government has invested an average of R2 billion a year on improving capacity through various grants to municipalities, training and skills development programmes as well as the deployment of experts. Over the 2019 MTEF, government will invest a further R9 billion on local government capacity development initiatives.

The returns to such investment in the past have been poor as many municipalities continue to perform dismally. There is therefore an urgent need for a thorough review of government capacity initiatives within the local government space.

11. The Commission would encourage government to reconsider the rate of growth of the LGES in outer years so that poor households are cushioned against the rising cost of free basic services. The Commission is of the view that while there is a need to ensure that the functions of local government are equitably funded from nationally raised revenues, municipalities should also efficiently utilise the available resources and where possible, optimise their existing own revenue bases.
12. In line with previous FFC recommendations against the proliferation of grants, it is envisaged that some of the grants will be consolidated over the 2019 MTEF. The Commission notes the envisaged increase in the amount of funds allocated to municipalities in the form of conditional grants, and welcomes the increasing consolidation of such grants, as it will improve efficiency in their administration and promotes integrated planning and service delivery.

### **Roll-Overs**

13. The Commission notes the reported roll-overs for this financial year amount to R258 compared to the year 2017/18 where there were no proposed (national) roll-overs for either the direct or indirect provincial conditional grants. The Commission would like to re-iterate the importance on the use of roll overs as per the Treasury Regulations section 6.4, which restricts roll-overs to among others; unspent funds on payments for capital assets which may only be rolled over to finalise projects or the acquisition of assets already in progress. The Commission would like to highlight the importance of using roll overs as per legislation to avoid wasteful and fruitless expenditure.

### **Infrastructure**

14. The Commission reiterates its concerns regarding the structural impediments in the bidding process of provincial infrastructure programmes that were made in its Submission on the 2018/19 Division of Revenue. It is also recommended that the government take heed of the Commission's recommendations on State-owned companies and Rural Development in the 2017/18 Submission on the Division of Revenue. The issue of infrastructure inefficiency no longer stops at the speed or the proportion of the conditional grant and indirect grant spending. The issue lies with what infrastructure spending delivers in terms of goods and services as real returns.



15. Conditional grants to local government are primarily used to fund development of bulk infrastructure that underpin the delivery of water, sanitation, electricity. Allocations in this regard are projected to decline by a real annual average of 1.1% over the next three years. The most significant reduction in local government conditional grants is in 2019 with a projected 8% real decline. In the context of Budget 2018 where broad ranging cuts that disproportionately affected infrastructure conditional grants were announced, this trend is not surprising. However, given the general sentiment and thrust of MTBPS 2018 which is heavily focussed on infrastructure development, this particular trend is inconsistent. In addition, the Commission notes the introduction of one new local government conditional grant (the integrated urban development grant) that is targeted at intermediate cities and which aims to inject some flexibility into the way in which these municipalities infrastructure development.
16. The Commission notes the utilisation of earmarked pockets of funding within existing conditional grants (specifically the Human Settlements Development Grant and the Urban Settlements Development Grant) to fund particular priorities. As noted in the Commission's Submission on the 2018 Division of Revenue, whilst the principle of earmarking is not entirely intolerable, it is of greater concern that government continuously seeks to address subnational delivery deficiencies through tighter expenditure discretion. Earmarking funding within a conditional grant creates excessive rigidity and curtails the ability of subnational governments to adjust their allocations in accordance with their specific circumstances. Research carried out as part of the Commission's Submission for the 2019/20 Division of Revenue confirms that earmarked conditional grants do not ensure better spending or delivery<sup>6</sup>.
17. The Commission welcomes efforts to publish expenditure reports of existing infrastructure projects to enhance accountability and transparency. This will minimise projects cost overruns and ensure timely completion of the projects. In addition to publishing expenditure records, government needs to invest in an infrastructure delivery inspectorate to ensure that projects are delivered in accordance with the required standards and quality.
18. The 2018 MTBPS further proposes establishment of an infrastructure fund that will comprise contributions from government, the private sector and development finance institutions (DFIs). While the operational details of the fund are being designed, government needs to consider the intergovernmental fiscal arrangements and ensure balance in the allocation of resources across the three spheres of government.

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<sup>6</sup> For further information see Chapter 2 of the FFC's Submission for the Division of Revenue 2019/20 entitled: Recentralisation – Implications for Service Delivery and Intergovernmental Fiscal Relations.

19. It is the view of the Commission that allocating funds and observing its spending trends alone will not yield the desired results of efficiency and impact. Government should take a new approach of “costing” its functions and performance with empirical data, to ensure the real productivity of the public sector. Related to this, greater efforts should be made on the part of government at all levels to develop a more effective public sector monitoring and evaluation framework to ensure public sector productivity and proper costing when deciding on budget allocations and timelines.

### **State-Owned Companies**

20. The poor financial health of the SOCs remains the biggest fiscal risk to economic recovery and the overall budget balance. Many SOCs remain in dire fiscal distress, are highly indebted and unable to meet both their financial and delivery obligations. The failure of these enterprises would spell disaster for the economy at large, given their heavy reliance on state guarantees and grants for recapitalisation and operational capital. The Commission has, on numerous occasions, cautioned against the long-term risks of contingent liabilities for the national budget and overall macro-economic balance. Without a stable and credible macro-economic climate, the proposed stimulus and recovery plan will not yield desirable results.
21. The Commission notes with concern that there has not been any action towards implementing previous budget statements regarding the proposal to either privatise SOCs or dispose equity stakes to private partners. The paucity of action in implementing such proposals undermines the credibility of the budget statement. Government should have a clearly set out framework outlining, tasks, processes and timelines towards diversifying the capital structure of SOCs. Most importantly, there should be a concerted effort to improve the balance sheet of SOCs and government's equity, prior to embarking on equity sales.
22. The selling of SOC equity stakes should not be carried out indiscriminately but instead it should consider government's delivery and developmental obligations. There is a compelling “public goods” argument for government to maintain effective and continued control of entities responsible for providing basic and transport services. The restructuring agenda within these entities should focus on addressing the mismanagement maladies and strengthening accountability structures. The Commission thus reiterates the need for government to set uniform rules and procedures for guarantees and bailouts taking into account the public value of services provided by the SOC, historical financial and non-financial performance and adherence to guarantee/bailout conditions.

### **Higher Education and Training**

23. In the higher education and training (HET) sector, in order to ensure optimal utilisation of the additional resources allocated to HET, the Commission recommends that the



government should develop a much clearer plan for implementing the comprehensive fee-free higher education policy both to address uncertainty in the institutions of higher learning and to ensure efficient and effective utilisation of these resources.

24. While implementation of fee-free higher education and training is to be welcomed as it is expected to increase access for students from poor households, government needs to implement measures to improve the quality of outputs and outcomes at all levels of the education system. In HET this is particularly urgent in the rural universities and the Technical Vocational Education and Training (TVET) colleges.



**Prof Daniel Plaatjies**  
**Chairperson: Financial and Fiscal Commission**

**Date:** 29/10/2018

