FINANCIAL AND FISCAL COMMISSION

Financial and Fiscal Commission Submission on the 2021 Budget

For an Equitable Sharing of National Revenue

01 March 2021

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1. Background

1.1. The 2021 Budget seeks to strike a balance between economic recovery and restoring public finances, in continuity with the 2020 Medium Term Budget Policy Statement (MTBPS). In addition, the budget policy measures are in line with the state of the nation address (2021) by the President's **four** major priorities:

i. Defeat (contain and overcome) the coronavirus pandemic by strengthening the health system and a massive, agile vaccination programme;

ii. Accelerate economic recovery to overcome poverty and hunger, joblessness and inequality. The Covid-19 relief announced last year is ongoing to provide cash directly to the poorest households, wage support to workers, and various relief to struggling businesses.

iii. Implement economic reforms to create sustainable jobs and drive inclusive growth through the Economic Reconstruction and Recovery Plan (ERRP), a massive Infrastructure Investment Plan and an R100 billion Fund rollout with technical skills at its focus.

iv. Fight corruption and strengthen the state.

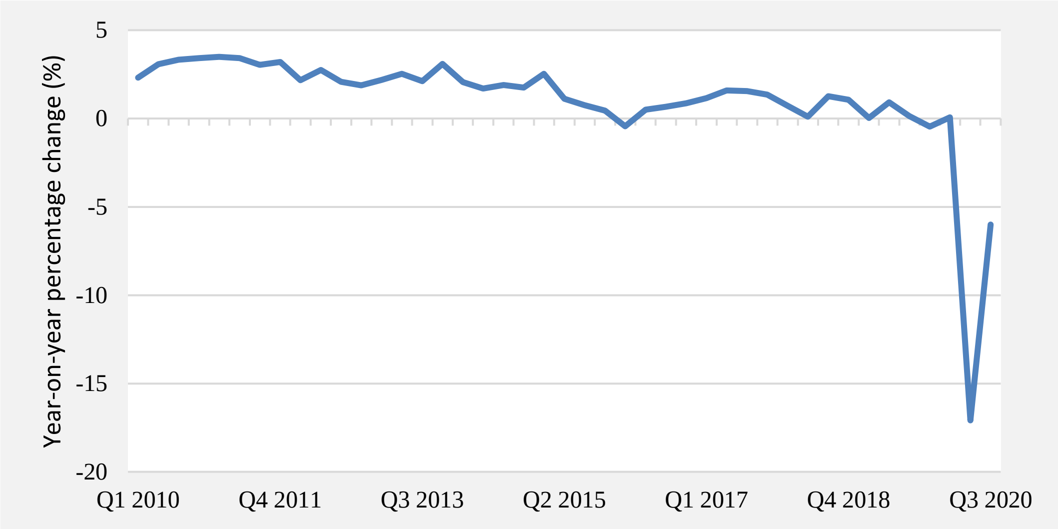
1.2. The 2021 Budget is set against the backdrop of a contracting economy, made worse by the onset of the Covid-19 pandemic with heightened uncertainties. In Q4 2020, the unemployment rate reached its new peak at 32.5% (Stats SA, 2020) deepening inequalities on all social and economic levels. Widening of the budget deficit due to revenue shortfall and emergency government spending, coupled with debt-service costs, requires drastic steps to avoid a debt spiral.

1.3. In line with the request from the Joint Meeting of the Finance and Appropriations Committees Standing Committee on Appropriations, the Commission makes this submission on the 2021 Budget (2021 Fiscal Framework and Revenue proposals, 2021 Division of Revenue Bill and 2021 Appropriation Bill), in terms of Section 214(1) of the Constitution and Section 35 of the Intergovernmental Fiscal Relations Act (1998) as well as S4(4c) of Money Bills Amendment Procedure and Related Matters Act or MBARARMA (Act 9 of 2009), as amended.

2. Economic Overview and Prospects

2.1. The current domestic economic downturn scale cannot be overstated, but tenuous signs of a rebound are emerging. Figure 1 shows quarterly real GDP from 2010 Q1 to 2020 Q3 using year-on-year percentage change (to remove seasonality in the series). In the second quarter of 2020, South Africa's gross domestic product (GDP) contracted by 17.1% year-on-year (y/y), an unprecedented decline (see Figure 1) primarily driven by the effects of Covid-19 and the measures taken to contain it.

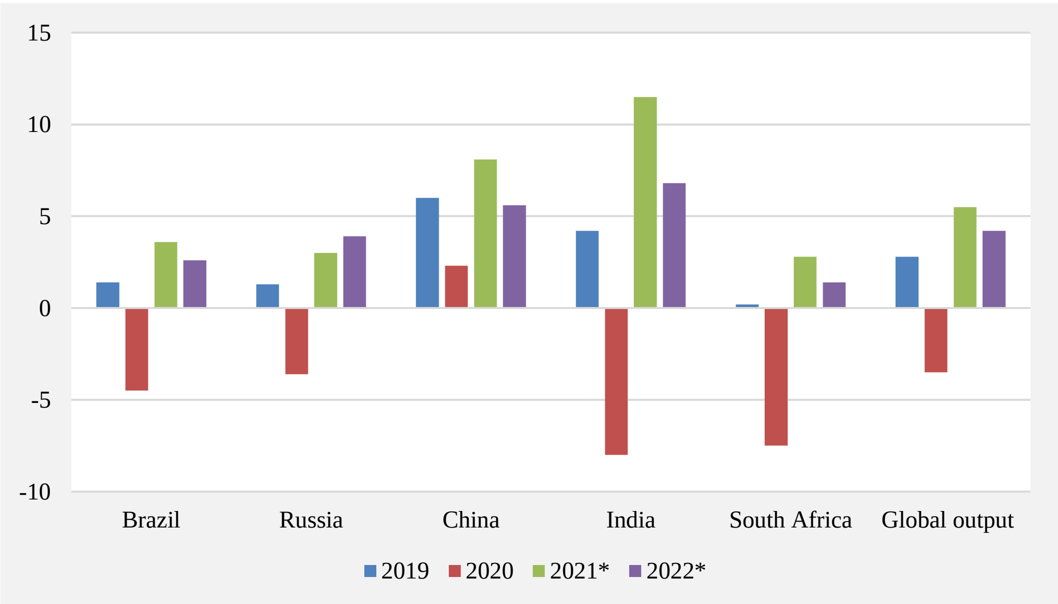
Figure 1: Quarterly Real GDP (% change year on year)



Source: Statistics South Africa (2021)

2.2. As an open economy, South Africa's economic recovery is linked to the global and emerging economies' recovery. The International Monetary Fund's World Economic Outlook current forecast suggests that the global economy is projected to grow by 5.5% in 2021 and 4.2% in 2022. Relative to other BRICS countries, South Africa's economy is projected to have a modest recovery at 2.8% in 2021 compared to Brazil (3.6%), Russia (3%), China (8.1%) and India (11.5%) (see Figure 2). Particularly for countries such as China, healthy fiscal positions provided a cushion for shocks such as Covid-19.

Figure 2: World Economic Outlook Projections (% Year on Year)

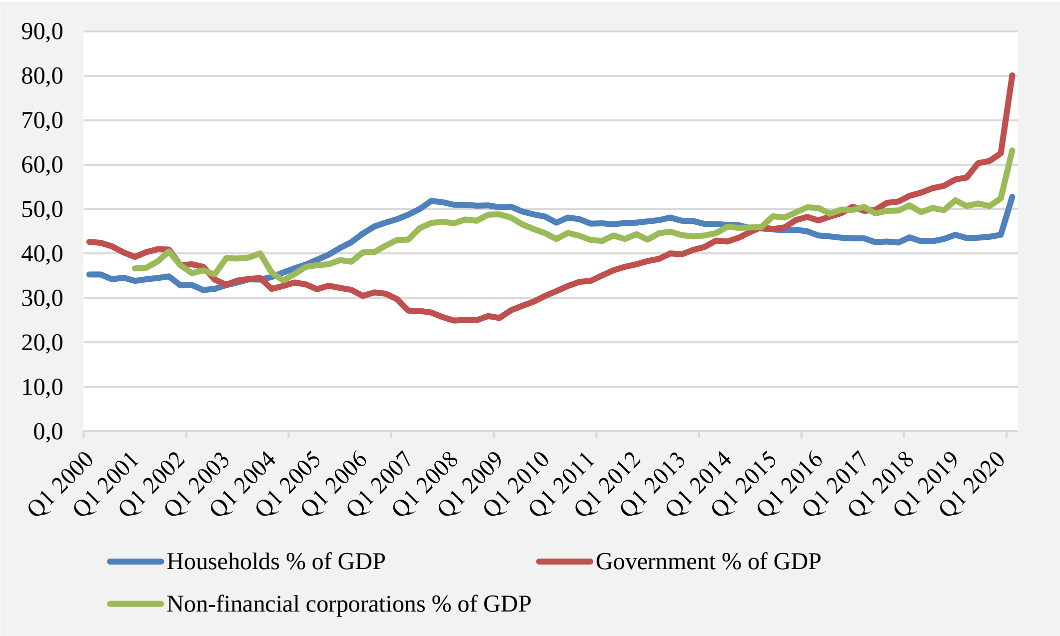


Source: International Monetary Fund (2021)

2.3. The projected recovery's strength varies across countries and depends on the severity of the Covid-19 pandemic in individual countries and their respective structural economic and fiscal parameters. When Covid-19 reached our shores, South Africa was already facing persistent structural challenges: low economic growth, high unemployment, narrowing tax base. Financial pressures and credit-rating weakness of contingent liabilities from State-Owned Enterprise's (SOE's) put further strain on the fiscus, resulting in fiscal credibility risk, and growing public debt.

2.4. The government introduced unprecedented fiscal and monetary policy responses to the Covid-19 pandemic. The response aims to help businesses to stay afloat, supporting households and helping preserve employment. Some of these measures resulted in increases in domestic debt levels, especially concerning the public debt. As a share of GDP, the domestic debt level shows that household and public debt increased in the second quarter of 2020 (see Figure 3). However, household debt levels have been stable in the years before the Covid-19 shock. Whereas government debt has been on a rapid rise in the years preceding 2020. The increase in domestic debt level in the second quarter primarily reflects the sharp drop in GDP experienced during the quarter. However, public debt increased substantially in response to the Covid-19 shock.

Figure 3: Domestic Debt levels (% of GDP)

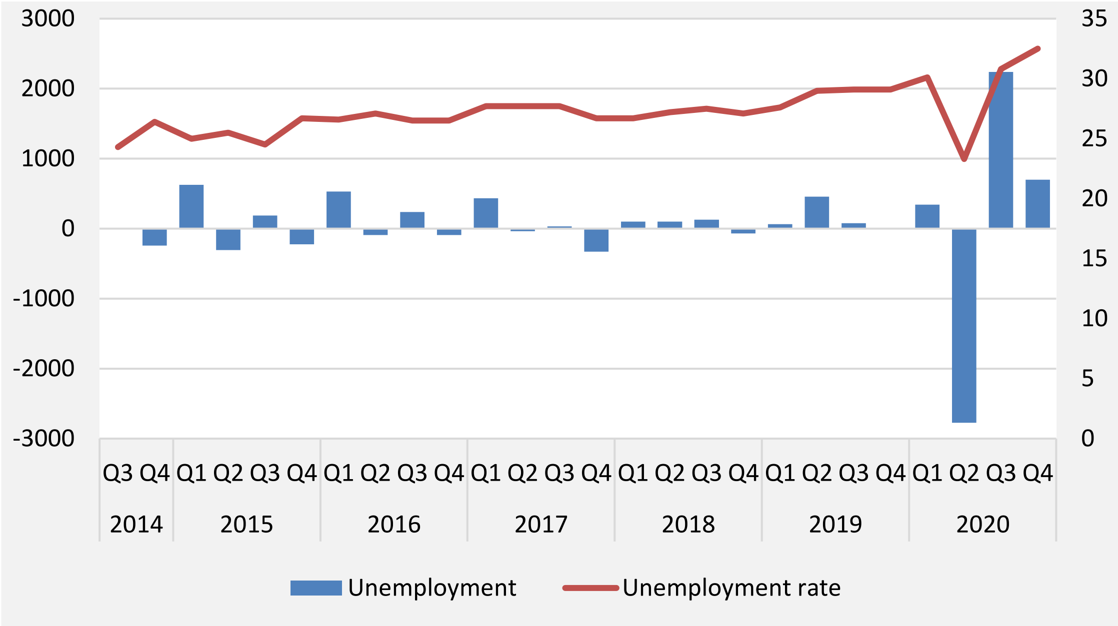


Source: South African Reserve Bank (2020)

2.5. The high government debt implies that the economy will be more vulnerable to future shocks and that the policy tools available to address shocks could be more limited. That is, the fiscal space may be limited to respond to further shocks. The risks of additional waves will put pressure on both households and the government. These may result in fundamental solvency problems as an increasing number of borrowers – households may start falling behind on their loan repayments.

2.6. This year's projected growth recovery follows a severe collapse in 2020 that has had adverse impacts on employment. The number of unemployed (job losses) increased by 2.2 million in the third quarter of 2020, following a decrease of 2.8 million in the second quarter of 2020. The number of unemployed persons increased by 701 000 in quarter 4, after an increase of 2.2 million in the third quarter of 2020 (see Figure 4). Lockdown measures implemented by the government mainly drove the quarter-to-quarter changes in unemployment. The decrease in unemployment in quarter 2 was driven primarily by job seekers' inability to look for employment, and the subsequent increases reflect the easing of lockdown restrictions.

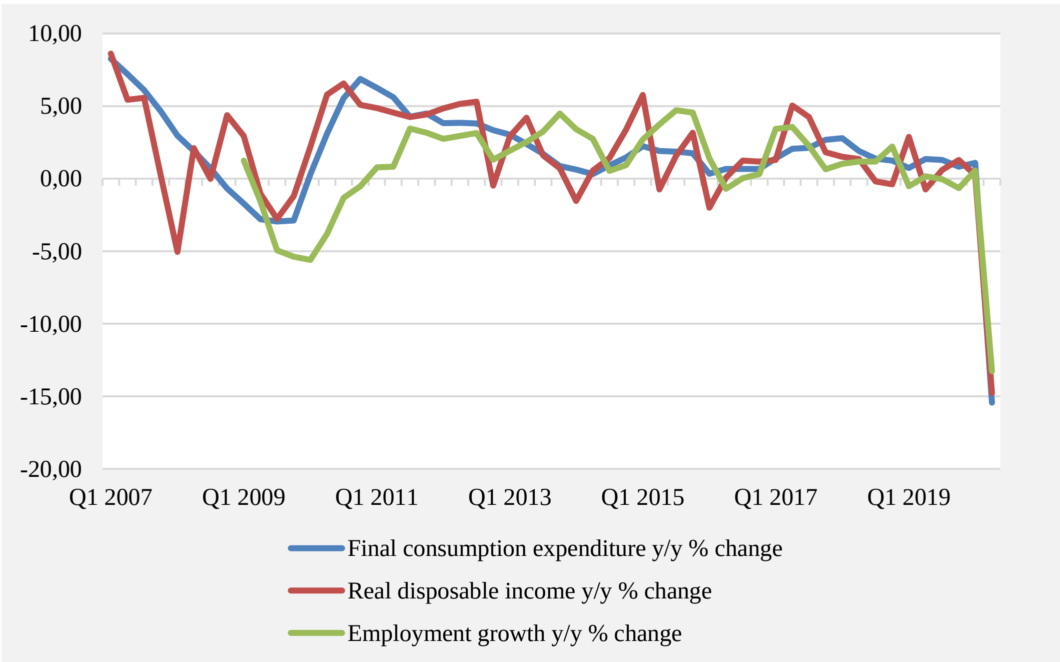
Figure 4: Quarter-to-quarter changes in unemployment



Source: Statistics South Africa (2021)

2.7. The job and income losses by households resulted in a decrease in households' consumption expenditure in the second quarter. A key driver of this outcome was the nearly 15% drop in real disposable income and a fall in employment over the same time frame (see Figure 5).

Figure 5: Real consumption, employment, and income growth rates (y/y % changes)



Source: South African Reserve Bank (2020)

3. Fiscal Framework and Revenue Proposals

The 2021 Fiscus

3.1. Table 1 presents the budget estimates of the 2021 Budget relative to the 2020 Budget for the 2021/22 financial year. The difference between the two budgets shows the policy shift in the fiscus for the year ahead and puts it in context as real fiscal values the government's intent. Examining the data shows the significant downward adjustment in tax revenue projected for the financial year ahead with a shortfall of R132.6 billion in total revenue. On the other hand, expenditure was only adjusted by R23.4 billion, resulting in the main budget balance to increase by R116.2 billion - R482.6 billion deficit for 2021/22 alone or 9% of GDP.

Table 1: Main budget: estimates of national revenue - 2020 vs 2021 Budget

R million	2020 Budget	2021/22 2021 Budget	Difference
Main budget revenue			
Current revenue	1 478 538.9	1 344 235.9	(134 303.0)
Tax revenue (gross)	1 512 193.8	1 365 124.3	(147 069.5)
Total revenue	1 484 294.1	1 351 672.1	(132 622.0)
Main budget expenditure			
Direct charges against the National Revenue Fund	872 909.4	830 023.0	(42 886.3)
Debt-service costs	258 482.1	269 741.1	11 259.1
Provincial equitable share	573 989.5	523 686.4	(50 303.2)
Appropriated by vote	988 835.6	980 583.9	(8 251.7)
Provisional reduction to fund Land Bank allocation	-	(5 000.0)	(5 000.0)
Provisional allocations not assigned to votes	1 852.6	12 645.2	10 792.6
Provisional allocation for Eskom restructuring	33 000.0	-	(33 000.0)
Infrastructure Fund not assigned to votes	4 000.0	4 000.0	-
Compensation of employees adjustments	(54 929.1)	-	54 929.1
Total	1 845 668.5	1 822 252.2	(23 416.3)
Contingency reserve	5 000.0	12 000.0	7 000.0
Main budget balance	(366 374.3)	(482 580.0)	(116 205.7)
Percentage of GDP	*-6.0%*	*-9.0%*	*-3.0%*
Financing			
Domestic short-term loans (net)	48 000.0	9 000.0	(39 000.0)
Domestic long-term loans (net)	278 161.0	319 185.0	41 024.0
Market loans	337 400.0	380 000.0	42 600.0
Redemptions	(59 239.0)	(60 815.0)	(1 576.0)
Foreign loans (net)	40 498.0	41 795.0	1 297.0
Market loans	44 790.0	46 260.0	1 470.0
Redemptions (including revaluation of loans)	(4 292.0)	(4 465.0)	(173.0)
Change in cash and other balances (- increase)	(284.7)	112 600.0	112 884.7
Total financing (net)	366 374.3	482 580.0	116 205.7

Source: Commission's own calculation using National Treasury Budget Review Statistical Annexure 2020/21

3.2. The total effect of fiscal consolidation at R23.4 billion in the main budget expenditure is the result of, among other things: reduction in the direct charge of the provincial equitable share at R50.3 billion for the financial year in concern compared to last year's main budget; Appropriation by vote to national departments at R8.3 billion; a provisional reduction to fund the Land Bank at R5 billion, and provisional allocation for Eskom.

However, counteracting this effort is debt-service costs at R11.3 billion; provisional allocation not assigned to votes (for public employment initiative); and compensation of employees adjustment. As uncertainty lingers in arresting the ballooning public sector wage bill through controlling the salary amount, as opposed to reducing the headcount attempted in 2018/19.

3.3. In particular, the rising debt-service cost, or funds that could be spent on economic and social priorities are being redirected to service debt, is expected to consume R269.7 billion, equivalent to 13.4% of the budget in one financial year alone (2021/22).

3.4. To cover the increased deficit at R116.2 billion and fund the total deficit of R482.6 billion for the 2021/22 financial year, the government has looked to raising funds in long-term domestic debt and foreign loans, as well as sacrificing the available cash and other balances of R122.6 billion for redemption.

3.5. In sum, the Fiscus tabled in the 2021 Budget is by all counts worse than compared to a year ago (the 2020 Budget), with total revenue declining sharply due to the Covid-19 pandemic. Despite reprioritisation efforts and repurposing with some additional consolidation, even coupled with the boost to corporate income tax receipts from the mining sector, the budget deficit grows.

3.6. South Africa's risk of falling into a debt trap remains, with more loans, cash, and debt-service cost - raised, used and needed to finance the widening deficit. In line with pro-poor government policies to continue temporary support for low-income households and unemployed workers, such as the special Covid-19 social relief of distress (SRD) grant is extended for three months. Unemployment benefits under the temporary employment relief scheme (TERS), and the public employment initiative of R11 billion under provisional allocations not assigned to votes to boost short-term employment. The government should remain vigilant of its fiscal parameters and perhaps even have acted sooner to impose hard transformation through financial and budgetary controls and adjustments.

Adapting fiscal policy

3.7. The fiscal position, which was already weak before the pandemic, has deteriorated sharply towards a debt spiral. Following the two policy objectives set out in the 2020 Medium Term Budget Policy Statement (MTBPS), the government's fiscal strategy promotes economic recovery within the crisis while stabilising the public finances to avoid a fiscal crisis.

3.8. More specifically, the fiscal stance is comprised of three R's:

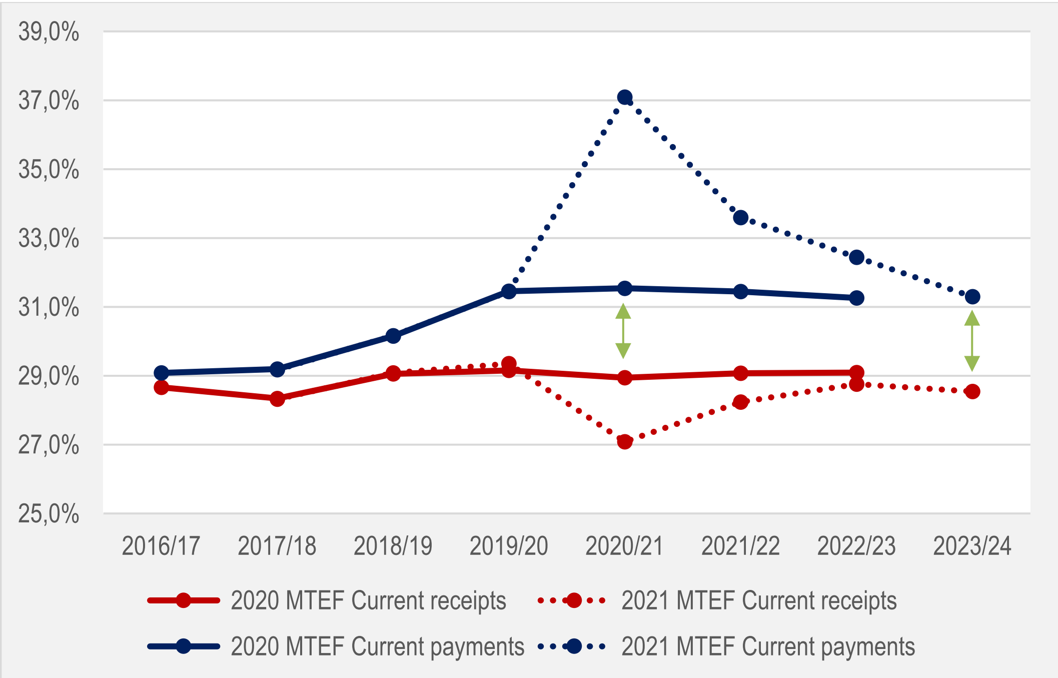
i. Restraining the compensation budget ceilings based on fairness, equity and affordability.

ii. Reversing public entities and local government's financial and operational positions caused by maladministration and governance failure through financial management.

iii. Refocusing on capital investment of infrastructure, specifically for buildings and other fixed structures.

3.9. Figure 6 confirms the policy stance in the shift between the 2020 Budget to the 2021 Budget over the MTEF. The original fiscal trajectory of the 2020 MTEF already showed a widening deficit between current receipts and current payments of the fiscal framework, where current payments outstrip current receipts at an increasing rate. In the 2021 MTEF, due to the onset of the Covid-19 pandemic and structural breaks in the economy, fiscal policy reacted with extraordinary measures to make payments to support the vulnerable as Covid-19 response, despite the fall in current receipts. The graph further shows that the government has undertaken to narrow the deficit by aggressively reigning expenditure down to sustainable spending levels while anticipating the lost revenue to recover over the MTEF. However, the fiscal trajectory as the government's policy position over the 2021 MTEF remains wide in the deficit.

Figure 6: Current receipts and payments in percent of GDP, 2020 vs 2021 MTEF



Note: Current receipts = Tax receipts (net of SACU transfers) + Non-tax receipts (including departmental receipts) + Transfers received; Current payments = Compensation of employees + Goods and services + Interest and rent on land + Transfers and subsidies. Current balance = current receipts – current payments.

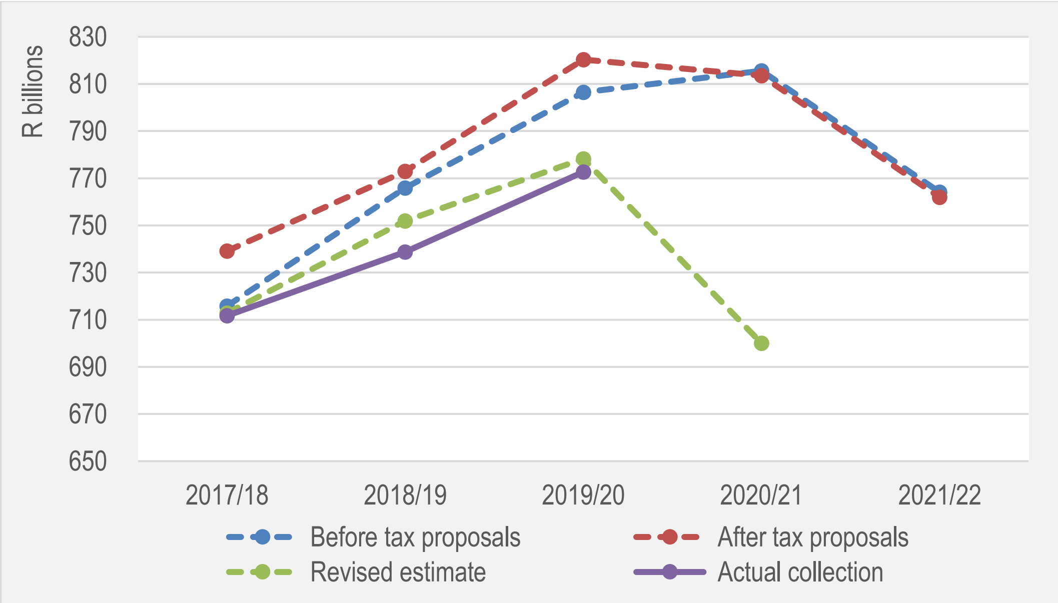
Source: Commission's own calculation using National Treasury Budget Review Statistical Annexure 2020/21

3.10. Had the government not taken the fiscal stance, it will lose its credibility by not generating sufficient revenue for the state to service debt. This will then lead to the risk of sovereign debt default and higher risk premium (i.e. cost of borrowing). Capital would cease to flow resulting liquidity issues; local currency depreciates as demand falters on the lack of finance.

Revenue trend and tax proposals

3.11. After much uncertainty and many revisions on economic growth and revenue trend[1], Gross tax revenue for 2020/21 is still expected to be hundreds of billions in Rands lower than originally estimated, bringing serious doubts to fiscal credibility. As demonstrated in Figure 7, it has been a long-standing phenomenon that trend estimate on the largest fiscal envelope source: income and profits suffer from a significant positive bias. Revenue outcome as the actual collection has disappointed all projections, whether it be before- or after-tax proposals or even revised estimates in December. These discrepancies in revenue estimates versus actual revenue, over time, have put further pressure on the deficit to widen and caused significant harm to the fiscal credibility of the government's fiscal policy in terms of revenue.

Figure 7: Taxes on income and profits before- and after-tax proposals, revised estimate and actual collection



Source: Commission's own calculation using National Treasury Budget Review Statistical Annexure 2020/21

3.12. However, it should be noted that the after-tax proposals for the 2020/21 and 2021/22 financial years, revenue is finally adjusting its positive-bias, as it estimates to be lower than the before-tax proposals. The ultimate *test of credibility* now lies in the actual revenue collection relative to the revised estimate for the 2020/21 financial year.

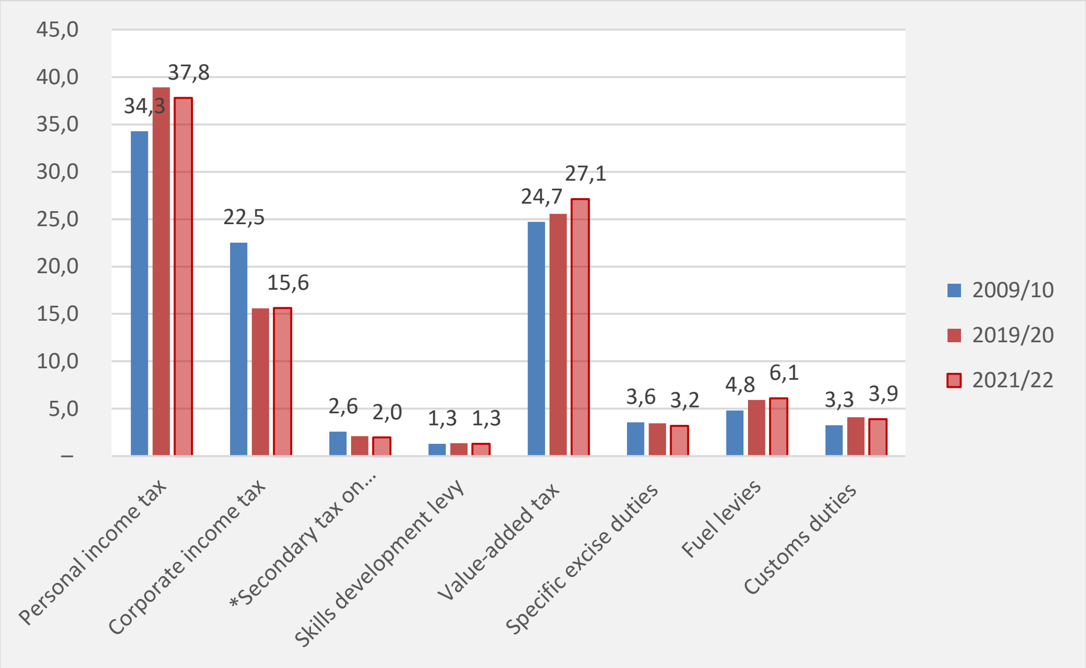
3.13. To avoid adding to the tax burden, the government has undertaken to withdraw the R40 billion proposed tax measures. The main tax proposals in the 2021 Budget include an above-inflation at 5% increase in personal income tax brackets and rebates to provide tax relief to specifically the taxpayers previously employed and paying taxes. The 8% increase in alcohol and tobacco excise duties should yield some revenue (estimated at

[1] A surge in provisional corporate tax payments in December exceeded expectations. This was primarily driven by the mining sector, with companies benefiting from high commodity prices and a relative recovery in the exchange rate.

R1.8 billion in total). However, this impact is negligible (on a tax base of 3.2% of total tax revenue) compared to the total tax revenue and the potential public health benefits (see Figure 8).

3.14. The government is also simplifying the tax code by reducing the number of tax incentives, expenditure deductions and assessed loss offsets to remove fiscal leakages[2]. More specifically, the government has taken a new approach in reducing the tax rate as an investment in building the tax base. Contrary to the previous revenue stance and tax proposals in overextending the tax rates and reliance on the assumption of tax buoyancy (i.e. tax revenue relative to GDP growth).

Figure 8: Share of total tax revenue (top-95~97%, in percentage)



Note: *Secondary tax includes taxes on companies/dividends tax and interest withholding tax.
Source: Commission's own calculation using National Treasury Budget Review Statistical Annexure 2020/21

3.15. To support the shift to a greener economy, the government will implement:

i. Plastic bags taxed at 25c/bag: a reduced levy of 12.5c/bag to bio-based plastic bags.

ii. The carbon tax rate increased by 5.2%, from R127 to R134 per tonne of carbon dioxide equivalent, from 1 January 2021.

iii. The levy for 2021 will increase by 1c to 8c/litre for petrol and 9c/litre for diesel from 7 April 2021.

[2] For instance, a National Treasury assessment determined that the venture capital company (VCC) incentive did not sufficiently achieve its objectives of developing small businesses, generating economic activity and creating jobs. Instead, it provided a significant tax deduction to wealthy taxpayers.

3.16. A bill to impose regulatory levies on the financial sector is expected to be tabled in early 2021 in line with implementing the Twin Peaks regulatory system. Reviews are also underway on the upstream petroleum industry, research and development tax incentive, and provisions for travel and working from home.

4. 2021 Appropriation Bill

Changes in appropriation by vote

4.1. Over the next three years, the total allocation to national departments (total appropriation by vote) will amount to R2.9 trillion. This translates to R981 billion in 2021/22, R963 billion in 2022/23 and R969 billion in 2023/24. In terms of real annual average growth, allocations to national departments are set to decline by 5.6% per annum. The largest decline will occur in 2021/22, where a 7.2% reduction is projected.

4.2. Table 2 illustrates the allocation and real growth of key spending components at the national level. There are two noteworthy points: the first is that in 2021, conditional grants to both provinces and municipalities are protected. Since conditional grants are mainly in respect of the development of basic services infrastructure, the robust real growth, particularly in respect of local government conditional grants, is welcomed. The second point relates to national government efforts to reign in spending and growth on the public service wage bill. In this regard, national departments' spending on personnel is projected to decline consistently over the next three years, with the largest reduction of 4.6% scheduled for 2021/22. The Commission notes that relying on cutting compensation as a means of reigning in spending is inherently risky, especially if the cuts do not materialise.

Table 2: Real Growth Trends for a Selection of Key Votes, 2020/21 to 2023/24

R'mil	**2020/21**	**2021/22**	**2022/23**	**2023/24**
Conditional grants to provinces	107,593.9	115,782.5	119,255.4	121,520.3
Conditional grants to municipalities	40,017.8	45,476.7	47,678.6	49,419.4
Infrastructure expenditure	132,984.0	136,246.6	144,274.9	149,468.2
Personnel expenditure	176,653.8	175,043.6	175,431.6	175,526.5
Training expenditure	3,264.3	3,309.1	3,393.8	3,468.2
Real growth		**2020/21-2021/22**	**2021/22-2022/23**	**2022/23-2023/24**
Conditional grants to provinces		3.6%	-1.2%	-2.4%
Conditional grants to municipalities		9.4%	0.6%	-0.7%
Infrastructure expenditure		-1.4%	1.6%	-0.8%
Personnel expenditure		-4.6%	-3.8%	-4.2%
Training expenditure		-2.4%	-1.6%	-2.1%

Source: 2021 ENE Summary Tables

4.3. In terms of proportional allocation of resources (excluding transfers to provincial or local government), on average, over the period 2020/21 to 2023/24, the Social Development vote receives the largest share of 22.1% of the total appropriation by vote. This is followed by the Cooperative Governance vote, which receives 10.7%, Higher Education and Training, which receives 10.0% and Police at 9.9% of the total appropriation by vote. The Health vote receives an average of 6.1% of the total appropriation whilst Basic Education receives 2.7%, and Agriculture, Land Reform and Rural Development receives 1.7% of the total resources allocated to national departments (Budget Review, 2021).

4.4. Table 3 illustrates the anticipated growth rates for a selection of votes. The Commission would like to emphasise the following points:

i. Allocations to the **Social Development** vote are set to decline by 14.4% in real terms in 2021/22. Whereas positive growth is projected for 2022/23, it is marginal with further reductions anticipated for the outer year (2023/24) of the MTEF period. Whilst implementation of social welfare services and Early Childhood Development (ECD) takes place at provincial level, there are two important programmes located under this vote namely: (a) the provision of targeted income support for the poor through the social security grants programme and (b) the conditional grant funding for ECD which aims to expand access to early learning programmes. Spending in respect of both these important programmes is set to be significantly reduced.

- Whilst the Commission welcomes the relief provided by the extension of the special Covid-19 social relief of distress grant, it is of concern that total spending on social security grants is projected to decline by 6.2% per annum over the next three years. Social security grants provide critical income support to the poor and as such this projected cut will adversely affect this group.
- The ECD conditional grant is set to decline by a real annual average of 8% per annum over the MTEF period. In its Annual Submission for the 2021/22 Division of Revenue, the Commission raised the issue of ECD funding and noted that not only is there a need to strengthen funding for ECD via this conditional grant but also that the grant, in its current form, does not reach the ECD centres and learners who most need it. ECD is the foundation where the basis for future academic performance is established. If this window of opportunity to provide sound, quality ECD is missed, it is much harder and, from a public finance point of view, incredibly costly, for children to catch up to their peers later in schooling. The Commission commends the R2.8 billion allocated to the ECD sector in 2020/21 as part of the President's Employment Stimulus Relief Fund. This injection of funds provides vital resources to all ECD centres (registered and non-registered, centre and non-centre based) to subsidise the cost of employment of ECD workers. However, these funds are not a permanent feature of the system and therefore the Commission reiterates its recommendation as contained in its Submission for the 2021/22 Division of Revenue to strengthen funding provided through the ECD conditional grant instrument.

ii. Allocations to the **Basic Education** vote are set to grow by 12.6% in real terms in 2021/22. This is significant, real growth and represents an improvement relative to the no growth scenario presented at the time of the 2020 MTBPS. The Education Infrastructure Grant (EIG) is projected to grow strongly (in excess of 20%) in 2021/22. School infrastructure has an essential role to play in addressing issues related to access and educational quality and thus the Commission commends the protection of this funding which provincial education departments rely on to construct, maintain, rehabilitate and upgrade educational infrastructure. However, the Commission would advise that oversight over the financial and non-financial performance of this grant be strengthened to ensure that money is prudently spent and that spending is accompanied by appropriate progress in terms of outputs as this has been one of the challenges characterising the performance of this conditional grant. Given that the delivery of basic education is labour intensive the cuts to compensation will affect the number of teachers. The Budget Review 2021 on page 59 explicitly notes that this will negatively affect class sizes and learning outcomes especially in no fee schools. At R242.8 million in 2021/22, the Leaners with Profound Intellectual Disabilities grant is the smallest conditional grant on the Department's budget. This grant is projected to decline consistently over the next three years with the largest decline of 3.8% in 2021/22. The Commission is concerned about intended reductions to the most vulnerable of learners and its impact on these learners and the government’s commitment to the creation of an inclusive education system.

iii. For the **Higher Education and Training** Vote and as a result the post school education and training sector, over the next three years, marginal growth is projected for 2021/22, followed by real declines in 2022/23 and 2023/24. Whereas subsidies to universities will show marginal growth of under 1% in 2021/22 and reductions over the rest of the MTEF period, subsidies to technical and vocational education and training (TVET) colleges are set to be hard hit. A real annual average reduction of 9.9% per annum is projected, the largest reduction in 2021/22 with a 15.3% real drop in spending. Allocations to the National Student Financial Aid Scheme (NSFAS) are also set to decline by a real annual average of 2.5% per annum. Given the role of the NSFAS in providing financial aid to poor students, the Commission is concerned at how the planned reductions will affect access of the poor to higher education and the impact on youth unemployment.

iv. A significant real reduction of 8% is anticipated for the **Cooperative Governance** vote in 2021/22. Important key conditional grants such as the municipal infrastructure grant (MIG) and the integrated urban development grant (IUDG) are located under this vote. Reductions are set to affect the Local Government Equitable Share (LES) allocation and the compensation budget. The LES is projected to decline by a real annual average of 4.8% per annum over the next three years. The largest reduction of 12.4% is set to be effected in 2021/22.The Commission is concerned about the impact that this cut will have on household access to quality water, sanitation, refuse removal, especially insofar as poor households are concerned.

v. Allocations to the **Health** vote grow solidly by 4.4% in real terms in 2021/22. However real reductions are projected for the rest of the MTEF period. The Commission notes this is linked to plans to fund the rollout the Covid-19 vaccines whereby an additional R9 billion has been allocated to the department's baseline (R6 billion in 2021/22 and R3 billion in 2022/23), as well as flexibility to draw from the contingency reserve should the need for additional funding arise. Health care services are located mainly at provincial level; however, the national department coordinates various health conditional grants. The National Tertiary Services Grant which compensates provinces for providing tertiary services to patients from elsewhere is projected to decline by 6% in real terms in 2021/22 with further cuts envisaged for both 2022/23 and 2023/24. The Health Facilities Revitalisation grant which, according to the 2021 Budget (ENE, 2021), is the largest source of funds for public health infrastructure, is projected to decline by 1.8% in 2021/22. Despite being critical to modernising health infrastructure.

vi. Real growth in the **Agriculture, Land Reform and Rural Development** vote is projected at 6.8% in 2021/22. As highlighted in the Commission's recently tabled Submission for 2021/22 Division of Revenue, farmers and the agricultural economy can be catalysts for economic development. The Commission thus welcomes the strong increase and protection of spending in this vote, particularly in respect of the Ilima Letsema and Comprehensive Agricultural Support Programme (CASP) grants. The Ilima Letsema grant is projected to grow by a real annual average of 9% per annum whilst the CASP (particularly the infrastructure component) is projected to show real annual average growth of 10.6% per annum.

vii. The **Trade, Industry and Competition** vote facilitates access to sustainable economic activity and employment in support of the economic reconstruction and recovery plan. In 2020/21, this vote received an allocation of R9.3 billion which is projected to increase marginally to R9.7 billion in 2021/22. To this end, the Broadening Participation and Industrial Incentives programme grows from R19.5 million in 2020/21 to R76.9 million in 2021/22. Support for infrastructure investment includes the development of special economic zones, the provision of critical infrastructure activities, and the rollout of infrastructure within industrial parks in support of the District Development Model. Funding in this regard increases from R1.3 billion in 2020/21 to R1.8 billion in 2021/22.

viii. The Small Business Development vote receives allocations towards access to finance through the Township and Rural Entrepreneurship Fund – R2.9 billion over the next three years. It has initiated a blended finance model that aims to facilitate financing for enterprises traditionally not supported by commercial banks/development finance institutions, over the next three years this initiative will be allocated a total of R882 million. The Commission implores government to ensure success in implementing this Fund in order to catalyse targeted local economic growth, and potentially broaden the local government revenue base.

ix. In 2021/22, the Tourism vote will receive an allocation of R2.4 billion. This represents a real increase of 63.9% from the R1.4 billion allocated to this vote in 2020/21. Following the impact that the Covid-19 pandemic and subsequent lockdown restrictions this revolves around rejuvenating the sector over. The large increase projected for

2021/22 is as a result of increased transfers to South African Tourism from R423 million in 2020/21 to a projected R1.3 billion in 2021/22. The Tourism Incentive programme increases from R59.8 million in 2020/21 to R327 million in 2021/22. This will be used to pilot the Tourism Equity Fund, intended to support commercially viable black-owned enterprises to acquire shares in tourism enterprises; promote the visibility of small, medium and micro enterprises (SMMEs); and facilitate the development of community assets and ownership patterns.

x. The Police and Defence votes are projected to decline consistently over the next three years. In the case of Police, the real growth reductions are amount to 6.9% in 2021/22, 3.5% in 2022/23 and 4.0% in 2023/24. In the case of Defence, a significant 17.8% real reduction is projected for 2021/22, followed by 3% and 3.4% cuts in 2022/23 and 2023/24 respectively. The implementation of the Police and Defence mandates are labour intensive, with spending on compensation amounting to just under 80% for the Police vote and 60% in the case of Defence. Reductions in these votes will largely be in respect of personnel.

xi. It is also notable that the **Justice and Constitutional Development** vote will grow by under 1% in real terms in 2021/22. Over the two outer years of the MTEF period, reductions of 2.7% in 2022/23 and 3.6% in 2023/24 are projected.

Table 3: Real Growth Trends for a Selection of Key Votes, 2020/21 to 2023/24

Vote	**2020/21-2021/22**	**2021/22-2022/23**	**2022/23-2023/24**
Cooperative Governance	-8.0%	1.9%	-3.1%
Home Affairs	-4.8%	-2.5%	-3.7%
Public Works and Infrastructure	5.0%	-1.7%	-3.8%
Basic Education	12.6%	0.1%	-2.1%
Higher Education and Training	0.2%	-0.9%	-3.7%
Health	4.4%	-5.4%	-7.7%
Social Development	-14.4%	0.6%	-3.8%
Women, Youth and Persons with Disabilities	18.7%	-2.2%	-3.8%
Correctional Services	-5.0%	-3.0%	-3.8%
Defence	-17.8%	-3.0%	-3.4%
Justice and Constitutional Development	0.8%	-2.7%	-3.6%
Police	-6.9%	-3.5%	-4.0%
Agriculture, Land Reform and Rural Development	6.8%	-2.6%	-3.0%
Employment and Labour	4.1%	-2.6%	-3.9%
Environment, Forestry and Fisheries	-15.2%	-2.2%	-3.5%
Human Settlements	4.9%	-1.1%	-0.2%
Mineral Resources and Energy	16.8%	6.7%	-2.0%
Science and Innovation	18.1%	-1.9%	-3.0%
Small Business Development	7.3%	-3.2%	-3.9%
Tourism	63.9%	-1.9%	-3.9%
Trade, Industry and Competition	1.1%	-1.6%	-3.1%
Transport	13.1%	1.1%	-1.1%
Water and Sanitation	0.5%	-1.0%	-0.9%
Total appropriation by vote	**-7.2%**	**-5.8%**	**-3.7%**

Source: ENE 2021, Summary Table 2.

Recommendations

- The Commission reiterates its recommendation made at the time of its 2020 MTBPS Submission - which called for departments to indicate to Parliament how they plan to absorb the cuts to their budgets and what might be foregone in terms of service delivery. Particular attention should be placed on estimating the cumulative effect of intended reductions on indigent and poor households and individuals, as a number of planned reductions will primarily affect the poor and vulnerable.
- In addition, where departments have received additional allocations, they should indicate in terms of service delivery how this will improve economic recovery and reform and/or address the Covid-19 pandemic.

5. COVID response and Intergovernmental Relations

5.1. The breakout of Covid-19 necessitated drastic budget and policy responses with serious impact on intergovernmental relations. The national government responded with a range of policy measures that were implemented disproportionally across the three spheres. National Government was generally responsible for economic relief measures while provinces and municipalities took control of health responses and only some social relief interventions such as temporary shelter for the homeless and delivery of water to schools. Table 4 below shows that national government was responsible for 92% of additional spending provided for the total Covid-19 responses in 2020/21.

5.2. The 2021 budget makes provision for a further R10 billion allocation to provinces through the Provincial Equitable Share (PES) to deal with pandemic related interventions – protecting health care professionals, acquiring personal protective equipment (PPE) and contact tracing. Approximately R2.4 billion of this will be allocated through the new Covid-19 component of the HIV/AIDS, Malaria and Community Outreach grant, to cater for vaccine rollout administration. The 2021 Budget Review further indicates that provinces had spent 60% of the R21 billion Covid-19 allocation by the end of quarter three in 2020/21. Much of the expenditure was directed at compensation of employees, additional hospital bed capacity and field hospitals, PPE and medical supplies as well as laboratory services. The 2021 budget is however unclear whether the R10 billion Covid-19 allocation to provinces also include the R6.6 billion two-year allocation to the National Department of Health for vaccine procurement. More importantly the size of the allocation seems incompatible with the ambitious government goals of achieving herd immunity within a 12-month period.

5.3. From the perspective intergovernmental fiscal relations and coordination, interventions such as the business loan guarantee scheme and support for SMMEs have not been gazetted or allocated per province using an equitable criterion as applied in most conditional grants. Similarly, the centralisation of vaccine procurement means that provinces cannot autonomously respond to their respective vaccination needs but could also evade responsibility. Further, a special audit of Covid-19 responses by the Auditor-

General indicates that the interventions at all government levels have been marred by maladministration, low take-up rates and slow spending, procurement irregularities and a lack of performance data. These blurs the lines of intergovernmental accountability for delivery arrangements across the three spheres.

Table 4: Breakdown of Covid-19 fiscal response package

<table>
<tr><th></th><th colspan="2">SAB 2020/21</th><th colspan="2">2021/2</th></tr>
<tr><th>Expenditure</th><th>Amount (R billion)</th><th>% share</th><th>Amount (R' billion)</th><th>% share</th></tr>
<tr><td>Health – Covid-19 intervention</td><td>R20</td><td>Provincial (4%)</td><td>R10</td><td>R100%</td></tr>
<tr><td>Municipal allocation</td><td>R20</td><td>Local (4%)</td><td></td><td></td></tr>
<tr><td>Social and basic income grant</td><td>R50</td><td rowspan="5">National (92%)</td><td></td><td></td></tr>
<tr><td>Job creation and support for SMEs and Informal sector</td><td>R100</td><td></td><td></td></tr>
<tr><td>Salary income support (UIF)</td><td>R40</td><td></td><td></td></tr>
<tr><td>Tax relief</td><td>R70</td><td></td><td></td></tr>
<tr><td>Business loan guarantee scheme</td><td>R200</td><td></td><td></td></tr>
<tr><td>Total</td><td>R500</td><td>100%</td><td>R10</td><td>100%</td></tr>
</table>

Source: Presidency 2020

Recommendations

- The Commission calls for better alignment of responsibilities for Covid-19 responses between national and subnational governments as per the Constitution and well synchronised resource allocation and vaccination goals.

6. 2021 Division of Revenue Bill – Provinces

Overview of provincial government allocation

6.1. The 2021 budget makes for provision for a total R1.5 trillion and R356 billion in PES and conditional grant allocations over the 2020/21 MTEF period respectively. The 2020 MTBPS indicated that the provinces are likely to bear the greatest burden of the Covid-19 induced fiscal constraints with the equitable share then expected to decline by R60 billion in 2021/22, R85 billion in 2022/23 and R64 billion in 2023/24 relative to the estimates tabled in the 2020 budget. Budget 2021 revised PES estimates compared to the 2020 Budget remain far below the forward allocation initially tabled.

6.2. However, in comparison to the revised allocation in the 2020 MTBPS the PES is adjusted upward by R9.7 billion while conditional grants increase by R0.4 billion in the 2021/22 financial year. Table 5 provides a comparison of PES and conditional grants baseline allocation changes over the four budget cycles.

6.3. The Commission notes the fluctuations of MTEF forward estimates with concern as this undermines the integrity of MTEF. Over optimistic MTEF estimates not only send wrong spending signals but also destabilise provincial budgets when implementation plans have to be suddenly adjusted. While the Commission appreciates that forward estimates are a function of growth projections, it is imperative that the fluctuations are kept to a minimum.

Table 5: Provincial allocation baseline changes

R' Billion		2020/21	2021/22	2022/23	2023/24
2020 Budget	PES	538.4	578	604	-
	Conditional grants	110.8	118	123.1	-
2020 SAB	PES	538.5	-	-	-
	Conditional grants	106.8	-	-	-
2020 MTBPS	PES	520.7	514	522	523.1
	Conditional grants	107.6	115.4	119.8	122.5
2021 Budget	PES	520.7	523.7	524.1	525.3
	Conditional grants	107.6	115.8	119.3	121.5

Source: National Treasury, 2020 & 2021

6.4. Recovery to budget stability for many provinces may take longer considering that the special adjustment budget proposed the repurposing of the PES by R20 billion to provide for Covid-19 responses. While inevitable, persistent erosion of provincial equitable share baselines is likely to destabilise provincial departmental delivery processes and performance plans if not managed well. Spreading the resources thinly through expenditure reprioritisation result in abandonment of projects, completion delays and importantly weakens the quality of delivery. The unprecedented budget cuts and reprioritisation over the past 5 years needs to be carefully managed through a coordinated and holistic process of expenditure review, rather than the current budget line item or sectoral approach. The sectoral approach promotes a culture of budget protectorate and may even hamper the proposed budget reforms, irrespective of the budgeting approach – from incremental to zero-based budgeting.

Provincial equitable share and formula

6.5. There are overwhelming concerns that the PES formula is not responsive to the unique needs of the various provinces. On the one hand, urban provinces lament the inability of the formula to address the impact of migration on provincial budgets, while the rural provinces note that the formula perpetuates historical development imbalances. PES formula reforms have been on the agenda of the Government and of Commission over the past decade - with Commission recommendations made in 2010, 2018 and 2020. In its submission to the 2021 budget the Commission recommended that the PES formula incorporate certain aspects of the costed norms approach such as acknowledging the high cost of delivering services the vulnerable groups.

6.6. It remains the Commission's position that the PES formula should remain simple to understand and not be overloaded with too many objectives. Complementary reforms are needed with respect to other elements of the intergovernmental fiscal system - particularly in respect of balancing the trade-off between subnational revenue and expenditure discretion on the one side and tightening oversight and accountability on the other hand.

Conditional grants for provinces

6.7. The total provincial conditional grants allocation for the 2021/22 financial year amounts to R116 billion, increasing from R110 billion in 2020/21 financial year. The 2020/21 allocation was reduced to R106 billion during the Supplementary Adjustment Budget before it was revised upwards to R107 billion in the 2020 MTBPS. Spending revisions were undertaken by delaying projects, suspending allocations to programmes with poor historical performance and repurposing funds for Covid-19 response. The largest reprioritisations were undertaken in the education infrastructure grant amounting to R6.6 billion mainly to provide for delivery of water, sanitation and PPE in schools. Table 6 shows baseline changes to selected conditional grants between the 2020/21 and 2021/22 financial year.

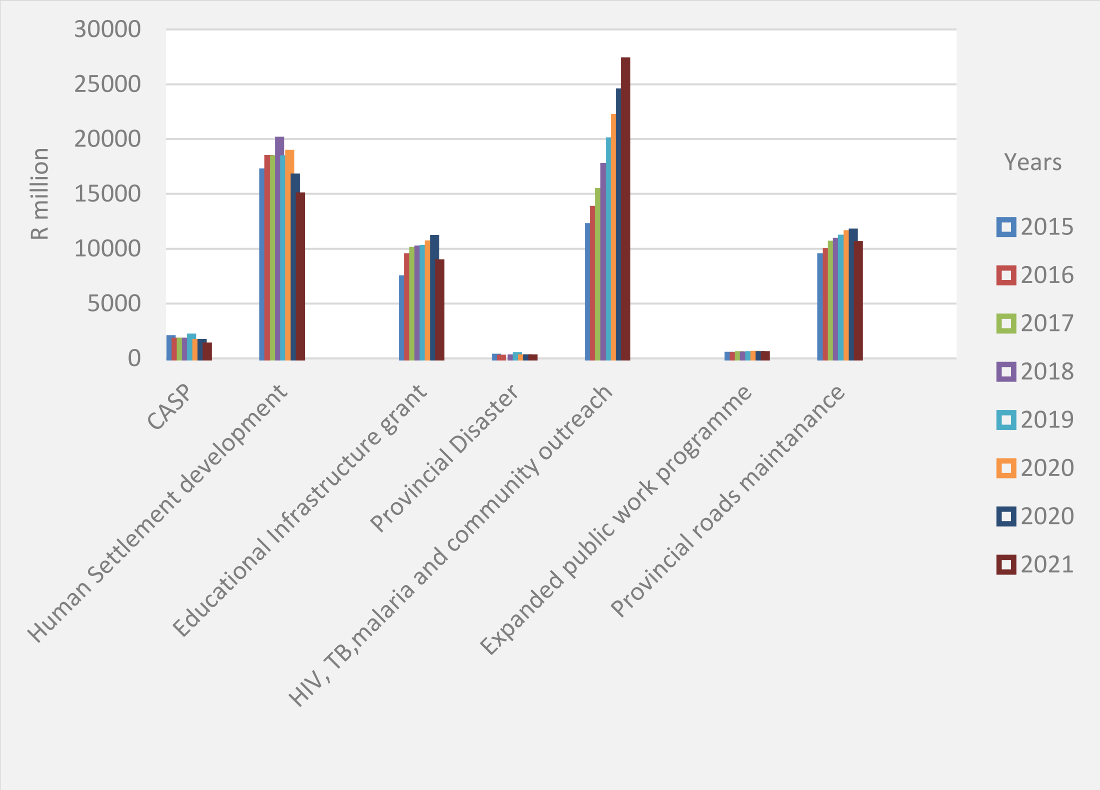
Table 6: Baseline Changes to selected provincial conditional grants

R' Million		2020/21	2021/22	2022/23	2023/24
	2020 Budget	16.621	13.414	13.871	
Human Settlement Development Grant	SAB	14.892			
	2021 Budget		13.708	14.000	14.024
	2020 Budget	1.522	1.620	1.672	
Comprehensive Agriculture Support	SAB	1.191			
	2021 Budget		1.598	1.592	1.618
	2020 Budget	11.008	11.710	12.255	
Education Infrastructure Grant	SAB	8.787			
	2021 Budget		11.689	12.229	12.678

Source: National Treasury, 2020 & 2021

6.8. Figure 9 below depicts the growth trajectory of the key largest conditional grants per sector. As can be seen that constant reprioritisation has had a negative impact on the Human Settlement Development grant since 2018 - a key instrument to deal with the growing housing backlog. Conversely, the HIV/AIDS, TB, Malaria and Community Outreach grant shows exponential year-on-year growth. While a healthy growth is commendable, the increase in the health-related grant may be reflective of failing health preventative measures. The Commission notes the proposed change outlined in the 2021 Budget to separate the Informal Settlement Upgrading program from the Human Settlement Development grant and cautions that this should not impede municipal integrated planning.

Figure 9: Provincial conditional grants growth trajectory (2015 – 2021)



Source: National Treasury, 2015 and 2021.

6.9. The Commission has on several occasions recommended the devolution of the housing function to municipalities with implementation capacity - in order to facilitate integrated spatial planning and development. Similarly, the partial conversion of the R10 billion in provincial government Covid-19 allocation into a conditional grant should be closely monitored in terms of its impact. The PES must be the primary default allocation mechanism for provincial expenditure responsibilities, ensuring provincial accountability and budget discretion. Similarly, the continued inability of the Department of Transport to deal with the incentive portion of the allocation thereby undermining the initial objective of introducing incentive portion of the conditional grant needs to be addressed.

Recommendations

- The Commission recommends that government provides parliament and provincial legislatures with regular reports on attainment of Covid-19 delivery targets. These reports should also detail the programs and projects affected that experienced cuts owing to the budget reprioritisation, and what the impact is on service delivery. The reports must indicate the projects stopped, delayed or scaled down – including the number of beneficiaries affected, especially the most vulnerable.

7. 2021 Division of Revenue Bill – Local Government

Introduction

7.1. The year 2021 will be a challenging one as municipalities face the Covid-19 related challenges first-hand. The Covid-19 pandemic has threatened the viability of many municipalities and further compounded deep seated financial, fiscal, governance and service delivery challenges. Although government provided R11 billion to relieve municipalities from Covid-19 related pressures, spending of such funds has been low. According to National Treasury, "from March 2020 to February 2021… municipalities had spent close to 40% of the R11 billion added to the local government equitable share"[3]

7.2. While the Covid-19 situation continues to evolve, it should be noted that it is already creating legacies for the local government sector, including the following:

i. Many municipalities will be left with wider deficit due to the rapid expansion of Covid-19 related expenditures in the face of widespread revenue under collections.
ii. Many municipalities will be left with higher debt.
iii. The Covid-19 circumstances have amplified challenges of access to basic services (housing, water, and sanitation).
iv. While the lockdown has accelerated the use of technologies (a legacy that needs to be captured), it has amplified inequalities as marginalised local communities cannot access this technology without a deliberate and direct investment.
v. The crisis has also amplified the need for long term change to make local government work effectively, efficiently and be accountable.

7.3. The political landscape of the local government will also change dramatically in 2021 because of the municipal elections. This year the sector will see the introduction of new councillors and many will be leaving, and the process will bring in its own governance and fiscal challenges. For example, uncertainties related to the formation of coalitions and non-return councillors will require gratuities. The budget statement proposes reprioritisation of monies from the direct conditional grants (i.e. the municipal infrastructure grant and the integrated urban development grant) to fund the once-off gratuities to non-returning councillors.

7.4. Other major developments in the sector in 2021 will include the roll out of the District Development Model and the review of the Local Government Capacity Building system. These initiatives, if fully undertaken, will move the local government sector forward and quicken the recovery process.

Local Government Fiscal Framework and Local Government Equitable Share

7.5. Over the 2021 MTEF the Local Government sector is set to receive transfers amounting to R456 billion; R432 billion as direct transfers and R23 billion in the form of indirect transfers from national votes. The share of local government allocations rises modestly

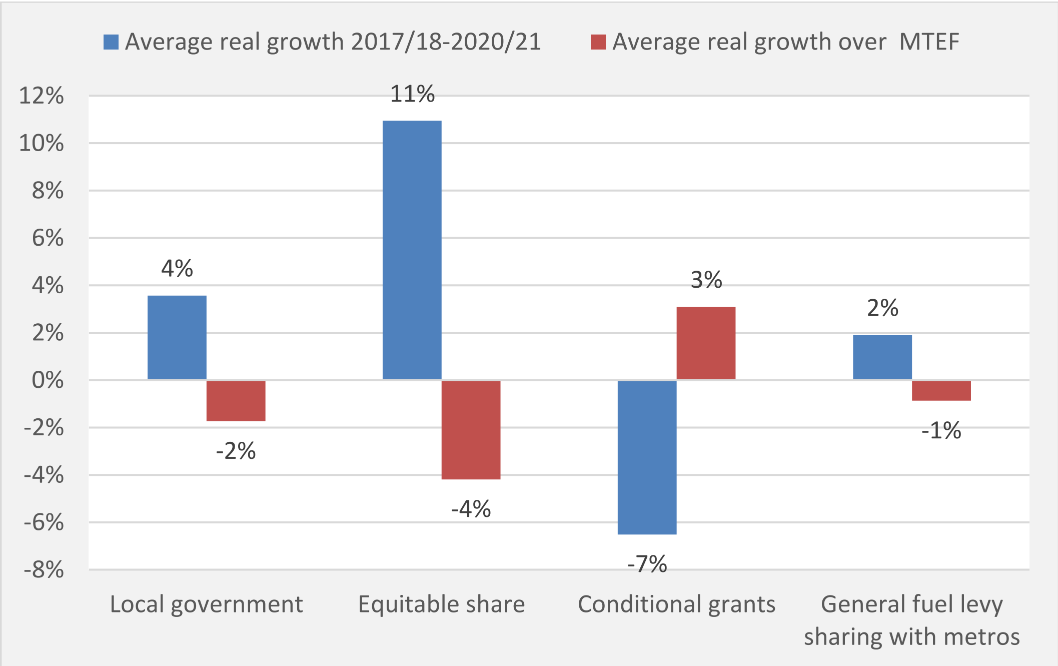
[3] Budget Review 2021; p 69

over the MTEF, from 9% in 2021/22 to 9.7% in 2023/24. It should be noted that this growth is not because more resources will actually be transferred to the sector, but rather a result of reductions to the public-service wage bill that affect the national and provincial spheres, reducing their shares in the reduced total government expenditure. The real growth rates of the local government transfers are shown in Figure 10 below.

7.6. The total local government transfers will decline by 2% (as part of the fiscal consolidation measures) over the MTEF. In nominal Rand amounts, the total local government transfers will be reduced by R20.2 billion - R15.5 billion from the local government equitable share allocation (4% of it), R2.7 billion from the General fuel levy (1%) and R2 billion from the conditional grants). The more most development is the decline of 4% in the real average growth rate of the local government equitable share allocation, this decline of R15.5 billion will adversely affect the delivery of basic services to the poor and vulnerable.

7.7. The poor and vulnerable are counting on government for relief in these difficult times of Covid-19 and sharply rising unemployment. Mindful of this, to mitigate the adverse impacts of these cuts on service delivery, the Commission implores municipalities to strengthen their revenue collection systems and to stop revenue leakages through harnessing new smart technologies. The use of new technologies, one of the legacies of the Covid-19 pandemic, needs to be sustained and embedded in all municipal policies and strategies.

Figure 10: Local Government Average Real Growth Rates



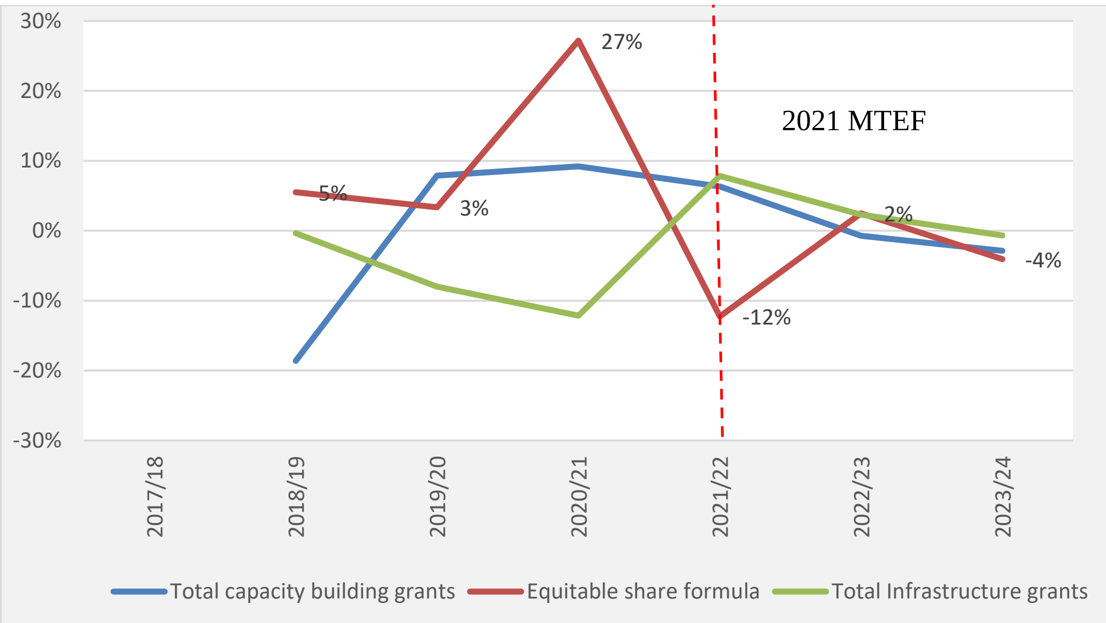
Source: FFC Calculations based on NT Budget data.

Local Government Conditional Grants

7.8. Over the 2021 MTEF conditional grants to municipalities amount to R143 billion as direct conditional grants, and R24 billion in indirect conditional grants. Considering the net effect of changes to allocations, conditional grants will increase modestly, by 3% in real terms (albeit from a very low base) during the 2021 MTEF (Figure 10). Figure 11 compares the real growth rates after inflation, of infrastructure and capacity building grants with the local government equitable share allocations. Figure 11 shows a steady decline in all these conditional grant transfer windows in real terms over the MTEF. It would seem the shift from consumption spending (LES) towards capital spending (conditional grants) observed in the 2020 Budget was short lived.

7.9. Figure 11 shows that, going forward, basic services provision will be under severe pressure, including infrastructure and capacity building programs. The Commission notes the ongoing review of capacity building systems and grants championed by National Treasury and other relevant stakeholders. This review was long overdue as the returns to municipal capacity building initiatives have been poor. Many municipalities continue to perform dismally, and many are dysfunctional despite government investing between R2 billion and R3 billion annually on local government capacity building systems.

Figure 11: Real Growth Rate in the three local government transfer windows



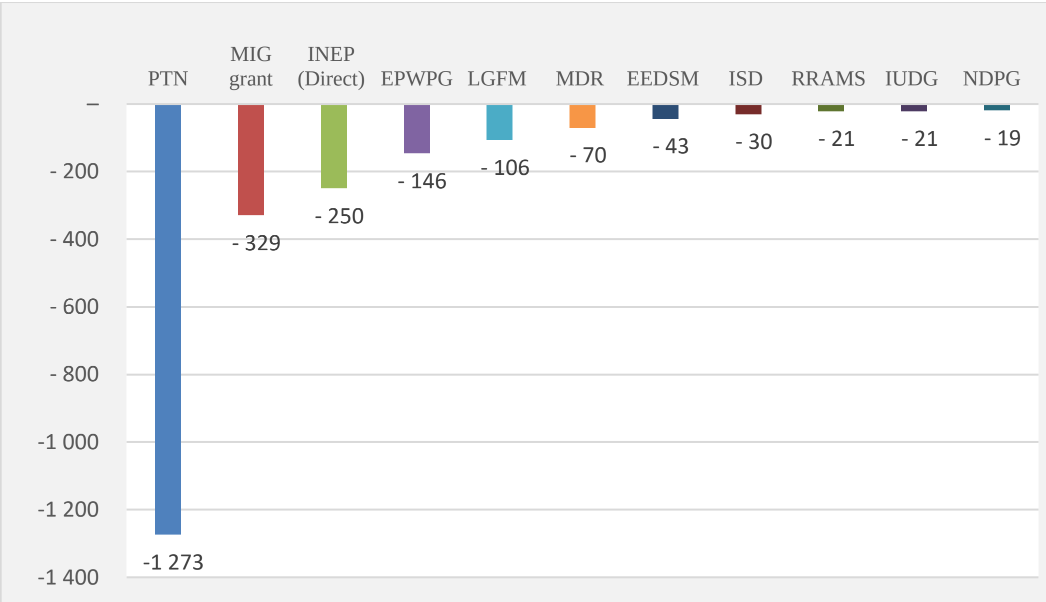
Source: FFC Calculations based on NT Budget data.

Conditional Baseline Cuts

7.10. Over the MTEF, the municipal conditional grants baseline will be cut by R2 billion. Figure 12 shows the spread of these cuts. According to government, the basis for these baseline cuts is underspending. The Commission would like to underscore the point that underspending may be a symptom of bigger challenges which need to be investigated with a view to resolving the issues first; before any cuts are affected or funds reprioritised to other areas. One of the reasons for underspending could be the Covid-19 circumstances, as the pandemic has imposed many restrictions and disruptions to the normal business of municipalities. As this is a global phenomenon and beyond the control of municipalities, caution must be taken when grant baselines are being cut due to underspending.

7.11. The public transport network grant, municipal infrastructure grant and the direct integrated national electrification programme grant will account for over 90% of the cuts. The public transport network grant will get the largest cut (R1.3 billion) due to the fact that 54% of the 13 cities receiving this grant, have not successfully established public transport systems. The project will be halted in three municipalities. The Commission implores the government to investigate the reasons why these cities have not successfully launched public transport systems. This should be done with a view to assisting the remaining cities to establish viable public transport systems. As has been note above, baseline cuts to municipal infrastructure grant (R329 billion) and the integrated urban development (R21billion) grant are meant to provide for once-off gratuities to non-returning councillors.

Figure 12: Baseline Reductions to Conditional Grants



Source: National Treasury Budget Review database.
Notes: PTN -Public transport network; MIG- Municipal infrastructure; INEP- (Direct) Integrated national electrification programme; EPWP- Expanded public works programme; LGFM- Local government financial management grant; MDR- Municipal disaster relief; EEDSM -Energy efficiency and demand-side management; ISD- Infrastructure skills development; RRAMS- Rural roads asset management systems; IUDG- Integrated urban development; NDG- Neighbourhood development

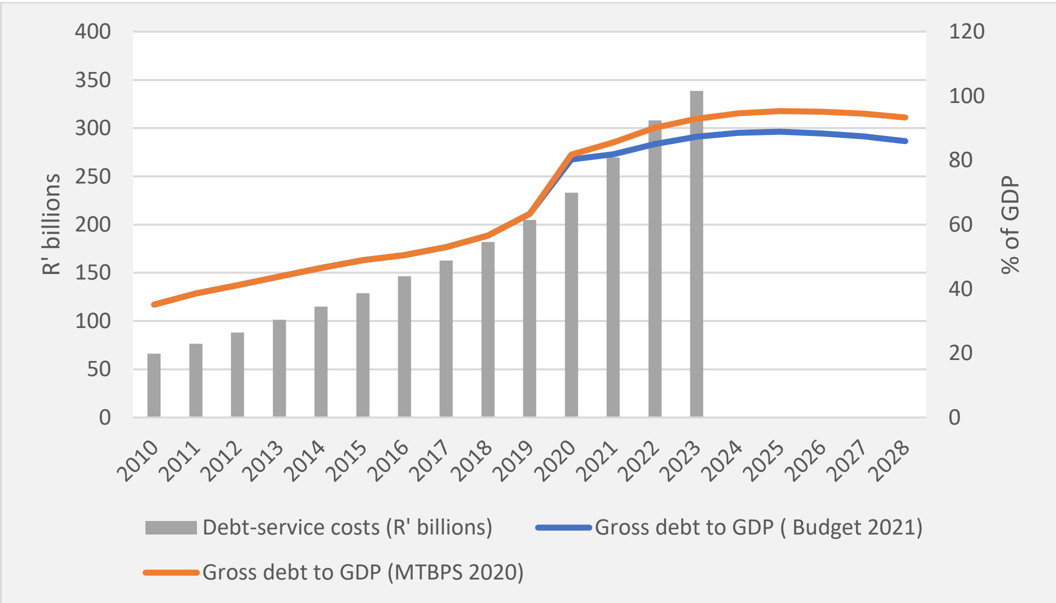
8. Government debt and contingent liabilities

Debt and financing costs

8.1. Despite the short-term relief offered by the improved 2020/21 revenue collections expected to be R99.6 billion above the 2020 MTBPS estimate revenue outlook, the debt burden remains. The increasing debt service costs are rapidly translating towards an unsustainable fiscal situation of a debt spiral whereafter the increase in outstanding public sector debt will no longer be stabilised through higher taxation and/or a decrease in discretionary expenditure.

8.2. Gross loan debt issuance is expected to increase from R3.95 trillion (80.3% of GDP), in 2020/21 to R5.23 trillion (87.3% of GDP), by 2023/24. Compared to the 2020 MTBPS, net reductions of non-interest spending items from the 2020 Budget amount to R264.9 billion over the medium-term expenditure framework (MTEF) period. These reductions will narrow the consolidated budget deficit from 14% of GDP in 2020/21 to 6.3% of GDP in 2023/24. Consequently, the gross national debt is now estimated to stabilise at 88.9% of GDP in 2025/26 compared to the 93.3% of GDP projected by the 2020 MTBPS (see Figure 13 below).

Figure 13: Gross debt-to-GDP outlook, 2020/21-2028/29 and Debt-service costs, 2010/11-2023/24



Source: National Treasury Budget Review, 2021

8.3. Still, the significant increase in debt issued by the government is increasing government spending that is allocated to debt servicing costs, which will increase by an average annual growth of 13.3% from R232.9 billion in 2020/21 to R338.6 billion in 2023/24 rendering it the fastest-growing category of expenditure (Figure 13). This while non-interest government expenditure is cut. However, debt-service costs are a first charge on the budget and now comprise the third largest consolidated spending item, after social development and learning and culture. Debt-servicing alone will consume almost 22 cents of every rand generated in gross tax revenue in 2023/24, effectively placing 22% of government revenue in the hands of bond holders (wealthier investors), thus perpetuating income inequality.

8.4. Debt service costs, which excludes any debt redemption, are accounting for an increasing proportion of limited public resources and therefore crowding out spending on South African social and economic investment. Debt-service costs accounted for 2.3% of GDP in 2010/11, this has increased to 4.7% in 2020/21 and is projected to reach 5.6% in 2023/24. Debt-servicing costs are increasing partly because of a larger credit risk premium being priced into both domestic and foreign currency-denominated debt. Opportunities to access lending facilities with the lowest interest costs must be sought and be taken advantage of.

8.5. Economic literature postulates that when GDP growth is higher than the average interest rate on the debt, the debt to GDP ratio will not increase to unsustainable levels. However, when the average interest rate on the outstanding debt exceeds the GDP growth rate, a primary budget in balance or in a deficit (that is budget before interest costs) will see an indefinite increase in the debt ratio[4]. In essence, when the cost of government debt increases more rapidly than the economy grows resulting in swift rise in the interest burden, government will eventually have to borrow money chiefly to repay interest on its debt i.e. spiralling debt servicing costs.

8.6. This interest-rate-growth differential is useful in understanding long-run fiscal sustainability. It determines the rate at which a country's public debt rises relative to its output. Currently South African interest rates exceed GDP growth rates. According to the International Monetary Fund, in South Africa, the interest rate-growth differential averaged 0.1% between 2009 and 2017. However, the interest rate-growth differential was 1.2 and 1.5% for 2018 and 2019 respectively. It is forecasted at 7.6% for 2020. The increasing differential means that South Africa must raise larger primary budget balance surpluses (i.e. raise revenue or cut other spending) to stabilise the debt-GDP ratio. However, the primary balance is only projected to be in surplus by 2025/26. The Commission emphasises that South African economic reconstruction and recovery is imperative.

Guarantees to state-owned companies

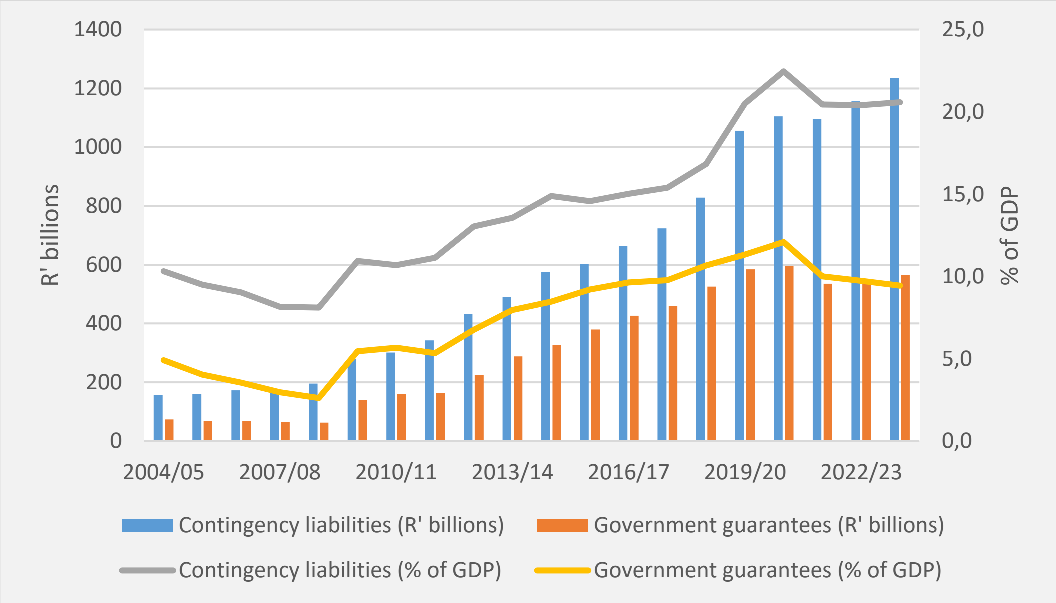
8.7. Contingent liabilities are government legal obligations to make a payment if a particular future event occurs and are typically not fully recognised until after a failure occurs. This means that the required size of government outlay if the failure realises, are uncertain. Contingent liabilities accounted for in the 2021 Budget amount to 22.5% of GDP in 2020/21 compared to just 10.3% in 2004/05. Their estimates increased by more than five times from R156 billion in 2004/05 to R1.1 trillion in 2020/21. Contingent liabilities are projected to reach R1.23 trillion in 2023/24 (see Figure 14 below). If a contingent liability realises, funds may be required from the fiscus in the form of an appropriation or a tax, like in the case of the Road Accident Fund that benefits from an increased fuel levy in the 2021 Budget.

8.8. Government guarantees to state owned entities (SOEs) accounted for 54% of total contingent liabilities in 2020/21. This component increased significantly from R74 billion in 2004/05 to R595 in 2020/21. Government guarantees have the purpose of the reduction of interest borrowing costs and the accompanying increasing investment for strategic SOEs. Albeit, government guarantees also represent a risk to government

[4] See Turner, David and Francesca Spinelli (2012), “Interest-rate-growth differentials and government debt dynamics”, OECD Journal: Economic Studies, Vol. 2012/1.

finances. Government guarantees to SOEs accounted for 4.9% of GDP in 2004/05 but this figure has significantly increased to 10.8% in 2019/20. Contingent liabilities to SOEs represent a rating weakness that could translate to a credit rating downgrade for South Africa, because of large size and high probability of migrating onto the government's balance sheet.

Figure 14: Contingent liabilities and government guarantees, 2004/05-2023/24



Source: National Treasury Budget Review, 2021 and Commission's own calculations

8.9. Eskom remains a significant risk to South Africa’s debt sustainability and to the economy, as unreliable electricity supply continues to throttle economic activity (Budget Review, page 12). Government guarantees to Eskom have amounted to R350 billion since 2010. In 2015/16, government guarantees to Eskom reached 8.5% of GDP and accounted for 74% of total guarantees to state owned entities. Government guarantees to Eskom remained, on average, more than 7% of GDP, accounting for over 70% of the guarantees to state owned entities between 2015/16 and 2019/20. Further, Eskom was allocated by appropriation R56 billion for 2020/21 and R31.7 billion for 2021/22.

8.10. Government guarantees to SANRAL, the Trans-Caledon Tunnel Authority and South African Airways (SAA) are also relatively substantial as they amounted to R37.9 billion, R43 billion and R19.1 billion respectively in 2019/20. Furthermore, SAA was allocated an appropriation of R10.3 billion in 2020/21, and R4.3 billion and R1.8 billion in 2021/22 and 2022/23 respectively. An addition R10.5 billion was appropriated at the time of the 20202 MTBPS for SAA in 2020/21. The SAA amended business rescue plan identified additional funding requirement amounting to R19.3 billion, of which R14 billion is expected to come from government, inclusive of the R10.5 billion allocated in 2020/21. The Land Bank defaulted on its debt in April 2020. It has been allocated R7 billion in recapitalisation over the medium term.

8.11. In 2021/22, the total amount for approved guarantee to SOEs is R581 billion, with an associated exposure estimated at R410 billion. The lack of financial performance of SOEs is putting considerable pressure on public finances. The government has already allocated SOE support of a cumulative R129 billion (2.6% of 2020 GDP) between 2020/21 and 2022/23, but more may be needed as the Covid-19 shock will weaken the finances of many SOEs.

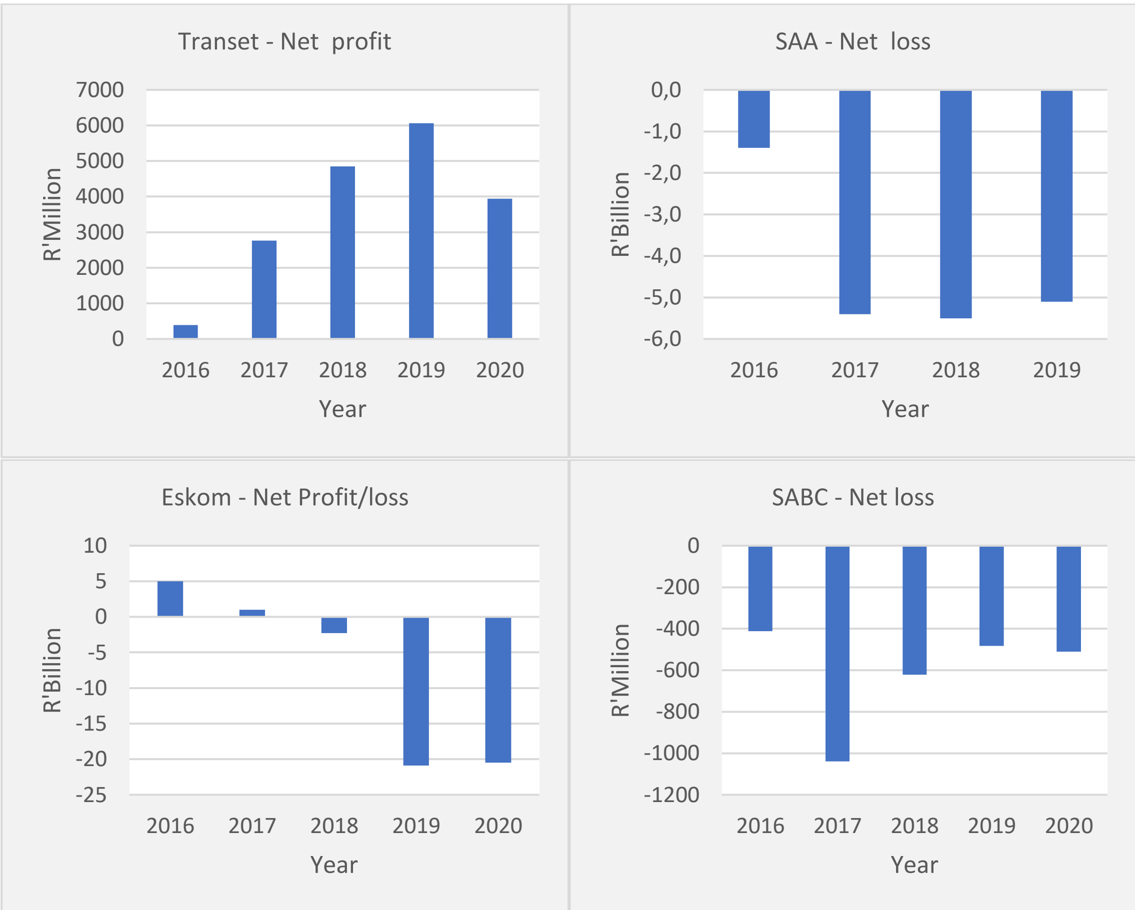
8.12. Most SOEs are marred by governance failure evident in inefficiency, corruption, and financial mismanagement. There is no effective governance framework for SOEs to ensure transparency, accountability and improvements in the quality of SOEs' boards.

9. Public-sector institutions and investment

Financial performance of state-owned companies

9.1. Several state-owned companies and public entities play a vital role with respect to public sector infrastructure delivery and the provision of basic services. These public sector institutions include Eskom, Transnet, South African Road Agency, Telkom and South African Airways (SAA). Apart from receiving direct funding from the fiscus, some of these public-sector institutions also receive state guarantees (see part 8 above) hence it is in the interest of the government to monitor their performance.

9.2. Figures below illustrate financial performance of four state-owned companies. Transnet is the only state-owned company that has shown positive net-profit over the past five years and has shown an increasing trend in four years, except for the reduced net-profit in 2020.



Source: 2021 Budget Review, National Treasury

9.3. Eskom's net profit declined but remain positive in 2016 and 2017. Eskom experienced a net loss of R2.3 billion in 2018 and it increased significantly and reached R20.9 billion in 2019. Eskom's net loss remained high at R20.5 billion in 2020. SAA's net losses increased from R1.4 billion in 2016 to R5.5 billion in 2019/20 according to the unaudited financial statements (ENE, 2021). In terms of audit outcomes, Transnet received a qualified audit opinion for year ended March 2020 with fruitless and wasteful expenditure of R108 million, this is an improvement as fruitless and wasteful expenditure was R484 million in a previous year.

9.4. Eskom received a qualified audit opinion with irregular expenditure of R25 659 million in 2019, increased from R21 048 million in 2018. The Auditor-General (AG) could not determine the extent of irregular expenditure or fruitless and wasteful expenditure with accuracy. Amounts reported for fruitless and wasteful expenditure for 2019 were R641 million and R143 million and for 2018 were R603 million and R53 million.

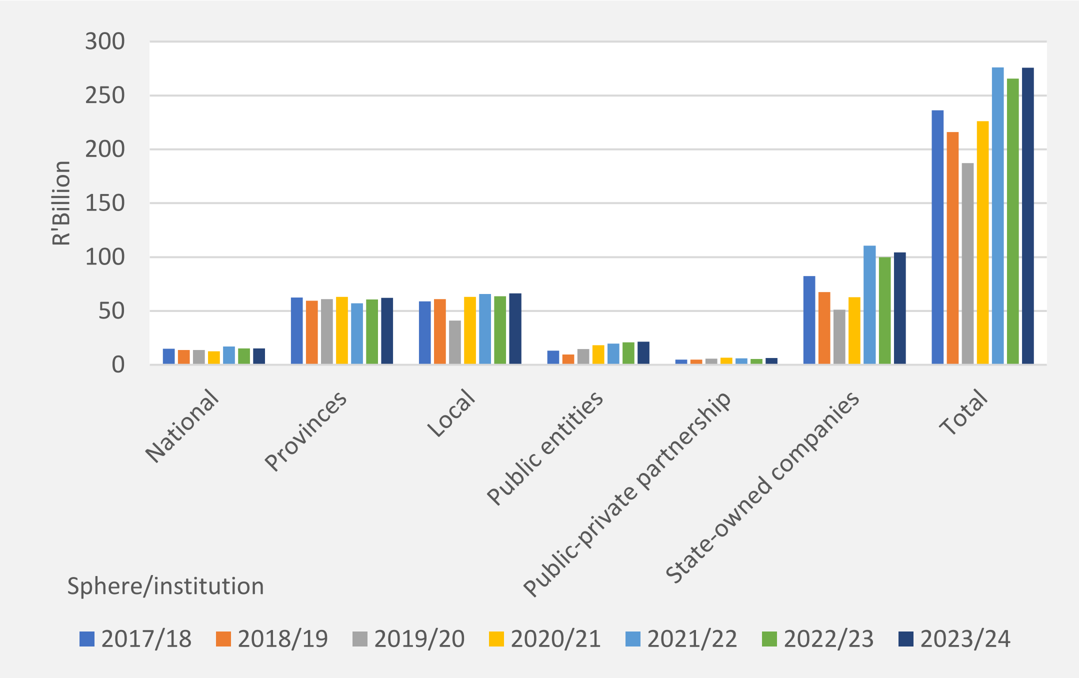
9.5. SABC received a qualified audit opinion for the year ending in March 2020. The AG was unable to determine if adjustments were necessary to the irregular expenditure stated at R5.3 billion which increased from R5.2 billion in 2019. With respect to SAA, it is significant to note that the AG was unable to give an audit opinion and determine the extent of irregular expenditure and fruitless and wasteful expenditure for 2010 and 2019. This is of grave concern.

Public sector infrastructure spending

9.6. Public infrastructure investment does not only directly contribute to an improvement to access to basic services but is also an enabler for private sector investment and attracts foreign direct investment. Public sector infrastructure investment broadly covers spending on new assets and replacing, maintenance and repairs, upgrading, renovation or refurbishment of existing assets. The National Development Plan identifies public infrastructure investment as key for national development. Public sector infrastructure investment plans and projects are implemented across the three spheres of government (national, provincial and local level) and through public sector institutions. When reporting on public infrastructure investment, the National Treasury differentiates between public entities and state-owned companies.

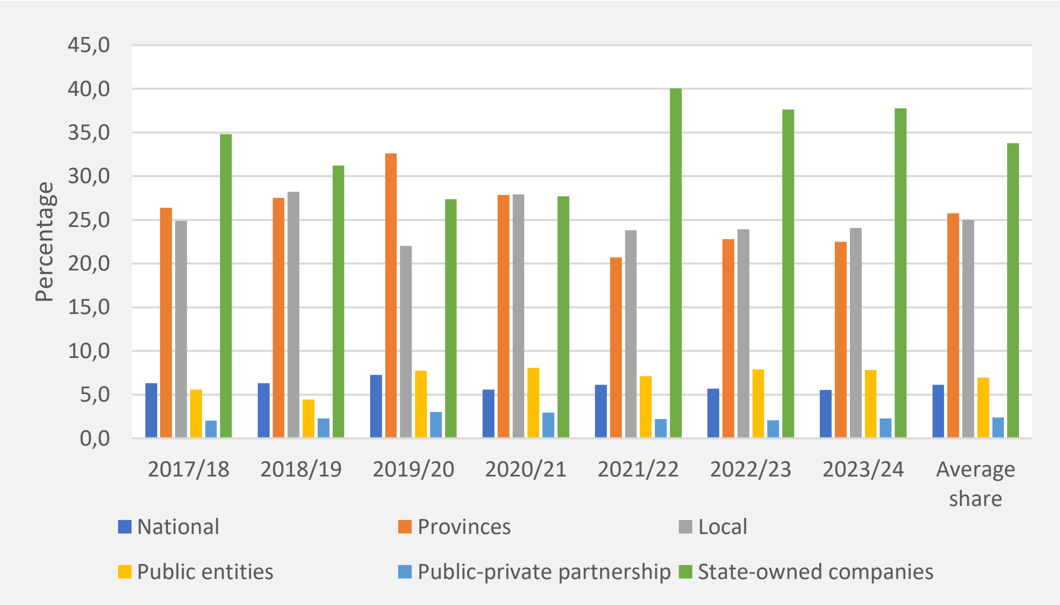
9.7. With respect to public infrastructure investment, Figure 15 illustrates that there has been a decrease in public infrastructure investment from R236.2 billion in 2017/18 to R226.1 billion 2020/21. The significant decrease was in 2019/20 mainly as a result of a decrease in investment by state-owned companies from R67.5 billion in 2018/19 to R51.2 billion in 2019/20, and local government investment which decreased from R61.0 billion to R41.2 billion over the same period. Public infrastructure investment picked up in 2020/21 as investment on state-owned companies and local government increased from R51.2 billion to R62.6 billion and from R41.2 billion to R63.1 billion respectively.

Figure 15: Public-sector infrastructure investment



Source: 2021 Budget Review, National Treasury

Figure 16: Shares of public-sector infrastructure investment



Source: 2021 Budget Review, National Treasury

9.8. With respect to shares of public infrastructure investment, there has been inconsistency in relative importance across provinces, local government, public entities and state-owned companies. For example, the share of local government increased from 21.9% in 2016/17 and reached 28.2% in 2018/19 and decreased thereafter. As expected, relative to its mandate, the national sphere of government share of infrastructure investment is only 6%.

9.9. With respect to average shares of public infrastructure investment, state-owned companies are key drivers of public infrastructure investment, in 2020/21 over 40% of public infrastructure investment was through state-owned companies as illustrated in Figure 16 above. It is of a great concern that key state-owned companies fail to deliver to the expectations as they exhibit net losses and irregular, fruitless and wasteful expenditure remains high. This poor performance indicates leakages in a large proportion of funding allocated for infrastructure investment in these companies. In this regard, the Commission notes the establishment of the Presidential State-Owned Enterprises Council announced by the President in his SONA. Provincial and local government average shares are both about 25%, while local government plays a key role in the delivery of basic services infrastructure, provinces also deliver key infrastructure such as school, health and human settlements.

Recommendations

The Commission recommends:

- Reform of the assessment and conditions in granting government guarantees to state-owned companies and for granting appropriation funding. These conditions should include a comprehensive and credible turnaround strategy.
- The acceleration of the restructuring of state-owned companies in general and of Eskom in particular. This must be based on a thorough appraisal of existing expenditures, and of the mandates and policies they are based upon to ensure efficiency, effectiveness, and affordability/profitability.
- Improvement of the governance of state-owned companies using a governance framework to clearly define detailed and precise profitability and non-financial objectives and improve the quality of state-owned companies' boards.

10. Concluding Remarks

10.1. The Commission notes the 2021 Budget and the fiscal position undertaken by the government. The policy position is consistent with the 2020 MTBPS and the 2020 Supplementary Budget, guided by the economic and social support response package to the Covid-19 pandemic. However, as the government is negotiating for a sustainable fiscal path, it should not lose sight of the Constitutional imperatives nor lead to the retrogression of citizens' socio-economic rights. Reprioritised current spending not devoted to addressing the Covid-19 pandemic - should be invested to yield maximum multiplier effects of economic returns, such as providing basic municipal infrastructure and services (i.e. water, electricity and refuse) as the backbone for local economic development. In turn, the volatile and excessive tariff (at 15.63% tariff hike for electricity) and municipal debt increases (due to debt owed by provincial, and national) on basic services are of grave concern and need an urgent resolution.

10.2. The fiscal credibility for spending lies in the actual expenditure and service delivery outcomes. The Commission calls for active engagement between the 3 spheres of government to ensure the formalization and alignment of provincial and local government economic reconstruction and developments plans with the ERRP. More specifically, provincial economic recovery plans should justify their strategic planning approach to stimulating economic growth at the provincial level and the implementation plans to address, among other things, reducing youth unemployment as a key priority. Reconstruction and recovery are not only about availability of budget, but also sacrifices, cooperation and hard work.

10.3. The Commission notes the financial and performance dysfunctionality, borne out in contract mismanagement, procurement irregularities and inefficiencies across the entire public sector - The Commission advises that a strategy be developed to address the public sector dysfunction with to restore accountability with consequence management as part of the consolidation effort, especially in local Government and state-owned companies. The Commission notes the recent Committee briefings by the SIU at the Public Accounts committee and National Treasury at both Finance and Appropriation Committees, on among other things: audit outcomes of the Land Bank, Eskom, South African Broadcasting Corporation (SABC), Passenger Rail Agency of South Africa's (PRASA), investigations into Covid-19 PPE procurement by state institutions and so on; where dysfunctionality persists.

10.4. In as early as the 2019 MTBPS submission, the Commission emphasised fiscal leakages as wastage and inefficiency that undermines fiscal credibility. The Commission notes that citizens do not get their rightful returns from public spending, especially as non-interest government spending is reduced. These issues must be addressed by:

i. A decisive and coherent strategy and the political will

ii. Implementation of the fiscal consolidation, targeting cuts at areas of underspending and questionable performance

iii. Eradication of duplication of functions – i.e., the merging or closing of departments and public entities where appropriate

iv. Investment in the use of technology and other areas of improving the capability of public sector personnel

v. Eradication of contract mismanagement and procurement irregularities

10.5. On the Division of Revenue and Appropriation, the 2021 Budget as policy statement can only ultimately be assessed in terms of its final outcomes. The reduction in conditional grants - key to both provincial and local economic infrastructure - will have a consequential effect on local and provincial economic development and therefore national economic development. The 2021 Budget should in promoting economic growth be more specific in supporting local demand and localised product procurement to support value chains, as endorsed by the President in the SONA towards economic transformation and development. This concept of a *localised product value-chain* approach towards growth was also recommended by the Commission in its 2021/22 Annual Submission for the Division of Revenue (Chapter 3, Recommendation 2), agreed to in the 2021 W1 Annexure: Explanatory memorandum to the division of revenue.

For and on behalf of the Financial and Fiscal Commission

Mr Michael Sachs

Acting Chairperson: Financial and Fiscal Commission

Date: 1 March 2021