FINANCIAL AND FISCAL COMMISSION

BRIEFING ON THE 2019 MEDIUM TERM BUDGET POLICY STATEMENT

Joint Standing and Select Committees: Appropriations and Finance

Tuesday, 05 November 2019

For an Equitable Sharing of National Revenue

BACKGROUND

- The Commission is a permanent constitutional body that advises all organs of state on economic, financial and fiscal matters
- Our recommendations *MUST BE* considered as per:
  - s214(2) Equitable shares and allocations of revenue;
  - s218(2) Government guarantees;
  - s228(2)(b) Provincial taxes;
  - s229(5) Municipal fiscal powers and functions;
- Submission made in terms of S4(4c) of MBPARMA (Act 9 of 2009)
  - Requires Parliamentary Committees to consider any recommendations of FFC during deliberations on Money Bills
- Also made in terms of FFC Act of 1997 as amended
  - Requires that FFC responds to any requests for recommendations by any organ of state on any financial and/or fiscal matter(s) relevant to its mandate

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INTRODUCTION

- The 2019 Medium Term Budget Policy Statement (MTBPS) is framed in an economic environment characterised by **muted** economic growth
- Despite the modest rebounding of the economy in the second quarter of 2019, growth is still **fragile**, with **growth prospects revised downwards** by many financial institutions.
  - National Treasury has revised GDP) growth downwards to 0.5 percent for this year from 1.5 percent as at the time of the February 2019 Budget; World Bank from 1.3 percent to 0.8 percent and IMF from 1.2 percent to 0.7 percent.
  - Low and fragile growth acts as a dead weight on the country's ability to raise tax revenues: In fact, revenue collection is projected to weaken further over the medium term- with a R52.5 billion revenue shortfall projected in 2019/20 financial year.
- Present environment of low fragile growth is making it difficult to tackle the **triple challenges of high unemployment, poverty and inequality**.
  - Roughly 55.5 per cent of the population are officially living in poverty [upper-poverty line]; Poverty headcount rose from a level that had reduced to 53.2 per cent in 2011;
  - Almost one in three individuals is unemployment (29.1 percent), [Q3 2019];
  - Gini Coefficient at 0.696 - the wealthiest 10 per cent of South Africa's population owned 70.9 percent of the wealth and the bottom 60 per cent had 7.0 per cent. [Poverty Trends in South Africa, 2015]

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INTRODUCTION [CONT.]

- Economic growth is faltering due to inter alia:
  - Inefficiencies in the way resources are used across the economy;
  - Fiscal leakages;
  - High incidences of corruption and inefficiencies in government procurement processes;
  - Intermittent electricity supplies; and
  - Infrastructure that is inadequately built or maintained even when budgeted for.
- Other risks include:
  - Policy and implementation uncertainty (e.g. e-Tolls, SOCs);
  - Contradicting signals affecting confidence and policy credibility; such as runaway public sector wage bill; and
  - SOCs that continue to haemorrhage state resources
- Commission agrees with Government that higher, inclusive and sustained growth is imperative.

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INTRODUCTION [CONT.]

- Commission notes the government initiatives launched to tackle these challenges:
  - the Jobs Summit of 2018 and the Investment Summit of 2018;
  - team of investment envoys in 2018
  - setting up of a presidential economic advisory panel;
  - Appointment of the Commission of Inquiry to deal with corruption,
  - strengthening of government institutions (e.g. NPA)
  - attempts to reorganise and reorient state machinery and SOCs to improve service delivery
  - the new District Development Model to improve service delivery to communities and
  - The recent "Economic Strategy for South Africa" paper to engage South Africans on defining the pathway to grow the economy
  - General protection of social spending and municipal basic services
- The Commission supports the thrust of the 2019 MTBPS and notes the candidness of the MTBPS about the current dire economic situation. This 2019 MTBPS was one of the toughest to craft as it seeks to strike a balance between resuscitating the economy and protecting social spending and delivery; and trade-offs are inevitable.
  - The Commission advises and implores government to institutionalise the above initiatives in order to ensure implementation and carry them through.

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Economic Outlook and Public Finances Overview

- South Africa's long-term economic growth prospects remain bleak, despite some feeble signs for positive improvements.
- In the first quarter of this year, the South African economy contracted by 3.1 per cent on a seasonally adjusted and annualised quarter-on-quarter basis, and a meagre growth of 0.1 per cent year-on-year basis.
- Gross tax revenue is projected to fall short of the 2019 Budget estimates by R52.5 billion in 2019/20 and R84 billion in 2020/21.
- With the weak economy and diminishing tax base, there is no room for fiscal options in the near future, which leaves fiscal reprioritisation, fiscal consolidation through restructuring and governance to be the only viable course of action to restore fiscal credibility for a sustainable future of South Africa.

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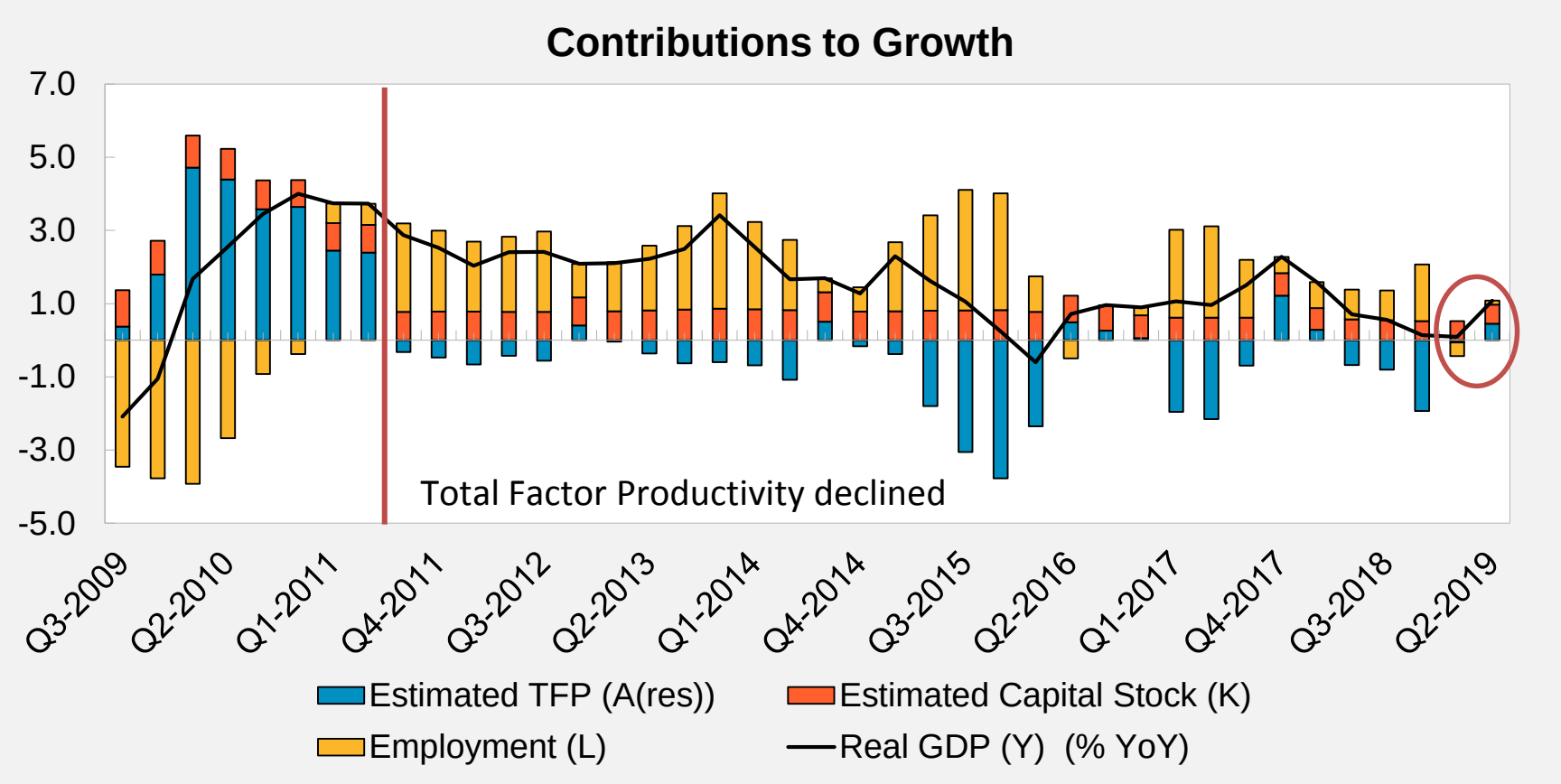
CONTRIBUTIONS TO GROWTH USING A PRODUCTION FUNCTION APPROACH*, Q3 2009 - Q2 2019



Source: *South African Reserve Bank, SARB (2019) and own calculations.*

Note: *In Macroeconomics, aggregate production function is an estimation framework to distinguish how much of economic growth to attribute to changes in factor allocation as Capital Stock (K), Employment (L) and Estimated Productivity of all the factors of growth (A(res)).*

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The Economy: A mixed picture with tenuous signs of recovery

- On the **supply side**, the mining and quarrying and construction industries suffered major contractions in the second quarter of 2018-2019 due to receding demands from both international as well as domestic markets.
- On the **demand side**, the growth contributions of:
  - **Private consumption** increased marginally due to a re-adjustment of the business cycle.
  - **Government consumption** to growth was sustained at 0.3 per cent.
  - **Public investment** softened slightly from 0.5 per cent to 0.4 per cent, though maintaining its positive position.
  - **Private investment** remained in the negative territory at negative 0.3 per cent.
  - **Inventories** increased by 0.7 per cent in Q2 2019.
- It is important that government **continues to take bold, informed steps** to eliminate inefficiencies and policy and implementation uncertainties in public institutions.
- Inefficiencies and uncertainties have become endemic due to fiscal leakages, dysfunctional state-owned companies and ineffective implementing agents.

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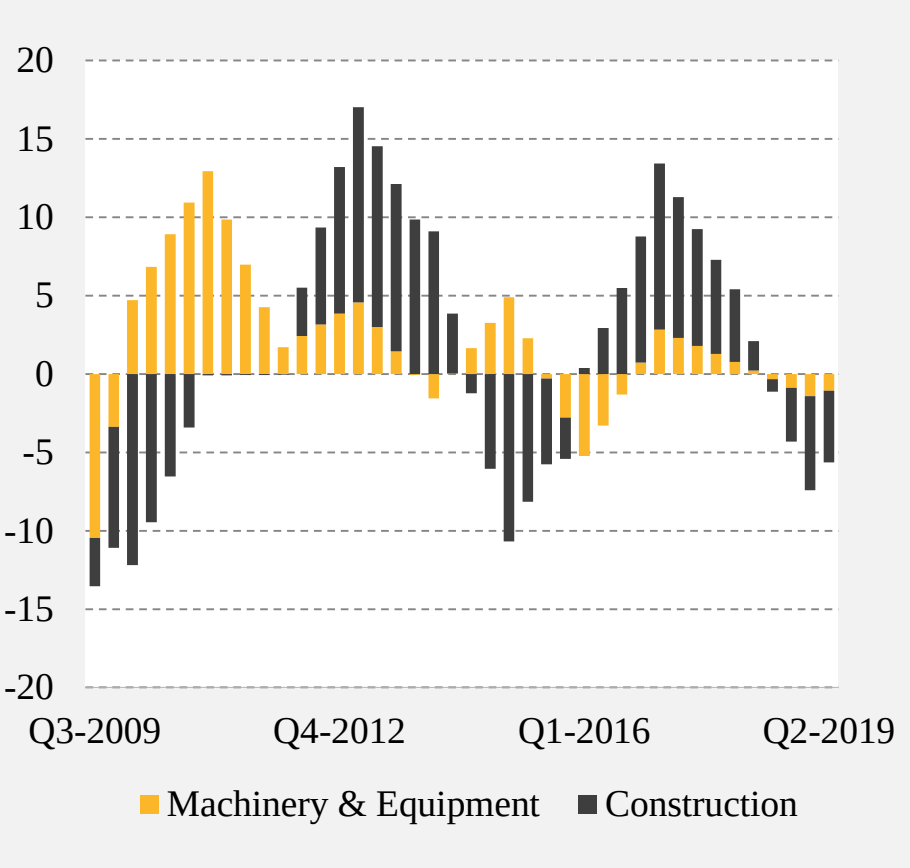
Investment is critical for future growth relative to current growth and consumption



- Private investments in machinery and equipment, which is vital to the production of goods and services on the supply side, remains muted.
- Private investment in construction suffered major declines in recent quarters as concerns over demand and future growth prospects remain present and depress building more structures to accommodate households and businesses.
- The Economy: a mixed picture with feeble signs of recovery as factors of productivity and capital stock increased recently.

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Anatomy of a Fiscal Crisis

- During the post 2008-2009 financial crisis, government revenue and expenditure trends have diverged significantly as fiscal positions with a focus on social functions of education, social development and health were effected.
- However, these prioritised investments funded by fiscal expansion did not yield the anticipated socio-economic results and outcomes as the triple challenges of poverty, inequality and unemployment deepened with low growth:
- Meanwhile, governance failures and fiscal leakages persist.
- The Commission has noted that despite fiscal consolidation announcements, total expenditure has remained far higher than total revenue, resulting in a continued deterioration of the cash book balance and the rising debt position.

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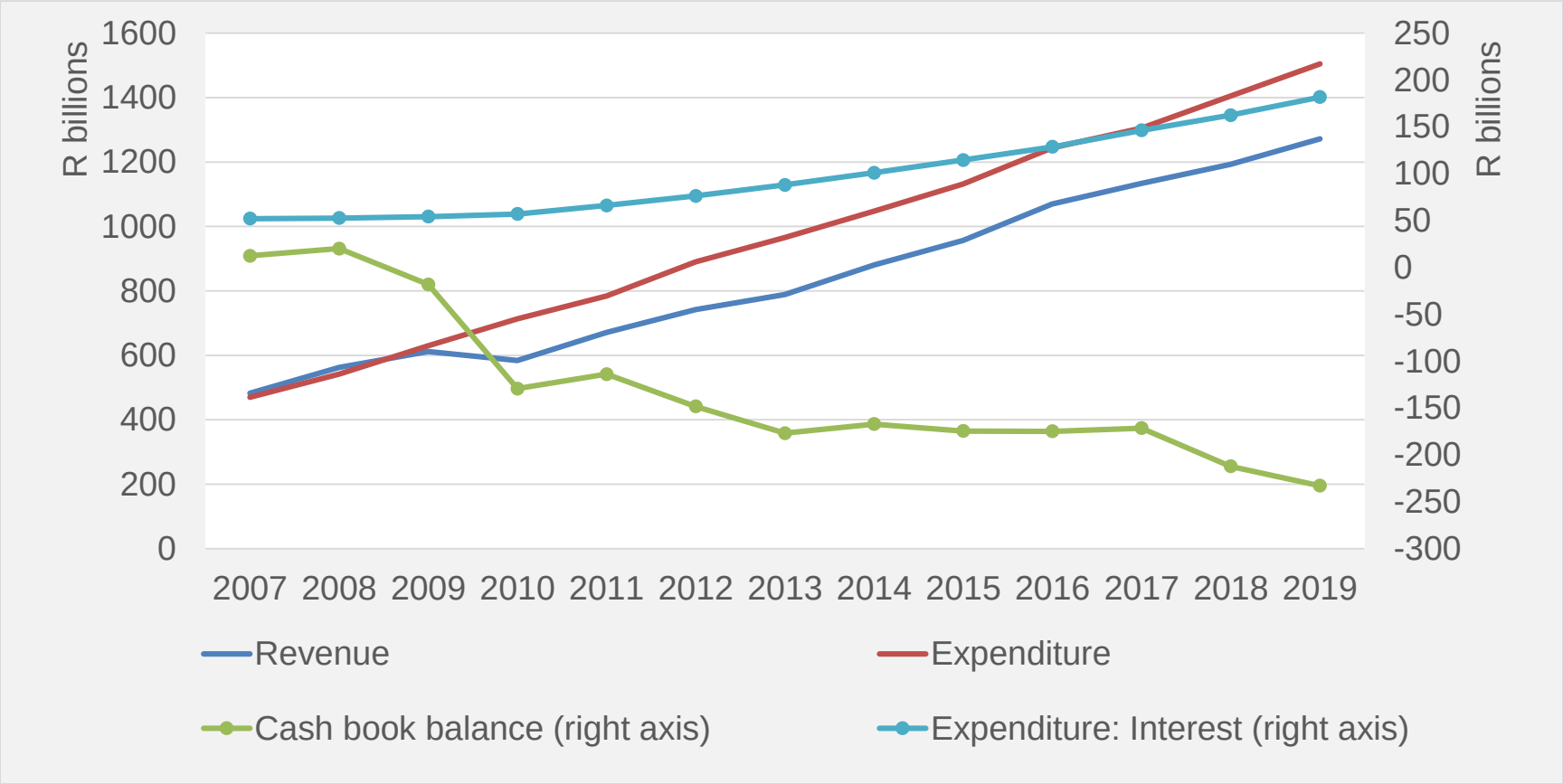
Government revenue, expenditure, cash balance and Interest



Source: *SARB (2019).*
Note: *Cashbook balance before borrowing = total revenue – total expenditure*

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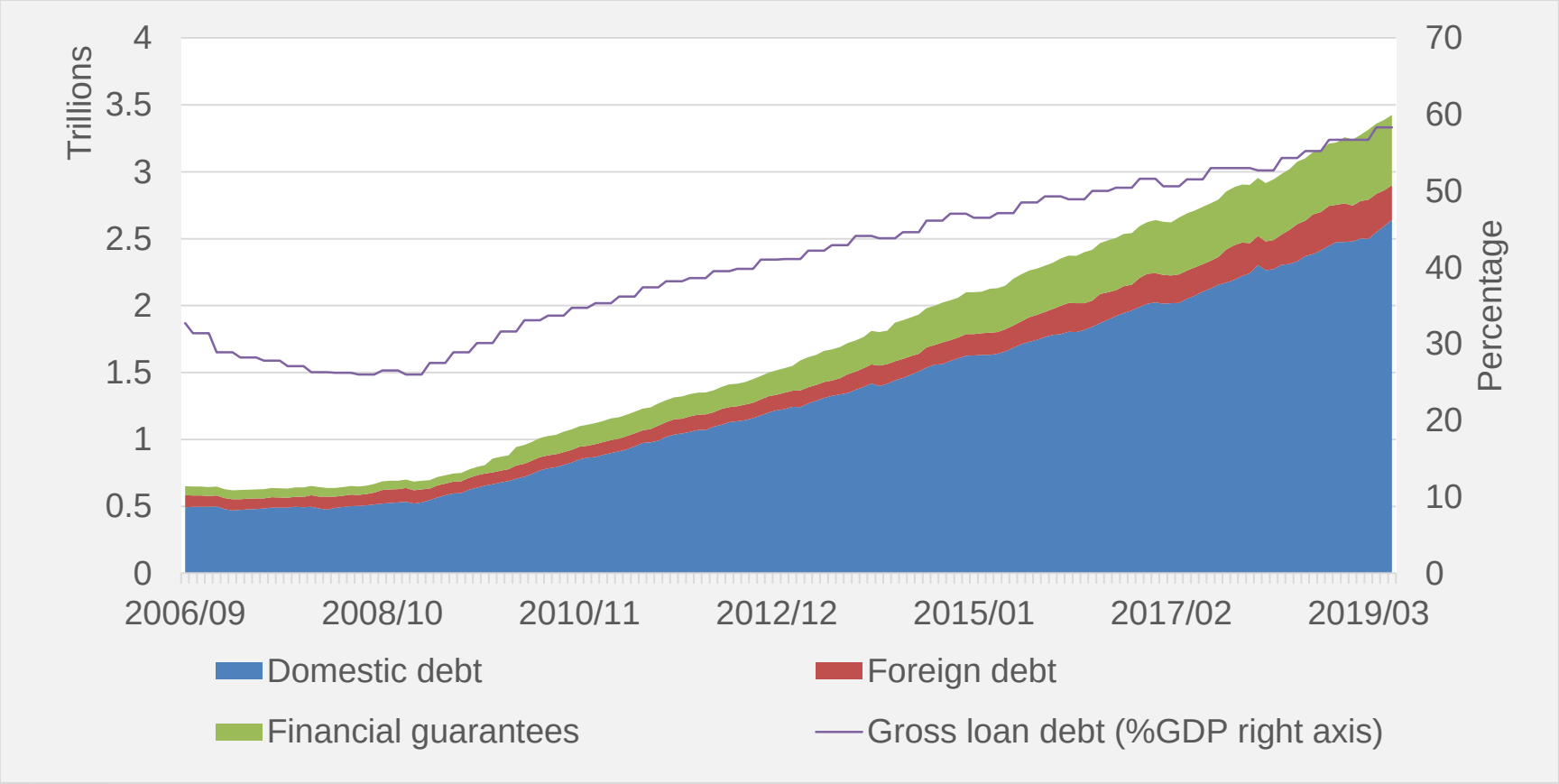
GROSS LOAN DEBT DECOMPOSITION



Source: *SARB (2019).*
Note: *Cashbook balance before borrowing = total revenue – total expenditure*

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Fiscal Reprioritisation, consolidation and credibility

Fiscal reprioritisation and consolidation:

- The Financial and Fiscal Commission believes that government must take bold, decisive and immediate actions to deepen its fiscal consolidation and reprioritisation commitments through restructuring and governance reforms to return South Africa to a sustainable fiscal path. Plans should be made for non-essential programmes, entities and implementing agents to be **rationalised** with its productive capacity redeployed to growth priority functions.

On debt-to-GDP:

- There is no universal debt-to-GDP threshold that is in keeping with the South African context. However, for the Commission debt incurred through public finances must be used for investing in productive growth activities only, with guaranteed future economic returns higher than the cost of debt or debt-service costs
  - A fiscal rule for borrowing in terms of quantum, composition and usage must be considered.

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Fiscal Reprioritisation, consolidation and credibility (cont.)

Fiscal credibility (crisis):

- The Commission notes that year after year, actual rates of economic growth and revenue collection have consistently failed to reach its projected targets.
- More specifically, notwithstanding the direct costs of adding to fiscal deficits as a result of over-estimating tax revenue and lower expenditure, the Commission is concerned over the indirect costs on fiscal credibility rendering policies and implementations ineffective. As well as the deadweight loss in disruptions to planning and execution of adjustments caused by failing to reach these fiscal targets.
- the Commission advises that an approach be adopted in extrapolating trajectories of economic growth and collection of fiscal revenue, and that the budget for spending is determined accordingly under a ceiling for expenditure with the fiscal borrowing rule.

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Commission's reflections on the National Treasury Economic Strategy for South Africa

- The Commission cautions against policy incrementalism that translates into resource wastage. The Economic Strategy should have commenced with a diagnostic analysis of the development policy landscape and status quo to inform reasons why previous policy interventions have failed.
- The strategy does not explicitly include township economies, equates rurality to agriculture, and does not explicitly consider support for the informal sector.
- It lacks specific details regarding some strategic interventions that it identifies and that are of importance for economic revival, such as specific fields where the tertiary skills are lacking and specific incentives for labour intensive production.
- The strategy does not clearly articulate the role and impact of institutions in key sectors.
- The Commission recommends the strengthening of the administrative capacity of the state for the purpose of the successful implementation of the strategy.

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Overview of 2019 Fiscal Framework

- The depressed economic situation highlighted above imposes constraints on the broader fiscal framework
- In total, Government is expected to spend R5.729 trillion over the three years relative to a revenue envelope of R4.579 trillion over the 2020 MTEF.
- In the 2019/20 financial year, growth in expenditure is projected to far outstrip growth in revenue.

R billion/percentage of GDP	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23
Main budget revenue	1137,90	1196,37	1274,74	1359,08	1425,91	1525,60	1627,88
Main budget expenditure	1305,49	1404,99	1506,73	1683,35	1801,21	1909,45	2017,72
Non-interest expenditure	1158,99	1242,34	1324,88	1479,62	1568,45	1644,88	1718,58
Debt-service costs	146,50	162,65	181,85	203,73	232,76	264,57	299,13
Main budget balance	-167,58	-208,62	-231,99	-324,27	-375,31	-383,85	-389,83
As % of GDP	-3,8%	-4,4%	-4,7%	-6,2%	-6,8%	-6,5%	-6,2%
Primary balance	-21,09	-45,97	-50,14	-120,54	-142,55	-119,28	-90,70
As % of GDP	-0,5%	-1,0%	-1,0%	-2,3%	-2,6%	-2,0%	

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MTEF Division of Revenue Amongst the Three Spheres

- Division of revenue amongst three spheres will generally be characterised by a nominal increase but negative real annual average growth, projected at -0.5%.
  - the main driver of this negative growth in allocations, is allocations to the national sphere (projected to grow by -2,9 percent).
  - Allocations to the local and provincial spheres have been prioritised due to the importance attached to the provision of education, health and municipal basic services such as electricity, water and sanitation and refuse removal.

	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22	2022/23	Real Average growth
R billion		**Outcome**		**Revised**	**Medium-term estimates**			
National departments	555,74	592,69	634,44	742,78	757,43	766,16	796,20	-2,9%
Provinces	500,38	538,55	571,95	612,82	651,46	694,85	731,06	0,7%
Equitable share	410,70	441,33	470,29	505,55	540,98	576,66	607,55	0,9%
Conditional grants	89,69	97,22	101,67	107,26	110,48	118,19	123,51	-0,5%
Local government	102,87	111,10	118,49	127,21	132,39	143,03	152,25	0,8%
Equitable share	50,71	55,61	60,76	68,97	74,68	81,06	87,21	2,7%
General fuel levy	11,22	11,79	12,47	13,17	14,03	15,18	16,09	1,5%
Conditional grants	40,93	43,70	45,26	45,07	43,68	46,78	48,95	-2,3%
Total	**1158,99**	**1242,34**	**1324,88**	**1479,62**	**1562,45**	**1638,88**	**1712,58**	**-0,5%**

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CONSOLIDATED GOVERNMENT EXPENDITURE BY ECONOMIC CLASSIFICATION

R billion	2019/20	2020/21	2021/22	2022/23	Real Annual Average Growth Rate
Current payments	1093,81	1180,96	1275,55	1363,86	2%
Compensation of employees	630,68	675,20	717,56	758,52	1%
Goods and services	252,18	264,35	284,94	297,30	1%
Transfers and subsidies	593,04	626,26	665,51	700,32	1%
Payments for capital assets	90,07	97,64	105,84	114,69	3%
	2018/19-2019/20	2019/20-2020/21	2020/21-2021/22	2021/22-2022/23	
Current payments	3%	3%	3%	2%	
Compensation of employees	3%	2%	1%	0%	
Goods and services	3%	0%	2%	-1%	
Transfers and subsidies	3%	0%	1%	0%	
Payments for capital assets	5%	3%	3%	3%	

- The Commission endorses the implementation of the measures to contain the wage bill announced in the MTBPS, i.e. freezing of salaries. These initiatives should be extended to SOCs and local governments. The Commission has advised previously that wage increases should be linked to productivity.
- Capital investment not growing commensurately with government's thrust of infrastructure led growth as well as government initiatives meant to grow the economy
- Growth in goods and services expenditure is declining; it could mean cost containment measures are bearing fruits or it may have negative social impact

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Revenue and Tax Proposals

- Projections of revenue shortfalls over the medium term: R52.5 billion in 2019/20, R84 billion in 2020/21 and R114.7 billion in 2021/22. This warrants a sustained increase in required economic growth and employment to improve revenue collection for the government to meet its social-economic objectives.
- Scope for increasing government revenue by raising taxes is shrinking because more tax hikes are most likely to impact negatively on the economy's performance and hence on revenue collection, as consumers are forced to economise on their purchases.
- Significant progressivity gains from the Personal Income Tax (PIT) are most likely to be constrained because of the limited buoyancy, meaning that the percentage change in GDP is now only exactly matched by the percentage change in tax revenue take. Therefore, additional increases in marginal tax rates of PIT could also have perverse incentives such as tax avoidance or evasion.
  - If households feel the need to acquire public sector services privately (e.g. health & education, the increasing tax burden may become untenable.

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Review of Actual Spending 2019/2020

- Highlights based on an analysis of aggregate spending for six months (April-September) in the 2019/20 financial year indicate:
  - Total government's spending by mid-year is R816 billion (48%), spending by all votes R448 billion (48%) and transfers of the Provincial Equitable Share are at 50% as expected.
- An assessment of individual departmental performance shows somewhat uneven spending patterns
  - Higher Education and Training spent 71% of its budget, and Basic Education at 58.5%.
  - Whereas other departments such as Environmental Affairs, Water and Sanitation, Human Settlements, Rural Development and Land Reform registered below average spending or just at 40%.
  - Unless departments' annual plans explicitly identify unusual spending, excessive deviations below or above the average are generally perceived as undesirable from a budget planning and execution's point of view.

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Revised Division of Revenue 2019/2020

- Declared unspent funds returned to the fiscus amount to R3.9 billion in 2019/20 which is a significant increase compared to R329 million that declared in 2018/19.
  - Larges amount of unspent funds are for the Department of Higher Education and Training (R897.1 million) due to slow capital expenditure and Department of Health (R346 million) as a result of slow expenditure on the NHI indirect grant.
  - The Commission is concerned about the unspent funds on these programmes given the critical role they play in addressing shortfalls at institutions of higher learning as well as the imminent health reforms through the NHI.
- Projected underspending for national government is estimated to total R1.183 billion in 2019/2020, a decline compared to the R2.7 billion projected in 2018/19.
- Largest roll-overs are registered for the Department of Water and Sanitation (R241.9 million) and Department of Health (R89.3 million) which is 96% of the total roll-overs of R344.9 million in 2019/20.
  - The Commission would like to re-iterate the importance of departments using roll-overs as per Treasury Regulations section 6.4 to avoid wasteful and fruitless expenditure

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Local Government Issues

- The 2019 MTBPS is tabled during a period where government has just introduced a new district-based service delivery approach, which is to improve coordination and planning among national, provincial and local governments
- This approach will have implications for the 2020 MTEF allocations to government, as there will be a need to align the government funding model to the new delivery model.
- The Commission welcomes the new approach as it has the potential to improve coordination and planning among the three spheres of government and ensure integrated service delivery
  - However, the Commission underscores the need for government to consider the current weaknesses in the government when implementing this model, in order to directly address them, particularly in district municipalities,
    - e.g. over 60 percent of district municipalities are dysfunctional and poorly capacitated

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LOCAL GOVERNMENT ISSUES [CONT.]

- Over the 2020 MTEF the local government is set to receive a total allocation of R427.7 billion, which is R20.5 billion lower than the originally planned allocation that was announced in the 2019 budget
  - The indicated cuts to future plans comprise a downward revision of the percentage share to be received by the local government in 2020/21 and 2021/22, from 9.0% to 8.6% and 9.2% to 8.9%, respectively.
  - The allocations are still projected to increase at a real annual average growth rate of 0.8% overall, to decline annually at 1.2% in 2020/21, and to grow at 2.6% in 2021/22, and 1.1% in 2022/23
- The Commission notes the reductions in the local government total allocations
  - However, it cautions about the implications of cuts on service delivery and is of the view that considering the declining share of local government allocations from the nationally raised revenue, government must prioritise own revenue raising capacity in the local government.
  - In its 2020/21 Annual Submission to the Division of Revenue, the Commission isolated supplementary revenue sources for local government that municipalities can exploit

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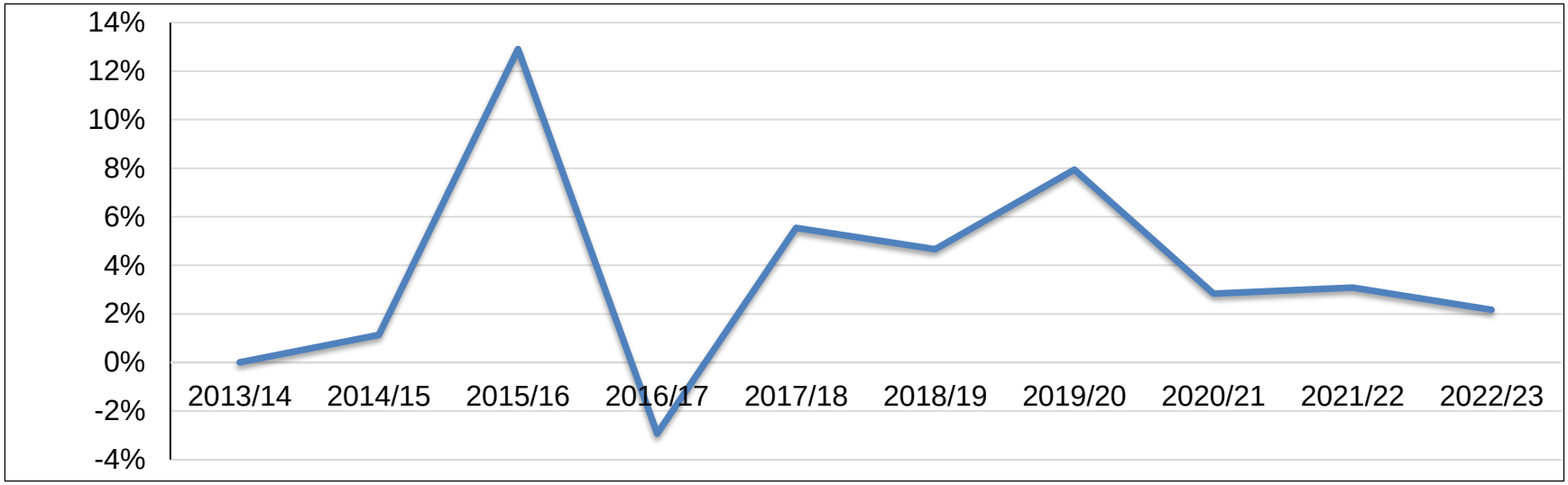
Local government Equitable Share



- The total LGES allocation is envisaged to increase from R127.2 billion in 2019/20 to R132.4 billion in 2020/21 and to increase to R152.2 in 2022/23
- Over the next three years, the allocations are expected to grow, albeit at a decreasing rate in real terms
- The Commission welcomes the nominal increase in the allocations but remains concerned about the projected decline in the real growth rate, as it may have an adverse effect on service delivery to communities.

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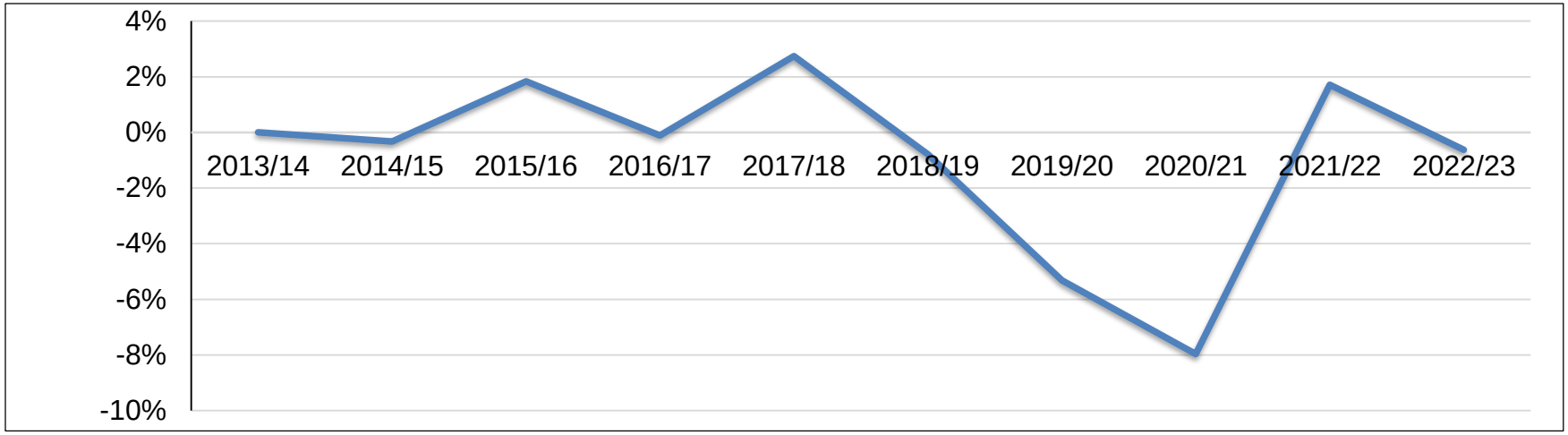
Local government Conditional Grants



- The conditional future allocations to the LG are envisaged to be lower than the allocations that were projected in the 2019 budget
- A total amount of R139.4 billion is projected for the 2020 MTEF, which is less by R3.2 billion
- Following an increase in the real growth rate of conditional grants to the local government sector in the year 2020/21, a decline of 0.6% is expected for the period 2022/23
- The Commission would like to see the reprioritisation towards the local government relative to the other spheres, and is of the view that the reductions should be implemented with caution, to ensure that service delivery is not adversely affected
- The Commission emphasises the need to consider past performance of each of the grants and avoid cutting on infrastructure grants as they are key for future service delivery and economic growth

Reflections on Allocative Efficiency, Challenges and Opportunities within Key Priority Areas: Infrastructure

- Infrastructure spending effects on South African growth are moderate
- Public infrastructure delivery management is weak and holds back potential investment returns to the economy
- There is a need to build the required government capacity to manage infrastructure projects effectively in order to ensure the economic benefits associated with capital investment
  - The newly introduced Budget Facility for Infrastructure Planning and Infrastructure Fund supported developments.
  - National infrastructure delivery improvement interventions should not disincentivise capacity development within provincial and local government.

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Reflections on Allocative Efficiency, Challenges and Opportunities within Key Priority Areas: Health, Human Settlement, Higher Education

Health

- The 2019 MTBPS allocates an adjusted budget of R222 billion to health at 8% increase from 2018.
- The Commission notes that Department of Health declared a R346 million unspent funds, of which R240 million (69.4%) is in respect of the NHI indirect grant.
- The Commission is concerned with the following statement in the MTBPS, page 37 regarding the NHI implementation:
  - "However, given the macroeconomic and fiscal outlook, the estimates to roll out NHI that were published in the NHI Green Paper in 2011 and White Paper in 2017 are no longer affordable."

Higher Education

- Post school education and training remains one of the major fiscal pressures for government due to growing demand for university and college education
- The Commission is of the view that funding for higher education should be underpinned by a comprehensive fee free higher education policy

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GOVERNMENT CONTINGENT LIABILITIES AND STATE-OWNED ENTITIES

- Contingent liabilities will reach an estimated R1.015 trillion in 2021/22, constituting almost a third of governments net loan debt. Guarantees to state owned entities (SOEs) will reach an estimated R552 billion in 2019/20, accounting for more than a third of the total government contingent liabilities. Guarantees to state-owned companies constitute a major risk to the fiscus.
- Guarantees to Eskom are estimated to account for over half (56 percent) of the total government guarantees to SOEs.
- The 2019 MTBPS revised in year expenditure upwards by R44.5 billion. The largest component of this revision (R36.8 billion) is allocated to the financial support for SOEs: R26 billion for Eskom; R5.5 billion for SAA; R3.2 billion for the SABC; R1.8 billion for Denel; and R300 million for SA Express Airways. These bailouts are substantially accelerating government debt.
- The high level of contingent liabilities and the high probability of a significant number of these contingent liabilities materialising represents a risk to South Africa's sovereign credit rating.

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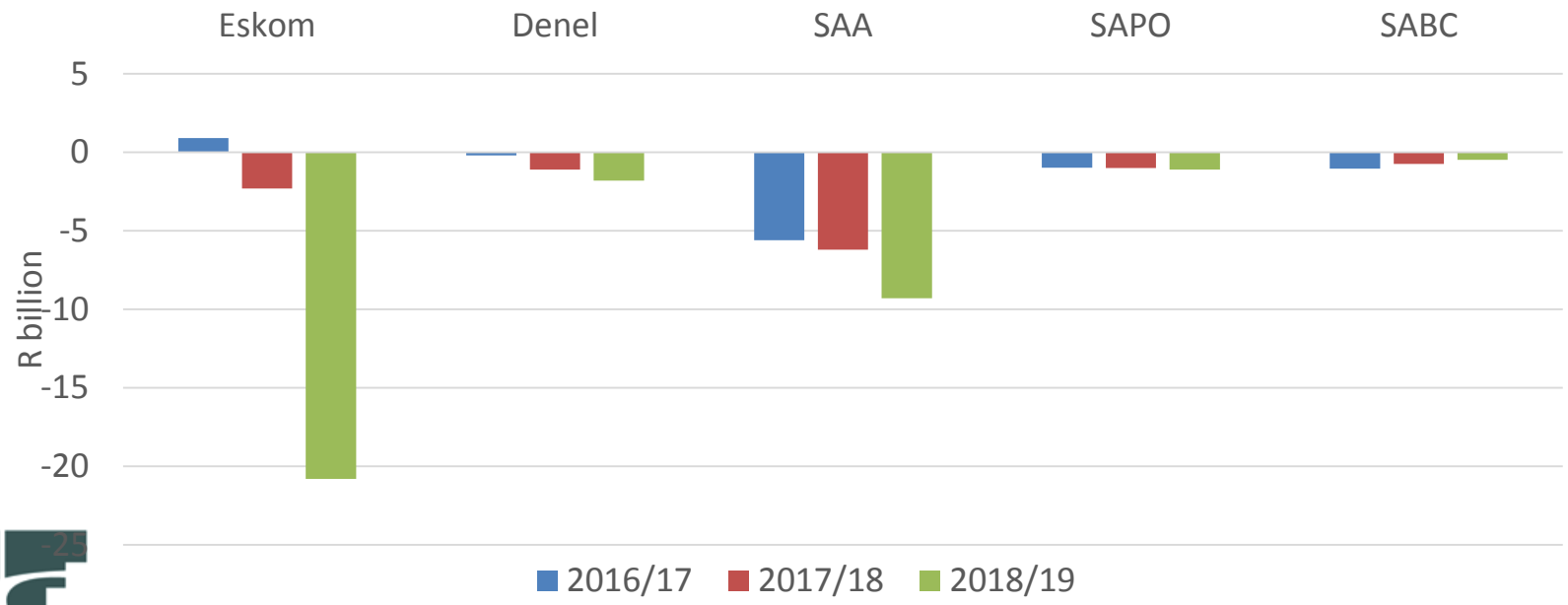
Financial Health of State-Owned Entities

- Several SOEs are not able to sustain themselves financially. Eskom, Denel, SAA, SAPO and SABC) have all posted losses for at least two successive years. Eskom has posted a cumulative loss of R23.1 billion between 2017/18 and 2018/19. Denel has posted a cumulative loss of R3.1 billion between 2016/17 and 2018/19, SAA (-R21.1 billion), SAPO (-R3.1 billion) and the SABC (-R2.3 billion).



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ESKOM ROAD MAP (1)

- In February 2019, government announced the separation of Eskom into three entities: electricity generation, transmission and distribution to facilitate cost efficiencies. While there has been limited progress in implementing the legal separation of the utility, government has now set a two-phase timeline for restructuring Eskom.
- A special paper on the roadmap for Eskom, defines the first phase as separating the generation, transmission and distribution functions into separate, wholly owned subsidiaries with independent Boards by 31 March 2020. The completion of the legal separation of distribution and generation functions is planned by 31 December 2021.

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ESKOM ROAD MAP (2)

- The view of the Commission is that the Eskom plan is the first step in the right direction in restructuring Eskom. The plan articulates how Eskom will relinquishing its monopoly of the electricity industry. The plan articulates how Eskom will relinquish monopoly of the electricity industry, and pave the way for private generators to supply the national grid.
- The Commission supports this reform because it is likely to enhance efficiency and cut costs.
- The plan does not contain some crucial details. The view of the Commission is that there should be an analysis and comparison of the options, including the costs and benefits of Eskom unbundling in order to evaluate the true financial and economic value.
  - Particularly regarding the transition from the existing dependence on fossil fuels to the mix of electricity energy sources.

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ESKOM ROAD MAP (3)

- An analysis of costs pressures as they relate to the transitioning of the staff contingent and the procurement of goods and services have not been incorporated in the plan and yet they are critical.
- The 2019 MTBPS did not provide details on Eskom's R441 billion debt management measures but did set several preconditions before debt relief will be considered.
- The Commission advised such preconditions to any debt relief to ensure that the structural reforms undertaken by SOCs are implemented.

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CONCLUSION & RECOMMENDATIONS

- The 2019 MTBPs has been tabled in bleaker conditions than the 2018 MTBPs or 2019 Budget statement. Growth is projected to be at 0.7%, while unemployed has risen to levels not seen since 2008.
- The South African economy is trapped in a precarious growth trajectory where the fiscal metrics are spiralling out of control. To return South Africa to a sustainable fiscal path the Financial and Fiscal Commission believes that government must take bold, decisive and immediate actions to restore fiscal credibility and boost confidence on the economy.
- Policy and implementation certainty are the cornerstone of restoring confidence and fiscal credibility.
- Overall the 2019 MTBPS reflects the major sentiments of the recommendations that the Commission has been making in the past decade: that growth and employment in South Africa can only be achieved by combining fiscal reprioritization and consolidation through restructuring and governance.

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Conclusion & Recommendations [cont.]

- Hence, the Commission supports:
  - Measures of reprioritising and tightening the budget
  - Rebuilding government institutions
  - Redirecting of government spending towards growth and employment creation
  - The protection of social expenditures
  - The proposed adjustments estimates
- The Commission implores government to carry through many of the initiatives to restore economic growth and create employment. There is need to improve on policy credibility and implementation.
- The Commission recommends that a cogent review of the public sector wage bill be undertaken.
- Time is of essence. Government has to restore governance systems and take bold, decisive steps to deal with SOCs whose social or economic value is negative.
- Government is implored to focus and strengthen state capabilities and grow the economy and employment, in order to address the triple challenges of poverty, inequality and unemployment

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