FINANCIAL AND FISCAL COMMISSION

Briefing by the Financial and Fiscal Commission on the 2018 Medium Term Budget Policy Statement

Tuesday, 30th October 2018

For an Equitable Sharing of National Revenue

BACKGROUND

- This submission on the 2018 Medium Term Budget Policy Statement (MTBPS) is made by the Commission in terms of:
  – Section 4(4c) of the Money Bills Amendment Procedure and Related Matters Act (MBAPRMA) (2009), which requires Committees of Parliament to consider FFC's recommendations when dealing with money bills and related matters
  – Part 1 (3)(1) of the FFC Act (2003) as amended, which provides for the Commission to act as a consultative body and make recommendations to organs of state in all spheres on financial and fiscal matters

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INTRODUCTION

- 2018 MTBPS was formulated in an economic environment characterised by extremely low growth, escalating public debt, and low levels of investment
- Ability of government to address the key socio-economic challenges of unemployment, poverty, and inequality is severely compromised by weak governance reflected, amongst other things, in: public and private sector corruption, the failure of state-owned companies (SOCs) to deliver on their development mandate, and the various developments and preliminary indication of a weakening of key functions in the South African Revenue Services (SARS)

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POLITICAL TRANSITION

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

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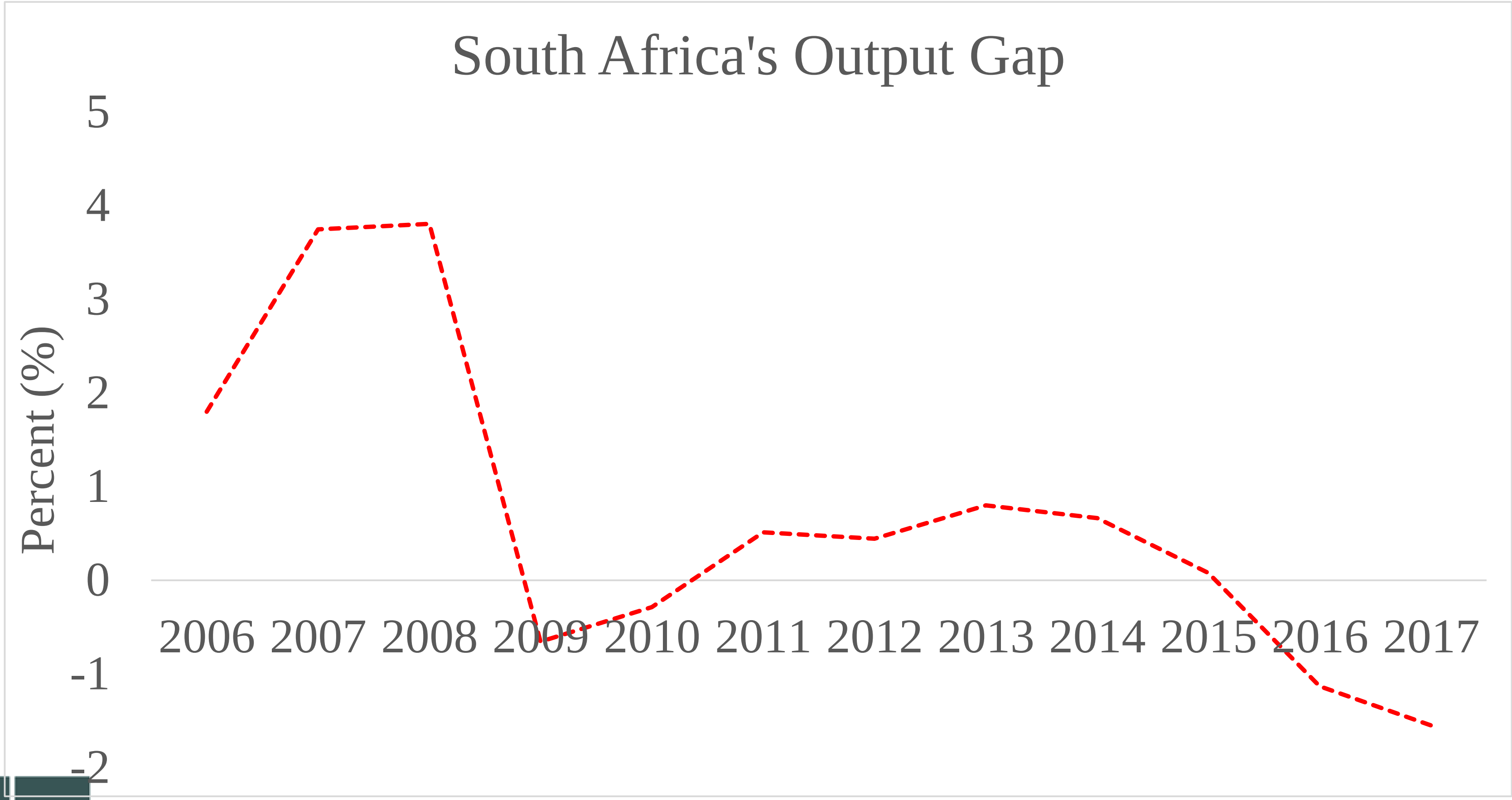
SOUTH AFRICA'S UNDERPERFORMING ECONOMY



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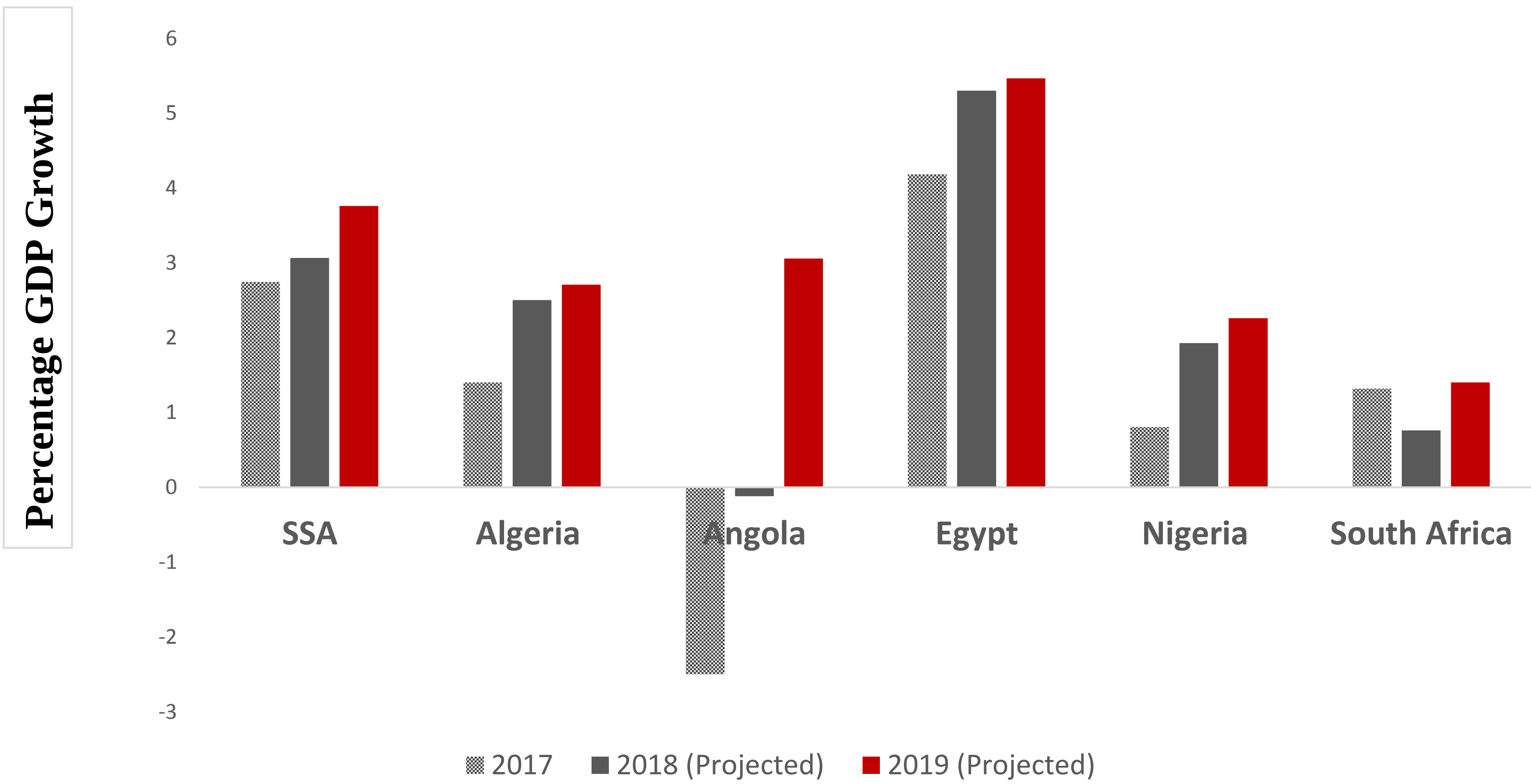
South Africa's Underperforming Economy



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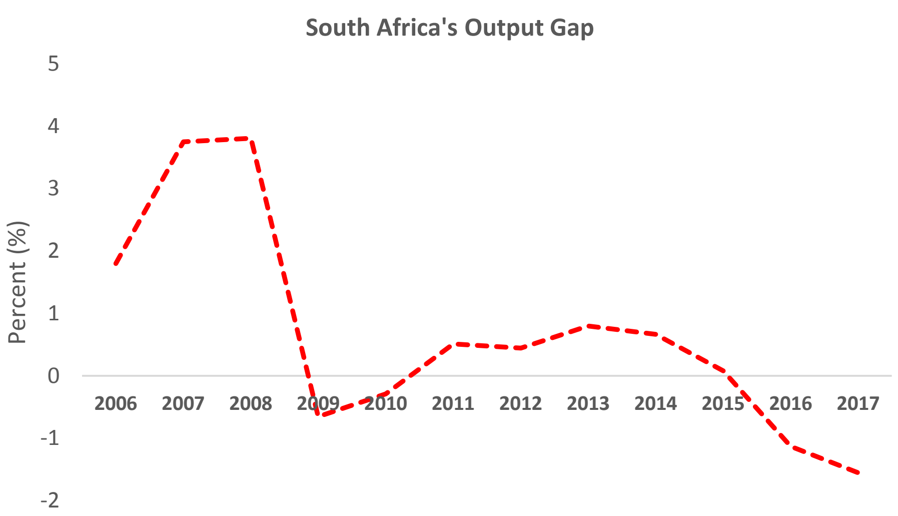
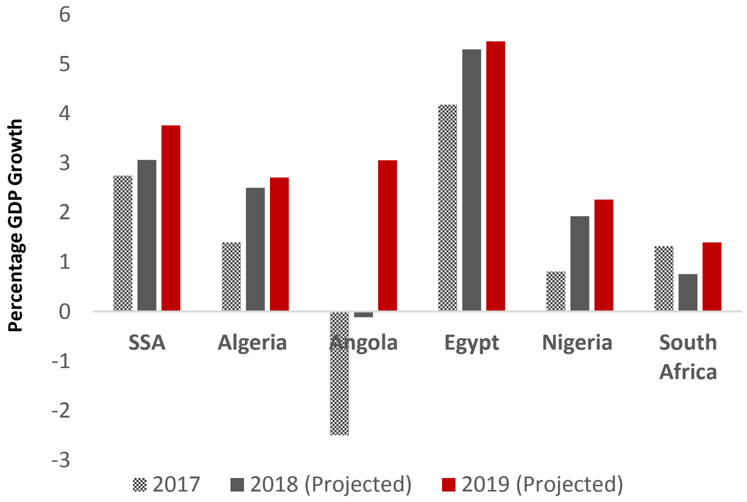
South Africa's Underperforming Economy





- South Africa's economy increasingly operating way below its potential
  - Economy operating at inefficient rate: spare capacity/slack due to tepid demand
  - Africa's most industrialized country unable to match pace of recovery in the continents other large economies

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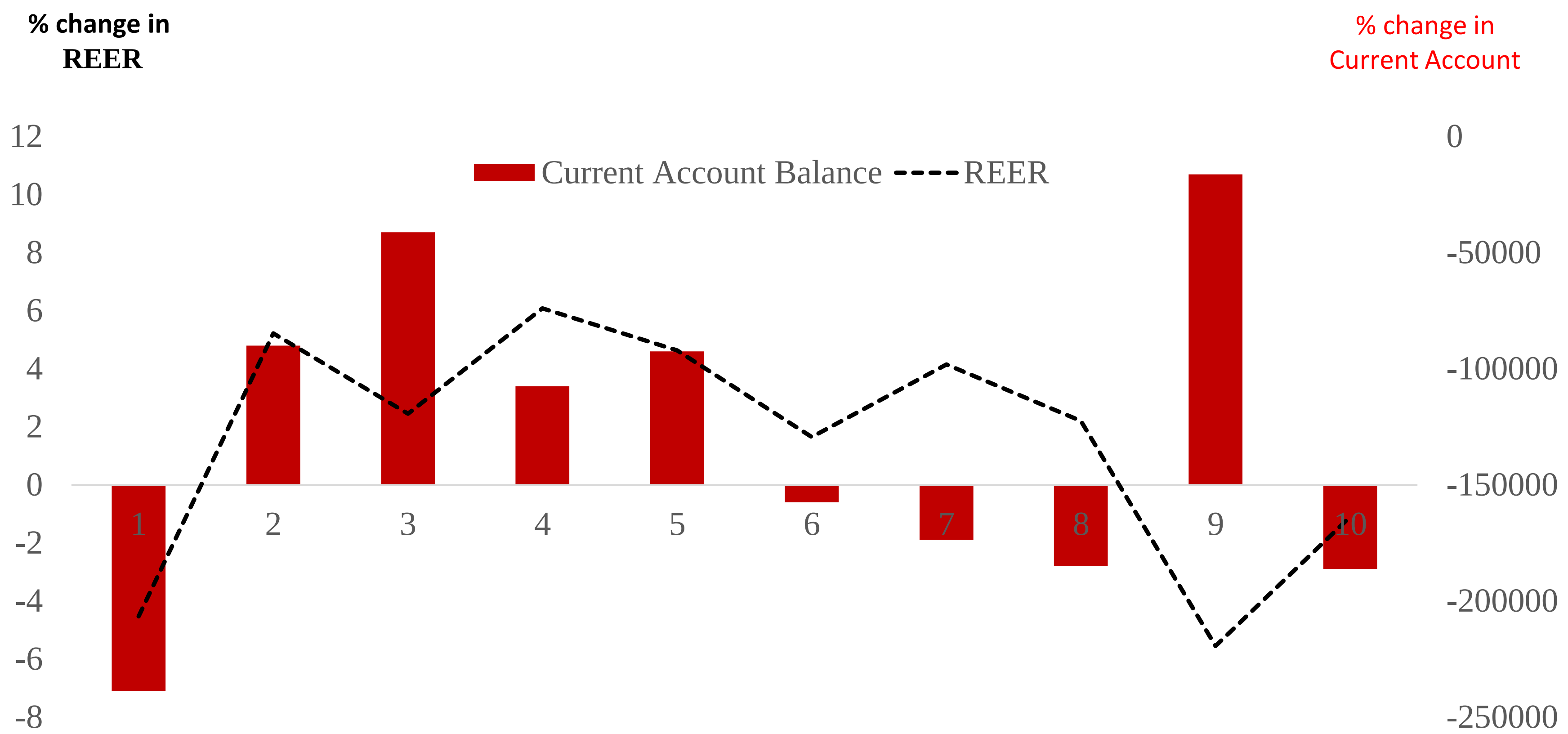
Why Underperformance? Diminished Capacity Of Levers Of Growth



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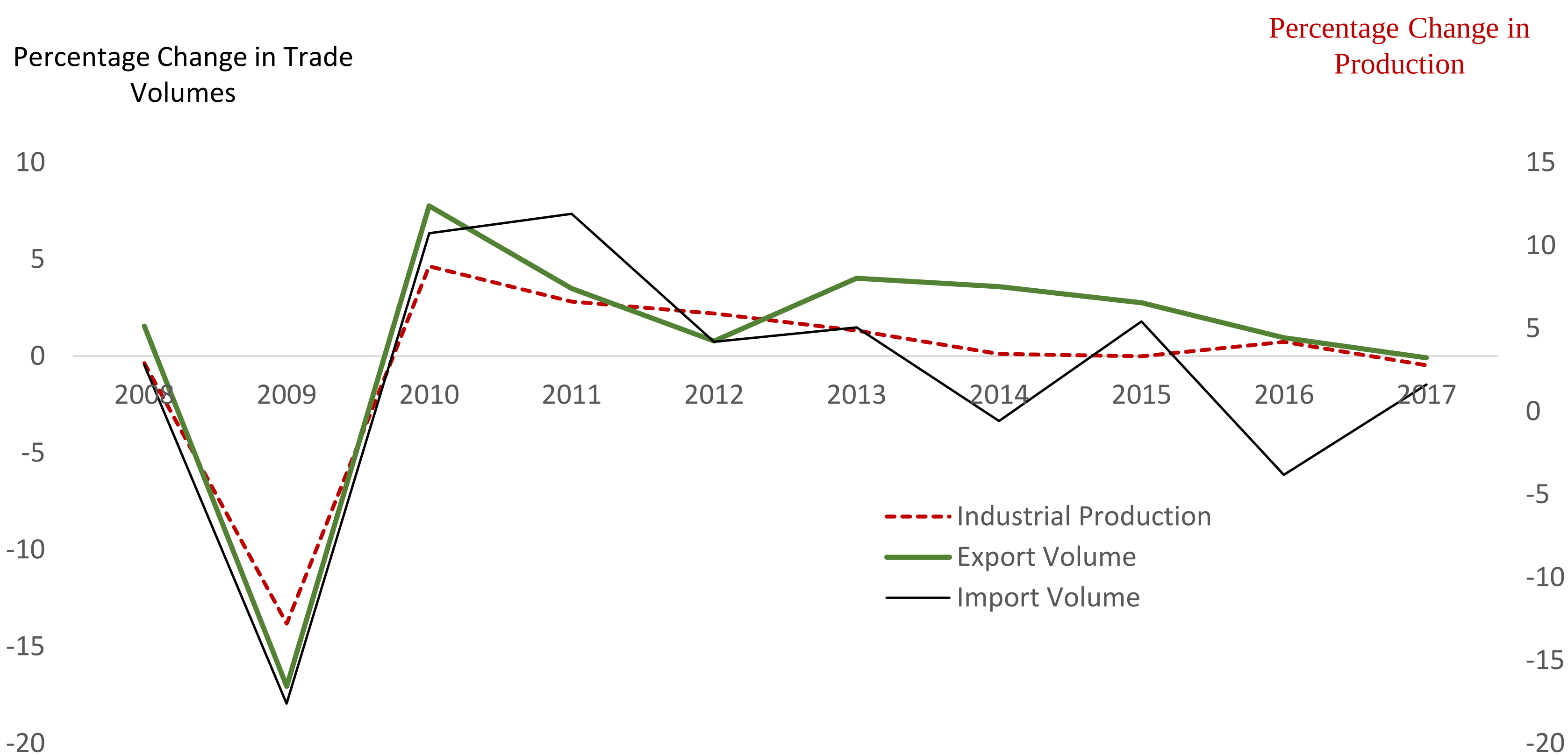

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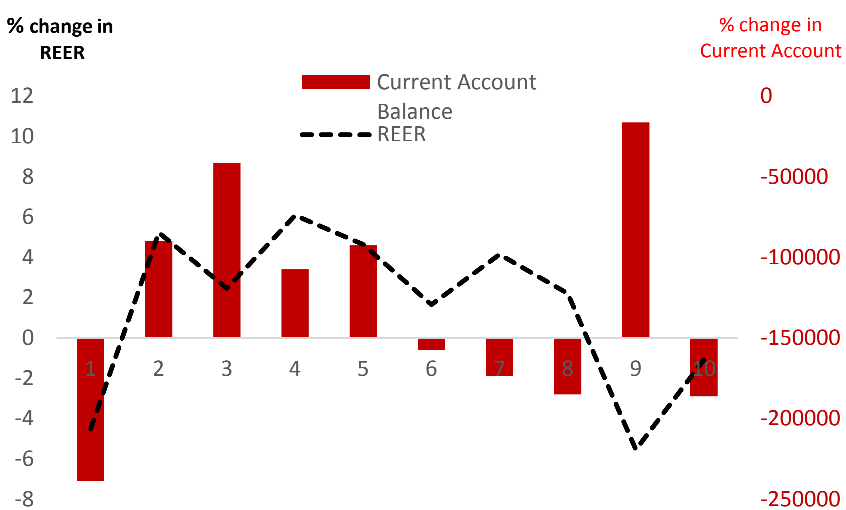
Why Underperformance? Diminished Capacity Of Levers Of Growth



- Export led-economic activity not materialised despite resurgent global economy
  - Notable depreciation of Rand but no appreciable impact on trade volumes
  - SA's share of world exports stagnant at 0.5% (compared to 2% average for Russia and India)
  - Illustrated by slowdown in trade volumes and industrial production

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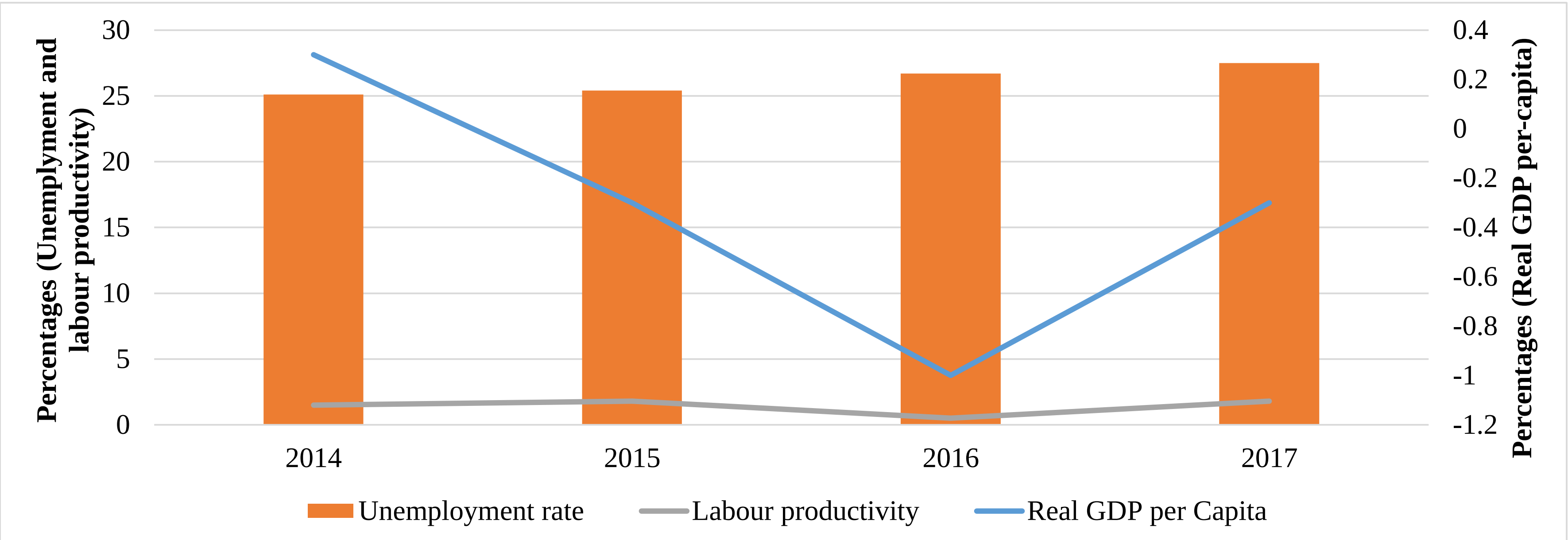
SLOW GROWTH AND INVESTMENT IS INCREASING UNEMPLOYMENT



- Slow private investment and consumption growth resulting from policy uncertainty and is translating into high levels of unemployment and income inequalities
- Inadequate integration into global value chains is precluding South Africa from exploiting new economic opportunities being offered by the global economy
- Low business and consumer confidence is constraining productivity growth thus GDP per-capita growth has decelerated from 0.3% in 2013 to -0.3% in 2017, unemployment has surged to 27% and with an income Gini coefficient of 0.68

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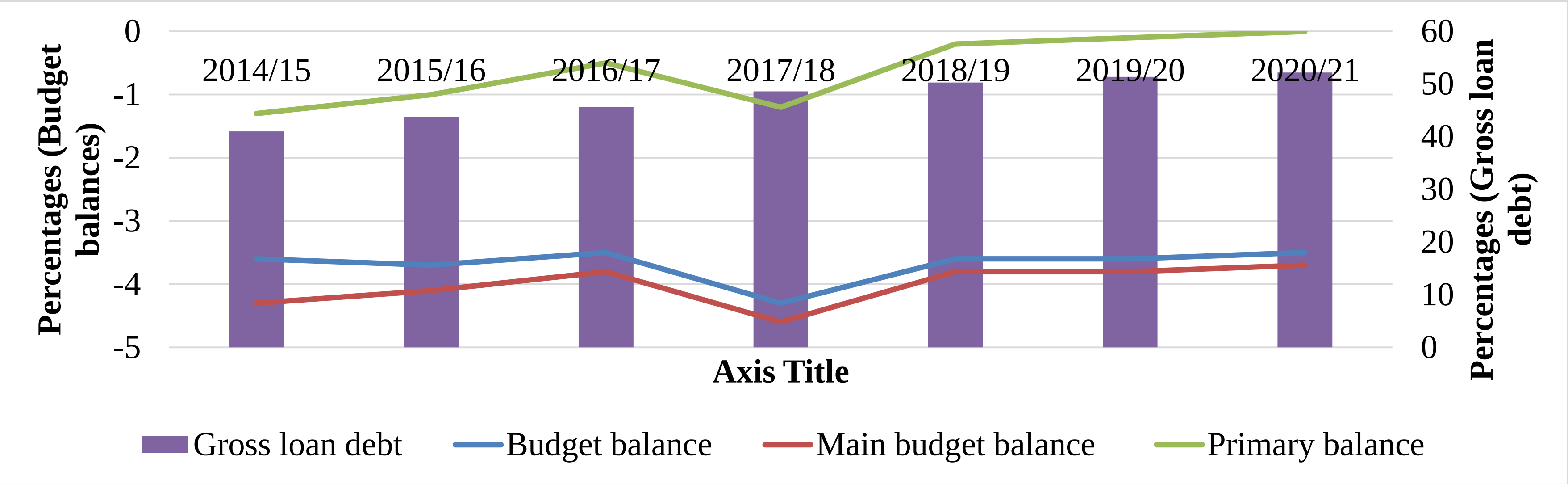
2018 MTBPS Represents A Fiscal Slippage



- The consolidated budget deficit is estimated at 4% in 2018/19, compared with the 2018 Budget projection of 3.6% of GDP. It accelerates to 4.2% in 2019/20 and 2020/21 before stabilising at 4% in 2021/22. The 2018 main budget deficit is now estimated to widen to 4.3% of GDP compared with the 2018 Budget estimate of 3.8%, mainly as a result of tax revenue shortfalls
- The primary deficit will now narrow from 0.7% in 2018/19 to 0.6% in 2019/20 and 0.5% in 2020/21 compared to the narrowing of the primary deficit to 0.2% in 2018/19, 0.1% in 2019/20, and 0% by 2020/21 announced in the 2018/19

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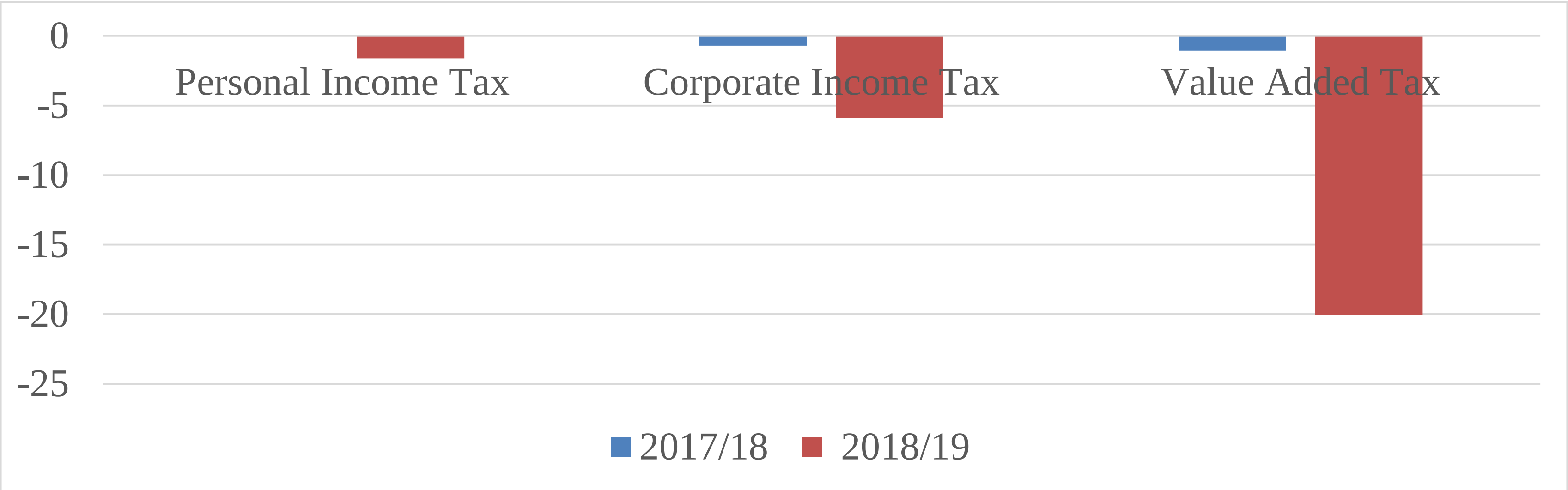
REVENUE SHORTFALLS ARE WIDENING



- Revenue shortfalls have widened over the past four years, with under-collections rising from R7.4 billion in 2014/15 to R49 billion in 2017/18
- Sluggish growth, coupled with once-off payment of overdue value added tax (VAT) refunds, will result in an in-year revenue shortfall of R27.4 billion, relative to the 2018/19 Budget estimate. Net VAT collections account for about R20 billion of the in-year revenue shortfall. The remaining R7.4 billion of the shortfall in the current year mostly reflects slower corporate income tax collections due to weak growth in wholesale and retail trade, manufacturing and transport

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ADDRESSING ECONOMIC CHALLENGES

- Regarding economic challenges facing the country, the **Commission recommends addressing structural bottlenecks in order to boost growth**
  - Structural reforms should focus on accelerating private investment, invigorating product market competition – particularly in network industries such as telecommunications, energy, logistics and water – correcting skills mismatches, and confronting and tackling corruption
- There is a need to build on comparative advantages to develop new domestic and international markets through higher productivity and innovation instead of depending on higher commodity prices
- Clarifying the framework governing the proposed "land expropriation without compensation" to prevent uncertainty by focusing it on intensifying agricultural productivity, enhancing land administration and reinforcing security of tenure is also critical

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Addressing Economic Challenges [cont.]

- Private sector investment will depend on policy certainty in key areas of the economy, especially mining, energy, telecommunications, tourism and other structural reforms
- The **Commission also reiterates the need to build fiscal space**
  - This can be done through: conservative debt levels and managing downward expenditure diversion to debt service costs, reducing the wage bill through natural attrition coupled with a review of government's functional organisation and abandoning the strict linking of wage increases to the consumer price index (CPI), deepening the fight against corruption, assessing the recent increases in the scope of service delivery priorities, addressing governance issues and rethinking the business models of SOCs

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ADDRESSING ECONOMIC CHALLENGES [CONT.]

- In its submission to the 2017 MTBPS the **Commission** lamented the persistent inability of government to achieve MTBPS economic growth targets and emphasised the need for government to lay a solid foundation for future growth during the downturn, through a **comprehensive review of budget programmes aimed at promoting growth**
  - It was especially evident in the 2018/19 budget that government was unable to reverse output declines, through increased borrowing, as there are growing fears of sovereign credit risk. Government must manage the debt portfolio in order to minimise debt service costs and sovereign credit risk
- The **Commission welcomes the tenets of the proposed economic stimulus and recovery plan to boost growth and employment**
- It is not apparent that the current stimulus package was underpinned by the earlier programme review envisaged by the Commission. Stimulus interventions that are superimposed on a structurally deficient economy will yield less than desirable results
  - Essentially, there are two fundamental tenets of a stimulus package from a fiscal policy perspective that is, lowering taxes and increasing spending. Counterintuitively, the current fiscal policy trajectory has been one of contraction, with the recent increase in VAT and the ongoing budget consolidation programme

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ADDRESSING ECONOMIC CHALLENGES [CONT.]

- The stimulus and recovery plans should be underpinned by solid economic policies and quality implementation
- There should be a coordinated, coherent and consistent policy trajectory between sector policies in line with the developmental objectives & the fiscal stance of the country
  - Current fiscal policy trajectory sends inconsistent investment signals (consolidation, VAT increases, stimulus)
- The 2018 stimulus is largely premised on quality execution of infrastructure spend
  - The growth and employment effect of public infrastructure expenditure has been muted as a result of poor execution and inefficiencies

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Wage Bill and Efficiency in the Public Sector

- Over half of provincial budgets are dedicated to personnel
  - A key risk to the provincial government fiscal framework is the higher than anticipated wage agreements for which additional funding will not be received
- The same is true for the national sphere where the personnel ceiling has been maintained
- The **Commission** is of the view that government departments must carefully manage this pressure and practise financial prudence to **ensure that wage pressures do not divert resources away** from key health and education, etc. inputs
- The **Commission** advises that in order to ensure real productivity within the public sector, **value for money must be sought more resolutely through costing institutional outputs and assessing performance**

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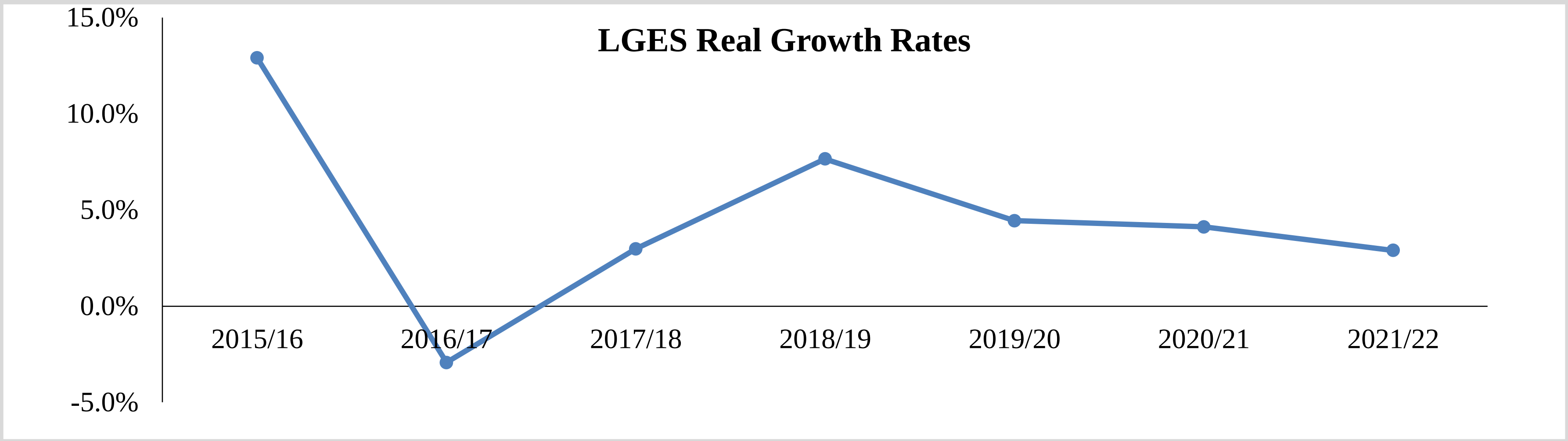
LOCAL GOVERNMENT EQUITABLE SHARE



- Commission commends efforts by Government to protect the local government equitable share (LGES), which is essential in maintaining and improving service delivery to communities
  - But remains concerned about the projected slower real growth rates of the LGES in outer years (2020/21 and 2021/22)
  - The Commission would encourage government to reconsider the rate of growth of the LGES in outer years so that poor households are cushioned against the rising cost of free basic services
  - Revenue raising and inefficiency problems in the sector to be eliminated

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Local Government Conditional Grants

- Conditional grants to local government are of strategic importance as they are used to fund development of bulk infrastructure that underpin the delivery of water, sanitation, electricity
  - Allocations in this regard are projected to decline by a real annual average of 1.1% over the next three years. The most significant reduction in local government conditional grants is in 2019 with a projected 8% real decline
  - In the context of Budget 2018 where broad ranging cuts that disproportionately affected infrastructure conditional grants were announced, this trend is not surprising
  - However, given the general sentiment and thrust of MTBPS 2018 which is heavily focussed on infrastructure development, this particular trend is inconsistent

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Local Government Issues

- Local Government Conditional Grants:
  - In line with **previous Commission recommendations against the proliferation of grants**, it is envisaged that some of the grants will be consolidated over the 2019 MTEF – Commission welcomes this, as it has the potential to improve efficiency in the administration of conditional grants, provided that it promotes integrated planning and service delivery
- Local Government Capacity:
  - The Commission further welcomes efforts to improve capacity within municipalities such as the recent deployment by CoGTA of experts to assist municipalities improve their performance and operational efficiencies
    - In the past 5 years government has invested an average of R2 billion a year on improving capacity, however returns to such investments have not yielded positive results. The **Commission calls for an urgent review of government capacity initiatives** within the local government space, focussing specifically on skills transfer to recipient municipalities

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LOCAL GOVERNMENT ISSUES [CONT.]

- A significant proportion of municipalities are distressed and dysfunctional – the fiscal health of many municipalities has deteriorated over the past few years
  - Thus the **Commission** recommends a **thorough and comprehensive review of the local government fiscal framework** in order to include a focus on governance and other institutional arrangements
- As the municipalities are the face of government in communities, it is important to underscore the point that they should not compromise on service delivery, and the division of revenue needs to respond to this call

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Infrastructure

- The 2018 MTBPS proposes a R855 billion infrastructure spend over the MTEF
- The 2018 MTBPS also proposes establishment of an infrastructure fund that will comprise contributions from government, the private sector and development finance institutions (DFIs)
  - While the operational details of the fund are being designed, government needs to consider the intergovernmental fiscal arrangements and ensure balance in the allocation of resources across the three spheres of government
- The **Commission welcomes efforts to publish expenditure reports of existing infrastructure projects** to enhance accountability and transparency
  - Will minimise projects cost overruns and ensure timely completion of the projects
  - In addition to publishing expenditure records, **government needs to invest in an infrastructure delivery inspectorate** to ensure that projects are delivered in accordance with the required standards and quality

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Infrastructure [cont.]

- It is the view of the Commission that allocating funds and observing its spending trends alone will not yield the desired results of efficiency and impact
- Government should take the approach of costing infrastructure in line with its functions and performance with empirical data, to ensure the real productivity of the public sector is realised

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State Owned Companies

- The **Commission** has **cautioned against the long term risks posed by SOCs**, they remain the biggest fiscal risk to economic recovery and the overall budget balance
  - Additions in the Adjustments Budget overwhelmingly favour SOCs
  - Without a stable and credible macro-economic climate, the proposed stimulus and recovery plan will not yield desirable results
- Government’s guarantee portfolio to SOCs amounts to R670 billion, while profits and the return on equity are on a downward spiral
- Continuous under-performance of SOCs does not justify the underfunding of other crucial social imperatives and the erosion of government borrowing capacity
- SOCs should commit to a short and long term agenda for reform
  - Address internal management deficiencies, aggressive cost containment, strict procurement controls and market repositioning

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Higher Education and Training

- In order to ensure optimal utilisation of the additional resources allocated to higher education and training (HET), the **Commission** recommends that **government should develop a much clearer plan for implementing the comprehensive fee-free higher education policy** both to address:
  - Uncertainty in the institutions of higher learning and
  - To ensure efficient and effective utilisation of these resources
    - Funding must be consistently available across all the students' years of study
    - Funding to be aligned for building skills sets to stimulate economic development
- While implementation of fee-free HET is to be welcomed, government needs to implement measures to improve the quality of outputs and outcomes at all levels of the education system
  - In HET this is particularly urgent in the rural universities and the Technical Vocational Education and Training (TVET) colleges

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CONCLUSION

Commission advises the joint Finance/Appropriations Committees to note:

- the need to address structural bottlenecks in order to boost growth
- the urgent need to build fiscal space
- the need for a comprehensive review of budget programmes aimed at promoting growth
- support for the tenets of the proposed economic stimulus and recovery plan to boost growth and employment
- the need for financial prudence to ensure that wage pressures do not divert resources away
- that value for money must be sought more resolutely through costing institutional outputs and assessing performance
- the need to guard against the proliferation of grants

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CONCLUSION [CONT.]

Commission advises the joint Finance/Appropriations Committees to note:

- **the need for an urgent review of local government capacity initiatives**
- **the need for a thorough and comprehensive review of the local government fiscal framework**
- **support for the publishing of regular expenditure reports on existing infrastructure projects**
- **the necessity of investment in an infrastructure delivery inspectorate**
- **caution against the long term risks posed by SOCs**
- **the need for development of a much clearer plan for implementing the comprehensive fee-free higher education policy**

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